VotorantimAsset

# Monthly Economic Outlook

May | 2015

## Fiscal adjustment is under way but confidence remains low

With the fiscal adjustment process now well under way, attention focuses this month on the spending cuts to be announced by the federal government. Media speculation suggests cuts of between R$60 billion and R$80 billion from the budget passed by Congress. It will be advisable to cut as much as possible, since tax revenue has been weak and will is set to remain so for some time because of the stalled economy. In 1Q 15 the Treasury cut expenses by 4.3%, but social security outlays rose 5.1%, reflecting the problem of federal budget rigidity. The consolidated public-sector primary surplus totaled R$19.0 billion, but this was less than required to assure achievement of the annual target.

In addition to reining in expenditure, the economic team are working with Congress to assure passage of the measures involving social benefits, but there are difficulties and compromises are inevitable. New measures have been announced to compensate for these, and more are probably in the pipeline. At the same time the federal government is seeking to increase its so-called extraordinary receipts, such as those derived from the sale of infrastructure investment project concessions, and endeavoring to bolster regional governments' contribution to fiscal consolidation by avoiding enforcement of a new formula that reduces the interest due on their existing debts to the Union.

Despite all this, strict control of expenditure is set to continue for the rest of the year. The difficulties are substantial but we expect the primary surplus target to be met. Brazil's sovereign rating and borrowing costs depend on its doing so, although more important than the target itself is the reversal of fiscal policy, which has already helped sustain the rating agencies' perception that Brazil is now on the right track.

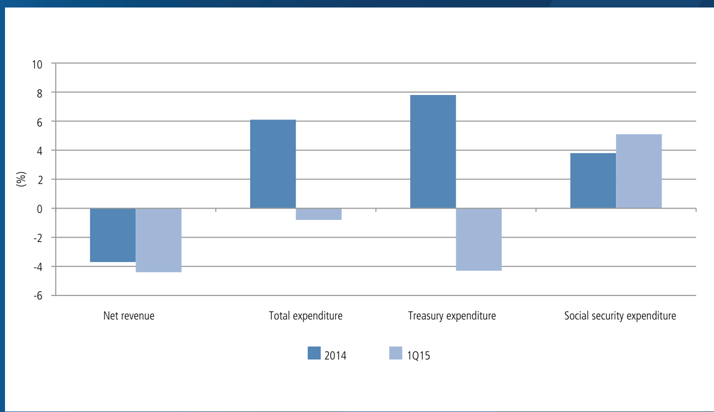
These demonstrations of the government's commitment to putting its house in order have moderately improved business and consumer confidence, according to the April surveys. We see this as a sign that confidence has stopped falling, although it is still very low. By now expectations have taken into account a substantial proportion of the new economic policy's effects. The exception is the manufacturing sector, which is in a more critical situation, but good news yet to be incorporated includes a significant reduction in the risk of electricity rationing and the resumption of auctions to sell infrastructure concessions, which should give the economy a fresh impetus, especially in construction. Stabilization of confidence does not imply an immediate reversal of the previous trend but will allow investment to resume at a later stage. In sum, we do not foresee a material change in projections for GDP growth in 2015. We continue to forecast a contraction of 1.0% due mainly to falling household consumption and investment. The external sector may contribute positively, but not enough to prevent the economy from contracting overall in 2015.

Brazilian financial assets posted strong gains at the start of the second quarter. The prospect of a gradual and uneven global economic recovery associated with undesirably low inflation encouraged central banks to persist with programs designed to keep liquidity abundant, so that investors felt more confident about pursuing higher yields on riskier assets. The Bovespa Index performed quite well, gaining 9.9% in local currency terms, or 17.1% in dollar terms considering the appreciation of the Brazilian Real (BRL) seen in April. Country risk improved sharply to 220 basis points, the level seen at the start of the year, after deteriorating for five straight months. This movement, intensified by publication of Petrobras's audited financial statements and other developments suggesting that the risk of extreme local events has diminished considerably, including the commitment to fiscal consolidation and reaffirmation of S&P's sovereign investment grade rating, contributed decisively to local currency appreciation of 5.7% in the month, taking the BRL/USD exchange rate close to 3.00. The longer-dated portion of the domestic yield curve fell by some 20 bps to about 12.70% in response to confirmation that the Central Bank's Monetary Policy Committee (Copom) had opted for another hike of 50 bps in the Selic rate.

In May we expect Brazilian assets to consolidate their recent gains, with US monetary policy set to remain unchanged. The BRL may even appreciate with the inflow of foreign funds but we expect this to be limited since the Central Bank has begun winding down the stock of dollar swaps.

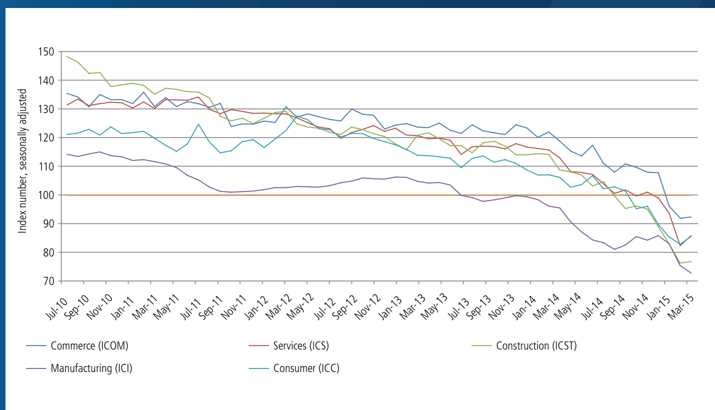
With regard to monetary policy we believe the Copom will enter fine-tuning mode from now on and expect two more Selic hikes of 25 bps. The monetary authorities are taking a more vigilant stance with the aim of guaranteeing at least the IPCA's convergence to 4.5% in 2016, but official documents have stressed that the progress achieved in combating inflation is not yet sufficient: upside pressures fueled by price realignment kept average monthly inflation on 1.26% in 1Q15, although deceleration is expected going forward. Following the announcement of a lottery price reset, however, we have revised up our IPCA projection for 2015 to 8.4%.

**Change in central-government expenditure and revenue, year-over-year (%)**




Source: National Treasury

**Confidence surveys**




Source: FGV