Brazilian Economic Outlook

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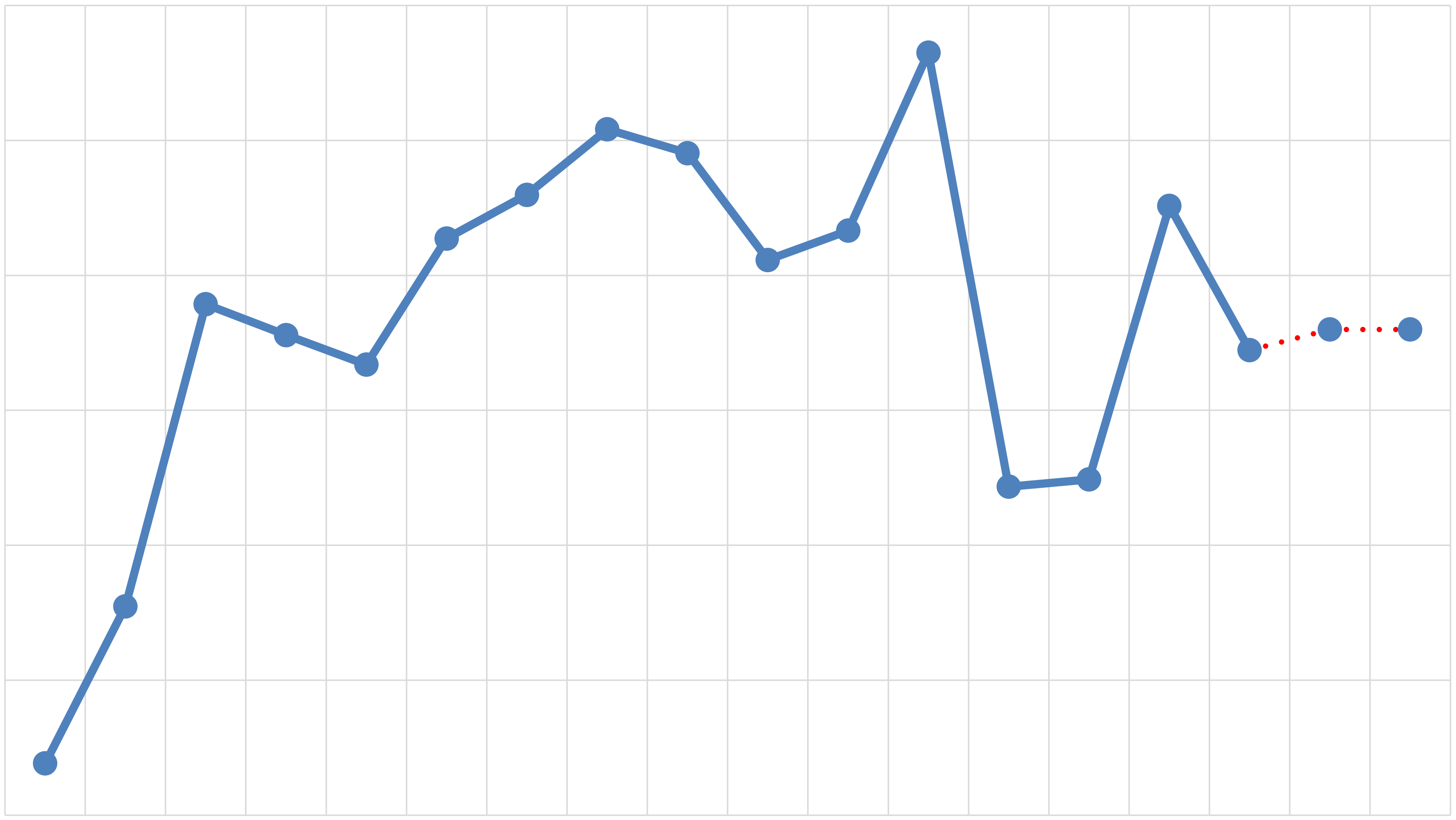
Four questions

