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The cost of disinflation

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The cost of disinflation

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The global economy is currently facing one of its most challenging moments in decades. This is the main message given by central bank leaders gathered at their annual meeting in Jackson Hole, Wyoming, at the end of August. These leaders unanimously emphasized the importance of fighting the highest inflation seen in four decades. "At least over the next five years, monetary policy making is going to be much more challenging than it was in the two decades before the pandemic struck," said Gita Gopinath, the deputy managing director of the International Monetary Fund.

Another chapter in this long and painful battle took place on September 13, when the U.S. consumer price index for August was released. Core inflation exceeded expectations, signaling that the inflationary process has become more persistent in the world's largest economy. Annual core inflation rose to 6.3% in August (up from 5.9% in July), very close to the peak of 6.5% recorded in April. The acceleration in service inflation is one of the factors of greatest concern. These higher-than-expected inflation figures caused a lot of volatility in the markets, which now believe that the Federal Reserve will have to carry out much greater monetary tightening to curb the rise in prices. As we warned in this publication, this was unfortunately the most likely scenario.

In the eurozone, although the inflationary process has different characteristics from the American one, several members of the European Central Bank have indicated that monetary tightening will continue. In the region, higher energy prices remain a dominant inflationary force. Europe's great dependence on energy imports, especially from Russia, has made the process even more challenging for the monetary authority, as supply shocks have also reduced economic growth. In fact, the intensification of the conflict between Russia and Ukraine in recent weeks has considerably increased geopolitical risks, aggravating instability in the financial markets and making prospects for the global economy more uncertain.

In short, despite the recent decrease in the prices of goods, the vast majority of prices remain on the rise and inflation will not return to the targets without a firmer monetary policy tightening. In many countries, this process is still in its infancy and far from a comfortable level in terms of future price dynamics. It is getting increasingly difficult to believe that this can be done without much impact on economies. Most likely, unfortunately, the cost of global disinflation will be high.

On the one hand, in countries where there is pressure from service inflation, a slowdown in the labor market and domestic demand is necessary. Without this, it will not be possible to win this "war." The main example in this group is the United States.

On the other hand, countries that are experiencing a shock in terms of the prices of energy, especially natural gas, also need to raise interest rates (which in most of them remain significantly negative in real terms), even if the necessary dose is much milder than in the countries of the first group, due to the negative effects of this supply shock on economic activity. Despite this impact on activity, the inflationary shock may become more persistent, so it needs to be tackled via monetary tightening. The challenge here is to calibrate the interest rates to be applied. This is clearly the case in European countries, where shrinking the European Central Bank's balance sheet is on the agenda and, in addition to activity, the maintenance of the euro as a common currency is of concern.

In countries like Brazil and in Latin America in general, there are also major inflationary pressures. Although we expect inflation in Brazil to be lower in 2022 than in 2021, and median projections have fallen in the last few months, mainly due to tax cuts and lower fuel prices, we have raised our forecast for service inflation. In other countries in the region, we now expect even higher inflation than was predicted just a few months ago. For 2023, all the signs indicate that inflation will remain high and above the respective inflation targets.

This situation is largely explained by the strong performance of activity in the region, due to the impetus generated by high commodity prices, the reopening of economies, the use of savings accumulated by families during the pandemic and the economic stimulus adopted in some of the region's countries. However, the acceleration of activity has taken its toll, in the form of higher inflation in 2022 and 2023. Accordingly, these countries are closer to the first group of countries mentioned above, in which the economy needs to slow down in order to fight inflation.

Of course, whether or not the authorities will have the necessary determination to follow this path is still uncertain. After all, as the IMF's deputy managing director pointed out, this is a protracted process, which will affect employment and income (and therefore the popularity of governments), and also have fiscal implications, due to higher interest payments on public debt, as already seen in Brazil. The temptation to procrastinate and emphasize rhetoric more than practice will be around for quite some time.

In Brazil, the Central Bank has already raised interest rates and so a slowdown in growth in the rest of 2022 and into next year is expected. We believe a similar thing will happen in other countries in the region, which like Brazil will perform better this year than previously expected but are likely to grow slowly or even shrink in 2023.

In the Brazilian case, the situation is also complicated by the fact that fiscal policy has been very expansionist in recent months. This would be unsustainable in the medium term, from the perspectives of both public debt and the fight against inflation. As summed up by IBRE research associate Samuel Pessôa, "The new president, or the current one, if reelected, will look at 2023 and see an economy at full employment with inflation well above the target. The political spending cycle will speak louder. In 2023, we will have fiscal contraction. Otherwise, it will be very difficult for the Central Bank to bring inflation back down to the target in 2024."[1]

In other words, the economy is already showing signs of growing above its potential. The unemployment rate has been below 9.5% since April 2022, considering monthly and seasonally adjusted data. Our estimate of the non-accelerating inflation rate of unemployment (NAIRU) is around 9.5%. Thus, the excellent performance of the labor market since the second quarter is not good news in terms of getting service inflation under control. In addition, despite the recent weakness in manufacturing, installed capacity usage has remained at a very high level and it has increased further in the third quarter, according to data from FGV IBRE's Industrial Survey. In the consumer nondurable and intermediate goods sectors, the levels are above those seen before the great recession of 2014-2016.

Given this pressure on the use of factors, and without any productivity growth,[2] the current pace of economic growth is unsustainable, especially in the context of efforts to control inflation. The only option is for growth to slow down. In 2023, the most likely scenario is that monetary and fiscal policies will converge in this direction.

