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Increasing global and domestic uncertainty

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It is not hard to identify the various sources of this heightened uncertainty. The continuing war in Ukraine, as well as the sanctions imposed in response to it, is one of them. The challenge that the pandemic continues to impose on the Chinese economy and, by extension, on global value chains, is another. Added to this are strong and to a certain extent surprising inflationary pressures. Prices are rising at a pace and with a degree of dissemination not seen in decades. This has resulted in additional uncertainty about how much and when monetary policy will need to be tightened, in virtually all countries, and how this will affect the level of activity. The prospect of recession is becoming increasingly likely in many economies.

Indeed, rising uncertainty has been a bad sign for global economic activity for some time. The WUI is based on quarterly data and higher uncertainty in the first quarter foreshadowed significant declines in world growth. According to the survey's authors, the increase in uncertainty in the first quarter could be enough to reduce annual global growth by as much as 0.35 percentage points.

Since then, the prospects have become even more challenging. At the end of the second quarter, demand lost traction in developed countries, reflecting the escalation of inflation and the deterioration in producers' expectations, especially in the manufacturing sector.

Recently, the main monetary authorities, while attending the annual conference of the European Central Bank, stressed that the era of low inflation and low interest rates had come to an end, after the inflationary shock caused by the pandemic and Russia's war against Ukraine. In the United States, the chairman of the Federal Reserve reinforced the need to raise interest rates quickly to fight inflation, noting that "the process is highly likely to involve some pain, but the worst pain would be from failing to address this high inflation and allowing it to become persistent."

Inflationary pressures have not eased in the United States. In June, the Consumer Price Index reached 9.1% in the previous 12 months, involving price increases across the economy. The job market is still very strong, with wages on the rise, putting pressure on service inflation. This inflationary picture has worried the Federal Open Market Committee's members, and their remarks show not only their intention to maintain the monetary tightening pace of 75 basis points, but also the possibility of future hikes of 100 basis points.

In Latin America, the monetary tightening cycle continues to advance. It will tend to be reinforced by the fact that economic activity has been beating expectations. This has also been contributing to a more inflationary environment, even though this improvement in activity will probably be transient. Thus, although activity was stronger than expected in some Latin American countries at the beginning of 2022 (partly helped by improved terms of trade, the reopening of the economy, the use of savings accumulated during the pandemic and more fiscal stimulus), future prospects are very negative. In fact, the much more challenging external environment, erosion of real income, monetary tightening and turbulent political environment in many countries are together expected to cause a slowdown in growth in the second half of the year and into 2023. Accordingly, although market players are revising their 2022 growth projections upward, they are cutting their 2023 forecasts.

In Brazil, the situation has not been very different. The forecasts also point to a strong deceleration in activity in 2023. However, in the short term, activity has surpassed expectations, especially in terms of the services sector and job creation. As a result, we have raised our growth forecast for the second quarter, compared to the first, from 0.4% to 0.8% (quarter-over-quarter). However, it is important to point out that second-quarter GDP was boosted by the early payment of Christmas bonuses to pensioners and the release of money from workers' Government Severance Indemnity Fund (FGTS). Therefore, given very high inflation and without further releases of funds, the tendency will be for a significant slowdown in household consumption growth in the third quarter.

As the elections approached, therefore, everything indicated that new measures to sustain income (and consumption) would be taken. The big question was how to design these policies, entailing a significant increase in public spending, but without increasing agents' risk perceptions. As at other times, although the federal government's spending ceiling continues to exist formally within the Constitution, in practice it has lost much of its credibility, and this will have negative impacts on activity going forward. Indeed, for the third year in a row, constitutional amendments have been passed to increase fiscal stimulus, raising spending above the ceiling. Constitutional Amendment Proposal 1 of 2022, which restored the state of emergency, will allow spending above the ceiling of R$42 billion. It included a temporary increase in the Brazilian Aid Program, of R$200 per month, the doubling of natural gas subsidies for low-income families, and the creation of a voucher for truck drivers worth R$1,000 per month.

In addition, temporary tax reduction measures that were implemented have significantly reduced inflation this year, especially in the third quarter, but they will generate higher inflation next year, which is the relevant horizon for monetary policy. In this context, inflation expectations for 2023 continue to deteriorate.

The worsening fiscal situation and inflationary expectations are putting further pressure on market interest rates. Fiscal efforts ought to be on the new administration's list of priorities, as one of the main issues in economic policy will be how to guarantee the sustainability of public debt in a context of higher interest rates, growing interest payments, a spending ceiling that has lost much of its usefulness and intensifying pressure for more social expenditure.

Returning to the path of fiscal consolidation will be critical to achieving a sustainable public debt trajectory. This implies the need for further structural reforms and a strong fiscal anchor. It is not clear how fiscal consolidation will be attempted in future: whether through increases in the tax burden or through spending cuts. It is worth mentioning here that our tax burden is already very high, having reached 33.9% of GDP in 2021, much higher than the average for Latin America and close to the average for OECD countries.

In all, because of the various measures discussed above, we have raised our growth forecast for 2022 from 0.9% to 1.7%. However, we have cut our growth forecast for 2023 from +0.4% to -0.3%. Therefore, there is nothing to celebrate.

