Santander
Macroeconomic Research

BRAZIL MACRO May 9, 2023
COPOM MINUTES

Lower Tail Risks in Fiscal Policy Do Not Change the BCB's Inflation Outlook

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- In our view, the Copom minutes (released this morning) reaffirm the tone of the communiqué, clearly making the case for holding interest rates steady for a prolonged period.
- In the minutes, the Brazil Central Bank (BCB) reiterates its commitment to the inflation target and reaffirms its concern about the signs of rising expectations (still seen partially related to the discussions on the inflation target) and the inertia of underlying inflation (still seen mostly as a by-product of excess demand in services).
- The BCB once again reaffirms the principle of separation of instruments — with monetary policy focused on fighting inflation and macroprudential measures seeking a proper functioning of financial and credit markets. The local credit slowdown is still seen as in line with BCB expectations, given the contractionary monetary policy stance.
- On the fiscal side, the BCB once again signals that there is no mechanical relationship between the fiscal framework and monetary policy, given that the disinflationary effects of the former will need to be channeled through inflation expectations and financial conditions. The BCB recognizes that the government proposal for a new fiscal framework reduced the probability of more extreme scenarios for the debt trajectory but points out that there were no significant changes in economists' inflation expectations and, therefore, in the BCB's IPCA projections.
- The authority continues to estimate inflationary convergence to the mid-target only in a scenario that simulates a counterfactual situation of stable interest rate (at 13.75%) by YE2024. The authority maintains the indication that the disinflation process is at the most difficult stage (given the spreading of pressures in services inflation), which requires a moderation in the economic activity and demands "serenity and patience" in the search for the target achievement. The BCB also indicates that it will not get carried away by the temporary drop in year-on-year inflation in the 2Q24.
- In general, the minutes reaffirm the BCB's current flight plan, and we continue to project a gradual decline in the Selic rate starting in November. We forecast a YE2023 interest rate of 13.00% and 11.00% for YE2024.

HIGHLIGHTS OF THE COPOM MINUTES

MONETARY POLICY SIGNALS: The Copom signals that the strategy of holding interest rate stable tends to be “enough to ensure the convergence of inflation towards to its targets”, as the BCB identifies a lower probability of “scenarios that could require a resumption of the monetary policy tightening cycle” [Paragraphs 19 and 20]. The Committee notes that inflation projections have remained stable[1] and, in the balance of risks, on the one hand “the probability of the most extreme scenarios for the public debt trajectory has reduced”, on the other hand “there was no relevant change in the inflation projections since expectations did not change significantly”. The Copom continues to reinforce the message that “there is no mechanical relationship between monetary policy and the fiscal framework”, and that the current stage of monetary policy requires “serenity and patience to incorporate the inherent delays in the inflation control through interest rates and, therefore, to reach the goals in the relevant monetary policy horizon.” The BCB emphasizes that “decisions that induce to the reanchoring of expectations and that raise confidence in the inflation targets would contribute to a faster and less costly disinflation process” [Paragraph 13]. The Copom also “assesses that the presentation of the fiscal framework has reduced the uncertainty associated with extreme scenarios of public debt growth”, but maintains the message that it “will continue to monitor the processing and implementation of the fiscal framework presented by the government and under discussion in the National Congress” and 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 15].

BCB'S VIEWS ON THE NEUTRAL INTEREST: The Copom keeps debating the structural level of interest rate[2] in the Brazilian economy, reinforcing the interpretation that “the possible adoption of expansionary parafiscal policies (...) can increase the neutral rate and reduce the power of monetary policy” [Paragraph 7]. Some members believe that “a scenario marked by a possible rise in neutral interest rates in major economies, resilience in Brazilian activity, and a slow disinflationary process could be compatible with a higher measure of neutral rate than that assumed by the Committee”, which would imply — according to the authority — a “a lower contractionary impact than that implicit in the Copom's scenarios.” For now, however, the majority " judged that this interpretation still seems premature and needs further corroboration by data.”

