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MONETARY POLICY – COPOM MINUTES

SELIC AT 13.75% FOR EVEN LONGER

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- The Brazilian Central Bank (BCB) published the minutes of last week's Copom policy meeting, when the authority maintained again the Selic policy rate at 13.75% but showed greater concerns about the inflationary risks. After a hawkish communiqué last week, the Copom minutes detail a little bit further the scenario and risks perceived by the monetary authority regarding the disinflation process ahead. The BCB also provided more information on its role during this process, including the plan for the next policy steps.

- In an extensive and heavily amended document vis-à-vis the previous Copom communication, Paragraph 27 summarizes the adjustment in the BCB's flight plan: to further extend the period with interest rate on hold at a contractionary level. According to the Copom, its own inflation projections "conditioned by the assumptions of the reference scenario [which assumed an easing cycle starting in September] do not show convergence to the target over the relevant monetary policy horizon". The BCB claims that "the introduction of a more extended monetary tightening, as in its alternative scenario [which assumes stable interest rates at 13.75% throughout the horizon], generates a relevant impact on the projections toward convergence to the targets." In our view, this confirms the BCB's intention to hold the Selic rate at current level (13.75%) amid an environment of relevant fiscal uncertainties and higher inflation expectations.

- The Committee reinforced the need to "remain vigilant, assessing if the strategy of maintaining the Selic rate for <u>a longer period than in the reference scenario</u> will be enough to ensure the convergence of inflation" [Paragraph 28]. Thus, we can conclude that, under the current economic conditions, the Copom does not envisage starting an easing cycle before 4Q23. And, conditional on the evolution of the fiscal scenario and inflation expectations, the projections for the start of a rate-cutting cycle can be postponed even further down the road.

- The Copom expressed discomfort with the ongoing increases in long-term inflation expectations (i.e., meaning the time-windows that go beyond the one targeted by the monetary authority for inflation convergence to the target, namely the six-quarter ahead horizon, or 3Q24 as of now). The BCB cites three possible reasons for this upward movement in longer-term expectations: (i) "a possible perception of BCB leniency with the targets"; (ii) "an expansionary fiscal policy that pressures the aggregate demand over the projection horizon"; (iii) "the possibility of changes in the inflation targets already set" [Paragraph 12]. The Copom states that "more important than analyzing the motivations for the rise in expectations, the Committee emphasizes that it will act to ensure that inflation converges to the targets" [Paragraph 15].

- For months, we have been forecasting the YE2023 Selic rate at 12.00%, which happened to be an above-consensus call until December (not anymore, of course). The probability is surely rising for the start of rate cuts to take even longer and for the whole eventual easing process to unfold much more slowly than previously thought. Our Selic rate forecast is currently under revision.

OVERVIEW

The BCB published the minutes of the February's Copom[1] policy meeting[2,3], when the authority again maintained again the Selic policy rate at 13.75% but showed greater concerns about the inflationary risks. After a hawkish communiqué last week, the Copom minutes detail a little bit further the scenario and risks perceived by the monetary authority regarding the disinflation process ahead. The BCB also provided more information on its role during this process, including the plan for the next policy steps.

In an extensive and heavily amended document vis-à-vis the previous Copom communication, Paragraph 27 summarizes the adjustment in the BCB's flight plan: to further extend the period with interest rate on hold at such a contractionary level. According to the Copom, its own inflation projections "conditioned by the assumptions of the reference scenario [which assumed an easing cycle starting in September] do not show convergence to the target over the relevant monetary policy horizon". The BCB claims that "the introduction of a more extended monetary tightening, as in its alternative scenario [which assumes stable interest rates at 13.75% throughout the horizon], generates a relevant impact on the projections toward convergence to the targets." In our view, this confirms the BCB's intention to hold the Selic rate at current level (13.75%) amid an environment of relevant fiscal uncertainties and higher inflation expectations.

