EXECUTIVE SUMMARY

Unit I: The Process of Federal Public Debt Strategic Planning

In Brazil, Federal Public Debt (FPD) strategic planning involves various aspects that can be grouped into three stages for didactic purposes:

- Definition of the desired long-term structure (benchmark);
- Medium-term planning (transition strategy); and
- Elaboration, publication and implementation of short-term strategy (Annual Borrowing Plan - ABP, first published in 2001).

The starting point and primary reference for the entire public debt planning process is a clear definition of its objectives. The objective defined for Federal Public Debt management is that of efficiently meeting federal government borrowing requirements at the lowest possible long-term financing cost, while ensuring prudent risk levels. Additionally, the aim is to the smooth operation of the Brazilian government securities market.

Considering the objective defined above as reference, the ABP presents a series of guidelines that orient the elaboration of FPD borrowing strategies. They are as follows:

- Increase the average maturity of the outstanding debt;
- Smooth the maturity profile, with special attention given to short-term maturities;
- Gradual replacement of floating-rate securities by fixed-rate and inflation-linked instruments;
- Improvement in the External Federal Public Debt (EFPD) profile through issuances of benchmark securities, buyback and structured operations;
- Development of the of the yield curve on both domestic and external markets and growth in the liquidity of federal government securities on the secondary market;
- Broadening of the investor base.

Taking into account the objective and guidelines set out in the ABP, macroeconomic scenarios, estimates of federal government borrowing requirements and the various public debt bond issuance strategies, each year the National Treasury calculates the expected values for the major FPD indicators: outstanding volume, composition by indexing factor, average maturity and percentage maturing in 12 months. On this basis, the ABP is used to announce the indicative limits of the upper and lower values that each of these indicators is expected to reach at the end of the year.

As the basis for ABP elaboration, strategic FPD planning defines a "transition strategy" from the current public debt composition to the long-term benchmark. The transition strategy seeks to respond to the following question: duly respecting the initial conditions (in other words, the current debt profile) and short and medium-term restrictions (particularly, macroeconomic restrictions and those implicit in the development of local financial markets), what should be the trajectory and speed of convergence to the desired long-term composition? The choice of transition strategies to the long term also explores the trade-offs between public debt costs and risks.

In its turn, the optimal long-term composition (benchmark) is the first stage to be discussed and approved by the Public Debt Committee, becoming the foundation for elaboration of the transition strategy and Annual Borrowing Plan approved for each year. In Brazil, development of the optimal public debt composition model was a natural consequence of a long process of improvement in the institutional framework used to evaluate FPD costs and risks. Initially, the government asset and liability management model was implemented. After that, the risk management instruments used by the National Treasury in FPD management were adopted. It was only at that point that studies were initiated on an optimal public debt composition model that would consider all of the relevant variables.

Unit II: The Analytical Framework of the Federal Public Debt Benchmark

With regard to defining an optimal long-term public debt composition (benchmark), it represents the desired profile for the debt structure and constitutes a guide for delineating the government's short and medium-term financing strategies. In the Brazilian case, the benchmark is expressed by a set of relevant debt indicators, including composition of the outstanding debt by type of index, average maturity and maturity structure, particularly the percentage of the debt maturing in the coming 12 months.

In defining the optimal public debt composition (benchmark), a set of models describes how relevant macroeconomic and financial variables to the public debt trajectory (interest rates, exchange rates, inflation and GDP) evolve over time. Based on simulated scenarios, evolution of the debt/GDP ratio is evaluated in order to derive cost and risk measurements of a given debt structure. Thus, following examination of multiple possible alternatives, one obtains the efficient frontier in terms of public debt costs and risks. On that basis, one chooses the structure in the frontier that possesses the desired profile for the long-term, complying with society's preferences between costs and risks.

An important question in the model is what should be the relevant concept of debt size in order to evaluate costs and risks. In the Brazilian case, we considered the Net Public Sector Debt/GDP ratio (NPSD/GDP) as the most relevant measurement, since it is the indicator most commonly utilized both by the federal government, to define its indebtedness targets and the primary surplus required to achieve them, and by analysts for the purpose of evaluating fiscal sustainability. Though the FPD is the National Treasury's work instrument, clear communication is sought between this debt and NPSD, the latter of which is a broader concept and an economic policy reference.

In the Brazilian case, the initial optimal composition proposal was published in the 2007 ABP. Simulations of this model suggested that efficient FPD management would result in growth in the proportion of fixed rate and inflation-linked securities, in detriment to the debt linked to floating interest rates or the exchange rate. More recently, refinement of the studies led to a definition of the desired composition, as presented in the 2011 ABP in the form of indicative long-term limits, as shown in the following table:

Optimal Long-term FPD Composition

	Lower limit	Upper limit
Fixed rate	40%	50%
Inflation-linked	30%	35%
Floating rate	10%	20%
Exchange rate	5%	10%

Source: National Treasury

The prescription that calls for seeking the composition described above should be qualified. First of all, it should be viewed as a guideline to be attained gradually, without generating pressures that could result in excessive transition costs. Secondly, one must avoid seeking FPD composition in any manner that is not coordinated with its maturity structure. Thirdly, the cost of altering the composition must be permanently monitored, since changes in the relative prices of public securities can result in adjustments in the FPD benchmark portfolio. Finally, though these limits provide up-to-date orientation for defining strategies, they must also reflect possible restrictions related to the development stage of Brazil's financial markets, the investor base profile and the outlook for future public security demand and liquidity.