PROJETA

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CARLOS GERALDO LANGONI

A CRISIS OF CONFIDENCE

- ✓ **A political component in the current Brazilian scenario has contributed to the sharp decline in business confidence. Popular demonstrations have leveraged the dissatisfaction with the course of the economy.**

- ✓ **The market continues to believe in low growth and high inflation. GDP has been cut to just 2%. The interest rate increase managed to interrupt the steep rise of inflation.**

- ✓ **Although fiscal policy remains the more complex problem, it is essential to reinforce economic fundamentals such as inflation targeting and the floating exchange regime.**

- ✓ **The announcement of the end of the monetary loosening in the US, together with domestic uncertainties, is responsible for the dollar appreciation.**

- ✓ **It becomes increasingly evident that the economic debate will dominate next year's electoral campaign.**

- ✓ **The fragile current economic scenario has given a new momentum to the opposition, which has yet to come up with ideas that will meet the demands of and motivate the new middle class.**

The **business confidence** index's sharp decline, as estimated by the National Confederation of Industry (CNI), is one more objective indication that expectations are deteriorating.

It has worsened in reference to both the present and the **future** business environments.

- **Expectations:**

  The **leading economic indicator** (calculated by the Getulio Vargas Foundation – FGV – and the Conference Board) dropped in June, confirming a climate of uncertainty and hardship, which affects sustainable growth.

  Popular demonstrations have leveraged dissatisfaction with the course of the economy and introduced a **political** component, so far minimized, into the perception of the Brazil risk.

  In view of this political component, speeding up the slow upturn economic activity through the recovery of **investments** will be even more difficult. Therefore, Brazil will continue to depend on consumption, which also shows signs of slowing down.

  Household consumption intent **(ICF)** fell in June, reflecting the high level of indebtedness and less optimism relative to employment and income.

- **Market:**

  For all the above reasons, the **market** continues to believe in a low growth and high inflation scenario. **GDP** has once again been cut to just2%, in line with estimates predicting the industrial sector will continue to skid at the same tepid pace.

  The necessary correction in the **macroeconomic policy mix** – an interest rate rise and more fiscal tightening – reinforces this discouraging trend.

  As far as **inflation** is concerned, the Central Bank's new and more conservative posture managed to at least interrupt the expected steep rise in prices. The consumer price index (IPCA) stabilized at a higher level, near 6%.

- **Dilemma:**

  The more complex problems lie with **fiscal policy**. Efforts to regain credibility in this area require public spending cuts, especially current expenditures. However, it is hard to get a number that makes sense, in order to generate a **primary surplus** of at least 2% of GDP, without any accounting alchemy.

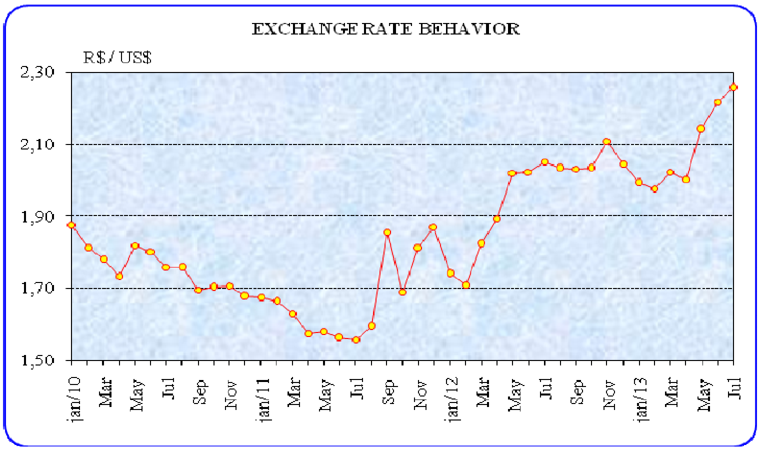
  In the short term, re-establishing a **consistent** macroeconomic policy will necessarily have a negative collateral impact on economic activity.

  The priority, however, is to rebuild the **foundations** for high quality growth in the future. To attain this objective, the economic fundamentals must be reinforced –fiscal responsibility, inflation targeting and a floating exchange regime– which had been relegated to a lower priority.

  This fine-tuning is essential to avoid the disaster scenario, i.e. the possibility of a **downgrading** of the country's risk rating, which Brazil currently occupies at the privileged position of investment grade.

- **Exchange:**

  Risk perception is the main domestic ingredient in the **exchange rate** formation. The most relevant foreign component is the behavior of prices, which are now showing a clearly unfavorable trend.



"The real depreciation bias is expected to go on"

Besides the appreciation of the US dollar on a global scale –in anticipation of the end of the monetary loosening - the real is impacted by the wave of **domestic uncertainties**.

For the above reason, as of the current month of July, there has been a trend toward **devaluation**. The short-term equilibrium level has moved to around R$ 2.20 – 2.30 / US$.

The base rate rise and the elimination of the financial operations tax (IOF) on foreign investments in fixed income **mitigated** the impact of devaluation.

More recently, growing doubts about the performance of the **Chinese economy** have reinforced this bias.

In short, Brazil is going through a delicate economic situation where **pessimism** seems to prevail.

The feeble performance of the economy is aggravated by pressures from the new middle class, which stimulate necessary changes from one side, but raise the risk of an **unorthodox relapse** on the other.

The government has to balance itself along this **razor´s edge** – correct distortions to re-establish confidence and accept the fact that it's not possible to change the prospect of a modest GDP in the coming years.

Concurrently, it must meet expectations which, actually, hinge on the **modernization of the state** and thus can only be attended to in the middle or long term.

It becomes increasingly evident that the economic debate will dominate next year's **electoral campaign**.

President Dilma's sudden drop in **popularity**, confirmed by the National Federation of Transports (CNT) – from 73.7% to 49.3% in June – is further proof of the country's changing climate which, beforehand, was excessively optimistic.

The fragile scenario has given a new impetus to the opposition forces which will, nonetheless, have to come up with ideas that meet the expectations of the new and demanding **middle class**.

The **private sector**'s capacity to adjust will once again be tested in an environment of high volatility, where the state's discretionary decisions prevail.