

Economic Watch

Brazil

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Economic Analysis

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The macro mix in Brazil: a new fiscal regime, to a new monetary policy

The dramatic decrease of real interest rates in Brazil will provide significant room for the government to lower its primary deficit target to around 2.3% of GDP. Although the outlook for debt burdens remains very solid, this could create some noise around long-term fiscal implementation and add some risks to inflation.

Lower real rates will ease fiscal accounts

The recent drastic drop in domestic interest rates is one of the most important changes in the Brazilian economy since the end of the hyperinflation era. Among other effects, this will trigger a significant re-shuffling of fiscal policy. To put basic numbers into perspective, from 2001 to 2011 public sector interest payments averaged 6.5% of GDP, of course driven by very high domestic interest rates (real rates averaged 8.5%). As a consequence, the country needed to generate significant primary surpluses to keep the total fiscal deficit under control and push public debt-to-GDP down. This fiscal regime worked very well, with the primary surplus averaging 3.2% of GDP in the decade through 2011 and public debt declining from 60.6% in 2002 to 39.1% in 2011.

Looking forward, we expect the government to use the room created by significantly lower interest payments to (sooner or later) formally ease its current fiscal target system. In fact, according to our forecasts, the government's interest burden will continue to decline to close to 4.0% over the next few years. There are multiple alternatives for adjusting the current fiscal target, such as the adoption of a structural target, but it seems to us that the most likely is a simple reduction of the required primary surplus from 3.1% to something around 2.3% of GDP.

In practice, the formal adoption of a less strict fiscal target would be another step to ease fiscal policy. This is because, since 2009, the fulfilment of the primary surplus target of approximately 3.1% of GDP has already been relaxed, with the government increasingly relying on non-recurring revenues ("creative accounting") to officially meet the target. These have included Petrobras capitalization, tax debt settlements, atypical dividends, as well as the withdrawal from the National Sovereign Fund. In particular, we expect primary surpluses to be around 2.3%, but for both public debt and the total deficit to continue to decline over time (see Charts 1 and 2). We expect this to also result in a more counter-cyclical fiscal policy than in the past.

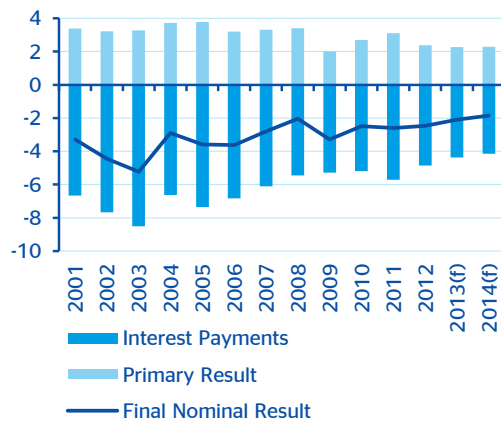
Not worrisome for debt sustainability...

This expected change in the fiscal regime is not unreasonable, as the Brazilian economy faces a much better environment (lower risk, public and external debt, and interest rates) than when targets were introduced back in 1999. Indeed, it might prove beneficial during times such as the present when the economy is running below potential. In fact, our debt estimates for 2012-2017, which build on our macro forecasts for Brazil, show that even under a significant reduction in the primary surplus target, public debt will continue to fall to levels between 29 and 27% of GDP (see Chart 2).

This is a very encouraging picture for overall debt sustainability and sovereign USD spreads in particular. Under this scenario, Brazil will transition into an economy with lower interest rate payments, a higher ability to implement counter-cyclical fiscal policy, and still declining debt ratios. Further, the outright debt levels themselves are approaching low levels, even compared to very strong EM credits. The bottom line is that, while the markets might react negatively on the short-term to lower fiscal targets, valuations for sovereign Brazilian debt remain very strong.

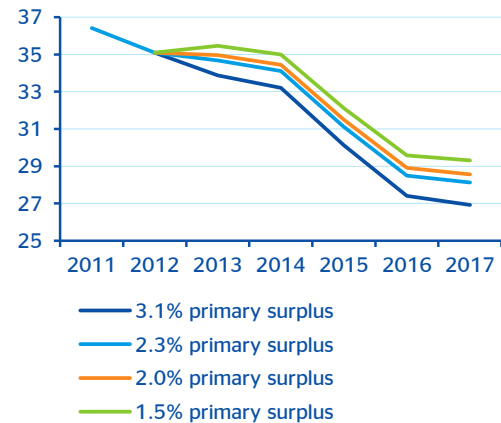
Indeed, although outright spread levels are currently tight, we would expect the market's performance to be dictated by any pressure on global rates (on the negative side) vs. continuous inflows into core EM markets such as Brazil (on the positive side). Against this balance, Brazilian spreads should trade broadly in line with solid EM peers, without much regard to the headline number for the fiscal accounts. A potential negative trigger, however, would be significant changes to the Financial Stability Law, as the government has indeed been signalling, which we will follow closely.

Chart 1
Fiscal accounts (% GDP): 2001-2014
Break-down nominal vs. primary result



Source: Bloomberg and BBVA Research

Chart 2
Net public debt / GDP dynamics (% GDP). Given assumptions on the primary surplus target



Source: Bloomberg and BBVA Research

...but further pressures on inflation

The pressure point from the relaxation of fiscal targets should come in the form of higher inflation and inflation expectations. Therefore, a successful adoption of a new fiscal regime requires the utilization of the fiscal room to reduce the tax burden and/or increase public investment, which remain open questions. In addition, it is important that fiscal and monetary authorities continue to coordinate the macro mix, something that did not happen in the last years of the Lula government and which was re-established when Dilma took office in 2011.

In our view, the fiscal relaxation should take some pressure off monetary policy, which should be less volatile than in the past. Fiscal policy should be made more expansive when domestic demand weakens (as in 2012 and the beginning of 2013) and less expansive when domestic demand strengthens and inflation concerns mount. This is what we expect from the middle of this year onwards, which would in turn help to prevent the BCB from implementing SELIC hikes. Even though we regard this fiscal policy's fine-tuning as challenging and potentially noisy, we think it will end up contributing to a scenario where inflation does not run out of control, but remains well above the 4.5% inflation target. We expect the SELIC to remain stable at 7.25% for a very long period (through 2013 and 2014).

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