LatAm Macro Update

October 6, 2022

2023 Budgets: Fiscal Prudence…Easier Said Than Done

Brazil: A Breach In The Spending Cap Around The Corner

Mexico: Holding On To Austerity Despite Growth Fears

Chile: Saving More Today To Spend More Tomorrow

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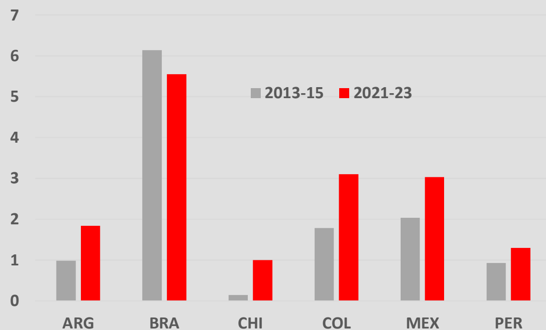
Colombia: Rosy Macro Assumptions Pose Risks To Fiscal Path

Peru: Peaking Tax Revenue Leaves Less Room for Spending

Overall: The overall health of a country's fiscal accounts can be summarized by the evolution of its interest debt burden as a % of GDP. If this metric tends to rise over time, we know that sooner or later macro problems could arise, either because the real interest rate is too high, or real GDP growth is too low, or the fiscal effort (defined by the size of the primary surplus) is insufficient, or a combination of all these factors.

In the past few years, we have seen interest payments rising in most of the LatAm region. Chile practically paid nothing in terms of interest ten years ago, but now the public debt is much higher, and the bill grew fast up to 1%/GDP. Peru is also on the rise and pays a bit more vs. Chile, but the uptrend is less steep. In Argentina, the interest bill peaked at 4%/GDP in 2019, but the debt burden proved unsustainable, and it was finally restructured. More recently, problems are back but in a different form: financing via money printing is translating into a painful inflation spiralization.

Interest payments as % of GDP, annual averages



2022-23 Santander estimates. Sources: IMF Fiscal Monitor, statistics offices.

Mexico and Colombia are similar cases, with interest bills reaching 3%/GDP from <2% in 2013-15, resulting from debt-to-GDP ratios in the 50-55% range. Having to deal with slower GDP growth, the Mexican government has been containing budget deficits in recent years. In contrast, Colombia will run an average 3.6% primary deficit in 2020-22, which could exert extra pressure on debt if fiscal consolidation fails to kick in soon. Finally, we have Brazil, where the interest burden is falling, but from very high levels. The spending cap plus lower interest rates in 2020-21 have helped here, but much more discipline is needed to reduce the public debt: primary surpluses above 3%/GDP do not seem to be politically sustainable in the EM universe.

This data confirms that fiscal dynamics have been slipping across the region and need to be tackled, although the sense of urgency varies among countries. All governments appear to be aware of this, which is why, in principle, budgets try to reassure investors and reaffirm public sector solvency. But the devil is in the details, and often budget intentions exceed reality by a margin. Next year inflation will give LatAm treasuries an opportunity: letting spending be outpaced by inflation is easier than announcing full-blown cuts. Brazil and Chile did some of this in 2022, but political pressures may interrupt these efforts next year: the trick is to keep going…

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Brazil: A Breach In The Spending Cap Around The Corner

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- **The 2023 budget bill projects a primary deficit of only 0.6%/GDP, the lowest in almost a decade. But as per our calculations, the actual deficit should be higher at 1.4%.**
- **Many key budget items are still under discussion, especially the size of the Auxilio Brasil program and the necessity to approve a constitutional amendment to maintain the stimulus.**
- **We expect higher expenditures compared to the budget, given the recent announcements of new stimulus. Other risks are the revenue value due to a higher GDP growth forecast and the revision of personal income tax brackets.**

2023 budget guidelines

On August 31, the government unveiled the 2023 Budget Law Proposal (PLOA) without including some fiscal stimuli that are likely to be extended for next year. The PLOA brought no major surprises and will need adjustments during the Congress debate, especially given the legal need to pass a constitutional amendment to maintain the Auxilio Brasil welfare program.

We calculate that maintaining the current parameters of this welfare program could imply a BRL150 billion budget alone (vs. the budgeted BRL105.7 billion). During the presidential campaign, both candidates are also promising complementary benefits (for women, formal employment, children, etc), which if implemented, could raise its cost by another BRL20 billion. Considering all political claims for more expenditure, a total "fiscal waiver" will be required to spend up to BRL100 billion more than what is currently set by the spending cap rule. Evidently, the final details will be provided by the government after the election runoff of October 30.

2023 fiscal policy outlook

Another important element that may reduce the fiscal space is inflation. Our current 2023 IPCA estimate stands at 5.8%, below the 7.2% assumed by the budget. If our estimate materializes, the constitutional spending limit for 2023 could fall by BRL24 billion. On the spending side, our number is ~BRL80 billion higher, considering the maintenance of the welfare program at BRL600 per month per beneficiary. In turn, the payment of "extra-cap" judicial claims are not included in the budget, but could accumulate another BRL50 billion for 2022-23.

