International Commentary — March 22, 2023

Brazilian Central Bank Preview - March 2023

Summary

Brazilian Central Bank (BCB) meetings have not yielded many surprises lately; however, with stresses in the global banking sector now present and an economy showing signs of a sharper slowdown, the BCB March 22 meeting may be noteworthy. While we believe BCB policymakers will keep rates on hold and maintain hawkish forward guidance in March, risks are now tilted toward the central bank signaling an easing cycle that could start earlier than we expect and be more pronounced than we forecast. Should this risk scenario materialize, we would maintain our constructive Brazilian real outlook; however, real strength could be more gradual as interest rate differentials may not be as supportive of the currency.

Economist(s)

Brendan McKenna
International Economist | Wells Fargo Economics
Brendan.McKenna@wellsfargo.com | 212-214-5637

March BCB Meeting May Be Interesting

Since August 2022, Brazilian Central Bank (BCB) policymakers have held the Selic rate steady at 13.75%. For the most part, monetary policy statements since last August have communicated a consistent message. Elevated interest rates are set to be in place for an extended period of time to ensure inflation consolidates toward the target range. In addition, BCB policymakers have regularly stated in official communications that risks have been tilted toward restarting the tightening cycle should fiscal policy decisions result in renewed inflationary pressures. We felt this stance and communication would be in place for the next few meetings. But given the challenges in the global banking sector combined with a Brazilian economy on the brink of recession and persistent attempts from the Lula administration to convince BCB policymakers to start lowering interest rates, the outlook for BCB monetary policy has become cloudier. New uncertainties and challenges, in our view, mean the March 22 Monetary Policy Committee (Copom) meeting may need more attention and could garner a reaction in financial markets.

As far as our forecast profile for the BCB, we believe policymakers will keep policy rates steady at 13.75% at the March 22 meeting. With inflation still above the upper bound of the BCB target range and the real experiencing depreciation pressure over the course of the latest risk-off episode, rationale to keep monetary policy settings restrictive and unchanged remains in place for March. In our view, we also believe forward guidance will remain the same—BCB policymakers will continue to suggest restarting the tightening cycle if conditions warrant higher rates. However, we now believe risks are tilted toward less hawkish language given challenges in the global financial system as well as a local economy that appears likely to enter a sharper recession in early 2023. Right now, we believe the BCB will initiate an easing cycle in Q3-2023, in line with broader consensus forecasts. Should the BCB indeed communicate a less hawkish outlook on policy at the March 22 meeting, we would likely pull forward the timing of Selic rate cuts to Q2-2023 and incorporate more easing into our overall BCB policy rate forecast. Financial markets are not fully priced for easing to begin in Q2, so a less hawkish stance could result in modest BRL downside in the immediate aftermath of the meeting.

For now, we believe this year's easing cycle will be more gradual than prior easing cycles. Inflation is likely to remain sticky, especially as the Lula administration begins to lift tax exemptions on energy purchases in the coming months, while an extension of fiscal support may not have fully worked its way through the real economy just yet. With this in mind, we believe BCB policymakers will lower the Selic rate in 25 bps clips as opposed to the 50 bps cuts they have typically moved in during previous easing cycles. To that point, we believe the Selic rate will end this year at 12.75%, which is higher than financial market pricing. This more gradual pace of easing relative to market pricing is a key input into our long-term view that the Brazilian real can outperform compared to the rest of the emerging market currency complex. Combined with broad-based U.S. dollar depreciation along with an assumption for fiscal discipline from the Lula administration, we believe the USD/BRL exchange rate can break below BRL5.00 by the end of this year. Should we pull forward the timing of our BCB rate cut forecast and potentially incorporate more easing, we would still maintain our constructive Brazilian real outlook. However, in this scenario, we would likely scale back the overall amount of forecasted BRL strength as interest rate differentials may not be as supportive for the Brazilian currency over the longer term.

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Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Senior Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Senior Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Seery	Economist	332-204-0693	Shannon.Seery@wellsfargo.com
Nicole Cervi	Economic Analyst	704-410-3059	Nicole.Cervi@wellsfargo.com
Jessica Guo	Economic Analyst	212-214-1063	Jessica.Guo@wellsfargo.com
Karl Vesely	Economic Analyst	704-410-2911	Karl.Vesely@wellsfargo.com
Patrick Barley	Economic Analyst	704-410-1232	Patrick.Barley@wellsfargo.com
Jeremiah Kohl	Economic Analyst	704-410-1437	Jeremiah.J.Kohl@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

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