BRAZIL MACRO

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DATA ANALYSIS – FISCAL POLICY

PUBLIC SECTOR REGISTERS HEFTY DEFICIT IN AUGUST ON ONE-OFF EXPENSES

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- Today, the Brazil Central Bank (BCB) announced the consolidated public sector's fiscal balance for August. In the month, the public sector posted a primary deficit of BRL30.3 billion, higher than our forecast (BRL26.5 billion). This result represents the second highest deficit for the month in the historical series (beginning in 2002), as a result of payments of court-ordered debt (a change in the year's calendar of payments). Regional governments registered a surplus of BRL18.5 billion, without the positive surprises of recent months, but including BRL23.6 billion from the *Campo de Marte* deal that cancelled São Paulo city's debt to the federal government (BRL23.6 billion) and ended the dispute over the management of the region.

- According to data published by the National Treasury on September 29, the central government posted a primary deficit of BRL50 billion in August. In YTD terms, the result totals a primary surplus of BRL22.2 billion, compared to a deficit of BRL82.2 billion in the same period in 2021 (in nominal terms). The August deficit was the second largest deficit ever posted for the month. With this result, the 12-month rolling balance reached BRL74.1 billion (from BRL114.2 billion in July), or 0.9% of GDP (from 1.4% of GDP). We forecast a BRL25 billion surplus this year (0.3% of GDP), with a slight upward bias considering the performance of corporate revenue.

- In August 2022, interest payments totaled BRL35.6 billion, compared to BRL46.5 billion in August 2021. In our view, the result last month was probably helped by profits from swap operations taking advantage of the FX depreciation (BRL11.3 billion gain, vs. a loss of BRL7.6 billion last year). In the 12-month period through August, nominal interest totaled BRL575.6 billion (6.2% of GDP), compared to BRL335.7 billion (4.0% of GDP) through August 2021.

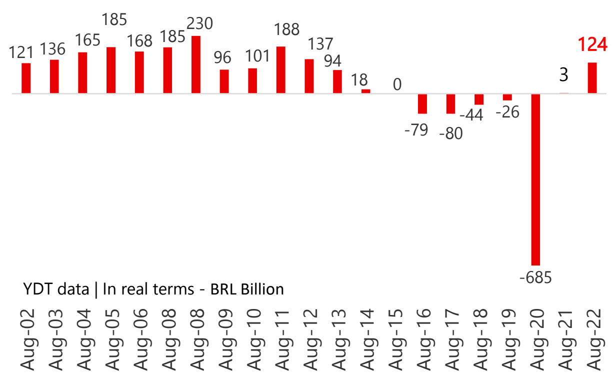
- In the 12-month reading, the public sector primary surplus reached BRL183.5 billion (2.0% of GDP) in August, boosted by regional governments' positive public sector results (BRL106.8 billion, or 1.1% of GDP). In our view, the public sector's primary surplus likely peaked in July, falling by 0.5 p.p. to 2.0% of GDP in August. While that is a still solid performance, we believe that a fiscal expansion in the pipeline (totaling ~2 p.p.) and the fading of commodity and activity cycles will likely prompt a return to a primary deficit in 2023 The nominal result reached BRL392 billion (4.2% of GDP).

- Debt registered mixed results last month. Gross debt dropped to 77.5% of GDP in August (-0.7 p.p. from July), on the heels of the increase in nominal GDP. Meanwhile, net debt reached 58.2% of GDP (+0.5 p.p. from July).

- Our 2022 gross-debt-to-GDP forecast is currently at 79.0%, 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 Brazil Central Bank (BCB) announced the consolidated public sector's fiscal balance for August. In the month, the public sector posted a primary deficit of BRL30.3 billion, higher than our forecast (BRL26.5 billion). This result represents the second highest deficit for the month in the historical series (beginning in 2002), as a result of payments of court-ordered debt (a change in the year's calendar of payments). Regional governments registered a surplus of BRL18.5 billion, without the positive surprises of recent months, but including BRL23.6 billion from the Campo de Marte deal cancelling Sao Paulo city's debt to the federal government. In the 12-month reading, the public sector primary surplus reached BRL183.5 billion (2.0% of GDP) in August, boosted by regional governments' positive public sector results (BRL106.8 billion, or 1.1% of GDP). In our view, the public sector's primary surplus likely peaked in July, falling by 0.5 p.p. to 2.0% of GDP in August. While that is a still solid performance, we believe that a fiscal expansion in the pipeline (totaling ~2 p.p.) and the fading of commodity and activity cycles will likely prompt a return to a primary deficit in 2023. The nominal result reached BRL392 billion (4.2% of GDP).

