Macro scenario - Brazil

June 10, 2024

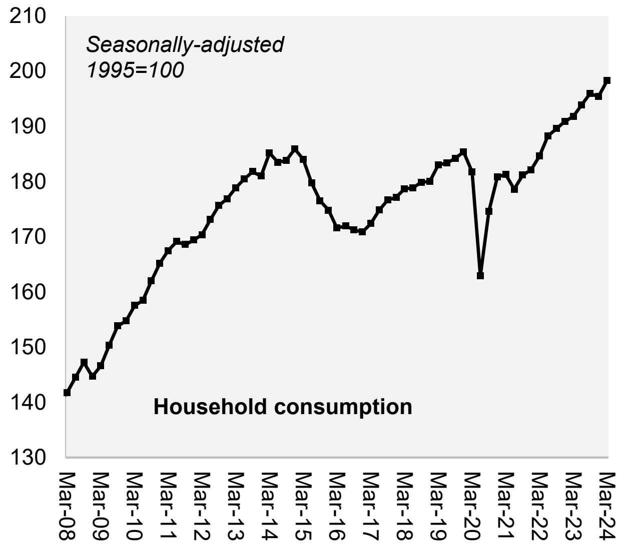
Easing cycle called off

- We are maintaining our GDP growth forecasts at 2.3% for 2024 and 1.8% for 2025. The effects of the floods in the South region have increased uncertainty regarding 2Q24 and added a downward bias to our full-year GDP estimate, but we prefer to wait for additional data to get a more accurate picture of the economic impact.
- Our estimates for the primary budget deficit are also unchanged at 0.6% of GDP for 2024 and 0.9% of GDP for 2025, with stronger revenues offsetting expenses associated with (clearly necessary) aid measures for Rio Grande do Sul. Fiscal risk remains high, given the difficulty of achieving a persistent convergence path in primary results, the robust growth in mandatory expenditures, and the limits to revenue growth – all of which increases the likelihood of changes in the key parameters of the fiscal framework approved last year.
- Our exchange rate forecasts remain at 5.15 BRL/USD for 2024 and 5.25 BRL/USD for 2025. External fundamentals (the strong dollar globally) and domestic fundamentals (amidst an increased risk premium and the significant deterioration of external accounts) prevent a more benign scenario for the Brazilian currency.
- Our call for the IPCA consumer price inflation for this year stands at 3.8%, but the balance of risks remains asymmetric, with upward pressures coming from food prices (due to the delayed reversal of shocks in fresh food prices as well as the floods in the South) and services prices (tight labor market). For 2025, we forecast inflation at 3.7%, with risks also showing upward asymmetry.
- Amid rising inflation expectations (already partially unanchored), resilient activity and increased domestic and external uncertainties, we see no more room for additional interest rate cuts. We have revised our forecast for the year-end 2024 Selic benchmark rate to 10.50% p.a. (from 10.25%), remaining at this level until the end of 2025.

Robust growth in 1Q24

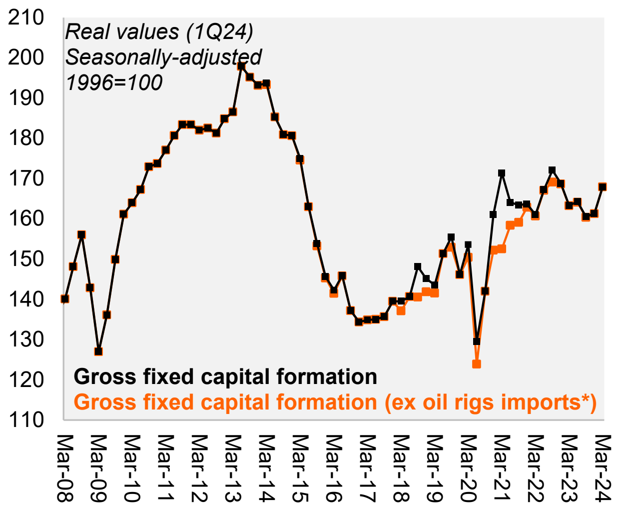
1Q24 GDP grew by 0.8% qoq/sa, slightly above expectations, and showed a benign composition. On the demand side, household spending delivered a noteworthy performance (+1.5% qoq/sa, up from -0.3% in 4Q23), while investment rebounded (+4.1% qoq/sa). Rising household income (thanks to a resilient labor market, a real increase in the minimum wage, and extraordinary disbursements of the court-ordered payments known as *precatorios*) and falling interest rates (which contributed to faster new loan growth in recent months) were behind this strong growth in the first three months of the year.

