Santander
Macroeconomic Research

BRAZIL MACRO

March 15, 2022

MONETARY POLICY PREVIEW

A 100-BP MOVE, WITH HAWKISH WORDING

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- The Copom is scheduled to announce its monetary policy tomorrow (March 16). In line with analysts' expectations, we look for another increase in the Selic rate, but this time of a magnitude of 100 bps, reaching 11.75%. This will be the highest interest rate since mid-2017.
- In our view, being consistent with the previous communication (of slower hikes) from the last policy meeting is justified by the (rather advanced) stage of the cycle and the still high magnitude of an adjustment of 100 bps per meeting, which we still see as consistent with an eventual extension of the tightening cycle – which is starting to show as necessary.
- Amid a sea of uncertainty regarding the baseline scenario after the outbreak of the Russia-Ukraine conflict (given its political and economic consequences), what is clear for now is an additional deterioration in the balance of risks for inflation and the need to raise the policy rate even further (i.e., a higher terminal Selic). The latter follows a worsening policy trade-off (i.e., higher inflation projections for any given Selic level) after the recent geopolitical developments, as shown by the latest Focus (expectations) report.
- We believe that in its communiqué, the Brazil Central Bank (BCB) will maintain the monetary policy pledge to advance further "into the restrictive territory", but leaving the next steps open-ended in terms of both speed at the next meeting and expected terminal Selic rate. We estimate that the (implicit) terminal Selic rate level in the BCB's inflation simulations could point to the necessity of an interest-rate level above 13% to bring the IPCA back to the mid-target for 2023 (the main policy horizon now).
- We understand that the BCB will seek to buy itself some flexibility (but to hike more, not less than analysts currently expect) given the even greater difficulty of anticipating the size, duration and effect of (the additional) shocks in progress. We do expect the committee to overreact (both in terms of actions and wording), but we do see the bias as clearly skewed to the upside when it comes to the size of monetary tightening expected ahead. Our 12.50% terminal Selic level included in our scenario (last updated on February 24) is certainly under revision.

The Copom, the monetary policy committee of the BCB, is scheduled to announce its monetary policy decision tomorrow (March 16). In line with analysts' expectations, we project another increase in the Selic policy rate, but this time at a magnitude of 100 bps, reaching 11.75%. This would be the ninth consecutive move in this tightening cycle—which started with the Selic at 2.00%—taking the rate to the highest level since 2017.

The Context and Backdrop

At the last Copom meeting[1] on *February 1-2*, the BCB raised interest rates by 150 bps (to 10.75%). Back then, the authority announced its intention to reduce the speed of adjustment in monetary conditions at the March meeting. Despite important changes in the outlook since early February, particularly in the external environment, also leading to changes in inflation expectations domestically, we do not see reasons for the BCB to abandon the plan (or scrap the signal) of deceleration in monetary tightening. **In our view, softening is justified by the (rather advanced) stage of the cycle and the still high magnitude of an adjustment of 100 bps per meeting, which we still see as consistent with an eventual extension of the tightening cycle – which is starting to show as necessary.**

In other words, at this juncture, an adjustment of 100 bps allows the BCB to move fairly quickly and, at the same time, accumulate additional information on the prospective scenario and risks, which will help determine the Selic level at the end of the cycle. According to the projections of the BCB and its balance of risks, as presented at the last meeting, the Copom would need to raise the Selic rate to a level above 12.25% to bring (expected) IPCA inflation back to the central target (of 3.25%) for 2023. But that calculation has probably changed.

