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Changes in Fiscal Risks

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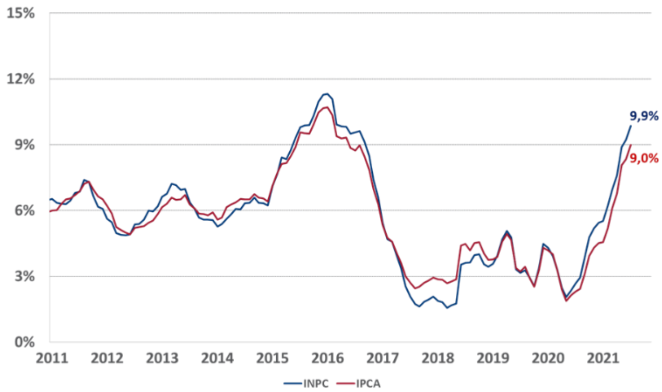
A little over a month ago, many analysts expected the 2022 budget to allow room for new expenditure. The Economy Ministry even estimated the leeway at BRL 25 billion due to the sharp rise in inflation measured by the first-half IPCA, which adjusts the spending cap, and the forecast of a fall in the INPC by year-end, as this index adjusts most of the government's mandatory expenditure. Although they comprise different baskets of prices, the IPCA and INPC have behaved similarly over the years, and most of the fiscal leeway comes from their different time horizons (Figure 1). Thanks to these differences, some spending demands, such as expansion of the *Bolsa Família* cash transfer program, could be accommodated.

Figure 1: Inflation (12 months)

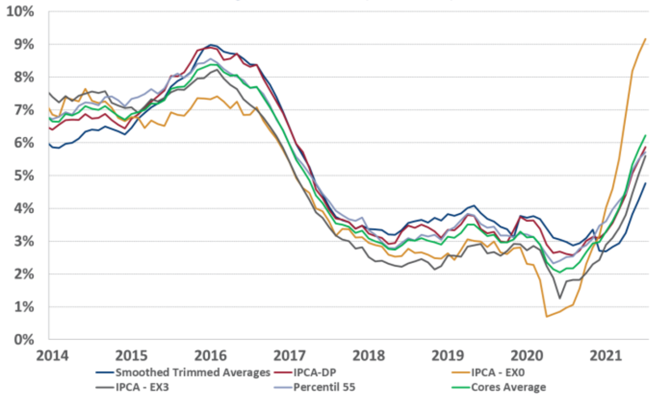


Source: IBGE

However, 2021 inflation forecasts have recently been revised up, owing to the inertial components of the core measures, which are accelerating and already running above 5% (Figure 2). More optimistic expectations about the resumption of job creation and a recovery in the service sector thanks to vaccine rollout and economic reopening have brought even more pressure to bear on prices.

The hydroelectricity crisis adds to this challenging outlook as dam reservoirs fall to levels that endanger load generation. In response, the National Electric Power Agency (ANEEL) announced the creation of a new "water shortage" surcharge to be added to electricity bills in September, staying in effect until April 2022. According to the economic team, every 1 percentage point rise in INPC inflation brings the spending cap closer by BRL 8 billion.

Figure 2: CPI Cores (12 months)



Source: Bocom BBM, BCB, IBGE

More important still was the surprise sprung by the amount of *precatórios* (court-ordered payment of federal debts) for 2022, which was BRL 89 billion, far exceeding the government's expectations (BRL 56 billion) and using up all the remaining room under the spending cap. This led to a discussion about how to accommodate the *precatórios* without infringing the spending cap, an important fiscal rule that has been responsible for the containment of government's expenditure and has hugely boosted confidence in Brazil's fiscal sustainability.