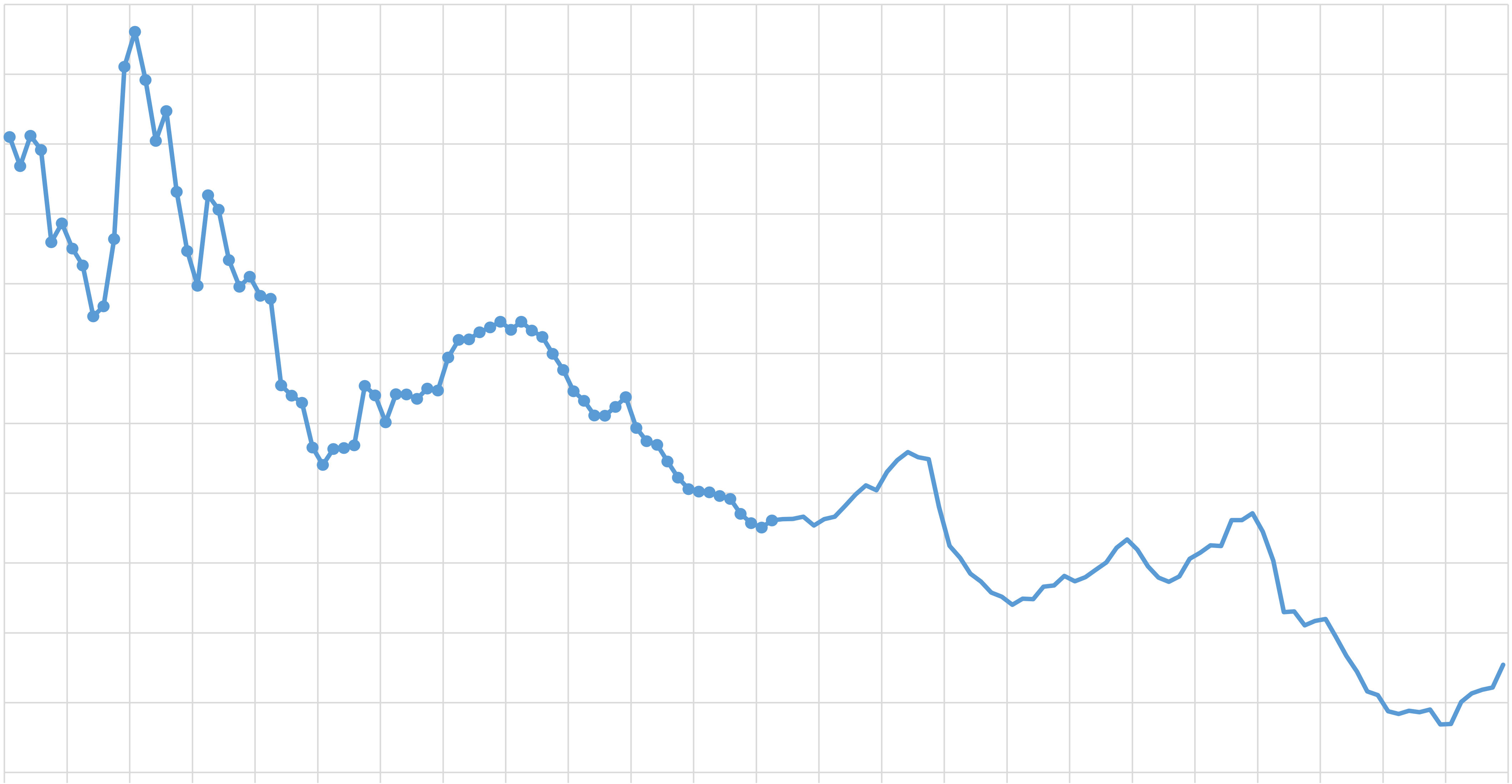
1) Why economic growth decelerated?
2) Why inflation accelerated?
3) What happened to fiscal policy?
4) What's next for the economy?

