CAPITAL ECONOMICS

LATIN AMERICA ECONOMICS FOCUS

Brazil: rate cuts won't prevent a sharp slowdown

- **Brazil's monetary easing cycle will probably lead to higher spending in interest rate sensitive areas, such as furniture and appliances, autos and construction materials. But that won't be enough to prevent overall GDP growth from slowing sharply – and by more than most currently anticipate – in 2024. While lower debt servicing costs will help the government with its goal of stabilising the public debt-to-GDP ratio, that won't get policymakers off the hook when it comes to the need for austerity.**
- Brazil's central bank has been at the leading edge of the global monetary cycle. It was one of the first to begin hiking interest rates in 2021, to stop hiking and then to start cutting (in August). Our interest rate forecasts are slightly higher than consensus expectations. But we still expect a sizeable 300bp or so of cuts in the Selic rate within the next 18 months. Local currency bond yields have come down a lot this year.
- Shifts in monetary policy can impact the economy through several channels (e.g. asset prices, the exchange rate, confidence), but the key one here is by affecting debt servicing costs as well as the incentive to save and borrow. While hard to gauge, **we think the impact of the previous tightening cycle has already filtered through to Brazil's economy, even accounting for the lags involved. The question now is the extent to which the economy will benefit from monetary loosening**. There are two angles to consider here: what lower interest rates mean for debt servicing costs and what they mean for new lending.
- **Starting with debt servicing costs, we see only moderate relief in the short term for households and corporates**. Our modelling suggests that private sector debt interest payments doubled as a share of disposable income between 2020 and 2023. This ratio will decline only a little in 2024. What's more, current elevated credit spreads may mean that our estimates overstate the reduction in interest payments.
- **The government stands to benefit most from lower debt servicing costs**. Its interest payment burden jumped from around 3% of GDP in 2021 to almost 7% this year as interest rates rose. With a large amount of the public debt stock (over 40%) indexed to the Selic rate, debt servicing costs will come down sharply – we estimate by a couple of percent of GDP over the next two years.
- **This will make it easier for the government to achieve its goal of stabilising the public debt-to-GDP ratio. But the debt dynamics will remain poor**. After all, the interest rate on government debt is still higher than nominal GDP growth, implying that primary budget surpluses are needed to stop the debt ratio from rising. **Further austerity will be needed if the authorities are to comply with their new fiscal framework.**
- **The impact of lower interest rates on *new* lending is likely to be muted too**. Although monetary easing cycles in Brazil have, in the past, preceded upturns in credit growth, credit growth was starting from a much weaker point in those past instances. And banks report that demand for borrowing remains soft. This probably reflects a desire by households and firms to deleverage rather than take on new debt.
- The upshot is that the central bank's monetary easing cycle is unlikely to provide a major impetus to domestic demand in the short term. Instead, the near-term outlook is likely to be dominated by headwinds, including a deterioration in the terms of trade, weakening wage growth, and fiscal tightening. **This underpins our view that GDP growth will slow to a below-consensus 0.8% next year. Brazil will be one of the few countries in the world where growth is weaker in 2024 than in 2023.**

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Brazil: rate cuts won't prevent a sharp slowdown

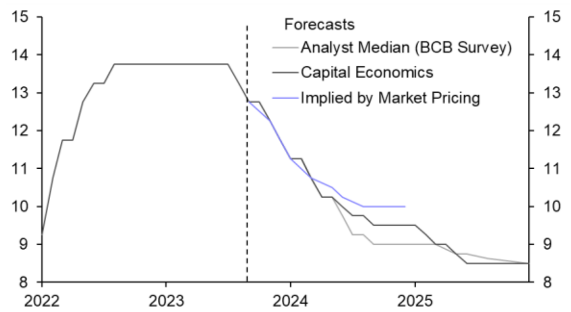
This *Focus* makes the case that, even though Brazil's central bank has been quick off the blocks to start a monetary easing cycle, this won't prevent GDP growth from slowing sharply into 2024.

Thinking through the impact of a lower Selic rate

Brazil's central bank has been at the leading edge of the global monetary cycle. It was one of the first central banks to begin hiking interest rates in early 2021. And it became one of the first to start cutting interest rates, kicking off its easing cycle in August with a larger-than-expected 50bp cut. It lowered the Selic rate by another 50bp, to 12.75%, last month.

We think that the Selic rate will be lowered to 9.50% by the end of 2024. That leaves us a little higher than consensus expectations, albeit below the profile implied by market pricing. (See Chart 1.) But the key point is that there's widespread agreement that the Selic rate will be lowered by a sizeable 300bp or so within the next 18 months.

