Macro Brazil

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Quarterly Inflation Report: Non-convergence on the horizon reinforces the prospect of significant tightening ahead

- The December 2024 Inflation Report (IR) showed higher inflation forecasts, which moved further away from the targets throughout the relevant horizon, with significant increases, especially in the forecast for 2025, which rose 0.8 pp to 4.5%, the upper limit of the tolerance range around the 3% target. According to the document, the increase in forecasts resulted mainly from stronger-than-expected economic activity, exchange rate depreciation (a rate of BRL 5.95 per dollar was used in the reference scenario) and deterioration of inflation expectations.
- In our view, this scenario reinforces the reading and signaling already given at the last Copom meeting, that the interest rate hike movement should keep advancing significantly. Our forecast of an increase in the Selic rate to 15.00% pa at the end of the cycle is consistent with this scenario. However, if the recent exchange rate movement is not reversed, we see asymmetric risks to the upside.
- In addition to the forecast revisions, a descriptive analysis of the performance of the manufacturing industry was presented, indicating that the recent increase in production appears to be associated with the increase in domestic demand. With a high level of capacity utilization, it can be concluded that the prospective growth of the industry depends on new investments and increased productivity, but that cyclical factors - namely, more restrictive monetary policy - may act in the opposite direction. In another study, it was empirically assessed that the consumption of durable goods is more sensitive to changes in the interest rate than the consumption of non-durable goods, concluding that such results are particularly relevant in the current outlook, marked by the current cycle of monetary tightening and a robust expansion in household income.

Central Bank forecasts

The table below shows the inflation estimates released for the IR reference scenario[1].

	Central Bank inflation (IPCA) forecasts														
	2023	2024				2025				2026				2027	
	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II
IPCA	4.6	3.9	4.2	4.4	4.9	5.0	5.0	5.1	4.5	4.2	4.0	3.8	3.6	3.4	3.2
Difference to previous IR (pp)	0.0	0.0	0.0	-0.2	0.6	1.0	1.2	1.6	0.8	0.7	0.5	0.4	0.3	0.2	-
Market-set prices	3.1	3.1	3.5	4.1	5.0	5.3	5.4	5.5	4.5	4.1	3.8	3.6	3.4	3.2	3.0
Difference to previous IR (pp)	0.0	0.0	0.0	-0.2	0.6	1.0	1.3	1.7	0.9	0.7	0.5	0.4	0.3	0.1	-
Regulated prices	9.1	6.4	6.4	5.5	4.6	4.1	3.9	4.0	4.5	4.6	4.6	4.4	4.1	4.0	3.8
Difference to previous IR (pp)	0.0	0.0	0.0	0.2	0.4	0.8	1.1	1.5	0.5	0.7	0.5	0.6	0.3	0.4	-

*Painted area = forecasts.

Source: Central Bank

[1] With the Decree 12.709/2024, starting in January 2025, the target refers to the accumulated inflation over 12 months, calculated month by month, also known as the "continuous target". The window of the projection horizon was set at ten quarters.

Compared to the estimates presented in the September Inflation Report (IR), inflation projections for 2024, 2025 and 2026 have increased to 4.9% (from 4.3%), to 4.5% (from 3.7%) and to 3.6% (from 3.3%), respectively, widening the distances from the 3.0% target. The projection for the most distant horizon, 2Q2027, presented for the first time, stands at 3.2%, still above target. According to the document, the increase in inflation estimates in the relevant horizon resulted mainly from stronger-than-expected economic activity, which led to an increase in the estimated output gap (from 0.5% to 0.7% compared to the last IR in the third quarter, and also 0.7% in the fourth quarter), exchange rate depreciation and the increase in inflation expectations. Recent inflation surprises and the revision of short-term projections also contributed, via inertia, as did the increase in the neutral interest rate considered. These factors more than offset the rise in the real interest rate, which, however, helped to prevent a sharper deterioration in the forecasts.

Addressing the recent past, the BCB notes that inflation observed in the quarter ending in November was 0.42 p.p. above the forecast, with the surprise concentrated in food at home, to a greater extent, in addition to the services segment – again, here, related to food, in this case, away from home, and vehicle insurance. The December forecast was revised to 0.58% from 0.44% in the previous IR, incorporating a less benign behavior of regulated prices and beef. January should register a slight deflation (-0.08%), followed by an increase of 1.17% in February and 0.42% in March, reaching 5.0% in the 12-month variation at the end of this period. In this scenario, the average of the core inflation rates should be around 4.5%.

