Brazilian Economic Outlook

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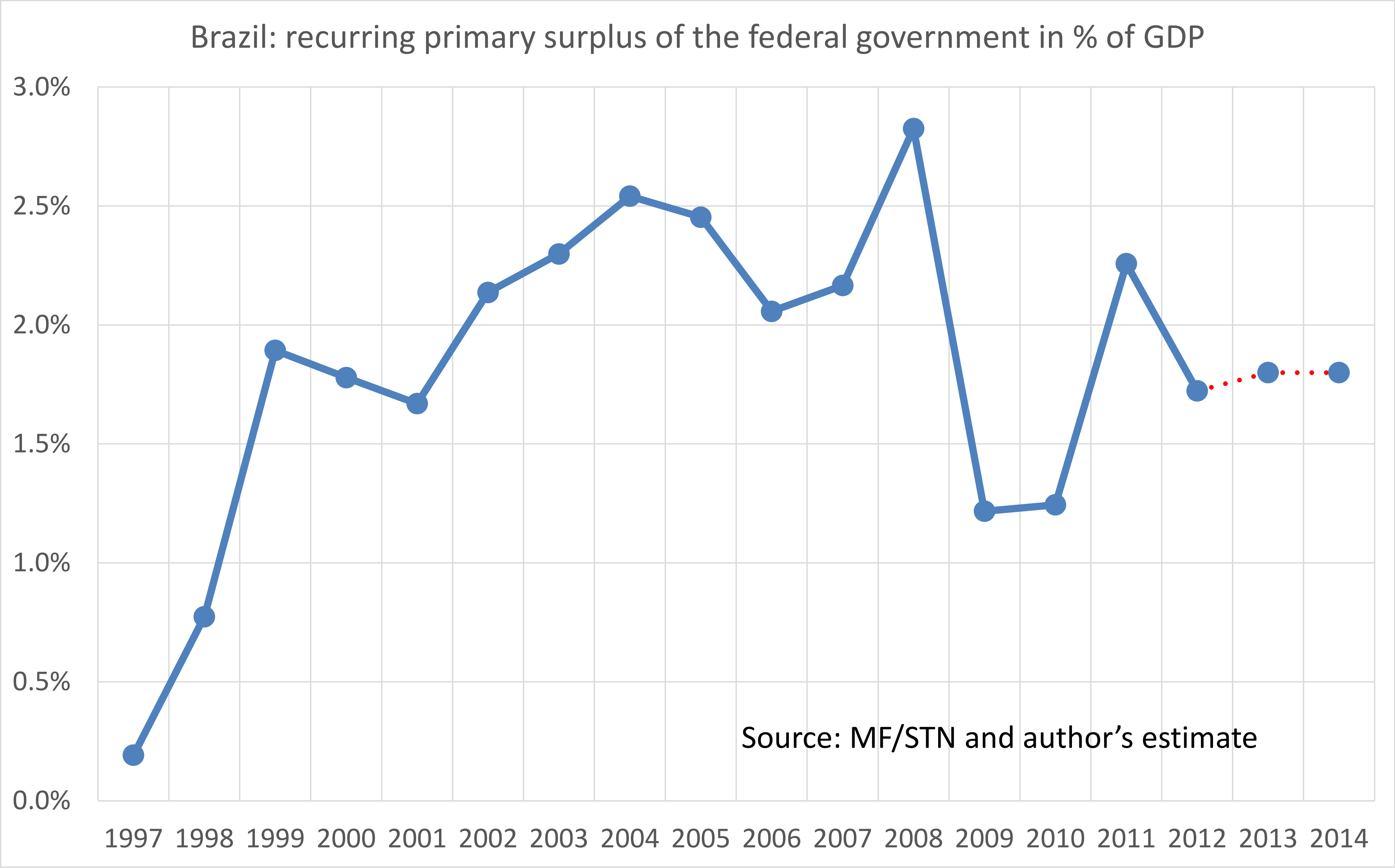
Four questions

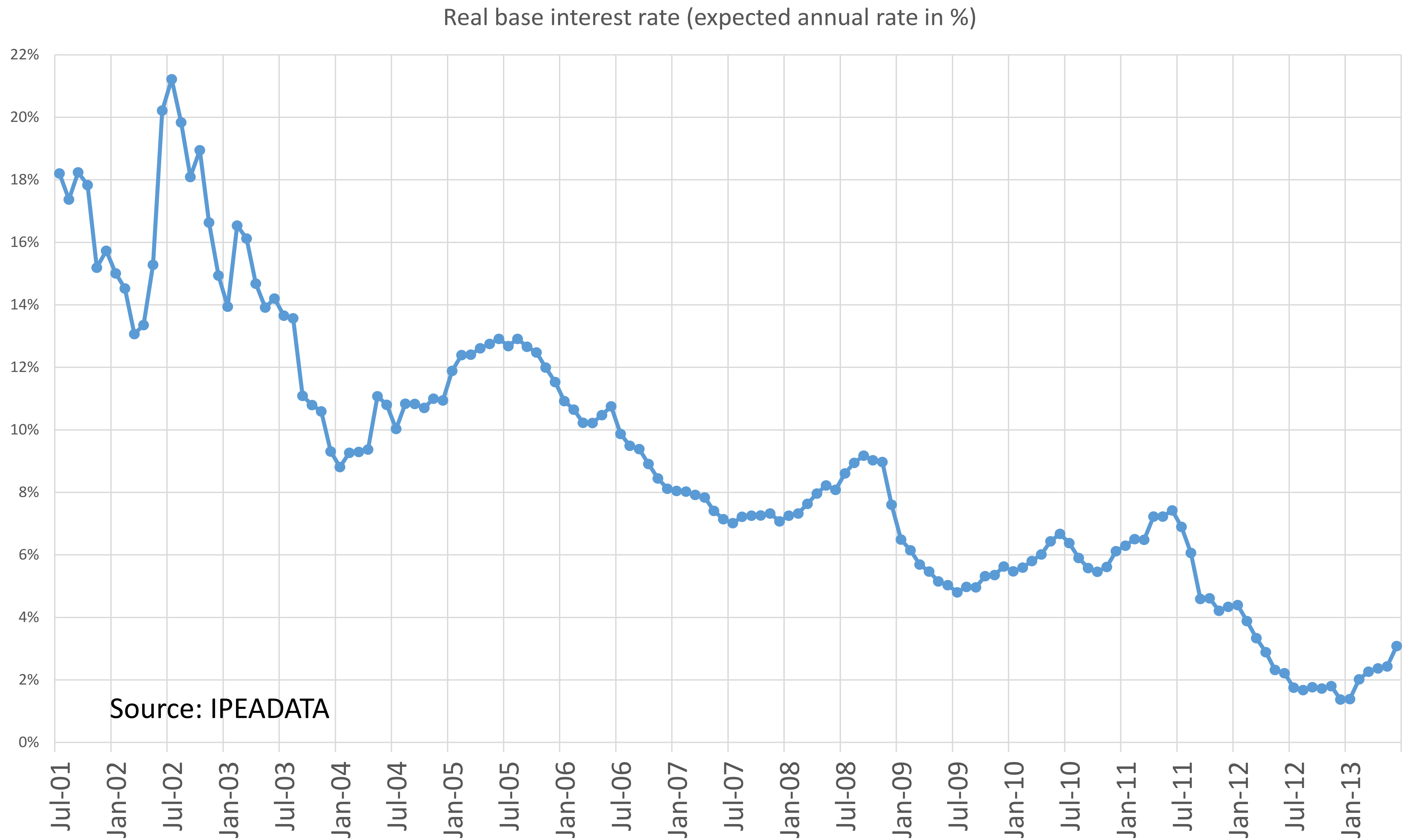
1) Why economic growth decelerated?
2) Why inflation accelerated?
3) What happened to fiscal policy?
4) What's next for the economy?

