Borrowing Requirements and Debt Management: The Importance of the Fiscal Adjustment

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- **In this report, we analyze the impact of heightened fiscal risks from the standpoint of debt management.**
- **In recent years, we have observed a significant drop in non-residents' share of total Brazilian public debt, especially after Brazil lost its investment-grade. Typically, these foreign investors hold longer-term securities, yet the pandemic has hastened the withdrawal of foreign investment from Brazil amid a significant increase in the debt level. Therefore, average debt maturity continues to shrink.**
- **In addition, with rising fiscal uncertainty, especially on the fate of the constitutional spending cap, more stringent borrowing requirements and higher risk premiums on debt securities are taking hold, as the Treasury's cash position is being used in a much more accentuated manner this year.**
- **Brazil Central Bank's (BCB) transfers to the Treasury (BRL325 billion) this semester, as well as better market conditions in August, contributed to the Treasury's optimization of the debt rollover process regarding new issuance. Moreover, as interest rates are at historical low levels, the cost of financing debt continues to fall, despite a greater risk premium generated by the fiscal uncertainty.**
- **However, due to the possibility of creating new mandatory expenses without reducing others, the fiscal risk has sharply increased and is affecting debt premia. The possibility of not complying with the spending cap rule and returning to the fiscal adjustment is affecting Treasury auctions, in our view.**
- **Therefore, we reiterate the importance of complying with the spending cap rule and advancing fiscal reforms in order to reduce structural risk, maintaining the neutral interest rate at low levels and also attracting foreign investment in Brazil, with a perspective of long-term debt solvency.**

In the last few weeks, the National Treasury held the largest auction in its history, in the amount of BRL40 billion, and mostly in short-term bonds. Since the beginning of the year, the institution had already experienced difficulties in holding longer-term bond auctions, a fact that worsened in the wake of the pandemic. Usually longer-term bond holders (e.g., foreigners) reduced their participation in debt stock from 20.5% in 2015 (when the country had investment grade rating) to around 9% of the total, according to the most recent data from August; Figure 1 illustrates this relationship. The risk related to the fiscal perspective has increased foreigners' withdrawal of funds in debt (-BRL33 billion year to date and -BRL82.5 billion in 12 months). This movement is related to the fiscal risk, mainly because of the increase in the debt level caused by the fiscal stimulus (to mitigate its effects) and the possibility of creating a new welfare program that increases mandatory expenses, without curbing others, for the next few years.

We have found several studies that detail the importance of foreign participation in the bond market, noting a negative correlation between changes in the bond yield and the share of securities held by foreigners[1]. Also, studies have shown that countries can improve foreign participation by reducing macroeconomic instability[2].

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[1] See: Andritzky, Mr Jochen R. *Government bonds and their investors: what are the facts and do they matter?* No. 12-158. International Monetary Fund, 2012.

Peiris, Shanaka J. *Foreign participation in emerging markets' local currency bond markets*. No. 10-88. International Monetary Fund, 2010.

[2] Burger, John D., and Francis E. Warnock. *Foreign participation in local currency bond markets*. Review of Financial Economics 16.3 (2007): 291-304.

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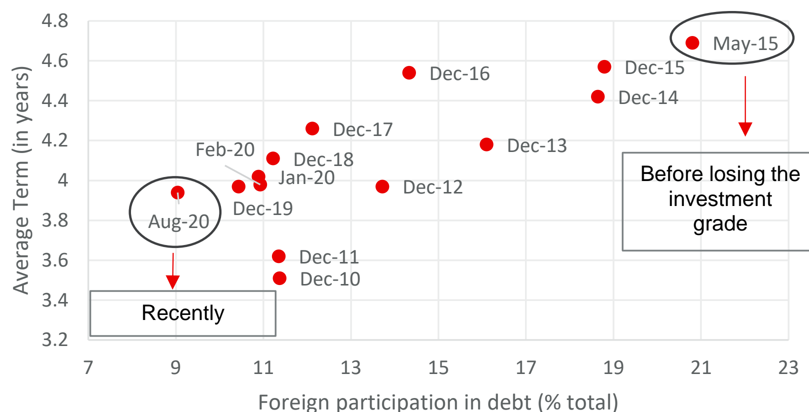
Figure 1. Foreign Participation in Debt and Debt Maturity



Sources: National Treasury and Santander.

