March 17, 2025

Copom Cockpit: the FX helps, but it doesn't do the full job

- The Copom will meet again on March 18 and 19. We expect a Selic rate hike to 14.25% per year, in a unanimous vote, delivering the second of two additional 100-bp moves that were signaled at the end of last year.
- Compared to the forecasts presented at the January meeting, the committee's inflation estimates in the reference scenario (which includes the exchange rate evolving according to the purchasing power parity and the interest rate according to the Focus survey) will likely decrease to 5.0% from 5.2% for 2025 and to 3.9% from 4.0% in the relevant horizon (3Q26).
- This meeting will take place amid discussions about potential inflection points that may have relevant implications for price dynamics and the balance of risks for inflation, and which concern precisely the factors that the committee stated it would monitor going forward: economic activity, exchange rate (and the pass-through to prices) and inflation expectations.
- We expect the Copom to continue to describe an upwardly asymmetric balance of risks for inflation (with some likelihood, however, that they will adjust the description of external risks). Against this backdrop, we expect authorities to signal at least one further adjustment, albeit of a smaller magnitude, at the May meeting.
- The pace of deterioration in inflation expectations shows marginal and erratic signs of deceleration, and the appreciation of the currency since the turn of the year reduces upside risks ahead. However, given the large gap between inflation and expectations in relation to the target and the mixed signals from economic activity, leaving the door open to the end of the adjustment cycle in Copom's communication would imply taking too much inflation risk. Such a change in stance, given the set of information available today, would probably be perceived as motivated by the concern to defend economic activity, to the detriment of inflation control, which is inconsistent with the mandate determined by the inflation targeting regime.

1 – Inflation projections

The tables below summarize the projections based on our model, which seeks to replicate the BCB's small-scale model, and the changes in the Focus survey since the committee's last meeting. The exchange rate used (at BRL 5.80/USD) considers the BCB's procedure of using the average of the last 10 business days.

Compared to the presented at the January meeting, the committee's inflation projections in the baseline scenario (which includes an exchange rate following purchasing power parity and an interest rate according to the Focus survey) will likely decrease to 5.0% for 2025 (from 5.2%) and to 3.9% in the relevant horizon (3Q26, from 4.0%).

Since the last Copom meeting, inflation expectations reported by the Focus survey have risen to 5.66% in 2025 (from 5.50%) and to 4.48% in 2026 (from 4.22%). For the Selic rate, projections remained at 15.0% for 2025 and 12.50% for 2026.

IPCA forecasts (%) according to "Central Bank model"*						
Period	July Meeting	September Meeting	November Meeting	December Meeting	January Meeting	March Meeting (forecast)
2025	3.6%	3.7%	3.9%	4.5%	5.2%	5.0%
Relevant horizon	3.4% (1Q26)	3.5% (1Q26)	3.6% (2Q26)	4.0% (2Q26)	4.0% (3Q26)	3.9% (3Q26)
Exogenous variables						
Exchange Rate (R$/US$)	5.55	5.60	5.75	6.00	6.00	5.80
Selic Interest Rate (%) 2025	9.50%	10.50%	11.25%	13.50%	15.00%	15.00%
Selic Interest Rate (%) 2026	9.00%	9.50%	9.50%	11.00%	12.50%	12.50%
Inflation Expectations (Focus) 2025	3.96%	3.95%	4.00%	4.59%	5.50%	5.66%
Inflation Expectations (Focus) 2026	3.60%	3.61%	3.60%	4.00%	4.22%	4.48%

Source: Bloomberg, Central Bank of Brazil, Itaú.
* Model developed by Itaú replicating Copom's model.

Focus forecasts *(%, year-end)*						
	2025		2026		2027	
	Previous Copom	Current*	Previous Copom	Current*	Previous Copom	Current*
IPCA	5.50	5.66	4.22	4.48	3.90	4.00
GDP growth	2.06	1.99	1.72	1.60	1.96	2.00
Selic rate	15.00	15.00	12.50	12.50	10.38	10.50
Exchange rate (BRL/USD)	6.00	5.98	6.00	6.00	5.93	5.90

*considering the latest Focus report.

Source: BCB, Itaú.

2 – Evolution of asset prices

Since the last Copom meeting and until the publication of this report, the exchange rate appreciated to BRL 5.71/USD, after registering intense volatility in the previous months. The perception of country risk measured by the 5-year CDS fell 3 bps, to 176 bps. The rate on the 10-year US Treasury note fell to 4.30% (compared to 4.53%), while the price of Brent crude oil fell to 71 USD per barrel (compared to 77 at the previous meeting), amid greater uncertainty about global demand and greater expectations of supply of the commodity by the main producers, including the US and OPEC members.

Asset prices		
	Previous Copom	Current*
UST 10Y	4.53	4.30
Oil price (Brent)	77	71
Agricultural commodities**	667	645
CRB RIND Index***	548	572
CDS 5Y	179	176
Exchange rate (BRL/USD)	5.87	5.71

*considering closing prices on the eve of publication of the report.
**geometric average of soy, corn and wheat prices, in US dollars.
***Commodity Research Bureau Index of Industrial Raw Materials.

