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Guarded optimism

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In general, the first four months of 2023 were marked by an improvement in the environment for emerging countries, especially Latin America, including Brazil. This was due to the depreciation of the U.S. dollar and also because China grew more than expected in the first quarter of this year (4.5% year-over-year), largely due to the reopening of its economy. On the supply side, the biggest boost came from the tertiary sector and, on the demand side, the main driver was household consumption. Consequently, the world's main commodity-producing countries benefited and their currencies strengthened.

Looking ahead, however, we can see that the world economy is entering a moment of transition, as the monetary tightening cycle in the major economies draws to an end, some of the risks involving the international financial system decline, and a reasonable deceleration of economic activity is expected. Meanwhile, inflation will remain high, limiting the scope for possible cuts in interest rates.

In China, the data related to March and April shows mixed signals, with growth in services, but at a more moderate pace, and a contraction in the manufacturing sector. Looking at the Purchasing Managers' Index for the manufacturing sector in April, the components related to domestic and international demand fell again. One point that draws attention is the behavior of the real estate market, in which the situation remains depressed, with a slowdown in home sales, which has contributed to a sharper drop in the price of iron ore. Chinese growth is likely to fall back after the reopening, as previously observed in other countries. We maintain our forecast of 5.7% for Chinese GDP growth this year.

In the United States, the Federal Reserve has a great challenge ahead, as it will have to balance measures aimed at combating the still-persistent inflationary risks (given that the job market remains tight and core inflation has eased very little) while avoiding a financial crisis, as financial institutions and other companies adjust to the end of the long period of very low interest rates. The Senior Loan Officer Survey shows that there has been a gradual reduction in the supply of credit since the Fed began its monetary tightening policy in March 2022. All the signs point to further tightening of financial conditions, contributing to the deceleration of activity after the resilience at the beginning of the year. In short, the possible end of the monetary tightening cycle is not due to a good reason. There are many risks involved in this process in relation to economic activity, financial stability and inflation control.

On the domestic front, after stagnation in the second half of 2022, we forecast that Brazilian GDP will expand 1.2% in the first quarter of 2023, compared to the preceding quarter. The numbers for the first quarter surprised some market analysts. However, as we have highlighted in previous editions of the Macro Bulletin, around 0.9 percentage points of this growth stems from the strong expansion of the agricultural sector. Furthermore, while manufacturing shrank 0.3% in the first quarter, compared to the last quarter of 2022, it would have performed even worse without the contribution of food production, which added 0.5 percentage points to the result. According to our food sector surveys, domestic demand has been recovering well, largely due to the slowdown in food prices, while external demand has remained at high levels in recent months. In fact, the agribusiness sector as a whole will be the highlight of the first quarter.

On the other hand, we expect a very poor result for investment in the quarter, despite some resilience in the construction sector. Production of capital goods declined 1.8% in the first quarter, compared to the last quarter of 2022, and there was a generalized slowdown in output of capital products for use in all sectors tracked by the national statistics agency, IBGE, including the agricultural, construction and power sectors. The decline was widespread and not only due to the already anticipated slump in truck production, caused by the eighth phase of the Brazilian emission standards program (Proconve P8), which came into force in January 2023. This caused an artificial spike in truck production and sales in 2022. We expect investment to fall in the first quarter by 3.0%, compared to the fourth quarter of 2022.

Finally, in the service sector, the indicators from FGV IBRE's surveys show a strong decline since the beginning of the year, especially in services provided to families, due to poor expectations for the coming months. In particular, in April, around 47% of service companies said that one of the limiting factors for this sector was insufficient demand. Accordingly, although the Monthly Services Survey indicates slight growth in the first quarter (0.3% compared to the last quarter of last year), expectations are still negative for the second quarter in this sector, which grew more than 9% last year.

