



# Global Macro Research

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#Emerging Markets / #Monetary Policy /

#Inflation

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## Fiscal slippage and Lula's frustration: Why Brazil's central bank has paused cuts and what to expect

The Brazilian central bank will keep policy on hold for the rest of the year as a combination of sticky inflation, fiscal concerns and economic resilience reduces the scope for rate cuts in the near term. However, we expect it to resume easing in 2025, as fiscal consolidation takes place and inflation concerns fade.

### Key Takeaways

- A combination of fiscal slippage, economic resilience and rising inflation expectations has increased the upside risks to the inflation outlook, leading the Brazilian central bank (BCB) to pause its cutting cycle and keep its policy rate at 10.50% since June.
- We expect the pause to continue through the rest of the year, as the BCB looks to ensure that Brazil's inflation doesn't reaccelerate.
- Indeed, we expect inflation to be slow to reach the BCB's 3% target mid-point on a sustained basis, averaging 4.2% in 2024 and 3.5% in 2025.
- However, a shift towards modest fiscal consolidation in the second half of 2024, along with still restrictive monetary conditions, will weigh on activity and ensure inflation remains broadly within the 3% +/-1.5ppts target band.
- With the US Federal Reserve set to begin its easing cycle in September, we think the BCB should have scope to resume cuts in 2025, taking the policy rate to 9.75% by year end.
- However, risks are skewed towards tighter policy. Renewed fiscal concerns in 2025 and an erosion of BCB independence could lead to investors becoming increasingly concerned about the inflation outlook with the BCB then having to keep policy more restrictive.

### BCB takes a (hawkish) pause

The Banco Central do Brasil (BCB) has signalled a prolonged pause in its policy easing cycle as it looks to keep policy conditions restrictive, marking a significantly more cautious path than in the first half of the year. The monetary policy committee (Copom) voted unanimously to keep the policy rate, the Selic rate, at 10.5% in July.

This follows the BCB's decision at its June meeting to pause easing after a run of seven consecutive policy meetings in which a total of 325bps of cuts had been delivered. Indeed, the BCB joins a growing group of emerging market central banks halting their rate cutting cycles in recent months.

The rationale for the pause was policymakers' concern that inflation would take longer to return to the BCB's 3% target than previously thought. In July, Copom revised its inflation forecast further away from its target, up 0.2pts to 4.2% in 2024 and 0.2pts to 3.6% in 2025, and introduced a six-quarters-ahead (Q126) forecast at 3.4%, indicating a slow disinflation process.

The drivers of the upward revisions were a combination of some stickiness in recent inflation prints, signs of a more resilient economy, currency weakness and uncertainty over the outlook for fiscal policy under President Luiz Inácio Lula da Silva.

These concerns are shared by market participants, who have lost their appetite for Brazil's high-interest rate currency as carry trade with lower-yielding currencies. The Brazilian *real* has weakened 17% year to date and markets are pricing in no further cuts and possibly a hike by year end.



We agree that the BCB will need to move more cautiously given the weakness of the currency, fiscal challenges and upside risks to inflation. But policy is still restrictive and there is scope to cut rates without policy becoming outright accommodative.

As such, we expect monetary policy to remain unchanged this year, but to see 75bps of policy easing to 9.75% in 2025.

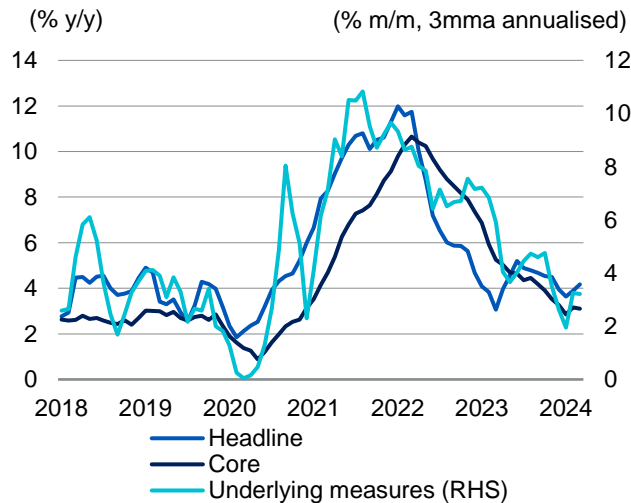
However, the risks are very much to the upside given the multitude of factors that could dissuade the BCB from cutting.

**Inflation challenge goes into extra time**

The rationale for the BCB’s easing cycle had been based on the view that considerable progress had been made on tackling inflation.