Source: CRB, BBG, Itaú.

3 – Data evolution

The table below shows the set of indicators released between the last Copom meeting and the next one. On the economic activity side, the main release was the 4Q24 GDP, which increased 0.2% q/q (3.6% y/y), indicating a growth of 3.4% in 2024. However, this result was below our estimate and the median of market expectations (both at 0.4% q/q and 4.0% y/y). On the labor market side, the unemployment rate for January was 6.5% (slightly below the consensus of 6.6%), while job creation delivered a upside surprise of 137 thousand jobs (compared with an expectation of 71 thousand).

For inflation, the most recent data was the IPCA for February, which recorded an increase of 1.31%, in line with the median of market expectations, but below our forecast (1.36%). The index recorded a significant acceleration in the month, largely due to the end of the Itaipu bonus on electricity prices. Additionally, even though the qualitative result was slightly better than expected, underlying services remain under pressure (7.8% in the MM3M SAAR, stable compared with January), suggesting the need for additional restrictions through monetary policy.

Economic Indicators: Result vs. Consensus

Release Date	Indicator	Result	Consensus
30-Jan-24	IGP-M (Jan/24) - MoM	0.3%	0.2%
30-Jan-24	Formal job creation (Dec/24) - Thousands	-535	-405
31-Jan-24	Primary fiscal result (Dec/24) - BRL bn	15.7	10.4
31-Jan-24	Unemployment rate (Dec/24)	6.20%	6.10%
5-Feb-24	Industrial production (Dec/24) - MoM	-0.30%	-1.10%
11-Feb-24	IPCA (Jan/24) - MoM	0.16%	0.17%
12-Feb-24	IBGE Services Sector Volume (Dec/24) - MoM	-0.50%	0.20%
13-Feb-24	Core Retail Sales (Dec/24) - MoM	-0.1%	0.0%
17-Feb-24	IBC-Br (Dec/24) - MoM	-0.7%	-0.4%
25-Feb-24	IPCA-15 (Feb/24) - MoM	1.23%	1.36%
26-Feb-24	Formal job creation (Jan/24) - Thousands	137	71
27-Feb-24	IGP-M (Fev/24) - MoM	1.06%	1.03%
27-Feb-24	Unemployment rate (Jan/24)	6.5%	6.6%
7-Mar-24	GDP (4Q24) - QoQ	0.2%	0.4%
11-Mar-24	Industrial production (Jan/24) - MoM	0.0%	0.4%
12-Mar-24	IPCA (Feb/24) - MoM	1.3%	1.3%
13-Mar-24	IBGE Services Sector Volume (Jan/24) - MoM	-0.2%	-0.1%
14-Mar-24	Primary fiscal result (Jan/24) - BRL bn	104.1	104
14-Mar-24	Core Retail Sales (Jan/24) - MoM	-0.1%	-0.1%
17-Mar-24	IBC-Br (Jan/24) - MoM	0.9%	0.30%

Data in red suggest more hawkish results for monetary policy (higher inflation or stronger activity than expected) and data in blue suggest more dovish results.

Source: IBGE, Brazilian Central Bank and Bloomberg

4 – Evolution of Communication and Copometer

At its last monetary policy meeting, Copom unanimously decided to maintain the pace of monetary tightening, delivering another 100-bp increase (the same magnitude as the previous meeting), raising the Selic rate to 13.25% p.a., as widely expected by the market.

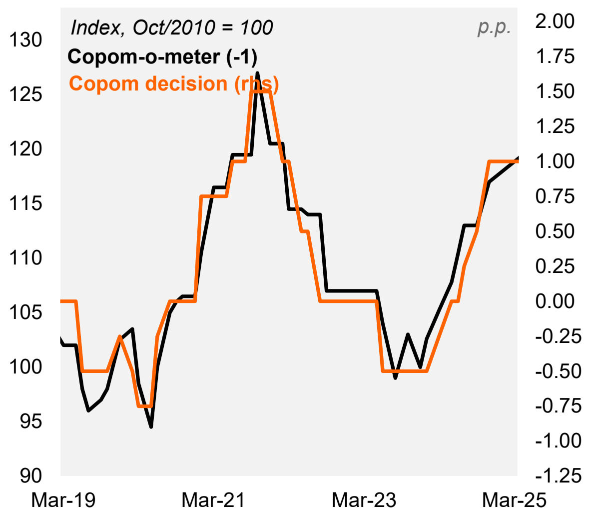
The statement and the minutes indicated that this was the second of three consecutive 100-bp hikes, which brings the Selic rate to 14.25% per year, in a more adverse scenario for inflation. The minutes, however, presented a more hawkish tone than the statement, highlighting concerns about the deterioration of inflation expectations and indicating that the committee is monitoring economic activity and paying attention to signs of a sharper slowdown, which differs from the baseline scenario (both ours and Copom's). The possibility of an increase in the neutral interest rate was also highlighted, driven by an even more expansionary fiscal and parafiscal policy. Although the overall tone of the minutes is harsher, the text indicates that the committee will monitor the evolution of economic activity, the exchange rate pass-through, and expectations. We believe that this might indicate an order of priority by the BCB, something that can be confirmed, or denied, with the next steps of monetary policy.

