Emerging Insight

Brazil – Key Things to Watch in 2024

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GEM Fixed Income Strategy & Economics
Global

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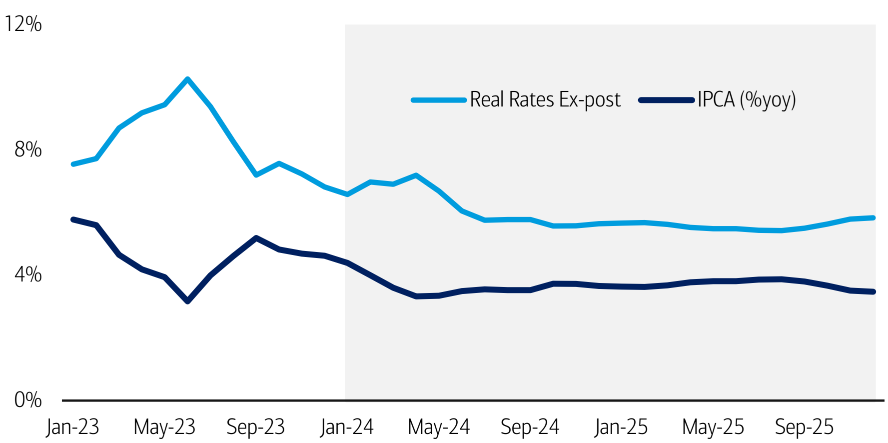
Key takeaways

- Eyes will remain on the fiscal, as the government attempts to achieve the zero deficit target set for 2024.
- Activity should show some moderate deceleration. Inflation and Selic rate expected to keep the downward trend.
- External basic balance should be stronger in '24, while political agenda will focus on Tax Reform and municipal elections.

By David Beker and Natacha Perez

Chart of the day: we expect real rates above 4.5% by the end of the cycle
Inflation (%yoy) and Real rate (%)



Source: BofA Global Research, BCB, IBGE

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Brazil in Focus

Top 5 questions for macro in Brazil for 2024

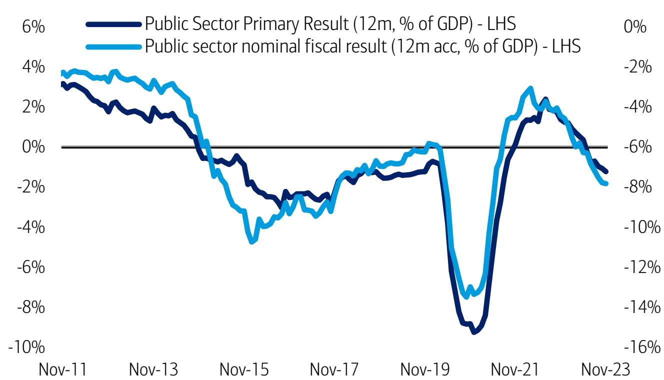
After a year of positive economic performance and relevant political gains, Brazil starts 2024 with several challenges and questions. In this piece we try to answer the five most important questions to get through the year. Fiscal discussions should remain again on the spotlight. The government will have to comply with the zero-deficit target established in the 2024 Budget, in an attempt to avoid contingency measures and sustain the credibility of the new fiscal framework. Regarding monetary policy, we expect Selic rate cuts to remain leading to a terminal rate of 9.50%.

Meanwhile, inflation measures should continue to decelerate towards 3.7% by 2024-end (from 4.6% in 2023). Activity is also expected to slow down this year, though we are still more optimistic than our peers, with GDP growing by 2.2% in 2024 (from expected 3.0% in 2023). For the external sector, our forecast for the Current Account Balance is at -US$41bn in 2024 (from -US$32bn in 2023), while Foreign Direct Investment (FDI) should pick up to US$65bn (from US$55bn). In the political agenda, it will be key to monitor: the advances in the VAT and Income Tax Reform, as well as the results of the municipal elections.

Will the fiscal (still) be a concern in 2024?

