Copom Warm-up: same pace, larger budget

- *Recent indicators suggest that the outlook for inflation remains challenging. Inflationary pressures are more persistent and widespread;*
- *Lower domestic growth and higher global uncertainties may represent a disinflationary vector ahead;*
- *We estimate that the Copom's inflation forecasts will be close to the target in its baseline scenario (using the Focus survey hypotheses);*
- *We expect the Copom to hike the Selic rate by 100 bps. The statement will probably keep a hawkish tone, stressing that it will do whatever it takes to bring inflation to the target path.*

Hawk-Dove Heatmap: inflation outlook remains challenging,

Hawk-Dove Heatmap*

Variables	Jan-21	Mar-21	May-21	Jun-21	Aug-21	Sep-21	Comment
Exchange rate (Ptax)	5.3	5.6	5.4	5.1	5.2	5.3	*Leveling off*
Ex-ante real interest rate (%)	0.0	0.3	1.1	1.7	3.1	3.7	*On the rise, reflecting fiscal risk and higher inflation*
GDP 2021 Fcst (%, Focus)	3.5	3.2	3.1	4.9	5.3	5.0	*Mixed current activity data*
GDP 2022 Fcst (%, Focus)	2.5	2.4	2.3	2.2	2.1	1.6	*Sharper fall more recently*
Output gap	-2.4	-2.8	-2.4	-2.3	-2.0	-1.8	*Gradually closing*
IPCA 12m (%)	4.5	5.2	6.1	8.1	8.4	9.7	*Inflation remais high and widespread*
IGP-M 12m (%)	23.1	28.9	31.1	37.0	35.8	31.1	*Recent decline concentrated in iron ore prices*
IPCA 2022 Fcst (Focus, %)	3.5	3.5	3.6	3.8	3.8	4.1	*Rising consistently*
Debt/GDP Forecast 2021	91.0	89.8	87.0	82.2	82.2	78.6	*Short-term ok, increasing risks ahead*
FGV Uncertainty Index	137.4	136.5	119.9	122.3	119.3	119.4	*Moving sideways*
CDS 5y	168.6	199.4	192.1	159.9	176.6	180.6	*Worsening*
Treasury 10y (%)	1.1	1.6	1.7	1.6	1.3	1.4	*Global financial conditions remain favorable*
Brent US$	55.9	63.5	69.3	72.7	76.3	75.3	*Remain at high high level*
CRB CMDT Index	454.0	496.5	532.1	563.5	562.2	555.5	*Declining somewhat, from high levels*
Occupation of ICU beds	68.0	85.0	79.1	82.3	49.9	32.6	*Improving markedly. Delta is a risk*
Deaths by Covid (mm7d)	969.4	1762.1	2480.7	2000.0	987.0	532.0	*Improving markedly. Delta is a risk*
Mobility index (Google)	-28.0	-34.0	-20.0	-33.0	-10.0	-7.0	*Normalising*
Reservoirs levels (%)	21.1	32.7	34.7	32.1	26.1	27.8	*Very low level, important risk ahead*

*The shades definition takes into account the historical evolution of the indicator, and a judging component of the XP Economy team

Data released since the last Copom meeting suggest that the outlook for inflation remains challenging.

PPI numbers show that there is still cost-push inflation in the pipeline. The headline PPIs were actually negative, but deflation was concentrated in iron ore prices. Most of other items accelerated compared to previous months.

At the consumer level, the August IPCA was not only higher than expected, but its diffusion index increased, indicating that price pressures are spreading throughout the economy.

Domestic risk perception also worsened since the previous Copom meeting, as represented in our heatmap by Brazilian 5y CDS spreads. By the same token, the exchange rate interrupted its appreciation trend and is no longer a positive driver for the inflation outlook.

Still on the negative side, the level of water reservoirs remains very low, posing a risk for the expected deflation of energy prices in 2022.

A worth noting fact since the last Copom meeting was the worsening perspective for economic activity. The Focus survey forecast for the 2021 GDP growth edged down in recent weeks, interrupting a long trend of upward revisions. The expectations for 2022 GDP growth, which had been relatively stable, dropped noticeably.

In part, weaker economic activity derives from tighter monetary policy expected ahead, therefore, may become a disinflationary driver. The other end, however, is linked to the hydrological supply shock, which jeopardizes output due to cost-push inflation.

Finally, on the positive end, global liquidity conditions continue to help the Copom, with interest rates in central economies remaining very low.

BCB model: 2022 IPCA forecast close to the target

The Copom inflation model's projection for 2022 should remain at 3.5%, with a higher interest rate trajectory expected by market participants not fully offsetting the inertia from higher inflation in 2021.

The table below summarizes our attempt to mimic the Central Bank's model, detailing the contribution of each component to the final forecast.

