BRAZIL MACRO

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COPOM MINUTES

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SHARPENING THE KNIFE

- In our view, the minutes of last week's Copom meeting which were released today, bring a more accommodative monetary policy signal, both in comparison with the previous minutes (this was already expected), but mainly in relation to the communiqué (in a way, it was an element of surprise).
- The minutes show that there is a group in the Committee that is "more confident" about the disinflation movement and the CPI convergence towards the target - this party includes the major number of committee members. There is also a minority and dissident group, which is more "cautious" about the inflation outlook.
- Our conclusion is that the elements of moderation in the evaluation of scenarios and outlook, as well as the forward guidance, with reference to the need for "parsimony, caution, serenity and patience", may tell more about the speed of the easing process than the timing itself – as the latter seems quite given.
- Our impression is that only unexpected developments could prevent a rate cut at the next Copom meeting. Thus, given an apparently dominant possibility of a 25-bps cut at the August meeting, we are changing our scenario and incorporating a (brand-new) 25-bps rate cut in August, followed by a similar move in September an acceleration to 50 bps at the last two meetings of the year (which we had already penciled in). Our Selic rate forecast is now 12.25% for YE2023 (previously 12.50%).
- We still see relevant external and domestic uncertainties for the conduct of monetary policy, in a context of recurring fiscal impulses, a heated labor market and services sector, and difficulties in the process of re-anchoring expectations. These factors feed risks of inflationary persistence ahead. Therefore, we continue to foresee a slow easing cycle ahead (on a historical perspective): our forecast for YE2024 is now 10.50% (previously 11.00%), implying that Brazil may still have to deal with double-digit interest rate until the coming year.

MONETARY POLICY SIGNALS

The minutes of the Copom meeting held on June 20-21 bring a quite different monetary policy communication and signaling, as compared to the previous meeting. The text also brings changes in the tone, as compared to last week's statement – which was quite surprising.

On the one hand, the Brazil Central Bank (BCB) highlights a scenario marked by “unanchored expectations for longer terms” and by a stage of the disinflation process “that tends to be slower”. The authority warns of the risk of false starting the rate reduction process, which might “lead to a reacceleration of the inflationary process and, consequently, to a reversal of the monetary easing process itself”, impacting “not only the credibility of monetary policy, but also the financial conditions.” The Copom continues to preach the need for “parsimony and caution in the conduct of monetary policy” [Paragraphs #17, #18].

On the other hand, the minutes show a division within the Committee, with a majority believing that “the continuation of the ongoing disinflationary process, with its consequent impact on expectations, may allow the necessary confidence to be built up to start a parsimonious process of inflection at the next meeting.” This view is in opposition to a dissident group (indicated in the minutes as a minority) that believes “the disinflationary dynamics still reflect the retreat of the most volatile components and that the uncertainty about the output gap creates doubt about the impact of the monetary tightening implemented so far.” These Copom voting members with a more cautious stance believe that “it is necessary to observe further reanchoring of long-term expectations and accumulate more evidence of disinflation in the more cyclically sensitive components” [Paragraph #19].

The minutes indicate that their unanimous decision was to signal in the communique that “the future steps of monetary policy will depend on the inflationary dynamics, especially the components that are more sensitive to monetary policy and economic activity, on inflation expectations, in particular the longer-term ones, on its inflation projections, on the output gap, and on the balance of risks.” A division of opinions within the Copom was already expected at some point – this is typical in moments of inflection in the monetary stance and given the speeches with a slightly dissonant tone by committee members. Yet most analysts (including ourselves) were surprised with the signal of a majority of the Committee already inclined to start rate cuts in August, especially given an absence of signal in the communiqué. In any case, given what seems to be a well-defined timing for the start of the new cycle (except for some major adverse surprises in key variables, such as inflation expectations or underlying inflation), it is possible that the cautious wording and the careful adjectives used by the Copom in previous communications (and including this very minutes), refers more to the speed of the easing process rather than the timing. And we continue to anticipate gradual rate cuts ahead.

