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External and domestic factors put pressure on real interest rates

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External and domestic factors put pressure on real interest rates

Armando Castelar Pinheiro and Silvia Matos

The second quarter began with the external scenario increasing its already considerable influence on asset prices and the prospects for the Brazilian economy this year. There was, doubtless, an intensification of geopolitical risks, with the possibility of an expansion of the conflict in the Middle East, following Iran's attack on Israel. Even though events like these, in general, and from an economic perspective, have transitory impacts, in the short term they increase risk aversion and contribute to reducing the attractiveness of assets from emerging countries, reducing the freedom they have in conducting their economic policy.

However, more important on the international scene promises to be the relevant change observed in the prospects for the beginning of interest cuts in the USA. As highlighted in previous editions, activity and inflation data did not corroborate the very optimistic view that the market had regarding American monetary policy. In fact, inflation numbers for March once again exceeded analysts' expectations, for the third consecutive month, with emphasis on the high inflation in services, indicating a more persistent inflationary process than the Fed and the market seemed to see. Even though it expects inflation to slow down in the future, given that activity is resilient and wages are still under pressure, the Fed should wait even longer before starting the process of easing interest rates.

The release of US retail data on 04/15 for March, well above expectations, confirms this conclusion, having raised the future interest rate curve even further in the US and Brazil. Meanwhile, the dollar registered a strong appreciation, including against the real, which closed at BRL 5.18 that day. In fact, there are already doubts among market agents as to whether there will be room in the US to reduce interest rates during this year. Let us see.

In this context, market volatility increases. Additionally, the booming global economy, in addition to the conflict in the Middle East, is putting pressure on the price of a barrel of oil, which in the case of Brent has risen almost 20% this year and is being traded above USD 90 per barrel. The valued dollar and the high price of a barrel put pressure on Petrobrás to readjust fuel prices, also putting pressure on inflation here.

Finally, public accounts are getting further and further away from a path that leads to fiscal balance. Less than a year after approval, the fiscal framework is already being changed, an initiative that should not encounter much resistance in Congress. Recently, it changed a provision of the fiscal rule anticipating the possibility of expanding expenses, allowing spending to be increased without depending on a new assessment of budget projections. In other words, given the difficulty in finding space in the public budget for expenses that are not always socially worthy, the framework can be easily changed.

In the announcement of the 2025 Budget Bill, the government proposed zero deficit, replacing the previous commitment to generate a primary fiscal surplus of 0.5% of GDP next year. As there is a tolerance range of 0.25% of GDP, more or less, we can again expect a negative primary result. Together with interest expenses on public debt of around 6.5% to 7.0% of GDP, this should keep the nominal deficit at a very high level.

Therefore, recent events, both the international and domestic context, have certainly contributed to the worsening of the economic scenario, intensifying the exchange rate devaluation and putting pressure on the market interest rate. As a result, the scenario for public debt, which was already worrying, becomes even more difficult. There are no signs of debt stabilization on the horizon in the coming years. And, after reaching 77% of GDP this year, debt is expected to rise to something around 80% of GDP in 2025.

Despite the data showing resilient economic activity and at the same time a more benign short-term inflation rate, we do not have much to celebrate. It is true that March inflation was a widespread downward surprise, including in underlying metrics. Core measures slowed again at the margin, due to the good result of industrial goods inflation. In the 12-month accumulated period, inflation fell from 4.5 per cent in February to 3.9 per cent in March. However, there is still reason for some caution as underlying services inflation has risen to 0.45% at the margin, holding at 5.7% over 12 months.

As the exchange rate is suffering significant devaluation, the good results that have been observed for the prices of industrial goods may be reversed. Furthermore, the scenario for fuel prices is more unfavorable. This situation makes it very difficult to reduce interest rates in Brazil. And the most likely scenario today is that the year-end Selic does not reach single digits.

As we have warned, the economy has grown above its potential, due to the expansionary fiscal policy and the very tight labor market, with wages growing above productivity, which makes it difficult to reduce inflation in services, even if financial conditions prove to be significantly tightened.

In short, there are several elements capable of influencing the pace and extent of the low interest rate cycle in Brazil. With the worsening of the international environment and the changes in the main parameters of the fiscal framework approved last year, everything indicates that the downward cycle will soon be ending.

With these questions in mind, we can summarize the highlights of this edition of the FGV IBRE Macro Bulletin:

- **Economic activity – page 7:** In February, the economy showed mixed signs, with a slowdown in the services sector and higher-than-expected growth in trade. The extractive industry maintained good results, and the manufacturing industry grew, to a large extent, driven by the effect of the recovery in the production of capital goods. Despite the mixed signals between sectors, as services came in line with expectations, we maintained the projection for GDP growth at 2% for 2024.

