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The dynamism of Brazil's economy and the space for rate cuts

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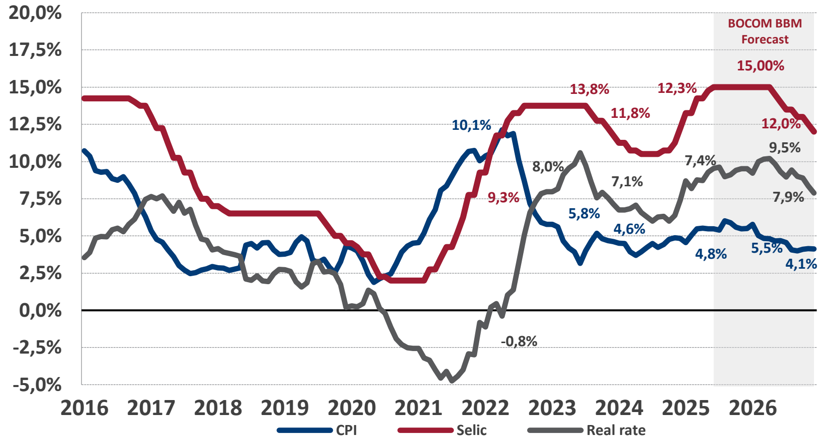
The effects of the rise in the Central Bank of Brazil's policy rate (Selic) since the start of the new monetary tightening cycle in September 2024 – 425 bps so far – and the historically high level of the Selic in real terms (Figure 1) would normally be expected to reduce the pace of economic growth, job creation, and household consumption. A comparative perspective shows that the Selic is almost at the same level in real terms as it was in 2023, when inflation fell from two digits to a single digit. But the disinflation process is not set to continue significantly this year or next, partly because of the strong dynamism of the economy, even though monetary policy seem to be in contraction territory.

Figure 1: Brazil – CPI, Selic Rate and Real Ex-post Interest Rate (YoY, %)

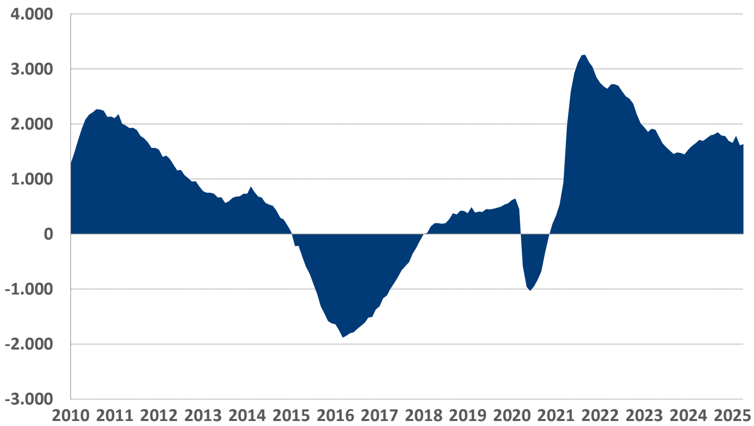


Source: BOCOM BBM, BCB, IBGE

Gross domestic product (GDP) grew significantly in the first quarter of 2025, rising 1.4% compared with the previous quarter. The main driver of this growth was the agricultural sector, thanks largely to a record soybean crop, but more cyclical sectors of the economy also contributed. Services rose 0.3%, for example, with practically all subcategories expanding. In addition, gross national expenditure (GNE) rose 1.2%, reflecting growth in household consumption and fixed capital formation.

First-quarter GDP is a lagging indicator, but early data on the second quarter also points in the same direction. In the labor market, creation of formal jobs was much stronger than expected, according to the Labor Ministry's CAGED report (Figure 2). IBGE's national household sample survey (PNAD), which covers both formal and informal employment, showed the unemployment rate continuing to fall. Indeed, it reached the lowest level since the start of the time series in 2012. In the credit market, the annual rate of growth in lending accelerated again despite the high level of interest rates on loans.

