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The Lagging Effects of Monetary Policy and the Start of Economic Slowdown

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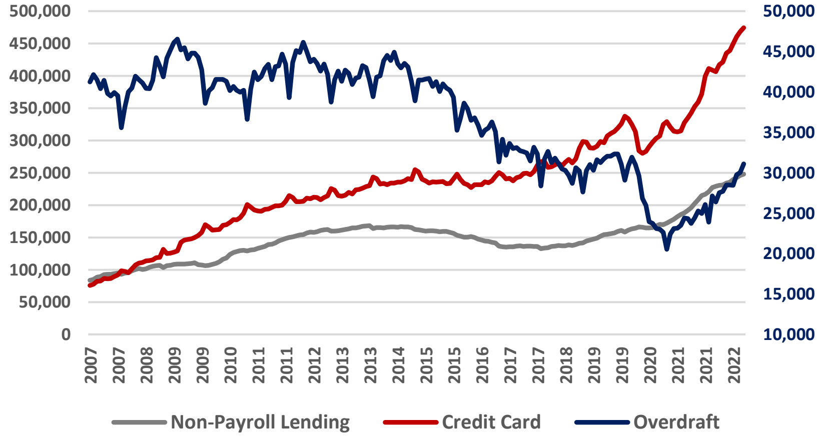
Between March 2021 and August 2022, the Central Bank of Brazil (BCB) raised its policy rate (Selic) by 1,175 bps. Owing to the lagging effects of monetary policy and the strong fiscal stimulus measures implemented during the year, several economic activity indicators have displayed resilience until recently. However, the latest GDP reading for the third quarter of 2022, as well as the numbers for job creation, household and corporate debt and delinquencies, show that a slowdown is under way, as expected.

One of the first channels through which monetary policy acts on the economy is interest rates on loans, as the Selic rate is the key variable in banks' costs. Higher rates restrict demand for credit and reduce consumption, containing price rises and contributing to disinflation. According to BCB, pass-through of the Selic to other interest rates in the economy is fast, frequently occurring within three months, but the lag can be longer owing to other mechanisms, such as the effects on the exchange rate, expectations and wealth. The signs of deceleration became visible only about two years after the sharpest rate hike since inflation targeting was introduced.

In line with pass-through from the Selic to other rates, spreads have risen steadily since June, and new loans fell in real terms in October. The sharpest drop was seen in unearmarked corporate loans (down 5.7% month on month) and earmarked household loans (-7.5%). Delinquencies also rose, especially in unearmarked household loans, reaching levels very close to those seen in 2015 and 2016, during the previous monetary tightening cycle, when the Selic ended up close to its current level. Debt-to-income reached 50%, and income commitment 30%; both were the highest in the respective time series, reflecting a significant change in the composition of the household loan portfolio, now concentrated in the costlier types of facility, such as non-payroll lending (Figure 1).

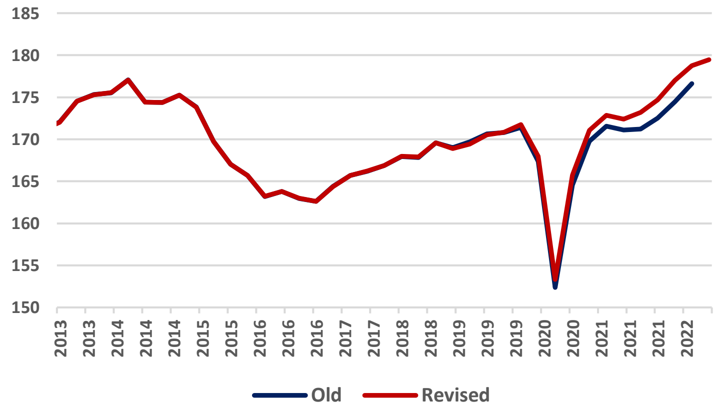
Third-quarter GDP came in below expectations. Growth was 0.4% compared with the previous quarter, whereas the markets expected 0.6%. This weak performance was largely due to a revision of the time series that jacked up growth in the first two quarters, raising the basis for comparison with the third quarter. Nevertheless, both services and industry grew less in Q3 and Q2, showing that the growth rate is now slower (Figure 2).

