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BRAZIL MONETARY POLICY

COPOM Minutes: Forward Guidance Further Clarified

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

- **The Brazilian Central Bank (BCB) published the minutes of its October 27-28 policy meeting. The COPOM took the opportunity to provide further insights on its forward guidance, both for the short and medium term, recalibrating the tone of the communiqué that has been perceived as quite light by market participants.**

- **The COPOM clarified that rate cuts are not actually possible for now, as the majority of the board believes that the Selic rate is already close to the effective lower bound. Fiscal uncertainties (via an asymmetrical balance of risks) are now considered a key factor to avoiding the implementation of further stimulus.**

- **The BCB reaffirmed its medium-term forward guidance (i.e., no hikes ahead), as the committee sees conditions still valid. Those conditions include an unchanged fiscal regime, inflation estimates below the target for the medium run and well-anchored expectations for the long run.**

- **The committee provided details on the interpretation of the fiscal clause of its forward guidance, where eventual changes adversely affecting the debt trajectory and fiscal anchor would lead to a reassessment (i.e. the end of the guidance), but with no mechanical rate hikes subsequently.**

- **Assuming no change in the effectiveness of the spending cap, our baseline scenario sees the COPOM on hold until 1Q22, and we believe that fiscal uncertainties still pose a major threat for the monetary policy outlook.**

Key Policy Takeaways from the Minutes

The BCB published minutes[1] from its October 27-28 COPOM policy meeting, when the authority kept the Selic rate at the historical low of 2.00%. The COPOM took the opportunity to provide more insights on its forward guidance, both for the short and medium term, recalibrating the tone of the communiqué that has been perceived as "very light" by a number of market participants.

As per the short term part of the forward guidance[2] (less relevant, in our view), where the BCB mentions the possibility of small rate cuts at some point, the minutes indicate that the majority of COPOM members believe that the Selic rate is already "close to the level from which further interest rate reductions could be accompanied by asset price instability." The COPOM also justified the maintenance of this part of the forward guidance, indicating that "this signaling is due to prudential restrictions regarding reductions of the Selic rate and, therefore, should be kept in communication." (Paragraphs 14 and 15)

Importantly, the COPOM also made it clear that the prudential element is not the only factor impeding further interest rate reductions, with the fiscal uncertainties also being a key factor avoiding the implementation of further stimulus. According to the minutes, the BCB board claims that regardless "of prudential restrictions, the COPOM considered that, at this moment, the upward asymmetry in the balance of risks caused by fiscal risks is sufficient to compensate for the fact that its inflation projections in the baseline scenario are below the target at the relevant horizon." (Paragraph 17)

Thus, the COPOM clarified that rate cuts are not actually possible for now. We see these clarifications as important, especially in a moment of market doubts about the current (likely temporary) spike in current inflation readings and a great deal of uncertainty about the fiscal policy implications for the monetary policy outlook. By downplaying the first part of the

[1] Refer to the COPOM minutes in English version (https://www.bcb.gov.br/en/publications/copomminutes).
[2] In the first (short-term oriented) part of the forward guidance, the authority notes that "that the current economic conditions continue to recommend an unusually strong monetary stimulus," but recognizes that the remaining space for additional stimulus "if it exists, should be small."

forward guidance (of possible rate cuts), we believe the BCB better fine tunes its communication, thereby improving its condition to keep expectations well anchored for the short/medium term.

As per the medium-term part of the forward guidance[3] (more relevant, in our view), where the authority shows a flight plan with no hikes if certain conditions are met, the BCB reaffirmed that these conditions still hold. According to the BCB, "inflation expectations, as well as inflation projections for its baseline scenario, are significantly 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." (Paragraph 16)

The COPOM also provided a more details on "the interpretation of the fiscal clause of its forward guidance." The BCB stated that "changes in the fiscal policy that affect the 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." (Paragraph 18)

In other words, the BCB indicated that it has no material reason to drop the forward guidance as of now, and its eventual dropping – led by a breach in the fiscal regime – could eventually lead to rate hikes, but would depend upon the evolution of the inflation outlook and balance of risks. That, in our view, probably reinforces recent BCB communications pointing to no mechanical hikes following the end of the forward guidance.

On the Scenario Assessment

Elsewhere in the minutes, the BCB made important remarks on the scenario assessment. On the inflation side, the COPOM once again noted the upside surprises and lingering pressures (expected to remain in place until year end), on the heels of the weaker FX depreciation, higher oil prices, and fiscal stimulus, affecting the path of both food and industrial goods.

While the COPOM recognizes the possibility of some (upward) payback in some prices that have been currently depressed (notably services) as mobility and activity recovers, the BCB noted that some prices "rose extraordinarily due to a temporary reduction in supply in conjunction with an occasional increase in demand", and "are expected to reverse." The authority concludes that "in spite of the stronger-than-expected inflationary pressure, the Committee maintains the diagnosis that this shock is temporary," although it will "closely monitoring its evolution." (Paragraph 5)

On activity, the COPOM continues to see "an uneven recovery in economic activity", with depressed activity in services affected by the social distancing, despite the solid recovery in spending on durable goods, favored by government transfers. The BCB highlights "the unpredictability associated with the pandemic evolution and the necessary adjustment in government spending from 2021 onwards", with this uncertainty about the pace of improvement implying "an even more gradual economic recovery" on its own. (Paragraph 12)

What to Expect Ahead?

We continue to see the monetary authority in waiting mode, ahead of important decisions to be taken by government and Congress on the fiscal side. As clearly mentioned in the BCB communications, such as the COPOM minutes, those decisions could materially affect impact the inflation outlook and thus, the BCB's strategy.

We envision a lack of sustained demand-led price pressures for the relevant monetary policy horizon (i.e., medium term). Despite a temporary pickup in headline inflation of late, the key fundamentals for monetary policy remain well behaved, with inflation expectations (and projections) below the mid target for the medium run and with the economy expected to keep running below its potential for considerable time.

If these conditions do materialize, depending upon the maintenance of the fiscal regime, we cannot help but project a stable Selic rate (at such an expansionary level of 2.00%) throughout the entirety of 2021. Our baseline scenario of fiscal convergence (i.e., constitutional spending cap still credible for the coming years, probably backed by reforms) contemplates the start of a gradual removal of monetary stimuli only in 1Q22.

Concerns about the effectiveness of the constitutional spending cap and the fiscal consolidation process, per se, are still the main threat for the inflation and monetary policy outlook in Brazil, in our view. Of course, a scenario of fiscal slippage would lead to different circumstance and forecasts for our entire macro scenario, with monetary policy clearly included.

[3] In the second (medium-term oriented) part of the forward guidance, the BCB makes it clear that "the COPOM does not intend to reduce the monetary stimulus" for as long as inflation projections (both by the Street and the BCB) remain significantly below the mid-target for the relevant horizon (2021 and 2022), long-term inflation expectations remain well anchored, and the current fiscal regime has not been changed.

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
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	598-1747-6805
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*	Head Equity Research Americas	mmachado@santander.com.mx	5255 5269 2228
Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Claudia Benavente*	Head, Chile	claudia.benavente@santander.cl	562-2336-3361
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Daniel Gewehr*	Head, Brazil	dhgewehr@santander.com.br	5511-3012-5787
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