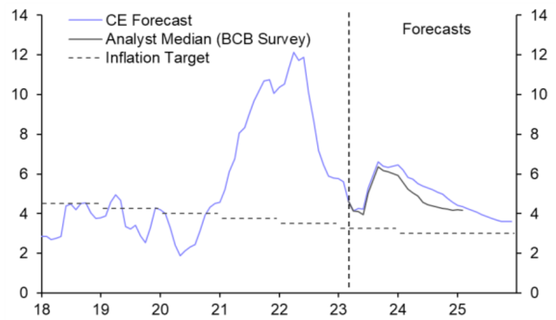
LATIN AMERICA ECONOMICS UPDATE

Copom pours cold water on near-term rate cut hopes

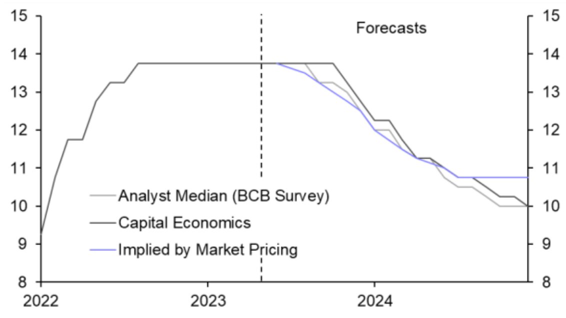
- **Brazilian policymakers gave a firm push back against any expectations for imminent monetary easing at yesterday's central bank meeting, supporting our view that interest rates will be lowered a bit more slowly over the next 6-12 months than most expect.**
- The decision by the central bank to leave the Selic rate unchanged at 13.75% never really appeared to be in doubt. We and almost all the other analysts polled by Bloomberg correctly anticipated the outcome (one analyst had predicted a 25bp interest rate cut).
- Attention, instead, was focused on whether the latest fall in inflation, to 4.2% y/y in the first half of this month (within the BCB's 3.25±1.5% target range for this year), and the new fiscal framework might prompt Copom to concede that interest rate cuts could come onto the table. The short answer is no they didn't; the statement was surprisingly hawkish.
- **On inflation risks, the accompanying statement reiterated that underlying inflation is "above the range compatible" with the BCB's target**. Policymakers again flagged that they believe that inflation expectations are unanchored, requiring tighter policy than would otherwise be the case to bring inflation to target.
- The statement also flagged the resilience of the labour market, something we have warned about for some time. Indeed, the strength of wage growth feeds into our view that inflation will be above target – and higher than most analysts' expectations – over our forecast horizon. (See Chart 1.)
- **The language on the fiscal front wasn't any less hawkish**. The statement identified 'lingering uncertainty' around the new fiscal framework as an upside risk to inflation and affirmed that the fiscal framework won't mechanically lower inflation and allow for interest rates cuts. This is an implicit rebuke to the government, which has suggested that the proposed fiscal measures now mean that the door is open to monetary easing. Copom wants more evidence. Lula and his team won't be happy.
- **We think the central bank's hesitancy here is warranted**. After all, the new fiscal framework relies on the government being able to both stick to expenditure restraint and raise revenues significantly. The jury is still out on whether these are politically palatable. We continue to forecast that the government debt-to-GDP ratio will rise over the coming years.
- **To be clear, we don't think this hawkish statement precludes interest rate cuts this year**. Real interest rates are extremely high and there is some scope for them to come down. Nonetheless, Copom's evident need to push back against suggestions that rate cuts could come very soon supports our relatively hawkish view on the monetary policy outlook over the next 6-12 months.
- **We expect the first interest rate cut to come in Q4, with the Selic rate being lowered to 12.75% by end-23 and to 10.00% by end-24**. Our Selic rate profile is somewhat higher than the analyst consensus and that priced into financial markets. (See Chart 2.)

Chart 1 : Consumer Prices (% y/y)



Sources: Refinitiv, Capital Economics

Chart 2: Selic Rate (%)



Sources: Bloomberg, BCB, Capital Economics

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