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Divergence between the current scenario and market sentiment

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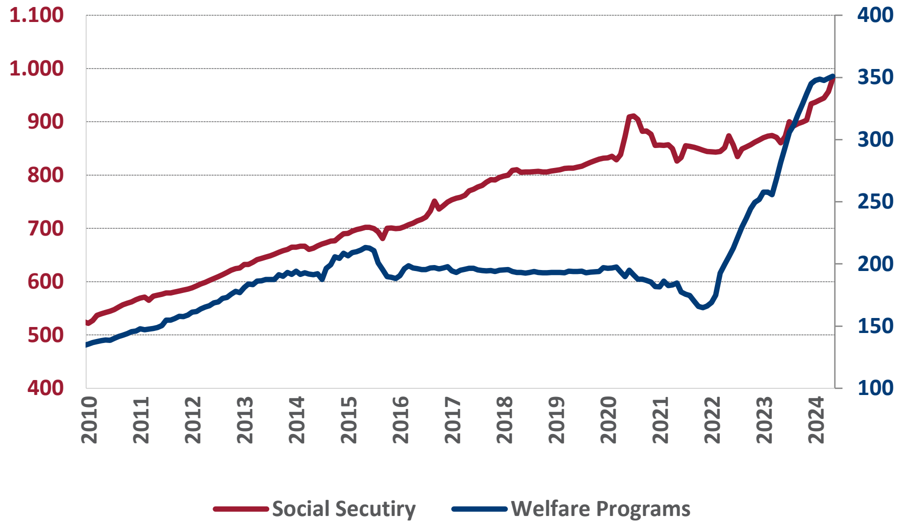
Not even the adverse impact of the rainstorms and floods in Rio Grande do Sul on economic activity and food prices, especially prices of fresh produce, have managed to change the favorable outlook for growth and inflation this year. One reason is that the provision of more than BRL 60 billion in federal funds to support the population affected by the flooding should be capable of normalizing the state's economy during the second half of the year. There are other reasons for the current positive outlook, however.

Among them is strong growth of aggregate incomes, a term that encompasses not only earnings from work but also household income from benefits, pensions and other welfare payments (Figure 1). In the labor market, the drivers of this growth include the rising number of people at work and above-inflation wage gains. With regard to other income sources, the rising number of beneficiaries of welfare programs such as BPC (cash transfers to the elderly poor and disabled) and recipients of social security allowances such as sickness benefit must be added to the effects of the new minimum wage policy, to which these payouts are indexed (Figure 2).

Figure 1: Real aggregate labor income (BRL Billion)

Source: BOCOM BBM, IBGE

Figure 2: Welfare programs and Social Security Expenses (BRL Billion)