1Q24 GDP shows a benign composition: strong performance in household consumption...



Source: Itaú

... and a rebound in investment



Ignoring accounting effects of REPETRO.

Source: Itaú

For 2024 we maintained our 2.3% GDP growth estimate, with sustained consumption and a recovery in investment. Growth is likely to slow down in the coming quarters, but the resilient labor market and benign credit scenario should enable positive quarterly GDP readings until the end of the year. The effects of the floods in the South region have increased uncertainty regarding 2Q24 and added a downward bias to our full-year forecast. However, we prefer to wait for more data – particularly the May figures – to get a better understanding of the extent of the damage, especially to agriculture and the industrial sector.

For 2025, we are also maintaining our forecast of a slowdown in GDP growth to 1.8%. Some factors that boosted activity this year are unlikely to be repeated next year. It is worth mentioning that the prospect of higher interest rates at the end of the easing cycle has a negative impact on the monetary impulse for growth next year. However, this effect has been offset by the positive impact of higher-than-anticipated court-ordered payments, which increase the fiscal impulse. The floods in the South region have also added uncertainty related to the destruction of installed capacity and need for reconstruction, which could affect our 2025 growth estimate going forward.

Finally, as labor market figures remain resilient, we are maintaining our forecast that the unemployment rate will stay at a historically low level of 7.8% in 2024. The latest data showed no signs of a cooldown, with gains in both informal and formal employment. In the three-month moving average for April, effective real wages for all jobs climbed by 0.5%. We anticipate a slight increase in the unemployment rate next year (to 8.0%) due to the slowdown in GDP.

Fiscal data: revenues on the rise, but mandatory spending under pressure

We expect a deficit of 0.6% of GDP (BRL 75 billion) in 2024, with better-than-expected revenues offsetting the expenses associated with aid for Rio Grande do Sul. On the one hand, we have incorporated stronger revenue expectations for the year, reflecting the positive surprises in current data – largely due to the limit on tax compensations – as well as higher-than-previously-expected dividends from state-owned companies. On the other hand, larger revenue transfers to states and municipalities and aid measures after the tragedy in Rio Grande do Sul are likely to offset the increase in revenues.

We estimate primary budget expenditures of BRL 27 billion (0.2% of GDP) in support of Rio Grande do Sul. Measures to aid the population and the state's economy are highly justifiable and necessary, but it is important to monitor the risk that these measures become permanent without compensatory revenues and/or that their scope is expanded beyond the effects of the flooding disaster, to other states and regions.

The main risks stem from the difficulty of achieving a persistent convergence trajectory of primary results to the level necessary to stabilize public debt (at least 1.5% of GDP) and from the possibility of changes being made to the main parameters of the framework approved last year. In particular, mandatory spending has grown faster than the government projected and there are limits to the revenue growth agenda, which together heighten the risk of changes to the spending limit in the fiscal framework. If implemented, such changes would further damage the credibility of the government's fiscal plan after the recent change in primary budget targets from 2025 onward.

For 2025, we are maintaining our previous forecast of a primary deficit of 0.9% of GDP (BRL 110 billion) – a further deterioration after the 0.6% deficit we expect for 2024. The projected worsening relative to 2024 reflects our expectation of lower extraordinary revenues and our assumption that new measures to boost tax revenues will not be approved.

In contrast with our previous scenario, we now assess that while some of the positive surprise in current revenues in 2024 is likely to become permanent, this will probably be offset by higher-than-anticipated disbursements of court-ordered payments by the federal government.

