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Reforms advance, but there are still challenges

Armando Castelar Pinheiro and Silvia Matos

The economic environment has improved in recent weeks, both in Brazil and abroad. In both cases, it was the result of a significant reduction in inflation rates, achieved despite highly favorable labor market indicators. There are growing expectations that it will be possible to get the post-pandemic inflationary escalation under control without the need for a recession. This would make room for looser monetary policy, whether by stopping the cycle of hikes in the United States earlier or by cutting interest rates more quickly and significantly in countries like Brazil. This has translated into a weaker dollar and a drop in long interest rates, which are generally good for emerging countries.

In Brazil, in addition to this perception of a more favorable domestic and external environment, it looks like the planned reform of taxes on goods and services will go ahead, after decades of discussions about the need for this. On July 6, a constitutional amendment proposal on this subject was approved by the House of Representatives by a large majority and the bill is now being examined by the Senate.

Various studies point out that our tax system on goods and services is an obstacle to productivity growth and consequently limits our growth potential. These studies show that the current system generates not only an inefficient allocation of productive resources but also a poor regional allocation of production, impacting income distribution.

Since 2015, when he participated in the creation of the Center for Fiscal Citizenship, Bernard Appy, an economist and tax reform secretary at the Finance Ministry, has been dedicated to defending reform of the Brazilian tax system. In 2017, in his book *Anatomy of Productivity in Brazil*, published by FGV IBRE, Appy gave a detailed description of the distortions that the existing tax system causes for the country's productivity, in the chapter called "Taxation and Productivity in Brazil."

The Institute for Applied Economic Research (IPEA) recently published a study that simulated the economic, regional and sectoral impacts of tax reform proposals on the productive structure of the Brazilian economy. The study, by researcher João Mario de Oliveira, titled "Tax Reform Proposals and Their Impacts: A Comparative Assessment," concluded that the execution of the Replacement for Constitutional Amendment Proposal 45 of 2019 would add 2.3 percentage points to the accumulated GDP growth up to 2032, in relation to the scenario without any reform.¹

The reform of our system may not only improve the business environment in Brazil, but also reduce the regional misallocation of production. However, there are still many controversial or uncertain points about the effective scope of the reform, generating questions that we hope will be resolved successfully, from the point of view of economic efficiency, by the Senate.

For example, what will the base rate be? What will be the impact on this base rate of concessions made to specific sectors of the economy, through the creation of special regimes and differentiated rates for certain

¹<https://www.ipea.gov.br/cartadeconjuntura/index.php/2023/07/propostas-de-reforma-tributaria-e-seus-impactos-uma-avaliacao-comparativa/>

goods and services? Does it make sense to alter the Constitution to grant permission for state governments to create taxes on primary and semi-manufactured products? Does it make sense to let mayors set the municipal property tax rate by decree?

There are many other questions. In particular, by the time it has finally been passed into law, to what extent will it deliver the benefits that were initially expected from Constitutional Amendment Proposal 45 of 2019? According to the aforementioned IPEA study, the effective rate of the new Brazilian tax on the consumption of goods and services would be 28.04%, the highest in the world.² To what extent may this high rate stimulate the informal economy and thereby jeopardize the projected gain in productivity and growth?

Nevertheless, despite all these doubts, the tax reform is a major institutional step forward and therefore represents good news. The same cannot be said of the new census data recently released by the national statistics agency, IBGE, which showed that between 2010 and 2022, the Brazilian population only grew 0.52% per year, just half of IBGE's previous estimate. According to figures from the Regis Bonelli Productivity Observatory, Brazil's per capita GDP growth was higher than its labor productivity growth between 1980 and 2010, due to the fact that labor was incorporated into production processes more quickly than the total population expanded, a phenomenon known as the "demographic bonus." However, the end of this bonus may have occurred even sooner than previously predicted. Consequently, the issue of productivity gains even more prominence in the debate on sustainable economic growth.

Another recent piece of good news was the National Monetary Council's decision to maintain the official inflation target for 2026 at 3%. As expected, following this decision, inflation expectations for 2025 and onward dropped significantly. In early June, they were 4%, but by the time the Brazilian Central Bank released its Focus Bulletin on July 17, they had fallen to 3.55% for 2025 and to 3.50% for 2026. In addition, the June Extended Consumer Price Index (IPCA) results indicated deflation of 0.08% and it seems likely that inflation will end this year below 5%.