The PLOA also included a provision of an additional BRL80.2 billion in tax breaks and other exemptions, including an extension of tax measures to mitigate the effects of fuel price shocks (BRL52.9 billion). It also sets BRL14.2 billion to readjust the wages of public servants by 4.5% in 2023. The Auxílio Brasil program assumes a BRL405 monthly benefit, worth BRL106 bn in total, but this will likely be revised to maintain the original BRL600 amount (which would cost BRL150 billion). Importantly, our revenue forecast is BRL15 billion lower than the one considered in PLOA 2023, as the budget is based on a 2.5% GDP growth estimate, when our estimate is close to 0%. Another potential revenue loss could come from the inflation correction to personal income tax brackets (where the last update dates from 2015), which we estimate would have a negative impact of more than BRL20 billion.

Our main fiscal forecasts

All in all, the PLOA 2023 foresees a primary federal fiscal deficit of BRL63.7 billion (0.6% of GDP). This is the lowest deficit since 2014, but in our view it is likely over-optimistic. We forecast a 1.4%/GDP deficit, with a negative bias in the wake of recent announcements of fiscal impulses. The public sector's primary surplus was 2.0%/GDP in August, below the 2.5% peak of July. Although we reckon this is a still solid performance as per historical standards, we believe that the fiscal expansion in the pipeline and the fading cycles of commodity prices and activity cycles will likely prompt a return to a deficit territory in 2023.

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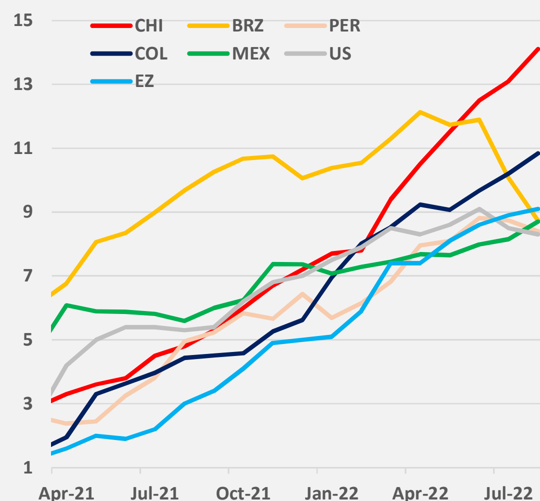
"The country needs to de-index and de-link public sector expenditures (from certain rules), we need a more flexible budget. 96% of the budget is earmarked, and only 4% is discretionary (…) The spending cap was designed to keep the federal government from growing, but it was ill-designed and has to be changed. Imagine a house with a roof but no walls: that means the roof will eventually fall onto your head."

Paulo Guedes, Ministry of Finance of Brazil (Sep 28, 2022)

CPI inflation in Latin America

Differences in inflation cycles continue to emerge across the region. Chile's steep trend stands out, now mainly fuelled by the weak CLP. Colombia's pattern is similar, but 300 bps below. Brazil's IPCA is the only one with a clear tipping point: in only three months it shifted from the highest-inflation country in LatAm to the lowest positions of the YoY ranking. Mexico's slope is flatter, but resists to reverse course.

Headline CPI, YoY change, 2021-2022



Sources: National statistics offices, central banks, Santander

Selected Macro Estimates & Forecasts (2022E-24F)

		ARG	BRA	CHI	COL	MEX	PER
GDP	2022E	+3.5%	+2.6%	+1.8%	+7.2%	+2.0%	+2.7%
(annual chg)	2023F	+2.4%	-0.2%	-1.0%	+1.3%	+0.8%	+2.0%
	2024F	+2.2%	+0.5%	+1.8%	+2.0%	+1.7%	+2.6%
Unemployment	2022E	8.0%	9.8%	7.4%	11.4%	3.3%	7.0%
(% of labor force, eop)	2023F	9.0%	10.5%	7.6%	10.9%	3.5%	6.7%
	2024F	8.1%	10.6%	7.2%	9.9%	3.5%	7.0%
Budget balance	2022E	-2.5%	+1.0%	+1.6%	-5.6%	-3.0%	-2.3%
(overall, % of GDP)	2023F	-3.0%	-1.4%	-2.5%	-4.5%	-3.6%	-2.5%
	2024F	-0.9%	-1.2%	-2.0%	-4.0%	-3.5%	-2.2%
Current account	2022E	+0.2%	-2.1%	-7.5%	-5.0%	-1.2%	-3.2%
balance	2023F	+0.0%	-2.2%	-6.0%	-4.8%	-1.1%	-2.1%
(% of GDP)	2024F	-0.3%	-2.4%	-4.5%	-4.5%	-1.2%	-1.9%

Sources: National statistics offices, central banks, Santander. Primary budget balance in Argentina and Brazil.

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Mexico: Holding On To Austerity Despite Growth Fears

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- **The government projects a 2023 fiscal deficit at 3.6%/GDP, higher than the 3% estimated for 2022 but still conservative considering the gasoline subsidies and the increase in the interest bill.**
- **In 2023 budget projections, real GDP growth appears to be too high and inflation too low, but the resulting nominal GDP is consistent with the deficit targets.**
- **The SAT campaign to collect past-due income taxes has become a quasi-recurrent and significant source of funds, which would allow Hacienda to keep numbers in check even in a likely difficult 2023.**

Fiscal trends in 2022

Despite the several economic challenges this year, the MoF estimates that the fiscal deficit will reach 3%/GDP this year, in line with year-to-date fiscal execution and slightly lower than the 3.1% projected in the original budget. We believe real GDP could grow much less than budgeted (2.4% vs 4.1% respectively), but average inflation could more than compensate for this (7.8% vs 4.1%), and so the actual nominal GDP could beat the budget reference.

