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Deceleration in sight

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Armando Castelar Pinheiro and Silvia Matos

It is true that the first half of this year has been marked by strong performance in terms of activity, but this is due to temporary factors, such as the reopening of the economy, the normalization of public services, fiscal stimulus and a significant rise in commodity prices. In fact, even though we previously wrote that there would be no recession in Brazil this year, we recognize that the short-term resilience of activity has been surprising.

It so happens, however, that these are very transitory impulses. In the absence of more stimulus, more restrictive monetary policy will increasingly predominate, and as always, it will impact the economy after a certain lag.

Economic dynamics in the rest of the world will also contribute to this deceleration. Brazil's economic growth in the first quarter was significantly influenced by the favorable external situation, which is unlikely to continue in the coming quarters, as the expected deceleration of the world economy will probably also be significant. The OECD recently reduced its 2022 global growth forecast to 3%, down from a previous projection of 4.5%. For 2023, the OECD is now forecasting growth of 2.8%.

The situation observed abroad has also been very unfavorable in terms of controlling inflation. Indeed, global inflationary pressures have triggered responses by the world's major central banks. In particular, the European Central Bank has not only announced the end of its asset purchase program, but it will also start monetary tightening in July. Furthermore, it held an extraordinary meeting to assess ways to contain the rise in interest rates in the region's peripheral countries. In turn, the Federal Reserve recently confirmed an interest rate hike of 75 basis points. In short, the upward movement in interest rates is becoming generalized and international monetary conditions are becoming much more restrictive than previously expected by the markets.

Both abroad and at home, monetary tightening will contribute to a slower expansion of activity. Inflation projections indicate a rate of almost 9% in OECD countries this year, double what was forecast a few months ago. The OECD notes that even if monetary policy cannot solve underlying supply shocks, it will convey the message that the authorities will not allow inflation to rise or spread further. Accordingly, in most economies, the OECD expects the normalization of monetary policy to continue over the next 18 months.

The present situation is very challenging for central banks, as any chance of interest rate reductions will take a long time to be envisioned, given that inflation is not expected to subside quickly, even with weaker economic activity.

However, despite the greater risk of worldwide recession, international growth has proved resilient in the short term, especially in the United States and Europe. In China, the reopening of the economy and government stimulus will probably prevent a sharper slowdown, in line with recent remarks by Prime Minister Li Keqiang that pro-growth measures will be taken to ensure "reasonable economic growth."

This situation was envisaged by our Global Barometers, which despite changing little in June, fell significantly in the two previous months. The Coincident Barometer rose a little in June and its level is compatible with the world economy's moderate growth in the second quarter. The Leading Barometer, unchanged in June, continues to reflect a pessimistic outlook for global economic growth in the coming months.[1]

All this means that the external context for emerging countries is changing rapidly, and the negative shock is only attenuated to some extent in commodity-producing countries. External financing crises cannot be ruled out in some of the countries that are most vulnerable to the strong reduction in international liquidity.

In Brazil, the situation is complicated by the approval of tax exemptions, mainly designed to curb fuel prices. They have not only increased fiscal risks, but also harmed inflationary expectations for the coming year and impacted Petrobras' share price. Amid the international strengthening of the dollar, the Brazilian real has suffered a lot, ending the week at R$5.13 = US$1, much weaker than at the end of April (R$4.73 = US$1). The recent deterioration of the situation led the Brazilian Central Bank to signal another rise in interest rates, of indeterminate size, at the Monetary Policy Committee's next meeting in August.

Based on information related to the second quarter, we have revised our 2022 GDP growth forecast from 0.7% to 0.9%, as our view now is that the economy will grow slightly more than previously expected in the first half of the year. Despite this, we expect a strong reduction in activity in the second half, and our forecast for the year remains below 1%. The negative impact of tighter monetary policy will be felt more intensely in the coming months, as the real interest rate only entered a contractionary level at the end of 2021.

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

- **Economic activity – page 7:** In April, as expected, high-frequency indicators showed a slowdown in the pace of economic growth. Services were stagnant at the margin, retail beat expectations and industry continued to suffer from logistical bottlenecks. As a result, we now estimate GDP growth of 0.4% in the second quarter of 2022, compared to the first quarter. We believe there is still scope for recovery in some service activities. However, on the demand side, household consumption, despite growing in the second quarter as well, is expected to be weak at the end of the year. We also expect a reduction in aggregate investment in 2022. Due to these factors and following the release of the first-quarter GDP figures, we slightly raised our growth forecast for the year, from 0.7% to 0.9%.

- **Business people's and consumers' expectations – page 9:** Our May survey results indicate the continued recovery of business confidence and the maintenance of consumer confidence at a low level. Services, commerce and industry boosted business confidence, while consumers are still feeling the impacts of high inflation. Our preliminary June data shows a similar situation, and despite this improvement, caution is still warranted, given that the macroeconomic environment is challenging. Consequently, it is hard to imagine confidence improving much in the second half of 2022.