Figure 1 – Consolidated Public Sector Result



Sources: Brazilian Central Bank, Santander.

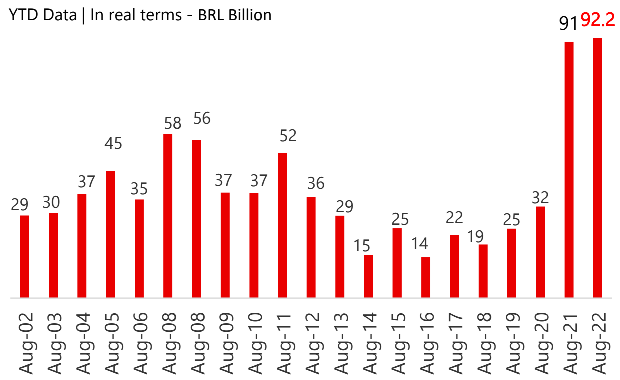
Figure 2 – Nominal Interest Result – BRL billion

Sources: Brazilian Central Bank, Santander.

Regional governments registered a surplus of BRL18.5 billion, in line with expectations, after months of significant positive surprises. The result is positive only when including the cancellation of São Paulo city's debt to the federal government (related to the transfer of the Campo de Marte region to the federal government). For the public sector this deal was neutral, while it was negative for the central government primary result. Excluding the deal, the regional government result would be a deficit of~BRL5 billion, in line with our forecasts.

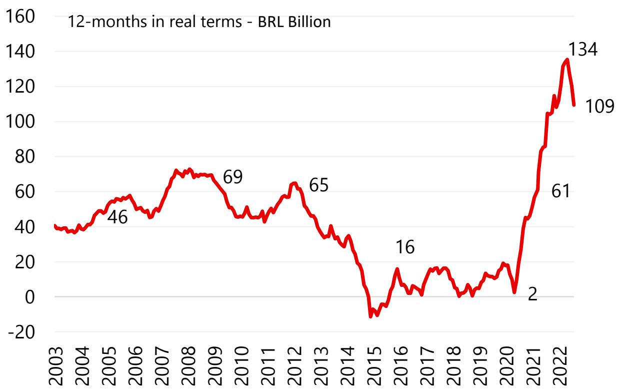
We expect negative budget results ahead, especially considering the impact of the cap on VAT (ICMS) taxes for essential goods, which we estimate will reduce 2H22 revenue. The fiscal result of subnational entities is currently showing an impressive surplus of BRL90.8 billion (BRL106.8 billion in the 12-month reading) — we believe the peak for this amount was in May, at BRL128.7 billion. The recent Supreme Court (STF) decision to allow the states not to pay the debt owed to the federal government (to offset the cap on VAT taxes) implies a BRL10 billion improvement in subnational entities' result for 2022, per our projections. For 2023, we estimate the full year impact could be above BRL70 billion. The fiscal impact of the VAT cap is still being debated in the Supreme Court by the states' representatives and the federal government. This issue will continue to be debated during 4Q22, after the elections. 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 years.

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.

According to data published by the National Treasury on September 29, the central government posted a primary deficit of BRL50 billion in August. In YTD terms, the result totals a primary surplus of BRL22.2 billion, compared to a deficit of BRL82.2 billion in the same period in 2021 (in nominal terms). The August deficit was the second largest deficit ever for the month. With this result, the 12-month rolling balance was BRL74.1 billion (vs. BRL114.2 billion in July), or 0.9% of GDP (vs. 1.4% of GDP). We forecast a BRL25 billion surplus this year (0.3% of GDP), with a slight upward bias considering the performance of corporate revenue.