Figure 2: Net Payroll Job Creation 12 Months (Thousands)

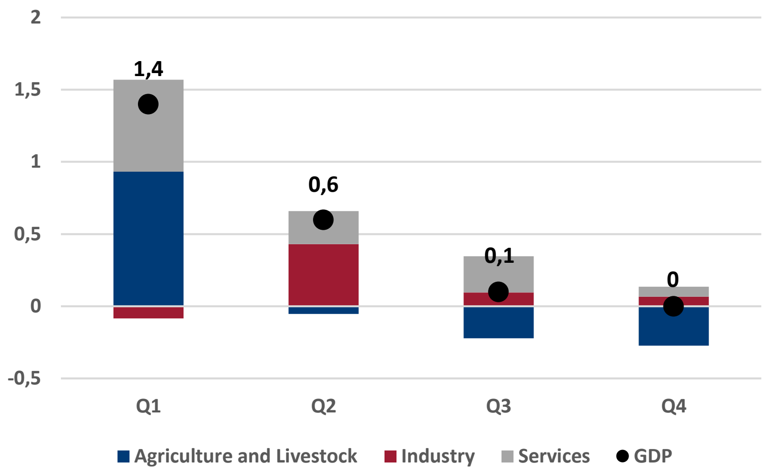


Source: BOCOM BBM, MTE

A restrictive monetary policy should be accompanied by a more evident economic slowdown, but this cannot be inferred from the current data. Moreover, while current inflation has shown signs of moderation recently, the core rates are still running above the target, and expectations are de-anchored.

According to our projections, the economy will indeed slowdown in the second half of this year, but new stimulus measures could produce surprises (Figure 3). Some measures announced recently by the government will give household income an extra boost. Examples include the release of FGTS severance fund deposits, expansion of the Minha Casa Minha Vida social housing program, and the gas voucher program (Vale Gás). Other newly launched measures, such as an employee loan program (Crédito do Trabalhador), will bolster consumer spending via an increase in disposable income.

Figure 3: Contribution to GDP Growth in 2025 (QoQ)



Source: BOCOM BBM, IBGE

In the opposite direction, shortfalls in federal revenue and projected growth in expenses on welfare and social security programs are forcing the government to freeze parts of its budget and seek new sources of revenue in order to comply with the fiscal deficit cap. One such proposal is a hike in the IOF financial transactions tax, which would raise the cost of corporate credit and could contribute to the economic slowdown. This appears unlikely to be passed by Congress, as do other proposed measures designed to boost revenue.

A climate of heightened uncertainty requires caution in the conduct of monetary policy. However, recent data suggests that the domestic economy continues to be surprisingly dynamic and could remain so throughout the second half thanks to new stimulus measures. In the global arena, progress in tariff negotiations between the United States and other countries appears set to favor world economic growth. All told, these factors may mean that Brazil's monetary policy may need to remain in restrictive territory for a prolonged period of time.

ECONOMIC FORECASTS	2020	2021	2022	2023	2024	2025F	2026F
GDP Growth (%)	-3.3%	4.8%	3.0%	2.9%	3.4%	2.5%	1.5%
Inflation (%)	4.5%	10.1%	5.8%	4.6%	4.8%	5.5%	4.1%
Unemployment Rate (eoy ,%)	14.2%	11.1%	7.9%	7.4%	6.2%	6.8%	7.5%
Policy Rate (eoy, %)	2.0%	9.3%	13.8%	11.75%	12.3%	15.00%	12.0%
External Accounts							
Trade Balance (US$ bn)	36	42	52	92	66	62	73
Current Account Balance (US$ bn)	-25	-40	-42	-28	-61	-70	-55
Current Account Balance (% of GDP)	-1.7%	-2.4%	-2.2%	-1.3%	-2.8%	-3.2%	-2.4%
Fiscal Policy							
Central Government Primary Balance (% of GDP)	-9.8%	-0.4%	0.5%	-2.1%	-0.4%	-0.7%	-0.6%
Government Gross Debt (% of GDP)	86.9%	77.3%	71.7%	74.4%	76.1%	80.5%	85.3%