Why economic growth decelerated?

- For statistical reasons, economic growth would have slowed anyway in 2011
- But the economy slowed down more than expected because of a combination of adverse factors
  - Excessively restrictive macro policy in 2011
  - Adverse changes in the international scenario
  - Generalized fall in private investment and delays in public investment

Brazil: GDP growth
8%
7%
6%
5%
4%
3%
2%
1%
0%
-1%
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
Markets' expectations
Source: IPEADATA


Brazil: recurring primary surplus of the federal government in % of GDP
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014
Source: MF/STN and author's estimate



Real base interest rate (expected annual rate in %)
22%
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
Source: IPEADATA
Jul-01
Jan-02
Jul-02
Jan-03
Jul-03
Jan-04
Jul-04
Jan-05
Jul-05
Jan-06
Jul-06
Jan-07
Jul-07
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Jan-10
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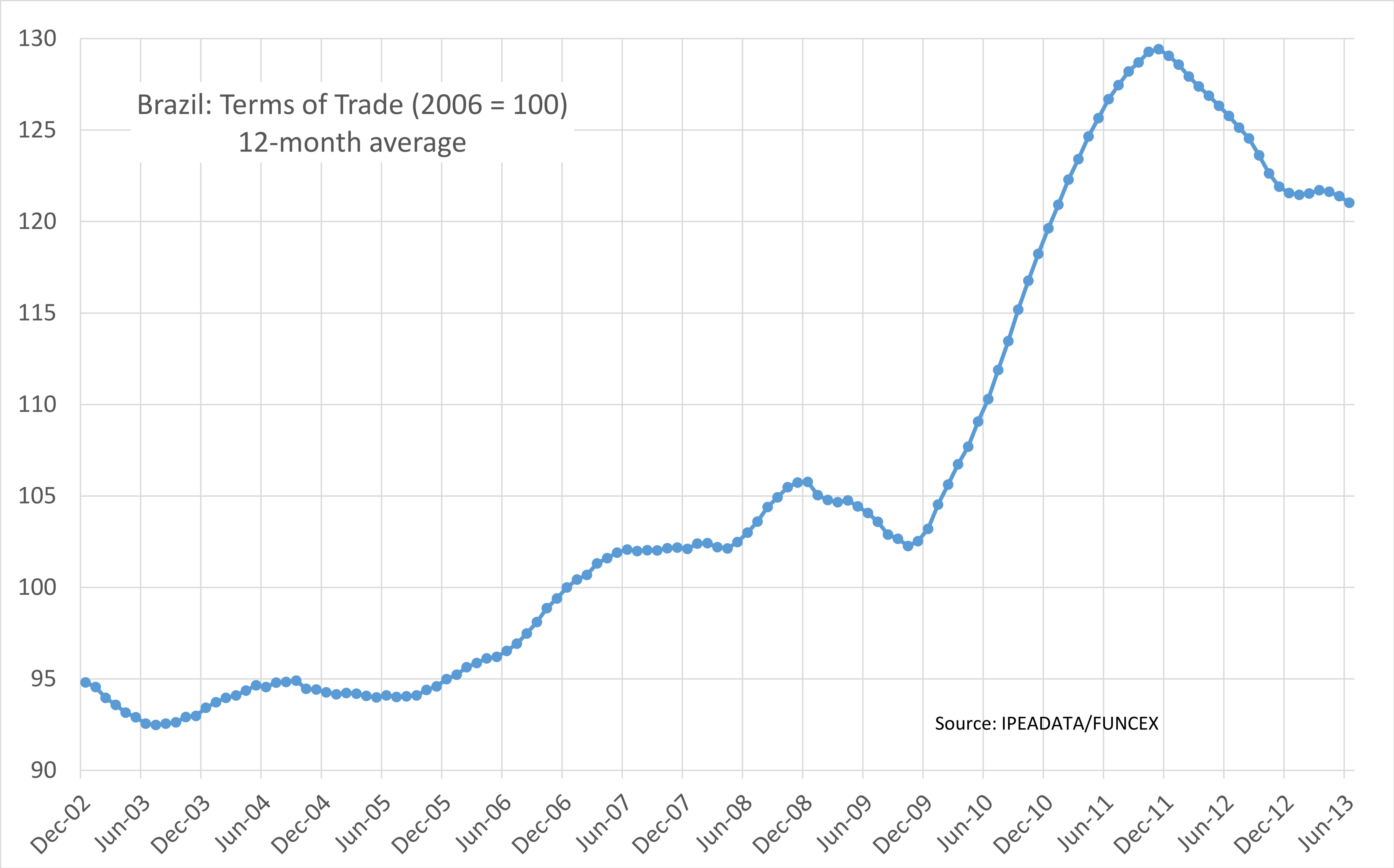
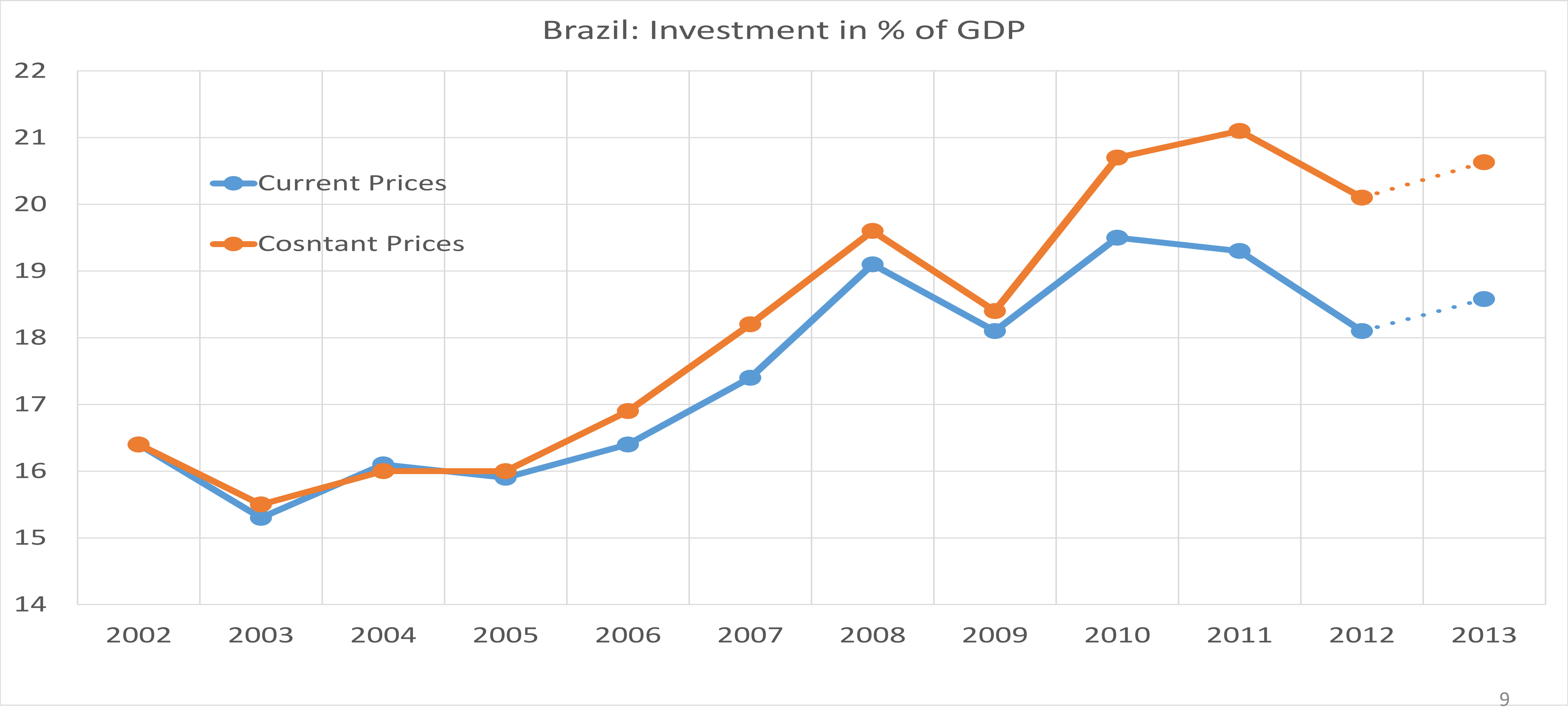
Jan-11
Jul-11
Jan-12
Jul-12
Jan-13