Indeed, Brazil’s headline inflation rate dropped 7.8ppts from its peak in April 2022 to 4.2% year over year in June (see Figure 1). Core inflation has also fallen sharply, running at a three-month average of 3.2% on a month-over-month annualised basis, and the diffusion index has been declining since January, suggesting disinflation is broadening out.

**Figure 1: Inflation returning to pre-pandemic rates**

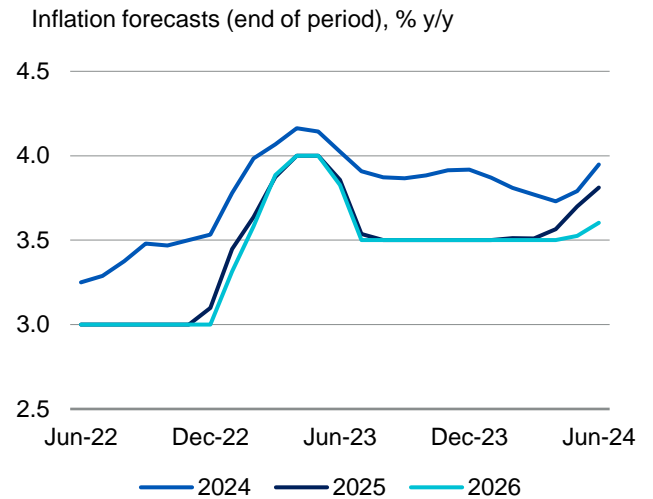


Source: Haver, abrdrn, August 2024

However, there are stickier elements within the CPI basket, particularly services inflation, which is running around the upper bound of the BCB’s 3% +/-1.5% target range, coming in at 3.7% on a sequential basis in June. More labour-intensive service prices have been running even higher.

As such, policymakers have consistently flagged concerns that the last leg of disinflation could prove more challenging than their estimates suggested, helping to explain the recent policy pause. The trajectory of inflation expectations is likely to be of particular concern, with the BCB’s weekly survey of market participants showing both short- and medium-term inflation expectations rising (see Figure 2).

**Figure 2: Inflation expectations have risen again**

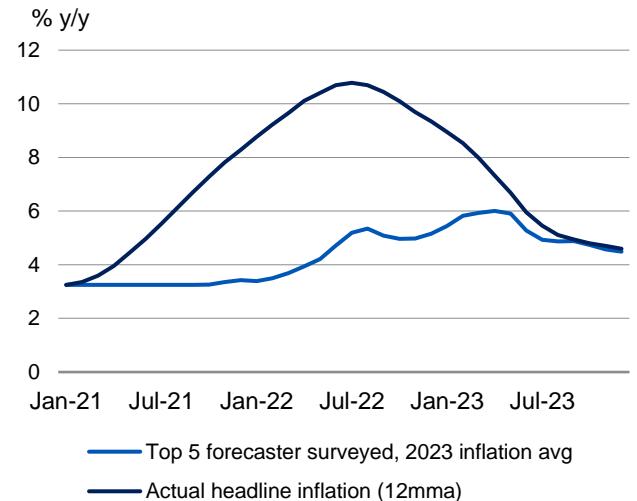


Source: BCB Focus Survey, Haver, abrdrn, August 2024. Note: how inflation forecasts have changed for each year-end.

That said, there is an element of recency bias and trend following in the forecasts, with forecasters raising their expectations after the inflation surge through 2021 and 2022 and being slow to lower them through 2023. In May of 2023, they were anticipating inflation to average 5.9% through the year, but it averaged 4.6% (see Figure 3).

So, inflation expectations could quickly adjust downwards if inflation begins to cool, which would make it easier for the BCB to ease.

**Figure 3: Even the best forecasters can overestimate inflation path**



Source: Haver, abrdrn, August 2024

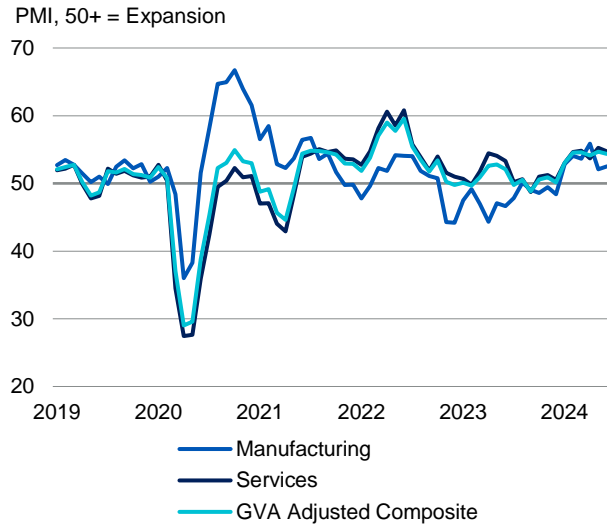
On balance, we think inflation will still run above the 3% target mid-point, but that concerns of an overheating economy are overdone. A recent uptick in food inflation means we now forecast headline inflation to average 4.2% in 2024. But base effects and cooling of economic activity should cause inflation to drop to an average of 3.5% in 2025.



