Research Institute – LatAm Letters

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#LatAm / #Monthly / #Fiscal Policy

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Brazilian fiscal: here's what to expect

Brazil's fiscal position remains a source of concern for investors, even though we expect only a modest rise in the public debt ratio over President Lula's term. Importantly, Brazil's debt structure disincentivises sustained fiscal slippage.

Key Takeaways

- Brazil's fiscal position will deteriorate over the course of President Lula's term, as he seeks to balance his desire to support lower income households with fiscal and political constraints.
- In our central case, Brazil's public debt ratio will rise as the global recession justifies fiscal support. The key question is: how will Lula's fiscal policies evolve beyond 2023?
- One underappreciated feature of Brazil's economy is that the high share of inflation and policy rate-linked debt acts as a deterrent against running a loose fiscal policy for a prolonged period. Alongside the BCB's independence, the structure of debt acts as another institutional constraint, reducing the chances that debt goes onto an explosive path.
- That said, debt is still likely to rise moderately over time, keeping fiscal policy at the forefront of investors' concerns. Debt reduction looks challenging given Brazil's low potential growth rate, Lula's pro-social spending policy stance and the risks of populism.
- Ultimately, the fiscal outlook will remain a key source of volatility for Brazilian assets over Lula's term. However, we would need to see a more radical policy shift to justify a significant increase to Brazil's risk premia.

Lula looks to navigate fiscal and political constraints

Faced with fiscal and political constraints, President Lula will need to balance boosting support to households with fiscal discipline over the course of his term. The left-leaning president initially spooked markets during his inauguration by extending fuel tax breaks, having already raised Brazil's spending cap at a combined cost of around 2% of GDP in 2023.

Brazilian bonds and the *real* promptly sold off as markets adjusted to the more stimulatory fiscal plan. However, fiscal concerns have since been pared back following the announcement of offsetting measures by Finance Minister Haddad on January 12. While we expect some of these will be watered down by congress, Brazil's primary balance is still likely to slip into a deficit over the course of Lula's term.

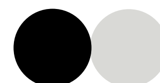
The attacks on three public institutions by Bolsonaro supporters in Brasilia is unlikely to move the dial on fiscal policy directly. Lula however may benefit from greater cooperation from centrist parties in the near-term, particularly in his efforts to reduce the risk of further riots.

The attacks are a reminder of the underlying social tension which generates the difficult political backdrop Lula must operate in. Resisting a swing to populism will be even harder as the economy deteriorates.

Indeed, even with a trade boost from Chinese reopening, Brazil faces a difficult domestic and external environment. The global recession factored into our forecasts will deal Brazil a heavy blow in 2023. This will dampen revenues and require higher spending. In this context, the key question for debt sustainability is how the economy and fiscal policy evolve over and beyond the global recession.

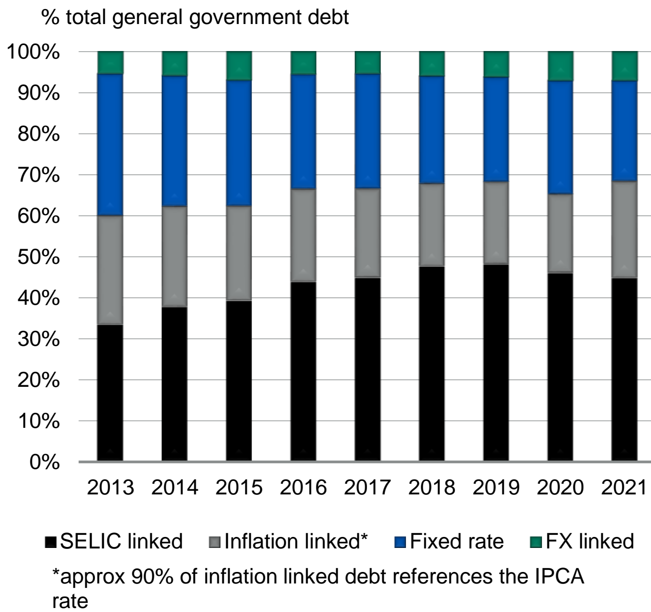
Brazil's already high gross public debt burden (96% of GDP), interest expense (5% of GDP), and unique mix of debt (see Figure 1) *should* limit the scope for significant fiscal stimulus beyond the global recession.

Importantly, the structure of Brazil's public debt acts as an institutional brake alongside the Banco Central do Brasil (BCB). First, inflation-linked debt accounts for 20-25% of the total, introducing a direct cost to policy actions that overheat the economy. Secondly, around 25% of debt is fixed rate but, with an average duration of less than 2 years, higher yields pass through quickly to interest rate expenses.



Finally, steps to tighten by the BCB influence the fixed rate portion of debt and the near 45% of the debt stock whose yields are tied to the Selic. These dynamics do not stop fiscal loosening, but they do at least provide some counterweight.

Figure 1: Debt structure leans against fiscal largesse



Source: Haver, aRI (December 2022)

Public debt will rise, but the pace should slow

Under our **central case**, we expect Brazil's public debt ratio to rise to around 108% by the end of Lula's term in 2026. A supportive fiscal stance will see the primary budget deficit averaging around 1.4% of GDP over the presidential term. While we expect the primary balance to deteriorate 4% of GDP through the economic downturn, we also forecast modest fiscal consolidation as the economy recovers. As inflation and rates fall back from recent highs – aided by the recession - Brazil's interest expense should also decline, helping debt dynamics.

