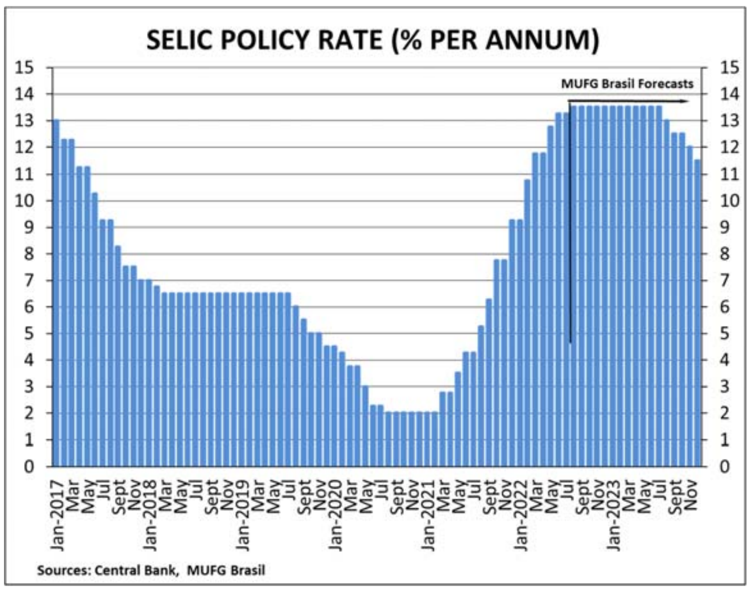
Copom

15 June 2022

Tightening cycle is not over

Central Bank views

The Central Bank (CB) decided unanimously to increase the Selic policy rate by 50bps to 13.25%, in line with market consensus.



Global scenario: the global environment has deteriorated further. Inflationary pressures are making market revise down global growth. The tighter financial conditions and the higher risk aversion are generating uncertainty and volatility, specially in EM economies;

Economic activity: the set of indicators released since the previous Copom meeting suggests a better-than-expected economic growth;

Inflation: Consumer inflation continued to surprise negatively. These surprises occurred both in the more volatile components and on the items associated with core inflation.

CB inflation model results in inflation of 8.8%, 4.0% and 2.7%, respectively for 2022, 2023 and 2024. In such reference scenario, Copom considers the Selic from the Focus survey, FX rates starting at 4.90 and moving by the Purchasing Power Parity (PPP), oil prices ending this year at USD100/barrel and energy flag at yellow by the end of 2022, 2023 and 2024.

Upward risks to inflation come from: (i) greater persistence of global inflationary pressures; and (ii) an increase in the risk premium due to the fiscal uncertainties. Factors that could lead to lower-than-expected inflation are: (i) a possible reversion, even if partial, of the increase in the price of international commodities measured in local currency; and (ii) a greater-than-projected deceleration of economic activity.

The discussion of tax exemptions or reduction on fuels, electricity and telecommunications are not included in the baseline scenario. However, if approved, the monetary authority considers it significantly reduces the current inflation, but it raises in smaller magnitude inflation in the relevant horizon.

Monetary policy: For the next meeting in August, Copom foresees as likely an extension of the cycle, with an adjustment of the same magnitude or lower. Copom stresses that the heightened uncertainty of the current scenario, the advanced stage of the current monetary policy cycle, and its impacts yet to be observed require additional caution in its action

Given its inflation projections and the risk of deanchoring the long-term expectations, it is appropriate to continue advancing in the process of monetary tightening significantly into even more restrictive territory. Copom emphasizes that it will persist in its strategy until the disinflation process consolidates and anchors expectations around its targets.

Our expectation

The Central Bank (CB) signaled another rate hike, once it needs to guide inflation expectation for this and next years, especially amid the context of greater inflated risks due to the impacts caused by the conflict between Russia and Ukraine on commodity prices, as well as the impact of covid-related lockdowns in China exacerbating supply chain disruptions. Additionally, CB needs to anchor inflation expectations once 2023 market call is getting closer to the 4.75% ceiling.

In our scenario, we still expect pressures on inflation once commodities and industrial prices tend to keep at higher levels than earlier this year. On the local side, we highlight the maintenance of high fiscal risks ahead in this electoral year also adding upward pressure on inflation scenario in the medium to long-run. In addition to that, the congress approved the ICMS tax cap on fuels, electricity and telecommunication, as well as a temporary reduction in federal taxes on fuels valid until the end of 2022. The congress is also analyzing the exemption of taxes on fuels also valid until the end of 2022.

If all approved without major changes, the overall impact would reduce inflation by around 2 percentage points. However, we consider a partial repass to prices, what means that our current call of 9.2% inflation this year would be reduced to around 8%. However, part of these measures is valid only for 2022, what means that they would increase in 2023 by a smaller amount as the ICMS tax cap would continue in place. This could bring our call for 2023 inflation from 3.5% closer to 4.5%. If we look the median of market expectation at 4.7% for 2023, the incorporation of the end of the temporary tax reduction would put inflation above the 4.75% ceiling.

Thus, monetary policy is expected to continue tight for longer in this scenario. As for the next monetary policy steps, we expect a final 25bps hike to 13.50% in August, no changing the end of cycle rate. But, the CB might keep the policy rate at its 13.50% for longer: until the end of the second half instead of end of 2022 as we previously expected. Such approach would be enough to guide inflation expectation for next years, making it converge to levels closer to the target more likely in 2024.

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