Brazil: Dire fiscal constraints imply binary outcomes

There are reasons to be optimistic about Brazil's economic future, but reform is urgently needed

Brazil: The overview

Brazil's fiscal accounts remain unanchored. Fiscal laws provide strict limits on government spending and its ability to issue debt, but fast-growing social security deficits suggest that, without a reform, either the laws would have to change or government activities would cease. Market reaction to any legislative effort to ease fiscal constraints would be very severe, eventually forcing Congress to approve a reform. This would be the primary reason to be optimistic about Brazil. In that case, prolonged fiscal tightening would pave the way for sustained monetary stimulus, with the SELIC rate stabilizing at an historical low for an extended period of time. State presence in the economy would also shrink considerably, with potentially large implications for investment, productivity, and project-related FX flows.

Fiscal outlook remains unanchored

Brazil's fiscal accounts remain unanchored, with the public-sector deficit still trending at excessively large levels (9%-of-GDP), ensuring an explosive trajectory for public debt, which surged 20ppt in the past three years, to 74% of GDP.

This situation contrasts with the stringent fiscal framework introduced last year, with the approval of a budget spending ceiling, which froze overall government expenditure at current levels (in inflation-adjusted terms) for the next ten years (through 2026). According to Finance Ministry estimates, assuming that GDP growth returns to historical trend, the ceiling will inevitably result in a large drop in (central) government spending, as a share of GDP, from about 20% in 2016 to close to 16% by 2026.

Another layer of budget control surfaced this year when, thanks to three years of sharp deterioration in fiscal results, the so-called "golden rule" for government spending became binding for the first time since it became law. Brazil's constitution forbids the Treasury to issue debt to finance current spending; only discretionary spending such as investment (along with debt-servicing) can be financed through debt issuance. According to the Treasury, to avoid breaking the "golden rule" through the end of next year, the Temer administration must find an alternative means to finance about BRL184bn (3% of GDP) in excess spending that has been budgeted for this period.

This has forced the administration to rely on the premature repayment of the loans the Treasury made to development bank BNDES in recent years. Of a total of BRL457bn that the BNDES still owed the Treasury (as of the end of August), the bank has already agreed to repay BRL180bn by the end of 2018. This is just a temporary fix for the problem, however. Without a significant improvement in the fiscal balance in 2019, the burden on BNDES to frontload its repayment schedule to the Treasury may be become unsustainable, unless the development bank issues considerable amounts of debt in the market and use the proceeds to pay back the Treasury.

Given these rigid fiscal constraints, in order to avoid breaking the law, in a manner that recently resulted in Dilma Rousseff's impeachment or some sort of government shutdown, Congress will soon be faced with three options:

1. Approve legislation that significantly curtails mandatory budget spending, such as social security outlays,
2. Hike taxes, or
3. Change the laws, to accommodate greater fiscal spending and larger deficits.

Any legislative attempt to change the laws would likely cause enormous turmoil in local financial markets, and we expect that to be a potent deterrent to such a scenario. Hiking taxes would also face enormous political resistance, and we suspect any such initiative would be even harder to gain traction in Congress than the remaining alternative, which is to cut spending.

Brazil's medium term outlook is complicated

The drastic scenarios we would eventually have to consider should Congress fail to reign in mandatory government spending (eg, government shutdown, default, impeachment) contrasts with the unusually positive virtuous cycle that would ensue if Congress successfully manages to cut spending, ensuring the long-term sustainability of the current fiscal framework.

Assessing Brazil's medium-term outlook has become especially complicated given the binary nature of these scenarios.

When considering the enormous downside represented by the failure-to-act scenario, current asset prices seem excessively optimistic. But, in our view, current pricing is justified by the assessment, shared by many within the government, that fiscal constraints are so strict, and the market reaction to any legislative action to undo those constraints so severe, that Congress will have no option but to approve a social security reform.

According to Finance Ministry estimates, without reform, social security outlays, as a share of the budget, would increase from 50% now to 71% by 2026. These numbers suggest that, without a reform, fiscal constraints would inevitably be broken. As a result, it is inevitable that a reform will eventually have to be approved. The question is when it will take place, in the next couple of months or in 2019, after the next administration takes office. The assumption that Congress will realize sooner rather than later that a reform must be approved is the primary reason to be optimistic about Brazil.

Congress is still distracted by the procedures related to the corruption charges against President Temer. The conclusion of those proceedings, likely next week on October 25, could unclog the legislative path to debate the social security reform. But most congressmen continue to resist the initiative, claiming popular disapproval and the associated political costs ahead of next year's general election (in October).

The economic team and government leaders still hope to get enough traction to approve a simplified version of the reform-draft that was submitted to Congress earlier in the year. The hope is that after approving key elements of the reform, such as a minimum retirement age and a minimum contribution period, the administration would be able to control the cost of the system through infra-constitutional changes, which require a much reduced Congressional support.