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DETAILS OF THE POLICY DISCUSSIONS

- **LONG-TERM EXPECTATIONS: In the minutes, the Copom expressed discomfort with the ongoing increases in long-term inflation expectations (i.e., meaning the time-windows that go beyond the one targeted by the monetary authority for inflation convergence to the target, namely the six-quarter ahead horizon, or 3Q24 as of now).** The BCB cites three possible reasons for this upward movement in longer-term expectations: (i) "a possible perception of BCB leniency with the targets"; (ii) "an expansionary fiscal policy that pressures the aggregate demand over the projection horizon"; (iii) "the possibility of changes in the inflation targets already set" [Paragraph 12]. The Copom states that "more important than analyzing the motivations for the rise in expectations, the Committee emphasizes that it will act to ensure that inflation converges to the targets" [Paragraph 15]. The authority also highlights the need "to remain even more vigilant in the conduct of monetary policy to reanchor expectations and thus reduce the future cost of the disinflation" [Paragraph 13]. In this context, Paragraph 26 is important because the authority explains there that, in addition to the direct impact of financial-market economists' inflation expectations on the authority's own inflation projections, "the rise in long-term expectations raises the cost of the disinflation by requiring greater participation of other monetary policy channels" , which implies "a wider output gap to obtain the same fall in inflation" (in other words, the Copom points to a worsening monetary policy trade-off, with a higher level of interest and a sharper drop in activity needed to produce a disinflation of same magnitude).

- **FISCAL POLICY EFFECTS: The BCB continues to highlight the risks generated by a scenario of uncertainty "on the fiscal side and with inflation expectations drifting away from the inflation target on longer horizons", which the BCB sees increasing "the cost of the disinflation that is needed to reach the targets" [Paragraph 18].** The BCB states that monetary policy is the "the macroeconomic adjustment variable used to mitigate any inflationary effects of the fiscal policy". In the minutes, the Copom indicates that "demand stimuli should be assessed in view of the stage of the economic cycle and the

[1] The Copom is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the minutes of the 252nd Copom meeting in English (https://www.bcb.gov.br/en/publications/copomminutes).
[3] Our analysis on the statement: **Santander Brazil Monetary Policy: "Copom *Decision: Pushing Back Expected Rate Cuts*"** – February 1, 2023 – Available on: https://bit.ly/Std-COPOM-feb23

degree of slack in the economy" [Paragraph 14], with the Copom also providing details on how the Committee evaluates the fiscal conditions following recent government measures to reduce the primary fiscal deficit projected in the 2023 Budget Law. According to the BCB, some Committee members note that analysts' projections for the 2023 primary deficit stand below the official budget estimate, "possibly incorporating the fiscal package announced by the Ministry of Finance". Even so, "the scenario for activity has not changed significantly", according to the minutes, perhaps reflecting the notion that the expected fiscal impulse (usually calculated by the estimated change in the structural primary balance) has not changed materially [Paragraph 16].

- **INFLATION PROJECTIONS: In Paragraph 27, the Copom reports that the Committee's IPCA projections reflected "the increase in both administered and market prices", with higher inflation expectations (as per the Focus survey) being the main factor behind the rise in the estimate for market-price inflation.** The Copom points out that, from April onwards, it will once again focus on monetary policy horizons coinciding with the calendar year, "since the six-quarter ahead horizon [3Q24, as of today] will coincide with the calendar year of 2024, and then there will be no direct effect of the tax changes in the usual horizon" [Paragraph 20]. According to the minutes, "some members evaluated the possibility of incorporating some increase in the neutral interest rate [in the models and simulations], towards the movement observed in longer-term inflation expectations extracted from the Focus survey". The latter already suggests a consensus analyst estimate of a structural real interest rate round 5%, which is relatively in line with our recent estimates. The BCB argues that, despite having maintained the hypothesis of a neutral interest rate of 4%, it "evaluated alternative scenarios and identified that the impacts on its projections of an increase in the neutral rate grow over time and become more relevant as of the 2H24" [Paragraph 8]. That is, an eventual increase in the neutral interest rate assumptions by the BCB could have material impacts on the Copom's own inflation projections in the relevant horizon and thereby on the actual policy steps.

