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Brazil Macro: Monetary Policy

COPOM PREVIEW: Adjusting the Forward Guidance?

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- **On Wednesday (December 9, 2020), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. We expect the Selic rate to remain at the historical low of 2.00%, in line with analysts' expectations and the broad pricing of the local yield curve.**
- **In its statement, we believe the committee could drop the mention of possible rate cuts (adapting the communication to new conditions) but keep the forward guidance of stable interest rates for the foreseeable future under the conditions of an unchanged fiscal regime and anchored inflation expectations. In our view, the BCB continues to see these conditions being met for now.**
- **We still see binary outcomes for our broad macro and monetary policy scenarios, with a stable interest rate call throughout 2021 if the fiscal regime is reaffirmed and with rate hikes if the constitutional spending cap is breached. We envision a gradual normalization of the economy, but in challenging cyclical conditions, so that we have difficulty forecasting demand-led pressures derailing CPI from the targeted path for 2021 and 2022**.

Overview

On Wednesday (December 9, 2020), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. We expect the Selic rate to remain at the historical low of 2.00%, in line with analysts' expectations and the broad pricing of the local yield curve.

We share the view of other market observers that the current level of the policy rate is notably expansionary—i.e., below the structural level. For now, the amount of stimulus still seems in accordance with the fact that inflation expectations are slightly below or at the mid-target for the relevant policy horizons and that economic slack should remain wide for a considerable period of time. In our view, these factors warrant holding the interest rate steady at this Copom meeting.

Scenario Assessment

In terms of the Copom statement, we believe the scenario assessment will probably show that the committee continues to see current price pressures as temporary, expecting them to dissipate in the relevant horizon (increasingly 2022). In addition, we think the BCB will probably continue to recognize a significant but uneven recovery in economic activity, highlighting downside risks with the end of the stimuli expected for early 2021.

Since the last Copom meeting, the evolution of the macroeconomic scenario shows a rebound of real activity in 3Q20 and a favorable start to 4Q20, following a sudden stop prompted by the pandemic (and the resulting social distancing measures) in late 1Q20 and early 2Q20. Yet the activity recovery occurs in a heterogeneous manner across sectors, with goods-related segments outdoing the segments dependent on services and (live) social interactions.

The Copom dataset also shows a notable inflation pickup for the short run, predominantly owing to volatile items (such as food), but also with signs of an exchange rate pass-through to industrial goods and slight spill-overs for both core measures and 2021 projections. Yet core numbers are still running within 2-3%, below the mid-target for the relevant policy horizons, with median inflation projections by analysts standing at 3.34% for 2021 (mid-target: 3.75%) and at 3.50% for 2021 (mid-target: 3.50%).

We expect the BCB to express a slightly more sanguine view of the external environment, with the recent developments (vaccine news, U.S. elections, talks about new budget stimulus in the U.S.) paving the way for further improvement in financial conditions for EMs. Alongside some soothing (yet inconclusive) news on the local fiscal front, the improvement in global market conditions has helped drive an appreciation of Brazilian assets and a slight reduction in the hefty premia still seen in some key local asset classes.

We maintain our assessment that the current pace of both economic recovery and inflation pickup are based on temporary factors, notably the large volume of government transfers to households implemented during the pandemic. In the case of consumer prices, the acceleration underway also reflects a temporary shift in the consumer spending profile, with a temporary migration of spending away from services and into goods. An exogenous shock in food and energy prices and a pass-through of the FX depreciation complete the list of culprits for the higher than expected inflation print this year, with IPCA poised to end 2020 at 4.3%, according to our own forecast (mid-target: 4.0%).

We see the “anecdotal” signs of supply-demand imbalances (e.g., reported scarcity of some inputs) more as temporary frictions rather than as a sign of a systemically overheated economy. Assuming the end of emergency stimuli in December, we expect the expanded wage bill to slump between 7% and 8% in real terms in 2021 (after an expected gain of 4% in 2020), and expect the average annual unemployment rate to exceed 16%, from (an expected) average of 13.4% in 2020 and 11.9% in 2019. Furthermore, the reopening of the economy should bring about a normalization of the consumer basket, in our view, favoring a rebalancing of supply-demand in the goods market. The latter is to offset the effects of a probable comeback in services activities (and inflation).

Assuming a commitment by policymakers to the effectiveness of the constitutional spending ceiling and the credibility of the fiscal consolidation process ahead, our baseline scenario is predominantly disinflationary for 2021 and 2022, and we have difficulty spotting signs of demand-led inflation for this horizon. Yet we believe the fiscal risks remain quite high, and, in our opinion, that is far and away the greatest threat to the monetary policy outlook and our call for a stable Selic rate throughout 2021.

