BRAZIL MACRO

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MONETARY POLICY – COPOM MINUTES

JUST WATCHING FOR NOW

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- The BCB published the minutes of its October 25-26 Copom policy meeting, when the authority kept the Selic policy rate at 13.75% for a second time running. Not only did the minutes keep the tone of the statement, but also brought a few additional elements to the BCB's scenario review and strategy. The latter continues to be "maintaining the Selic rate for a sufficiently long period" and assessing if this "will be enough to ensure the convergence of inflation." The committee still signals it "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected."

- The Copom minutes reinforced the message that, according to the BCB estimates, the "12-month inflation projection for the second quarter of 2024 [at 3.2%], in the scenario using the interest rate trajectory extracted from the Focus survey [i.e., Selic rate at 13.75% for YE2022; 11.23% for YE2023; 8.00% for YE2024], remains consistent with the strategy of inflation convergence to around the target over the relevant horizon." The BCB says it will continue to pay special attention to the evolution of the output gap, activity projections and services inflation. In the BCB's assessment, the risks "remain high, requiring continuous monitoring and serenity in their assessment" regarding the inflation outlook.

- The Copom "considers that there has been some decrease in the estimated slack since its latest update", but the authority continues to estimate "an increase in slack throughout the monetary policy horizon, as a result of the monetary adjustment undertaken in recent quarters." The BCB points to "a more moderate pace of growth" in the data that "contribute to the assessment of the degree of slack" and sees the initial impact of monetary policy on bank lending and the broader economic activity.

- On inflation, the authority continues to recognize that CPI remains high as the BCB sees "the inflation of the components more sensitive to the economic cycle and the monetary policy, which present greater inflationary inertia" still running above the target. The minutes also maintain an extensive discussion on the global scenario, still seen as "adverse and volatile", given the expected slowdown following the tightening monetary policy, especially in large economies facing persistent inflation pressures.

- Judging from the tone of recent official BCB communications (minutes and statement), we see the authority trying to avoid signaling excess optimism about the pace of disinflation underway now. Looking ahead, despite the message that the BCB could eventually turn back to "tightening mode", we believe a change in the flight plan (of rate stability for long) would require a massive deviation from the BCB's scenario. We continue to see the BCB dealing with inflation risks from now on by "autonomously" making its monetary stance more contractionary over time, with its policy steps lagging the gradual pace of decline in inflation expectations. We pencil in Selic rate at 13.75% for YE2022, as we see the room for imminent cuts narrowed by cyclical elements that could prompt a resilient inflation in the medium term (i.e., the absence of slack in both economy and employment). We forecast rate cuts only in 2H23 and look for YE2023 Selic at 12.00%.

OVERVIEW

The BCB published the minutes of its October 25-26 Copom[1] policy meeting[2][3], when the authority kept the Selic policy rate at 13.75% for a second time running. Not only did the minutes keep the tone of the statement, but also brought a few additional elements to the BCB's scenario review and strategy. The latter continues to be "maintaining the Selic rate for a sufficiently long period will be enough to ensure the convergence of inflation", with the committee still signaling it "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected."

DETAILS OF THE POLICY DISCUSSION

The Copom minutes reinforced the message that, according to the BCB estimates, the "12-month inflation projection for the second quarter of 2024 [at 3.2%], in the scenario using the interest rate trajectory extracted from the Focus survey [i.e., Selic rate at 13.75% for YE2022; 11.23% for YE2023; 8.00% for YE2024], remains consistent with the strategy of inflation convergence to around the target over the relevant horizon[4]". The BCB notes a "slight increase" in its inflation forecasts (both for administered and free-market prices) and highlights that it continues to "emphasize the six-quarter-ahead horizon for its projections, and stresses that this decision is conditional on the temporary nature of" the recent tax breaks. The authority also reaffirmed that "if the alternative scenario of maintaining tax exemption on fuels in 2023 materializes, it will again emphasize usual horizons that include the first quarter of 2023." Yet the Copom makes it clear that such fiscal policy decisions would have no relevant impact in the interest-rate outlook, as the primary effects of the tax breaks are not influencing the Copom moves. (Paragraphs #14, #15 and #16)

The BCB will continue to pay special attention to the evolution of the output gap, activity projections and services inflation. The minutes show that "the Committee continues to monitor different metrics and strategies for the assessment of the output gap, as well as for current and prospective activity". The document make explicit that "the Committee is following with special attention the evolution of services inflation, which depends on both inflationary inertia and the output gap, and whose trajectory will become clearer over time." In the BCB's assessment, the risks "remain high, requiring continuous monitoring and serenity in their assessment" on the inflation outlook. (Paragraphs #16)

