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MONETARY POLICY – INFLATION REPORT

DETAILS OF THE BCB'S SCENARIO, AMID THE UNCERTAINTIES

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- The Brazilian Central Bank (BCB) published its 1Q22 inflation report today, with further information on the authority's economic analyses, simulations, forecasts, and policy discussions.

- On economic activity, the authority continues to forecast 2022 GDP at +1.0%, compared to the consensus of +0.5%. The stability in this estimate may reflect a balance between a higher carry-over (from 4Q21) and a tighter monetary policy (and Selic expectations). The BCB sees the economy running 2.3% below its potential in 4Q22 — a gap about 0.2 pp wider than estimated in the 4Q21 inflation report. The BCB notes that this forecast is based on an even tighter monetary policy stance (both realized and expected).

- The 1Q22 inflation report also shows that actual IPCA inflation stood a full 0.8 pp above the BCB's forecast for the period between November and February. With the BCB's inflation estimates for the policy horizon (mainly 2023) already known, what is new here is the monthly and quarterly path for these numbers. What strikes our attention is that, in Scenario A (previously known as "alternative", assuming oil prices at USD100/bbl at YE2022), the BCB estimates inflation at 2.1% QoQ for the period between March and May (Santander: 1.5%). This implies to us that the bar is high for another short-term upside surprise in headline IPCA, even though (depending on the size) a surprise could have little bearing on the BCB's policy, since 2022 will be out of the policy horizon from now on.

- In one of the most important "boxes" of studies in the 1Q22 inflation report, the BCB delves into the pass-through of oil prices in local currency to consumer prices. The BCB concludes that the impact is quite meaningful and expects it to increase this year. This justifies a cautious stance about the outlook, which still entails considerable uncertainties in this regard (i.e., commodity and oil prices).

- In terms of policy signals, there is no change from the previous communications — March's Copom communiqué and minutes. The BCB continues to signal another move of 100 bps at the next meeting, along with its belief that this terminal Selic level for this cycle (12.75%) could be enough to bring IPCA down to the mid-target for 2023. At the press conference, the BCB's governor mentioned that a rate hike in June "is not the most likely outcome". But the authority continues to leave the door open to eventually change the flight plan (and hike a bit more) if conditions worsen.

- Our Selic rate forecast includes a hike of 100 bps in May (to 12.75%) and a last move of 50 bps (to 13.25%) in June. Despite the BCB's flight plan, which seems quite clear, our expectation for this last move in June is in line with our view that inflation expectations for 2023 may continue to rise a bit in the coming weeks, before eventually stabilizing.

The BCB has published its 1Q22 inflation report[1], with further information on the monetary authority's macroeconomic analyses, simulations, and forecasts, as well as policy discussions.

Macroeconomic Parameters and Forecasts by the BCB

With the BCB having already published its inflation estimates for the relevant policy horizon, the main elements comprising the balance of risks, and the key policy messages in the Copom statement[2] and minutes[3], today's inflation report provides estimates and more information on key macroeconomic parameters used by the BCB in its simulations, forecasts, and decisions.

On economic activity, the authority continues to forecast 2022 GDP at +1.0%, compared to the consensus of +0.5%[4]. The stability in the authority's estimate is based on an apparent balance between the effects of tighter financial conditions (mainly on the heels of monetary policy expectations and signals) and a greater statistical carry-over from 2021 (given the better than expected 4Q21 GDP reading). Sector-wise, a downward revision for farm output (to 2.0% from 5.0%, reflecting adverse weather conditions especially hitting the summer grain harvest) is offset by the expectation of a softer decline in industrial GDP (to -0.3% from -1.3%, based on more favorable estimates for construction and utilities). Services GDP was also revised a bit higher (to 1.4% from 1.3%), mostly on transportation and IT.

Accounting for this revised GDP path, the BCB sees the economy running 2.3% below its potential in 4Q22 — a gap about 0.2 pp wider than in the last inflation report. The BCB notes that this forecast is based on its tighter monetary policy stance (in place since March 2021) and the increase in interest rate expectations (from which the BCB extracts the future Selic rate trajectory used in simulations). The BCB points to a temporary interruption in an otherwise narrowing output gap trend (in progress since 2Q20), as the authority estimates that GDP was 1.5% below potential in 3Q21 and sees that widening to -1.6% in 4Q21 and -1.8% in 1Q22. However, the BCB notes that these estimates indicate a narrower gap compared to the estimates in the previous inflation report, given the better than expected numbers for headline GDP and lower than expected jobless rate of late.

