Santander
Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY PREVIEW

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TALKING THE TALK AND WALKING THE WALK

- The Copom is scheduled to announce its interest rate decision on Wednesday, May 3. In line with consensus (as signaled by both analyst surveys and the yield curve pricing), we expect the Brazilian Central Bank (BCB) to maintain the Selic rate at 13.75%, a contractionary level.
- Since the last Copom policy meeting, the evolution of macroeconomic data and (expected) policy suggests no significant changes in the BCB's inflation outlook. Abroad, monetary policy is continuing to turn a bit tighter in advanced economies (with some major central banks still hiking, given a lack of worrisome new episodes in financial markets). This probably means a still challenging environment for EMs, in the BCB's view.
- Domestically, the data continues to point to a normal functioning of the local credit market and no aberrant changes in financial conditions. The most important news, however, has been the release of the government's proposal for a new fiscal framework, which is now under discussion in Congress. As far as monetary policy goes, the key takeaway is that, while on the one hand the bill does imply lower tail risks for fiscal outcomes ahead, on the other hand it does not assuage uncertainty about the debt trajectory and the degree of fiscal stimulus (or budgetary impulse). Those are key elements for inflation expectations.
- With core inflation trending around 6% QoQ-saar, we anticipate no change in the BCB's assessment of current inflation. We also envision no major changes in the BCB's inflation projections for the relevant policy horizon, which is YE2024 as of now. Activity has likely evolved in accordance with the BCB's scenario, with a gradual loss of momentum in cyclical sectors and resilience in services and employment.
- In recent speeches, authorities have explained the BCB's policymaking approach and framework, emphasizing the need to persevere in the fight against inflation to obtain socially favorable economic outcomes. Overall, the whole pack of BCB communications in recent weeks has reaffirmed the authority's flight plan, with no monetary easing envisioned for the short term.
- Thus, we believe the BCB statement will keep the recent hawkish tone, with no major change to the flight plan, especially with the Copom maintaining the signal that it will continue evaluating whether the strategy of holding rates for a prolonged period will ensure the convergence of inflation to the target.
- We still believe that a change in the flight plan (of rate stability for an extended period) would require 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 March Copom meeting[1], the BCB kept the Selic policy rate at 13.75%, as widely expected. Nevertheless, the tone of the policy messages was more hawkish than some market participants had been looking for. **In recent speeches, authorities have explained the BCB's policymaking approach and framework, emphasizing the need to persevere in the fight against inflation to obtain socially favorable economic outcomes. Overall, the whole pack of recent BCB communications has reaffirmed the authority's flight plan, with no monetary easing envisioned for the short term.**

In terms of the policy signals at March's Copom meeting, in the policy statement the BCB maintained the signal that it "remains vigilant, assessing if the strategy of maintaining the Selic rate for a long period will be enough to ensure the convergence of inflation." The authority reaffirmed its commitment to reaching the inflation target and repeated the message that it "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected." We continue to think that the latter is more an expression of the BCB's reaction function than an actual signal of an imminent change in the policy strategy[2].

On that occasion, the Copom continued to show particular concern about the deterioration of inflation expectations. No wonder: the additional (20-bp) gain in the BCB's IPCA forecasts for the relevant monetary policy horizons was likely driven by the rise in economists' consensus projections (which feeds into the BCB models). The official inflation simulations[3] point to IPCA inflation at 3.6% for YE2024, assuming the consensus path of the Selic rate according to analysts (i.e., cuts to 12.75% for YE2023 and 10.00% for YE2024). Convergence to the mid-target (3.0%) is estimated to occur only when the BCB assumes a stable interest rate trajectory all the way to the target (at 13.75%). The models convey a message that, in the absence of major changes in key variables influencing them, there is no room for Selic rate cuts in the short term.

In the minutes[4], the Copom explained in detail the major role of inflation expectations in the actual price dynamics and, consequently, the conduct of monetary policy. Amid (what then looked like) turmoil in financial markets, the BCB reaffirmed the separation principle of instruments — with monetary policy focused on fighting inflation and with macroprudential measures seeking to maintain the good functioning of financial and credit markets. The ongoing deceleration in local credit was still seen as being in line with the Copom's expectations.

