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ECONOMICS

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Brazil – Public Sector Debt

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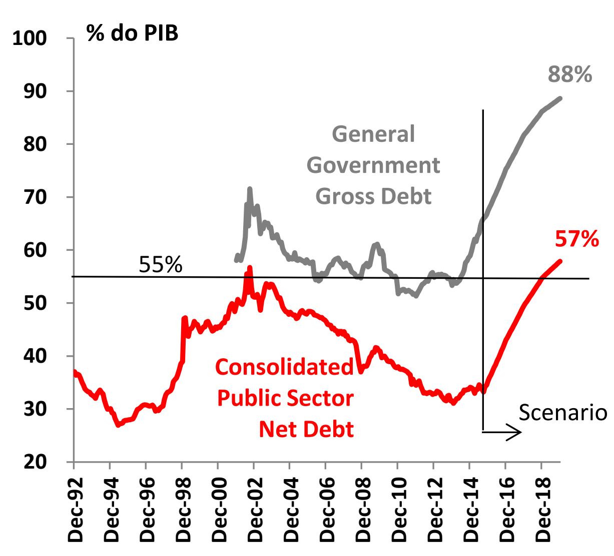
The Walking Dead? (Part II): How High Will Public Sector Debt Go?

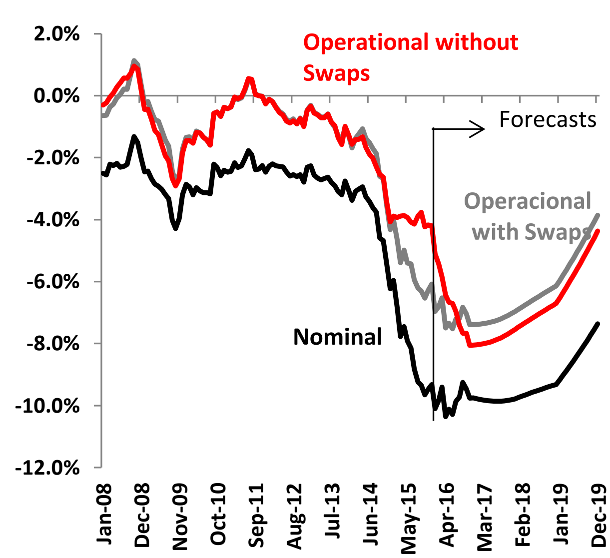
- **Without severe fiscal measures, we project general government gross debt will likely increase from 66% of GDP (Sep/15) to 75% at the end of next year. We do not rule out its reaching almost 90% in 2019.**
- **In terms of consolidated public sector net debt to GDP ratios, after remaining virtually stable over the last four years (between 31% and 34% of GDP), we believe they will increase toward 43% in 2016. We estimate the current unstable dynamics, even if mitigated by some economic recovery after 2016 and modest adjustment of the primary surplus, could raise net debt to 60% of GDP by 2020.**
- **After a period in which debt dynamics were propelled (apart from the primary deficit) mostly by the exchange rate (which could be considered a nonrecurring driver), we believe the real interest rate will probably be the most important factor behind weaker readings for the operational deficit. Therefore, we see limited room for the nominal deficit (currently close to 10% of GDP) to fall in the near term. Most likely the operational deficit will surpass 7% of GDP in 2016, according to our projections.**
- **Although public sector debt conditions and dynamic seem to be critical, we do not see the current public sector balance sheet reaching a situation as serious as that of 2001-03 before 2019. The previous historical peak in terms of net debt probably will *not* be reached within the next three years.**
- **Even considering the current dynamics as unsustainable, under current conditions we do not believe they will necessarily lead to a disruptive scenario or a debt crisis. In our view, the current favorable external position (international reserves), the floating exchange rate regime, and the fact that 80% of public sector debt is held by local investors give policymakers time to pursue a permanent fiscal consolidation.**
- **However, the longer it takes for the primary surplus to reach a level compatible with a reduction of debt, the lower potential growth will be and the higher real interest rates will be, thereby making it increasingly difficult to achieve fiscal equilibrium, in our view.**

Public Sector Debt (% of GDP)



Source: Santander estimates based on BCB data.