Brazil: Terms of Trade (2006 = 100)
12-month average
130
125
120
115
110
105
100
95
90
Source: IPEADATA/FUNCEX
Dec-02
Jun-03
Dec-03
Jun-04
Dec-04
Jun-05
Dec-05
Jun-06
Dec-06
Jun-07
Dec-07
Jun-08
Dec-08
Jun-09
Dec-09
Jun-10
Dec-10
Jun-11
Dec-11
Jun-12
Dec-12
Jun-13

Reduction in investment

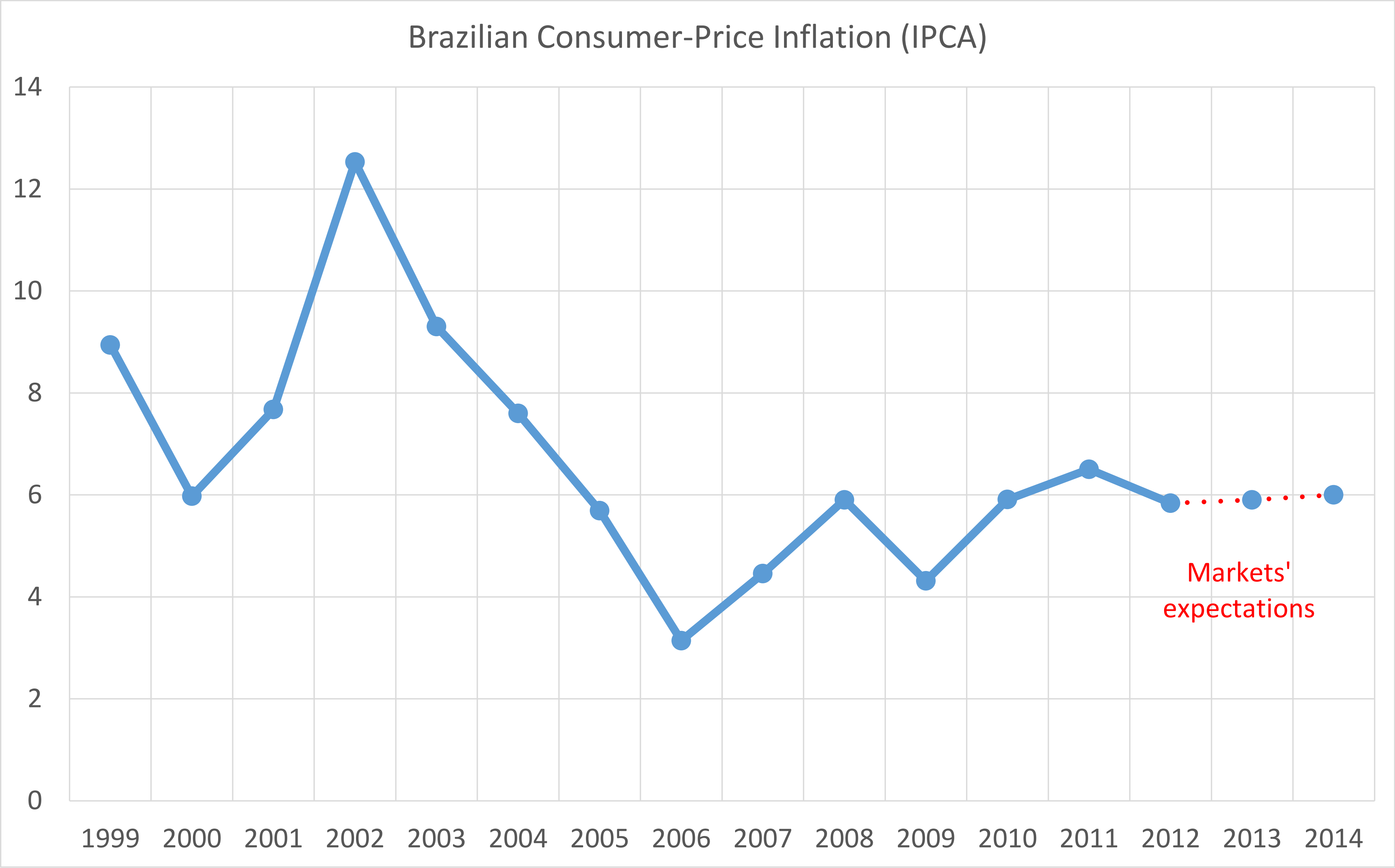
- **Commodity producers**: slowdown in global mining and comprehensive reevaluation of Petrobras's investment plan
- **Capital goods**: adverse product cycle in trucks and buses and delays in government programs (PSI)
- **Residential construction**: deceleration in construction due to the transition in the governments' housing program (MCMV 1 and 2)
- **Infra-structure**: reduction in public investment in transports, uncertainty about government regulation and delays in the government concessions' program

