

How the risks of the ME conflict are materializing

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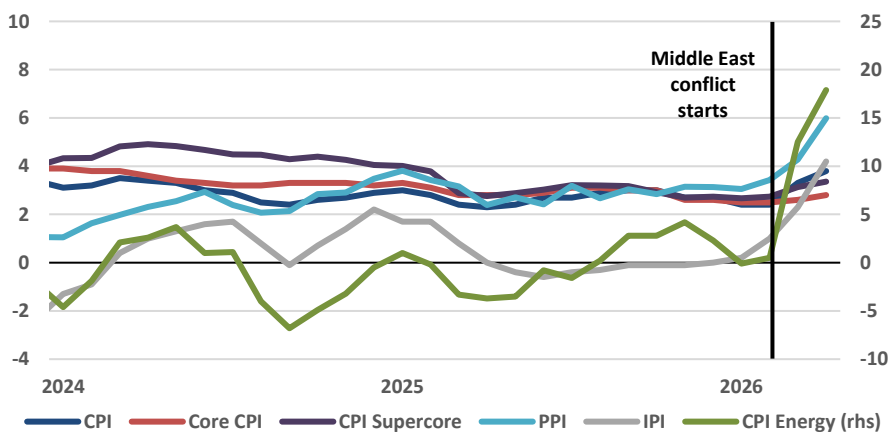
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The persistence of the conflict in the Middle East, which has now lasted close to 100 days, continues to change the global outlook profoundly. The jump in oil prices and the supply chain disruption due to the logistics bottleneck created by the war have halted the disinflation process and resulting normalization of monetary policy previously seen around the world. Re-acceleration of inflation has led to a sharp global rise in interest rates, a steady reduction in the scope for rate cuts, and discussions on the need for monetary tightening in several countries.

The sources of inflationary pressure are not limited to fuel prices and are indirectly affecting all supply chains for tradables. Rising freight and insurance costs are driving up the prices of industrial goods, while fertilizer supply difficulties are adding to food inflation. The jet fuel price shock is already reflected by air fares and entails additional risk for transportation and logistics chains.

In the United States, the latest CPI readings confirmed a significant acceleration not only of the energy component, which spiked from 0.48% in the 12 months prior to the war to 17.87% in April, but also of others such as core services ex-housing (sometimes called the “supercore” CPI), which accelerated from 2.74% to 3.37%. In addition, the rise in producer price inflation (from 3.4% to 6.0%) and import price inflation (from 1.0% to 4.2%) suggests that the impact on inflation may be more protracted (Figure 1).

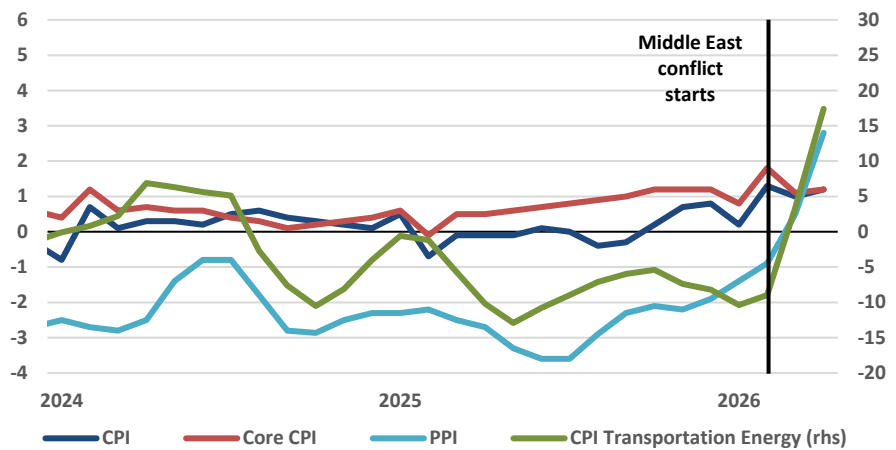
Figure 1: US - Inflation Metrics (YoY, %)



Source: BOCOM BBM, Macrobond, BLS

In China, producer price inflation jumped from -0.9% in the 12 months before the war to 2.8% in April, after almost four years in negative territory. Consumer inflation, currently 1.2%, is the highest it has been for years, with energy and travel services rising most of all (Figure 2). Similar trends have been reported in the European Union and United Kingdom, with headline inflation rising since the start of the war owing to higher energy costs, although the upside pressure on other components has remained relatively limited so far.