Here, delays in defining the direction of fiscal policies coupled with inflationary shocks (even if predominantly from supply, by nature) seem to feed risks for the anchoring of inflationary expectations, in our view. Although we still see recent increases in economists' projections for 2021 IPCA, mainly associated with exogenous shocks and weather-related risks and events, we see a risk of losing the anchoring power in the absence of greater clarity about future fiscal policy steps. This time around, the news flow seems to have been a bit more positive than at the time of the previous meeting, given the indications from top government officials that the 2020 stimulus program will not be extended into 2021. While reforms to curb mandatory expenses are key for the sustainability of the constitutional spending cap over time, we think the scrapping of plans to boost spending in welfare (another category of mandatory expenses) could mean one less source of pressure on the fiscal regime, if this stance is maintained throughout 2021.

We continue to see fiscal risks propping up the effective lower bound for interest rates, with the current Selic rate likely at that level now. We maintain our assessment, and with greater conviction now, that new stimuli via interest rates at this point could, with high probability, generate counterproductive effects on the economy.

Given the potentially adverse effects of a fiscal deterioration on the neutral interest rate and, especially, on the anchoring of inflationary expectations, we continue to believe that keeping the monetary policy stance unchanged remains an appropriate policy for the time being. In our view, this is a time to observe the direction of fiscal policy and how the economy responds to the strong stimuli already implemented. In particular, it will be important to observe how the economy reacts to the end of emergency aid (coronavouchers), especially in 1Q21.

Forward Guidance

On the policy message, we believe that the committee will continue to mention the necessity of maintaining monetary stimulus, with interest rates below the neutral level. Yet we think the BCB could make some adaptations to the forward guidance, especially when it comes to the short-term outlook.

In our view, the Copom could drop the mention of possible rate cuts, adapting the BCB communication to a different context (with no risks of an actual deflationary pattern, and further evidence of closeness to the effective lower bound of interest rates).

But we believe the authority will keep the (most important part of the) forward guidance of stable interest rates for the foreseeable future, under the conditions of an unchanged fiscal regime and anchored inflation expectations. In our view, the BCB probably continues to see those conditions being met, as expectations remain below or at the mid-target and as there has been no change in the inflation regime (with the likelihood that this will happen in the short term declining slightly, if anything).

Our View

We continue to see binary outcomes for our broad macroeconomic and monetary policy scenarios. In 2021, with government fiscal stimulus and a consumer spending pattern looking increasingly as they did before the pandemic, and with a more difficult cyclical situation (judging from the standpoints of both output and employment gaps), we have difficulty in forecasting systematic demand-led pressures derailing inflation from the targeted path for 2021 and 2022.

Thus, we continue to see the BCB on hold for a considerable time ahead if the credibility of the fiscal regime is maintained (especially via reforms). In case of a future breach in the spending cap, then a disruptive scenario in terms of inflation expectations and market conditions would make the BCB change gears, in our opinion. That said, we continue to project the Selic rate at 2.00% for end-2021, 4.00% for end-2022, and 6.00% (neutral level) for end-2023, in the baseline scenario (fiscal discipline). In the alternative scenario (fiscal slippage), the Selic rate could be as high as 9% for 2022, with the pace of hikes and terminal rates under these conditions being hard to estimate.

