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Uncertainty about Fiscal Sustainability

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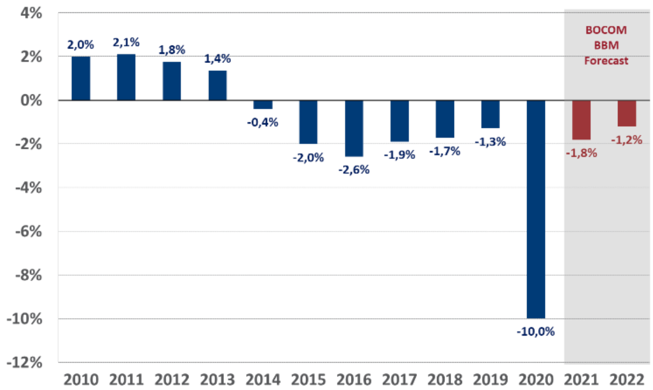
There was little doubt about the need for a constitutional amendment to make the federal budget comply with the fiscal rules in force. The main surprise relating to the 2022 budget was the amount of court-ordered debts (*precatórios*) to be paid, which reached BRL 89 billion, sharply up from BRL 56 billion paid in 2021. When added to the other items in the budget, this took total expenditure well beyond the legal limit known as the spending cap, making a change to the rule unavoidable.

Enshrined in Brazil's Constitution since 2016, the spending cap is an important fiscal rule that limits growth in government spending and lends credibility to the sustainability of the public debt. Before the measure was passed, a primary surplus corresponding to 1.4% of GDP became a deficit of 2.6% in the relatively short period from 2013 to 2016 (Figure 1). In tandem, the debt-to-GDP ratio shot up from 54% to 70% in the same period. This was accompanied by low economic growth and restrictive interest rates.

Figure 1 - Fiscal Primary Balance (%, GDP)



Source: Banco Central do Brasil

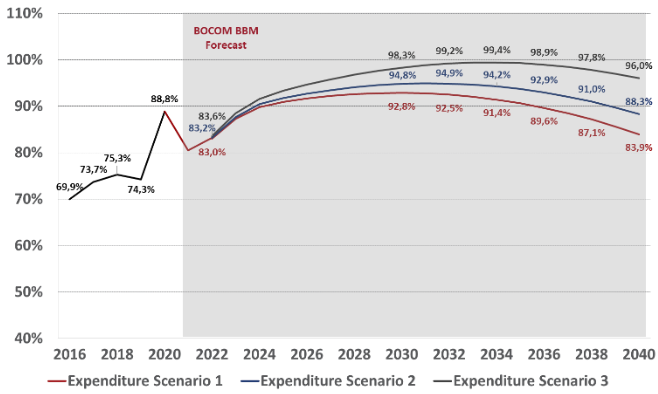
Stipulating that total expenditure in any year must not surpass the previous year's plus inflation in the 12 months up to June of the previous year, the cap is designed to ensure that spending falls as a proportion of GDP. The aim is to bring about a gradual fiscal adjustment, with risk premiums and interest rates trending down as it progresses. Its clarity makes the budgetary process predictable, anchors expectations, and reduces macroeconomic volatility. Any attempt to change the rule or circumvent it does the opposite.

The constitutional amendment on which Congress is now voting (PEC 23/2021) sets a "sub-cap" inside the spending cap, limiting the payment of court-ordered debt in accordance with 12-month inflation. However, it also alters the rule for adjusting the cap itself (as well as the sub-cap) for inflation. The rule is now based on inflation in the 12 months to December instead of June. The consensus forecast for the IPCA in 2021 is currently 9.5%, well above the 12-month inflation until June, thus providing room for a substantial rise in spending.

On the surface, it may appear that the measure provides for a net increase of "only" BRL 106 billion in 2022 (BRL 59 billion due to the new rule for adjusting the cap for inflation and BRL 42 billion due to the cap of BRL 47 billion on payment of the court-ordered debts). However, any such casuistic change to the rule suggests similar changes could be made in future, undermining the credibility the rule lends to the trajectory of public spending. The markets' reaction in the past few days has been to the end of the cap's credibility more than to the growth of expenditure in the 2022 budget.

