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Macroeconomic Research

BRAZIL MACRO

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COPOM MINUTES

SERENITY AND PATIENCE REQUIRED FOR CONVERGENCE

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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 rate steady for a prolonged period.
- The Brazilian Central Bank (BCB) reinforces its commitment to the inflation target and reaffirms its concern with signs of unmooring in inflation expectations (seen partially associated with the discussion on the inflation target) and the inertia of underlying inflation (driven by excess services demand). In the minutes, the Copom explains in detail the major role of inflation expectations for the actual price dynamics (and therefore for the conduct of monetary policy).
- With a serene tone amid recent episodes in financial markets (here and abroad), the BCB reaffirms the separation principle of instruments – with monetary policy focused on fighting inflation and with macroprudential measures seeking to keep the well-functioning of financial and credit markets. The ongoing deceleration in local credit is still seen as in line with Copom's expectations, so that downside surprises are observed only in a few modalities, for now.
- On the fiscal side, the BCB signals there is no mechanical relationship between the new fiscal framework (to be announced shortly) and monetary policy, given that the disinflationary effects of the former will need to be channeled through inflation expectations, projections of government debt, and asset prices.
- The authority mentioned that the disinflation process, which is now seen at a more difficult stage given the spreading of pressures in services costs, requires moderation in economic activity, along with some dose of "serenity and patience" for the convergence of inflation to the target.
- Overall, we sense the recent batch of BCB communications (i.e., via both Copom statement and minutes) reaffirm the current flight plan, which does not seem to contemplate rate cuts for the short term. We continue to envision gradual Selic cuts starting only in November, with the policy rate closing 2023 at 13.00% and ending 2024 at 11.00%.

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HIGHLIGHTS OF THE COPOM MINUTES

Signals for Monetary Policy in Brazil: In PARAGRAPH #18, the Copom states that it "will continue monitoring the elaboration, discussion, and implementation of the fiscal framework that will be presented by the Government and voted by the National Congress," highlighting that there is no "mechanical relationship between the convergence of inflation and the presentation of the fiscal framework, since the former remains conditional on the reaction of inflation expectations, the public debt projections, and the asset prices." But the Copom recognizes that the "the materialization of a scenario with a solid and credible fiscal framework might result in a more benign disinflationary process through its effect on the expectations channel", in addition to more reduced macroeconomic uncertainty and risk premia. In this context, the Copom states that "decisions that induce a reanchoring of expectations would reduce the disinflationary cost and uncertainties associated with this process". In addition, the BCB signals that "the credibility of pursued targets is a fundamental component of the inflation targeting regime and contributes to the proper functioning of the expectations channel, making the disinflation quicker and less costly". The process of unanchoring of inflation expectations is seen as "partially related to the questioning about a likely change in future inflation targets" (PARAGRAPH #23). The Copom states that the disinflation process will demand "serenity and patience in the conduct of monetary policy for the convergence of inflation to its targets" (PARAGRAPH #15).

Lessons and Views From Other (International) Central Banks: Looking at the global scenario, the BCB also seems to draw conclusions that may be valid at the local level. The Copom indicates in PARAGRAPH #10 that "the reduction of inflationary pressures continues to require the commitment and determination of central banks with the control of inflation through a more prolonged tightening of financial conditions". The authority seems to stress on the effectiveness of the medicine (i.e., interest rate) to cure the disease (i.e., high inflation), despite some bitterness for the short run: in the minutes, the Copom states that, despite a "likely impact upon asset prices in the short term", a firm stance in the fight against inflation "contributes to a more credible and lasting global disinflationary process." In PARAGRAPH #12, the authority notes challenges for the conduct of monetary policy (on a global scale), with "increased risks both around the inflationary scenario and in relation to financial stability". Here, the BCB also reaffirms the view that the "the best contribution of monetary policy continues to be in combating inflationary pressures and smoothing out economic fluctuations", with the BCB reaffirming the separation principle of instruments in the pursuit of inflation control and financial stability. In this context, the BCB points out in PARAGRAPH #17 that it "has the appropriate and necessary liquidity instruments linked to macroprudential policy to address localized relevant frictions in the [financial] system", noting that "monetary policy is more appropriate to act in a counter-cyclical manner on the aggregate demand." Finally, with the market proving to be alert to the details of the BCB wording, the authority maintained the indication that "future monetary policy steps can be adjusted and will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected" (PARAGRAPH #27). For now, we believe that this phrasing is more of an indication of the conditionality in the BCB's decisions rather than an effective signal about the flight plan. In our view, at least for now, the latter is still outlined by "the strategy of maintaining the Selic rate for a long period".