The probability of an even greater monetary adjustment cycle, and/or an even slower return to the neutral (or structural) level subsequently, has recently increased on the heels of the conflict in Eastern Europe. The latter has caused a sharp rise in commodity prices in USD, whose impact was only partially mitigated by the more appreciated BRL. More importantly, the war has already produced unwanted inflationary effects in Brazil, which for now have translated into higher inflation expectations, as shown by the latest BCB survey among professional forecasters[2] (as of March 11, 2022). Since the last Copom meeting, inflation projections have risen about 1.1 pp for 2022 (already a less important policy horizon) and 0.2 pp for 2023 (the key policy horizon now). And that occurred even as analysts revised upwardly their estimates for the Selic rate by 100 bps for YE2022 (to 12.75%) and 75 bps for YE2023 2023 (to 8.75%), which mean analysts anticipate an even worse policy trade-off for the BCB at the moment.

As an upshot, we believe that the BCB is likely to present a much higher IPCA projection for 2022 (probably a few tenths above 6%, from 5.4% previously) and a slightly higher reading for 2023 (probably a few tenths above the mid-target of 3.25%, from 3.2% previously). The estimates will largely depend on the assumptions that the BCB adopts for the trajectory of oil prices ahead, which might create clearly upward effects for 2022 but uncertain effects for 2023[3].

Policy Messages and Outlook

In terms of policy message, we believe that in its communiqué the Copom will maintain signals that monetary policy is to advance even further into restrictive territory, with the BCB identifying upside risks (both fiscal and geopolitical) for the anchoring of inflationary expectations. Amid a sea of uncertainty regarding the inflation outlook, what seems clear for now is an additional deterioration in the balance of risks for inflation over the relevant policy horizon, and the necessity for an even higher terminal Selic level (as compared to the previous meeting).

Although we believe that the BCB will probably keep mentioning the current stage of the cycle and the expected lagged effects of the cumulative Selic hikes so far, we think the Copom will leave the range of alternatives for the next steps somewhat open, both in terms of speed at the next meeting and in terms of the terminal Selic

[1] **Santander Brazil Monetary Policy - *"Slower But Not Lower"* –** February 2, 2022 - Available on: https://bit.ly/Std-COPOM-feb22
[2] See details in the link (https://www.bcb.gov.br/en/publications/focusmarketreadout).
[3] If the Copom adopts a hypothesis of very high oil prices this year and eventually lower oil costs for 2023, this could create a downward base effect for the inflation estimate for next year. That may or may not top the impact of a higher inflation inertia inherited from 2022.

rate in the cycle. For instance, we expect no pre-announcement of a certain outcome (judged as most likely) at the next meeting.

But with the BCB's inflation simulations showing that a 12.75% terminal Selic rate will probably not be enough to guarantee IPCA convergence to the center-target next year, and with the BCB probably reaffirming the wording of the last Copom minutes[4] that the upward asymmetry in the balance of risks entails a necessity for an even tighter policy than implied in the reference scenario, it may be implicit that the flight-plan correction will probably include a terminal Selic above 13% for the cycle.

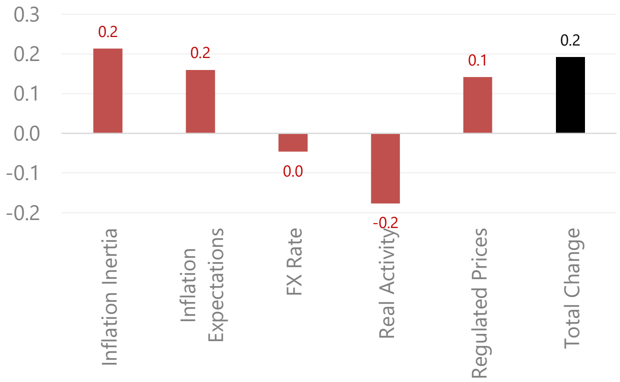
In any case, we believe the BCB will seek to buy some flexibility for the trajectory (but not to tighten less than analysts are currently expecting) given the even greater difficulty of anticipating the size, duration and effects of ongoing shocks, in addition to possible secondary developments via inflation expectations.

Our scenario (last updated on February 24) projects the end-of-cycle Selic at 12.50%, with a gradual decline starting in 1Q23, reaching 9% at the end of 2023 and 7% in 2024. Clearly, the risks are skewed to the upside for the future trajectory of interest rates, especially when it comes to our estimate for the terminal Selic rate, which is now under revision.

