Santander

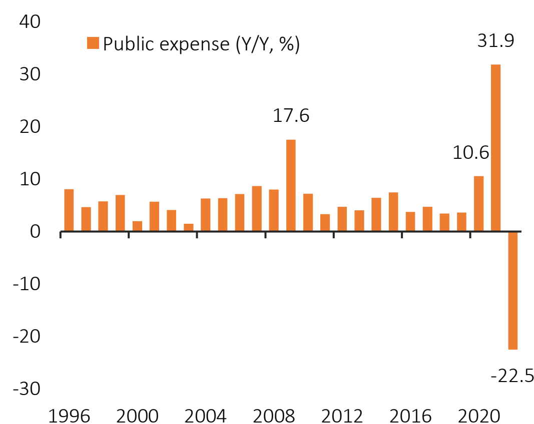
2022 Budget delivers powerful signal of fiscal consolidation

Ahead of the month-end deadline, the Government entered the 2022 Budget Law project in Congress, with a strong reduction in spending (-22.5% y / y) compared to the estimated execution for this year. With this, it would return to levels as a fraction of GDP similar to those prior to the pandemic (around 24% of GDP) and the deficit would be reduced from 8.5% of GDP projected for this year to 2.8% of GDP. The amount of the spending reduction is consistent with the fiscal commitment to bring the structural deficit from 11.5% of GDP this year to 3.9% of GDP and is somewhat more ambitious than we had anticipated in previous reports, where we estimated that the cut could be between 15% and 20%.

This significant fiscal consolidation is essential for the public debt (which will close the year at around 35% of GDP) to return to a sustainable path over time. Already at the beginning of the week, the Autonomous Fiscal Council (CFA) had warned that, if there was not a significant correction in spending, there was a risk of entering an unsustainable dynamic for debt, which in a few years could double. With the amount contemplated in the Bill, the debt will remain below 40% of GDP at the end of next year.

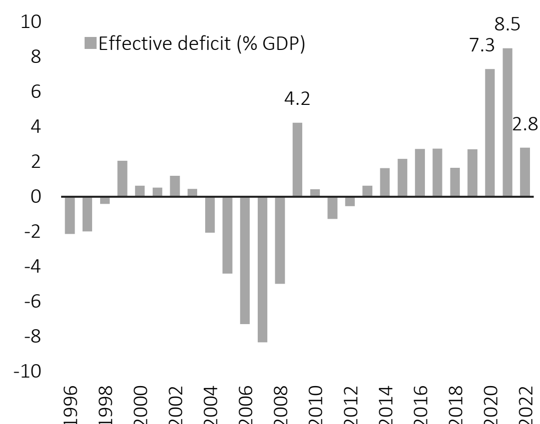
The sharp drop in public spending will imply a significant brake on the fiscal impulse (the public deficit falls by more than 4pp of GDP, while the structural deficit does so by more than 6pp of GDP), with the consequent impact on domestic demand and GDP growth. Given the above, it is unlikely that the Central Bank will seek to bring monetary policy to a contractionary terrain, which would imply putting a double brake on the economy. For the same reason, we estimate that the Board will be very cautious in its following rate movements and the MPR would not exceed its neutral level as anticipated by financial prices. Thus, it is likely that in the coming days we will see downward corrections in the yield curve.

Announced expense contraction is unprecedented in recent history



Note: 2021 is a Santander estimate
Source: Dipres and Santander

The Government projects that the effective deficit could reduce to 2.8% of GDP



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However, this year's experience makes it clear that in the face of a worsening of the health situation, the authorities could push extraordinary measures –such as the universal IFE–, which in 2022 becomes more relevant considering that it will be the first year of a new administration. Thus, although the Government's proposal goes in the right direction to channel fiscal policy on a sustainable path, while the pandemic is latent, it is not possible to rule out higher expenditures than budgeted. A key difference, however, is that the ability to finance extraordinary expenses with resources from sovereign wealth funds is practically non-existent (the Economic and Social Stabilization Fund (FEES) went from having more than US $ 14,000 million in the third quarter of 2019 to a current balance close to US $ 2.5 billion), so seeking to go beyond the budget will require new authorizations from Congress.

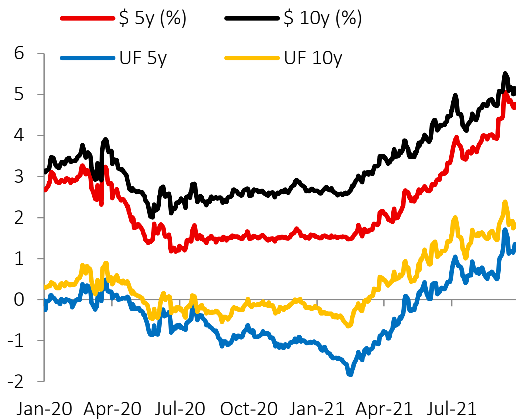
Local markets show losses again

After a week with lots of news and high international volatility, local assets showed significant falls. The main index of the local stock market moved again below 4,400 points, accumulating a weekly fall of 2%. This was influenced by the collapse of global stock markets and the announcement by the Government of the reduction of various tax exemptions to finance the draft of the short pension law, including the payment of taxes for capital gains in the stock market.

The exchange rate closed around $ 790, with a new depreciation (1% in the week). This, after the correction in the price of copper derived in part by the difficulties of the real estate giant Evergrande in China and by the strengthening of the dollar at the international level in reaction to the announcements of the Fed.

