Brazil Macro | August 2023

Monetary Policy

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BRIEF OVERVIEW

01

SUMMARY

- **This chartbook brings details our Monetary Policy outlook, contemplated in our latest Scenario Update, released on August 4 – "Better Growth Outlook in 2024 Given a Less Contractionary Monetary Policy" - available in: https://tinyurl.com/Std-scenreview-aug23**

- Given the favorable developments regarding the inflation outlook lately, the BCB has started a new monetary easing cycle. The Copom cut the Selic policy rate in 50bps to 13.25% in the August meeting and signaled this as the expected cruise speed ahead. The BCB still sees a tight policy stance as warranted and still signals that the terminal level of interest rate for this cycle will be data dependent.

- Despite the August surprise, we believe the BCB does not have room to consistently beat consensus (both speed and level-wise) in this easing cycle, given the partial re-anchoring of inflation expectations and a still resilient underlying inflation. Moreover, real activity is slowing gradually, meaning no real reason to buy much "insurance" against a major activity slowdown.

- Looking ahead, given the challenges on the fiscal side and an overheated services sector (and job market) our scenario still incorporates a double-digit Selic rate at the end of next year. We are changing our Selic path to 11.75% for YE2023 (previously: 12.25%) and 10.00% for 2024 (previously: 10.50%). Our forecast remains above the consensus for up to next year, but **we recognize the risks are skewed to the downside, given an increased uncertainty about the BCB's reaction function**.

MONETARY POLICY COMMUNICATION

02

Highlights from the Last Copom Meeting

BCB VIEWS ON KEY POLICY TOPICS

- The BCB sees "a stage in which the **disinflationary process tends to be slower**", with "partial re-anchoring of inflation expectation". "**Serenity and moderation** in the conduct of monetary policy" are seen required.
- EXPECTATIONS: The Copom lists possible factors behind the **residual unmooring of expectations**:
  - ✓ *(i) fiscal issue; (ii) global inflation;*
  - ✓ *(iii) doubts about the BCB's policy steps, such as "the hypothesis of the agents' perception that, over time, the BCB would become more lenient in fighting inflation".*
- FISCAL POLICY 1: The Committee understands that "the maintenance of the **fiscal commitment** in addition to a **reduction in uncertainties about the tax measures** that underpin the implementation of this objective, would contribute to a faster disinflationary process".
- FISCAL POLICY 2: An eventual "lack of commitment with structural reforms, the increase of earmarked credit granting, and the uncertainties about the stabilization of the public debt have the potential to **raise the neutral interest rate** of the economy, with harmful impacts on the monetary policy power".

Highlights from the Last Copom Meeting

THE SIGNALS ABOUT THE NEXT POLICY STEPS

- The BCB also tries to anchor expectations regarding the next policy steps, **by unanimously signaling a possible "cruise-speed" pace of 50 bps per meeting along this cycle.** That is appropriate cruise speed "to keep the **necessary contractionary monetary policy** for the disinflationary process".
- The Copom sees a "**low probability of an additional intensification in the pace of adjustment**". This would require "**substantial positive surprises** that would raise even further the **confidence** in the prospective disinflationary dynamics", with a "**significant change in the fundamentals**":
  - ✓ *a much more solid reanchoring of expectations,*
  - ✓ *a sharp widening of the output gap,*
  - ✓ ***OR** a services inflation dynamics substantially more benign than the expected".*
- In a live interview given to Poder360, **BCB Governor Campos Neto said "the bar is high"** to speed up or slow down the current pace of Selic cuts, which is 0.5 percentage points per meeting.

Highlights from the Last Copom Meeting

IN OUR VIEW...

- Based on the latest set of BCB communications, the recent actions by the Copom could reflect that:
  - ✓ *(i) the BCB may have opted to **give more weight to the balance of risks than on inflation projections***
  - ✓ *(ii) amid a context of higher than usual inflation persistence, the BCB could be more willing to accept a slightly **slower CPI convergence towards 3%.***
  - ✓ *(iii) **MARKET MAY ASK**: is the BCB seeking a target of 3.5% or 3.0% for the current policy horizon?*
- Today, we see the BCB "nearly pre-announcing" a decision to cut 50bps for the coming meetings => **OUR SCENARIO CONSIDERS 50bp TO BE THE PACE FOR (NEARLY) THE ENTIRE CYCLE (1ST PHASE)**
- But given the possible evolution of the scenario and a little uncertainty regarding the BCB's reaction function, **WE CANNOT RULE OUT SOME ACCELERATION TOWARDS 75bp AT SOME POINT, ESPECIALLY FROM DECEMBER 2023 ONWARDS**

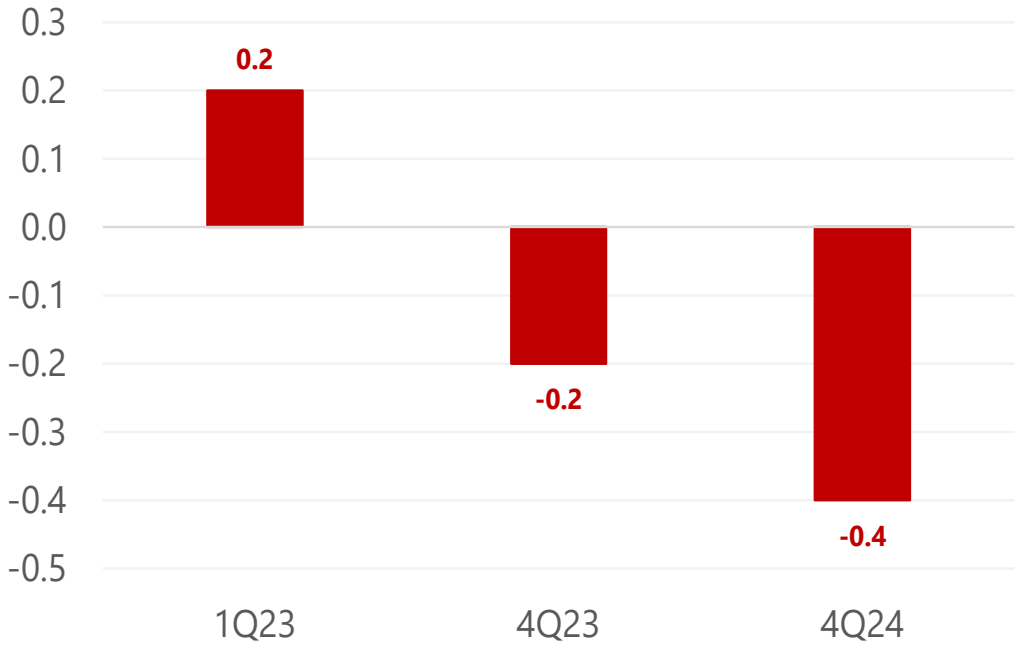
ACTIVITY

03

Estimation and Expected Evolution of the Output Gap

- The June Pre-Copom survey showed a positive gap in the 1Q23, widening downwards in 2023 and 2024.
- From the last inflation report, the BCB's output gap estimates were large and negative. In the last minutes, the Copom signaled an upward revision of those metrics [numbers currently unavailable], which influenced their inflation expectations.

