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Issues for 2024

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Issues for 2024

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January is a natural time to make or revise predictions for the year ahead. In doing so, however, it is important to recognize that these forecasts are always uncertain, since what will happen over the next 12 months depends directly on how economic policy develops, both here and abroad, which in turn depends not only on politics itself – and 2024 will be a year marked by important elections – but also on economic policy's success, or otherwise, in achieving its objectives.

On the international front, one of the decisive issues in defining how the year will go is when monetary easing will begin and at what pace in the developed economies, especially in the United States. One point that stands out in this process is that, even though inflation targets are only expected to be reached in 2025 or 2026, the world's main central banks decided to halt their monetary tightening cycles in 2023. In addition, as of November, there was a strong change of circumstances in the United States, and American long interest rates fell to below 4%, after reaching 5% in the middle of the second half of the year.

Although 2024 began with the reversal of some of the optimism that marked the last two months of 2023, a process helped by recent remarks by some members of the Federal Reserve, which dashed some highly optimistic expectations about the start of interest rate reductions, the fact is that the Fed funds futures markets continue to signal the expectation that the base interest rate will begin to fall in March of this year and it will have gone down 144 basis points by December.

However, everything indicates that the fundamentals are still in place for interest rates to remain at high levels for longer. Inflation in the United States has been falling, but core measures remain at high levels. The labor market continues to show resilience, as unemployment has only risen slightly, largely due to people entering the workforce rather than layoffs. As a result, real income continues to grow sustainably. In addition, there has been significant fiscal stimulus, together with a sharp increase in the primary deficit. This, combined with higher interest payments on debt, will further increase the public debt in the coming years. It's hard to imagine that there will be much room for the American central bank to cut interest rates significantly unless there is a stronger slowdown in activity, especially since fiscal policy will continue to counteract monetary policy in the run-up to the presidential election in November.

In Europe, the situation is a little clearer, as activity has been much weaker and inflation has been lower. But there too, the European Central Bank's directors have warned that the markets are too optimistic about when and with what force interest rates will start to fall.

Undoubtedly, from the point of view of the monetary authorities, and Brazil is no exception, it will be necessary to curb the process of monetary loosening and there will certainly be volatility in this process, as we have seen recently.

While from the markets' perspective, inflation seems to be losing prominence in terms of risks for this year, geopolitical issues are gaining prominence. A recent survey of Goldman Sachs clients showed that there is concern about conflicts in Europe and the Middle East, and about rising tensions between China and Taiwan. In particular, the intensification of conflicts in several parts of the Middle East is a worry, as it poses a risk to world trade and global supply chains.

Finally, there are the elections in the United States, especially the presidential one. Given the possibility of former president Trump returning to office, there is a risk of major changes in trade policies and geopolitical orientations. In short, 2024 will be a year of volatility and uncertainty on the international stage.

How do Latin American countries fare in this context, including Brazil?

Naturally, these external variables will continue to exert a big influence on asset prices in these countries, especially in terms of the exchange rate. Among other things, when and how much interest rates fall in the United States and Europe will also influence Latin American central banks' decisions, as well as having an impact on activity, via the wealth effect and a greater or lesser appetite for risk.

That said, in general, the region's countries are likely to continue to cut interest rates, against a backdrop of falling inflation and slowing economic activity, in line with the global cycle. This will not prevent some countries' performance from suffering more than others in terms of economic growth. This is the case with Brazil, largely due to the more persistent and intense effects of the El Niño phenomenon on economic activity and inflation.

As we have pointed out in previous editions of the Macro Bulletin, agriculture is expected to have a negative impact on GDP this year, after accounting for a third of total growth seen last year, considering only the direct effects of this sector on GDP. Due to the worse performance expected for soybean and corn production this year, we forecast that agriculture will shrink 3.4%, giving rise to a negative contribution of 0.2 percentage points to total GDP. It's also important to note that, as expected, activity in the second half of last year was relatively stagnant, reducing the carry-over effect for this year, estimated at 0.2%, well below last year's figure of 0.9%.

