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Armando Castelar Pinheiro e Silvia Matos

Inflation remains high, surpassing expectations and breaking records in many countries. In the eurozone, it is at an all-time high. In the United States and United Kingdom, the rates are the highest in four decades. Finally, the world's main central banks have changed their stance and abandoned their argument that the rise in prices is "transitory" and will sort itself out. They have started to accept that it is high time to abandon the expansionism that has characterized monetary policy in their countries in recent years.

Interest rates have begun to rise and they will continue to do so, central banks have said. The question that arises now is how much will rates rise, and for how long. In Brazil, too, although to a much lesser degree, this same question is on the agenda. Once again, inflation is set to significantly exceed the top of the target range. So, how far will the Brazilian Central Bank raise the benchmark Selic interest rate?

Information released in the last few weeks corroborated the need for greater monetary tightening in the United States. GDP decreased at a seasonally adjusted annual rate of 1.4% in the first quarter of 2022, and at first glance this might suggest the opposite, but not if we look at the numbers in detail. In particular, this drop was largely explained by the negative contribution of net exports, while private domestic demand expanded 3.7% in the period.

Looking ahead, there are many reasons to think that inflation will remain high. In particular, the data shows that the labor market remains very tight by historical standards, with an unemployment rate of 3.6% in March, among other indicators pointing in the same direction. For example, the Employment Cost Index (ECI),[1] which includes wages and benefits paid by companies, rose 1.4% in the first quarter compared to the fourth quarter, after increasing 1.0% in the last quarter of 2021. The April data was also positive, although it lost impetus. There are also bottlenecks in supply chains, which continue to be significant and were intensified by the Omicron outbreak in China, making the inflationary process even more challenging.

In Europe, the signs also point to higher interest rates, but with a certain lag in relation to the United States, as activity in the region is directly experiencing the contractionary impact of the war in Ukraine. China is also going through a slowdown process, with short-term challenges caused by COVID-19. Given the prospect of interest rates rising more and earlier in the United States, as well as heightened risk aversion due to the likelihood of a global slowdown, the dollar is gaining strength, which in turn is putting pressure on activity in emerging economies.

[1]Employment Cost Index released by Bureau of Labor Statistics.

A global slowdown is therefore expected. This is shown by FGV IBRE's Coincident and Leading Global Economic Barometers,[2] which fell for the second month in a row. In May, the Coincident Barometer remained below the long-term average of 100 points, while the Leading Barometer moved away from the average, indicating an increased risk of a sharper deceleration in many countries.

All coincident sector indicators also dropped sharply in the month. The biggest declines were in the Construction and General Economy sectors (consumer and aggregate business evaluations), followed by Industry, Services and Commerce. As a result, all five sector indicators are now below the historical average level of 100 points.

In Brazil, after the expected increase in interest rates to 12.75%, the Monetary Policy Committee's latest statement and minutes said that an extension of the monetary tightening cycle is likely, but a smaller increase is envisaged at the June meeting. Will there be further increases after that? If so, to what extent? As already mentioned, inflation remains very high, and the expectations for 2023 are increasing. The minutes of the Monetary Policy Committee's last meeting left these questions open. On the one hand, they expressed concern about the lagged effects of monetary policy and its negative effects on economic activity. On the other hand, they also expressed concern about the speed of industrial good disinflation, which may prove to be much slower than previously predicted.

Because of higher inflation, which has been surpassing expectations, as well as tighter monetary policy here and abroad, domestic financial conditions have inevitably worsened, making the prospects for economic activity in Brazil even more challenging. Thus, we understand that the positive results for activity in the first quarter, which exceeded expectations, will not be repeated in the coming months.

The economic reopening process, now that the pandemic is partially under control, contributed to positive results for services and commerce. For the first quarter, we have revised our growth forecast from 0.4% (quarter-over-quarter) to 0.9%. Data from the start of the second quarter also points to a moderately more positive quarter than previously anticipated. However, we believe that the second half of the year may experience a more intense deceleration. Consequently, we have only revised our growth forecast for the year slightly, from 0.6% to 0.7%. For 2023, we have reduced our growth forecast from 0.7% to 0.4%.

As highlighted in previous editions of IBRE's Macro Bulletin, the current situation of continued monetary tightening for a longer period is weighing negatively on activities more related to the economic cycle. In addition, uncertainties about the upcoming elections and the fiscal framework that will be in force in the coming years make it hard to return to a sustainable fiscal path and consequently to reduce the economy's equilibrium real interest rates.

The rising benchmark Selic interest rate and prospects of low economic growth will harm the nominal result and public sector debt later on. This will make the fiscal agenda for the next government even more challenging. Mandatory public spending needs to be curbed through reforms that are very difficult to carry out politically. At the same time, there is not much room for an increase in the tax burden, which already reached 33.9% of GDP in 2021, well above the average for Latin America (excluding Brazil) and close to the average for OECD countries. There are no reasons to celebrate.

