

ECONOMICS: LATIN AMERICA PERSPECTIVES

BRAZIL: A NEW (UPHILL) FISCAL BATTLE

+ Fernando J. Losada, Senior Economist—Latin America Research, [REDACTED]

S&P's decision to downgrade Brazil to junk status this month prompted the government to announce a more ambitious fiscal plan. But politicians' reaction to the proposal was lukewarm at best, suggesting the government may not be able to put it fully into action.

After the Downgrade, a Swift Reaction

Shortly after S&P became the first of the big three ratings agencies to cut Brazil's sovereign credit rating to junk status, the government ditched an earlier budget proposal and recommitted itself to fiscal discipline. President Dilma Rousseff rallied around her finance minister, Joaquim Levy, and announced a primary surplus target of 0.7% of gross domestic product (GDP) for fiscal year 2016.

It was the government's recent decision to backpedal on its fiscal promises by reducing its primary surplus targets and increasing its expected primary fiscal deficit that cost Brazil its investment-grade rating. As S&P correctly pointed out, the backpedaling would have caused Brazil's debt ratios to deteriorate sharply over the next couple of years.

What's more, there appeared to be a lack of widespread support for fiscal discipline as a way to address the country's economic malaise. As a result, the S&P kept the rating on negative outlook, suggesting that the rating agency's next move is more likely to be another downgrade rather than a move back into investment-grade territory.

To forestall this, the government has called for a combination of revenue increases and spending cuts worth some BRL60 billion (US\$16 billion). The cornerstone of the revenue increases is the reenactment of a financial transactions tax, known as the CPMF, which is expected to generate more than 93% of the projected BRL34 billion incremental revenue. The idea is to maintain the CPMF at a rate of at least 0.2% during the remainder of Rousseff's term.

The government also proposed increases in capital gains taxes and reductions in export subsidies. The main items included in the BRL 26 billion worth of proposed spending cuts include a delay in civil servant salary increases until July 2016, and reductions of housing subsidies, an infrastructure investment program and healthcare outlays (*Display 1, next page*).

The Devil's in the (Political) Details

In principle, the announcement is good news because it suggests Rousseff hasn't given up on the notion of fiscal reform. It also implies that Levy still exerts some influence when it comes to economic policy. We think this recommitment to fiscal discipline could persuade other

ratings agencies to delay any downgrades of their own. Moody's, which still considers Brazil investment grade, welcomed the news.

However, we think there's a substantial risk that the government will find itself unable to implement the plan in full. The initial reaction from legislators was barely lukewarm. Eduardo Cunha, the chairman of the lower house, said he wouldn't support the CPMF, though he did vow not to block the initiative in Congress. But he added that he thought Congressional approval this year "is close to impossible."

Meanwhile, local media reported that business leaders don't support the tax plan, especially given Brazil's worsening recession, and would prefer to see more aggressive spending cuts. It's unclear whether the federal government's offer to share the revenues from the CPMF with state governments will be enough in the current anti-tax environment.

Even some lawmakers from the ruling Workers Party oppose the plan, according to local newspapers, especially the proposal to freeze public workers' salaries. The more leftist wing of the Workers Party

has called for special taxes on the banking sector and the wealthy. Even former President Luiz Inácio Lula da Silva has reportedly suggested relaxing the fiscal stance and lowering interest rates to boost growth. Organized civil servant unions have warned that they could go on strike.

Congress, Bribery Probe Still Problems

At this point, it looks as though Congress will water down the plan. That will make it difficult for the government to deliver on its fiscal promises in 2016. If Congress strikes the CPMF down, the government may have to rely on nonlegislated taxes such as a special contribution on gasoline consumption, known as the CIDE tax. This would result in less than half of the revenues that would have been generated by the CPMF. It would also push prices higher, thus compromising Brazil's anti-inflation strategy.

To be fair, the fiscal plan is mostly a patchwork rather than a comprehensive strategy to deal with structural fiscal difficulties, including spending rigidity and wage indexation rules. This most likely reflects the Rousseff administration's lack of political capital, which makes it hard to get Congress to sign off on deep reforms.

If Congress changes the plan significantly or if the president lacks the ability to push it through Congress at all, Levy may resign. That could lead to asset price volatility and provide extra incentive for the political opposition to push impeachment proceedings against Rousseff.

And let's not forget that the ongoing corruption investigation, which makes the political climate even more volatile, also

Display 1
The New Fiscal Plan

Impact of Main Projected Fiscal Adjustment Measures (BRL Billion)

Spending Reductions	
Delay in Public Wage Increases	7.0
Reduction in Housing Subsidy	4.8
Reduction in Healthcare Outlays	3.8
Reduction in Infrastructure Investment	3.8
Government Employment Freeze	1.5
Reduction in Agricultural Subsidies	1.1
Other	4.2
Total	26.2

Revenue Increases	
Financial Transactions Tax	32.0
Increase in Tax on Capital Gains	1.8
Reduction in Export Subsidies	2.0
Reduction in Subsidies on Interest Income	1.1
Other	2.8
Minus Lower Projected Revenue From Existing Taxes	5.5
Total	34.2

Total Projected Fiscal Adjustment	60.4
--	-------------

Through September 16, 2015
Source: Local Newspapers and AB

makes it harder for the government to garner support for its fiscal plans. This week, the federal prosecutor's office formally accused 15 political figures, including former President Lula's chief of staff, of bribery. The probe has also extended to involve several high-profile

international banks that Brazilian prosecutors say may have been involved in a pay-to-play scheme aimed at securing access to official contracts.

