Public debt drivers

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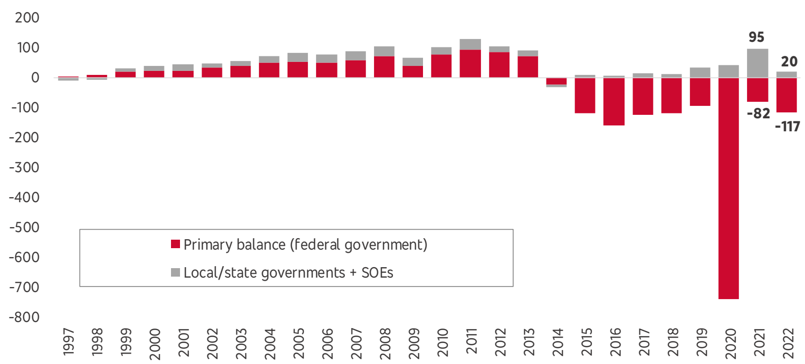
The consolidated primary balance of the public sector will be positive for the first time since 2013, with a BRL 13 billion surplus. The federal government will continue to post a deficit – BRL 82 billion – but state and local governments and state-owned enterprises will have a surplus of nearly BRL 95 billion this year, exceeding expectations. With the surplus, gross debt will fall from 89% (2020) to 81% of GDP (2021). Despite these encouraging results, these numbers are very much impacted by inflation, in addition to the cyclical recovery in GDP, resulting from the vast amounts of stimulus injected during the pandemic, which also help explain inflation. Since these factors are not expected to repeat next year, the interest rate will continue to rise to contain inflation and the structural primary balance remains very similar to pre-pandemic levels, we expect debt to grow again in 2022 and stay close to 90% of GDP in the coming years if there are no changes to fiscal policy.

Chart 1: Primary Balance
billions of BRL

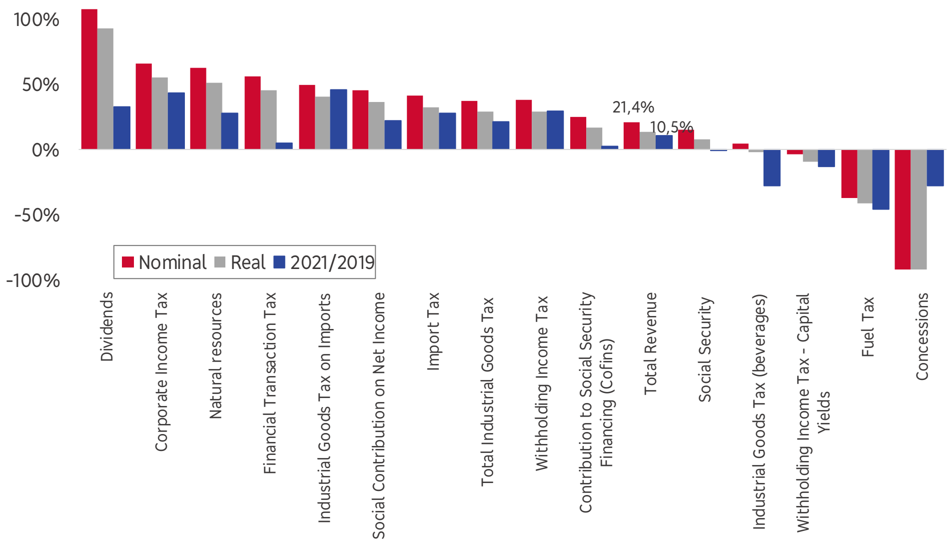


Source: BCB, Bradesco

Federal revenue collection has been better than expected since the beginning of the year, due to a positive combination of growth recovery, currency devaluation and inflation. Total revenue grew 21% in the 12 months to October, a BRL 327 billion increase. Adjusting for inflation, revenue grew 14% in the period. Part of that growth is associated with factors that should not be recurrent: **i)** some taxes and contributions were deferred in 2020, as one of the measures aimed at mitigating the impacts of the pandemic on the economy. This is the case with Cofins, whose collection is up 17% in 2021, in real terms, but only 3% above 2019[1]; **ii)** the currency devaluation inflated the import tax collection, up 33%, as well as the IPI collection on imports, up 40%; **iii)** the sharp increase in the price of some commodities, such as oil and iron ore, helped royalty revenues, which are up 52%.

(1) Comparison in real terms, Jan-Oct 2021 and 2019. Even this comparison is not perfect, as new deferrals also occurred in 2021. Based on this metric, total revenue grew 10% in 2021.

Chart 2: Federal Revenue Collection
BRL billion, 12-months to October and January-October vs. 2019



Source: National Treasury, Bradesco

Revenue collection also received a boost from the employment and GDP recoveries. Individual Income Tax collection is up 29% through October, in real terms, while Corporate Income Tax rose 18% compared with the same period in 2019, after adjusting for inflation and the atypical collection of IRPJ and CSLL of 2021. In addition, state-owned enterprises provided a boost in dividends earned by the Federal Government, approximately BRL 11.5 billion more than in 2020 – with BRL 9.3 billion coming from Petrobras. Some of these results may be more persistent than the effects described in the previous paragraph.

