BANK OF COMMUNICATIONS BBM

Macro Monthly Letter

November 2023

The primary fiscal target and the 2024 fiscal result

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With less than two months to go until the end of the year, the economic debate has begun to revolve around the possibility of altering the primary fiscal target for 2024. The Budget Guidelines Bill (PLDO) sent to Congress in the middle of the year targets a zero deficit, but slow movement through Congress of the taxation measures proposed by the government to achieve it and uncertainty about their fiscal impact have heightened perceptions that revenue and expenditure will not balance out next year.

Leaving the target as it is, it goes without saying, would signal the government's commitment to fiscal discipline and suggest that as much pressure as possible will be brought to bear on Congress to pass the taxation measures, as in the case of the proposal to tax single-investor and offshore funds, which has passed the lower house and is now before the Senate. Not changing the target also increases the probability that the executive will be obliged to implement a partial spending freeze (*contingenciamento*) as soon as there are signs that tax revenue will not be compatible with the proposed fiscal expansion.

According to the new fiscal framework, missing the primary target does not configure a breach of the Fiscal Responsibility Law (LRF) as long as steps are taken to limit commitment and disbursement of funds. In practical terms, *contingenciamento* is mandatory but capped at 25% of discretionary spending requirements. The government updates its revenue and expenditure projections throughout budget execution, implementing *contingenciamento* as needed to achieve the target. If any of the periodic reviews show an improvement, the partial freeze is lifted.

Lowering the target would increase the primary deficit and reduce the extent to which the government limits discretionary spending. For 2024, we project a primary deficit corresponding to 0.9% of GDP. If the target were left on zero, *contingenciamento* would reduce the deficit to 0.3%, showing that *contingenciamento* is effective as a measure to align results with the proposed target (Table 1). However, our basic scenario assumes the target will be changed so that *contingenciamento* is not required. This assumption is based on the observed reluctance to cut spending, especially investment in public works and infrastructure, as recently signaled by the government.

Table 1: Fiscal Scenarios

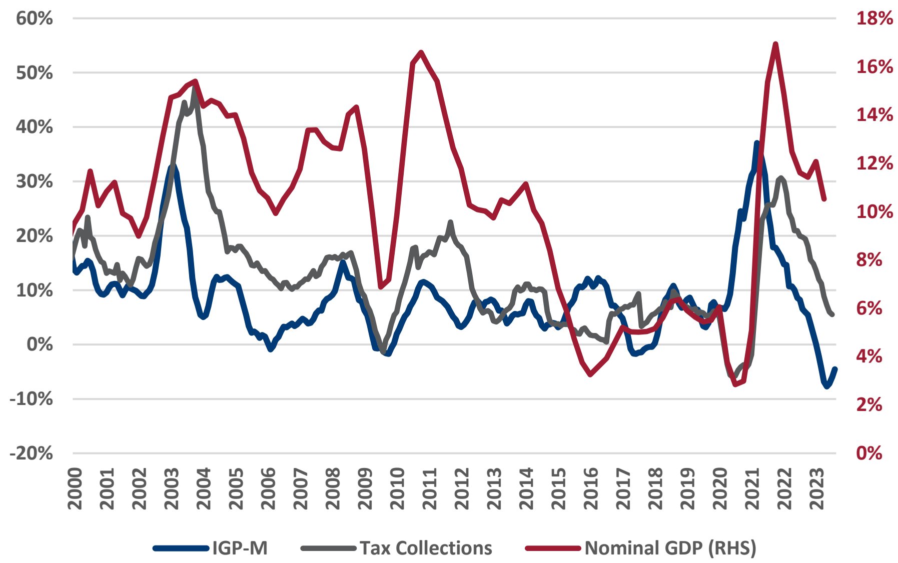
Scenarios	Target (% GDP)	Contingenciamento (R$ bn)	Primary Result (% GDP)	Debt (% GDP)
Alternative Scenario 1	0.00%	60	-0.30%	78.4%
Alternative Scenario 2	-0.50%	12	-0.75%	78.9%
Baseline Scenario	-0.75%	0	-0.90%	79.0%

Source: BOCOM BBM

On the revenue side, it is worth recalling that the fiscal accounts fell back into the red last June owing to increased spending in 2024 resulting from the constitutional amendment passed in 2023 (PEC da Transição), as well as the sharp deceleration in federal tax revenue.

