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GDP better than expected, but not all that glitters is gold

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Armando Castelar Pinheiro and Silvia Matos

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However, some sectors have performed a lot better than others. Output and demand in relation to goods have both slowed down considerably, in line with monetary tightening, but service-related activity has been much more resilient than projected. Also, since services are labor intensive, the labor market data has also been surprisingly positive.

In Brazil, in particular, comparing GDP growth in 2022 and 2023, we can see that even though the annual growth rates may be similar, the main components that explain each result are not the same. In other words, the GDP results are once again better than envisioned, but it's not exactly the same story repeating itself.

In 2022, even though activity decelerated throughout the year, growth was basically generated by cyclical activities, more dependent on monetary and fiscal policies, which accounted for 2.7 percentage points of the 2.9% GDP expansion in the year. The rest was explained by "exogenous" activities, including agriculture, mining, public services and real estate.[1]

This year, in light of the GDP results for the second quarter, we revised our growth forecast from 1.8% to 2.5%. Around 60% of this figure (1.5 percentage points) is explained by the excellent performance of agriculture and mining. The contribution from cyclical activities will be 1.0 percentage point, well down on last year.

With regard to surprises in cyclical activities, we can highlight two determining factors. The first is related to the positive impacts of both agriculture and the extractive sector on these activities. Within manufacturing, the food industry and the oil and biofuels sector are the main positive highlights. In addition, some components of the services sector, such as transportation, have benefited from the outstanding performance of agriculture. According to calculations by the University of São Paulo's Center for Advanced Studies in Applied Economics (CEPEA), employment generated by agricultural services grew 7.4% in the first half of this year, compared to the same period of last year, while total employment increased 1.6% (excluding agricultural self-consumption). It is estimated that almost 680,000 jobs were created in this activity, while total employment according to the National Household Sampling Survey (PNAD) increased 640,000 in the same period.[2]

Consequently, on the demand side, the excellent performance of these exporting sectors increases the contribution of external demand to this year's GDP results.

A second factor is related to the growth in public spending and income transfers, as well as the use of savings accumulated during the period of social isolation. One thing that stands out is the acceleration in household

[1] The added value of real estate activities is strongly influenced by imputed rent. According to IBGE's methodology, it has a very high inertial component and it is affected less by the impact of monetary policy on activity.

[2] See the Brazilian Agribusiness Labor Market Bulletin (https://www.cepea.esalq.usp.br/br/mercado-de-trabalho-do-agronegocio.aspx).

consumption in the second quarter (up 0.9% from the first quarter), as well as government consumption (up 0.7% from the first quarter).

As highlighted in the Monetary Policy section, there is a conflict between fiscal policy and monetary policy. The latter, in order to bring inflation down, is set in restrictive mode, but the former is clearly in expansionary mode. This conflict will likely hinder more intense reductions in interest rates. In fact, the real interest rates on long-term NTN-Bs (Treasury bonds issued on the domestic market and traded in reais, with a fixed maturity of 30 years) are very close to their historical average. In other words, market participants don't seem particularly confident in Brazil's public finances, because at the moment, when buying public bonds, they are demanding real interest rates very close to what they have always demanded, on average, in the past.

At the same time, despite the recent improvement in inflation, projected inflation for the relevant horizon is above the target of 3.0%. According to the Brazilian Central Bank's Focus Bulletin of September 18, inflation is forecast to be 3.86% next year and 3.50% in 2025 and 2026.

Undoubtedly, in this context of high real interest rates, investments are penalized. In the national accounts, investment was close to stable in the second quarter of 2023 but, as expected, it is shrinking compared to the same quarter of last year. Data for the third quarter indicates a sharp contraction in the absorption of machinery and equipment. Estimates up to August point to a drop of around 11% to 13% in this indicator between July and August of this year compared to the same period of 2022. Despite the better performance of construction, investment looks set to drop 0.9% this year, after growing just 0.9% in 2022.

