VotorantimAsset

Monthly Economic Outlook

December | 2014

Fiscal turn-around

The trajectory of public finance currently requires adjustments. Course corrections are imminent, with short-term costs but benefits for the nation's future. Complete implementation of the required fiscal adjustment is vital if consumer and above all business confidence is to recover, if economic growth is to resume, and in order to adjust the key macroeconomic variables, especially inflation, the exchange rate and interest rates. This means the fiscal tightening cycle that is just beginning could last three years.

The process will be led by a highly qualified person, incoming Finance Minister Joaquim Levy, who has experience in this kind of task and inspires confidence that the objectives established will be achieved. At the press conference held to announce his appointment, he said the 2015 primary surplus target would be 1.2% of GDP, less than the target indicated by the outgoing team, but a simple, comprehensible and transparent target that will re-anchor the markets' expectations. It is indeed a challenge, but it is feasible.

The official 2014 primary surplus will be very close to zero. The total budget deficit (including interest) will exceed 5% of GDP. The level of public debt is rising significantly despite the absence of economic growth, and there is no prospect of a reversal. Public-sector net debt (PSND) corresponded to 36.1% of GDP in October, and gross debt (PSGD) to 62.0%.

Without the large volume of extraordinary (non-recurring) revenue, the 2014 fiscal result would be a primary deficit corresponding to about 0.7% of GDP. From this point, achieving the 1.2% primary surplus target in 2015 will require significant fiscal tightening, equivalent by our estimates to 1.5% of GDP in terms of recurring revenue and expenditure, although the 2015 budget assumes a certain amount of revenue from concessions, dividends and the Refis tax recovery program (all of which is projected to correspond to 0.35% of GDP).

The effects of this policy will be felt nationwide. We expect the economy to contract again in the initial part of next year, not least because the public sector was the main driver of activity in 2014. An improvement in the fiscal situation is required by the low investment rate and economic stagnation, as the only way of reversing this negative outlook.

Taking Finance Minister Levy's track record into account, we believe he will prioritize controlling and reducing expenditure to execute his principal mandate, while raising taxes to some extent. The tax burden is considered very high, many firms are already in financial difficulties, and inflation is persistently high. Some tax hikes on specific items are inevitable to balance the books, however, given the high rigidity of public expenditure.

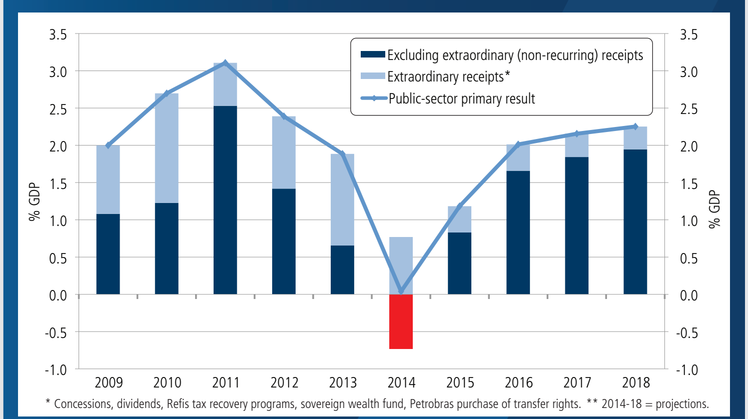
A tight rein on regional governments will be added to the central-government effort. Because Finance Ministry permission is required for states to borrow for investment purposes, we believe tougher controls will be implemented and expect the regional-government primary surplus to rise from almost zero in 2014 to 0.35% of GDP in 2015 and 0.5% in 2016.

The 2015 consolidated public-sector primary surplus will probably just reach the target. In the following year, when a more strenuous fiscal effort will be required to reach 2.0%, maintenance of fiscal austerity will be essential, although no new major spending cuts will necessarily be called for. There will also be time until then to prepare new taxes, such as resurrection of the CPMF tax on banking transactions, and the pace of economic growth should be more favorable. From 2017 on, the probable outlook is a maintenance scenario in which it will be easier to achieve more than 2.0%, as has now been stipulated, provided the government continues to manage its accounts with serenity.

Achievement of these targets and the projected behavior of the key macroeconomic variables point to a continuing rise in the public debt in proportion to GDP during the adjustment process. We expect PSGD to reach 67% of GDP by 2017, with PSND possibly reaching 42%, following probable stabilization. These numbers are not high enough to worry investors or rating agencies unduly, as their perceptions are influenced by tendencies. By then the macroeconomic variables concerned will be at more favorable levels, indicating an imminent reversal of the debt's relative trajectory.

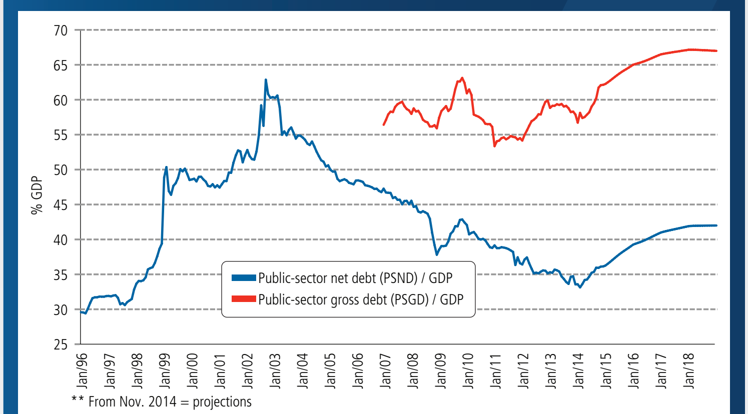
The entire process requires effort and political support, but future rewards will be substantial. The consistency of economic policy will rebuild business confidence, showing that the economy is on the right track and set to resume growth. Fiscal equilibrium will eliminate the prospect of sudden tax hikes and changes in the rules of the game to balance the books, and interest rates will be able to start falling again. New investment projects will increasingly be seen as feasible, and employment and economic growth will be fostered.

Public-sector primary result



Source: Central Bank of Brazil; National Treasury | Chart: Banco Votorantim

Public debt



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