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Fiscal unpredictability and the trajectory of public debt

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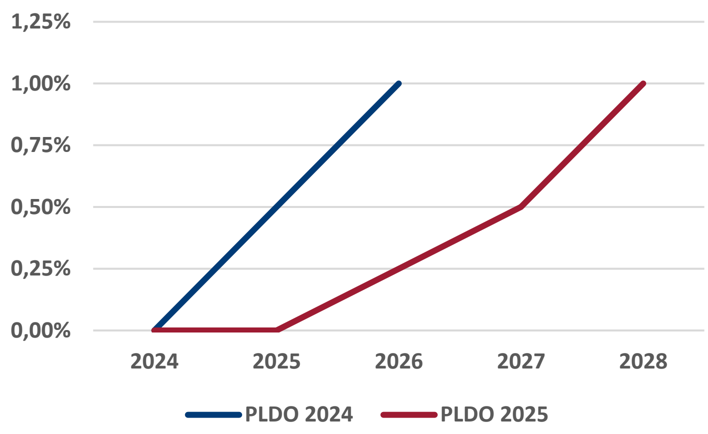
Delivery of the 2025 Budget Guidelines Bill (PLDO) to Congress by the federal government last month was accompanied by the announcement of a reduction in the primary result targets for the next three years. Eight months after setting a primary surplus target equivalent to 0.5% of GDP for 2025, the government decided to revise the target down to 0%. The proposal also reduces the fiscal effort for ensuing years by targeting a rise in the primary surplus equivalent to 0.25 pp of GDP per year until 2027, down from an initially planned 0.5 pp per year (Figure 1). These changes postpone stabilization of the national debt for two years, according to the government's own projections (Figure 2).

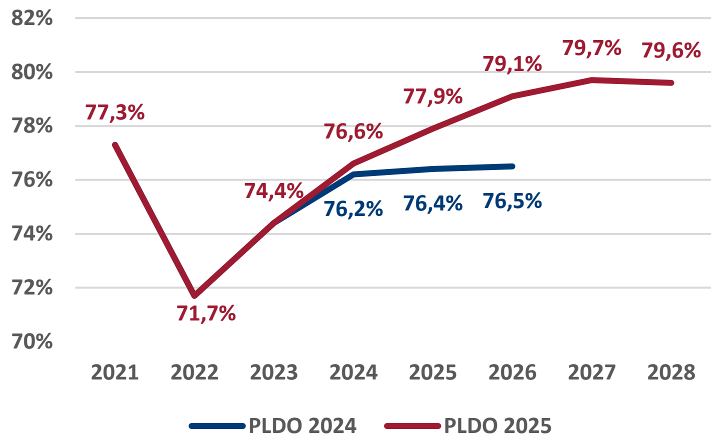
Figure 1: Primary Result Target (% GDP)



Source: BOCOM BBM, PLDO 2025

The revisions highlight an already known flaw in the new fiscal framework, which is that primary result targets can be redefined each year during the budget approval process or even during budget execution by means of a legislative proposal sent to Congress. The aim is to avoid major fiscal adjustment measures, such as spending freezes or adjustment triggers. In short, resetting the target is a way of averting adjustments, making the trajectory of primary results unpredictable and fueling uncertainty regarding the sustainability of the debt.

