

Macro Monthly Letter

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The start of rate cut cycle in Brazil

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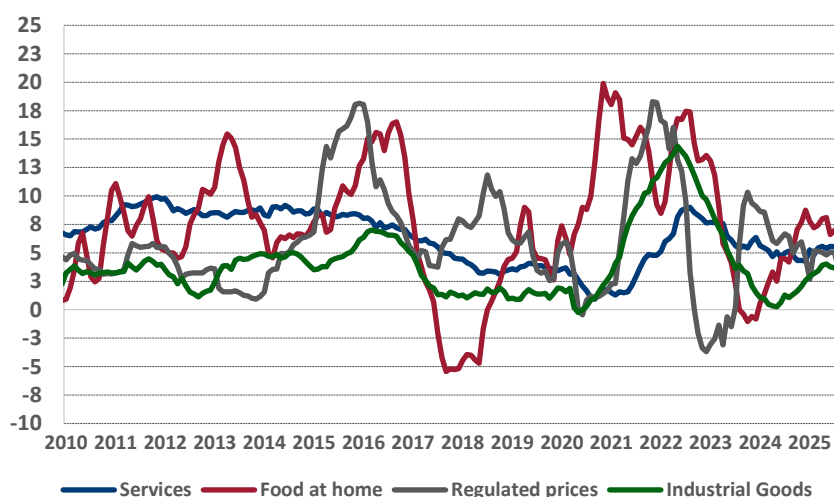
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The latest meeting of the Central Bank of Brazil's Monetary Policy Committee (Copom) marked the start of a new stage in the monetary policy cycle. After having raised its policy rate (Selic) by 450 basis points, the Copom decided to pause the tightening cycle at its July meeting, with the aim of evaluating whether at 15% the Selic would assure the convergence of inflation to the target. Although it is unlikely that the rate will have to be raised to an even more restrictive level, the committee did not officialize the end of the tightening cycle until September, signaling that the Selic will be held steady for a "very prolonged period".

In light of the significantly contractionary level of the Selic, it is natural to expect that the new stage of the monetary policy cycle will involve rate cuts. But what conditions will need to be met in order for these to materialize?

In recent months the balance of risks to inflation evolved in a benign manner. Local currency appreciation and falling commodity prices contributed to a reduction in current inflation, especially in tradables, such as food and manufactures (Figure 1). Inflation expectations also displayed moderation, not only at short horizons but also for the longer term. Despite these improvements, inflation expectations remain de-anchored, with current inflation still above the upper limit of the target band, indicating that more progress still needs to be achieved.

Figure 1: Inflation Accumulated in 12 months



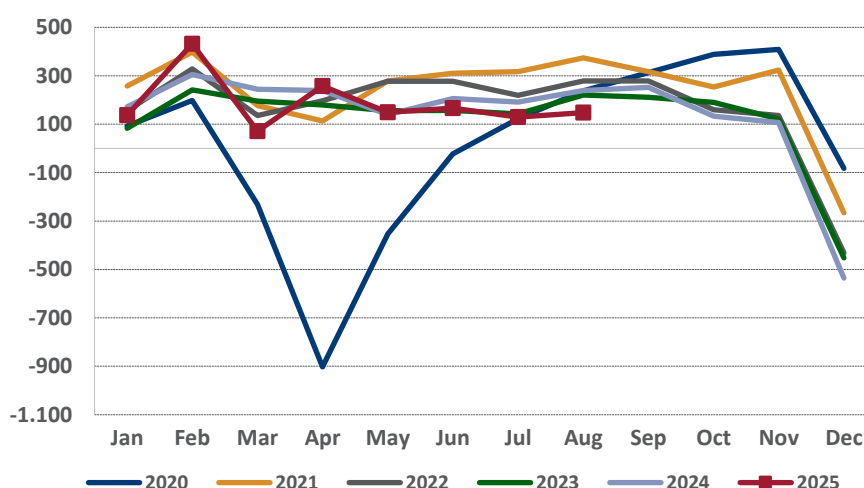
Source: BOCOM BBM, IBGE

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The Central Bank's projection for inflation at the relevant horizon is 3.4% (the target is 3%). This projection takes into account the consensus forecast of around 275 bp in rate cuts between January and December 2026 detected by the Focus survey, but given the above issues the onset of the loosening cycle may be delayed somewhat or the Selic may not be lowered quite as much in the period.