Brazilian Central Bank: Base Scenario	2021			2022			2023		
	Previous Copom	This Copom	Impact on IPCA	Previous Copom	This Copom	Impact on IPCA	Previous Copom	This Copom	Impact on IPCA
Exchange rate	5.15	5.25	0.04	5.15	5.25	0.09	5.15	5.25	0.00
CRB**	562.5	555.9	-0.01	-	-	0.00	-	-	0.00
Interest rate Selic (year-end)*	7.00	8.25	-0.02	7.00	8.50	-0.34	6.50	6.75	-0.03
Inflation expectations*	6.79	8.35	0.88	3.81	4.10	0.16	3.25	3.25	0.00
Inertia	-	-	0.00	-	-	0.27	-	-	0.00
IPCA	**6.50**	**8.31**	**1.81**	**3.50**	**3.47**	**-0.03**	**3.25**	**3.20**	**-0.05**
Market-set price	5.33	6.92	1.19	3.13	3.46	0.25	2.80	2.73	-0.05
Monitored price	10.00	12.48	0.62	4.60	3.49	-0.28	4.60	4.60	0.00

* Focus survey - reference period September 17th 2021

** We consider the entire impact of CRB increase in 2021. For 2022 and 2023, the effect is via inertia.

Electricity prices remain uncertain. In the last Inflation Report, published on June 24, the Copom adopted the electricity tariff flag "red level 1" for 2021, 2022 and 2023 year-end. Therefore, we use this hypothesis for the forecasts in the table above.

However, due to the recent worsening of the water crisis, and the creation of the "water crisis" electricity flag, the Central Bank may change the "flag" scenario for 2022, raising it to "red level 2". This would take 2022 IPCA forecast to 3.8% as per our estimates.

Monetary policy decision and Statement: keeping the pace, "budget" signaling will come through inflation forecasts

Our call is that Copom will raise the Selic rate again by 100bps (to 6.25% from 5.25%).

The call that the tightening pace will remain the same gained momentum with a recent speech by CB president Roberto Campos, who stated that the Copom should not react to every single data released (implicitly referring to August IPCA).

In our latest monthly report (written before Campos' statement), we discuss the possibility of CB stepping up the pace, as priced in future rate markets. A higher pace could be feasible given that i) the spread of inflation may suggest a prompter action; and ii) the Selic today is still relatively far from the market consensus endpoint (between 8% and 10%).

We opted for keeping the 100-bps call, given the still uncertain economic scenario. Unfavorable inflation today is the result of excessively expansionary monetary and (mainly) fiscal policies in the past. Inflation in 2022 and 2023 will face the impacts of both monetary and fiscal policies closer to neutral level.

Moreover, risks coming from China also suggest caution.

In the statement, we believe the policy paragraphs will present minor. The wording will likely say that the current pace is adequate and that the focus lies on the total size of the adjustment to be implemented.

It will be difficult for Copom to materially express its flight plan regarding cycle length. We understand that the most the Committee can say is that interest rates will go beyond neutral - something already present in last meeting's statement.

In our view, this signaling will come through the inflation forecasts presented in the baseline scenario, with Focus Survey's interest rates path. The Focus survey predicts today the Selic at 8.50% at the end of the current tightening cycle. If this is the Copom's flight plan, the baseline IPCA forecast will be at inflation target. If the Copom understands that it will need to go further, the printed forecast will be above the target.

We believe that the Copom will opt to publish an inflation forecast close to the target, indicating that the Focus survey forecast is aligned to its flight plan.

If we are correct in our assessment, a possible wording for the final paragraphs of the statements is:

> Taking into account the baseline scenario, the balance of risks, and the broad array of available information, the Copom unanimously decided to increase the Selic rate by 1.00 p.p. to 6~~5~~.25% p.a. The Committee judges that this decision reflects its baseline scenario for prospective inflation, a higher-than-usual variance in the balance of risks, and is consistent with the convergence of inflation to its target over the relevant horizon for monetary policy, which includes 2022 and, to a lesser extent, 2023. The adjustment also reflects the Committee's perception that 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. The Committee understands that, at this moment, ~~the strategy of a quicker monetary adjustment is the most~~the current pace of monetary adjustment is appropriate to guarantee the anchoring of inflation expectations. Without compromising its fundamental objective of ensuring price stability, this decision also implies smoothing of economic fluctuations and fosters full employment.
>
> At this moment, the Copom's baseline scenario and balance of risk indicate as appropriate a tightening cycle of the policy rate to a level above the neutral.
>
> For the next meeting, the Committee foresees another adjustment of the same magnitude. The Copom emphasizes that it will do whatever it takes to bring inflation to the target path within the monetary policy relevant horizon. In this sense, the full size of monetary adjustment and its future policy steps could be adjusted to ensure the achievement of the inflation target and 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.

XP Scenario: Selic rate at 8.5% at the end of the tightening cycle

August IPCA numbers show inflation pressures are spreading throughout the economy.

The role of monetary policy, in the face of a supply shock, is to avoid secondary impacts. The spread of inflation shows that, for now, we are not out of the woods yet.

The risk of an excessively expansionary fiscal policy – and its impacts on aggregate demand and on the exchange rate – make finding our way out even harder.

Under this scenario, we see the Copom raising the Selic rate to 8.50% - 200 bps above the level considered neutral. We expect two hikes of 100 bps, followed by 1 hike of 75 bps and a final one of 50 bps.

If fiscal policy proves to be more expansionary and unsustainable than envisaged in our baseline scenario, the burden on monetary policy will be heavier.

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