Santander Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY PREVIEW

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PREPARING TO LAND?

- We remain aligned with consensus and forecast another 150-bp Selic hike to 10.75% for the February 1-2 Copom meeting. In the statement, we believe the Copom will maintain its previous monetary policy signal. Specifically, we expect the Committee to signal that it will advance "even more in the contractionary territory", with the Brazil Central Bank (BCB) still identifying (fiscally driven) risks for the process of anchoring inflation expectations.
- In terms of guidance for the next steps, although we project a further increase of 150 bps for the Selic at the March 15-16 meeting, we believe the BCB will seek greater flexibility in what could eventually turn out to be the last movement of this cycle. Thus, in next week's statement, we believe that the BCB will leave options a little more open for the subsequent meeting, granting itself more degrees of freedom (than has been the norm) to calibrate the terminal level of the Selic rate sometime between late Q1 and early Q2.
- In order to avoid an undesirably high dispersion of expectations regarding the end of the Selic hiking cycle, the BCB could signal an adjustment of 100-150 bps as plausible scenarios for the March Copom meeting. In our view, however, the BCB will not yet signal that this future move would be the last, leaving the next steps a little more data-dependent.
- We continue to foresee a total adjustment taking the Selic rate to 12.25% at the end of this cycle (and stability for the rest of the year). This means a considerably tight monetary policy stance, as a response to risks that could be both external (e.g., commodities) or domestic (e.g., fiscal de-anchor). These factors could potentially hamper the speed of the disinflation process going forward.

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

In the last Copom policy meeting[1], held on December 7-8, the BCB continued to hike the Selic rate by 150 bps (reaching 9.25%) and signaled the same pace for the subsequent meeting. According to the official communication at the time, "given the increase in its inflation projections and in the risk of a de-anchoring of long-term expectations, it is appropriate to advance the process of monetary tightening significantly into the restrictive territory." Importantly, the BCB board also pledged to "persist in its strategy until the disinflation process and the expectation anchoring around its targets consolidate."

The Copom minutes[2] complemented the message, as the BCB put a good deal of emphasis on the upwardly skewed balance of risks for inflation, which is especially fed by "the risk of a de-anchoring of longer-term expectations, derived from developments in the fiscal scenario." Owing to this asymmetry in the balance of risks, the "Copom evaluated that its [inflation] projections are above the target for both 2022 and 2023", despite the results of the baseline scenario showing the BCB projection at 3.2% (mid-target: 3.25%) for 2023, the key policy horizon from now on. The authority concludes that "the monetary tightening process should be more restrictive than that used in the baseline scenario throughout the relevant horizon."

In the 4Q21 inflation report[3], important macro parameters have been re-estimated: the neutral interest rate is now seen at 3.6% (previously: 3.0%), which is in line with the thesis we have been supporting since 1Q21 and implies a higher terminal rate for the tightening cycle. The higher structural interest rate helped drive higher the BCB's own inflation forecasts. The 3Q21 output gap was calculated at -1.7%, and forecast at -1.8% for 4Q21 and -2.1% (revised from -1.2%) for 4Q22, with persistent economic slack reflecting a tighter monetary policy and worse financial conditions. The gap follows markdowns in the BCB's GDP forecasts (2021: to 4.4% from 4.7%; 2022: to 1.0% from 2.1%).

In recent documents[4] and speeches (as of January 2022), BCB officials reaffirmed the intention to hike the Selic rate at the same speed (150 bps, to 10.75%), as the BCB continues to identify risks for the anchoring of inflation expectations. In the open letter to the Ministry of Economy (to justify the IPCA 2021 above the upper end of the tolerance band), the BCB claims it will persevere in the strategy not only to seek disinflation in the economy but also to put inflation expectations at the mid-target.

The Context for the First Meeting of 2022

In light of the BCB's inflation projections, its assessment about the balance of risks, as well as the market's inflation expectations, we estimate that the Copom could need to raise the Selic (policy) rate to a level around 12% to bring IPCA inflation back to the center target of 3.25% in 2023. It is important to note that from 1Q22 onward, the horizon of 2023 becomes the focal point for monetary policy.

