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ECONOMICS – Forecast Changes

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Brazil Under a New Administration

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- **A new set of economic policies is likely to be applied in Brazil in the next few months, with particular emphasis on fiscal adjustment and the addition of market-friendly names to the policymaking team. Moreover, we think government support in Congress is set to substantially improve.**
- **If implemented, these policies, in our view, could result in a widespread recovery in confidence — among market participants, business, and consumers — in the short term.**
- **We believe fiscal measures compatible with a fiscal adjustment of 3% of GDP in 2017-18 will be announced, increasing substantially the likelihood of stabilization of the debt/GDP ratio after the 2018 elections.**
- **Such a stabilization of the debt/GDP ratio would lead to a cycle of relative optimism and gains for Brazilian assets, in our view. We think Brazil's five-year CDS spread could converge to around 275 bps, with the BRL/USD exchange rate possibly trading at 3.20 at some point in 3Q16.**
- **A scenario of falling inflation together with short-term fiscal consolidation could help to anchor expectations and leave space for more aggressive cuts in the policy rate. As a result, we are changing our forecast for the Selic by the end of 2017 from 11.5% to 10% p.a.**
- **We think a virtuous cycle of confidence, falling risk premiums and interest rates could lead to a faster and stronger GDP recovery. We are changing our forecast for GDP growth in 2017 from 1.2% to 2.0%, well above current consensus (0.5%).**
- **In this report, we explore what we deem as important economic measures expected for Brazil, as well as the likelihood of their implementation, the potential for obtaining Congressional support, likely impact on market consensus forecasts, and the main challenges/risks for a more upbeat outlook for the country.**

I. Introduction/Conclusion

Brazil's Senate has just decided to move forward with an impeachment process against President Rousseff. Therefore, she will have to step aside, for a maximum period of 180 days, while tried in the Upper House. Mr. Michel Temer, Vice President until early May 2016, will assume the role of Acting President for up to six months during the trial and would finish the term through the end of 2018 if President Rousseff is convicted.

In this piece, we address the main set of policies we expect to be carried out, based on previous statements and already disclosed plans of the new Acting President and main macroeconomic policymakers. We also analyze the implications in terms of our macroeconomic scenario.

In our view, a market friendly set of policies will probably be applied with particular emphasis on the fiscal adjustment. This will likely trigger a virtuous cycle, in which lower risk premiums and a stronger BRL will help to anchor inflation and restore economic growth, at a faster and more intense pace than previously expected.

We are changing our forecast according to the following table.

	2015	2016f	2017f
GDP Growth (constant prices, % y/y)	-3.8%	-3.7%	~~1.2%~~ 2.0%
Exchange rate (eop BRL /USD)	3.90	~~4.10~~ 3.65	~~4.20~~ 3.95
Inflation (IPCA, % y/y)	10.7%	7.0%	~~6.0%~~ 5.2%
Base rate (Selic, % p.a., eop)	14.25%	~~13.0%~~ 12.75%	~~11.5%~~ 10.0%

Source: Santander.

II. <u>General Policy Orientation</u>

We believe economic policy will lean toward a much more market-friendly approach in coming months. This view is based on, not only previous statements, publications and actions of policymakers just assigned by the Acting President, but also by a document recently released in the name of Mr. Temer himself. By the end of October 2015, then Vice President Michel Temer presented proposals for economic growth, titled "Uma Ponte para o Futuro" ("A Bridge to the Future"). The text was drafted by a foundation linked to PMDB and was read as a wish list for markets and investors, with proposals to liberalize industrial relations and reform pensions and government spending (available only in Portuguese: http://pmdb.org.br/wp-content/uploads/2015/10/RELEASE-TEMER_A4-28.10.15-Online.pdf).

In our view, the most important policy guidelines will be the following:

1. <u>Economics—Short Term: Confidence shock</u>

- We expect fiscal initiatives to return debt/GDP to a sustainable path. In our view, this would include short- and long-term measures that would lead to additional reduction of risk premiums.
- Monetary policy: We think the government will take steps to improve credibility and autonomy. We anticipate a discussion of institutional independence that would help to re-anchor inflation expectations. FX appreciation may leave room for deeper cuts in the Selic rate, in our view.
- A stronger growth recovery could follow: lower interest rates combined with increased business and consumer confidence can be powerful triggers, in our view.

2. <u>Social Policy: from universalization to targeting</u>

- We expect social programs targeting the poorest 40% of the population to be prioritized, instead of policies of widespread distribution of benefits. This would reduce spending without damage to the lower-income population.
- *Bolsa Família* (conditional cash transfer program): We expect the government to improve identification/targeting, eliminating fraud and inclusion errors. Expected target: savings of 15% (BRL2 billion).
- We expect a similar treatment of childcare, vocational education (Pronatec), and college funding (FIES) policies. Stricter rules to reduce inefficiencies and avoid fraud should be enforced.
- We might see zero-based budgeting and continuous evaluation of social programs.

3. <u>Foreign policy: reinserting Brazil in world trade</u>: Among these changes, we expect negotiation of bilateral treaties, with less importance accorded to Mercosur.

