Macroeconomic Policymaking

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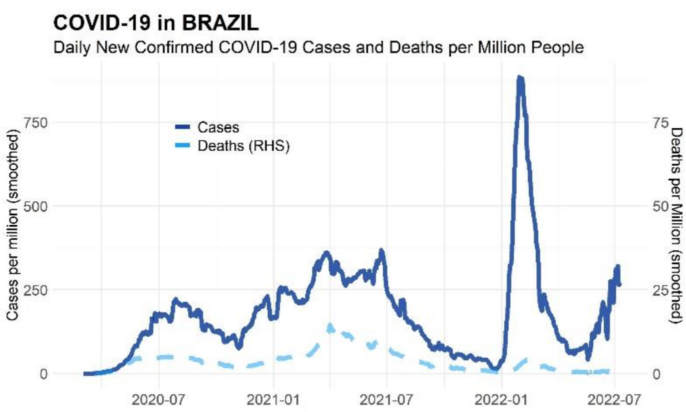
How could Brazil recover from COVID-19?

Monetary and Fiscal Policy Recommendations

By Juan Felipe Serrano Ariza

Introduction

Since February 26, 2020, when Brazil's first COVID-19 case was reported, the country has seen over 15 million cases and 400,000 deaths attributable to the coronavirus[1].



In contrast with slowing case volumes and deaths elsewhere, Brazil reached its highest peak in March 2021, reporting over 100,000 confirmed cases on a single day. Most states have over 90% ICU occupancy and little oxygen and sedatives remaining[2], reflecting significant challenges for the federal and subnational governments. The government deserves congratulation for vaccinating 16.9 million people (7.9% of the total population) and securing 100 million Pfizer and 10 million Sputnik V vaccine doses in addition to existing Coronavac and AstraZeneca/Oxford contracts[3]. I encourage increased spending on vaccination campaigns and healthcare while implementing stricter social distancing measures and efficient contract tracing mechanisms to prevent a collapse of an overburdened healthcare system.

Last March, the National Congress declared the pandemic a public calamity, exempting federal and subnational budgets from their 2020 deficit goal and accompanying Fiscal Responsibility Requirements. Additionally, the Minister of Finance announced US$150 billion in stimulus to face the economic impacts of COVID-19. These policies made Brazil a worldwide leader in fiscal generosity for its people during this difficult time. However, these policies cost 14.6 percent of 2020 GDP[4] (8.3% of GDP on spending and 6.3% of GDP on forgone revenue). It is recommended to extend policies through this year with a drawdown in 2022, dependent on continued COVID-19 caseloads[5]. Given Brazil's macroeconomic history, one concern is that markets may lose confidence in the country's ability to repay, leading to significant negative long-term consequences.

Since 1960, Brazil has experienced extensive macroeconomic instability. From 1960-1978, Brazil suffered relatively high inflation and rapid economic growth as it embraced import substitution-led domestic manufacturing. Policies were financed by expanding the monetary base and adding external liquidity, yielding inflation and debt. From 1975 onwards, global interest rates increased, squeezing Brazil's ability to finance its debt[6]. Higher taxes lowered growth, and then these issues were amplified by rising inflation[7]. Then, in 1985, the new Democratic Congress increased spending, leading to hyperinflation. This period was characterized by a toxic combination of high fiscal deficits, passive monetary policy, and constraints to debt financing.

In 1994, Brazil launched the "Real Plan", which reduced inflation from 2477% in 1993 to 9.5% in 1996[8]. Foreign capital inflows resumed after a long process of debt rescheduling. Many institutional reforms were accomplished, like the introduction of a monetary policy committee, inflation targeting, and the Law of Fiscal Responsibility. In 1999, Brazil moved to a floating exchange regime and adopted an inflation-targeting regime, further increasing institutional discipline. The Real Plan's fiscal adjustments were crucial to overcoming hyperinflation and providing long-term macroeconomic stability.