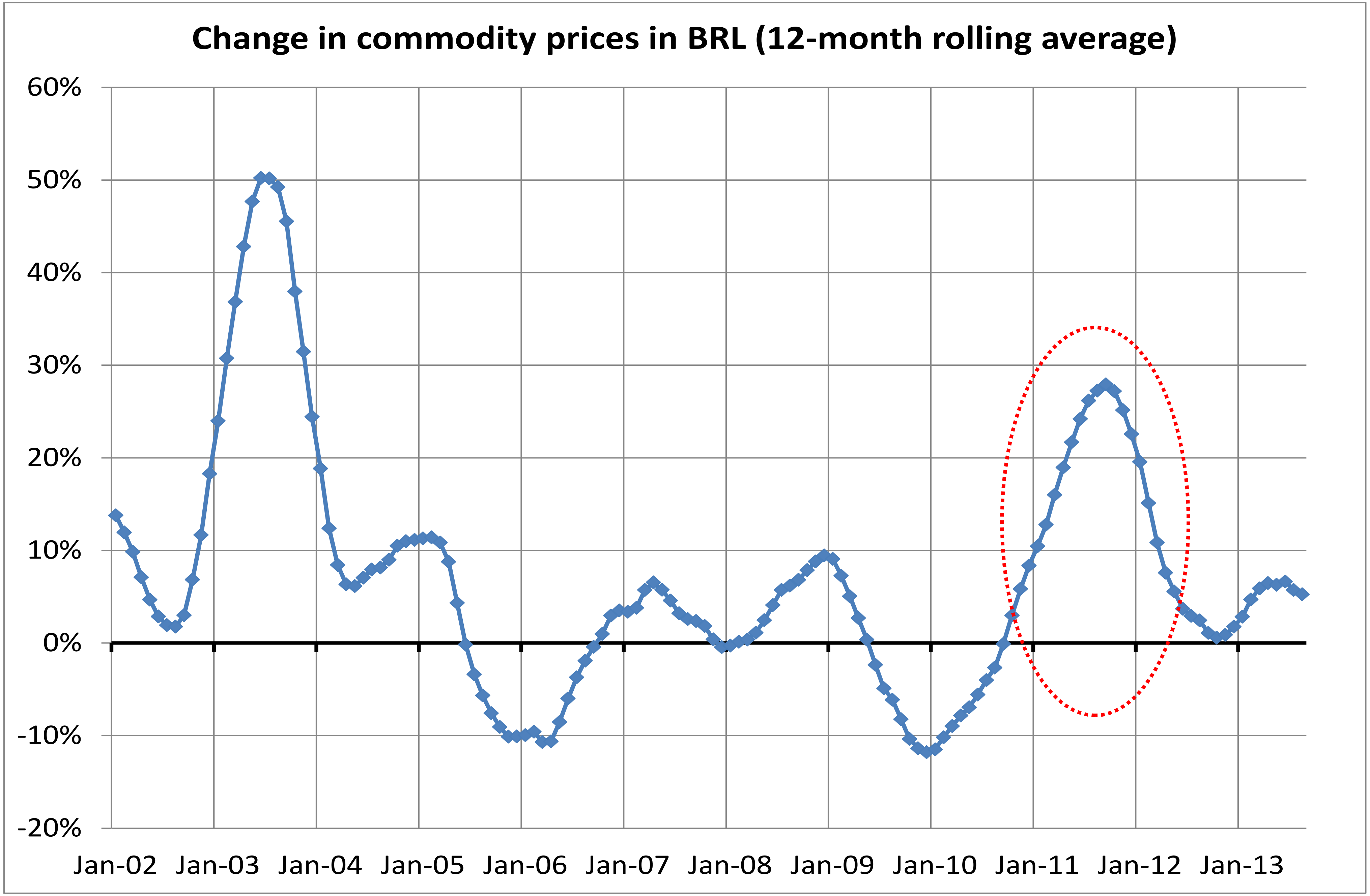
Investment-GDP ratio: despite the faster growth of investment in relation to GDP, the country's investment ratio did not go up substantially because there was also a reduction in the relative price of fixed capital (ER appreciation and tax cuts)



Why inflation accelerated?

- Sequence of adverse exogenous shocks, domestic and international, pushed prices up
- Demographic trends and government’s policies resulted in very low unemployment rates, which in turn kept services’ inflation high
- The recent depreciation of the BRL also raised inflation
- And mixed signals from the government increased the transmission of localized shocks to inflation expectations (SELIC and the exchange rate)


Brazilian Consumer-Price Inflation (IPCA)
14
12
10
8
6
4
2
0
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014
Markets' expectations


Change in commodity prices in BRL (12-month rolling average)
60%
50%
40%
30%
20%
10%
0%
-10%
-20%
Jan-02
Jan-03
Jan-04
Jan-05
Jan-06
Jan-07
Jan-08
Jan-09
Jan-10
Jan-11
Jan-12
Jan-13

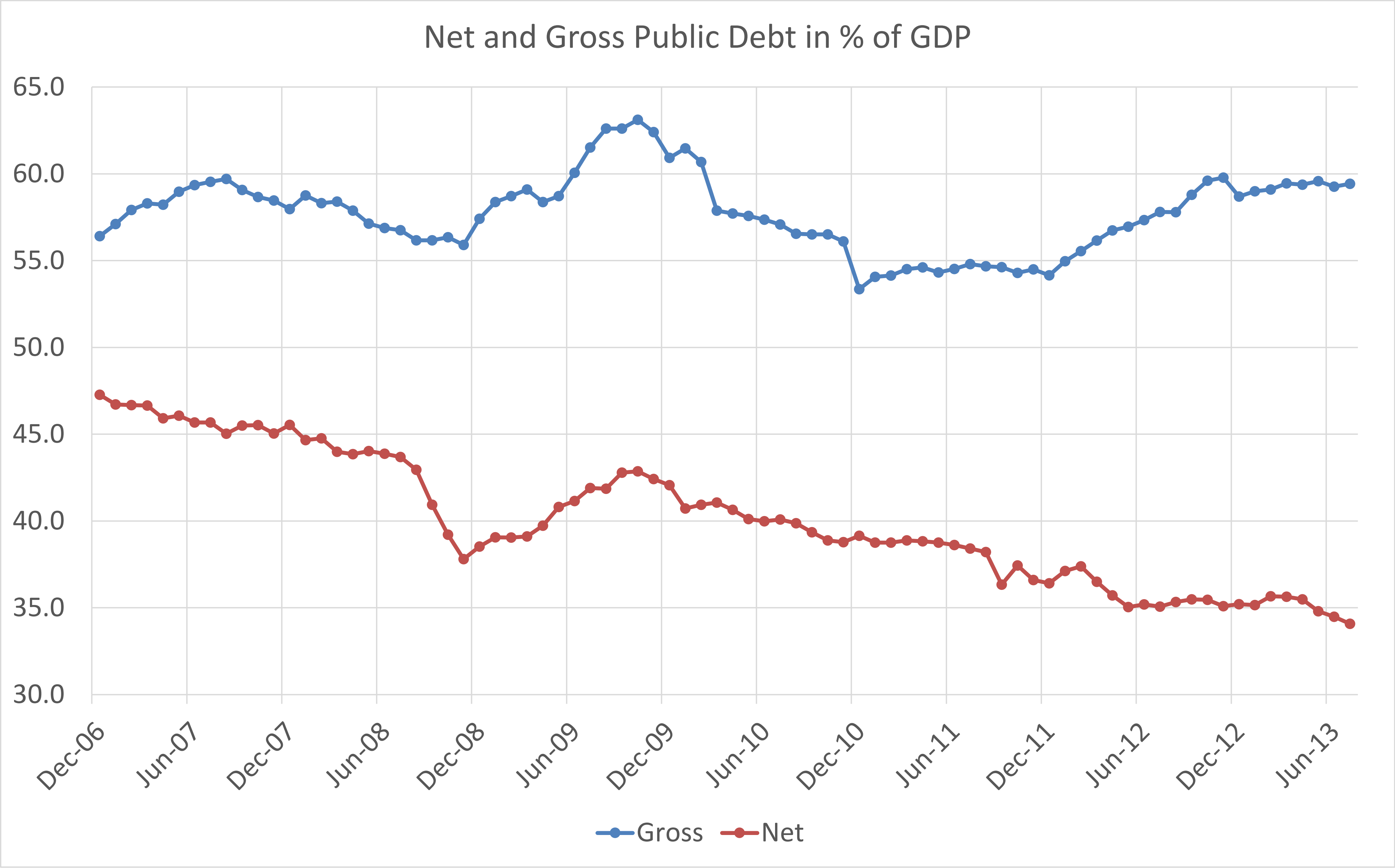
What happened to fiscal policy?