2023 budget guidelines

On the oil front, actual international prices turned out to be much higher than in the original budget: US$94/bl vs. an initial projection of only US$55.1/bl. The government decided using this excess oil revenue was to cover the large gasoline subsidy to final consumers. Likewise, the government raised extra revenue from past-due income taxes, for around 0.8%/GDP, and this allowed to cover the increase in the interest payments bill (due to higher nominal rates, which reached 7.5% vs the 5% included in the budget) and some other extra expenditures without breaching the overall deficit target of 3.0%/GDP.

The MoF expects the economy to grow 3.0% in 2023, above our 0.8% forecast and the 1.2% Banxico survey consensus. Assumed at 3.2%, inflation next year also seems very low: instead, we estimate 5.6% and market consensus is at 4.8%. Even Banxico recently revised its 2023 inflation forecast to 4.0% from a previous 3.2%. As a result, the 2023 nominal GDP budget projection (which in the end is the relevant base for tax revenue) appears to be conservative, in our view. We also expect nominal interest rates risk to be higher than projected in the budget. The MoF foresees the 28-day interest rate reaching 9.5% by December 2022, vs. market implied levels of 10.5% (coinciding with our own estimate). Finally, the 2023 budget estimates oil prices averaging at US$68.7/bl, which in our view, seems reasonable. If prices are higher, the extra revenue is expected to fund the gasoline subsidy, and if prices are lower the government could count on the protection provided by oil put options (to be purchased before year-end).

2023 fiscal policy outlook

For 2023 the MoF projects a fiscal deficit of 3.6%/GDP, with a -0.2% primary balance and an interest bill of 3.4% (vs. our +0.1% and 3.1% estimates for this year, respectively). This is consistent with a debt-to-GDP ratio still below 50%.

As the budget assumes global oil prices would fall next year, the gasoline subsidy would be lower as well. Then the main fiscal risk next year is a larger interest burden (as we saw this year), but again this could be compensated by additional income tax revenue collection. The SAT (tax collection agency) has been successful in going after big companies with past-due taxes. When this campaign started in 2020, it was seen as a positive one-off boost to tax revenue, but it has finally become a recurrent source of funds which is not considered by the budget. For example, in 2020 federal income-tax revenues grew 0.9% with GDP at -8.2%. As a % of GDP, we estimate this item would rise to 8.2%/GDP in 2023, vs only 6.9% in 2019. The SAT recently announced it still has 12,000 big companies to audit and will leave 9,000 for next year.

The budget's macro implications

From a broader macro perspective, we can say that tight fiscal accounts during the pandemic made the Mexican economy more dependent on U.S. growth, and we could argue this is still the case. Most of the post-COVID recovery has come from exports to the U.S., boosting employment and real wages, with positive implications on private consumption. Nevertheless, that could work backwards in case of a recession in the U.S. next year. Despite that possibility, we anticipate that the fiscal accounts could stay austere leaving economic growth more vulnerable and making real wage increases still inflationary.

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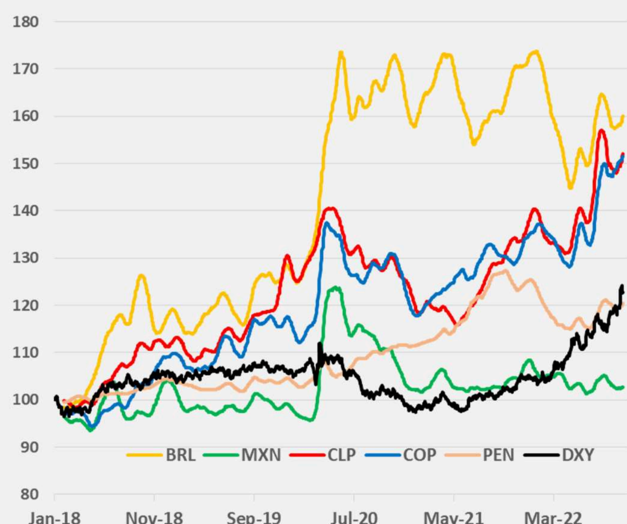
"The financing costs projected in the 2023 budget bill reflects the effects of one of the 'monsters' that affected us in the 80s and 90s, the one that generated our debt crisis those years: the increase in the interest rate. This increase in financing costs represents 0.8% of GDP, which is equivalent to 26% of the total increase in our budget (…) Following instructions from the President, this budget sets the basis for a responsible, orderly and smooth transition toward the next administration (to take office in 2024) "

Rogelio Ramírez de la O, Secretary of Treasury of Mexico (Sep 28, 2022).

Latin American currencies

After the last round of Fed hawkishness, LatAm currencies adjusted but quite in line with DM peers. PEN and notably MXN remain well anchored, while BRL continues to trade weak vs. recent years' average but firmly in recent months. Persistent weakness in CLP and COP appears related to elevated political noise, wide current account deficits and not-hawkish-enough central banks.

Nominal FX rates per US dollar (100=Jan 2018)



Sources: Bloomberg, Santander
Moving 30-day averages. As of August 9, 2022.

