BRAZIL MONETARY POLICY

COPOM Minutes: Clues on When to Drop the Forward Guidance

Mauricio Oreng*
(+55 11) 3553-5404
mauricio.oreng@santander.com.br

- **The Brazilian Central Bank (BCB) published the minutes of its December 8-9 policy meeting. The authority provided more information on the conditioners for the planned dropping of the forward guidance (of stable interest rates under certain conditions) sometime soon, as signaled in the COPOM statement last week;**

- **The end of the forward guidance could follow: (i) an eventual increase of 2021 inflation expectations toward the mid-target; or (ii) the switching of the policy horizon from YE2021 (when inflation is seen below the target with stable Selic next year) to YE2022 (when inflation is seen at the target, but only with Selic hikes next year);**

- **Since we believe the natural change of policy horizon is the most likely candidate to prompt the adjustment in the BCB's flight plan, and given that the first meeting of the year is historically too soon to change the horizon, we believe the March COPOM is a stronger candidate (than January) for the end of the forward guidance.**

- **In any case, we see the BCB setting the stage for the elimination of the forward guidance sometime in 1H21 and believe this could mean risks of slightly sooner rate hikes than we have been expecting (our baseline scenario used to have Selic hikes only in 2022).**

Key Policy Takeaways from the Minutes

The BCB published minutes[1] from its December 8-9 COPOM policy meeting, when the authority kept the Selic policy rate (for a third meeting) at the historical low of 2.00%.

The focus of the policy discussion remains on the forward guidance, whereby the BCB has been signaling the intention not to "reduce the monetary stimulus as long as specified conditions are met[2]." The authority continues to pave the way for the removal of the forward guidance at some point ahead, since the conditions for it may not continue to hold in the near future, according to the minutes.

In paragraph 21, the COPOM addresses this topic. The authority claims that "inflation expectations reverted their declining trend relative to the target for the relevant horizon", since the introduction of the forward guidance. Additionally, the authority claims that "the 2021 calendar-year should become less relevant than the 2022 calendar-year, for which projections and expected inflation are around the target". The COPOM reaffirms the message that "inflation expectations converging to the target suggests that the conditions for maintaining the forward guidance may soon no longer apply,".

Importantly, the authority continues to indicate that the dropping of the forward guidance "does not mechanically imply interest rate increases, since economic conditions still prescribe an extraordinarily strong monetary stimulus". The subsequent policy steps after aborting the guidance will be data dependent (i.e., based on the evolution of the inflation outlook and balance of risks).

In paragraph 17, the COPOM discusses on the conditioners for the scrapping of the forward guidance, based on the clause of inflation expectations gap vis-à-vis the mid-target. Two possibilities are mentioned: (i) a rise in inflation expectations for 2021 (currently at 3.34%) toward the mid-target (3.75%); or (ii) a switch of the relevant policy horizon from YE2021 toward

[1] Refer to the COPOM minutes in English version (https://www.bcb.gov.br/en/publications/copomminutes).
[2] For the time being, according to paragraphs #14 and #20 of the COPOM minutes, conditions for keeping the forward guidance still apply. The BCB states that despite "having increased since the last meeting, in particular for 2021, inflation expectations, as well as inflation projections for its baseline scenario, are still below the inflation target for the relevant horizon for monetary policy; the current fiscal regime has not been changed; and long-term inflation expectations remain well anchored."

YE2022, a horizon for which the BCB states that "expectations and projections are, at this moment, close enough to the target."

In our view, these two possibilities give us clues on the possible timing for the removal of the forward guidance next year, leading us to believe March is more likely than January. Firstly, analyzing alternatives: Alternative #1: Regarding expectations for 2021, we see limited possibilities that median IPCA projections of the Focus report[3] for next year will head toward 3.75%[4], especially given the increased signs of softening in the food price shock (according to daily price monitors) and the likely removal of emergency fiscal stimulus. In our view, this rules out Alternative #1 as a driver for the removal of the forward guidance.

As per Alternative #2, dealing with the shift in the policy horizon from 2021 to 2022, it is important to bear in mind that the first COPOM meeting of each year is historically too soon for a change in the policy horizon. In 2019 and 2020, the current calendar-years were still the focal horizon in the first COPOM meeting, with a gradual transition taking place in the second COPOM meeting and a final change taking place in the third COPOM meeting. Thus, Alternative #2 for the dropping of the forward guidance is more likely to apply for the second COOPM policy meeting of the year (March 16-17) rather than the first one (January 19-20).

Even though the forward guidance is about to expire soon, the COPOM keeps details on the interpretation of the fiscal clause of its forward guidance, which shows the conditions for the strategy of no rate hikes based to the maintenance of the fiscal regime (paragraph 16). The BCB once again stated that "changes in fiscal policy that affect public debt trajectory, or compromise the fiscal anchor, would motivate a reassessment, even if the spending ceiling in nominal terms is still maintained". This reassessment "would follow the usual guidance of an inflation targeting regime, based on prospective inflation and its balance of risks."

In the minutes, the COPOM also continues to signal that it "deemed adequate the current level of monetary stimulus, which is being provided by the maintenance of the policy rate at 2.00% p.a. and by the forward guidance" (paragraph 15).

On the Scenario Assessment, Balance of Risks

The BCB made just a few additional remarks on the scenario assessment, in comparison to last week's policy statement.

The COPOM recognizes the upward inflation surprises of late, with a high headline CPI also expected for December, on the heels of an extraordinary price collection of school tuition costs (possibly capturing an end to pandemic-related discounts) and the upward revision of the electricity tariff-flag to Red 2 (the highest bracket for an extra-charge based on hydrological and short-term market conditions). The authority "maintains the diagnosis that the current shocks are temporary, but continues to monitor closely its evolution, in particular, the core inflation readings" (paragraph 5).

