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Disinflation Risks

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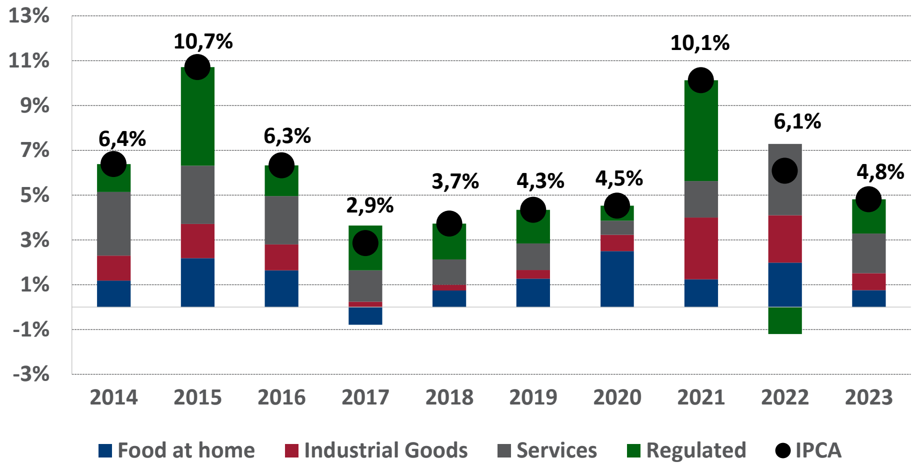
After about a year of inflation surprises taking the 12-month IPCA in April 2022 to 12.1%, the highest since 2003, inflation finally began to decelerate. The IPCA for July was negative, lowering the 12-month rate to 10.07%. We now project 6.1% for end-2022. As these numbers show, the speed of disinflation is significant, but a continuation of the process in 2023 faces challenges.

Part of the ongoing disinflation is due to a sharp reversal in prices of manufactures and regulated items, which were precisely those that contributed most to inflation in 2021 (Figure 1).

Figure 1: Inflation decomposition (YoY, %)



Source: IBGE, BOCOM BBM

The end of social isolation and the post-pandemic increase in mobility have helped regularize supply chains and production and distribution of goods, while also reorienting household consumption back to services. Prices of regulated goods such as fuels and energy, which shot up at the start of the year owing to problems caused by the Russia-Ukraine war, have now dialed back, but the continuing conflict remains an element of uncertainty as far as the outlook for energy commodities is concerned. On one hand, interruptions in the supply of gas to Europe heighten the risk of oil price rises. On the other, the possibility of energy rationing and an even sharper global economic slowdown point in the opposite direction.

Another part of disinflation is due to the many tax measures recently passed by Congress to lower consumer prices mechanically. These include a reduction in ICMS (state sales tax) on fuels, electricity and telecoms, cuts in PIS and COFINS (federal taxes on revenue), a cut in the CIDE tax on fuels, a change in the basis for calculating tax on gasoline, and the right to discount tax credits from electricity bills earlier than originally scheduled (Figure 2). All told, these measures correspond directly to a drop of at least 250 basis points (bps) in this year's inflation, but their indirect effects include a reduction in the cost of other goods and services, as well as less inflation inertia in 2023.

Figure 2: Impact on 2022 Inflation (bps)	
ICMS tax cuts	**-147**
Electricity	-65
Fuels	-72
Communications	-10
Federal tax cuts on fuels	**-60**
PMPF 60 months average	**-23**
Antecipation of tax credits on electricity	**-20**
Total	**-250**

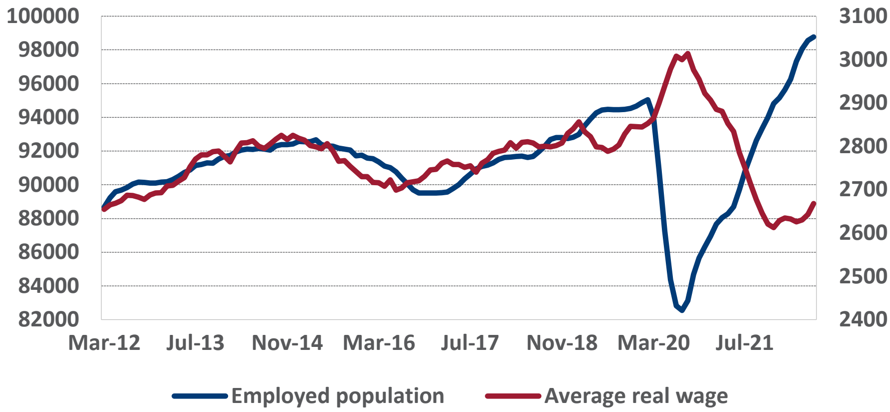
Source: BOCOM BBM

Considering that much of the improvement in inflation has come from government measures and cooling commodity prices, there are risks to the convergence of inflation toward the target in 2023.

First, the rise in interest rates since 2021 has probably pushed monetary policy into restrictive territory, but the administration's fiscal stimulus measures and other actions are providing support for economic activity, which shows few signs of deceleration. Second-quarter GDP and the high-frequency data point to robust expansion in the service sector, continuing growth in the industrial sector and a favorable outlook for agricultural production in 2023.

Second, real wage mass gains observed in the labor market reflect growth of the occupied workforce more than real pay hikes (wage mass = no. of formal workers x average wage). The fall in the unemployment rate to the lowest level since 2015 casts doubt on the existence of labor market slack (Figure 3). Although pressure for pay hikes and salary recomposition has not yet materialized, inflation will be affected in 2023 if it does.

Figure 3: Employment and Real Wages



Source: IBGE, BOCOM BBM

Third, high temperatures and drought will tend to reduce agricultural output in the northern hemisphere, and the high cost of natural gas in Europe will drive up fertilizer prices. Despite good projections for the agricultural sector in Brazil, international demand will continue to subject food prices to upside pressure.

We project 4.8% inflation in 2023, taking into account a more favorable outlook for energy commodities, assuming that the recent tax breaks will be made permanent, and considering that the reduction in inflation in 2022 adds less inertia to next year's inflation. However, there are significant risks in the opposite direction: economic activity remains resilient, many pay hikes are yet to occur, and the global food supply faces challenges. Lastly, there is a great deal of uncertainty about the next president's economic agenda and the future of the fiscal rules after the election, and it may well be necessary to raise taxes. Our projections for the key macroeconomic indicators follow.

ECONOMIC FORECASTS	2019	2020	2021	2022F	2023F
GDP Growth (%)	1.1%	-3.9%	4.6%	2.7%	0.7%
Inflation (%)	4.3%	4.5%	10.1%	6.1%	4.8%
Unemployment Rate (eoy ,%)	11.7%	13.9%	11.1%	8.7%	8.5%
Policy Rate (eoy, %)	4.5%	2.0%	9.3%	13.75%	11.25%
External Accounts					
Trade Balance (US$ bn)	48	32	36	68	45
Current Account Balance (US$ bn)	-65	-24	-28	-25	-35
Current Account Balance (% of GDP)	-2.8%	-0.9%	-1.8%	-1.4%	-1.8%
Fiscal Policy					
Central Government Primary Balance (% of GDP)	-1.2%	-10.0%	-0.4%	0.2%	-0.8%
Government Gross Debt (% of GDP)	74.3%	88.8%	80.3%	77.7%	82.9%