BRAZIL MACRO

October 31, 2022

DATA ANALYSIS – FISCAL POLICY

SEPTEMBER WAS MARKED BY HIGHER INTEREST PAYMENTS

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- Today, the Brazil Central Bank (BCB) unveiled the consolidated public sector's fiscal balance for September. In the month, the public sector posted a primary surplus of BRL10.7 billion, better than our forecast (BRL5.5 billion) and close to the market median (BRL11 billion). The main surprise to our forecast was the primary result for regional governments (+BRL0.3 billion): we were expecting a primary deficit of -BRL6.2 billion, considering a revenue reduction triggered by the legislation that capped the VAT (ICMS) tax on essential goods.

- According to the data published by the Treasury on October 27, the central government posted a primary surplus of BRL11 billion in September. It was the best result for the month since 2010. Expenditures dropped 1.1% YoY in real terms, with a reduction in discretionary outlays. Revenue rose 9.3% YoY, particularly thanks to taxes based on corporate revenue and SOE dividends of BRL13.5 billion. In YTD terms, the result totals a primary surplus of BRL33.8 billion, compared to a deficit of BRL81.6 billion in the same period in 2021 (in nominal terms). In the 12-month reading in real terms, the result rose to a surplus of BRL85 billion (vs. BRL74 billion in August) or 1.0% of GDP (vs. 0.9% of GDP). We forecast a BRL45 billion surplus this year (0.5% of GDP).

- In the 12-month reading, the public sector primary surplus reached BRL181 billion (1.9% of GDP) in September, boosted by regional governments' positive public sector results (BRL96.7 billion, or 1.0% of GDP). The public sector's primary surplus seems to have peaked in July, falling by 0.6 p.p. to 1.9% of GDP in September. For the public sector, we forecast a BRL100 billion (1.0% of GDP) surplus. While that is a still solid performance, we believe that fiscal expansion is in the pipeline (totaling ~2 p.p.) and that the fading of commodity and activity cycles will likely prompt a return to a primary deficit in 2023.

- In September 2022, interest payments totaled BRL71.4 billion, compared to BRL55 billion in September 2021. The last month result was affected by losses from swap operations (BRL24.7 billion loss, vs. a loss of BRL16.8 billion last year). In the 12-month period up to September, the nominal result totaled BRL411 billion (4.4% of GDP), +0.16 p.p. from August.

- Debt registered mixed results last month. Gross debt fell to 77.1% of GDP (-0.4 p.p. in the month), with the increase in nominal GDP. Net debt remained flat at 58.3% of GDP. Voluntary deposits in the BCB (not included in debt statistics) jumped to 1.0% of GDP.

- Our 2022 gross-debt-to-GDP forecast is currently at 78.2%. 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.

- We now see even more pressure for a "fiscal waiver" (meaning another once-and-for-all increase in the constitutional spending cap) next year, due to a lack of space to accommodate plans of higher spending for 2023 onward. According to our calculations, this lack of space is in part due to the reduction in the IPCA forecast to 5.5%, compared to the 2023 Draft Budget.

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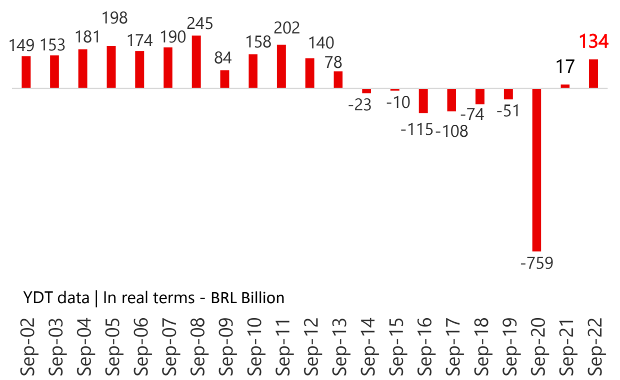
In the 12-month reading, the public sector primary surplus reached BRL181 billion (1.9% of GDP) in September, boosted by regional governments' positive public sector results (BRL96.7 billion, or 1.0% of GDP). The public sector's primary surplus seems to have peaked in July, falling by 0.6 p.p. to 1.9% of GDP in September. 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 BRL410 billion (4.4% of GDP).

Figure 1 – Consolidated Public Sector Result

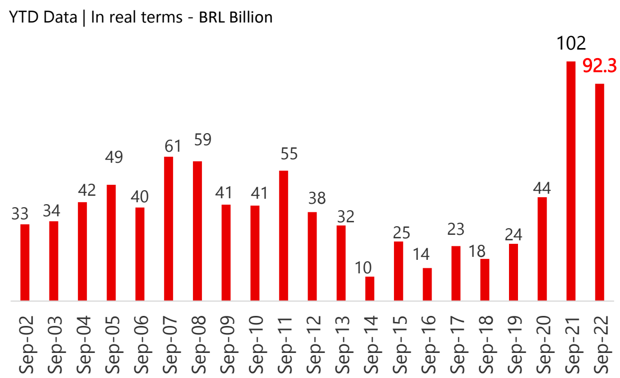


Sources: Brazilian Central Bank, Santander.

Figure 2 – Nominal Interest Result – BRL billion

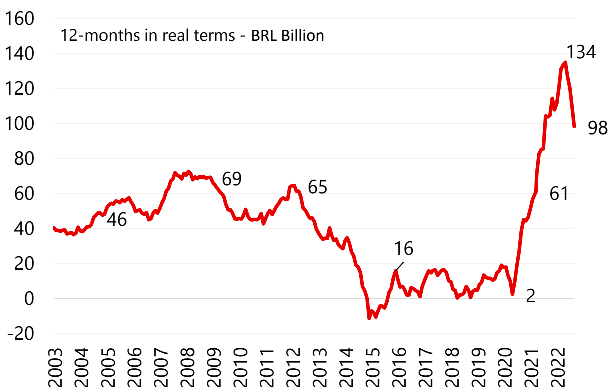
Sources: Brazilian Central Bank, Santander.