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





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

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
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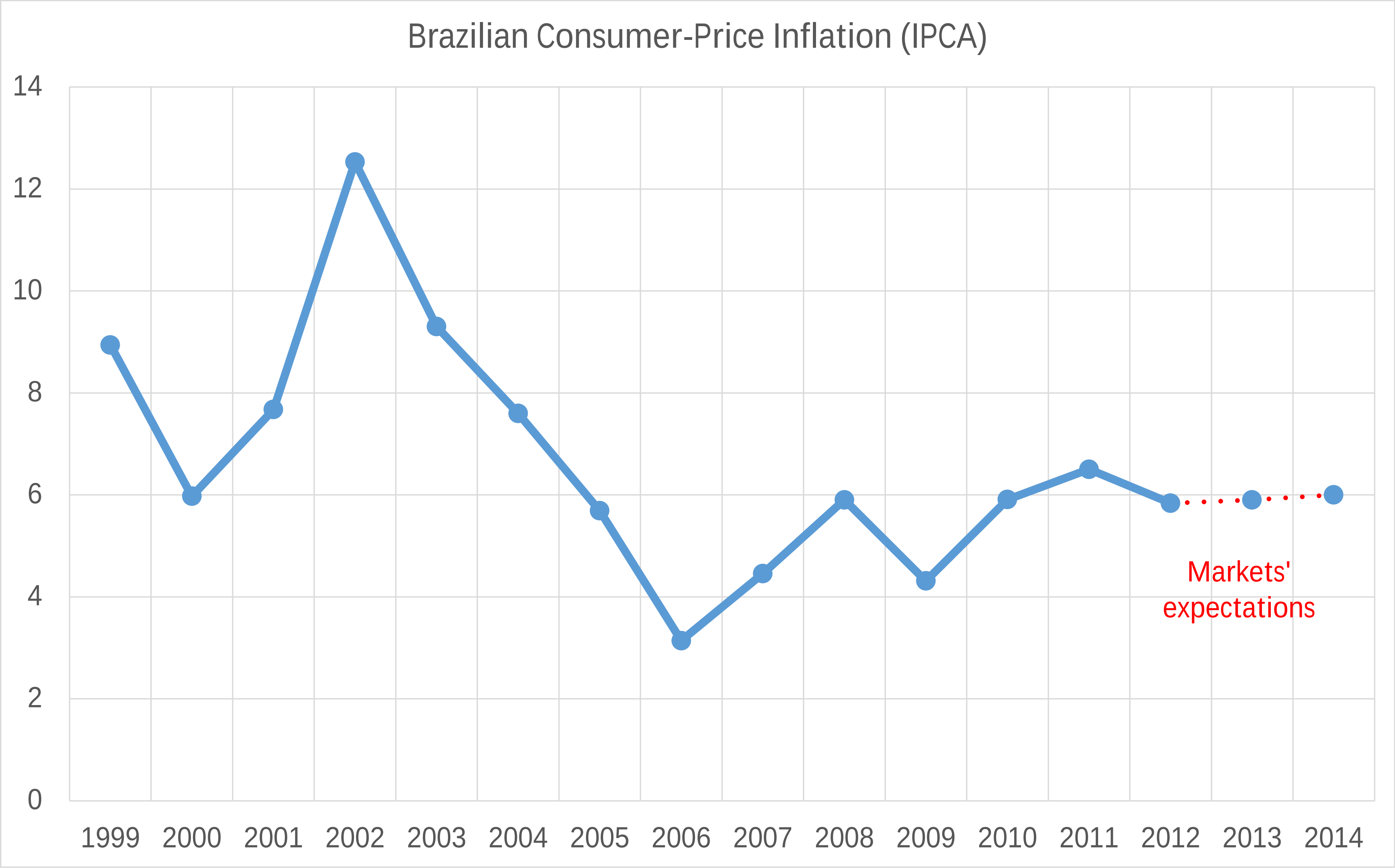
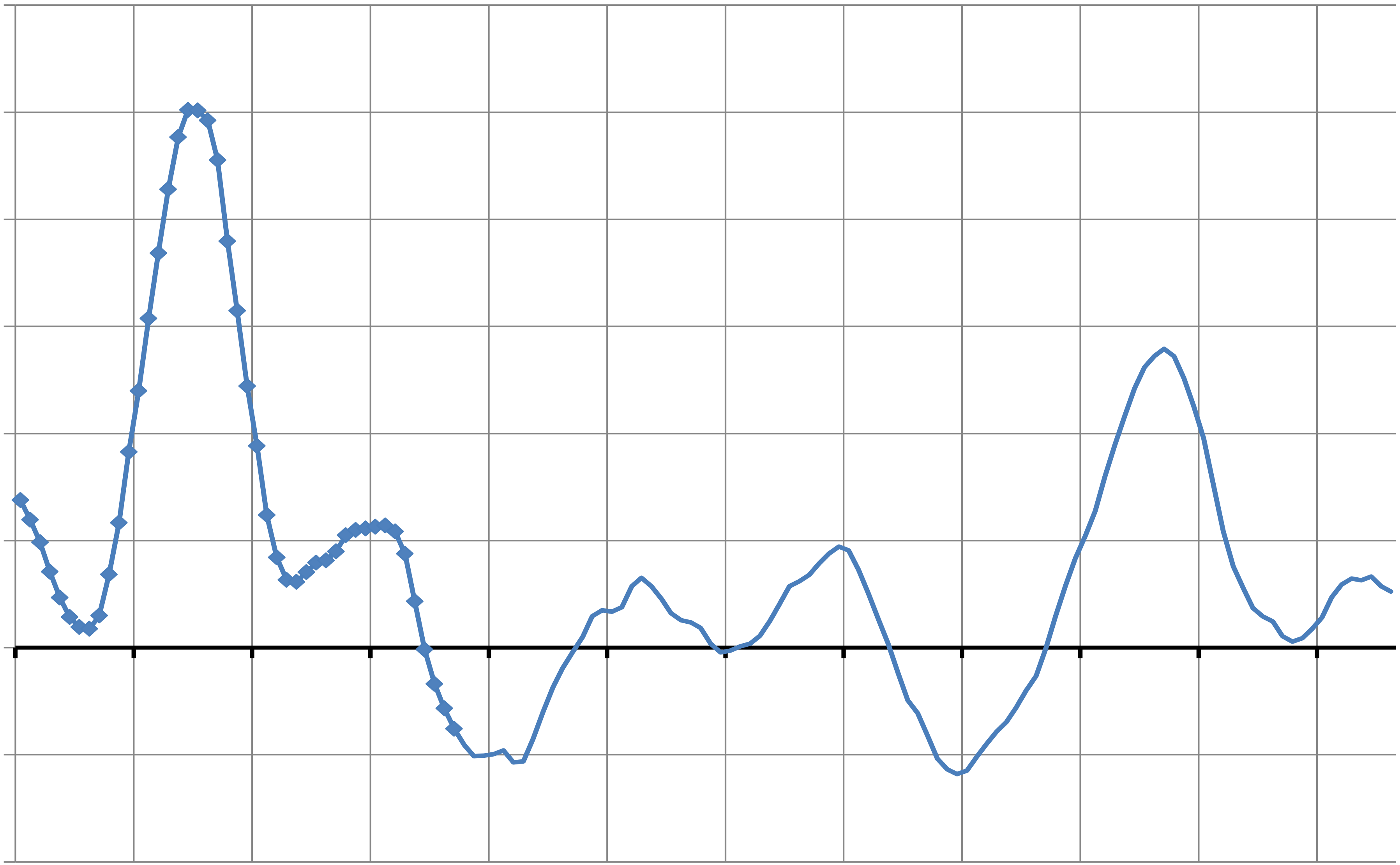
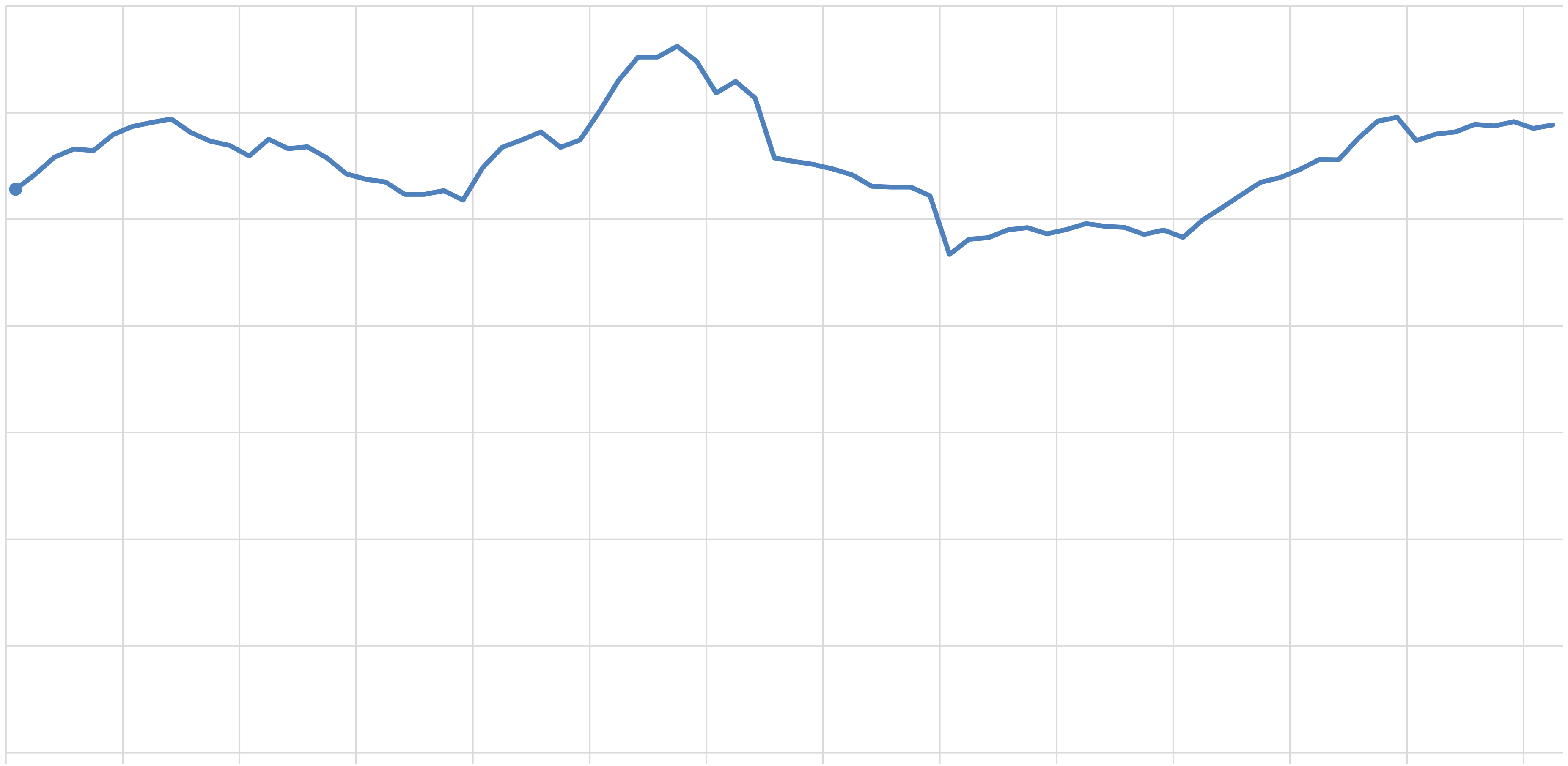