Chart 1: Selic Interest Rate (%)



Sources: Refinitiv, Bloomberg, Capital Economics

Broadly speaking, there are four channels through which monetary policy can affect the economy: the exchange rate, asset prices, confidence, and the channel through which changes in interest rates affect the incentive to save and borrow. (For more detail, see our *Global Economics Focus*.)

We doubt that the first three will be significant. Starting with the exchange rate, nominal interest rates will come down which should, in principle, cause the real to weaken. We do think that the real will remain under pressure, but that's less to do with interest rates (Brazil's interest rate differential vis-à-vis developed economies will remain very high) and more to do with global risk appetite and volatility, which will affect the attractiveness of the carry trade, as well as Brazil's terms of trade. These factors underpin our view that the currency will end the year at 5.10/$ (roughly its level at the time of writing).

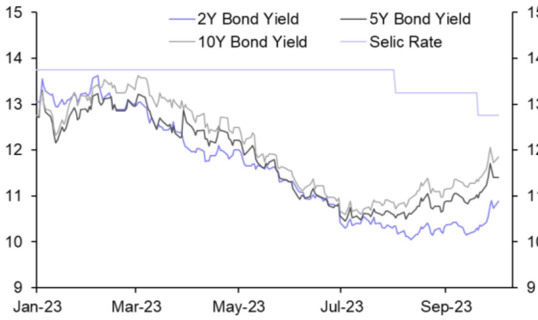
In a similar vein, the biggest drivers of financial asset prices in Brazil are likely to be commodity prices and risk appetite, rather than local monetary policy settings. In any case, 'wealth effects', the channel through which higher asset prices raise households' net wealth and trigger a rise in consumption, would be small anyway because households' assets are small. The FGV estimates that per capita net wealth (based on financial and real assets) amounts to around 47 thousand reais, or around US$10 thousand. And wealth is distributed extremely unevenly.

Finally, the impact via confidence is likely to be muted too. Although households and businesses will welcome lower interest rates, there's little relationship between confidence and the monetary policy stance. Indeed, business and consumer confidence increased over the first half of last year, even though the central bank was raising interest rates to very high levels. (If anything, this would suggest that inflation, which was falling at the time, rather than interest rates is a bigger driver of shifts in confidence.)

Instead, the most important channel will be that through which lower interest rates make saving less attractive and reduce debt servicing costs, so households and businesses may spend more. A lower interest rate on new bank lending would make it more attractive to borrow too.

In this regard, it's worth noting that it's not just the policy interest rate that has fallen. Longer maturity local currency government bond yields have, despite a recent rise, declined by as much as 150-250bp since the start of this year. (See Chart 2.) This has been aided by easing fiscal risks and the decline in core inflation, both of which have helped to reduce the term premium embedded in the yield on these bonds.

Chart 2: Selic Rate & Local Currency Government Bond Yields (%)



Sources: Refinitiv, Capital Economics

Peak pain has probably happened

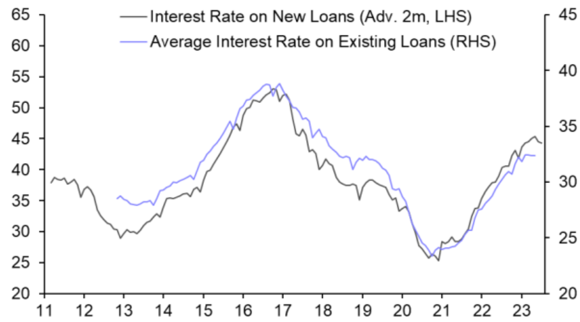
When discussing the pass through from changes in interest rates to the economy, one current debate – particularly in developed markets – concerns how much of the impact of monetary tightening has already occurred and how much is still to come.

It's extremely difficult to determine the answer to this – and all the more so in emerging markets where the data are limited and the nature of bank lending may have changed rapidly. **In Brazil's case, though, we think it's fair to say that most of the impact of the central bank's tightening cycle has already filtered through to the economy**. For one thing, bond yields – both at short and longer maturities – peaked some time ago. (See Chart 2 again.)

What's more, debt servicing costs appear to be plateauing. Based on the central bank's estimates, the average interest rate on *outstanding* credit has flattened off in recent months. And given its historic relationship with new lending rates, it's hard to see significant further increases. (See Chart 3.)

Within this, different sectors will be affected to different degrees. Interest rates on corporate credit are often floating and determined by short-term interest rates. So lower interest rates will already be feeding through. Household credit tends to be issued with fixed interest rates, so there may still be some pain from higher interest rates to come through. That said, it's worth noting that household credit made at market-based interest rates ('non-earmarked credit') has short maturities, averaging around two years. A lot will already have been rolled over at high interest rates. (A large portion of longer-maturity household loans has subsidised interest rates.)