On the fiscal side, the BCB signaled that there was no mechanical relationship between the new fiscal framework (which still had not been announced at that time) and monetary policy, given that the disinflationary effects of the former will need to be channeled through inflation expectations, projections of government debt, and asset prices. The authority also mentioned that the disinflation process — which is now seen as being at a more difficult stage, given the spreading of pressures on services costs — requires moderation in economic activity, along with some dose of "serenity and patience" to guarantee convergence to the CPI target.

The BCB also published the 1Q23 inflation report[5], providing analyses guiding policy decisions as well as details and updates on macroeconomic forecasts. The BCB raised its 2023 GDP estimate to 1.2% (previously 1.0%) and calculated a bit less slack in the economy, seen as running 1.3% below potential in 1Q23. Projecting growth of 7.6% in the total loans balance in 2023 (still respectable, albeit slower than the 14.0% gain seen in 2022), the BCB continued to envision a deceleration process in the credit growth rate compatible with the monetary tightening cycle. In other words, no credit crunch on the BCB's horizon. The BCB projected IPCA 2025 at 3.2% in a scenario assuming rate cuts as expected by analysts, meaning the authority foresees a slower (but still a) convergence to mid-target if it follows that policy path. That is another reason why we believe one should not overestimate the importance of the Copom's wording regarding the possibility of hiking rates again.

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[1] **Santander Brazil Monetary Policy: "*Copom Decision: No Blinking*"** – March 22, 2023 – Available on: https://bit.ly/Std-COPOM-mar23.
[2] In our view, the most material evidence on that sense is the fact that the BCB models point to IPCA convergence to mid-target in the relevant policy horizon in a simulation with stable Selic path for the Selic rate (at 13.75%).
[3] The simulations assume FX rate departing from USD/BRL 5.25, and then moving along with PPP (purchasing power parity). Oil price following the futures curve for six months and stable in real terms in USD; energy tariff flag "yellow" for both December 2023 and 2024.
[4] **Santander Brazil Monetary Policy: "*Copom Minutes: Serenity and Patience Required for Convergence*"** – March 28, 2023 – Available on: https://bit.ly/Std-COPOM-min-mar23.
[5] **Santander Brazil Monetary Policy: "*Inflation Report: Details Leading To The Same Message*"** – March 30, 2023 – Available on: https://bit.ly/Std-infla-report-1Q23.

THE CONTEXT FOR THE MAY MEETING

Since the last Copom policy meeting, the evolution of macroeconomic data and (expected) policy suggests no significant change in the BCB's inflation outlook.

Looking at the international environment, despite lingering risks for some financial institutions — particularly in the U.S. — there are signs of stabilization in the general condition of (and perceptions about) the health of the banking system. We recognize that this process still requires monitoring, though. The strength in tertiary activity, job markets, and underlying inflation remains a key theme, leading some of the major monetary authorities in advanced economies to remain in tightening mode — even though in some cases (notably the Federal Reserve) that process could already be close to an end. Overall, we believe the BCB will maintain its assessment of a still challenging global environment for EMs.

Domestically, the data continues to point to a normal functioning of the local credit market and no aberrant changes in financial conditions. In fact, the most recent numbers continue to indicate a gradual slowdown in lending activity[6]. We recognize the need to continue monitoring the credit market, but for now our assessment continues to be that this transmission channel reflects a contractionary monetary policy, with no indications of anomalies. Our financial conditions index — which maps the transmission channel of asset prices — has even pointed to a bit of easing of late, despite the still "tight" level of the index.

The most important news on the domestic front, however, has been the release of the government's proposal for a new fiscal framework, which is now under discussion in Congress. In our view, the proposal is an important sign of goodwill to promote some budgetary adjustments and impose certain boundaries for spending growth. However, we note that the proposed bill indicates an adjustment more focused on the revenue side, implying substantial cyclical dependence for the execution of the plan and achievement of a positive primary balance within a few years[7].