[1]Completou-se a recuperação pós-pandemia." "Ponto de Vista" column, Brazilian Economy Magazine, September 2022 (https://blogdoibre.fgv.br/posts/completou-se-recuperacao-pos-pandemia).

[2]See Regis Bonelli Productivity Observatory: "Após nova queda na margem, PTF continua abaixo da tendência pré-pandemia" (https://ibre.fgv.br/sites/ibre.fgv.br/files/arquivos/u65/indicadores_trimestrais_de_ptf_-_2t2022_-_final.pdf).

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

- **Economic activity – page 7:** Following the release of GDP figures for the second quarter and data referring to July and August, we believe there will be a less intense deceleration of activity in the third quarter. In July, high-frequency indicators suggested stability in industry, a positive boost from services and a decline in the retail sector. However, within the retail sector, sales of fuels and lubricants stood out positively. Services outperformed expectations, especially in the transport sector, which is now 20.2% above the level of February 2020. As a result, we are now projecting GDP growth of 0.4% in the third quarter of this year, relative to the preceding quarter. We believe there is still room for recovery in some service activities but the reopening will lose steam in the coming months. Some measures passed by Congress will also boost growth in the third quarter. Given all the uncertainty surrounding the intensity of the slowdown that is expected to occur in the fourth quarter, we have revised our GDP growth forecast for the year from 1.7% to 2.5%. In 2023, we expect a drop of 0.4%.
- **Business people's and consumers' expectations – page 9:** Business and consumer confidence generally improved in August, although there was a slowdown in the service sector. Consumers indicated a greater intention to purchase durable goods, except in the lowest income group. Our preliminary September results signal continued improvement in confidence indicators in the coming months, although at a slower rate, especially considering the elections, which may still generate increased uncertainty, a deceleration in economic activity and higher inflation.
- **Labor market – page 11:** In July, the Continuous National Household Sampling Survey (PNADC) indicated an unemployment rate of 9.1%, in line with FGV IBRE's forecast. In seasonally adjusted terms, unemployment fell from 9.2% to 9.0%, and a further decline is expected, to 8.9%, in the next three-month period. Despite the decline in July, the number of employed people did not change significantly in the monthly series. On the other hand, labor earnings continued to increase, with contributions from both lower inflation and the composition of jobs created. The General Employment Registry (CAGED) indicated a slight deceleration, with 219,000 jobs created in July (207,000 in seasonally adjusted terms). We project another reduction in job creation in August: 137,000 in seasonally adjusted terms (270,000 without seasonal adjustment).).
- **Inflation – page 14:** The spread of inflationary pressures, triggered in 2021 by recurrent rises in fuel and electricity prices, transmitted costs to industrial activity and the provision of services, and this gradually began to drive up inflation, causing it to reach numerous goods and services. However, due to a reduction in Tax on Circulation of Goods and Services (ICMS) and the risk of a global recession, the prices of energy and important raw materials are expected to remain lower in the coming months. As a result, our forecast for 2022 inflation has fallen significantly. We now project that inflation could end the year at 5.6%, considering a sharp deceleration in food prices and other components of the Extended Consumer Price Index, to be computed in the next editions of the index.
- **Monetary policy – page 15:** The monetary policy section highlights the Central Bank's success in signaling an end to the cycle of interest rate hikes and notes the major risk that this cycle will have to be resumed. The risk referred to by our analyst has to do with current discussions about a "fiscal waiver," meaning a temporary suspension of the government's fiscal rules, to enable supposedly indispensable public expenditure that is not included in the 2023 budget bill. The markets fear that this fiscal waiver could be too generous, especially if it is not accompanied by measures to strengthen the government's fiscal rules.
- **Fiscal policy – page 17:** The section on fiscal policy analyzes the 2023 budget bill. In short, the proposal sheds light on fiscal challenges. In particular, several elements not incorporated in the budget proposal seem

to make a further worsening of the primary result more likely next year. Indeed, the economic team itself is working to expand the Brazilian Aid Program ("Auxílio Brasil") and increase income tax brackets. The next president will have the delicate task of indicating a realistic and responsible approach to dealing with fiscal risks in 2023.

- **External sector – page 18:** Between August 2021 and the same month of 2022, export prices (5.7%) and import prices (17%) went up by the least amount so far this year. This suggests a trend of decelerating prices in world trade, but without deflation. The bigger increase in import prices than export prices will cause Brazil's terms of trade to worsen. Export volumes grew 6.6%, the highest figure since March 2022, while import volumes soared 16.4%, the highest rate so far this year. The latter increase reflects the improvement in activity indicators. Our analyst believes the outlook for Brazilian exports will be less positive in 2023, given the likelihood of recession in the United States and Germany, and the fact that Brazil's main trading partners in South America, such as Argentina and Chile, are going through political crises. In this context, unlike at other times of global recession, China will probably not play a powerful countercyclical role to boost Brazilian exports.
- **International panorama – page 22:** The international economics section analyzes U.S. monetary policy now and in future, while examining the behavior of financial markets in terms of inflation expectations and the evolution of nominal and real interest rates. This analysis reveals that market participants have been overly optimistic about the behavior of inflation and they have failed to fully realize that the current inflationary framework will require tough and persistent monetary measures from the Federal Reserve. Despite some recent revision to this optimistic outlook, the need to deepen monetary tightening will likely still cause major surprises for market participants.
- **IBRE in focus – page 25:** Finally, the IBRE In Focus section, written by researcher Ana Maria Castelo, is called "Construction: 2022 Will Be Another Year of Significant Growth."

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