Santander Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY PREVIEW

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A LITTLE FLEXIBILITY FOR THE FINAL CHAPTERS?

- The Copom gathers next week to announce its monetary policy decision on Wednesday (June 15).
- Analyzing the scenario dynamics since the last meeting (May 3-4), we note further deterioration in inflation conditions and the news flow. This follows the continued rise in inflation expectations for the policy horizon, the signs of spreading price pressures in the IPCA reports, the persistence of the exogenous shocks (e.g., commodities, supply-chains), the signs of narrower domestic economic slacks (both from the GDP and jobs standpoints), and, last but not the least, the recent focus of fiscal policy discussions (with a view to temporarily reduce inflation). The latter could further impact the anchoring of expectations and balance of risks in the medium term.
- In line with market expectations (i.e., both analysts' forecasts and yield-curve pricing), we project another policy rate hike, but this time of 50bps, reaching 13.25%. We still see the evolution of macroeconomic scenario and inflation outlook consistent with the Brazil Central Bank's (BCB) guidance (i.e., for "an adjustment of lower magnitude") announced during the May policy meeting. The deceleration in Selic hikes largely reflects the late stage of the tightening cycle and the expected policy lags, as signaled by the BCB.
- In its statement, we believe the monetary authority may reinforce the signal that the cycle is near completion, further highlighting its message that the process of monetary tightening has so far been strong, rapid, and is already at a well-advanced stage. In this context, the BCB may reaffirm the expectation that economic and inflationary effects would materialize, with the due policy lags, from 2H22 onward.
- Yet, amid tremendous uncertainty in current macroeconomic conditions and outlook, we believe the BCB may seek to retain some degrees of freedom for the next steps. As we see the BCB trying to calibrate the final dose of tightening necessary to achieve its goal (inflation convergence to mid-target of 3.25% in 2023) given its own inflation scenario, forecasts, and balance of risks, the Copom may leave the door open for another rate hike of up to 50bps, but also admit the possibility of staying put in August.
- We project another move of 25bps in August (last one in the cycle), with Selic likely remining stable at 13.50% until 3Q22. While our scenario of higher rate for longer has Selic at 10.50% for YE 2023 and 8.00% for YE2024 (above the consensus call), we see risks skewed to the upside, especially for 2023 and beyond.

Some Background on the BCB's Recent Policy Decisions and Signals

In the last policy meeting[1], the Copom hiked the Selic rate by 100 bps (the ninth move in the cycle), taking it to 12.75%, the highest level since 1Q17. At that meeting, the BCB estimated 2023 IPCA inflation at 3.4% (+0.3 p.p. from the previous meeting), slightly above the mid-target (of 3.25%) for what is now the focal policy horizon. In the baseline scenario, the BCB assumed oil prices at US$100/bbl at YE2022 (stable in real terms afterward), the FX rate at USD/BRL 4.95 (subsequently moving in accordance with purchasing power parity), and the Selic rate at 13.25% for YE2022 and 9.25% for YE2023 (as per the Focus survey among professional forecasters, as of April 29, 2022). At that point, the change in the BCB's inflation forecast and the worrisome inflation conditions and composition have likely been the tipping points for the authority to revise its flight plan once again to the upside. Thus, in May's Copom, the committee indicated "as likely an extension of the cycle", signaling for the June 14-15 meeting "an adjustment of lower magnitude", in contrast to the previous signals of a terminal Selic rate of 12.75%.

The BCB continues to signal proximity to the end of the cycle, even as it suggests that the terminal rate is still somewhat data dependent. In the Copom minutes[2], the BCB highlights that the monetary tightening carried out so far has been intense and timely, and that its effects have not fully worked through the economy yet. In recent speeches[3], some Copom members have admitted the possibility of extending the cycle a bit further "if a more negative [adverse] inflationary reality" materializes. In our view, both the inflation outlook and the balance of risks have further deteriorated since the last policy meeting.

The Context for the June 14-15 Copom Meeting

Since the last Copom meeting, the Focus report[4] shows IPCA inflation expectations for 2022 have risen by 1.0 p.p. to 8.89%, which implies greater likelihood of even more inflationary inertia for next year. For 2023, the relevant policy horizon, median IPCA forecast rose 0.3 p.p. to 4.39%, drifting further away from the mid-target (3.25%). Although the lack of broader data on the economists' expectations survey[5] affects our (already-restricted) capacity to anticipate the future movements of BCB's inflation forecasts, as published in every Copom meeting, our preliminary calculations show it is plausible that the BCB models will point to an increase of about 0.2 p.p. in the official IPCA estimate for 2023 to ~3.6%. Additionally, the wider gap from the center target could pressure the authority into further raising the planned dose of rate hikes in this cycle.