As far as monetary policy goes, the key takeaway is that, while on the one hand the bill does reduce tail risks for fiscal outcomes ahead, on the other hand it does not assuage uncertainty about the debt trajectory and the degree of fiscal stimulus (or budgetary impulse). Thus, it is not surprising that inflation expectations did not react to the recent news[8], although certain asset classes (notably the FX rate and the yield curve) apparently showed a slight reduction in risk premia. For now, we think this discussion is insufficient to warrant a change in the BCB's strategy.

Economic activity continues to lose steam, as indicated by the data on economic activity for 1Q23. There is a gradual loss of momentum in cyclical sectors, along with a good deal of resilience in the service sector and the labor market. Analysts' projections for 2023 GDP even rose slightly, to around 1%. For now the deceleration of real activity is in line with the scenarios of both the market and the BCB. In this context, the level of economic slack continues to be a big question mark and an important source of uncertainty: our numbers point to a much narrower output gap than the estimates the BCB presented recently.

On inflation, even though the preview report for April (IPCA-15) points to the lowest headline CPI since October 2020, reaching 4.2% YoY, that move is largely driven by base effects. The most important evidence of such a temporary drop is the fact that core inflation gauges — including the EX3, the most closely correlated with economic activity and monetary policy cycles — are running at a pace of around 6% QoQ-saar. Thus, we anticipate no change in the BCB's assessment of current inflation. We also envision no major changes in the BCB's inflation projections for the relevant policy horizon, which is YE2024 as of now.

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[6] Refer to **Santander Brazil Credit: "*Household Debt Continues to Fall*"** – April 26, 2023 – Available on: https://bit.ly/Std-credit-apr23.
[7] Refer to **Santander Brazil Fiscal Policy: "*CHARTBOOK: In Search for a Primary Balance*"** – April 13, 2023 – Available on: https://bit.ly/Std-chart-fiscal-apr23.
[8] In fact, the consensus for IPCA inflation for 2024 (key policy horizon) and 2025 has increase by about 7-10bps since the last Copom meeting, settling around 4.0-4.5%, above the mid-target of 3.0%.

WHAT CAN WE EXPECT FOR THE MEETING AND FUTURE STEPS?

We expect the BCB to keep the policy Selic rate unchanged at 13.75%, in line with analyst consensus and with the yield curve. Once again, we believe that, in general, macroeconomic developments since the last meeting do not meaningfully alter the inflation outlook, thus underlining the suitability of the current BCB strategy of maintaining interest rates at a high level for an extended period.

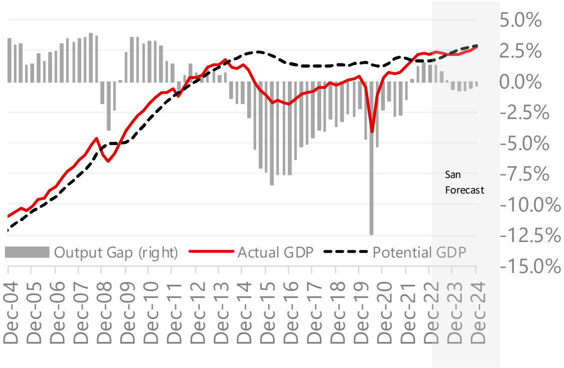
In the statement accompanying the decision, we believe that the BCB will not make significant changes in its tone or in the main signals of monetary policy, maintaining the indication that it will continue evaluating whether the strategy of maintaining the Selic rate for a sufficiently prolonged period will suffice to ensure the CPI convergence to the target. We also believe the BCB will continue to signal the possibility of changing course (i.e., with interest rate hikes) in case of disappointment with the disinflation process.

BCB communications (i.e., both communiqué and Copom minutes) will likely continue to refer to external and domestic financial and credit issues, as potentially bearish elements for the activity outlook and a downside risk for inflation. These factors are expected to remain in the balance of risk analysis, but that will probably continue to be netted out with the risks of further gains of expectations (de-anchoring). However, we think it is possible that the BCB will continue to suggest (albeit implicitly) an absence of bias, which contrasts with our assessment of upward asymmetry, mainly due to the fiscal outlook (and its impact on expectations).

Given the upside risks to the future trajectory of inflation, we believe that any change in strategy by the BCB at this point would be premature, requiring — in our view — the materialization of a scenario and hypotheses that are very different from those currently embraced by the authority. We continue to anticipate (gradual) interest rate cuts starting in 4Q23, bringing the Selic rate to 13% by the end of 2023.