In this context, we see gross debt increasing from 74% of GDP in 2023 to 77% of GDP in 2024 and 81% of GDP in 2025.

External and domestic fundamentals weaken the BRL

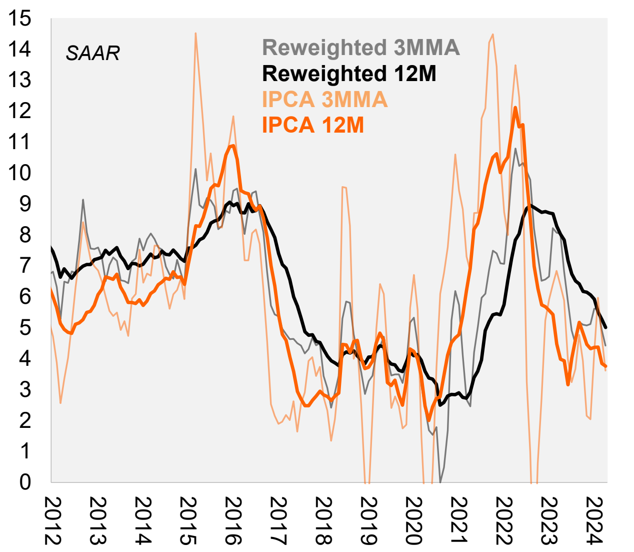
Our exchange rate forecasts remain at 5.15 BRL/USD in 2024 and 5.25 BRL/USD in 2025. External and domestic fundamentals suggest that there is little room for currency appreciation. The dollar will probably remain strong globally, supported by robust growth in the U.S. economy. Domestically, the Brazilian Central Bank is expected to keep the Selic rate in the double-digits, but fiscal uncertainties have increased the domestic risk premium. Moreover, the current account deficit, which has widened considerably in recent months, will likely be larger than the 2023 level by the end of this year.

Our forecasts for the current account deficit have widened to USD 43 billion in 2024 (from USD 30 bn) and to USD 53 bn in 2025 (from USD 43 bn). We have incorporated a less favorable trade balance (especially amid rising imports of crypto assets) and a larger services deficit (led by transportation, telecommunications, and recreation).

Unchanged inflation forecasts for 2024 and 2025

Our call for inflation in 2024 stands at 3.8%. The balance of risks has an upward asymmetry because the tight labor market could drive underlying services inflation closer to 6% (vs. 5.5% in our scenario). Additionally, the delayed reversal of the shocks in fresh food prices as well as the floods in the South could exert even more pressure on food prices. On the other hand, the increase in state-owned electricity company Eletrobras' grant in order to zero balance of the accounts related to the COVID pandemic and water scarcity add downside risk to our forecast.

Tight job market exerts pressure on inflation for labor-intensive items



Source: Itaú

Our inflation forecast for 2025 remains at 3.7%. Importantly, the balance of risks also shows an upward asymmetry because the labor market is likely to remain tight, contributing to sticky services inflation. Moreover, the La Niña weather pattern could extend throughout the next year, affecting both food and energy prices.

Monetary policy: easing called off

The Brazilian Central Bank's Monetary Policy Committee (Copom) will meet again on June 18 and 19 after weeks of intense market volatility – fueled, along with other reasons, by the dissent among committee members at the time of its previous decision. The BRL reached its weakest levels of 2024, decoupling from peer currencies. Our broad measure of country risk – which is based on asset prices and their relative performance – went up again after reaching post-pandemic lows earlier this year. It's reasonable to state that the domestic uncertainties mentioned in the committee's latest communications remain elevated and might even have increased.

Among the economic activity releases, we highlight the robust GDP and labor market figures. In the PNAD survey, the seasonally adjusted unemployment rate fell to 7.2% in the quarter ending in April (moving further away from our 9% call for the neutral rate), with wage growth accelerating at the margin. The labor ministry's CAGED registry delivered another month of strong formal job creation (199,000, seasonally adjusted, compared with a "neutral" pace of approximately 60,000). The 1Q24 GDP growth report showed a slightly stronger-than-anticipated result (0.8% vs. 0.7%), resilient consumption, and a recovery in investment.