In terms of the macro scenario evolution, we still see a complex global picture, with signs of faster and more widespread monetary tightening cycles planned by the main central banks (e.g., now with the European Central Bank adding to the list and signaling rate hikes to start in 3Q22). This raises the risk of a slowdown in global activity, especially with a backdrop of lingering impact from geopolitical developments (read war in Eastern Europe), which conspire for a higher inflation and a slower growth. Commodities continue to be under upward pressure due to several factors, amid strong demand and low supply elasticity in the short term (given geopolitical sanctions, environmental restrictions for new investments, low inventories and a lack of spare capacity).

The Copom dataset points to a slight FX appreciation recently, with the 5-day rolling average for the USD/BRL showing probably no more than a 2% gain for the Brazilian currency compared to the USD/BRL 4.95 level (of departure) assumed in the last Copom scenario. However, the BRL strength so far seems insufficient to reverse the hefty gains in key measures of raw material prices. In national currency terms, we see no more than a mere stabilization in input costs, with no imminence of a massive deflation that could speed up the contribution of flexible prices for the CPI slowdown expected ahead.

As per the current inflation readings, although year-on-year IPCA likely reached its peak for the cycle in May, the inflation figures remain quite ugly, with headline inflation having reached in April the highest level since 2003 (at 12.1%). While May IPCA shows that the inflation peak is likely behind (with the YoY reading slowing a bit to 11.7%), the inflation composition is an even greater source of concern, with important underlying

[1] **Santander Brazil Monetary Policy: "*Recalculating the Route*"** – May 05, 2022 – Available on: https://bit.ly/Std-COPOM-may22
[2] **Santander Brazil – Monetary Policy: *"Keeping All Degrees of Freedom"* –** May 10, 2022- Available on: https://bit.ly/Std-Copom-min-may22
[3] https://valor.globo.com/financas/noticia/2022/05/18/analise-serra-tempera-sua-mensagem-de-politica-monetaria.ghtml (Portuguese only)
[4] The Focus report is the BCB's weekly survey among professional forecasters.
[5] The weekly release of the Focus report has been interrupted recently due to the strike of federal workers.

measures (such as IPCA EX3) pointing to trend inflation at an annualized pace of nearly 14% in recent months. Diffusion indices also continue to show widespread price pressures, with the seasonally adjusted diffusion index standing at ~77% in May, more than two standard deviations above the historical average (for monthly data since January 2000).

Owing to the reopening, (the usually slow-moving) services inflation is picking up, with the sequential trend in IPCA services reaching double-digit territory for the first time since 2014. The latter seems to mirror a context of more reduced slacks in both the economy and the job market. Speaking of which, activity and employment figures showed a favorable evolution this year, with a respectable sequential GDP growth of around 4% annualized in 1Q22, and with the recent household survey by IBGE pointing to the lowest unemployment rate since 2015 (9.4% in seasonally adjusted monthly terms, based in our own calculation[6]).

In terms of economic policy, some recent developments may generate possible spillovers on the monetary policy front. Ongoing negotiations between the Executive Branch (both federal and states governments) and the National Congress to use tax relief measures to curb prices of essential goods and services (notably energy) for businesses and consumers may "distort" somehow the inflationary trends (and expectations). Some of the initiatives under discussion would be of a temporary nature while others would be permanent. Despite our preliminary estimates for a possible reduction in annual IPCA of around 1.4 to 3.1 p.p. for 2022, depending on the policy design, the high fiscal cost of (the package of) measures – potentially adding to ~1% of GDP – make the relief temporary. Especially as the measures can lead to an upward CPI effect of about 0.6 p.p. for 2023, the BCB's policy horizon[7].

In addition to a possible dent to the CPI outlook for the horizon now aimed by the BCB, it is also important to note that, at the current stage of the economic cycle - given a less open output gap - and given that a fiscal consolidation process remains a necessity, the implementation of tax cuts without compensatory spending cuts means a new fiscal impulse that tends to be inflationary for the medium run. Therefore, some of the tax measures being debated could further harm the process of anchoring inflation expectations for the medium and long term, leading to a worse balance of risks for inflation. And it is possible that the BCB may recognize that in the statement.

What to Expect for the Meeting and Afterwards?

Broadly speaking, we believe that the scenario remains consistent with the BCB's "pledge" to proceed with its tightening cycle in June, even at a slower pace than in May (as duly signaled). The slowing pace of Selic hikes may particularly reflect the advanced stage of the monetary cycle and the expected policy lags. Thus, <u>we expect the Copom to hike the Selic rate by 50bps to 13.25% in the June 14-15 Copom meeting</u>.

