Ministry of Finance

# FISCAL POLICY IN BRAZIL


## Márcio Holland

### Secretary of Economic Policy


**Washington, DC - April 15th 2011**

# Counter-cyclical policy in Brazil – The 2008 Turmoil

- **Brazil:**
  - One of the last major economies to be hit by the 2008 financial crisis;
  - One of the first ones to recover from it.
- **Up until the 3rd quarter/2008:**
  - Brazil was showing a strong growth performance
  - Controlling inflation (due to booming domestic demand and rising world commodity prices), was the main macroeconomic problem to be solved.
- **The 2008 crash changed the situation abruptly:**
  - International credit crunch led to a sharp reduction in the domestic supply of credit;
  - The fall in commodity prices and world-trade flows also hurt exports
  - And along with the increase in capital outflows, the Real/US Dollar exchange rate was substantially pushed up at the end of 2008.

# Counter-cyclical policy in Brazil – The Responses

- The government responded to the world crisis with unprecedented expansionary actions in the country´s recent economic history.

- Monetary and fiscal counter-cyclical actions were adopted to:
  - ❖ Stymie contamination of the international crisis to financial system
  - ❖ Resume growth as soon as possible.

- After almost three years, these two objectives have been achieved.
  - ❖ The worst of the crisis has been absorbed without any major disruption in the Brazilian banking system.
  - ❖ Most importantly, the economy resumed growing in the 2nd quarter/09, the unemployment rate did not shoot up, the real wages continued to grow and consumer and business confidence are back.

# Counter-cyclical policy in Brazil – The Responses

- Due to macroeconomic soundness, Brazil was able to soften the impact of the crisis:
  - **Active monetary policy**
    - Expand credit
    - Reduction of interest rate
  - **Compensatory fiscal measures**
    - Tax exemptions
    - Increase of public investments

# The Responses: Monetary Policy and Credit

- Reduction of banking reserves requirements and interest rate
- Credit for Agriculture and Car Industry
- Expansion of State-Owned Bank credit and capitalization of BNDES US$ 42,5 billion
- Increase of pre-shipment export financing (ACC)
- Increase of credit lines to finance private externaldebt.

# The Responses: Fiscal Policy

- **Tax exemptions**
  - ❖ Reduction on Individual Income Tax (R$ 5,6 bi in 2009)
  - ❖ Temporary tax exemptions (IPI): for motor vehicles, kitchen appliances and building construction materials. (R$ 5,6 bi in 2009)
  - ❖ Temporary zero tax (PIS/COFINS) for motorcycles, wheat, flour and bread.
  - ❖ Tax reduction (IPI) for capital goods.
  - ❖ Tax reduction in credit
- Growth Acceleration Program (PAC)
- New Housing Program (Minha Casa Minha Vida): 1 million units

# Measures on the Revenue Side

| FISCAL RESPONSE MEASURES | IMPACT IN 2009 | IMPACT IN 2010 |
|---|---|---|
| **Revenue Side** | **14.6bn** | **2,9 bn** |
| **% GDP** | **0,46** | **0,08*** |
| Of Which: | | |
| Personal Income Tax | 5.6 bn | - |
| IPI Measures | 5.8 bn | 2,7 bn |
| Financial Transaction Tax Reductions | 3.1 bn | - |
| Other Measures | 0.1bn | 0,2 bn |

Source: MF/RFB and STN. *GDP compatible with the parameters of the Budget Law 2010.

# Measures on the Expenditure Side

- Housing Program ("Minha Casa, Minha Vida") resources;
- Maintenance and expansion of welfare programs, like "Bolsa Família" (Budget 2010: R$ 14 bn) and "LOAS/RMV" (Budget 2010: R$ 20,2 bn);
- Increase of minimum-wage (Budget 2010: impact of R$ 9.9 bn);
- Expansion of resources to PAC investments and to the agricultural program (Plano Safra 2009/2010: R$ 107 bn in 2009-2010).

| FISCAL RESPONSE MEASURES | IMPACT IN 2009 | IMPACT IN 2010 |
|---|---|---|
| **Expenditure Side** | **16.0 bn** | **19.3 bn** |
| **% GDP** | **0,51** | **0,56*** |
| Of Which: | | |
| Social Inclusion Program | 0.6 bn | 1,3 bn |
| Unemployment Insurance Extension | 0.4 bn | |
| Housing/Construction Support | 1.6bn | 7.2 bn |
| Investments increasing** | 5.9 bn | 9.0 bn |
| Federal Gov. transfers to subnational governments | 2.0bn | 0.4 bn |
| Equalization costs | 5.5 bn | 1.4 bn |

Source: MF and STN/Cesef. * GDP compatible with the parameters of the Budget Law 2010.
** To 2009 it is equal to the difference between the total payments in 2009 and 2008. To 2010 it is the difference between the budget in 2010 and 2009, weighted by the 2009 percentage of total payments in relation to the budget of this year.

# BRAZIL:

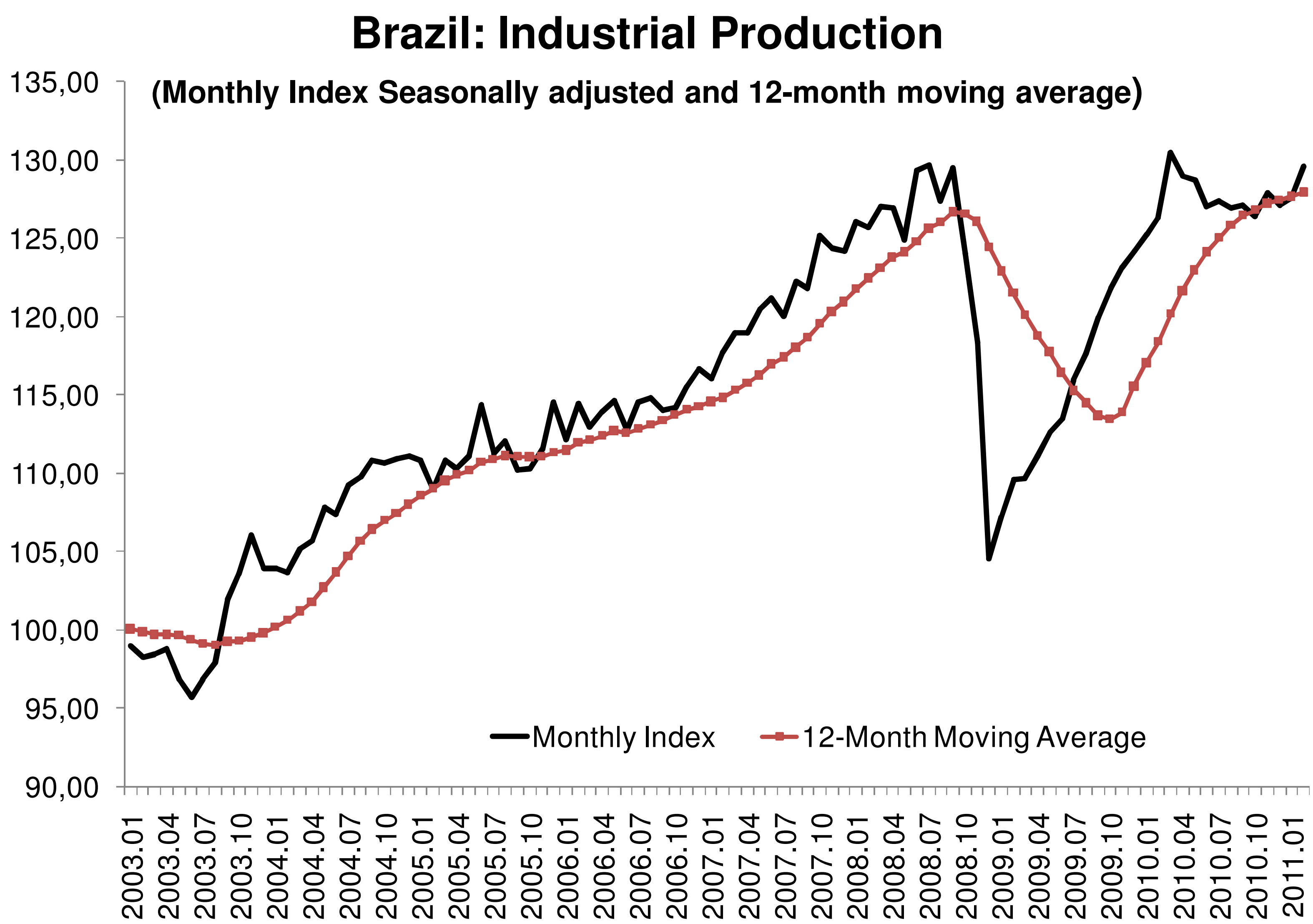
# MACROFUNDAMENTALS

# IN GOOD SHAPE

# After dropping -0,6% in 2009, GDP growth recovered strongly in 2010...now it is time to accommodate it to its potential level