Scenario Assessment – Inflation: In the minutes, the BCB reaffirms the message that consumer inflation remains high, highlighting that the "the components more sensitive to the economic cycle and the monetary policy, which present greater inflationary inertia, remain above the range compatible with meeting the inflation target" (PARAGRAPH #5). The authority also notes that "inflation is widespread in the services segment" (PARAGRAPH #10). The BCB envisions a two-stage disinflation process: in the first stage, which the BCB considers already concluded, "there is a greater speed of disinflation, with a greater effect on administered prices and an indirect effect on market prices through less inertia". In the second stage, in which the economy finds itself now, "the speed of disinflation is slower and core inflation – which is more affected by the aggregate demand and the interest rate policy – is reduced at a slower pace, responding to the output gap and inflation expectations." The BCB recognizes that the current inflationary dynamics "driven by excess demand initially in goods, and which has currently shifted to the services sector", which entails the need for "moderation of

economic activity for monetary policy channels to act" (PARAGRAPH # 15). In the minutes, the BCB also seeks to explain the focus and emphasis on inflation expectations, with their deterioration being widely debated in the committee. According to the BCB, the "behavior of expectations is a fundamental aspect of the inflationary process since it affects the setting of present and future prices and wages". The authority says it follows the best international practice by incorporating "expectations in its decision-making process, analyzing and including them as one of the factors affecting its inflation projections" (PARAGRAPH # 16).

Inflation Projections, Neutral Rate, Balance of Risks: The BCB recognizes that "the economic growth outlook has not changed significantly in the recent period" (PARAGRAPH #13), so that the authority signals that it was the recent increase in inflation expectations (as published by the Focus survey among professional forecasters) that explains a good deal of the increase in the committee's own inflation projections. As per the BCB's analysis of the balance of risks for the inflation outlook, there is no change vis-à-vis last week's statement, with the BCB highlighting that the committee's debate on the risks took place, " on the one hand, between a greater deanchoring of inflation expectations in longer terms and, on the other hand, a more abrupt reduction in the domestic or global credit granting affecting the economic activity" (PARAGRAPH #24). Despite the lack of an explicit mention in the balance of risks, the theme of neutral interest rate was addressed in the Copom minutes, with the authority opting to run the inflation simulations under the unchanged assumption of a neutral real interest rate at 4% . The BCB points out that, in alternative scenarios assuming a higher neutral interest rate, "the impacts (…) on its projections grow over time and become more relevant as of the [2H24]" (PARAGRAPH #8). Copom members continue to agree that "the possible adoption of expansionary parafiscal policies, which can increase the neutral rate and reduce the power of monetary policy" (PARAGRAPH #9).