Figure 1: Loan portfolio balance with non-earmarked resources - Households (R$ million, Real)



Source: BCB, BOCOM BBM

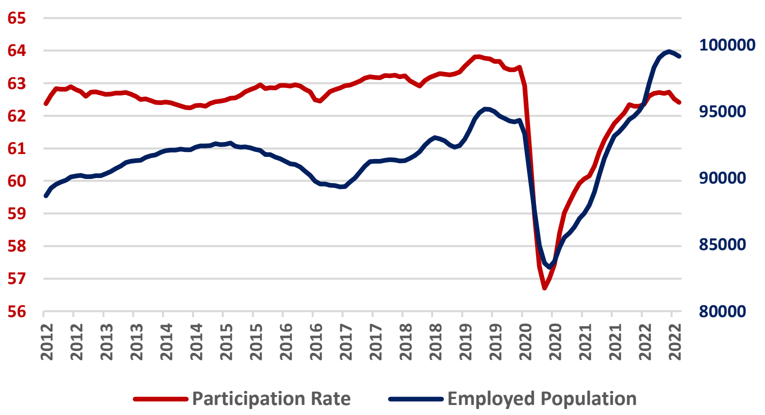
Figure 2: GDP



Source: IBGE, BOCOM BBM

The unemployment rate continued to fall, reaching 8.3%, the lowest since June 2015. This mainly reflected a drop in the workforce participation rate, which was 62.6%, almost 1 pp lower than the level seen before the pandemic, in line with the effects of cash transfer programs on the labor supply. The number of people in work continued to rise, with signs of deceleration at the margin, showing that the labor market is responding to the fiscal stimulus measures implemented and that the effects of monetary tightening on job creation have yet to appear (Figure 3).

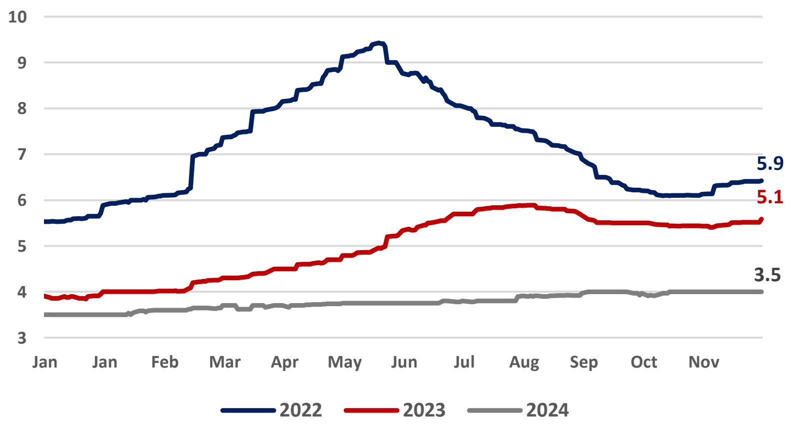
Figure 3: Participation Rate and Employed Population (SA)



Source: IBGE, BOCOM BBM

Credit, employment and activity taken together show that the economy is (probably) decelerating, which helps the disinflation process, but there are risks to convergence to the inflation target in 2023, since various projections, including our own, are pricing in only some of the several risks inherent in administered price inflation for next year. These include discussions on reinstating federal taxes on fuel and ICMS (sales tax levied by states) on electricity transmission and distribution and excluding gasoline from the essential goods category. Also, the spending cap waiver set to be approved by the constitutional amendment currently being negotiated in Congress will shore up economic activity and fuel inflationary pressure. Most risks for 2023 point in the same direction, and the markets' inflation expectations according to BCB's Focus survey, which were revised down during much of the year, have now been revised up (Figure 4).

Figure 4: Inflation Expectation (Focus)



Source: BCB, BOCOM BBM

Our inflation forecast has risen to 5.8% for 2022 and 5% for 2023. In light of the fact that the lagging effects of monetary policy are partly making themselves felt right now, we expect BCB to leave the Selic on 13.75 p.a. for much of 2023, with scope for cuts depending on the pace at which the most inertial components of inflation converge to target. For 2023, our scenario assumes rate cuts amounting to 250 bps, taking the Selic to 11.25% by year-end, but the risks suggest there may not be this much scope for cuts. Our other projections are shown below.

ECONOMIC FORECASTS	2019	2020	2021	2022F	2023F
GDP Growth (%)	1.1%	-3.9%	4.6%	2.9%	1.2%
Inflation (%)	4.3%	4.5%	10.1%	5.8%	5.0%
Unemployment Rate (eoy ,%)	11.7%	13.9%	11.1%	8.2%	8.5%
Policy Rate (eoy, %)	4.5%	2.0%	9.3%	13.75%	11.25%
External Accounts					
Trade Balance (US$ bn)	48	32	36	41	43
Current Account Balance (US$ bn)	-65	-24	-28	-59	-48
Current Account Balance (% of GDP)	-2.8%	-0.9%	-1.8%	-3.2%	-2.4%
Fiscal Policy					
Central Government Primary Balance (% of GDP)	-1.2%	-10.0%	-0.4%	0.7%	-0.7%
Government Gross Debt (% of GDP)	74.3%	88.8%	80.3%	74.7%	77.4%