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Challenging times ahead, here and abroad

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Challenging times ahead, here and abroad

Armando Castelar Pinheiro and Silvia Matos

Four main forces have shaped the performance of the economy this year and they will continue to do so in 2023: monetary and fiscal policies, geopolitics and the normalization of health conditions, including families' decisions on what to do with the savings they built up in the lockdowns. However, the direction and intensity of these forces are likely to change significantly next year, generating different results.

The first half of 2022 was much more favorable for economic activity in Brazil than expected a few months ago. We estimate that in the second quarter, GDP grew 1% compared to the first. That is, it was possible to maintain, in aggregate terms, the same pace of expansion recorded in the first three months of the year. On the supply side, the main highlight has been the robust growth of the service sector. On the demand side, the main highlight has been household consumption. According to our GDP Monitor, around 85% of annualized growth in household consumption can be explained by growth in consumption of services. This result partly reflects services' high share of Brazilian families' consumption, but also the impact of the normalization of activities after the pandemic came under control.

The reopening of the economy and normalization of various service activities that are in-person and therefore more labor-intensive account not only for a significant portion of the good GDP performance in this period, but also for the labor market's better-than-expected results. On the other hand, despite the marginal increase in the real wage bill, demand for goods has slowed down, negatively impacting retail and industry.

What can we expect for the second half of this year and 2023?

Despite the fact that activity outperformed expectations in the first half of the year, all the signs indicate that the near future will be very challenging for household consumption and the economy in general. Fiscal stimulus and temporary reductions in energy prices and other regulated prices will help in the second half of the year, but they will lose impetus or go into reverse in 2023. The contractionary effects of monetary policy will become increasingly strong, even if the Brazilian Central Bank starts to reduce the benchmark Selic interest rate in 2023, as the markets predict. In turn, the slowdown in the world economy is likely to depress commodity prices, although not to the point that they return to pre-pandemic levels. The impact of the normalization of health conditions is also likely to lessen, except perhaps in China.

In fact, we can observe that the deceleration of economic activity is already under way. This is shown by FGV IBRE's sector and consumer confidence indicators. The commerce sector continues to shrink and we also expect a reduction in the broad retail sector in the third quarter. With regard to services, although the results were still favorable in July, our preliminary data points to a decline in August.

Construction is another sector that has stood out this year, expanding almost 9% in the first half, compared to the same period of 2021. However, it has also been losing steam. This sector benefited a lot from the stimulus measures taken during the pandemic, and at the end of the second quarter of 2022 it was around 11% above the level observed in the last quarter of 2019, before the pandemic. This result was much higher than GDP growth, which we estimate to have been 2.8% over the same period. However, our July construction survey indicated a decline in expectations for the coming months, although perceptions regarding current activity remained favorable, reflecting the strong cycle of the last two years.

Investment, which in the second quarter managed to offset its losses of the first three months of 2022, is likely to shrink this year. This is due to monetary tightening and economic uncertainty, which remains at a historically high level. The elections and related political uncertainty will harm investment in the second half of this year, contributing to low economic growth in the period. In July, our political uncertainty indicator rose again, as did our fiscal policy uncertainty indicator. Studies show that increased uncertainty affects investment more than private consumption and aggregate GDP. This result is consistent with the fact that investment decisions usually have a greater degree of irreversibility and are typically more affected by expectations. It is also consistent with the greater fluctuation of investment over the economic cycle.[1]

Accordingly, we believe there is little cause for optimism about investment performance in 2023, despite the upward trajectory of the investment rate in the last few years. At current prices, investment reached 19.2% of GDP in 2021, compared to 15.5% in 2019, equivalent to a real increase of 16.5% in this period. In part, this increase reflected some very specific and temporary factors, including new rules deeming oil exploration and production platforms to constitute domestic investment, higher relative investment prices in relation to GDP, and the concentration of investments in sectors that have benefited from rising commodity prices and very low real interest rates, such as agriculture, energy and construction.[2]

