

## POSITIVE RESULTS ON THE HEELS OF HIGHER INFLATION

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- The consolidated public sector posted a primary surplus of +BRL24.3 billion in April, better than our forecast (+BRL18.2 billion) and the market's median estimate (+BRL17.2 billion). This represented the best result for the month since 2014, boosted by the impact on revenue of a more persistent inflation shock—in both federal and local terms. In YTD data, the regional government surplus reached an all-time high.
- The current fiscal result for the year implies a positive bias to our fiscal forecasts. However, in our view, extrapolating a full year forecast from the most recent positive revenue surprises continues to require caution. On the expenditure side, it is worth mentioning that expenses are expected to increase in the coming months, especially disbursements to mitigate the impact of COVID-19 (not considered as coming under the spending cap rule), as well as the “normalized” outlays flow following presidential sanction of the 2021 budget at the end of April.
- In addition, after the budgetary deadlock in 2021 and with discretionary spending at minimum levels, we believe strict fiscal discipline will be important in order to comply with the spending cap rule (we see a significant risk of a partial shutdown of some public services).
- Debt indicators showed a decline, with the positive primary surplus result and an increase in nominal GDP. Gross debt reached 86.7% of GDP in April 2021, a reduction of 2.2 pp from the March reading—on the heels of the increase in nominal GDP (-1.5 pp of impact). Meanwhile, net debt was 60.5% of GDP, 0.6 pp lower on the same basis of comparison.
- According to our forecasts, the consolidated public sector deficit should reach BRL250 billion in 2021 (3.0% of GDP). We expect gross debt to fall this year to 85.0% of GDP, however, assuming higher nominal GDP (driven by the inflationary shock), and we expect that BNDES will repay the Treasury a total of BRL100 billion (BRL38 billion has already been transferred).

According to data published yesterday by the BCB, in April the consolidated public sector posted a primary surplus of BRL24.3 billion, better than our forecast (+BRL18.2 billion) and the market's median estimate (+BRL17.2 billion). In the accumulated result for the year, the consolidated public sector registered a surplus of BRL76.9 billion in real terms, compared to a deficit of BRL88 billion in the same period of 2020, which was mainly due to the massive fiscal stimulus last year. It was the best result for the period in the BCB series since 2012 (see Figure 1).

The primary deficit reached BRL544.5 billion (7.1% of GDP) in the 12-month reading. The consolidated government's primary target for the year is currently BRL250 billion (3.0% of GDP). However, we think it is important to note that -BRL70 billion in expenses will not be considered in the official calculation of the primary target for the central government result, as is legally permitted by recently approved laws (*PEC emergencial* and *PLN2/2021*). The 12-month nominal deficit was BRL827 billion (10.8 % of GDP). We expect the nominal deficit to reach 7.4% of GDP by the end of the year. Additionally, considering all the expenses (even those not considered for calculating the fiscal rules—the constitutional spending cap and primary target), we estimate the consolidated public sector deficit could reach BRL250 billion in 2021 (3.0% of GDP). In our view, the primary result could be slightly better, due to our upward bias based on domestic activity and a greater impact of inflation on federal tax collection, both leading to rising revenue. However, in our view, extrapolating a full year forecast from the most recent positive revenue surprises continues to require caution.