THE INFLATION SCENARIO, AS SEEN BY THE COPOM: In paragraph 13, the BCB points to a slight deterioration at the margin in inflation expectations, a movement that the Copom observes “with concern”, as the authority assesses that unanchored expectations raise the cost of bringing inflation back to target. The BCB reaffirms that recent data support “support the view of a slower disinflation process, in line with the view of an inflation driven by excess of demand, mostly in the services segment” [Paragraph 11]. The Committee highlights some expected volatility in year-on-year IPCA, as it expects a “relevant drop” in 2Q23, “due to the base effect of the previous year”, but projects that “the effects of the tax measures that reduced the price level” in 3Q22 will no longer have effect on annual inflation in 3Q23. If one adds “this year's tax measures” to the picture (leading to higher gasoline costs), the result is an increase in trailing 12-month IPCA in 2H23 [Paragraph 12]. The Copom reiterates that “such behavior [of headline inflation] does not reflect the underlying inflationary dynamics, nor does it change the view on future prospects”. The Copom points out that “the disinflationary process tends to be slower in an environment of deanchored inflation expectations, requires further attention when conducting monetary policy” [Paragraph 17], and recognizes that not only is there “increased resilience and lower speed (…) in the latest releases” of service and core inflation, but also admits that “inflation expectations remain deanchored, partially related to the questioning about a possible change in future inflation

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[1] As presented in last week's communiqué, the BCB’s inflation models seem to convey a message that, in the absence of major changes in key variables (or BCB hypotheses) influencing them, there is no room for Selic rate cuts in the short term. The numbers also reinforce, once again, that the authority does not need to raise interest rates to achieve its objectives. As per the inflation simulation in the reference scenario, assuming the Selic trajectory according to the Focus survey (with rate cuts starting in September, reaching 12.50% for YE2023 and 10.00% for YE2024), the BCB’s IPCA estimate remained unchanged at 3.6% YE2024, which is now the main policy horizon (and for which the mid-point inflation target is 3.00%). As per the simulation in the alternative scenario, assuming the Selic rate remains stable at 13.75% over the entire horizon, the projection slid by a tenth (since March) to 2.9% for YE2024. The projections assume: (i) USD/BRL at 5.05 and then evolving with the purchasing power parity (PPP); (ii) oil price following the futures curve for the next six months and then stable in real terms in USD (i.e., up 2% annually subsequently); (iii) energy tariff flag "green" (down from "yellow") for both December 2023 and 2024. In the minutes, the BCB explains the change in this hypothesis, indicating for 2023 more comfortable hydrological conditions and, for 2024, the need to “avoid an excessive impact of the assumption about energy tariff flags, which are inherently affected by a lot of uncertainty for longer horizons, on inflation projections and with possible impacts on the conduct of monetary policy.”

[2] The Copom defines the neutral real interest rate as “the rate in which, in the absence of impact from other factors, the inflation rate remains stable, and the output grows according to its potential, reflecting productivity gains and changes in the structural fundamentals of the economy”.

targets." [Paragraph 19]. Once again, the authority reiterates "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."

THE STATUS OF ECONOMIC ACTIVITY: The Copom observes that "the economic growth outlook has not changed significantly in the recent period.", despite an upward revision by the authority on its own GDP projection for 1Q23. In paragraph 19, the Copom also identifies an outlook without major changes in the projected output gap (i.e., the level of slack in the economy). According to the minutes, the most recent data point to "a moderate pace of growth at the margin, with emphasis on the support given by consumption, on the demand side, and by the agricultural and livestock sector, on the supply side." The Copom highlights the resilience of the labor market, stating that "formal employment data continued to reveal increase of job creation in the most recent period" and that some "members noted that there is a movement towards a partial recomposition of recent losses in real wages." Some BCB board members note that "methodological changes in monthly activity surveys may increase uncertainty in GDP projections and in the current assessment of activity" [Paragraph 10]. Regarding the local credit market conditions, a theme that has generated recent market concerns, the committee still believes that new loans remain in line with the current stage of the monetary policy cycle, "despite the persistence of a stronger decrease in the supply of credit in specific modalities." [Paragraph 14]. The Copom reiterates that it "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" and highlights that it "has the appropriate and necessary liquidity instruments, associated with macroprudential policy, to deal with relevant frictions in the system, should they occur."

