

## Brazil-Copom Preview, how fast and how far?

September 20, 2021

Bottom line: According to the latest communication from governor Campos, Bacen is unlikely to react to every high frequency inflation print that comes higher than expectations and in doing so reaffirmed the policy guidance of a tightening pace of 100bp per meeting. A faster pace would have been preferable to reach neutrality sooner and from there gauge how tight policy needs to be. For now, Bacen deserves the benefit of the doubt regarding the pace. In the meantime, the latest inflation print not only was higher than expected but its composition was nasty. We saw acceleration of indices across the board and momentum picked up. All 5 definitions of core inflation accelerated, and the average of all annual core measures reached 6% in August while headline hit 9.7%. In addition to the news on inflation, developments since the last meeting have been mostly unfriendly for inflation dynamics. Inflation expectations through 2022 have increased sharply notwithstanding a good performance of the currency, and news on the fiscal outlook remain worrisome. At best, market surveys now expect convergence to the 3.25% target in 2023. The combination of a tax reform that will lose money, an increase in the size and coverage of the Auxilio Brasil coupled with clumsy attempts to find adequate permanent funding, serious concerns about obeying the fiscal responsibility law and the spending cap, and a tense political calm suggest that Bacen will end up moving above the historical average of the real ex ante policy rate of about 4%. In the charts below we see that during Dilma's impeachment the real ex-ante policy rate stood above 8% for good reason and is now at zero, exceedingly low and close to the lowest levels since at least the GFC. For Wednesday's meeting, I expect a substantial upward revision to the 2021 inflation projection to mid 7's and Selic of at least 8.25% putting the real ex-ante policy rate at about 4%, acceptable if risks were "normal" but today it looks insufficient given the impending fiscal and political risks. For those reasons I believe that a terminal rate of 9.25% in 2022 would be preferable setting the real policy rate at about 5%, nothing exceptional by historical standards. Jan 23's are already pricing 10.25%; I have seen enough in my career to challenge market wisdom. I expect governor Campos to continue to press the mantra that he will do whatever is necessary to make inflation converge to the target which in my book implies a more extended tightening cycle than market surveys show.

Chart 1

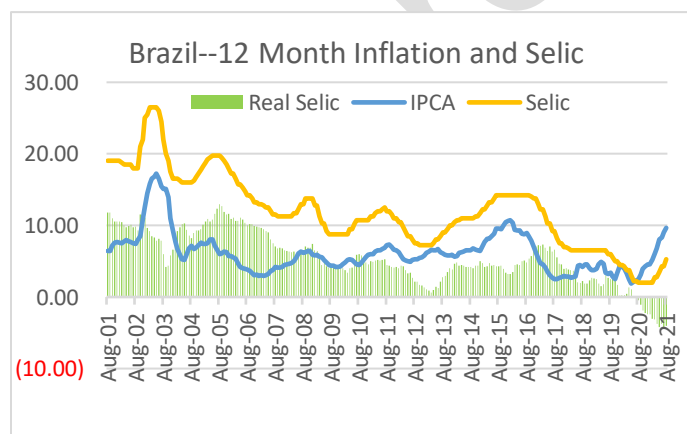
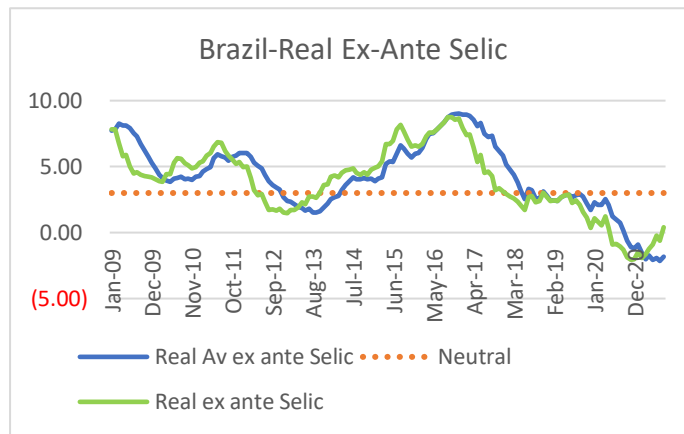


Chart 2



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