## Economic rebound has further cooled the urgency for cuts

One factor behind concerns of higher inflation has been Brazil's recent economic resilience. After stalling in late-2023, activity has rebounded. The services sector continues to perform well, with the sector's PMI indicating healthy activity through Q2 (see Figure 4).

**Figure 4: Services strength help to boost activity**



Source: Haver, abrdrn, August 2024

Confirming the domestic strength; retail volume sales surged 8.1% year over year in May, above consensus expectations of 4%.

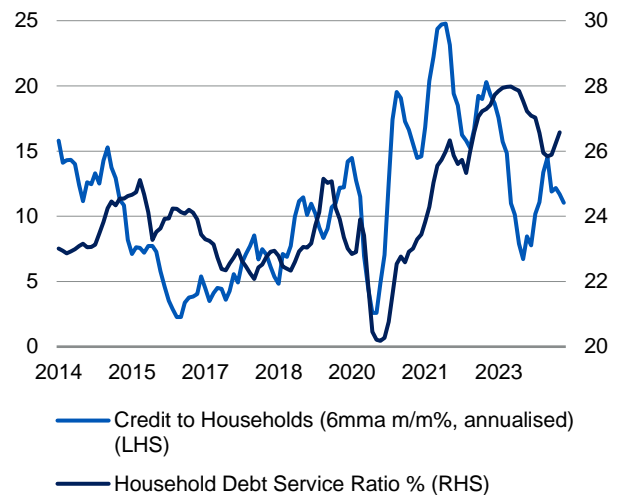
The resilience of domestic demand is reflective of the rebound in real incomes, which have been surging since 2022. The labour market has been supportive of this rise in real earnings, with the three-month moving average unemployment rate falling to its lowest level since 2015 (6.9% in June).

Alongside fiscal support for low-income earners and public sector workers, domestic demand has held up through the first half of 2024.

That said, there remains some slack on the participation rate front, which is around 1.3ppts lower than where it was before the pandemic and hasn't shown any recovery in 2024. This should help slow wage growth as people return to the formal workforce.

Private sector sentiment indicators also suggest that the rebound may be losing steam and beginning to roll over. Policy conditions will continue to weigh, with household debt servicing ratio at elevated levels and slower household credit growth (see Figure 5).

**Figure 5: Consumer credit conditions have tightened**



Source: Haver, abrdrn, August 2024

On balance, a cooling of economic activity looks likely through the second half of 2024. This should take some of the heat out the labour market. But we still expect real GDP growth to run slightly above trend through the year at 1.8%.

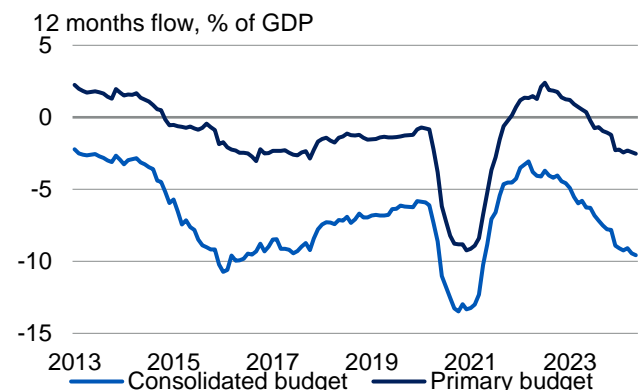
## Brazil benefits from some fiscal guardrails

Fiscal slippage has also complicated the BCB's efforts to tame inflation and contributed to market concerns around Brazil's inflation path.

In June, the consolidated public sector posted a nominal deficit of BRL 136 billion, larger than the consensus expectation of BRL 102 billion. As a share of GDP, the deficit has widened to 9.9%.

The sharp rise in interest expense can largely explain this, but the slippage can also be seen on the primary balance, which stood at a deficit of 2.4% in June (Figure 6).

