BRAZIL - MONETARY POLICY

COPOM: Staying the Course Amid Temporary Pressures

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- **As widely expected, the Brazilian Central Bank (BCB) kept the Selic rate at the historical low of 2.00%.**
- **The communiqué brought an updated assessment of the macroeconomic scenario, especially highlighting the recent inflation pickup, seen more as a temporary development.**
- **While recognizing upwardly skewed risks, especially owing to the fiscal problems, the BCB signals a constructive medium-term inflation outlook, enabling the authority to see the current policy stance as "adequate," both via the Selic rate and the forward guidance. Importantly, the BCB still sees conditions holding for its flight plan of no hikes ahead.**
- **Our baseline scenario sees the COPOM on hold all the way until early 2022, assuming no change in the fiscal regime. Concerns about the effectiveness of the constitutional spending cap are still the main threat for the inflation and monetary policy outlook.**

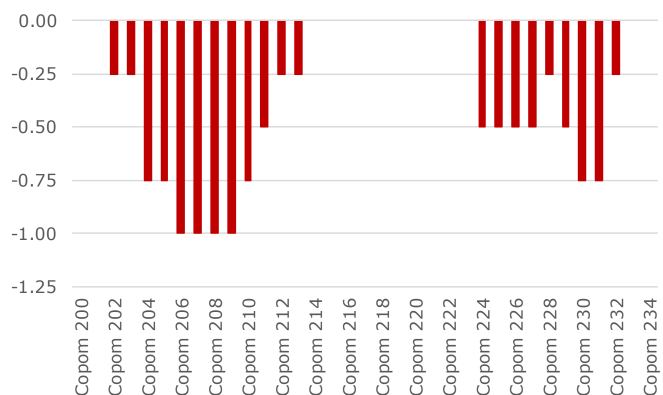
Policy decision, forward guidance

The COPOM[1] has once again kept the Selic policy rate at its historical low of 2.00% in nominal terms. This outcome was widely expected by analysts (according to forecasters' surveys) and traders (according to the local yield curve)[2].

Figure 1-A: Path of nominal Selic rate (monthly average, % p.a.)

Sources: Santander, Brazilian Central Bank.

Figure 1-B: Selic rate moves in recent Copom meetings (p.p.)



Sources: Santander, Brazilian Central Bank.

The communiqué brought an updated assessment of the macroeconomic scenario (especially highlighting the recent inflation pickup), but with no material changes to the policy signals. Basically, the authority expressed the belief that the current monetary policy stance is "adequate," with the Selic rate at the current level and with its forward guidance.

In that sense, the BCB reaffirms the forward guidance inaugurated a couple of meetings back, as the authority sticks to the flight plan with no interest rate hikes for some time under certain conditions, and mentions the possibility of a small additional stimulus, conditioned on the scenario evolution (but limited by prudential and financial stability reasons).

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[1] The Copom is the monetary policy committee of the Brazilian Central Bank (BCB).
[2] Refer to the statement of the 234th COPOM meeting in English (https://www.bcb.gov.br/en/monetarypolicy/copomstatements).

In the first (short-term oriented and maybe less important) part of the forward guidance, the authority notes that "that the current economic conditions continue to recommend an unusually strong monetary stimulus," but recognizes that the remaining space for additional stimulus "if it exists, should be small." In our view, more than a commitment or signal, this part of the guidance looks more like an option (or hedge) for the BCB in the event of a massively disinflationary scenario (as mentioned in the balance of risks), which seems unlikely at this juncture (and levels), in our view. The idea by the COPOM here could be buying itself maximum flexibility amid unusually high uncertainty.

In the second (medium-term oriented and maybe more relevant) part of the forward guidance, the BCB makes it clear that "the COPOM does not intend to reduce the monetary stimulus" for as long as inflation projections (both by the Street and the BCB) remain significantly below the mid-target for the relevant horizon (2021 and 2022), long-term inflation expectations remain well anchored, and the current fiscal regime has not been changed.

Importantly the COPOM sees these conditions still holding, particularly highlighting that the fiscal regime remains the same. While we believe this is the most interesting part of the guidance, it also falls quite short of a commitment, given that the interest rate outlook seems increasingly dependent on upcoming decisions on the fiscal front. Thus, as the central bank tried to indicate, holding rates steady is just a conditional plan for scenarios of fiscal convergence (from the standpoint of long-term government debt outlook).

Scenario assessment, inflation forecasts, balance of risks

In the scenario assessment, the COPOM updates the global scenario and indicates that "the strong recovery in some economic sectors seems to be subsiding, partly due to the pandemic resurgence in some major economies." Despite the risk-off tone of global markets in recent days, the COPOM sees "the moderation in financial assets volatility keeps resulting in a relatively favorable environment for emerging economies."

The economic recovery in the Brazilian economy is seen as "uneven", with a depression in sectors "more directly affected by social distancing measures" (read services). The board continues to mention doubts about the pace of recovery towards the end of the year, amid a likely fading of emergency stimulus measures.

On inflation, the COPOM apparently sought to tell apart the analysis for the short and medium term. For the short term (2020), the BCB admits the upside surprises of late and projects faster prices until year end, on the heels of food and industrial goods. Those pressures are seen led by "persistent exchange rate depreciation, the oil price rise, and the income transfer programs." For the medium term, however, the COPOM maintains a tranquil view, as "the Committee maintains the diagnosis that this shock is temporary," while closely monitoring as it unfolds.

