Monetary policy clout and Selic rate adjustment cycles

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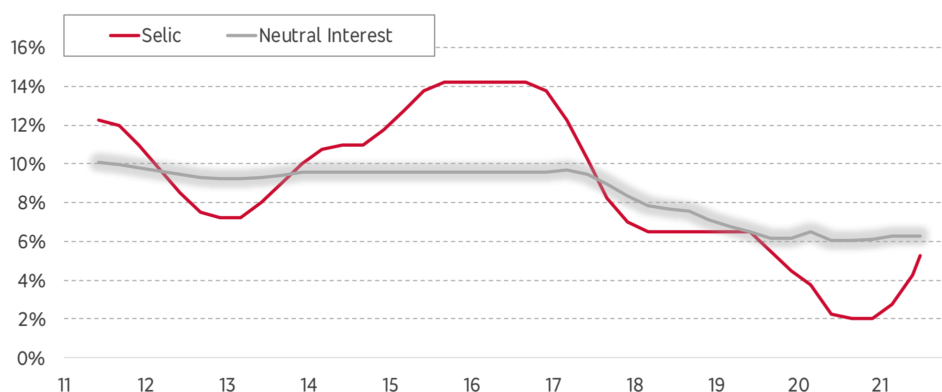
Several reasons suggest a decrease in neutral interest rates and a buildup in monetary policy strength in Brazil in recent years. Some of these reasons include: (1) the end of three decades of fiscal expansions above inflation, following the implementation of the spending cap; (2) changes to the TJLP calculation rule; (3) expansion of banking loans and capital market; (4) lower para-fiscal spending; and (5) contained expansion of public banks.

Besides these factors, certain conditions set the current interest rate hike cycle apart from those seen in the past, particularly the one in 2014. Among these conditions, we highlight: (1) a significantly lower deviation of expectations from the inflation target; (2) real wages and unemployment with diametrically opposed behavior to those seen in previous periods; (3) unique service inflation dynamics; and (4) absence of a lag in most regulated prices.

The economy has experienced monetary stimulus since 2017 (i.e. with the Selic rate below what would be the neutral level). Such stimulus was far greater with the outbreak of the pandemic in 2020, and started being removed in March this year. In its latest decision, the Monetary Policy Committee (Copom) clearly stated that it is "appropriate to have an interest rate increase cycle to a level above neutral", which we estimate to be around 6.5% and 7%[1]. In other words, the Central Bank believes that current economic conditions already warrant some monetary tightening, in order to contain the spread of inflationary pressures.

Chart 1: Selic rate and neutral interest



Source: BCB, Bradesco

In the last monetary tightening cycle, the Selic rate surpassed the neutral level after 8 months of the beginning of the process and maintained a restrictive level for 45 months. The current scenario seems to be quite different than other tightening cycles, particularly the one in 2014, which is why we do not foresee an excessively restrictive Selic tightening trend. On the "unfavorable" side of the current cycle, the IPCA accumulated in the last 12 months reached 8.7% – 5 p.p. above the center of the target. In the beginning of the last cycle, inflation was 2.1 p.p. above the cap, and reached 1.3 p.p. when the Selic rate reached 10% and surpassed the neutral rate. In the maximum point, in July 2015, this delta between current inflation and the target stood at 5.1 p.p.

[1]The estimated neutral rate is 3% in real terms. For the nominal rate, we used the inflation expectation one year ahead.