**Figure 6: Fiscal tightening needed to meet 2024 target**



Source: Haver, abrdrn, August 2024

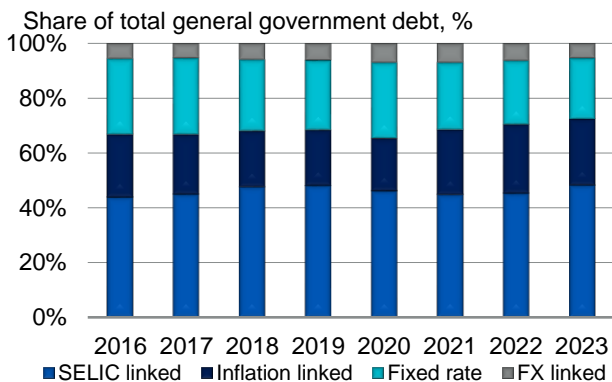
While this includes a one-off 0.9% of GDP court settlement expense in December 2023, fiscal consolidation will be needed in the second half of 2024 to hit the government's primary budget target of -0.25% of GDP in 2024.



The deterioration in the fiscal position, alongside Lula's questioning of the need for fiscal tightening and hostility towards the central bank's pause, has weakened investor sentiment.

However, we expect fiscal policy risks to ease in the near term. Brazil's mix of public debt acts a guardrail against a shift from economic orthodoxy. The high share of inflation-linked debt and short-duration debt can raise the interest expense quickly in the event of the government seeking to pursue aggressive inflation policies. This makes such policies less attractive to pursue in the first instance (see Figure 7).

**Figure 7: Fiscal guard rails to curb Lula's ambitions**



\*approx 90% of inflation linked debt references

Source: Haver, abrdrn, August 2024

Indeed, Finance Minister Fernando Haddad announced a budget freeze in July (curtailing BRL 15 billion in planned expenditure), slightly exceeding market expectations of BRL 10 billion. Further fiscal tightening is likely in September, which should quell some of the market pressures.

Bi-monthly reviews of the fiscal trajectory also means that further tightening could come in November in an effort to hit the government's -0.25% of GDP primary budget target.

However, the incremental approach to fiscal consolidation means that the BCB and market forecasters will be slow to fully adjust their outlooks to reflect the tighter fiscal path. Moreover, at 85% of GDP (IMF definition), even with some fiscal consolidation, Brazil's public debt will persist as a concern for investors.

Ultimately, we do expect fiscal tightening to help to moderate growth and push down on inflationary pressures in the second half of 2024. As the BCB takes this into account, we see scope for a tentative resumption of the cutting cycle before year-end.

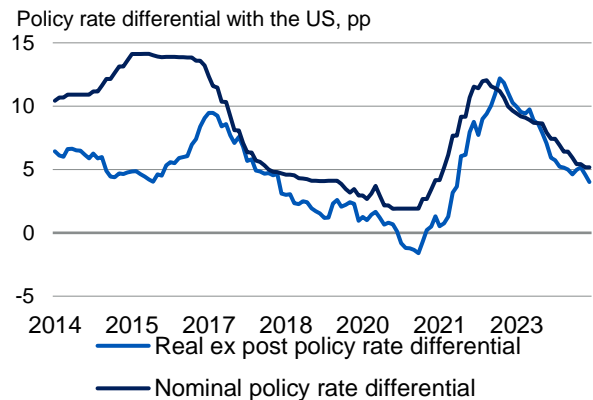
**Market unease increases the importance of the Fed**

The uncertainty around the fiscal trajectory has been compounded by the Fed's continued pause.

The nominal gap between Brazil and US policy rates is at its lowest level since August 2021, at 5.2ppts. Similarly, the real ex. post policy differential is at its lowest since November 2021.

Outside the extraordinary pandemic response, the differentials were only lower than their current levels during the first year of Jair Bolsonaro's term in office (2019 to 2022), in which he took a less combative approach with markets and continued fiscal consolidation.

**Figure 8: Differentials suggest less room to operate**



Source: Haver, abrdrn, August 2024

In contrast, Lula and his Workers' Party (PT) are tainted with the economic malaise and fiscal slippage of the mid-2010s during his prior stint as president.

Another area of concern is the future independence of the BCB. Current governor Roberto Campos Neto's mandate ends this year and Lula will have a say in deciding who his replacement is, with fears of a more dovish governor being appointed.

Another headwind could arise from municipal elections in October. While not generally reflective of national political sentiment, a poor performance for the PT and declines in Lula's approval ratings could lead to attempts for more radical economic policies to boost support.

As such, much will depend on the Fed's policy path. We currently expect two Fed cuts before the end of the year, with scope for additional easing in 2025. Assuming some fiscal consolidation and an easing of inflation upside risks, this should spur the BCB to resume its cutting cycle.

As the BCB moves to a new target, using a rolling 12-month target of 3% +/-1.5ppts, from 2025 and as inflation gradually declines, we think there is room to lower the policy rate closer to 9.75% in 2025.

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