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Disinflation in two stages

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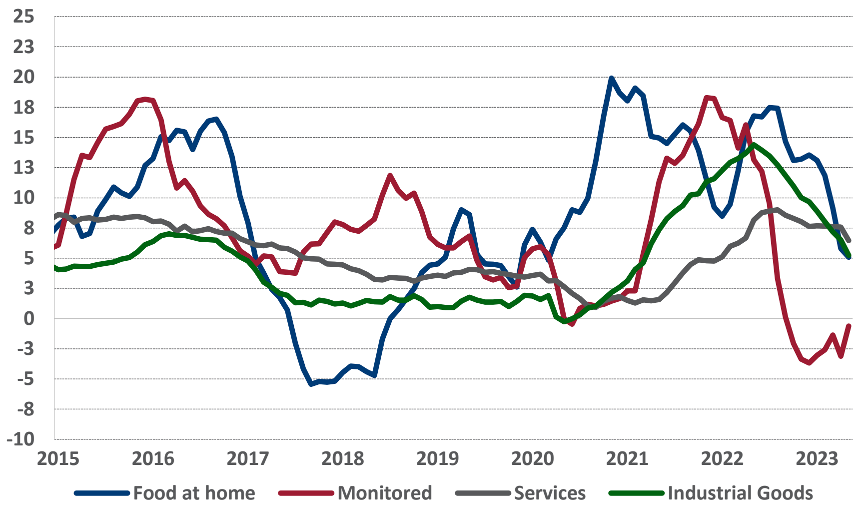
The Central Bank of Brazil has described the dynamics of disinflation as a two-stage process. In the first stage, the speed of disinflation is faster, with direct (and stronger) effects on monitored prices and indirect (and weaker) effects on free prices. In this first stage, 12-month inflation of monitored prices can already be seen to have fallen from 18.3% to -0.6% (Figure 1). In the second stage, the speed of disinflation is slower, and the core rates – the most inertial components of inflation – respond to economic growth and inflation expectations via the effects of monetary policy on aggregate demand.

Figure 1: Inflation by Components (Accum. 12 Months)

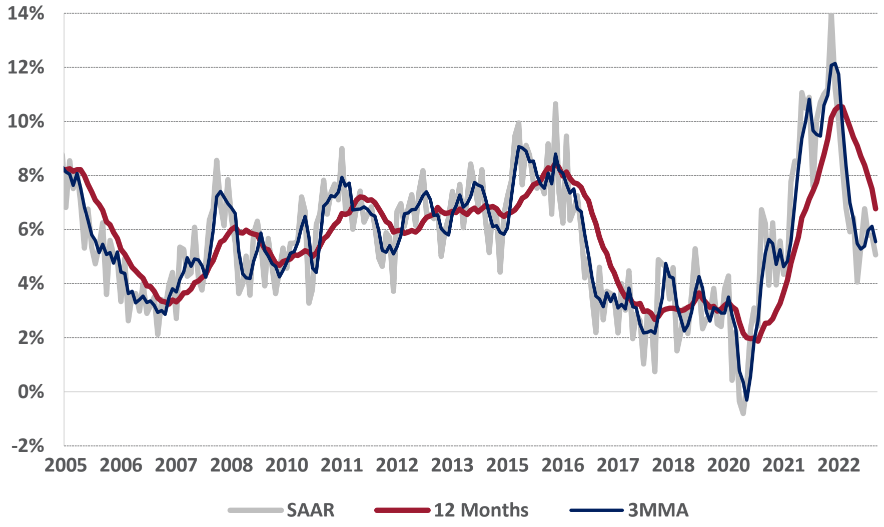


Source: IBGE, BOCOM BBM

The core rates are running at about 6.8% on average, substantially above the headline inflation rate, which is 4.1% (Figure 2). Despite evident deceleration at the margin – the annualized moving average for the last three months is 5.5% – it is legitimate to wonder whether the recent improvement in the core rates is linked to the second stage of the disinflation process (via the effects of monetary policy on aggregate demand) or a continuation of the first stage (via the indirect effects of administered prices on free prices).

High-frequency indicators for the service and retail sectors already pointed to still resilient activity in the first quarter, and the recently announced GDP numbers confirmed this trend. Although the 1.9% GDP growth seen in the first quarter was largely due to agriculture (21.6%), both industry and services outperformed the markets' projections, albeit with negative or modestly positive numbers (-0.1% and 0.6% respectively).