		THIS TIME	LAST MEETING	1y AGO
INFLATION				
Forecasts (% p.a.) - BCB's Focus report				
Forecast for a year ahead	↑	3.86	3.53	3.88
Forecast for 2020 (Focus) - target: 4.00%	↑	4.21	3.01	3.60
Forecast for 2021 (Focus) - target: 3.75%	↑	3.34	3.10	3.75
Forecast for 2022 (Focus) - target: 3.50%	→	3.50	3.50	3.50
Forecast for 2023 (Focus) - target: 3.25%	→	3.25	3.25	3.50
Forecast for 2024 (Focus) - target: ??????	↓	3.20	3.24	-
Breakeven inflation rates (% p.a.)				
1-year	↓	4.9	5.0	4.4
2-year	↓	4.2	4.3	4.0
5-year	↓	4.1	4.3	4.0
10-year	↑	4.2	4.2	3.9
Actual CPI data				
Headline (% YoY)	↑	3.9	3.1	3.3
Headline (% QoQ, saar)	↑	7.5	5.8	2.0
Core IPCA X3 (% YoY)	↑	2.1	1.7	2.9
Core IPCA X3 (% QoQ, saar)	↑	4.6	2.4	2.6
New cores average (% YoY)	↑	2.9	2.8	3.1
New cores average (% QoQ, saar)	↑	4.0	2.7	2.7
Diffusion index (sa)	↑	63%	61%	58%
Diffusion index ex-food (sa)	↑	62%	57%	59%
MONETARY POLICY				
Selic rate (% p.a.)				
Actual	→	2.00	2.00	5.00
Forecast for 2020 (Focus)	→	2.00	2.00	4.50
Forecast for 2021 (Focus)	↑	3.00	2.75	6.50
Forecast for 2022 (Focus)	→	4.50	4.50	6.50
Forecast for 2023 (Focus)	→	6.00	6.00	6.50
Forecast for 2024 (Focus)	→	6.00	6.00	-
Yield curve (% p.a.)				
1-year OIS swaps (pré-DI)	↓	3.0	3.2	4.6
2-year OIS swaps (pré-DI)	↓	4.4	4.8	5.2
Ex-ante real interest rate (% p.a.)				
1-year (OIS swaps vs. inflation forecast)	↓	-0.9	-0.3	0.7

Sources: IBGE, Brazilian Central Bank, Bloomberg, and Santander.
Note: “THIS TIME” as of December 4, 2020; “LAST MEETING” as of October 23, 2020; “1y AGO” as of December 6, 2020.

		THIS TIME	LAST MEETING	1y AGO
REAL ACTIVITY				
GDP forecasts (% p.a.) - BCB's Focus report				
Forecast for 2020 (Focus)	↑	-4.40	-4.81	2.25
Forecast for 2021 (Focus)	↑	3.50	3.41	2.50
Forecast for 2022 (Focus)	→	2.50	2.50	2.50
Forecast for 2023 (Focus)	→	2.50	2.50	2.50
Forecast for 2024 (Focus)	→	2.50	2.50	-
Actual activity data				
IBC-Br (% QoQ, saar)	↑	43.6	27.0	2.0
Industrial production (% QoQ, saar)	↓	74.0	123.0	-2.9
Retail sales (% QoQ, saar)	↑	137.6	121.9	6.1
Services volume (% QoQ, saar)	↑	39.2	11.5	3.3
Unemployment rate (% 3m, SA)	↓	14.2	14.3	11.6
Real average wage (% YoY, 3m)	↑	8.3	8.1	0.1
Real wage bill (% YoY, 3m)	↑	-4.9	-5.7	1.8
Caged payrolls (thousands, SA, 3m)	↑	237	153	56
Economic confidence (2011=100)	↓	82.0	83.1	88.7
EXTERNAL SECTOR				
FX rate (USD/BRL)				
Actual	↓	5.13	5.62	4.12
Actual (rounded 5-day average)	↓	5.20	5.60	4.20
Forecast for 2020 (Focus)	↓	5.22	5.40	4.10
Forecast for 2021 (Focus)	↓	5.10	5.20	4.00
Forecast for 2022 (Focus)	→	5.00	5.00	4.02
Forecast for 2023 (Focus)	↑	4.94	4.90	4.10
Forecast for 2024 (Focus)	→	5.00	5.00	-
Current account balance (USD Billions, 12m)				
Actual	↑	-15.3	-24.9	-52.2
Forecast for 2020 (Focus)	↑	-4.2	-5.6	-60.0
Forecast for 2021 (Focus)	↑	-14.1	-16.1	-53.2
Forecast for 2022 (Focus)	↑	-26.0	-27.1	-54.0
Forecast for 2023 (Focus)	↑	-32.8	-34.7	-49.7
Forecast for 2024 (Focus)	↑	-42.6	-47.6	-
ASSET PRICES				
CRB Commodity Index	↑	160	147	181
IC-Br (% YoY)	↓	30.7	37.0	6.1
Brazil 5-year CDS (basis-points)	↓	153	220	110
Ibovespa stock index (points)	↑	113,750	95,369	110,964
DI Jan-21 (% p.a.)	↓	1.91	1.97	4.62
DI Jan-22 (% p.a.)	↓	3.09	3.51	5.23
NTN-F 2023 (% p.a.)	↓	4.62	5.07	5.68
NTN-F 2027 (% p.a.)	↓	6.74	7.20	6.59
NTN-B 2040 (% p.a.)	↓	3.89	4.08	3.40
NTN-B 2045 (% p.a.)	↓	3.98	4.32	3.42

Source: IBGE, Brazilian Central Bank, Bloomberg, and Santander.
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