However, despite the improvement in the headline inflation rate, the core rate (an indicator used to smooth out volatility and supply shocks in order to gauge the impact of monetary policy) has decelerated much more slowly. Among other indexes released by IBGE, there is IPCA-EX3, which only includes selected types of services and industrial goods. Studies indicate that the inflation components that it includes are more sensitive to the economic cycle.³ At the moment, IPCA-EX3 for the last 12 months is running at 7.4%, down from 10.2% a year ago. Looking at the headline Extended Consumer Price Index, inflation fell much more sharply in the last year, from 11.9% to 3.2%.

That is, the June data consolidates the process of disinflation in food and industrial goods, a movement that should continue to be supported by the drop in commodity prices, the recent appreciation of the Brazilian real, the normalization of global value chains and lower demand for goods, as shown by IBGE's trade and industry surveys. However, it also confirms greater pressure on items that are more sensitive to the economic cycle, such as services.

Furthermore, as expected, alongside data showing higher core and service inflation, there was some good news regarding the resilience of the labor market, with the unemployment rate hovering around 8% in seasonally adjusted terms, as well as strong growth in the service sector (as borne out in the Monthly Services Survey).

In this context, the big question is: how are we going to manage to reduce inflation without imposing costs in terms of job creation and household consumption?

²https://www.ipea.gov.br/cartadeconjuntura/wp-content/uploads/2023/07/230706_cc_60_nota_01_reforma_tributaria.pdf

³It excludes food at home, goods with regulated prices, electronic devices, new cars, used cars, ethanol, tobacco and non-underlying services.

Even though monetary easing is expected in August, it is important to emphasize that some members of the Brazilian Central Bank's Monetary Policy Committee have expressed greater caution, noting that "the next steps in monetary policy will depend on the evolution of inflationary dynamics, especially in components that are most sensitive to monetary policy and economic activity." Accordingly, although there is room for monetary easing to begin, we are still a long way from sharp reductions.

This view is supported by the fact that, contrary to monetary policy goals, the government has enacted policies to stimulate economic activity, such as tax breaks for cars, trucks and buses; the "Desenrola" ("Untangling") program, aimed at reducing household indebtedness; the return of off-budget subsidies on loans from the national development bank, BNDES; the significant increase in the "Bolsa Família" ("Family Grant") program; and the increase in the real value of the minimum salary. Everything indicates that this tension between expansionist fiscal/quasi-fiscal policy and restrictive monetary policy will continue for some time.

At the present moment, as the external environment improves but other emerging countries are relatively less attractive, Brazil's domestic assets may have appreciated due to the Senate's passing of the new fiscal framework and the House of Representatives' approval of the tax reform and the bill to give the Finance Ministry back its casting vote in Administrative Council of Tax Appeals (CARF) meetings. However, this cycle of appreciation – including the strengthening of the Brazilian real, rising stock market and decline in long-term interest rates – already seems to have stopped, at least for now, perhaps reflecting the fact that the country still faces domestic challenges for a more sustained acceleration in activity, with inflation on target and fiscal sustainability.

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

- **Economic activity – page 8:** The second-quarter data released so far paints a less negative than expected picture for the service sector. Industry and broad retail shrank in May, compared to April, but the service sector grew, after a relatively sharp decline in April. After the May data was released, we revised our GDP growth forecast for the second quarter and for the whole of 2023, from 1.6% to 1.8% (year-over-year), and from 1.3% to 1.6%, respectively. Nevertheless, we expect GDP to decrease 0.4% in the second quarter, compared to the first (compared to our projection of a 0.6% decline in our June 2023 Bulletin). In this context, marked by a significant deceleration in investment and without productivity gains, the challenges for more robust growth of cyclical activities in 2023 are high, especially considering the likely persistence of strong monetary tightening, and notwithstanding the expected beginning of the easing of benchmark interest rates this quarter.
- **Business people's and consumers' expectations – page 10:** Confidence indexes ended the second quarter on a high, signaling a possible recovery in the cyclical sectors of the economy. However, there are still signs of caution, such as low confidence in certain sectors and among lower-income families, as well as our preliminary July figures, which indicate stability in the Consumer Confidence Index and a drop in the Business Confidence Index. Regarding uncertainty, favorable signs have taken this indicator back to the pre-pandemic level.
- **Labor market – page 13:** According to the Continuous National Household Sampling Survey (PNADC), Brazil's unemployment rate was 8.2% in May 2023, as forecast by FGV IBRE. In seasonally adjusted terms, unemployment fell from 8.3% to 8.1%, but the labor market remains relatively sluggish. We project that unemployment will remain at 8.2% in June, equivalent to 8.2% in seasonally adjusted terms. However, the participation rate has finally stopped falling, which it had been doing since the third quarter of 2022. This will favor the occupancy rate, which is still close to the level of March 2016, when Brazil was going through an economic crisis. Finally, the General Employment Registry (CAGED) indicates that 155,000 net new jobs were

created in May 2023, slightly below FGV IBRE's projection of 191,000 and representing a decline of 107,500 in seasonally adjusted terms (down from a reduction of 173,000 in April). In June, we forecast that CAGED will record a net 137,500 new jobs, or practically the same, 133,800, in seasonally adjusted terms, indicating a halt to the recent slowdown in the labor market, although this indicator will still be below the level recorded in the months prior to April.

