May | 2014

Monthly Economic Outlook

The challenges of Brazilian fiscal policy

> Brazil's long-term foreign-currency debt rating from BBB to BBB-

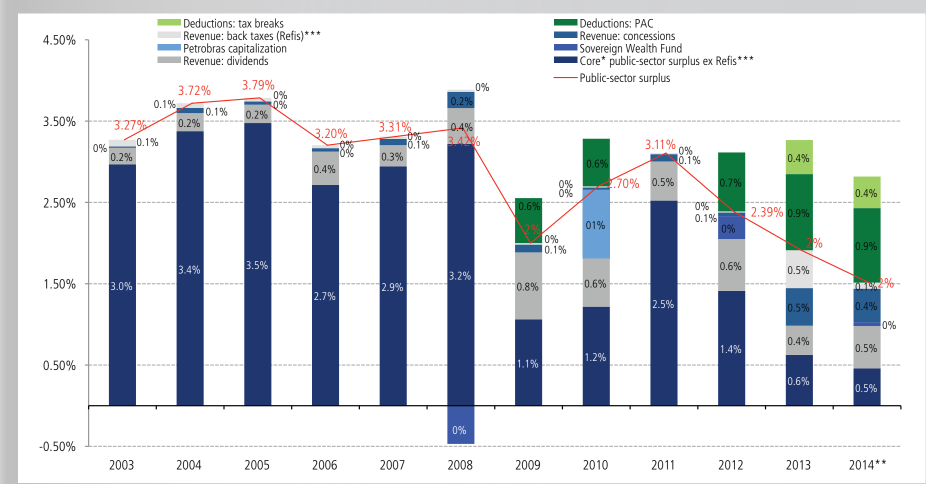
On March 24, 2014, Standard & Poor's published its decision to downgrade Brazil's sovereign debt rating, which it had placed on negative outlook in June 2013. It cut Brazil's long-term foreign-currency debt rating from BBB to BBB-, the lowest on its investment grade scale. S&P said the downgrade mainly reflected a combination of fiscal slippage in recent years and the prospect that fiscal execution will remain weak amid subdued growth going forward. At the same time it revised its outlook from negative to stable, making another downgrade unlikely in 2014 and hence assuring maintenance of investment grade for the foreseeable future.

In our July 2013 monthly outlook newsletter we stressed the need for government rigor in conducting fiscal policy, not only to avoid possible downgrades but also to help the Central Bank in its hard task of bringing inflation back to levels close to the midpoint of the target band. This downgrade by S&P suggests an even more urgent need for caution in the coming years.

An analysis of the public-sector primary fiscal result for 2013 shows that although it corresponded to 1.9% of GDP (at just over R$91 billion, in compliance with the budget target[1] for central and regional governments), it was obtained thanks to two atypical events that generated non-recurring revenue for central government: payment of a signing bonus for concession of the Libra oilfield in the amount of R$15 billion (or 0.3% of GDP), and collection of tax arrears under the Refis recovery program in the amount of R$22 billion (or 0.5% of GDP). As can be seen from the first chart, excluding the revenue we consider non-recurring, the core primary surplus corresponded to 0.6% of GDP (R$30 billion). This level is uncomfortable for the future dynamics of structural fiscal result generation (obtained via recurring and more predictable revenue and expenditure). Moreover, it provides negligible assistance to monetary policy in terms of the effort to cool aggregate demand and control inflationary pressure.

We expect additional deterioration in

Consolidated Public-Sector Primary Surplus



* Primary result adjusted by subtracting non-recurring revenue (excluding proceeds from sale of rights to oilfields, Sovereign Wealth Fund, dividends, concessions).
** Projected by VWM&S. *** Refis = Programa de Recuperação Fiscal (Tax Recovery Program).

Source: National Treasury; Central Bank of Brazil | Chart: VWM&S

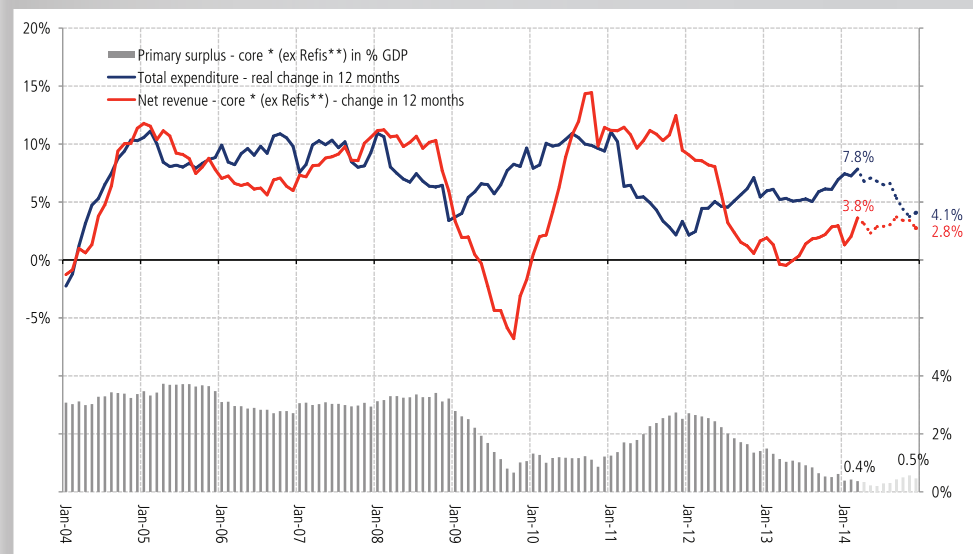
More than 75% of central-government primary expenditure is relatively non-discretionary and hence unlikely to fall in the near term

the public-sector fiscal surplus, both nominal and core (excluding non-recurring receipts) in 2014: we project 1.5% and 0.5% of GDP respectively. This opinion is corroborated by the fact that primary expenditure has risen faster than core net revenue since mid-2012. The reason is that more than 75% of central-government primary expenditure is relatively non-discretionary (earmarked for welfare benefits, social security, civil service pay, and conditional cash transfer programs) and hence unlikely to fall in the near term. Nevertheless, we expect real growth of expenditure to decelerate to 4.1% in the year (see second chart, right) thanks to tighter government control of discretionary spending and investment in infrastructure under the Growth Acceleration Program (PAC), which can be limited to some extent by direct decision of the executive. On the revenue side, the continuing impact of the tax breaks granted by the government since the 2008-09 global financial crisis, in conjunction with the moderate pace of economic growth, prevents a strong recovery of growth in recurrent revenue. We project real growth of 2.8% year over year in 2014.

In the medium term we believe the required fiscal adjustment will probably entail a debate on highly delicate subjects from the political standpoint, such as a change in the rule for annual minimum wage resets (the main driver of rising expenditure on social and conditional cash transfer programs as well as pensions and social security generally) as well as the withdrawal of tax breaks and even possible increases in the tax burden. These and similar issues are highly likely to be at the top of the next president's agenda on taking office in January 2015. Until then it is mainly up to the monetary authorities to control aggregate demand and anchor inflation expectations, currently in the range of 6.5% for 2014 and 6.0% for 2015, according to the Central Bank's latest *Focus* survey.

[1]The target of R$156 billion established by the 2013 Budget Guidelines Law (LDO) allowed for the deduction of investment under the PAC program and of up to R$65 billion in revenue foregone due to tax breaks granted to specific sectors.

Central-Government Revenue/Expenditure and Core* Primary Surplus



* Core adjusted by subtracting non-recurring revenue (excluding proceeds from sale of rights to oilfields, Sovereign Wealth Fund, dividends, concessions).
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