The extra room to spend enables the government to expand the conditional cash transfer program previously known as Bolsa Família, and to consider other spending items of interest in the run-up to a general election (such as the so-called "rapporteur's amendments", a form of logrolling; the cooking gas allowance; and an extension to payroll tax exemptions). Assuming the growth in spending permitted by the new cap becomes permanent, the debt-to-GDP ratio will stabilize only in 2027 (Figure 2, scenario 1). However, pressure for a more generous safety network (with a higher average benefit) or wider welfare coverage (with more beneficiaries) may drive expenditure further above the new cap, leading to an even more alarming trajectory for the debt-to-GDP ratio (Figure 2, scenarios 2 and 3).

Figure 2 - Debt to GDP Ratio - Different Expenditures in 2022

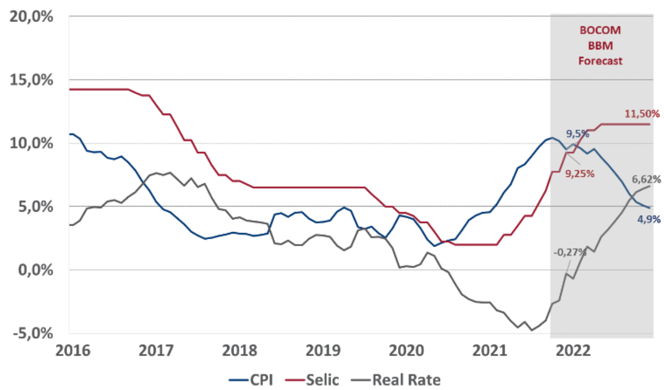


Source: Bocom BBM

Uncertainty about fiscal sustainability contaminates the prices of almost all assets, including the exchange rate, whose depreciation adds more pressure to inflation. Moreover, the latest preview of the 2021 IPCA again exceeded market expectations, and inflation in October was the highest for the month since 1996, with surprises mainly in services and underlying services, where inflation is particularly persistent.

At its latest meeting, the Copom ratcheted up the pace of rate hikes in response to this significant change of scenario. The anticipated fiscal deterioration and loss of fiscal credibility had an evident impact on inflation expectations. The Central Bank of Brazil's survey of professional forecasters (Focus) reported a deterioration of expectations for the IPCA in 2022. The committee signaled that it will again raise the policy rate (Selic) by 150 basis points at the next meeting.

Figure 3 - Selic Rate, CPI e Real Ex-post Interest Rate (%)



Source: Bocom BBM, Banco Central

We now project a year-end Selic of 9.25% in 2021 and 11.5% in 2022 (Figure 3). A tighter monetary policy has a negative impact on economic growth, and we have revised down our projection for GDP growth in 2022 to 0.7%. Our inflation forecast for 2022 has also deteriorated: we now project 4.9% (up from 4.1% previously).

ECONOMIC FORECASTS	2018	2019	2020	2021F	2022F
GDP Growth (%)	1,3%	1,1%	-4,1%	5,2%	0,7%
Inflation (%)	3,7%	4,3%	4,5%	9,5%	4,9%
Unemployment Rate, SA (eoy ,%)	12,2%	11,7%	13,9%	13,0%	12,5%
Policy Rate (eoy, %)	6,50%	4,50%	2,00%	9,25%	11,5%
External Accounts					
Trade Balance (US$ bn)	53	48	51	69	46
Current Account Balance (US$ bn)	-42	-51	-13	-14	-15
Current Account Balance (% of GDP)	-2,2%	-2,8%	-0,9%	-0,9%	-0,9%
Fiscal Policy					
Fiscal Primary Balance (% of GDP)	-1,7%	-1,2%	-10,0%	-1,8%	-1,2%
Government Gross Debt (% of GDP)	75,3%	74,3%	88,8%	80,6%	83,0%