The official inflation projections continue to point to headline CPI figures below or in line with the target for the focal BCB horizon (probably somewhere in between year-end 2021 and year-end 2022). Thus, the simulations seems to strengthen the BCB message of a constructive inflation outlook for the foreseeable future.

Assuming for all simulations an USD/BRL exchange rate at 5.60 now and flat in real terms afterwards (i.e. moving alongside the purchasing power parity, PPP[3]), the COPOM simulates IPCA inflation at 3.1% for 2021 (previously: 2.9%) and stable at 3.3% for 2022, assuming Selic rate flat at 2.00% all the way until year-end 2022. With the policy rate following the path expected by economists[4], 2.00% for year-end 2020, at 2.75% for year-end 2021, and at 4.50% for year-end 2022, the BCB sees IPCA inflation at 3.2% for 2021 (previously: 3.0%) and at 3.8% for 2022 (stable from the previous meeting). A reminder: the mid-target for next year is 3.75% and for 2022 it is 3.50%.

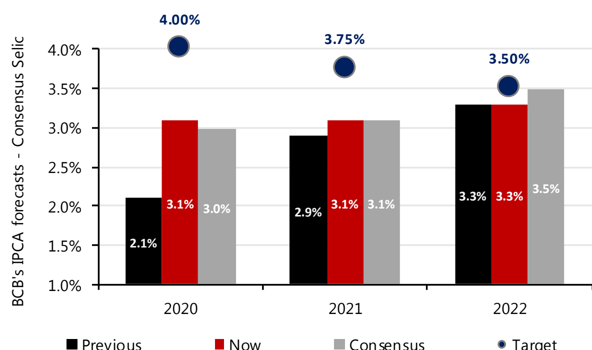
The COPOM emphasizes that the high fiscal risks continue to feed "an upward asymmetry to the balance of risks, i.e., in the direction of higher-than-expected paths for inflation over the relevant horizon for monetary policy." Other than that, the COPOM cites roughly the same elements as in the last meeting, some on the upside and some on the downside.

On the upside (for inflation), the authority mentions that the "the extension of fiscal policy responses to the pandemic that aggravate the fiscal path or a frustration with the continuation of the reform agenda may increase the risk premium." On the downside, the COPOM claims that "economic slack may continue to produce a lower-than-expected prospective inflation trajectory, especially when the slack is concentrated on the service sector." The potential impact of the latter increases in case of precautionary savings following an eventually slower reversal of the pandemic, according to the BCB.

[3] In this meeting, the COPOM inaugurates a new approach on the inflation simulations, as previously the BCB simulated inflation either under a nominal stability assumption or assuming the consensus path for the exchange rate, according to the weekly BCB report on market forecasts.

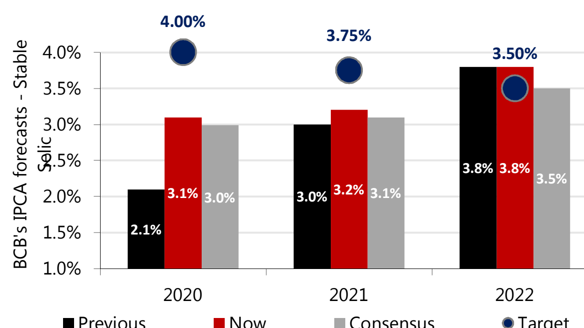
[4] Refer to the latest weekly BCB report on market forecasts, as of October 23, 2020 (https://www.bcb.gov.br/content/focus/focusmarketreadout/R20201023.pdf).

Figure 2-A: BCB's inflation simulation (Selic as per consensus)



Sources: Santander, Brazilian Central Bank.

Figure 2-B: BCB's inflation simulation (Stable Selic at 2.00%)



Sources: Santander, Brazilian Central Bank.

Figure 2-C: Selic rate assumptions for the BCB's inflation simulation

		SELIC ASSUMPTIONS	
		Now	Previous
Consensus Selic Rate	2020	2.00%	2.00%
	2021	2.75%	2.50%
	2022	4.50%	4.50%
Stable Selic Rate	2020	2.00%	2.00%
	2021	2.00%	2.00%
	2022	2.00%	2.00%

Sources: Santander, Brazilian Central Bank.

What to expect ahead?

While the minutes will provide the BCB with another opportunity to give more details on the scenario assessment and policy guidance, we sense the monetary authority is in waiting mode, ahead of important decisions to be taken by both government and Congress on the fiscal side. Those decisions can have material impact on the inflation outlook and therefore on the BCB's strategy.

We continue to envision a lack of demand-led price pressures for the relevant monetary policy horizon (i.e. medium term). Despite a temporary pickup in headline inflation recently, the key fundamentals for monetary policy remain well behaved, with inflation expectations below the mid target for the medium run and with the economy expected to keep running below its potential for considerable time. If these conditions do materialize, depending on the fiscal regime, we cannot help projecting a stable Selic rate (at such an expansionary level of 2.00%) all across 2021.

Our baseline scenario of fiscal convergence (i.e., constitutional spending cap still credible for the coming years, probably backed by reforms) contemplates the start of a gradual removal of monetary stimuli only in 1Q22. Under these circumstances, the BCB would not be behind the curve and would have time to adjust the policy rates very gradually, with hikes of 25 bps per meeting, until the policy stance is back to neutral (real rate of 3.00%) in 2023.

Of course, a scenario of fiscal slippage would lead to very different conditions and forecasts.

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