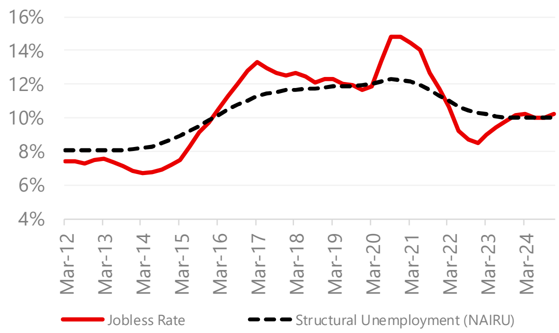
Refer to a summary of the Copom dataset and the following graphs.

Figure 1. GDP and the Output Gap



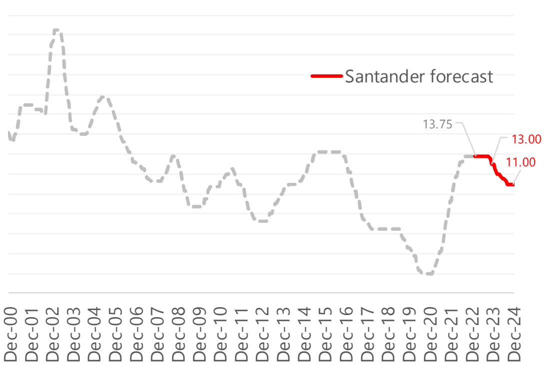
Note: Quarterly data.
Sources: IBGE, Santander.

Figure 2. Joblessness and Structural Unemployment



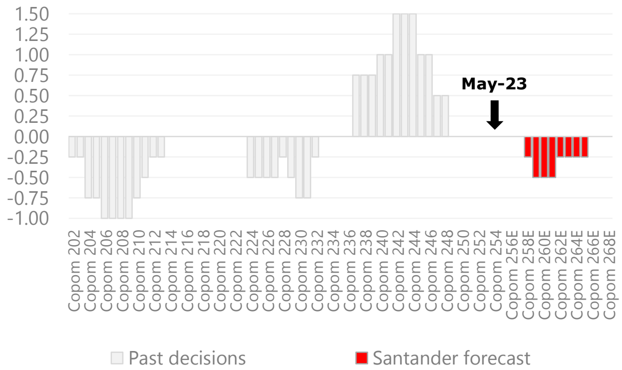
Note: Quarterly data.
Sources: IBGE, Santander.

Figure 3. Santander Selic Forecast (% pa)



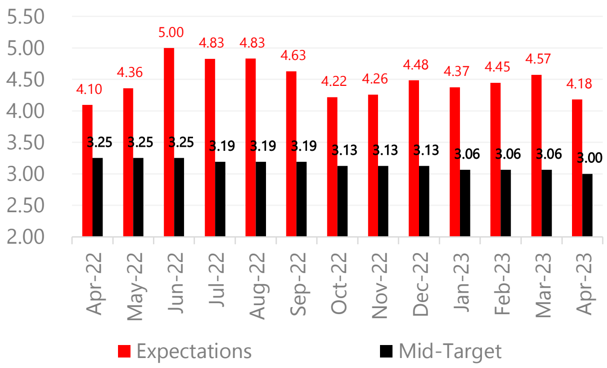
Sources: Brazilian Central Bank, Santander.

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



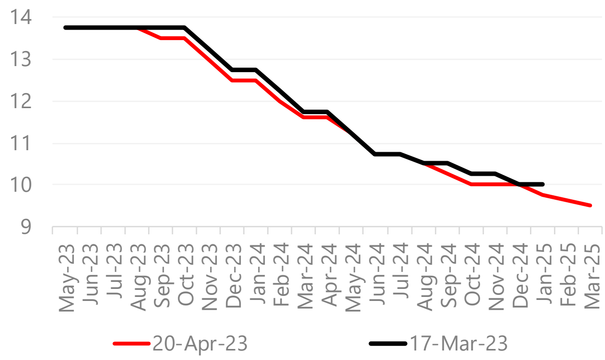
Sources: Brazilian Central Bank, Santander.

