Copom

22 September 2021

100 bps hike, as expected

What happened

The Central Bank (CB) decided unanimously to increase the Selic policy rate by 100 bps to 6.25%, in line with our call and the wide majority of market.

External scenario: there are two additional risk factors to the growth of emerging economies. First, reduction in the growth forecasts for Asian economies, reflecting the path of the Covid-19 Delta variant. Second, a tightening of monetary conditions in various emerging economies, as a reaction to recent inflation surprises. However, the long-lasting monetary stimuli and the reopening of major economies still sustain a favorable environment for emerging markets.

Economic activity: robust economic recovery expected for the second half of this year.

Inflation: industrial goods price increases – due to higher input costs, supply restrictions, and redirecting of services demands towards goods – should remain a pressure in the short run. In addition, services inflation has accelerated in recent months, reflecting the gradual normalization of the sector, as expected. Finally, pressures persist in volatile items such as food and fuel prices and especially electricity fares, due to factors including the exchange rate, commodity prices, and adverse weather conditions. The energy flag is assumed to be "hydric scarcity" in December 2021 and "red level 2" in December of both 2022 and 2023.

Assuming the basic scenario that considers the Selic from the Focus survey (8.25% by the end of 2021, 8.50% during 2022, and reduction to 6.75% along 2023), and FX rates starting at 5.25 and moving by the Purchasing Power Parity (PPP), CB inflation model results in inflation of 8.5%, 3.7% and 3.2%, respectively for 2021, 2022 and 2023.

Downward bias to inflation relies on a possible reversion, even if partial, of the recent increase in the price of international commodities measured in local currency would produce a lower-than-projected inflation in the baseline scenario. And upward bias relies on further extensions of fiscal policy responses to the pandemic that increase aggregate demand and deteriorate the fiscal path. Despite the recent improvement on debt sustainability indicators, the balance of risks for inflation is tilted to the high due to the fiscal risks. And the recent deterioration of inertial components of inflation, in a moment of reopening of the service sector, could result in an additional deterioration of inflation expectations.

Monetary policy: For the next meeting in October, Copom foresees another 100 bps hike of the Selic rate. Future monetary policy steps will depend on the evolution of economic activity, on the balance of risks, and on inflation expectations and projections for the relevant horizon for monetary policy.

At this moment, the Copom's baseline scenario and balance of risk indicate as appropriate to advance the process of monetary tightening further into the restrictive territory.

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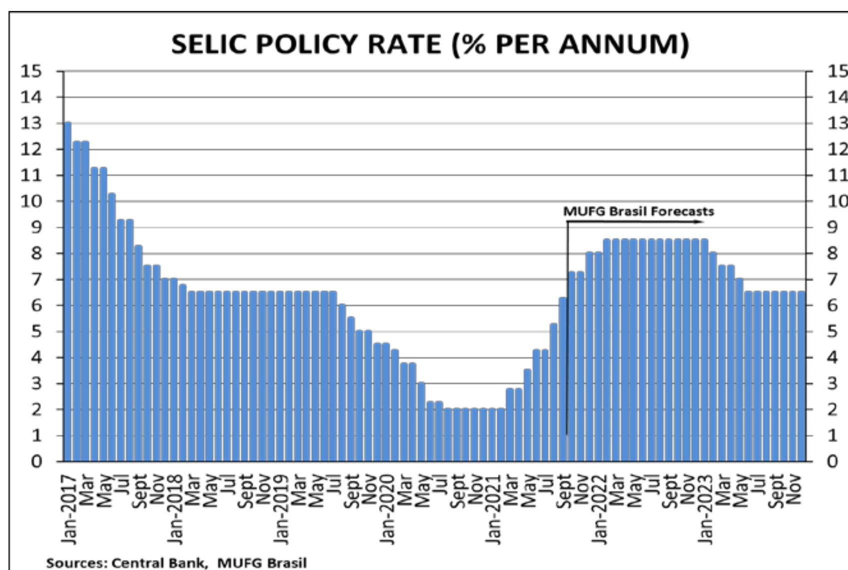

Our expectation

The Central Bank showed another hawkish message as expected. In our view, it will hike Selic rate by another 100 bps to 7.25% in the next meeting on the 27th October, followed by 75 bps in December meeting, thus ending up this year at 8.00%. And we expect a final rate hike in February 2022 reaching 8.50%.

The major concern of the Central Bank is to avoid the contamination of the current high inflation (now we expect IPCA at 8.5% for this year) to inflation expectation for next year, especially amid the scenario of reopening of the economy with potential impact of services inflation, which requires a more hawkish stance by the Central Bank. Another potential source of pressure on inflation relies on the fiscal risks, currently especially related to the discussion on the scope and financing of the new "Bolsa-Familia", as well as the court ordered payments so-called precatórios. At last but not at least, there are further sources of uncertainties to the economic scenario coming from the risk of energy rationing, and the presidential elections next year.

In such scenario, we expect Selic rate to be maintained at 8.50% for the whole 2022, and to be gradually reduced to 6.50% neutral level along 2023, and stabilize at this level from then on. Of course, such scenario assumes that the pandemic will be fully under control, no fiscal slippage, new administration taking office in 2023 committed to the reforms and FED actions to normalize the monetary policy in the US will not bring severe impact on EM economies.

CARLOS PEDROSO
Chief Economist
cpedroso@br.mufg.jp

MAURICIO NAKAHODO
Senior Economist
mnakahodo@br.mufg.jp

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Banco MUFG Brasil S.A.
Av. Paulista, 1.274
São Paulo - SP - Brazil
Ombudsman Toll-free (and DDG): 0800 770 4060
Email: ouvidoria@br.mufg.jp

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Banco MUFG Brasil S.A.
Av. Paulista, 1.274
São Paulo - SP - Brasil
Ouvidoria DDG: 0800 770 4060
Email: ouvidoria@br.mufg.jp

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