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The Inflationary Peak

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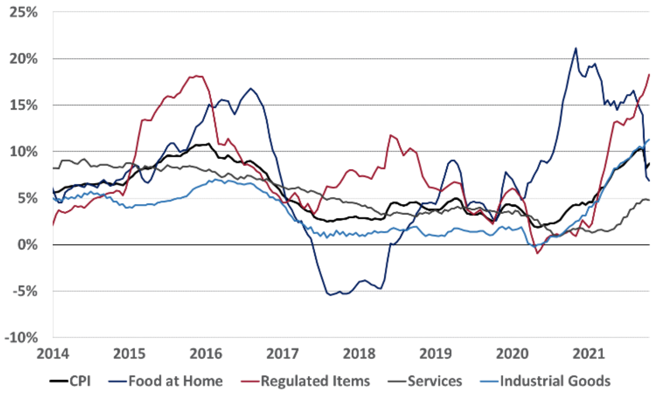
In November, 12-month inflation reached 10.7%, the highest since January 2016, when double-digit inflation returned to Brazil after a long period of relative price stability.

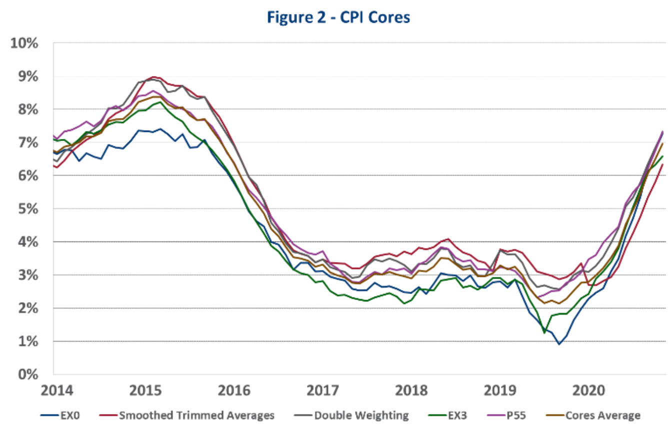
Inflation appears to have peaked, but continues to cause concern. First, although the acceleration in the IPCA was driven largely by volatile components such as fuel and electricity, among other regulated items, other components also accelerated, including services and industrial goods (Fig. 1).

Figure 1 - CPI 12 Months



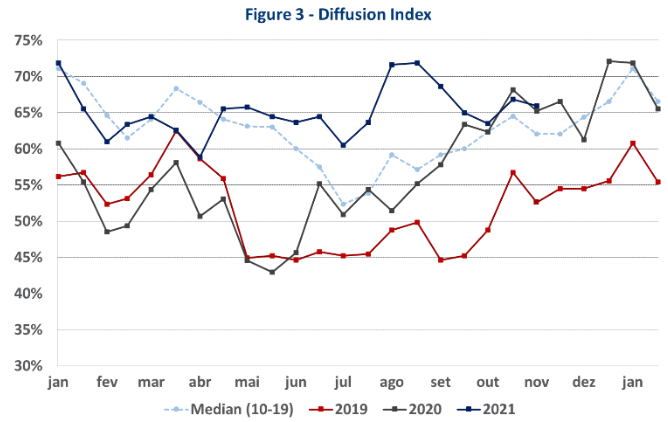
Source: IBGE, Bocom BBM

The core rates, which capture the trend in less volatile prices, also accelerated (Fig. 2). The core rates reflect price changes of a fundamental nature, which may be caused by demand pressure on production capacity, secondary effects of relative price shocks or changes in inflation expectations with inertial impacts that persist over time.



Source: Brazilian Central Bank, Bocom BBM

In the latest issue of *Focus* (the Central Bank of Brazil's survey of professional forecasters), inflation expectations for 2022 rose to 5.02%, above the midpoint of the target, which is 3.5%. The diffusion index (the proportion of items whose prices have increased) reached 65%, confirming the spread of higher inflation throughout the economy (Fig. 3). The risk of de-anchoring is evidenced by the enormous dispersion of market expectations for inflation in 2022, with differences of more than 3 percentage points between highs and lows.



Source: Bocom BBM

Overall, 2021 has seen a number of adverse shocks, many of which were of external origin. On the supply side, mobility restrictions led to huge disruption of supply chains and bottlenecks in the production and distribution of inputs and finished goods. The impact of the energy crisis on the developed economies affected the prices of oil and other energy commodities. In Brazil, electricity prices were impacted by alarmingly low dam reservoir levels in the second half of the year.

Like Brazil, several countries including the developed economies have experienced similar inflationary shocks, but in Brazil the level of inflation as well as its composition and diffusion have particularities. Fiscal stimulus during the pandemic enabled many households to continue consuming, and this added even more pressure to goods inflation on the demand side. Meanwhile, the Selic rate was stimulatory during the pandemic, and as a result real ex ante interest rates remained in negative territory throughout 2020 and much of 2021.

Several important factors that have pressured inflation this year recently began to show signs of easing off. The latest readings of the IGP-M suggest a degree of deceleration in its main component, which measures producer price inflation. The fall in prices of some commodities, such as iron ore and soybeans, contributed to this result. Even fuel prices have begun to benefit from the recent fall in oil prices. Reservoir levels have risen, and a disastrous turn in the energy crisis has at least been delayed.

In its last communication, the Central Bank expressed concern with the de-anchoring of expectations and indicated that monetary tightening could proceed into even more restrictive territory. Since then, the balance of risks has improved – including damage control in the fiscal sphere – and economic activity has begun to display stronger signs of a slowdown, as evidenced by the latest confidence indices and sectoral surveys, as well as third-quarter GDP, which was somewhat lower than expected. But the monetary authorities face a tough choice in attempting to achieve the necessary fine tuning of monetary policy, which has lagging effects, given that inflation is still high despite the deceleration and this requires more rate hikes even though their effects remain latent.

Our inflation forecast is now 10.3% for 2021 and 5.0% for 2022. In light of the slowdown seen in the high-frequency indicators of economic activity, and the projected Selic rate of 12% at the end of the cycle, we have revised down our forecast for GDP growth to 4.7% in 2021 and 0.7% in 2022.

ECONOMIC FORECASTS	2018	2019	2020	2021F	2022F
GDP Growth (%)	1,3%	1,1%	-4,1%	4,7%	0,7%
Inflation (%)	3,7%	4,3%	4,5%	10,2%	5,0%
Unemployment Rate, SA (eoy ,%)	12,2%	11,7%	13,9%	12,5%	12,0%
Policy Rate (eoy, %)	6,50%	4,50%	2,00%	9,25%	12,0%
External Accounts					
Trade Balance (US$ bn)	53	48	51	39	46
Current Account Balance (US$ bn)	-51	-65	-24	-20	-20
Current Account Balance (% of GDP)	-2,2%	-2,8%	-0,9%	-1,0%	-1,0%
Fiscal Policy					
Fiscal Primary Balance (% of GDP)	-1,7%	-1,2%	-10,0%	-1,1%	-1,3%
Government Gross Debt (% of GDP)	75,3%	74,3%	88,8%	79,8%	82,9%