Fiscal Deficit (% of GDP in 12 months)



Source: Santander estimates based on BCB data.

Debt to GDP Dynamics Framework

We have recently developed and detailed a framework aimed at understanding the dynamics of net consolidated public sector debt and general government gross debt, as a percentage of GDP (see *The Walking Dead? (Part I): Useful Alternative Fiscal Indicators and Debt Tutorial*, November 25, 2015). We believe the most important contribution has been the establishment of close relationships between financial market variables (exchange rate, Selic, TJLP, and Treasury yields) and the implied interest rate of debt. These links are useful to estimate the cost of debt, which, added to primary results, will lead to the nominal deficit and debt variation according to the usual formula:

$d(D) = (i – y)D – pr + Aj$,

where d(D) is the variation of debt, i is the implied cost of debt, y is GDP growth, pr is the primary balance, and Aj is the exchange rate adjustment of public sector assets and liabilities and other adjustments such as the incorporation of unrecognized debt or proceeds of privatizations not accounted in the primary surplus.

We also (in the same report) described and estimated the operational deficit, by eliminating the inflation component from the interest rate. This approach also leads to a more straightforward application of the previous equation, in which real interest rates and real GDP growth can be used, instead of nominal variables.

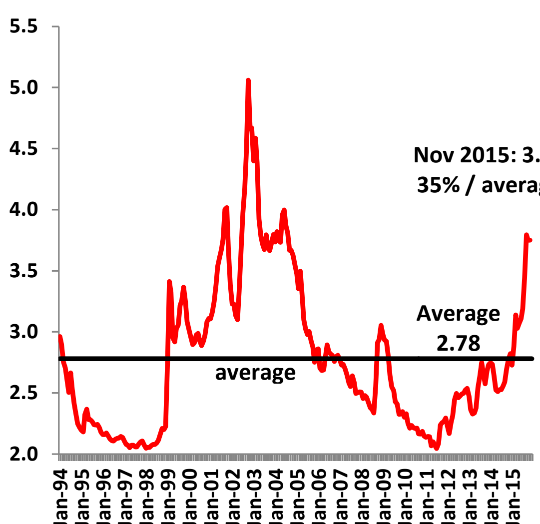
Therefore, equipped with assumptions for financial market variables (exchange rate, Selic, TJLP, Treasury Bond yields), GDP growth, inflation, and primary surplus, we can run simulations on the future path of public sector debt to GDP.

Assumptions – Base Case

1) We believe that, in real terms, the Brazilian **exchange rate** is currently not far from its long-term equilibrium. Our scenario assumes the BRL will depreciate by the same rate as inflation, reaching BRL4.10/USD by the end of 2016.

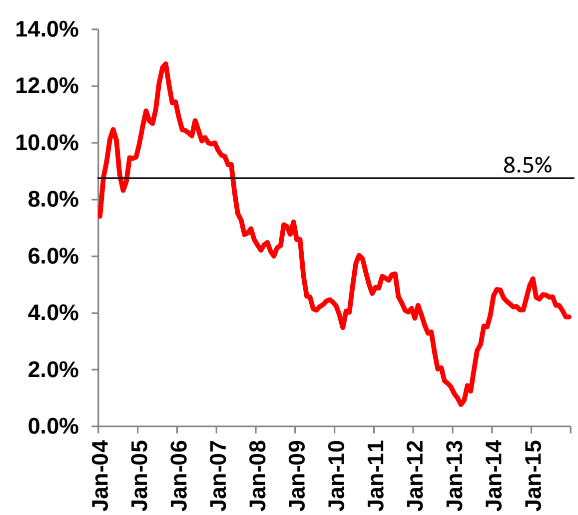
2) **Real interest rate** (Selic (-) ex post IPCA). In our view, the current adverse political and fiscal conditions will impose higher real interest rates on the Treasury in near future. Our base case assumption will be a Selic 8.5% above inflation, not far from levels observed in the beginning of the last decade. From the point of the latest readings, this seems to be a conservative hypothesis, as the Selic will be at 14.25% p.a. by the end of the year vs. inflation of 10%, meaning a real interest rate not far from 4%. But apart from fundamental considerations, we are considering the possibility of the base rate moving to somewhere around 15.5% in 2016, with inflation near 7%.

