Santander
Macroeconomic Research

BRAZIL MACRO

March 20, 2023

MONETARY POLICY PREVIEW

Mauricio Oreng*
mauricio.oreng@santander.com.br
+5511 3553 5404

STAYING THE COURSE, AT LEAST FOR NOW

- The Copom is scheduled to announce its interest rate decision on Wednesday (March 22). In line with consensus (as signaled both by analysts' surveys and the yield curve pricing), we expect the Brazilian Central Bank (BCB) to maintain the Selic rate at 13.75%, a fairly contractionary level.
- In the statement, we believe that the BCB will not make major changes to the flight plan, maintaining the signal that it will continue evaluating whether the strategy of keeping interest rates unchanged for a prolonged period will be able to ensure the convergence of inflation.
- On the one hand, inflationary (and fiscal) risks remain high and we still see an upward asymmetry in the outlook. On the other hand, we recognize that activity is losing strength and that external and domestic financial events require monitoring (perhaps with a bigger role given by the BCB to these elements in the balance of risks for inflation).
- We believe that a change in the monetary policy strategy (and signaling) would be premature at this point, given (i) a lack of evidence on the size of the potential impacts of the credit or global slowdown on local activity (and hence inflation); (ii) the first line of defense against situations of undesirable tightening of credit conditions are actions in the regulatory or macro-prudential scope; and (iii) except for major shocks (again, which requires monitoring), fiscal impulses can still offset a good deal of the "drag" prompted by these new factors.
- We still believe that a change in the flight plan (of rate stability for long) would require the confirmation of significant deviations from the BCB's scenario and hypotheses. We continue to anticipate gradual interest rate cuts starting in 4Q23, bringing the Selic rate to 13% at the end of 2023 and 11% at the end of 2024.

A LITTLE BACKGROUND ON PREVIOUS POLICY SIGNALS

At the February Copom meeting[1], the Brazilian Central Bank (BCB) kept the Selic policy rate at 13.75% as widely expected. However, the monetary authority came up with a hawkish message.

In terms of policy signals in the statement, the BCB upped the tone on inflation risks, as fiscal uncertainties remained high, and inflation expectations kept rising and drifting further away from the path of the mid-point targets. The BCB believed that this scenario would raise "the cost of the disinflation that is needed to reach the targets established by the National Monetary Council." The BCB turned much less confident that the path for the Selic rate as projected by analysts back then would suffice to assure inflation convergence to the target. Remember: in late January, interest rate was seen on hold at 13.75% until September, then falling to 12.50% for YE2023 and 9.50% for YE2024.

The BCBs inflation forecast[2] showed a clear deterioration from the previous Copom (December), driven mainly by the increase in inflation expectations. The BCB estimated IPCA inflation at 3.6% for 3Q24 (the key policy horizon); in December the BCB estimated 3.3% for 3Q24. Inflation was seen by the BCB at 3.4% for 2024 (previously 3.0%), assuming the consensus path for the Selic rate. The BCB also introduced another simulation, assuming a stable path for the Selic rate at 13.75% for the entire forecasting horizon: this simulation yielded an IPCA estimate of 3.1% for 3Q24 and 2.8% for 2024. By presenting this alternative simulation, the BCB showed that, in their models, a path with no Selic cuts until YE2024 takes the IPCA much closer to their objectives. Given its new forecasts, the BCB adjusted its wording by stating that would continue to assess "if the strategy of maintaining the Selic rate for a *longer period than in the reference scenario* will be enough to ensure the convergence of inflation" (our own highlight).

In the Copom minutes[3], not only did the BCB reaffirm the need to assess if the strategy of "maintaining the Selic rate for a longer period than in the reference scenario will be enough to ensure the convergence of inflation", but also expressed discomfort with the increases in long-term inflation expectations. The BCB cited possible reasons for the upward movement in longer-term expectations: (i) "a possible perception of BCB leniency with the targets"; (ii) "an expansionary fiscal policy that pressures the aggregate demand over the projection horizon"; (iii) "the possibility of changes in the inflation targets already set". The Copom stated that "more important than analyzing the motivations for the rise in expectations, the Committee emphasizes that it will act to ensure that inflation converges to the targets".

