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BRAZIL: FISCAL POLICY

Consolidated Public Sector: "Better" October Performance

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October's fiscal performance was "better" than expected, due to regional governments' surprising results, tax deferrals payments, the return of unused funds, and reduced fiscal stimulus. The primary deficit and debt continue to deteriorate, although at a slower pace in October, after six consecutive months in which the monthly deficit has been higher than that for a full year.

According to data published today by the Brazil Central Bank (BCB), the public sector posted a primary budget surplus of BRL3.0 billion in October (see Figure 1a), better than our forecast (deficit of BRL2.0 billion) and market consensus (deficit of BRL6.6 billion). Regional governments' surprising results were the highlight, posting a surplus of BRL5.2 billion, likely affected by the impact emergency aid had on local economies (totaling BRL21.0 billion in October) — which improved tax collection—and transfers from the central government to offset declining tax collection.

The "better" results mainly were attributable to non-recurring factors. General government net revenue increased 9.8%YoY, boosted by the payment of a COVID-19-related tax deferral in 2Q20 (BRL16.3 billion in October). On the expenses side, there was the transfer of unused funds of credit-measures back to the Treasury (BRL6.1 billion), lowering the expenses accounted for the month. Fiscal stimulus also declined, marking the second month of emergency aid at BRL300 per beneficiary. Total expenses related to COVID-19 fell from BRL73.5 billion in September to BRL29 billion in October.

Year to date, the public sector's primary fiscal balance is a negative BRL633.0 billion (10.6% of GDP), the worst number in the entire historical series. The 12-month primary deficit also points in the same direction, standing at BRL661.8 billion (9.1% of GDP — see Figure 1b).

BCB numbers show a relatively "better" year-to-date performance from subnational entities (vs. the central government). In the 12-month reading, regional governments posted a primary fiscal surplus of BRL38.1 billion (0.53% of GDP), while government-owned firms posted a primary fiscal surplus of BRL14.6 billion (0.20% of GDP). Given the considerable headwinds for the economy and tax collection, we expect a deterioration in the fiscal position of subnational entities — particularly states and municipalities — in 2021. The subnational entities will face the challenge of reestablishing fiscal equilibrium after these fiscal stimuli are over, in our view.

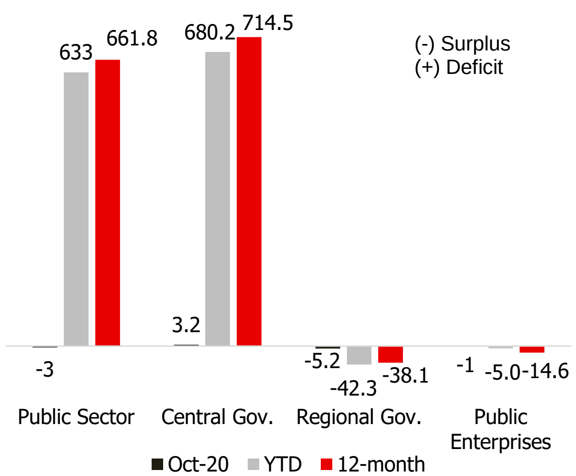
Year to date, BCB calculations indicate that the central government's primary fiscal deficit stands at BRL680.2 billion (11.4% of GDP). Before 2020, the worst primary balance for the first half of the year was in 2017 (-1.7% of GDP). For the last 12 months, the central government's fiscal gap (from the standpoint of the BCB estimates) is now BRL714.5 billion, or 9.9% of GDP, also the worst number on record.

In addition, gross debt reached 90.7% of GDP in October (see Figure 2b), an increase of 15.0 percentage points from the end of last year. Meanwhile, net debt reached 61.2% of GDP, 5.5 percentage points higher on the same basis of comparison. We expect both to continue deteriorating in the coming months.

These figures reinforce our forecast that the 2020 public sector primary fiscal deficit will amount to 12.4% of GDP, leading the gross general government debt to nearly 95% of GDP.

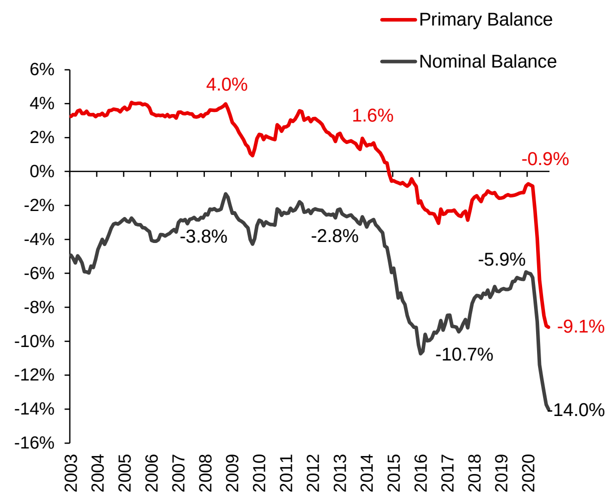
We believe that the massive fiscal stimulus will be temporary, but that the risk of creating new mandatory spending has increased significantly, which could undermine the fiscal consolidation framework, in our opinion. In order to return to the gradual fiscal adjustment, it is important to comply with the spending cap constitutional amendment from 2021 onward, in our view, and in order to address the fiscal rule, it is important to approve fiscal reforms in order to reduce mandatory expenses.

Figure 1a. Primary Result - (BRL bn)



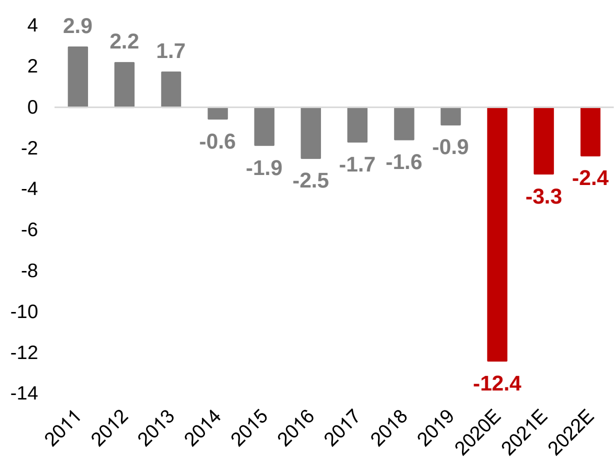
Sources: BCB and Santander

Figure 1b. Consolidated Public Sector - (12m % GDP)



Sources: BCB and Santander

Figure 2a. Primary Result Forecast (% GDP)



Sources: BCB and Santander forecast

Figure 2b. Public Sector Debt (12m % GDP)

Sources: BCB and Santander

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