Real Exchange Rate (BRL adjusted by inflation differentials – Brazil x Trading Partners Weighted by Total Trade) (at BRL Sep 2013 prices)



Source: BCB.

Real Ex Post Interest Rate (Selic (-) YoY IPCA)



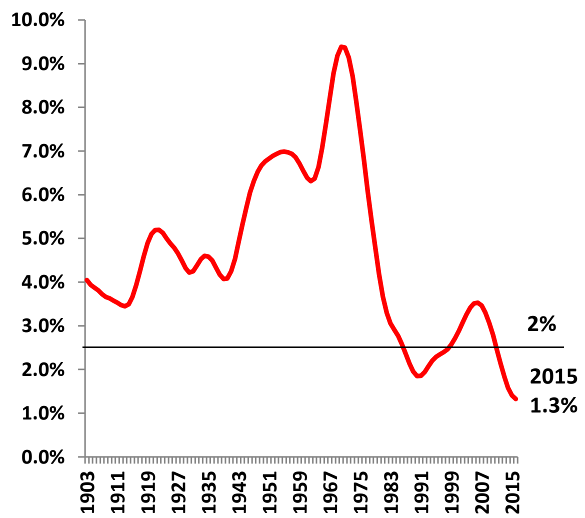
Source: Santander estimates based on BCB and IBGE data.

3) After projecting GDP contraction of 2% in 2016, we will incorporate a conservative hypothesis of flat real GDP in 2016 (considering -2% for 2016 seems optimistic at this point) and +2% thereafter.

4) In our view, current political conditions and contracting GDP suggest the primary balance will remain in the vicinity of -1% of GDP in 2016. Our assumption for the following years is an improvement of 1 p.p. per year and a steeper increase in 2019, to 3% of GDP.

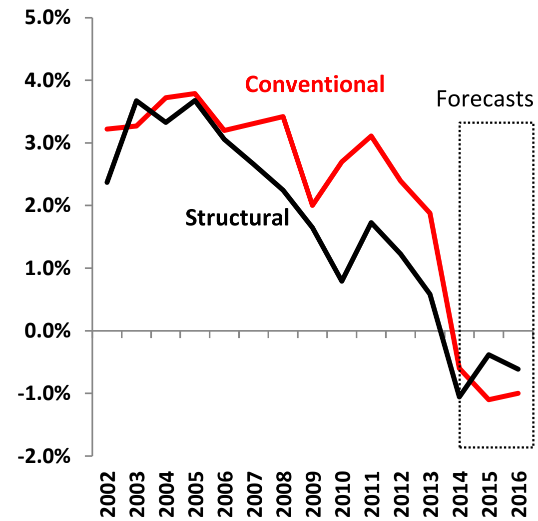
5) Other assumptions: TJLP of +1% (in real terms), two-year Treasury yields linearly going from the current 0.7% p.a. to 4.0% in 2019, and additional lending/capitalization by public-owned companies (and/or banks) of 3 p.p. of GDP.

Real GDP Growth – Trend (HP Statistical Filter)



Source: Santander estimates based on IPEA data.

Primary Surplus (% of GDP)

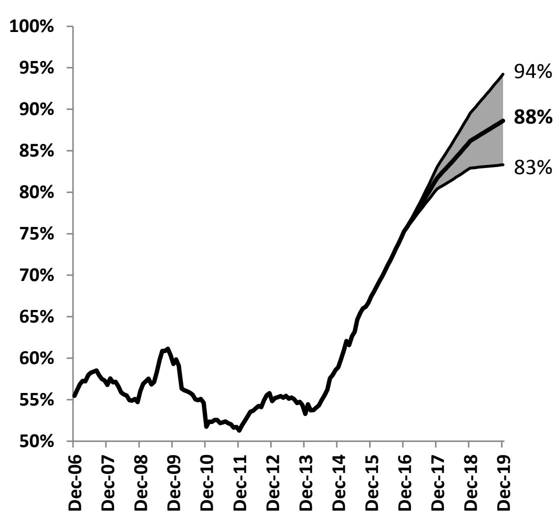


Source: Santander estimates based on BCB data.