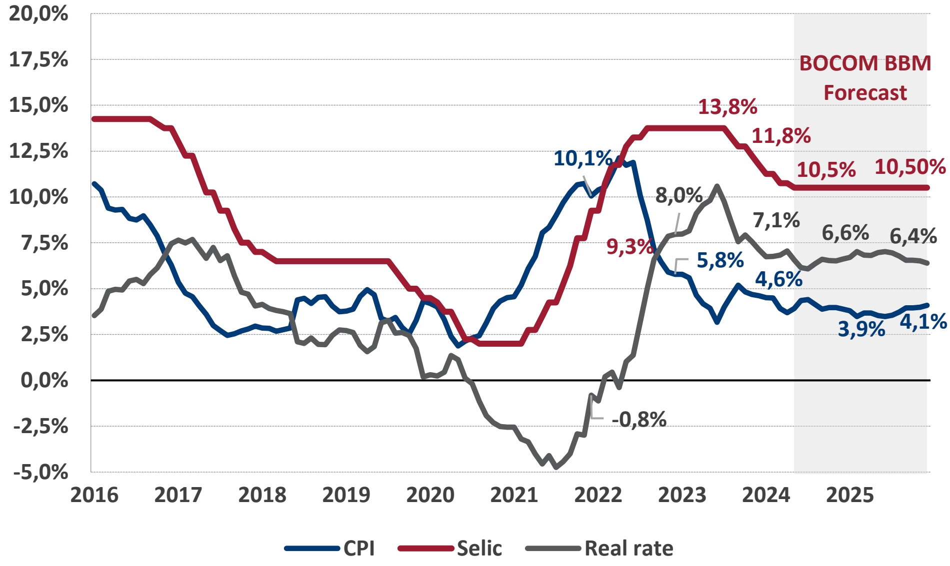
Source: BOCOM BBM, Tesouro Nacional

The resilience of economic activity became evident after the publication of first-quarter GDP data, with surprises concentrated in services (on the supply side) and household consumption (demand), but the high-frequency data available so far for the second quarter has brought more surprises, triggering fresh rounds of revisions to growth projections. Ours is now 2.1% (up from 1.8%), in line with the consensus forecast according to the Central Bank of Brazil's weekly survey of financial analysts ("Focus").

Although rising incomes may also hinder convergence of inflation to the target, some of the latest readings of the IPCA fell short of market expectations. However, the more inertial metrics, such as core rates and underlying services, which are closely tracked by the Central Bank, have followed the expected trajectory. Our inflation forecast for 2024, now 3.9% (up from 3.8%), therefore reflects only corrections due to the supply shock in food produced in Rio Grande do Sul, ignoring any adjustments for potential deterioration in the dynamics of the core rates and underlying services.

Overall, the current indicators show continuing improvement in terms of disinflation and the dynamism of the economy, but 2025 is set to present more challenges. In response to local currency depreciation and rising inflation expectations for longer horizons, the Monetary Policy Committee revised up its inflation projections for next year, interrupting the cycle of rate cuts and stating in its communication that its alternative scenario posits inflation closer to the target if the Selic is left on hold for a longer period. In light of this, we have revised up our projection for the end-2025 Selic from 9% to 10.5% (Figure 3).

Figure 3: CPI, Selic Rate and Real Ex-post Interest Rate (YoY, %)



Source: BOCOM BBM, IBGE, BCB

The Central Bank's more contractionary monetary policy has led us to revise down our projection for GDP growth in 2025 to 1.9% (from 2%), but we have revised up our 2025 inflation projection marginally to 4.1%, taking into account the de-anchoring of expectations and the probability that actual growth will still be very close to potential growth (around 2%), as these two factors will hinder the last stage of the disinflation process.

Local currency depreciation and rising inflation expectations for longer horizons reflect the markets' concern about fiscal performance: expenditures are rising much faster than revenues, including those contemplated by the rules established in the new fiscal framework, which cap expenditure growth at 2.5% in real terms. Any rise in expenditure above the level specified in the budget for the year and a failure to comply with the zero primary deficit target are expected to lead to a spending freeze, but there is little scope for adjustment as the rules governing expenditure are strict.

This raises questions as to the sustainability of the fiscal framework without structural reforms to cut spending, contributing to the more pessimistic market mood. The best remedy would be a clearer indication from the government as to how it means to achieve the targets set. Our other projections are shown in the table below.

ECONOMIC FORECASTS	2019	2020	2021	2022	2023	2024F	2025F
GDP Growth (%)	1.2%	-3.3%	4.8%	2.9%	2.9%	2.1%	1.9%
Inflation (%)	4.3%	4.5%	10.1%	5.8%	4.6%	3.9%	4.1%
Unemployment Rate (eoy ,%)	11.1%	14.2%	11.1%	7.9%	7.4%	7.8%	7.9%
Policy Rate (eoy, %)	4.5%	2.0%	9.3%	13.8%	11.75%	10.50%	10.50%
External Accounts							
Trade Balance MDIC (US$ bn)	35	50	61	62	99	90	95
Trade Balance (US$ bn)	27	32	36	44	81	68	73
Current Account Balance (US$ bn)	-68	-28	-46	-48	-31	-34	-43
Current Account Balance (% of GDP)	-3.6%	-1.9%	-2.8%	-2.5%	-1.3%	-1.5%	-1.8%
Fiscal Policy							
Central Government Primary Balance (% of GDP)	-1.3%	-9.8%	-0.4%	0.5%	-2.1%	-0.7%	-0.8%
Government Gross Debt (% of GDP)	74.4%	86.9%	77.3%	71.7%	74.4%	77.9%	80.4%