In addition, food inflation is expected to be above 5%, reducing the purchasing power of lower-income families. We predict inflation of 3.9% in 2024, with service inflation, excluding airfares, still very resilient. This should limit the expansion of household consumption somewhat.

On the other hand, in a municipal election year, the government will continue to stimulate the economy in order to mitigate the slowdown in activity. We forecast a primary deficit of around 0.8% of GDP for the consolidated public sector this year, down considerably from an estimated 2.3% of GDP in 2023, but we expect that fiscal policy will remain expansionary.

Although it is hard to measure the impact of payments of court-ordered obligations on GDP, and even though the cost of this expense was concentrated last year, its expansionary effects will only be felt this year. The Economic Policy Secretariat recently announced that it expects an impact of between 0.24 and 0.28 percentage points of GDP.[1] From an economic point of view, rather than an accounting one, the deficit is likely to be very similar in both years. Even so, it's a smaller boost than the one that occurred between 2022 and 2023, as we went from a surplus of 1.3% of GDP in 2022 to a deficit of 1.4% of GDP, not including court-ordered obligations, in 2023.

In addition to the stimulus coming from fiscal policy, we expect the positive effects of the loosening of financial conditions, with continued cuts in the benchmark Selic interest rate, to also help improve the performance of activity over the course of the year. Consequently, we expect growth to accelerate in the second half of the year compared to the first, with GDP ending the year up 1.4%.

In short, we continue to see a conflict between monetary and fiscal policies, the extent of which will influence the quality and profile of the economy's performance in 2024. In particular, for inflation to converge to the target, it will be necessary to keep interest rates in contractionary territory in 2024. In other words, Selic will have to remain above the neutral rate. The point is that an expansionary fiscal policy raises the neutral rate. According to a study by Borges and Pessoa (2021),[2] the decline in Brazil's neutral interest rate to atypically low levels in 2016/17

[1]See: https://valor.globo.com/opiniao/coluna/vantagem-dos-pagamentos-antecipados-de-precatorios.ghtml.

[2]See: https://blogdoibre.fgv.br/posts/os-determinantes-do-juro-de-equilibrio-brasileiro-em-2001-2019.

at the time of the study was the result of both a change in the cyclical orientation of fiscal and quasi-fiscal policy, compared to what was observed in much of the 2001-2014 period, and the favorable influence of the international environment. These two variables have since reversed and they could complicate life for the Brazilian Central Bank this year. This provides a warning about the harmful effects of expansionary fiscal policy on the neutral rate, on interest rates and, therefore, on private investment. There is no free lunch in economics.

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

- **Economic activity – page 7:** Economic projections point to a challenging outlook for Brazilian GDP in 2024. The trend of decelerating activity seems to have persisted in the last quarter of 2023, while 2024 has started off at a slow economic pace. Within industry, the extractive sector is doing well, while manufacturing faces obstacles. Retail, after beating expectations in November, played a crucial role in boosting household consumption, offering relief to the economic situation. However, the service sector remains vulnerable, impacted by uncertainties. The exceptional performance of agriculture in 2023, including a record harvest and growth estimated at 16.2%, will not be repeated in 2024, given the unfavorable weather forecast for this year, adding downside risks to GDP. Our conservative projection for 2024 GDP growth, maintained at 1.4%, reflects the persistent uncertainty in manufacturing and services, as well as the challenges for the agricultural sector.

- **Business people's and consumers' expectations – page 9:** FGV IBRE's confidence indexes ended 2023 in different situations. While the Consumer Confidence Index rose in December, closing the year up 5.7 points, the Business Confidence Index fell again in December, remaining stable over the year. Despite their improved confidence, consumers are still experiencing difficulties with their family finances, while business people show a certain optimism for 2024, reflected in the answers to some of the special questions asked in December.