Meanwhile, IPCA projections for 2022 (now a less important horizon for the BCB, due to the lagged effect of monetary policy) point to a considerable risk that once again headline CPI will breach the tolerance band, with consensus projecting inflation of 5.15% for this year and the BCB estimating 4.7%[5].

As mentioned above, in recent communications the BCB signaled its intention to maintain the speed of adjustment in monetary conditions for the February meeting, at a pace of 150 bps. That makes perfect sense, since we identified just a few noteworthy changes in the (current and prospective) scenario for inflation since the last meeting. Among the highlights, a continued sequence of weak trend numbers on economic activity

[1] **Santander Brazil Monetary Policy - *"Inflation Expectations, Target. And (Almost) Nothing Else Matters"* –** December 8, 2021 - Available on: https://bit.ly/Std-COPOM-dec21

[2] **Santander Brazil Monetary Policy - *"Focus on Inflation Expectations, Aiming (Interest Rate) Above the Baseline"* –** December 14, 2021 – Available on: https://bit.ly/Std-Copom-min-dec21

[3] **Santander Brazil Monetary Policy - *"Higher Neutral Rate and Stickier GDP Slack"* –** December 16, 2021 - Available on: https://bit.ly/Std-InflaReport-4Q21

[4] **Santander Brazil Macro Compass - *"November Rain (Of Upside Activity Surprises)"* –** January 14, 2021 - Available on: https://bit.ly/Std-macrocomp-011422, see details in the Monetary Policy section.

[5] According to our simulations, the Copom statement could show small fluctuations in the inflation estimates of the BCB for 2022 and 2023, in comparison with the figures presented in the 4Q21 inflation report, published in December.

(despite a November uptick), continued deterioration in the inflation composition, as well as headline CPI and underlying inflation still pointing to sequential numbers well above the mid-target.

A key aspect to note in recent weeks is the proposal for legislative changes altering the regulated price framework, given announced intentions to reduce taxes in the energy sector, with no compensatory tax measures or changes in government expenses. While still lacking details, this initiative could generate downward effects for inflation in the short term, but inflationary consequences for the medium term, conditional on the expectations channel. In any case, there is now another factor of uncertainty in the inflation outlook, adding more complexity to an already misty landscape for the BCB to navigate through.

At this stage, the BCB's hawkish speech and signaling seems to have sufficed to contain further deterioration of inflation expectations. Perhaps this could have been a bit influenced by some short-term improvement in the budget performance and a perception of “fiscal space” for stimulus, with the public sector expected to post for 2021 the first primary surplus in eight years, even if this is highly due to exogenous and temporary factors influencing revenue, such as gains in terms of trade. One way or another, the recent signs of stabilization in inflation expectations seem to contribute to the maintenance of Copom's flight plan, at least for now.

What to Expect for the Meeting and Afterward?

We remain aligned with the consensus[6] and forecast another 150-bp Selic hike, to 10.75% for the February 1-2 Copom meeting. In the statement, we believe the Copom should keep the same monetary policy signal, still willing to advancing “even more in the contractionary territory”, as the BCB still identifies (fiscally driven) risks for the process of anchoring inflation expectations.

If our assessment on the total budget of hikes envisaged by the BCB today is on the mark, the Copom could signal in the February communiqué that the end of the tightening cycle is near. For that, the BCB could use the language that it will soon have to observe the effects of monetary policy on the economy and inflation, given the lagged expected effects of previous Selic hikes.

Although we project an additional 150-bp Selic increase at the March 15-16 meeting, we believe the BCB will seek greater flexibility in what could eventually turn out to be the last movement of this cycle. Thus, we believe that the BCB will leave options a little more open for the subsequent meeting, granting itself more degrees of freedom (than has been the norm) to calibrate the terminal level of the Selic rate.

In order to avoid an undesirably high dispersion of expectations regarding the end of the Selic hiking cycle, the BCB could signal an adjustment of 100-150 bps as plausible scenarios for the March meeting. In our view, however, the BCB will not yet signal that this future move would be the last, leaving the next steps a little more data-dependent.