THE BALANCE OF RISK AND THE SCENARIO ASSESSMENT

- **BALANCE OF RISKS: The balance of risks remained relatively unchanged, with the BCB highlighting (basically the same) factors in both directions.** Among the upside risks to the inflationary outlook, the authority highlights: (i) "a greater persistence of global inflationary pressures"; (ii) "heightened uncertainty about the country's future fiscal framework and fiscal stimuli that support aggregate demand"; and (iii) "an output gap tighter than the one currently adopted by the Committee in its reference scenario, especially in the labor market". Among the downside risks, the BCB considers: (i) "an additional reduction in the prices of international commodities measured in local currency"; (ii) "a greater than projected deceleration of global economic activity"; and (iii) "the continuity of tax cuts assumed to be reversed in 2023". In Paragraph 24, the BCB highlights remaining uncertainties regarding the global disinflation process, and emphasizes that the "risks are likely to persist as long as a tight labor market is observed in several advanced economies". On the domestic front, predominantly in the fiscal camp, the Copom notes that "the fiscal framework revision reduces the visibility on public accounts for the coming years, introduces premia on asset prices, and impacts inflation expectations". Additionally, the minutes indicate that the Copom will continue to monitor the fiscal stimuli and their effects on economic activity and inflation: according to the Copom, "in an environment of a narrowed output gap, the impact on inflation tends to outweigh the desired impact on activity". The minutes also indicate that the BCB "will continue to assess data and models for a more thorough understanding" of the degree of slack in the economy (i.e., output gap).

- **SCENARIO ASSESSMENT – INTERNATIONAL ECONOMY: The Copom assesses that the "global environment continues to be marked by prospects of below-potential global growth for next year", although some recent elements (e.g., reopening in China, milder winter in Europe, resilient jobs in the US) may smooth this process for the coming quarters [Paragraphs 1 and 9].** With regards to global inflation, although the BCB recognizes that "recent data suggest some moderation at the margin in several countries", the environment is still seen as challenging. According to the BCB, the reduction of inflationary pressures in the goods markets (industrials, commodities) contrasts with a scenario of limited slack in employment and widespread, persistent inflationary pressures, especially in the services sector. As an upshot, the BCB expects "long-lasting period of high interest rates [in advanced economies] is foreseen after the process of increasing interest rates, which calls for greater caution in the conduct of economic policies also by emerging economies" [Paragraphs 2 and 3]. According to the BCB, in China, "adjustments in sanitary restrictions should lead to a cyclical recovery in demand and a reduction in the risks of supply disruptions", but the long-term growth prospects for the World's second largest economy should remain below pre-pandemic [Paragraph 9].

- **SCENARIO ASSESSMENT – LOCAL ACTIVITY: The Copom highlights again that "the set of indicators released since the previous Copom meeting continues to be in line with the scenario of deceleration expected by the Committee**". The authority notes"that confidence indicators dropped and industrial production, trade, and services indicators downturned", which adds to a slowdown in bank lending activity and in the labor market. The latter is seen through a loss of breath in the payroll gains (Caged) and a stability of the jobless rate with adverse composition, supported by a lower job-market participation rate [Paragraphs 4 and 11]. The Copom indicates that it "will continue to monitor the labor market releases, continuously assessing the role of lagged inflation and labor market pressures on wage adjustments". In general, envisioning an intensification of the monetary policy lags going forward, the BCB continues to project an even more pronounced deceleration of economic activity in the coming months [Paragraph 11]. This process is seen by the authority as necessary "for the monetary policy channels to act and for inflation to converge to its targets" [Paragraph 22].

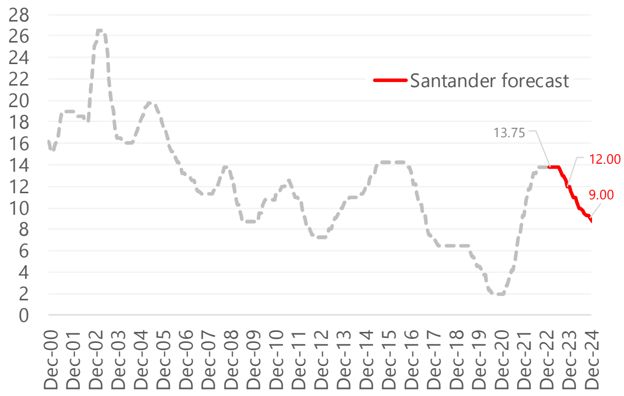
- **SCENARIO ASSESSMENT – INFLATION IN BRAZIL: In the minutes, the BCB reaffirms the message that despite "the slowdown at the margin, consumer inflation remains high", with core inflation trends running above the target, even as it shows "some marginal moderation" [Paragraph 5].** In Paragraph 23, the BCB explains that the "Committee focuses on services inflation since it responds to inflationary inertia and economic activity more directly". The authority highlights that these "factors are expected to put less inflationary pressures over the horizon" ahead, but believes that "his dimension continues to call for attention". The Committee promises to keep evaluating "the speed with which the convergence process will take place".

WHAT TO EXPECT AHEAD?

