FGV IBRE

Macro BULLETIN

January 2023 • No 139

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2023: a year of many challenges

Armando Castelar Pinheiro and Silvia Matos

Although 2023 started in a very turbulent way, the government's economic policy became clearer in the first few weeks, in particular regarding the economic team and economic agenda.

The first major economic policy issue is related to the size of the fiscal deficit in 2023. According to the Budget Guidelines Law, the primary deficit will be around R$232 billion, more than 2% of GDP. The Finance Ministry subsequently announced a set of measures to reduce this deficit, to increase tax revenue by around R$190 billion and cut spending by a mere R$50 billion in relation to the Budget Guidelines Law (i.e., still up significantly from 2022). These tax increases and spending cuts would yield an estimated R$240 billion, enough to generate a primary surplus in 2023. However, even the government itself is not very confident that these figures will be achieved. Instead, the finance minister has said that the realistic goal is to obtain a primary deficit of under 1% of GDP.

The second issue (and it will take some time to find out its details) is the establishment of a new fiscal framework to replace the spending ceiling as a fiscal anchor. This framework needs to be ambitious enough to produce primary surpluses from 2024 onward, and thus attenuate public debt growth in the coming years. This will be essential to offer any prospect of stabilizing or even cutting the debt in the long term. If this new rule is credible and well designed, we can expect a reduction in interest rates and a resumption of economic growth, while keeping inflation under control. We will see.

In addition to overall fiscal policy, some other topics, such as tax reform, the model for public-private partnerships and the role of state-owned banks and Petrobras will also be crucial for economic performance not only this year, but also in the years to come.

However, in the short term, the news on the activity front is not good. As highlighted in previous editions of IBRE's Macro Bulletin, although economic activity beat expectations in the first half of 2022, the expected outcome in the second half is much less bright. Fiscal stimulus and temporary reductions in energy prices and other regulated prices helped, but not enough to reverse the ongoing slowdown. Following growth of 0.4% in the third quarter, we believe that economic activity stagnated in the fourth quarter. The high-frequency indicators corroborate this belief.

For 2023, we have maintained our growth forecast of 0.2%. Despite the fiscal impulse generated by growing government spending, the worsening of financial conditions, the maintenance of high interest rates until the end of the year, stubbornly high inflation and a low carry-over effect (around 0. 4%) will make it difficult for a more optimistic scenario to materialize.

In addition to domestic challenges, the international outlook for 2023 also remains very unfavorable for emerging countries. International interest rates are expected to remain high, together with a slowdown in world growth.

This is indicated by FGV IBRE's Coincident and Leading Global Economic Barometers,[1] which signal a sharp slowdown in the global economy in early 2023. Both indicators recorded a decline in January and reached levels that had not been observed since 2009, except for the worst moment of the COVID-19 crisis.

[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/system/files/2023-01/barometros-globais-kof-fgv_press-release_01_2023.pdf.

The result was influenced by the Asia, Pacific & Africa region, while in the other regions the indicator improved slightly. In January 2023, the Coincident Global Economic Barometer dropped 3.3 points to 76.5 points, the lowest level since July 2020 (68.5 points). The Leading Global Economic Barometer fell 2.1 points, to 79.6 points, the lowest level since June 2020 (59.6 points).

With regard to sectors, in the case of the coincident indicators, Services, Industry and the General Economy (consumer assessments and business aggregates) fell in January, while Commerce and Construction moved in the opposite direction. All sector indicators are far below the long-term average of 100 points, suggesting a widespread economic slowdown across sectors.

However, it is worth noting that since mid-October, pessimism regarding economic activity has diminished somewhat, thanks to prospects of a more moderate rise in U.S. interest rates, a smaller deceleration in Europe and recovery in China, resulting from the end of lockdown policies and various stimulus measures being taken by the country's government.

With regard to China, researcher Lívio Ribeiro estimates GDP growth of 4.7% this year, after a 3.0% increase in 2022. The Chinese economy slowed down throughout 2022, leaving a negative carry-over effect for 2023.

Finally, for Latin America, after two years of robust growth, the region's economies are expected to grow at a much slower pace this year, due to strong monetary tightening and the reduction in world growth, impacting commodity prices, as well as political uncertainties plaguing the region.

In other word, the global and domestic situations will be relatively synchronized in 2023: growth will slow down and high interest rates will persist for longer. Without a doubt, there are no shortcuts that will allow us to swim against this current: only a consistent and credible economic agenda will be able to deliver a more optimistic situation in 2023 and the following years. The diagnosis and prescription are very well known.

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 prognosis for the end of last year, so our estimate for fourth-quarter GDP remains stable at the margin, with 3.0% growth in 2022. Looking ahead, a slowdown in growth is inevitable. There are increasingly clear signs that the service sector recovery, driven by post-pandemic normalization, is running out of steam, while industry and retail continue to suffer from weak domestic demand, as shown in their November indicators. Given the combination of no productivity gains and great uncertainty in the economy, we maintain our growth forecast of 0.2% for 2023, believing that the strong monetary tightening will persist until the end of the year in order to bring inflation under control.