Public Sector Debt: Simulations

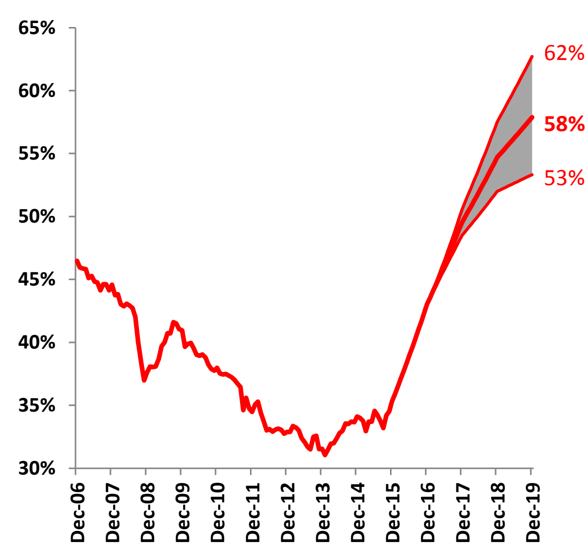
The following charts show our forecasts for general government gross debt and consolidated public sector net debt as a percentage of GDP, after incorporating previous assumptions into our model. **We also illustrate those trajectories with more benign/pessimistic assumptions for real interest rates and GDP. The benign scenario assumes GDP growth 1 p.p. higher and a real interest rates 2 p.p. lower than the base case, from 2017 onward. In the pessimistic scenario, the Selic is 2 p.p. higher and GDP growth 1 p.p. lower than the benchmark scenario.**

Gross Debt (% of GDP)



Source: Santander estimates based on BCB and Bloomberg data.

Net Debt (% of GDP)



Source: Santander estimates based on BCB and Bloomberg data.

Why So Bad?

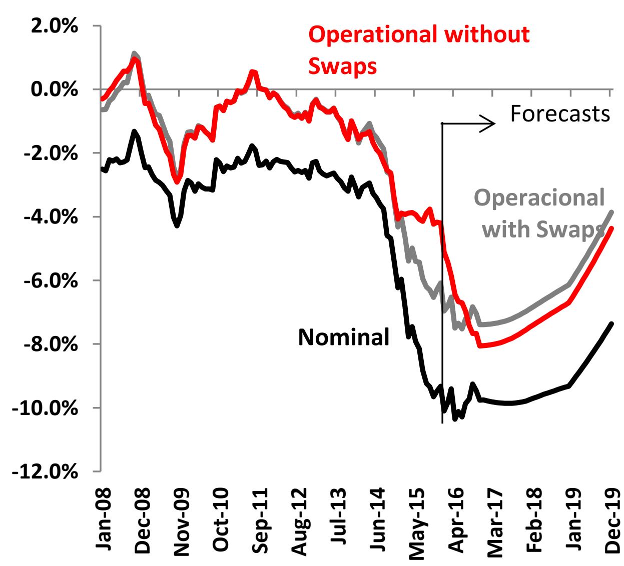
In our previous *Walking Dead* report mentioned previously (*The Walking Dead? (Part I): Useful Alternative Fiscal Indicators and Debt Tutorial*, November 25, 2015), we argued that the deterioration of fiscal accounts should not be fully judged by the notably high nominal deficit, both because that deficit is temporarily boosted by the impact of the exchange rate on the swaps and because of higher inflation. In order to carry out a deeper analysis of fiscal results, we calculated an estimate of the operational deficit, which has shown much more benign dynamics, remaining virtually stable at around 4% of GDP (in 12 months) since the beginning of 2015.