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



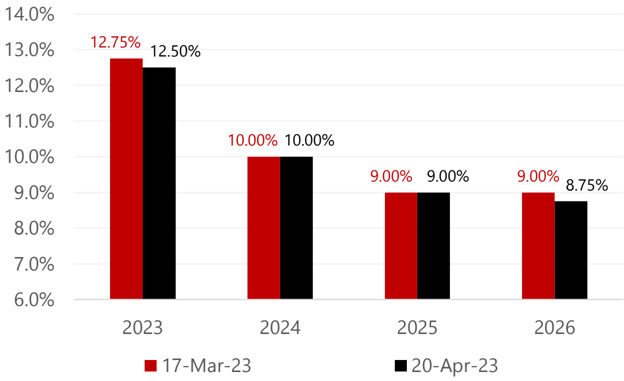
Sources: Brazilian Central Bank, Santander.
Note 1: IPCA expectations and target adjusted for the weight of each calendar-year as a policy horizon. For 2Q23, this means YE2024.
Note 2: Figures for the end of month. For April 2023 up to the 20th.

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



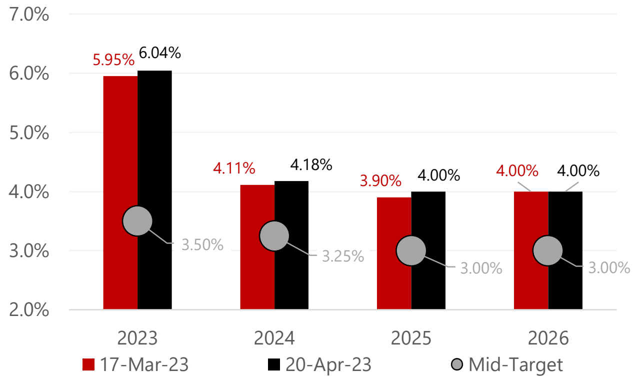
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: As of the most recent BCB Focus report: April 20, 2023.

Figure 7. Median Selic Rate Expectations
(% annual)



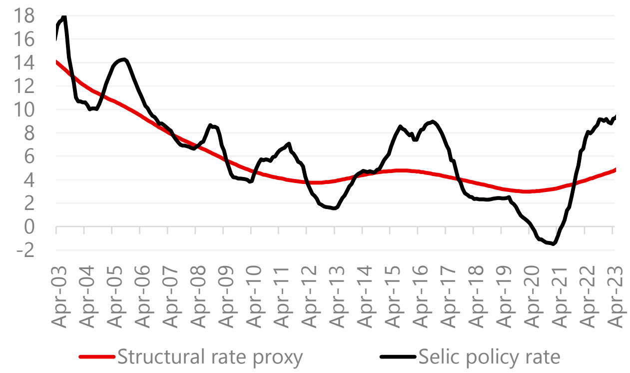
Sources: Brazilian Central Bank, Santander.
Note: As of the most recent BCB Focus report: April 20, 2023.

Figure 8. Median IPCA Inflation Expectations
(% annual)



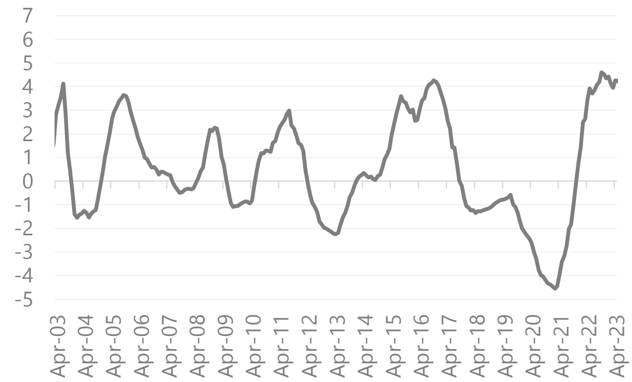
Sources: Brazilian Central Bank, Santander.
Note 1: As of the most recent BCB Focus report: April 20, 2023.

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 April 2023 up to the 20th.

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 April 2023 up to the 20th.