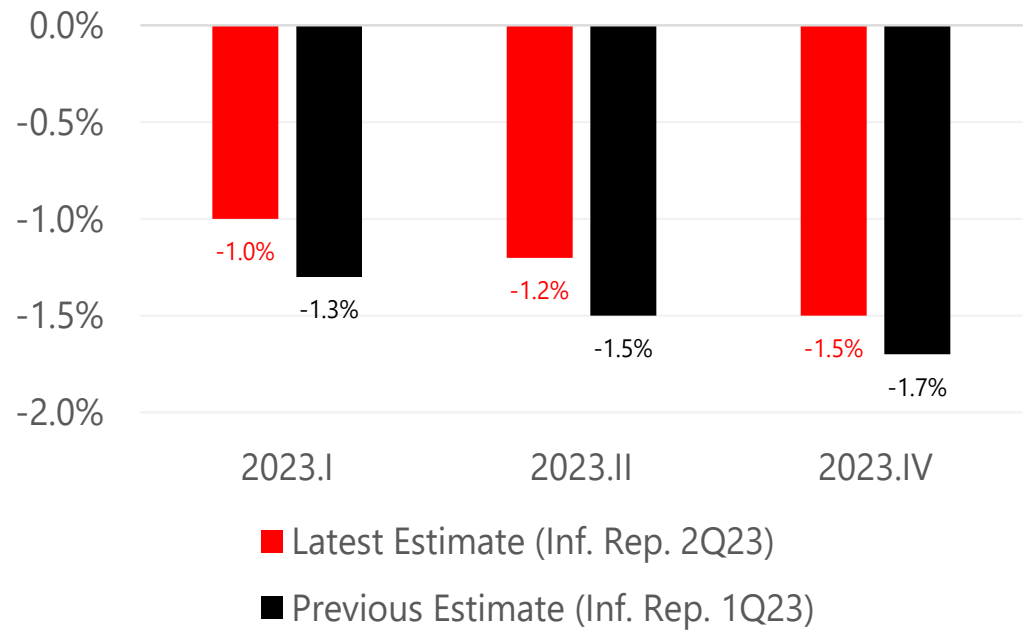
Consensus on Output Gap: June Pre-Copom Survey (%)



Sources: Brazilian Central Bank, Santander.

Note: Economists estimate potential GDP of +1.6% in the short run, converging to ~2% in 5 years' time.

BCB's Output Gap Estimates: Inflation Report (%)

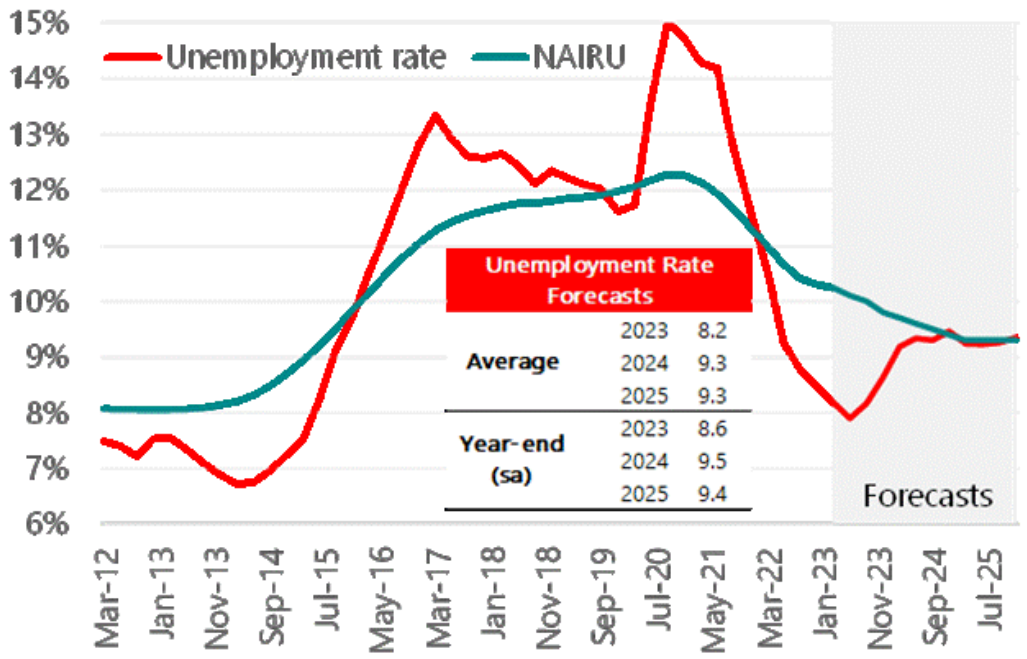


Sources: Brazilian Central Bank, Santander.

Resilience in the Labor Market, as the Participation Rate Remains at Low Levels

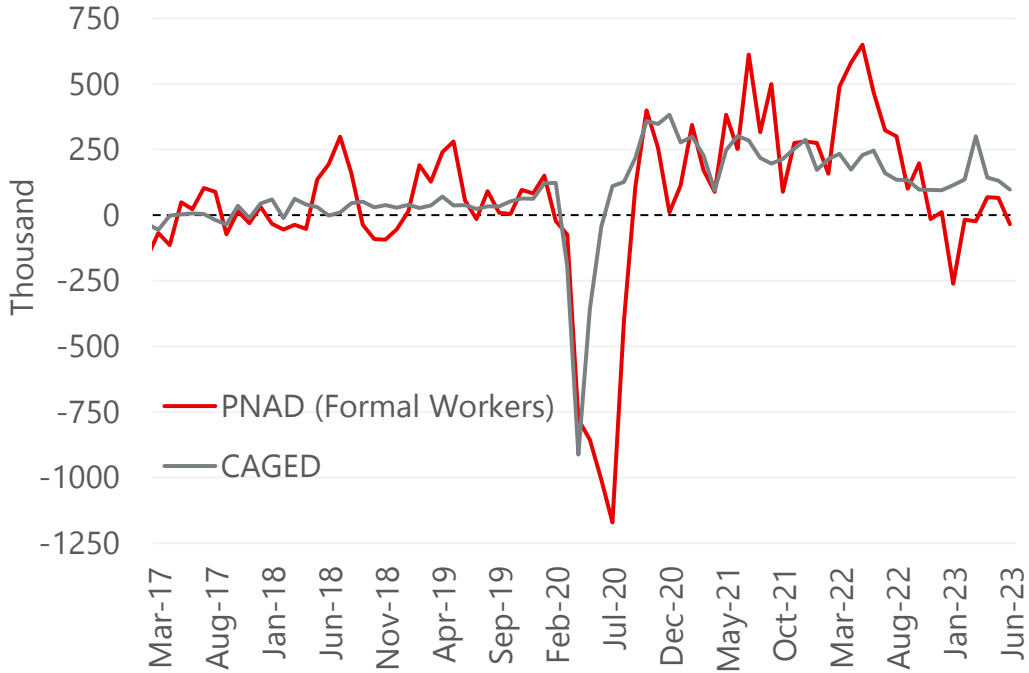
- The labor market shows signs of resilience, as it remains in overheated territory. We see a tight job market until 2024.
- The June results indicated a strong increase in formal employment, but the PNAD and CAGED surveys indicate different paces. We project the "expanded" real wage bill to grow 3.9% and 0.9% in 2023 and 2024, respectively.

