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Macroeconomic Research

BRAZIL MACRO

March 30, 2023

MONETARY POLICY – INFLATION REPORT

DETAILS LEADING TO THE SAME MESSAGE

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- The Brazilian Central Bank (BCB) has just released the 1Q23 inflation report, which provides economic analyses guiding its policy decisions as well as further details on the BCB's macro forecasts.

- The BCB raised its 2023 GDP estimate to 1.2% (previously 1.0%) and now sees a bit less slack in the economy, which it estimates as running 1.3% below potential in 1Q23. The BCB's scenario of an activity deceleration ahead remains valid. On inflation, the BCB now sees the probability that IPCA will breach the upper target (4.75%) for 2023 at 83%, compared to 57% probability in the 4Q22 inflation report.

- Regarding the medium term, in the reference scenario the authority estimates IPCA inflation at 3.6% for 2024 (vs. 3.0% in the 4Q22 inflation report, with the increase led roughly equally by free-market and regulated prices) and 3.2% for 2025 (vs. 2.8% in the 4Q22 inflation report, with the increase mainly led by free-market prices). These numbers mean that, in a scenario assuming the rate cuts expected by analysts, it would take much longer to reach convergence to the center target (3%).

- Projecting total loans balance growth of 7.6% in 2023, the BCB assesses that its estimates "continue to indicate a deceleration process in the credit growth rate compatible with the monetary tightening cycle." In other words, no "credit crunch" is seen on the BCB's horizon for now.

- As in the Copom statement and minutes, the BCB reaffirms the main policy messages 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," and also that it "will persist until the disinflationary process consolidates and inflation expectations anchor around its targets."

- All in all, the message continues to be consistent with the strategy of holding rates steady for long, amid risks of de-anchoring expectations on the one hand and a lack of evidence of significant deflationary shocks on the other hand. We continue to project (gradual) rate cuts starting in November, bringing the Selic rate down to 13% for YE2023 and 11% for YE2024.

KEY TOPICS

We highlight the following takeaway points from the 1Q23 inflation report.

- **GDP FORECAST:** The BCB raised its 2023 GDP estimate to 1.2% (previously 1.0%). According to the BCB, the revision came as a result of "positive surprises in some components of the services sector" in 4Q22 (leading to a better carryover for 2023), higher forecasts for mining, and early activity releases for January and February. The numbers remain consistent with the BCB's view of a slowing economy ahead, as a reflection of lagged effects of a tighter monetary policy.

- **OUTPUT GAP:** The BCB claims that the output gap reversed a closing trend as of 2H22, with the authority estimating that the economy was running at -1.0% and -1.3% (i.e., below its full potential) in 4Q22 and 1Q23, respectively (compared to output gap estimates of -1.1% and -1.5% in the previous inflation report). The estimate of less economic slack is due to upward revisions in short-term activity forecasts, according to the Copom. However, the authority continues to expect an increase in slack ahead, as a byproduct of previous Selic hikes.

- **SHORT-TERM INFLATION NUMBERS AND OUTLOOK:** In the three months to February, the BCB notes that IPCA inflation stood 0.4 pp below its forecast for that period (2.4% QoQ), so that year-over-year inflation ended that period at 5.6% YoY. That surprise was largely led by administered prices, especially the postponement of the reestablishment of a federal gas price tax, which was partly reincorporated in March. The BCB anticipates monthly IPCA gains of 0.87%, 0.63%, 0.28%, and 0.29% for the period spanning March to June, leading to a 1Q23 estimate of 2.3% QoQ and a 2Q23 estimate of 1.2% QoQ. (For now, Santander Brazil pencils in 2.0% QoQ for 1Q23 and 1.7% QoQ for 2Q23, with annual IPCA ending the first half at 4.0% YoY, vs. the BCB's projection of 3.8% YoY. Note: our scenario is currently under revision.) The authority notes that its scenario "considers that the mark-up is maintained for the ICMS [states' VAT] tax base for electricity, according to the preliminary decision of the STF [Supreme Court]." The scenario also assumes no changes in the ICMS [states' VAT] taxes on gasoline.

