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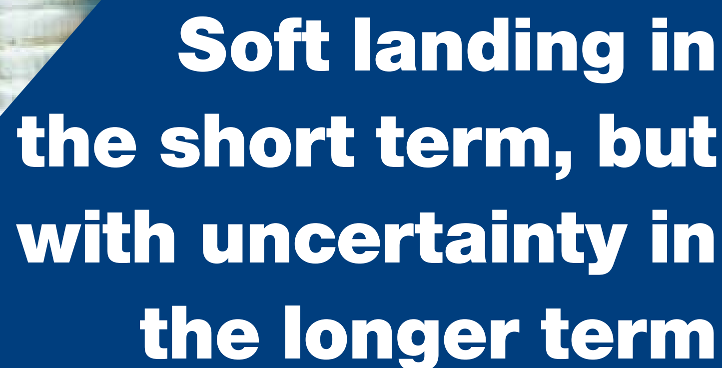

Soft landing in the short term, but with uncertainty in the longer term

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Soft landing in the short term, but with uncertainty in the longer term

Armando Castelar Pinheiro and Silvia Matos

The data released in recent weeks reinforces expectations of a moderate slowdown in economic activity in Brazil and, at the same time, the continuation of the ongoing disinflationary process, albeit with core inflation falling at a much more gradual pace.

This context is not unique to Brazil. In fact, the process has been similar in the vast majority of developed and emerging countries. In Latin America in particular, the appreciation of currencies, the fall in the prices of commodities and industrial goods and the slowdown in activity largely explain this picture. Countries that began monetary tightening earlier are seeing more favorable inflation data and, as a result, central banks have begun to ease monetary policy. This is the case in Brazil.

As for the main central banks of developed countries, the trend is signaling that they are close to ending the interest rate hike cycle, as inflation is slowing down, despite very resilient economic activity. In the United States in particular, growth continues to be sustained by domestic demand, with the labor market decelerating very slowly, as reflected in still-expanding employment earnings. Even so, core inflation in the previous 12 months was 4.7% in July, down from 6.6% in September 2022. Headline inflation fell to 3.2% in July, down from a peak of 9.1% in June 2022. Goods deflation has undoubtedly been key to these results, but at the same time there are signs of a slowdown in wages, contributing to a more favorable outlook. Nevertheless, all the signs indicate that the Federal Reserve will keep interest rates high for a long time.

Therefore, we can say that the current debate is shifting toward issues related to the neutral interest rate. Activity has been more positive, so the outlook is for higher neutral interest rates, more persistent inflation and, as a result, higher premiums for longer maturities. Consequently, yields on longer-term U.S. and global bonds have risen in recent weeks. In addition, there has been a need to issue more U.S. Treasury bonds, due to the higher budget deficit, as well as the need to replenish the reserves spent during the debt ceiling negotiations. It is also worth noting the impact of the changes in monetary policy adopted by the Bank of Japan.

Accordingly, we now expect inflation to remain high for a long time to come and to have higher real interest rates in the medium term. Consequently, longer-term interest rates will be higher as well. This is a very different context from what prevailed between the Great Financial Crisis and the start of the pandemic. The landing may be soft, but it won't take the economy back to the past.

In the euro area, GDP grew 0.3% in the second quarter compared to the first quarter, which had been stable. As for inflation, the headline 12-month indicator fell from 5.5% in June to 5.3% in July, but core inflation remains at a high level of 5.5%. Service inflation continues to exert pressure. In this context, the European Central Bank, after raising the benchmark rate by 25 basis points to 3.75%, stated that its next move is undecided and it will be discussed at its next meetings. It highlighted its concern about underlying inflation and the worsening of the Governing Council's projections. As activity continues to show positive signs, everything points to another interest rate increase in September.

Finally, as predicted in the Macro Bulletin, the data from China continues to indicate a more intense slowdown in activity than expected by the markets. This is likely to continue, despite the monetary easing that took place on August 15. In addition to weak external demand, domestic demand is also showing no signs of picking

up. Added to this, the problems in the real estate sector are intensifying. For the time being, our researcher Lívio Ribeiro[1], forecasts GDP growth of 5.0% in 2023, as he believes that the government's stimulus is unlikely to reverse the ongoing slowdown, which is of more of a structural nature. In 2024, growth is projected to fall again, to closer to 4%.

In this context, the picture of a softer landing in the short term in the United States is gaining force. In Brazil, we also saw relatively stable activity in the second quarter, with the service sector and household consumption standing out. Thus, despite expectations of a negative contribution from less cyclical activities, such as agriculture, the greater resilience of services contributed to a more favorable result. We have revised our GDP growth forecast for the second quarter, compared to the first, from -0.4% to -0.1% (quarter-over-quarter). For the year as a whole, we have revised our growth projection from 1.6% to 1.8%. However, around two-thirds of this growth comes from activities that are more exogenous to monetary policy and only one-third comes from cyclical activities. It is important to note that the variation in cyclical activities also reflects the participation of activities that make up the agribusiness sector, such as agroindustry and services associated with the sector.

