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Waiting for the new fiscal framework

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Waiting for the new fiscal framework

Armando Castelar Pinheiro and Silvia Matos

Everything indicates that the economy may be at a turning point, both here and abroad. In Brazil, the focus in the second half of March will be on defining the long-awaited “new fiscal framework.” This is the main domestic topic of discussion, due to its importance for economic performance in the remainder of the current presidential term. Abroad, problems adapting to the reality of less expansionist monetary policy, after a decade and a half of negative real interest rates, cast doubt on the size of additional interest rate hikes. The Fed Funds futures rate for December of this year has fallen 0.85 percentage points in the space of a month.

Details about the proposed rules to replace the Brazilian government’s spending ceiling as a fiscal anchor will be released soon, but at the time of writing this summary, little was publicly known. It is hoped that the rules will comply with some basic principles, such as simplicity, predictability and feasibility. Ideally, it will be quick and simple for society to gauge compliance with them. There are high hopes regarding their degree of ambition, meaning the results that this new framework is designed to achieve in the coming years, in terms of reinstating primary surpluses and getting the public debt on a sustainable path.

Some other dimensions will also be the focus of attention. For example, the adoption of a continuous public spending review could contribute to greater acceptance of the new rules and increase the efficiency of expenditure over time. Furthermore, no less important is knowing whether the rules will enjoy strong political support – a crucial element for them to have credibility and be able to anchor expectations.

Abroad, turbulence in the international financial markets has dominated the agenda in recent weeks. In the United States, there has been a reduction in the system’s liquidity, especially for smaller banks, and some institutions have been finding it difficult to adapt their balance sheets to the new monetary policy, leading some regional banks to fail and other smaller institutions to struggle to maintain their activities. If this crisis is not resolved, a credit crunch situation may occur and the Fed may have to postpone its plans to contain inflation, in order to prioritize financial stability. For now, however, they are only risks to be monitored by the monetary authorities. Activity in the U.S. continues to be strong and inflation remains persistent.

The situation is not very different in the eurozone, as suggested by investors’ recent crisis of confidence in Credit Suisse. The news that the Swiss central bank will inject up to 54 billion Swiss francs into Credit Suisse eased the strain on the European banking sector, bringing a moment of relief to the markets. However, the question on investors’ minds is whether more banks are in trouble. We will see.

Even so, the European Central Bank decided to raise interest rates by 0.5 percentage points. Growth prospects have recently improved in the region, given the reduced risk of an energy crisis, and activity data has been stronger than expected. At the same time, core inflation remains high. According to remarks by the ECB’s president, Christine Lagarde, inflation will stay very high for some time and there is a long way to go before it is brought back down to the target, but the next monetary policy decisions will depend on what the data shows. The more dovish tone of the ECB’s statement, abandoning clear signs of further hikes in the next meetings, shows that the institution is sensitive to the difficulties that the region’s banks are experiencing, as they struggle to hold on to deposits and post losses on their government bond portfolios.

Finally, in China, recently released data confirmed the recovery of the economy at a speed compatible with growth of around 5% in 2023. (See the IBRE In Focus section.)

In Latin America, economic growth in several countries will be below potential in 2023. A major contraction is expected in Argentina, due to the severe drought that is devastating the country and also affecting southern Brazil. Other countries are also expected to perform poorly. In fact, there has been a slowdown across the region. At the same time, inflation expectations remain high and so there is not much scope for monetary stimulus.

Brazil is following the same trend. GDP was stagnant in the second half of last year and the carry-over effect for 2023 is close to zero. As stated in previous editions of this bulletin, this deceleration in activity is likely to continue in 2023 and FGV IBRE's surveys confirm a picture of weakening activity. Due to the excellent performance of agriculture, GDP is projected to grow 1.0% in the first quarter, in relation to the last quarter of 2022. However, if agriculture had grown at the same rate recorded in the first quarter of 2022, GDP would have declined 0.2%, quarter-over-quarter, in the first quarter of this year.

Overall, GDP growth is expected to decelerate from 2.9% in 2022 to just 0.3% in 2023, as the accumulated effects of contractionary monetary policy, the slowdown in the world economy and the high degree of uncertainty in the national economy more than offset expansionary fiscal policy measures.

Despite all the present challenges, Brazil could theoretically perform slightly better in 2023 and, above all, in the coming years. Undoubtedly, the definition of the new fiscal framework and the approval of a well-designed tax reform are crucial requirements to move in this direction. If we restore our fiscal sustainability while passing a well-executed tax reform, we could boost productivity, which remains very weak, reducing our potential growth rate, as borne out in indicators released by the Regis Bonelli Productivity Observatory. We will soon start to see whether or not this will happen.