Foreign Exchange and Interest Rate Estimates, 2022E-24F

	FX Rate (year-end)			CPI (y/y, year-end)			MonPol rate (Dec levels)		
	2022E	2023F	2024F	2022E	2023F	2024F	2022E	2023F	2024F
ARGENTINA	173.1	277.0	470.9	95.0%	84.8%	66.8%	75.00%	75.00%	67.00%
BRAZIL	5.30	5.40	5.50	6.3%	5.3%	3.0%	13.75%	12.00%	9.00%
CHILE	900	910	850	12.0%	6.0%	3.5%	11.50%	7.50%	4.50%
COLOMBIA	4500	4200	4400	12.3%	7.2%	3.9%	11.50%	9.50%	7.25%
MEXICO	21.0	21.8	22.2	8.7%	5.6%	4.0%	10.50%	8.50%	8.00%
PERU	4.05	3.90	3.80	8.1%	5.4%	3.1%	7.00%	5.50%	3.00%

Source: Santander. Headline CPI. Official exchange rate in Argentina.

Argentina: Fiscal Consolidation and Elections, Never Good Friends

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- **The government's 2023 budget bill includes efforts to consolidate fiscal accounts as committed in the IMF program, but the underlying macro assumptions look fragile.**
- **Monetization has practically disappeared as a source of financing; local debt issuance has therefore gained prominence, and will require decent levels of investor confidence.**
- **Key presidential elections in 4Q23 could make fiscal consolidation politically difficult. We expect the primary deficit to increase to 3%/GDP in 2023, and surpass the IMF target of 1.9%.**

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2023 budget guidelines

The government has already submitted the 2023 budget bill to Congress and discussions have started. The bill sets a primary fiscal deficit at 2%/GDP (in line with the IMF agreement) and a 3.8%/GDP overall deficit (the interest bill is projected at 1.9%).

The budget's main macro assumptions for next year are real GDP growth at 2%, 60% CPI inflation, and a 62% increase in the official exchange rate USDARS rate, to 269. However, the likelihood of inflation falling to 60% next year is low, in our view: as per the last BCRA survey, the market forecast stands at 85%, and the trend is clearly on the upside. As a result, we believe the FX crawling-peg will be higher than the 62% set by the budget, in order to avoid an excessive real currency appreciation, and this could keep inflationary pressures high. In 2021, measured at the official rate, the REER appreciated 17% and another 12% year-to-date.

Financing needs in 2023

Regarding financing needs for next year, the government expects to cover 60% of the deficit (2.3%/GDP) through the local ARS debt market, which is a challenging goal: this year it will raise funds for 2.6%, but a significant 2% correspond to the bond purchases BCRA made in June and July to counter the market run on sovereign bonds after the resignation of Economy Minister Guzmán.

To obtain net financing for 2.3%/GDP from the local market in 2023, the implicit roll-over ratio should be at least 130%, i.e., the Treasury will have to issue 30% more than the large amount of maturities. The Treasury also faces 0.5%/GDP payments to the IMF next year. Other sources of financing will be BCRA loans for 0.6%/GDP and multilateral lending (0.2%/GDP). Against such a backdrop, private sector appetite for public debt will have to remain high next year, and we could see the BCRA acting as a lender of last resort in case market confidence eventually falters.

2023 fiscal policy outlook

Presidential elections will take place next year, so political considerations are important for fiscal policy in 2023. Primaries will be held in August and general elections in October. As a result, fiscal consolidation will be hard to achieve: we expect the primary fiscal deficit to reach to 3%/GDP in 2023, vs. 2.5% in 2022 and the 1.9% IMF target for next year. More than 60% of public expenditure is linked to inflation (directly or indirectly), and will be hard to reduce in a high-inflation context. In addition, political pressures to keep social and capital expenditure untouched will be high. That said, the utility rate adjustment for households recently launched by authorities could add some release for fiscal accounts next year, accounting for around 0.3%/GDP.

Last but not the least, it is worth noting that the 2022 budget bill was never approved by Congress (the law sets that in such cases the government can repeat the previous year's by presidential decree). We cannot rule out this happening again in 2023, but we expect the Congress to finally pass the budget in order to show some degree of political consensus in the middle of a demanding IMF program.

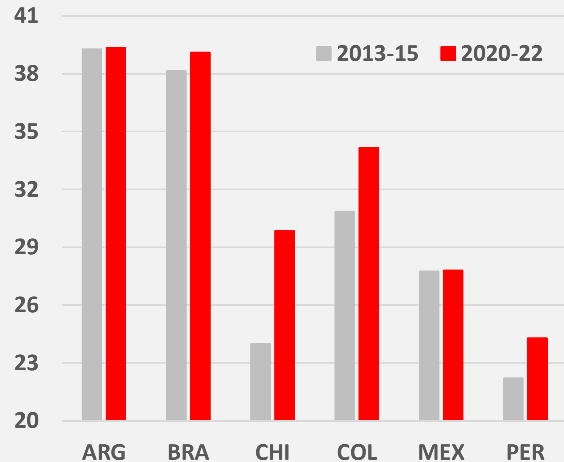
"Our 2023 budget bill is prudent and realistic, it complies with the goals included in the program agreed with the IMF (…) projected GDP growth is 2% because it has to be an attainable target, when Congressmen vote they have to feel these are feasible goals (…) Social subsidies, including energy, will be capped at 1.6% of GDP: we don't want citizens to pay more for their bills, but save more energy."