Yes. After 2021 and 2022 registering positive results, with primary surpluses and reduction in gross government debt (Exhibit 1and Exhibit 2), public accounts deteriorated in 2023. Despite 2021 and 2022 prints, fiscal stimulus measures weren't particularly low in the two-year period and summed over R$500bn. In 2023, some of these stimulus measures remained, but without reforms to help reduce costs, government indebtedness increased.

Exhibit 1: 2023 public sector maintained 2H22 negative trend...
Public Sector's Primary Result/GDP (%)



Source: BCB, National Treasury, BofA Global Research

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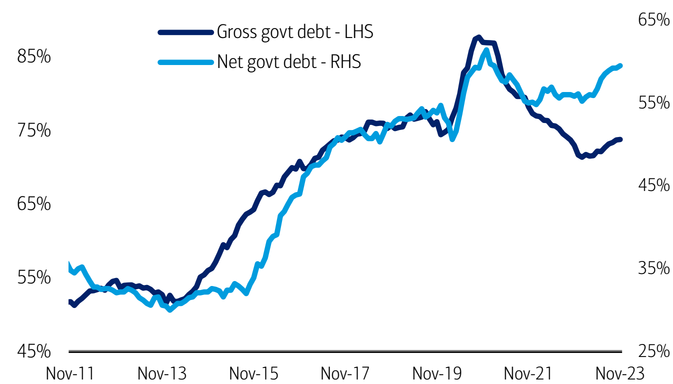
Exhibit 2: ... which translated into higher debts
Debt/GDP (%)



Source: BCB, National Treasury, BofA Global Research

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A key drag in 2023 was the increase in Bolsa Família's stipend from R$400 per family to R$600, generating an additional cost of R$80bn last year, accumulating R$160bn in 12months until November 2023 (from R$32.9bn in 2019). In addition, the country continues to face a deeper historical problem regarding its levels of expenditures, which even surpass its Latam peers. The rigidity of the budget, with about 90 percent of mandatory spending, also makes it more difficult to deliver larger cuts in the budget without structural reforms.

Also jeopardizing the headline for 2023, the government was allowed to open extraordinary credit to pay the accumulated stock, of about 95 billion reais on court-ordered debts, with an extraordinary credit. This is positive for the economic team, as such payments are not limited by the new fiscal rule and do not affect primary targets for 2025 and 2026. Executive technicians expressed that the objective is to start 2024 without this pending liability. The ruling pleases the economic team, easing fiscal risks related to court-ordered debt payments throughout Lula's term. Still, it does not end the conflict permanently, with discussions on court-ordered debts and judicial decisions remaining a fiscal risk in the longer term.

Even though 2023 ended on a sour note, with a large primary deficit, Finance Minister Haddad was a positive surprise. Ever since the presentation of the new fiscal rule and the zero-deficit target, the MoF continued committed to such goal and was able to get all revenue boosting measures presented to Congress approved before year-end – despite some dilution.

Nonetheless, consensus forecast for 2024 primary result (according to the latest focus survey) continues to be around a deficit of 0.8% of GDP – sitting far below the tolerance band of ±0.25% of GDP. Noise around a revision to the target has only faded regarding the timing. Though the budget has already been approved and enacted, the executive branch still has the power to change the primary target at any time, by sending an amendment bill to Congress. In our view, were the government to change the target, it is more likely to do so by March, after the 1st Primary Revenue and Expenditure Assessment Report for the year, as revenues expectations would be more accurate by then.

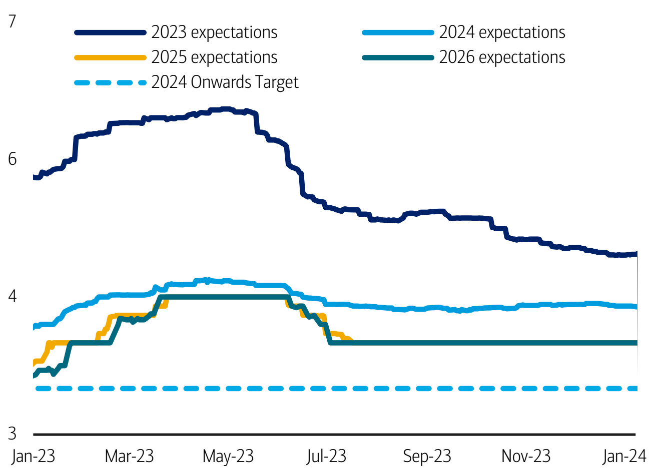
Recall that not meeting the target would trigger a reduction on the expenditure growth next year, with the percentage of spending growth going to 50% (instead of 70%) of the revenue.