- **Inflation – page 15:** The Extended Consumer Price Index (IPCA) fell 0.08% in June, suggesting price stability more than deflation. This result was partly driven by temporary factors, but there was some good news in the data. On the other hand, price increases in some segments, particularly services with unregulated prices, remain persistent and seem largely unaffected by Brazil's high interest rates.
- **Monetary policy – page 16:** The recent decision by the National Monetary Council to maintain its 3.0% inflation target and to turn it into a continuous goal should be seen as arising from favorable factors that started to benefit the macroeconomic environment in the last three or four months. In a way, reality imposed the measures that were taken. In any case, it is essential to note that the adoption of this continuous target system in no way alters the essence of monetary policy execution. The Central Bank will continue to be responsible for managing the “convergence horizon,” i.e., determining the speed of return to the target on occasions when it is missed. Costs associated with bringing high inflation back down to the target will continue to exist, which is why it will be important to actually get inflation to remain on target at all times.
- **Fiscal policy – page 18:** This section is called “Sense and Nonsense in the Tax Reform.” The House of Representatives recently approved a constitutional amendment to formally initiate the long-planned consumption tax reform. The bill is now before the Senate and it is expected that the reform will be passed in the second half of this year. The approval of this constitutional amendment proposal will generate substantial gains for the system. Despite tax breaks and other special exemptions that were granted, the new system will reduce the level of distortions. It is important for the Senate to preserve the trend toward standardization, as this will be the reform's main benefit (although gains will not be seen in the short term). After the constitutional amendment proposal has been approved, several complementary laws will need to be passed to regulate the new system. Following this, tax administrators will have a lot of work to do to standardize thousands of regulations. In a country that is growing so feebly, it seems very complacent that this reform is only scheduled to enter the implementation stage in 2026.
- **External sector – page 20:** Brazil's foreign trade performance in 2023 has differed from that of 2022 in terms of price and volume indicators, as noted in previous bulletins. In 2022, the improvement in exports was driven by price increases, which outweighed declines in volume. This year, increased volume has boosted exports, despite falling prices. In this section, we explore the behavior of export volumes in recent years to identify the main trends, mainly an upward trend in export volumes, especially in agriculture, followed by mining. Fluctuations in export prices do not affect the volume trajectory over time. On the other hand, manufacturing exports have been stagnant.
- **International panorama – page 25:** The American Consumer Price Index results for June were lower than expected. There is clearly a process of disinflation under way. We knew that 2023 would see a reversal of the numerous price shocks that had affected the world economy since the second half of 2019. However, the extent of the reversal suggests that after all these shocks have been reversed, inflation could end up closer to 3-3.5% than to 4-5%. The big question is whether the strong disinflation observed in the Consumer Price Index will also be seen in the Personal Consumption Expenditures Price Index. In particular, we will see whether the

service indicator that excludes housing and energy (known as supercore inflation), which has been particularly important to the Federal Reserve's monetary policy decisions, will show the sharp drop recorded in the CPI. The entire market will be waiting for the June PCE supercore results, to be released at the end of July.

- **Political outlook – page 26:** In recent years, Brazil's Congress has grown stronger, especially in the budgetary area. Since 1985, the parliamentary right has never been as strong as it is now. The strengthening of Congress in terms of the budget means that federal representatives and senators no longer need to have direct influence over ministers in order to transfer public resources to their constituencies. There have been significant changes in the functioning of coalition presidentialism, which the current administration has taken into account. Precisely for this reason, the government has been slowly consolidating its majority in Congress, step by step. However, it should be noted that not all these changes are negative. This is the case with President Luiz Inácio Lula da Silva's tied hands with regard to the Health Ministry. Furthermore, in the medium term, the reduction in party fragmentation should generate good results. The lines of continuity lie in the fact that coalition presidentialism remains alive as a very flexible and potentially effective way of governing, if in the hands of moderate and politically astute presidents, such as Fernando Henrique Cardoso and Lula.
- **IBRE in focus – page 28:** Finally, the IBRE In Focus section, written by researchers Janaína Feijó and Paulo Peruchetti, is titled, "Recovery of the labor market in Brazilian regions loses momentum in early 2023."



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