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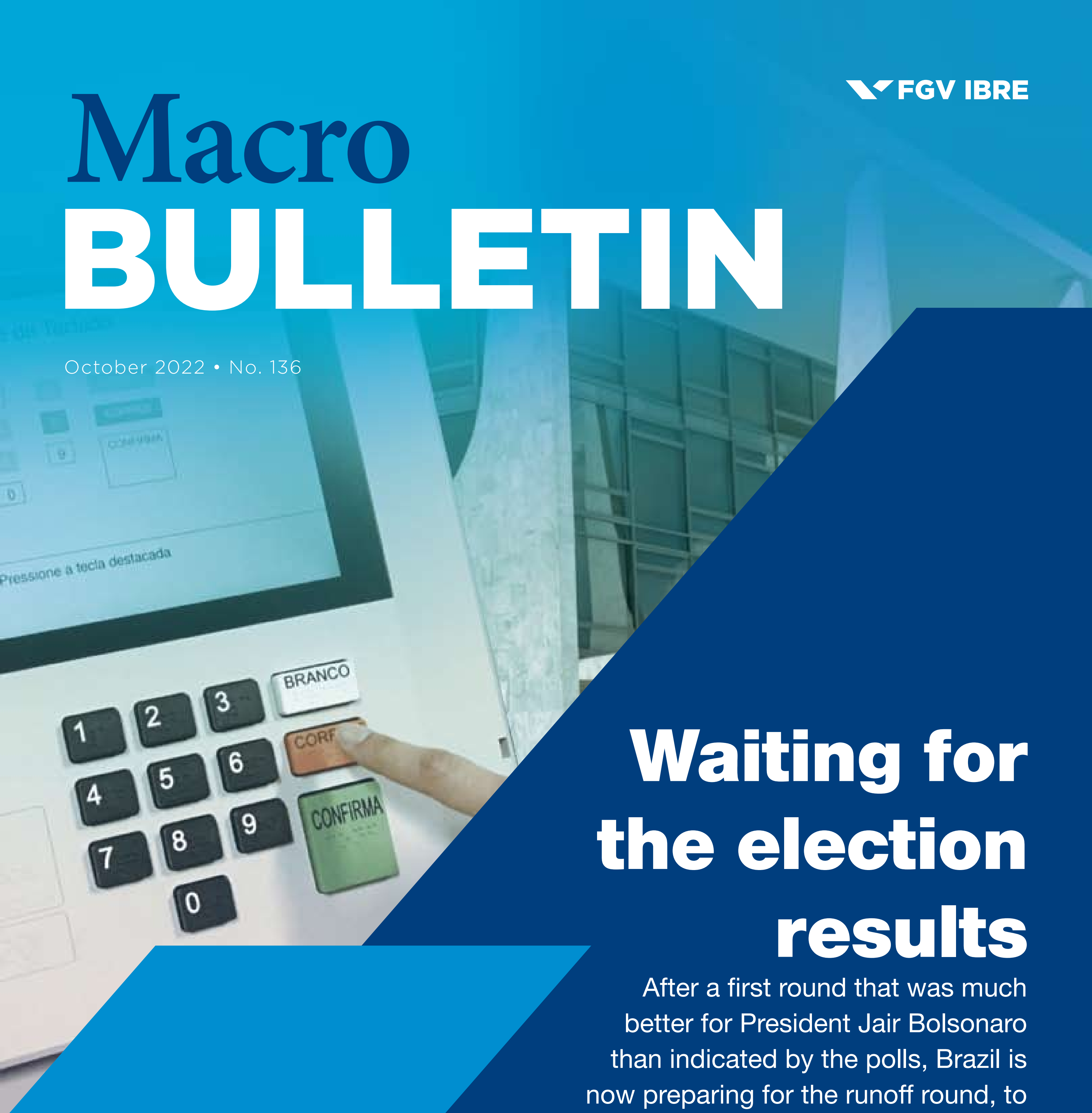

Waiting for the election results

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Armando Castelar Pinheiro and Silvia Matos

After a first round that was much better for President Jair Bolsonaro than indicated by the polls, Brazil is now preparing for the runoff round, to take place on October 30. The surprise of the first round adds more uncertainty to an election that otherwise seemed predictable. We will now have to wait a little longer to find out who will preside over the country in the next four years and, in particular, what economic policy will be adopted by him, since little or nothing was said about this in the electoral debates.