All in, we believe the public sector will post a primary deficit of -0.4% of GDP in 2024 (from a 0.8% deficit in 2023), due to higher growth in revenues expected from the new measures. Besides, the breakdown of GDP growth next year should be more favorable for revenue collections, despite deceleration in overall activity. The deterioration of interest payments ahead should also take gross debt-to-GDP to 77.8% in 2024, from 76.1% in 2023.

Will inflation and rates continue to decline?

Yes. IPCA had a positive year in 2023, with inflation ending within the target (4.6%yoy in YE23, from 5.8% in YE22) after two years of misses. Headline and underlying measures decelerated throughout the year, driven by lower commodities prices and lagged effects of increases in interest rates. Looking at core components, both industrial goods and services trended down. After the end of federal taxes exemptions in the middle of the year, regulated prices represented a relevant pressure to the print (mainly for gasoline). Overall, inflation in 2023 surprised analysts to the downside, particularly compared with mid-year forecasts (Exhibit 3).

Exhibit 3: Inflation expectations still de-anchored
Key focus in longer horizons



Source: BCB

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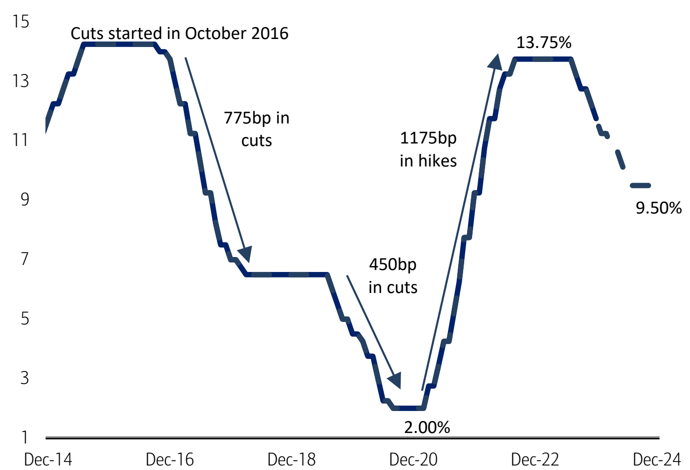
Exhibit 4: BCB started the easing cycle in Aug23
We expect a terminal rate of 9.50%p.a. to be reached in July



Source: BCB

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For 2024, we forecast inflation at 3.7% by year-end, lower than in 2023, but still above mid-target. Inflation should stay more well behaved throughout the year, impacted by high real rates and base effects from federal tax reoneration, which may lead to declining core component and regulated prices. But, risks are more tilted to the upside, and will depend on the severity of El Niño effects and possible escalation of geopolitical conflicts.

El Niño has emerged and has already caused negative impacts on recent crops. In case of a more intense phenomena, our calculations points to a possible increase of 100bps in 1Q24 inflation, as extreme weather events may jeopardize crops harvests (For more, see: Brazil Viewpoint: El Niño: Bad boy, whatcha gonna do?). Besides that, a deterioration on geopolitics backdrop could also affect supply chains, diminishing access to items transportation and production, which could lead to higher global prices.

