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Alternative scenarios for public debt

Ana Beatriz Moreira dos Santos
Myriã Bast

Despite the increase in public spending beyond the cap, public debt is expected to drop in 2021. This situation is possible due to surprises with collection and nominal growth, in addition to a reduced real interest level. Even so, it is important to note: with the spending cap fiscal rule – albeit weakened – it will be possible to stabilize public debt and reap the benefits of low real interest rates, in addition to the growth dividends for debt control, even after the major deficit expansion last year. If a more relaxed rule were in place, which would allow a strong increase in spending, there is a possibility that these two effects would not materialize. Whether good or bad, the existence of the cap limits the possibility of uncontrolled spending outside the emergency situation of the pandemic.

The advancement of fiscal consolidation in recent years was important to facilitate the sanctioning of lower interest rates in Brazil, also allowing the economy to be stimulated last year. Chart 1 shows the 1-year interest rate trend. After the approval of the spending cap and subsequent passing of the pension reform, there is a drop in interest rates. The reduction in demand from lower government spending and the long-term fiscal consolidation, resulting from the reforms in question, sanctioned a reduction in structural interest rates.

Chart 1: 1-year interest rate, Selic and fiscal reforms

Source: Bloomberg, Central Bank of Brazil, Bradesco

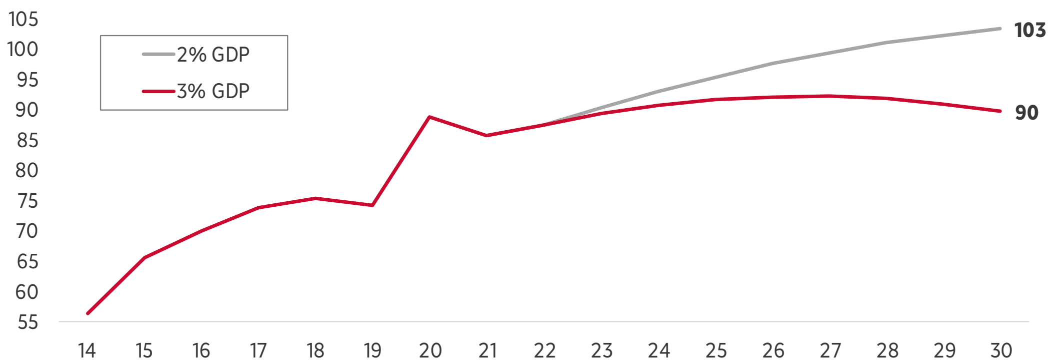
However, the commitment to strict fiscal rules has been tested several times in recent months. There have been some attempts to remove expenditures from the limits imposed by the cap and difficulties in accommodating all budgetary spending within the rules. It is true that these discussions have not evolved and the fiscal rules remain legally valid. However, this type of uncertainty tends to reduce confidence and increase risk premiums, in addition to deteriorating the quality of debt. There was a shortening of the securities debt, largely due to the increase in short-term fixed-rate bond issues, such that the portion of the debt due in twelve months rose from 21% in March last year to 28% this year. The cost of issuing long-term bonds has become higher. In addition, the Treasury is experiencing a high volume of maturities to be fulfilled within one year.

Therefore, persistence in the fiscal consolidation agenda, with credible and effective rules, is essential for the country to stabilize debt growth and keep interest rates low. In the exercises that follow, we elaborated scenarios for the evolution of the gross debt trend until the end of the decade for different fiscal assumptions, economic growth and real interest rates. In all of these conjectures, we used our projections of the short-term base scenario between 2021 and 2022, effectively changing the assumptions as of 2023.

In our simulations, the sensitivity of the public debt to the GDP occurs not only due to the denominator effect, but also due to collection. As illustrated by chart 2, the growth differential significantly affects the speed of expansion of public debt as a proportion of the GDP. In other words, the lower the growth, the debt is doubly penalized, with less revenue and with a lower denominator effect. In these scenarios, with real interest rates of 3% and the spending cap remaining for the entire period, the debt stabilizes with the GDP at 3% and shows an upward trend, until the end of the decade, with economic growth of 2.0%. We do not consider asset sales in either case.

