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# The Cost of Inflation Expectation Deanchoring


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Six months after the monetary tightening cycle that raised the Selic from 2% to 13.75% p.a. between March 2021 and August 2022, we are at last starting to see signs that an economic slowdown is under way, with the latest data showing a drop in the numbers of new loans and people in work, while the service sector is flat. Owing to the lagging effects of monetary policy on economic activity, many analysts believe there could be room for the Central Bank of Brazil (BCB) to cut the Selic at some point this year. However, the statement issued after its last meeting clearly signaled that it does not plan to do so any time soon.

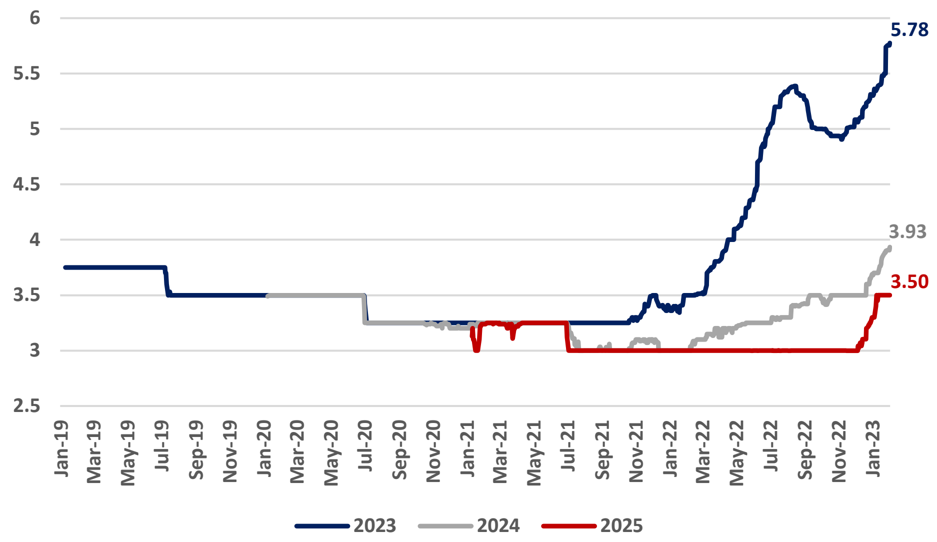
While on one hand an economic slowdown is an important condition for inflation convergence, on the other it is only one of the factors that influence the dynamics of inflation. In 2022, for example, tax breaks helped bring down inflation, alongside several other factors. In tandem with their indirect effects on prices of other goods and services, tax cuts contributed to rapid convergence of inflation to 5.8% by year-end.

However, in contrast with what happened in second-half 2022, when inflation expectations were successively revised down, projections for 2023 are being revised up. In the last three months, the consensus forecast has risen from 4.9% to 5.8%, according to BCB's weekly survey of analysts (Focus). Projections for 2024 and 2025 are also still well above the 3% target, on 3.9% and 3.5% respectively (FIGURE 1).

For this year, most of the revisions reflect the return of some taxes that were lowered in 2022, the rise in gasoline prices, and higher-than-expected hikes in the prices of some items in the consumer basket, such as vehicle licenses. We have taken all these factors into account in our basic scenario for inflation in 2023.

This distancing of inflation expectations from the target established by the National Monetary Council for longer horizons points to the possibility of deanchoring. A sufficiently restrictive monetary policy should be capable of bringing inflation back to the target under usual conditions. The fact that expectations are above the target almost two years ahead casts doubt on BCB's credibility in terms of fulfilling its mandate. The doubt is currently being fueled by criticism from the incoming administration, with questioning of the law that guarantees BCB's independence and of the inflation targets set for the years concerned, as well as a view that rates are already high enough.