Overall, we have raised our Brazilian GDP growth forecast for 2023 to 0.8%, up from 0.3% before, but we have maintained, at least for the time being, our forecast of 0.9% growth in 2024. The labor market is still resilient and demand for goods is slightly better than previously expected. Because of this, we revised our projection for household consumption growth this year from minus 0.6% to 0.5%. On the supply side, manufacturing has also shown better results than we expected.

If these numbers are confirmed, the output gap will return to negative territory, especially in the second half. This would contribute to a more intense deceleration in service inflation, which tends to be more persistent. We know that the power of monetary policy has increased in recent years. According to Brazilian Central Bank Special Study 77 of 2020 (as mentioned in the bank's March 2020 Inflation Report), interest rates on credit operations involving free resources are more sensitive to changes in the base interest rate than rates on credit operations involving earmarked resources. The transformations that have occurred in financial intermediation and in the credit market in recent years, together with the expansion of the capital markets and the reduction in loan subsidies caused by the end of the use of the benchmark Long-Term Interest Rate (TJLP), have tended to increase the power of monetary policy.

However, fiscal policy has been expansionary. Furthermore, in the 12 months to March, earmarked credit expanded 14.2%, while free credit grew 10.5%. In the first quarter, free credit shrank 0.5%, year-over-year, while earmarked credit expanded 1.9%. Real estate and farm loans play a major role in earmarked credit and they are less affected by growth in the benchmark Selic interest rate.

To sum up, if this trend continues, there are risks that the impact of high interest rates on activity – and consequently on inflation – will become smaller. The government may reap more GDP growth in the year, but less disinflation in core and service inflation, reducing the effectiveness of monetary policy and postponing the right moment to start cutting interest rates consistently, without losing credibility.

In fact, the disinflation process is taking place, but very gradually. April's Extended Consumer Price Index (IPCA) result exceeded market expectations and it was also unfavorable in qualitative terms, as underlying service inflation rose slightly and diffusion was also at a high level. We are in the middle of the disinflation process, which is slow and needs a slowdown in demand to consolidate. This process is becoming even more costly, as inflationary expectations are unanchored, which could make medium-term inflation consistently higher.

Undoubtedly, if the fiscal framework approved by Congress includes measures that genuinely limit the scope for government spending growth going forward, it will be a great advance in terms of consistency of the rules, and there will be less pressure from demand and greater credibility. Changes to the original proposal have been presented and discussed in the House of Representatives since mid-May. So far, the proposed fiscal framework and the complementary measures to increase revenues would reduce extreme risks to the fiscal situation. However, the desired results will only be achieved if there is a significant increase in revenue.

Progress in the fiscal framework and less political pressure in discussions of monetary policy decisions are crucial to re-anchor expectations and consequently to reduce the cost of the disinflation process. Finally, a premature reduction in interest rates will not solve our country's potential growth challenges. There are no easy ways out of difficult problems.

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

- **Economic activity – page 7:** The high-frequency indicators for March set the tone for this year's growth: it seems that the economy is slowing down, not including the agricultural sector. Both services and industry shrank in relation to the fourth quarter. Retail still shows some resilience, but weak demand now means that a slowdown is likely in the rest of the year. Despite having slowed down slightly in the first quarter, industry is showing less negative signs than previously seen. The agricultural sector has also contributed to better results in both services and trade. Consequently, we have revised our 2023 GDP growth forecast from 0.3% to 0.8%. In this context, without productivity gains and with a high level of uncertainty in the economy, the challenges for more robust growth in 2023 are great, especially considering that strong monetary tightening will probably persist until the end of the year at least.

- **Business people's and consumers' expectations – page 10:** Confidence indexes ended the first quarter on a downward trend and started the second quarter reflecting a weak level of economic activity in the cyclical segments of the economy. The preliminary results of our May surveys signal a decline in business confidence, with a worsening in industry, services and construction. The service sector, which was already showing signs of slowing down in 2023, reinforces this picture of stability at a low level, despite some recovery in professional services and transportation, which partly reflects the impact of agriculture's strong performance. On the consumer side, the reduction in expectations in April reflects worsening expectations, but we expect this result to be reversed in the preliminary May results. The low level of the Current Situation Index for consumers continues to reflect the highly unfavorable situation for consumers, given Brazil's macroeconomic, labor market and social conditions.