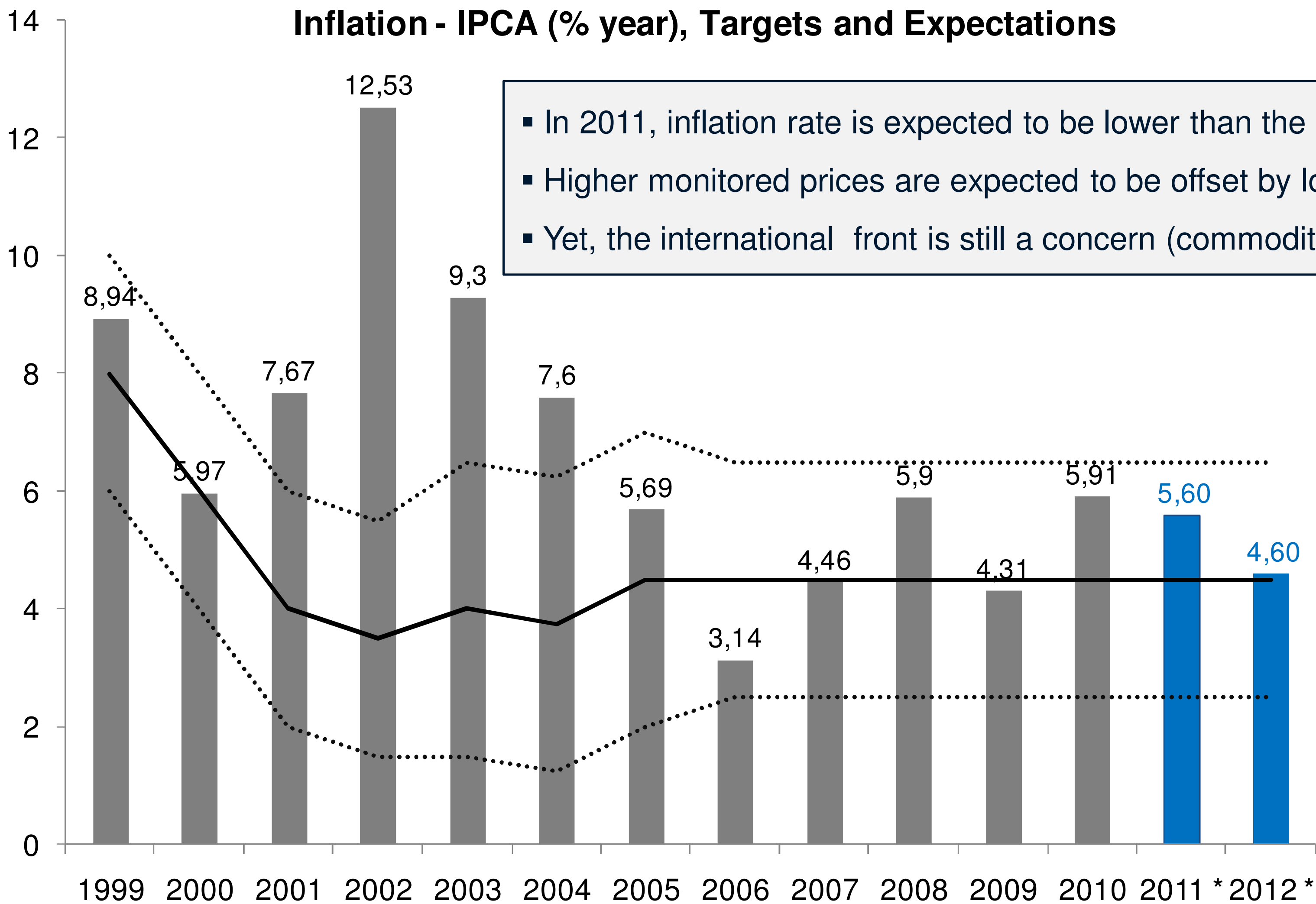

Source: IBGE * MF Forecast Produced by: MF/SPE

# Industrial Production: the "V" shape recovery in Brazil




Source: IBGE; Produced by: MF/SPE

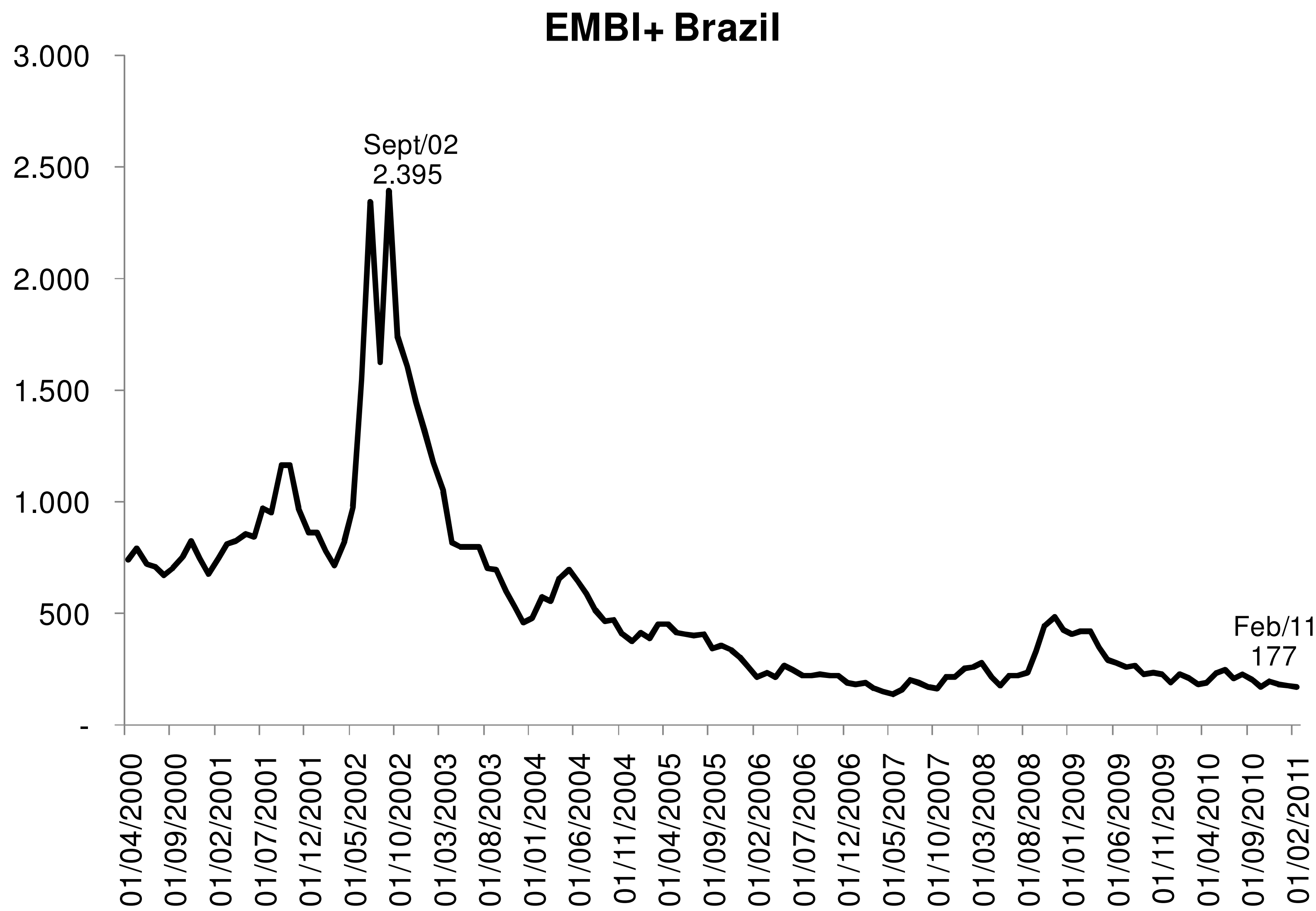
# In 2010 inflation rate was impacted by commodity price shock and now it is moving back to its target




- In 2011, inflation rate is expected to be lower than the observed in 2010.
- Higher monitored prices are expected to be offset by lower food prices.
- Yet, the international front is still a concern (commodities and oil).

Source: IBGE * Estimations: Central Bank, Brazil Produced by: MF/SPE

# Country risk is no longer an issue in Brazil




Source: Bloomberg Produced by: MF/SPE

# BRAZIL:

# THE FISCAL FRONT

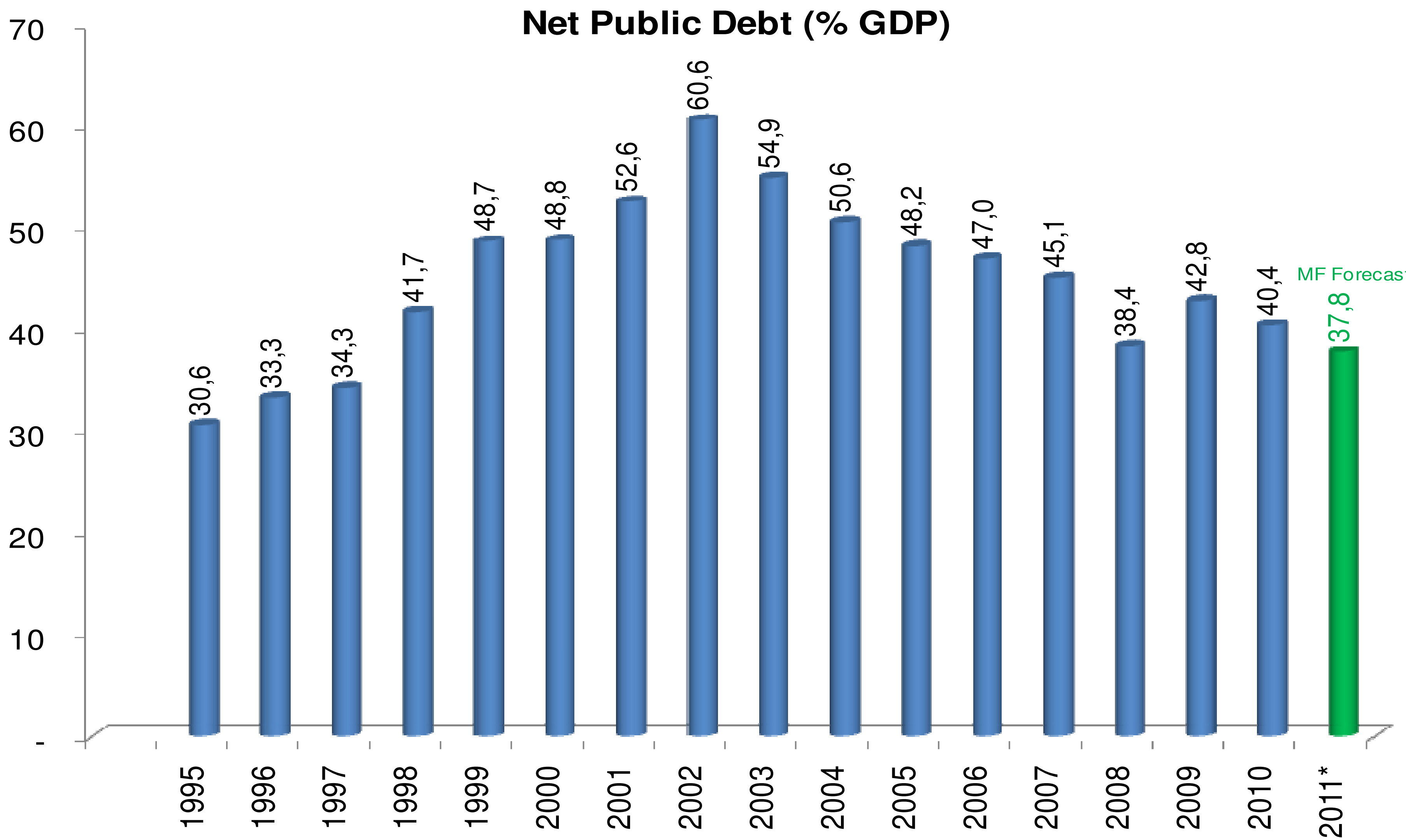
# The Fiscal Front: The 2008 financial crisis was almost undetectable to the fiscal front

- Debt to GDP increased in the aftermath of the financial turmoil, but now has been declining to a lower level
- Fiscal balance deteriorated a little bit due to the financial crash
- The participation by indexing factors registered the following evolution:
  - ❖ The % of securities indexed to exchange rates remained stable at 0.5%;
  - ❖ The % of securities linked to the Selic rate stood at 28%;
  - ❖ Fixed-rate bonds rose to 28%, due to net issues of LTN and NTN-F;
  - ❖ The percentage of securities linked to price indexes stood at 24%.

# The Fiscal Front: The 2008 financial crisis was almost undetectable

- Such changes were offset by repo operations, which had their share reduced to 18.5%.
- At the end of March 2011, the maturity structure of the securities debt on the market was as follows:
  - R$ 249.5 billion (15.7% of the total) maturing in 2011;
  - R$ 303.1 billion (19.1% of the total) maturing in 2012;
  - R$ 1033.4 billion (65.2% of the total) is owed in 2013 and later.