Compared to domestic investors, foreign investment usually is in long-term bonds (on average), yet as the percentage of the latter dropped after Brazil lost investment grade, average maturity also fell significantly (Figure 2A). The average maturity of foreign investment in debt has fallen mainly due to decreased participation in inflation-linked securities (see Figure 2B). Inflation-linked securities have had a longer average duration; since 2011 the average of these securities has been more than seven years. Since Brazil's loss of investment grade, foreign participation in this type of security has fallen from 10% of the total to just over 1.5% at present.

Figure 2A. Average Debt Term - (in years)

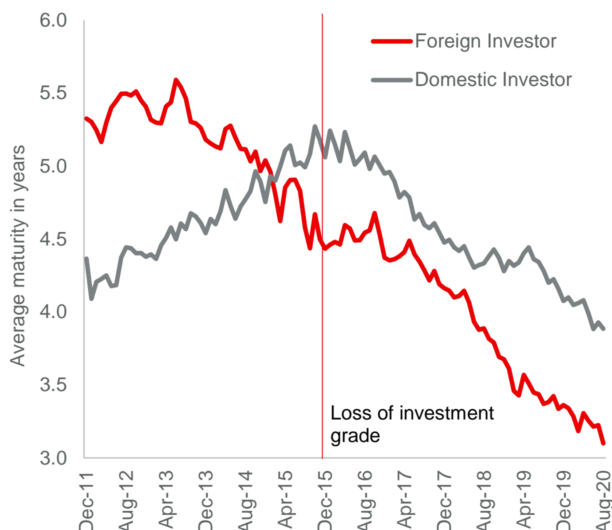
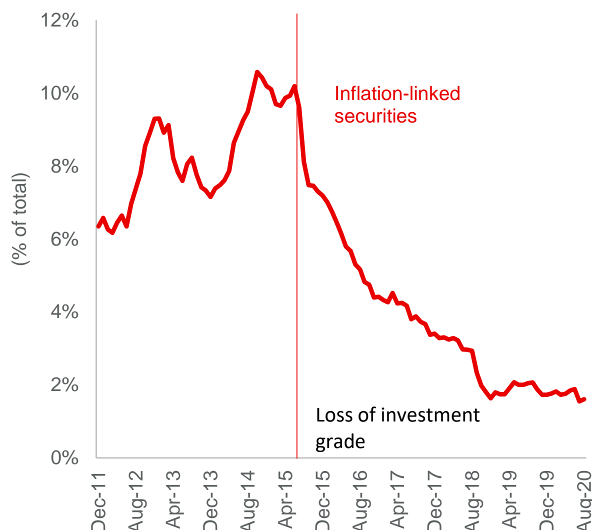


Figure 2B. Foreign Participation - (% total)



Sources: National Treasury and Santander.

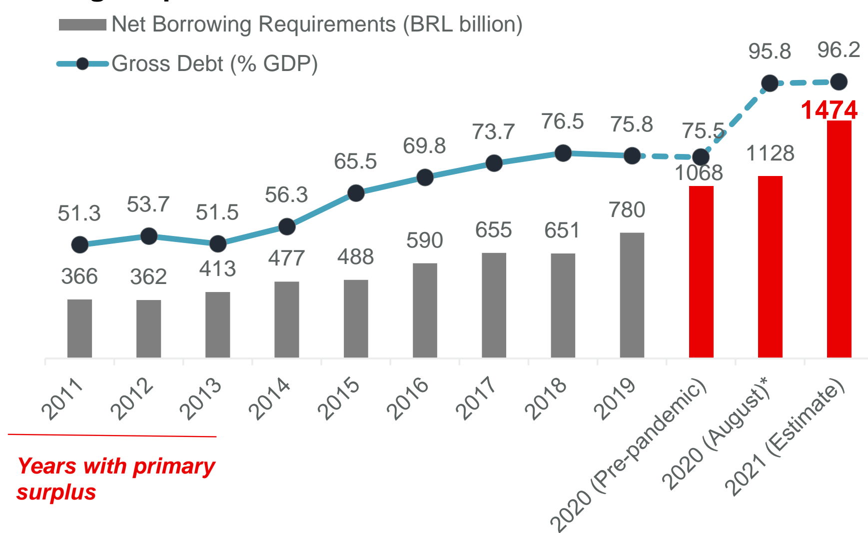
The pandemic has hindered debt management, as higher borrowing requirements to finance expenses to mitigate the effects of the pandemic, which should add up to BRL 605 billion (8.7% of GDP) in 2020, according to our estimate. This effect led to a reduction in the Treasury's cash position in 2020 (BRL287 billion), which triggered the transfer of resources corresponding to the BCB's FX result in 1H20 to the Treasury, which is allowed by Law No. 13,820/2019 in the event of intense liquidity constraints. This transaction totaled BRL325 billion and will allow for an increase in the Treasury's liquidity cushion, which should help to optimize both the debt rollover process and new issuance. However, due to the high shortening of debt, possibly the largest in 15 years, we believe that the scenario may worsen if the country does not have a better fiscal outlook and if a neutral interest rate is not maintained at lower levels (for further details on this topic, see page 8 of this report).

