FGV IBRE

Macro BULLETIN

November 2022 • No. 137

Waiting for a new fiscal framework

Without a doubt, the main theme of the current domestic debate is what will be the fiscal framework that will be in force in the coming years. The only certainty we have so far is that the public sector will run a deficit in 2023, but how big is very unclear

Waiting for a new fiscal framework

Armando Castelar Pinheiro and Silvia Matos

Without a doubt, the main theme of the current domestic debate is what will be the fiscal framework that will be in force in the coming years. The only certainty we have so far is that the public sector will run a deficit in 2023, but how big is very unclear. And, of course, this is not an unimportant detail. On the contrary. Additionally, depending on what measures are adopted, the public finances may remain in the red for many years. In other words, in the coming years we may remain far from reaching the primary surplus needed to stabilize the public debt.

The proposal for the so-called Transition Constitutional Amendment Proposal presented to congressional leaders on November 16 excludes expenditures totaling R$175 billion from the ceiling, forever. This includes the R$600-per-month handout to low-income people through the "Auxílio Brasil" welfare program and R$150 a month for poor families with children up to six years old. It is important to mention that extending the R$600 benefit and giving an extra R$150 would require around R$70 billion, for which there is no room within the spending ceiling. Hence the need to approve an exception to the rule, known as a "fiscal waiver." However, this is less than half of the total extra amount that the government wants to spend. In other words, despite the claim that the exceptional spending will be for social programs, around R$105 billion was already included in the budget and in the ceiling, and it would only be necessary to add R$70 billion to the proposal. Consequently, the proposal is to release R$105 billion of funds without any specific allocation.

A fiscal waiver of around R$200 billion per year will increase public spending by R$1 trillion in the space of five years. This is equivalent to around 10% of the GDP assigned to direct expenditure, plus the interest that will accrue on the public debt that will have to be issued to finance this increase in spending.

The possible consequences of this permanent increase in spending include greater inflationary pressure through the demand channel, as well as through the mechanism of increased country risk, which will further depress the Brazilian real on currency markets. There will be more pressure on current and future inflation, contaminating inflation expectations. The Central Bank will be forced to react by initiating a new cycle of monetary tightening or at least not going ahead with the cut in interest rates projected for next year.

As a result, in addition to negative impacts on economic activity, employment and tax revenue, there will higher interest expenditure on the public debt, making the public finances even weaker. Ultimately, there will be pressure to increase social spending and higher public debt, in a negative spiral of the type seen in Brazil in the past. There is nothing new here. Poverty cannot be fought with fiscal irresponsibility.

We know that public spending decisions are political decisions. However, it is important to emphasize that if we want to spend more on welfare programs, we have to reduce other non-social spending and/or find new sources of tax revenue. The problem is not that we need to spend more on welfare, but how to finance it. Furthermore, the proposed fiscal waiver is much higher than the amount that would be necessary to finance the extension of the "Auxílio Brasil" program and this means that the government plans to spend much more than is justified by purely social concerns.

Fiscal sustainability will continue to be the main challenge for the next administration. What will be the new fiscal framework in an emerging economy with high public debt and high funding costs? Until this framework has been defined, uncertainty in the economy will remain very high, worsening the ongoing slowdown in activity.

As predicted by IBRE's Macro Bulletin, activity has been slowing in the second half of this year. We expect growth of 0.6% in the third quarter compared to the second quarter, i.e., half of what was recorded in the second quarter (1.2% quarter-over-quarter). At the margin, we expect that only agriculture and public services will record faster output growth than in the previous quarter. Even so, the main driver of the economy remains the services sector, which we predict will grow 1.1% quarter-over-quarter, only slightly slower than in the second quarter (1.3% quarter-over-quarter). This trend should continue in the last quarter of the year, when we project a contraction of 0.2% in GDP compared to the third quarter, which will lead to growth of 2.7% for the full year.

It is worth noting that this projection has a particularly high degree of uncertainty, as it may change after the national statistics agency, IBGE, releases its annual GDP revision for 2020. IBGE may also revise the quarterly GDP figures from 2021 onward. This information will only be available after the third-quarter GDP figures are published on December 1.