- **Labor market – page 11:** The unemployment rate averaged 7.5% in the three months to November 2023, slightly below FGV IBRE's projections. In seasonally adjusted terms, the indicator remained at 7.8%, following the trend of stability observed after the gradual reduction in unemployment seen over the course of the year. We expect this indicator to remain unchanged in December, in terms of both the raw and seasonally adjusted figures. A noteworthy point is the convergence between the trends in average income and employment earnings, indicating that the variation in employment earnings is now almost entirely explained by the increase in wages. Despite the stable unemployment rate, the level of employment has been increasing, due to a slow recovery in the participation rate since the second quarter of 2023. Finally, the General Employment Registry (CAGED) reported the net creation of 130,100 jobs in November 2023, exceeding FGV IBRE's expectations. In seasonally adjusted terms, there was a slowdown, indicating stabilization of job creation at around 100,000 jobs per month. In December, we forecast a reduction of 450,000 jobs, corresponding to an increase of 129,000 in seasonally adjusted terms.

- **Inflation – page 13:** The section on inflation presents an analysis of the Extended Consumer Price Index (IPCA) in December 2023, which rose 0.56% in the month, ending the year up 4.6%. It highlights the influence of factors such as fiscal policy, the reinstatement of fuel taxes after the elections and the positive contribution of the robust agricultural harvest in moderating commodity prices. The text also discusses the accumulated 45% increase in food prices since 2020 and its social implications. It also explores inflation expectations for 2024, influenced by the El Niño phenomenon and forecasts of slower global economic growth, suggesting a mixed panorama of challenges and opportunities in inflation management.

- **Monetary policy – page 15:** It's not certain that Brazilian inflation will converge to the 3.0% target, but it is a possibility. The Brazilian Central Bank has been working toward this goal. In view of this, it is worth remembe-

ring that it is not enough to bring inflation to the target; it is important for inflation to reach the target and then stabilize at that level. To achieve this, the central bank will have to keep interest rates in contractionary territory until the whole process is consolidated.

- **Fiscal policy – page 16:** This section deals with "The Fiscal Challenges of 2024," one of which is to harmonize the speed of the possible fiscal adjustment with political expectations regarding the budget. This will be fundamental to reducing the conflict between the government and the markets. Another important challenge is to mitigate the slowdown in economic activity in 2024, reducing the pressure on the country's public finances. However, although the 2024 budget is contractionary from the point of view of the primary result, there are two major sources of fiscal stimulus. The first is the extraordinary payment of court-ordered obligations, which improves the long-term fiscal outlook, but at the same time promotes a stimulus concentrated in the short term. The second source of stimulus is the announcement of accelerated depreciation put forward by the government through Bill 2 of 2024. There are not many details about the proposal, given that regulations concerning the sectors to benefit from it will be issued later. However, according to the author, accelerated depreciation is one of the most cost-effective measures in terms of tax incentives for investment, and the modernization of machinery is important, given Brazil's long period of low investment rates.
- **External sector – page 17:** In 2023, Brazil posted a record trade surplus of US$98.8 billion. In the context of falling prices, an increase in export volumes and fall in import volumes explain this result. The agricultural and mining sectors led the increase in exports, while manufacturing recorded a decline. China led the way as a destination for exports, as Brazil's volume of exports to the Asian country expanded 29.5%. As a result, China accounted for 52% of Brazil's trade surplus. In 2024, we expect that the surplus will be lower, at around US$80 billion. Foreign trade continues to impose no restrictions on Brazil's macroeconomic situation.
- **International panorama – page 23:** Since the end of 2023, there have been a series of curve balls on the international scene, inducing massive fluctuations in asset prices and in assessments of future prospects. Despite these surprises, there is a growing consensus that the cycle of monetary easing in the developed world will begin in 2024. It remains to be seen how intense it will be and who will lead this process. We begin 2024 with significant changes in the short-term outlook, greatly increasing the uncertainty under which economic policy and investment decisions will be made. There is still a lot to settle in the global economic context, combining geopolitical shocks and sudden reassessments of prospects. We continue to experience enormous volatility in data and narratives, and this is likely to set the tone in at least the first few months of 2024. In this environment, the chance of misjudgments and errors in managing public policies increases, and this is an issue we must not lose sight of.
- **IBRE in focus – page 25:** Finally, the IBRE In Focus section, written by researcher Lia Valls, is titled, "The G-20 and the Foreign Trade Agenda."

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