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Deciphering the next steps

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Deciphering the next steps

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After the second round of the presidential elections, attention turned to understanding what the elected government's economic policy will be, especially with regard to the formation of the economic team and fiscal prospects for 2023 and onward.

In recent weeks, doubts about the economic team started to be resolved, as many of its members were announced. Regarding the future administration's fiscal policy, however, all that is available so far is the Transition Constitutional Amendment, which circumvented the federal government's spending ceiling. It has already been approved by the Senate and it has a high chance of being passed by the House before the parliamentary recess. This was not a good start.

Since the speech by the president-elect, Luiz Inácio Lula da Silva (Workers' Party), on November 10, in which he criticized the importance given to primary surpluses and preserving the spending ceiling, real interest rates on 30-year bonds have risen to above 6%, increasing the cost of financing the public debt. The measures taken since then make it unlikely that there will be any decline in funding costs anytime soon. In addition to the higher primary deficit, therefore, government expenditure on interest is expected to rise, expanding the public deficit on both sides of the equation and causing a strong and unsustainable growth in public debt in the medium and long term.

However, this does not seem to worry the supporters of the constitutional amendment. In the report on the proposal for the amendment, Senator Alexandre Silveira justified this significant increase in spending using concepts from Modern Monetary Theory (MMT). According to MMT, an expansion in public spending without any compensating increase in revenue is not bad, since the multiplier effects of this spending will boost the economy. Silveira argued that there is no risk of fiscal insolvency, as the higher debt will not generate a crisis of mistrust, given that it is issued in the country's own currency.[1]

Undoubtedly, one of the hot topics in macroeconomics is the value of the fiscal multiplier, meaning fiscal policy's capacity to stimulate the economy. In short, this is nothing more than the variation in Brazilian reais (R$) of some variable of economic activity (typically GDP) caused by an additional R$1.00 of government spending. In particular, the multiplier becomes the object of special interest when it is higher than 1. This means that adding R$1.00 to government expenditures boosts the economy by more than R$1.00, meaning that the government manages to induce some increase in private expenditure. This, in turn, will expand tax revenue, and this will partly help finance the increase in spending. So, what is the value of this multiplier in Brazil?

In Brazil, the fiscal multiplier seems to be between 0.4 and 0.7, i.e., a low level, according to research by Julio Mereb and Eduardo Zilberman (2017).[2] The literature on this subject also indicates that during periods of recession, the fiscal multiplier tends to be higher, but on the other hand, in situations of fragile public finances, the multiplier is very low and possibly even negative.

[1]For an extensive discussion of MMT, see the articles published in the "EU& Fim de Semana" supplement of newspaper Valor Econômico (in Portuguese): https://valor.globo.com/eu-e/noticia/2019/05/31/eduardo-loyo-diferencas-entre-a-moderna-teoria-monetaria-e-a-teoria-fiscal-do-nivel-de-precos.ghtml; https://valor.globo.com/eu-e/noticia/2017/02/03/neofisherianismo-vai-entender.ghtml; https://valor.globo.com/eu-e/coluna/taxa-de-juros-e-inflacao.ghtml, https://valor.globo.com/eu-e/noticia/2017/01/20/nada-de-novo-no-debate-monetario-no-brasil.ghtml, entre outros.

[2]https://blogdoibre.fgv.br/posts/politica-fiscal-nos-bons-e-maus-tempos (in Portuguese).

So, given the cyclical moment in which the Brazilian economy finds itself, close to full employment, and in view of the high level of public debt, excessive fiscal expansion has harmful effects on the economy. Brazil is not in recession. In fact, from a cyclical point of view, the immediate priority is to let monetary policy perform its role of controlling inflation, as it has been trying to do, slowing down the economy, before we can then start the process of reducing interest rates and thus allow the economy to resume its growth path without putting pressure on inflation.

There are therefore no arguments of an economic nature to justify the constitutional amendment proposed by the elected government and under discussion in Congress. On the contrary. The government's highly expansionary fiscal policy, which will put even more pressure on the public debt in the coming years, will contribute to a period of low growth and very high inflation and interest rates.

