BRAZIL MACRO
July 29, 2022

DATA ANALYSIS – FISCAL POLICY

PUBLIC SECTOR POSTED A BRL33 BILLION PRIMARY DEFICIT IN MAY

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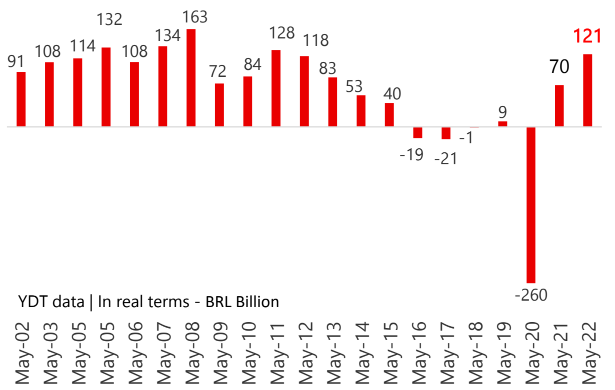
- Today, the Brazil Central Bank (BCB) unveiled the consolidated public sector's fiscal balance for May. (The release was initially scheduled for June 30 but was delayed due to the BCB workers' strike. In May, the public sector posted a primary surplus of BRL33 billion, higher than our forecast (BRL28.5 billion) and close to the market's median estimate (BRL30 billion). Regional governments continued to show a robust performance in May (BRL7.4 billion surplus), albeit lower than we expected (BRL12 billion surplus).
- This result is related to the data published by the Treasury a month ago, on June 29, when the central government posted a primary deficit of BRL39.2 billion for May. It was the second worst result for the month in the historical series. However, in the latest Treasury release yesterday (July 28), the central government posted a BRL14.4 billion primary result, close to our forecast (BRL15.1 billion) and the market median (BRL14.2 billion). It was the best result for the month since 2011. In 2Q22, the result totals a surplus of BRL4.0 billion, compared to -BRL86.9 billion in 2Q21 (in real terms). In the 12-month reading, the result rose to a surplus of BRL75.1 billion (in real terms), or 0.93% of GDP.
- In May, interest payments reached BRL32.9 billion, compared to BRL21.9 billion in May 2021. The result of FX swap operations in the period contributed positively to this reduction (gain of BRL26.7 billion in May compared to a gain of BRL11 billion in May 2021).
- Debt results were mixed. Gross debt dropped to 78.2% of GDP in May (-0.8 pp from April), on the heels of the increase in nominal GDP. Meanwhile, net debt reached 58.8% of GDP (+0.5 pp from April), affected by the FX rate appreciation in the month.
- Our 2022 gross-debt-to-GDP forecast is currently at 79.9%, virtually stable compared to 2021. We continue to forecast a deterioration in the nominal (headline) budget results due to higher debt costs (associated with the high Selic rate), implying a still steep upward trajectory for government debt in the medium term.

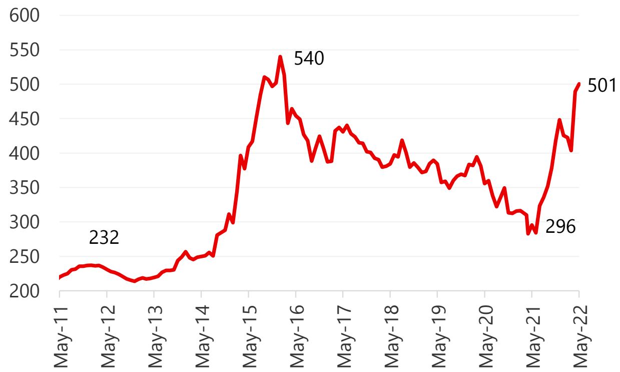
Today, the BCB unveiled the consolidated public sector's fiscal balance for May. (The release was initially scheduled for June 30 but was delayed due to the BCB workers' strike. The date for release of July's data still has not been set, probably on the next official release on August 31) In May, the public sector posted a primary surplus of BRL33 billion, higher than our forecast (BRL28.5 billion) and close to the market's median estimate (BRL30 billion). Regional governments continued to show a robust performance in May (BRL7.4 billion surplus), albeit lower than we expected (BRL12 billion). In the 12-month reading, the public sector primary surplus reached BRL119.9 billion (1.3% of GDP) in May, boosted by positive results for regional governments' public accounts (BRL128 billion, or 1.4% of GDP). The nominal result reached BRL380 billion (4.2% of GDP).