In terms of inflation, the BCB provides more details on the IPCA forecasts both in Scenario A (previously named "alternative" in the communiqué, assuming an oil price decline toward USD100/bbl later in 2022 and stable in real terms afterward) and in Scenario B (the usual "reference" scenario projection, "mechanically" assuming oil prices nearly flat at around USD120/bbl). We remind readers that, as already announced in the statement and minutes, Scenario A has IPCA at 6.3% and 3.1% for 2022 and 2023 (respectively), whereas Scenario B has IPCA at 7.1% and 3.4% for the same period: both scenarios point to inflation below 2.5% for 2024[5], reflecting the tighter monetary policy path. However, that is still beyond the policy horizon. These forecasts assume the path of the Selic rate as per the consensus as of March 11 (peak at 12.75% in mid-2022, then declining from early 2023 onward, reaching 8.75% in YE2023) and the FX rate starting at 5.05 and moving in tandem with PPP (purchasing power parity) afterward.

Interestingly, at the press conference, BCB governor Roberto Campos Neto clarified the interpretation of inflation estimates in Scenario A, mentioning BCB's cold-numbered IPCA 2023 forecast running *just below* the mid-target and, when incorporating the (upwardly skewed) balance of risks, the result being an inflation estimate *just above the mid-target*. The governor explained that (maybe out of caution, in our view) the official communications in the statement and minutes referred to results "around the target" for both simulations.

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[1] Refer to the Inflation Report boxes (https://www.bcb.gov.br/en/publications/inflationreportboxes) and presentation (https://www.bcb.gov.br/en/about/presentatspeechs)
[2] **Santander Brazil Monetary Policy - *"COPOM Meeting: A Plan Amid the Uncertainty"* –** March 16, 2022- Available on: https://bit.ly/Std-COPOM-mar22
[3] **Santander Brazil Monetary Policy - *"Copom Minutes: Reinforcing the Commitment to The Flight Plan If Conditions Allow"* –** March 22, 2022 – Available on: https://bit.ly/Std-COPOM-min-mar22
[4] Refer to the BCB's Focus weekly survey among professional forecasters (https://www.bcb.gov.br/en/publications/focusmarketreadout)
[5] The mid-point inflation target is 3.50% for 2022, 3.25% for 2023 and 3.00% for 2024. The targeted band has a 1.5 pp tolerance interval in either direction.

While the BCB's inflation estimates within the policy horizon (mainly 2023) were already known, what is new is the monthly and quarterly path for these numbers. What strikes our attention is that, in Scenario A, the BCB estimates inflation at 1.02% MoM for March, 1.21% for April, and -0.14% for May, totaling a 2.1% QoQ IPCA change for the period. In comparison, our numbers are as follows: 1.17% for March, 0.85% for April, and -0.5% for May, leading to inflation of 1.5% for the three-month period ending in May. Part of this gap (0.1-0.2 pp) is explained by the adoption of a "Yellow" electricity tariff flag from May onward, while we forecast a "Green" flag for that period. So, the possibility of another inflation surprise in the short term appears relatively low, in our view, as the bar set by the BCB's short-term inflation forecast seems a bit high. Importantly, the 1Q22 inflation report shows that actual IPCA inflation stood a full 0.8 pp above the BCB's forecast for the period between November and February (totaling an IPCA change of 2.3% for this four-month period). That additional upside surprise did weigh on the BCB forecasts, especially for 2022.

The BCB mentions the main factors driving its inflation estimates since the last 4Q21 inflation report. As the key *upward pressures*, the BCB mentions: (i) higher than expected inflation readings of late; (ii) higher oil prices; (iii) greater inertia; (iv) higher inflation expectations (Focus report); and (v) better than expected activity. As for the *forces that helped cushion the upward movement* in inflation forecasts, the BCB cites: (i) higher Selic rate forecasts (Focus report); (ii) stronger FX; (iii) change in the YE2022 electricity flag to "Yellow" from "Red II"; (iv) lower economic uncertainty index, as measured by FGV; and (v) lower oil costs in Scenario A later in 2022.