THE CONTEXT FOR THE MARCH MEETING

The evolution of the economic data and inflation outlook since the last Copom meeting has been more complex and less unidirectional (as was the case of the February meeting), with rising fears of malfunctioning in global financial markets and signs of a slowing credit and overall economic activity in Brazil on one side, but with no signs of truce in the process of rising inflation expectations, stubbornly high core inflation, and a still high fiscal uncertainty, on other side.

On the one hand, we believe that inflationary risks remain high, and we still see an upward bias for the outlook and risks. There is still considerable uncertainty on the fiscal front. Although the government's initiative to accelerate discussions on the new fiscal framework is positive, in our view, few details of the proposal that will be submitted to the National Congress are known at this time. We continue to believe that the room allowed for increases in government spending will be a key driver for inflationary expectations for the coming years. For now, analyst surveys continue to show deterioration in expectations for the IPCA: since the last Copom meeting (February), there has been an additional gain of 20-50 bps in economists' inflation projections for 2023 to 2026, with our adjusted metrics for the policy-horizon[4] rising 21bps to 4.57%, drifting further away from the de adjusted mid-target (3.06%). Long-term estimates have risen even faster, with 2025

---

[1] **Santander Brazil Monetary Policy: "Copom *Decision: Pushing Back Expected Rate Cuts"*** – February 1, 2023 – Available on: https://bit.ly/Std-COPOM-feb23

[2] The simulations assume USD/BRL at 5.15 and then evolving with purchasing power parity (PPP) as well as oil prices following the futures curve for the next six months and then stable in real terms in USD. The scenarios assume energy tariff flag "yellow" for both December 2023 and 2024.

[3] **Santander Brazil Monetary Policy: "*Copom Minutes: Selic At 13.75% for Even Longer"*** – February 7, 2023 – Available on: https://bit.ly/Std-COPOM-feb23

[4] At this juncture, this metrics means a weighted average of 25% for YE2023 and 75% for YE2024.

and 2026 horizons seeing gains of 40bps and 50bps, respectively, toward levels around 4% (central target: 3%). Breakeven inflation rates (BEIRs) have seen mixed movements since the last Copom, with a decline for 1-2 years and an increase for 5-10 years: in any case, even taking into account a historical risk premium, the BEIR measures continue to signal that traders see inflation around 6% ahead.

The level of economic slack remains under discussion and is an important source of uncertainty: our numbers point to a close output gap (with GDP standing more than 1 pp above potential, as of 4Q22) and an overheated job market (with the unemployment rate more than 1 pp below our estimate of inflation-neutral joblessness, as of January 2023). Indirect signs of possible overheating in the economy favor our conclusion, such as: (i) the strong gains in average wages, in both real terms (~8%YoY as of January) and nominal terms (~14%YoY as of January), meaning a likely quick rise in unit labor costs; (ii) the persistence of underlying inflation, as signaled by some key cyclical core gauges (with IPCA EX3 ~6—7% t/t-a.s.a.); and (iii) a current account deficit of ~3% of GDP, above the historical average.

On the other hand, we recognize that economic activity is losing momentum, as indicated by the 4Q22 national accounts data. The most recent (but still scant) activity reports concerning the beginning of 2023 signal the continuation of a deceleration process in cyclical sectors, despite some resilience in services and employment. For now, of all this seems to be in line with the BCB's (and analysts') scenario, as the loss of dynamism confirms the initial (but lagged) effects of a contractionary monetary policy stance.

Another theme that has had some influence on market expectations regarding the interest rate trajectory concerns the actual conditions in the local credit market (an important transmission channel for monetary policy), in the wake of corporate bankruptcy episodes, a reduction in capital market transactions, an increase in credit spreads. All of this happens in the context of rising concerns about the health of some financial institutions abroad, which can produce a more intense global slowdown. Although the uncertainties related to a global slowdown and bank lending should probably be reinforced or included (respectively) in the balance of risk analysis in the statement — as potential downside elements for inflation — we believe that a change in the course of monetary policy or signals is premature at this stage, given (i) a lack of evidence of the potential impacts of the credit slowdown on broad activity, (ii) the fact that the first line of defense for situations of undesirable tightening in credit conditions involves actions on the regulatory or macro-prudential front and (iii) a more intense cooling in the global economy and local credit can barely offset a domestic fiscal impulse of 1-2 pp of GDP seen of late.