Temporary factors that bumped up revenue in 2022, such as higher commodity prices, rising inflation and strong real GDP growth, have gone into reverse (Figure 1), and economic activity showed clear signs of a loss of momentum in the third quarter, as evidenced by the performance of the labor market, where the number of people in paid employment fell, despite real wage gains in recent months (Figure 2).

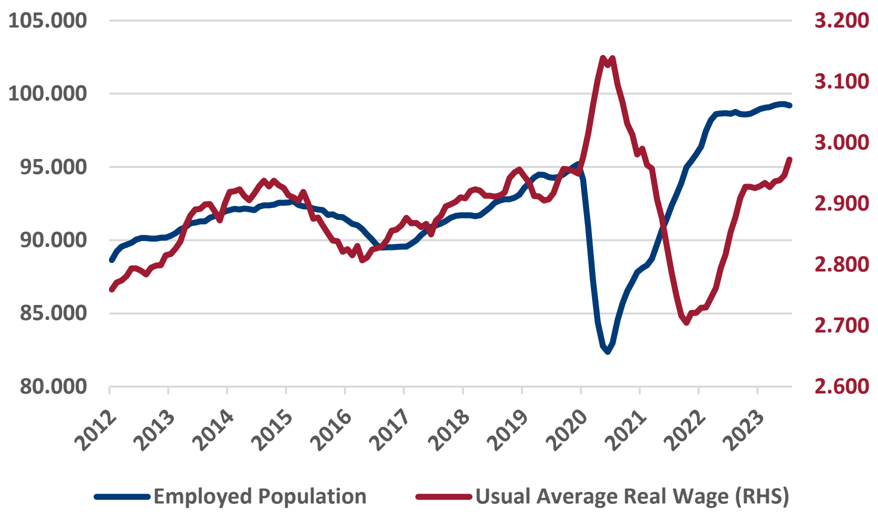
Figure 1: Wholesale inflation (IGP-M), Federal Tax Collections and Nominal GDP (Var. Accum. 12M)



Source: BOCOM BBM, Tesouro Nacional, IBGE, FGV

Regarding monetary policy, the fundamentals of the domestic economy continue to point to maintenance of the pace of rate cuts at 50 bps per meeting, with inflation remaining benign even in more inertial items. Nevertheless, the latest statement from the Monetary Policy Committee (COPOM) indicated a marginal deterioration in inflation projections for 2024 and 2025, with only partially re-anchored inflation expectations and a more adverse external environment due to rising longer-term US rates and geopolitical risks.

Figure 2: Employed Population and Usual Average Real Wage



Source: BOCOM BBM, IBGE

More than usual uncertainty at home and abroad will require caution in the conduct of monetary policy in Brazil. We have left our projections for the Selic rate unchanged, although our fiscal projections assume the primary fiscal target will be altered. It should be borne in mind that altering the target will also undermine the credibility of fiscal policy in the years ahead, affecting the trajectory of the exchange rate and inflation expectations in the longer term, all of which will hinder the ongoing disinflation process.

ECONOMIC FORECASTS	2019	2020	2021	2022	2023F	2024F
GDP Growth (%)	1.2%	-3.3%	5.0%	2.9%	2.8%	1.5%
Inflation (%)	4.3%	4.5%	10.1%	5.8%	4.4%	3.8%
Unemployment Rate (eoy ,%)	11.1%	14.2%	11.1%	7.9%	7.8%	8.4%
Policy Rate (eoy, %)	4.5%	2.0%	9.3%	13.75%	11.75%	9.5%
External Accounts						
Trade Balance (US$ bn)	27	32	36	44	69	57
Current Account Balance (US$ bn)	-68	-28	-46	-56	-35	-37
Current Account Balance (% of GDP)	-3.6%	-1.9%	-2.8%	-2.9%	-1.6%	-1.7%
Fiscal Policy						
Central Government Primary Balance (% of GDP)	-1.3%	-9.8%	-0.4%	0.6%	-1.0%	-0.9%
Government Gross Debt (% of GDP)	74.3%	86.9%	78.8%	72.9%	75.6%	79.0%