For the time being, we expect the Copom to maintain its monetary policy signal that "it is appropriate to continue advancing in the process of monetary tightening significantly into even more restrictive territory". In our view, however, the BCB may also seek to further highlight the signal that the cycle is near completion, reinforcing the indication that the process of monetary tightening has been strong, speedy and is already at a well-advanced stage. The BCB could further emphasize that the lagged effects of cumulative Selic hikes will impact the economy and inflation in 2H22. For now, we do not foresee an explicit signal that June's hike will be the last move in the cycle, but that outcome may be hinted as an alternative. In other words, we see the BCB seeking a bit of flexibility to shape the final steps in this cycle. Another possibility that we envision is the start of a discussion about trade-offs between raising more aggressively now or keeping interest rates higher for longer, in the context of a possible interest-rate smoothing. If it happens, the authority could seek to explain that an eventual smoothing strategy in the current cycle would not indicate lenience with higher inflation over the relevant policy horizon, as it could mean a more rigid stance in the easing cycle expected for 2023.

In an all, as the BCB calibrates the total tightening in the cycle necessary to achieve its goal (i.e., inflation convergence for 2023), given its own inflation scenario, forecasts and balance of risks, we

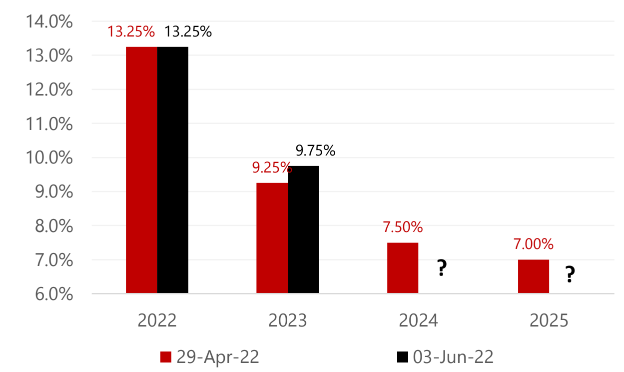
[6] **Santander Brazil – Economic Activity:** ***"Labor Market: Monthly Unemployment Rate Estimate Back to Single-Digit Territory"*** **–** May 31, 2022- Available on: https://bit.ly/Std-labor-053122.

[7] **Santander Brazil – Special Report:** ***"Measures To Curb the Increase On Prices"*** **–** June 09, 2022- Available on: https://bit.ly/Std-special-060922.

believe the Copom may leave door open for another rate hike of up to 50bps, but also admitting the possibly of staying put in August. Amid tremendous uncertainty in current macroeconomic conditions and outlook, we believe the BCB may seek to retain some degrees of freedom for the next steps.

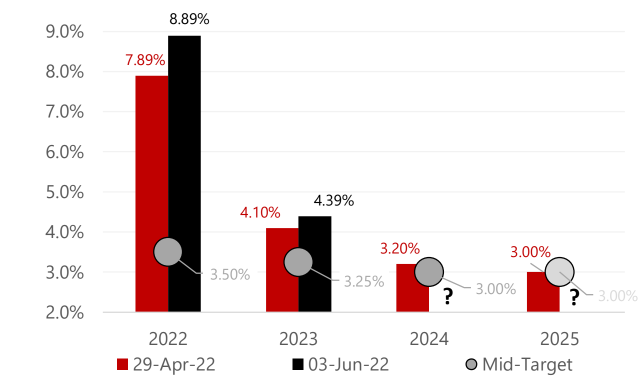
In our last scenario review[8], we have once again raised our expectations for the Selic rate, but especially for the medium term (2023-24). We see the cycle ending at 13.50% in 3Q22 (following a final hike of 25 bps in August). And looking ahead, while in 1H23 monetary policy will reach its tightest stance since 2009, the persistence of inflation pressures leads us to think this will not be enough to put inflation at the mid-target next year. Thus, we believe this will lead to an even more cautious approach by the BCB in the ensuing easing cycle expected to start in 2023: our YE2023 Selic forecast is now 10.50% and our YE2024 estimate is now 8.00%. Given the challenges for the disinflation process, and the uncertainties regarding local policymaking and global interest rates (both for the shorter and longer term), **we continue to see risks skewed to the upside for our interest rate scenario, especially for 2023 and beyond.**

Figure 1. Median Selic Rate Expectations (% annual)



Sources: Brazilian Central Bank, Santander.
Note: As of the most recent BCB Focus update: June 03, 2022. The full numbers have not been published owing to the strike of federal workers.

Figure 2. Median IPCA Inflation Expectations (% annual)



Sources: Brazilian Central Bank, Santander.
Note 1: As of the most recent BCB Focus update: June 03, 2022. The full numbers have not been published owing to the strike of federal workers.
Note 2: Assumes the maintenance of the 2024 inflation target for 2025

[8] **Santander Brazil – Scenario Review: *"A Bittersweet Scenario"* –** June 02, 2022- Available on: https://bit.ly/Std-scenreview-jun22.

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