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

- **Economic Activity – page 7:** In March, high-frequency indicators showed faster normalization of the economy. Services showed strong growth, retail beat expectations and industry continued to suffer from logistical

[2]The Global Economic Barometers are a system of indicators that allow timely analysis of global economic development. They are compiled collaboratively by the KOF Swiss Economic Institute at ETH Zurich, Switzerland and Fundação Getulio Vargas. See https://portalibre.fgv.br/sites/default/files/2022-05/barometros-globais-kof-fgv_press-release_05_2022.pdf.

bottlenecks. Accordingly, we have revised our GDP growth projection for 2022 marginally, from 0.6% to 0.7%, but with stronger growth at the margin in the first quarter, 0.9%, compared to the fourth quarter of 2021. We believe there is still room for recovery in some service activities. However, on the demand side, household consumption is likely to be weak and investment is set to shrink this year.

- **Business people's and consumers' expectations – page 9:** Business confidence appears to be on an upward trend for the third consecutive month, while consumer confidence may decline if our preliminary results in May are confirmed. Both results were influenced by expectations for the coming months. The easing of the pandemic and better than expected results for economic activity in the first quarter seemed to improve business people's mood in May, but inflation remains the most important factor for consumers, who have been allocating their spending more cautiously, such as paying bills and purchasing essential consumer goods. It is clear that inflation is once again an issue signaling economic uncertainty. The feeling of lost purchasing power is also felt by consumers through the inflation expectations indicator, which continued to rise in April.
- **Labor market – page 12:** In March, the Continuous National Household Sampling Survey (PNADC) indicated an unemployment rate of 11.1%, 0.4 percentage point below FGV IBRE's forecast. In seasonally adjusted terms, unemployment fell significantly, from 11.3% to 10.9%. However, the recent movement is mostly explained by a reduction in the participation rate. In turn, the General Employment Registry (CAGED) showed net employment growth of 136,000, close to FGV IBRE's projection of 118,000. For April, we project net employment growth of 148,000, or around 163,000 in seasonally adjusted terms.
- **Inflation – page 15:** The deceleration shown by April's Extended Consumer Price Index (IPCA) result does not put an end to inflationary pressures. The 12-month rate, currently 12.16%, is likely to remain above 10% at least until August. The inflation deceleration trajectory will be slow and smaller than expected at the beginning of the year. The uncertainty caused by the war between Russia and Ukraine, the outbreak of COVID-19 in China and the risk of further supply chain disruption are intensifying tensions related to the future of prices. So, greater vigilance regarding the inflation trend is called for.
- **Monetary policy – page 16:** In the section on monetary policy, our author examines the two recent episodes in which Brazilian inflation reached more than 10% per year, in 2015 and 2021. On the first occasion, the authorities managed to bring annual inflation down to around 3% in two years. In the present episode, the Central Bank aims to reduce inflation at a pace similar to that seen previously, that is, from more than 10% to around 3%. (The official target is 3.25% in 2023.) However, there are various obstacles to achieving this goal. The article compares the circumstances in 2015 to those currently in force and points out that the present ones are much more adverse.
- **Fiscal policy – page 18:** Public investment dropped again in 2021. The sum of investment at the three levels of government, plus investment by federal government-owned companies, was 2.05% of GDP, the second lowest public investment rate since 1947, when our Fiscal Policy Observatory's historical series begins. The agenda of freeing up fiscal space to allow more public investment remains current. However, the challenge lies in obtaining these financial resources and making improvements to investment governance so that such projects have high social returns and can promote economic development in partnership with the private sector.
- **External sector – page 19:** The lockdowns in China have intensified inflationary pressures and Brazil's import prices continue to rise faster than export prices. Import prices are rising for both commodities and

non-commodities. The effect of the increase in export prices on the terms of trade is smaller than at the beginning of the 2010s. In April, the trade balance results caused alarm, due to a decrease in export volumes. Even though import volumes fell as well, the price trajectory suggests a drop in the trade surplus in 2022 compared to 2021.

- **International panorama – page 22:** Affected by its "COVID zero" policy, China's April data suggests that the second quarter of 2022 will be a lost one in terms of growth. Some analysts are now projecting a year-over-year decline in GDP, although for now we consider this to be overly pessimistic. We have revised our year-over-year GDP growth forecast for the quarter to just 0.2% and cut our 2022 growth forecast to 4.3%. Achieving the GDP growth target of "around 5.5%" in 2022 is now practically impossible.
- **IBRE in focus – page 25:** Finally, the IBRE In Focus section, written by researchers Janaina Feijó Filho and Paulo Peruchetti, is titled "Labor market recovery in Brazilian regions still causes concern."

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