Figure 2: Inflation - Average of Cores



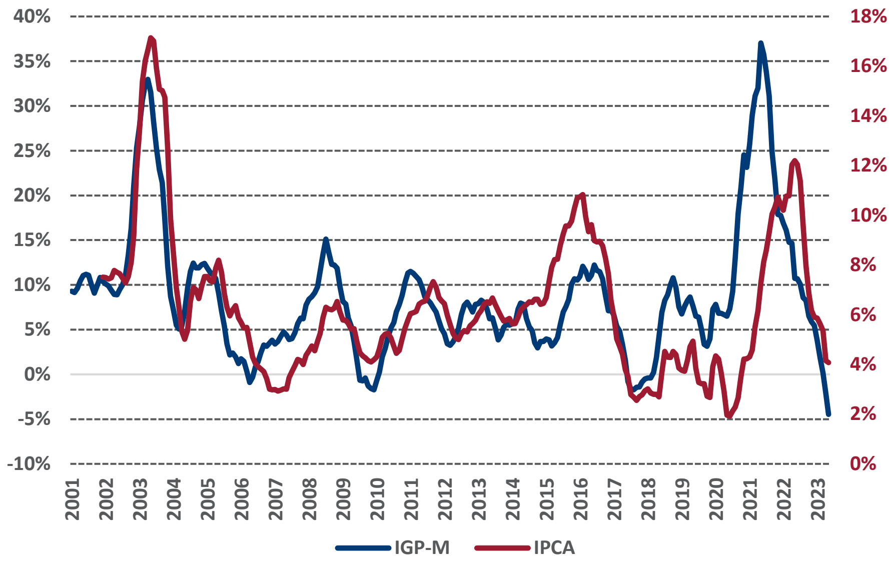
Source: IBGE, BOCOM BBM

Some of the effects on activity in the first quarter have dated explanations, such as the spillover from the primary sector to other sectors of the economy – in machinery and equipment, manufacturing inputs and contracting of services for agribusiness, for example. However, others relate to an economy strengthened by fiscal expansion: transfers rose 74% in the first quarter compared to the same period of 2022 in real terms, and an additional fiscal impulse is expected in the second half from the minimum wage hike, advance payout of the thirteenth wage and a pay raise for civil servants.

Moreover, the labor market has been surprisingly resilient. The unemployment rate is 8.5%, the lowest since 2015. Even at this juncture in the monetary tightening cycle, we are still seeing net job creation. With pay raises expected to exceed current inflation, this helps shore up the real wage mass (the number of formal workers times the average wage) and household purchasing power.

On the other hand, the outlook for industrial goods and food inflation has improved. The fall in production costs linked to supply chain reorganization and local currency appreciation against the dollar have driven down wholesale prices of industrial goods (Figure 3). Pass-through to consumers was conspicuous in the May IPCA preview, with a fall in prices of durables, and this process is set to intensify in the months ahead. Meanwhile, this year's bumper grain crop has flooded the domestic market, driving down wholesale food prices. In global markets, prices of agricultural commodities in BRL fell 13.4% in the 12 months to April, according to the Central Bank of Brazil's Commodity Index (IC-Br). These factors tend to put downside pressure on prices of protein sources with high weights in the IPCA, such as beef and chicken.

Figure 3: Consumer Prices vs Wholesale Prices



Source: IBGE, FGV, BOCOM BBM

All the signs point to a continuing contribution by the positive trend in industrial goods and food prices to disinflation in free prices, albeit indirectly in some cases, but disinflation in core rates and services is expected to gather momentum as the evidence of economic deceleration becomes clearer, especially in labor market indicators. Convergence of the inflation expectations captured by the Central Bank in its survey of analysts' forecasts ("Focus") contributes to the disinflation process: expectations for 2023 and 2024 are down, although expectations for 2025 and 2026 have held steady above the target.

We have revised up our projection for GDP growth in 2023 to 2.0%, but we continue to expect an economic slowdown in the second half. We have revised down 2023 inflation to 5.2%. Our other projections are shown 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%	5.2%	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%	-1.2%
Government Gross Debt (% of GDP)	74.3%	86.9%	78.8%	72.9%	76.6%	81.4%