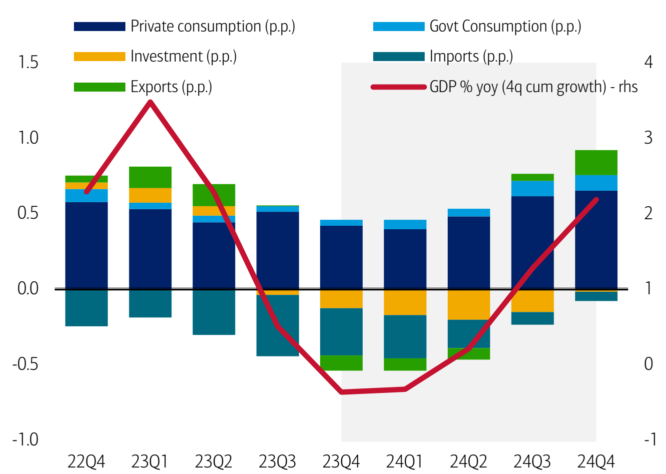
On the monetary policy arena, BCB started the easing pace in Aug23. Amid a still benign inflation momentum, we expect the BCB board members to maintain the same magnitude of the easing pace during 1H24 and, then, deliver one last 25bp clip in July, taking Selic to a terminal rate of 9.50% (Exhibit 4). The easing cycle should end with rates still in contractionary level to guarantee that the monetary authority credibility is not harmed and that long-term expectations converge to mid-target. Higher cuts are also not expected, as the board commits to persevere with a contractionary stance, amid uncertainties regarding external and fiscal scenario.

It is also worth noting that the January MPM (monetary policy meeting) will be the first participation of the two new board members – Rodrigo Alves Teixeira (Administration) and Paulo Picchetti (International Affairs). During the year, three more BCB members' terms will come to an end. The current governor Roberto Campos Neto is one of them. With this, the majority of the board (7 out of 9 members) will be composed of nominees appointed by the current government, as the board is expected to lean towards a more growth-oriented profile.

Will GDP growth in 2024 be as strong as in 2023?

No. We expect GDP growth to decelerate in 2024, but still register a relevant growth of 2.2% (from 3.0% expected in 2023). Activity should be weaker in 1H24 and more moderate in 2H24 (Exhibit 5). While 2023 activity surprises came mainly from net exports – driven by record crops in the country; in 2024, we believe the growth driver should be domestic demand, as the lagged effects of monetary tightening fades. Brazil's decision to cut rates ahead of the rest of the world should bring positive tailwinds for growth.

Exhibit 5: A more moderate activity for 2024
'23 was significantly driven by net exports



Source: IBGE

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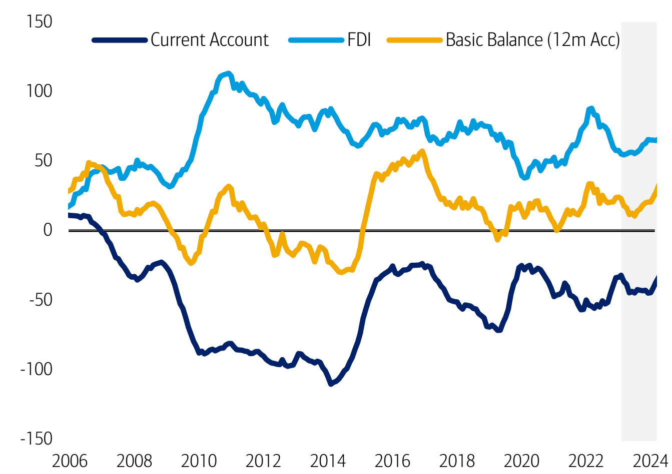
Exhibit 6: Basic Balance (CA+FDI) to remain positive (US$ bn)
A strong external balance has been supporting BRL



Source: BofA Global Research, FUNCEX, BCB

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Consumption is expected to be driven by declining interest rates and better credit market conditions, while inventories also move down. Default reduction programs should also increase new loan originations to consumers. Government consumption will also likely increase, as we normally see higher public expenditures in municipal (local) election years.

For exports, despite higher commodities prices from El Niño effects, a smaller crop and an appreciated BRL could have a negative impact on the trade balance. On the import side, a better composition of internal conditions will increase the demand. Meanwhile, though progress in key bills and the issuance of green bonds may lead to capital inflows, fiscal sustainability will continue to be the determinant factor for investment decisions.

Will external accounts remain strong?

