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The cycle of interest rate cuts is set to begin soon, but its full extent is uncertain

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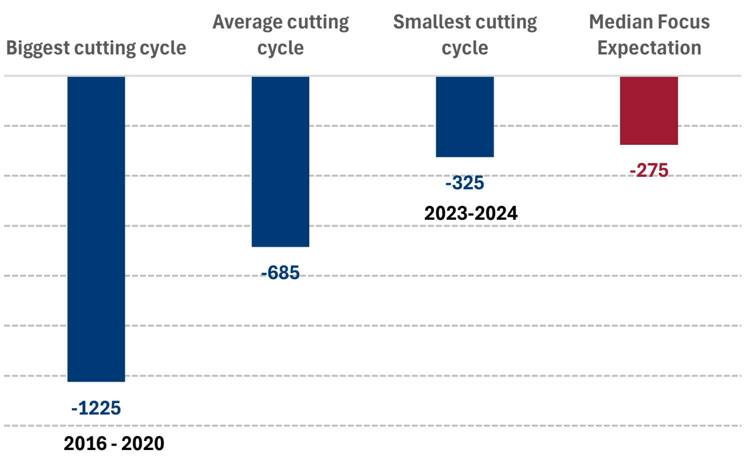
The improvement in current inflation and falling inflation expectations, alongside the economic slowdown, local currency appreciation and a drop in commodity prices, have consolidated the conditions for calibration of interest rates, which are now at one of the highest levels ever seen in Brazil. The Monetary Policy Committee (Copom) therefore announced at its January meeting that monetary easing was to begin in March. While the start of the cycle is certain, the policy rate (Selic) is likely to be lowered far less than in past periods of interest-rate cuts.

The model used by the Central Bank of Brazil (BCB) shows inflation near the target at the relevant horizon on the basis of the trajectory of the Selic forecasted by leading financial analysts in the BCB's Focus survey. The forecast assumes a cycle of cuts amounting to 275 basis points, with the Selic falling from 15% p.a. to 12.25% and hence remaining at a restrictive level throughout 2026.

This would be the smallest reduction in the Selic for the past 20 years (Figure 1). Uncertainty about the presidential election scheduled for October and hence about the economic policies to be implemented by the next administration, which will take office in January 2027, make this cycle more challenging. Whichever candidate wins, a degree of fiscal adjustment to make the trajectory of the public debt more sustainable is expected (Figure 2). Only one of the last six presidential election campaigns saw the start of a cycle of rate cuts. This happened in 2002. The BCB had to reverse direction very soon after the election (Figure 3).

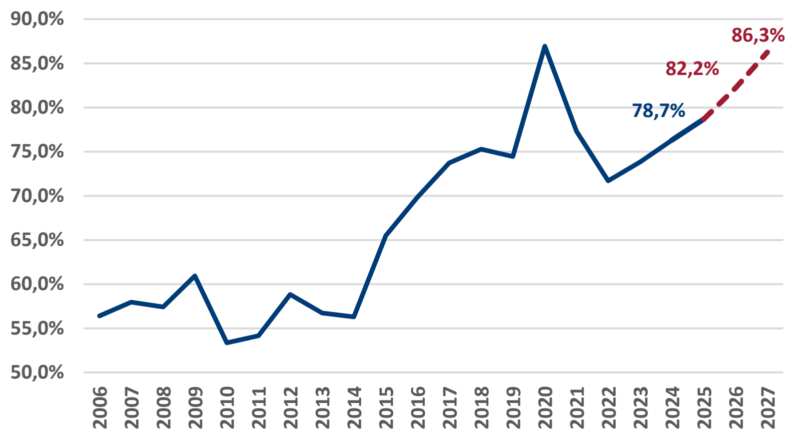
Figure 1: Cutting cycles over the last 20 years (bps)



Source: BOCOM BBM, BCB

On one hand, service inflation remains resilient, and the labor market is tight. On the other hand, monetary policy operates with a time lag. The slowdown in the more cyclical and credit-related sectors suggests its transmission to the economy is taking effect. It is reasonable to assume that a decline in employment, wages and, lastly, service inflation will take longer to become visible.