Unemployment Rate and the NAIRU



Sources: National Treasury, IBGE, Ministry of Economy, Santander

Net Formal Job Creation (SA)



Sources: National Treasury, IBGE, Ministry of Economy, Santander

	2022	2023(E)	2024(E)	2025(E)	Long-Term
Real Wage Bill (With Government Transfers)	+8.7%	+3.9%	+0.9%	+1.4%	+1.4%

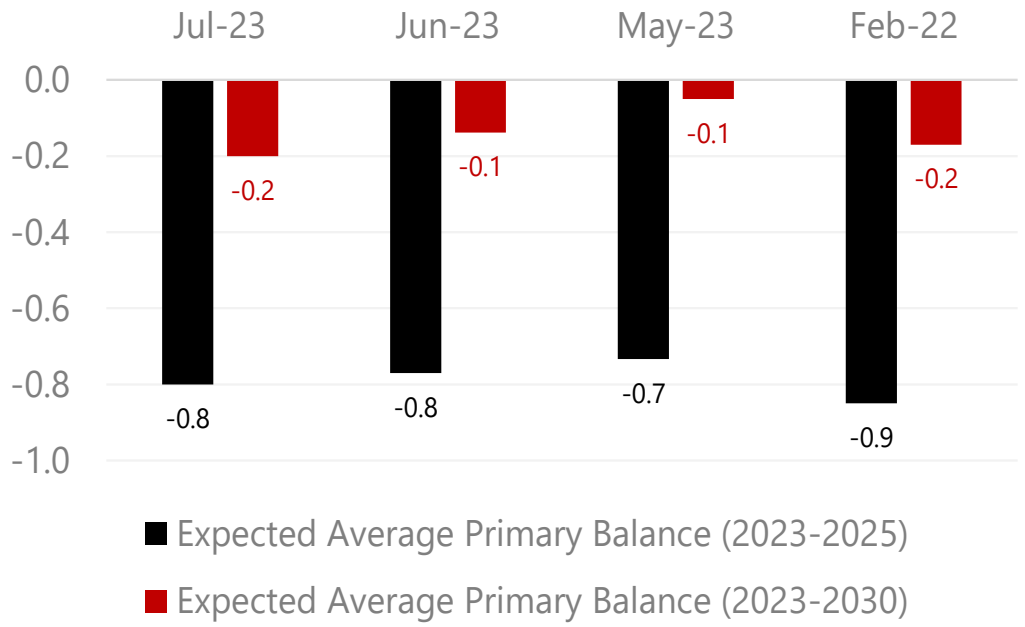
FISCAL POLICY

04

Evolution of Fiscal Policy Expectations Since the Last Copom

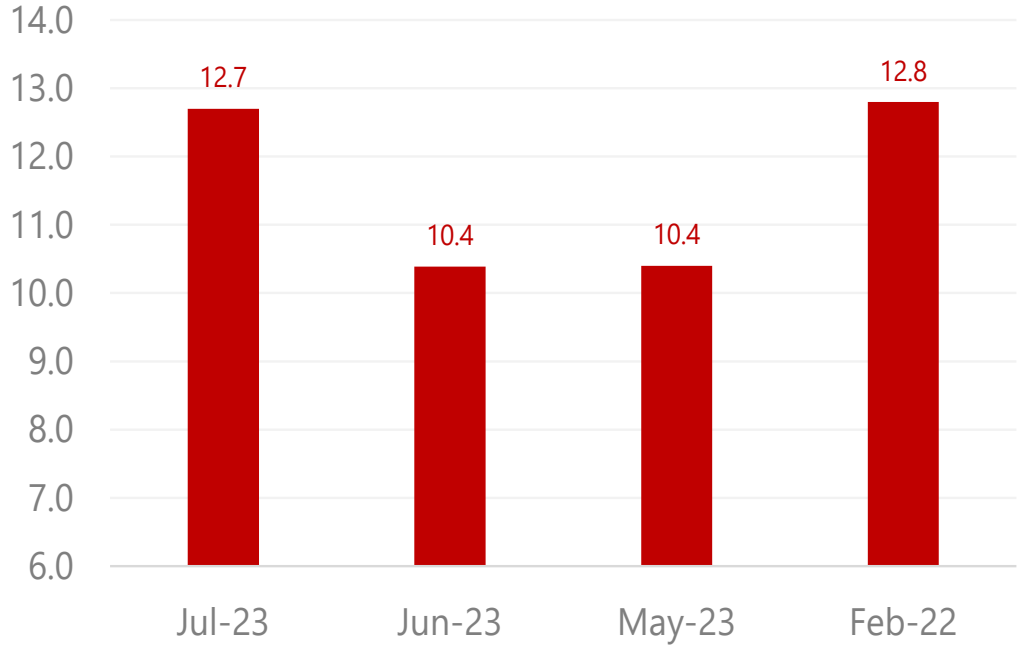
- Fiscal uncertainties remain.
- The expected primary balance average result for 2023-2025 shows deficits. Up until the last Copom meeting, economists did not expect a stabilizing debt for the coming years.

Focus Expectations for Primary Balance (% GDP)



Sources: Brazilian Central Bank, Santander.

Focus Expected Increase in Govt Debt Up to 2030 (p.p. of GDP)



Sources: Brazilian Central Bank, Santander.

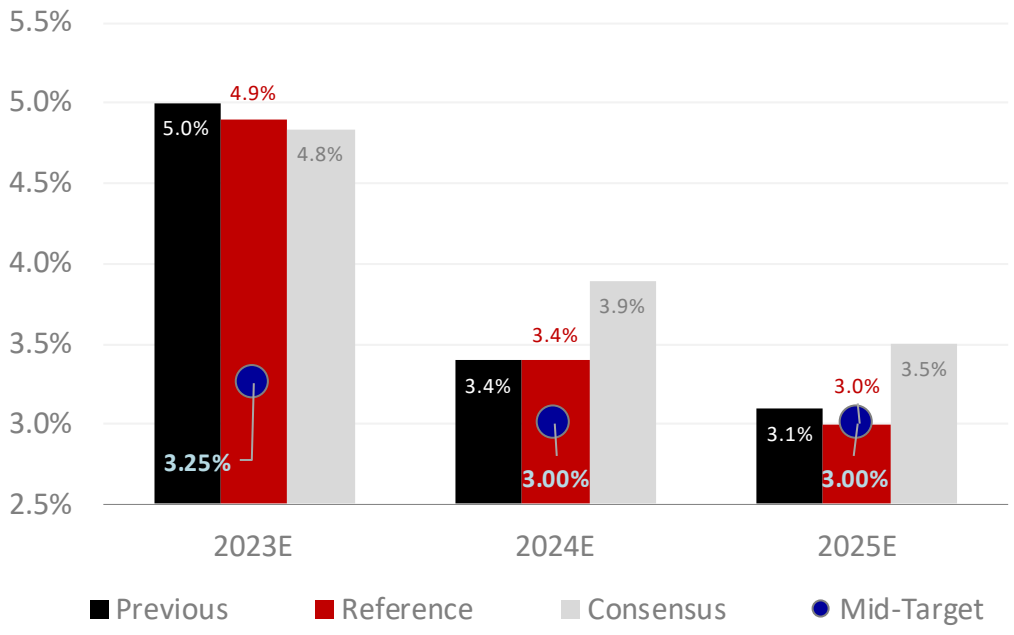
INFLATION

05

Convergence to Mid-Target to Take Longer?

- There is a divergence in BCB and consensus forecasts for IPCA in 2024 and 2025. This is exacerbated when considering free market prices only.
- In both estimates, convergence to mid-target is slow.

