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Armando Castelar Pinheiro and Silvia Matos

In retrospect, and despite many challenges, the Brazilian economy performed better than expected in 2022. GDP is estimated to have grown 3%, while core inflation is showing signs of easing, due to the lagged effects of monetary policy. In spite of a highly contested election, the Brazilian real appreciated against the dollar. The public sector ended the year with a primary surplus and the government's gross debt plummeted as a proportion of GDP. The year's trade figures were also healthy.

Undoubtedly, compared to other countries, Brazil performed well, benefiting from global circumstances. The country is far from major geopolitical conflicts. The invasion of Ukraine intensified increases in commodity prices, contributing to strong activity and mitigating the negative effects of measures to curb inflation.

Looking ahead to 2023, Brazil is expected to complete the dismantling of measures taken in the pandemic. Core inflation is projected to decline further, and by the middle of the year, we predict that a cycle of interest rate reductions will begin. Consequently, following a slowdown in activity that began in the second half of 2022 and will extend into much of 2023, there will be higher growth in 2024 and the last years of Lula's third administration, in a context of lower inflation and interest rates.

However, this outcome will only be possible if fiscal policy fulfills its role, which is to generate prospects for a fiscal surplus from 2024 onward, facilitating the decline in interest rates and strengthening a scenario of public debt sustainability over the next few years. Additionally, there must not be any drastic changes in the economic policy framework in general, especially regarding the role of public sector banks (including the national development bank, BNDES), the model for public-private partnerships, relations with state-owned companies, the Central Bank's autonomy, and so on. Finally, the country needs to maintain its agenda of reforms, above all tax reform.

There are still many questions and few certainties about whether these requirements will be met. In the field of reforms, it seems there is a good chance that the Brazilian tax system will be changed, at least in terms of the taxation of goods and services. According to research by Bernard Appy, who was recently appointed the Finance Ministry's tax reform secretary,[1] the impacts on efficiency gains in the economy could be significant, but this of course depends on what reform will actually be approved. There are also many doubts about the fiscal outlook. We will only be able to assess the issue of public debt sustainability after a new fiscal framework has been defined. The good news is that the finance minister, Fernando Haddad, has stated that the new fiscal framework will be presented next month, earlier than previously expected.

However, there are still many uncertainties about the broader economic policy agenda, such as whether there will be higher outlays by state-owned banks, interference in fuel price policies, reversals of privatizations, labor reform revisions and/or higher inflation targets, among many possibilities raised by the new administration. In other words, will there be a return to the past, featuring policies that were adopted and/or intensified during

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[1] "Tributação e Produtividade no Brasil." In: Regis Bonelli. Fernando Veloso; Armando Castelar Pinheiro. (Org.) Anatomia da Produtividade no Brasil. 1st edition, Rio de Janeiro, Elsevier, 2017, v. 1.

Dilma Rousseff's first and second administrations? It is important to mention that there are many studies demonstrating the terrible results of many economic policies adopted during this period.[2]

From a macroeconomic point of view, fiscal uncertainties contribute to heightened uncertainty in the economy, as shown by FGV IBRE's indicators, affecting activity in the short term.[3] In addition, expansionist fiscal policy permanently raises the economy's neutral real interest rate, according to a study by Borges and Pessoa (2021).[4] Among other findings, they write, "The decline in Brazil's neutral interest rate to unusually low levels since 2016/17 resulted both from a change in the cyclical orientation of fiscal and quasi-fiscal policy in relation to that observed in a good part of the period from 2001 to 2014 and also from the influence of the international environment." Consequently, this study provides a warning about the likely costs brought about by a new cycle of expansion of public spending.

In short, from an economic policy perspective, the administration's early days have been very turbulent, floating proposals that seem more aimed at undoing recent reforms than at improving the economic environment and suggesting measures in the fiscal area that do not promote the smooth economic landing that seemed to be the central scenario at the end of 2022. All of this has been generating a lot of uncertainty and made the outlook much more worrying.