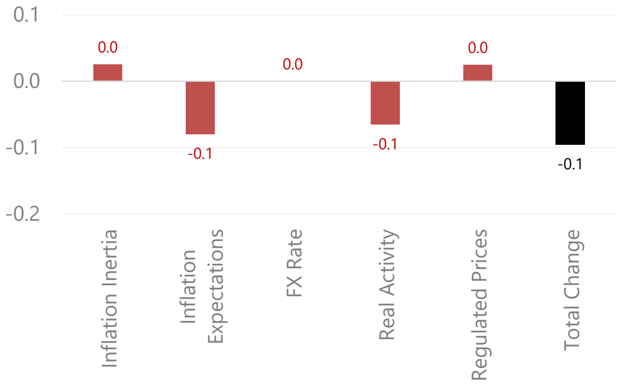
With signals issued by the Committee in the last Copom minutes about an upwardly skewed balance of risks and its implication in terms of a tighter monetary policy path than in the baseline scenario, we continue to foresee a total adjustment taking the Selic rate above 12% at the end of this cycle: our projection for the terminal Selic rate is 12.25% in March, with stability for the rest of the year. This means really tight monetary policy stance, as a response to risks that could be both external (e.g., commodities) or domestic (e.g., fiscal de-anchoring). These factors could potentially hamper the speed of the disinflation process going forward.

In any case, despite the BCB's strong response, we believe that adverse inflationary conditions will make the IPCA fall more slowly than expected in the coming months, which increases the probability that the tighter monetary stance will be there for longer than (the consensus of) economists think today.

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

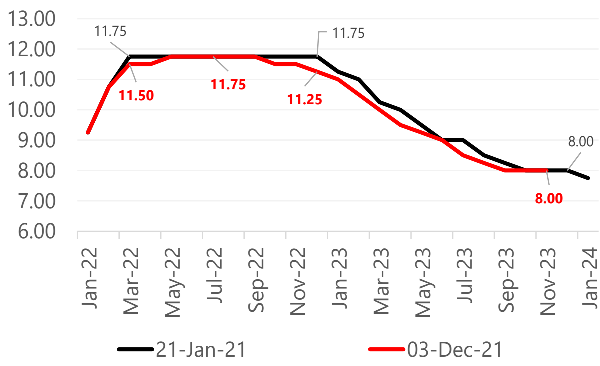
[6] As per the BCB’s weekly Focus survey among professional forecasters, as of January 21, 2022.

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



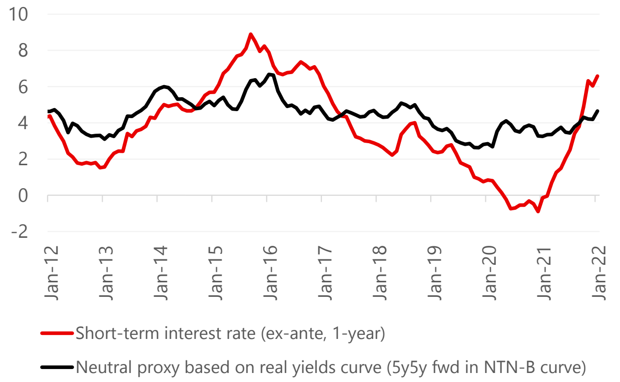
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: Based on the model elasticities published by the authority

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



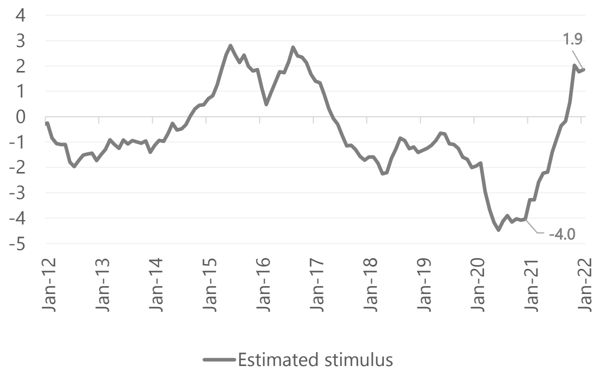
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: As of the most recent BCB Focus report: January 21, 2022.

