VotorantimAsset

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Monthly Economic Outlook

Brazil’s Fiscal Policy Continues to Follow a Loosening Trajectory

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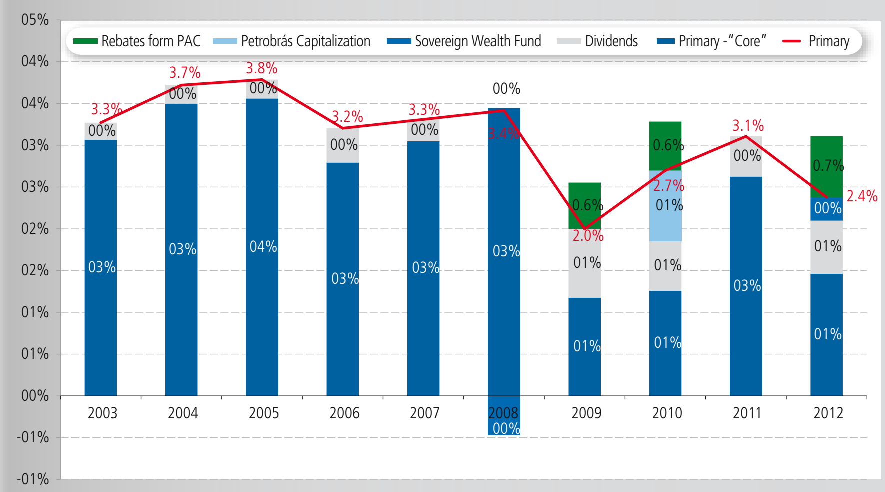
This first graph illustrates the trajectory of the loosening of fiscal policy that has occurred in Brazil over the last few years. While the public sector primary surplus (the difference between revenues and expenditures, excluding interest expenses) registered 3.5% of GDP on average between 2003 and 2008, after the onset of the international financial crisis that average fell to 2.5% of GDP between 2009 and 2012. In 2012 the target primary surplus of 3.1% of GDP was only achieved through a rebate of 0.7% of GDP in expenditure investments in Brazil’s Growth Acceleration Program (PAC). So in addition to the fact that the actual surplus was only 2.4% of GDP, the accounting maneuvers that were performed at the end of the year in order to reach the target have been at the center of a lot of criticism from the business press. In this sense, we can calculate what the "core" figure for the primary surplus would be. It can be observed in the graph that after excluding the use of Sovereign Fund resources (0.3% of GDP) and the revenue from company dividends (0.6% of GDP) that in fact the core surplus in 2012 was equivalent to only 1.5% of GDP. It should also be noted that with the anticipation of paid dividends, these revenues reached a level that is almost three times higher than that which was recorded during the period before the crisis, making the level of 0.6% of GDP to appear unsustainable.

Faced with the slow recovery of economic activity, the Brazilian government has signaled that fiscal stimulus will most likely continue into 2013. To that effect, the government has been setting aside more resources for tax cuts and signaling that the loss of revenue from those cuts will be extracted from the primary surplus target, as is foreseen by current legislation for expenditures for the Growth Acceleration Program (PAC). Total tax cuts in 2013 are likely to surpass 1% of GDP, and certainly some very positive economic impact will result from those cuts. In the current situation where there is a clear need for reforms that will enhance the competitiveness of the Brazilian economy, the reduction of industrial electricity costs and the lightening of the payroll tax burden are truly welcomed measures. However, it should be noted that several tax cutting measures have continued to focus on the end consumer, even though demand for consumer goods is still quite robust. This can be clearly seen in the retail sales figures

Public Sector Primary Surplus

(“Core” of Primary Result and Rebates form PAC (% of GDP))



Source: Banco Central do Brasil. | Preparation: VAM.

calculated by IBGE, which have grown at around 8% per annum since 2006, and which over the last twelve months have grown 8.6%.

As previously noted, domestic demand continues to be robust, despite the fact that the overall economy is still recovering at a very slow pace (GDP grew only around 1% in 2012, and we are forecasting growth of just 3.0% in 2013). Economic sectors, which have been exposed to fierce international competition, as can be seen in global industry since the 2008 crisis, have watched their market shares slip away. In 2012 industrial production recorded an uncomfortable 2.7% drop, and it is currently 4.9% lower than it was in Q3 2008 before the onset of the global financial crisis. However, during that same time period retail sales registered an accumulated increase of 32.7%. One result of this asymmetry in Brazil's economic activity is that while declining industrial production is pushing GDP growth down, domestic demand is pushing inflation up. This inflationary pressure is especially strong when it comes to goods and services that cannot be acquired from other national economies, such as school tuitions, medical expenses, hairdressers, barbers, dentists, etc. These services carry significant weight in the IPCA consumer price index, and they have registered an increase that is almost two times higher than the Central Bank's inflation target of 4.5%. It is our projection that during 2013 inflation in the service sector will once again surpass 8.0%, pushing the Extended National Consumer Price Index - IPCA above the CB's central target. In this regard, we believe that the gradual loosening of fiscal policy increases the risk that monetary policy will have to be tightened in order to keep inflation close to the Central Bank's target ceiling of the 6.5%

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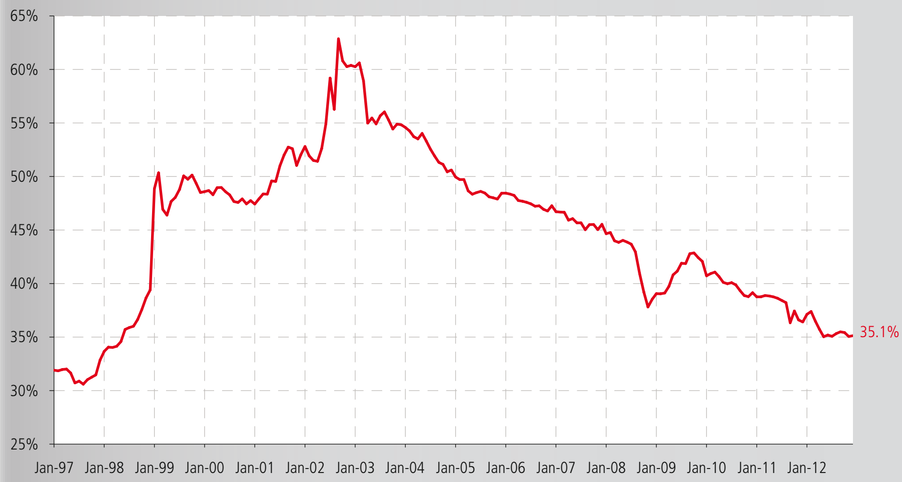
Public Debt
(Public Sector Net Debt and Gross Debt (%GDP))



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