# Decreasing Path of Public Debt




Source: BACEN

Produced by: MF/SPE

# Debt Profile and maturity have improved again

## Brazil: Federal Public Debt Profile (% total)

| | Dec-04 | Dec-05 | Dec-06 | Dec-07 | Dec-08 | Dec-09 | Dec-10 | Feb-11 |
|---|---|---|---|---|---|---|---|---|
| **Fixed Rate** | 16,05% | 23,88% | 32,48% | 35,08% | 29,91% | 32,20% | 36,63% | 33,63% |
| **Inflation Linked** | 11,90% | 13,15% | 19,92% | 24,12% | 26,56% | 26,72% | 26,64% | 28,05% |
| **Floating Rate (Selic)** | 47,82% | 45,64% | 35,40% | 32,59% | 33,86% | 34,52% | 31,59% | 33,33% |
| **FX-Exchange** | 24,22% | 17,33% | 12,20% | 8,22% | 9,68% | 6,56% | 5,14% | 4,99% |
| **TOTAL (R$ bi.)** | **1.014,21** | **1.157,26** | **1.236,94** | **1.333,75** | **1.397,34** | **1.497,39** | **1.694,04** | **1.671,78** |
| **FPD MATURITIES HELD BY THE PUBLIC** | | | | | | | | |
| **Average (years)** | 2,9 | 2,8 | 3 | 3,3 | 3,5 | 3,5 | 3,5 | 3,5 |
| **Up to 12 Months** | 39,30% | 36,30% | 32,40% | 28,20% | 25,40% | 23,60% | 23,90% | 23,60% |

Source: National Treasury/Ministry of Finance, Brazil Produced by: MF/SPE

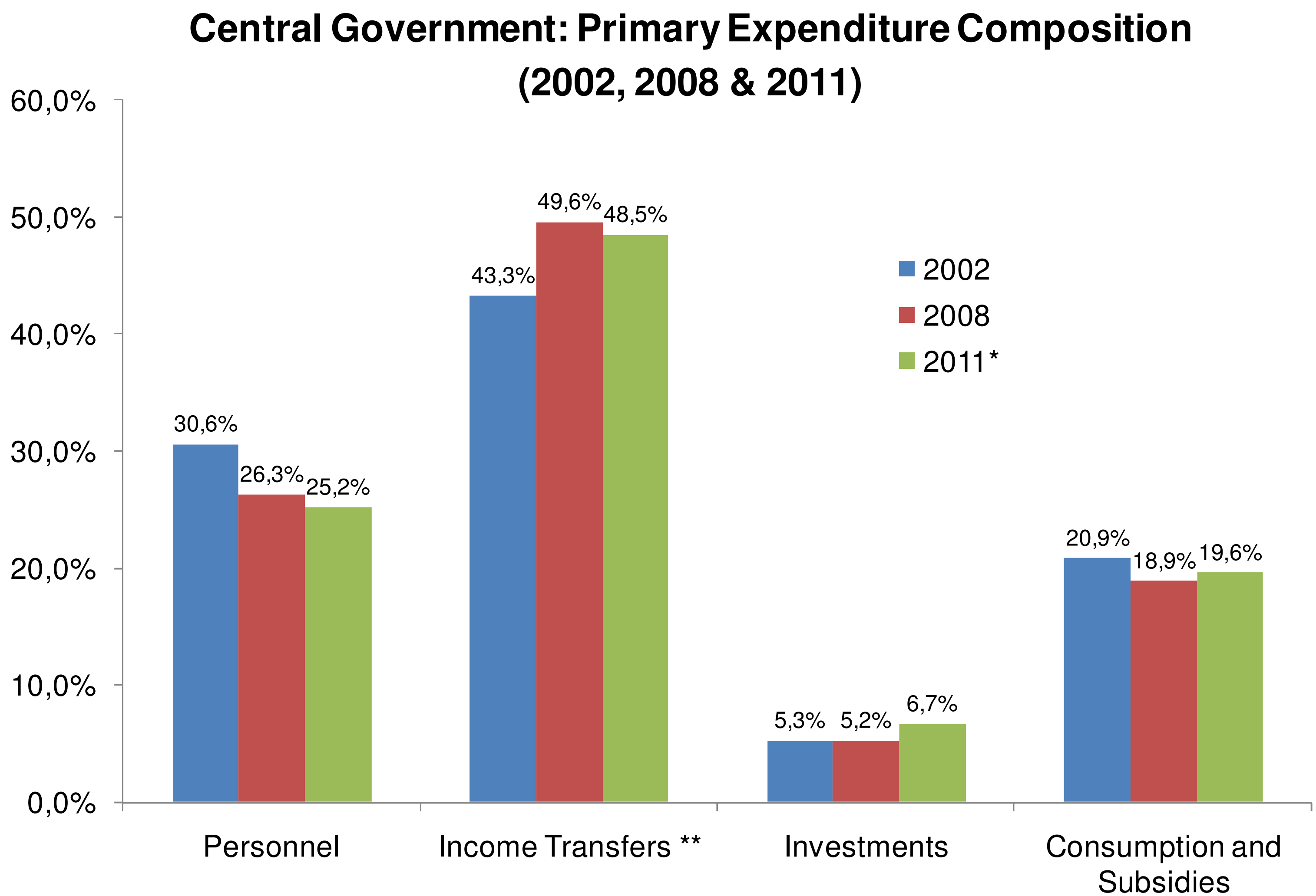
# Income transfers: important for income distribution and also to build a solid domestic market

| Federal Primary Budget (% of GDP) - Central Government | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011* |
| Gross Revenues | 21,7 | 21,0 | 21,6 | 22,7 | 22,9 | 23,3 | 23,6 | 23,2 | 23,0 | 23,3 |
| Federal Transfers to States and Municipalities | 3,8 | 3,5 | 3,5 | 3,9 | 3,9 | 4,0 | 4,4 | 4,0 | 3,8 | 4,0 |
| NET PRIMARY REVENUES | 17,9 | 17,4 | 18,1 | 18,8 | 19,0 | 19,3 | 19,2 | 19,2 | 19,2 | 19,4 |
| | | | | | | | | | | |
| PRIMARY EXPENDITURES | 15,7 | 15,1 | 15,6 | 16,4 | 17,0 | 17,1 | 16,4 | 18,0 | 17,9 | 18,0 |
| - Government Payroll | 4,8 | 4,5 | 4,3 | 4,3 | 4,5 | 4,4 | 4,3 | 4,8 | 4,5 | 4,5 |
| - Income Transfers | 6,8 | 7,2 | 7,7 | 8,1 | 8,4 | 8,5 | 8,1 | 8,9 | 8,7 | 8,7 |
| - Investments | 0,8 | 0,3 | 0,5 | 0,5 | 0,6 | 0,7 | 0,9 | 1,0 | 1,2 | 1,2 |
| - Health and Education | 1,7 | 1,6 | 1,7 | 1,8 | 1,7 | 1,8 | 1,7 | 1,9 | 2,0 | 2,0 |
| - Other | 1,6 | 1,6 | 1,5 | 1,8 | 1,7 | 1,7 | 1,4 | 1,4 | 1,4 | 1,5 |
| PRIMARY BALANCE | 2,1 | 2,3 | 2,5 | 2,5 | 2,1 | 2,2 | 2,4 | 1,2 | 2,1 | 2,2 |

*/ 12-month accum. up to Feb/2011 ; Source: MF/STN Produced by: MF/SPE

Ministry of Finance

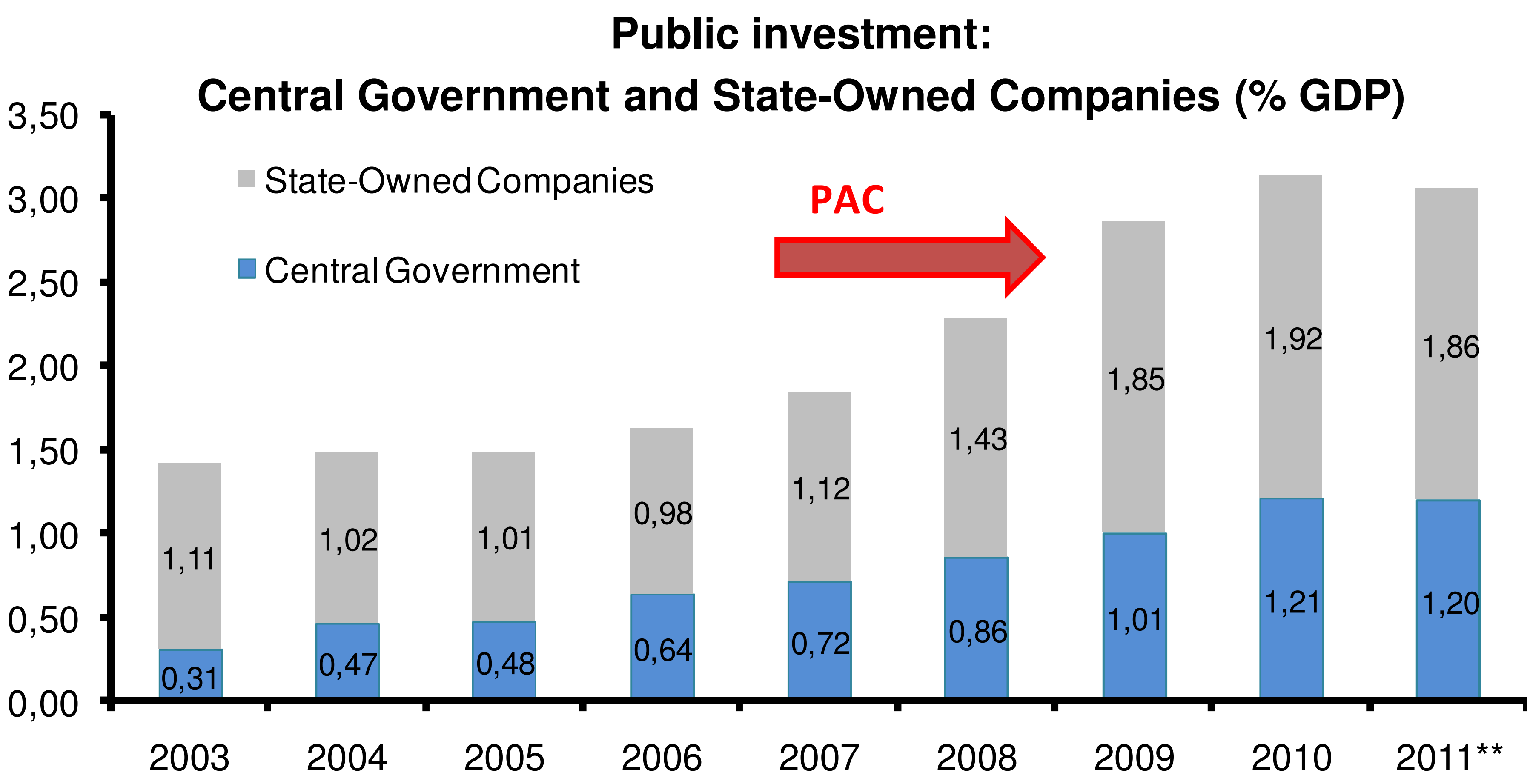
# Expenditures: The aim is on investments and income transfers as social inclusion




*/ 12-month accum. up to Feb/11.
**/ Including "Bolsa Família" Benefits.

