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“Higher for longer”

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Armando Castelar Pinheiro and Silvia Matos

This expression has been widely used to characterize the current state of American monetary policy, but the same expression could also be used to describe the situation in Brazil. In both cases, what we have seen in recent weeks is a reduction in relative optimism about how quickly and how far the monetary authorities will be able to cut interest rates this year. In both cases, this is also due to the pressure coming from expansionary fiscal policy, which has kept activity growing at a fast pace and the labor market buoyant, nullifying a large part of the effect sought by monetary policy.

In the United States, the Federal Reserve has signaled that it will keep rates high for longer, until it is confident that inflation is moving toward the 2% target. In fact, the so-called “last mile” of the disinflation process, which entails bringing inflation down from the current level of 3.4% (3.6% for core inflation) to the target, has been much more challenging than the Fed expected. One of the main reasons for this is that, despite signs of moderation, the labor market and economic activity continue to perform well. As a result, service inflation remains under pressure, making the disinflation process longer and more uncertain. The issues highlighted recently by Fed officials show a more conservative bias; in other words, they are more concerned about making a mistake by prematurely cutting interest rates than about any delay.

In Brazil, despite disagreements between members of the Central Bank’s Monetary Policy Committee regarding the decision to cut interest rates at the meeting on May 7 and 8, the minutes released the following week showed that everyone agreed that monetary policy should remain on more contractionary ground than previously anticipated. No indications were made about the next moves, “given the uncertain global context and domestic circumstances marked by resilient activity and unanchored expectations.” All the members also agreed that the terminal interest rate should consolidate the process of disinflation and the anchoring of expectations around the targets.

In fact, after the previous meeting there was a worsening of the external and domestic context, underscoring the need to keep interest rates higher and for a longer time. First, activity data for the first quarter of the year came in stronger, while labor market data confirmed strong growth in employment and income. As a result, we revised our Brazilian GDP growth forecast up from 0.6% to 0.7%, quarter-over-quarter. Even more noteworthy, we revised our forecast for growth in household consumption in the first quarter from 0.9% to 1.5%, quarter-over-quarter. If this figure is confirmed, consumption will have grown by around 1% per quarter since the second half of 2021, outstripping quarterly GDP growth of 0.7%.

This strong growth in household consumption is largely explained by a real increase in gross disposable income. According to data released by the Brazilian Central Bank, since October of last year there has been an acceleration in the growth of disposable income, which had been expanding at a moderate pace. Undoubtedly, the payment of court-ordered obligations contributed to this result, especially at the beginning of the year. Ad-

ded to this is the real increase in the minimum salary, as well as welfare payments and pensions linked to the minimum salary, plus early payments of Christmas bonuses to National Social Security Institute users and the payment of regular court-ordered obligations for 2024. All of this fueled higher growth in household consumption in the first half of the year. Consequently, we expect a slowdown in the second half.

On the other hand, despite projections of healthy growth in investment in the first quarter of this year (3.7%, quarter-over-quarter), there are many doubts as to the sustainability of this recovery. It is important to note that this result was influenced by a rebound in truck production compared to the same period of last year, when there was a sharp drop in the production of these vehicles, as highlighted in previous editions of this report[1] Maintaining the real interest rate at high levels is likely to inhibit a sustained acceleration in investment this year. So, for the time being, we expect growth of 3.5%, after a 3% decrease in 2023.

In this context of stronger activity than expected and robust growth in demand, even more caution is needed when conducting monetary policy – even more so when inflation expectations for longer horizons are not only above the target, but rising.

Added to this is the expectation that fiscal policy this year will be even more expansionary than previously forecast. There is no doubt that the catastrophic floods in Rio de Grande Sul require government action to mitigate, albeit partially, the devastating effects on the region. Unfortunately, it would be necessary to have more balanced public finances, with a fiscal surplus in normal times, in order to have fiscal space for increased spending in exceptional times. We haven't yet been able to gauge the full impacts of the tragedy on the economy, but a worsening fiscal situation is almost certain.[2]

According to the minutes of the last Monetary Policy Committee meeting, reduced fiscal efforts and uncertainties about the stabilization of the public debt "have the potential to raise the economy's neutral interest rate, with harmful impacts on the power of monetary policy and consequently on the cost of disinflation in terms of activity." In addition, the committee reaffirmed that "a credible fiscal policy committed to debt sustainability would help anchor inflation expectations and reduce the risk premiums of financial assets, consequently impacting monetary policy."

In short, the message was clear, and the terminal interest rate will be higher and is likely to stay high for longer. The big question in this context, in both the United States and Brazil, is whether it is just a matter of time, or whether it will actually be possible to bring inflation down to the target without a shift in fiscal policy. Furthermore, in the meantime, the monetary authorities might start to work with higher inflation targets, even if this is not formalized. The presidential elections in the United States in November and the change in the composition of the Brazilian Central Bank's Monetary Policy Committee at the end of the year add to this uncertainty.

