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Fiscal Discipline and Real Interest Rates in Brazil

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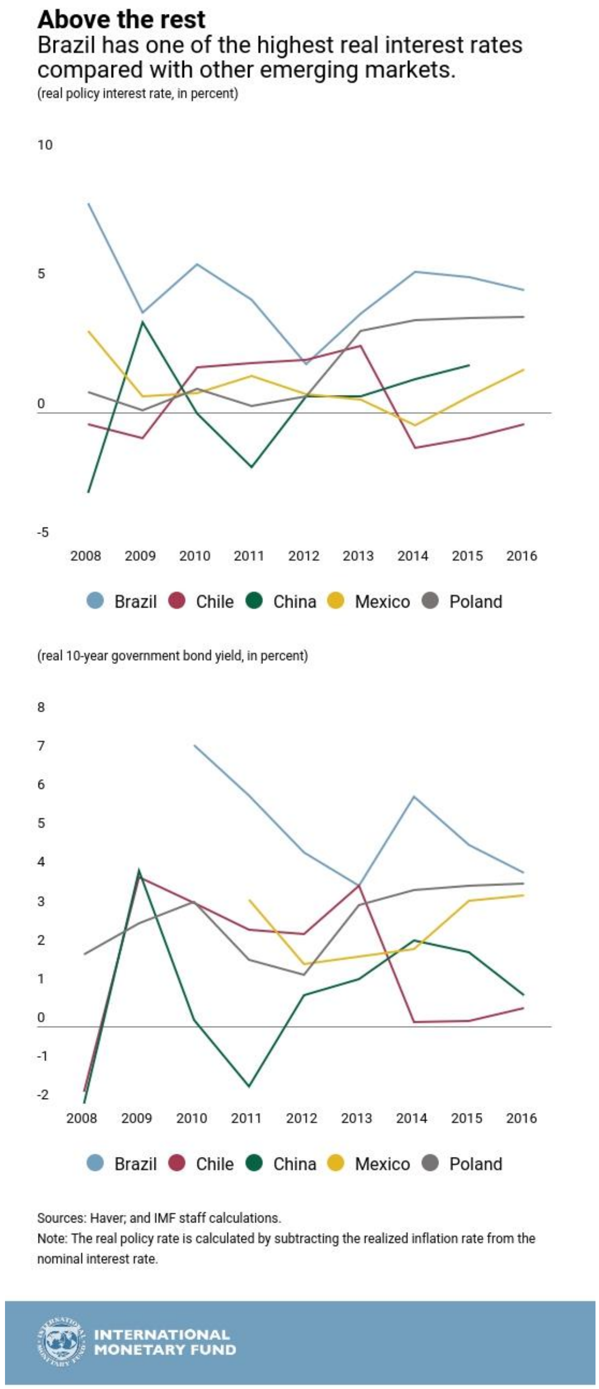
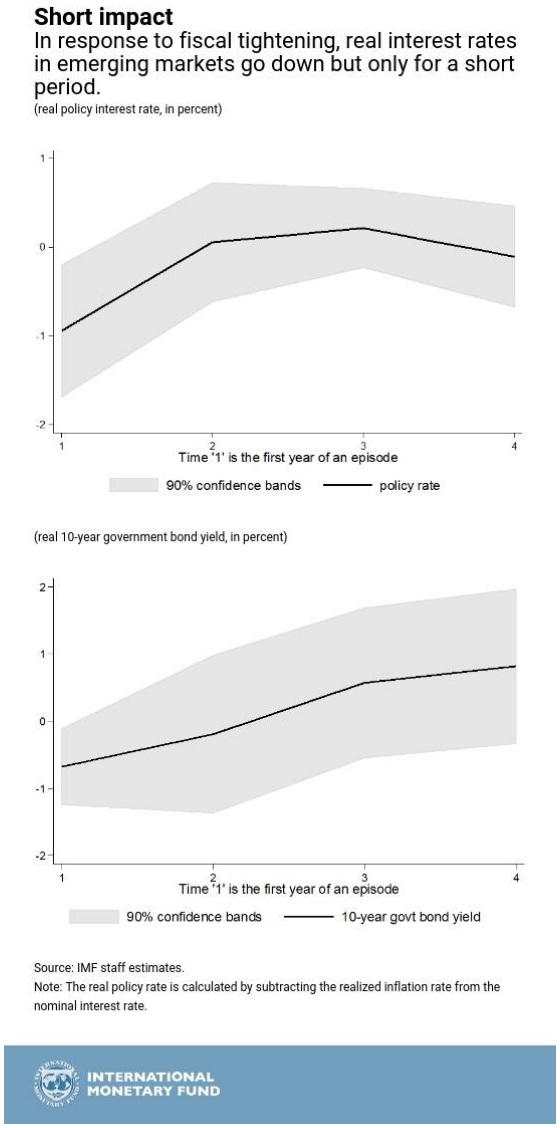
Digital TV tower construction in Brasilia, Brazil (photo: Wagner Santos/Avalon/Newscom)