Overall, with inflation (and fiscal) risks still predominantly tilted to the upside, but with recent external and domestic financial events requiring close monitoring (as per the potentially negative effects on economic activity), we believe that any change by the BCB in its monetary policy or signaling (in either direction) would be premature at this juncture.

WHAT CAN WE EXPECT FOR THE MEETING AND FUTURE STEPS?

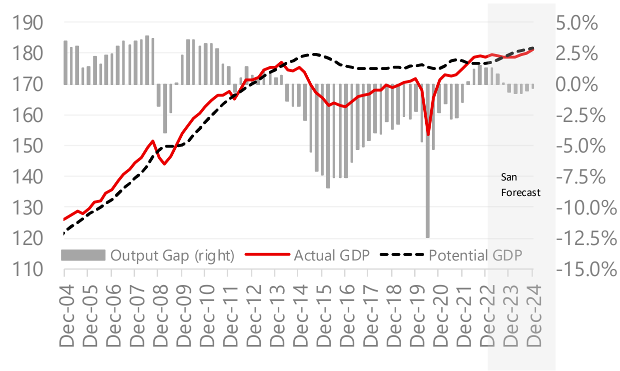
The Copom — Monetary Policy Committee of the BCB — is scheduled to announce its interest-rate decision on Wednesday (March 22). In line with a broad consensus (via both curve pricing and analyst projections), we expect the BCB to maintain the Selic rate at 13.75%. In the Copom statement, we believe the BCB will maintain its flight plan, signaling once again that it will continue evaluating whether the strategy of holding rates steady for a prolonged period will ensure the convergence of inflation to the target.

In our view, the aforementioned incorporation in the balance of risk of local credit developments as a potentially downside risk does not necessarily mean that the BCB is committing to a change in strategy going forward. That **change** would naturally hinge on the extent that this theme will contribute to dampen activity, erase the effects of fiscal impulses and reduce inflation (and expectations) ahead. Financial markets will also pay close attention to the assessment on how the global financial risks could impact the outlook for inflation and monetary policy in Brazil. Other than those, we believe the BCB will not make major additional changes in the statement.

We continue to believe a change in the flight plan (of rate stability for long) would require a significant deviation from the BCB's scenario. We continue to foresee (gradual) interest rate cuts starting in 4Q23, bringing the Selic rate to 13% by YE2023 and 11% by YE2024.

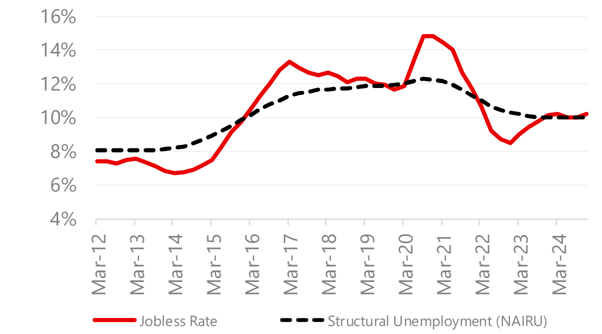
Refer to a summary of the Copom dataset and the following graphs.

Figure 1. GDP and the Output Gap



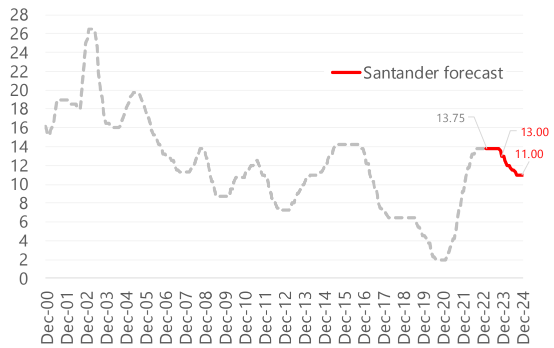
Sources: IBGE, Santander.