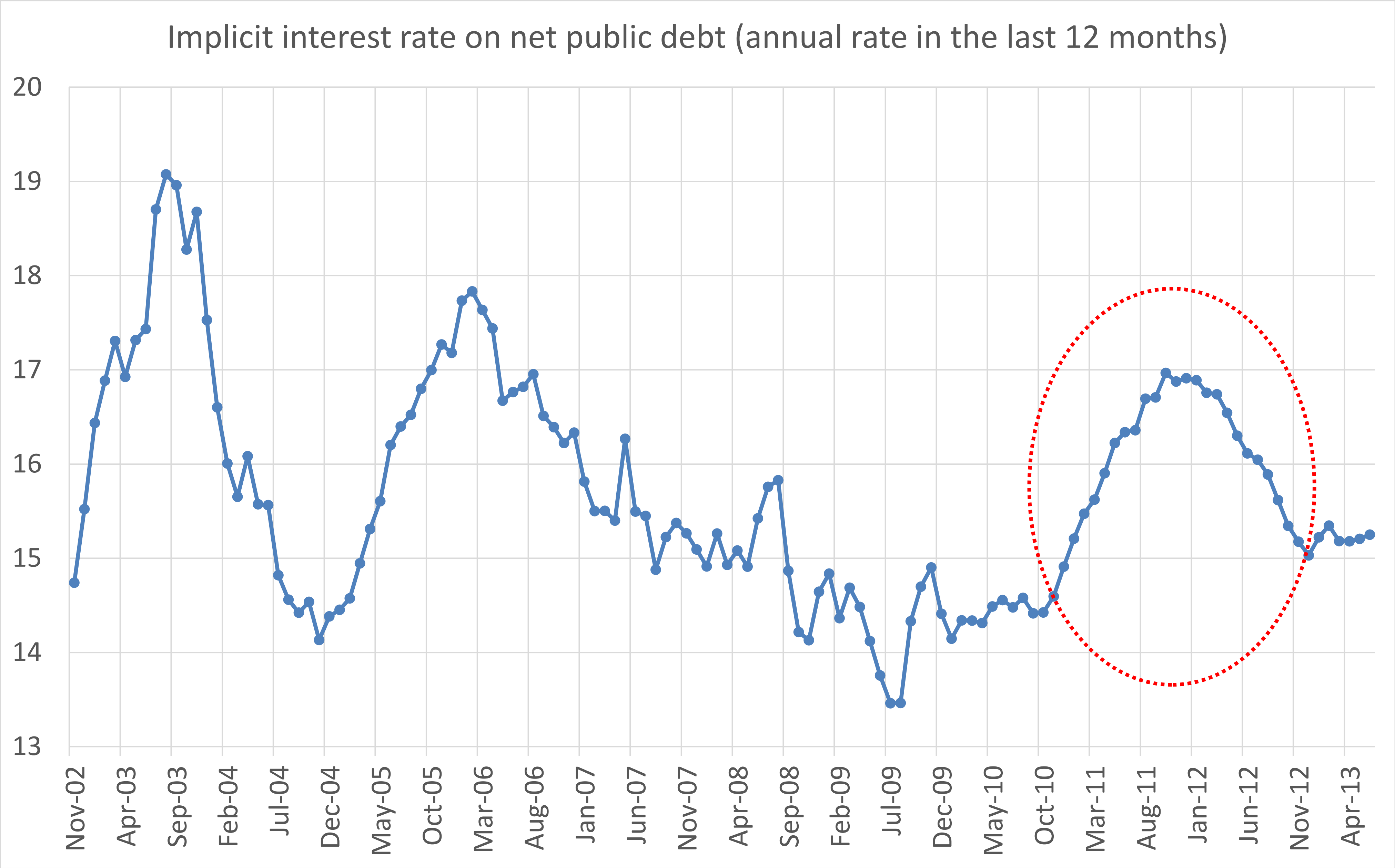
- Excessive fiscal restrain in 2011 eroded the sustainability of high primary surpluses in 2012 and 2013
- The government adopted a series of tax cuts to accelerate growth and control inflation
- Many policies were based on financial incentives rather than on primary expenditures to avoid reducing the primary balance further (increase in gross debt)
- The result was a declining net public debt, but with a very high implicit interest rate (increase in the “neutral” primary surplus)

Brazilian primary budget in % of GDP: the increase in the federal primary expenditures was concentrated in income transfers to families, through social-security benefits (indexed to the minimum wage) and cash transfers to the poor (Bolsa Familia).