Finally, with regard to the external environment, it has become more turbulent as long interest rates have risen in the United States. Given that the fight against inflation continues there too, the Federal Reserve is likely to keep monetary policy tight for a longer period. (See the International section.) Furthermore, China's economic slowdown continues. As highlighted in this month's In Focus section, "There are both structural and temporary reasons that explain the delicate moment, associated with a certain inadequacy of the public policies under way. We don't think there's any reason for panic in the markets, but it's important to be prepared for a China that will grow less – not only now, but also in the future."

The situation therefore remains challenging, both domestically and abroad, despite the positive surprise of an economy that is expected to expand more this year than previously forecast. With these issues in mind, this edition of FGV IBRE's Macro Bulletin includes the following highlights:

- **Economic activity – page 7:** The data released by Brazil's national statistics agency, IBGE, for the second quarter reveals a more favorable picture than expected for the services sector, particularly transportation and other services, and for mining. We have therefore revised our GDP growth projection for the year from 1.8% to 2.5% (year-over-year). For the third quarter, we project quarterly growth of minus 0.4% and year-over-year growth of 1.5%. Data from the beginning of the quarter indicates that manufacturing is still struggling and shrinking at the moment. The service sector saw its fourth consecutive month of growth while the broad retail sector experienced a small decline in July, influenced by the end of subsidies for car purchases. It seems that cyclical sectors will make a slightly negative contribution to GDP in the third and fourth quarters, after growing a lot more than forecast in the second quarter. We also expect sectors that are less sensitive to the economic cycle to make negative contributions going forward. In terms of numbers, we predict that the exogenous components of GDP will contribute 1.5 percentage points to growth this year, while the cyclical components will contribute 1.0 percentage point. In this context of a sharp slowdown in investment and no productivity gains, maintaining robust growth of cyclical activities will be a major challenge, despite the projected reduction in interest rates at the next few Monetary Policy Committee meetings, especially when considering the persistence of monetary tightening expected in the United States and Europe.

- **Business people's and consumers' expectations – page 10:** FGV IBRE's confidence indexes rose in August, for both entrepreneurs and consumers. On the business side, progress is slower, with a further drop in industrial confidence drawing attention. On the consumer side, the fourth consecutive rise in confidence was more widely spread across income groups, but there is still a large gap between the expectations and present situation indicators. Our preliminary figures for September also send out a warning signal, indicating a possible drop in both indexes.

- **Labor market – page 13:** The July 2023 edition of the Continuous National Household Sampling Survey (PNADC) revealed that the unemployment rate in the previous three months was 7.9%, in line with FGV IBRE's projections. The level of employment rose from 56.6% to 56.8% of the working-age population between the last two rolling three-month periods, still below the recent peak of 57.4% recorded in 2022. At the same time, the General Employment Registry (CAGED) indicated that 142,700 jobs were created in July 2023, just above the 121,000 projected by FGV IBRE. In seasonally adjusted terms, the number of jobs created fell from 93,600 to 90,700, indicating a slowdown in employment growth. In August, we predict that 69,800 jobs will be created in seasonally adjusted terms, signaling a further slowdown.

- **Inflation – page 15:** Fuel prices have a direct impact on consumers' income and the costs of various industries. While the gasoline price directly and significantly affects the Extended Consumer Price Index (IPCA), the diesel price has an indirect influence, affecting the costs of productive activities. In addition, the prices of other products based on oil may go up, although there haven't yet been significant price increases, according to the Broad Producer Price Index (IPA). This price stability is unlikely to last amid rising oil prices. In the international context, the oil price is on the rise, due to supply cuts by Saudi Arabia and Russia, as well as weather events in Libya. These factors could boost the prices of oil products and further impact inflation. In Brazil, gasoline and diesel prices are lagging behind, so future price increases may be required, causing the IPCA to surpass the inflation target and perhaps even the tolerance range.

