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The slow convergence of inflation

Cecilia Machado
Chief Economist

Nicolau Curi
Economist

Emanuelle Pires
Intern

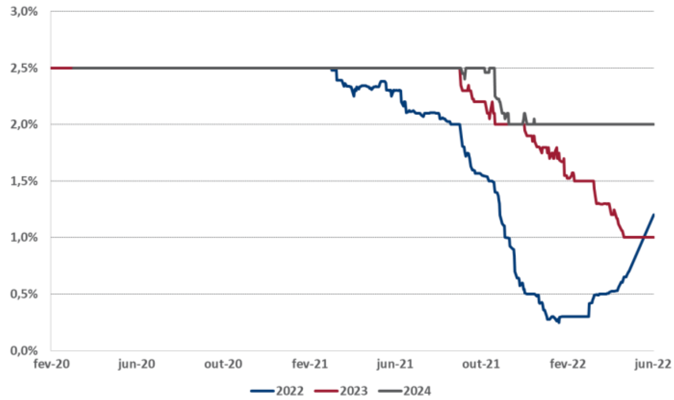
João Freitas
Intern

Marcos Alves
Intern

Victor Cota
Intern

The latest data on activity in Brazil points to a far sounder economic recovery than many analysts predicted only a short time ago. Whereas at the start of the year the economy was expected to grow 0.3% in 2022, according to *Focus*, the weekly survey of some 140 banks and other institutions by Central Bank of Brazil (BCB), the consensus forecast is 1.2% in the most recent readout, which dates from early June after one month without any releases due to the strike by BCB staff. For 2023, growth expectations were lowered from 1.8% to 1% in the same period (Figure 1).

Figure 1 - Brazil: Yearly GDP Growth (FOCUS)

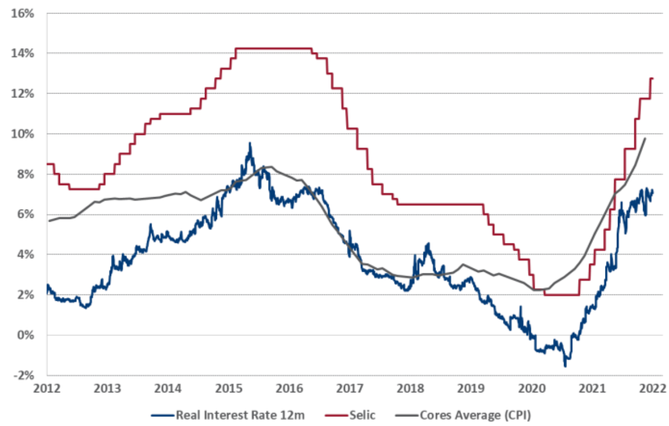


Source: BCB, Bocom BBM

The change in economic growth prospects for 2022 and 2023 is the opposite of what is expected when monetary policy enters contractionary territory, which could be the case in light of the fact that the tightening cycle in Brazil began last year, and since then the Central Bank's policy rate (Selic) has risen 1,075 basis points, reaching 12.75% at the last meeting. The end of targeted lending to specific sectors via subsidized public credit, unification of targeted interest rates via creation of the Long-Term Rate (TLP) in 2017 and increasing penetration of various segments of the population by banks and the credit market are all factors that make monetary policy more powerful now than in the past, reinforcing the channels through which monetary policy acts.

The ex-ante real interest rate – calculated by subtracting expected inflation 12 months ahead from the current Selic rate – is already about 7%, above what many analysts believe to be the neutral rate, which is the real rate that supports the economy while keeping inflation constant. Nevertheless, inflation remains high, indicating acute persistence of more inertial components (such as core measures that exclude volatile items), as well as generalized hikes in the prices of the standard basket of consumer goods. The proportion of items that have gone up in price remains elevated at 75% (Figure 2).

Figure 2 - Ex-Ante Real Interest Rate, Selic, Cores Average (CPI)



Source: Bloomberg, BCB, Bocom BBM

There are many possible explanations for the paradoxical coexistence of persistent inflation in a robust economy with restrictive interest rates in 2022. First, the continuity of the Russia-Ukraine conflict has helped to keep prices of several commodities high. Some of these, such as soybeans, improve Brazil's terms of trade and the real income of the economy, while others, such as crude oil and petroleum products, weigh on inflation via international price parity (Figure 3).

Figure 3 - Commodities Prices (01/jan/12=100)

Source: Bloomberg, Bocom BBM

Second, several recently implemented fiscal measures, such as the expansion of social programs, permission for withdrawal of cash from FGTS severance fund accounts, and early payment of the year-end bonus known as the 13th salary, are shoring up household income and consumption. The service sector has fully recovered from the pandemic, although there is room for more growth in some segments, such as domestic service.

Third, monetary policy has lagging effects, and it will take many months for the recent rate hikes to impact the economy, making disinflation a long process. In addition, inflation expectations have been steadily revised up in response to persistently high current inflation, fueling a price hike feedback loop.

Looking ahead, it is hard to envisage a different situation for commodities, considering the persistence of the geopolitical conflict, and the difficulty for many countries of making a transition to a cleaner energy mix with less reliance on fossil fuels. However, fiscal impulses are short-lived. In particular, advances and cash transfers only shift household income and consumption intertemporally. Lastly, BCB readiness to end the tightening cycle with expectations deteriorating may require an extension of the monetary policy horizon.

An economic slowdown with a lower rate of growth in 2023 will be an immediate consequence of the monetary policy lag and the waning effect of the fiscal stimulus measures in force this year. We have therefore updated our growth projections to 1.4% and 0.5% in 2022 and 2023 respectively. As for inflation, we now project 9.4% in 2022 and 5% in 2023. The other projections are shown in the table below.

ECONOMIC FORECASTS	2019	2020	2021	2022F	2023F
GDP Growth (%)	1,1%	-3,9%	4,6%	1,4%	0,5%
Inflation (%)	4,3%	4,5%	10,1%	9,4%	5,0%
Unemployment Rate (eoy ,%)	11,7%	13,9%	11,1%	10,8%	11,6%
Policy Rate (eoy, %)	4,5%	2,0%	9,3%	13,5%	9,0%
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%	-0,3%	-0,6%
Government Gross Debt (% of GDP)	74,3%	88,8%	80,3%	77,4%	80,7%