Regarding the fan charts of inflation forecasts, which illustrate the probability distribution of expected inflation outcomes perceived (or estimated) for the relevant policy horizons, the BCB sees an 88% probability of breaching the upper end of the inflation target band (5.00%) this year. For 2023, the central bank estimates a probability of 12% that IPCA could come in above the upper target (4.75%), which is even a bit lower than the 17% likelihood associated with a scenario where IPCA breaches the lower bound of the target for that year (i.e., IPCA below 1.75% for 2023).

"Boxes": Focus on Supply and Oil Shocks as Well as Employment

In one of the most important "boxes" of studies in the 1Q22 inflation report, the BCB delves into the pass-through of oil prices in local currency to consumer prices. The BCB concludes that the impact is quite meaningful[6] and expects it to increase further this year. The BCB also notes the higher volatility in oil prices of late, which can bring about swings in inflation forecasts and add uncertainty to the outlook. The BCB then takes the opportunity to reaffirm the previous communication that such an "environment of high uncertainty and volatility demands serenity in assessing the long-term impacts of the current shock and its secondary impacts on inflation over the relevant horizon" (our own translation). The BCB reminds the public that in the medium term "the effects of monetary policy are greater, as opposed to the short term, when the effects of commodity shocks are felt more intensely."

In another box, the BCB studies how the inflationary supply shocks have affected consumer spending in Brazil. The study focuses on the impact of fuel, electricity and food items, under the assumption that the recent changes in these prices followed entirely the effects of supply shocks (with no influence from domestic demand). The BCB concludes that the impact is rapid, meaningful, and especially greater for non-essential goods. The authority believes that while the easing in electricity prices may provide some relief for consumers, the recent increase in some commodity prices in BRL may weigh on personal spending this year.

Another section sheds light on job market conditions, as the BCB presents alternative employment indicators to complement the analysis on formal jobs. The list of new indicators includes unemployment insurance claims data and withdrawal authorizations from mandatory savings accounts (FGTS) due to termination of job contracts, among others. The BCB concludes that formal employment trends are probably between what is signaled by IBGE's household survey (PNAD) and the new methodology for the establishment survey (CAGED), which have continued to diverge of late. The authority highlights that while formal jobs have surpassed pre-pandemic levels, recently there have been signs of softening. The BCB also sees evidence of

[6] The BCB noted that fuel costs accounted for a third of last year's IPCA inflation (printing just above 10%).

a partial recovery in real income. The authority refers to the possibility that the household survey could be underestimating the level of aggregate income, given the trends seen in (payroll-based) social security revenue.

Policy Signals

In terms of policy signals, there is no change from the previous communications — March's Copom communique and minutes, with Governor Campos Neto reinforcing further the BCB's flight plan (next policy steps). The Copom reaffirmed the message that it is appropriate that the monetary tightening cycle continues to advance significantly into even more contractionary territory and that the committee's aim is to combat the secondary effects from the current supply shocks, and notes that the latter could take a while to materialize. According to the BCB, the current "projections indicate that the interest rate cycle in the evaluated scenarios is sufficient for the convergence of inflation to a level around the target over the relevant horizon". At the next meeting, "the Committee anticipates another adjustment of the same magnitude." According to the BCB governor, during the press conference, a rate hike in June "is not the most likely outcome". Yet the BCB leaves the door open to eventually change the flight plan, saying that if the pressures prove "more persistent or greater than anticipated, the Committee will be ready to adjust the size of the monetary tightening cycle."

Looking Ahead

Our Selic rate forecast includes a hike of 100 bps in May (to 12.75%) and a last move of 50 bps (to 13.25%) in June. Despite the BCB's flight plan, our expectation for this last move is in line with our view that inflation expectations for 2023 may continue to rise a bit in the coming weeks, before eventually stabilizing. Looking further ahead, we expect a tight(er) policy stance for long(er): we forecast rate cuts to start only in March 2023, with the Selic at 10.00% for YE2023 and 7.00% (neutral level) only by YE2024[7].

[7] This expected convergence to the structural level (7%) is conditional on the maintenance of a long-term inflation target of 3%. Interestingly, during the press conference, the BCB governor indicated that the BCB believes a change in the inflation target would not help the anchoring process, even as the authority recognizes that this is a decision by the CMN monetary council (where the BCB president has one of three votes).

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