Numbers in % of GDP	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012		Change 2002-12
Net primary revenue	17,9	17,4	18,1	18,8	19,0	19,3	19,2	18,9	18,7	19,7	20,0		2,1
Net primary expenditure	15,7	15,1	15,6	16,4	17,0	17,1	16,4	17,7	17,4	17,5	18,3		2,6
Government payroll and pensions	4,8	4,5	4,3	4,3	4,5	4,4	4,3	4,7	4,4	4,3	4,2		-0,6
Income transfers to families	**6,6**	**7,2**	**7,6**	**8,1**	**8,4**	**8,5**	**8,1**	**8,7**	**8,5**	**8,6**	**9,2**		**2,6**
Investment	0,8	0,3	0,5	0,5	0,6	0,7	0,9	1,0	1,2	1,2	1,3		0,5
Other primary expenditures	3,5	3,2	3,2	3,5	3,4	3,5	3,1	3,2	3,3	3,4	3,5		0,0
Primary balance*	2,1	2,3	2,5	2,5	2,1	2,2	2,8	1,2	1,2	2,3	1,7		-0,4

* The number does not include non-recurrent revenues and expenditures, Source: Brazilian MoF and author's calculation


Net and Gross Public Debt in % of GDP
65.0
60.0
55.0
50.0
45.0
40.0
35.0
30.0
Dec-06
Jun-07
Dec-07
Jun-08
Dec-08
Jun-09
Dec-09
Jun-10
Dec-10
Jun-11
Dec-11
Jun-12
Dec-12
Jun-13
Gross
Net



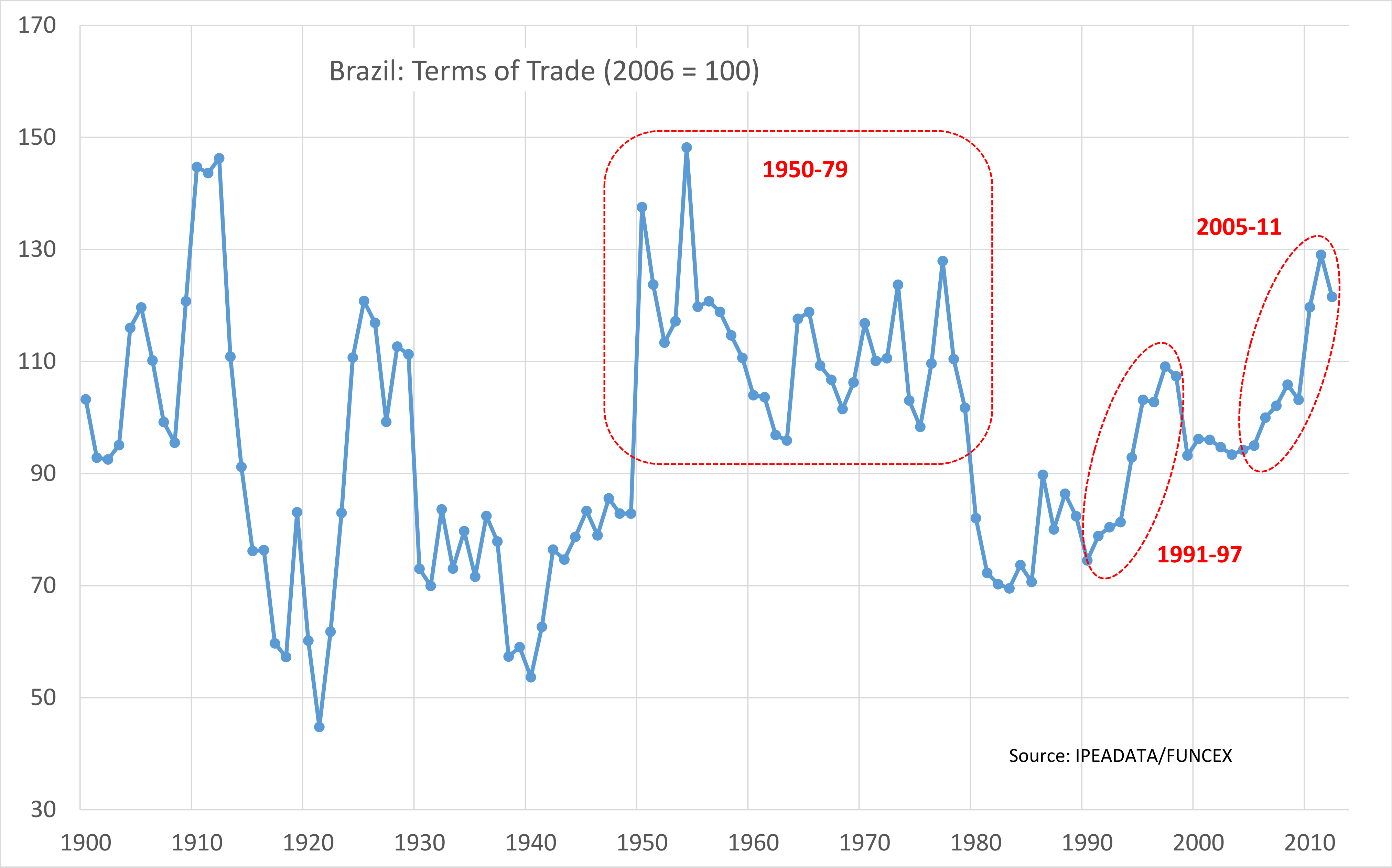
Implicit interest rate on net public debt (annual rate in the last 12 months)
20
19
18
17
16
15
14
13
Nov-02
Apr-03
Sep-03
Feb-04
Jul-04
Dec-04
May-05
Oct-05
Mar-06
Aug-06
Jan-07
Jun-07
Nov-07
Apr-08
Sep-08
Feb-09
Jul-09
Dec-09
May-10
Oct-10
Mar-11
Aug-11
Jan-12
Jun-12
Nov-12
Apr-13

Markets' vs People's Demands

- The economy cannot return quickly to its pre-crisis primary balance
- Society's demands on the state require new tax cuts and/or an increase in some expenditures (health, education, public transportation, etc)
- But market agents recommend a more restrictive fiscal policy (the expansionary fiscal contraction one more time)
- The short-run solution lies in more transparency and accountability rather than on more austerity
- And the lower primary balance can and should be compensated by slower growth of financial operations and gross debt

What’s Next?

