Macro Monthly Letter

June 2024

The importance of inflation expectations for the conduct of monetary policy

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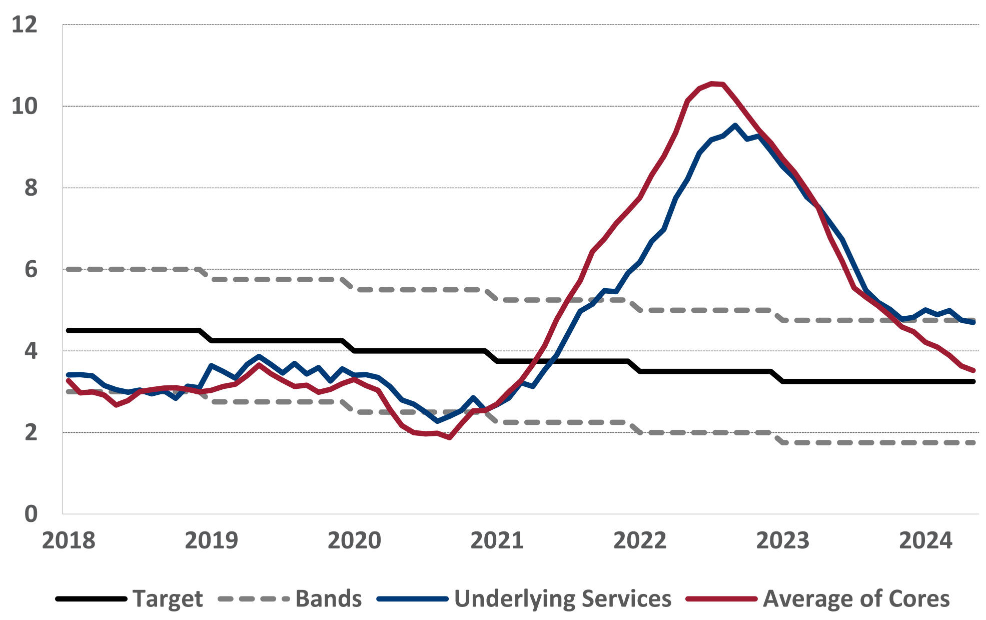
At the start of the year, the consensus among the financial analysts polled by the Central Bank of Brazil (BCB) for its weekly survey Focus was that there was room for interest-rate cuts to continue for some time and that the end-of-cycle Selic rate would be 9% p.a. The consensus forecast is now 10.25%, corresponding to only one more cut of 25 bps. On the other hand, the markets have priced in the end of monetary easing and an unchanged Selic on 10.5% until year-end. The cycle is seen to have ended even though the dynamics of current inflation indicators are benign and the global outlook is more favorable.

With regard to inflation, the data produced positive surprises in the last few months, such as numbers below market expectations and a better composition. The average core rate is already near the target, while underlying services inflation continues to trend down, albeit more gradually (Figure 1). In the United States, inflation and economic activity have both begun to decelerate, which should help the Fed feel sufficiently confident to begin cutting rates this year. These factors would favor monetary easing to continue in Brazil.

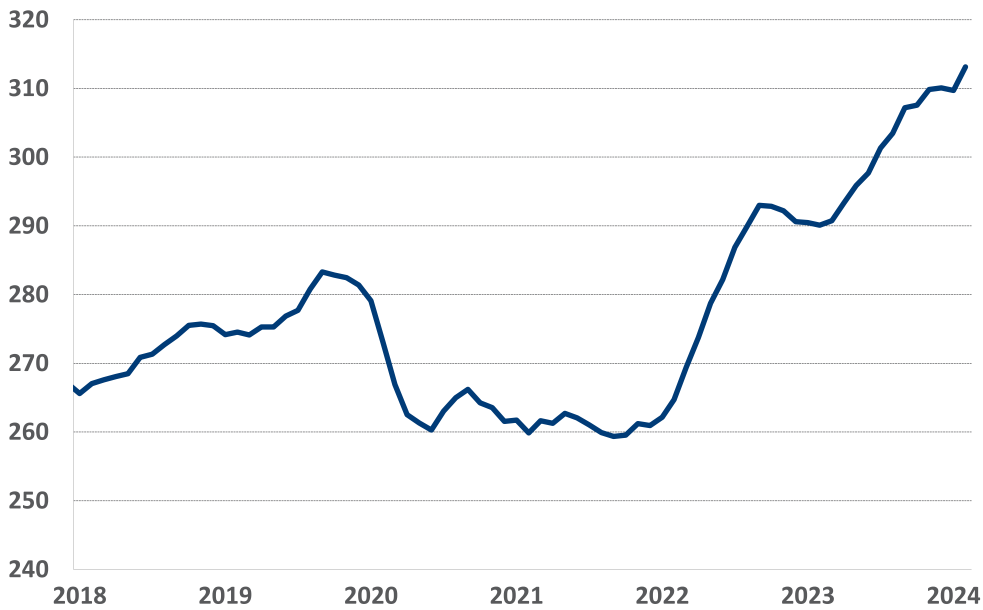
Figure 1: Inflation (% YoY)



Source: BOCOM BBM, IBGE

However, the labor market in Brazil is still impressively vigorous. Both IBGE's national household sample survey (PNADC) and the formal employment numbers (Caged) show the number of people in work rising month after month, and real incomes are also rising. As a result, the real aggregate labor income (the number of workers x average wage) is already almost 8% above the 2023 level (Figure 2). Almost 960,000 formal jobs were created in the first four months of the year, surpassing the number for the same period of 2023. In light of these trends, service disinflation remains challenging, and underlying services inflation is still fluctuating in the region of the upper limit of the target band.