Figure 2. Joblessness and Structural Unemployment



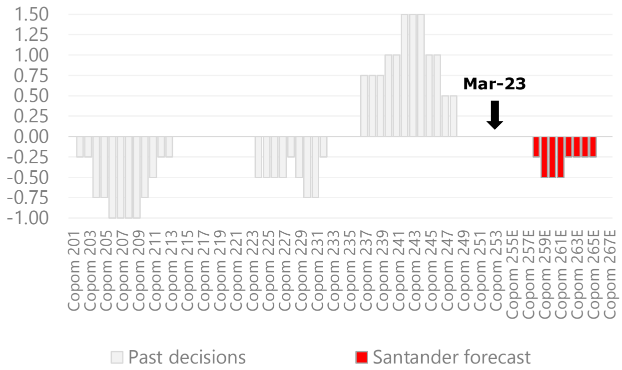
Sources: IBGE, Santander.

Figure 3. Santander Selic Forecast (% pa)



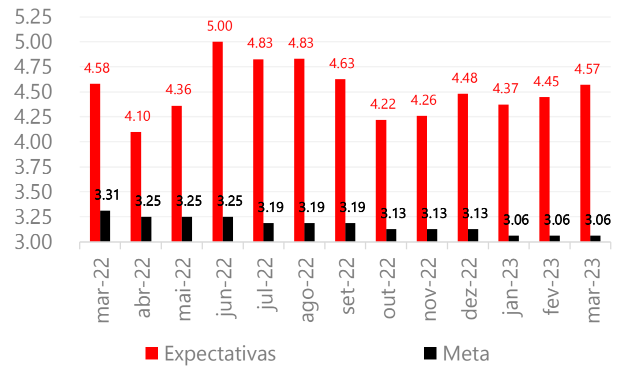
Sources: Brazilian Central Bank, Santander.

Figure 4. Historical, Expected BCB Moves (% pp)



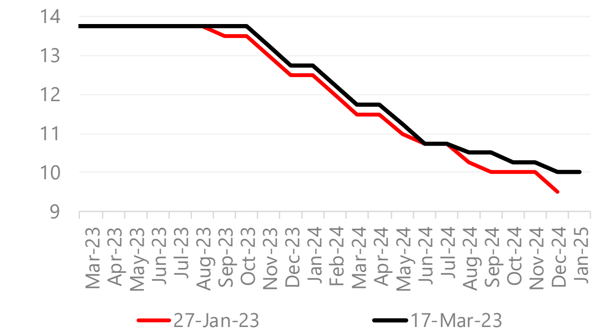
Sources: Brazilian Central Bank, Santander.

Figure 5. Calendar-Adjusted IPCA Estimates, Target *(18 months ahead)*



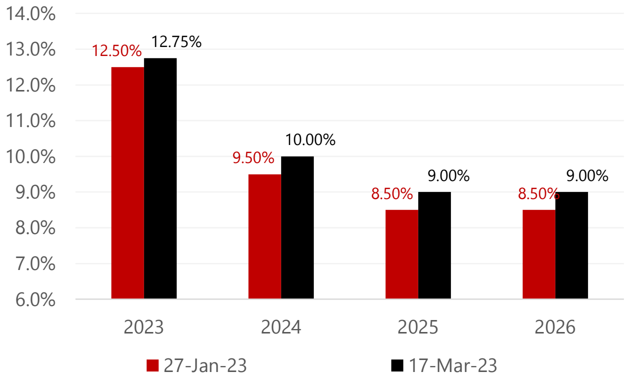
Sources: Brazilian Central Bank, Santander.
Note 1: IPCA expectations and target adjusted for the weight of each calendar-year as a policy horizon. For 1Q23, this means 25% for 2023 and 75% for 2024.
Note 2: Figures for the end of month. For March 2023 up to the 17th.