In December 2016, Brazil introduced a new fiscal rule that limits the growth in federal noninterest spending to the rate of consumer inflation. Markets have welcomed this spending cap, which will help reduce the government deficit over time, ultimately supporting economic growth. Another potential benefit of this rule is its contribution to lowering real interest rates. This matters because Brazil's market real interest rates have for a long time been among the highest in emerging market economies, constraining economic growth and development.



A recent IMF study attempts to quantify the effects of reducing fiscal deficits on real interest rates (the nominal rate minus the inflation rate) in a sample of 73 advanced and emerging market countries that made an effort to bring down their fiscal balances during 2000–2015. By contrasting the experience of emerging markets to other countries in the sample, our study draws some lessons for policymakers and finds that improving fiscal balances in Brazil can potentially contribute to lower real interest rates.



Effects on real interest rates in emerging markets

Our analysis shows that reduced fiscal deficits are accompanied by a decrease in real interest rates in emerging market economies, but the effect is relatively short-lived. In response to a fiscal consolidation episode equal to an improvement in the primary balance (fiscal balance excluding interest payments and adjusted for the business cycle) of 2 percentage points of GDP over two years, the real short-term interest rate decreases by approximately 100 basis points (equivalent to 1 percent). The real long-term rate—as measured by the 10-year government bond yield—follows a similar path, decreasing by about 70 basis points. For both real rates, the effect, however, appears to be significant only for a short period while the fiscal consolidation takes place.

Short-lived impact

One explanation for the short-lived impact of fiscal tightening on interest rates seems to be fiscal consolidation reversals—a situation where fiscal deficits are allowed to grow back after a few years.

In the sample of countries studied, such reversals occur on average after the second year, and almost all emerging market economies experience reversals in the fiscal adjustment by the fourth year following the consolidation.

Countries with larger debt levels

Evidence from previous research suggest that higher debt levels tend to amplify the response of interest rates to movements in fiscal policy. Our study corroborates these findings to some extent. In our sample, a fiscal consolidation episode in a high-debt country is accompanied by a reduction in the real policy rate of almost 200 basis points. However, the reduction in the real 10-year government bond yield is of the same magnitude as without controlling for outstanding debt levels (around 70 basis points).

Lessons for Brazil

It is possible to draw some lessons for Brazil.

First, fiscal problems may not be the sole reason for high real interest rates in the Brazilian experience, implying that other factors such as inefficiencies present in the financial sector could provide further explanation for the behavior of interest rates.

Second, Brazil's episode of fiscal consolidation is likely to be different from most of those in our sample. The fiscal tightening has been preannounced, as it is embedded in a constitutional rule, and in its early phase it will be accompanied by monetary accommodation, which is helping initially to reduce real interest rates. Most importantly, the fiscal consolidation is meant to be sustained over many years, as prescribed in the constitutional amendment which established the spending ceiling. The experience of other countries we have studied suggests that, if implemented in such durable fashion, fiscal consolidation in Brazil can contribute to an environment of lower real interest rates than in the past.

Nina Biljanovska is an Economist in the IMF's Western Hemisphere Department, currently covering Brazil and Ecuador. Previously, she worked in the IMF's Institute for Capacity Development. Her research has mainly focused on policy design, uncertainty, and behavioral finance. She holds a Ph.D. in Economics from Goethe University Frankfurt.