Scenario Assessment – Activity: In PARAGRAPH #4, the Copom highlights again that "the set of indicators released since the previous meeting still corroborates the scenario of slowdown in the growth expected by the Committee". The authority highlights the moderation "observed in the coincident indicators of activity", including the credit market and the labor market. In PARAGRAPH #13, the BCB points out in hindsight that "after a period of strong recovery in the last two years, a process of deceleration of growth has begun in the durable goods sector (…) which is more sensitive to interest rate policy". At the moment, the BCB sees the "deceleration spread to the non-durable goods sector and, subsequently, to the services sector, although in a milder way". The BCB reinforces that "the economic slowdown underway is necessary to guarantee the convergence of inflation to its targets, particularly after a prolonged period of inflation above the target". In the midst of market discussions about the current state of credit conditions in the Brazilian economy, the Copom observes an additional tightening in credit conditions for some modalities (PARAGRAPH #17). In this context, the committee shows a slight divergence of opinion, with some board members assessing that it is a movement in line with expectations, reflecting the lagged effects of interest rate hikes, but with other board members believing that "the tightening of credit granting was more intense than expected, but focused on some specific markets".

Scenario Assessment – International Economy: The Copom recognizes that the global economic environment has deteriorated since the previous policy meeting (as of February 1). According to the minutes, the "episodes involving banks in the United States and Europe have increased the uncertainty and the volatility in markets and require monitoring", with the main central banks following "the principle of separation of objectives and instruments in the conduct of monetary and macroprudential policies." The BCB understands that "most monetary authorities signal a prolonged period of high interest rates is necessary to fight inflationary pressures." The Copom also points out that, on the one hand, "recent data on global activity and inflation remain resilient and the process of monetary policy tightening in major economies continues to advance." On the other hand, "the impact on financial conditions and consequently on global growth of the recent episodes involving the banking system in major economies is still uncertain but has a negative bias" (PARAGRAPHS #1, 2 and 3). Amid recent deals involving financial institutions seeing difficulties in advanced countries, the BCB states in PARAGRAPH #11 that the "Committee will continue to closely monitor this situation (…) but

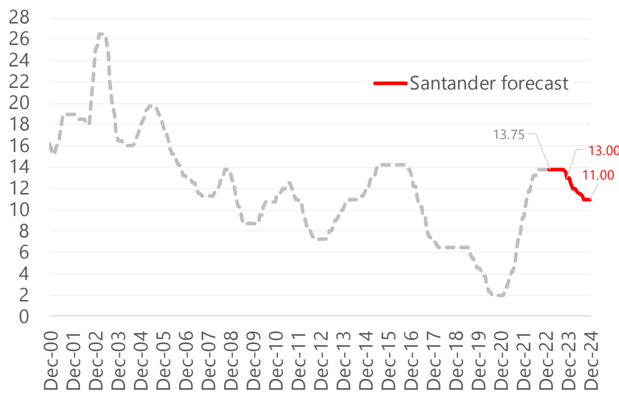
assesses that the direct impact on the domestic financial system and other emerging countries is, so far, limited, with no changes in the stability or efficiency of those financial systems."

OUR TAKE

Judging by the latest set of Copom communications (both statement and minutes), the BCB seems to keep the flight plan with stable interest rates for an extended period, as a response to fiscal uncertainties and the unmooring of inflation expectations. By focusing on the main variable (inflation expectations) influencing its main objective (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. We continue to see any 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 (such as the inflation target, maybe). For now, we continue to project (gradual) rate cuts starting in November, bringing the Selic rate down to 13% for YE2023 and 11% for YE2024.

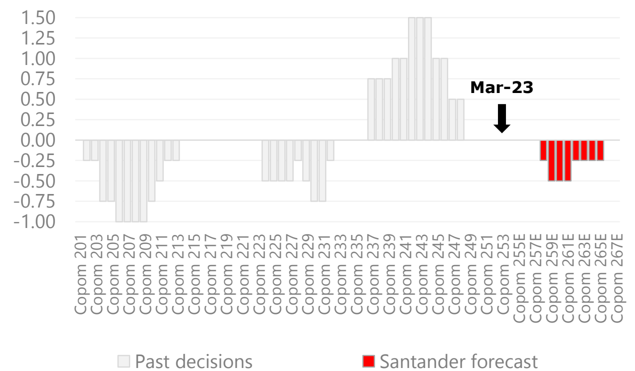
Refer to graphs on the next page.