Figure 3 details the evolution of net borrowing requirements (NBR) and gross debt/GDP compared to our forecasts. We note that since the advent of a primary deficit, the NBR increased significantly by around BRL300 billion from 2014 to 2019. Even with the gradual reduction of the primary deficit, the NBR jumped to around BRL1.06 trillion for 2020, according to National Treasury, due to increased debt. With the onset of the pandemic, this amount jumped to BRL1.12 trillion, already considering the transfer of the BCB's FX result of BRL325 billion, which reduced these borrowing needs. In other words, we estimate that it could have reached a total of BRL1.45 trillion. For 2020, we estimate that gross debt has increased by around 20 p.p., demonstrative of the pressure on financing needs.

For 2021, we made an estimate based on the debt maturities disclosed in the monthly debt report for August[3], and on the deficit estimates for 2021. The result is around BRL1.5 trillion, even assuming a primary deficit reduction from BRL880 billion in 2020 to BRL250 billion in 2021, according to our forecast.

Our estimate (see formula in the Appendix) is divided into approximately BRL1.21 trillion of debt maturities for next year, divided in BRL1.04 trillion for domestic debt, BRL 35 billion of external debt and BRL131 billion in BCB interest charges (considering the average increase in recent years). In addition, we added BRL15 billion in honors and guarantees (as the situation in the Brazilian states should remain challenging next year). Meanwhile, as a proxy for the balance of the primary expenses account minus budgetary resources, we made the simplifying hypothesis for next year's deficit to be around BRL250 billion. It is worth mentioning that this amount can be reduced by BRL100 billion if the BNDES repays this amount to the Treasury, for loans owed to the federal government. For 2021, we did not add new transfers from the BCB to the Treasury, which can be made in the event of a liquidity crisis, in accordance with the previously mentioned law.

Figure 3. Net Borrowing Requirements and Gross Debt increase



* It includes BRL325 billion from the transfer from BCB to the Treasury, allowed by law nº 13,820/2019

Sources: National Treasury and Santander.

In the wake of the greatest adversity to finance the massive fiscal stimulus, the balance of the Treasury's cash position decreased by approximately BRL287 billion from January to August—not as bad as it could have been considering better market conditions in August (August saw better conditions for Treasury issuance in light of the more consistent resumption of domestic and international activity, as well as a reduction in international risk [see Figure 4A]). This improvement reinforces our idea that positive market conditions make it possible for the Treasury's cash position not to deteriorate, as occurred in July; this improvement in financial conditions is closely related with the expectation of fiscal consolidation.

Another aspect to consider is that just over 60% of the Treasury's cash account is exclusively linked to debt management, that is, the so-called "liquidity cushion" of the Treasury is closer to BRL771 billion, according to

[3] Adding up the auction of September and October 1, this amount jumps more BRL87 billion, considering the issuances set to mature next year.

August data (Figure 4B), and registered a decrease of BRL70 billion in 2020. Up to July 2020, the drop was BRL362 billion for the year, reflecting the importance of market conditions for the recovery of this account.