Sergio Massa, Minister of the Economy of Argentina.

Fiscal spending in Latin America

Political pressures to increase social spending have been rising all across the region even before the pandemic. In Brazil and Argentina, the burden of the public sector is already too high, with public debt at uncomfortable levels. Threatened by social unrest, the Andeans are moving up fast, from low starting points. Mexico's stability in the last ten years reflects well the austerity approach of the current administration.

General government spending (% of GDP)

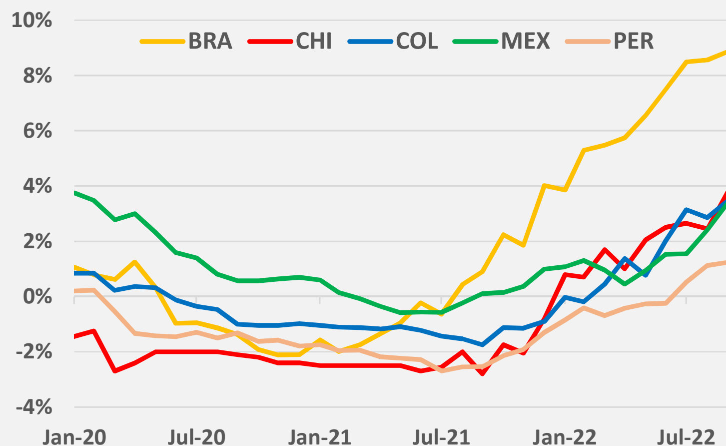


Sources: IMF WEO database. Annual averages, IMF definition.

The monetary policy cycle in the region

Brazil's steep rise in policy interest rates has finally paid off, with spot CPI and inflation expectations now adjusting downwards. In Mexico, Chile and Colombia, ex-ante, short-term real rates are all at 4% p.a., but in Mexico this level plus the Fed-mirror guidance is enough to keep FX conditions well anchored, which is not the case in the latter two countries. Peru has adjusted much less but has at least moved into positive territory for real rates (around 1%).

Central Bank reference rates net of inflation expectations (%)



Sources: Central banks, Santander. 12-month ahead inflation expectations as per central bank surveys.

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Chile: Saving More Today To Spend More Tomorrow

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- **This year the Treasury will run the first fiscal surplus since 2008, thanks to strict spending control and large revenue surprises.**
- **The 2023 budget deficit is set at 2.7%/GDP, which is not high per se but compares with a 1.6% surplus in 2022. Part of the 2023 deficit could be funded with this year's savings.**
- **How to revamp social infrastructure in a fiscally responsible way continues to be MinFin Marcel's big challenge: so far, so good.**

Fiscal trends in 2022

Fiscal consolidation has been impressive this year. The Piñera administration set an ambitious 22% cut to the 2022 budget, through the elimination of many COVID-related aid programs that ended in a massive 7.7%/GDP deficit in 2021. After President Boric took office this year, many doubted such a stringent stance could effectively last. However, Finance Minister Marcel's execution has been impressive so far: in the Jan-Aug period, the government ran a CLP7.3 trn **surplus** (equivalent to 4%/GDP), vs a CLP11.2 trn **deficit** (-7%/GDP) a year ago. Spending is being executed as budgeted, but revenue surprises have been all saved. For 2022 as a whole, the Treasury now projects a final surplus (the first one since 2008) of 1.6%/GDP. With these numbers, Minister Marcel's promises to pursue ambitious social reforms in a fiscally responsible way now look much more credible to market eyes.

2023 budget guidelines

The 2023 budget guidelines already submitted to Congress set a fiscal deficit of 2.7%/GDP, consistent with a 4.2% increase in spending (in real terms). The macro assumptions behind it appear quite realistic: real GDP growth at -0.5% and 6% average CPI inflation. Regarding revenue, the Treasury expects a 3% nominal loss in revenue, due to lower copper prices and corporate income tax receipts. Total spending would hit 26.5%/GDP, compared with the 24.0% registered in 2019 (before the pandemic) and the 31.5% peak of 2021.

2023 financing needs

On the financing front, 2023 borrowing needs will total US$15 billion, of which MinFin Marcel announced that c. US$12 billion would be covered by external and local debt issuance. . This implies a reduction vs. debt issuance in 2020-2021, and a public debt ratio relatively stable at 39%/GDP. Even more, we think that the government could potentially issue much less than that, if it decides to use part of the net financial assets it has accumulated in 2022.

Although the Reject win in the constitutional referendum eliminated the tail risk of massive fiscal relaxation medium term, voters' claims for better social infrastructure have not disappeared. Hence, our medium-term call is that overall spending in Chile will end up increasing to 30%/GDP in 6-8 years (+3-4 p.p, vs 2023), one way or another, in line with similar per-capita-GDP countries.