In relation to external conditions, the situation is also challenging. This is borne out by FGV IBRE's Coincident and Leading Global Economic Barometers.[3] The Global Barometers fell again in August, indicating a significant slowdown in world growth in the quarter. The Coincident Barometer has now fallen for seven months in a row, while the Leading Barometer fell again after leveling out in July. The results also signal a pessimistic outlook for global economic growth in the coming months. The coincident sector indicators fell in all sectors, most notably construction, which dropped 4.0 points, to 71.5 points, the lowest level out of all sectors. As a result, all indicators deviated even further from the long-term average of 100 points.

In particular, across Latin America, although several countries have recently recorded good economic activity performance, like Brazil, expectations for 2023 are not bright. More restrictive monetary policy, added to more adverse global conditions, including declining commodity prices, will lead to a sharper slowdown in growth in 2023. Latin American countries are going through an economic cycle with a certain degree of synchronization. However, in addition to the factors mentioned above, political risks are also playing an important role, especially in Chile and Colombia.

In Brazil, some of this year's new fiscal stimulus policies are likely to become permanent, making it even harder to keep public debt on a sustainable path. The dismantling of the fiscal framework, in a context of higher real interest rates here and abroad, and amid pressures to maintain or even increase public spending, makes fis-

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[1]See "Incerteza e atividade econômica." Estudo Especial 65/2019. Brazilian Central Bank. Available at https://www.bcb.gov.br/conteudo/relatorioinflacao/EstudosEspeciais/EE065_Incerteza_e_atividade_economica.pdf.

[2]See https://blogdoibre.fgv.br/posts/investimento-em-alta-no-brasil-mas-nem-tudo-que-reluz-e-ouro.

[3]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/2022-08/barometros-globais-kof-fgv_press-release_08_2022_1.pdf.

cal prospects for 2023 even more nebulous. Most likely, GDP will decline. Thus, we have maintained our forecast of -0.3% for next year.

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

- **Economic activity – page 7:** In June, our high-frequency indicators showed a positive result for services but a deceleration in retail and industry. Services beat expectations, ending the quarter with strong growth, similar to that seen at the beginning of the year. As a result, we have revised our GDP growth forecast for the second quarter from 0.8% to 1.0%, compared to the first quarter. We believe there is still room for additional recovery in some service activities. However, on the other hand, although we expect a strong second quarter for household consumption, overall demand activity is likely to be weak at the end of the year, and aggregate investment is expected to decline in 2022. Certain measures passed by Congress mean that GDP is expected to grow 1.7% in 2022. However, these measures will be temporary, so we project that GDP will drop 0.3% in 2023, partly due to this year's stronger base.

- **Business people's and consumers' expectations – page 9:** FGV IBRE's confidence indexes started the second half of the year with different trends. Our preliminary August results indicate an improvement in consumer confidence and an undefined trend for business confidence. The impending elections may be negatively impacting the resumption of confidence. In the medium and long term, caution is still warranted, because even though the results have improved, the unemployment rate and inflation remain far above ideal, and the economy is expected to slow down at the turn of the year.

- **Labor market – page 12:** In June, the Continuous National Household Sampling Survey (PNADC) indicated an unemployment rate of 9.3%, in line with FGV IBRE's projection. In seasonally adjusted terms, unemployment fell from 9.6% to 9.2%. Overall labor earnings were boosted by this further decline in unemployment, but even more so by a significant rise in earnings per hour worked. In turn, the General Employment Registry (CAGED) indicated the net creation of 278,000 jobs, similar to FGV IBRE's forecast of 240,000. For July, we project 250,000 net new jobs, or around 233,000 in seasonally adjusted terms.