Chart 2: Scenarios with 2% or 3% GDP growth.

Note: Both scenarios consider a real interest rate of 3% and maintenance of the spending cap for the entire period.

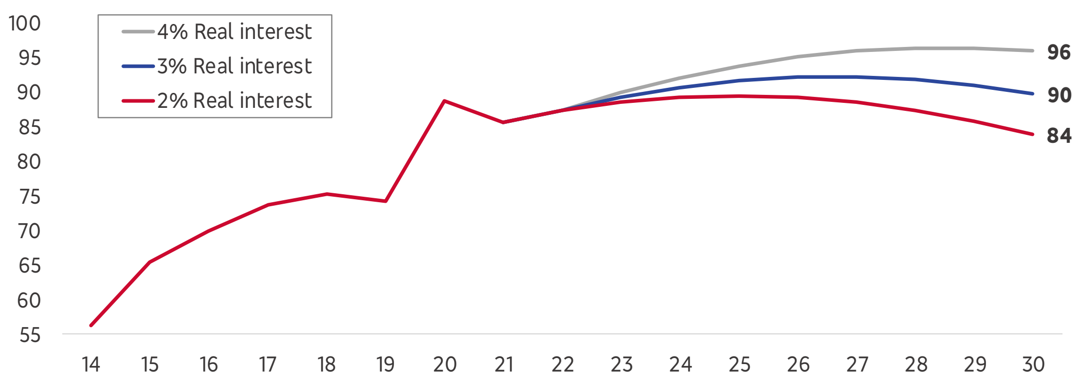


Source: Central Bank of Brazil, Bradesco

Similarly, we repeated the exercise by changing the real interest assumptions. We observed that the increase of 1 percentage point in the real interest rate led to an upswing in the estimate of gross debt by about 6 GDP points at the end of the analyzed period (chart 3). In these scenarios, we considered GDP growth of 3% per year between 2023 and 2030.

Chart 3: Scenarios with 2, 3 and 4% real interest rates

Note: The three scenarios consider a GDP growth rate of 3% and maintenance of the spending cap for the entire period.



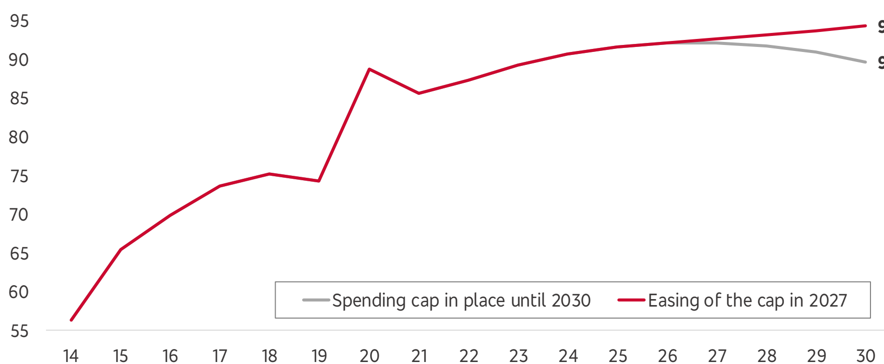
Source: Central Bank of Brazil, Bradesco

All of these scenarios assume maintenance of the spending cap until the end of the decade. If there is a change in the fiscal rule, the scenarios for public debt will shift. Assuming compliance with the spending cap in the coming years, it will be possible to achieve a small primary surplus in 2026. This is also the closing year of the first 10 years of this fiscal rule's effective term, when it may be extended or reassessed.

We then considered some scenarios for easing the spending cap. We assumed easing of the cap as of 2027, with a change in the indexer, such that expenses are only stable as a percentage of the GDP, that is, they grow with inflation and the real GDP. In this case, it is possible to note that the debt trend will not be reversed before the end of the decade, even with low real interest rates and GDP growth above the historical average.

Chart 4: Scenarios for maintaining and easing the spending cap

Note: Both scenarios consider a GDP growth rate and real interest rates of 3% between 2023 and 2030.
Easing of the cap: change of the indexer in 2027, such that expenses are linked to the variation of the nominal GDP.