With regard to cyclical activities, despite the contractionary effects of monetary policy, growth has been sustained by income, due to income transfer policies and also the labor market, which has been stronger than expected. Data from the General Employment Registry (CAGED) indicates a slowdown in the number of people with a formal employment contract, but the employed population continues to grow. As a result, we now expect this year's average unemployment rate to be 8.5%, which is below our estimate of the non-accelerating inflation rate of unemployment (NAIRU), meaning the highest unemployment rate that does not generate higher inflation. We estimate Brazil's NAIRU to be between 9.0% and 9.5%.

On the one hand, positive surprises in the labor market will boost consumption in the short term, but on the other hand, they could make it harder for service inflation to continue falling ahead. In addition, the participation rate is expected to remain below the average seen in 2019, which could make it difficult for the economy to recover without inflationary pressures. We estimate that the seasonally adjusted unemployment rate was 8.2% in June 2023, but it would have been around 11% if the participation rate had been at the 2019 average. In other words, the tightening of the labor market wouldn't exist if the participation rate had remained the same, which would allow a sharper drop in interest rates, without inflationary risks.

One very negative point that stands out is the contraction in investment in the second quarter compared to the same period of last year. At the margin, we expect moderate growth in the quarter, of 0.8%, insufficient to offset the 4.6% accumulated drop in the last quarter of 2022 and the first quarter of 2023. Therefore, it will be insufficient to offset the negative carry-over effect for the year.

To make the picture ahead even more challenging, the slowdown in economic activity and the reduction in commodity prices are depressing tax revenue, while revenues are also falling due to the decision to reduce the distribution of dividends by state-owned companies. At the same time, government spending has intensified, which led the consolidated public sector to record a primary deficit of 0.24% of GDP in the 12 months to June, compared to a surplus of 0.38% of GDP in the previous month. Everything points to a primary deficit of around 1% of GDP this year and the risk is that it will be even higher in 2024.

There is still a lot of uncertainty about the government's ability to reduce the deficit in 2024. The government is expected to announce additional measures to increase revenue and eliminate the primary deficit, but they will need to be approved by Congress. The 2024 budget proposal will be submitted to Congress by August 31 of this year. It is expected that the new fiscal framework will also be approved by the House of Representatives in the

[1]FGV IBRE's associate researcher is among the world's five best analysts when it comes to predicting Chinese GDP, according to Bloomberg.

coming weeks, although its final content is more uncertain. Thus, there are still many challenges ahead for the government to achieve its goal of a zero primary deficit in 2024. Hopefully, we will soon have more details about the government's ability to increase its revenue in a context of continuous spending growth.

So, as you might expect, the question of the fiscal framework's credibility has intensified. Following the launch of the new Growth Acceleration Program, discussion of new exceptions to the fiscal target rules has returned, since the government's intention is to exclude investments made by state-owned companies as part of this program from the target. Undoubtedly, this ends up creating a situation that we have seen happen in the past, whereby the credibility of the fiscal rules is reduced. The best solution for the Growth Acceleration Program would be to allocate this spending to lawmakers' amendments or to the public budget itself, but not to exclude it from the rule.

There are no easy ways out of difficult problems. We have to deliver fiscal results, meaning return to primary surpluses, which will generate debt stabilization going forward and allow a more consistent reduction in real interest rates. For the time being, we are very far from this situation. The most favorable result in the short term, in terms of sustaining activity and reducing inflation, does not ensure that this context will continue in future. The challenges remain.

With these issues in mind, this edition of FGV IBRE's Macro Bulletin includes the following highlights:

- **Economic activity – page 8:** The data already released for the second quarter shows a less negative picture than expected for the services sector, in particular transportation and other services, and for extractive industry. We have therefore moderately revised our GDP growth forecast for the second quarter (from 1.8% to 2.2% year-over-year and from -0.4% to -0.1% quarter-over-quarter) and for the full year (from 1.6% to 1.8%). In June, manufacturing industry shrank compared to May, the service sector saw its second consecutive month of growth, after a relatively sharp drop in April, and the broad retail sector had a more favorable result, boosted by subsidies granted for car purchases. In the present context, cyclical sectors will make a positive contribution to GDP in the second quarter, but this should slow down over the course of the year. Furthermore, for sectors that are less sensitive to the economic cycle, the coming contribution is likely to be negative, limiting GDP growth in 2023. In figures, the exogenous components of GDP are projected to contribute 1.2 percentage points to growth in the year, while cyclical components will contribute 0.6 percentage points. In this context of a significant slowdown in investment and no productivity gains, the challenges for more robust growth in cyclical activities in 2023 are high, especially considering the persistence of tight monetary policy, notwithstanding the expected reductions in interest rates at the next few Monetary Policy Committee meetings.

- **Business people's and consumers' expectations – page 11:** Our business and consumer confidence indexes moved in opposite directions in July. While business confidence lost steam, consumer confidence advanced once again, reaching a higher level than business confidence for the first time in three years. The business result showed greater dispersion between sectors. Industry stands out for its return to the weak level seen at the beginning of the year, while the service sector remains resilient. The preliminary figures for August suggest timid progress for both companies and consumers.

