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GLOBAL ECONOMICS

LATAM DAILY

March 17, 2022

Latam Daily: Another Rate Hike by Brazil's BCB

- **Brazil: BCB delivers 100 bps hike; we are revising our terminal rate call to 13.50% based on the recent spike in commodity prices**

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BRAZIL: BCB DELIVERS 100 BPS HIKE; WE ARE REVISING OUR TERMINAL RATE CALL TO 13.50% BASED ON THE RECENT SPIKE IN COMMODITY PRICES

As was widely expected, the BCB's COPOM policy committee unanimously decided to increase the SELIC rate to 11.75% on March 16, as market expectations of inflation adjusted to recent spikes in commodity prices. All but six of the 43 economists surveyed by Bloomberg expected the BCB to hike the SELIC rate 100 bps in Wednesday's meeting. Those not anticipating a 100 bp hike, expected an increase of 125 bps or 150 bps. The IPCA inflation print for February, published on Match 11, had come in slightly above expectations at 10.54% y/y (chart 1), relative to a consensus call for 10.47% y/y. At the same time, growth has been disappointing, with the latest print (January) of the monthly economic activity index coming in at a weak 1.3% y/y.

The Brazilian economy thus looks stuck in a borderline stagflation environment, with consensus GDP estimated at 0.5% for 2022, and inflation at 7.6%. As a single-mandate inflation targeting central bank, the BCB is prioritizing inflation, hiking rates from 2.0% in March 2021 to 11.75%. Markets are now discounting a terminal rate of 13.75%.

The BCB's decision to hike 100 bps was driven by a general worsening of the inflation environment:

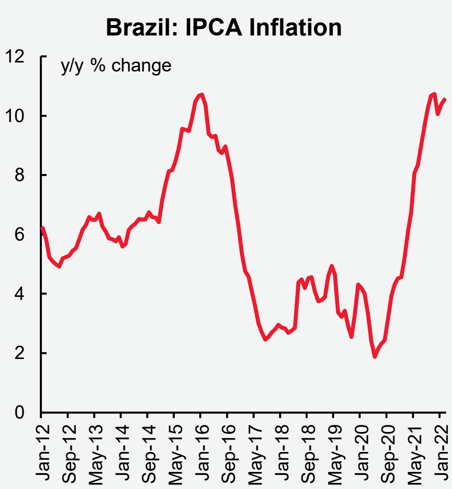
- The COPOM describes the external scenario as having deteriorated markedly, with commodity prices spiking and tightening financial conditions for emerging markets.
- On the domestic inflation front, the BCB continued to be surprised by higher-than-anticipated outcomes, with the COPOM highlighting elevated risks to its inflation outlook, including risks stemming from the oil price spike.
- The BCB's base case scenario envisions the SELIC rate climbing to 12.75% in 2022, before declining to 8.75% in 2023, while the COPOM signaled that it will likely pull the trigger on another 100 bp hike in its next meeting.

Looking at recent inflation by components, the Brazilian story has some similarities with other Latam countries, but also discrepancies:

- The main drivers of inflation since the second half of 2021 have been transportation (18.3% y/y in February), Household goods (14.4% y/y in February), housing (14.6% y/y in February), and food & beverages (9.1% y/y in February). With the Ukraine conflict spike in energy prices, it is likely that recent decline in transportation costs will be reversed in March.
- On the flip side, two components that have served as anchors for inflation have been health & personal care (3.6% y/y in February) and communications (2.9% y/y in February). In the latter case, however, recent prints have shown an upward trend, further suggesting that inflation is building self-reinforcing inertia.

Based on what is priced into financial markets, the SELIC rate is expected to increase through September 2022, reaching a peak of 13.75%, before the BCB begins to gradually cut rates in Q1-2023. However, markets discount a 12% SELIC rate by the end of 2023, which would suggest a real policy rate of 8.0% based on the consensus expected inflation at that time. This pricing is at odds with the economists' consensus (Bloomberg), which anticipates a real rate of around 4% at the end of 2023.

Chart 1



Sources: Scotiabank Economics, IBGE.

Before the start of the Ukraine conflict, and the ensuing spike in commodity prices, we called for a terminal SELIC rate of 12.25%, to be reached in Q3-2022. However, the spike in commodity prices is likely to further pressure inflation higher, and risks contaminating the price formation mechanism, which in our view will push the BCB to tighten rates further. Consensus and Scotiabank anticipate that inflation will remain above target over a two-year policy horizon, meaning that policy setting will likely have to remain tight for some time to bring inflation back in check. Accordingly, we have raised our forecast of the SELIC rate, resulting in larger hikes in the near-term meetings to the following path (table 1).

Table 1: Brazil—Economic and Financial Forecasts

	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
Selic rate (%)	11.75	13.50	13.50	13.00	12.50	12.00	11.50	11.00
IPCA inflation (%)	11.27	10.31	9.23	8.10	6.32	5.01	4.36	3.44
Unemployment (%)	11.3	11.1	11.0	10.8	10.8	10.7	10.6	10.3
Real GDP (%)	1.3	-0.1	1.3	1.6	2.2	2.4	2.7	2.5
USDBRL	4.98	5.04	4.92	4.72	4.68	4.55	4.58	4.68

Source: Scotiabank Economics.

—Eduardo Suárez