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Internal and external constraints on Selic rate cuts

Cecilia Machado
Chief Economist

Luana Miranda
Economist

Victor Cota
Analyst

Mariana Rodrigues
Intern

Dafne Sznajder
Intern

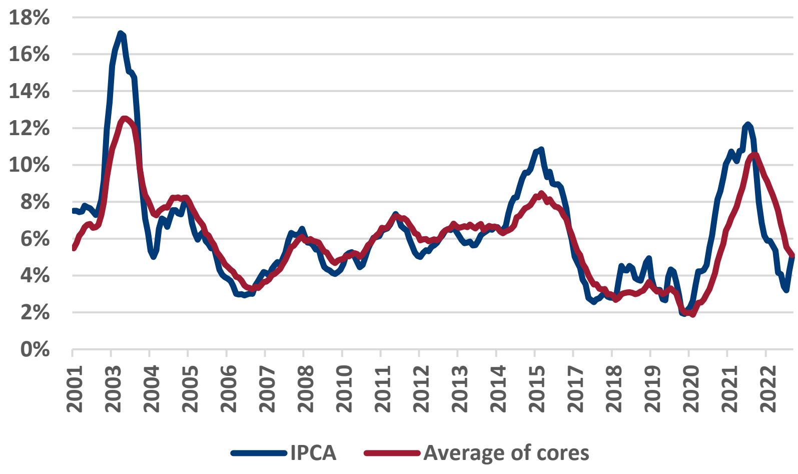
Lara Bonatti
Intern

Eudes Barros
Intern

At its last meeting, the Central Bank of Brazil's Monetary Policy Committee (Copom) decided unanimously to cut its policy rate (Selic) by 50 basis points to 12.75% p.a. and signaled similar cuts at forthcoming meetings. This guidance took into account its risk scenarios and the information available at the time, but the domestic and global environment has changed since then. On one hand, inflation dynamics remain benign, despite the continuing resilience of economic activity and de-anchored inflation expectations for the longer term. On the other hand, the rising US yield curve, especially at the long end, is leading to repricing of many assets, including the Brazilian yield curve and exchange rate.

On the home front, inflation has surprised positively, especially as far as the behavior of its more inertial components is concerned. Food at home has exhibited sharp deflation month by month, disseminated among the items that make up the group, and industrial goods, especially durable goods, have disinflated. Even more important than the strong direct effect of these categories on the IPCA are the secondary effects they have had on the core measures and underlying services, which have fallen every month even though activity and job creation have been more resilient than expected (Figure 1).

Figure 1: IPCA and Average of Cores (Accum. 12 months)

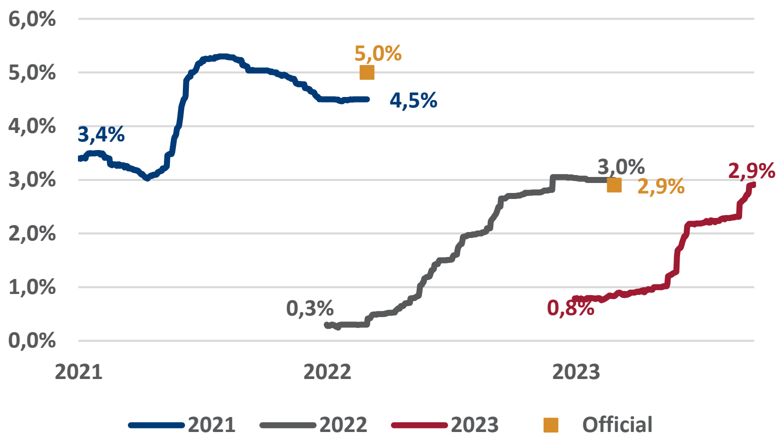


Source: BOCOM BBM, IBGE, BCB

However, the current disinflation has not been sufficient to lessen the de-anchoring of expectations for longer horizons, which remain 0.5 of a percentage point above the midpoint of the target band in 2025 and beyond. This phenomenon is a concern for the Central Bank, which believes several factors may be contributing to its persistence, such as uncertainty about the fiscal situation and global disinflation, as well as possible perceptions of weakness in the Copom's commitment to combating inflation.