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[1] New York Times, Brazil Coronavirus Tracker
[2] Reuters
[3] Brazil Overview (worldbank.org)
[4] https://www.imf.org/en/Publications/FM/Issues/2021/03/29/fiscal-monitor-april-2021
[5] Brazil: Tax developments in response of COVID-19 - KPMG Global (home.kpmg)
[6] Ayres, Joao, Marcio Garcia, Diogo A. Guillén, and Patrick J. Kehoe. *The monetary and fiscal history of Brazil, 1960-2016*. No. w25421. National Bureau of Economic Research, 2019.
[7] GDP Growth and Inflation figures: https://economics.rabobank.com/publications/2014/january/brazils-macro-economy-past-and-present/
[8] https://economics.rabobank.com/publications/2014/january/brazils-macro-economy-past-and-present/

Recently, Brazil reverted to primary deficit governance, even with a high tax burden. The pandemic has exacerbated concerns of fiscal and monetary discipline, which is recommend to be addressed immediately to avoid a return to macroeconomic instability.

Description of the problems

The sooner Brazil controls the pandemic, the quicker the economy can return to normal. Brazil's health system must be adequately resourced for COVID-19 patient care and vaccine distribution at free or affordable prices. The government's decentralized health response has failed, and continued failure at vaccine distribution will derail any near-term economic recovery.

Brazil's efforts to support its citizens during the pandemic have been noteworthy, but expensive. The pandemic has resulted in a significant decline in both demand and supply, bringing uncertainties to macroeconomic policymaking. Once the virus has been controlled, strong fiscal consolidation and implementation of structural reforms must occur to support long-term economic stability and inspire confidence in financial markets. With the general election in October 2022, this year is key to revitalizing the government fiscal reform agenda by boosting budgetary flexibility and maintaining the credibility of the spending cap.

Economic activity and Unemployment

Recent Brazilian growth figures reflect the impact of the federal government's expenditure. In Q3 of 2020 when government spending was highest, economic growth was 7.7%. Last quarter, many government programs expired, and the economy grew only 3.2%[9]. BCB's economic activity index expanded during the first months of 2021, also indicating the continuity of activity in the recovery. However, Brazil will suffer the biggest hit to Q2 GDP due to ongoing state- and city-level lockdowns to fight the rising death toll.

Even with the stimulus package, the unemployment rate rose in Q4 of 2020, reaching the highest values since 2012. This increase reflects concerns of getting sick, continued social distancing, less economic activity, and wide government transfer programs. Part of the divergence between the economic recovery indicators and the weakening labor market is also due to a growing workforce.

Inflation

Annual inflation rose to 6.1% in March 2021, above February's 5.2%, marking the highest inflation rate since December 2016 and exceeding this year's 3.75% inflation target[10]. A combination of rising international commodity prices, supply chain disruptions, Brazil's large exposure to commodities, and the depreciation of the Brazilian real can explain most of Brazil's inflationary pressures.

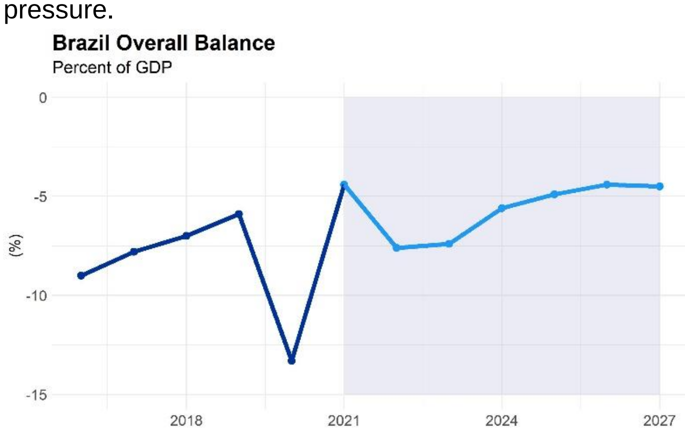
Continued increases in global and domestic commodity prices reflect atypical shocks on both global supply and demand forces. Demand has started to recover, especially in China, where industry and infrastructure investments have increased demand for commodities. Simultaneously, countries' shutdowns and lockdowns have curbed supply. As restrictions relax, these transitory shocks on the supply side should prove to be temporary.