On activity, the BCB reaffirms that "recent indicators suggest the uneven recovery in economic activity continues, as expected" (paragraph 2). The board discusses on the sectoral asymmetry of the output gap, as "the Committee believes that the pandemic continues to have heterogeneous effects on different economic sectors." According to the COPOM, government transfers have reduced slacks in the goods sector, but with services still struggling with lower demand (especially in case of segments more impacted by social distancing measures). The BCB indicates that "the evolution of these sectoral gaps will depend on the pandemic evolution and on the adjustment in public spending" (paragraph 13). The authority also believes that "the risks associated with the pandemic evolution may imply a domestic scenario characterized by an even more gradual recovery" (paragraph 12).

We believe those remarks on activity indicate that the BCB is still concerned about the impact on the economic recovery from an expected fiscal cliff and an apparent second-wave of COVID-19, which continue to feed an unusually high level of uncertainty for upcoming monetary policy decisions.

On the global outlook, the BCB notes once again the contrast between the short-term activity impact from the pandemic resurgence in major economies and promising results from COVID-19 vaccine trials, improving the outlook for the medium term. With monetary stimulus expected to last long in advanced economies, amid the presence of economic slacks for a prolonged period, the BCB sees a backdrop of good liquidity and capital flows, meaning a favorable environment for emerging economies (paragraphs 1 and 11).

In the balance of risks, the COPOM cites the same elements, in both directions. On the upside (for inflation), the authority mentions that "an extension of fiscal policy responses to the pandemic that aggravates the fiscal path or a frustration with

[3] Please refer to https://www.bcb.gov.br/en/publications/focusmarketreadout
[4] Our baseline scenario projects IPCA at 3.0% for 2021

the continuation of the reform agenda may increase the risk premium". Fiscal risks are still seen implying an upward asymmetry in the balance of risks (paragraph 10). On the downside (for inflation), the COPOM claims that "economic slack may continue to produce a lower-than-expected prospective inflation trajectory, especially when the slack is concentrated in the service sector." The potential impact of the latter increases in case of precautionary savings following an eventually slower reversal of the pandemic (paragraph 9).

What to Expect Ahead?

In our opinion, the BCB continues to set the stage for the elimination of the forward guidance (of stable interest rates if certain conditions are met) sometime in the 1H21. For now, we continue to believe that this future change will be driven by the natural switching of the policy horizon from end-2021 (when inflation is seen below the target with stable Selic rate next year) to end-2022 (when inflation is seen at the target, with some Selic rate hikes next year). Thus, this suggests that March is a more likely date than January for the removal of the forward guidance, in our view. The May meeting is also a candidate.

Looking ahead, we continue to envision a lack of demand-led price pressures for the relevant monetary policy horizon (i.e., medium term). Despite a surprisingly strong pickup in headline inflation recently, on the heels of temporary factors (food price shocks, change in consumer basket), the key fundamentals for monetary policy remain well behaved, with inflation expectations well anchored for the key policy horizons and with the economy expected to keep running below its potential for a considerable time (especially given the removal of emergency fiscal stimulus in 2021).

If these conditions materialize, and assuming there is no change in the credibility of the fiscal regime, we envision inflation below the mid-target for both 2021 and 2022. While we see room for downward revisions in the BCB's inflation projections at some point ahead, given our view on the fundamentals, we do hear the BCB's message and see risks of slightly sooner rate hikes than what we used to expect in our baseline scenario (we had been projecting stable Selic all across 2021).

CONTACTS / IMPORTANT DISCLOSURES

Brazil Macro Research			
Ana Paula Vescovi*	Chief Economist	anavescovi@santander.com.br	5511-3553-8567
Mauricio Oreng*	Head of Macro Research	mauricio.oreng@santander.com.br	5511-3553-5404
Jankiel Santos*	Economist – External Sector	jankiel.santos@santander.com.br	5511-3012-5726
Ítalo Franca*	Economist – Fiscal Policy	italo.franca@santander.com.br	5511-3553-5235
Daniel Karp Vasquez*	Economist – Inflation	daniel.karp@santander.com.br	5511-3553-9828
Lucas Maynard*	Economist – Economic Activity	lucas.maynard.da.silva@santander.com.br	5511-3553-7495
Felipe Kotinda*	Economist – Credit	felipe.kotinda@santander.com.br	5511-3553-8071
Global Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Juan Cerruti *	Senior Economist – Argentina	jcerruti@santander.com.ar	54 11 4341 1272
Ana Paula Vescovi*	Economist – Brazil	anavescovi@santander.com.br	5511-3553-8567
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888
Fixed Income Research			
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Mauricio Oreng*	Senior Economist/Strategist – Brazil	mauricio.oreng@santander.com.br	5511-3553-5404
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Equity Research			
Miguel Machado*	Miguel Machado*	Miguel Machado*	Miguel Machado*
Alan Alanis*	Alan Alanis*	Alan Alanis*	Alan Alanis*
Andres Soto	Andres Soto	Andres Soto	Andres Soto
Claudia Benavente*	Claudia Benavente*	Claudia Benavente*	Claudia
Walter Chiarvesio*	Walter Chiarvesio*	Walter Chiarvesio*	Walter
Daniel Gewehr*	Daniel Gewehr*	Daniel Gewehr*	Daniel Gewehr*
Electronic			
Bloomberg		SIEQ <GO>	
Reuters		Pages SISEMA through SISEMZ	

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. ("Santander Investment Bolsa"), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: Mauricio Oreng*.

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.

Santander
Corporate & Investment Banking