Chart 3: Bank Lending Rates (%, Non-Earmarked Lending)



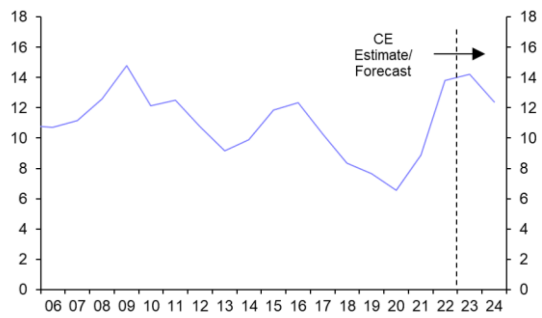
Sources: BCB, Capital Economics

Debt servicing costs: coming down but still high

This then begs the questions of how quickly lower interest rates will feed through to Brazil's economy and how large the impact will be. There are two angles to consider here: what lower interest rates mean for debt servicing costs and what they mean for new lending.

Starting with the former, our modelling of private sector (that is, household and non-financial corporate) debt interest payments, which is based on debt stocks and the historic link between bond yields and the average interest rate on debt, shows that these roughly doubled as a share of disposable income between 2020 and 2023. (See Chart 4. For more, see our *Emerging Markets Focus*.)

Chart 4: Private Sector Debt Interest Payments (% of Disposable Income)

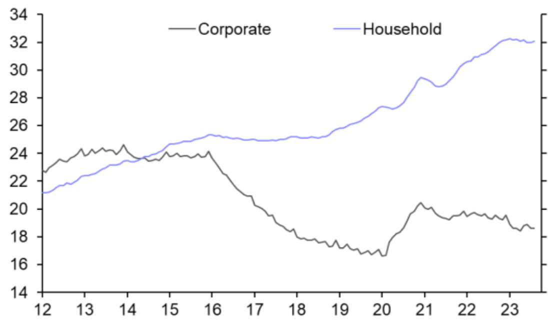


Sources: Refinitiv, Capital Economics

Our forecasts also imply a decline in debt interest payments in 2024, but one that leaves payments at a very high level of disposable income (the highest, outside 2022-23, since 2011).

The figure remains high for three reasons. The first is because there will be lags in the pass-through from lower bond yields to debt servicing costs. The second is that we're expecting interest rates to remain much higher than their pre-pandemic level. And the third, and underappreciated reason, is that there was a household credit boom during the pandemic. Loans to households have increased by over 5% of GDP since the start of the pandemic. (See Chart 5.) As a result, household debt interest payments will be higher for any given interest rate than in the past.

Chart 5: Outstanding Bank Lending (% of GDP)

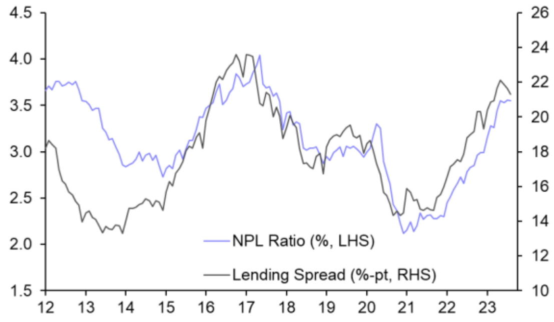


Sources: Refinitiv, Capital Economics

If anything, our modelling may overstate the extent to which interest payments will decline. One notable feature of Brazil's financial system is that credit spreads – the difference between the actual lending rate and the cost for the bank of receiving funds – are extremely high and exert an enormous influence on overall lending rates. Credit spreads add an average of 22%-pts to lending rates at the moment, and almost 50%-pts for market-based household credit.

These high spreads have their roots in a range of complex factors including the legacy of high inflation (which prompts banks to charge high interest rates to compensate for inflation risk), the difficulty of securing collateral, and market concentration in the banking sector. The level of non-performing loans (NPLs) appears to play an important role too. When NPLs are higher, credit spreads are higher – as is the case at the moment. (See Chart 6.) High(er) spreads, in turn, may limit the extent to which lending rates decline.