Refer to a summary of the Copom dataset and a few interesting graphs in the next pages.

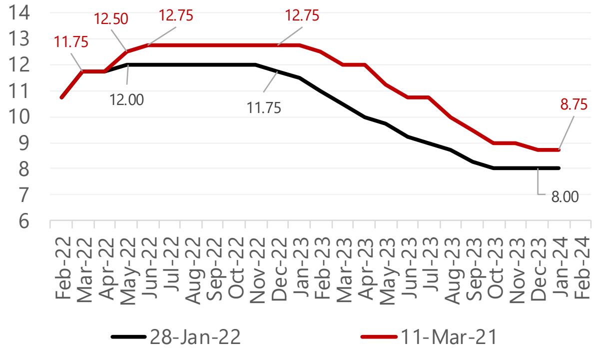
[4] **Santander Brazil Monetary Policy - *"Ratifying the Tone"* –** February 8, 2022 - Available on: https://bit.ly/Std-COPOM-min-feb22

Figure 1. Contributions for the Change in BCB's Inflation Forecasts (IPCA 2023, in percentage points)



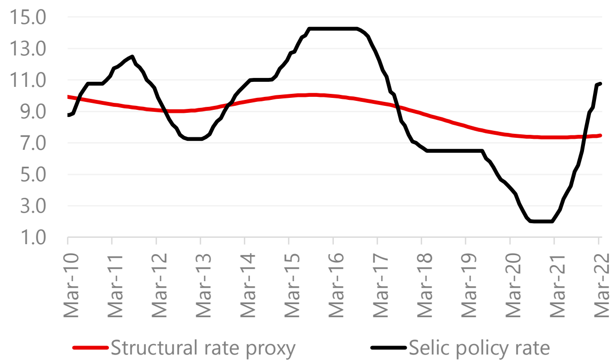
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: Based on the model elasticities published by the authority

Figure 2. Median Selic Rate Expectations (% annual, monthly path)



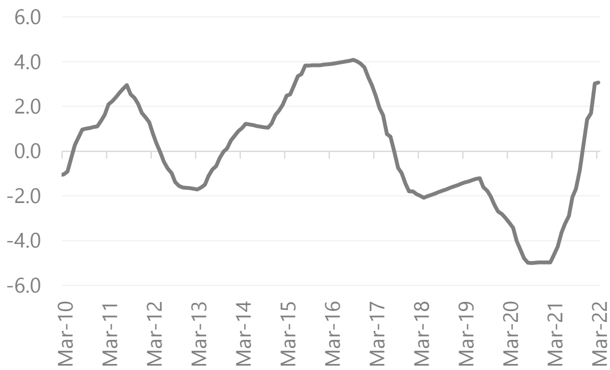
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: As of the most recent BCB Focus report: March 11, 2022.

Figure 3. Real Yields: Short Term vs. Long Term (monthly average, % annual)



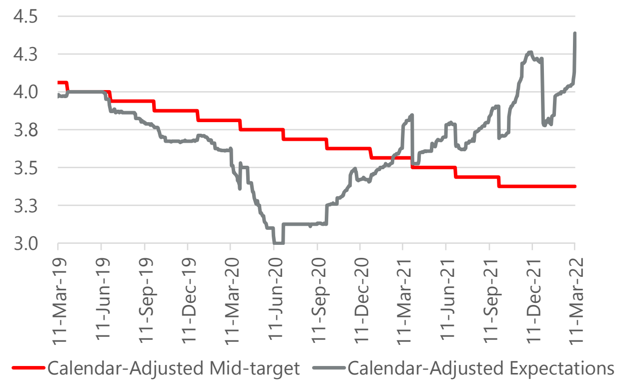
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note 1: The neutral rate proxy is based on long-term real yields (5y5y forwards) adjusted by a constant historical term premium of 100bps.
Note 2: Average data for March 2022 up to the 11th.

