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BRAZIL ECONOMIC FOCUS: JANUARY 2015

Summary

Brazil Economic Scorecard for 2014

Brazil's economic performance in 2014 assessed. Better prospects for the direction of economic policy in 2015. Much needed fiscal correction is on its way, now the main focus of the government. Monetary tightening cycle continues and should slowly bring inflation down. Growth is likely to be flat, but confidence is being restored through a more stable and predictable economic policy. Risks remain in finding the right balance of fiscal and monetary correction without jeopardising growth unduly.

Clear Direction Set but Tough Challenges Ahead

Government's new economic team adjusts previous economic policy significantly. Fiscal transparency and letting regulated prices adjust are but two of the measures already being taken. The Government is keen to re-establish market confidence and avoid a debt downgrade.

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Access FCO economic political publications on Brazil on the UKTI website here

Brazil Economic Scorecard for 2014

1. **2014 was marked by the World Cup and elections. Economic problems were postponed and now need to be faced.** A stronger than expected slowdown means 2014 growth of just 0.1-0.2% is forecast. Loose fiscal policy persisted till the elections in October, delaying the implementation of corrective measures and increasing the cost of adjustment. 2015 is the year of difficult decisions necessary to restore market confidence. Dilma's new economic team hopes to create the conditions for a return to higher growth.

2014 IS PERFORMANCE IS EXPRESSED IN COLOURS. 2015 TREND IN ARROWS.

			Trend
Unemployment	2013: 5.1% 2014: 5.2%* 2015: 5.4-6.1%*	Unemployment at lowest level since the series began in 2002. Total working population is also falling, as young people avail of subsidised education opportunities. Layoffs are happening in industry, notably automotives, but so far services have absorbed these job losses. Unemployment is expected to rise in 2015, by how much is unclear.	
Inflation *(Amber to Red)*	2013: 5.9% 2014: 6.4% 2015: 6.0-6.9%*	Inflation is expected to remain above the 4.5% target till 2016. A weaker Real and rising regulated prices will continue to increase inflation in the first half of 2015. In 2014 it was just within the target band. The base interest rate is expected to rise to 12.5-13% in early 2015. Inflation in unregulated prices should begin to fall in the second half of the year.	
GDP Growth	2013: 2.5% 2014: 0.1-0.2%* 2015 -0.3-1%*	Brazil's economy grew more slowly in 2014 than predicted. Growth in 2015 faces headwinds of fiscal and monetary tightening. Confidence may rise due to more credible macroeconomic management but significantly higher growth requires structural reform. Front loaded fiscal and monetary policy contraction will likely cause contraction early this year.	
Fiscal Deficit[1] *(Amber to Red)*	2012: -2.9% 2013: -3.3% 2014: -5.8% (12 months to Nov)	A -0.2% primary fiscal in 2014 means first time in 17 years not saving anything to pay interest on its debt. . A new economic team is now implementing fiscal correction – see Section 2. The fiscal target is a primary surplus 1.2% of GDP in 2015 and more than 2% in 2016 and 2017.	

Current Account Deficit[1]	2013: -3.5% 2014: -4.2% 2015: -3.8%*	2014 was the worst result since 2001. Commodity exports volumes grew but not value as prices fell. Iron ore exports volume grew 4.5% but earnings contracted by a fifth. The car sector was particularly hard hit by Argentina's woes. A healthy trade surplus has been paying for part of the large services deficit.	⇩
Exchange Rate	2013: R$ 2.36 / US$ 2014: R$ 2.66 / US$ 2015: R$ 2.80 /US$*	The Real is weakened more than anticipated in 2014 as QE ended in the US and growth slowed at home. The Brazilian Central Bank is only guaranteeing to provide half the 2014 level of swaps in 2015 and, so far only during Q1. The Real may weaken further in 2016 but unlikely to overshoot what fundamentals warrant especially if confidence in economic management rises.	⇩
Industrial Production *(Amber to Red)*	2013: 1.2% 2014: -1.95%* 2015: 1%*	Industrial production contracted in 2014 hit by weak domestic demand and falling exports to key regional markets such as Argentina and Venezuela. A modest recovery is possible in later 2015 if confidence rises.	⇨
Retail Sales	2013: 4.1% 2014: 2.6%* 2015: 3.0%*	Slowest retail growth in 11 years in 2014 reflects the pressures on consumers spending as real wage growth slows and purchasing power is reduced by high inflation and more expensive credit. The retailers association predicts a very modest increase in retail growth for 2015.	⇨
Credit Growth	2013: 14.0% 2014: 12.0%* 2015: 12.0%*	Credit growth has slowed as the average interest rate on loans rose to over 21%. The Central Bank reversed macro-prudential measures adopted in 2010 and 2011. These changes had a modest effect in stimulating credit. The announcement of a higher transaction tax on personal credit and higher interest rates should cause a further fall in credit growth in 2015. Default rates are still at record low (5.0% overall credit lines).	⇩

* indicates market forecast(s)

In Focus: Clear Direction Set but Tough Challenges Ahead

1. **The new economic team is adjusting policies implemented during the Government's first term.** These did not deliver higher growth and proved fiscally unsustainable. Changes include:
    - Using transparent fiscal targets and private sector indicators for GDP growth and inflation will improve the credibility in the eyes of the market ;

[1] As a % of GDP.