- **Labor market – page 13:** The March results of the Continuous National Household Sampling Survey (PNADC) show an unemployment rate of 8.8%, as projected by FGV IBRE. In seasonally adjusted terms, unemployment fell from 8.5% in February to 8.3% in March, and we expect it to decline further in April, to 8.2%, corresponding to 8.5% in seasonally unadjusted terms. However, even though the unemployment rate is low, compared to its long-term levels, overall effective employment earnings are still 7.3% lower than we would have now if the pre-pandemic trend had continued, and three-quarters of this gap is explained by lower average earnings. In turn, the General Employment Registry (CAGED) increased again, indicating the net creation of 195,000 jobs (233,000 in seasonally adjusted terms). For April, we expect that CAGED will indicate around 183,000 new jobs (143,000 in seasonally unadjusted terms).

- **Inflation – page 15:** Services with unregulated prices have experienced great inflationary persistence. In this segment, several components sustain a very high 12-month inflation rate, including pay TV (19.2%), accommodations (17.3%) and driving lessons (16.9%). This is hard to explain in a context of such high interest rates. Currently, it would be natural to expect a rapid deceleration in service prices, especially after 12 months with benchmark Selic interest rate above 10%, but this has not yet happened, and the prices of key items in this group have not even stabilized, let alone fallen. The recent reduction in fuel prices, a major cost for the provision of services, is expected to help curb these prices, causing the annualized rate, currently around 7.5%, to fall by the end of 2023.

- **Monetary policy – page 18:** Properly dealing with the issue of the inflation target constitutes a fundamental step toward allowing us to enter an effective cycle of reductions in base interest rates. In the section on monetary policy, our author examines the importance of the government abandoning the idea of changing the inflation target, keeping it at 3.0%, while transforming it into a continuous goal. Resisting the temptation to widen the tolerance range seems equally essential.
- **Fiscal policy – page 20:** This section is called “Some additional observations on the new fiscal framework.” According to the author, the success of the new fiscal rules requires an efficient system of incentives. Enforcement of a punitive nature does not guarantee that economic policy managers will strive to meet fiscal targets. In practice, fear of punishment results in the setting of goals that are not very challenging, as has been the case in recent years. On the other hand, it is important to note that a very weak enforcement system can produce the opposite effect: the government can set absolutely unreasonable targets and not make an effort to achieve them, damaging the credibility of the economic system and fiscal policy. Therefore, we do not want to go back to the old system, which established inadequate incentives and was unable to solve problems, but to modernize it in light of international best practices. The author lists some suggestions for improving the new fiscal framework.
- **External sector – page 22:** Agriculture has been the main source of dynamism for Brazilian exports recently, led by increases in volumes. It was the only sector in which value increased between April 2022 and April 2023 (+10.6%), explained by higher export volumes (+20.1%), even as prices fell (-8.2%). In this period, the sector accounted for 32% of the total value of Brazilian exports.
- **International panorama – page 26:** The big question today about the international economic situation is the nature of the American inflationary process. This topic has been repeatedly addressed in this bulletin. The key point is the amount of pain it will take for inflation to return to the target of 2% a year. Following the reversal of shocks, everything suggests that inflation will stabilize at a level of between 4% and 5%. One indicator that has drawn attention, as it better reflects the state of aggregate demand and therefore the dynamics of inflation free of shocks, is service inflation excluding rents and energy bills, which is also running at between 4% and 5%. Most likely, pain will be necessary. We will see.
- **IBRE in focus – page 27:** Finally, the IBRE In Focus section, written by researchers at the Regis Bonelli Productivity Observatory, is titled “Labor productivity in Brazil: An analysis of sectoral results since 1995.”

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