NEUTRAL INTEREST RATE

The Copom minutes show that after an “extensive debate and based on the accumulated evidence over recent meetings”, the BCB has decided to raise its estimate of the neutral (structural) real interest rate from 4.0% to 4.5% – which brings the BCB number closer to the market consensus, around 5%. The BCB evaluated “the different factors that justify an increase and converged on the conclusion that there was a rise in the neutral rate.” The list of factors include “the likely increase of neutral interest rates in the major economies, the resilience in the Brazilian economic activity jointly with a slow disinflationary process, as well as an analysis of supporting models that incorporate different methodologies.” [Paragraph #6]

The latter may implicitly include fiscal risk as one of the explanatory factors for the rise in structural interest rates, although this factor has not been explicitly mentioned by the BCB in this context. In fact, the BCB removed from the minutes a previous mention that the possible adoption of expansionary quasi-fiscal policies could potentially raise the neutral rate and reduce the power of monetary policy.

The change in view on the structural interest rate was already debated within the Committee – as signaled in the May policy minutes – and was likely one of the upward factors affecting the authority's official inflation projections. Perhaps the incorporation of this hypothesis has prevented a steeper drop in the Copom's inflation projections, especially for 2024. As already indicated in the communiqué, in the baseline scenario, which assumes the Selic trajectory according to the Focus survey (with rate cuts starting in August, reaching 12.25% by the end of 2023, and 9.50% by the end of 2024), the estimate for IPCA 2024 declined to 3.4%, compared to an estimate of 3.6% in the May Copom[1] [Paragraph #5]. It is possible that the incorporation of a higher neutral interest rate will have effects on the 2025 inflation estimate, for which we expected a drop from 3.2% (in the March inflation report) to around 3.0%, at the occasion of the June inflation report publication, scheduled for Thursday (June 29)

INFLATION CONDITIONS, OUTLOOK

In our view, the minutes bring a slightly softer tone from the BCB regarding the assessment of current inflation conditions. The authority points out that CPI "has been reduced in the recent period, with emphasis on the dynamics in industrial goods and food" and also indicates that the "components more sensitive to the economic cycle and the monetary policy, which present greater inflationary inertia, showed an incipient improvement". Yet the BCB continues to see those running "above the range compatible with meeting the inflation target" [Paragraph #4].

The BCB continues to refer to a two-stage disinflation process: one that has already ended, where "the speed of disinflation was greater, with a greater effect on administered prices and an indirect effect on market prices through less inertia"; and another one, still in progress, where "the speed of disinflation is slower, and core inflation – which is more affected by the aggregate demand and the interest rate policy – declines at a slower pace, responding to the output gap and future inflation expectations." The BCB reinforces, on the one hand, that "the disinflation process at its current stage demands serenity and patience in the conduct of monetary policy to ensure the convergence of inflation to its targets" [Paragraph #10]. On the other hand, the Copom removed a previous mention of inflation driven by excess demand, particularly in the services segment.

In Paragraph 11, the Copom highlights "the recent benign behavior of wholesale prices was emphasized, both for food and industrial goods", influenced by weather-related and logistical factors, respectively. The BCB assesses that "the consolidation of such dynamics contributes to the disinflationary process and should have some indirect impact on the other items." The authority highlights the swings in annual headline inflation, which should fall temporarily in 2Q23, only to rise again in 2H23. This will follow base effect of last year's tax cuts and the impact of the reincorporation (and normalization) of some taxes this year.

The authority reinforces the signal that it "will also continue to monitor inflationary dynamics in underlying inflation measures, which best reflect the current inflation trend as well as its prospects." Regarding expectations, the BCB indicates that they "remain deanchored from the targets set by the National Monetary Council, with a small reduction of the deanchoring at the margin." The Committee goes on to point out that "decisions that induce the reanchoring of expectations and that raise confidence in inflation targets would contribute to a faster and less costly disinflation process, allowing monetary easing." [Paragraph #12].

STATUS OF ECONOMIC ACTIVITY

The Copom maintains its assessment that "the recent set of indicators suggests a scenario of gradual deceleration" [Paragraph #3] and continues to project a slow widening of the output gap (or degree of economic slack, as per Paragraph #20).