Simultaneously, oil prices have gradually recovered after a steep plunge in 2020. Still, excess crude oil capacity remains, dampening inflationary pressures in comparison to other commodities.

On May 6, 2021, the Central Bank of Brazil raised the policy rate to **3.5%**[11], partly in response to rising inflation after cutting the interest rate to a record low of 2%.

Fiscal

Brazil faces a difficult post-pandemic fiscal situation. The general government deficit more than doubled from about 5.9% of GDP in 2019 to 13.4% in 2020. This deficit reflects a 35.0% increase in expenditures and a 10.6% drop in revenues[12]. Over a quarter of Brazil's outstanding public debt matures in the next 12 months, increasing fundraising pressure.



[9] Banco Central Do Brasil. (2021, Marzo). Inflation Report. Banco Central Do Brasil. Retrieved May 09, 2021, from https://www.bcb.gov.br/

[10] Andersson, H. (2021, April 09). Brazil Inflation March 2021. Focus-economics. Retrieved May 08, 2021, fromhttps://www.focus-economics.com/countries/brazil/news/inflation/inflation-hits-over-four-year-high-in-march

[11] Copom increases the Selic rate to 3.50% p.a. (bcb.gov.br)

[12] Banco Central Do Brasil. (2021, Marzo). Inflation Report. Banco Central Do Brasil. Retrieved May 09, 2021, from https://www.bcb.gov.br/

The fiscal stimulus was the main driver of increased 2020 expenditures. However, current expenditure generally accounts for 95% of total expenses and has grown quickly during the last few years[13]. In particular, wages account for most government expenditure, with little room elsewhere to cut. Civil servants do receive around 50% public wage markup in comparison to the private sector, signaling potentially higher compensation than necessary[14]. The federal government has supported struggling states and municipalities with debt service, but structural reforms are urgently needed.

At the federal level, fiscal policy is constrained by the:

- Golden rule: The main principle of the rule is to define a dual budget that discriminates capital expenditures (allowed to be financed through credit operations), in relation to current expenditures (debt as a financing alternative is prohibited).
- Primary balance target: It is set every year at the beginning of the budget process. It is set for the current year and indicatively for the following two years.
- Expenditure ceiling: A forced gradual reduction of 5% in federal primary expenditure as a share of GDP over a decade.

The expenditure ceiling has been an effective fiscal anchor at the national level. The ceiling forces public trade-offs between mandatory expenditures and investment allocations, increasing credibility while reducing spending.

Global Economic System

Economic recovery in the US and China intensified demand pressure on commodity prices, contributing to the recent volatility and higher inflation expectations. In Q1 2021, the US dollar also strengthened against other currencies. Most Latin American central banks will likely start raising interest rates from their current record low levels to avoid disorderly adjustments in exchange rates and further inflation. Brazil's target rate is unprecedentedly low; further reductions would cause the gap between the Fed funds rate to widen, which would encourage capital outflow and greater pressure on the Brazilian real.

Although the worsening pandemic in Brazil delayed economic recovery, sectors like manufacturing and trade are showing positive trajectories. A possible extension of fiscal policy response to the pandemic and other uncertainties is likely to exacerbate inflationary pressures.