Against this backdrop, we think the risk of more ratings downgrades is high.■

The information contained herein reflects the views of AllianceBernstein L.P. or its affiliates and sources it believes are reliable as of the date of this publication. AllianceBernstein L.P. makes no representations or warranties concerning the accuracy of any data. There is no guarantee that any projection, forecast or opinion in this material will be realized. Past performance does not guarantee future results. The views expressed herein may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. AllianceBernstein L.P. does not provide tax, legal or accounting advice. It does not take an investor's personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions. This information should not be construed as sales or marketing material or an offer or solicitation for the purchase or sale of any financial instrument, product or service sponsored by AllianceBernstein or its affiliates.

Note to Canadian Readers: AllianceBernstein provides its investment management services in Canada through its affiliates Sanford C. Bernstein & Co., LLC and AllianceBernstein Canada, Inc.

Note to European Readers: This information is issued by AllianceBernstein Limited, 50 Berkeley Street, London W1J 8HA. Registered in England, No. 2551144. AllianceBernstein Limited is authorised and regulated in the UK by the Financial Conduct Authority (FCA).

Note to Austrian and German Readers: This information is issued in Germany and Austria by AB Europe GmbH. Local paying and information agents: Austria—Uni-Credit Bank, Austria AG, Schottengasse 6-8, 1010 Vienna; Germany:—BHF-Bank Aktiengesellschaft, Bockenheimer Landstrasse 10, 60323 Frankfurt am Main.

Note to Swiss Readers: This document is issued by AllianceBernstein Schweiz AG, Zurich, a company registered in Switzerland under company number CHE-306.220.501. AllianceBernstein Schweiz AG is authorised and regulated in Switzerland by the Swiss Financial Market Supervisory Authority (FINMA) as a distributor of collective investment schemes. This document is directed at Qualified Investors only. Swiss Representative & Swiss Paying Agent: BNP Paribas Securities Services, Paris, Succursale de Zürich. Registered office: Selnaustrasse 16, 8002 Zürich, Switzerland, which is also the place of performance and the place of jurisdiction for any litigation in relation to the distribution of shares in Switzerland.

Note to Australian Readers: This document has been issued by AllianceBernstein Australia Limited (ABN 53 095 022 718 and AFSL 230698). Information in this document is only intended for persons that qualify as "wholesale clients," as defined in the Corporations Act 2001 (Cth of Australia), and should not be construed as advice.

Note to New Zealand Readers: This document has been issued by AllianceBernstein New Zealand Limited (AK 980088, FSP17141). Information in this document is only intended for persons who qualify as "wholesale clients," as defined by the Financial Advisers Act 2008 (New Zealand), and should not be construed as advice.

Note to Readers in Vietnam, the Philippines, Brunei, Thailand, Indonesia, China, Taiwan and India: This document is provided solely for the informational purposes of institutional investors and is not investment advice, nor is it intended to be an offer or solicitation, and does not pertain to the specific investment objectives, financial situation or particular needs of any person to whom it is sent. This document is not an advertisement and is not intended for public use or additional distribution. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in any of the above countries.

Note to Readers in Malaysia: Nothing in this document should be construed as an invitation or offer to subscribe to or purchase any securities, nor is it an offering of fund management services, advice, analysis or a report concerning securities. AllianceBernstein is not licensed to, and does not purport to, conduct any business or offer any services in Malaysia. Without prejudice to the generality of the foregoing, AllianceBernstein does not hold a capital markets services license under the Capital Markets & Services Act 2007 of Malaysia, and does not, nor does it purport to, deal in securities, trade in futures contracts, manage funds, offer corporate finance or investment advice, or provide financial planning services in Malaysia.

Note to Singapore Readers: This document has been issued by AllianceBernstein (Singapore) Ltd. ("ABSL"; Company Registration No. 199703364C). ABSL is a holder of a Capital Markets Services Licence issued by the Monetary Authority of Singapore to conduct regulated activity in fund management and dealing in securities. AllianceBernstein (Luxembourg) S.à r.l. is the management company of the portfolio and has appointed ABSL as its agent for service of process and as its Singapore representative.

Note to Taiwan Readers: AllianceBernstein L.P. does not provide investment advice or portfolio-management services or deal in securities in Taiwan. The products/services illustrated here may not be available to Taiwan residents. Before proceeding with your investment decision, please consult your investment advisor.

Note to Hong Kong Readers: This document is issued in Hong Kong by AllianceBernstein Hong Kong Limited (聯博香港有限公司), a licensed entity regulated by the Hong Kong Securities and Futures Commission. This document has not been reviewed by the Hong Kong Securities and Futures Commission.