Approval remains unlikely but is not off-the-table

Approving the constitutional reform, which requires a larger 60% majority to get approval, with just two months left in the year would be a challenge, and still seems unlikely judging by informal surveys of congressional support for the initiative. But approval is not off-the-table yet, as the Temer administration has repeated surprised on this front over the past year. Failure to get approval in the Lower House by December would mean that the reform will be left for the new administration, however, as no major legislation is expected to get approved (in the Lower House) next year, given the turbulent electoral cycle.

Failure to approve the reform should keep fiscal uncertainties elevated through 2019, increasing the stakes for the election result. It would also possibly lead S&P to act on its "negative" outlook guidance and downgrade the credit (to BB-) early in 2018. Investor tolerance with a scenario of heightened fiscal uncertainties is hard to assess. At a minimum, we would expect financial assets to trade with a weakening bias and increased volatility throughout 2018, reacting especially to electoral dynamics (candidate surveys).

Fiscal action would reinforce monetary easing bias

The benefits of approving a social security reform that ensures the survival of the current fiscal policy framework would extend much beyond its direct impact on fiscal accounts, ie, repositioning public debt onto a sustainable trajectory.

Fiscal rules currently in place would force a marked reduction in the state presence in the economy, as evidenced by the recent decisions vis-à-vis development bank BNDES, creating the space for greater private sector expansion. Funding needs would also intensify the ongoing effort to privatize state-controlled-enterprises and implement concessions, notably in transportation infrastructure.

So far this year, despite the political turmoil, the administration has been able to successfully sell several mid-sized airports, hydro-plants (CEMIG) and oil exploration rights. And the pipeline for future asset sales has grown markedly, in line with the government's funding needs, with even Petrobras being mentioned by the Mining and Energy Minister recently. Lastly, the need to appeal to private investors would intensify the pro-market bias of regulatory decisions.

Fiscal and BNDES changes have deep implications

Perhaps more importantly, placing fiscal policy on a prolonged restrictive bias would have deep implications for monetary policy. In fact, the fiscal adjustment together with the phasing-out of the subsidized long-term funding rate used by BNDES that starts next year, with the market-based TLP replacing the TJLP rate, are estimated to lead to an overall reduction on the neutral level of interest rates in Brazil, possibly of about 2pts. This compares with current neutral levels estimated (using CB surveys) at about 4-5% in real terms. In that scenario, for instance, a SELIC rate of 7% with inflation expectations anchored at 4% (the target for 2020) would be characterized as "neutral", instead of expansionary as it is today.

The implications for the SELIC rate

This suggests that the SELIC rate could stabilize at a historical low for a prolonged period of time. A feedback loop would also be created in this case, with permanently lower interest rates reinforcing the impact of the fiscal adjustment over the public-debt trajectory, such that reduced debt-servicing costs together with higher economic growth would contribute to stabilize debt-GDP dynamics much sooner than currently expected.

Brazil's monetary policy committee (COPOM) is widely expected to lower the SELIC policy rate by 75bp at next week's policy meeting (October 25), to 7.5%. The decision has been extensively telegraphed by authorities, who indicated that a "moderate reduction" in the pace of cuts, from the 100bp-clip that prevailed in the past four meetings, would be "appropriate at this time", as the easing cycle is nearing its conclusion.

A 50bp cut in December is likely

In our view, the biggest question is whether COPOM will signal with greater clarity the terminal rate the SELIC rate is likely to reach. Judging by the inflation forecasts included in the latest Quarterly Inflation Report and the stated intention to create a tapering profile at the end of the cycle, bank officials appear committed to another 50bp rate cut on December 6, but they have yet to provide a definitive stance relative to the possibility of one last cut (25/50bp) in February.

Current pricing in the local yield curve is consistent with market expectations of close to a 50% chance of a last 25bp cut in February. In our opinion, the February decision should be conditional on the evolution of fiscal legislation. Should the social security reform get approved before then, the BRL would likely rally and pave the way for BACEN to extend the cycle a bit further. Otherwise, the decision should remain questionable. FX and other short-term indicators such as CPI could play a deciding factor in that meeting.

Macroeconomic indicators

Fig 3 Macroeconomic indicators

	2014	2015	2016	2017F	2018F
Nominal GDP (US$ bn)	2454	1797	1801	2091	2270
Per capita GDP (US$)	12098	8778	8729	10055	10830
Real GDP (% YoY)	0.5	-3.8	-3.6	0.7	2.4
CPI (% YoY)	6.4	10.7	6.3	2.9	4.0
BRL/USD (yr-end)	2.66	3.96	3.26	3.15	3.25
BRL/USD (avg)	2.36	3.34	3.48	3.20	3.20
CB policy rate (%) yr-end	11.75	14.25	13.75	7.00	7.00
Trade balance (US$ bn)	-7	18	45	63	56
Current acc bal (% GDP)	-4.2	-3.3	-1.3	-0.6	-1.1
Primary fiscal balance (% GDP)	-0.6	-1.9	-2.5	-2.2	-1.9
Nominal fiscal balance (% GDP)	-6.0	-10.2	-9.0	-7.9	-7.0
Public sector debt (gross, % GDP)	56.3	65.5	69.9	75.0	77.5
FX reserves (US$ bn)	374	369	372	376	376

Source: ING, Macrobond

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