However, while we think Lula's incentives and constraints reduce the likelihood of both looser and tighter fiscal policy, it's worth exploring alternative scenarios for Brazil's debt path given the size of the country's debt load, and the sensitivity of investors to fiscal easing.

As **Scenario 1** shows (Figure 2), a more stimulatory fiscal programme over the course of Lula's term could drive the debt ratio higher by around 8pp compared to the central case (to an estimated 116%). There's a chance that Lula would push for a larger fiscal response to a global recession in an effort to boost the economy, and/or that domestic politics pushes Lula further to the left.

Significant fiscal stimulus would have the effect of boosting nominal GDP and tax revenues via higher inflation and somewhat higher real GDP. But it would also limit the scope for policy rate cuts by the BCB. A looser fiscal stance would also raise Brazil's risk premia and push up external funding costs. Debt Sustainability Analysis (DSA) modelling suggests that these combined factors worsen the balance between real interest rates and real growth (r-g), putting debt on a sharply higher and more dangerous path.

Ultimately, this, combined with the institutional and political constraints, reduces the probability of Lula taking such a fiscal path. This is due to the fact that such a programme would quickly face funding challenges, which could spiral higher until policy pivoted to a more fiscally prudent path.

Scenario 2 outlines the path needed for the debt ratio to decline over the course of Lula's term. It is unlikely that Lula will enact reforms to dramatically unlock major productivity gains that boost Brazil's potential growth. As such, much of the decline would need to come via a more austere fiscal stance, in which the primary balance runs at a surplus for multiple years (which hasn't occurred since 2013).

In this scenario, we factor in an average primary budget surplus of 1% of GDP over Lula's term. This would prove a drag on growth but also disinflationary, helping the Selic and market rates to decline. This in turn should reduce debt costs given Brazil's debt structure.

That said, the challenge would be imposing fiscal austerity without crushing the economy. And it is unlikely that austerity would be compatible with Lula's policy agenda.

Implications for investors

In the near-term, declining inflation will at least improve debt sustainability given the composition of debt. It should also allow the BCB to pivot in H2 2023, supporting local currency bonds.

Over the medium term, fiscal concerns are likely to remain, but a full-blown fiscal crisis remains a low probability for Brazil. Only 16% of government debt is held externally and FX exposure is relatively small.

However, as our scenarios show, reducing Brazil's debt ratio will be challenging, particularly given Lula's prosocial spending tendencies. Ultimately, Brazilian bonds and the *real* will remain sensitive to fiscal announcements but we would look for a more significant shift away from fiscal prudence before a higher risk premium could be justified.

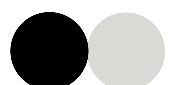
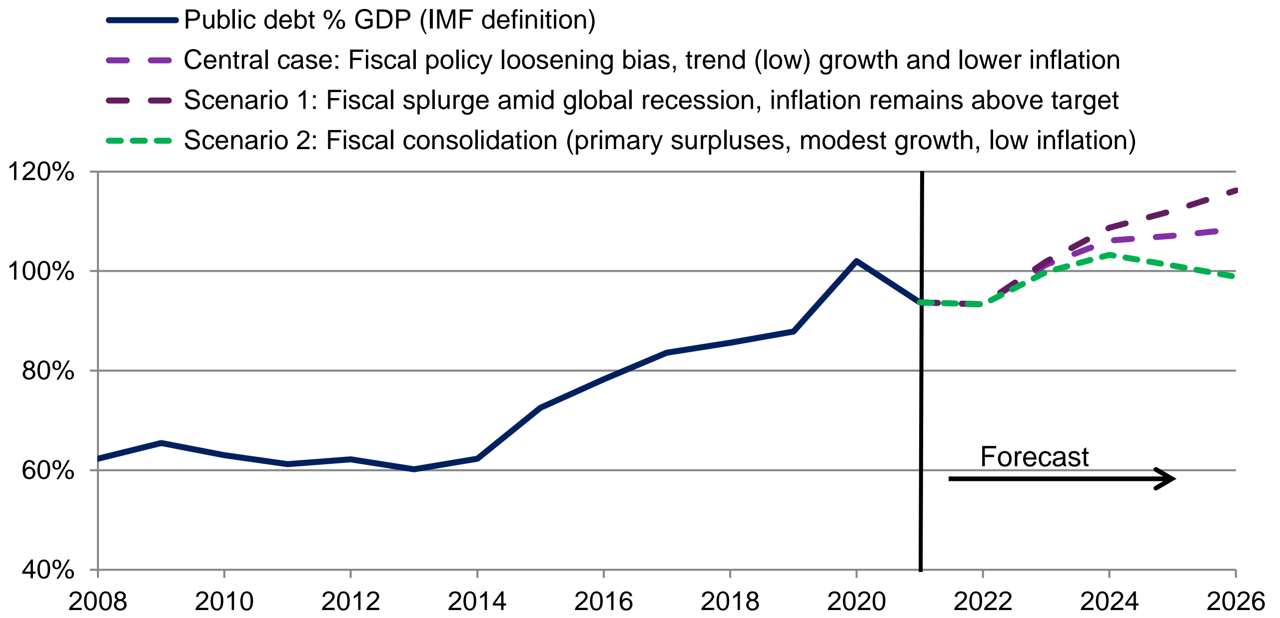


Figure 2: Fiscal consolidation unlikely



Source: Haver, aRI, December 2022

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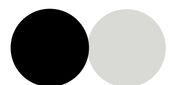

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