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“Moment of change in monetary policy”

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“Moment of change in monetary policy”

Armando Castelar Pinheiro and Silvia Matos

Last week was marked by monetary policy decisions made by the central banks of the world's major economies. In Brazil, the next monetary policy decision will be the highlight of this week, as the Brazilian Central Bank's Monetary Policy Committee is scheduled to meet on June 20 and 21. Overall, the feeling around the world is that we are approaching a turning point, albeit of different natures, depending on the stage of the adjustment cycle in each economy.

In the United States, despite resilient inflation, labor market and economic activity data, the Federal Reserve decided to keep its policy rate unchanged in the 5.00%-5.25% range. The post-meeting communiqué was harsh, signaling that the institution may resume its cycle of interest rate hikes in future, as also signaled in projections by Federal Open Market Committee members, who mostly predicted two more increases this year.

The main justification for this pause is the need to better assess how much the tightening already carried out will impact activity and prices. In other words, the Fed wants some time to see how the data will evolve. If the scenario projected by the institution comes to fruition, interest rates will rise a little further ahead, as higher GDP growth is expected, putting even more pressure on the Core Personal Consumption Expenditure price index, which is now projected to end the year at 3.9%, up from a previous forecast of 3.6%. In short, it will take longer for inflation to converge back to the target, and everything indicates that monetary tightening will remain firm, although not because there will be sharp rises in interest rates, but due to the maintenance of rates slightly above the current level, including for a significant portion of next year, contrary to what the markets had been pricing until recently.

In turn, in line with expectations, the European Central Bank raised the interest rate to 3.50% and signaled another hike in July, given that inflation rates and expectations both remain high. In fact, it is possible that interest rates may be raised twice, taking the rate to 4.0%, not least because the ECB is further behind the curve than most other central banks. Nevertheless, it looks like interest rates will soon level off in the Eurozone as well.

In China, there has also been a change in monetary policy, although in the opposite direction. The People's Bank of China recently announced a reduction of 10 basis points in one of its base interest rates. There are also growing indications of additional stimulus measures, including of a fiscal nature, due to the loss of dynamism in the Chinese economy after a robust first quarter. In fact, the high-frequency activity indicators for May were in line with the Macro Bulletin's projections, showing less vigorous activity following the complete lifting of COVID-19 lockdown restrictions.

According to studies by researcher Lívio Ribeiro, the Chinese economy faces insufficient demand (both internal and external), as well as significant disruption in key sectors of the economy, such as real estate, local public finance and credit. Despite recent reductions in China's benchmark interest rates and indications of new policies to stimulate the real estate market, the outlook is challenging, given that so far, such policies have had little effect on the country's central problem, which is lack of demand.

Finally, the Brazilian Central Bank's Monetary Policy Committee is about to make its next interest rate decision. After many months of tight monetary policy, with real interest rates in restrictive territory since the end of 2021, the Central Bank is starting to reap the rewards: current inflation and inflationary expectations are subsiding, albeit gra-

dually. As expected, monetary policy transmission mechanisms have been acting on domestic demand (household consumption and investment), consequently affecting sectors whose activities largely depend on this demand.

As we have previously highlighted, in Brazil, around 65% of value added in the economy is made up of activities that are more sensitive to monetary policy. This part of the economy is called “cyclical GDP.” The other sectors, such as agriculture, extractive industry, public services and real estate activities,¹ are considered “exogenous GDP.” Since the third quarter of last year, cyclical GDP has been practically stagnant, after considerable growth in the first half of 2022. In particular, around 1.7 percentage points of the surprisingly strong seasonally adjusted quarterly growth of 1.9% in the first quarter came from activities less sensitive to monetary policy, i.e., exogenous GDP.

As mentioned in previous bulletins, part of cyclical GDP’s positive results is related to the broad agricultural economy, which, according to CEPEA², accounts for 25% of Brazil’s total economy, if we include agriculture-related manufacturers and service segments linked to the sector, such as transportation and storage. On the demand side, in line with our projections, household consumption has recently been sluggish and there has been a sharp reduction in investment.

The April data also confirms a sharp deceleration in cyclical GDP. In particular, FGV IBRE’s Economic Activity Indicator rose 0.7% compared to the previous month and 3.4% compared to April 2022. However, once again, a large part of this growth came from the exogenous part of the economy, which contributed 2.9 percentage points of the annualized change, while the cyclical component only contributed 0.5 percentage points.

