**Brazil's Inflamed Inflation and Fiscal Fiasco**

*By Livio Maya*[1]

*November 8, 2021*

As Brazilian consumer price inflation moves into double-digit territory, the Brazilian Central Bank (BCB) has fully opened its toolbox to fight against it. The outcome of the last monetary policy committee meeting was a 1.5% increase in the SELIC rate, the central bank's main policy instrument. That is the largest push since SELIC as adopted, in 1999 (along with the June-2001 hike).

While the BCB indicates it will not hold back on the pursue of its stable price mandate, market signals highlight investors' skepticism. Breakeven inflation and survey-based measures of expected inflation have been rising almost non-stop since January, derisively oblivious to all the BCB's efforts.

The explanations offered by Faria Lima Street (the Brazilian Wall Street) economists almost always point out to the same culprit. Most analysts blame the BCB's so-far ineffective attempts to tackle inflation on the growing fear regarding the country's fiscal scenario.

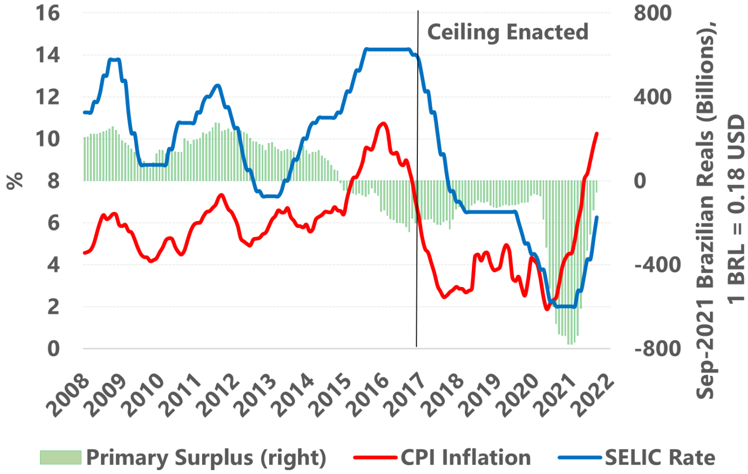
They have a point. And given the exploding public debt in many other countries, the latest Brazilian fiscal fiasco deserves special attention.

Enacted in 2016, the Brazilian Spending Cap Rule is often celebrated as the main driver of the country's fiscal credibility reconquest. In its nine amendments, the law stipulates that expenditure by different branches of government can only increase to match CPI growth. The idea is that, with spending halted, primary surpluses - gone since 2014 - would eventually resurface as a natural consequence of economic growth. Primary surplus, not public spending, is the key variable when it comes to inflation control. It retires public nominal liabilities and pays for the increased fiscal costs that higher interest rates entail.

As the graph shows, the promise of surpluses appears to be on its way of materializing since 2016, with the exception of the Pandemic's emergency spending. Results came along: interest and inflation rates dropped from 14% and 10% in 2016 to 2% each in early 2020.

But the cap is currently under threat. Lawmakers want to increase the size of direct transfers to the very poor, an understandable policy. However, it is not possible to fit such increase under the cap along with the surprisingly large volume of lawsuit payments to be made in 2022, as determined by the judiciary in August. Cutting discretionary spending, possibly the best solution, becomes less likely by the day. Ergo the ongoing efforts to change the way

[1]The opinions expressed in this article are solely mine and by no means represent the position of any other person or institution.




the cap is calculated and to impose on lawsuit payments a cap of their own.

At this point, the circumvention of the Cap Rule is, sadly, not so much a question of "if" as it is a question of "how". And the "how", I argue, almost doesn't matter. It is (was) all about the "if".

Why doesn't the "how" matter? Market economists forecast that proposed changes will allow, *in 2022*, for an additional spending of 100 billion Brazilian reals (about 20 billion dollars). Approximately 1% of GDP. The impact on spending in the following years, however, is likely to be small, or even negative since lawsuit payments will be bounded. Thus, the proposed change represents, at worse, a once-and-for-all increase of 1% in a debt-to-GDP ratio that currently reads 83%. Far from despairing.

The "if" part matters much more. The Spending Cap Rule - sticking to it - represents to the government a *credibility* anchor. A message to the public saying "I have a rule, I will comply to it". That is an invaluable commitment device to a government with multiple debt distress episodes on its résumé. The "if" matters because *any* change in the law denies that important message. In fact, it signals the exact opposite, for a rule that can be changed at convenience is akin to no rule at all.

And so, we go back to inflation.

Most modern monetary models dictate that a successful inflation stabilization plan involves *some* form of fiscal adjustment. Current or credibly promised. The Brazilian government runs in the opposite direction. The spending cap imbroglio offers a clear reason for the high - higher than in peer countries - and ever-increasing inflation observed in the Latin American giant.

It is also a warning to other countries' monetary authorities and policymakers in general. Especially in times of almost unlimited public spending, justified or not.

Central banks can and should do everything in their power to guard the value of their currency. But efforts will be in vain if they work alone. Central governments play a key role in fighting inflation, and should be aware of it. Explain their spending, and where resources to pay for it are coming from.

Fiscal discipline is a critical condition for price stability. History taught Brazilians that lesson the hardest way. We would all be wise not to forget it.