For 2023, for the time being, we now project GDP growth of 0.1%, as we have significantly raised our forecast for agricultural output growth to 8%. We expect lower output in all other sectors, as well as lower household consumption, on the demand side.

In addition to domestic challenges, international conditions in 2023 will remain very unfavorable for emerging countries. The strong dollar is likely to persist, causing a slowdown in global growth.

This is shown by FGV IBRE's Coincident and Leading Global Economic Barometers,[1] which retreated again in November, after indicating a slight improvement in the previous month. As a result, the Coincident Barometer reached its lowest level since August 2020, while the Leading Barometer is at its second-lowest point since June 2020, higher only than it was last August. According to the Global Economic Barometers' latest press release, "The drop in global barometers in November reinforces our concern about key challenges for the level of activity in the coming months, across all regions and most sectors. Among these challenges, the highlights are the global inflationary picture, the conflict in Ukraine and the effects of China's zero tolerance COVID policy."

With regard to China, the topic of this month's IBRE In Focus section, researcher Lívio Ribeiro estimates GDP growth of just 3.2% this year. He notes that "in October, the qualitative indicators of the Purchasing Managers' Index (which gauges the buoyancy of certain sectors of the economy in advance) confirm that there is only a slim chance that growth will accelerate this year. They show an economy in deceleration at the beginning of the fourth quarter, leaving a negative legacy for 2023."

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

- **Economic Activity – page 7:** The results of our high-frequency indicators were in line with our expected scenario. Therefore, we continue to project 0.6% growth in the third quarter, compared to the second quarter, and full-year growth of 2.7%. A slowdown in growth is inevitable and it has become even more likely due to the first announcements of the newly elected government. For 2023, we maintain our projection of a 0.2% reduction in activities that depend on the economic cycle (cyclical GDP), considering that strong monetary tightening should persist at least until the middle of next year. However, we have raised our growth forecast for agriculture and therefore for aggregate GDP, which we expect to grow 0.1%, compared to our previous forecast of a decline of 0.4%.

[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/2022-11/barometros-globais-kof-fgv_press-release_11_2022.pdf.

- **Business People's and Consumers' Expectations – page 10:** FGV IBRE's confidence indexes signal a sharp drop in November, halting the recent improvement in the behavior of business and consumer confidence indexes. The results across all economic sectors and for consumers show a clear deceleration trend in economic activity, which had already been priced in previously. The coming year will be challenging, due to high fiscal and international risks. The slowdown will be further exacerbated by these new levels of business and consumer confidence.
- **Labor Market – page 14:** According to the Continuous National Household Sampling Survey (PNADC), unemployment was 8.7% in September, in line with FGV IBRE's projection. In seasonally adjusted terms, it fell from 8.9% to 8.8%, and we expect another reduction, to 8.7%, in the next three-month period. This represents a continuous slowdown in relation to the previous months, even though the participation rate has been stable since April 2022. However, employment income's upward trend accelerated, going from quarterly growth of 3.0% to 3.7% in terms of effectively received income. This movement was driven by both the level effect and composition effect. In turn, the General Employment Registry (CAGED) indicates a slowdown, with 278,000 jobs created (143,000 in seasonally adjusted terms). We expect another reduction in employment growth in October, to 200,000 (128,000 in seasonally adjusted terms).
- **Inflation – page 17:** Without the notable contribution of gasoline (whose price fell 32.6% in the last four months), the anchor that had allowed negative Extended Consumer Price Index (IPCA) rates was weakened, taking the overall rate to a new level. New contributions to a pickup in inflation included food at home. Between September and October, this group's inflation rate increased significantly, from minus 0.9% to 0.8%, especially in raw foodstuffs, whose prices are more sensitive to weather variations typical of the hottest months, thereby constituting a transitory source of inflationary pressure. Despite seasonal pressures, in the medium term, the agricultural commodities monitored by the Broad Producer Price Index (IPA) point to a deceleration in inflationary pressures. Coffee (-2.3% to -16.3%), live poultry (-2.7% to -4.7%) and corn (0.6% to -0.3%) are examples of commodities whose prices have been declining in view of the forecast of robust harvests and a slowdown in major economies. These numbers recorded by the IPA indicate a deceleration in consumer food prices, alleviating inflationary pressures in the medium term and favoring a stronger deceleration in food prices.
- **Monetary Policy – page 18:** Naturally, discussions about increasing public spending, without any mention of a new fiscal rule, have made the financial markets uneasy. This is exacerbated by the fact that the future finance minister – the "Mr. No," who can to some extent curb unrealistic demands – has not taken part in these debates. As a result, implicit inflation in market prices and real interest rates in inflation-indexed securities have risen. The yield curve has started to contemplate the possibility of higher benchmark interest rates in the short term, although the Central Bank's latest Focus Bulletin survey does not yet reveal a similar movement. All this makes it clear that the Central Bank was right to signal that it will not hesitate to resume an upward interest rate cycle. It also underlines the cost of trying to fulfill campaign promises immediately, without taking proper care to set new and more lasting fiscal rules.
- **Fiscal Policy – page 19:** This section is entitled "The Fiscal Consolidation Should Also Look at Revenues." The size of the fiscal waiver has been worrying analysts. The adoption of permanent measures during this phase of the transition reduces the incentive for a more general overhaul of the tax system, as had been expected. One important debate concerns a new fiscal rule. There are several possible fiscal rules that will have to reconcile fiscal sustainability with the viability of the public budget. However, a thorough analysis of the fiscal situation is needed before we can design a credible fiscal regime, think about viable reforms and control