Although commenting on the positive surprise with 1Q23 GDP, the Copom highlights that "most of the surprise reflecting the agricultural performance", with less dynamism seen in the more cyclical sectors [Paragraph #3]. The Committee highlights "a deceleration in the sectors most sensitive to the economic cycle", anticipating that "the process of moderating growth (…) will deepen over the following quarters" [Paragraph #8].

The Copom reinforces that the labor market has shown resilience, "with a net increase in job creation and relative stability in the unemployment rate", even as the latter also follows a reduction in the participation rate.

[1] The Copom explains some of the main assumptions used in the inflation simulations. According to the authority, in the reference scenario, the trajectory for interest rate is extracted from the Focus survey. The exchange rate starts at USD/BRL 4.85, evolving according to purchasing power parity (PPP). The price of oil roughly follows the forward curve for the next six months and then increases by 2% a year thereafter. The BCB works with the hypothesis of a "green" electricity tariff flag for December 2023 and 2024.

The BCB cites the details: on the one hand, “formal employment data continued to reveal increase in job creation” recently; on the other hand, “the unemployment rate remains relatively stable, but with a lower participation rate than in the pre-pandemic period” [Paragraph #9].

The Copom discussed but did not present conclusions about the drop (permanent or temporary?) in labor supply in Brazil. The BCB recognizes an ongoing process of partial recovery in real wages, but expects that to precede a deceleration in nominal wages going forward. On credit, the BCB continues to observe a deceleration “compatible with the current stage of the monetary policy cycle”. The BCB “anticipates a moderation in credit granting over the next few months, but in line with what has been observed in previous monetary policy tightening cycles”, noting that it has “the appropriate and necessary liquidity instruments, associated with macroprudential policy, to deal with relevant frictions in the system, should they occur.” [Paragraph #13]

FISCAL POLICY OUTLOOK

The Copom evaluates that “the presentation and processing of the fiscal framework have substantially reduced the uncertainty surrounding fiscal risk”, in which there are challenges to meet the targets set for the primary result”. But the BCB recognizes government efforts in pursuit of that budgetary goal. The Copom declares again that “there is no mechanical relationship between the convergence of inflation and the approval of the fiscal framework since the inflation path is conditional on the reaction of inflation expectations and financial conditions.” [Paragraph #14]

GLOBAL ECONOMIC OUTLOOK

The Copom signals that despite “some attenuation on the stress involving banks in the U.S. and Europe and the limited contagion on financial conditions so far”, the Brazilian authority anticipates “a tightening in the U.S. credit markets with still uncertain impacts but with a negative bias for the economic growth”. The BCB also points out that “central banks of major economies remain committed to bringing inflation back to its targets, in an environment in which inflation has been resilient”, noting “the resumption of the cycle of interest rate hikes in some economies”. The BCB anticipates a “prolonged period of high interest rates to fight inflationary pressures, which calls for greater caution in the conduct of economic policies also by emerging countries.” [Paragraphs #1 and #2]

But the Committee believes “the international outlook is somewhat more favorable for the inflationary process in Brazil”, signaling that the “the recent dynamics of the exchange rate and international commodity prices, although with greater volatility, also contribute to slowdown international pressures”. The BCB also believes that a credit slowdown in major economies “contributes to a more credible and lasting global disinflationary process” [Paragraph #7].

BALANCE OF RISK ANALYSIS

As in the communiqué, this section remained practically unchanged, showing the same upside and downside elements. Only notable changes refer to (i) the mention by the BCB that there is still "some residual uncertainty about the final fiscal framework to be approved by the National Congress", on the list of upside risks and (ii) that a " sizeable portion" of the (expected?) decline in commodities in local currency has already been observed, on the list of downside risks.

However, the BCB continues to note that, regarding the fiscal issue, the focal point for monetary policy lies in the " impacts on the expected paths of the public debt and of inflation expectations, and on risky assets." The upside of the balance of risk assessment also maintains the possibility of “a larger or more persistent deanchoring of long-term inflation expectations.” The downside continues to acknowledge the possibility of adverse conditions in the global financial system, as well as " a slowdown in domestic credit concession larger than what would be compatible with the current stance of monetary policy." As has been the case in previous communications, the BCB does not point to an asymmetry in the balance of risks.

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