Yes, as we will likely see larger FDI inflows. Last year was marked by positive news in Brazil's external accounts, notably on trade balance. Though Brazilian main commodities – such as soybean and corn – presented drop in its prices, the record crops and higher volumes exported more than offset this effect. Taking this scenario into account, trade balance, as measure by the BCB, should post a historical surplus of US$74.3. Nevertheless, looking at 2024, the outlook is less favorable. On the import side, a better internal demand explains the increase in volumes. Regarding exports, we are expecting a 2% smaller crop, but the rise in commodity prices and in production of iron ore and oil are expected to offset such headwind. Overall, we expect the 2024 trade balance at US$64.3bn.

The oil trade surplus accounted for 1.3% of GDP in 2023 and should contribute with 1.4% surplus of GDP in 2024. Indeed, The Brazilian oil complex trade balance has rebounded, shifting from a longstanding deficit (that peaked at US$17bn in 2013) to increasingly significant surpluses. Production increased with the discovery of pre-salt reserves around 2006. Looking beyond 2024, the oil boom is positive for growth, trade, fiscal and the BRL. (For more, see: Brazil Viewpoint: The oil frontier shines bright with promise 16 January 2024)

Regarding the services balance, while international travel deficit widened last year, oil prices reached a lower average, meaning more benign cost of freight, which narrowed the deficit in transportation. While we expect a -US$37bn in 2023 services account, transportation deficit should widen in 2024. International travel should also increase as internal demand strengthens, leaving a larger services deficit for 2024 at US$40bn. The income balance, by its turn, should slightly narrow from the US$73bn deficit in 2023 to a US$69bn deficit in 2024. Interest payment outflow should increase, while intercompany loans are expected to fall in the years ahead. Earnings and dividends payments continue to be the largest responsible for the deficit, yet at a smaller level. All in, our current account (CA) balance forecast is -US$41bn (or -1.9% of GDP) in 2024, from an expected -US$32bn (or -1.5% of GDP) in 2023.

On Foreign Direct Investments (FDI), despite initial favorable prospects for the beginning of 2023, the external scenario plus political uncertainties held back the optimism. However, for 2024, we see a relief given the expected improvement in external liquidity, with less restrictive monetary policy in advanced economies. Thus, we expect FDI for 2024 to be US$65bn (from US$55bn at YE23). FDI will continue to fund the CA deficit, with a larger external basic balance (CA+FDI) for this year (US$24.1bn), when compared to the US$22.9bn print in 2023 (Exhibit 6).

On the FX front, a narrower current account deficit than previously expected has supported a more stable currency, even with a challenging external environment. Though higher levels of US Treasury put some downward pressure on FDI, the persistently strong trade balance results in the last months have supported the BRL. Besides that, despite fiscal risks raising some concerns, lower global rates should back a stronger currency for Brazil in 2024, with USD/BRL being at 4.75 in 2024-end (from 4.86 in 2023-end).

What will be the political agenda for 2024?

2023 was a year of important victories for the government, with approval of the long awaited Tax Reform. Changes in the Brazilian tax code have been discussed for more than 30 years in Congress. The main change is the consolidation of five taxes into a non-cumulative dual VAT - one for federal taxes (IPI, PIS and Cofins) and one for states

(ICMS) and municipalities (ISS) - plus an excise tax (federal) on items that are harmful to citizens' health or the environment. With a simplification of Brazil's tax system in the long term, the reform is expected to boost productivity ahead.

With the approval of the PEC (Constitutional Amendment), the government will now have 180 days to send to Congress the supplementary laws needed by the new legislation. During 1H24, discussions should focus on secondary legislation setting the details for the new tax system, which includes the VAT rates. The follow-on legislation will also rule on governing specific regimes, the parameters for credits based on the old tax system (PIS, Cofins, ICMS, ISS), the detailed list of goods and services receiving VAT discounts, exempts and those subject to excise tax regulation.

On the Income Reform front, the constitutional amendment of the Tax Reform compels the government to send within 90 days a bill reformulating progressive taxes. The focus should be on updating the income tax threshold and creating a tax on dividends and profits, as well as reducing the Corporate Income Tax (IRPJ). The next phase will require a significant legislative effort in a short span, given that the level of activity in Congress is expected to reduce during municipal elections in 2H24.