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



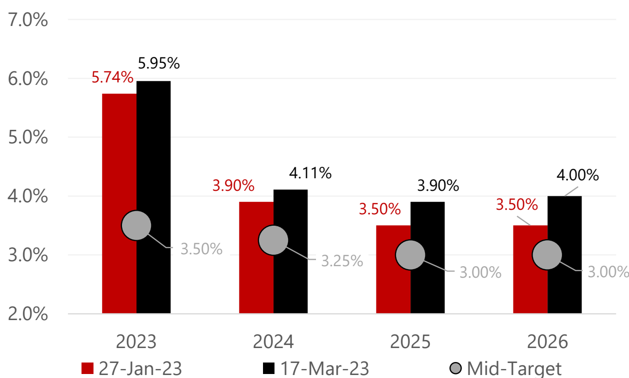
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



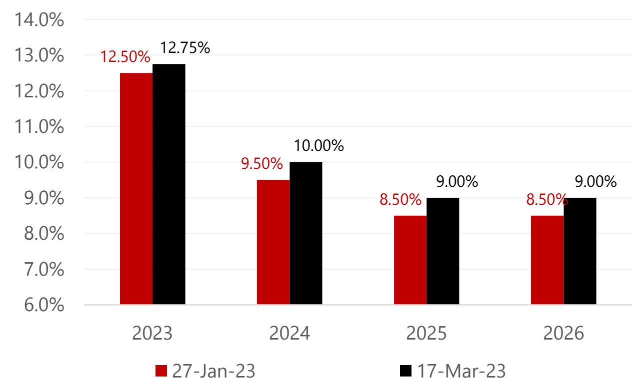
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Annual IPCA Forecasts (Consensus)



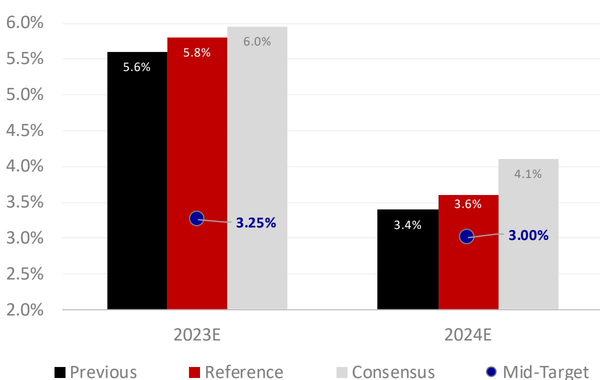
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout) as of March 17, 2023 (just before the Copom meeting).

Figure 4. Median Annual Selic Forecasts (Consensus)



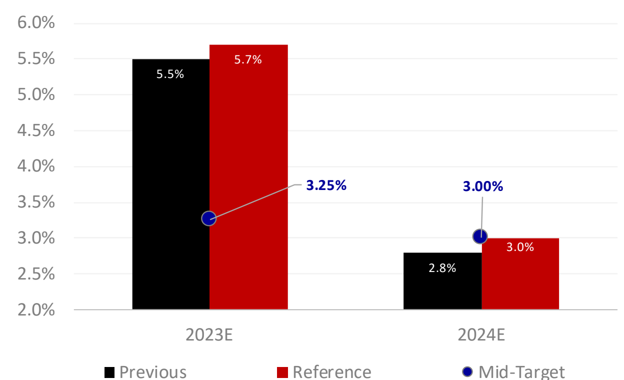
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout) as of March 17, 2023 (just before the Copom meeting).

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



Sources: Brazilian Central Bank, Santander.
Note: Assuming FX rate departing from USD/BRL 5.25, 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. **This scenario uses the consensus forecast for the future path of interest rate**.

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



Sources: Brazilian Central Bank, Santander.
Note: Assuming FX rate departing from USD/BRL 5.25, 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. **This scenario uses a path of stable interest rate at 13.75% for the entire horizon**.

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