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Inflection point in global monetary policy

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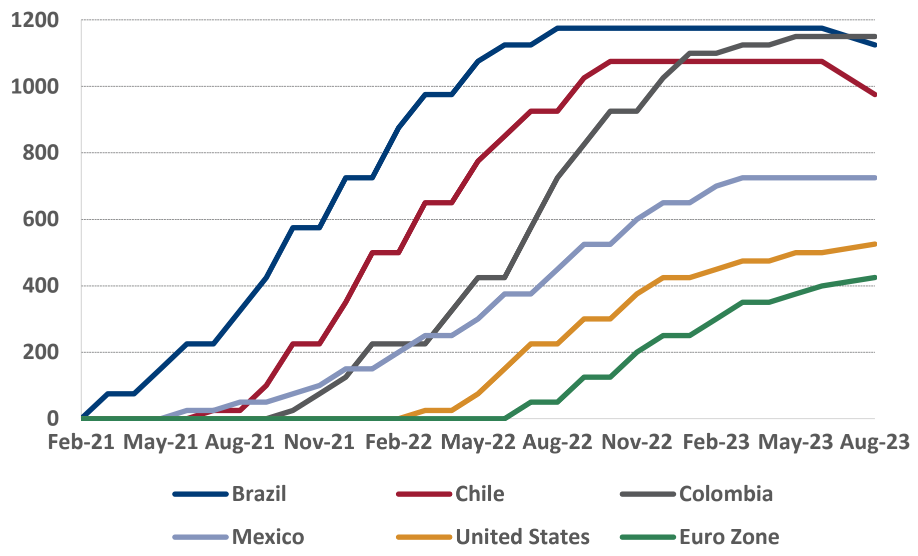
The post-Covid inflation surge – which resulted from a combination of fiscal stimulus, supply chain disruption, reorientation of consumption from services to goods, and rising commodity prices – propagated at varying speeds from country to country, so that some embarked on the monetary tightening cycle well before others (Figure 1). In Brazil, the cycle began in 2021, when projections were starting to show that inflation would be above target for the period considered by the monetary authorities. The length of time during which monetary policy remained in restrictive territory and its effect on the dynamics of disinflation ushered in the conditions for rate cuts to begin in the countries that began raising rates soonest. The first among emerging-market countries was Chile, followed by Brazil.

Figure 1: Monetary Policy Rate Change since March 2021 (bps)



Source: BIS, BOCOM BBM

In Chile, the first rate cut was 100 basis points. The decision was unanimous and, although a cut was widely expected, the market consensus was 75 bps. Slower growth, lower-than-expected inflation dynamics and continued anchoring of expectations were the main reasons for the decision. Cuts are expected to total more than 500 bps in the 12 months ahead.

The Central Bank of Brazil also embarked on a monetary loosening cycle at its latest meeting, cutting the Selic policy rate by 50 bps. This surprised part of the market, which expected 25 bps. Indeed, four of the nine members of the Monetary Policy Committee (COPOM) voted for the smaller cut. The central bank's governor and the two new members appointed by the Lula administration voted with the majority.

The rapid improvement in current inflation, alongside a reduction in the de-anchoring of long-term inflation expectations, provided the confidence required for monetary loosening to begin. The main rationale for the larger-than-expected cut was the considerable downside distance to be covered before neutral territory is reached. Cuts are expected to total at least 400 bps in the next 12 months (Table 1).

Table 1: Current Policy Rate and Cumulative Pricing for 1, 2 and 3 Years Ahead (bps)

Country	Policy Rate	1 Year	2 Years	3 Years
USA	5.38	-55	-162	-184
Brazil	13.25	-427	-436	-287
Euro Zone	3.75	-12	-77	-92
Chile	10.25	-515	-553	-557
Colombia	13.25	-389	-514	-535
Mexico	11.25	-170	-364	-391