Figure 4A. Treasury's Cash Position - (BRL bn)

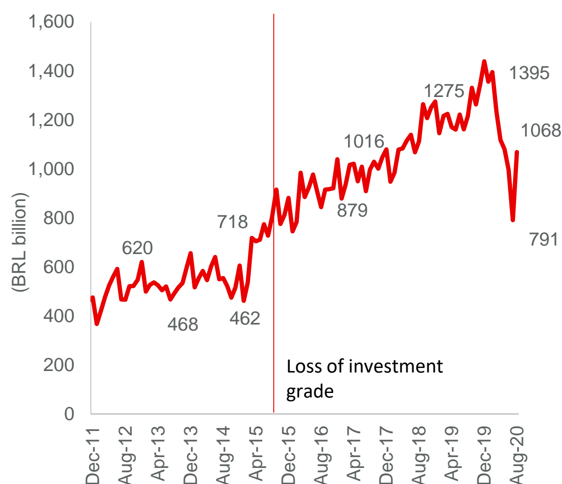
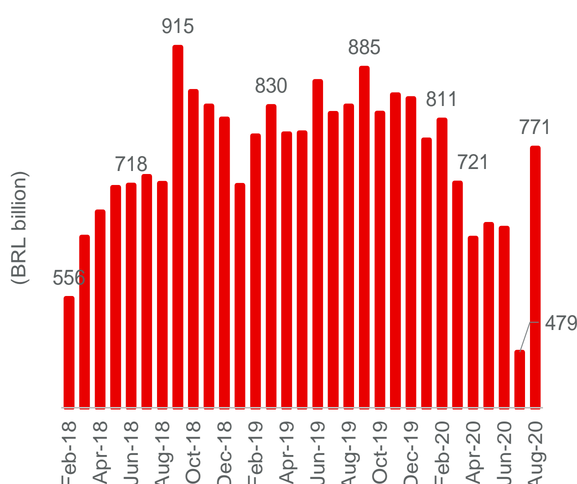


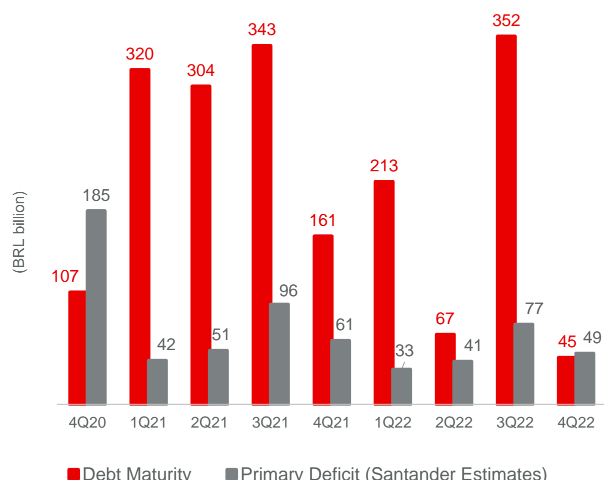
Figure 4B. Cash "Liquidity Cushion" - (BRL bn)



Sources: National Treasury and Santander.

In the last few weeks, as mentioned above, the Treasury has held quite a few auctions, particularly of fixed-rate bonds: approximately BRL37 billion were sold in the September 10 auction, BRL20.2 billion on September 17 and BRL21.7 billion on October 1. In addition, BRL107 billion will mature in the fourth quarter (BRL91 billion in October), as well as a primary deficit to finance of approximately BRL185 billion in the last three months of the year (Figure 5A). As Figure 5B illustrates, fixed-rate and floating rate bonds account for most of this maturity, both with lower average terms. Considering that 11 more Treasury auctions are to be held in 2020 [LTN and NTN-F] to finance this BRL292 billion (we note that this amount could be lower considering the October 1 auction), the auctions would have to be higher than BRL20 billion not to use the Treasury's cash position. Finally, as public debt maturities have shortened, most of security maturities are concentrated in 2021, and these aforementioned auctions may increase this value.