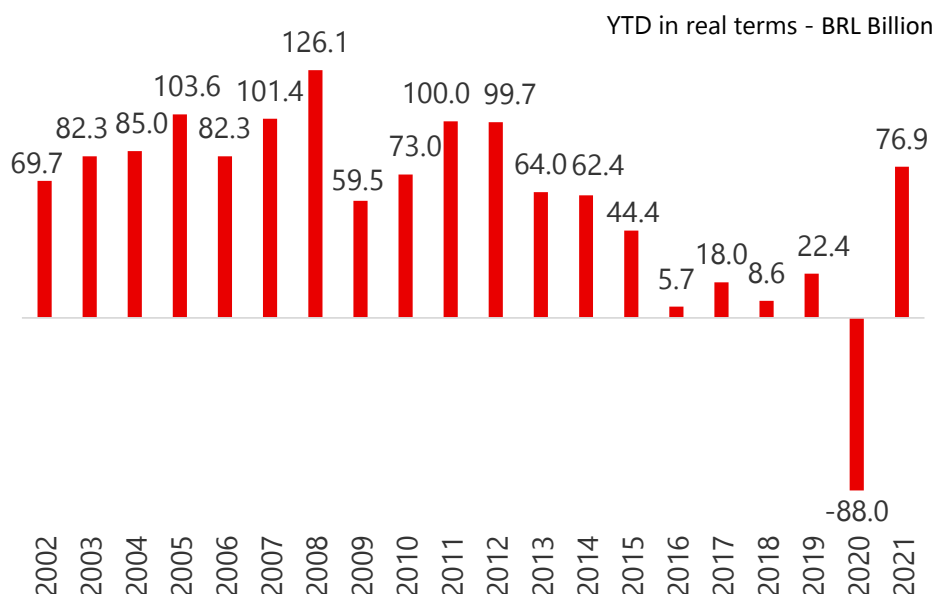
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**Figure 1 – Consolidated Public Sector Result**



Sources: Brazilian Central Bank, Santander.

Although the fiscal result was quite positive for the first four months of the year, some (possibly temporary) factors have helped boost the fiscal result so far. The results occurred on the heels of atypically low discretionary expenses (owing to a tight execution rule before the approval of budget 2021), leading to an all-time low in the 12-month reading. Higher inflation and FX depreciation also helped the fiscal statistics from the standpoint of revenue. In addition, the regional government surplus remains high due to fiscal transfers and a robust recovery in activity in the last few months.

In April, the regional governments' results were positive once more (+BRL7.0 billion compared to a deficit of BRL1.9 billion in April 2020), probably due to the lagged effects of the 2020-21 fiscal stimulus on local economies, added to the impact of the inflation shock on tax collection—and the activity recovery in the last few months. In the YTD reading, regional governments posted a primary fiscal surplus of BRL33.7 billion (1.3% of GDP)—the best result in real terms for the period. In our view, for now the subnational entities should continue to present a positive result in the short run. Yet the regional governments will face the challenge of reestablishing fiscal equilibrium in the medium term after the fiscal stimuli are over, in our view. In addition, the resurgence of the pandemic may affect local revenue, in a context of higher disbursements for public health. We believe this is likely to increase pressure for new transfers from the federal government.

Additionally, according to National Treasury data published on May 27, the central government posted a primary surplus of BRL16.5 billion in April 2021, better than our forecast (+BRL12.6 billion) and the market's median estimate (+BRL10.3 billion). In year-to-date data, it was the best primary result since 2012 for the period. During the period, total revenue rose 16.6% YoY, considering the positive result for federal tax collection (boosted by inflation and FX depreciation) and extraordinary revenue, while total expenditures dropped 12.2% YoY (-34.4% YoY in April). On the expenditure side, a key factor was the lower level of discretionary spending (-35.2% YoY in the year)—currently at an all-time low in 12-month nominal terms (BRL98.5 billion). In the 12-months reading, the deficit reached BRL646 billion (7.9% of GDP).

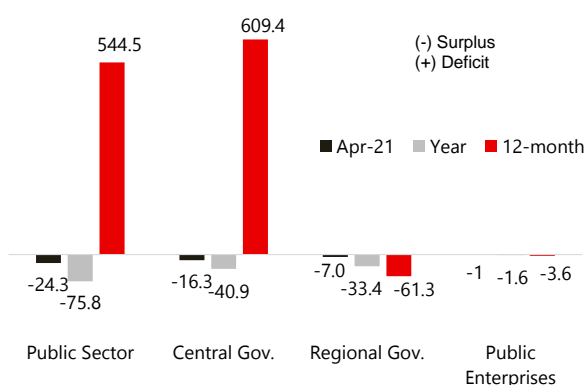
In the coming months, we expect the central government's fiscal results to be affected by the increase in discretionary spending (following the approval of the 2021 budget), higher expenditures related to mitigate the COVID-19 effects, which are not considered in the constitutional spending cap rule ("extra-cap") (more than BRL13 billion), and anticipation of the payment of pensions (13th bonus payment) for May to July. On the revenue side, it will be important to assess the use of the tax credit and the impact of inflation on federal tax collection, which boosted the result in the last few months. For 2021, we estimate a central government primary deficit of BRL265 billion (3.1% of GDP).