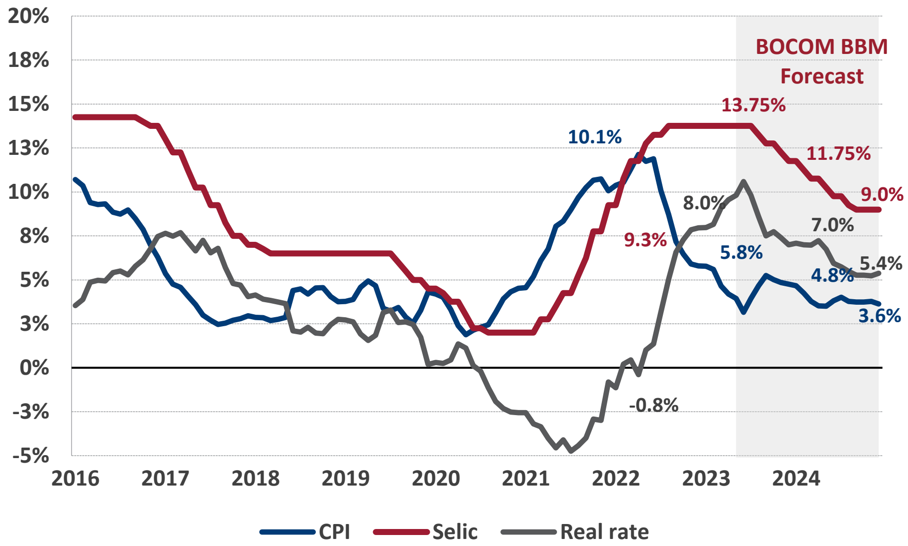
Source: Bloomberg 08/03/23, BOCOM BBM

Other countries, such as the United States, waited longer to start raising their policy rate, believing that inflation would be mostly temporary and would dissipate as soon as the economy reopened, supply chains regularized and the fiscal impulse lost momentum. They were mistaken.

In response to the persistence of inflation, the Fed has hiked its policy rate by more than 500 bps since March 2022. At its latest meeting, it decided to raise the fed funds rate by 25 bps but signaled that the end of the tightening cycle is near, although it expects to stay in restrictive territory for a long time. Next steps will depend on the behavior of the key economic indicators. The markets do not expect more rate hikes and foresee one or perhaps even two cuts in the next 12 months. The European Central Bank will soon have to decide whether to advance further into restrictive territory, depending on how the data behaves. The scope for cuts in the next 12 months is unclear in the euro zone.

Disinflation has been fueled by a huge shock in prices of tradables, with indirect (secondary) effects on prices of items with a more inertial trajectory, such as services and core inflation. In Brazil, strong deflation continues in wholesale, showing that the fall in consumer prices of manufactured goods and food prices is still incipient. Local currency appreciation and the gradual economic slowdown are also key drivers of this process. Nevertheless, the conjuncture continues to require patience and serenity in the conduct of monetary policy. Next steps will depend on how the dynamics of inflation unfold, especially the components most sensitive to monetary policy and economic activity, and also on inflation expectations, the central bank's inflation projections, the output gap, and the balance of risks. If rates remain in restrictive territory throughout the loosening cycle, inflation stands a strong chance of converging toward the 3% target (Figure 2).

Figure 2: Brazil - CPI, Selic and Real Ex-post Interest Rate (YoY, %)



Source: BCB, IBGE, BOCOM BBM

We now project 4.8% inflation in 2023 and 3.6% in 2024. Our other macroeconomic projections are set out in the table below.

ECONOMIC FORECASTS	2019	2020	2021	2022F	2023F	2024F
GDP Growth (%)	1.2%	-3.3%	5.0%	2.9%	2.0%	1.0%
Inflation (%)	4.3%	4.5%	10.1%	5.8%	4.8%	3.6%
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%	11.75%	9.0%
External Accounts						
Trade Balance (US$ bn)	27	32	36	44	60	42
Current Account Balance (US$ bn)	-68	-28	-46	-56	-39	-50
Current Account Balance (% of GDP)	-3.6%	-1.9%	-2.8%	-2.9%	-1.8%	-2.3%
Fiscal Policy						
Central Government Primary Balance (% of GDP)	-1.3%	-9.8%	-0.4%	0.6%	-1.1%	-1.2%
Government Gross Debt (% of GDP)	74.3%	86.9%	78.8%	72.9%	76.6%	81.4%