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



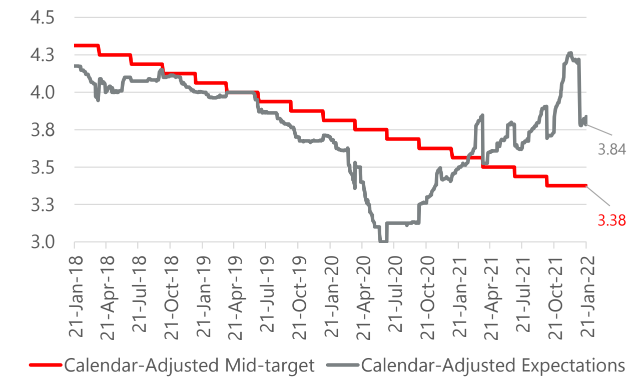
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note 1: Based on historical averages, the neutral rate proxy based on long nominal yields is adjusted by a constant term premium of 200bps, with the neutral rate proxy based on real yields adjusted by a premium of 100bps.
Note 2: Average data for January 2022 up to the 21st.

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



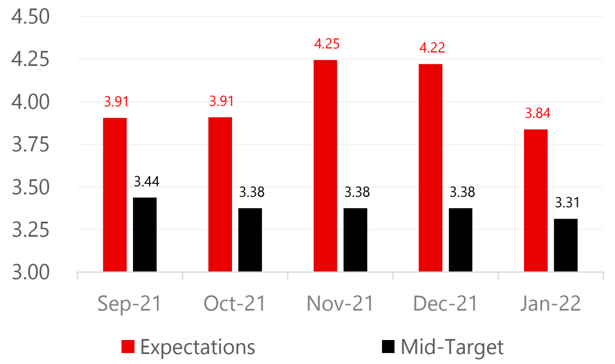
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note 1: To calculate the stimulus, we compared the short-term rate presented in the left-hand graph with the neutral rate proxy.
Note 2: Average data for January 2022 up to the 21st.

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



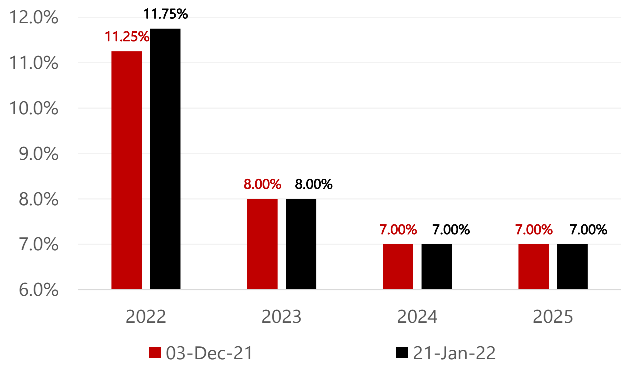
Sources: Brazilian Central Bank, Santander.
Note: IPCA expectations and target adjusted for the weight of each policy horizon. For January 2022, this means 25% for 2022, and 75% for 2023.

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



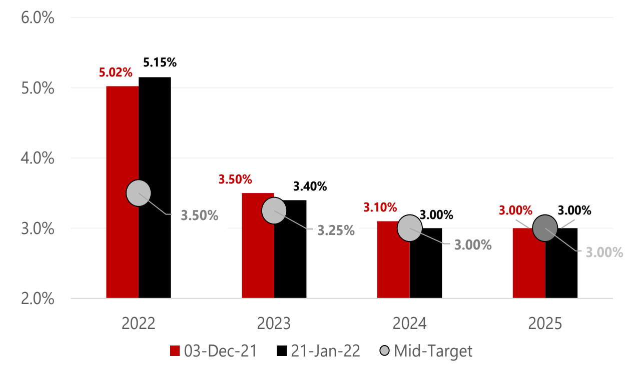
Sources: Brazilian Central Bank, Santander.
Note: IPCA expectations and target adjusted for the weight of each policy horizon. For January 2022, this means 25% for 2022, and 75% for 2023.

Figure 7. Median Selic Rate Expectations (% annual)



Sources: Brazilian Central Bank, Santander.
Note: As of the most recent BCB Focus report: January 21, 2022.