- **Business people's and consumers' expectations – page 9:** FGV IBRE's confidence indexes ended 2022 with different trends but they converged negatively in the preliminary January results, among both business people and consumers. Looking at different sectors, commerce drove the decline in confidence, but the signs are that this trend will deepen in other sectors, such as services and construction, with consequences for the labor market (a factor already perceived by consumers, who are showing caution even for new purchases). The situation at the start of 2023 is challenging and it will take great efforts from the new government to reverse this process and put the economy back on track.

- **Labor market – page 11:** Brazil's national statistics agency, IBGE, did not release the November edition of its Continuous National Household Sampling Survey (PNADC). Instead, it focused its efforts on setting up a task force to complete the 2022 census, which has been suffering from delays and other difficulties in response rate. Notwithstanding this, FGV IBRE forecasts an unemployment rate of 8% for both November and December, implying a reduction of just 0.1 percentage points in seasonally adjusted terms, followed by stagnation. This is in line with the continuous deceleration in the decline in unemployment seen in recent months. Making adjustments to harmonize variables related to overall effective earnings, this variable is now at its highest level since records began, but only 5.5% above the 2014 average, which corresponds to average annual growth of just 0.7%. In turn, the General Employment Registry (CAGED) indicates a further slowdown, with 135,000 jobs created in November (80,000 in seasonally adjusted terms). In December, we project that 111,000 jobs will be created in seasonally adjusted terms (a decline of 365,000 without seasonal adjustment).

- **Inflation – page 13:** With few risks on the radar screen, food could contribute to a decline in inflation in 2023. The slowdown in major economies, stable weather and lower volatility in oil prices could contribute to a less intense rise in food prices. Part of this effect can already be noticed in the downward trajectory of the prices of important commodities, which may also contribute to the generalized decline in protein prices, leading to lower inflation in 2023, despite Brazil's fiscal risk and its effect on fuel prices.

- **Monetary policy – page 15:** There has been much talk about the need for greater coordination between fiscal and monetary policy. However, we should bear in mind that any movement in this direction will only be effective in the event that measures in the fiscal field act to reinforce the effects of the current contractionary monetary policy. Any relaxation of monetary policy, given the current state of our public finances, would be disastrous. The recent package of fiscal adjustment measures may perhaps be seen as a first step in the right direction, but we are certainly still a long way from a combination of fiscal and monetary policies capable of enabling a sustainable drop in real interest rates while reducing inflation.

- **Fiscal policy – page 17:** This section takes a close look at Constitutional Amendment 126 of 2022 (the Transition Constitutional Amendment), the 2023 budget and the future challenges of fiscal policy. Among other things, it is argued that in order to maximize the constitutional amendment's effects on the economy, it is necessary to present a fiscal action plan in order to maintain the prospect of economic policy sustainability. For example, the IMF has proposed a more flexible set of fiscal rules. They would be able to deal with short-term uncertainties and also consider more potential scenarios to reinforce their role as a fiscal anchor and anticipate fiscal risks. Communication and transparency are important elements of this paradigm, so that economic agents are able to understand fiscal policy decisions. In the case of Brazil, a country with a very rigid budget structure, the combination of new fiscal rules with a fiscal and budgetary action plan could make the new rules more credible over time. After so much debate in recent years, the authors hope, at the very least, that the new fiscal rules will benefit from best practices and a better understanding of their role within the fiscal system.

- **External sector – page 21:** In 2022, compared to 2021, the value of Brazil's exports grew 19.1%, while the value of imports expanded 24.3%, leading to a trade surplus of US$61.8 billion, up slightly from US$61.4 billion in 2021. The average projection had been for a trade surplus of US$59 billion. Higher trade surpluses in November and December, compared to the previous year, surprised analysts and they explain the improvement in the whole year's surplus. The increase in trade surplus in the last two months of the year was driven by China, despite the smaller surplus with this country between 2021 and 2022. Agriculture was the only sector to record an increase in trade surplus in 2022, given that extractive industry's surplus fell and manufacturing's deficit increased.

- **International panorama – page 27:** There are clear signs of a slowdown in U.S. inflation. The Federal Reserve has signaled three or four more 0.25-percentage-point increases in the base rate, until it reaches 5% to 5.25% or 5.25% to 5.5%. The American economy will enter a recession sometime in the second half of 2023, which will take the unemployment rate to between 5.5% and 6.0%. This recession will be enough to bring inflation back to the target at some point in 2024 or 2025. Despite the slowdown in the international economy, the situation unfolding for 2023 will probably not be so negative for Brazil. Commodity prices are falling (which will be moderated by China's recovery in the second half), but there will be disinflationary pressure from the world economy. President Luiz Inácio Lula da Silva has tended to be lucky in terms of international conditions during his administrations. All the signs suggest that this will be repeated.

- **IBRE in focus – page 28:** Finally, the IBRE In Focus section, written by researcher Lia Valls Pereira, is called "Some questions for Brazil's foreign trade policy agenda."

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