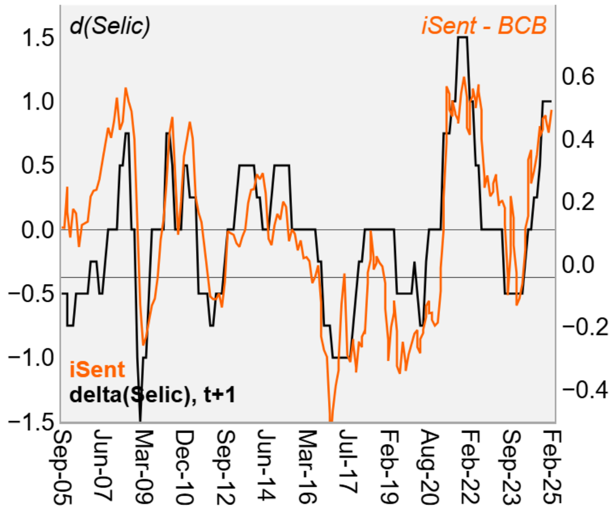
In an attempt to anticipate Copom's decisions, we used the *Copometer*, an index that measures the degree of restriction or expansion implicit in the Central Bank's communication. Applying the methodology, which is based on scores attributed to the committee's relevant communications, we see it as consistent with a 100-bp hike.

In addition to the *Copometer*, our data science team developed iSent, Itaú's Central Bank Sentiment Classifier, based on GPT-4, by using sentences published in official documents from central banks labeled by our economists. Our labeled dataset consists of approximately a thousand sentences from official documents of the Central Bank of Brazil. Each was classified as dovish, neutral, hawkish, or out of context, and the index is built based on the relative presence of each class within the document. The index is represented as a value between -1 and 1 and is higher when the perceived tone is more hawkish.

The iSent-BCB has a good adherence to current and future interest rate changes in Brazil (correlation of around 0.8). A visual analysis confirms a good adherence of the index to the Selic rate variation one meeting ahead. In fact, the index has accurately captured most of the changes in the last 18 years, mainly the hike cycles in the late 2000s and early 2020s. For the next meeting, it suggests that the recent communication is consistent with a 100-bp interest rate hike.

Copômetro Itaú Unibanco e Classificador do Itaú iSent





5 – Our vision

The Copom will meet again on March 18 and 19. We expect a Selic rate hike to 14.25% per year, in a unanimous vote, delivering the second of two additional 100-bp moves that were signaled at the end of last year. This meeting will take place amid discussions about potential inflection points that may have relevant implications for price dynamics and the balance of risks for inflation, and which concern precisely the factors that the committee stated it would monitor going forward: economic activity, exchange rate (and the pass-through to prices) and inflation expectations.

Starting with the factor that had a more favorable evolution, the global weakening of the dollar contributed to bringing the exchange rate of the real from R$6.00/USD at the last meeting to an average of 5.80 over the past 10 days. We believe this movement reflects, in a more lasting way, the perception that uncertainty surrounding U.S. economic policy will result in weaker growth in that country. Consequently, we have revised our exchange rate projection for the end of 2025, from 5.90 to 5.75 reais per dollar (see more details in our updates on the global and domestic outlook).

Regarding economic activity, fourth-quarter data (including GDP) showed a sharper slowdown than expected. These releases, along with recent communications, had a significant impact on market pricing for upcoming interest rate moves. However, we understand that the economic slowdown is consistent with the gradual deceleration scenario that the committee not only anticipates but also considers necessary for inflation to converge to target. By the way, our high-frequency data indicate better activity at the start of 2025 than at the turn of the year. Additionally, prospects for the harvest, combined with an increase in the real minimum wage, point to a still-resilient GDP in the first quarter. Given these factors, the committee is likely to maintain a cautious approach regarding the possibility that an economic inflection point is underway.

Finally, on the inflation expectations front, after consecutive rounds of deterioration, the Focus survey is showing incipient signs of stabilization. Despite an improvement in dynamics compared to the recent past, a significant degree of de-anchoring remains.

We expect Copom to continue describing an upwardly asymmetric balance of risks for inflation (with some likelihood, however, that they will adjust the description of external risks). Against this backdrop, we expect authorities to signal at least one further adjustment, albeit of a smaller magnitude, at the May meeting.

The pace of deterioration in inflation expectations shows marginal and erratic signs of deceleration, and the appreciation of the currency since the turn of the year reduces upside risks ahead. However, given the large gap between inflation and expectations in relation to the target and the mixed signals from economic activity, leaving the door open to the end of the adjustment cycle in Copom's communication would imply taking too much inflation risk. Such a change in stance, given the set of information available today, would probably be perceived as motivated by the concern to defend economic activity, to the detriment of inflation control, which is inconsistent with the mandate determined by the inflation targeting regime.

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