Figure 11. Proxy for the Copom Dataset, Part 1

ECONOMIC TOPIC *Key Variables*	LATEST DATA *When?*		THIS MEETING *Apr-23*	LAST MEETING *Mar-23*	SECOND LAST *Feb-23*
INFLATION					
Forecasts (% p.a.) - BCB's Focus report					
Calendar-Weighted Forecast (~18 months)	20-Apr-23	↓	4.18	4.57	4.36
Calendar-Weighted Target (~18 months)	20-Apr-23	↓	*3.00*	*3.06*	*3.06*
Calendar-Weighted Expectations Gap	20-Apr-23	↓	*1.18*	*1.51*	*1.30*
Forecast for a year ahead (12 months)	20-Apr-23	↓	5.26	5.44	5.63
Forecast for 2023 - target: 3.25%	20-Apr-23	↑	6.04	5.95	5.74
Forecast for 2024 - target: 3.00%	20-Apr-23	↑	4.18	4.11	3.90
Forecast for 2025 - target: 3.00%	20-Apr-23	↑	4.00	3.90	3.50
Forecast for 2026 - target: 3.00%	20-Apr-23	→	4.00	4.00	3.50
Breakeven inflation rates (% p.a.)					
1-year	20-Apr-23	↓	6.00	6.18	6.36
2-year	20-Apr-23	↓	6.02	6.22	6.38
5-year	20-Apr-23	↓	5.15	6.97	7.57
10-year	20-Apr-23	↓	6.24	6.60	6.49
Actual CPI data					
Headline (% YoY)	Mar-23	↓	4.7	5.6	5.8
Headline (% QoQ, saar)	Mar-23	↓	7.2	7.3	6.0
Core IPCA EX3 (% YoY)	Mar-23	↓	9.1	9.9	10.3
Core IPCA EX3 (% QoQ, saar)	Mar-23	↓	5.6	7.4	7.1
New cores average (% YoY)	Mar-23	↓	7.8	8.4	8.7
New cores average (% QoQ, saar)	Mar-23	↓	6.0	6.7	5.9
Diffusion index (sa, 3m)	Mar-23	↓	61.0%	62.9%	61.5%
Diffusion index ex-food (sa, 3m)	Mar-23	↓	64.0%	64.6%	61.8%
MONETARY POLICY					
Selic rate (% p.a.)					
Current level	20-Apr-23	→	13.75	13.75	13.75
Forecast for 2023	20-Apr-23	↓	12.50	12.75	12.50
Forecast for 2024	20-Apr-23	→	10.00	10.00	9.50
Forecast for 2025	20-Apr-23	→	9.00	9.00	8.50
Forecast for 2026	20-Apr-23	↓	8.75	9.00	8.50
Yield curve (% p.a.)					
1-year OIS swaps (pré-DI)	20-Apr-23	↑	12.8	12.7	13.5
2-year OIS swaps (pré-DI)	20-Apr-23	↓	11.9	12.0	12.9
Ex-ante real interest rate (% p.a.)					
1-year (OIS swaps vs. inflation forecast)	20-Apr-23	↑	7.1	6.9	7.5
FISCAL POLICY					
Primary Fiscal Balance (% GDP)					
Forecast for 2023	20-Apr-23	↑	-1.0	-1.0	-1.1
Forecast for 2024	20-Apr-23	→	-0.8	-0.8	-1.0
Forecast for 2027	20-Apr-23	→	0.0	0.0	0.0
Forecast for 2030	20-Apr-23	↑	0.7	0.0	0.6
Gross General Government Debt (% GDP)					
Forecast for 2023	20-Apr-23	↓	77.0	77.8	79.0
Forecast for 2024	20-Apr-23	↓	80.2	80.9	82.0
Forecast for 2027	20-Apr-23	↓	84.8	85.5	88.0
Forecast for 2030	20-Apr-23	↓	87.5	89.0	91.8

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

Last update: April 25, 2022.