Table 1: Comparison of monetary tightening cycles – inflation

	Date	Selic	IPCA	IPCA ex0	Services	Industrial	Adm	Alim dom	Focus t+1	IPCA - target	Ex0 - target	Focus t+1 - target	IC-Br 12m	Real exch. rate	Real exch. rate 12 months %
Cycle start	mar-13	7.25%	6.6%	6.5%	8.4%	4.1%	1.6%	15.2%	5.7%	2.1%	2.0%	1.2%	7.2%	2.87	13.6%
Exceeds neutral	nov-13	10.00%	5.8%	7.1%	8.5%	5.3%	0.9%	8.1%	5.9%	1.3%	2.6%	1.4%	5.1%	3.16	5.1%
Max. Point	abr-14	11.00%	6.3%	7.3%	9.0%	5.1%	3.8%	6.0%	6.0%	1.8%	2.8%	1.5%	6.5%	3.20	7.4%
Cycle restart	out-14	11.25%	6.6%	7.0%	8.5%	5.1%	5.6%	6.3%	6.3%	2.1%	2.5%	1.8%	8.0%	3.17	5.2%
Max. Point	jul-15	14.25%	9.6%	6.9%	8.6%	4.6%	16.0%	10.5%	5.4%	5.1%	2.4%	0.9%	9.3%	3.80	10.6%
Cycle start	mar-21	2.75%	6.1%	3.1%	2.0%	5.9%	7.7%	17.6%	3.5%	2.3%	-0.6%	0.0%	32.8%	5.49	25.1%
Current	jul-21	5.25%	8.7%	5.4%	3.2%	9.6%	13.6%	15.7%	3.8%	5.0%	1.7%	0.3%	45.0%	5.19	13.3%

*results accumulated in 12 months ended on the exposed date or immediately preceding effective results.
** real bilateral exchange rate
Source: BCB, IBGE, Bradesco

However, there is an important difference in this comparison. In 2013, core prices persistently stayed above the center of the target until 2015, 2.5 p.p. on average. The composition of this core was also different, with a strong influence from services in the previous cycle (around 8.5% to 9% throughout the entire period). Service inflation was the main concern at the time, precisely because of their more historically inertial nature. The job market was quite heated, with the unemployment rate around 7% and real income growing approximately 3.5% per annum.

At this point, service inflation remains low, at 3.2%, with the unemployment rate at 14% and real income at -4.5%. Although some services show unusually low variations – since activities were unable to operate normally – the expected price recomposition as the economy reopens should be limited by the job market's dynamics. Although the economic policy has been shown to be expansionary coming out of the pandemic, as we will discuss further ahead, both the monetary and fiscal policies are being reversed in their intensity.

In the case of industrial goods, despite currently high levels, the nature of inflation seems to be different. In addition to the previously mentioned difference in the job market, industrial goods are also strongly influenced by the upsurge in commodity prices, exchange rate depreciation, and the concentration of demand for goods during the pandemic. Recent inflation readings breakdown are not enough to reject the hypothesis that the acceleration is related to shocks and the economic reopening process. Exchange rate and commodity shocks were significantly stronger this cycle.

In 2014, other issues started to sway inflation, with the end of damming of regulated items. This process made it even more difficult for inflation to converge towards the target. In the current cycle, with very few exceptions, regulated prices are near their "fair" values, not posing any relevant risk (asymmetry) moving forward.

Growth conditions were also very different in the last cycle, when the GDP grew more than 2.5% and we were undeniably above the potential. There were many signs pointing to a lack of idleness, such as low unemployment rate, real income with persistent gains, high current account deficit and, of course, rising inflation – especially due to service demand. We estimate that the GDP gap was positive virtually throughout the entire period, with growth yielding only in 2015, after a long period of interest rate above the neutral level. The current growth scenario is quite different: the GDP only started growing against in the first quarter of the year, returning to its pre-pandemic level, keeping the gap open, despite differences in idleness between sectors. Idleness signs are compatible with results in the current account and the job market, currently[2].

[2]The same applies to the new hire wages registered by CAGED, which shows more favorable hiring dynamics.