Furthermore, in our view, it is also a mistake to believe that the constitutional amendment is justified from the perspective of social policy. The need to reconcile social spending with fiscal balance is crucial to preserving the sustainability of social advances. The poorest people are the hardest hit by low growth combined with high inflation. As experience shows, it is strong labor market performance, more than any other policy, that reduces poverty and improves income distribution.

The most likely scenario for next year is for GDP to grow by just 0.2%, after rising 3.0% this year (the latter figure having been revised since last month's Bulletin). This result, which points to GDP expansion in 2023 below the carry-over effect implicit in our projection, stems from revisions of growth estimates since 2021, raising last year's growth from 4.6% to 5.0% and this year's growth from 2.7% to 3.0%.

The deceleration process that began in the second half of 2022 is expected to intensify. The effect of post-pandemic normalization, which benefited the service sector greatly in 2022, will lose strength. Household credit, which boosted domestic demand, is also shrinking, becoming more expensive and scarce. The global slowdown, in turn, will continue to weigh on commodity prices and also have a negative effect on activity in these sectors. Furthermore, the new government's stated intention of undoing some of the reforms of recent years, ranging from the State-Owned Enterprises Law to the new regulatory framework for sanitation, will weigh on investment.

In turn, monetary policy will help even less than we previously anticipated. We no longer expect any reduction in interest rates next year. The disinflation process has been very gradual and continued uncertainty about the future of the country's fiscal framework, resulting from excessive fiscal stimulus, is the most likely scenario.

The Brazilian Central Bank has emphasized that fiscal uncertainty calls for prudent risk assessment and that it will closely monitor the evolution of fiscal policy and its effects on country risk, asset prices and inflation expectations. Once again, the Monetary Policy Committee has stressed that it will persevere until the disinflation process is firmly under way and expectations have been anchored around its targets. The Central Bank also says that future monetary policy steps may be adjusted and that it will not hesitate to resume the adjustment cycle if the disinflation process does not go as expected.

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

- **Economic activity – page 7:** The results of high-frequency indicators were in line with our prediction of an economic slowdown, and so we project stability at the margin in the fourth quarter. For the year as a whole, we have revised our GDP growth estimate to 3.0%, up from 2.7% previously, largely due to a revision of the historical series. Due to high inflation, which has not yet subsided in the service sector, a slowdown in growth is inevitable, and we expect the service sector to barely grow at all in the fourth quarter, despite extra government welfare payments and the improved job market. Industry and retail were in line with market projections in October, while the service sector did worse than expected. Given the lack of productivity gains in the Brazilian economy, we maintain our forecast for 2023 of a 0.2% decline in cyclical GDP, but we have revised our aggregate GDP forecast from 0.1% to 0.2%.

