Macro Monthly Letter

September 2024

Accelerating growth or higher potential growth?

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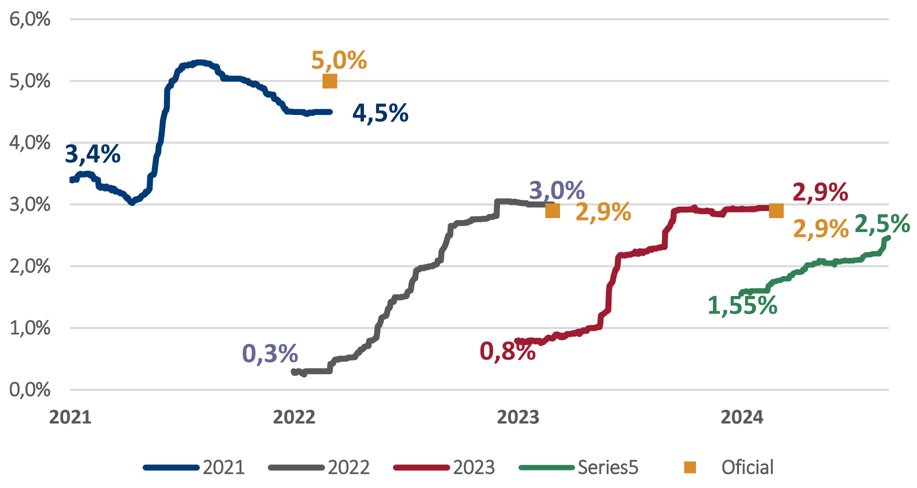
The announcement of second-quarter GDP set off a new round of revisions to 2024 growth forecasts. At the start of the year, the median forecast according to Focus (the Central Bank of Brazil's weekly survey of financial analysts) was 1.5%. By end-August, it had risen to 2.5% (Figure 1), and it is set to reach 3% or more following this latest GDP readout. The uptrend is hardly surprising, given the acceleration in quarter-on-quarter growth to 1.4% on top of the excellent first-quarter performance (1.0% QoQ) despite the floods in Rio Grande do Sul, which accounts for 8% of Brazil's GDP.

Figure 1: Market Expectations for GDP Growth (%)



Source: BOCOM BBM, BCB

This economic dynamism is also reflected in the labor market, which has sustained both real wage gains and sufficiently robust job creation to bring the unemployment rate down to the lowest level since 2012. Wages and rising conditional cash transfers to households have driven growth in total income above 7% in real terms in the year to date.

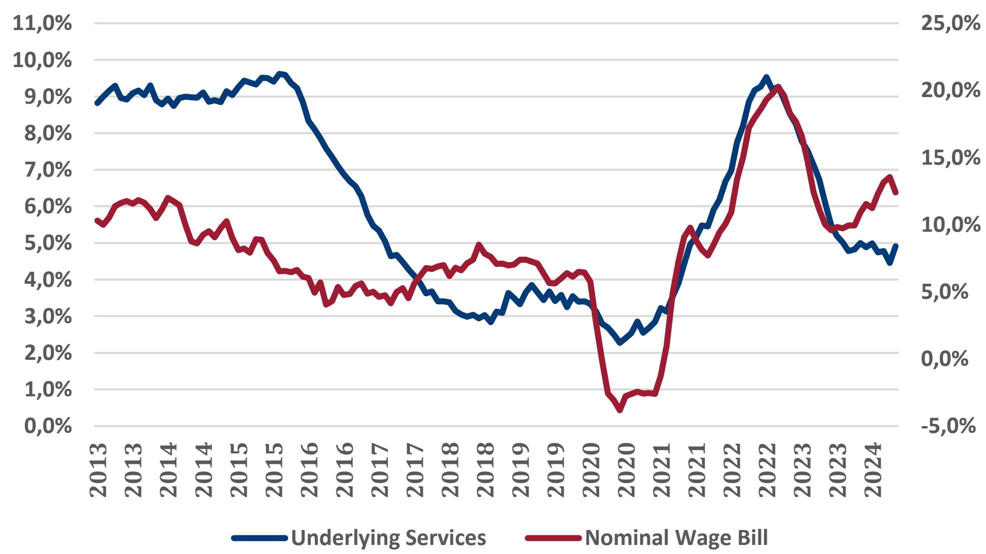
There may be a number of explanations for the fourth consecutive year of surprises in GDP growth. In contrast with 2023, when the agribusiness sector was the main driver of GDP growth, this year's performance appears to be due to a combination of several other factors, ranging from fiscal expansion as a driver of aggregate demand to the lagging effects of economic reforms on potential output.