Figure 5A. Debt Maturity - (BRL billion)



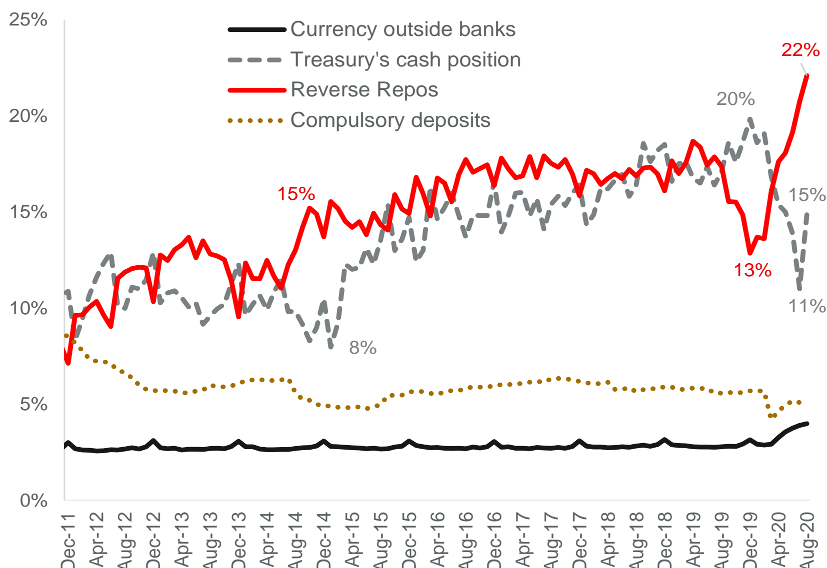
Sources: National Treasury and Santander.

Figure 5B. Profile by Categories - (BRL billion)

Quarter	Fixed Rate	Floating Rate (selic)	Inflation-Linked	FX-Exchange	Other	Total
4Q20	91.7	-	11.8	1.1	2.7	**107.3**
1Q21	118.0	183.4	15.2	2.8	0.9	**320.4**
2Q21	184.6	-	81.8	36.7	1.3	**304.4**
3Q21	97.0	227.9	14.8	2.7	1.0	**343.4**
4Q21	150.0	-	9.2	-	1.9	**161.1**
1Q22	88.1	107.2	14.5	2.6	0.9	**213.2**
2Q22	57.0	-	8.9	-	1.1	**67.0**
3Q22	77.8	129.1	142.1	2.4	0.8	**352.3**
4Q22	33.9	-	8.7	-	2.1	**44.7**

Another consequence of the monetary and fiscal stimulus measures related to the pandemic has been the need for greater reverse repos from the BCB for liquidity management. These operations have jumped by BRL494 billion year to date, reaching BRL1.5 trillion, or 22% of GDP as of August (Figure 6), compared to the average of 14.1% of GDP from 2011 to 2019, and 16.7% of GDP last year.

Figure 6. Demand for Liquidity - Sub Items of BCB Liabilities - (% GDP)



Sources: National Treasury and Santander.

Another consequence of the pandemic has been the shortening of debt, which makes it difficult to manage the Treasury's cash position in the event of more unfavorable market conditions. As new issuance is focused on shorter maturity bonds, and with the increase in the reserve repo operations by the BCB, the average term of both, as measured in months, dropped from 39 months in January to around 34 months in August. If we consider only the Treasury data on federal public debt, this term fell from 46 months in January to 44 months in August, below the historical maximum of 57 months in 2016. We expect the fall in the average maturity of debt securities to continue, as the Treasury continues to issue shorter bonds, even more with higher borrowing requirements, as we showed earlier (see Figure 3). Currently, adding up reverse repos and public debt represents 45.5% of total gross debt or the equivalent of 40.4% of GDP with maturities up to 2021.

Figure 7A. Reverse Repos - (BRL billion)