ON THE INTERNATIONAL ENVIRONMENT: The Copom reiterates the assessment, already made in the communiqué, that the external scenario remains "challenging". On the one hand, the BCB highlights "the low degree of labor market slack in some economies and a persistently high current inflation" as well as "widespread in the services sector", which suggest that inflationary pressures could last longer. On the other hand, the minutes note a greater tightening of credit conditions in the U.S., despite a "limited contagion from the recent financial instability in the U.S. banking sector". The BCB believes will prevail "a scenario with a more restricted credit supply and, consequently, lower economic growth" in the World's largest economy. Even so, the BCB believes that "reducing inflationary pressures continues to require the commitment and determination of central banks to control inflation by maintaining the tightening of financial conditions for a longer period." The BCB understands that "most monetary authorities signal a prolonged period of high interest rates necessary to fight inflationary pressures, which calls for greater caution in the conduct of economic policies also by emerging countries" [Paragraphs 1, 2, 8 and 9].

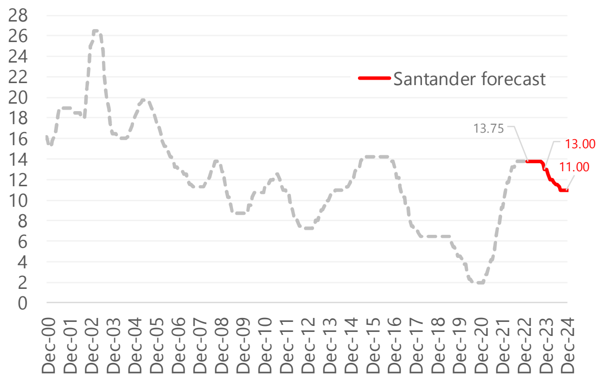
OUR TAKE

Judging by the recent batch of BCB communications (i.e., both the Copom statement and minutes), the authority is for now maintaining its flight plan of stable interest rates for an extended period, as a response to fiscal uncertainties and the unmooring of inflation expectations. The latter remains a major concern of the committee. By focusing on the main variable (inflation expectations) influencing its main objective (the inflation target), we believe the BCB is taking an approach that could favor the potential growth of the economy for the medium to long run, despite some natural cost in terms of output in the short term.

We see a change in the BCB strategy as premature at this point and believe that the BCB might only revise it in case of important deviations from its key current hypotheses and policy parameters. We are thus sticking to our scenario of a later-than-expected start to the easing cycle: we project (gradual) interest rate cuts starting in November, bringing the Selic rate down to 13% for YE2023 and 11% for YE2024.

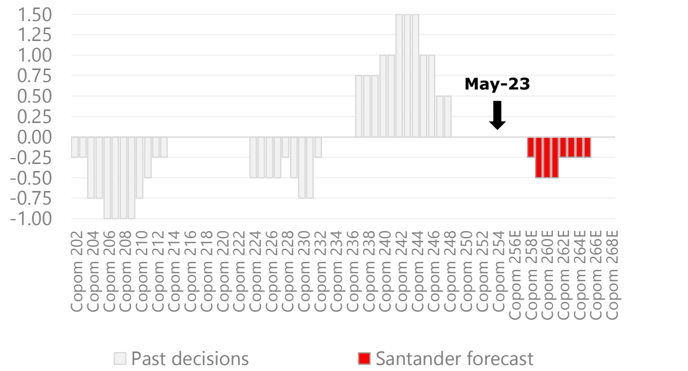
Refer to graphs on the next page.