Figure 4. Proxy for the Degree of Stimulus (gap between long and short-term real rates)



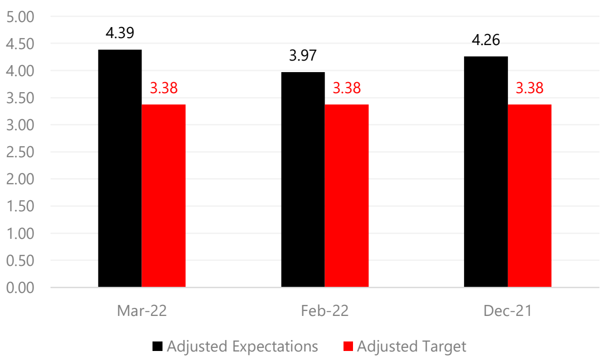
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note 1: To calculate the policy stimulus, we compare the real policy rate with the real neutral rate proxy (see graph on the left side).
Note 2: Average data for March 2022 up to the 11th.

Figure 5. Calendar-Adjusted Expectations vs. Target (18 months ahead)



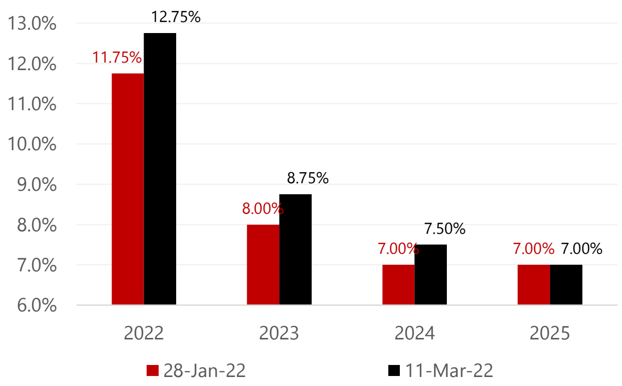
Sources: Brazilian Central Bank, Santander.
Note: IPCA expectations and target adjusted for the weight of each policy horizon. For March 2022, this means 25% for 2022, and 75% for 2023.

Figure 6. Calendar-Adjusted Estimates (18 months ahead)



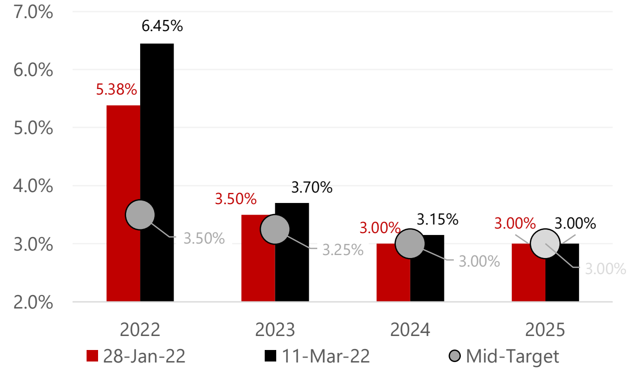
Sources: Brazilian Central Bank, Santander.
Note 1: IPCA expectations and target adjusted for the weight of each calendar-year as a policy horizon. For 1Q22, this means 25% for 2022, and 75% for 2023.
Note 2: Figures at the end of the week before the respective Copom meeting (e.g., for March 2022, data from the 11th).

Figure 7. Median Selic Rate Expectations (% annual)



Sources: Brazilian Central Bank, Santander.
Note: As of the most recent BCB Focus report: March 11, 2022.

