VotorantimAsset

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# Monthly Economic Outlook

## Tough test for Brazil and other emerging markets in early 2014

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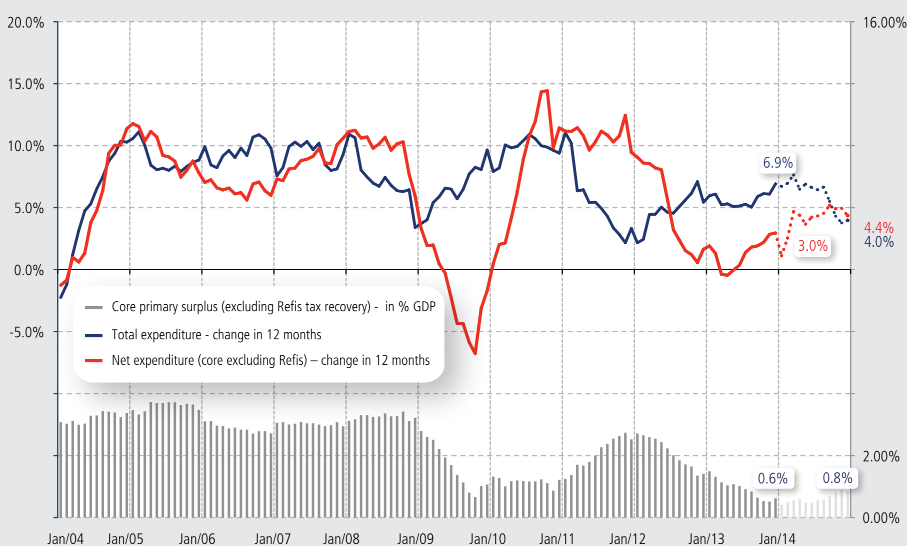
The early months of 2014 are proving to be hard times for the emerging economies. Brazil is no exception. The tension washing in from global markets drove an additional fall of 7.5% in the Ibovespa stock index in January, as well as a 2.6% rise in the exchange rate, taking the Brazilian Real above 2.40 per US Dollar. Dwindling international liquidity as a backdrop for these trends cannot be considered a novel aspect of 2014. After all, the FOMC decided that the Fed would soon begin phasing out quantitative easing at its December meeting, and the move had long been anticipated. The problem is that for the emerging markets this mopping-up of liquidity, with the resulting repatriation of short-term capital to the developed countries, especially the US, can be compared to a closed room full of gas. A single spark could lead to an explosion. The main EM economies have built up weaknesses in no small measure in the past few years, and their vulnerability is now becoming more visible. The January 23 devaluation of the Argentine Peso that reached 15% compared with the previous day evidenced this with particular force, not least because Argentina's international reserves currently amount to only 28 billion dollars, or a mere 7% of Brazil's. Other EMs were forced to raise interest rates more than expected by significant local currency depreciation, in an attempt to head off the inflationary pressures fueled by devaluation. Turkey, South Africa and India were examples of this movement, which led to questioning of other countries, such as Brazil, as to how they would respond in terms of economic policy.

**Fiscal Scenario with Federal Spending Cuts of R$40 bn**
Deflated federal revenue and expenditure and core primary surplus



Source: Tesouro Nacional. Chart: VWM.

February will be a very important month for answers to these questions about Brazil's economic policy response to the more adverse global context. The federal government has set February 20 as a deadline for announcing the target for its 2014 fiscal effort. Pressure for more cautious fiscal policy is coming precisely from the more adverse international context, with the risk of additional devaluations and of a downgrade for Brazil by the big rating agencies. We have therefore revised up our projection for federal spending cuts in the current year to R$40 billion. Under this scenario the primary surplus could reach R$67 billion, equivalent to 1.3% of GDP. In our view, cuts of this size are crucial to halt the slide in the primary surplus seen in recent years, thus improving the outlook for

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public debt solvency and the credibility of Brazil's fiscal policy. However, as shown in the chart below, this same reduction in public spending would not help significantly to reduce inflationary pressures (we project inflation in the range of 6% this year, on top of last year's 5.91% for the IPCA). It can be seen from the chart that even with this projected fall in public spending (blue line), the core primary surplus (gray bars) excluding extraordinary receipts would correspond to 0.8% of GDP in 2014, or practically the same as in 2013 (0.7% of GDP). There are two main reasons for this. The first is that by our estimates a substantial proportion (R$43 billion) of the projected primary surplus (R$67 billion) will come once again from non-recurring sources, such as the sale of concessions and special dividends from state-owned enterprises, which are excluded from our own and the Central Bank's methodology, as these fiscal revenues do not affect the prospects for aggregate supply and demand. The second reason for which a spending cut of R$40 billion will not produce such a significant decrease in aggregate demand is that much of this reduction in expenditure is necessary simply to keep pace with the inevitable fall in projected revenue when the budget proposal revises down the GDP growth projection included in the last official document. This official projection (GDP growth of 4.5% in 2014) is undoubtedly unrealistic and will have to be revised down. In short, a major spending cut on the order of R$40 billion is a necessary condition to reinforce Brazil's fiscal robustness in this dangerous year of 2014, but not a sufficient condition for an economic policy response, such as has proved necessary in other EMs, especially Turkey, South Africa and India, in terms of strengthening the basis for economic stability. A reduction in inflationary pressure still appears necessary to create the conditions for faster, more sustainable growth going forward. Thus Brazil's second policy response to the adverse international environment will come on February 26, when the Central Bank's Monetary Policy Committee (Copom) is set to continue raising the Selic rate. We expect the current tightening cycle to end with the Selic reaching 11.25% in April.

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