The BCB continued to stress the need to "remain vigilant, assessing if the strategy of maintaining the Selic rate for a sufficiently long period will be enough to ensure the convergence of inflation." The Copom pledges to "persist until the disinflationary process consolidates and inflation expectations anchor around its targets" and continues to signal that it will observe "the accumulated impacts to be observed of the intense and timely monetary policy cycle already undertaken." (Paragraphs #17 and #18)

COMPLEMENTARY VIEWS ON THE SCENARIO ASSESSMENT

Elsewhere in the minutes, one finds details on the authority's scenario assessment, both regarding the global and domestic economies.

On activity, the BCB points to "a more moderate pace of growth" in the data that "contribute to the assessment of the degree of slack". The BCB highlights the upward demand impulses (expected to slow down in the future) from "the reopening of the economy in the services sector and the fiscal stimuli" contrasting with the lagged impact of monetary policy, whose contractionary effects "tends to worsen in the coming quarters." (Paragraphs #4 and #9)

[1] The Copom is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the minutes of the 250th Copom meeting in English (https://www.bcb.gov.br/en/publications/copomminutes).
[3] Our analysis on the statement: **Santander Brazil – Monetary Policy: *"Copom Decision: The Strategy Remains The Same"* –** October 26, 2022- Available on: https://bit.ly/Std-Copom-oct22
[4] The mid-point inflation target is 3.25% for 2023 and 3.00% for 2024 (these are the main policy horizons as per the 4Q22).

The Copom "considers that there has been some decrease in the estimated slack since its latest update", but the authority continues to estimate "an increase in slack throughout the monetary policy horizon, as a result of the monetary adjustment undertaken in recent quarters." (Paragraph #16)

The BCB already sees the initial impact of monetary policy on bank lending and, consequently, the broader activity. According to the minutes, the authority notes "an impact in recent data regarding both the composition of new household credit operations and the moderate increase in the delinquency rate, partly related to the behavior of the real disposable income, which suggests some reduction." (Paragraph #10)

On inflation, the authority continues to recognize that CPI remains high, despite "the recent reduction, driven by items which are more volatile and affected by tax measures". While referring to the softening in industrial costs on the heels of the "decrease in producer prices and the reduction of pressures in global value chains", the BCB sees "the inflation of the components more sensitive to the economic cycle and the monetary policy, which present greater inflationary inertia" still running above the target. (Paragraphs #5)

The minutes keeps an extensive discussion on the global scenario, still seen as "adverse and volatile". The BCB continues to expect a slowing global activity ahead, noting "downward revisions on prospective global growth". The BCB refers to a challenging global inflation environment, given "the low level of labor market slack in some economies, coupled with high current inflation and a high degree of diffusion." The BCB believes the services inflation pressures could "last longer". With this backdrop, the BCB highlights that the "process of normalization of monetary policy in advanced economies continues towards contractionary rates synchronized across countries, tightening financial conditions", which is seen "raising the risk of abrupt repricing movements in the markets." (Paragraphs #1, #2 and #3)

The BCB also discusses the "stronger market sensitivity to developments affecting the fiscal fundamentals." According to the BCB, the "combination of higher interest rates and sovereign debts at historically high levels, raises questions about the sustainability of public debt in several countries." These fiscal concerns are also magnified in the context of "the lower liquidity of the sovereign securities markets". (Paragraph #8)

WHAT TO EXPECT AHEAD?

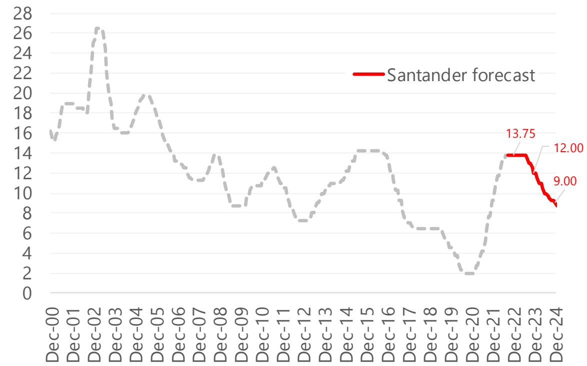
Judging from the tone of recent official BCB communications (minutes and statement), we see the authority trying to avoid signaling excess optimism about the pace of disinflation underway now. That makes perfect sense, in our view: while the numbers confirm that headline inflation and some underlying components have peaked, there is no compelling evidence that inflation is actually heading for the mid-target for the relevant horizon. At this juncture, when the cyclical position of the economy points to a possible erosion of labor and output slack, conditions seem more prone for better pricing power by Brazilian firms. And there could still be significant (repressed) costs to pass along to consumers ahead (e.g., in the services sector). Thus, we believe a conservative approach and a balanced communication is warranted for now.