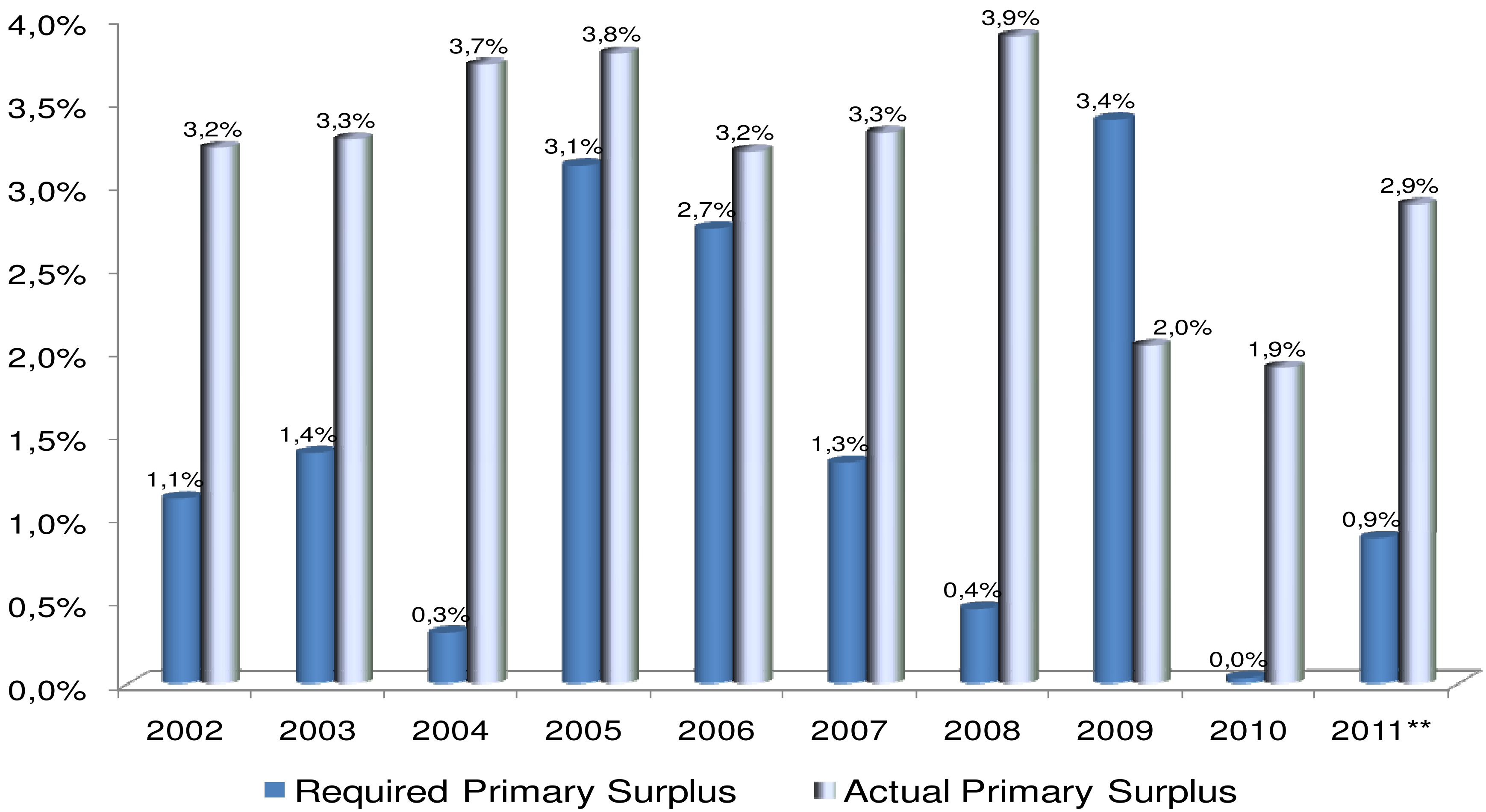
Source: National Treasury/Ministry of Finance, Brazil Produced by: MF/SPE

# Public investment will continue to play a central role in the Brazilian development




Source: MF/STN; MP/DEST *Investments abroad not included; ** 12-month accum. up to Feb/11 Produced by: MF/SPE.

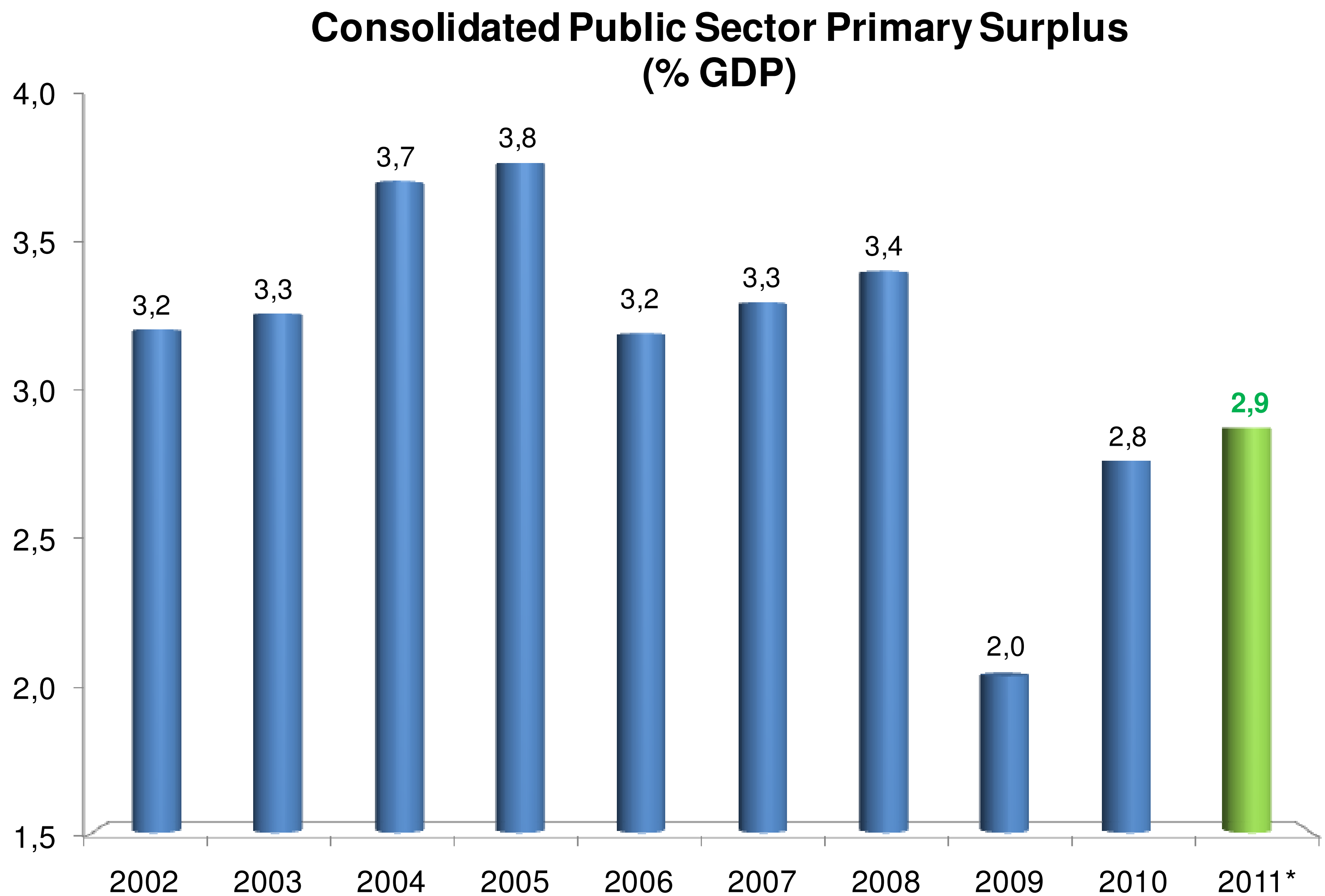
# Primary Surplus will be back to 2.9% of GDP in 2011
# Required surplus has been more than enough




The required surplus takes into account the current level of debt, the interest rate and economic growth forecast to measure what fiscal effort has to be made by the government in order to stabilize debt.

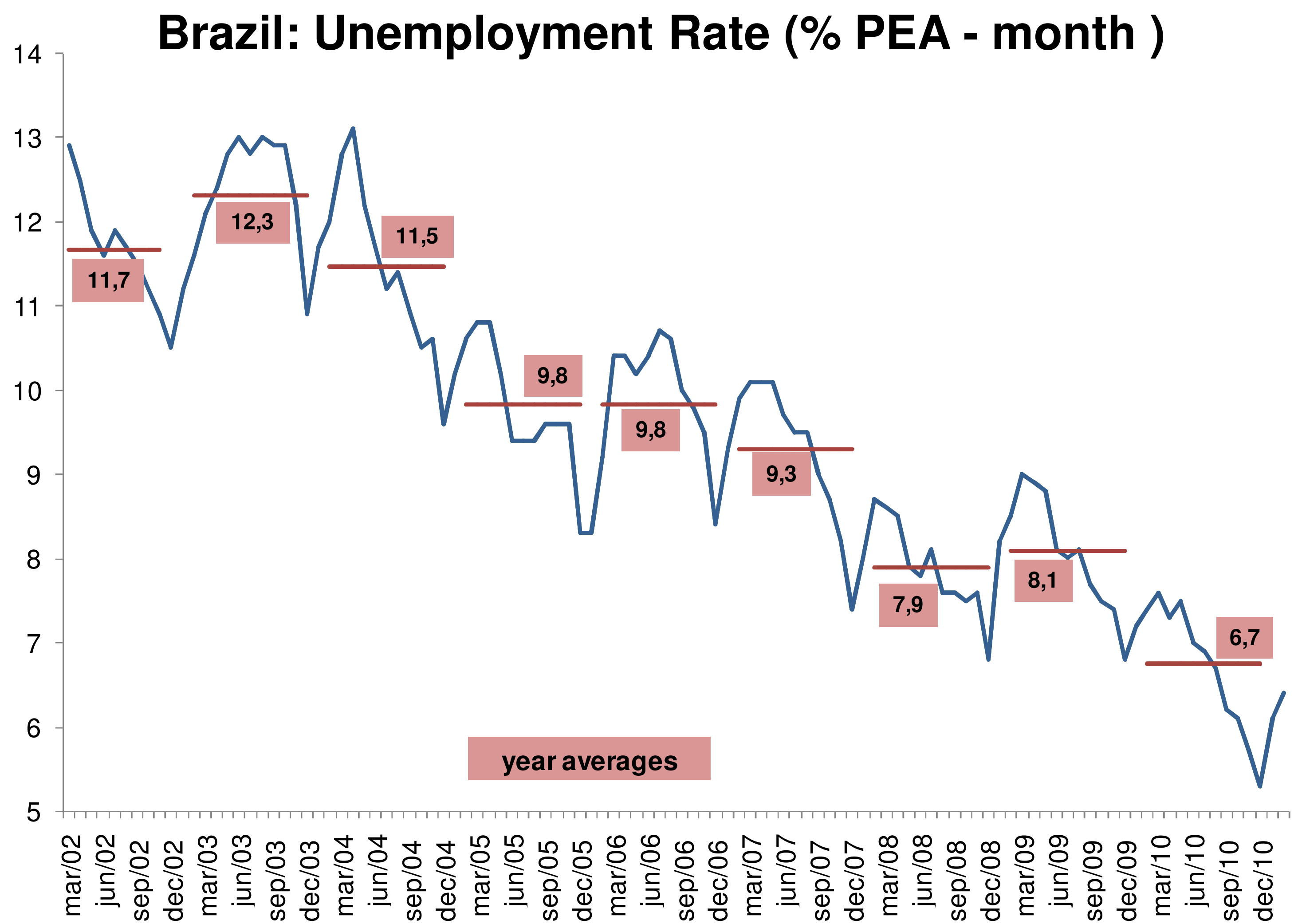
Source: BACEN **/ Forecast Produced by:MF/SPE

