Macro Monthly Letter

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Supply Shock, Rising Inflationary Pressure and Restrictive Monetary Policy

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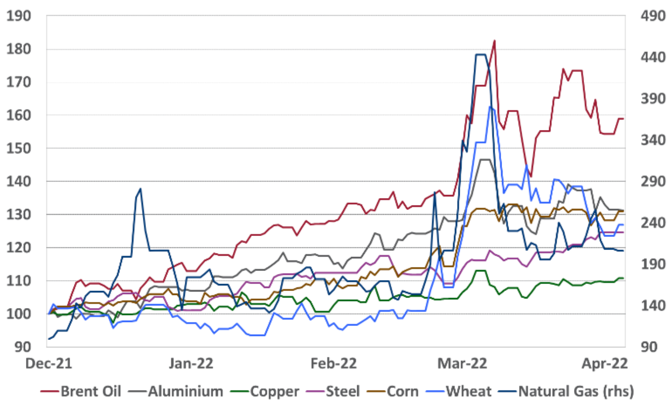
On the international front, the continuing war between Russia and Ukraine poses challenges to global growth, such as supply chain disruption, rising prices of intermediate goods, and distribution and logistics bottlenecks. Uncertainty about the end of the war is increasing, in light of the various failed attempts at negotiating a truce. Prices of crude oil and other important commodities were highly volatile in the month, making the magnitude of the supply shock produced by the war extremely hard to forecast (FIGURE 1).

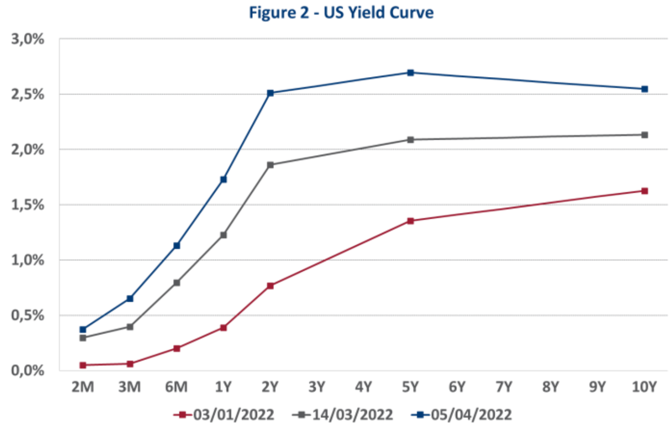
Figure 1 - Commodities Prices (Dec/21 = 100)



Source: Bloomberg, Bocom BBM

The escalating violence in the conflict, as seen in the evidence of a massacre in Bucha, a suburb of Kyiv, has been accompanied by fresh economic sanctions, such as the European Union's proposal to ban imports of Russian coal and the recent decision by the United States to block Russian deposits in US banks for payment of debts.

International financial conditions became even more restrictive with the Fed's decision to begin a tightening cycle in the US. At the last FOMC meeting, the fed funds rate was raised by 25 bps, and the markets have priced in further hikes, which will be sharper. The rates implicit in Treasuries are pointing to more eight hikes of 25 basis points in 2022 and another three hikes in 2023, reaching 3% by the end of next year (FIGURE 2). The FOMC also undertook to reduce its balance sheet and will gradually sell the assets purchased in 2020 and 2021 in an additional monetary policy move designed to reduce liquidity in the economy.

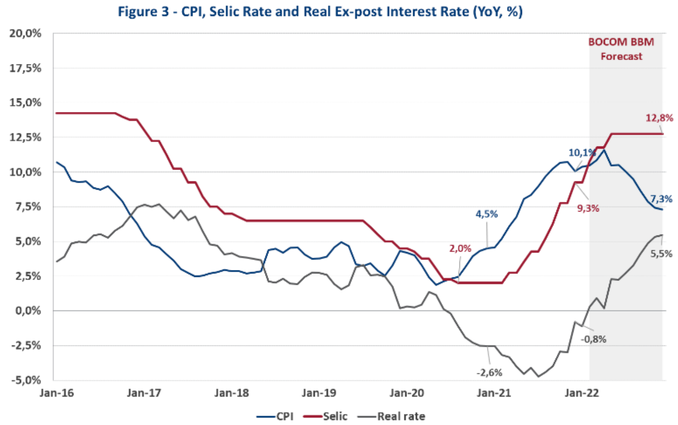


Source: Bloomberg, Bocom BBM

Both the budget proposed for 2023 and the monetary policy now being implemented offer clear signals of a change of direction. According to the FOMC's projections, the rate increases will cool the economy to the right extent, moderately slowing growth and bringing inflation down toward the target in a soft landing. However, high levels of household and corporate savings, inflationary pressure due to the fiscal and monetary stimulus measures introduced during the pandemic, a tight labor market and the additional side-effects of the war in Ukraine on prices of energy commodities and intermediate inputs are a combination that may require much more monetary tightening than the markets have priced in so far. Time will tell.

In China, the high-frequency indicators are already pointing to deceleration, and the government's 5.5% growth target is starting to look increasingly hard to achieve without relying on even more expansionary monetary and fiscal policies. In line with the growth target, the plan calls for a 50% increase in the fiscal deficit in 2022, permitting various economic stimulus measures, such as tax refunds and state investment in infrastructure. The severe lockdowns introduced in response to outbreaks of Covid-19 in several cities, with confirmed daily cases rising to the highest levels seen since the start of the pandemic, are drastically hampering the economic recovery, and the government will be obliged to resort to even more stimulus measures.

In Brazil, the latest COPOM meeting signaled the end of the tightening cycle at the next meeting with a rise of 100 bps, taking the terminal Selic rate to 12.75% per annum (FIGURE 3). The post-meeting statement noted that the outlook remains one of high volatility but that the sharp rise in rates starting last year from a baseline of 2% p.a. will have lagging effects.



Source: Bocom BBM, IBGE, Brazilian Central Bank

In response to the rise in the Central Bank of Brazil's policy rate and in the prices of the commodities Brazil exports (raising the terms of trade), the exchange rate has appreciated, fueling inflation. However, global supply chain bottlenecks, energy commodity inflation and the Central Bank's indication that the tightening cycle will end on 12.75% at the next meeting triggered upward revisions to inflation projections. We now project 7.3% in 2022 and 3.8% in 2023. GDP growth is set to accelerate in view of the labor market recovery, as well as less restrictive fiscal and monetary policies, and we have revised up our growth projection for 2022 to 0.9%. The new commodity boom is good news for tax revenue and the prospects of fiscal sustainability, outweighing the effects of monetary tightening, and we project a debt-to-GDP ratio of 80.9% in 2022. Our projections are shown in detail below.

ECONOMIC FORECASTS	2019	2020	2021	2022F	2023F
GDP Growth (%)	1,1%	-4,1%	4,6%	0,9%	1,7%
Inflation (%)	4,3%	4,5%	10,1%	7,3%	3,7%
Unemployment Rate (eoy ,%)	11,7%	13,9%	11,1%	11,8%	11,6%
Policy Rate (eoy, %)	4,5%	2,0%	9,3%	12,8%	8,0%
External Accounts					
Trade Balance (US$ bn)	48	32	36	68	45
Current Account Balance (US$ bn)	-65	-24	-28	-14	-40
Current Account Balance (% of GDP)	-2,8%	-0,9%	-1,8%	-0,8%	-2,6%
Fiscal Policy					
Central Government Primary Balance (% of GDP)	-1,2%	-10,0%	-0,4%	-0,9%	-0,9%
Government Gross Debt (% of GDP)	74,3%	88,8%	80,3%	80,9%	86,4%