Brazilian Consumer-Price Inflation (IPCA)
14
12
10
8
6
4
2
0
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014
Markets' expectations

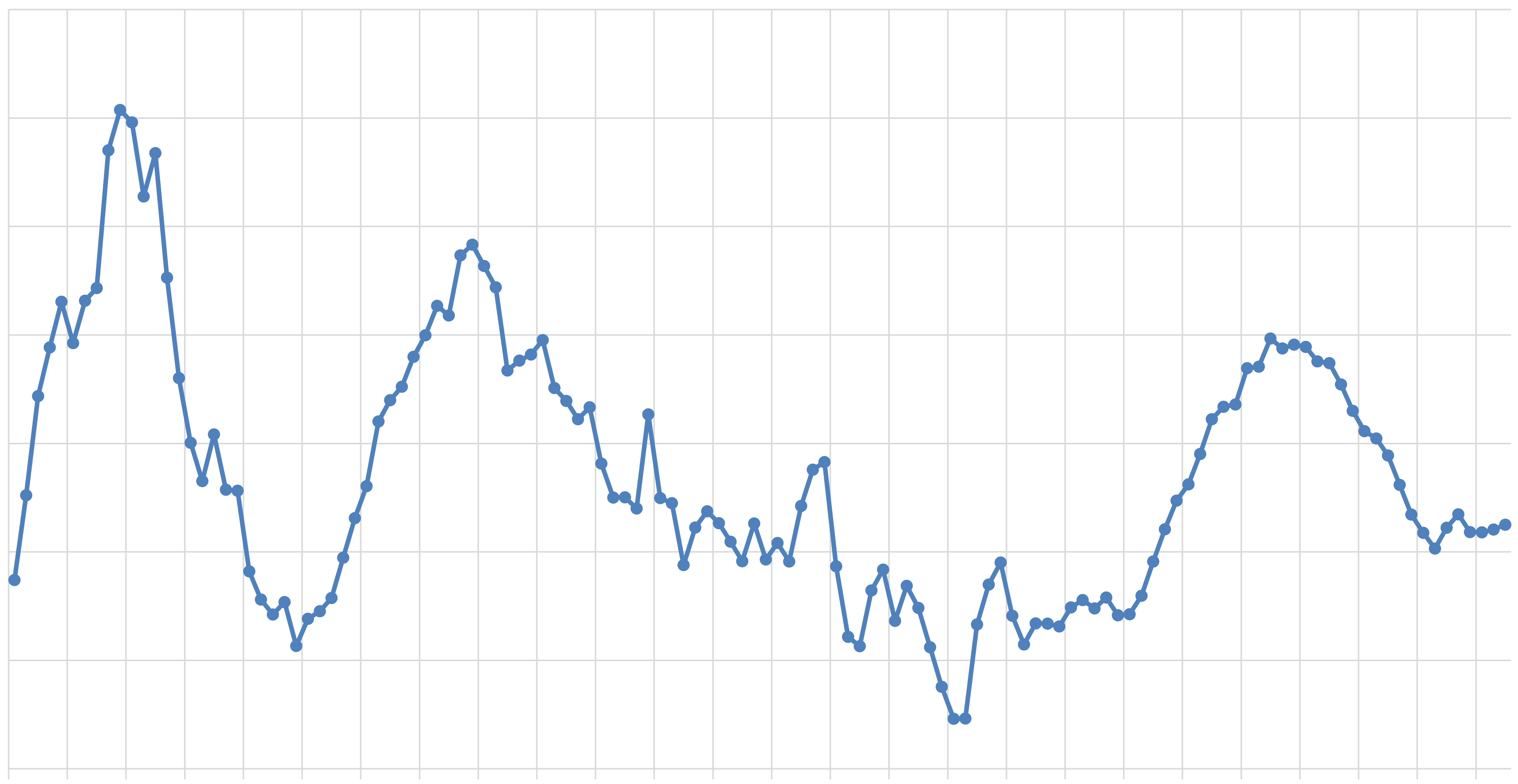


What happened to fiscal policy?

- 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).