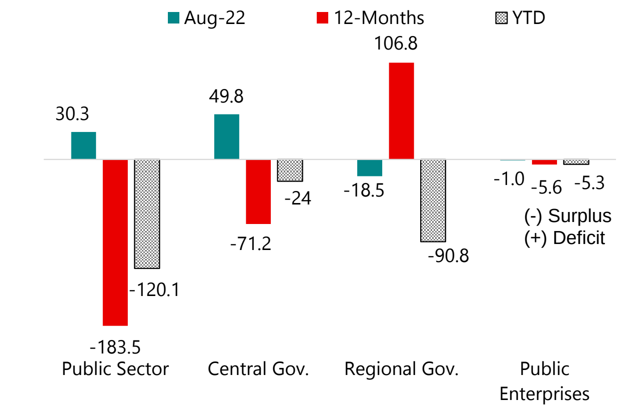
For revenue, the central government registered a solid performance (+9.3% YoY in the month and +14.4% YoY in YTD terms), particularly thanks to taxes based on corporate profits and labor-related tax collection and oil proceeds. Expenditure increased 36.4% YoY in the month and was up 2.6% YoY in YTD terms.

The official forecasts for compliance with the so-called "golden rule" (fiscal rule) for 2022 point to a surplus of BRL20.7 billion. We expect that this fiscal rule will not be binding in 2022 due to higher revenue, especially with a higher level of extraordinary proceeds.

Regarding debt statistics, gross debt dropped to 77.5% of GDP in August (-0.7 pp from July), on the heels of the increase in nominal GDP. Meanwhile, net debt reached 58.2% of GDP (+0.5 pp from July). Our 2022 gross-debt-to-GDP forecast is currently at 79.0%, 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.

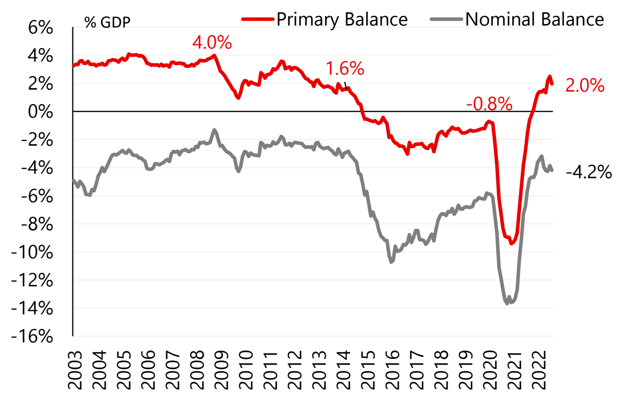
For the long term, since we assume the commodity cycle will not, by definition, be permanent (the cycle typically lasts five years), we continue to see a risky path toward debt stabilization, in the context of less efficacious fiscal rules, along with popular pressure to increase expenditures during a period of high inflation. We consider in our scenario that the *Auxílio Brasil*'s BRL600 monthly benefit will be maintained for 2023, with the approval of a constitutional amendment to open a fiscal margin allowing a breach of the constitutional spending cap.

Figure 5 – Primary Result (BRL billion)



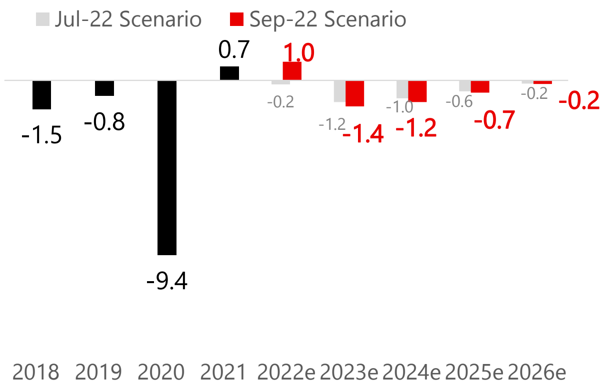
Sources: Brazilian Central Bank, Santander.

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



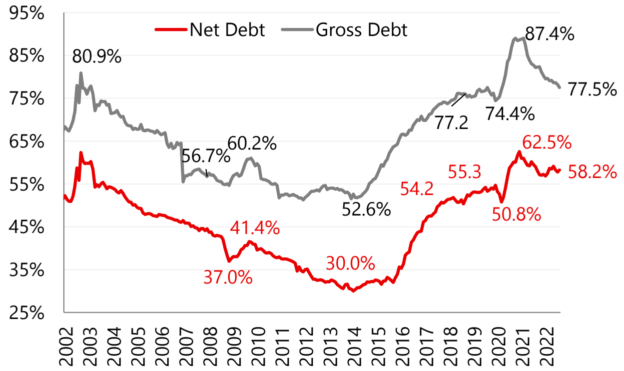
Sources: Brazilian Central Bank, Santander.

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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