On the external front, the year also began fairly turbulently, with asset prices very sensitive to high-frequency indicators and what they signal about the disinflation process sought by the world's main central banks. Although there are uncertainties about global growth this year, prospects have improved in recent months, especially in the eurozone, which has shown more resilient economic growth (to which the mild winter contributed), and in China, where the reopening of economy has contributed to the resumption of activity.

This better performance helps explain the recent weakening in the dollar, but the most recent figures for the U.S. economy partially reversed this process, showing that activity in the country remains more resilient than projected. In the United States, in fact, as highlighted in the International section, there are a lot of doubts about the (de)inflationary process, which entails equal uncertainty about the size of monetary tightening still needed to bring inflation back down to the target. The labor market remains strong and still represents an upside risk, and inflationary inertia may gain prominence, despite much more favorable expectations. We will see.

Overall, notwithstanding some risks, the international situation is likely to be more benign this year than previously expected. This is what FGV IBRE's Coincident and Leading Global Economic Barometers show.[5] In February 2023, they rose for the first time since November 2022, across all regions. The Coincident Barometer went up 6.2 points, to 83.3 points, while the Leading Barometer rose even more, by 11.2 points, to 90.5 points, the highest level since March 2022. As a result, the Coincident Barometer has recovered almost 50% of the losses recorded in the previous three months, while the Leading Barometer has reversed more 100% of its losses in the same period.

In short, risks exist, but Brazil seems relatively well positioned in terms of the external situation. We will benefit from the reopening of the Chinese economy and high commodity prices (not as high as in 2023, but still

[2]"Para não esquecer: políticas públicas que empobrecem o Brasil," Marcos Mendes (Org.) Editora Autografia, 2022. Also see the studies released by Brazil's Public Policy Monitoring and Evaluation Council (https://www.gov.br/economia/pt-br/acesso-a-informacao/participacao-social/conselhos-e-orgaos-colegiados/cmap).

[3]See https://portalibre.fgv.br/noticias/incerteza-da-economia-sobe-06-ponto-em-janeiro.

[4]See https://blogdoibre.fgv.br/posts/os-determinantes-do-juro-de-equilibrio-brasileiro-em-2001-2019.

[5]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/2023-02/barometros-globais-kof-fgv_press-release_02_2023.pdf.

high). We are a major player in the renewable energy market. Therefore, international investors are more optimistic about Brazil. The external winds are favorable.

Accordingly, the performance of the Brazilian economy during Lula's third administration will fundamentally depend on the economic policy choices to be made early on. The government has a crucial role in setting the economic agenda, which needs to be credible and consistent. As the philosopher Seneca said, "If one does not know to which port one is sailing, no wind is favorable."

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

- **Economic activity – page 7:** High-frequency indicators were uneven in the fourth quarter of 2022 and they did not affect our projection of stable GDP at the margin, implying 3.0% growth in 2022. The resilience of services is once again being tested, the goods sector continues to suffer from weak demand and a slowdown in growth is inevitable. In this context, without productivity gains and with a high level of uncertainty in the economy, we maintain our forecast of 0.2% GDP growth in 2023, considering that high interest rates are likely to persist at least until the end of the year.

- **Business people's and consumers' expectations – page 9:** FGV IBRE's first confidence indexes in 2023 show a continuation of the negative trajectory that started at the end of last year, across different sectors and segments. A slowdown in activity can be perceived in cooling demand, especially in the Commerce and Services sector, higher inventories and shortages of inputs in some segments. High uncertainty reduces investments, hiring and consumption, and may hinder monetary policy in the coming months. The labor market seems to be decelerating, mainly in the service sector, as workers also feel more insecure. A recovery is not yet in sight.

- **Labor market – page 12:** The November results of the Continuous National Household Sampling Survey (PNADC), released late, indicate an unemployment rate of 8.1%, 0.1 percentage points higher than projected by FGV IBRE. Seasonally adjusted, the decline was 0.2 percentage points, and a reduction of the same magnitude is expected in the three months to December 2022. However, even though there was a significant slowdown in the decline in unemployment, both the formal employment rate and effective earnings continued to rise sharply, reversing previous trends. In turn, the General Employment Registry (CAGED) shows a clear trend of deceleration, indicating that 431,000 jobs were lost in December (58,800 in seasonally adjusted terms), and an even greater reduction is expected in January: 46,800 in seasonally adjusted terms and 21,600 without seasonal adjustment.