# Primary Surplus will be back to 2.9% of GDP in 2011



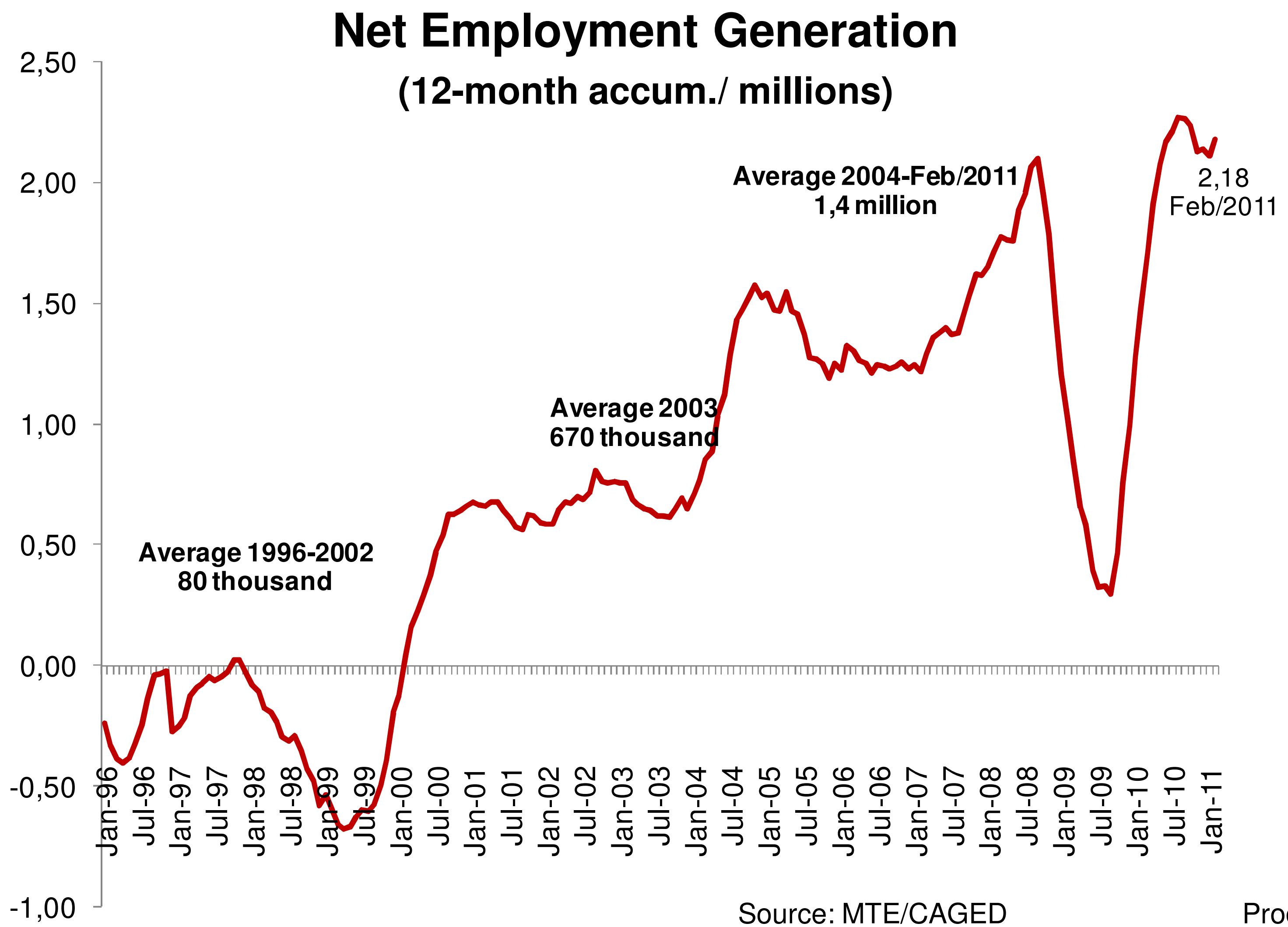

Source: BACEN */ ForecastProducedby:MF/SPE

# Domestic Market is booming: unemployment rate has reached very low levels




Source: IBGE/PME. Produced by: MF/SPE

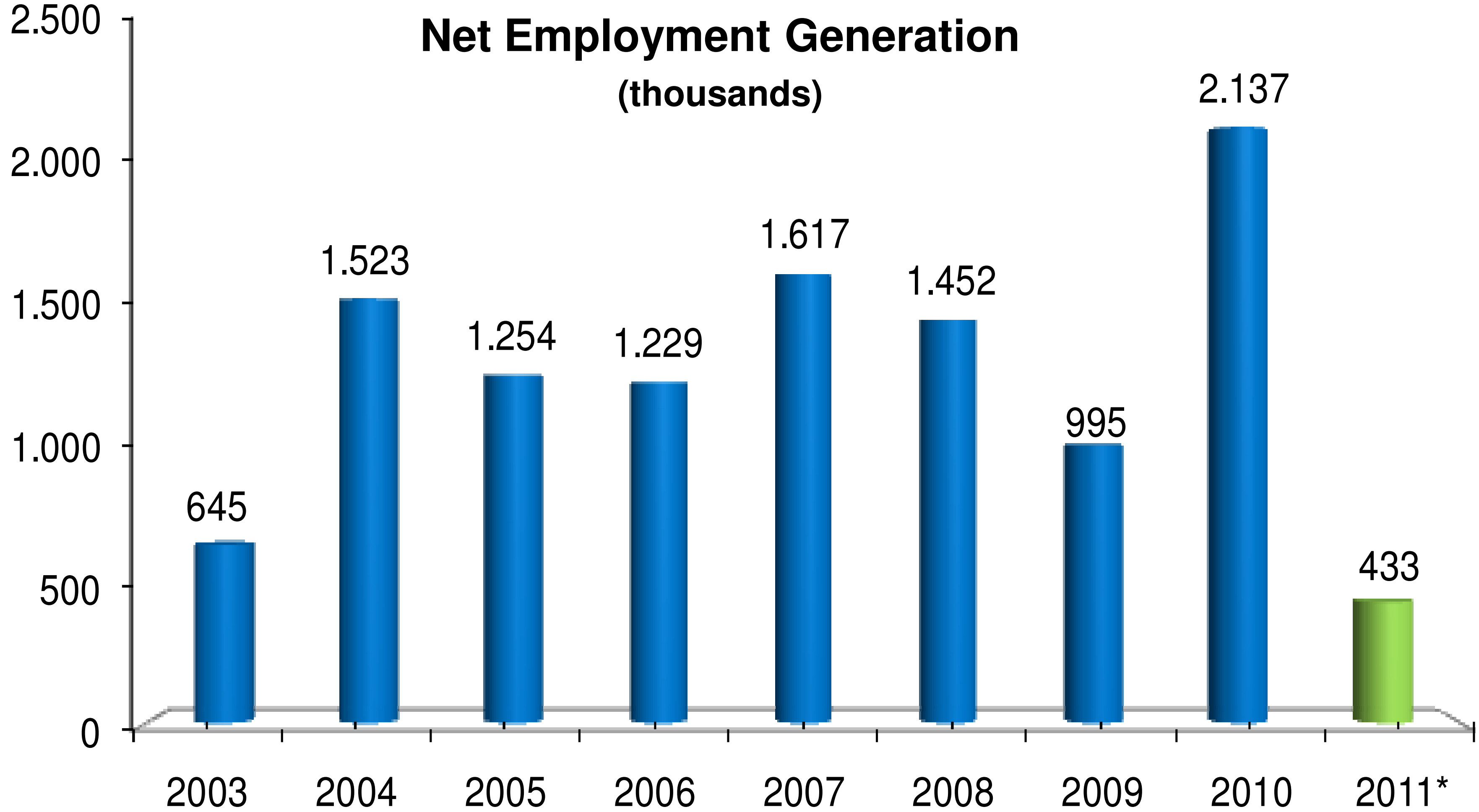
# Important transformation in the domestic market: more formal than informal jobs have been created




Source: MTE/CAGED

Producedby: MF/SPE.

# Record Job Creation: 15 million (2003-2010)




*/ Acum. Jan-Feb/11 Source: MTE/CAGED

Produced : MF/SPE.

# Important Issue

- **The fiscal consolidation program in Brazil in order to strengthen fiscal credibility:**
  - ❖ Getting primary surplus is only part of the solution.
  - ❖ More about quality of the public spending with improvement in fiscal balance and decline in the debt/GDP ratio
- **Finding ways to do more with less resources**

# Reprogramming 2011 Annual Fiscal Budget

- Reverse the 2009/2010 fiscal stimulus
- Reduce government consumption
- Improve spending efficiency
- Preserve social programs
- Preserve investments
- Give the condition for interest rate cuts

# Focus on the sustainable growth

- **We aim at investment-led growth at 5% with:**
  - ❖ Inflation rate in the target (inflation target at 4.5%, due to 2012, with efforts to get it in its target in 2011)
  - ❖ Decrease in the nominal deficit
  - ❖ Reduction in the net debt to GDP
  - ❖ Convergence of the interest rate to somewhat a “normal” level

# Fiscal Consolidation has begun: first step is the reprogramming of the 2011 annual budget

- **Reduction in mandatory spending (R$ 15,8 bi.**

**Reductions in Mandatory Spending**

R$ mi.

| | Budget Law ( a ) | Budget Reprogramming (b) | Difference ( c = b - a ) |
|---|---|---|---|
| | | | |
| **Changes in Mandatory Expenses** | **506.823,8** | **491.061,3** | **-15.762,4** |
| Personnel | 183.004,1 | 179.504,1 | -3.500,0 |
| Pension Benefits | 278.404,9 | 276.405,0 | -2.000,0 |
| Unemployment Benefits | 30.090,2 | 27.090,2 | -3.000,0 |
| Subsidies | 15.264,5 | 6.342,1 | -8.922,3 |
| Development Funds (Amazon and Northeast Regions) | 0,0 | 1.500,0 | 1.500,0 |
| Transfers: National Agency for Water | 60,1 | 219,9 | 159,8 |