Figure 12. Proxy for the Copom Dataset, Part 2

ECONOMIC TOPIC	LATEST DATA		THIS MEETING	LAST MEETING	SECOND LAST
Key Variables	*When?*		*Apr-23*	*Mar-23*	*Feb-23*
REAL ACTIVITY					
GDP forecasts (% p.a.) - BCB's Focus report					
Forecast for 2023	20-Apr-23	↑	0.96	0.88	0.80
Forecast for 2024	20-Apr-23	↓	1.41	1.47	1.50
Forecast for 2025	20-Apr-23	→	1.70	1.70	1.89
Forecast for 2026	20-Apr-23	→	1.80	1.80	2.00
Actual activity data					
IBC-Br (% QoQ, saar)	Jan-23	↓	-5.0	-7.1	-5.2
Industrial production (% QoQ, saar)	Feb-23	↑	0.6	1.6	0.2
Retail sales (% QoQ, saar)	Feb-23	↑	4.8	2.5	3.8
Services volume (% QoQ, saar)	Jan-23	↑	3.1	4.9	5.7
Unemployment rate (% 3m, SA)	Feb-23	↓	8.3	8.4	8.4
Real average wage (% YoY, 3m)	Feb-23	↓	7.5	7.7	8.3
Real wage bill (% YoY, 3m)	Feb-23	↓	11.4	11.9	12.8
Caged payrolls (thousands, SA, 3m)	Feb-23	↑	109	96	96
Economic confidence (2011=100)	Mar-23	↑	84.7	82.5	83.0
EXTERNAL SECTOR					
FX rate (USD/BRL)					
Current level	20-Apr-23	↓	5.05	5.24	5.05
Actual: 5-day average (previous week)	20-Apr-23	↓	4.99	5.26	5.12
USD/BRL (to be) used in simulations	20-Apr-23	↓	5.00	5.25	5.15
Forecast for 2023	20-Apr-23	↓	5.20	5.25	5.25
Forecast for 2024	20-Apr-23	↓	5.25	5.30	5.30
Forecast for 2025	20-Apr-23	→	5.30	5.30	5.30
Forecast for 2026	20-Apr-23	↓	5.32	5.40	5.30
Current account balance (USD Billions, 12m)					
Current level (12-month rolling)	Jan-23	↓	-55.7	-52.5	-60.4
Forecast for 2023	20-Apr-23	↑	-48.6	-50.0	-46.0
Forecast for 2024	20-Apr-23	↓	-52.5	-50.7	-45.0
Forecast for 2025	20-Apr-23	↓	-50.4	-48.6	-48.0
Forecast for 2026	20-Apr-23	↓	-46.8	-46.0	-45.5
ASSET PRICES					
Santander Brasil's financial conditions index*	**Apr-23**	↓	**0.94**	**1.15**	**1.14**
IC-Br (% YoY)	Feb-23	↓	-7.6	-6.9	-1.6
CRB Commodity Index (Futures, USD terms)	Apr-23	↑	272	259	272
CRB Commodity Index (Futures, BRL terms)	20-Apr-23	↑	1,371	1,362	1,386
CRB Commodities in BRL: 50-day average	20-Apr-23	↓	1,374	1,391	1,426
Brent Oil Price (USD bbl) / 1st Active Future	20-Apr-23	↑	81	76	82
Brazil 5-year CDS (basis-points)	20-Apr-23	↓	229	247	225
Ibovespa stock index (points)	20-Apr-23	↑	104,367	100,221	112,074
DI Jan-24 (% p.a.) / Futures	20-Apr-23	↑	13.23	13.02	13.59
DI Jan-25 (% p.a.) / Futures	20-Apr-23	↓	11.97	12.05	12.89
DI Jan-26 (% p.a.) / Futures	20-Apr-23	↓	11.79	12.09	12.85
NTN-F 2029 (% p.a.) / Pre-Fixed Rate	20-Apr-23	↓	12.40	12.78	13.00
NTN-F 2033 (% p.a.) / Pre-Fixed Rate	20-Apr-23	↓	12.61	13.05	13.10
NTN-B 2045 (% p.a.) / Inflation-Linked	20-Apr-23	↓	6.10	6.35	6.42
NTN-B 2060 (% p.a.) / Inflation-Linked	20-Apr-23	↓	6.07	6.31	6.47

*Note: Lower (higher) levels means easier (tighter) financial conditions.

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

Last update: April 25, 2022.

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