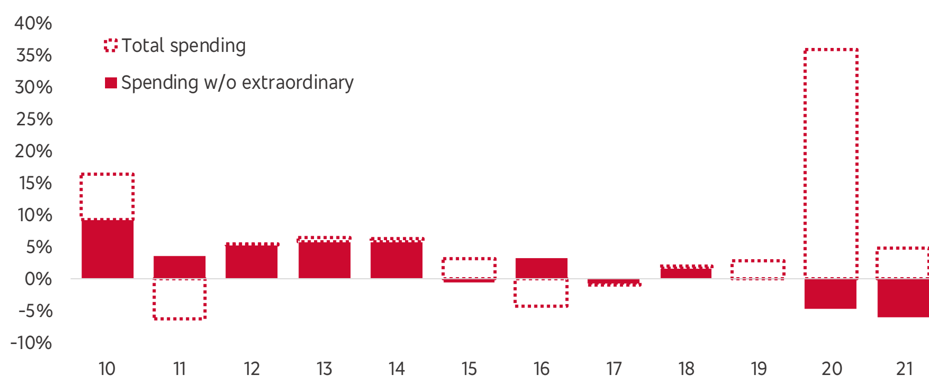
Table 2: Comparison of monetary tightening cycles – economic activity and fiscal accounts

	Date	Selic	Unemployment rate	Real income	GDP	Gap	Primary balance	Real spending %	DBGG	C/A GDP
Cycle start	mar-13	7.25%	7.5%	2.3%	2.6%	0.7%	1.4%	5.2%	54.0%	-3.3%
Exceeds neutral	nov-13	10.00%	6.9%	4.4%	3.1%	1.8%	1.6%	5.0%	52.9%	-3.3%
Max. Point	abr-14	11.00%	6.7%	3.3%	2.9%	2.5%	1.4%	4.3%	51.9%	-3.4%
Cycle restart	out-14	11.25%	6.9%	1.5%	1.2%	1.2%	0.4%	4.8%	54.8%	-4.0%
Max. Point	jul-15	14.25%	8.4%	-1.0%	-1.3%	-1.0%	-0.8%	4.2%	61.0%	-4.3%
Cycle start	mar-21	2.75%	14.3%	0.1%	-3.5%	-2.4%	-9.5%	-4.8%	88.7%	-1.6%
Current	jul-21	5.25%	14.0%	-4.5%			-4.7%	-6.0%	84.7%	-1.3%

*results accumulated in 12 months ended on the exposed date or immediately preceding effective results.
** real expense excluding extraordinary expenses
Source: BCB, IBGE, Bradesco

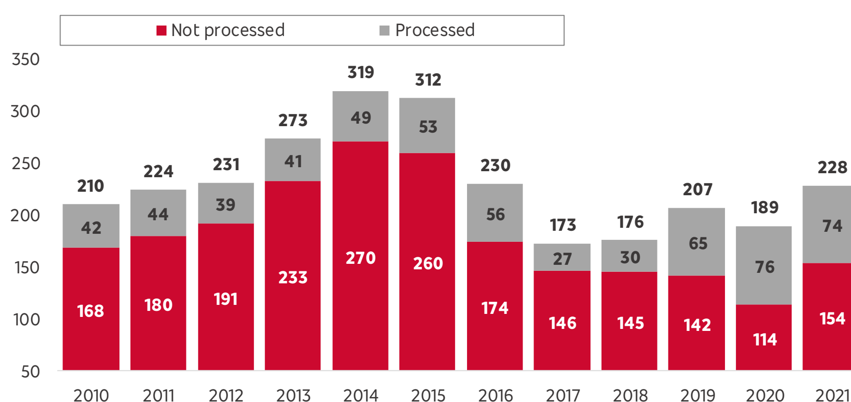
Apart from the conjuncture differences between the cycles, there is a major difference in the fiscal policy. In the cycle that began in 2013, the fiscal policy was expansionary throughout the entire period, including with multiple parafiscal instruments widely used. The primary result showed surpluses until 2015, but with multiple stimulus measures applied beyond the federal budget and increased accrued liabilities. Nonetheless, primary spending grew by 5.7% in 2013 and 2014, already discounting the effect of inflation.