Figure 2: Gross Debt to GDP ratio



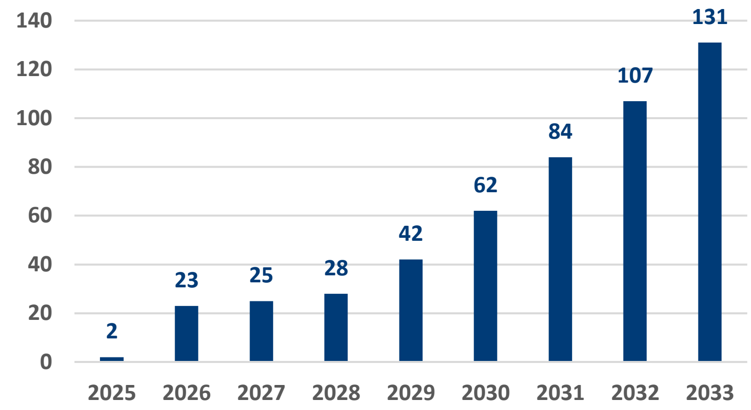
Source: BOCOM BBM, PLDO 2025

In the logic of the new framework, fiscal adjustment occurs mainly through significant and recurring increases in federal revenues, given the extreme rigidity of non-discretionary spending obligations in the budget. Moreover, the return of mandatory minimum spending on education and health indexed to current-year revenue, as well as the new rule governing annual adjustment of the national minimum wage, to which social security, unemployment and other benefits are indexed, mean that any drop in real revenue between one year and the next would require real spending cuts that would be difficult to execute.

In view of these conditions, the government's efforts cannot be confined to seeking new sources of revenue but must include substantial reforms of public spending. Abolishing the indexation of social security and welfare benefits to the minimum wage is among the changes that would deliver the most significant results. This measure would lead to savings of some BRL 15 billion this year alone, followed by rising amounts of savings in each subsequent year, as every year's real minimum wage hike is built on the previous year's.

Decoupling health and education expenditure from revenue growth is another important measure: spending on these items is rising more than the 2.5% limit established by the fiscal framework and puts pressure on federal discretionary spending. According to the Treasury's simulations in the latest Fiscal Projections report, replacing indexation to current revenue with indexation to population growth in the previous year could save around BRL 131 billion by 2033 (or make room for an equivalent addition to discretionary spending).

Figure 3: Fiscal savings in the scenario of health and education expenditure indexation to population growth



Source: BOCOM BBM, National Treasury

However, although changes to indexation rules would help stabilize public finance, they would be unpopular and hence extremely hard to implement, especially because the primary result targets could be redefined to prevent them from materializing.

At the same time as perceived fiscal risk is deteriorating owing to primary result target revisions, global conditions are becoming more challenging. The resilience of inflation and economic activity in the United States has led this year to an important postponement of the start of monetary easing by the Fed. Members of the FOMC now acknowledge that the federal funds rate will have to remain at the current level for a longer period. In this context, the BRL has depreciated sharply against the USD, and members of the Central Bank of Brazil's monetary policy committee (Copom) have stated publicly that the prevailing uncertainty is likely to entail a slower pace of rate cuts here. We have therefore revised our projections for the year-end Selic rate from 9.5% to 10% in 2024 and from 8.75% to 9% in 2025. The need to keep real rates higher for a longer period further fuels concern about the government's capacity to stabilize the dynamics of debt growth.

ECONOMIC FORECASTS	2020	2021	2022	2023	2024F	2025F
GDP Growth (%)	-3.3%	4.8%	3.0%	2.9%	1.8%	2.0%
Inflation (%)	4.5%	10.1%	5.8%	4.6%	3.6%	4.0%
Unemployment Rate (eoy ,%)	14.7%	11.7%	8.3%	7.4%	8.4%	8.5%
Policy Rate (eoy, %)	2.0%	9.3%	13.8%	11.75%	10.00%	9.00%
External Accounts						
Trade Balance MDIC (US$ bn)	50	61	62	99	87	78
Trade Balance (US$ bn)	32	36	44	81	67	58
Current Account Balance (US$ bn)	-28	-46	-48	-29	-34	-43
Current Account Balance (% of GDP)	-1.9%	-2.8%	-2.5%	-1.3%	-1.5%	-1.8%
Fiscal Policy						
Central Government Primary Balance (% of GDP)	-9.8%	-0.4%	0.5%	-2.1%	-0.7%	-0.8%
Government Gross Debt (% of GDP)	86.9%	77.3%	71.7%	74.3%	77.9%	80.1%