Regarding the other variables, the GDP growth estimate for 2024 increased to 3.5% from 3.2%, driven by positive revisions mainly for household consumption and investment. The estimate for 2025 oscillated to 2.1% from 2.0%. According to the report, this apparently small change is due to factors in opposite directions, with a positive contribution from agriculture (in line with better forecasts for the grain harvest) and this year's statistical carryover, partially offset by the expectation of lower growth due to the scenario of greater monetary tightening.

In the credit market, projections were revised lower in both 2024 and 2025, reflecting, for this year, fewer corporate credit concessions, and, for the next, the expectation of higher interest rates. Regarding external accounts, there was also a worsening for 2024, incorporating the worse-than-expected trade balance, but a slight improvement for 2025, with a reduction in imports compared to the previous scenario.

Gross domestic product forecasts (accumulated in the year)

	September		December	
	2024	2025	2024	2025
GDP (current prices)	3.2%	2.0%	**3.5%**	**2.1%**
Agriculture and livestock	-1.6%	2.0%	**-2.0%**	**4.0%**
Industry	3.5%	2.4%	**3.3%**	**2.4%**
Services	3.2%	1.9%	**3.8%**	**1.9%**
Household consumption	4.5%	2.2%	**5.3%**	**2.4%**
Government consumption	2.7%	2.0%	**1.9%**	**1.6%**
Gross fixed capital formation	5.5%	2.0%	**7.3%**	**2.9%**
Exports	3.2%	2.5%	**3.0%**	**2.5%**
Imports	11.3%	2.5%	**13.7%**	**2.5%**

Source: Central Bank.

Credit balance forecasts (12-month change)				
	September		December	
	2024	2025	2024	2025
Total	11.1%	10.3%	**10.6%**	**9.6%**
Non-earmarked	10.5%	10.2%	**10.4%**	**9.6%**
Households	12.0%	11.0%	**11.5%**	**10.0%**
Corporations	8.5%	9.0%	**9.0%**	**9.0%**
Earmarked	12.0%	10.5%	**10.8%**	**9.7%**
Households	12.0%	10.5%	**12.0%**	**10.0%**
Corporations	12.0%	10.5%	**8.5%**	**9.0%**
Total households	12.0%	10.8%	**11.7%**	**10.0%**
Total corporations	9.7%	9.5%	**8.8%**	**9.0%**

Source: Central Bank.

External accounts forecasts (USD billion)				
	September		December	
	2024	2025	2024	2025
Current account	-51	-60	**-54**	**-58**
Trade balance	68	64	**65**	**65**
Exports	335	341	**337**	**338**
Imports	267	277	**272**	**274**
Services	-48	-49	**-48**	**-49**
Primary income	-72	-75	**-73**	**-75**
Investment - liabilities	102	85	**108**	**85**

Source: Central Bank.

Summary of the IR studies

We present below summaries of the studies published in the IR, with links for the complete reports.

- ### Recent Performance of Manufacturing
  Full study (only in Portuguese) here.

  - This study provides a descriptive analysis of the performance of the manufacturing industry in recent years. While in 2023 economic growth was driven by less cyclical sectors such as agriculture and extractive industries, growth in 2024 has been more widespread and led by activities more sensitive to the economic cycle, including the manufacturing industry.

  - After decades of relative stagnation in industrial production, the industry has shown greater dynamism since the end of 2023. The study shows that industrial production has grown broadly across all usage categories, with notable expansion in capital goods and durable consumer goods. The increase in capital goods production was mainly due to activities in vehicles and information technology products. Vehicles also significantly contributed to the growth in durable consumer goods production, as well as electrical appliances and materials. The growth in demand for industrial goods can be confirmed by the evolution of industry inventories and the increase in the level of capacity utilization.

- Conclusion: the increase in production appears to be associated with the heating up of domestic demand, particularly consumption and investment. With a high degree of capacity utilization, the prospective increase in production depends on new investments. Therefore, increasing productivity and production factors are essential to maintaining the expansion trend. In the short term, however, cyclical factors may act in the opposite direction, such as a more restrictive monetary policy.

Interest rate, income and consumption of durables and non-durables

Full study (only in Portuguese) here.

- In another study, it was empirically evaluated, via an autoregressive vector (VAR) model, a possible heterogeneity in the effects of interest rates and income on the consumption of durable and non-durable goods in the Brazilian economy.

- Among the findings, it was indicated that interest rates and family income – which includes work remuneration and social benefits – significantly influence consumption.

- As expected, the study showed that the consumption of durable goods is more sensitive to changes in the interest rate than the consumption of non-durable goods. Among the possible reasons is that, due to the high price relative to the monthly income, durable consumer goods are often purchased in installments, and their acquisition is therefore more influenced by the interest rate.

- The text concludes by stating that these results are particularly relevant in the current outlook, marked by a recent past of reduction in interest rates, the current cycle of monetary tightening and a robust expansion in family income.

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