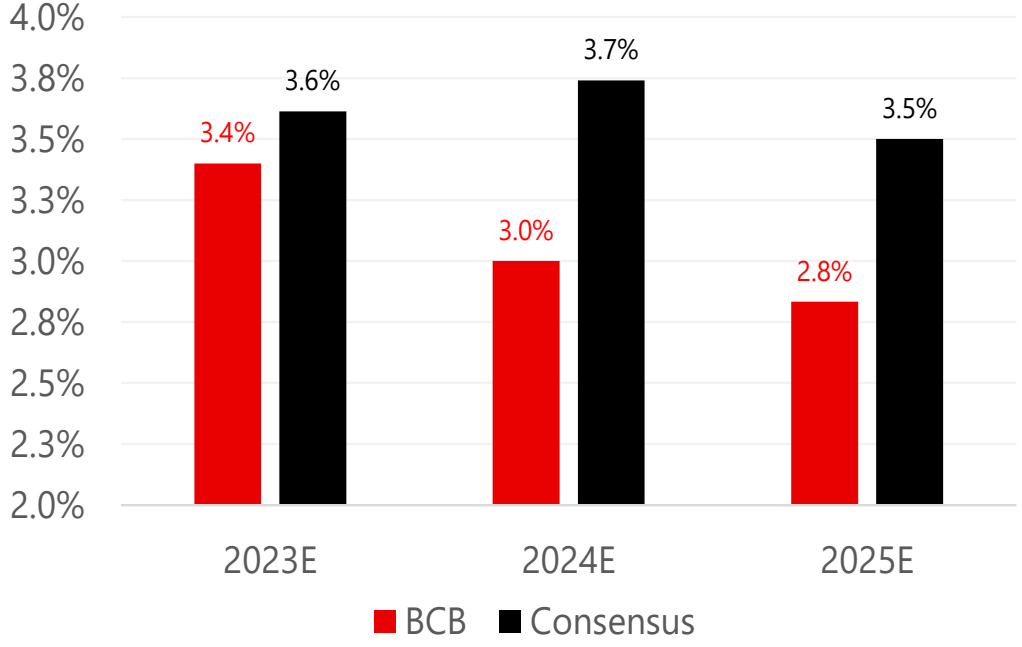
BCB's Inflation Forecast – Reference Scenario



Sources: Brazilian Central Bank, Santander.

Note: Assuming FX rate departing from USD/BRL 4.75, and then moving along with the PPP (purchasing power parity). Oil price following the futures curve for six months and stable in real terms in USD. The BCB assumes energy tariff flag "green" for both December 2023 and 2024. Consensus forecast for the future path of interest rate: 12.00% for YE2023, 9.25% for YE2024, and 8.75% for YE2025

BCB's Inflation Forecast – Free Market Prices

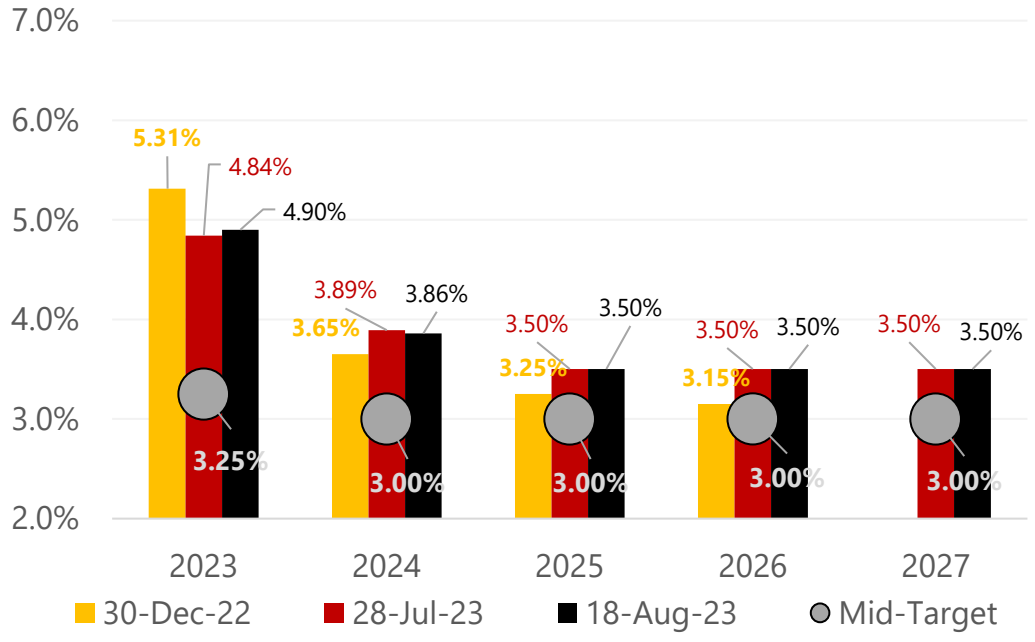


Sources: Brazilian Central Bank, Santander.
Note: Consensus as of the week before the last Copom meeting (Jul 28, 2023)

Expectations Partly Unmoored for the Policy Horizon

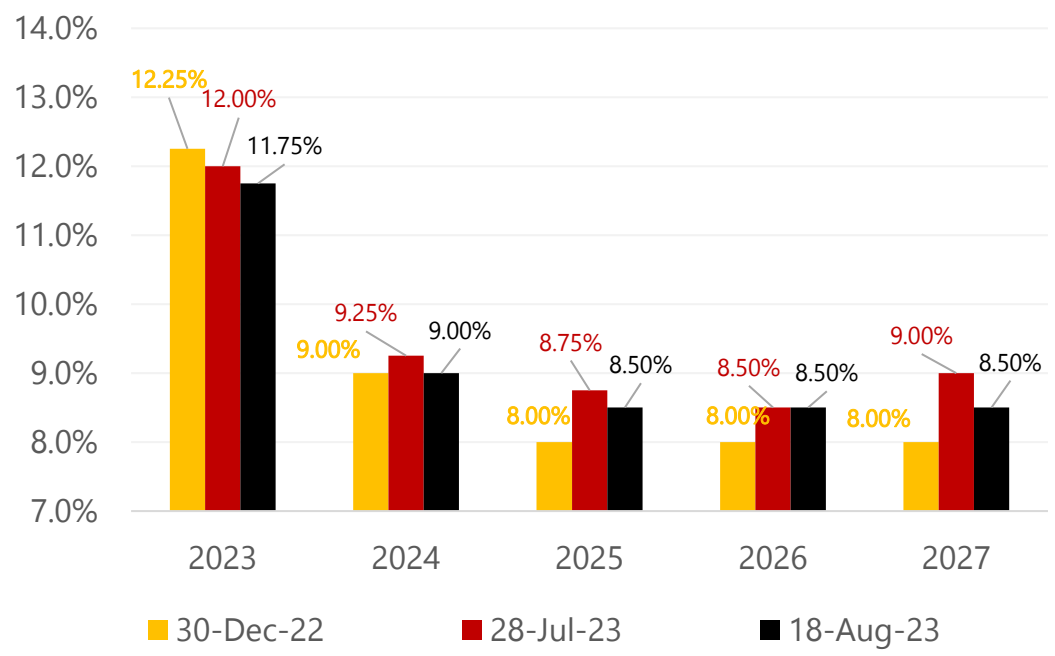
- Contrasting to the BCB's IPCA expectations for longer horizons, median consensus expectations have only partially re-anchored.
- This might point towards a perception by market economists of a lower relative weight to the inflation gap in a BCB reaction function. An alternative view can be of an implicit inflation target different from the official mid-target announced.

Median IPCA Focus Expectations (% annual)



Sources: Brazilian Central Bank, Santander.