Figure 6. Median Selic Rate Expectations *(% annual, monthly path)*



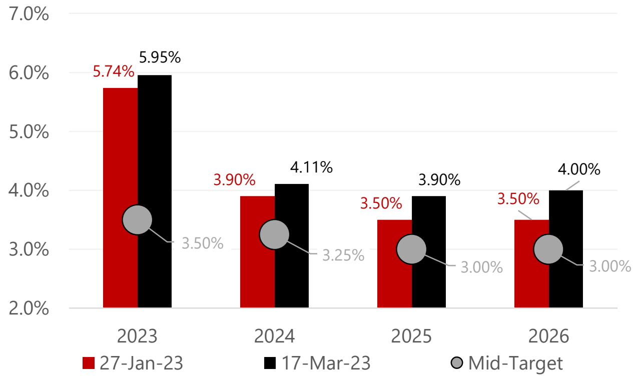
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: As of the most recent BCB Focus report: March 17, 2023.

Figure 7. Median Selic Rate Expectations
(% annual)



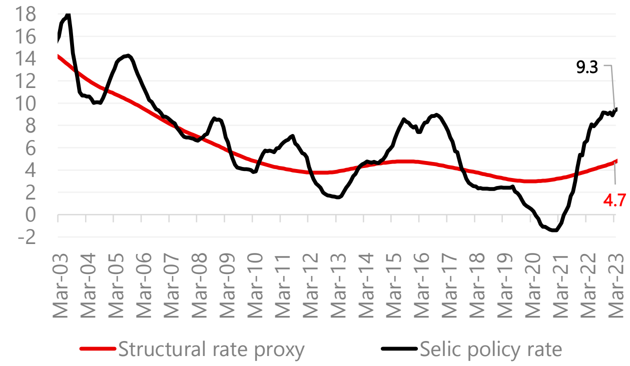
Sources: Brazilian Central Bank, Santander.
Note: As of the most recent BCB Focus report: March 17, 2023.

Figure 8. Median IPCA Inflation Expectations
(% annual)



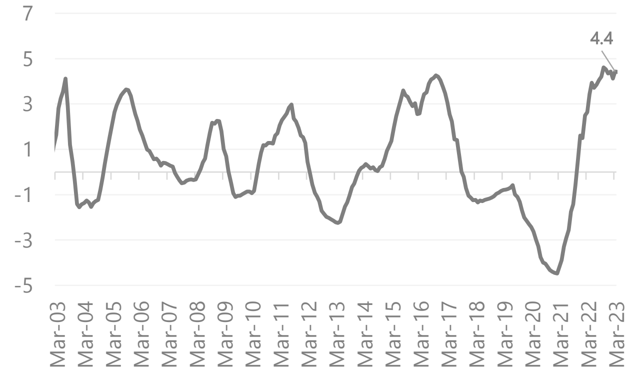
Sources: Brazilian Central Bank, Santander.
Note 1: As of the most recent BCB Focus report: March 17, 2023.

Figure 9. Real Rates: 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 150bps.
Note 2: Average for March 2023 up to the 17th.

Figure 10. Estimated Monetary Policy Stance
(gap between long and short-term real rates)



Sources: Brazilian Central Bank, Bloomberg, Santander.
Note 1: To calculate the policy stimulus, we subtract from the real policy rate the real level of neutral rate proxy (see graph on the left side).
Note 2: Average for March 2023 up to the 17th.