This is another complication for a situation that, after this year's pleasant surprises, looks set to become quite challenging. Above all, a sharp slowdown in economic growth is expected, together with a partial reversal of the unexpected gains that have been observed in the labor market. Three main factors will contribute to this drop in the pace of activity.

The first is the deterioration of the external situation, with less growth, a strong dollar, less liquidity and lower commodity prices. Around the world, and in developed economies in particular, inflation remains persistently high. Despite the slowdown in global demand for goods, core inflation remains at very high levels. This has led central banks, most notably the Federal Reserve, to insist on keeping its promise to pursue a policy of monetary tightening, which will tend to cause a recession in 2023, as well as relative volatility in the financial markets.

In China, the prospects are also unfavorable. The services sector seems to be shrinking, according to the Caixin Purchasing Managers' Index, which stood at 49.3 in September, down from 55.0 in August. This fall ended three months of expansion in activity, with the index falling below 50, the value that separates expansion from contraction. Furthermore, measures recently taken to contain new outbreaks of COVID-19 are likely to further damage the sector. China is only projected to grow 3.2% this year, according to researcher Lívio Ribeiro.

In addition, OPEC+ recently announced an aggressive cut in production, which should help keep oil prices at a high level, despite the slowdown in the world economy. Finally, the war in Ukraine has entered a new and much more worrying phase. Following Russia's annexation of Ukrainian territory, Moscow has been firing missiles at Kiev and other cities since October 10, in the biggest air strike since the war began. The war remains a cause of great concern around the world.

In this context, the International Monetary Fund recently updated its inflation and growth projections, raising the first and reducing the second. Despite maintaining its 2022 global growth forecast at 3.2%, it reduced its projection for 2023 by 0.2 percentage points, to 2.7%. This will be the lowest rate since 2001, not including the worst moment of the global financial crisis in 2009 and the acute phase of the COVID-19 pandemic in 2020. The IMF also warned of the possibility that a third of the countries monitored by it will fall into recession in 2023. For example, Germany and Italy are expected to shrink, while the United Kingdom will grow very little and the United States will slow down to 1%, after projected growth of 1.6% this year.

According to the IMF, "the global economy's future health rests critically on the successful calibration of monetary policy, the course of the war in Ukraine, and the possibility of further pandemic-related supply-side disruptions, for example, in China."

In the case of Brazil, the IMF raised its 2022 growth forecast to 2.8%, while slightly reducing its projection for next year to 1.0%. This is in line with revisions made for the Latin America and Caribbean region: 2022 growth of 3.5%, up 0.5 percentage points, and 2023 growth of 1.7%, down 0.3 percentage points. As we have highlighted in this bulletin, the better-than-expected activity in the first half in this region was due to "favorable commodity prices, still-favorable external financing conditions and the normalization of activities in sectors dependent on personal contact." The IMF warned that growth in the region will slow down this year and next year, in the face of weakening trading partners, tightening financial conditions and falling commodity prices.

A second factor that will depress our growth is the lagged effect of the monetary tightening carried out by the Brazilian Central Bank. In particular, this will tend to involve lower household borrowing, which proved to be stronger than expected this year, further boosting the Brazilian economy's performance in 2022.

In a context of significant increases in real interest rates, families are less able to roll over their debts, so defaults have grown more common and credit costs have risen. Additionally, data released by the Brazilian Central Bank shows that banks' funding costs have increased and the modalities that are growing the most are the most expensive ones, namely emergency credit, such as accumulated credit card balances and overdrafts, which are more used in hard times. No less important, Brazilian families' debts to the financial system ended July (the most recent date for which data is available) at 53.1% of income, an all-time record. In June, this indicator was 52.9%. If real estate debts are discounted, debt stood at 33.6% of income, also an all-time record. In July, households allocated 28.6% of their income to bank debt (interest and amortization), up from the previous month and a new record.[1]

It is always good to remember that in macroeconomic theory, monetary policy typically affects aggregate demand through demand for credit, through the change in relative prices that occurs after a change in the real interest rate. In fact, studies show that monetary policy has an impact not only on credit demand but also supply. So, these are the expected effects of a contractionary monetary policy aimed at controlling inflation. There are no surprises here.