Figure 8. Median IPCA Inflation Expectations (% annual)



Sources: Brazilian Central Bank, Santander.
Note 1: As of the most recent BCB Focus report: March 11, 2022.
Note 2: Assumes the maintenance of the 2024 inflation target for 2025

Figure 9. Proxy for the Copom Dataset, Part 1

ECONOMIC TOPIC	LATEST DATA		THIS MEETING	LAST MEETING	SECOND LAST
Key Variables	***When?***		***Mar-22***	***Feb-22***	***Dec-21***
INFLATION					
Forecasts (% p.a.) - BCB's Focus report					
Calendar-Weighted Forecast (~18 months)	11-Mar-22	↑	4.39	3.97	4.26
Calendar-Weighted Target (~18 months)	11-Mar-22	→	*3.38*	*3.38*	*3.38*
Forecast for a year ahead (12 months)	11-Mar-22	↑	5.67	5.29	5.36
Forecast for 2022 - target: 3.50%	11-Mar-22	↑	6.45	5.38	5.02
Forecast for 2023 - target: 3.25%	11-Mar-22	↑	3.70	3.50	3.50
Forecast for 2024 - target: 3.00%	11-Mar-22	↑	3.15	3.00	3.10
Forecast for 2025 - target(e): 3.00%	11-Mar-22	→	3.00	3.00	3.00
Breakeven inflation rates (% p.a.)					
1-year	11-Mar-22	↑	5.85	5.47	5.09
2-year	11-Mar-22	↑	5.87	5.49	5.10
5-year	11-Mar-22	↑	6.68	4.60	6.27
10-year	11-Mar-22	↑	6.05	5.36	5.42
Actual CPI data					
Headline (% YoY)	Feb-22	↑	10.4	10.1	10.7
Headline (% QoQ, saar)	Feb-22	↓	7.4	9.9	12.7
Core IPCA EX3 (% YoY)	Feb-22	↑	7.6	7.1	6.5
Core IPCA EX3 (% QoQ, saar)	Feb-22	↑	9.2	8.2	6.4
New cores average (% YoY)	Feb-22	↑	7.9	7.4	7.2
New cores average (% QoQ, saar)	Feb-22	↓	8.6	9.0	9.3
Diffusion index (sa)	Feb-22	↑	69.5%	67.4%	62.6%
Diffusion index ex-food (sa)	Feb-22	↑	72.5%	69.3%	70.0%
MONETARY POLICY					
Selic rate (% p.a.)					
Current level	11-Mar-22	↑	10.75	9.25	7.75
Forecast for 2022	11-Mar-22	↑	12.75	11.75	11.25
Forecast for 2023	11-Mar-22	↑	8.75	8.00	8.00
Forecast for 2024	11-Mar-22	↑	7.50	7.00	7.00
Forecast for 2025	11-Mar-22	→	7.00	7.00	7.00
Yield curve (% p.a.)					
1-year OIS swaps (pré-DI)	11-Mar-22	↑	13.3	12.1	11.3
2-year OIS swaps (pré-DI)	11-Mar-22	↑	13.0	11.4	11.0
Ex-ante real interest rate (% p.a.)					
1-year (OIS swaps vs. inflation forecast)	11-Mar-22	↑	7.2	6.5	5.7
FISCAL POLICY					
Primary Fiscal Balance (% GDP)					
Actual level (12-month rolling)	11-Mar-22	↑	1.2	0.7	0.1
Forecast for 2022	11-Mar-22	↑	-0.7	-1.0	-1.2
Forecast for 2023	11-Mar-22	↑	-0.5	-0.7	-0.8
Forecast for 2024	11-Mar-22	↑	-0.2	-0.3	-0.4
Forecast for 2027	11-Mar-22	↑	0.7	0.6	0.8
Forecast for 2030	11-Mar-22	↑	1.5	1.4	1.4
Gross General Government Debt (% GDP)					
Actual level	11-Mar-22	↓	79.6	80.3	81.1
Forecast for 2022	11-Mar-22	↓	83.0	84.1	83.5
Forecast for 2023	11-Mar-22	↓	85.0	86.5	85.1
Forecast for 2024	11-Mar-22	↓	85.9	88.8	86.6
Forecast for 2027	11-Mar-22	↓	88.4	91.9	87.6
Forecast for 2030	11-Mar-22	↓	87.2	91.3	86.6

Sources: IBGE, FGV, Brazilian Central Bank, Anbima, Bloomberg, Santander.
Last update: March 14, 2022.