- **Business people's and consumers' expectations – page 9:** FGV IBRE's confidence indexes rose again in March, but, on average for the quarter, results between companies and consumers were heterogeneous. The first group ends the quarter on a high, driven by the consistent improvement in industry confidence, indicating that 2024 tends to be a more favorable year for the sector. On the consumer side, March was the first positive result of the year, and it is necessary to wait for future results to define whether this will be a new trend or just accommodation after a sequence of falls.

- **Labor market – page 11:** The Continuous National Household Sample Survey (PNADC) of February 2024 recorded an unemployment rate of 7.8%, slightly below the IBRE projection. Seasonally adjusted, it remained constant at 7.7%, the lowest level since April 2015. Despite the general growth in income among the various occupation categories, from February 2023 to February 2024, the sectoral analysis indicates a slowdown until December 2023, followed by a slight recovery. Among categories, employers showed greater volatility, while public employees showed more stable earnings. Private sector employees with a formal contract and domestic workers without a formal contract had the least favorable performances, even though income grew consistently for all categories. The February 2024 Caged exceeded expectations, with the creation of 306.1 thousand vacancies, a number that drops to 158 thousand after seasonal adjustment. We forecast a balance of 123.6 thousand jobs for March, or 131.8 thousand with seasonal adjustment.

- **Inflation – page 14:** In March 2024, the IPCA rose just 0.16%, below the expectation of 0.25%, influenced by the drop in the prices of fresh foods, such as tubers, roots, and vegetables. Despite the expectation that inflation will continue to slow down, due to a milder autumn and the weakening of El Niño, April begins contrary to forecasts, with sharp increases in the prices of items such as tomatoes and papayas. Furthermore, April will capture the readjustment of medicines, potentially raising the forecast inflation to 0.59%. Continuous price monitoring and adaptive monetary policy are essential to direct inflation, projected at 3.9% for 2024, towards the inflation target.
- **Monetary policy – page 15:** There are several elements capable of influencing the pace and extent of the low interest rate cycle in Brazil. Despite the good result of the IPCA in March, concerns persist about services inflation, largely fueled by the strength of real wages and the wage bill. Inflation expectations remain unanchored and could be adjusted upwards again. The government's propensity to spend continues to make the future of public accounts particularly uncertain. Real interest rates, fixed interest rates, and implicit inflations that have been rising since the beginning of the year make clear the market's concerns about the future of inflation and interest rates in Brazil, concerns that only increased with the March CPI in the USA. In view of the foregoing remarks, the market is already indicating the possibility that, at the end of 2024, the Selic will not reach single digits. It is difficult to deny the realism of this new vision of the market.
- **Fiscal policy – page 18:** This section is about "Change of the New Framework and fiscal strategy". In the announcement of PLDO 2025, the economic team revised the fiscal target, which now becomes that of having a balanced primary deficit again. This year's result, whose target is difficult to achieve, includes many non-recurring revenues that are unlikely to materialize again in 2025. The economic agenda, in turn, becomes more difficult to achieve due to the political calendar. Even with the target reduction, the fiscal effort to meet it next year, if that happens, is quite relevant.
- **External sector – page 19:** The worsening of export performance in March does not define the trajectory of the trade balance for 2024. The intensification of conflicts in the Middle East, initially, should not have a negative effect on Brazilian exports.
- **International panorama – page 22:** The ECB kept benchmark interest rates unchanged at its April meeting, showing growing comfort with the disinflation process. Barring a major surprise, the start of monetary easing will occur at the June ECB meeting. We understand that the European scenario will evolve more consistently than the market imagines, leaving room for at least a 100bps reduction in reference rates by the end of 2024.
- **Political outlook – page 24:** The Political Observatory, authored by researcher Octavio Amorim Neto, is titled "The Carnation Revolution and the Rise of the Far Right". On April 25th, Portugal will celebrate the fiftieth anniversary of the Carnation Revolution, which put an end to the Salazarist Estado Novo, one of the longest-lasting authoritarian regimes in Europe in the 20th century. Ironically, the party that grew the most in the parliamentary elections held in Portugal on March 10 was Chega, a far-right populist party. The author discusses how Portuguese political elites chose to build a "sanitary cordon" around Chega, in order to protect the achievements made possible by the Carnation Revolution. What achievements are these? The laborious construction of a liberal democracy welcoming immigrants (the majority of whom are Brazilians) and a welfare state that brou-

ght a minimum of dignity to all citizens, construction that, finally, made Portugal a nation at par with its peers in western Europe.

- **IBRE in focus – page 25:** Finally, in the In Focus Section, authored by researchers Fernando Veloso, Silvia Matos, Fernando de Holanda Barbosa Filho, and Paulo Peruchetti, the theme is: “Labor productivity in Brazil: an analysis of sectoral results in the period 1995-2023.”.

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