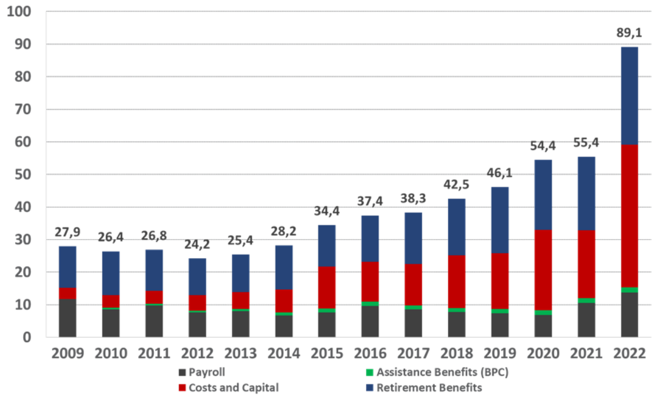
It appears doubtful that the 2022 budget will comply with the spending cap even if it obeys the applicable rules without any additional expenditure. A solution could involve mediation by the judiciary or a constitutional amendment, although the latter would take longer. However, both possibilities would create a dangerous precedent for the fiscal rules if they were accompanied by pressure for more spending, which is indeed already appearing.

From the standpoint of the Brazil risk premium, the best solution would be to accommodate the value of the *precatórios* within the spending cap, using up all the remaining room without considering any expansion of expenditure, and deal with additional commitments by means of the "account reconciliation" procedure, deducting transfers from federative units to the Union from the value of the *precatórios*.

Other solutions are being discussed in parallel, but they all infringe the spending cap one way or another. One would be to exclude *precatórios* relating to FUNDEF (the fund for basic education) from the cap, or even to exclude the part of *precatórios* that cannot be paid without infringing the cap, as an exceptional measure. Those types of solution at least signal strong concern about the credibility of the fiscal rules. Other solutions that create "extra room" under the cap and allow expenditure to expand would endanger fiscal sustainability.

In any event, the outstanding *precatórios* evidently represent a risk for the years ahead as well. Between 2013 and 2020, disbursement for the payment of *precatórios* rose substantially (Figure 3), and there are doubts as to whether the large amount budgeted for 2022 will recur in future. A document issued by the National Treasury outlining fiscal risks (*Anexos de Riscos Fiscais*) does indeed point to very large amounts of spending on this item. Around BRL 50 billion were actually paid under *precatórios* in 2020, but possible risks on court-ordered debt totaled BRL 1.3 trillion, which corresponds to 68% of primary expenses.

Figure 3: Court Ordered Debt Payment (real, BRL Billion)



Source: Bocom BBM, STN

In this climate of fiscal uncertainty, alongside the electricity crisis and accelerating inflation, we have revised down our growth forecast to 5.2% for 2021 and 2.0% for 2022, while revising up our projections for the IPCA in 2021 and 2022 to 7.8% and 3.8% respectively. Monetary policy remains contractionary, and a rate hike of 100 bps is expected at the next Central Bank meeting. We forecast 7.5% p.a. for the Selic by year-end 2021, and 8.0% p.a. by end-year 2022.

ECONOMIC FORECASTS	2018	2019	2020	2021F	2022F
GDP Growth (%)	1,3%	1,1%	-4,1%	5,2%	2,0%
Inflation (%)	3,7%	4,3%	4,5%	7,8%	3,8%
Unemployment Rate, SA (dec ,%)	12,2%	11,7%	13,9%	13,5%	13,0%
Policy Rate (dec, %)	6,5%	4,5%	2,0%	7,5%	8,0%
External Accounts					
Trade Balance (US$ bn)	53	48	51	69	46
Current Account Balance (US$ bn)	-42	-51	-13	-2	-15
Current Account Balance (% of GDP)	-2,2%	-2,8%	-0,9%	-0,1%	-0,9%
Fiscal Policy					
Fiscal Primary Balance (% of GDP)	-1,7%	-1,2%	-10,0%	-1,9%	-1,1%
Government Gross Debt (% of GDP)	75,3%	74,3%	88,8%	81,3%	82,1%