Figure 11. Proxy for the Copom Dataset, Part 1

ECONOMIC TOPIC	LATEST DATA		THIS MEETING	LAST MEETING	SECOND LAST
Key Variables	*When?*		*Mar-23*	*Feb-23*	*Dec-22*
INFLATION					
Forecasts (% p.a.) - BCB's Focus report					
Calendar-Weighted Forecast (~18 months)	17-Mar-23	↑	4.57	4.36	4.29
Calendar-Weighted Target (~18 months)	17-Mar-23	→	*3.06*	*3.06*	*3.13*
Calendar-Weighted Expectations Gap	17-Mar-23	↑	*1.51*	*1.30*	*1.17*
Forecast for a year ahead (12 months)	17-Mar-23	↓	5.53	5.63	5.28
Forecast for 2023 - target: 3.25%	17-Mar-23	↑	5.95	5.74	5.08
Forecast for 2024 - target: 3.00%	17-Mar-23	↑	4.11	3.90	3.50
Forecast for 2025 - target: 3.00%	17-Mar-23	↑	3.90	3.50	3.00
Forecast for 2026 - target: 3.00%	17-Mar-23	↑	4.00	3.50	3.00
Breakeven inflation rates (% p.a.)					
1-year	17-Mar-23	↓	5.99	6.72	6.66
2-year	17-Mar-23	↓	6.10	6.26	6.35
5-year	17-Mar-23	↑	6.67	6.47	6.32
10-year	17-Mar-23	↑	6.79	6.52	6.39
Actual CPI data					
Headline (% YoY)	Feb-23	↓	5.6	5.8	5.8
Headline (% QoQ, saar)	Feb-23	↑	7.6	6.2	5.1
Core IPCA EX3 (% YoY)	Feb-23	↓	9.9	10.3	11.1
Core IPCA EX3 (% QoQ, saar)	Feb-23	↑	7.6	7.2	8.3
New cores average (% YoY)	Feb-23	↓	8.4	8.7	9.1
New cores average (% QoQ, saar)	Feb-23	↑	6.9	6.1	6.1
Diffusion index (sa, 3m)	Feb-23	↑	63.4%	62.0%	63.3%
MONETARY POLICY					
Selic rate (% p.a.)					
Current level	17-Mar-23	→	13.75	13.75	13.75
Forecast for 2023	17-Mar-23	↑	12.75	12.50	11.75
Forecast for 2024	17-Mar-23	↑	10.00	9.50	8.50
Forecast for 2025	17-Mar-23	↑	9.00	8.50	8.00
Forecast for 2026	17-Mar-23	↑	9.00	8.50	8.00
Yield curve (% p.a.)					
1-year OIS swaps (pré-DI)	17-Mar-23	↓	12.7	13.5	13.9
2-year OIS swaps (pré-DI)	17-Mar-23	↓	12.1	12.9	13.1
Ex-ante real interest rate (% p.a.)					
1-year (OIS swaps vs. inflation forecast)	17-Mar-23	↓	6.8	7.5	8.2
FISCAL POLICY					
Primary Fiscal Balance (% GDP)					
Forecast for 2023	17-Mar-23	↑	-1.0	-1.1	-0.9
Forecast for 2024	17-Mar-23	↑	-0.8	-1.0	-0.5
Forecast for 2027	17-Mar-23	→	0.0	0.0	0.0
Forecast for 2030	17-Mar-23	↓	0.0	0.6	0.8
Gross General Government Debt (% GDP)					
Forecast for 2023	17-Mar-23	↓	77.8	79.0	81.7
Forecast for 2024	17-Mar-23	↓	80.9	82.0	83.6
Forecast for 2027	17-Mar-23	↓	85.5	88.0	88.7
Forecast for 2030	17-Mar-23	↓	89.0	91.8	90.7

Sources: IBGE, FGV, Brazilian Central Bank, Anbima, Bloomberg, Santander.

Last update: March 20, 2022.