Chart 2: Annual variation of primary spending
Total and excluding extraordinary expenses, in real terms



Source: STN, Bradesco

Chart 3: Accrued liabilities – constant billions of BRL



Source: STN, Bradesco

Therefore, at that time, while the fiscal policy stimulated growth, the monetary policy attempted to contain inflation. With different economic policy goals, interest rates had to climb higher to deflate the economy. Today's fiscal scenario is more complex in terms of indebtedness, but, for now, less expansionary in flow and fiscal impulse. The most important measure to regulate the fiscal policy was the spending cap, which led to a strong control over primary spending and approval of the social security reform. Even during the war against the pandemic, we saw regular primary spending[3] dropping in real terms. Extraordinary expenses with the pandemic surely contributed to support demand and put pressure on prices, but they are currently on an important deceleration trend.

This commitment with fiscal control is, in our view, crucial for the interest rate cycle. These advances are what led to the drop in neutral interest rate and the inflation target. Therefore, the fiscal framework is now working in the same direction of the monetary policy, limiting the expected Selic rate hike. Changes to such framework, as recognized by the Central Bank itself, could significantly change this prognosis.

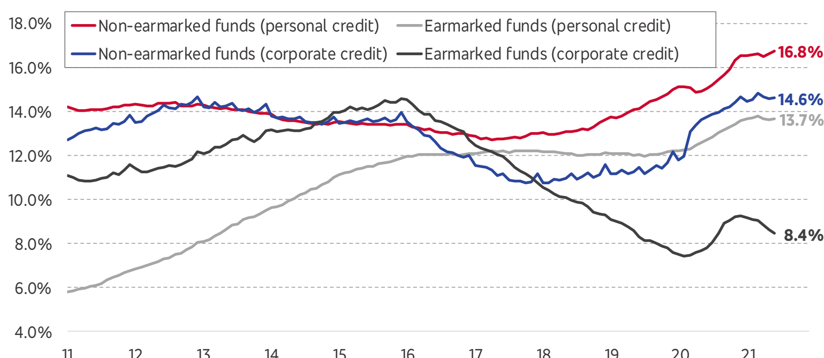
Another important difference between the cycles is the greater clout of the monetary policy in recent years[4]. Changes in the credit market explain such growth, with greater participation in non-earmarked loans and development of the capital market. Interest rates in non-earmarked loans are able to keep up with Selic movements quicker, as an important driver of monetary policy transmission. Also in this case, the change of fiscal and parafiscal policy was important, with lower volumes of funds granted via public banks, with subsidized interests below the Selic rate, misaligned with the monetary policy, at the time. In the current cycle, the *ex-ante* real interest rate is the most important to measure the impact on economic activity – which already grew by 400 b.p., leaping from -1.0% to +3.0% recently, similarly to the rate that led to the interest rate cut preceding the pandemic.

Table 3: Sensitivity of interest rates of concessions compared to the Selic rate.

	Non-earmarked funds		Earmarked funds	
	Individuals	Corporations	Individuals	Corporations
Adjustment speed	-0.10	-0.16	-0.19	-0.12
Short-term Ef.	2.78	1.26	0.42	0.70
Long-term Ef.	0.98	0.70	0.29	-0,1[a]

[a] statistically non-significant
Source: STN, Bradesco

Chart 4: Total loans, breakdown – % of GDP



Source: STN, Bradesco

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[3] Therefore, excluding temporary expenses, such as the Emergency Aid, since these programs will not be renewed for the coming years.
[4] As presented by the Central Bank in the RTI of Mar/20, "Power of the Monetary Policy".

Chart 5: Real interest rate
Swap-pre interest rates, deflated by IPCA expectation

Source: Bloomberg, Bradesco

Therefore, several elements of the current cycle suggest that we are not facing a significant monetary retraction cycle. Inflation is high, following a combination of several shocks, not yet dissipated, as the economic reopening starts to gain momentum. Indications of the conventional lack of idleness indicate that growth remains below its potential, with some sectoral bottlenecks, but with extensive idleness in the job market. And, mainly, the economic policy (monetary and fiscal) is in reversal, especially if fiscal rules are followed, aligned to the goal of limiting the spread of inflationary pressures.

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