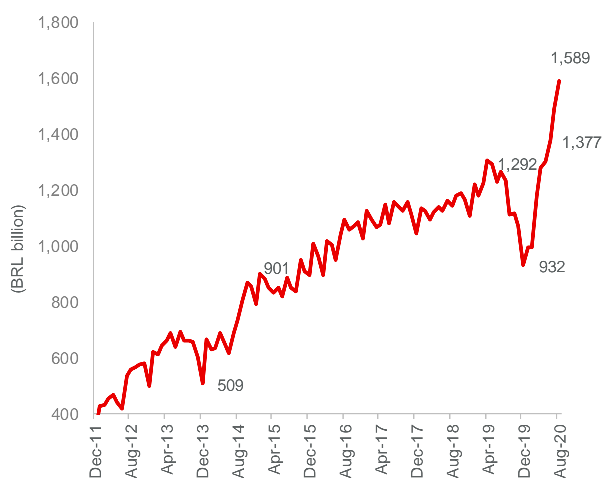
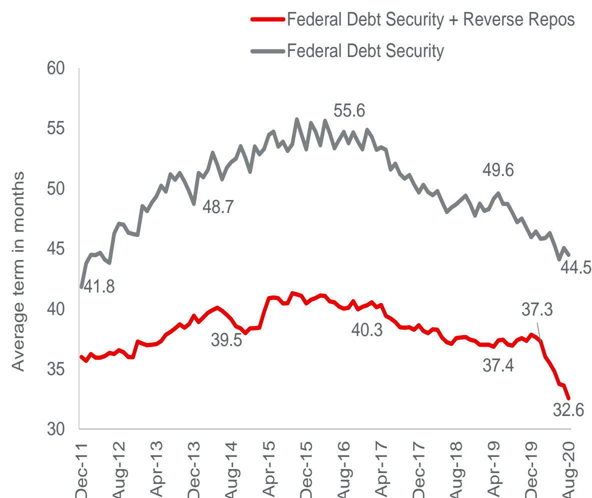


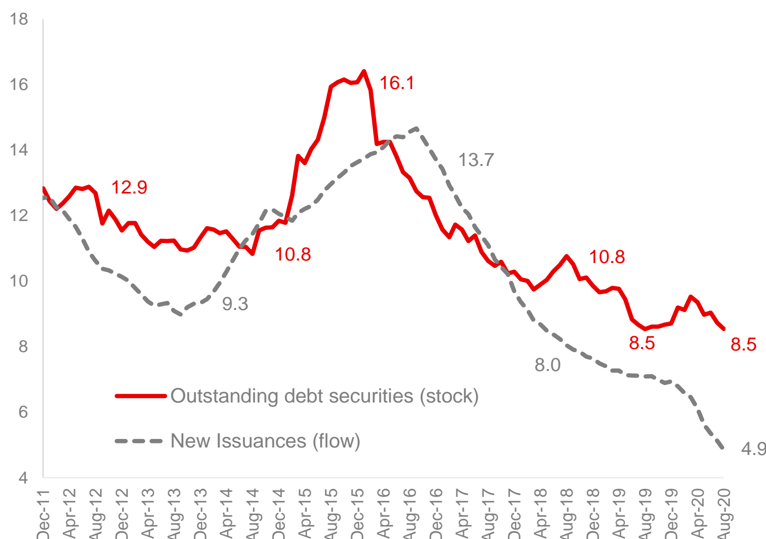
Figure 7B. Average Maturity - (in months)



Sources: National Treasury, BCB and Santander.

Despite this shortening of debt and the need for greater issuance, a positive is that the base interest rate (*Selic*) has reached an all-time low (2.0% per year) and should stay at this level for a prolonged period, in our view, if the BCB maintains the current balance, inflation remains well-behaved and adheres to the current fiscal regime. As a result, the cost of debt has fallen and is also close to historical lows. In addition, the cost of new issues is 4.85% per year, the lowest on record. Although the market has been demanding higher premia due to fiscal uncertainty, the rate is still relatively low (see Figure 8), which ensures, in our view, that positive conditions for debt management are maintained within the spectrum of deterioration in the fiscal framework.

Figure 8. Average Cost of Federal Public Debt in the Last 12 months – (%)



Sources: National Treasury and Santander.

Despite this reduction in interest rates, the risk embedded in the creation of new permanent expenses is raising interest rates/premia at the long end of the yield curve, which has hampered the issuance of longer bonds by the Treasury. Figure 9A shows how the longest securities are at rates above 8.0% per year, which is linked to increased fiscal risk perception, in our view. In addition, the Treasury has been issuing bonds with a shorter term and paying a higher premium. Despite the basic interest rate being at its historical minimum, premia for post-fixed securities (LFT - linked to *Selic*) are already up to 0.30% per year (see Figure 9B), also reflecting uncertainty about fiscal consolidation and a healthy debt trajectory outlook.