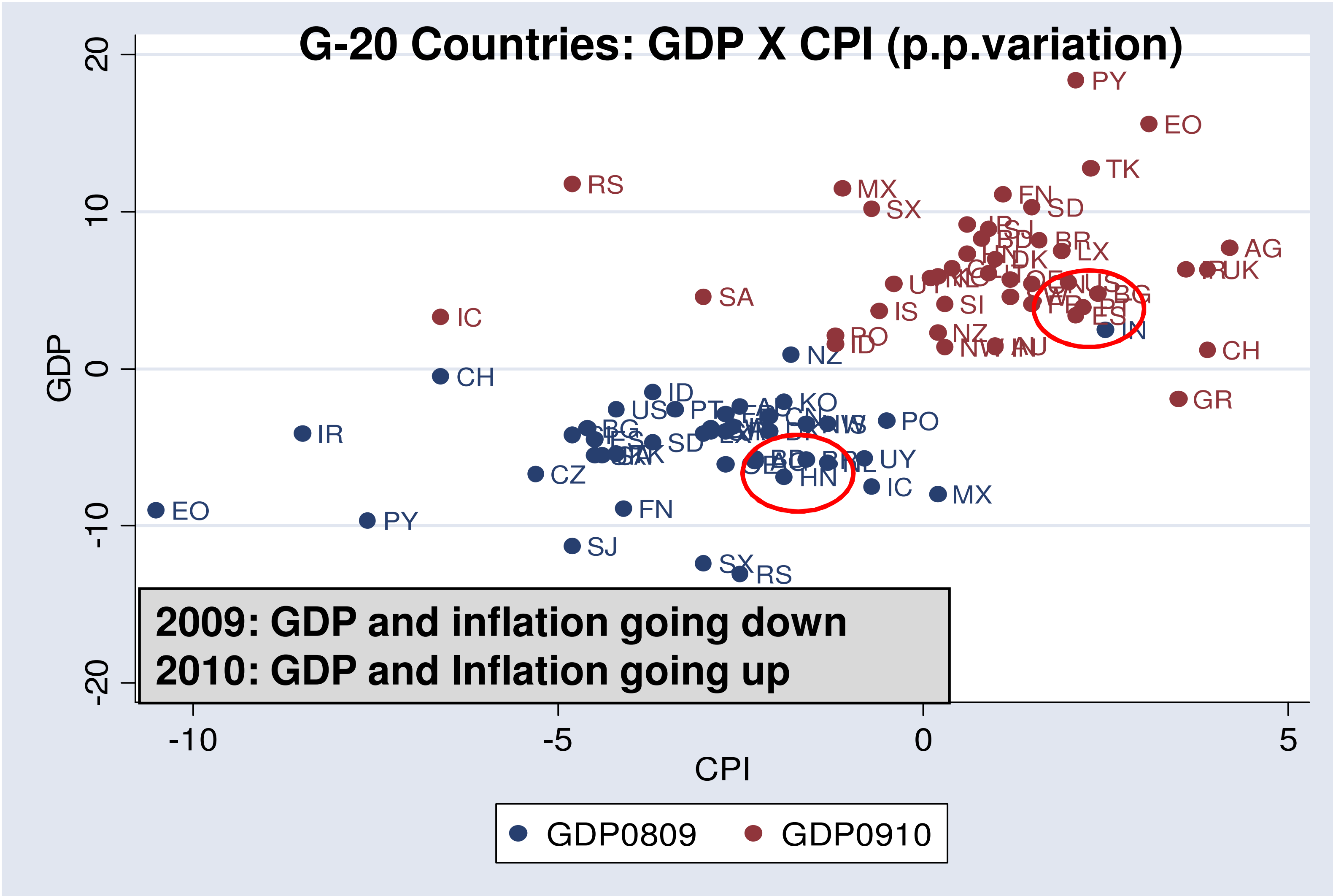
Source: Planning and Finance Ministries

# Budget Reprogramming: (% GDP)

| | 2010 | Budget Reprogramming | Difference |
|---|---|---|---|
| **TOTAL REVENUES** | **23,03** | **23,95** | **0,92** |
| **Federal Transfers to States and Municipalities** | **3,62** | **4,05** | **0,43** |
| NET REVENUES | 19,40 | 19,9 | 0,49 |
| PRIMARY EXPENDITURES | 18,1 | 17,88 | 0,24 |
| - Personnel | 4,53 | 4,43 | 0,10 |
| - Pension Benefits | 6,93 | 6,81 | 0,12 |
| - Other Mandatory Expenses | 2,06 | 2,01 | 0,05 |
| - Other Discretionary Expenses | 4,6 | 4,63 | 0,04 |
| | | | |
| **PRIMARY BALANCE** | **1,27** | **2,02** | **0,74** |
| Impact of Petrobras Caps. | 0,87 | - | 0,87 |
| **PRIMARY BALANCE - Treasury** | **2,14** | **2,02** | **0,13** |
| | | | |
| Contribution for the Primary Balance - Public Sector | 4,9 | 6,07 | 1,17 |

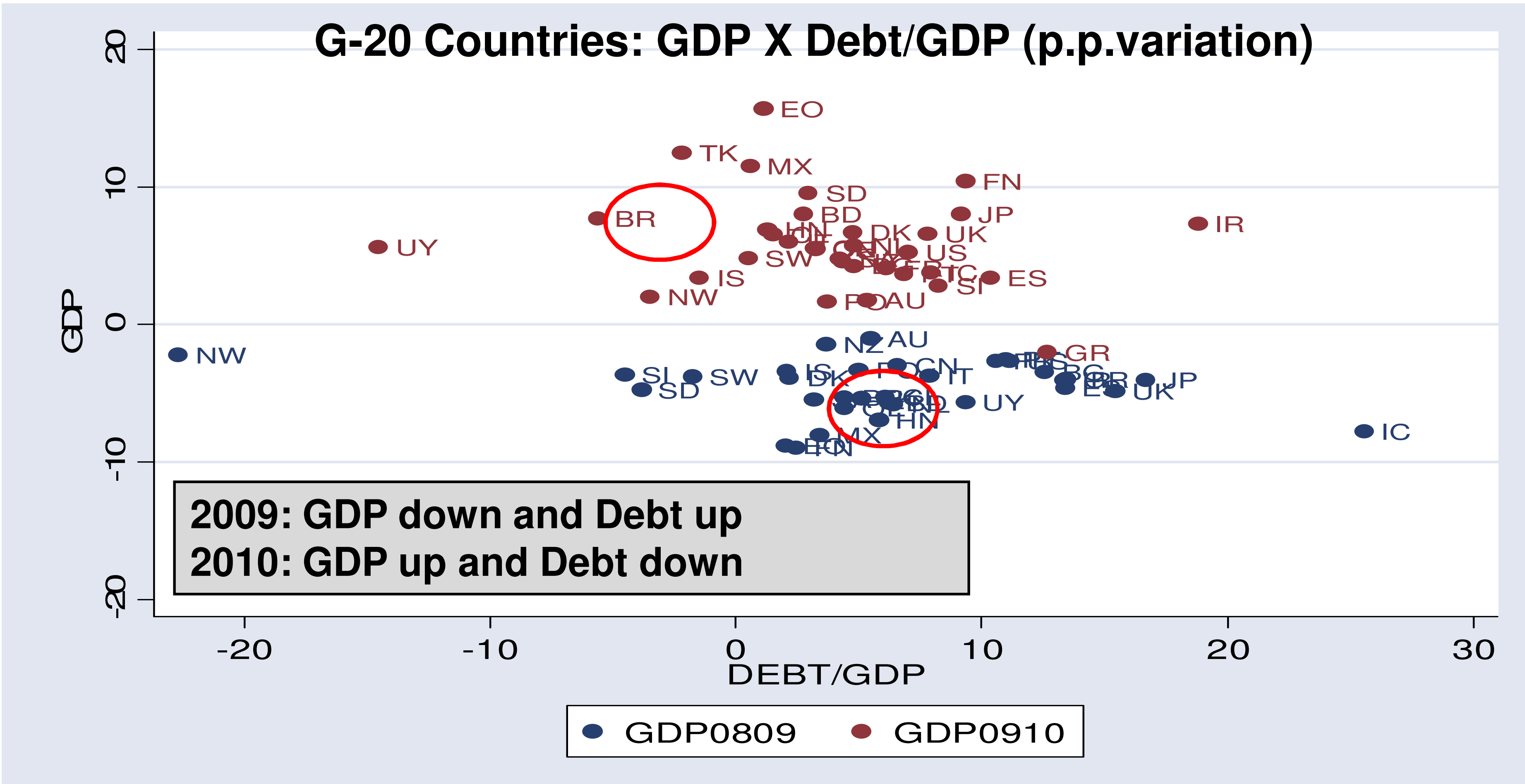
# INTERNATIONAL COMPARISON

# **Brazil is no different than other G-20:** the pace of recovery in Brazil is faster than in the G-20 countries along with inflation



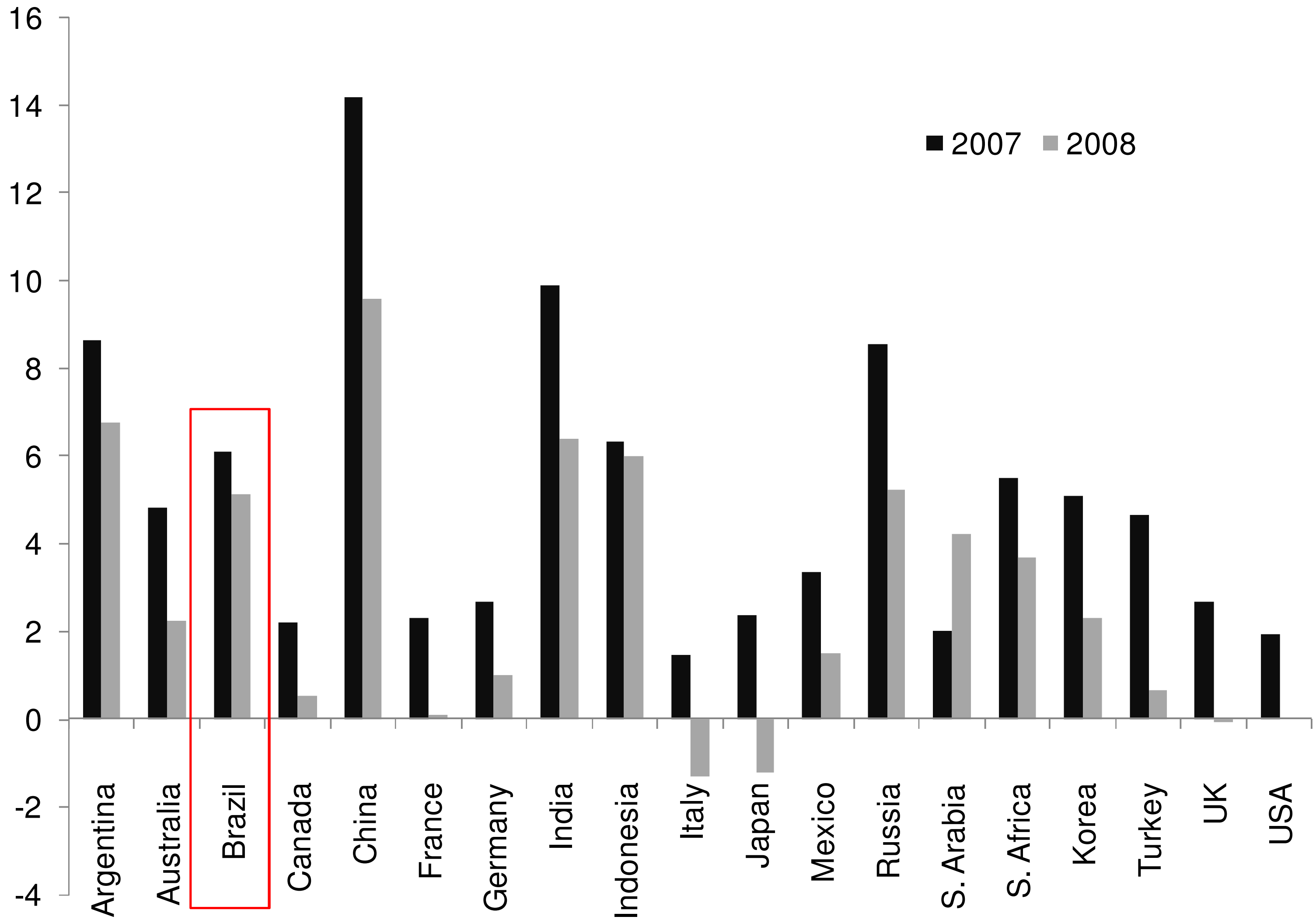

GDP: GDP growth (annual %); CPI: inflation, consumer prices (annual %); Source: 2008-2009 (WDI); 2010 (EIU).