Figure 2: China - Inflation Metrics (YoY, %)

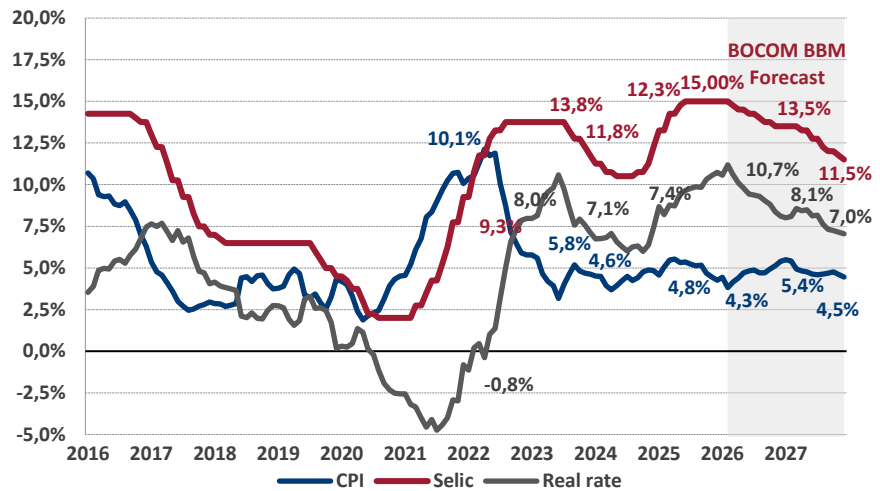


Source: BOCOM BBM, Macrobond, NBS

These abrupt changes in the global outlook make further rate cuts unlikely in Brazil. Even before the start of the war, the extent of monetary tightening was expected to be limited because the improvement in inflation was mostly due to tradables, while the core measures remained at levels incompatible with the inflation target. Our projection for the IPCA in 2026 was around 4% before the war and is now 5.4%. Besides the impact on current inflation, longer-term expectations are also being affected and remain de-anchored. These factors, combined with the resilience of the economy, which re-accelerated in the first half of the year, and with the dynamism of the labor market, have considerably narrowed the scope for more monetary easing (Figure 3).

Uncertainty about the end of the conflict remains acute, but a deal could lead to partial reversal of energy prices and less supply chain disruption. Even so, the effects of a resolution to the war are unlikely to be seen in the short term, as trade flows will first have to be restored and inventories replenished.

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



Source: BOCOM BBM, BCB, IBGE

ECONOMIC FORECASTS	2020	2021	2022	2023	2024	2025	2026F	2027F
GDP Growth (%)	-3.3%	4.8%	3.0%	2.9%	3.4%	2.3%	2.0%	1.5%
Inflation (%)	4.5%	10.1%	5.8%	4.6%	4.8%	4.3%	5.4%	4.5%
Unemployment Rate (eoy, %)	14.2%	11.1%	7.9%	7.4%	6.2%	5.1%	5.6%	6.2%
Policy Rate (eoy, %)	2.0%	9.3%	13.8%	11.75%	12.3%	15.0%	13.50%	11.50%
External Accounts								
Trade Balance (US\$ bn)	36	42	52	92	66	60	81	75
Current Account Balance (US\$ bn)	-25	-40	-42	-28	-66	-69	-54	-50
Current Account Balance (% of GDP)	-1.7%	-2.4%	-2.2%	-1.3%	-3.0%	-3.0%	-2.0%	-1.9%
Fiscal Policy								
Central Government Primary Balance (% of GDP)	-9.8%	-0.4%	0.5%	-2.1%	-0.4%	-0.5%	-0.4%	-0.3%
Government Gross Debt (% of GDP)	86.9%	77.3%	71.7%	74.4%	76.1%	78.7%	82.7%	86.8%

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