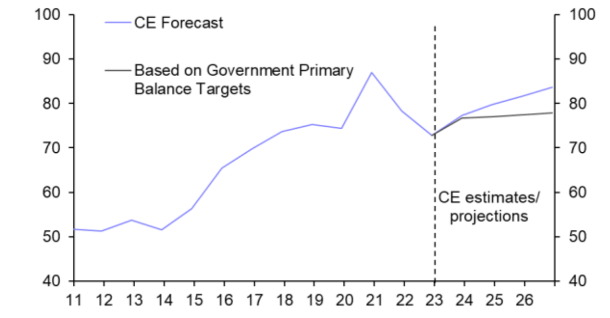
# LATIN AMERICA ECONOMICS UPDATE

## Brazil's new fiscal plans: yet to convince

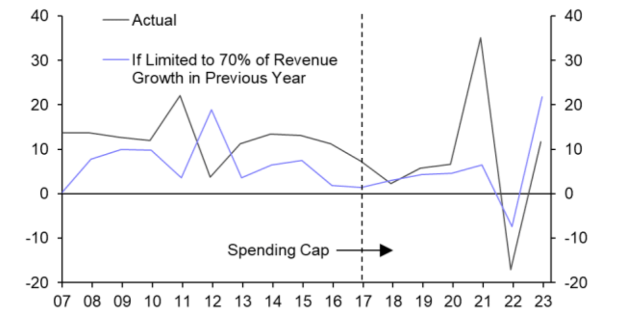
- **The new fiscal rule proposed today by Brazil's finance minister would, if implemented in full, go some way towards stabilising the public debt ratio. But the government has a lot to do convince investors that it can credibly commit to the fiscal tightening needed to meet its targets.**
- The new fiscal rule will replace the spending cap, which was approved in 2016 and limits growth in federal primary expenditure to the rate of inflation. The main detail of the new rule is that primary spending growth will be limited to 70% of the growth rate of revenues in the previous year. The government has set a target for the primary budget balance of zero in 2024, 0.5% of GDP in 2025 and 1% in 2026. If the primary balance exceeds these, the surplus can be used for investment; if the balance is below these (with a tolerance of 0.25% of GDP), spending growth in the next year will be capped at 50% of revenue growth.
- **In principle, if the government can hit the primary balance targets, the debt ratio should start to stabilise**. This is shown by the black line in Chart 1, which is based on those targets and a fall in the average interest rate on government debt to the 2017-19 average. That may explain the initial positive reaction in financial markets after details were leaked to media (although markets have since pared those gains).
- **But some pretty big question marks continue to hang over the new rule**. First, we don't know how it will be amended in congress. The bill will reportedly be sent to congress next week and congressional leaders have said that it will be voted on quickly, but that's by no means guaranteed.
- Second, it's not clear that the government is fixing problems that arose with the design of the spending cap. One key issue was that the spending cap lacked an 'escape clause', which would allow the rule to be broken in exceptional circumstances (like the pandemic). Instead, the government had to use a constitutional amendment to allow higher spending. And such amendments continued to be used in the recovery, fundamentally undermining the credibility of the rule as a fiscal anchor. (For more, see here.)
- And finally, **while the new rule would help to avoid the very large rises in spending seen in the 2000s and 2010s, which ultimately laid the grounds for Brazil's current fiscal problem (see Chart 2), we're sceptical that the government has the appetite for the tightening needed to meet its budget targets**. President Lula, after all, has already pushed through higher social welfare spending into this year. Unless the government can raise revenues significantly – which seems to be the plan, but the details are vague – expenditure will need to be very constrained (perhaps to 4-5% y/y in 2024-26) to meet the budget targets.
- For our part, we had anticipated (and, for now, will continue to forecast) a primary budget balance c.0.5% of GDP worse than the government's projections out to 2026, which is not dissimilar to the consensus. That would keep the public debt ratio on an upwards trajectory. (See the blue line in Chart 1.)
- **Given these uncertainties, it seems unlikely that the presentation of the new fiscal rule will let the central bank turn towards interest rate cuts any time soon (despite the government's vocal demands)**. Indeed, the minutes to the March Copom meeting made clear that it's primarily focused on inflation and expectations, and pushed back against the idea of easing. (We'll be covering this in tomorrow's *Weekly*.)

**Chart 1: Gross General Government Debt Ratio (National Definition, % of GDP)**




Sources: Refinitiv, Capital Economics

**Chart 2: Federal Government Primary Expenditure (% y/y)**




Sources: Refinitiv, Capital Economics

**William Jackson**, Chief Emerging Markets Economist, william.jackson@capitaleconomics.com

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TORONTO NEW YORK LONDON SINGAPORE

Email **sales@capitaleconomics.com** Visit **www.capitaleconomics.com**