Median Selic Focus Expectations (% pa)

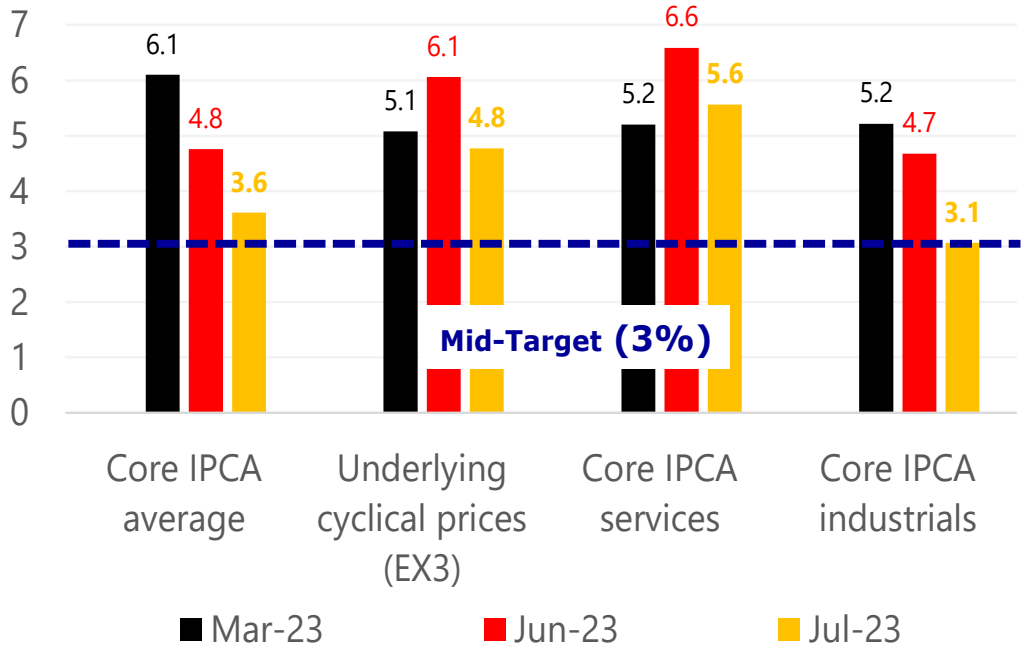


Sources: Brazilian Central Bank, Santander.

Recent Developments

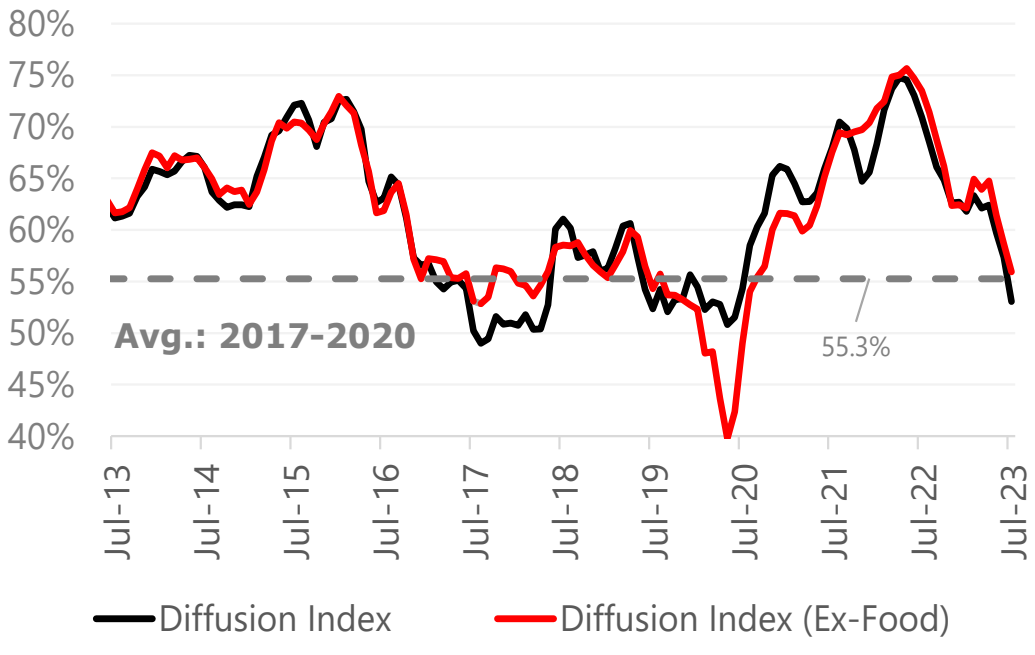
- Core IPCA services still have a long way towards the mid-target level.
- The 3mma diffusion index is now below its 2017-2018 average, indicating a broader deceleration among items, ranging over different groups. An incipient improvement, but still requiring caution considering its Ex-Food equivalent.

Recent Trends in Core Inflation (% QoQ-saar)



Sources: IBGE, Brazilian Central Bank, Santander.

IPCA Diffusion Indexes (3-month average)

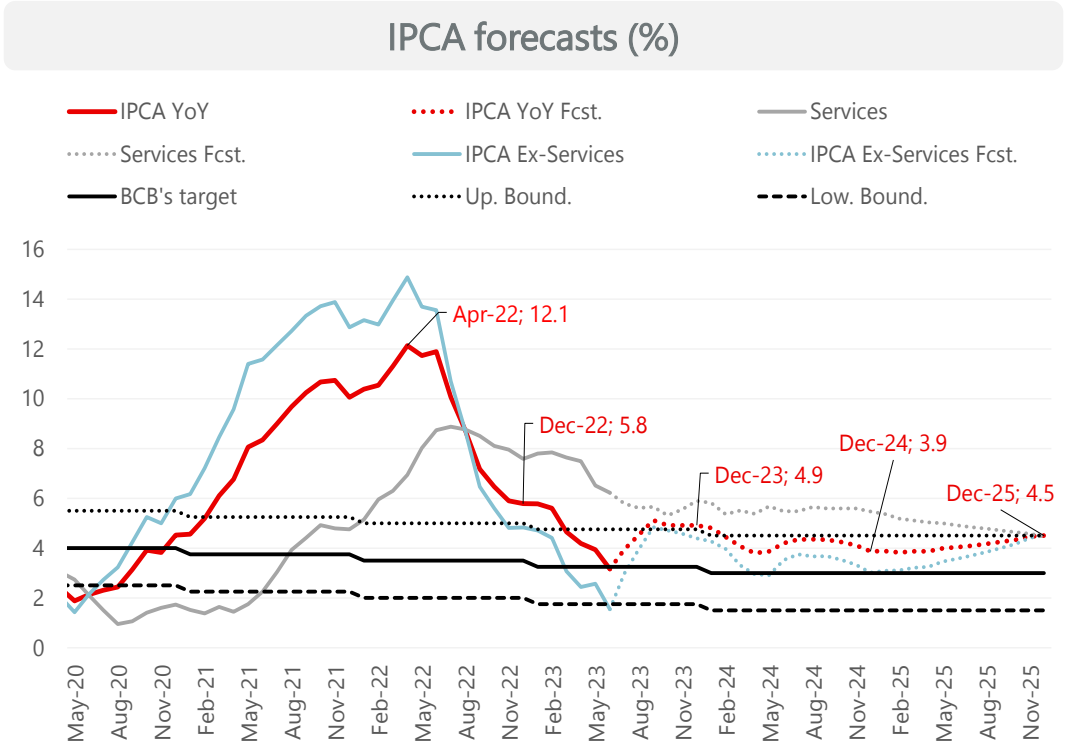


Sources: IBGE, Brazilian Central Bank, Santander.

Services Preventing a Sharper Deceleration in the Short Run

- For IPCA 2023 there was a downward adjustment based on recent inflation dynamics (from 5.2% to 4.9%).
- Services' resilience still limits disinflation.
- For IPCA 2024 we kept our projection at 3.9%, but we've changed its composition (less services, more food-at-home)