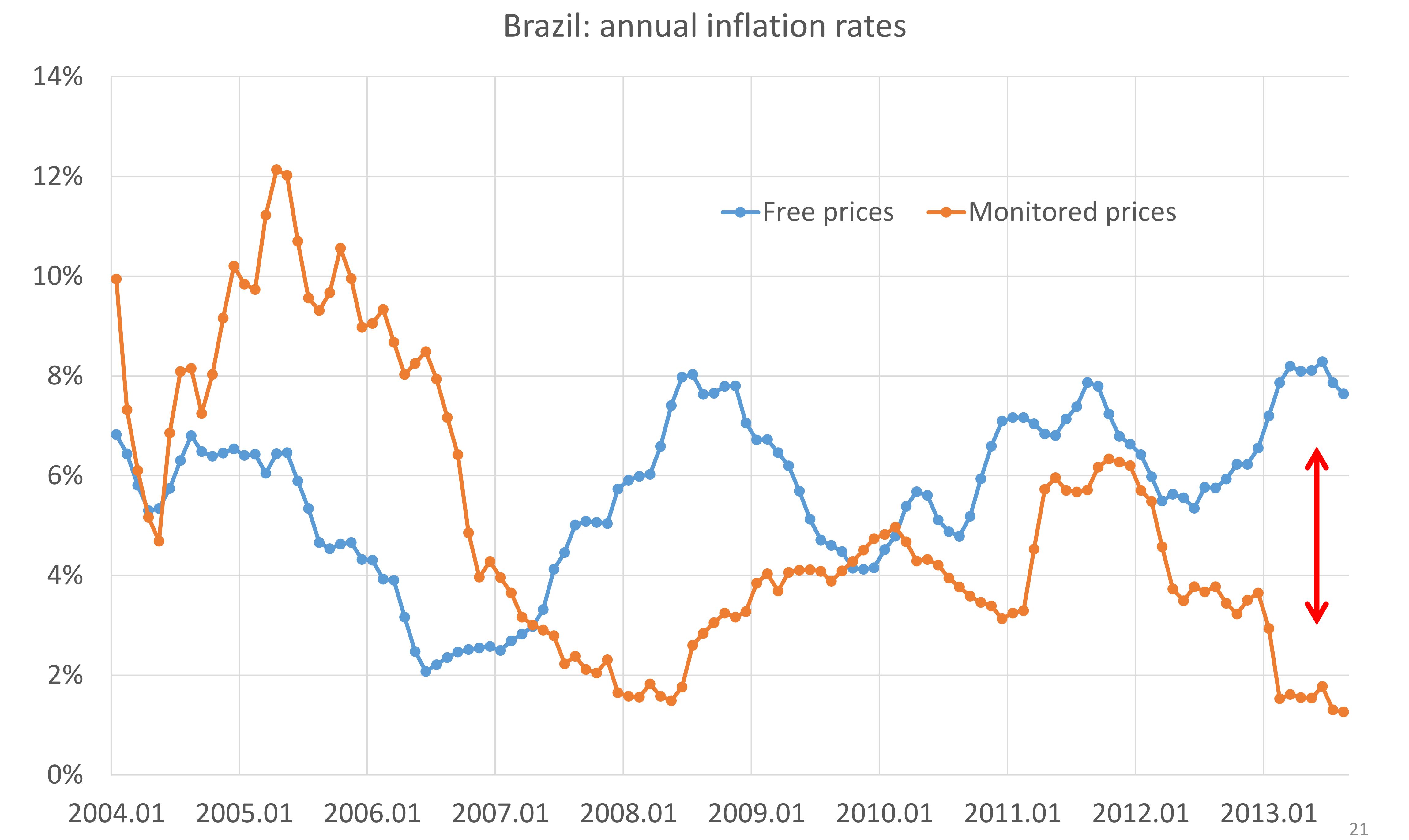
- Despite the recent macroeconomic results, Brazil still has a favorable growth potential
  - Commodity production (food, mining and oil)
  - Expansion and modernization of infra-structure
  - Expanding middle class and residential investment
  - Urban development (mass transport, water and sanitation)
- The main challenge is to combine the above domestic “growth avenues” with product diversification and innovation in a more adverse international scenario, in which ER appreciation can no longer help inflation targeting



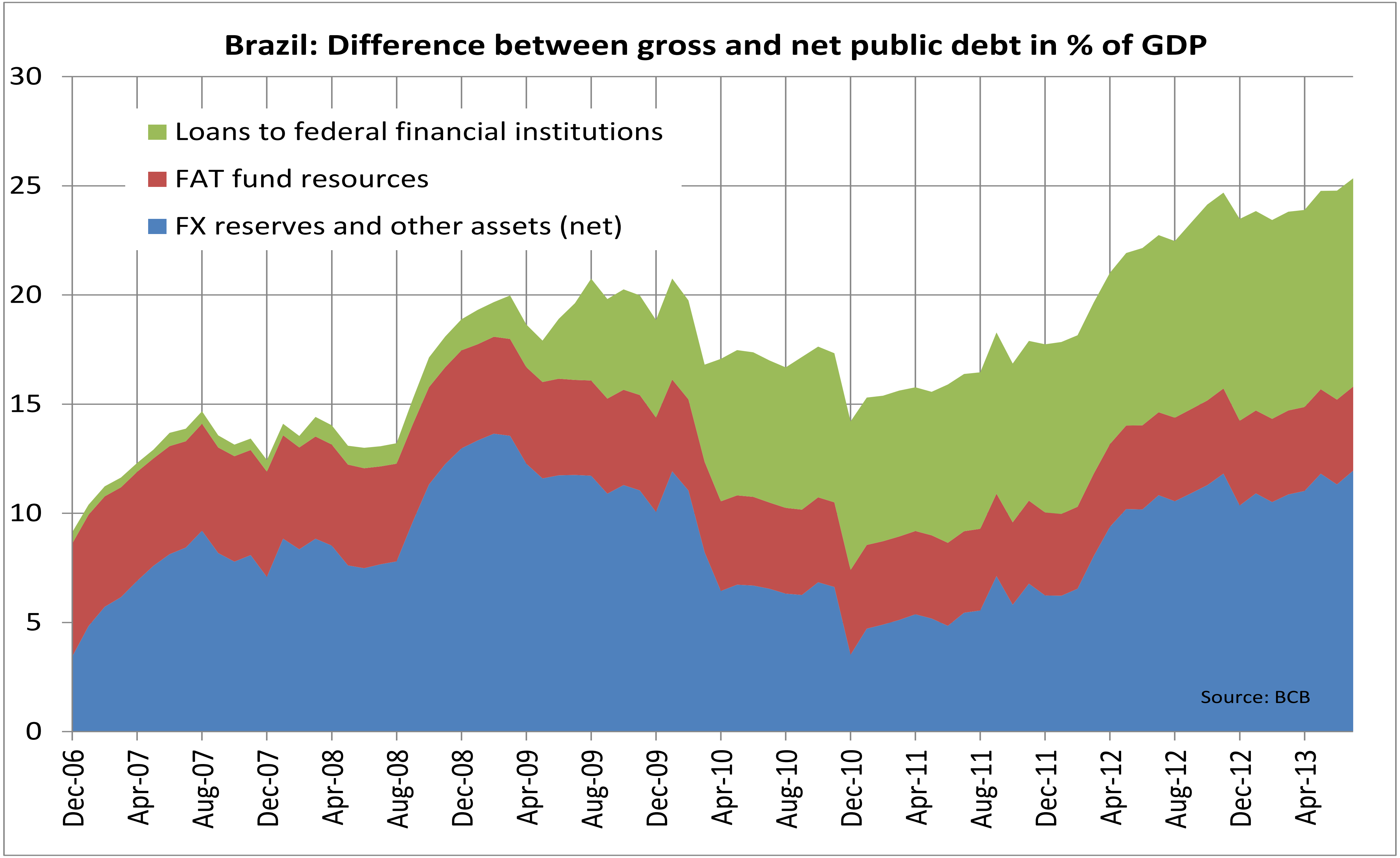
Brazil: Terms of Trade (2006 = 100)
1950-79
2005-11
1991-97
Source: IPEADATA/FUNCEX
170
150
130
110
90
70
50
30
1900
1910
1920
1930
1940
1950
1960
1970
1980
1990
2000
2010