At this point, however, some caution is warranted. The GDP recovery was significant and sharper than previously expected, but it was also driven by large amounts of fiscal and monetary stimulus. The total fiscal stimulus package alone came to BRL 633 billion[2]. In addition to cutting the benchmark Selic rate to 2%, the Central Bank also provided BRL 1.27 trillion to bolster liquidity in the credit market. That led to robust growth, but this stimulus level is not permanent, and the post-pandemic cyclical recovery has basically run its course. In fact, these incentives are being pulled back, with fiscal programs being cut for 2022 and the Selic moving quickly into contractionary territory. In other words, we are not going to continue to see the same accelerated growth driven by stimulus packages, and GDP growth is expected to dip from nearly 5% to 0.75%. The change in economic policy from expansionary to restrictive will lead to a slowdown in inflation, and revenues should be doubly affected by less growth and less inflation. The structural primary balance, which is the metric that takes into account the cyclical position of the economy and cleans up the one-off effects on revenue and expenditure, is expected to come in at -1.7% in 2022, in line with pre-pandemic levels.

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(2) https://www.tesourotransparente.gov.br/visualizacao/painel-de-monitoramentos-dos-gastos-com-covid-19

(3) https://www.bcb.gov.br/conteudo/home-ptbr/TextosApresentacoes/Apresentacao_RCN_TCU_17.8.20.pdf

There were no surprises with expenses in 2021, as results came within the budget approved in early 2021. With the spending cap rule being eased in 2022, expenditures could grow by BRL 110 billion more than was expected before Congress began discussions on Constitutional Amendment 23/2021. Total expenditures will come in well below 2020 and 2021 levels, around 1.2% of GDP. But the credibility cost of changing the rule is greater than the actual increase in expenditures[4]. The constitutional rule proved less restrictive than had been imagined, keeping a cloud of uncertainty hanging over the future of fiscal policy. Additionally, as the constitutional amendment bill moved through Congress, the new income-transfer program known as Auxílio Brasil became permanent – meaning that another non-discretionary expense had to be accommodated under the spending cap, starting at the hefty sum of BRL 95 billion in 2022. That decision squeezed the budget even tighter and, as a result, it will be increasingly difficult for the government to come in under the cap, creating the need for new reforms to reduce non-discretionary spending.

The expanded spending cap will be met in 2022 and a new challenge will be set for 2023. We estimate that the government will need to accommodate BRL 11 billion in expenses in 2023 – a manageable amount, but one that deserves attention, since discretionary expenses have been at very low levels for a few years.

Table 1: Brazilian public spending
billions of BRL (current)

	2019	2020	2021	2022	2023
Total Expenditure	**1.442**	**1.947**	**1.628**	**1.733**	**1.821**
Social Security Benefits	**627**	**664**	**706**	**789**	**843**
Payroll	**313**	**321**	**332**	**356**	**374**
Other Non-Discretionary	**195**	**720**	**323**	**270**	**266**
Allowance and unemployment	56	60	46	66	66
Other social security spending	60	63	68	77	81
Extraordinary Credit	3	430	129	0	0
Controlled Non-Discretionary	**143**	**134**	**147**	**227**	**243**
Bolsa Família/Auxílio Brasil	33	19	27	95	100
Discretionary	**164**	**108**	**121**	**91**	**96**
Under/over cap				0,3	-11,2

Source: National Treasury, Bradesco

Thus, gross debt will reach 81% of GDP this year, before climbing to 88% in 2022. The primary balance and interest rates explain part of the debt reduction from last year, with strong revenue results and a historically low benchmark interest rate. However, this statistic can also be explained by its denominator – nominal GDP –, which grew 16.5% in 2021, but is expected to grow just 5.6% in 2022[5].

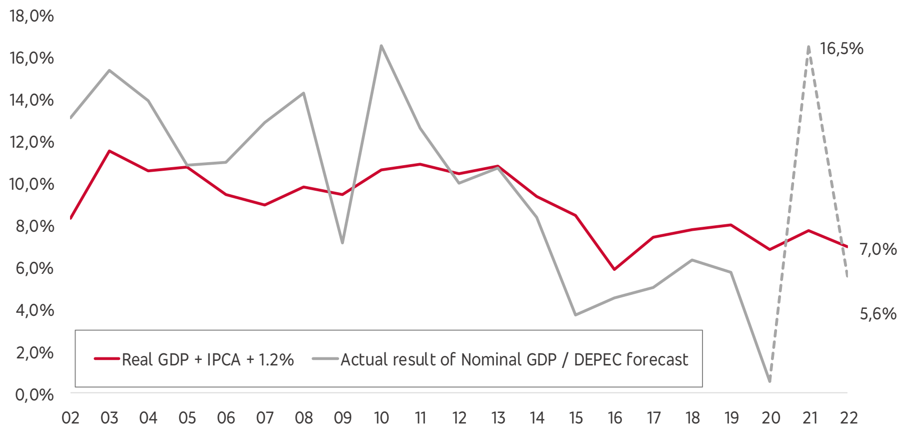
Without the help of inflation, revenue growth should also contribute less and we expect the consolidated primary balance to show a deficit of BRL 100 billion in 2022. To help slow down the inflation rate, the Central Bank has been raising interest rates, which will cause interest payment expenses to jump from BRL 438 billion to BRL 658 billion in 2022.