The resilience of economic activity and the labor market has justified a lack of conviction on the part of some members of the Copom that it is correct to extrapolate the benign behavior of the core inflation rates. Indeed, market participants have been positively surprised by GDP growth for three consecutive years. The median forecast was less than 1% at the start of the year, according to the Central Bank's weekly survey ("Focus") but is now in the 3% range (Figure 2). The acceleration largely reflects the excellent performance of commodity producers and its spillover effects on other sectors, especially services. The discussion has also taken into account other conjunctural factors, such as rising cash transfers and rising numbers of people in paid jobs, as well as structural factors such as the various reforms enacted by Congress in the past decades.

Figure 2: Market Expectations for the GDP Growth



Source: BOCOM BBM, BCB, IBGE

Fiscal uncertainty continues to be one of the mainstays of the balance of risks to inflation. The new fiscal rule recently passed by Congress has not assuaged the market's fears about the trajectory of the debt. Doubt persists as to whether the primary deficit will really be reduced to zero, as promised by the government, and hence whether the triggers required by the law that introduced the new rule will or will not be tripped. Speculation on these matters may have contributed to the local currency depreciation seen in the past few weeks.

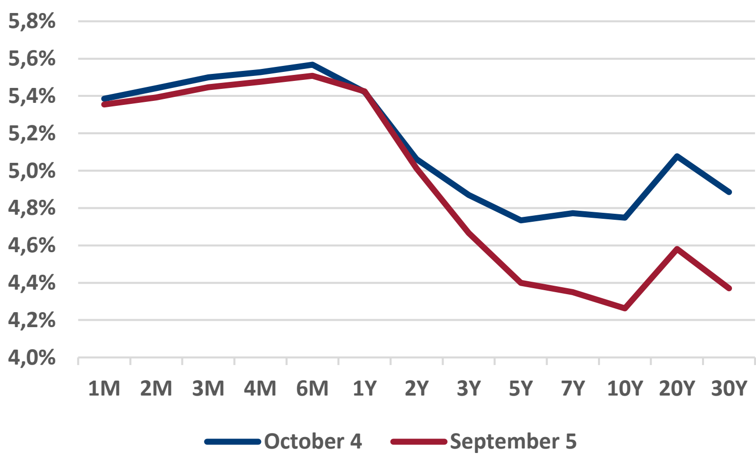
In the global arena, inflation indicators have improved in the main developed economies, and in some cases, such as the euro zone, the improvement has been accompanied by an economic slowdown. The European Central Bank (ECB) raised its policy rates by 25 basis points to 4% at its latest meeting. The signs are that this was the end of the monetary tightening cycle in the region. Although ECB President Christine Lagarde has not referred explicitly to the end of the cycle, she has said that keeping interest rates at their current level "for a sufficiently long period" will help bring inflation back to the target.

In the United States, the FOMC decided to leave the fed funds rate unchanged on 5.25%-5.5% at its latest meeting, but the Committee members' economic projections point to a further rise of 25 bps before year-end. Although the median projection for 2023 remained unchanged on 5.5%-5.75%, it is worth noting that a continuation of the tightening cycle is by no means certain, since seven of the Committee's 19 members expect the rate to stay on hold while 12 expect it to rise. Moreover, the economy remains resilient according to current data and the FOMC's growth projections, which have risen for both 2023 and 2024.

Although the end of the monetary tightening cycle is approaching in the main developed economies, the rise in the long end of the US yield curve seen in the past month will mean additional tightening of monetary conditions and will hinder the monetary loosening cycle in Brazil (Figure 3). There is still room for cuts in the Selic rate, but a narrower interest-rate differential between Brazil and the US will tend to make the Copom more cautious about lowering the rate.

We maintain our expectation of 50 bps in cuts at forthcoming meetings, but we have revised up our projection for the 2024 Selic to 9.5%.

Figure 3: United States Yield Curve



Source: BOCOM BBM, Bloomberg

ECONOMIC FORECASTS	2019	2020	2021	2022	2023F	2024F
GDP Growth (%)	1.2%	-3.3%	5.0%	2.9%	2.9%	1.4%
Inflation (%)	4.3%	4.5%	10.1%	5.8%	4.5%	3.6%
Unemployment Rate (eoy ,%)	11.1%	14.2%	11.1%	7.9%	8.5%	9.0%
Policy Rate (eoy, %)	4.5%	2.0%	9.3%	13.75%	11.75%	9.5%
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%	-1.0%	-0.9%
Government Gross Debt (% of GDP)	74.3%	86.9%	78.8%	72.9%	75.6%	79.0%