Medium-term fiscal outlook

The Boric administration is currently working on a tax reform to raise up to 3%/GDP in four years, to fund its social reform agenda. As per the original 2022-2026 fiscal framework, the public debt would stabilize at 43%/GDP in 2026, once the tax reform is fully effective. The fiscal deficit path would go from 2.7%/GDP in 2023 to 0.7% in 2026, averaging 1.6%. But all these targets look challenging after the referendum, as the government has no majority in Congress and its bargaining power has weakened. Hence, despite this year's austerity, the risk here is social spending eventually rising at the expense of larger deficits. A simple sensitivity analysis indicates that an average deficit of 3%/GDP in 2024-2026 would push the debt ratio to 48% in four years.

This is not positive, but we are not particularly concerned. As per the 2022 IMF Fiscal Monitor, Chile has the 29th highest gross public debt in a list of 39 EM countries. If the debt goes to 48%, it would rise to the 24th position (all else equal), so it wouldn't be a material change from a foreign investor standpoint. As we see it, Chile's public debt will rise in coming years, but the key point is where all that money will go. If it eventually funds a revamp in social infrastructure that permits to leave social unrest definitely behind, a 50% public debt ratio will be a price worth paying, in our view.

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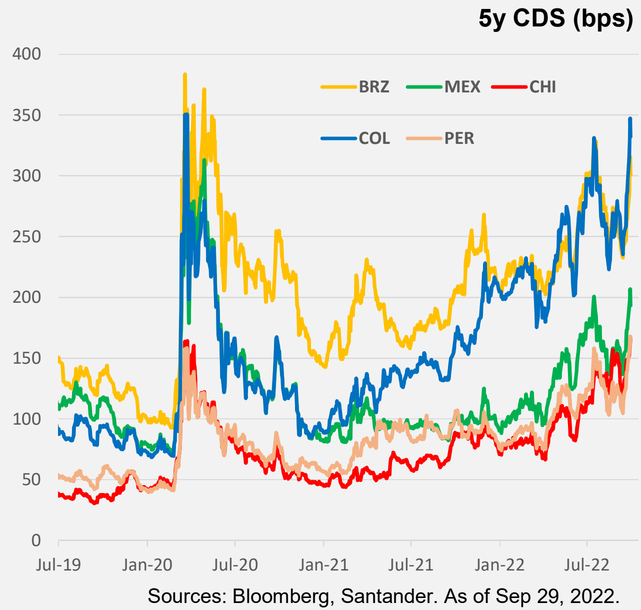
"This year fiscal accounts are going to be quite more positive than expected, even compared with the small deficit we estimated (…) This is important for the trajectory of the public debt, which was one of the themes cited by Moody's to justify the stable outlook of our credit rating (…) On the debt side, next year we'll be cutting issuance by a half, to roughly US$12 billion."

Mario Marcel, Minister of Finance of Chile (September 29, 2022)

Credit risk in Latin America

Ironically, the fastest-growing LatAm economy now leads the ranking of CDS spreads: Colombia is trading at 330 bps in 5yr, almost hitting the pandemic high. The global mood is not helping, and credit spreads are widening all across the region, with Mexico also suffering in recent weeks as fears about a U.S. recession intensify.

5y CDS (bps)



Sources: Bloomberg, Santander. As of Sep 29, 2022.

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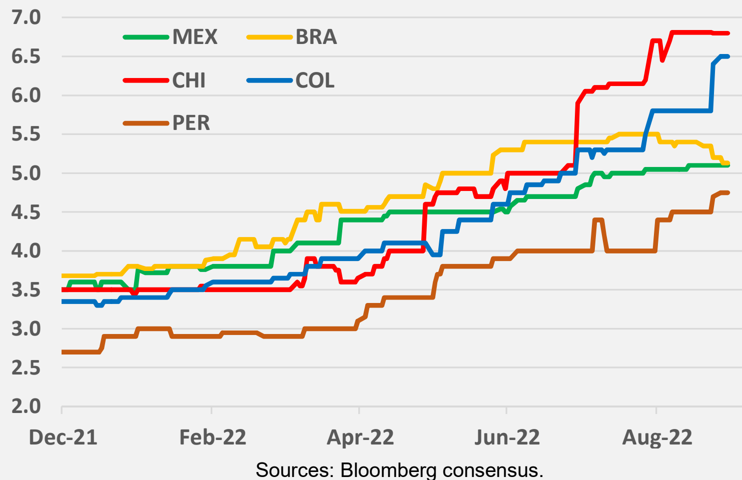
The inflation cycle in Latin America

The overall direction of 2023 inflation expectations remain up, but some encouraging signs have emerged in recent weeks. In Brazil, the mix of government subsidies and the ultra-tight monetary policy already generated a turning point, while in Mexico increases have slowed. In Chile and Colombia, expected inflation for next year are the highest in the region, in part reflecting steady weakness in their currencies. Peru closes the list, but the uptrend is still steep.

2023 Inflation Expectations in Latin America



Sources: Bloomberg consensus.