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



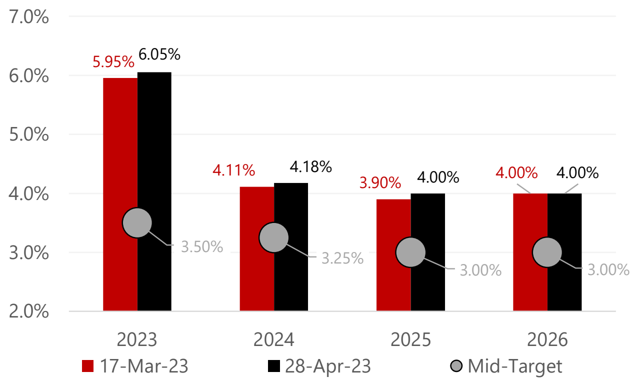
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



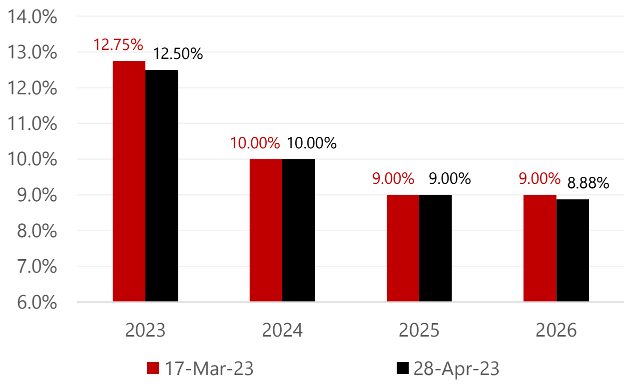
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Annual IPCA Forecasts (Consensus)



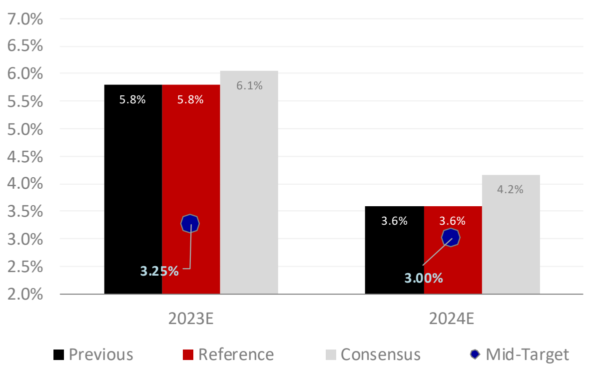
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout). As of April 28, 2023 (before the Copom meeting).

Figure 4. Median Annual Selic Forecasts (Consensus)



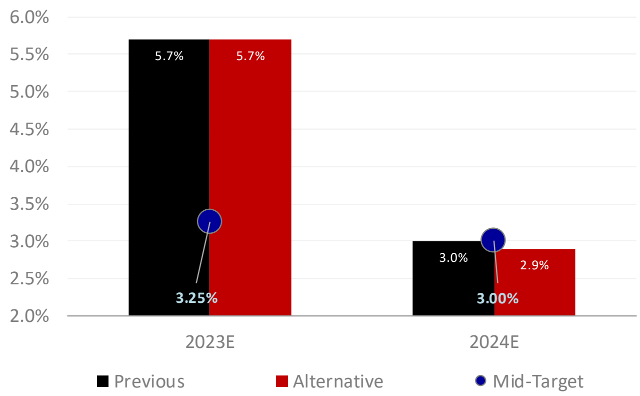
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout). As of April 28, 2023 (before the Copom meeting).

Figure 5. BCB's Inflation Estimates (%, Reference)



Sources: Brazilian Central Bank, Santander.
Note: Assuming FX rate departing from USD/BRL 5.05, 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 the consensus forecast for the future path of interest rate.

Figure 6. BCB's Inflation Estimates (%, Alternative)



Sources: Brazilian Central Bank, Santander.
Note: Assuming FX rate departing from USD/BRL 5.05, 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 a path of stable interest rate at 13.75% for the entire horizon.

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