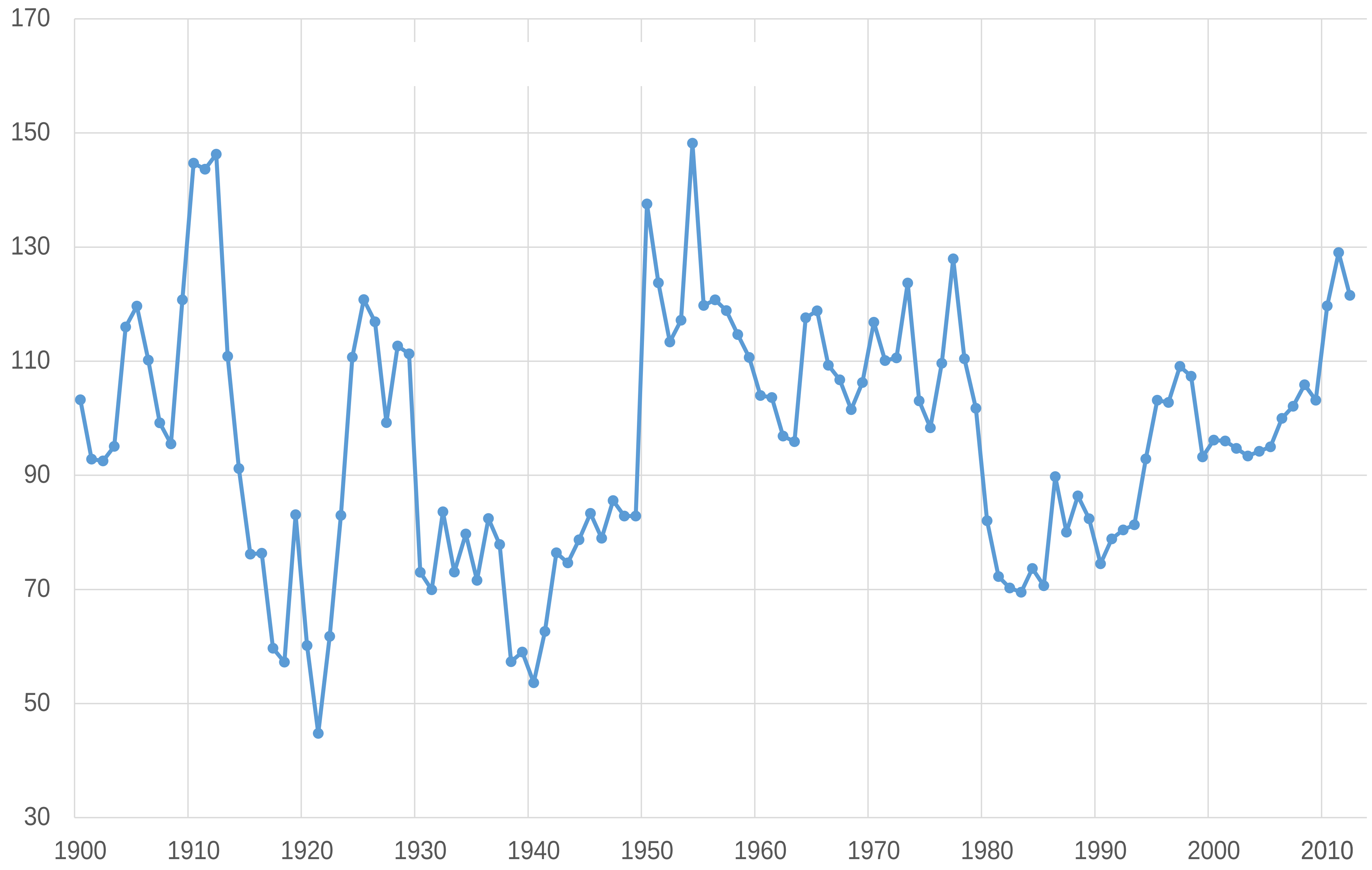


Markets' vs People's Demands

- 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


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


[redacted]

The government's response

- 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
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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