- **Inflation – page 15:** In July, the Extended Consumer Price Index (IPCA) fell 0.68%. This significant drop was not caused by a general decline in the prices of goods and services, but by a reduction in electricity and gasoline taxes. The other items that make up IPCA went up 0.7%, much higher than in July. For August, we forecast that IPCA will decline again, by 0.3%. Aside from the tax reduction, Petrobras has been cutting its gasoline prices and this will help keep inflation in negative territory for another month. Recent reductions in the prices of oil and other agricultural and mineral commodities reflect fears of a slowdown in the world economy. If this movement reaches IPCA, the deceleration in consumer prices could go beyond that sustained by the reduction in energy prices. For this reason, we believe that IPCA's annual rate will continue to decrease until December and it may end the year below 7%.

- **Monetary policy – page 16:** According to the annualized quarterly moving average criterion, market price inflation dropped to 12.5% in the latest edition of the Extended Consumer Price Index (IPCA), down from 14.4% the previous month. Likewise, average growth in the five core inflation indicators most closely monitored by the Brazilian Central Bank declined to 10.9%, from 12.8% the previous month. This suggests that the reduction in the prices of some significant items, even if obtained through irregular means, such as the inappropriate passing of a constitutional amendment, has ended up influencing the trajectory of inflation as a whole, at least for a certain time. It also suggests that it is feasible to keep the benchmark Selic interest rate unchanged for some time, although it is already known that in this regard, the official inflation projections will have more weight in the Brazilian Central Bank's decisions.

- **Fiscal policy – page 17:** In recent weeks, a proposal for a "fiscal waiver," meaning a temporary suspension of the government's fiscal rules, has gained traction and become an increasingly likely short-term response to Brazil's fiscal dilemma. This solution is not new. In 2023, the government will face a shortfall of R$430 billion (4.2% of GDP), considering changes to the spending ceiling rule, reduced tax revenue, financial expenses and risks. Naturally, we need to be aware of the situation to be tackled before we can make better decisions. As Brazil's fiscal imbalance grows ever larger, a fiscal waiver is becoming the most likely short-term solution. If this is the path to be followed, it is important to reach a robust political agreement, because interest rates and inflation still require great care.

- **External sector – page 18:** Recognizing that the value of imports will be much higher than previously expected, the Economy Ministry has reduced its trade balance forecast for 2022. The Central Bank has not yet adjusted its methodology accordingly, so its trade surplus projection now seems excessive. Therefore, we expect the Central Bank's trade balance projection to decline sharply going forward, implying convergence to our current account deficit forecast of 0.8% of GDP in 2022.

- **International panorama – page 22:** After the Chinese economy underperformed expectations in the second quarter of 2022, the first signs in the third quarter have not been very encouraging either. The country's economy is going through a delicate moment. Consequently, we have cut our 2022 Chinese GDP growth projection to +3.4%, despite the major government stimulus programs under way.

- **Political outlook – page 26:** The Political Outlook section, written by researcher Octavio Amorim Neto, is called "The Defense of Democracy and Brazil-USA Relations." The domestic policies of Brazil and the United States have changed a lot in the last decade. Diplomatic relations between the two countries have not been unscathed by these changes. If Bolsonaro is reelected and the Republican Party gains a majority in the U.S. Congress, starting in the November 2022 legislative elections, it will be hard to avoid rising tensions between Biden and Bolsonaro. Harmony between them seems impossible, but a complete break in relations is unlikely. After all, Washington fears the rise of China in Latin America more than the collapse of democracy in Brazil. We have seen similar things before.

- **IBRE in focus – page 28:** Finally, the IBRE In Focus section, written by researcher Daniel Duque, is titled "Employment Grows but Participation Rate Remains Below Pre-Pandemic Level, Influenced by Income Transfers."

We are an institution of a technical, scientific, educational and philanthropic nature, founded on December 20, 1944, as a legal entity subject to private law. Our purpose is to act in the field of the social sciences, particularly economics and administration, as well as to contribute to environmental protection and sustainable development.

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