- Allowing regulated prices (electricity and bus fares) to rise to give truer signals to consumers and investors instead of holding down regulated prices at the cost of higher public subsidy ;
- Establishing a more level playing field by removing subsidies to key sectors and stimulating a private sector less dependent on government credit (BNDES state development bank, subsidised education loans helping large private university companies) and tax breaks (reduced manufacturing tax for automotives and other sectors).

2. **Several lengthy meetings between the President and her economic team show she is engaged in detail with the announcements.** In late December a series of welfare reforms make unemployment assistance and survivor's pensions, amongst other welfare benefits, more difficult to obtain. The Government raised the matriculation level for eligibility for the subsidised student loan programme FIES; in future the loans will only be available to students that persist with the same course in the same university. On 9 January, Finance Minister Joaquim Levy announced a R$1.9bn cut in permitted monthly discretionary spending by Government departments until passage of the 2015 Budget. 13 January came the announcement that subsidies to the electricity sector from the public purse are to end. The economic team is demanding a definitive solution to pricing in the sector including passing on the cost to the consumer. 19 January Levy announced a package of tax increases on fuel, personal credit transactions, cosmetics and imports.

3. **50-50 fiscal balance: cutting spending and increasing tax.** The Government has announced a package of measures that put it firmly on track to generate a primary fiscal surplus of 1.2% of GDP. It is already over the half way mark to raise R$80-100bn or £20-25bn.

Spending Cuts – R$27bn	**Amount R$ bn**	**% GDP**
Survivors Pension and Health Assistants	2	0.04
Unemployment Benefit and Low wage Bonus	16	0.3
Electricity Subsidies	9	0.2
Tax Increases – R$27bn		
Fuel Tax	12	0.2
Manufactures Tax	7	0.1
Financial Transaction Tax on Personal loans	7	0.1
Cosmetics and imports	1	0.02
Total	**54**	**1.0**

4. **Risks remain**. If economic growth slows, other tax receipts will fall. In addition, some categories of expenditure are still likely to rise. Factoring this in leads to a likely requirement of at least a further 0.5% of GDP to hit the 1.2% primary target. Not to mention. The water crisis which is affecting both electricity and water supply and may require higher expenditure while hurting economic growth and tax revenue. The Petrobras scandal may also significantly delay investment in2015. Petrobras alone accounts for 10% of investment in Brazil and most of the main construction companies are embroiled in the scandal leading to a squeeze on their financing and potential delays to their infrastructure projects.

5. **Inflation is likely to be above the 6.5% target in the first half of the year**. The removal of subsidies to the electricity sector and also the increases in taxes on fuel, imports, cars, furniture, and cosmetics will all boost inflation. The electricity price rises may be up to 30% and add up to 0.9% to

inflation. Some relief will come from new lower hydroelectric contracts that will be signed mid-year. However, a third year of drought means that thermal generation will likely run all year long at higher prices. The fuel tax will also cause higher inflation.

6. **The Central Bank Monetary Policy Committee announced a 0.5% increase in the base interest rate to 12.25% on 21 January**. It has promised "to do what it takes" to deal with the short term inflation spike and bend the trend downwards towards the 4.5% target by 2016. The increase in tax on personal credit from 1.5% to 3% will also help contain credit growth and curb inflation. Hitting the target in 2016 will not be an easy task. Regulated price inflation will be very high next year – 8.25% is the market expectation. A weaker Real (see December Economic Focus) would also boost inflation by making imports more costly. On the other hand the reduction in demand through fiscal and monetary tightening should see unregulated services and goods inflation continue to fall. The Central Bank hopes this will begin to bring inflation down in the second half of 2015.

Key Macroeconomic Indicators					
	Dec-13	**Mar-14**	**Jun-14**	**Sep-14**	**Dec-14**
Inflation (accum.)	5.91	6.15	6.52	6.75	6.41
Benchmark Interest Rate	10.5	10.75	11	11	11.75
Unemployment (%)	4.3	5	4.8	4.9	4.5*
Trade Balance (US$ bn)	2.6	0.1	2.3	-0.9	0.3
Exports (US$ bn)	20.8	17.6	20.4	20.6	17.2
Imports (US$ bn)	18.2	17.5	18.1	19.6	17.5
	Q4/2013	**Q1/2014**	**Q2/2014**	**Q3/2014**	**Q4/2014**
GDP (% var. QoQ)	0.5	-0.2	-0.6	0.1	

*Estimated