**The same applies to public debt:** the pace of fiscal consolidation in Brazil is faster than in the G-20 countries



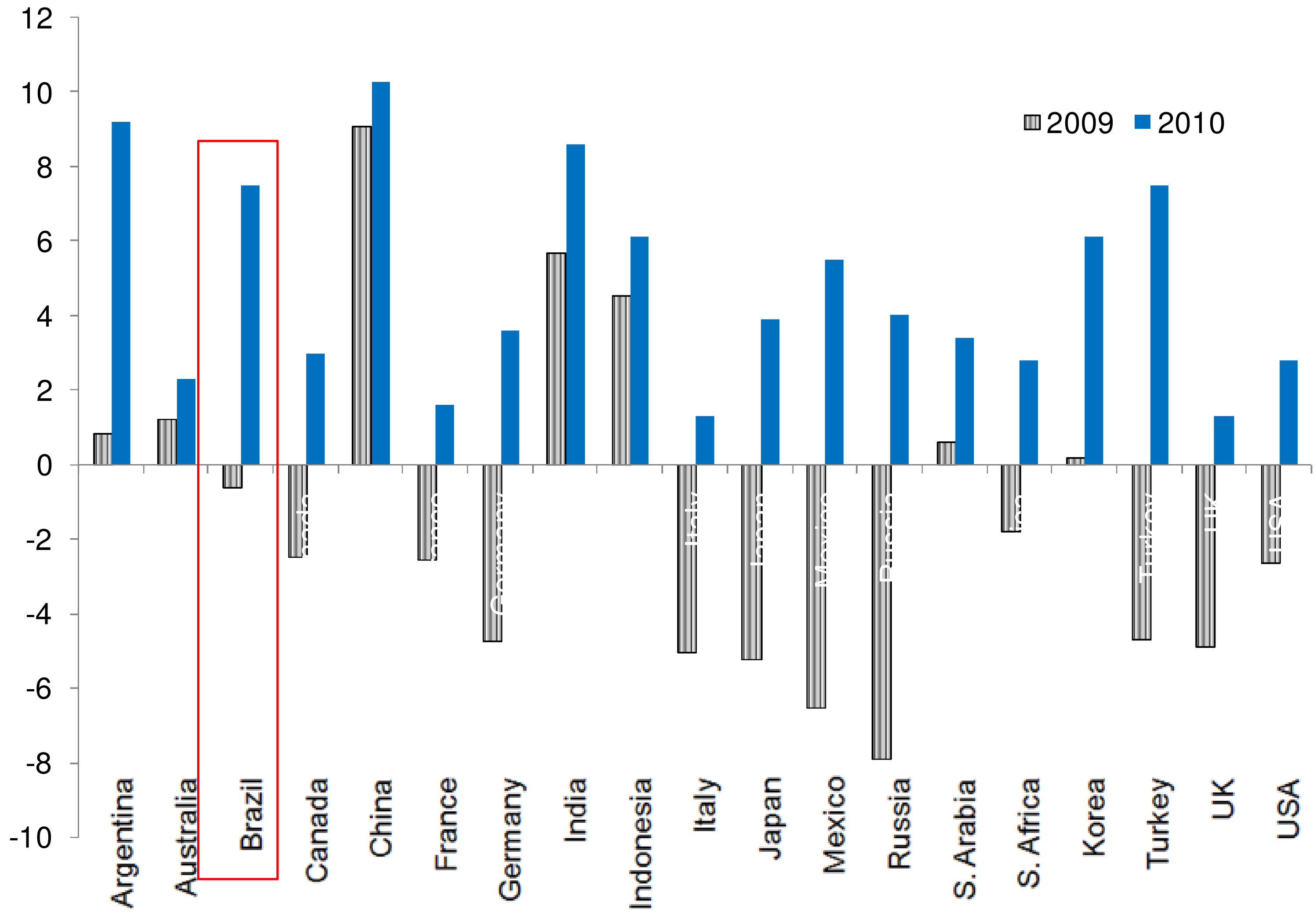

GDP: Annual percentages of constant price GDP are year-on-year changes; the base year is country-specific.
Debt: Net debt is calculated as gross debt minus financial assets corresponding to debt instruments. These financial assets are: monetary gold and SDRs, currency and deposits, debt securities, Source: WEO