Figure 12. Proxy for the Copom Dataset, Part 2

ECONOMIC TOPIC	LATEST DATA		THIS MEETING	LAST MEETING	SECOND LAST
Key Variables	*When?*		*Mar-23*	*Feb-23*	*Dec-22*
REAL ACTIVITY					
GDP forecasts (% p.a.) - BCB's Focus report					
Forecast for 2023	17-Mar-23	↑	0.88	0.80	0.75
Forecast for 2024	17-Mar-23	↓	1.47	1.50	1.71
Forecast for 2025	17-Mar-23	↓	1.70	1.89	2.00
Forecast for 2026	17-Mar-23	↓	1.80	2.00	2.00
Actual activity data					
IBC-Br (% QoQ, saar)	Dec-22	↓	-5.7	-4.0	-0.3
Industrial production (% QoQ, saar)	Dec-22	↓	-1.8	-3.1	-3.2
Retail sales (% QoQ, saar)	Dec-22	↑	3.7	4.5	-1.0
Services volume (% QoQ, saar)	Dec-22	↑	3.9	4.9	10.0
Unemployment rate (% 3m, SA)	Jan-23	→	8.5	8.5	8.6
Real average wage (% YoY, 3m)	Jan-23	↓	7.7	8.3	7.1
Real wage bill (% YoY, 3m)	Jan-23	↓	11.9	12.8	13.0
Caged payrolls (thousands, SA, 3m)	Jan-23	↑	93	94	108
Economic confidence (2011=100)	Feb-23	↓	82.5	83.0	85.2
EXTERNAL SECTOR					
FX rate (USD/BRL)					
Current level	17-Mar-23	↑	5.28	5.05	5.22
Actual: 5-day average (previous week)	17-Mar-23	↑	5.26	5.12	5.25
USD/BRL (to be) used in simulations	17-Mar-23	→	5.25	5.15	5.25
Forecast for 2023	17-Mar-23	→	5.25	5.25	5.25
Forecast for 2024	17-Mar-23	→	5.30	5.30	5.23
Forecast for 2025	17-Mar-23	→	5.30	5.30	5.21
Forecast for 2026	17-Mar-23	↑	5.40	5.30	5.30
Current account balance (USD Billions, 12m)					
Current level (12-month rolling)	Jan-23	↓	-55.7	-52.5	-60.4
Forecast for 2023	17-Mar-23	↓	-50.0	-46.0	-43.0
Forecast for 2024	17-Mar-23	↓	-50.7	-45.0	-44.2
Forecast for 2025	17-Mar-23	↓	-48.6	-48.0	-39.5
Forecast for 2026	17-Mar-23	↓	-46.0	-45.5	-45.1
ASSET PRICES					
Santander Brasil's financial conditions index*	**Mar-23**	↑	**1.26**	**1.06**	**1.11**
IC-Br (% YoY)	Feb-23	↓	-7.6	-6.9	-1.6
CRB Commodity Index (Futures, USD terms)	Mar-23	↓	255	272	266
CRB Commodity Index (Futures, BRL terms)	17-Mar-23	↓	1,342	1,386	1,384
CRB Commodities in BRL: 50-day average	17-Mar-23	↓	1,398	1,426	1,460
Brent Oil Price (USD bbl) / 1st Active Future	17-Mar-23	↓	73	83	78
Brazil 5-year CDS (basis-points)	17-Mar-23	↑	248	225	247
Ibovespa stock index (points)	17-Mar-23	↓	101,982	112,074	109,069
DI Jan-24 (% p.a.) / Futures	17-Mar-23	↓	12.97	13.59	13.85
DI Jan-25 (% p.a.) / Futures	17-Mar-23	↓	12.06	12.89	13.04
DI Jan-26 (% p.a.) / Futures	17-Mar-23	↓	12.20	12.85	12.79
NTN-F 2029 (% p.a.) / Pre-Fixed Rate	17-Mar-23	↓	12.98	13.00	12.84
NTN-F 2033 (% p.a.) / Pre-Fixed Rate	17-Mar-23	↑	13.19	13.10	12.86
NTN-B 2045 (% p.a.) / Inflation-Linked	17-Mar-23	↓	6.37	6.46	6.16
NTN-B 2055 (% p.a.) / Inflation-Linked	17-Mar-23	↓	6.35	6.46	6.19

Sources: IBGE, FGV, Brazilian Central Bank, Anbima, Bloomberg, Santander.

Last update: March 20, 2022.

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
Tomas Urani*	Economist – Global Economics	tomas.urani@santander.com.br	5511-3553-9520
Lucas Maynard*	Economist – Economic Activity	lucas.maynard.da.silva@santander.com.br	5511-3553-7495
Felipe Kotinda*	Economist – Commodities	felipe.kotinda@santander.com.br	5511-3553-8071
Gabriel Couto*	Economist – Special Projects	gabriel.couto@santander.com.br	5511-3553-8487
Fabiana Moreira*	Economist – Credit	fabiana.de.oliveira@santander.com.br	5511-3553-6120
Gilmar Lima*	Economist – Modeling	gilmar.lima@santander.com.br	5511-3553-6327
Global Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Rodrigo Park *	Economist – Argentina	rpark@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
Mike Moran	Head of Macro Research, US	mike.moran@santander.us	212-350-3500
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
Alan Alanis*	Head, Mexico	aalanis@santander.com.mx	5552-5269-2103
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Mariana Cahen Margulies*	Head, Brazil	mmargulies@santander.com.br	5511-3553-1684
Electronic			
Bloomberg		SIEQ <GO>	
Reuters		Pages SISEMA through SISEMZ	