We claimed that the deterioration of the operational deficit would be much more related to the dynamic of the primary surplus than to the monetary policy tightening process. But considering our set of assumptions, the opposite will probably be true in the near future. An eventual reduction of inflation and a stabilization of the real exchange rate tend to substantially increase the implied cost of net debt and the operational deficit, even without further worsening of the primary surplus.

However, after a period in which debt dynamics were propelled (apart from the primary deficit) mostly by the exchange rate (which could be considered a nonrecurring driver), the real interest rate will probably be the most important factor behind the weaker readings for the operational deficit, in our view.

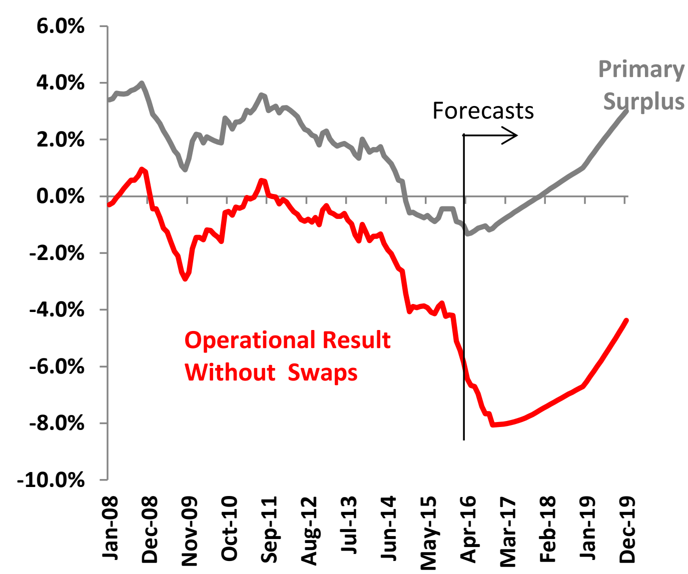
Therefore, we see limited room for the nominal deficit (currently close to 10% of GDP) to fall in the near term. Most likely the operational deficit will approach 8% of GDP, according to our projections.

Fiscal Deficit (% of GDP in 12 months)



Source: Santander estimates based on BCB data.

Fiscal Deficit (% of GDP in 12 months)



Source: Santander estimates based on BCB data.

Conclusions

1) Without severe fiscal measures (more extensive than those already announced and not even fully implemented thus far), general government gross debt will likely increase from the current (Sep/15) 66% of GDP to 75% at the end of next year. We do not rule out the possibility that it will reach almost 90% before 2020.

2) In terms of consolidated public sector net debt to GDP ratios, after being virtually stable (between 31% and 34% of GDP) in the last four years, they will increase toward 43% in 2016, according to our forecasts. The current unstable dynamics, even if mitigated by some economic recovery after 2016, could raise net debt toward 60% of GDP by 2020, in our view.

3) If the real exchange rate stabilizes (as suggested by our scenario), net debt will likely increase faster than gross debt. In our view, this should happen due to a much less intense correction of public sector net assets denominated in foreign currency (which have recently offset most of the expansion of liabilities). At the same time, we believe slower depreciation of the currency, which weighs heavily on external debt and swaps, should be less burdensome for gross debt dynamics.

4) The level of Brazilian gross debt is already very high compared to that of other economies and tends to reach levels comparable only with developed economies, which are able to finance their debt at a much lower cost.

5) Although public sector debt conditions and dynamics seem to be critical, we do not see the current public sector balance sheet reaching a situation as serious as it was in 2001-03 before 2019. Gross debt will likely be much higher, but the previous historical peak in terms of net debt probably *will not* be reached within the next three years, in our view.

6) Even considering the current dynamics as unsustainable, under current conditions we do not believe they will necessarily lead to a disruptive scenario or a debt crisis in the near term. The current favorable external position (international reserves), the floating exchange rate regime, and the fact that 80% of public sector debt is held by local investors provide some time for policymakers to generate a permanent fiscal consolidation, in our opinion.

7) However, the longer it takes for the primary surplus to reach a level compatible with a reduction of debt, the lower potential growth will be and the higher real interest rates will be, in our view, thereby making it increasingly difficult to achieve fiscal equilibrium.

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