In addition, after the budgetary deadlock we have seen in 2021 and with discretionary spending at minimum levels, we believe strict fiscal discipline will be important in order to comply with the spending cap rule (we see a significant risk of a partial shutdown of some public services). Moreover, Congress still needs to approve the law that restores the mandatory expenses that were cut.

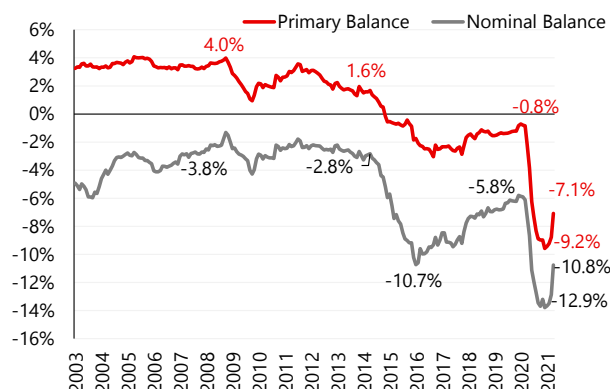
Meanwhile, gross debt came in at 86.7% of GDP in April (see Figure 5), a drop of 2.2 pp from March— on the heels of the increase in nominal GDP (-1.5 pp of impact). At the same time, net debt was 60.5% of GDP, 0.4 pp lower on the same basis of comparison. We project gross debt to fall this year to 85.0% of GDP, however, assuming higher nominal GDP due to the effect of the inflationary shock on the GDP deflator, and we expect that the BNDES will repay the Treasury at least BRL100 billion (BRL38 billion has already been transferred).

Figure 2 – Primary Result (BRL billion)



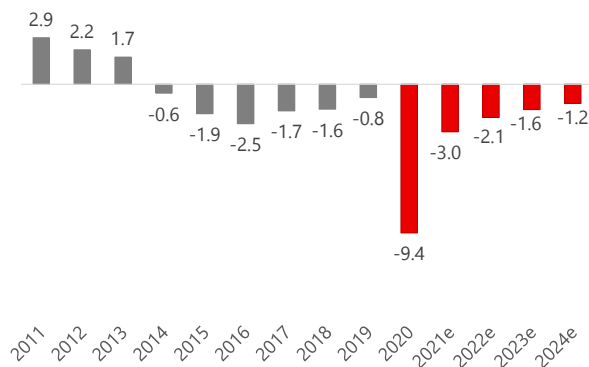
Sources: Brazilian Central Bank, Santander.

Figure 3 – Consolidated Public Sector (12m % GDP)



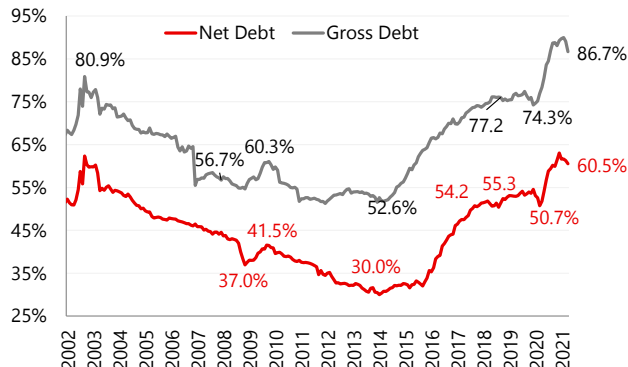
Sources: Brazilian Central Bank, Santander.

Figure 4 – Primary Result Forecast (% GDP)



Sources: Brazilian Central Bank, Santander.

Figure 5 – Public Sector Debt (12m % GDP)



Sources: Brazilian Central Bank, Santander.



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