	2017-2019	2020	2021	2022	2023e	2024e
Headline IPCA	**3.7**	**4.5**	**10.1**	**5.8**	**4.7**	**3.9**
Free prices	**2.7**	**5.2**	**7.7**	**9.4**	**3.1**	**3.5**
Food-at-home	**2.5**	**18.2**	**7.9**	**13.2**	**-1.2**	**3.9**
Industrial goods	**1.3**	**3.2**	**12.0**	**9.6**	**2.3**	**2.0**
Tradables	1.2	3.2	10.8	10.1	2.4	2.0
Non-Tradables	1.7	3.0	5.4	8.8	4.7	2.0
Services	**3.8**	**1.8**	**4.8**	**7.6**	**5.7**	**4.5**
Food-service	3.6	4.8	7.2	7.5	5.6	4.8
Airline tickets	7.4	-17.2	17.6	23.5	7.6	4.9
Economic activity	2.9	0.7	3.6	7.1	5.3	4.0
Education	6.0	1.1	2.8	7.5	7.8	5.5
Inertial	2.9	2.9	5.1	8.2	6.3	4.3
Salaries	4.4	1.8	2.5	5.4	5.1	4.3
Administered prices	**6.6**	**2.6**	**16.9**	**-3.8**	**9.7**	**5.0**
Gasoline	7.2	-0.2	47.5	-25.8	13.9	5.0
Energy	8.0	8.9	24.4	-19.0	7.7	5.0
Health insurance	11.0	2.5	2.3	6.9	11.6	6.0
Bus fares	5.6	1.3	1.2	2.8	3.9	3.0
MEMO:						
Core Average	***3.5***	***2.8***	***7.4***	***8.5***	***5.1***	***3.5***

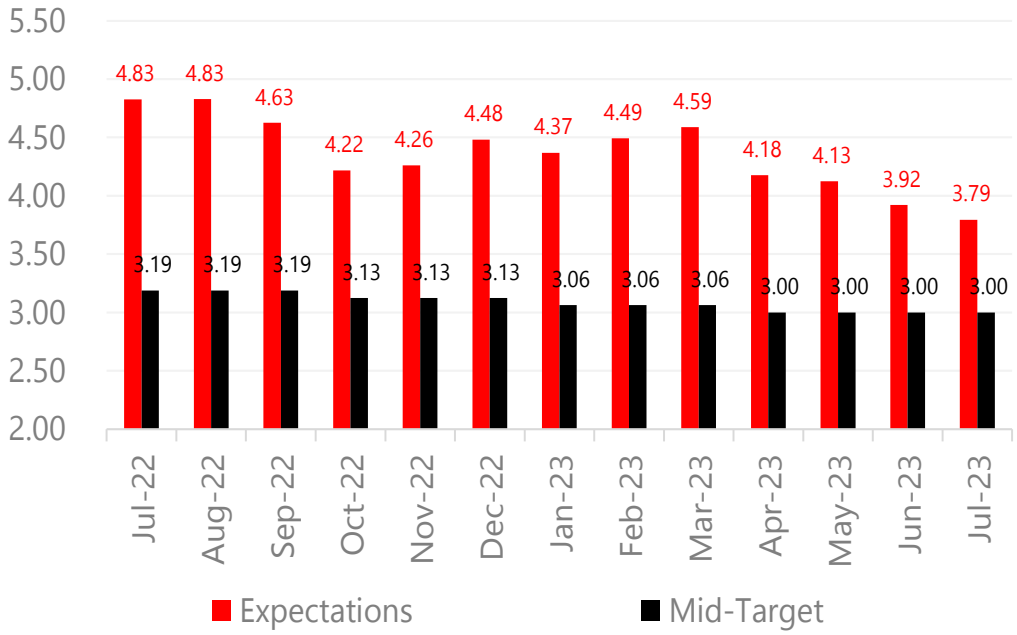


Sources: IBGE, BCB, Santander.

Recent Developments

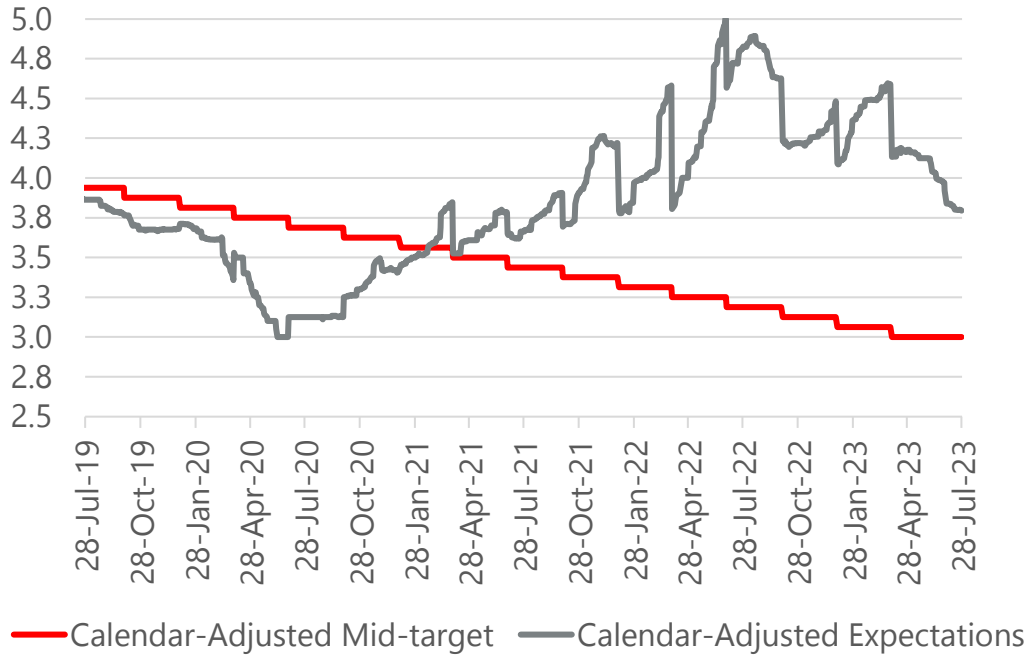
- Considering the BCB's rule-of-thumb for the policy-relevant horizon (18m), the inflation expectations gap sits now at +0.8.

Focus Expectations (18m) At the End of Month



Sources: IBGE, Brazilian Central Bank, Santander.

Daily Data on Focus Expectations (18m)



Sources: IBGE, Brazilian Central Bank, Santander.

Unfavorable Waters to Navigate

- Considering the last 15 year of monetary policy history in Brazil, this easing cycle started with the largest positive inflation expectations gap.
- This preemptive move presents itself as a risky choice given the objective of curbing inflation expectations towards the target, and thus requires a still contractionary stance, in line with the Copom's communication.

Start	End	Phase	Total Selic Change	Selic at Start	Selic at End	Core CPI Gap (Start)	Core CPI Gap (End)	CPI Expect. 18m (Start)	CPI Expect. 18m (End)	Expect. Gap (Start)	Expect. Gap (End)
21-Mar-01	22-Aug-01	Tightening	3.75	15.25	19.00	0.15	1.09	3.80	4.30	0.2	-0.4
14-Oct-02	19-Mar-03	Tightening	8.50	18.00	26.50	3.56	2.47	5.20	9.06	-1.7	2.6
15-Sep-04	15-Jun-05	Tightening	3.75	16.00	19.75	1.49	2.52	5.55	5.00	1.0	0.5
16-Apr-08	29-Oct-08	Tightening	2.50	11.25	13.75	0.26	1.55	4.40	4.75	-0.1	0.2
28-Apr-10	31-Aug-11	Tightening	3.75	8.75	12.50	0.55	2.51	4.80	5.03	0.3	0.5
17-Apr-13	02-Sep-15	Tightening	7.00	7.25	14.25	1.98	3.07	5.70	5.27	1.1	0.7
17-Mar-21	21-Sep-22	Tightening	11.75	2.00	13.75	-0.20	6.40	3.79	4.63	0.2	1.4

Start	End	Phase	Total Selic Change	Selic at Start	Selic at End	Core CPI Gap (Start)	Core CPI Gap (End)	CPI Expect. 18m (Start)	CPI Expect. 18m (End)	Expect. Gap (Start)	Expect. Gap (End)
25-Mar-99	06-Oct-99	Easing	-26.00	45.00	19.00	-5.48	-2.58	-	-	-	-
29-Mar-00	14-Feb-01	Easing	-3.75	19.00	15.25	-0.5	0.0	4.7	3.8	0.2	0.2
20-Feb-02	21-Aug-02	Easing	-1.00	19.00	18.00	3.1	2.9	4.2	4.6	-2.8	-2.9
18-Jun-03	19-May-04	Easing	-10.50	26.50	16.00	3.5	1.3	7.4	5.1	1.8	0.5
14-Sep-05	17-Oct-07	Easing	-8.50	19.75	11.25	1.9	-0.6	4.7	4.1	0.2	-0.4
21-Jan-09	02-Sep-09	Easing	-5.00	13.75	8.75	1.4	0.4	4.6	4.4	0.0	-0.1
31-Aug-11	28-Nov-12	Easing	-5.25	12.50	7.25	2.5	1.3	5.0	5.5	0.5	0.9
19-Oct-16	16-May-18	Easing	-7.75	14.25	6.50	2.5	-1.7	4.8	4.0	0.2	-0.2
31-Jul-19	16-Sep-20	Easing	-4.50	6.50	2.00	-1.0	-1.8	3.9	3.1	-0.1	-0.5

Sources: Santander.

