Macro Monthly Letter

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Waiting for rate cuts

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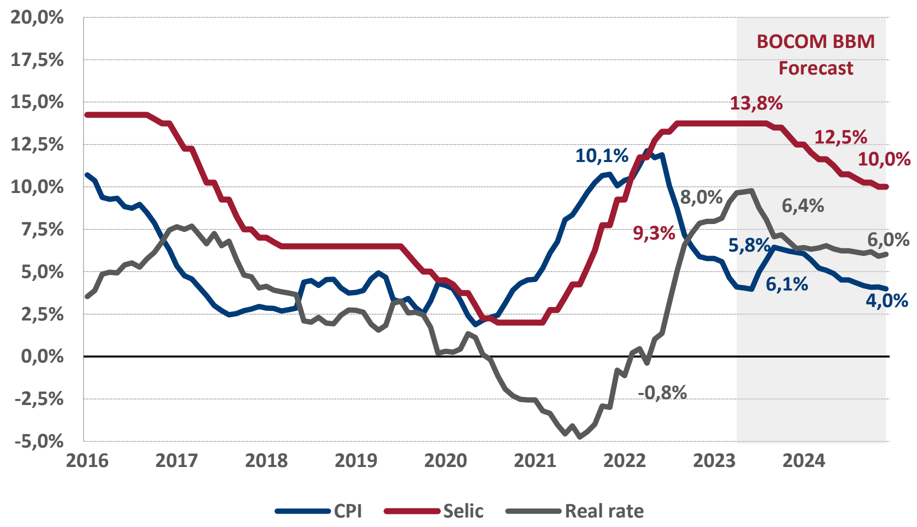
Monetary policy has become fairly synchronized worldwide in the wake of the COVID-19 pandemic. In response to the inflation surge triggered by more expansionary fiscal policies, supply chain disruption in many sectors and changing patterns of consumption and mobility, central banks in both emerging and developed countries embarked on a monetary tightening cycle, albeit at different times. In Brazil, the cycle began in March 2021 and ended in August 2022, and the policy rate (Selic) has remained unchanged on 13.75% per annum since then. Given the tightening of financial conditions, contraction of credit, deceleration of the economy and continuing disinflation, rate cuts are expected in the near future (Figure 1).

Figure 1: CPI, Selic Rate and Real Ex-post Interest Rate



Source: BCB, IBGE, BOCOM BBM

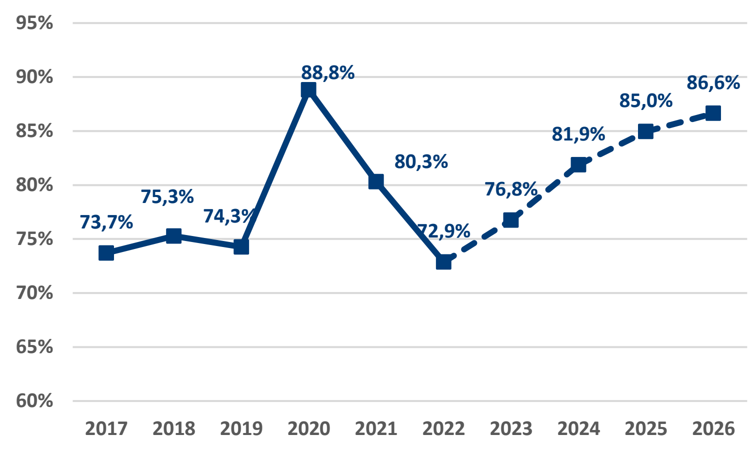
At its latest monetary policy meeting, the Central Bank of Brazil (BCB) left the Selic rate unchanged on 13.75%. This was a conservative decision based on the need for "serenity and patience" in the conduct of monetary policy, with the aim of consolidating the disinflation process and anchoring expectations around its target. However, the decision was accompanied by important innovations in inflation projections and communication. Although the inflation projection for 2024 remained unchanged on 3.6%, the scenario considered assumed a less restrictive trajectory for the Selic in 2023 (12.5% vs 12.75%). Furthermore, the projection for 2024 fell from 3% to 2.9%, or just below the target, in the alternative scenario assuming no change in the Selic throughout the relevant period. The post-meeting statement also signaled that the government's presentation of a new fiscal framework reduced part of the uncertainty fueled by fiscal policy, with a probable impact on inflation expectations for the longer term. We have therefore revised down our projection for the end-2023 Selic to 12.5% and expect the cycle of rate cuts to begin at the end of the current year.