Clear and Immediate Problems

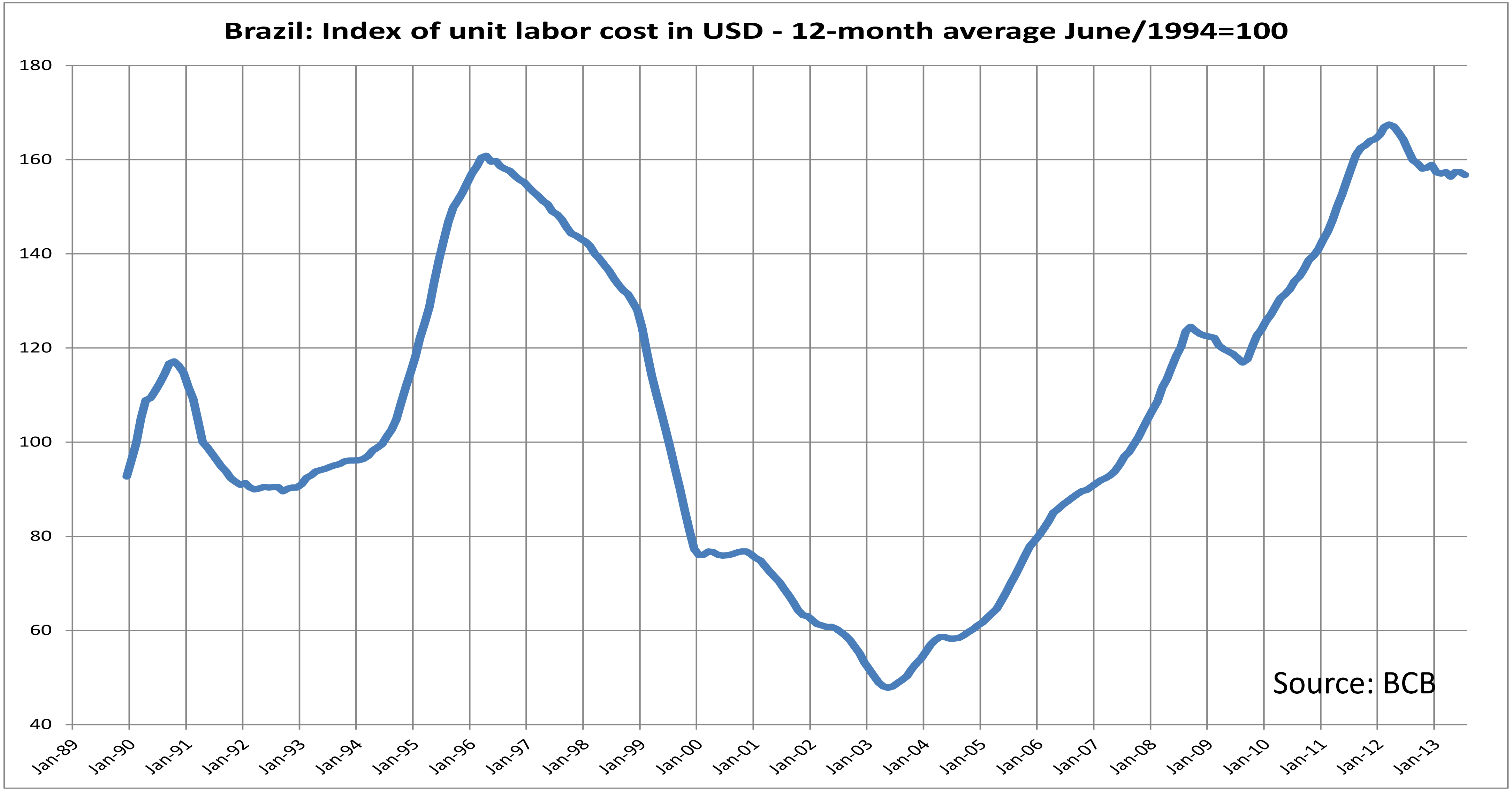
- **Repressed inflation**: fuel prices, electricity prices and tariffs on public transportation have been kept constant for too long
- **Gross debt**: the increase in financial operations through state-controlled banks (Caixa and BNDES) blocks the reduction in the net financial cost of public debt
- **Exchange-rate realignment**: high current account deficits and changes in the terms of trade indicate that the BRL will have to depreciate further before stabilizing at a new value



Brazil: annual inflation rates
14%
12%
10%
8%
6%
4%
2%
0%
Free prices
Monitored prices
2004.01
2005.01
2006.01
2007.01
2008.01
2009.01
2010.01
2011.01
2012.01
2013.01


Brazil: Difference between gross and net public debt in % of GDP
Loans to federal financial institutions
FAT fund resources
FX reserves and other assets (net)
Source: BCB
30
25
20
15
10
5
0
Dec-06
Apr-07
Aug-07
Dec-07
Apr-08
Aug-08
Dec-08
Apr-09
Aug-09
Dec-09
Apr-10
Aug-10
Dec-10
Apr-11
Aug-11
Dec-11
Apr-12
Aug-12
Dec-12
Apr-13

<u>Brazilian unit-labor cost:</u> the impact of high TOT on the exchange rate increased the country's ULC in USD, which in its turn reduced the competitiveness of the tradable sector and resulted in a two-velocity economy in recent years.



<u>The government's response</u>

- Improvements in the **communication** of macroeconomic policy
  - FX interventions with no commitment to a specific value of the ER
  - Lower but more realistic fiscal targets
  - Back to inflation targeting through changes in the SELIC rate
- Reduced **intervention** in regulated markets
- Reduction in financial loans to **state banks**
- Adjustment of **fuel prices** in the near future (?)

Eppur si muove

- Despite the markets' perception that reforms have stalled after 2005, many important initiatives have been implemented in recent years
  - **2009**: new regulation for housing finance
  - **2010**: new private financial instruments (LF and project bonds)
  - **2011**: PRONATEC, new antitrust law and new credit rating system
  - **2012**: new savings deposits and FUNPRESP
  - **2013**: concessions in infrastructure and ABGF

What to expect in 2015-18?

- **Monetary policy**: price liberalization will generate a temporary increase in inflation, which will slow or even stabilize real interest rates in the near future
- **Infra-structure**: increase in investment with greater participation of private capital (concessions, PPPs, etc)
- **Fiscal reform**: low primary balance, but with a reduction in gross public debt and more fiscal transparency and accountability, especially of financial operations
- **Structural reforms**: continuing tax reform (PIS/COFINS and ICMS), and financial deepening (less BNDES and more private sources of long-term funding)

What are the main challenges?

- **Social security**: labor unions demand changes in the current system ("fator previdenciário"), which are not sustainable in the long run
- **Labor regulation**: need of modernization must be matched by an increase in Union participation
- **Reindustrialization**: increase industrial density and product diversification of the economy (more innovation and investment in ICT) without wage repression