Monetary Policy Recommendations

Inflation is significantly higher than the 3.75% target, prompting the BCB to increase the interbank interest rate. However, inflation will likely increase due to temporary factors. Taking these factors into consideration, the following measures are recommended:

1. **Maintain the target interbank interest rate at 3.5%.** The interest rate is already above Taylor's Rule recommendation. However, moderate increases in the benchmark interest rate should not be ruled out due to the gradual normalization of policy rates and because inflationary expectations are biased upward. Increases should be done timely and cautiously to promote an orderly adjustment of the markets.
2. **Implement a securities swap:** The Brazil Central Bank can improve the maturity profile of government securities and promote higher liquidity in the secondary market. By swapping short-term maturity debt with longer-term debt, Brazil can smooth its upcoming payment schedule, so debt capacity is not compromised. With a reduced risk of default, financial markets will feel more comfortable and be willing to lend at lower rates.
3. **Finance small and medium enterprises through multiple banking institutions:** By helping backstop micro, small, and medium-sized loans to corporations, the BCB can provide short-term capital relief for medium-term economic support, with a cost close to the target interest rate.
4. **Continue foreign exchange interventions:** Brazil has enough foreign reserves and the ability to gain foreign reserves from its large export base. The dynamics driving Brazil's currency rate are also improving but remain exposed to changing global investor's perceptions of emerging market risks. Therefore, the BCB should engage in a smaller number of interventions to signal that it is ready to intervene to reduce volatility.

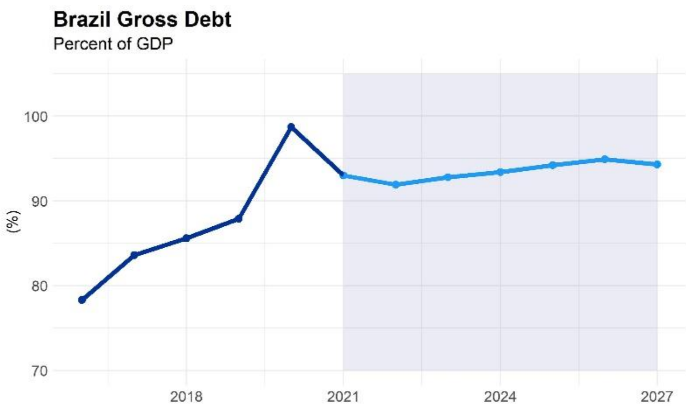
Fiscal Policy Recommendations

The COVID crisis increased Brazil's fiscal debt complexity, as the country increased expenditures to compensate citizens for income shocks. One-time spending increased

[13] Paulo, R., Marco, B., & Claúdio, F. (2021, April). Public Investment and Fiscal Crisis in Brazil. IDB. https://publications.iadb.org/publications/english/document/Public-Investment-and-Fiscal-Crisis-in-Brazil-Finding-Culprits-and-Solutions.pdf

[14] Soto, M., & Izabella, K. (2018). Rightsizing Brazil's Public-Sector Wage Bill. IMF. https://www.imf.org/en/Publications/WP/Issues/2018/10/08/Rightsizing-Brazils-Public-Sector-Wage-Bill-46194

general government debt to GDP ratio by 10 percentage points to 99% in 2020, exhibiting Brazil's vulnerability and generating nervousness in the debt markets.



A sustainable economic recovery will require both short-term and structural level changes at a national and subnational level. Considering the context presented above, the following is recommended:

1. Immediate spending strategy should be focused on vaccinating the population. Vaccination would allow the economy to open up much more quickly and also translate into cumulative gain from savings via reduced spending on lifelines for people and firms.
2. Maintain the expenditure ceiling during the 2021 budget but be prepared to provide additional fiscal support if economic or sanitary conditions are weaker than the government expected. Without a credible commitment to the expenditure ceiling, the sovereign risk premium could rise, further steepening the yield curve.
3. Reform to ensure greater fiscal space for discretionary expenditures and curbing mandatory expenses, especially at the subnational level. Reducing non-discretionary spending by aligning public compensation with the private sector and/or adding a constitutional rule limiting subnational' personnel expenditures relative to net revenues, triggering adjustment measures when getting close to a certain limit. Besides, it is necessary to unify the accounting standards to guarantee that all personnel expenditures are accounted for, including outsourced employees and several items that remunerate government employees but are classified, on purpose, as discretionary public expenditures[15].
4. Investing in building a robust and **credible medium-term framework** attuned with economic growth and extending the horizon for fiscal policymaking beyond the annual budget. To this end, commitment devices should be utilized, where some examples are strengthened rules-based or principles-based fiscal frameworks with increased transparency and accountability mechanisms and legislation such as **"preapproval" of future tax reforms** can also enhance policy credibility. To avoid undermining the credibility of Brazilian fiscal rule, the country should clearly communicate pathways for reinstating its rule (and, in some cases, recalibrate the rules' limits or improve their design) and reducing deficits and debt below the required limits. This framework should state actions towards the next objectives:

   a. **State clear actions:** to solve the short-term debt problem and its collaboration with the Central Bank operations.
   b. **Coordinating and monitoring national and subnational fiscal policy:** by creating a specialized regulatory agent and implementing alternative fiscal rules like the ones mentioned above to support the necessary fiscal adjustment.
   c. **Strengthen public revenues:** Revenue collection should be strengthened through a medium-term revenue strategy that includes the details in which tax policy and revenue administration are going to be coordinated. Tax and benefit structures should be coupled with better enforcement. The government should also take advantage of the crisis to tax activities that are detrimental to health or the environment and put in place taxes on carbon and land use.
   d. **Decreasing tax avoidance and exemptions:** Revenue measures aimed at widening the tax base would also facilitate a faster reduction of debt.
   e. **Formalizing the informal economy:** Reducing labor taxes would help to increase formal employment and reduce informality. The consequence of doing this would be an increase in productivity as well as an increase in the base of various taxes. To face informality, the implementation of programs that reward formal employment has proven to be effective, while

[15] Paulo, R., Marco, B., & Claúdio, F. (2021, April). Public Investment and Fiscal Crisis in Brazil. IDB. https://publications.iadb.org/publications/english/document/Public-Investment-and-Fiscal-Crisis-in-Brazil-Finding-Culprits-and-Solutions.pdf

facing out noncontributory social programs for informal workers[16].

f. **Extended support from COVAX** a multilateral mechanism for equitable access to vaccines.
g. **Reallocate resources under the expenditure ceiling** to strengthen the social safety net on a permanent basis. This requires limiting the leakage of benefits to unintended beneficiaries. Increasing the progressivity of net transfers will be important as well and would require reducing the benefit withdrawal as earnings increase.

Conclusion

In Brazil, federal and subnational governments have taken actions to attenuate the negative effects of coronavirus on the economy. This has had critical fiscal consequences in terms of results and the country's fiscal framework, which requires the government to take action on the monetary and fiscal fronts.

Under the current circumstances, the main priority of the government should be to control the pandemic by resourcing the health system for COVID-19 patient care and vaccine distribution. At the same time, the government needs to work on a robust and credible medium-term fiscal framework attuned with economic growth and that includes a horizon beyond the annual budget. To this end, strengthening public revenues, reducing tax avoidance and exemptions, and assessing state and subnational fiscal rules should be under consideration.

On the monetary front, the central bank should focus its efforts on controlling the inflationary pressures that the country has experienced during this year. Recent signals of economic recovery have allowed for a 1.5% interest rate increase. Now, it is suggested that the bank can hold the rate at its level of 3.5% for an extended period and continue using other monetary mechanisms such as the implementation of security swaps and foreign exchange interventions.

[16] Opportunities for Stronger and Sustainable Postpandemic Economic Growth. Chapter 2. IDB. https://publications.iadb.org/publications/english/document/2021-Latin-American-and-Caribbean-Macroeconomic-Report-Opportunities-for-Stronger-and-Sustainable-Postpandemic-Growth.pdf