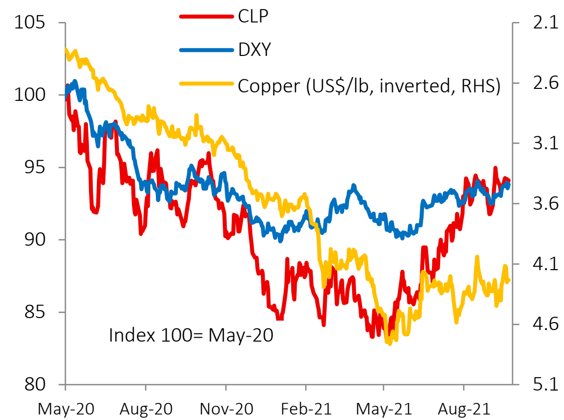
Local interest rates that had accumulated significant falls until the middle of the week (-10 bp) have risen again most recently, with the 10-year BTP closing at 5.2%, in line with the rise in international rates and the uncertainty associated with the parliamentary discussion regarding the fourth withdrawal of pension funds. Meanwhile, swap rates show new increases of three to four bp, which does not seem to yet incorporate the impact of the scenario of greater fiscal adjustment, according to the announcement of the Budget Law by the Government.

Long term interest rates increase in-line with international rates



Source: Bloomberg and Santander

Exchange rate depreciates due to strengthening of Dólar globally



Source: Bloomberg and Santander

Fed anticipates start of tapering in November and global markets turn their attention to financial situation in China

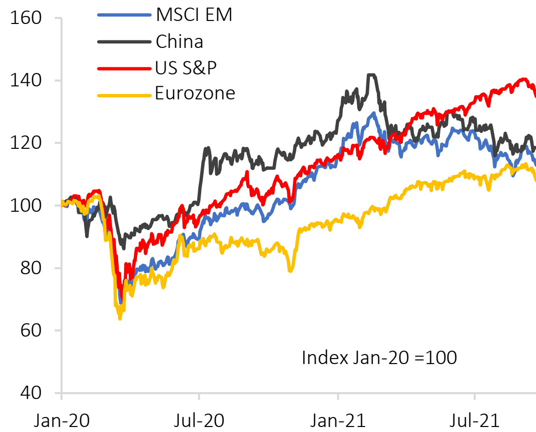
During the week, the main news were the signals that central banks gave -especially in the United States and England- to advance the start of the withdrawal of stimuli given the advance of the economic recovery but, above all, in a context of high inflationary pressures, which led long-term rates to rise significantly (+10 bp on average). In the case of the Fed, at the press conference, Powell pointed out that the moderation in asset purchases could begin as early as November and continue until mid-2022, at which point it is warned that monetary normalization could begin (previously expected in 2023). Now, nine of 18 Committee members point to an increase in the rate over the next year (vs. seven at the June meeting). Given the increase in Covid-19 infections and the possible slowdown in economic reactivation, they forecast less GDP growth in 2021 (correction from 7.0% to 5.9%) and more unemployment (from 4.5% to 4,8%). They also anticipate higher inflation this year (4.2% vs. 3.4% previously), remaining above 2.0% until 2024. The latter highlights the still latent concern that inflationary shocks will have a more permanent effect than expected.

China also became the focus of attention in international markets, given the possibility of bankruptcy of one of its largest and most indebted real estate companies -Evergrande, with liabilities of more than US $ 300 billion- which defaulted yesterday on the payment related to a bond in dollars for US $ 83.5 million, thus initiating a grace period of 30 days before the default. The Chinese authorities, so far, have only supported market liquidity, but there are no signs of a direct bailout yet, so the risks of bankruptcy and the impact on global financial markets are assessed. At the time of this report, no statements from the company were known. Additionally, the People's Bank of China declared virtual currency transactions illegal financial activity, adding volatility to the market.

In this context, the main stock market indices closed the week with mixed movements, eliminating part of the week's gains (MSCI Emerging: -0.5%; USA: + 0.2%; Euro Zone: +0.8 %; China: -0.1%) and with a rebound in risk aversion (VIX: once again above 20 points). For its part, the price of copper fell slightly and remained around US $ 4.2 per pound, while WTI oil continued with an upward trend (+

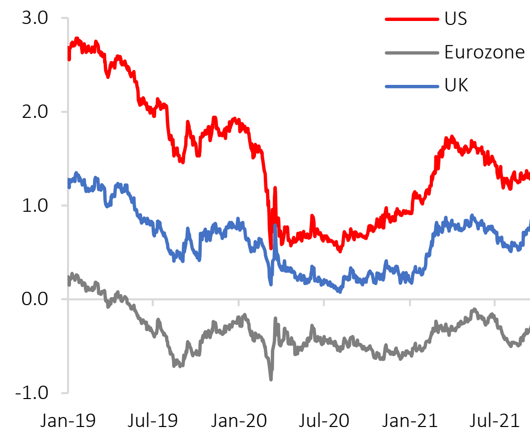
2%; US $ 73.4 a barrel), with the Global dollar strengthening slightly compared to the close of the previous week (DXY: -0.2%).

Advances made by exchange indexes reduce at the close of the week due to the debt crisis in China



Source: Bloomberg and Santander

Long term rates increase strongly due to hawkish signals of Central Banks



Source: Bloomberg and Santander