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Colombia: Rosy Macro Assumptions Pose Risks To Fiscal Path

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- **Congress has already approved the spending side of the 2023 budget, including a large increase of 2.5%/GDP vs. pre-pandemic.**
- **We expect the 2023 fiscal deficit at a still high 4.5%/GDP, compared with our 5.6% estimate for 2022 and the fiscal rule committee's projection of 4%.**
- **We believe that a key fragility of the 2023 budget is next year's GDP growth, assumed at 3.2% vs. our 1.3% estimate.**

Fiscal trends in 2022

Congress approved a record COP405.6tn (US$93bn) budget spending for 2023, which includes a COP14.2tn (1%/GDP) addition aimed at social programs and reforms proposed by President Petro during the campaign (these figures correspond to the national budget and not just the central government budget, which investors track more closely). Fiscal plans for 2023 show primary spending levels (operating plus investment) 1.3%/GDP higher than in 2022, and 2.5% vs pre-pandemic. MinFin Ocampo earlier noted that the spending increase would be funded by additional tax revenues and credits from multilateral banks. However, more recently he stated that the extra resources (COP12.5tn – 0.6%/GDP) budgeted for next year are insufficient to finance all projected expenditures, so a greater part of the shortfall may have to be financed from the proposed tax reform bill (which at the time of this writing has yet to be approved). Importantly, these spending plans do not include payments for the Fuel Price Stabilization Fund (FEPC) and could represent a source of fiscal slippage. Congress has until October 20 to approve the overall budget bill.

2023 budget guidelines

With an official 2022 deficit estimate of around 5.6%/GDP, net debt levels are expected to fall to 56.5%/GDP in 2022 (from 60.8% in 2021). In the first stage of budget definitions, the Medium-Term Fiscal Plan (MTFP) had proposed a 3.6%/GDP deficit by 2023, which would bring the net debt level down to 56.2%. As per the fiscal rule, the medium-term goal is capping the debt ratio at 55% in 2024, but this requires a larger primary surplus (an extra 1.2%/GDP), the political viability of which looks challenging.

Later on, the Fiscal Rule Committee estimated a 2023 deficit of 4.0%/GDP, consistent with the Fiscal Rule, though we note that the additional revenues expected from this year's tax reform would be fundamental in complying with the fiscal consolidation. We believe revenues estimated by the MTFP and the 2023 budget may be on the optimistic side in terms of economic growth and average oil prices, a potential risk for revenue undershooting next year. Therefore, without additional revenues measures (beyond pending revisions in the current tax reform bill and when they will start to be collected) and a potential trimming in expenses further down the line, achieving fiscal consolidation as planned could prove ambitious. We estimate that the final 2023 deficit at around 4.5%/GDP.

2023 fiscal policy outlook

The key risks for the projected fiscal trajectory arguably lie within the macroeconomic assumptions embedded in the core budget scenarios. For example, these assume 3.2% GDP growth in 2023. However, as per the recent oil & mining royalty bill, the MinFin already adjusted the 2023 growth forecast to 1.8% and maintained the 2024 growth at 3.2%. Even considering this downward revision, we think some of the key assumptions are optimistic and the risk points to lower-than-expected tax revenues in both 2023-24. This would imply potentially higher realized deficits (yet allowed by the fiscal rule) and a debt consolidation trajectory that may well miss targets over the next two years. In this context, 2023 borrowing requirements would remain sizeable with COP40.4tn in internal and US$3.2 billion in external funding (roughly a 70-30% funding mix). Either way, this is likely to leave Colombia's fiscal deficit high, and probably the current account deficit too, given the "twin deficit" problem.

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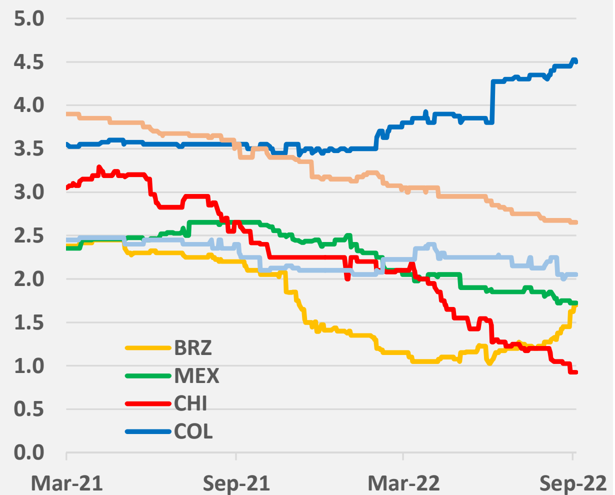
"Recovering investment-grade status from international credit agencies won't be easy. It's worth reminding that the last time we lost the investment grade, the country had to wait 11 years to regain it. It shouldn't take so long this time, but in any case this is not a short-term issue for us. (…) We will add some COP11 trn (around US$2.5 billion) to the budget, but the increase will be well financed, there's no extra debt, they are all genuine resources – tax revenues are doing very well (…) and we also have found some financial savings in various public entities."

José Antonio Ocampo, new Minister of Treasury of Colombia.

Growth outlook in Latin America

The softening expected for the global economy to fight inflation is taking its toll in the region too, with two exceptions: Colombia and Brazil. Consensus surveys see Colombia growing by a combined 9% in 2022-23, while Brazil's forecasts are still low but recovering. Pessimism lingers in the rest of countries, with Chile standing out with a pronounced decline for both years.