Chart 6: Credit Spreads & Non-Performing Loan Ratio



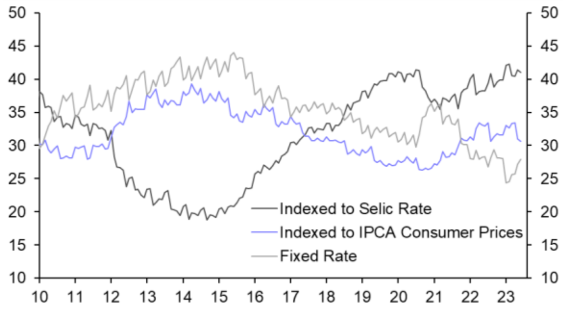
Sources: Refinitiv, Capital Economics

Government a bigger beneficiary

While there may only be a muted gain for the private sector from lower interest rates, it's more clear cut that the government will benefit. The public sector's debt interest payments have doubled as a share of GDP since 2021, from just over 3% to more than 6% at present.

But bond yields have now fallen significantly, which will allow the government to roll over fixed rate debt (some 25% of the total) at lower interest rates. More importantly, a large amount – over 40% – of openly-traded federal debt (i.e. excluding the government bonds held by the central bank that can be used to absorb surplus liquidity) is indexed to the Selic rate itself. (See Chart 7.) So a lower Selic rate will feed directly into lower public sector debt servicing costs.

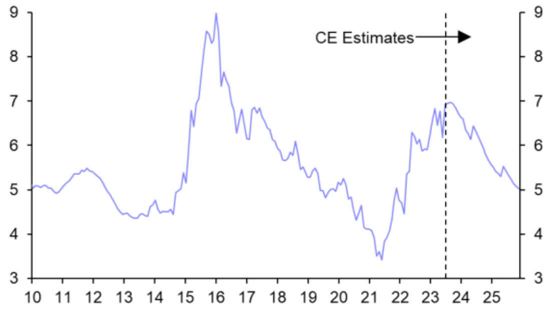
Chart 7: Openly-Traded Federal Debt Stock by Indexation (% of Total)



Sources: BCB, Capital Economics

We estimate that the fall in the Selic rate that we're forecasting will cause public sector debt interest payments to decline by some 2% of GDP over the next couple of years. (See Chart 8.)

Chart 8: Public Sector Interest Payments (% of GDP, 12m Sum)



Sources: BCB, Refinitiv, Capital Economics

This will make it easier for the government to achieve its goal of stabilising the public debt-to-GDP ratio. But the debt dynamics will remain poor. After all, the interest rate on government debt is still higher than nominal GDP growth, implying that primary budget surpluses are needed to stop the debt ratio from rising. At the moment, the primary balance is heading in the opposite direction – into deficit.

The upshot is that while fiscal pressures will ease a little, the government still needs to pursue austerity if it is to meet the targets set out in the fiscal framework. In other words, the boost to the public sector from lower debt servicing costs will need to be saved rather than spent.

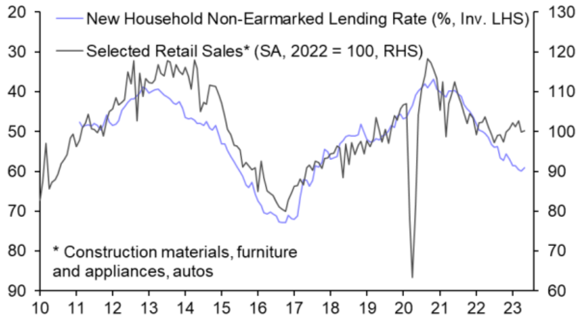
Perhaps the big risk in this regard is if the central bank lowers interest rates below the level consistent with its inflation target in order to help the fiscal dynamics (so-called 'fiscal dominance'). This seems unlikely under the current leadership at the BCB and isn't embedded in our forecasts. But the likelihood of this scenario could increase from 2025 when the government will be able to nominate a new governor. Such a shift in policy would help to steady the public debt ratio but at the cost of higher inflation.

Upturn in the credit cycle unlikely

When considering the economic impact of lower interest rates, the other angle to think about is whether they will trigger a pick-up in credit growth (i.e. an increase in *new* lending).

There's a pretty clear (and contemporaneous) relationship between new bank lending rates and spending on interest rate-sensitive goods like autos, furniture and appliances, and construction materials. (See Chart 9.) It seems likely that these sectors will receive a boost from lower interest rates. But the gains may be moderated by the fact that spending on these goods didn't fall as far this year as the past relationship with lending rates would have suggested. And there remains an open question of whether we'll see a broader upturn in credit growth.