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

- **Economic activity –** **page 7:** In March, industry recorded growth of 0.9% compared to the previous month and a decline of 2.8% compared to the same period in 2023. Oil and gas production increased, but at a slower pace than in February. The manufacturing sector expanded 0.8% month-over-month, despite the fact that motor vehicle manufacturing fell by 6.0% compared to the previous month. Narrow retail saw growth of 5.7% compared to the previous year, driven by government income transfer policies. However, broad retail sales declined 1.5% year-over-year. The services sector grew 0.4% compared to the previous month, with services provided to families standing out. As a result, we have adjusted our forecast for year-over-year growth in the

[1]Due to a set of new emissions rules, "Proconve 8," there was a 38% decline in truck production in January 2023, compared to 12 months earlier, according to figures from the National Association of Motor Vehicle Manufacturers (ANFAVEA).

[2]Preliminary estimates point to a reduction of 0.3 percentage points in 2024 GDP. See the Economic Activity section.

first quarter of 2024 to 2.4%, equivalent to quarter-over-quarter growth of 0.7%. For the time being, we have not yet incorporated the effects of the floods in Rio Grande do Sul on activity and we maintain our 2% forecast for GDP growth in 2024.

- **Business people's and consumers' expectations – page 9:** Brazil's confidence indexes remained on a favorable path in April, although the pace of progress was slow. On the consumer side, better results merely compensated for the poor ones at the start of the year. The improvement was driven by more positive expectations for the economy and family finances in the coming months. On the business side, the month's stable result was obtained by a significant rise in confidence in commerce and a moderate fall in services and construction. The preliminary results for May point to a drop in confidence in the month, influenced by the severe flooding in Rio Grande do Sul. However, the size of this drop is still uncertain, given the difficulty in obtaining information for the region at the moment and the partial nature of data collection up until the closing of this edition of IBRE's Macro Bulletin.
- **Labor market – page 11:** The March 2024 edition of the Continuous National Household Sampling Survey (PNADC) revealed a decrease in the unemployment rate to 7.3%, the lowest level since February 2015, and projections point to further reductions ahead. The 2023 annual PNADC report broke down different sources of income, showing growth in both private and public sector income, although the latter grew faster than the former between 2020 and 2023. Different categories of public sector income, such as public pensions, disability welfare payments and Family Grant Program handouts, showed varying growth trends, with the latter two showing more significant increases. In addition, the General Employment Registry (CAGED) indicated net employment growth of 244,300 in March 2024, beating expectations and representing an acceleration in relation to the previous month. Our projections for the near future are optimistic.
- **Inflation – page 14:** In April, the Extended Consumer Price Index (IPCA) rose 0.38%, driven mainly by the prices of fresh food, medicines and gasoline. The flooding in Rio Grande do Sul is likely to affect inflation in the coming months, although significant losses in the production of key foodstuffs have not yet strongly influenced changes in food prices. In this context, FGV IBRE's Inflation Monitor anticipates a 0.4% rise in IPCA in May, without too much of an impact on the prices of food consumed at home, which according to our most recent survey are expected to increase by 0.5%, half the rate recorded in April. Nevertheless, prices may rise further as the impact of the flooding is taken into account.
- **Monetary policy – page 15:** The Brazilian Central Bank has faced many obstacles in its struggle to bring inflation down to the target in a sustainable manner. An expansionary fiscal policy, unanchored inflation expectations, an adverse external environment and factors such as the exchange rate, fixed interest rates, real interest rates and implicit inflation reveal serious concerns about the future of inflation and interest rates. In this context, the Central Bank had to reduce the rate of reductions in the benchmark Selic interest rate to 25 points in May and signal the possibility of an end to the cycle of interest rate reductions. There may still be some differences of opinion among the members of the Monetary Policy Committee, but regardless, it is unlikely that the benchmark interest rate will reach the single digits in 2024. At most, we're likely to see an additional 25-basis-point cut.
- **Fiscal policy – page 17:** This section is called "An evaluation of the primary result in the first quarter of 2024." Achieving the fiscal target will depend on the Brazilian government's ability to maintain the high tax revenues seen in the first quarter – which should prove difficult, given that there was a series of one-off tax windfalls in early 2024 – and to keep mandatory spending under control. With regard to spending, the items that have

been expanding the fastest are public pensions, Disability Welfare Program benefits, the Basic Education Fund and health. It is also important to distinguish between structural issues, which are still being adjusted, and the aid needed to rebuild the state of Rio Grande do Sul, as the impact of the recent floods there will take a few years to be mitigated.

- **External sector – page 20:** Although our projection for Brazil's current account deficit in 2024 has increased, the situation remains very comfortable. Our external accounts are a safe haven.
- **International panorama – page 23:** Stronger inflation in the United States has led to a sharp repricing of interest rates in the American interbank market, with the usual impacts on the exchange rate and, above all, on the local yield curve. However, a study by Ben Bernanke and Olivier Blanchard suggests that there has been a process of reducing tightening in the labor market, one of the main causes of high inflation. This study indicates that a soft landing is still in the cards, despite the higher U.S. inflation results in the first quarter of 2024.
- **IBRE in focus – page 25:** Finally, the IBRE In Focus section, written by researcher Anna Carolina Gouveia, is titled "Economic uncertainty at a moderate level, but facing future challenges."

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