2022-2023 average GDP consensus (annual %)

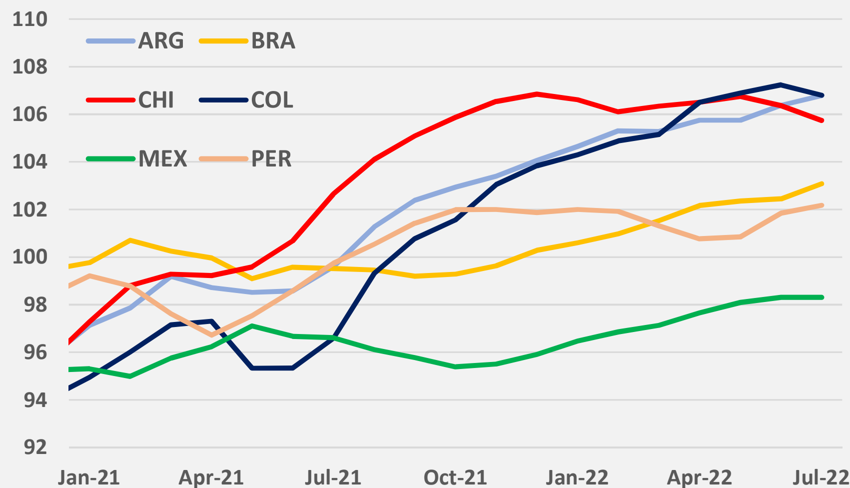


Bloomberg consensus. Sources: Bloomberg, Santander

Economic Activity in Latin America

The major LatAm countries can be divided into three groups when it comes to recent growth trends. Colombia, Argentina and Chile lead with 6%-7% gains vs pre-pandemic levels, yet only Colombia's path looks really sustainable short term. In the middle appear Brazil and Peru, although momentum is notably better in the former. Mexico improves a bit but almost three years after the pandemic, the economy is still smaller than in early 2020.

Monthly real GDP Indicators, s.a. Levels, Last 3M Averages



Sources: Central banks, national statistics offices, Santander. Base 100=January 2020.

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Peru: Peaking Tax Revenue Leaves Less Room for Spending

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- **Public spending to increase by a generous 9% (nominal), which nonetheless should keep the deficit in check at 2.4%/GDP.**
- **Debt levels remain at very manageable levels, at 35%/GDP now and below 38% as per the revised fiscal rule, especially compared with LatAm peers.**
- **Slowing growth and commodity-related revenues present risks for 2023, so we believe there is some downside in the tax revenue projection at 20.5%/GDP.**

2023 budget guidelines

The draft Public Sector Law for FY 2023 proposes increasing government spending by 9% (versus previous year) in nominal terms and 4% in real terms (based on official projections for inflation). Spending priorities (as highlighted in the Impulso Peru plan) geared towards three "policy axes" including i) boosting private spending; ii) accelerating public investment; iii) restoring confidence among economic agents. Overall, much of the emphasis falls on boosting or extending current expenditures via various fuel, food, and housing-related subsidies and other exemptions to vulnerable households. Together with tax incentives for private investment (including R&D and mining and hydrocarbon exploration), the MEF estimates a positive impact of 0.3%/GDP for 2023 and up to 0.5% from public investment initiatives. Based on these official projections, the government's overall budget deficit forecast remains at 2.5%/GDP for 2022 and 2.4%/GDP for 2023, then falling further to 2.0%/GDP for 2024.

For regional context, Peru's fiscal trajectory remains manageable relative to the rest of LatAm and the proposed budget increases should not jeopardize the overall path for 2023-24, though it is not without risks. Indeed, the current administration has reiterated its commitment to a responsible fiscal sustainability plan, including stabilising annual budget shortfalls and net public debt levels according to revised fiscal rule guidance. Based on these latest fiscal rule limits, the general government deficits shall be no greater than 2.4%/GDP in 2023, 2.0%/GDP in 2024 and 1.5%/GDP in 2025, while public debt levels shall be no greater than 38% GDP (currently at 34.9%/GDP) for 2023 and converging to a maximum limit of 30% by 2032. In terms of the budget deficit targets, there is not a lot of room for slippage if fiscal rules are to hold and thus spending discipline needs to remain strong. However, in practice, government underspending (vs previous planned budgets) is a frequent occurrence leaving some scope for lower actual expenditures, particularly at the regional level (more typical in public investment execution).

2023 fiscal policy outlook

While the strong post-covid rebound in economic activity has been a significant driver in the outperformance of tax revenues, the more moderate growth trajectory over the coming years suggest government income growth is likely normalize too. Given a significant portion of tax revenues (60%) are derived from consumption taxes (such as IGV), a pronounced slowdown in private spending (as witnessed during periods of lockdowns) poses considerable negative shocks to the fiscal balance. While this is an extreme example, the more modest GDP growth outlook (Peru could slow to 2% in 2023) suggests cyclical peaks in tax collection in 2021/22 may have already been reached and likely to plateau (or decrease slightly) in 2023. Add to this, the positive boost from higher commodity prices and disrupted production trends in Peru's key exports are also fading (as observed in the slowing trade surpluses and terms of trade metrics). Current official forecasts for tax revenue of 20.5%/GDP in 2023 is susceptible to modest downside risks in our view, with the shortfall either accounted for by pressure to reduce budgeted expenditures and/or increased borrowing requirements. As already outlined in the multiannual macro projections (MMM, Aug 2022), the MEF anticipates an increase in 2023 borrowing requirement to PEN31.3bn (from PEN27.6bn for 2022) which we think could be made up of roughly two-thirds domestic issuance and one-third in USD debt.

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