Last but not least, there is a need to put a brake on the growth in primary public spending, which this year is expected to exceed the original version of the spending ceiling rule by around R$200 billion. However, there is strong pressure for even higher spending in 2023. During their election campaigns, both candidates have indicated support for 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 any measures to strengthen Brazil's fiscal rules.

Although we do not yet know who the president will be next year, Congress' composition has already been defined: in the next four years, the Senate and House will have a much more center-right profile. According to some analysts, despite the uncertainties about the next administration's economic policy, fiscal difficulties and the much more challenging external situation, a Congress with this profile will make it hard to adopt very reckless fiscal policies. However, this is just a hypothesis. In fact, a study by Marcos Mendes and Marcos Lisboa shows that in the last two years, a series of fiscally irresponsible laws, constitutional amendments and regulations have been passed. Many of these measures were supported by the overwhelming majority of right and center lawmakers.[2]

A decision to expand primary expenditure even more in real terms in 2023 would further complicate the situation outlined here. On the one hand, it would make the Central Bank's work more difficult, possibly requiring more increases in the base rate to bring inflation down to the target. On the other hand, it would increase the risk of public sector insolvency. Both effects would lead to higher interest payments on the national debt, worsening the fiscal picture, which will also be impacted by the slowdown in growth and lower commodity prices.

There is no easy way out, regardless of who wins the elections. The question of fiscal responsibility is the great challenge and there is no guarantee that a solution to it will be found. We shall see.

[1]Stripping out real estate loans, debt servicing accounted for 26.6% of income in July, up from 26.0% in June, also an all-time record.

[2]https://braziljournal.com/opiniao-o-executivo-e-o-congresso-distribuiram-presentes-a-conta-vai-chegar/ e
https://www1.folha.uol.com.br/colunas/marcos-lisboa/2022/10/congresso-fiscalmente-responsavel.shtml

In the short term, however, although the elections are not yet over, electoral uncertainties are now more contained, which will help make prospects for economic activity less negative. In fact, after a very positive first half of the year in terms of growth, the pace of deceleration in the second half has been very moderate. The economy has been sustained by the services sector, although the beneficial impact of the end of lockdowns will decline as the year comes to an end. Other countries in the region have also grown faster than expected, including Colombia, Mexico and even Argentina. The surge in commodity prices, the use of savings accumulated during the pandemic, the vigorous recovery in services and the stimulus measures adopted in some countries, including Brazil, largely explain this picture.

In fact, the preliminary August data indicates a more positive third quarter than previously expected. As a result, we have raised our GDP growth forecast for the third quarter, in relation to the second quarter, from 0.4% to 0.6%. Falls in industrial production and retail sales, despite the very positive surprise in services, reinforce the picture of a slowdown in the pace of activity in this quarter in relation to the second (1.2%, quarter-over-quarter), although this was less intense than previously foreseen.

Nevertheless, we expect GDP to decline in the fourth quarter, given that families will have to spend more on debt servicing and they have much less favorable conditions to take out new loans, contributing to a drop in private consumption. We should remember that household consumption accounts for more than 60% of GDP. For the whole of 2022, we have raised our growth forecast from 2.5% to 2.7%.

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

- **Economic Activity – page 8:** Because of better-than-expected service sector figures in August and given that results in July and August were more favorable than previously envisioned, we have revised our third-quarter GDP growth projection from 0.4% to 0.6%, and our full-year forecast from 2.5% to 2.7%. The reduction in taxes on fuels and lubricants has boosted the transport sector, but we believe that services have shrunk in recent months, despite the increase in government income transfers and job market improvement, because inflation has not yet decreased in this sector. Industry slightly beat expectations in August, while the broad retail sector underperformed. Because of the recent lack of productivity gains and considering that tight monetary policy is likely to continue until the second half of next year, in order to control inflation, we have maintained our projection of a 0.4% decrease in GDP in 2023.

- **Business People's and Consumers' Expectations – page 11:** Confidence indicators improved until September, and then business confidence started to show signs of a slowdown. The preliminary October data shows that this may now be happening and so the Business Confidence Index is likely to drop going forward. On the consumer side, positive results in September seem aligned with the reduction in inflation and labor market improvement. The tendency for the end of the year is uncertain but there are already signs of deceleration.