Figure 1 – Consolidated Public Sector Result



Sources: Brazilian Central Bank, Santander.

Figure 2 – Nominal Interest Result – BRL billion

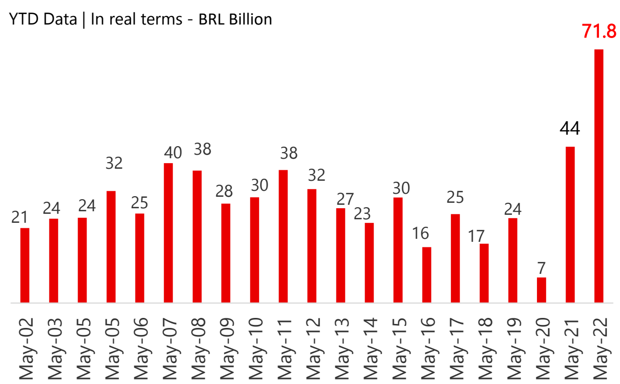


Sources: Brazilian Central Bank, Santander.

In February, regional governments' primary result (BRL7.3 billion) was again the main surprise relative to our fiscal forecast (this time lower than we expected: BRL12 billion). In the year so far, the fiscal result of subnational entities is currently showing an impressive surplus of BRL69.6 billion, BRL128.7 billion in the 12-months reading. We believe the cap on VAT (ICMS) taxes on essential goods is likely to reduce revenue in 2H22. In our view, subnational entities will continue to present positive results in the short term. Our forecast for 2022 is a surplus of BRL50 billion (0.5% of GDP), though this projection is highly dependent on the duration of the price shock effect and the impact of the reduction in taxes.

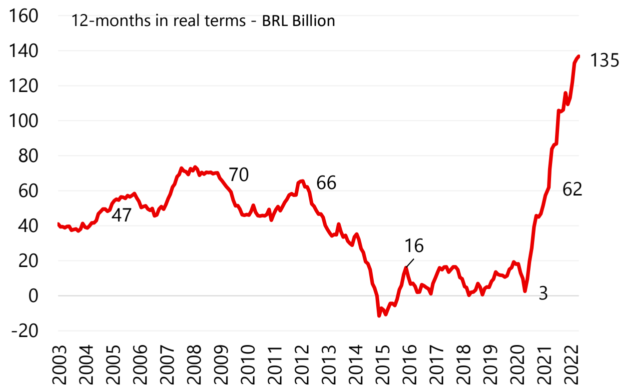
In the coming years, however, we believe that regional governments could face the challenge of reestablishing a fiscal balance as fiscal and monetary stimuli come to an end — mainly, in our view, because of pressure to increase mandatory expenditures in the following year (for example, pressure to increase public servants' wages after years without a nominal increase).

Figure 3 – Regional Gov.– Primary Result – YTD Data



Sources: Brazilian Central Bank, Santander.

Figure 4 – Regional Gov. – Primary Result – 12-Month Data



Sources: Brazilian Central Bank, Santander.

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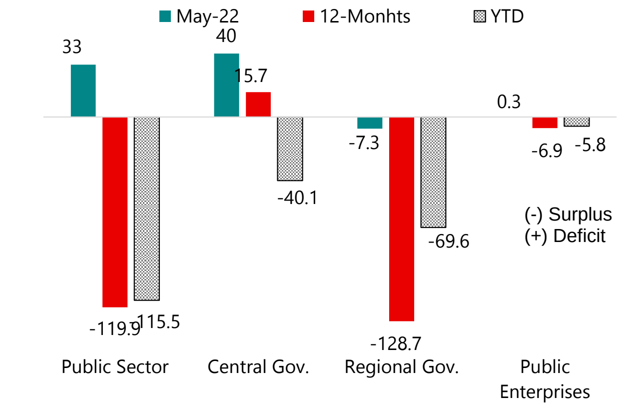
We forecast a BRL20 billion primary deficit for the public sector result in 2022, considering an increase in expenditures and some softening in revenue growth — although a more lasting price shock effect and better activity figures add a positive bias to revenue numbers. More recently the request by the federal government for more SOE dividends could improve revenue for 2022. However, we still see an increase in fiscal risks, with a substantial part of the recent improvement due to temporary factors.