# G-20 Countries: comparing GDP growth rates



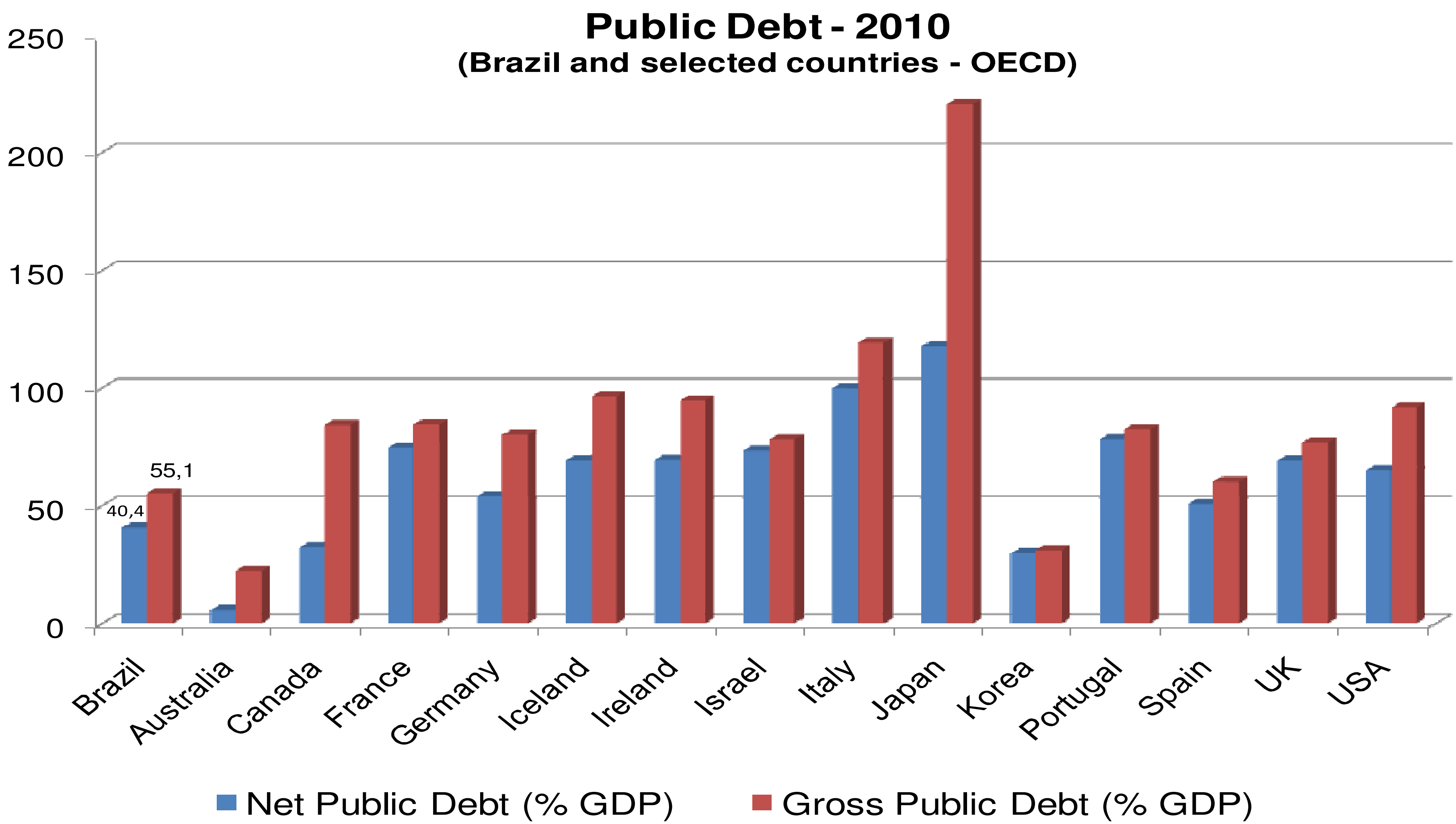

Source: WEO Produced by:MF/SPE

# G-20 Countries: comparing GDP growth rates



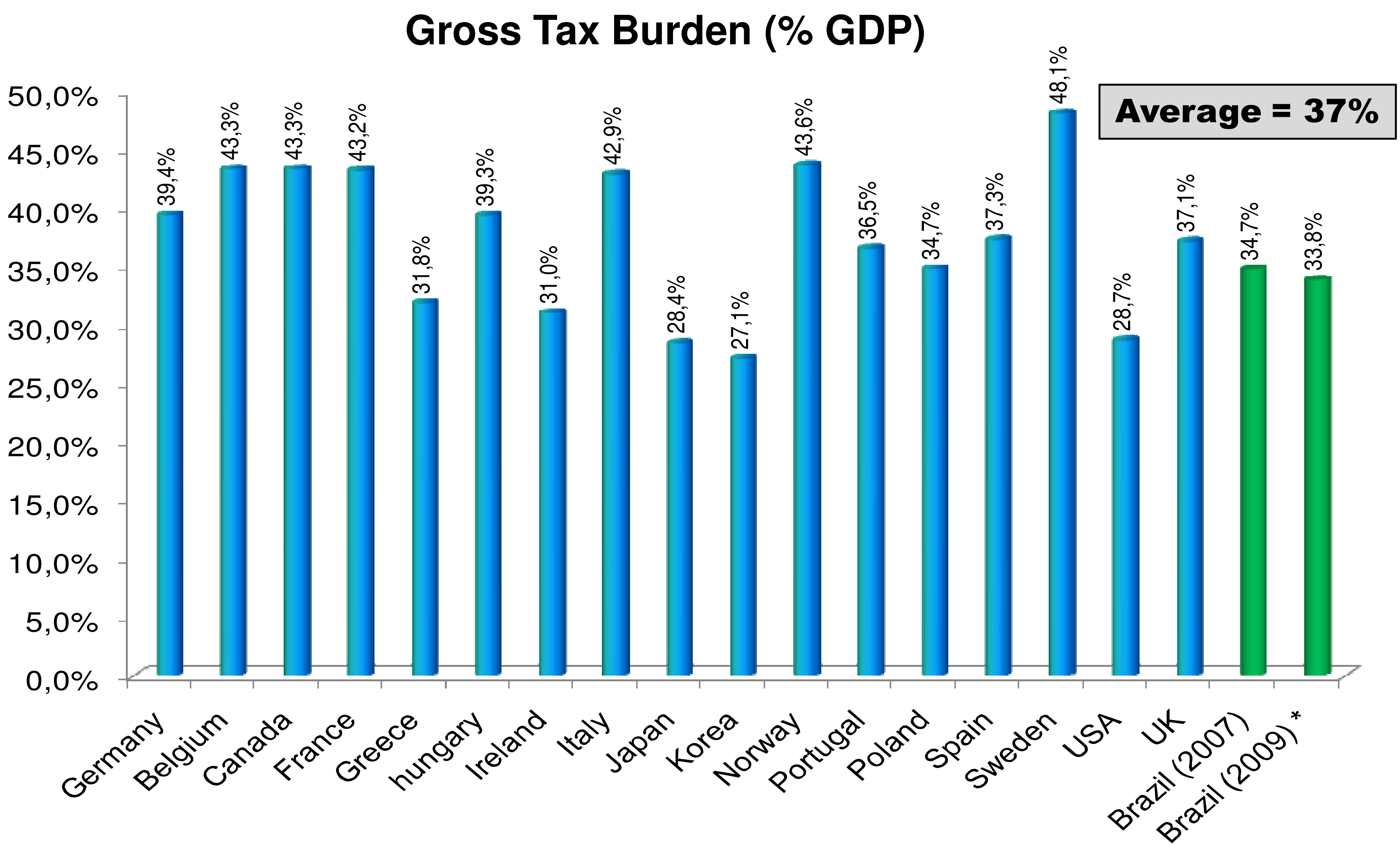

Source: WEO Produced by:MF/SPE

# Brazil´s fiscal situation is much better than the majority of the OECD economies



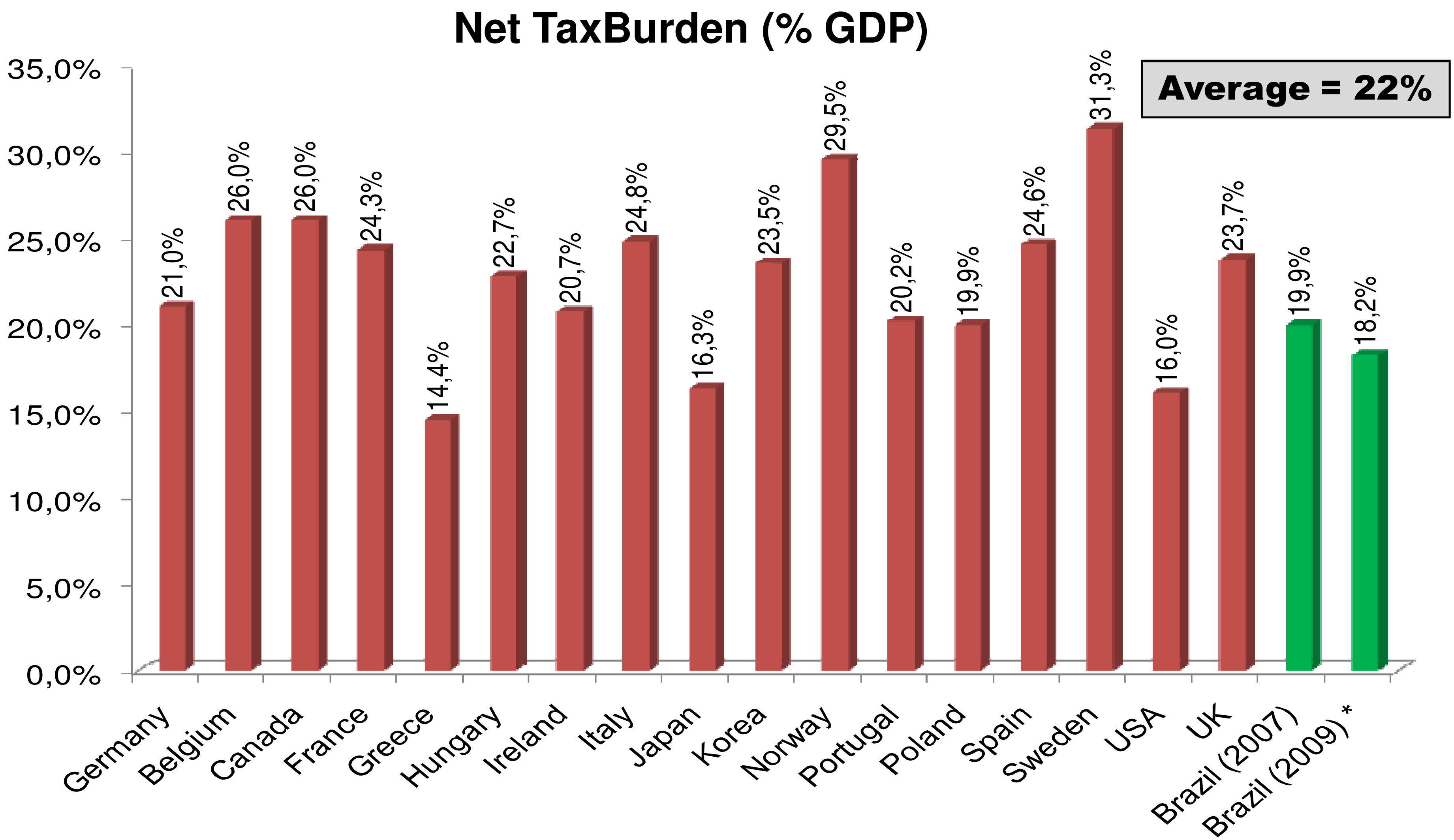

Source: BACEN e Fiscal Monitor IMF 2011 Produced by:MF/SPE

# Tax burden in Brazil is lower than in its peers




Source: BACEN e Fiscal Monitor IMF 2011 */ Forecast Produced by:MF/SPE

# The net tax burden is also low




NTB: excludes income transfers (social security, social programs, interest rate, etc)

Source: BACEN e Fiscal Monitor IMF 2011 */ Forecast Produced by:MF/SPE

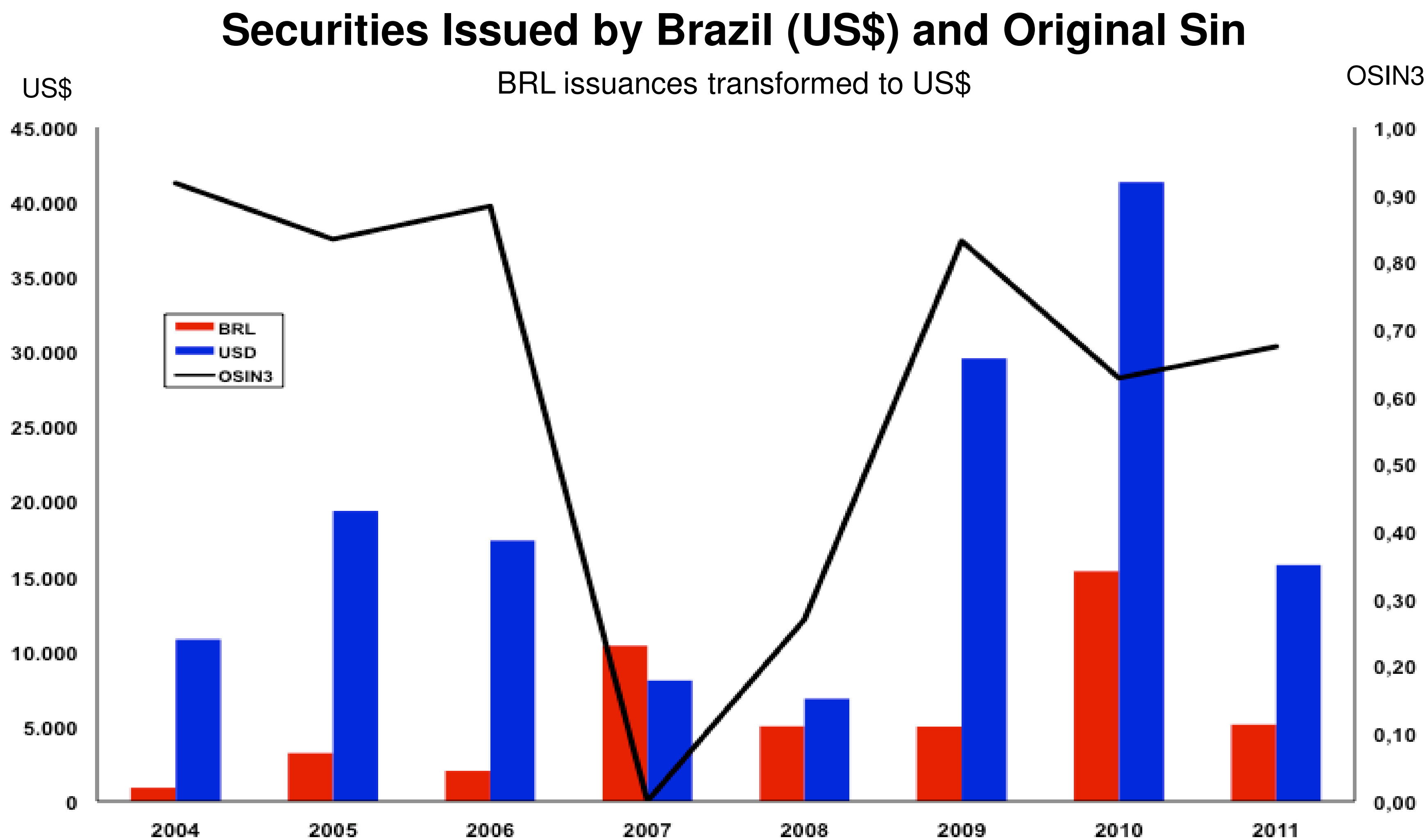
# Once upon a time...

- The World Bank used to classify Brazil as a **"lower middle income and severely indebted country"**
  - External debt is no longer a problem less than a decade after this classification

# Once upon a time...

- **Eichengreen, Hausmann and Panizza**:
  - ❖ Because Brazil is a country unable to borrow abroad in its own currency it suffers from “original sin”.
  - ❖ Brazil has issued Real-denominated bonds abroad and dollar-denominated domestic debt is irrelevant;
    - ❖ Particularly in 2007 it was issued abroad more Real-denominated bonds than US Dollar-denominated ones! The road to redemption was found even thought temporarily.
  - ❖ short-termism in the debt has been coped with solid fiscal policy

# In 2007, Brazil found the road to redemption !




OSIN3 = max(1 - securities in BRL/securities issued by Brazil, 0)

Source: Bloomberg

# Once upon a time...

- **Reinhart, Rogoff and Savastano (2003):**
  - ❖ Brazil could be considered a “serial defaulter” because of its debt intolerance
  - ❖ Since 2008 Brazil migrated to investment grade and more upgrades are expected soon thanks to good fiscal and monetary policies and also sound domestic banking and financial system.
  - ❖ Nowadays, probability of default is close to zero.

# THE AGENDA

# Fiscal agenda in Brazil

- **Given that:**
  - ❖ Debt sustainability is no longer a big issue.
  - ❖ And that the required consolidated public sector primary surplus is lower than the target one

- **It is expected, as the next step, that we should:**
  - ❖ Intensify the lengthening of domestic debt
  - ❖ Put focus on the quality of the public spending and on the effectiveness of the public policies (unemployment insurance, salary bonus, illness benefit, public payroll...)
  - ❖ Focus in nominal results as far as primary surplus

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**Márcio Holland**

**Secretary of Economic Policy**


**Washington, DC - April 15th 2011**