In the fiscal sphere, the growth of spending on social security payments, welfare benefits and other items indexed to the minimum wage, in conjunction with the return of constitutionally mandated minimum investment in healthcare and education, helps explain the rise in household and government consumption. Together with outlays for court-ordered payment of federal debts (*precatórios*) frozen in previous years, these fiscal stimuli have had a clear effect on aggregate demand, albeit at the cost of increasing public indebtedness.

In the years ahead, compliance with the new fiscal framework should limit the effects of fiscal expansion on economic activity, but it is worth noting the challenges posed by the extreme rigidity of the budget (due to the fact that mandatory expenditure accounts for 92% of federal government disbursement) and the administration's focus on garnering more revenue for fiscal consolidation purposes. The 2025 annual budget bill (PLOA), which the government sent Congress on August 31, assumes BRL 121.5 billion in extraordinary revenue and BRL 46.7 billion in conditional revenue, but some of the sources for these are highly uncertain and beyond the government's control because they depend on approval by Congress.

On the other hand, it is also plausible that structural factors such as labor law reform, central bank independence and the basic sanitation framework are behind some of the recent economic growth surprises. The fact that current inflation remains relatively low (around 4.5%) and that the core indices are well-behaved by historical standards (Figure 2) despite the dynamism of economic activity and the labor market supports this view. And the strong growth of gross fixed capital formation in the last three quarters (7.4%) may be reflecting the consequence of reforms that are boosting the productivity of the economy.

Figure 2: IPCA Underlying Services and Wage Bill (% YoY)



Source: BOCOM BBM, IBGE

It is yet too soon to know if the reforms enacted in the past will improve potential growth, but the fact that activity is responding to the fiscal expansion brings implications for the conduct of monetary policy, as an output gap in positive territory implies that inflation will converge to the target more slowly.

Thus, although the emerging-market economies are benefiting from a more benign global outlook with lower interest rates, market pricing now indicates that a cycle of rate hikes in Brazil will begin in September (Table 1). In light of the de-anchoring of inflation expectations and local currency depreciation, we project a short cycle of rate hikes, with the Selic reaching 11.25% at year-end. Our other projections are shown in the table below.

Table 1: Monetary Policy Pricing

Monetary Policy Pricing (as of 06/09)			
Country	Rate (%) last decision	Pricing 6M (bps)	Pricing 1Y (bps)
Developed Markets			
United States	5.38 =	-159	-230
Canada	4.25 ↓	-100	-153
Euro Zone	3.75 =	-101	-163
United Kingdom	5.00 ↓	-78	-133
Japan	0.25 ↑	13	27
Emerging Markets			
Brazil	10.50 =	169	202
Mexico	10.75 ↓	-89	-197
Chile	5.50 ↓	-85	-140
South Korea	3.50 =	-38	-79
India	6.50 =	-37	-64
South Africa	8.25 =	-84	-146

Source: BOCOM BBM, Bloomberg

ECONOMIC FORECASTS	2019	2020	2021	2022	2023	2024F	2025F
GDP Growth (%)	1.2%	-3.3%	4.8%	2.9%	2.9%	3.1%	1.7%
Inflation (%)	4.3%	4.5%	10.1%	5.8%	4.6%	4.3%	4.1%
Unemployment Rate (eoy ,%)	11.1%	14.2%	11.1%	7.9%	7.4%	7.0%	7.3%
Policy Rate (eoy, %)	4.5%	2.0%	9.3%	13.8%	11.75%	11.25%	10.50%
External Accounts							
Trade Balance MDIC (US$ bn)	35	50	61	62	99	90	95
Trade Balance (US$ bn)	27	32	36	44	81	86	91
Current Account Balance (US$ bn)	-68	-28	-46	-48	-31	-35	-32
Current Account Balance (% of GDP)	-3.6%	-1.9%	-2.8%	-2.5%	-1.3%	-1.6%	-1.4%
Fiscal Policy							
Central Government Primary Balance (% of GDP)	-1.3%	-9.8%	-0.4%	0.5%	-2.1%	-0.7%	-0.9%
Government Gross Debt (% of GDP)	74.4%	86.9%	77.3%	71.7%	74.4%	77.3%	80.3%