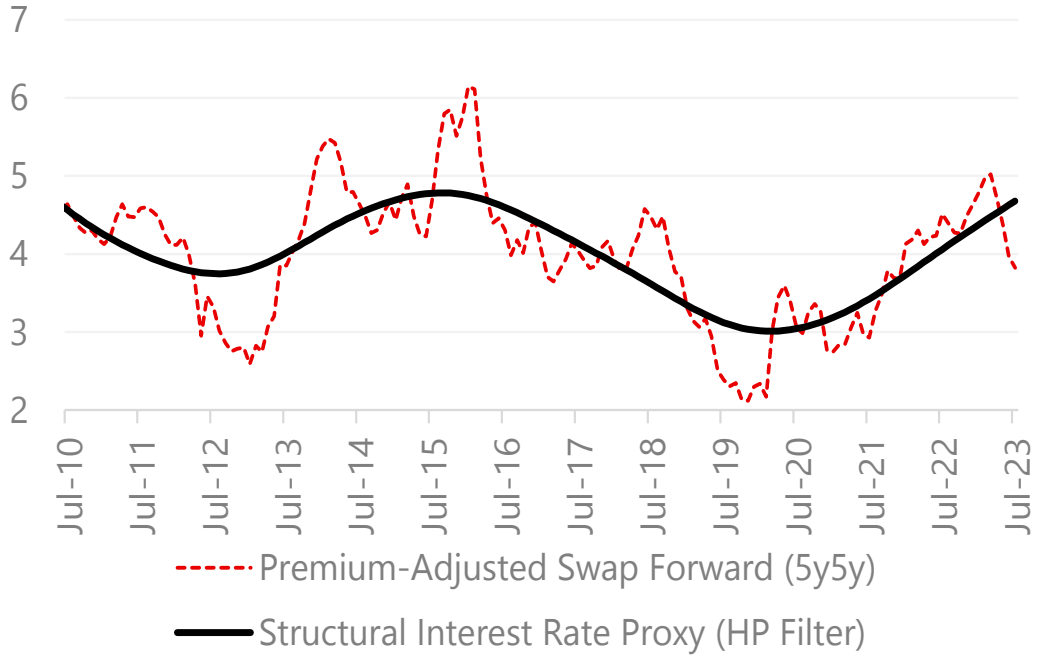
RATES AND FORECASTS

06

Neutral Rate Debate

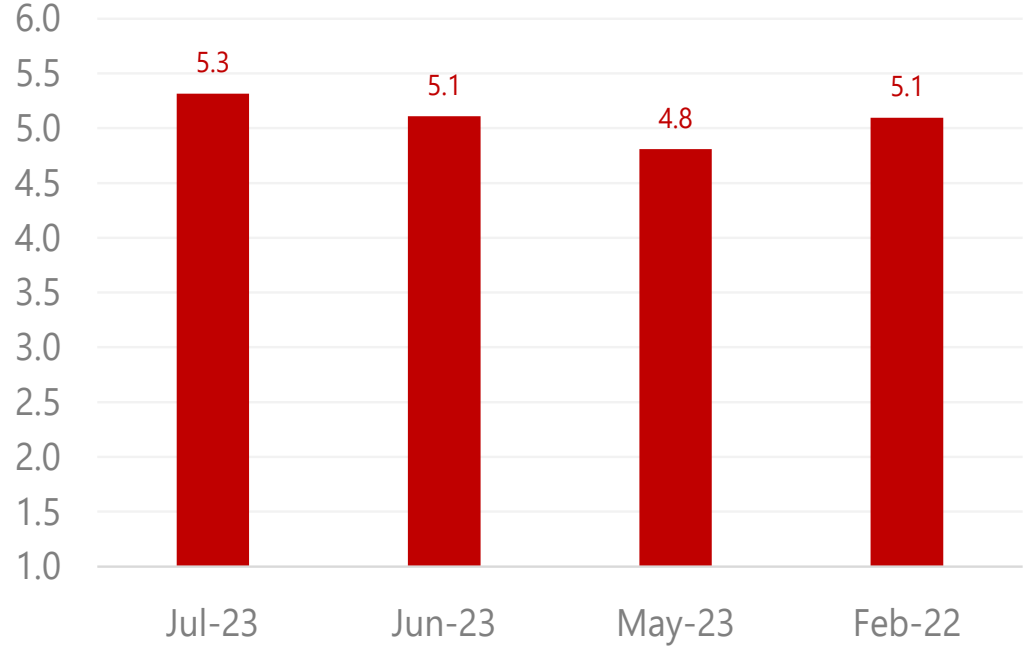
- The debate of structural interest rate has apparently been a growing concern (or point of interest) by the technical staff of the BCB.
- Incorporation of a 5% assumption for structural rate could make the gap between BCB projections and target to hold for a bit longer.

Santander's Real Neutral Rate Proxy



Sources: Santander.

Implicit Consensus for Real Neutral Rate



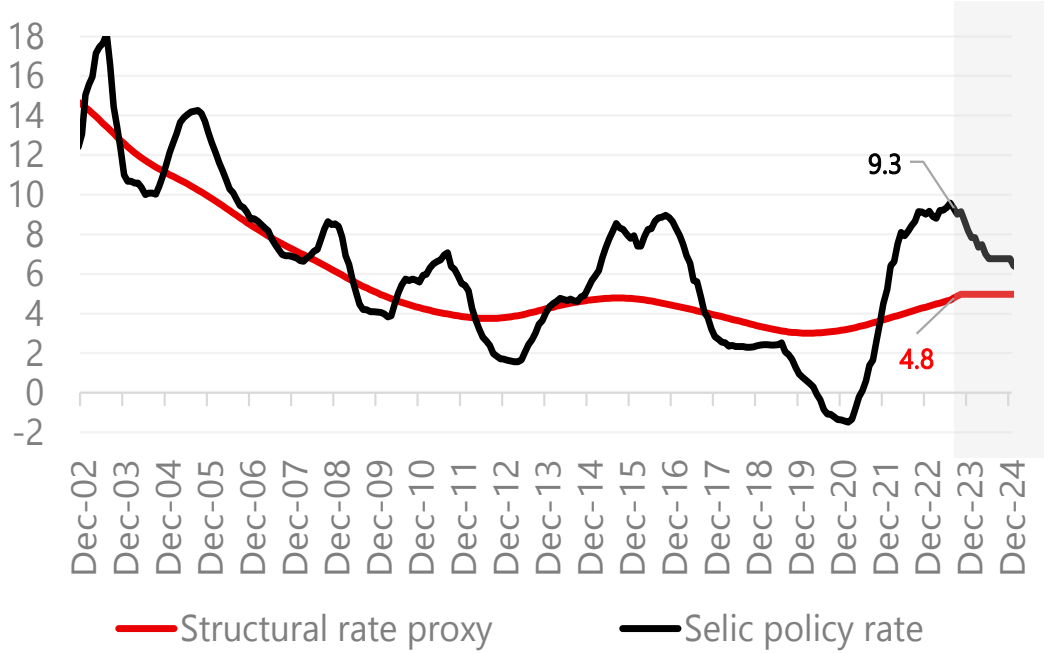
Sources: Brazilian Central Bank, Santander.