Figure 9B. Yield Curve in Brazil - (%)

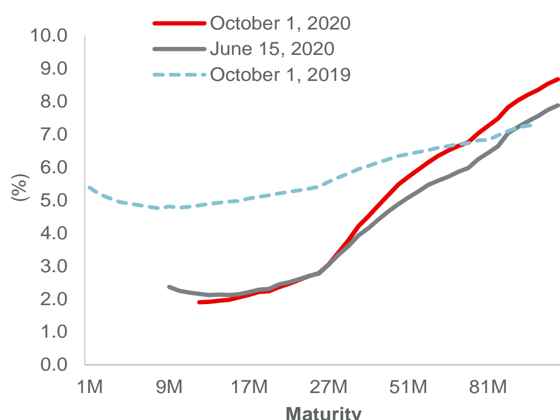
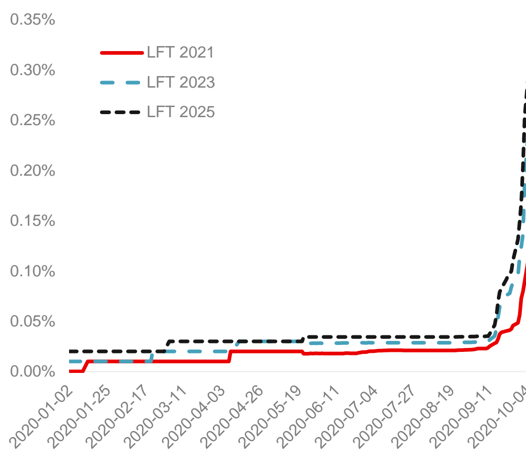


Figure 9B. Floating Rate Premium - (%)



Sources: National Treasury, BCB and Santander.

In this sense, rates can only remain at low levels if the country returns to fiscal rebalance. That is, despite the increasing demand for new mandatory expenditures, compliance with the spending cap in 2021 and a clear path for curbing mandatory expenses in the coming years is necessary, in our view. In the Figures below, we see that the spending cap helped reduce interest rates to low levels. Additionally, the pension reform helped to reduce the interest rate level. With the spending cap rule, there was a minor increase in total expenses (see Figure 10B), which decreased the average interest rate. If the perception of fiscal adjustment changes, there would be further increases in the interest rate, in our view, as occurred in 2013, when the country started to register successive primary deficits.

Figure 10A. 1-Year Interest Rate - (%)

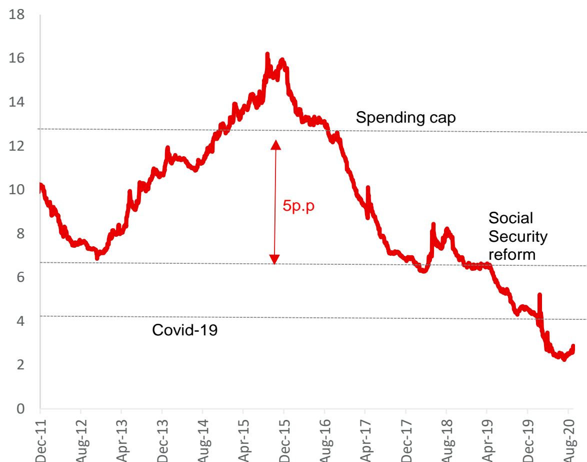
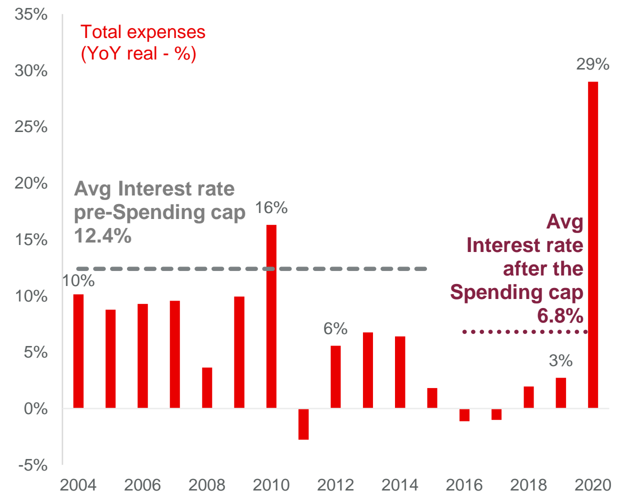


Figure 10B. Fall in Average Interest



Sources: National Treasury, BCB and Santander.