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

- **Economic activity – page 7:** In May, high-frequency indicators showed a slowdown in the pace of economic growth, although industry's results were more positive for the second month in a row. Services grew again at the margin, while retail did worse than expected and industry, despite its slightly more favorable two-month period, continued to suffer from logistical bottlenecks. As a result, we revised our GDP growth projection for the second quarter from 0.4% to 0.8%, compared to the first quarter of 2022. We believe there is still room for some service activities to recover. On the other hand, on the demand side, although we expect a strong second quarter for household consumption, activity across the year as a whole is likely to be weak, and investment is set to shrink in 2022. Accordingly, and following the approval of some fiscal stimulus measures by Congress, we raised our growth forecast for the year from 0.9% to 1.7%. This revision was due to temporary measures. At the same time, we cut our 2023 growth projection from +0.4% to -0.3%, given the more favorable basis of comparison this year and the discontinuation of stimulus next year.

- **Business people's and consumers' expectations – page 9:** Business and consumer confidence indexes ended the second quarter on a high. Despite these favorable results, our preliminary numbers for July signal a possible deceleration in the second half of the year. The effects of fiscal incentives will be temporary and partly offset by higher household debt, so the consumption of goods and services is not expected to rise significantly. The service sector, which had been recovering, seems to be slowing down, raising concerns about the continued recovery of the labor market. In addition to the challenging macroeconomic environment, the looming elections will make the evolution of confidence in the coming months more uncertain.

- **Labor market – page 11:** The May results of the Continuous National Household Sampling Survey (PNADC) indicate an unemployment rate of 9.8%, 0.4 percentage points below FGV IBRE's forecast. In seasonally adjusted terms, this result indicates another strong fall in unemployment, from 10.2% to 9.6%. The recent declines are mainly explained by an acceleration in the number of informal economy workers. The service sector, which boosted employment until April, recorded a drop in May, offset by agriculture and industry. The labor market's better dynamics are explained by both the composition of GDP recovery and the dynamics of labor earnings. In turn, the General Employment Registry (CAGED) indicated net employment growth slightly above that projected by FGV IBRE: 277,000 jobs (compared to our projection of 200,000). For June, we forecast the net creation of 240,000 jobs, or around 334,000 in seasonally adjusted terms.

- **Inflation – page 14:** The reduction in Tax on Circulation of Goods and Services (ICMS) will slow inflation down but not come close to solving this issue definitively. Prices have been rising in all parts of the Brazilian economy. According to FGV IBRE's Official Inflation Monitor, the diffusion index shows that 70% of the Extended Consumer Price Index's components are still rising. Core inflation also shows how prices are persistently rising. The world economy is going through a troubled period, rocked by bottlenecks in production chains, war, COVID-19 and accelerating inflation. Given these challenges, the major economies are committed to containing inflation. Its persistence has led to greater monetary tightening – a bitter medicine whose side effect may be recession. The risk of this happening is increasing and this seems to be the real remedy against global inflation.

- **Monetary policy – page 15:** In the monetary policy section, our analyst highlights uncertainties surrounding the future of the macroeconomic environment in Brazil and the difficulties that this situation imposes on the execution of Central Bank policy. The author looks at two different hypotheses related to a possible slowdown in inflation, starting in August. The possibility of an adjusted inflation target being adopted is ruled out in this analysis. The conclusion is that, quite possibly, our inflation targeting regime will not be dismantled, but it will work below its potential, due to the absence of a numerical objective that can be seen as realistic.

- **Fiscal policy – page 16:** Brazil's fiscal indicators continue to improve. Despite this, there is a growing climate of concern. Congress recently passed a constitutional amendment containing a series of fiscal stimulus measures, which will have a projected impact of R$41.2 billion, equivalent to just over 0.4% of GDP. From a macroeconomic point of view, most of the measures aim to alleviate inflation's impact on the most vulnerable groups. Partly for this reason, it will be hard to make any significant fiscal efforts next year. Furthermore, there is an imbalance in several types of expenditure, including personnel and discretionary spending, which have dropped considerably in real terms. So, the markets seem to have realized that short-term signals are not a good long-term guide in the current circumstances. The government is having problems rolling over the public debt and the upcoming elections are strengthening the idea of a lack of coordination between monetary and fiscal policies, which always de-anchors expectations.

- **External sector – page 17:** The trade figures for the first half of 2022 show an increase in exports led by prices, while export volumes only expanded 0.2%. Imports also rose, due to higher prices, outweighing a decline in volumes. However, import prices rose more than export prices, leading to a drop in Brazil's terms of trade, which has a negative effect on the country's income. The volume exported to China continues to fall, while the recent growth in exports to Argentina is unlikely to be sustained as that country's crisis worsens.
- **International panorama – page 23:** The big question that exists today for the international economy is the degree of inertia in American inflation. In this context, the most worrying thing is core inflation indicators, derived from original indexes, constructed in order to better capture the cyclical component of inflation (meaning the component most directly linked to excess demand in relation to supply). Given that inflation is widespread, the only doubt is whether the reversal of inflation in the (few) items that have experienced strong supply restrictions in recent years will be able to make the entire index fall. The evidence indicates that the U.S. economy will have to go through a recession produced by monetary policy in order to bring prices down.
- **IBRE in focus – page 25:** Finally, the IBRE In Focus section, written by researcher Anna Gouveia, is titled "Global Economic Uncertainty Soars Again, While Brazil's Uncertainty Remains Moderately High." The war in Ukraine has accentuated global value chains' difficulties and generated new supply problems, especially in Europe, putting even more pressure on world inflation. This has heightened the risk of stagflation (low growth together with rising prices). In Brazil, short-term factors have held back the rise in uncertainty, but inflationary, economic and political (electoral) factors in the coming months mean that uncertainty is likely to increase in the second half of the year.

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