Sources: Brazilian Central Bank, Santander.

Contractionary Stance in 2023/24, Expansionary Stance in 2025/26

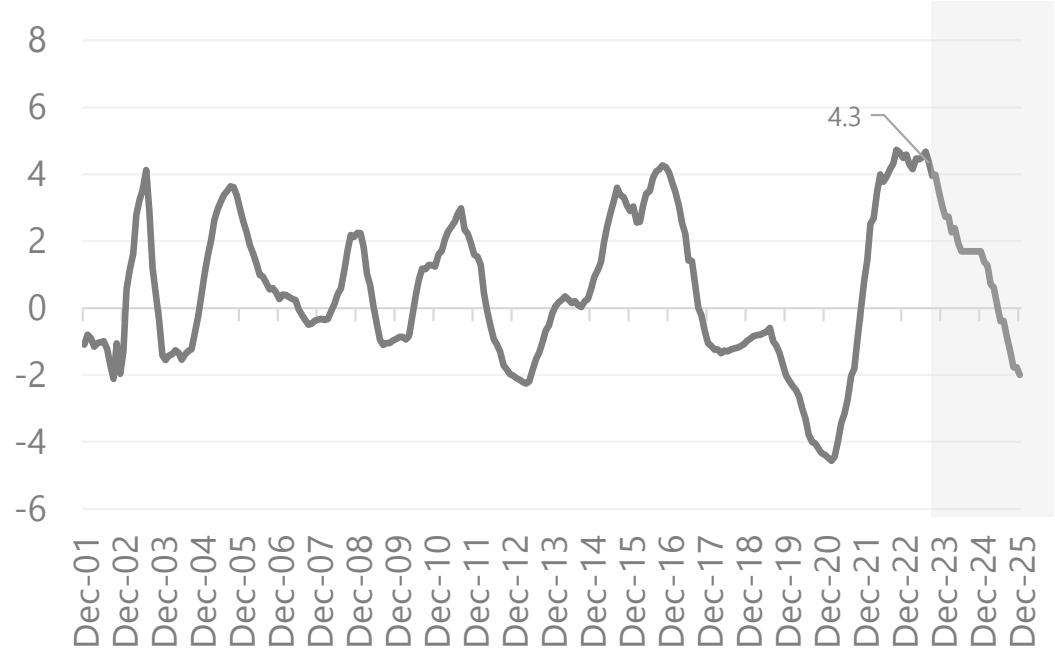
- Our forecast is in line with the BCB's communication and predicts a restrictive stance until YE2024.
- On the other hand, we forecast a turn to an expansionary stance in 2025, as growth data presents unexceptional results. Our forecast remains above the consensus for up to next year, but we recognize the risks are skewed to the downside.

Real and Neutral Rates (%)



Sources: Brazilian Central Bank, Santander.

Real Rate Gap (%)

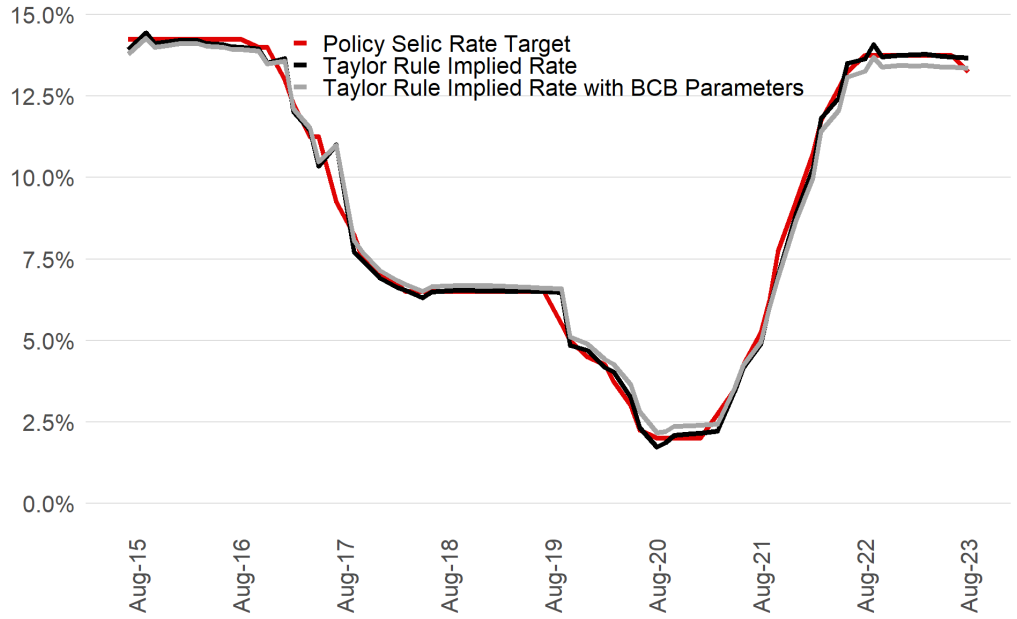


Sources: Brazilian Central Bank, Santander.

Taylor Rule Implied Rates

- The BCB Aggregate Small Scale Model from the 4Q21 Inflation Report presented the latest version of the Taylor Rule used by the BCB.
- We estimated the equation and compared the fitted results to both the actual Selic rate and the fitted values from the same equation using the BCB's results.
- On a separate exercise, we recursively estimate the natural rate from the same equation and noticed it has returned to 2012-2016 levels.

Selic Rate and its Implied Values from Taylor Rules (%)



Sources: Brazilian Central Bank, Santander.

Natural Rate Proxied form Recursive Taylor Rule (%)

Sources: Brazilian Central Bank, Santander.

MACRO SCENARIO: Forecasts

Macroeconomic Variables		Previous		Current
GDP (%)	2023E	1.9	→	1.9
	2024E	0.5	↑	1.0
	2025E	1.5	→	1.5
IPCA (%)	2023E	5.2	↓	4.9
	2024E	3.9	→	3.9
	2025E	4.5	→	4.5
Selic Rate (% end of period)	2023E	12.25	↓	11.75
	2024E	10.50	↓	10.00
	2025E	7.00	↑	7.50
FX Rate - USDBRL (end of period)	2023E	5.40	↓	5.20
	2024E	5.50	↓	5.35
	2025E	5.55	↓	5.40
Current Account Balance (% of GDP)	2023E	-2.6	↑	-2.5
	2024E	-2.9	↑	-2.7
	2025E	-2.8	↑	-2.7
Primary Fiscal Balance (% of GDP)	2023E	-1.0	→	-1.0
	2024E	-1.0	↑	-0.9
	2025E	-0.8	↑	-0.7
Gross Public Debt (% of GDP)	2023E	77.3	↓	77.0
	2024E	81.6	↓	81.1
	2025E	84.6	↓	83.9

Source: Santander. Note: The arrows denote the direction of changes since our previous scenario publication (as of June 16, 2023)

The forecasts refers to our latest Scenario Update

"Better Growth Outlook in 2024 Given a Less Contractionary Monetary Policy"
(sent on August 04, 2023)

For the full report click on the link:

https://bit.ly/Std-sceupdate-Aug23

Thank you.

Our purpose is to help people and businesses prosper.

Our culture is based on believing that everything we do should be:

Simple Personal Fair

Santander

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