The economic slowdown in the last two quarters contributed to this view. For the first quarter, we continue to see resilience in economic activity: job creation remains strong, retail sales are surprisingly positive, and services are still running at a high level. Activity is additionally favored by this year's record grain crop, as reflected in March by the largest monthly trade surplus ever. On the other hand, the high-frequency indicators for the second quarter point to a loss of momentum in all sectors of the economy, which, when combined with the sharp tightening of financial conditions due to deteriorating bank credit and capital market indicators, suggests rapid deceleration of economic activity during the rest of this year. After a strong start to the year, with 1.2% QoQ growth in the first quarter, our models point to a technical recession in the second half – i.e. two consecutive quarters of contraction.

With regard to the fiscal framework, the proposal submitted by the government to Congress provided more detail on the functioning of the rule. Its two main pillars – a trajectory for the primary results in the next four years and a formula for limiting expenditure in accordance with revenue growth – were maintained, but some points caused concern regarding the sustainability of the new fiscal regime. In particular, only the primary result target for the following year will be fixed, whereas the other projections will be allowed to change over time. In addition, the framework does not call for any type of penalty or legal sanction for non-compliance; nor does it establish triggers to contain expenditure in order to meet the target. Finally, given that any incoming government can change the key parameters in the framework, the predictability of the projected debt-to-GDP trajectory is lost for periods exceeding four years.

Considering that the new framework sets targets for the primary result that will require a substantial effort to increase revenue, with an uncertain outcome, we have adjusted our projection for the primary result taking into account only the new rule governing the permitted rise in expenditure. Thus, we project a primary deficit in the next four years and a debt-to-GDP ratio of 86.6% in 2026 (Figure 2).

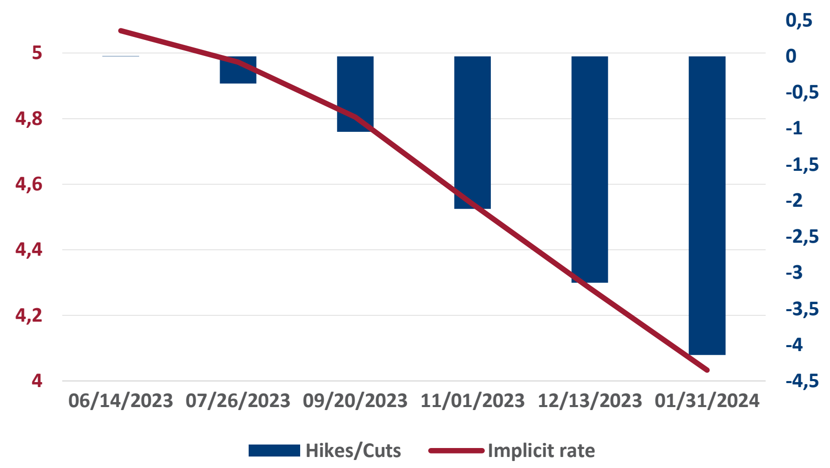
Figure 2: Gross Debt (% GDP)



Source: BCB, BOCOM BBM

Turning to the external outlook, the Fed continued to tighten, raising the fed funds rate by another 25 bps to 5%-5.25%. It signaled that the extent of the tightening cycle continued to depend on incoming information and the evolution of the economy, but removed from its communication the idea that rate hikes might be appropriate, supporting expectations of a pause in the tightening cycle. Although the Fed does not expect the US economy to enter a recession and believes the US banking system to be "sound and resilient", more regional banks, such as PacWest, show signs of fragility following the collapse of SVB, Signature and First Republic. The markets remain highly attentive to the stability of the financial system and have priced in rate cuts despite the Fed's insistence that they are not appropriate in the context of persistently high inflation (Figure 3).

Figure 3: US Implied Policy Rate (05/05/23)



Source: Bloomberg, BOCOM BBM

Our projections are summarized in the table below. We have revised up our current-account projection for 2023, taking into account mainly this year's bumper grain crop and the significant boost to exports. For 2024, we expect the deficit to grow in light of the less favorable outlook for commodities due to the global economic slowdown.

ECONOMIC FORECASTS	2019	2020	2021	2022	2023F	2024F
GDP Growth (%)	1.2%	-3.3%	5.0%	2.9%	1.3%	1.0%
Inflation (%)	4.3%	4.5%	10.1%	5.8%	6.1%	4.0%
Unemployment Rate (eoy ,%)	11.1%	14.2%	11.1%	7.9%	8.8%	9.3%
Policy Rate (eoy, %)	4.5%	2.0%	9.3%	13.75%	12.50%	10.0%
External Accounts						
Trade Balance (US$ bn)	27	32	36	44	50	40
Current Account Balance (US$ bn)	-68	-28	-46	-56	-45	-50
Current Account Balance (% of GDP)	-3.6%	-1.9%	-2.8%	-2.9%	-2.2%	-2.4%
Fiscal Policy						
Central Government Primary Balance (% of GDP)	-1.3%	-9.8%	-0.4%	0.6%	-1.1%	-1.5%
Government Gross Debt (% of GDP)	74.3%	86.9%	78.8%	72.9%	76.8%	81.9%