As per the BCB strategy, despite the remarks that the Copom could eventually restart the hiking cycle in the foreseeable future, we believe that a change in the flight plan (of rate stability for a sufficiently long period) would require a large deviation from the BCB's scenario and forecast. In fact, we still see the BCB dealing with the inflation risks in the future by autonomously making its monetary stance more contractionary over time, with its policy steps lagging a bit from the gradual speed of decline in inflation expectations. In fact, our scenario anticipates that 2Q23 will see the tightest monetary policy stance in more than 20 years. That seems to be a necessary condition for a center target-achievement in the medium run.

Regarding our scenario, we pencil in YE2022 Selic rate at 13.75%, as we see the room for rate cuts in the short term narrowed by cyclical elements that could generate risks of resilient inflation in the medium term. We forecast stable interest rates until the end of 1H23 and look for gradual rate cuts to start in the 2H23. We see the Selic down to 12.00% by YE2023.

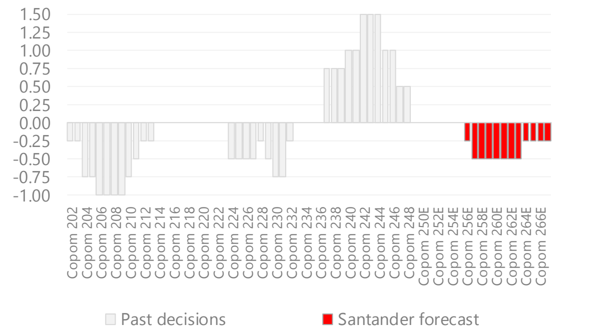
Please see graphs on the next page.

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



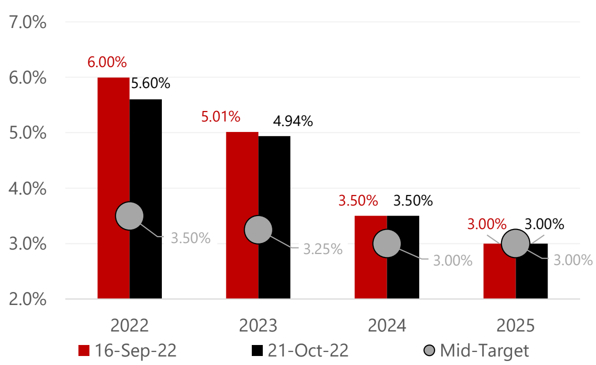
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



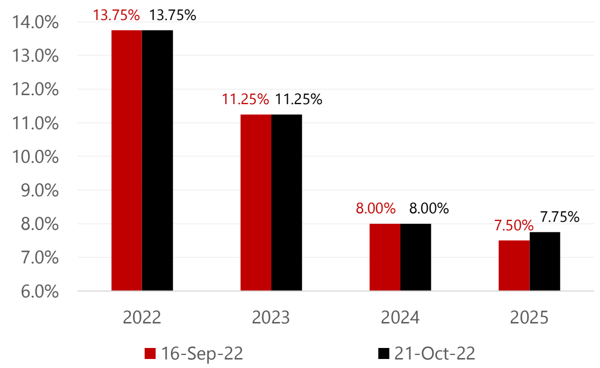
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Annual IPCA Forecasts (Consensus)



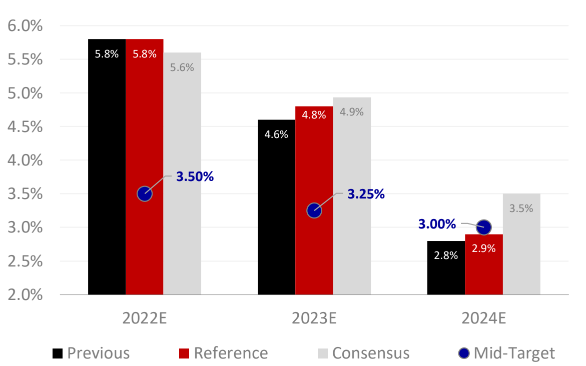
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).
As of October 24, 2022.

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 October 24, 2022.

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



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).

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