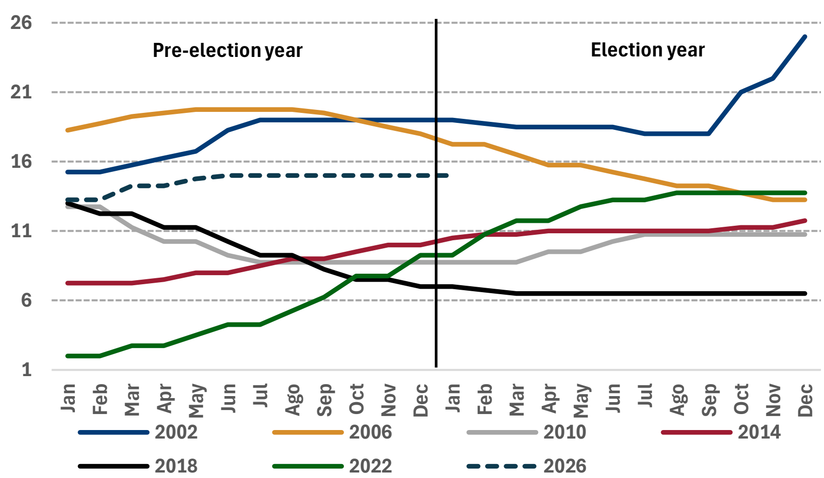
Figure 2: Gross Debt (% GDP)



Source: BOCOM BBM, BCB

Nevertheless, there are many risks on the horizon. New demand impulses fueled by fiscal policy may boost the dynamism of the economy and the resilience of inflation. The government has launched several credit and income transfer programs, with the budget for the main initiatives amounting to some BRL 100 billion so far. In the context of a tight labor market, these measures will increase household income and delay an adjustment via consumption.

Figure 3: Selic rates in election years (level, %)



Source: BOCOM BBM, BCB

Another factor that could limit the extent of the cycle of cuts is exchange-rate volatility, which typically increases during election years. In this regard, however, consistent local currency appreciation, driven mainly by the USD's global weakness, will contribute positively to the disinflation process. Prices of food and energy commodities are also on a benign inflation path, and household consumption is gradually slowing down. In addition, the fall in prices of imports from China is helping to limit tradables inflation.

The direction displayed by the data during the year and the materialization of risks should dictate the pace and magnitude of the cycle of rate cuts. We anticipate slightly less than the cycle priced in by the markets, with the Selic ending the year on 12.5% p.a., and inflation slowing to 3.8% in 2026 and 3.5% in 2027. If the incoming administration takes steps toward the necessary agenda of fiscal reforms, the cycle of cuts could be longer and continue into 2027. Our complete scenario is shown in the table below.

ECONOMIC FORECASTS	2020	2021	2022	2023	2024	2025F	2026F	2027F
GDP Growth (%)	-3.3%	4.8%	3.0%	2.9%	3.4%	2.3%	1.8%	1.8%
Inflation (%)	4.5%	10.1%	5.8%	4.6%	4.8%	4.3%	3.8%	3.5%
Unemployment Rate (eoy ,%)	14.2%	11.1%	7.9%	7.4%	6.2%	5.1%	5.5%	6.2%
Policy Rate (eoy, %)	2.0%	9.3%	13.8%	11.75%	12.3%	15.0%	12.5%	10.50%
External Accounts								
Trade Balance (US$ bn)	36	42	52	92	66	60	70	71
Current Account Balance (US$ bn)	-25	-40	-42	-28	-66	-69	-60	-57
Current Account Balance (% of GDP)	-1.7%	-2.4%	-2.2%	-1.3%	-3.0%	-3.0%	-2.5%	-2.2%
Fiscal Policy								
Central Government Primary Balance (% of GDP)	-9.8%	-0.4%	0.5%	-2.1%	-0.4%	-0.5%	-0.4%	-0.7%
Government Gross Debt (% of GDP)	86.9%	77.3%	71.7%	74.4%	76.1%	78.7%	82.2%	86.3%