Voters across Brazil will go to the polls to choose mayors and councilors, who will play fundamental roles in the administration of their respective cities. After the tightest difference in 2022 presidential elections, the 2024 race is expected to also be polarized by the political strength of Lula (PT) and names supported by the former president Jair Bolsonaro – namely, the PL party. On one hand, PT has been losing representatives in city halls across the country in recent elections, dropping from a high of 11% in 2012 to 3% in 2020 (Exhibit 7). On other hand, 2022 demonstrated the strength of names linked to Jair Bolsonaro, as Congress tilted toward a more right-leaning profile. When we look at the number of state and district deputies, the PL party became the largest group after the 2022 election, tripling from 43 (in 2018) to 129.

Overall, while right-wing parties are likely to continue to gain strength, it will also be important to monitor President Lula's influence on the race. Regarding centrist parties, they should continue to carry most of the municipalities, as it has historically been. All in, It will be key to monitor the winning parties in state capitals, as the results have meaningful implications in the political backdrop. As municipal elections represent the primary electoral basis for political parties, a higher number of positions held by each party normally translates into increases in parties' political strength and bargaining power.

Exhibit 7: Center parties have carried most of the municipalities historically

For 2024, the strength of right-win parties in 2022 should still be seen

	Number of mayors per party			
Party	**2008**	**2012**	**2016**	**2020**
(P)MDB	1201	1024	1028	784
PSDB	791	702	793	520
PSD	-	497	539	654
PP	551	469	494	685
PSB	310	442	413	403
PDT	352	311	334	314
PL/PR	385	275	295	345
DEM	496	278	265	464
PTB	413	295	262	212
PT	558	635	256	183
PPS/Cidadania	129	123	118	139
PRB/Republicanos	54	79	104	211
PV	75	96	101	47
Others	41	336	500	607
Total	5356	5562	5502	5568

Source: BofA Global Research, Arko Advice

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News and Views

Brazil: IGP-10 increased 0.42% mom in January

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IGP-10 inflation increased 0.42% mom in January (from 0.62% in December), just below market expectations at 0.46%, reaching -3.2% yoy (from -3.6%). Wholesale inflation was the main contributor increasing 0.42% mom (from 0.81% mom previously), while agriculture prices went up by 2.22% mom (vs 1.82%). Consumer prices rose by 0.46% mom (vs 0.22%), with the main upward pressure being Food (1.41%, from 0.40%, mainly due to perishable items). Meanwhile, construction inflation increased 0.39% mom (from 0.01%).

- **To follow:** We expect inflation acceleration in the beginning of 2024, mainly in annual metrics due to base-effect.

Brazil: market expectations shifting towards a stronger BRL

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According to the Brazilian Central Bank's (BCB) weekly survey (Focus), exchange rate expectations moved to a more appreciated level for 2024 and 2026. The consensus for FX rate is now at R$4.92/US$1 (from R$4.95/US$1) for YE24 and R$5.05/US$1 (from R$5.06/US$1) for YE26, while YE25 and YE27 still stood at R$5.00/US$1 and R$5.10/US$1, respectively. Regarding inflation, IPCA forecast went slightly down to 3.86% (from 3.87%) for 2024, though staying unchanged for 2025, 2026 and 2027 (at 3.50%). GDP consensus dynamics were similar, with a slight increase in 2024 to 1.60% (from 1.59%) and the rest of the horizon (2025-2027) stable at 2.00%. No changes for Selic rate median expectations, which remain at 9.00% for YE24 and 8.50% for ‘25, ‘26 and ‘27.

- **To follow:** Consensus for IPCA is above our forecast of 3.7% for 2024-end, though remained similar for the rest of the horizon at 3.5%. Regarding interest rates, consensus see a lower Selic as our estimation is a terminal rate of 9.5% this year without later increases. GDP consensus is below our 2.2% growth expectation for 2024 and 2.5% in 2025. Regarding the FX, market participants foresee a weaker currency in 2024 (R$4.75/US$1), though similar in 2025 (R$5.00/US$1).

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