- **Monetary policy – page 17:** There was nothing dovish about the Brazilian Central Bank's decision at the beginning of August. By starting the cycle of lowering the benchmark Selic interest rate with a 50-point drop and signaling that it would maintain this pace at "the next few meetings," the bank's Monetary Policy Committee acted conservatively. It defined its strategy in such a way as to have a minimum level of control over the future path of interest rates. Going forward, it is much more important to try to understand how far the Central Bank will take the downward cycle than to discuss whether or not the pace of interest rate cuts will accelerate (which is very unlikely). Two factors seem to suggest that the cycle will be interrupted sooner than imagined: inflation projected for the relevant horizon is above the target of 3.0% and uncertainties in the fiscal area do not seem to indicate a rapid reversal of this situation. It is hard to continue a cycle of interest rate cuts when projected inflation is above the target. So, there is a high chance that the decreases in the benchmark interest rate will end when it reaches 10.0%, or even a little earlier.

- **Fiscal policy – page 19:** This section is about the first budget under the government's new fiscal framework. The 2024 Annual Budget Bill was submitted with a balanced primary budget and a revenue and expenditure forecast of 19.2% of GDP. This means an increase in revenue, net of transfers to states and municipalities, of 1.4 percentage points of GDP – a significant fiscal adjustment. There are two types of risk in the government's proposals. The first risk is related to changes to the Finance Ministry's Administrative Council of Tax Appeals (CARF) and tax settlements. These changes are expected to raise R$96.8 billion, a very significant amount, although the degree of confidence in these estimates is very low. The second risk lies in the processing of other measures to increase tax revenue, which could be unsuccessful. There are some other fiscal risks, including optimistic estimates of expenditure in areas such as social security. Because of these uncertainties, there has been a lot of discussion about changing the fiscal target. However, it seems too early to broach this subject, given that doing so would make Finance Minister Haddad's package unfeasible and therefore absolutely counterproductive.

- **External sector – page 21:** Based on Brazil's peculiar but positive trade balance situation, we expect a current account deficit of only 1.7% of GDP in 2023. We project that the deficit will rise to 2.3% in 2024, which is still a low level and will not put pressure on the economy.
- **International panorama – page 24:** It seems increasingly likely that from now on, the Federal Reserve will try to avoid being aggressive in conducting its interest rate policy. This does not mean, however, that the recent almost systematic rise in 10-year interest rates in the United States, observed over the last few months, will necessarily be halted. The reason is that the fight against inflation is far from over, so this will force the Fed to keep monetary policy tight. This could lead to new revisions in market participants' expectations of when the Fed will begin the cycle of interest rate cuts. To the extent that this happens, financial arbitrage operations could cause the increase in 10-year interest rates to continue.
- **Political outlook – page 26:** The Political Outlook section, written by researcher Octavio Amorim Neto, is called "Lula's Third Term, José Múcio and the Armed Forces." José Múcio's objective as defense minister, an objective set by President Luiz Inácio Lula da Silva, is pacification: pacification of the military with Lula and pacification of the country after four years of Jair Bolsonaro as president and his supporters' coup attempt on January 8, 2023. The depoliticization of the military is the second key purpose of the current head of the Defense Ministry. Perhaps next year – as a result of the Joint Congressional Inquiry into the Acts of January 8, 2023 and future Supreme Court rulings on those involved in the incident – there will be greater concern with defense policy and greater emphasis on strengthening civilian control of the military. In addition, in 2024, the government will have to carry out a four-yearly review of the White Paper on National Defense, the National Defense Strategy and the National Defense Policy. This will be a great opportunity for Lula in his third term to involve actors outside the Defense Ministry and the Armed Forces in the decision-making process and prove to be more innovative than he has been so far.
- **IBRE in focus – page 28:** Finally, this section, written by researcher Livio Ribeiro, is titled "China: When Reality Imposes Itself."

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Brazilian Institute of Economics

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Luiz Guilherme Schymura de Oliveira

Deputy Director
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