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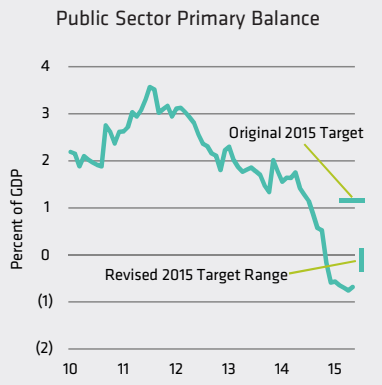
ECONOMICS: LATIN AMERICA PERSPECTIVES

BRAZIL: REASSESSING FISCAL PROJECTIONS

+ Fernando J. Losada, Senior Economist—Latin America Research, fernando.losada@abglobal.com

The Brazilian government has announced a deeper-than-expected cut to its primary fiscal surplus target for this year and next. This reduction has economic and political implications, and could result in sovereign-credit-rating downgrades even sooner than we initially expected.

Display 1
A Less Ambitious Target



Through July 23, 2015
Source: Banco Central do Brasil and AB

A Large Downward Revision

On July 22, the economic team of Brazil's Finance Minister Joaquim Levy and Brazilian Planning Minister Nelson Barbosa announced a downward revision to Brazil's primary fiscal surplus targets. The revision itself wasn't surprising, but its magnitude was, given the disappointing economic performance so far this year.

This year's target was reduced from 1.1% of gross domestic product (GDP) to just 0.15%, and the 2016 target was lowered from 2% to 0.7%. The authorities also established a 1.3% target for 2017 and a 2% target for 2018. The new target for 2015 may not even apply; achieving it will depend on securing revenues stemming from a still-to-be-approved bill to repatriate private capital as well as from infrastructure concessions and a reduction in the payroll tax exemption. If those revenue sources don't materialize, the primary deficit could be as much as 0.3% of GDP this year (*Display 1*).

The Repercussions of Lower Surplus Targets

The market had anticipated the reduction in the surplus target for some time, because Brazil's economy is actually contracting this year. That's a much worse showing than the expansion of nearly 1% expected at the beginning of the year, when fiscal goals were first established.

Until recently, local media was reporting that Levy opposed a large target cut: it would make a sovereign-credit-rating downgrade more likely and could also prompt a more relaxed attitude among some congressmen toward the urgent need for fiscal adjustment. Meanwhile, Barbosa and Brazil's Cabinet Chief Aloisio Mercadante reportedly advocated a much lower target.

The economic deceleration has been evident for quite some time, even while Levy continued to defend a high target until a few days ago. Thus, it's hard not to interpret this week's announcement as a political defeat for the finance minister, as it can't be argued that the slowdown was a surprise. At the very least, defending a high target until very late in the game and then accepting a goal even lower than expected by the market may have been a blunder in managing expectations. Market sentiment—and possibly credit ratings—have hinged on the perception that Levy's economic policy agenda was the absolutely dominant view within the administration. As a result, the market reacted negatively to the announcement of lower targets.

Another factor may have had a role in the lower target. The National Accounting Board is investigating the transparency of fiscal accounts during President Dilma Rousseff's first term, and local political observers even mentioned that finding evidence of wrongdoing could lead to presidential impeachment. Therefore, it's possible the government wanted to be as clear and realistic as possible with this year's fiscal targets.

Sovereign Credit Ratings at Risk

Officials made an effort to convey the message that the fiscal adjustment plan will continue; they increased the budget freeze by about R$8 billion to some R$78 billion. Levy also hinted that the government could outperform the target this year.

Because some extraordinary revenue measures may fail to materialize or be approved too late in the year to make an impact, we believe that the lack of a primary surplus—or even a small deficit—is likely this year. Indeed, the new annual surplus target for the public sector is equivalent to R$8.7 billion, while the first five months of the year have seen a surplus of R$25.5 billion. In other words, the new target already implies the economy will generate a primary deficit in the second half of the year—a gap that could range between R$16.8 billion and R$42.9 billion.

The current combination of high interest rates and low economic growth implies that Brazil must generate a primary fiscal surplus of more than 2% of GDP in order to stabilize its public debt/GDP ratio. The new set of targets conveys the message that debt dynamics will remain unfavorable at least until 2018. Rousseff's popular support is at a record low and domestic politics are volatile, amid the ongoing investigation of corruption allegations by politicians and leading businesspeople. Given this environment, Brazil's ability to deliver progressively higher fiscal tightening over several years may be in question.

Also, 2018 is an election year, and election years typically see spending pressures. So, the announcement will likely hurt Brazil's credit ratings. S&P currently rates the country's foreign-currency long-term debt at BBB–, the lowest level of investment-grade ratings; the outlook is neutral. Moody's Investor Service's rating is Baa2, one notch above the minimum level of investment grade, but with a negative outlook since last September. Finally, Fitch rates Brazil at BBB, and has had a negative outlook since April.

Given the expected worsening in debt ratios, downgrades could occur this year. We believe that Brazil will maintain its investment-grade status with all three major rating agencies for at least this year. However, the country will need to show evidence of fiscal progress and restored economic growth next year to keep from losing its coveted investment-grade status.

The announcement of weaker fiscal targets will also likely pressure Brazil's central bank—the prospects for a nearly completed rate-hike cycle may have to be reconsidered, given the projected less contractionary fiscal stance over the next two to three years. All else considered, a lower primary surplus target should require tighter monetary policy to achieve a given inflation level. The next monetary policy meeting, scheduled for July 29, is to shed light on the central bank's reaction to the news.■