- **MEDIUM- AND LONG-TERM INFLATION FORECASTS:** The BCB now sees the probability that inflation will breach the upper target (4.75%) for 2023 at 83%, compared to a 57% probability in the 4Q22 inflation report. The authority projects 2023 IPCA at 5.8% in the reference scenario[1], 0.8 pp higher than in the 4Q22 report. As previously published in the statement and minutes, the BCB has raised considerably its IPCA estimates for the relevant policy horizons and the long run, reflecting mainly an increase in analysts' estimates for IPCA inflation, a key element influencing the BCB's models. Yet the BCB recognizes that an estimate of a more closed output gap (than previously thought) is also part of the story. In the reference scenario, the authority estimates IPCA at 3.6% for 2024 (vs. 3.0% in the 4Q22 inflation report, with the increase led roughly equally by free-market and regulated prices) and 3.2% for 2025 (vs. 2.8% in the 4Q22 inflation report, with the increase mainly led by free-market prices). The numbers mean that, in a scenario assuming the rate cuts expected by analysts, it would take much longer to reach convergence to the center target (3%). The latter is no longer is seen as taking place for the relevant horizon (YE2024, as of 2Q23, considering the moving horizon).

- **CREDIT MARKET CONDITIONS AND FORECAST:** With financial markets paying close attention to the evolution of credit numbers and the BCB's assessment and reaction, the authority's estimates in that area take on added relevance at this juncture. The BCB recognizes that there were some downside surprises in the non-earmarked lending late in 2022, leading to slightly disappointing growth last year (14.0% vs. 15.1% expected). This downside surprise, coupled with the increase in expectations for the average policy interest rate throughout the year, led to a downward revision in the loan balances growth estimated for 2023: the number is now 7.6% (previously 8.3%). The BCB assesses that its estimates "continue to indicate a deceleration process in the credit growth rate compatible with the monetary tightening cycle." In other words, no "credit crunch" is seen on the BCB's horizon for now.

[1] The reference scenario assumes the Selic trajectory according to the Focus survey (as of March 17, with rate cuts to 12.75% for YE2023 and 10.00% for YE2024). The simulations assume USD/BRL at 5.25 and then evolving with the 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 (i.e., up 2% annually subsequently). The scenarios assume energy tariff flag "yellow" for both December 2023 and 2024.

- **METHODOLOGICAL BOXES:** The 1Q23 inflation report provides two methodological boxes (studies). In one of those, the BCB seeks to explain its decision-making process, including the scenarios and forecasts. The authority claims that it is "of paramount importance that the work of central banks is structured around a framework that ensures that this decision-making process is done systematically and in a coherent way over time, taking into account the entire set of available information." The BCB also reaffirms the message that it follows "the best international practices in central banks and is constantly improving." In another box, the BCB provides details on its forecasting methodology, presenting "the latest version of the midsize structural model [SAMBA]", also "discussing the changes in its structure, presenting some relevant parameters (including details about estimation) and describing the possibilities of use resulting from this new structure." The BCB claims to be seeking the "highest degree of transparency possible in communicating monetary policy, understands that publishing updates on its models is fundamental to clarify your decision-making process for all economic agents."

- **POLICY MESSAGES:** As in the Copom statement and minutes, the BCB reaffirms the main policy messages 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", and also that it "will persist until the disinflationary process consolidates and inflation expectations anchor around its targets". The Copom maintained the signal that it "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected." Thus, no changes in the flight plan are seen for now, as already known from the previous communications in recent days.

OUR TAKE

Judging by the latest set of Copom communications (statement, minutes, and inflation report), the BCB seems likely to keep its flight plan of stable interest rates for an extended period, as a response to fiscal uncertainties and the unmooring of inflation expectations. By focusing on the main variable (inflation expectations) influencing its main objective (inflation target), we believe the BCB is taking an approach that could help the growth of the economy in the medium to long run. We continue to see any change in the BCB's strategy as premature at this point and believe that the BCB might only revise it in case of important deviations from its key current hypotheses and policy parameters (such as the inflation target, maybe). For now, we continue to project (gradual) rate cuts starting in November, bringing the Selic rate down to 13% for YE2023 and 11% for YE2024.

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