- **Labor market – page 11:** According to the Continuous National Household Sampling Survey (PNADC), the unemployment rate was 10.5% in April, 0.4 percentage points lower than projected by FGV IBRE. In seasonally adjusted terms, unemployment fell strongly again, from 10.7% to 10.3%. This decline is mainly explained by an acceleration in the creation of jobs in the informal economy. In addition, the participation rate also rose, following six months of stability. In turn, the General Employment Registry (CAGED) indicated net employment growth of 196,000, slightly above the 148,000 figure projected by FGV IBRE. For May, we forecast net employment growth of 200,000, or around 193,000 in seasonally adjusted terms.

[1]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_06_2022.pdf.

- **Inflation – page 14:** In May, the Extended Consumer Price Index (IPCA) was lower than median market forecasts. However, the annualized average of nine different core inflation rates estimated by the Brazilian Central Bank went up in May for the 21st time, to 9.8%, indicating how widespread and persistent inflation is. In response, the bank's Monetary Policy Committee, at its 247th meeting, raised the benchmark Selic interest rate from 12.75% to 13.25%, and in the minutes, it noted the need for another increase at its next meeting. Our inflation forecast for 2022 is now 9.2%. For 2023, our estimate has moved toward 4.5%. We therefore expect IPCA to be close to the top of next year's inflation target range, 4.75%.

- **Monetary policy – page 15:** Between the last two meetings of the Brazilian Central Bank's Monetary Policy Committee, the median inflation forecast for 2023, which is now considered the relevant time horizon, rose from 4.1% to 4.7%. At the same time, in the Central Bank's baseline model, projected inflation has increased from 3.4% to 4.0%. In itself, this information seems to justify the bank's decision to "raise the Selic rate again, by an equal or lesser amount" at the next meeting, thereby extending the monetary tightening cycle. Of course, even more increases have not been ruled out. Analysis of the circumstances surrounding Brazil's inflationary process suggests that the Central Bank could not make any other decision.

- **Fiscal policy – page 16:** The improvement in fiscal indicators following the pandemic has been equally striking and controversial. The fiscal improvement is evidently closely related to the inflationary process. As inflation becomes embedded, the fiscal indicators are likely to deteriorate, as the real interest rate will be high and this will put pressure on interest payments and public debt. The most critical moment for fiscal consolidation will occur in the next two years, and it will culminate in a possible revision of the fiscal framework and an increase in real interest rates, which is bound to happen. The fiscal situation is delicate, but this will be transitory if the revision of the fiscal framework is able to reinforce the necessary sense of stability, to the extent allowed by Brazil's political reality. To achieve this, it is necessary to ensure that extraordinary resources are used well – exactly the opposite of what the government intends to do at the moment.

- **External sector – page 17:** The narrative that supports the optimistic official projections for the trade balance in 2022 seems to be fragile, given that, contrary to predictions, Brazil's terms of trade are deteriorating. Due to lower trade surpluses, we expect a US$10bn current account deficit in 2022. There are unlikely to be any major problems financing this relatively small amount, but the situation is less comfortable than the official narrative suggests.

- **International panorama – page 21:** The basic message in the Federal Reserve's decision to step up the pace of interest rate hikes to 75 points, along with other signals given in Chairman Jerome Powell's interview after the last Federal Open Market Committee meeting, is that the institution appears to believe that only drastic monetary tightening will be capable of bringing inflation down to the target, and the Fed intends to rigorously pursue this objective. It seems that the Fed is willing to take on this fight. The fact that inflation in the United States has become a kind of public enemy number 1 gives some comfort to the Fed in moving forward. For society as a whole, it is essential to curb inflation. Nothing works satisfactorily in a society where inflation is excessive. However, as usual, getting things right comes at a cost. The Fed's determination is likely to lead to worsening international financial conditions and the increased risk of a recession in the United States in 2023.

- **Political outlook – page 23:** This section, written by researcher Octavio Amorim Neto, is called "The Crisis in the Brazilian Social Democracy Party (PSDB)." The implosion of João Doria's presidential bid has worsened the serious crisis that the PSDB has been going through since May 2017, when the scandal involving

Aécio Neves broke out. Luiz Inácio Lula da Silva's recent mockery of the party (he said that "the PSDB is over") is a deplorable mistake for a candidate who needs a broad front, not only to win the presidential election, but to take office and govern. If Lula da Silva is elected president for the third time in October, the end of the PSDB will make his task much more difficult.

- **IBRE in focus – page 24:** Finally, the IBRE In Focus section, written by researcher Ana Maria Castelo, is titled "The Construction Sector Continues to Grow, but for How Long?"

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