Brazil's looming fiscal risks

INTERNATIONAL FINANCIAL MARKETS seem more concerned about Brazil's fiscal problems than the administration appears to be. Already this year Moody's has lowered its outlook on Brazil's credit rating from positive to stable, though its Baa2 rating for Brazil is still considered investment grade, and Standard & Poor's cut its outlook on Brazil from stable to negative. An outright downgrade of Brazil's rating early next year has become a real possibility; that would make it more expensive for Brazil to borrow money from international markets. Since mid-October, international investors have also been asked to pay more interest on credit default swaps (CDSs), the insurance again Brazil defaulting on its sovereign bonds. Between October 16 and November 15, interest paid on five-year Brazil bonds went up by 0.47 percentage points, compared to 0.05 for Chile; Mexico CDSs actually went down by 0.01.

The rapid deterioration of public finances was brought about by a variety of tax breaks to stimulate a sluggish economy, and steep increases in public expenditures. Now, as former finance minister Antonio Delfim Netto said in a November 15 interview with *Agência Estado*, to recover credibility, the government needs to report transparently the actual position of its accounts, without any of last year's accounting gimmicks. Brazil will have to meet a budget primary surplus goal of 2% of GDP in 2014 if it is to avoid a lower credit rating from international agencies. Improvement in public accounts is also necessary to regain the harmony between fiscal and monetary policies that existed in 2011. Rescuing the credibility of the administration, Delfim says, could help bring inflation down to 4.5% in two years.

One persistent problem has been the government's lack of consistent medium-term fiscal goals and a strategy to achieve fiscal sustainability. Two recent events were particularly disturbing. First, a large majority in the House of Representatives approved renegotiation of state and municipality debt, which violates the Fiscal Responsibility Law. Proposals for greater borrowing autonomy for state and local governments are also certain to weaken fiscal discipline. Second, the Senate approved the Mandatory Budget, which compels the government to carry out representatives' spending amendments for public works and projects approved by Congress. The government needs to regulate both measures properly to prevent a substantial weakening of fiscal discipline.

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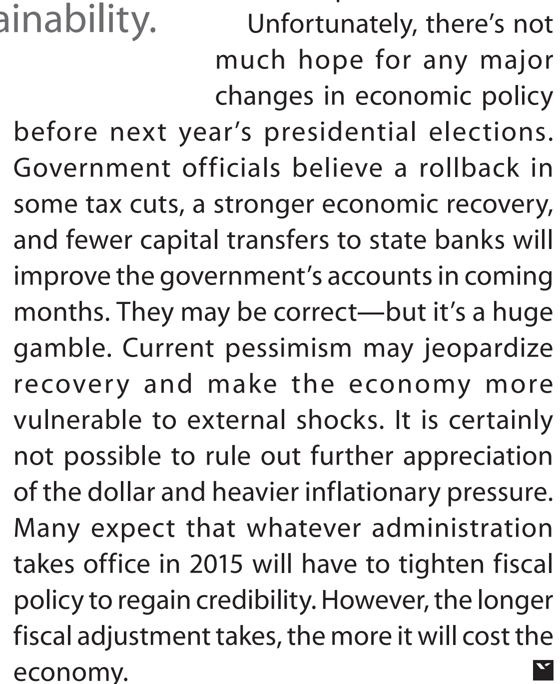

Unfortunately, there's not much hope for any major changes in economic policy before next year's presidential elections. Government officials believe a rollback in some tax cuts, a stronger economic recovery, and fewer capital transfers to state banks will improve the government's accounts in coming months. They may be correct—but it's a huge gamble. Current pessimism may jeopardize recovery and make the economy more vulnerable to external shocks. It is certainly not possible to rule out further appreciation of the dollar and heavier inflationary pressure. Many expect that whatever administration takes office in 2015 will have to tighten fiscal policy to regain credibility. However, the longer fiscal adjustment takes, the more it will cost the economy.