Figure 8. Median IPCA Inflation Expectations (% annual)



Sources: Brazilian Central Bank, Santander.
Note 1: As of the most recent BCB Focus report: January 21, 2022.
Note 2: Assumes the maintenance of the 2024 inflation target for 2025

Figure 9. Proxy for the Copom Dataset, Part 1

ECONOMIC TOPICS	LAST DATA		THIS TIME	LAST MEETING	SECOND LAST
Key Decision Variables	*When?*		*Jan'22*	*Dec'21*	*Oct'21*
INFLATION					
Forecasts (% p.a.) - BCB's Focus report					
Calendar-Weighted Forecast (~18 months)	21-Jan-22	↓	3.84	4.26	3.84
Calendar-Weighted Target (~18 months)	21-Jan-22	→	*3.38*	*3.38*	*3.38*
Forecast for a year ahead (12 months)	21-Jan-22	↓	5.07	5.36	4.90
Forecast for 2022 - target: 3.50%	21-Jan-22	↑	5.15	5.02	4.40
Forecast for 2023 - target: 3.25%	21-Jan-22	↓	3.40	3.50	3.27
Forecast for 2024 - target: 3.00%	21-Jan-22	↓	3.00	3.10	3.02
Forecast for 2025 - target(e): 3.00%	21-Jan-22	→	3.00	3.00	3.00
Breakeven inflation rates (% p.a.)					
1-year	21-Jan-22	↑	5.5	5.1	5.5
2-year	21-Jan-22	↑	5.6	5.1	5.5
5-year	21-Jan-22	↓	4.3	6.3	6.8
10-year	21-Jan-22	↑	5.7	5.4	6.0
Actual CPI data					
Headline (% YoY)	Dec-21	↓	10.1	10.7	10.7
Headline (% QoQ, saar)	Dec-21	↓	10.0	12.7	13.8
Core IPCA EX3 (% YoY)	Dec-21	↑	7.1	6.5	6.6
Core IPCA EX3 (% QoQ, saar)	Dec-21	↑	8.2	6.4	8.0
New cores average (% YoY)	Dec-21	↑	7.4	7.2	7.0
New cores average (% QoQ, saar)	Dec-21	↓	8.9	9.2	9.8
Diffusion index (sa)	Dec-21	↑	66.5%	62.3%	62.5%
Diffusion index ex-food (sa)	Dec-21	↓	68.7%	69.5%	69.3%
MONETARY POLICY					
Selic rate (% p.a.)					
Current level	21-Jan-22	↑	9.25	7.75	6.25
Forecast for 2022	21-Jan-22	↑	11.75	11.25	9.50
Forecast for 2023	21-Jan-22	→	8.00	8.00	7.00
Forecast for 2024	21-Jan-22	→	7.00	7.00	6.50
Forecast for 2025	21-Jan-22	→	7.00	7.00	6.50
Yield curve (% p.a.)					
1-year OIS swaps (pré-DI)	21-Jan-22	↑	11.9	11.3	11.2
2-year OIS swaps (pré-DI)	21-Jan-22	↑	11.5	11.0	11.7
Ex-ante real interest rate (% p.a.)					
1-year (OIS swaps vs. inflation forecast)	21-Jan-22	↑	6.5	5.7	6.0
FISCAL POLICY					
Primary Fiscal Balance (% GDP)					
Actual level (12-month rolling)	21-Jan-22	↑	0.1	-0.2	-0.6
Forecast for 2022	21-Jan-22	↑	-0.9	-1.2	-1.0
Forecast for 2023	21-Jan-22	↑	-0.6	-0.8	-0.6
Forecast for 2024	21-Jan-22	↑	-0.4	-0.4	-0.2
Forecast for 2027	21-Jan-22	↓	0.6	0.8	1.1
Forecast for 2030	21-Jan-22	↓	1.2	1.4	1.7
Gross General Government Debt (% GDP)					
Actual level	21-Jan-22	↓	81.1	82.3	82.3
Forecast for 2022	21-Jan-22	↑	84.0	83.5	83.3
Forecast for 2023	21-Jan-22	↑	86.0	85.1	84.9
Forecast for 2024	21-Jan-22	↑	88.6	86.6	85.2
Forecast for 2027	21-Jan-22	↑	91.9	87.6	85.6
Forecast for 2030	21-Jan-22	↑	91.3	86.6	82.3

Sources: IBGE, FGV, Brazilian Central Bank, Anbima, Bloomberg, Santander.
Last update: January 24, 2022.

