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Brazil: greater fiscal clarity, more uncertain future

- The government announced the country's new fiscal framework that proposes an increase in fiscal spending that is conditional to rises in revenues and targeted surpluses from 2025 onwards.
- Brazilian asset prices initially reacted upwards; consensus was pessimistic given recent signals from economic authorities.
- Further analysis suggests inconsistencies and stresses how the proposal does not tackle the economy's structural issues.
- We maintain a defensive stance towards Brazilian equities and bonds.

GOVERNMENT ANNOUNCES NEW FISCAL FRAMEWORK

Attention in Brazil has focused on the government's commitment to fiscal sustainability, highlighting what the proposal for a new fiscal rule would be given the increases in social spending on President Lula da Silva's agenda. The uncertainty around the announcement raised the risk sentiment and delayed expectations of cuts in the Selic reference rate for the 4th quarter of this year (100 bps to 12.75%). Finally, after several weeks of discussions within the government, Finance Minister Fernando Haddad announced a proposal on April 2, with further relevant details forthcoming.

The new fiscal framework establishes that spending would be limited to 70% of revenue growth for the past 12 months, which would allow fiscal spending to grow between 0.6% and 2.5% per year. This implicitly sets a floor for expenditures, which raises concerns for a government spending scheme already viewed as disproportionate and inefficient.

The new fiscal structure aims at achieving a primary budget deficit equal to zero in 2024, surpluses of 0.5% in 2025 and 1% in 2026. Altogether, this would imply a substantial increase of tax burden, currently at 34% of GDP (up from 24% in 1991) given that there are no significant improvements to productivity on the horizon. Additionally, a 1% surplus is not enough to stabilize the country´s debt situation in the long term. To be able to issue additional debt, Brazil - already a highly indebted country- should demonstrate a more disciplined and prudent fiscal plan. This would also postpone a rate cut cycle by the Central Bank of Brazil, given that the proposal does not help tame inflation.

This official proposal dissipates part of the uncertainty, but it remains quite vague. Additional measures are needed in the future, along with more details on how some ambitious objectives would be achieved. The fiscal framework project must be discussed and approved by both chambers in Congress, where the ruling party does not hold a majority and must negotiate with the opposition. This raises the risk of additional higher tax burden for companies and sectors that have a relatively low tax bill, in particular exporters, mining and agri-businesses. There is also the specter of new taxes being imposed in different capital markets structures.

We remain skeptical on the country's economic path in the short and medium term. The fiscal framework does not offer a viable solution to the Brazilian economy's structural issues. Inflationary risks and the need for a contractive monetary policy remain present.

The implications for both equities and fixed income are that the current situation should favor caution. This should be coupled with a preference towards companies with stable capital structures, low debt, healthy liquidity, low refinancing risks and access to markets and shareholders for resources. In bonds, we favor low duration papers and an overweight in cash.