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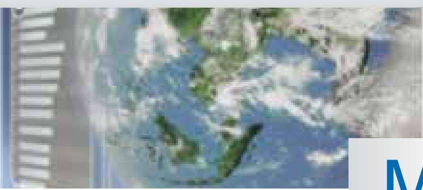

Monthly Economic Outlook

July | 2013

Fiscal policy is once again the focus of the Government and the Market

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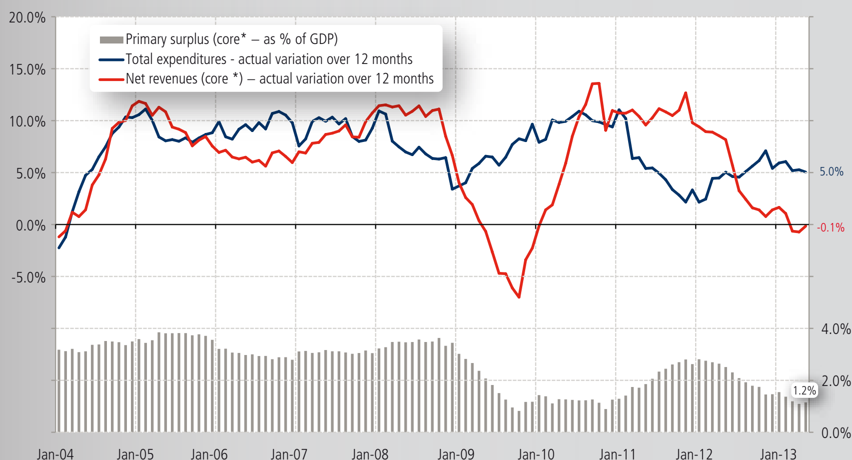
When the crisis hit the global economy in 2008, the Brazilian government adopted a countercyclical fiscal policy; firstly, in an attempt to revive aggregate demand which had suffered from the impact of international turbulence, and secondly, in an effort to revive domestic economic activity in order to ensure higher rates of GDP growth. The first graph illustrates two separate occasions (2009-2010 and 2012-2013) when the pace of expenditure growth clearly accelerates, in combination with a reduction in net revenues (excluding transfers to states and municipalities). On these two occasions higher current expenditures, combined with a drop in tax revenues resulting from weaker economic activity and sector and payroll tax exemptions, led the core primary outcome (excluding - dividend income paid by state enterprises and other non-recurring income) to a lower and admittedly expansionary level that even the Central Bank acknowledged in the latest minutes of its Monetary Policy Committee meetings and in its quarterly Inflation Reports.

Last month the subject of public accounts regained prominence on the Brazilian political and economic agenda. This was mainly due to Standard & Poor's Ratings Services' decision on June 6th to lower the outlook for Brazil's sovereign debt rating from ("stable" to "negative", while reaffirming its investment-grade ratings on the country's long-term and short-term debt). Another contributing factor was President Dilma Rousseff's proposal of a new fiscal pact in response to the demonstrations that sporadically took over the streets of Brazil throughout the month of June.

Cited by Standard & Poor's as one of the reasons for the ratings downgrade (along with a slower pace of GDP growth than was previously projected), the worsening of the public sector primary surplus has now become the central concern in pronouncements coming from government representatives. At a time when a large part of the Brazilian population has gone to the streets to call for the improvement of basic public services (such as health, education and urban mobility) by demanding increased government spending and investment in these areas, it is important that political authorities strengthen their commitment to reaching the primary budget surplus target, and demonstrate to the market and to society as a whole that they have a firm commitment to the pre-established plan for fiscal policy set forth in the Budget Guidelines Law (LDO), in that all new spending shall be offset by the

Revenues and expenditures of the Central Government and the core* of the primary surplus



* Core: Adjusted by subtracting non-recurring income ding accounts of onerous transfer for Petroleum, Brazil's Sovereign Fund and Dividends).

Sources: The Brazilian Ministry of Finance and the Central Bank of Brazil. Preparation: VWM&S

reduction of other previously scheduled expenditures. As our second graph demonstrates with the projections for the consolidated net income of the government, both in its entirety and in its core revenues and expenditures, we expect that fiscal policy is likely to remain at a slightly expansionary level for the next two years. According to our projections, the primary surplus should remain between 2.1% and 2% of GDP, while the result for the core will remain at slightly lower levels of (1.4% and 1.3% of GDP for 2013 and 2014) due to the large volume of revenues that will be collected by the Government with the payment of dividends.

In the current scenario in which the Central Bank is seeking to cool down aggregate demand and control inflation expectations by raising the basic interest rate (Selic), rigorous cost controls by federal, state and municipal governments have become even more necessary. A fiscal policy that seeks more neutral impact regarding the expansion of expenditures (which generate pressure on demand) and stays closer to the targets set by the government, would help the monetary authority in its efforts to bring inflation (currently at an accumulated 6.5% for the last 12 months) down to lower levels that are closer to the 4.5% center of the inflation target.

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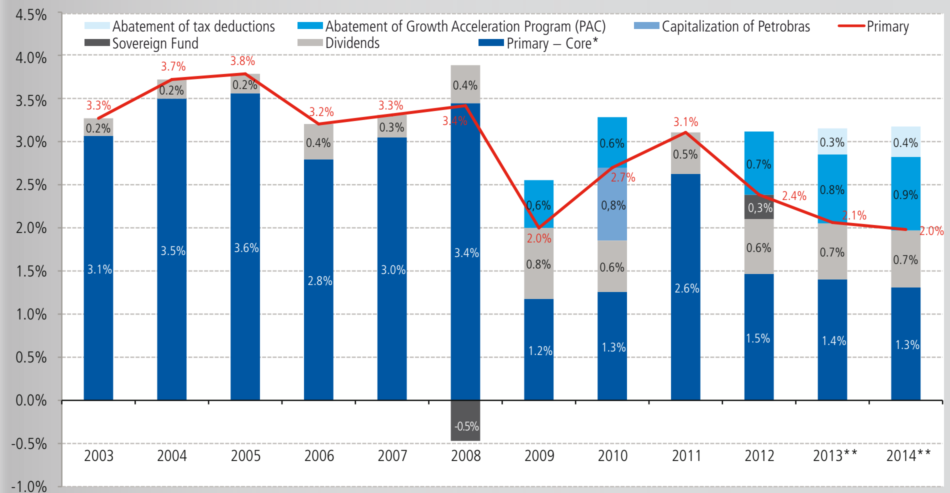

* Core: Adjusted by subtracting non-recurring incom (excluding accounts of onerous transfer for Petroleum, Brazil's Sovereign Fund and Dividends). **Projected values VWM&S.

Sources: The Brazilian Ministry of Finance and Central Bank of Brazil. Preparation: VWM&S

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