- **Labor market – page 14:** According to the Continuous National Household Sampling Survey (PNADC), the unemployment rate was 8.2% in June 2023, equivalent to the level projected by FGV IBRE. In seasonally adjusted terms, this represents a slight increase from the previous month, from 8.1% to 8.2%, driven by a small rise in the participation rate. However, we forecast that the rate will decline in July, to 7.9%, representing no change in seasonally adjusted terms. The PNADC microdata shows that since the second quarter of 2019, the North and Midwest regions have experienced strong increases in employment, formal employ-

ment and earnings, followed by the Southeast and South and, finally, the Northeast. On the other hand, the distribution of income in the country has become less concentrated in this period, due to a strong rise in the incomes of the poorest and a real-terms loss for higher-paid workers. Finally, the General Employment Registry (CAGED) indicated the net creation of 157,000 jobs in June 2023, slightly higher than FGV IBRE's projection of 137,500, but representing a further drop in the seasonally adjusted series, from 118,800 to 93,100. In July, we forecast that CAGED will record a net 121,000 new jobs, or 73,500 in seasonally adjusted terms, indicating a further slowdown.

- **Inflation – page 18:** With regard to the latest increase in fuel prices in Brazil, authorized as of August 15, an average increase of 5% in gasoline prices at the pump is expected. This will raise the Extended Consumer Price Index (IPCA) by 0.25 percentage points, with half of this impact captured in August and the other half in September. However, the behavior of prices in other sectors will tend to offset the influence of fuels. Food prices, especially those of basic items, continue to fall, as do the prices of durable goods. These items are expected to act as anchors for inflation in 2023. For this reason, inflation expectations for 2023 should rise a little, but without getting too far away from those sustained before Petrobras' announcement. This should allow the cycle of base interest rate reductions to continue as announced at the last Monetary Policy Committee meeting, which revealed cuts of 0.5 percentage points at the next three meetings scheduled for 2023.
- **Monetary policy – page 19:** Every downward cycle in interest rates gives rise to a certain tendency for euphoria. Disregarding those who live off financial investments (the so-called rentiers), it's hard to think of anyone who doesn't welcome a declining trend in interest rates. It was precisely in order to contain the probable excess enthusiasm for the start of the new downward interest rate cycle that the Brazilian Central Bank announced that the benchmark Selic interest rate would be reduced by 50 basis points at "the next few meetings." There was nothing dovish about this, as many people imagine, and it was justified by the purpose of keeping the future course of interest rates under a modicum of control. Without this, there is no way the central bank could continue the fight to bring inflation down to "close to the target" by 2025.
- **Fiscal policy – page 20:** This section deals with public sector investment and the Growth Acceleration Program. The FGV IBRE Fiscal Policy Observatory has published a time series showing public investment from 1947 to 2022. Despite a recovery last year, due to higher disbursements by state and municipal governments, public investment has remained at a very low level since the latest fiscal adjustment process began in 2015. Following the launch of the Growth Acceleration Program, some people have criticized it for presenting "old ideas" or accused it of being "inflated with unfinished construction projects." The best way to discuss the program at the moment is to evaluate the projects in the pipeline and the measures planned to overcome long-standing challenges needed to unlock public and private sector investment. The Growth Acceleration Program has a broad set of institutional measures that include improving the regulatory, credit and environmental licensing environments, together with incentives for the ecological transition. More than just a plan to increase public investment, the Growth Acceleration Program is a comprehensive government initiative.
- **External sector – page 21:** The main contributor to the reduction in Brazil's current account deficit has been the trade balance, and this is set to continue in the coming months. However, this contribution will be smaller going forward. Export and import prices continue to behave similarly, which is reflected in stability in the terms of trade. The behavior of import volumes, associated with the level of domestic activity, should continue to slow down compared to 2022. Export volumes, which had been growing compared to 2022, are expected to fall.

- **International panorama – page 26:** This section discusses some possible scenarios for the American economy. At the last Federal Reserve meeting, the fed funds rate was raised to between 5.25% and 5.50%. It is possible that there will be a further increase of 0.25 percentage points or that interest rates will remain high for a long time. How long is not known and it will depend on the context. Under the most likely assumption that there won't be a credit event in the next 24 months, there are three scenarios for economic activity: a moderate recession, a soft landing and reacceleration. The high credibility of the inflation targeting regime acquired by the Fed has greatly reduced the social cost of disinflation, since at no time have inflation expectations three to four years ahead been affected. According to the author, the most probable outcome is a soft landing. However, depending on the speed of disinflation, the start of the interest rate reduction cycle may occur earlier or later.
- **IBRE in focus – page 27:** Finally, the IBRE In Focus section, written by researcher Anna Carolina Gouveia, is titled "Brazil's economic uncertainty recedes and ranks among the 10 lowest out of 21 countries."

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