Debt results were mixed. Gross debt dropped to 78.2% of GDP in May (-0.8 pp from April), on the heels of the increase in nominal GDP. Meanwhile, net debt reached 58.8% of GDP (+0.5 pp from April), affected by the FX rate appreciation in the month

Our 2022 gross-debt-to-GDP forecast is currently at 79.9%, virtually stable compared to 2021. We continue to forecast a deterioration in the nominal (headline) budget results due to higher debt costs (associated with the high Selic rate), implying a still steep upward trajectory for government debt in the medium term.

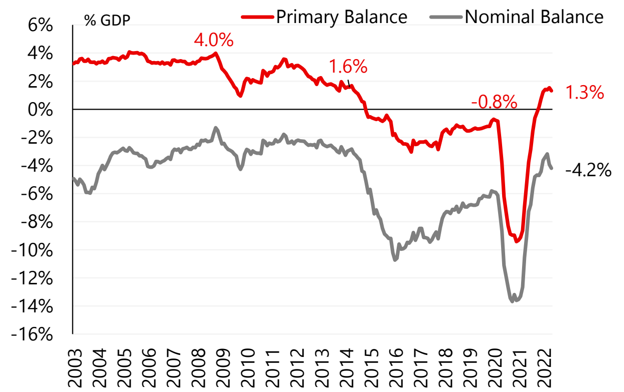
For the long term, since we assume the commodity cycle will, by definition, not be permanent (the cycle typically lasts five years), we continue to see a risky path toward debt stabilization, in a context of the reduced efficacy of fiscal rules along with the social pressures to increase expenditures during a period of high inflation. We consider in our scenario that the *Auxílio Brasil* BRL600 monthly benefit will be maintained for 2023.

Figure 5 – Primary Result (BRL billion)



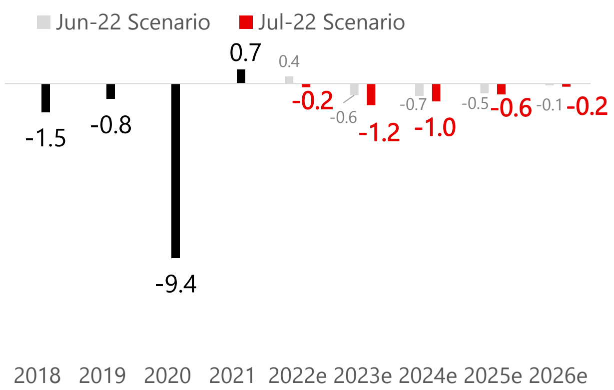
Sources: Brazilian Central Bank, Santander.

Figure 6 – Consolidated Public Sector (12m % GDP)



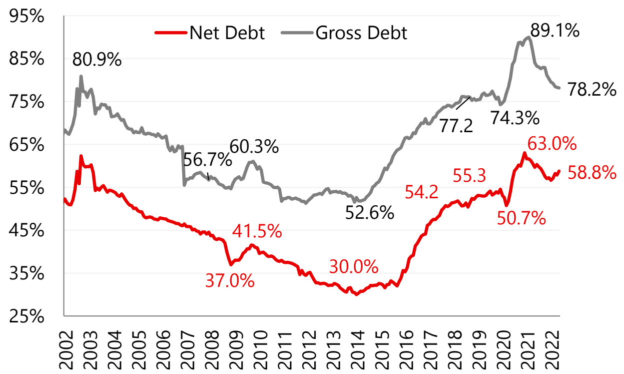
Sources: Brazilian Central Bank, Santander.

Figure 7 – Primary Result Forecast (% GDP)



Sources: Brazilian Central Bank, Santander.

Figure 8 – Public Sector Debt (12m % GDP)



Sources: Brazilian Central Bank, Santander.

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