fiscal risks. Among other things, a careful assessment of the tax revenue situation is essential. With political leadership, common sense and good technical analysis, fiscal and social responsibilities will go hand in hand in Brazil. This is the challenge at the present moment.

- **External Sector – page 21:** Finally, recognizing a much more modest trade surplus, the official projection for Brazil's current account balance in 2022 is now close to ours. This year, we expect a current account deficit of 2.5% of GDP. However, there are significant differences in the projected deficit for 2023, arising once again from differences in the trade surplus. We expect a current account deficit of 3.7% of GDP next year.
- **International – page 27:** The topic addressed in this section is "The American Economy: How Far Will the Upward Interest Rate Cycle Go?" According to the author, and as noted in the October edition of IBRE's Macro Bulletin, there has been an inconsistency in the forecasts made by members of the Federal Open Market Committee. They predict that inflation will return to the 2% target in 2024 and 2025, but without any appreciable increase in unemployment and without the recession being too deep. Based on the results of the paper "Housing Is the Business Cycle," by Edward E. Leamer (2007), our author argues that a recession has been building up in the American economy for some time and he expects it to materialize in the second half of 2023. Since the second quarter of 2021, real estate investment has fallen 15%. The Atlanta Fed's survey of activity in the fourth quarter of 2022 suggests that this indicator is set to decline another 2%. In other words, it would seem that a recession is on its way.
- **IBRE In Focus – page 28:** Finally, the IBRE In Focus section, written by researcher Lívio Ribeiro, looks at "The Chinese Economy."

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.

Praia de Botafogo, 190 – CEP 22250-900 – Rio de Janeiro – RJ
Caixa Postal 62.591 – CEP 22257-970 – Tel.: (21) 3799-4747

Brazilian Institute of Economics

Director
Luiz Guilherme Schymura de Oliveira

Deputy Director
Vagner Ardeo

IBRE's Macro Bulletin

General and Technical Coordination
Silvia Matos

Editorial Revision
Fernando Dantas

Artwork Editing
Marcelo Nascimento Utrine

Permanent Team
Aloisio Campelo Jr.
André Braz
Armando Castelar Pinheiro
Daniel Duque
José Júlio Senna
Lia Valls Pereira
Livio Ribeiro
Manoel Pires
Marina Garrido
Mayara Santiago
Rodolpho Tobler
Samuel Pessôa
Viviane Seda

FGV | BRAZILIAN INSTITUTE OF ECONOMICS

Macro BULLETIN