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

- **Economic activity – page 7:** High-frequency indicators of extended credit and financial conditions have shown signs of slowing down since the end of last year. With regard to credit, the slowdown was particularly intense at the beginning of the year. Consequently, we maintain our low growth expectation for 2023, of just 0.3%, below the median market projection. In this context, without productivity gains and with a high level of uncertainty in the economy, it will be hard to obtain more robust growth in 2024, especially considering that strong monetary tightening will likely persist at least until the end of the year.

- **Business people's and consumers' expectations – page 9:** FGV IBRE's confidence indexes show the continuation of the deceleration path at the beginning of the year, across all sectors and segments. However, our preliminary March results signal a possible reduction in pessimism in the coming months, although it is not yet widespread. Despite being positive, this result should be interpreted with caution, given the still-tricky macroeconomic situation and challenges for growth in economic activity and labor market improvement. Industry is expected to perform unevenly between segments, with some doing well while others face input supply problems.

- **Labor market – page 11:** The January edition of the Continuous National Household Sampling Survey (PNADC), released late, indicated an unemployment rate of 8.4%, higher than forecast by FGV IBRE and the markets. Seasonally adjusted, unemployment rose 0.2 percentage points and another increase of the same magnitude is expected in the three months from December to February 2023. The unemployment rate has dropped sharply since mid-2021 and effective earnings inequality has fallen significantly, to lower than it was before the COVID-19 pandemic. On the other hand, the participation rate has counteracted this trend, falling more among adults with a low level of schooling. The lower supply of jobs may have put pressure on wages in sectors that require less skilled workers, while pay has risen more in sectors that require more educated workers. In turn, the General Employment Registry (CAGED) indicated an acceleration of employment growth

in January. A net 83,300 jobs were created (90,600 in seasonally adjusted terms), beating expectations. In February, we predict that 212,000 jobs will be created (106,000 in seasonally adjusted terms).

- **Inflation – page 14:** The main core inflation indicators stand at around 8.5% in the last 12 months. High inflation is both persistent and very widespread, judging by the diffusion index. This shows that 65% of the products and services consumed by families rose in price in February – a level that has been sustained for many months.
- **Monetary policy – page 15:** There has been speculation about the possibility that the financial turmoil abroad and the announcement of the new fiscal framework here in Brazil will contribute to a significant change in the conduct of the Brazilian Central Bank's policy. However, the author of this section explains the reasons why he does not believe that recent external events will exert any influence here. As for the fiscal issue, the central argument is that in order to make a significant difference, the new framework will need to really impress stakeholders and cause significant changes in the main factors that currently shape the Central Bank's actions.
- **Fiscal policy – page 16:** The announcement of the new fiscal framework is eagerly awaited. The administration is set to present its new set of fiscal rules and its planned fiscal policy strategy for its term in office. What does eliminating the primary deficit in 2024 imply? According to the authors, starting with a primary deficit of 0.9% of GDP in 2023, and making some assumptions, revenue would have to grow by approximately 0.7 percentage points of GDP for this to be achieved. This is potentially doable, but it will not only depend on variables controlled by the government, since higher tax revenue will also require getting bills passed by Congress. If the economy weakens, the task will become even harder, regardless of the government's efforts, requiring the adoption of some type of contingency rule or escape clause.
- **External sector – page 18:** Incorporating methodological revisions introduced at the end of last year and new paths expected for the fundamentals of the external sector, we project current account deficits of just below 3.0% of GDP in 2023 and 2024. Although this figure may seem high, we don't expect any pressure on the balance of payments results, as the external outlook seems fair.
- **International panorama – page 23:** In the United States, it is not uncommon for interest rates to be reduced in the wake of financial turmoil. However, current circumstances do not seem to support such an initiative, at least not at the moment. It is essential to keep in mind that the "big swing" in the financial markets did not make inflation disappear. It is necessary to continue the process of combating inflation, although the Fed may avoid resuming 50-basis-point hikes. At the meeting scheduled for April 22, a rise of 25 points seems more likely. If the base rate is left unchanged, it will be necessary to complement this decision with hawkish remarks to make market players abandon the idea of a reduction in interest rates in 2023 once and for all.
- **IBRE in focus – page 24:** Finally, the IBRE In Focus section, written by researcher Lívio Ribeiro, is titled "The Chinese Economy."

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