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 the data published by the Treasury on October 27, the central government posted a primary surplus of BRL11 billion in September. It was best result for the month since 2010. The expenditures dropped 1.1% YoY in real terms, with a reduction in discretionary outlays. Revenue rose 9.3% YoY, particularly thanks to taxes based on corporate revenue and SOE dividends of BRL13.5 billion. In YTD terms, the result totals a primary surplus of BRL33.8 billion, compared to a deficit of BRL81.6 billion in the same period in 2021 (in nominal terms). In the 12-month reading in real terms, the result rose to a surplus of BRL85 billion (vs. BRL74 billion in August) or 1.0% of GDP (vs. 0.9% of GDP). We forecast a BRL45 billion surplus this year (0.5% of

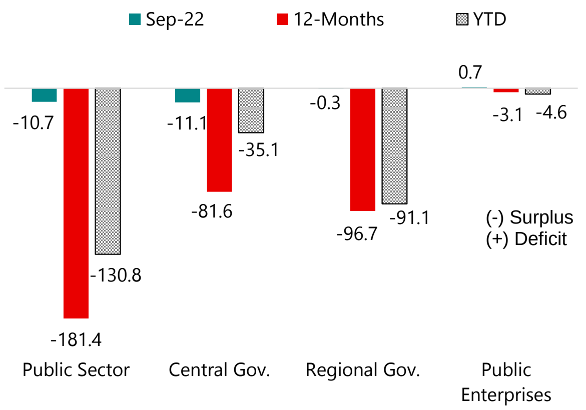
GDP). The official forecasts for compliance with the so-called "golden rule" (fiscal rule) for 2022 point to a surplus of BRL20.7 billion. We expect that this fiscal rule will not be binding in 2022 due to higher revenue, especially with a higher level of extraordinary proceeds.

We now see even more pressure for a "fiscal waiver" (meaning another once-and-for-all increase in the constitutional spending cap) next year, due to a lack of space to accommodate plans of higher spending for 2023 onward. According to our calculations, this lack of space is in part due to the reduction in the IPCA forecast to 5.5%, compared to the 2023 Draft Budget.

Debt registered mixed results last month. Gross debt fell to 77.1% of GDP (-0.4 p.p. in the month), with the increase in nominal GDP. Net debt remained flat at 58.3% of GDP. Voluntary deposits in the BCB (not included in debt statistics) jumped to 1.0% of GDP. 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.

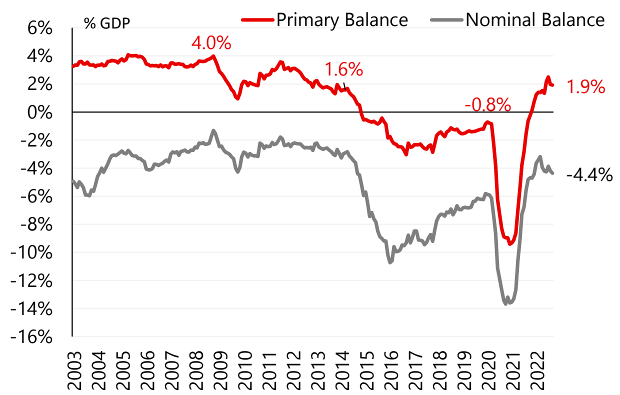
For the long term, since we assume the commodity cycle will not, by definition, be permanent (the cycle typically lasts five years), we continue to see a risky path toward debt stabilization, in the context of less efficacious fiscal rules, along with popular pressure to increase expenditures during 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)



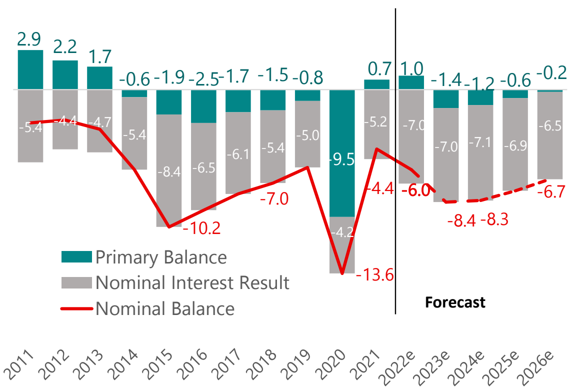
Sources: Brazilian Central Bank, Santander.

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



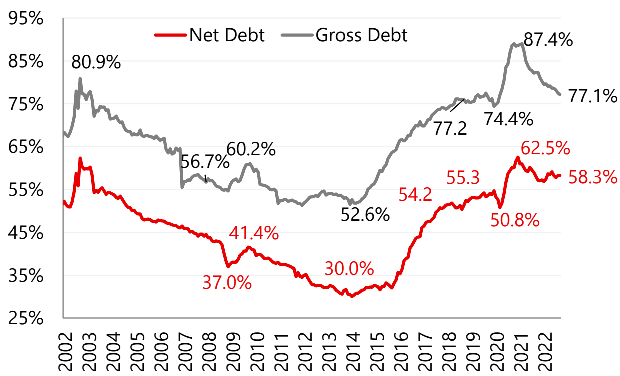
Sources: Brazilian Central Bank, Santander.

Figure 7 – Fiscal Balance (% GDP)



Sources: Brazilian Central Bank, Santander.

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



Sources: Brazilian Central Bank, Santander.

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