On the fiscal outlook, the public accounts adjustment process had been taking place gradually up to 2019 (Figure 11A). With the onset of the pandemic, Brazil must register the all-time fiscal deficit. Considering a higher debt level (it should reach 100% of GDP in the coming years, per our forecast), the need for fiscal discipline and the necessity to move forward with reforms becomes more important. The main anchor in the short term will be the spending cap, considering that the other rules will be less restrictive next year. The room to accommodate new expenses in it is quite scarce, in fact, even without creating new mandatory expenses, a fiscal adjustment of around BRL130 billion is needed after 2023, according to our estimates.

Figure 11A. Primary Balance - (% GDP)

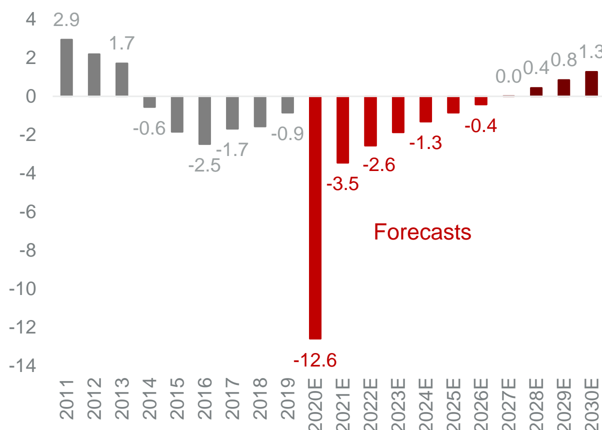
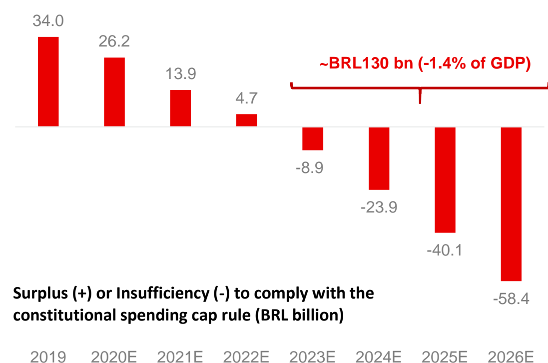


Figure 11B. Spending Cap Rule - (BRL billion)

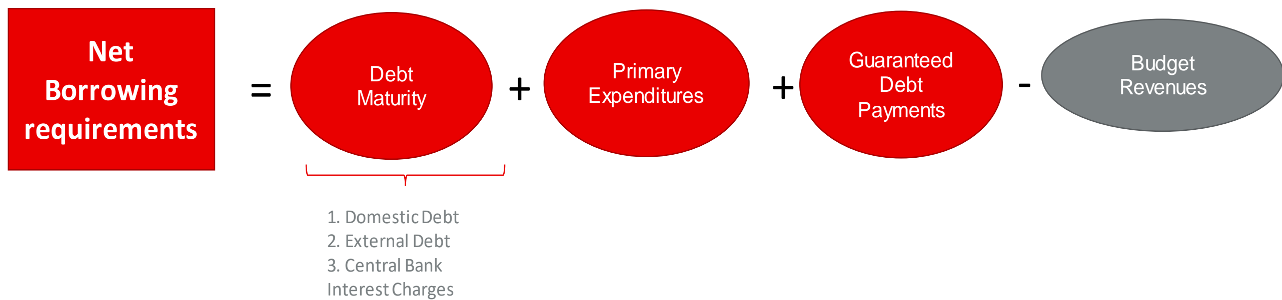


Sources: National Treasury, BCB and Santander.

Thus, a scenario in which there is compliance with the spending cap and advances in reforms, signaling the commitment to the convergence of the debt (solvency) in the long run, is essential for debt management. Once we are past the pandemic, despite greater borrowing requirements, interest rates could remain low with a neutral rate closer to 3.0% (according to our base scenario); in addition, market conditions could be improved for new issuance. The postponement of reforms and the fiscal consolidation agenda could harm the dynamics of the debt, in addition to increasing the perception of risk and generating a tightening of financial conditions. Finally, we believe that strong demand for liquidity in the market—in addition to the Treasury—can harm debt management in the event of a more adverse scenario and move closer to our alternative scenario (for details see September 25 report, *Scenario Revision: Reaffirming the Recovery but Recognizing the Risks*).

ANNEX

Figure 12. Net Borrowing Requirements Composition



Sources: STN and Santander.

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