(4) See DEPEC Highlight from November 3, 2021, “Spending cap and fiscal policy credibility.”

(5) About a quarter of Nominal GDP is deflated by price indexes other than the IPCA. One of the implicit deflators of the nominal GDP of the Agricultural and Industrial sectors is the Wholesale Price Index (IPA) of each sector. In 2020, when the Agricultural IPA rose 49.4% and the Industrial IPA climbed 25.3%, nominal GDP grew 1.1% while real GDP fell 3.9%. We expect the opposite to occur in 2022, as these deflators are expected to decelerate.

Thus, even if inflation helps reduce gross debt in 2021, the cost of raising interest rates creates an opposite effect for the following years, with a new increase in debt levels. After a few years in which the interest rate component of the debt had been reducing, there will be a reversal starting in 2022.

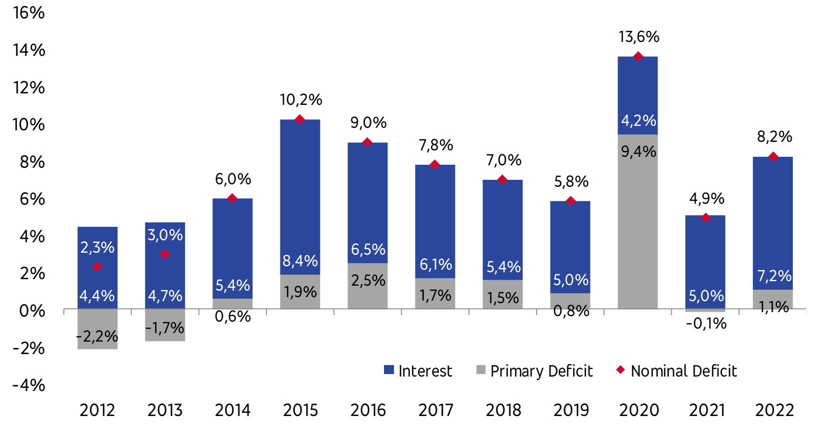
Chart 3: Nominal GDP
annual %



*Real GDP + IPCA +1.2%: standard rule for estimating nominal GDP, considers GDP and IPCA expectations featured in the Focus report for the following year. 1.2% is the average difference between the change in nominal GDP and the sum of real GDP and IPCA.

Source: IBGE, Bradesco

Chart 4: Nominal Deficit
% of GDP

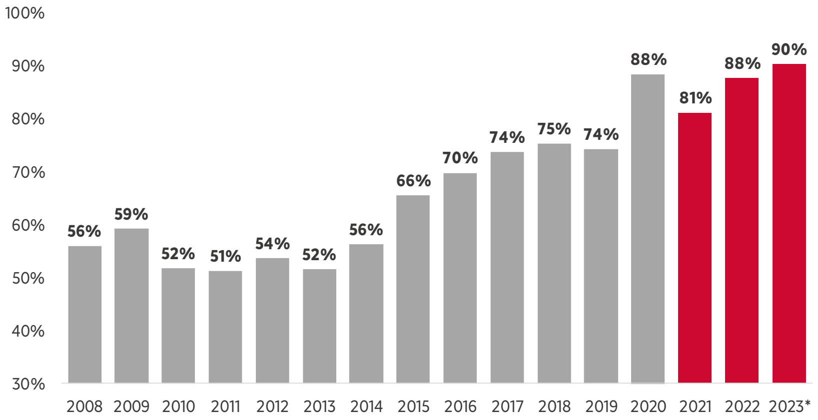


Source: BCB, Bradesco

The results bode well for the fiscal health of the Brazilian government in 2021, but caution is needed when extrapolating these numbers to the years ahead. The improvement is closely associated with rising inflation, the upsurge in commodity prices and currency devaluation. We are also seeing a cyclical recovery in 2021, resulting from the large amounts of stimulus that have been pumped into the economy. These factors will not be repeated going forward and the structural primary balance will continue to see a deficit of 1.7% of GDP, with the budget squeezed even tighter.

Evidently, a 81% debt-to-GDP ratio is much better than expected at the beginning of the year (90.7%, according to the Prisma Fiscal report of January 2021), but it is likely to worsen, and the path to fiscal consolidation will still be long. That is why tax regime and fiscal policy issues will be at the forefront in the years ahead and have a significant impact on asset price formation in 2022.

Chart 5: Gross Debt
% of GDP



Source: BCB, Bradesco

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