Figure 10. Proxy for the Copom Dataset, Part 2

ECONOMIC TOPIC *Key Variables*	LATEST DATA *When?*		THIS MEETING *Mar-22*	LAST MEETING *Feb-22*	SECOND LAST *Dec-21*
REAL ACTIVITY					
GDP forecasts (% p.a.) - BCB's Focus report					
Forecast for 2022	11-Mar-22	↑	0.49	0.30	0.51
Forecast for 2023	11-Mar-22	↓	1.43	1.55	1.95
Forecast for 2024	11-Mar-22	→	2.00	2.00	2.10
Forecast for 2025	11-Mar-22	→	2.00	2.00	2.00
Actual activity data					
IBC-Br (% QoQ, saar)	Dec-21	↑	0.1	-1.7	-1.2
Industrial production (% QoQ, saar)	Jan-22	↑	2.1	-0.5	-6.5
Retail sales (% QoQ, saar)	Jan-22	↓	-0.1	-7.2	-10.5
Services volume (% QoQ, saar)	Dec-21	↑	1.6	-0.5	3.6
Unemployment rate (% 3m, SA)	Dec-21	↓	12.2	12.3	12.5
Real average wage (% YoY, 3m)	Dec-21	↓	-11.4	-11.1	-11.1
Real wage bill (% YoY, 3m)	Dec-21	↓	-2.6	-1.9	-0.8
Caged payrolls (thousands, SA, 3m)	Jan-22	↑	131	110	171
Economic confidence (2011=100)	Feb-22	↑	80.1	79.1	81.4
EXTERNAL SECTOR					
FX rate (USD/BRL)					
Current level	11-Mar-22	↓	5.08	5.27	5.53
Actual: 5-day average (previous week)	11-Mar-22	↓	5.05	5.43	5.64
USD/BRL (to be) used in simulations	11-Mar-22	↓	5.05	5.45	5.65
Forecast for 2022	11-Mar-22	↓	5.30	5.60	5.55
Forecast for 2023	11-Mar-22	↓	5.21	5.50	5.40
Forecast for 2024	11-Mar-22	↓	5.20	5.40	5.30
Forecast for 2025	11-Mar-22	↓	5.20	5.39	5.35
Current account balance (USD Billions, 12m)					
Current level (12-month rolling)	Jan-22	↑	-27.7	-27.9	-30.6
Forecast for 2022	11-Mar-22	↑	-20.6	-23.4	-19.0
Forecast for 2023	11-Mar-22	↑	-33.4	-34.7	-24.5
Forecast for 2024	11-Mar-22	↑	-40.0	-43.8	-35.0
Forecast for 2025	11-Mar-22	↑	-42.7	-47.5	-35.2
ASSET PRICES					
IC-Br (% YoY)	Feb-22	↑	30.2	40.4	50.7
CRB Commodity Index	11-Mar-22	↑	295	259	227
Brazil 5-year CDS (basis-points)	11-Mar-22	↑	225	213	215
Ibovespa stock index (points)	11-Mar-22	↓	111,713	111,894	108,096
DI Jan-23 (% p.a.)	11-Mar-22	↑	13.14	12.13	11.37
DI Jan-24 (% p.a.)	11-Mar-22	↑	12.99	11.47	10.90
NTN-F 2025 (% p.a.)	11-Mar-22	↑	12.57	11.00	10.69
NTN-F 2027 (% p.a.)	11-Mar-22	↑	12.37	10.94	10.70
NTN-B 2045 (% p.a.)	11-Mar-22	↑	5.90	5.59	5.16
NTN-B 2055 (% p.a.)	11-Mar-22	↑	5.89	5.54	5.19

Sources: IBGE, FGV, Brazilian Central Bank, Anbima, Bloomberg, Santander.
Last update: March 14, 2022.

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