- **Inflation – page 15:** The recent behavior of inflation seems to be related to the current benchmark Selic interest rate, but the real anti-inflation anchor will come from foodstuffs, whose prices, already in decline for producers, will soon fall for consumers as well. The challenges in 2023 will involve regulated prices. For fuel and energy, the temporary removal of federal and state taxes is expected to end in 2022. This could cause headline inflation to end 2023 at a level close to last year's, meaning that inflation will once again far exceed the target.

- **Monetary policy – page 16:** Monetary policy has been in contractionary territory for nearly six quarters. This period is usually considered the relevant time horizon for reaping the benefits of Central Bank actions. However, the joint action of the executive and legislative branches last year resulted in a high degree of artificiality in some prices, and this will affect the 12-month inflation trajectory in 2023. Furthermore, apart from uncertainties surrounding the future of the public finances, recent official attacks on various aspects related to the conduct of monetary policy have helped worsen inflation expectations – a fundamental factor affecting inflation. These factors will make it harder to harvest the fruits of monetary austerity.

- **Fiscal policy – page 18:** The subject of this section is income tax in Brazil and the tax wedge. The authors show that the Brazilian tax burden on labor is very high, due to social security and public pension contributions, while income tax has a small weighting. For this reason, the tax wedge is less progressive than it could be. Furthermore, there are few deductions for dependents. The combination of an expansion of the 0% band and an increase in deductions for dependents would bring taxation closer to Lula's campaign pledge, especially for some more vulnerable household profiles. In this way, we would have a slightly more progressive tax system.
- **External sector – page 21:** The end of the lockdown in China and projections of higher economic growth in the Asian country, in relation to 2022, will offset the expected slowdown in Brazil's other main export markets. The January trade balance results do not yet confirm this theory, but it cannot be ruled out. We should also note the recent increase in exports to the European Union, led by oil sales, resulting from the war in Ukraine.
- **International panorama – page 24:** This section looks at inflation in the United States, highlighting the role of inertia and expectations. To begin with, inflation was clearly the result of a supply shock. The prices of industrial goods – affected by the disruption of global supply chains – and food rose. However, the very rapid recovery produced an equally rapid reduction in the unemployment rate. Currently, it is close to an all-time low. The tight labor market has caused wage and service inflation. On the other hand, there are signs of a decline in inflationary expectations for the next 12 months. The markets are practically pricing in a soft landing, whereby the U.S. economy reaches equilibrium with inflation on target and unemployment just above the natural rate. However, the January numbers raised a red flag. Perhaps inflationary inertia will win this battle.
- **Political outlook – page 25:** The Political Outlook section, written by researcher Octavio Amorim Neto, is titled "The Performance of the Third Lula Administration's Democratic Coalition." In the wake of the chaos caused by coup plotters in Brasilia, Lula obtained the support of the leaders of the judiciary and legislature, almost the entire political class, broad sectors of civil society and countless countries in all regions of the world, including Russia and China, to defend the country's political order. This support strengthened the government's democratic coalition character. On the negative side, the main problem has been Lula's harsh criticism of the Central Bank's president, Roberto Campos Neto, and the high interest rates that the bank has been setting. This is an unnecessary mistake, which could affect the country's economic prospects, as well as clashing with the promise of political peace repeatedly made by Lula. However, our regime is presidential, which means that the executive power is vested in the head of state. In the recent history of coalition presidentialism, the successful presidents have been those who knew how to practice the difficult art of combining unilateral and vigorous action, as permitted by the Constitution, with three political imperatives: being genuinely moderate, making substantial concessions, and consulting with all allies on a permanent basis.
- **IBRE in focus – page 26:** Finally, the IBRE In Focus section, written by researchers Fernando Veloso, Silvia Matos, Fernando de Holanda Barbosa Filho and Paulo Peruchetti, is called "Stylized facts about the evolution of labor productivity in Brazilian regions since the early 2000s."

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