Agriculture still played a major role at the beginning of the second quarter, but this did not continue throughout the quarter, as the all-important soybean harvest is concentrated in the first quarter. Agriculture is expected to make a negative contribution to GDP in the second quarter and other indicators support the belief that the deceleration in domestic demand is continuing.

Consequently, the decline in inflation, as measured by core rates, is occurring consistently but gradually. Thus, we expect the Brazilian Central Bank’s Monetary Policy Committee to keep the benchmark Selic interest rate at 13.75% at its June meeting, while signaling that the next steps will be more dependent on the data, especially that related to underlying inflation and inflation expectations. If everything proceeds as expected, the first cut should take place in August or September.

Undoubtedly, more favorable market expectations in relation to economic policy have also contributed to this outlook of gradual monetary relaxation. Among other things, the markets expect the inflation target to be maintained at 3%, and this helped to bring down average inflation projections for 2025, 2026 and 2027 in the Brazilian Central Bank’s latest Focus Bulletin to less than 4.0% per year, following several months stuck at this level after a sharp rise due to concerns about a possible increase in the target.

To cap off this good moment, S&P Global Ratings recently changed its outlook for Brazil’s sovereign credit rating of BB- from “stable” to “positive” as a result of past decisions and reforms. Corroborating this, we must persist in the search for economic policies to reduce public debt in the coming years and enact reforms to boost the country’s growth potential.

There is a long way to go before we can achieve a “BB” rating, not least because S&P projects that between now and 2026, Brazil will experience average real growth of under 2%, an investment rate lower than that of 2022 and a primary deficit in all years.

¹According to IBGE’s methodology, the added value of real estate activities is primarily associated with imputed rent, which has a persistent impact on the sector’s results.

²Center for Advanced Studies in Applied Economics (CEPEA), School of Agriculture, University of São Paulo, in partnership with the Brazilian Confederation of Agriculture.

Now is the time to persist!

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

- **Economic activity – page 7:** The GDP figures released by Brazil's national statistics agency, IBGE, indicate annualized growth of 4.0% in the first quarter of 2023. Separating the effects of cyclical components from those of exogenous components, it can be seen that cyclical GDP grew 2.8% year-over-year while exogenous GDP grew 6.3%, making contributions of 1.9 and 2.1 percentage points to aggregate annualized GDP growth, respectively. Looking at each component's contribution to seasonally adjusted quarterly GDP growth, the result is even more striking: exogenous GDP contributed 1.7 percentage points of aggregate growth of 1.9% (quarter-over-quarter). In addition, according to data from the beginning of the second quarter, it seems that the economy will slow down. Services, industry and broad retail all shrank in April, compared to March. In this context, without productivity gains and given the high level of economic uncertainty, the challenges for more robust growth in 2023 are great, especially considering that strong monetary tightening is likely to persist, although it may start to ease in the second half. All in all, after the first-quarter GDP figures were released, we revised our 2023 GDP growth forecast from 0.8% to 1.3%.
- **Business people's and consumers' expectations – page 9:** Confidence indexes recorded positive results in May, and the preliminary June numbers suggest that this trend will be maintained at the end of the first half of this year. As a result, the distance between the Business Confidence Index and Consumer Confidence Index is expected to decline to the lowest level since 2020. Overall, however, the business outlook is still very cautious, given that no sector has managed to recover what was lost at the end of 2022. In order for the favorable results recently observed to be maintained in the second half of 2023, macroeconomic variables will have to improve, given that they affect the level of confidence.
- **Labor market – page 12:** According to the Continuous National Household Sampling Survey (PNADC), unemployment was 8.5% in April, as projected by FGV IBRE. In seasonally adjusted terms, unemployment only declined 0.1 percentage points, from 8.3% to 8.2%, indicating labor market stability. In May, we forecast an unemployment rate of 8.5%, or 8.2% in seasonally adjusted terms. However, this low unemployment rate is partly due to the low participation rate, which not only has not recovered since the beginning of the pandemic but has also declined again since the third quarter of 2022. Breaking down changes in earnings since 2019 between level effect and composition effect, we can see that the latter in relation to employment was positive in two moments: after the onset of the pandemic, when informal workers exited the labor market and the public sector grew; and between the first and third quarters of 2022, when there was a considerable increase in the number of workers formally employed in the private sector. Furthermore, regarding economic activities, the "information, communication, financial, real estate, professional and administrative activities" sector, known for its high levels of qualifications and salaries, has driven a continual increase in the composition effect since 2022. Finally, according to the General Employment Registry (CAGED), a net 180,000 jobs were created in April 2023, slightly above FGV IBRE's projection of 143,000, although in seasonally adjusted terms, the number fell from 240,000 to 194,000. For May, we forecast that 191,000 jobs will be created, or 156,000 in seasonally adjusted terms, indicating a further slowdown.
- **Inflation – page 17:** The May Extended Consumer Price Index (IPCA) result undershot market expectations. This generated an extra dose of optimism regarding a stronger decline in inflation in 2023, supported by the good behavior of food prices. In fact, the slowdown was not restricted to this group. Services with unregulated prices, which had previously kept the 12-month inflation rate above 7%, finally retreated to 6.5%, a level not seen since March 2022. In June, we expect the prices of durable goods to drop, due to a reduction in