Figure 10. Proxy for the Copom Dataset, Part 2

ECONOMIC TOPICS	LAST DATA		THIS TIME	LAST MEETING	SECOND LAST
Key Decision Variables	When?		Jan'22	Dec'21	Oct'21
REAL ACTIVITY					
GDP forecasts (% p.a.) - BCB's Focus report					
Forecast for 2022	21-Jan-22	↓	0.29	0.51	1.40
Forecast for 2023	21-Jan-22	↓	1.69	1.95	2.00
Forecast for 2024	21-Jan-22	↓	2.00	2.10	2.25
Forecast for 2025	21-Jan-22	→	2.00	2.00	2.25
Actual activity data					
IBC-Br (% QoQ, saar)	Nov-21	↓	-3.1	-3.1	-3.2
Industrial production (% QoQ, saar)	Nov-21	↓	-8.0	-9.5	-7.8
Retail sales (% QoQ, saar)	Nov-21	↓	-11.0	-14.5	-6.2
Services volume (% QoQ, saar)	Nov-21	↓	-1.3	2.9	11.8
Unemployment rate (% 3m, SA)	Dec-21	↓	12.1	12.3	13.0
Real average wage (% YoY, 3m)	Dec-21	↓	-11.1	-11.1	-9.5
Real wage bill (% YoY, 3m)	Dec-21	↓	-1.9	-0.8	0.7
Caged payrolls (thousands, SA, 3m)	Nov-21	↑	199	162	179
Economic confidence (2011=100)	Dec-21	↓	81.4	81.9	84.0
EXTERNAL SECTOR					
FX rate (USD/BRL)					
Current level	21-Jan-22	↓	5.45	5.53	5.54
Actual: 5-day average (previous week)	21-Jan-22	↓	5.49	5.62	5.59
USD/BRL (to be) used in simulations	21-Jan-22	↑	5.60	5.25	5.15
Forecast for 2022	21-Jan-22	↑	5.60	5.55	5.45
Forecast for 2023	21-Jan-22	↑	5.50	5.40	5.20
Forecast for 2024	21-Jan-22	↑	5.40	5.30	5.10
Forecast for 2025	21-Jan-22	↑	5.39	5.35	5.12
Current account balance (USD Billions, 12m)					
Current level (12-month rolling)	Nov-21	↓	-30.8	-26.8	-23.5
Forecast for 2022	21-Jan-22	↓	-24.3	-19.0	-19.0
Forecast for 2023	21-Jan-22	↓	-31.1	-24.5	-29.5
Forecast for 2024	21-Jan-22	↓	-42.5	-35.0	-34.0
Forecast for 2025	21-Jan-22	↓	-45.0	-35.2	-35.0
ASSET PRICES					
IC-Br (% YoY)	Dec-21	↑	50.7	49.7	50.4
CRB Commodity Index	21-Jan-22	↑	248.5	227.1	238.9
Brazil 5-year CDS (basis-points)	21-Jan-22	↑	221	215	230
Ibovespa stock index (points)	21-Jan-22	↑	108,942	108,096	106,363
DI Jan-23 (% p.a.)	21-Jan-22	↑	11.88	11.37	11.51
DI Jan-24 (% p.a.)	21-Jan-22	↑	11.46	10.90	11.79
NTN-F 2025 (% p.a.)	21-Jan-22	↑	11.24	10.69	11.63
NTN-F 2027 (% p.a.)	21-Jan-22	↑	11.30	10.70	11.71
NTN-B 2045 (% p.a.)	21-Jan-22	↑	5.68	5.16	5.50
NTN-B 2055 (% p.a.)	21-Jan-22	↑	5.70	5.19	5.54

Sources: IBGE, FGV, Brazilian Central Bank, Anbima, Bloomberg, Santander.
Last update: January 24, 2022.

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