Recent activity indicators confirmed the economic slowdown that began in the second quarter. The labor market is still very tight but has begun to show signs of a turnaround, with net job creation surprising negatively according to the Ministry of Labor's employment report (CAGED) (Figure 2), and both the number of people in paid work and earned incomes decelerating according to IBGE's national household sample survey (PNAD). Leading indicators such as the Cielo broad retail index (ICVA), and vehicle production and licensing according to Fenabrave and Anfavea, pointed to slower economic activity in August, to which should be added weaker credit data, with new loans extended falling sharply while past-due loans and household debt both rose.

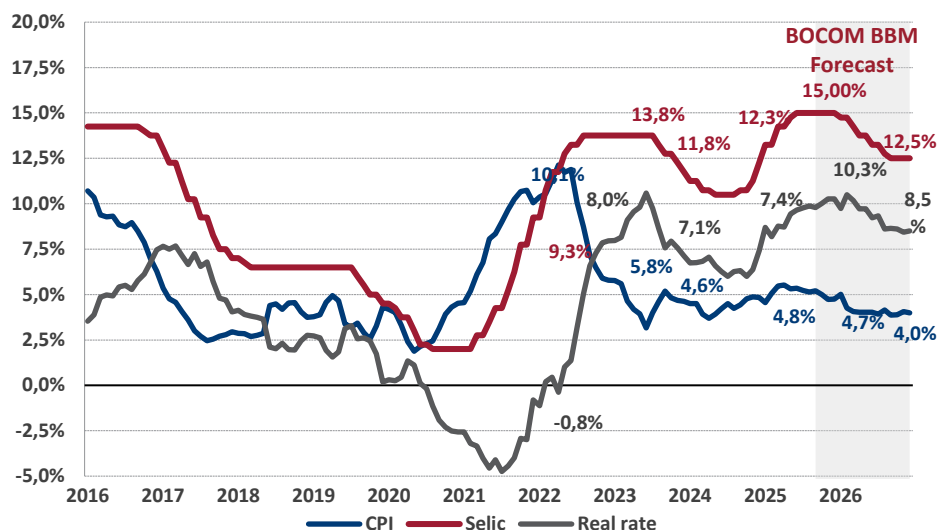
Figure 2: CAGED - Balance of Jobs (Thousand)



Source: BOCOM BBM, MTE

The outlook presents a number of risks to continuation of the disinflation process. The Central Bank expects the output gap to move from positive to negative territory, with a fall of about 1 percentage point between the third quarter of this year and the start of 2027, but surprises in economic dynamism have required many revisions to output gap forecasts in recent years. Moreover, fiscal policy has historically been expansionary in the runup to presidential elections, and this too is a source of considerable uncertainty.

Despite the significant doubts about the economic outlook, the Copom has signaled that the bar for the onset of monetary loosening is high. Although the USD's weakness may favor the BRL, leading to further local currency appreciation, a fresh round of improvements to inflation expectations and a sharper economic slowdown also appears to be necessary. We have therefore revised our projections for the Selic to 15% in 2025 and 12.5% in 2026 (Figure 3).

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


Source: BOCOM BBM, BCB, IBGE

ECONOMIC FORECASTS	2020	2021	2022	2023	2024	2025F	2026F
GDP Growth (%)	-3.3%	4.8%	3.0%	2.9%	3.4%	2.1%	1.5%
Inflation (%)	4.5%	10.1%	5.8%	4.6%	4.8%	4.7%	4.0%
Unemployment Rate (eoy, %)	14.2%	11.1%	7.9%	7.4%	6.2%	6.5%	7.0%
Policy Rate (eoy, %)	2.0%	9.3%	13.8%	11.75%	12.3%	15.00%	12.5%
External Accounts							
Trade Balance (US\$ bn)	36	42	52	92	66	62	73
Current Account Balance (US\$ bn)	-25	-40	-42	-28	-61	-72	-55
Current Account Balance (% of GDP)	-1.7%	-2.4%	-2.2%	-1.3%	-2.8%	-3.3%	-2.4%
Fiscal Policy							
Central Government Primary Balance (% of GDP)	-9.8%	-0.4%	0.5%	-2.1%	-0.4%	-0.5%	-0.7%
Government Gross Debt (% of GDP)	86.9%	77.3%	71.7%	74.4%	76.1%	80.3%	85.1%

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