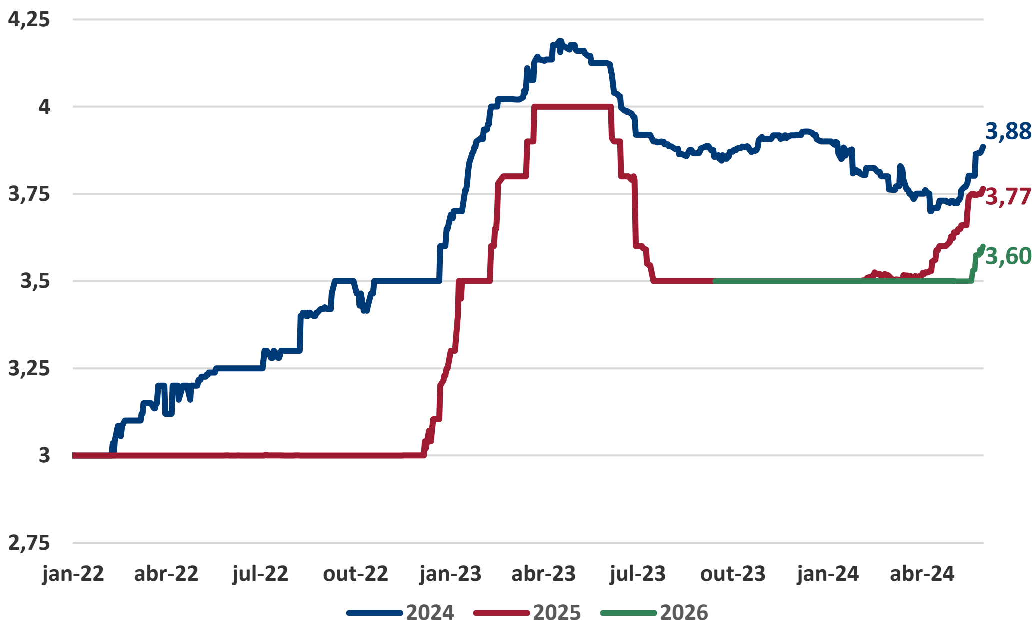
Figure 2: Real aggregate labor income (BRL Billion)



Source: BOCOM BBM, IBGE

While wage hikes are a cause for concern for the dynamics of inflation, the de-anchoring of inflation expectations, especially for longer horizons, has become the most relevant factor for the conduct of monetary policy as the end of the cycle approaches. In the first quarter of 2023, expectations for 2025 reached 4% just as a possible change to the target was under discussion. When the decision to leave the target on 3% was announced, expectations fell somewhat, but have since remain de-anchored by 0.5 of a percentage point. Recently, following the 4-5 split vote at the last meeting of BCB's Monetary Policy Committee (Copom), when four new members opted for a larger rate cut than that actually adopted, inflation expectations for 2025 turned back up again and became even more de-anchored, as did expectations for 2026 (Figure 3).

Figure 3: Median Inflation Expectations (Focus)



Source: BOCOM BBM, BCB

There are many possible reasons for the rise in longer-term inflation expectations, as discussed in the minutes from the last Copom meeting. They include: (i) the deterioration in the global outlook; (ii) the recent fiscal policy announcements and the resulting deterioration in the projected trajectory of the national debt; and (iii) economic agents' perceptions regarding the strength of BCB's commitment to the inflation target over the years, which could change as new Copom members are appointed. Although the committee has insisted that, regardless of the cause, it will pursue a re-anchoring of expectations, the fact is that they continue to trend up.

Above-target inflation expectations make the disinflation process slower and more costly, because when people and businesses believe inflation is going to rise, they raise wages and prices sooner rather than later, and inflation also rises sooner than it would otherwise. The rise in longer-term inflation expectations contaminates shorter-term inflation expectations, and more restrictive rates are needed in order to bring inflation back down to the target. We have therefore revised up our projection for the end-2024 Selic to 10.5%, as the effects of the de-anchored longer-term inflation expectations have surpassed the positive outlook of current inflation in recent months. Our other projections are shown in the table below.

ECONOMIC FORECASTS	2020	2021	2022	2023	2024F	2025F
GDP Growth (%)	-3.3%	4.8%	3.0%	2.9%	1.8%	2.0%
Inflation (%)	4.5%	10.1%	5.8%	4.6%	3.8%	4.0%
Unemployment Rate (eoy ,%)	14.7%	11.7%	8.3%	7.4%	8.4%	8.5%
Policy Rate (eoy, %)	2.0%	9.3%	13.8%	11.75%	10.50%	9.00%
External Accounts						
Trade Balance MDIC (US$ bn)	50	61	62	99	87	78
Trade Balance (US$ bn)	32	36	44	81	67	58
Current Account Balance (US$ bn)	-28	-46	-48	-29	-34	-43
Current Account Balance (% of GDP)	-1.9%	-2.8%	-2.5%	-1.3%	-1.5%	-1.8%
Fiscal Policy						
Central Government Primary Balance (% of GDP)	-9.8%	-0.4%	0.5%	-2.1%	-0.7%	-0.8%
Government Gross Debt (% of GDP)	86.9%	77.3%	71.7%	74.3%	77.9%	80.4%