- **Business people's and consumers' expectations – page 9:** Confidence indexes declined further in November, indicating a slowdown in the economy in the last quarter of the year. Preliminary data for December shows that business confidence is likely to suffer in December, while consumer confidence is showing signs of offsetting the latest declines. In periods of turbulence such as elections, the use of current situation indicators is recommended, and they also show low confidence at the end of the year. In 2023, it is possible that things may improve, despite the challenging macroeconomic situation.
- **Labor market – page 12:** According to the Continuous National Household Sampling Survey (PNADC), the unemployment rate was 8.3% in October, slightly lower than FGV IBRE's projection. In seasonally adjusted terms, the rate fell from 8.7% to 8.5%. We expect another decline, to 8.3%, in seasonally adjusted terms, in the following three months, representing a continuous deceleration compared to previous months, due to the participation rate's downward trend, which is now 1 percentage point below the level recorded in February 2020. Both the employed population and effective income grew less, although the latter still grew at a quarterly rate of 2%, continuing to boost overall earnings, which surpassed the pre-pandemic level and are approaching the trendline in place prior to COVID-19. In turn, the General Employment Registry (CAGED) showed a sharp deceleration in employment growth in October: 159,000 new jobs or 79,000 in seasonally adjusted terms. We expect employment growth to be roughly the same in November, with 140,000 jobs created, or 80,000 in seasonally adjusted terms.
- **Inflation – page 14:** Based on inflation between January and November 2022, and the preliminary December figures in FGV IBRE's Inflation Monitor, we forecast that the Extended Consumer Price Index (IPCA) will be 5.6% in 2022, exceeding the top of the inflation target range. Four spending classes account for 90% of total inflation in the year to November: food and beverages (43.6%), health and personal care (21.6%), clothing (13.5%) and personal expenses (12.9%). Although inflation will end above the tolerance range, the real highlight this year was the drop in energy and fuel prices, thanks to the reduction in Tax on Circulation of Goods and Services (ICMS). Without this drop, inflation would have been around 9%. In 2023, there will be no lack of challenges and the biggest one will be the fiscal situation. The benchmark Selic interest rate is expected to remain high, discouraging household consumption and private investment. As a result, GDP is unlikely to beat expectations, as it did in 2022. In addition, some other countries are also raising interest rates, which may put downward pressure on the prices of agricultural commodities, minerals and oil. Even so, we predict that inflation in Brazil will exceed 5% in 2023, once again above the upper limit of the tolerance band.
- **Monetary policy – page 16:** The new administration's attempt to obtain authorization for a high volume of public spending, outside the spending ceiling, on a permanent basis, has left an impression of a strong spending tendency. To the extent that this impression is not effectively dispelled, by whatever means, we can predict that high real interest rates will remain for a long time. In this environment of high interest rates, the low pace of economic growth predicted in 2023 will probably give rise to major tensions between the federal government and the Central Bank, especially if the latter needs to raise the benchmark rate even more.
- **Fiscal policy – page 19:** After the elections, the government assembled its transition team and the main political leaders negotiated a constitutional amendment to reorganize the budget proposal. After some comings and goings, this proposal was approved in the Senate and forwarded to the House, where it is now being examined. This constitutional amendment would release R$145 billion per year, for a period of two years,

outside the spending ceiling. This money may be allocated freely, but most of it is expected to go on health, education and the continuation of the Brazilian Aid Program ("Auxílio Brasil"), which pays recipients R$600 per month. There is also over R$23 billion earmarked for investment, resulting in R$168 billion in increased spending. This allocation of R$23 billion will also be available in 2022 to the current government to resolve recent budget problems.

- **External sector – page 20:** In November, Brazil posted a trade surplus of US$6.7 billion, the highest since current records began in 1998. The main reason was higher export volumes to China, up 14% between November 2021 and November 2022. However, the trade surplus between January and November changed little between 2021 and 2022. In line with FGV IBRE's model, we project a trade surplus of US$59 billion in 2022, close to the 2021 total.
- **International panorama – page 24:** The Federal Reserve has repeatedly pointed out that the work of bringing inflation down to the target is far from complete. Therefore, its decision to reduce the pace of base rate hikes may seem strange. However, this decision is not inconsistent. When monetary policy approaches its tightest point, it does indeed make sense to slow down the speed of adjustment. Furthermore, a recent study by the Federal Reserve Bank of San Francisco shows that the current degree of monetary tightening in the U.S. is greater than what can be inferred when only considering the level of the fed funds rate.
- **Political outlook – page 26:** The Political Outlook section, written by researcher Octavio Amorim Neto, is titled "The Military Transition of Lula's Third Administration." According to the author, national defense was the only area that did not have a transition team appointed by Luiz Inácio Lula da Silva to liaise with the outgoing administration. Lula has already picked José Múcio, a right-wing politician with links to Bolsonaro, to be the new defense minister as of January 1. Lula's choice surprised many people, but it makes sense. After all, the Armed Forces are among the national organizations most intertwined with Bolsonaro's movement. Over the course of 2022, the current defense minister, General Paulo Sérgio de Oliveira, stood out, not for his defense-related decisions, but for his criticism of Brazil's excellent electronic voting system. Thus, he spearheaded the main line of attack by President Bolsonaro against the country's institutions, especially the Federal Supreme Court and Superior Electoral Court.
- **IBRE in focus – page 27:** Finally, the IBRE In Focus section, written by researchers Janaína Feijó and Paulo Peruchetti, is called "In-person services dictate pace of employment recovery in Brazilian regions."

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