- **Labor Market – page 13:** According to the Continuous National Household Sampling Survey (PNADC), the unemployment rate was 8.9% in August, in line with FGV IBRE's forecast. In seasonally adjusted terms, the rate fell from 9.1% in July to 8.9% in August, and another decline, to 8.8%, is expected in the next three-month period. This represents a sharp slowdown, despite a stable participation rate. Employment income has also decelerated, although the sector composition of jobs created has been marginally favorable. The General Employment Registry (CAGED) indicates a noticeable slowdown, with 278,000 jobs created in August (152,000 in seasonally adjusted terms). In September, we expect 250,000 jobs to be created (154,000 in seasonally adjusted terms).

- **Inflation – page 16:** The cycle of negative results for the Extended Consumer Price Index (IPCA) has come to an end. Between July and September, the official index fell 1.3%. This sequence of declines did not happen for general reasons, but because of a reduction in Tax on Circulation of Goods and Services (ICMS) on utilities. For the next quarter, the trend is likely to change. According to FGV IBRE's Inflation Monitor, IPCA may rise in October, influenced by the acceleration in regulated prices and new inflationary pressure involving food. By the end of the month, there will be room for less intense decreases in fuel prices and we forecast that the Weekly Consumer Price Index (IPC-S) will end October up 0.6%. IPCA is expected to follow this trend.

- **Monetary Policy – page 18:** Market players and the general public hope that the Central Bank will initiate a new downward interest rate cycle at some point in 2023. In the section on monetary policy, it is argued that any move by the Central Bank in this direction will essentially depend on how the new government deals with its fiscal problems. In the current situation, the order of events will affect the outcome. In other words, the need for a new fiscal rule should be addressed before we think about having some kind of "fiscal waiver," which is supposedly indispensable in light of growing pressure for even higher public spending.
- **Fiscal Policy – page 19:** The topic of this section is "Britain's Fiscal Crisis and Lessons for Brazil." In recent months, this section has discussed the federal government's inevitable "fiscal waiver" next year. The United Kingdom's experience offers some lessons. Fiscal loosening must be properly justified and implemented through measures that can boost economic growth. The value of a fiscal waiver must be carefully scrutinized, as very large numbers can cause distrust in the markets, with undesirable results. Finally, the application of a fiscal waiver does not remove the need for a new fiscal regime designed to anchor expectations.
- **External Sector – page 21:** Brazil's trade surplus between January and September of this year was US$47.7 billion, down from US$56.4 billion in the same period of 2021. This article identifies extractive industry, especially metal mining, as the main reason for the deterioration in the trade surplus. The main sources of surpluses and deficits in manufacturing are also highlighted. The biggest surpluses are associated with several products classified as commodities. From a macroeconomic point of view, it is noted that the trade surplus has reduced the risk of external restrictions on growth, despite Brazil's high dependence on commodities, which represent 68% of the country's exports.
- **International – page 24:** This section is titled "The Federal Open Market Committee's Inconsistencies." According to the author, in order to have significant disinflation in the United States and for inflation to fall to the target, an overall reduction in economic activity and an increase in unemployment will be required. The committee predicts that the unemployment rate will rise by 0.9 percentage points, from 3.5% now to 4.4% in 2023. It also forecasts that growth in 2023 and 2024 will be 1.2 % and 1.7%, respectively. Given that potential GDP growth is 1.8%, according to the FOMC, growth will be 0.7 percentage points below potential in this two-year period. This seems too little for the necessary disinflation. In other words, either the interest rate will have to rise even more than predicted by the members of the FOMC, or there will be a sharper slowdown of the economy and a much higher increase in unemployment than expected.
- **Political Outlook – page 25:** This section, written by researcher Octavio Amorim Neto, is called "The Time Has Come." The author notes that on October 30, Brazil will choose from between Lula and Bolsonaro. It will be one of the most important elections in our history, as it will determine whether the country will undergo regime change under Bolsonaro or continue to experience democracy under Lula. According to the author, if Bolsonaro is reelected, there will not be a military coup, of the type seen in 1964. Democracy will simply degrade further and become a mere facade. If Lula wins, democracy will have another chance. He and his party never threatened the democratic regime. The economic policy mistakes made by Dilma Rousseff and the fact that the Workers' Party was involved in corruption scandals should not be confused with threats to democracy.
- **IBRE In Focus – page 27:** Finally, the IBRE In Focus section, written by researchers Paulo Pichetti and Anna Carolina Gouveia, is titled "Global Barometers and the Likelihood of Recession in the Current Situation of Monetary Tightening."

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