**Figure 1: Inflation Expectations (Focus)**




Source: BCB, BOCOM BBM

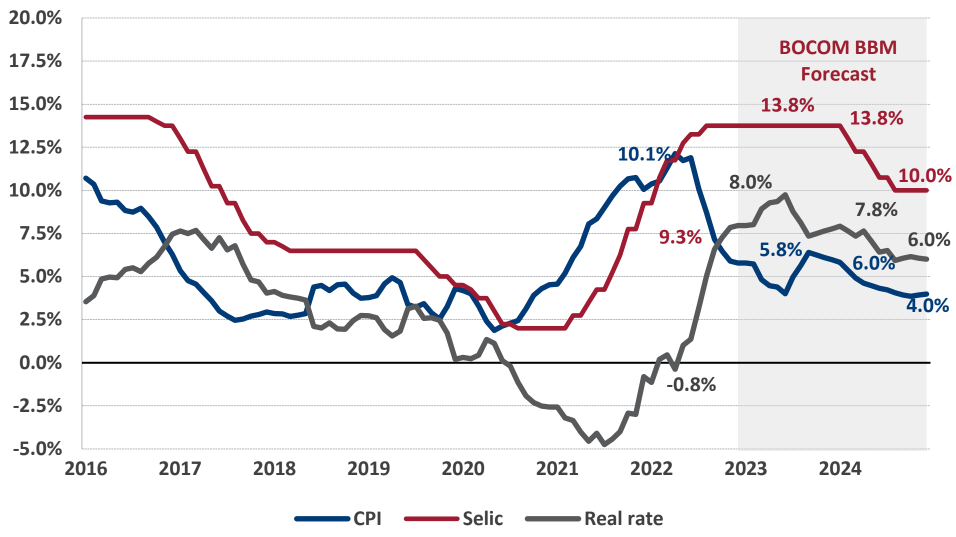
Expectations are an important monetary policy transmission channel and affect current inflation in accordance with how people and companies expect prices to behave in future. Intuitively, if consumers and businesses start believing that tomorrow's inflation will exceed the target, prices will rise and inflation will go up in the short run. Deanchored expectations therefore pose additional challenges to inflation convergence, since deanchoring tends to drive up current inflation.

According to BCB's projections, inflation reaches 3.4% in 2024, under a scenario in which Selic falls to 12.5% in 2023 and 9.5% in 2024, but converges to 2.8% under an alternative scenario in which the Selic remains unchanged (on 13.75%) throughout the relevant period.

These projections mean the Selic is set to remain in restrictive territory for longer. An economic slowdown will not be a sufficient condition for BCB to lower the Selic. In particular, it is hard to see room for rate cuts while inflation expectations are so far above the target in the longer term.

We maintain our projection that the Selic will be left on hold on 13.75% and that scope for cuts will materialize only in 2024 as and when expectations converge to the target (FIGURE 2). Our other economic projections are show below.

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




Source: BCB, IBGE, BOCOM BBM

| ECONOMIC FORECASTS | 2019 | 2020 | 2021 | 2022F | 2023F | 2024F |
|---|---|---|---|---|---|---|
| GDP Growth (%) | 1.2% | -3.3% | 5.0% | 2.9% | 1.5% | 1.0% |
| Inflation (%) | 4.3% | 4.5% | 10.1% | 5.8% | 6.0% | 4.0% |
| Unemployment Rate (eoy ,%) | 11.1% | 14.2% | 11.1% | 8.2% | 8.5% | 9.0% |
| Policy Rate (eoy, %) | 4.5% | 2.0% | 9.3% | 13.75% | 13.75% | 10.0% |
| External Accounts | | | | | | |
| Trade Balance (US$ bn) | 27 | 32 | 36 | 44 | 43 | 35 |
| Current Account Balance (US$ bn) | -68 | -28 | -46 | -56 | -48 | -52 |
| Current Account Balance (% of GDP) | -3.6% | -1.9% | -2.8% | -2.9% | -2.4% | -2.5% |
| Fiscal Policy | | | | | | |
| Central Government Primary Balance (% of GDP) | -1.3% | -9.8% | -0.4% | 0.6% | -1.1% | -0.8% |
| Government Gross Debt (% of GDP) | 74.3% | 86.9% | 78.8% | 73.5% | 79.9% | 85.1% |