On the inflation side, the latest readings showed a benign composition, but this factor was more than offset by rising inflation expectations in the Focus survey. Since the publication of the minutes from the last meeting – in which the authorities highlighted their firm commitment to achieving the target and re-anchoring expectations – median market estimates have increased sharply to 3.77% from 3.64% for 2025 and, more importantly, to 3.60% from 3.50% for 2026.

Under these conditions, even if exchange-rate performance improves, we see no more room for additional interest rate cuts. Therefore, we have revised our forecasts for the Selic rate to 10.50% p.a. (from 10.25%) at both YE24 and YE25.

Brazil | Forecasts and Data

	2019	2020	2021	2022	2023	2024F		2025F	
						Current	Previous	Current	Previous
Economic Activity									
Real GDP growth - %	1.2	-3.3	4.8	3.0	2.9	**2.3**	2.3	**1.8**	1.8
Nominal GDP - BRL bn	7,389	7,610	9,012	10,080	10,856	**11,524**	11,553	**12,188**	12,221
Nominal GDP - USD bn	1,872	1,475	1,670	1,951	2,175	**2,263**	2,269	**2,342**	2,348
Population (millions)	210.1	211.8	213.3	214.8	216.3	**217.7**	217.7	**219.0**	219.0
Per Capita GDP - USD	8,910	6,964	7,830	9,084	10,055	**10,394**	10,424	**10,693**	10,721
Nation-wide Unemployment Rate - year avg, NSA	12.0	13.8	13.2	9.3	8.0	**7.5**	7.8	**7.9**	8.0
Nation-wide Unemployment Rate - year end (*)	11.7	14.8	11.7	8.4	7.9	**7.8**	7.8	**8.0**	8.0
Inflation									
IPCA - %	4.3	4.5	10.1	5.8	4.6	**3.8**	3.8	**3.7**	3.7
IGP–M - %	7.3	23.1	17.8	5.5	-3.2	**3.0**	2.6	**3.0**	3.0
Interest Rate									
Selic - eop - %	4.50	2.00	9.25	13.75	11.75	**10.50**	10.25	**10.50**	10.25
Balance of Payments									
BRL / USD - eop	4.03	5.19	5.57	5.28	4.86	**5.15**	5.15	**5.25**	5.25
BRL / USD - average	3.95	5.16	5.40	5.17	5.00	**5.09**	5.09	**5.20**	5.20
Trade Balance - USD bn	35	50	61	62	99	**85**	85	**70**	70
Current Account - % GDP	-3.6	-1.9	-2.8	-2.5	-1.3	**-1.9**	-1.3	**-2.3**	-1.8
Direct Investment (liabilities) - % GDP	3.7	3.0	2.8	4.7	2.9	**3.1**	3.1	**3.7**	3.7
International Reserves - USD bn	367	356	362	325	355	**340**	340	**360**	360
Public Finances									
Primary Balance - % GDP	-0.8	-9.2	0.7	1.2	-2.3	**-0.6**	-0.6	**-0.9**	-0.9
Nominal Balance - % GDP	-5.8	-13.3	-4.3	-4.6	-8.9	**-7.1**	-7.0	**-7.4**	-7.2
Gross Public Debt - % GDP	74.4	86.9	77.3	71.7	74.4	**77.5**	77.2	**80.9**	80.6
Net Public Debt - % GDP	54.7	61.4	55.1	56.1	60.9	**63.7**	64.0	**67.3**	67.3

Source: IBGE, FGV, BCB and Itaú

(*) Nation-wide Unemployment Rate measured by PNADC.

(**) We await the release of the complete statistics of the demographic census of 2022 by IBGE. Thus, we have not yet incorporated the estimate of 203.1 million inhabitants in 2022.

Macro Research – Itaú

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