Brazil

Economic Watch

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Economic Analysis

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Dilma Rousseff's initial steps

First economic actions are positive, especially because of good fiscal signs

- **The first fiscal measures are positive and the mix of macroeconomic policies is now expected to be more balanced than in recent years,** but more is needed for the government's fiscal policy to recover its lost credibility.

- **High-frequency indicators showed that the economy moderated in December**
  The slow down is expected to continue in coming months following the change in the tone of macroeconomic policies.

- **SELIC adjustment shows that the Central Bank remains focused on keeping inflation under control**
  "Macro-prudential" measures emerge as a new instrument to help to slow down the economy.

- **Inflation will benefit from activity moderation, but will continue to be pressured by commodity prices**
  We expect the SELIC to be adjusted upwards by an extra 100bps, but commodity prices are a risk for the materialization of this call.

- **All in all, we see the first developments of the Dilma government as positive**
  They suggest that not only the main macroeconomic policies but also the pragmatism of the previous government will be continued and even enhanced.

The first fiscal measures are positive and the mix of macroeconomic policies is now expected to be more balanced than in recent years, but more is needed for the government's fiscal policy to recover its lost credibility

In line with previous declarations, the government announced on February 9th that federal expenditures included in the budget approved by the Congress for 2011 will be cut by R$ 50 billions (7% of total primary expenditures, and around 1.2% of GDP). The size of the cuts was in line with the most optimistic market expectations.

As significant as implementing this adjustment was to hear members of the government in charge of implementing fiscal policy that expenditures should be cut to take some pressures off the monetary policy. This is a big departure from the implicit disputes between the monetary authority and the Ministry of Finance observed in the last years of Lula's government. More than a rhetorical twist we think this could signal a new approach to coordinate macroeconomic policies and create space for interest rates to decline in the medium term.

In addition to that, fiscal efforts will also be supported by the approval of the new minimum wage being proposed by the government. The proposal would make the minimum wage R$545, instead of R$560 or more, as unions and opposition parties have been demanding. The value being proposed by the government this year implies a 1% real adjustment in the minimum wage, in comparison to a 6% real increases legislated on average during the eight years under Lula. The limitation of the minimum wage's adjustment is important for fiscal accounts and for anchoring inflationary expectations, since as it is used as a reference for a series of public expenditures (especially pensions).

These measures are clearly positive as they will complement counter-cyclical monetary policy's efforts and, therefore, help avoid overheating the economy, different from what happened at the end of the previous government when the weight of the adjustment was essentially borne by monetary policy.

Although these first fiscal steps are positive, more time and more actions are required to eliminate the concerns regarding the role of fiscal policy in Brazil, especially because the just announced measures do not seem to be enough to guarantee that this year's fiscal goals will be met, and also because total expenditures are still too high. Regarding the former, the size of the expenditure cuts do not seem enough to guarantee that the primary surplus of the public sector will meet the R$118 billions (2.9% of GDP) target for the year (see our calculations on our most recent "Brazil Economic Outlook"). If these expenditure adjustments are finally implemented, the primary surplus of the public sector is forecasted to reach 2.8% of GDP (higher than 2010's primary surplus net of Petrobras' extraordinary resources: 1.6%). And with respect to the latter, federal primary expenditures (which exclude interest payments) are expected to reach 18% of GDP this year, lower than the 19.1% figure observed in 2010 (and practically the same if we exclude Petrobras' extraordinary expenditures from last year's accounts). This level, however, is higher than the levels observed before the crisis (16.8% on average for the 2006-2008 period).

High-frequency indicators showed that the economy moderated in December. The slow down is expected to continue in coming months following the change in the tone of macroeconomic policies

Economic activity slowed down in December. Industrial production declined 0.7%m/m and retail sales remained stable (0.0%m/m) in the last month of 2010, significantly lower than markets expected (+0.9%m/m and 0.4%m/m, respectively) and lower than observed in the previous month (-0.2%m/m and 0.4%m/m). The economic activity indicator of the Central Bank (IBC-Br) expanded by only 0.07%m/m in December, the weakest performance since June.

The moderation of the economy has been caused by the implementation of macro-prudential measures in December, a lagged effect of the monetary tightening implemented last year, and the impact of increasing inflation on demand. The recent change in the tone of both fiscal and monetary policies will provide an extra stimulus to guarantee the needed deceleration of the economy during coming months.

This environment is in line with our current GDP forecasts: we expect GDP to expand by slightly less than 1%q/q in the last quarter of the year (figure to be released on March 3) and 4.1% in 2011. Our forecasts are lower than the market, but many analysts are already downgrading their growth estimations for the fourth quarter and for 2011 (market's call for GDP growth was around 1.3%q/q for the fourth quarter of 2010 and the consensus for 2011 declined to 4.5% from 4.6% this week).

SELIC adjustment shows that the Central Bank remains focused on keeping inflation under control. "Macro-prudential" measures emerge as a new instrument to help to slow down the economy

After leaving the SELIC rate unchanged during the second half of 2010, the Central Bank decided to adjust the reference interest rate up 50 bps to 11.25%. The decision to tighten monetary policy followed the recent deterioration of inflation (observed inflation: 6.0%y/y in Dec '10; market forecasts: 5.7% for Dec '11). The hike of the SELIC rate was also, in our view, an important sign of the Central Bank's independence (and of its new Governor Alexandre Tombini) from political pressures. This is especially important to ease the concerns that the monetary authority could be more tolerant with inflation under Dilma Rousseff's government.

The move reinforces the view that monetary policy will mainly be focused on controlling inflation and that the weight of avoiding exchange rate appreciation will have to be carried by other policies.

In its communiqués, in addition to stressing the role of "macro-prudential" measures (meaning measures to moderate and control the current process of credit expansion, such as those implemented in December and the announcement that domestic banks will need to adopt Basel III regulations 2 years before they come into effect internationally), the Committee highlighted the importance of fiscal policy for future monetary policy actions. For the Committee of Monetary Policy of the Central Bank, it is important "to note that the generation of primary results in line with [the Centrals Bank's] assumptions for inflation forecasts will contribute to slow down the gap between supply and demand growth rates and to consolidate the declining trend exhibited by the ratio public debt over GDP."

Explicitly linking monetary policy to fiscal policy performance is an advance in the public discussion about economic policies in the country.

Inflation will benefit from activity moderation, but will continue to be pressured by commodity prices. We expect the SELIC to be adjusted upwards by an extra 100bps, but commodity prices are a risk for the materialization of this call

We expect the news of activity moderation - together with the recent announcement of expenditure cuts - to limit the expansion of inflation expectations for the end of 2011 and consolidate the view that the SELIC will be adjusted upwards to 12.25% from 11.25% this yea, but not more than that as some are currently betting (market's consensus for the SELIC in the end of the year is currently at 12.50%). Our lower growth forecasts and maybe our higher trust on the implementation of a tighter fiscal policy are behind our deviation from the consensus.

In case the economy refrains from moderating as we are currently expecting, the Central Bank should then implement more macro-prudential measures. In this scenario, the chance of more fiscal measures is higher, in our view, than the market is currently discounting. We see additional hikes of the SELIC as a last resource instrument at this moment.

Commodity prices, however, impose a clear risk to our scenario. If these prices refrain from moderating as we are currently expecting, the chances of a stronger monetary tightening will increase.

All in all, we see the first developments of the Dilma government as positive. They suggest that not only the main macroeconomic policies but also the pragmatism of the previous government will be continued and even enhanced.

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