the prices of new cars. As a result, we project that IPCA will be approximately -0.20% in June. Consequently, inflation expectations for 2023 are now lower. Considering effects to be captured by the index's main groups, median inflation projections for the full year are now close to 5%, one percentage point below where there were a month ago.

- **Monetary policy – page 20:** Victory against inflation is far from assured. There's still a lot to do. However, we are faced with an encouraging set of signals. Implicit inflation, country risk and real interest rates are falling. The exchange rate has been behaving well. It's time to make the most of this good moment. Precisely for this reason, it is now more likely that the National Monetary Council will maintain its inflation target at 3.0%. If it decides to do this, it will cause an extraordinarily favorable shift in expectations, with positive effects in several areas, particularly with regard to inflation expectations and country risk. In fact, this scenario would effectively enable a sustained drop in interest rates.
- **Fiscal policy – page 21:** This section is titled “Consumer Tax Reform: Economic Gains and the Regional Development Fund.” Congress' Tax Reform Working Group recently presented its report, setting out guiding principles for the new system. As expected, the working group proposed to create a value-added tax and it made some concessions on some important points to allow the reform to advance in Congress. For example, the working group suggested carrying out a cost-benefit assessment regarding very high sums allocated to the Regional Development Fund, considering that if the reform is more flexible, it will have a smaller impact on economic growth and the fund can be smaller. In addition to the financial perspective, there is the economic dimension. The purpose of the Regional Development Fund is to create a development alternative for Brazil's poorest states. However, if the tax is set too high, this could amplify the distortions that lawmakers and the government want to eliminate, largely negating the benefits of the reform. Thus, it is important to be clear about the size of existing tax incentives, which is another aspect to be discussed. Such metrics will help guide the debate, which is mainly political but also needs to be rational.
- **External sector – page 24:** Incorporating a positive revision of our estimate for Brazil's trade balance this year, and despite a not-so-positive change in fundamentals, we reduced our projection of the current account deficit to 1.9% of GDP in 2023. Although we project that the deficit will expand to 2.5% of GDP in 2024, we do not see any external constraints in the foreseeable future.
- **International panorama – page 28:** In itself, the Federal Reserve's decision to halt its cycle of interest rate hikes did not catch anyone off guard. It was already expected and fully incorporated in prices. The surprise came when the individual projections of the Federal Open Market Committee's members became known regarding the future behavior (until the end of 2023) of the Fed Funds Rate and revisions that the GDP, unemployment and core inflation projections underwent. These projections do not seem compatible with the decision to pause interest rate hikes. In any case, the belief that additional interest rate increases will be needed to bring inflation down to the target is borne out when we examine the recent behavior of key variables for monetary policy decisions.
- **IBRE in focus – page 29:** Finally, the IBRE In Focus section, written by researcher Ana Maria Castelo, is titled “The Construction Recovery Loses Steam.”



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Praia de Botafogo, 190 – CEP 22250-900 – Rio de Janeiro – RJ
Caixa Postal 62.591 – CEP 22257-970 – Tel.: (21) 3799-4747

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