For months we have been forecasting YE2023 Selic rate at 12.00%, which happened to be an above-consensus call for a long period until December (not anymore, of course). **The probability is surely rising for the start of rate cuts to take even longer and for the whole eventual easing process to unfold much more slowly than previously thought. Our Selic rate forecast is currently under revision.**

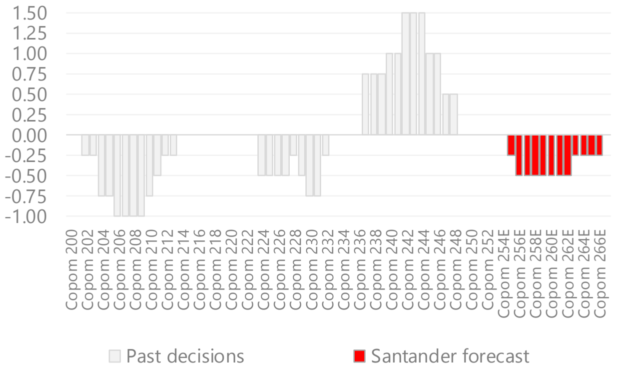
Please see graphs on the next page.

Figure 1. The Path for the Selic Policy Rate (monthly average, % p.a.)



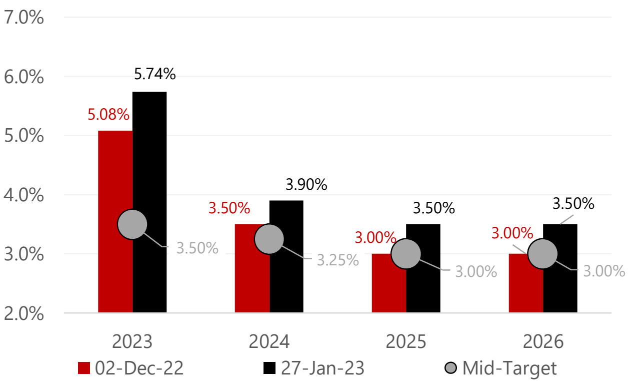
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 2. Selic Rate Moves in Copom Meetings: History and Forecast (in percentage points)



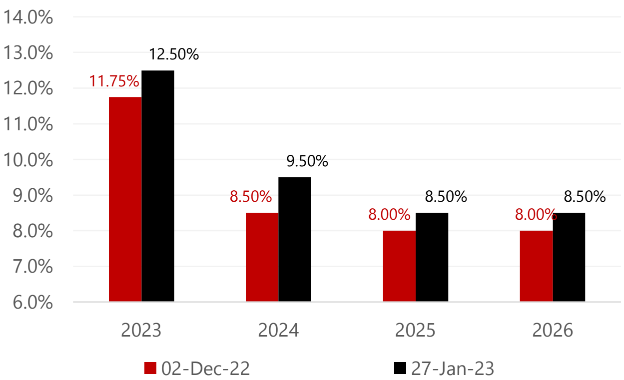
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Annual IPCA Forecasts (Consensus)



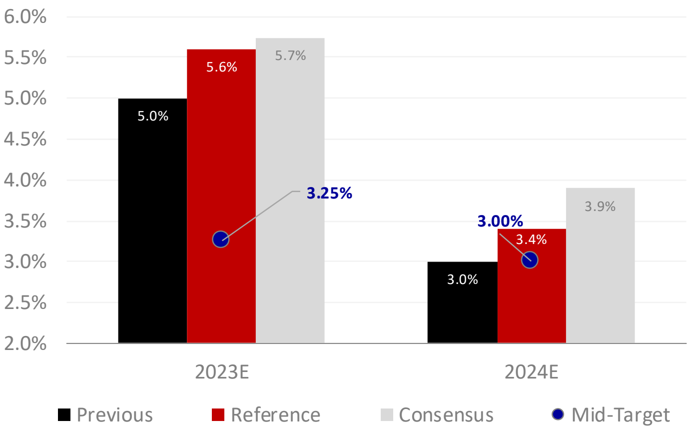
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 4. Median Annual Selic Forecasts (Consensus)



Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 5. BCB's Inflation Estimates (% Annual IPCA) – Reference Scenario



Sources: Brazilian Central Bank, Santander.
Note: Assuming FX rate departing from USD/BRL 5.15, and then moving along with the PPP (purchasing power parity). Oil price following the futures curve for six months and stable in real terms in USD. Uses consensus forecast for the future path of interest rate.

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