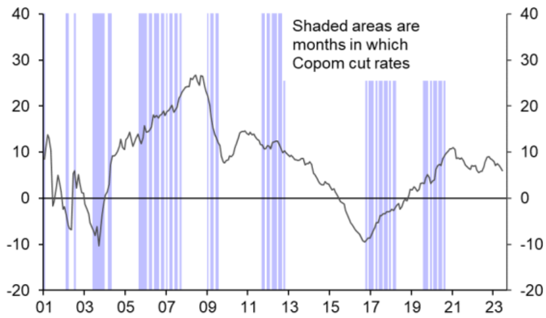
Chart 9: New Lending Rates on Non-Earmarked Household Credit & Selected Retail Sales



Sources: Refinitiv, Capital Economics

Historically, the start of easing cycles in Brazil has frequently coincided with an acceleration in bank lending – in the early and mid-2000s, in 2016/17 and again in 2019. (See Chart 10.)

Chart 10: Real Credit Growth (% y/y)

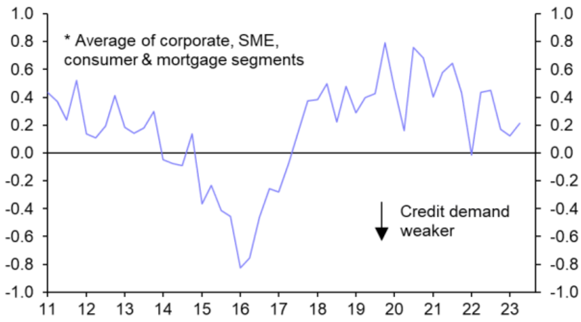


Sources: Refinitiv, Capital Economics

Nonetheless, there are reasons to think that this time might be different. For one thing, interest rate cuts have generally triggered a pick-up in credit growth when it has been very weak, such as in the early 2000s and in 2016/17. This time around, credit growth is starting from a much stronger point.

What's more, according to the central bank's credit conditions survey, demand for loans appears to be weak. (See Chart 11.) This may reflect the impact of the pandemic era boom in credit mentioned earlier as well as still-high interest rates, which may have reduced demand for loans and prompted firms and households to seek to deleverage instead.

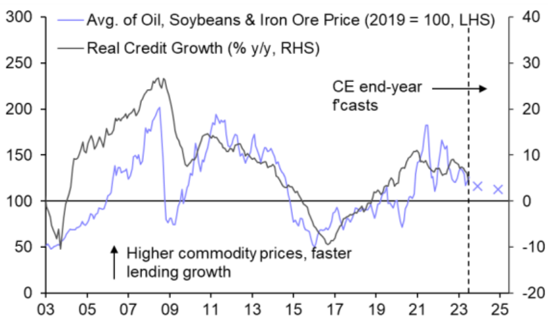
Chart 11: Reported Loan Demand*



Sources: Refinitiv, Capital Economics

It's worth noting, too, that shifts in Brazil's credit cycle – particularly since the global financial crisis – have tended to have a closer relationship with the country's commodity export price basket (essentially oil, soybeans and iron ore) than changes in interest rates. That may be because commodity prices are a bigger driver of confidence, incomes (and therefore debt servicing capacity) and projected returns on investment. Our commodity price forecasts are consistent with weaker credit growth. (See Chart 12.)

Chart 12: Commodity Export Price Basket & Real Credit Growth



Sources: Refinitiv, Capital Economics

If anything, we think the impact of the current monetary loosening cycle on credit growth will be more like that in 2011/12, when credit growth continued to slow because of other factors including declining commodity prices and easing demand for credit.

Lower rates won't offset other growth headwinds

So, the Brazilian central bank's easing cycle will provide a boost to investment and spending on interest-rate sensitive goods. But there are reasons to think that it won't lead to a marked turnaround in domestic demand. Debt servicing costs are likely to remain high and demand for new credit soft.

The government will be the main winner from lower interest rates, but that won't provide space for fiscal loosening that would boost demand. Indeed, further austerity is still needed to generate the primary budget surpluses needed to comply with the fiscal framework. (For our part, we expect it to raise revenues, but fall short of the framework's targets.)

As a result, we think headwinds to the outlook will dominate. These include:

- The unwinding of the agricultural boom in Q1, in which output in the sector increased by more than 20% q/q;
- A deterioration in Brazil's terms of trade, which will weigh on the country's income (see Chart 12 again);
- Tighter fiscal policy, as the government attempts to raise revenues to try to hit its fiscal targets;
- And slower wage growth (although we still expect wage growth to remain too high for the central bank to lower interest rates more aggressively).

All told, we think that the economy will weaken significantly over the coming quarters. After growth of 3.5% over 2023 as a whole, we expect the economy to expand by just 0.8% next year. **Our 2024 forecast is below consensus expectations (1.5%) and would make Brazil one of the very few countries in the world where GDP growth will be weaker next year than in 2023**. (For more, see our *Latin America Outlook*.)

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