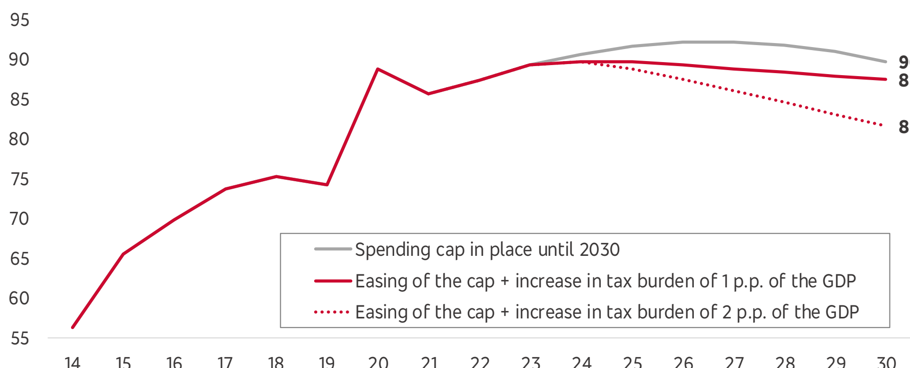


Source: Central Bank of Brazil, Bradesco

Without maintaining the spending cap rule, debt stabilization will require an increase in the tax burden. We then simulated the public debt trend with an increase in the tax burden of 1 percentage point of the GDP, starting in 2024, the second year of the next presidential term, when the first year's reforms usually take effect. With this increase in the tax burden, it is possible to offset the effect of easing the spending cap on debt/GDP. Naturally, this is a worse combination for the real economy in which there is an increase in the burden and expenses, simultaneously pressuring growth downwards and interest rates upwards. In Brazil, on the other hand, there is little evidence of the benefits of increasing public spending on the structural growth of the economy, given the choice of the type and quality of public expenditures made.

Chart 5: Spending cap maintenance and easing scenarios with increased tax burden

Note: The three scenarios consider a GDP growth rate and real interest rates of 3% between 2023 and 2030.



Source: Central Bank of Brazil, Bradesco

The Emergency Constitutional Amendment approved earlier this year provides for a subsidy reduction plan. The Constitutional Amendment foresees submission of a bill to reduce tax subsidies, currently at 4% of the GDP, to a maximum of 2% of the GDP in eight years. If passed, this plan would have an impact similar to a gradual increase in the tax burden by 2 p.p. of the GDP, leading to a more intense debt reduction (Chart 5 simulation). On the other hand, the withdrawal of ICMS from the PIS/Cofins tax base, which became effective as of the date of the 2017 STF decision, should lead to an increase in tax offsets, which may partially or completely cancel this reduction, depending on the size of the contingent liability.

In short, there are alternatives for stabilizing and reducing public debt in the medium term. The spending cap rule can be maintained after 2026, another arrangement of fiscal rules that rescues the primary surplus target can be considered, as well as limits on indebtedness, a reduction of subsidies, an increase in burden or even a genuine reinforcement of the golden rule or the Fiscal Responsibility Law. There are alternative arrangements to the current one, which can guarantee debt convergence. What needs to be taken into account is that there are consequences in the choice of this fiscal arrangement, with greater or lesser effect on growth, equilibrium interest rates and the speed of convergence, which should not be so slow as to be imperceptible or leave us no room for maneuvering to react to possible shocks in the future. What is certainly not an option is abandoning a credible fiscal arrangement that signals debt stabilization in the coming years.

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Technical Staff

Director of Economic Research and Studies Fernando Honorato Barbosa

Economists Ana Beatriz Moreira dos Santos/ Constantin Jancsó / Ederson Luiz Schumanski / Fabiana D'Atri / Felipe Wajskop França / Myriã Tatiany Neves Bast / Priscila Pacheco Trigo / Renan Bassoli Diniz / Robson Rodrigues Pereira / Thiago Coraucci de Angelis / Thomas Henrique Schreurs Pires

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