III. <u>Politics: relationship with Congress.</u>

We are optimistic not only about policymaker's willingness to conduct a fiscal adjustment and some reforms, but also on the ability of politicians to make it happen in Congress. The new political coalition may encompass previous "centrists" parties, which has been supporting PT and previous opposition, potentially leading to support from 75% of representatives both in the Lower House and in the Senate. Moreover, Acting President Michel Temer and his closest allies, Eliseu Padilha and Romero Jucá, are well known for their strong negotiating skills in Congress.

However, we see meaningful threats to the benign political scenario down the road, particularly related to Congress's agenda in 2016, which may pose difficulties to the appreciation of adjustment measures and reforms. At first, the Senate will be almost fully focused on the impeachment process, while the Lower House will be choosing its new spokesman, as the previous one was set aside by the Supreme Court. Moreover, recess is scheduled for July and municipal elections in October may blur the discussion of fiscal measures.

	Lower House		Senate	
PT Allies	PT	58	12	PT
	PDT	20	4	PDT
	PCdoB	13	1	PCdoB
"Centrists"	PMDB	69	18	PMDB
	PTB	19	3	PTB
	PSD	32	3	PSD
	PR	40	4	PR
	PP	48	6	PP
	PRB	22	1	PRB
Opposition	PSDB	48	11	PSDB
	PSB	31	7	PSB
	DEM	28	4	DEM
	SD	14		SD
	PPS	9	1	PPS
	PSC	12	1	PSC
	PTN	13		
Independents	PV	6	1	PV
	Outros	20	3	Outros
	PSOL	6		PSOL
	Rede	5	1	Rede
Total:		513	81	
Constitutional Amendment		308	49	

321 52

385 59

Sources: Santander simulation based on Congress data.

IV. Short-Term Fiscal Adjustment (for further details, please see the Appendix at the end of this report)

We expect urgent fiscal measures to be announced, aimed at adjusting the primary surplus by 2 to 3 p.p. of the GDP in 2017-18, being 2/3 in additional taxation and 1/3 in spending cuts. The following table summarizes some possibilities.

Short-Term Fiscal Adjustment, Main Expected Measures

Measure	Impact (% GDP)	Instrument	Probability
1. Tax revenue	**2.0%**		
1.1) Income tax	0.1%	Supplementary Law	High
1.2) Tax on dividends	0.6%	Supplementary Law	High
1.3) PIS / Cofins (taxes for social security financing)	0.5%	Constitutional Amendment	High
1.4) CIDE (tax on fuels)	0.2%	Presidential Decree	High
1.5) IOF (tax on financial transactions)	0.1%	Presidential Decree	High
1.6) Reversal of tax cuts	0.4%	Supplementary Law	High
1.7) Concessions	0.1%	Presidential Decree	High
1.8) Tax on interest over equity (18%)	~~0.4%~~	Supplementary Law	Low
1.9) CPMF (0.38% tax on financial transactions)	~~1.5%~~	Constitutional Amendment	Low
2. Spending cuts	**1.0%**		
2.1) Removing revenue earmarks	0.3%	Constitutional Amendment	High
2.2) Wage freeze for government employees	0.5%	Presidential Decree	High
2.3) Discretionary spending (investments)	0.2%	Presidential Decree	High
2.4) Zero-base budgeting	Unknown	Supplementary Law	Low
2.5) Removing indexation of social programs	Negligible	Ordinary Law	High
2.6) Removing indexation of the minimum wage	Negligible	Ordinary Law	Low
2.7) Reduction in the number of ministries	0%	MP	High

Source: Santander.

V. Medium-Long Term Initiatives and Reforms

Apart from urgent adjustment measures, we expect initiatives to show commitment with the stabilization of debt to GDP ratios in a medium to long-term horizon, to be announced still in 2016. The following is a list of potential initiatives, their fiscal impact and our assessment of the likelihood of implementation.

1. Social security reform

- **Expected broad terms of the proposal:** We believe the proposal will include a minimum retirement wage for private sector workers (under the General Regime of Social Security) or lengthening the years of contribution required for retirement, with transition rules; gradual increase of inactive public sector workers' contribution from 11% to 14%.
- **Fiscal impact:** We project an impact between 1% and 2% of GDP in 15 years and between 2.5% and 4.5% of GDP in 25 years, according to the table below.

Funding Gap of the General Regime of Social Security – % of GDP

	2015	2030	2040
Current regime	**1.5%**	**3.0%**	**5.0%**
Modest reforms	**1.5%**	**1.9%**	**2.8%**
Broad reform (60 years minimum wage for male/female, rural/urban)	**1.5%**	**0.7%**	**0.6%**

Source: Santander.

- **Instrument:** Constitutional Amendment (3/5 of representatives in two voting rounds, in both Houses).
- **Probability:** We see a high probability of modest reforms being introduced through 2017.

2. Spending growth ceiling:

- **Expected broad terms of the proposal:** We believe the proposal will include automatic spending cuts (restrictions on hiring and wage raises, discretionary spending, minimum wage correction, etc.) triggered when the spending growth ceiling is reached.
- **Fiscal impact:** The main impact we expect is greater budget flexibility, which can be critical when fiscal adjustment is needed.
- **Instrument:** Constitutional Amendment (3/5 of representatives in two voting rounds, in both Houses).
- **Probability:** Moderate, most likely in 2017, in our view.

3. Unifying ICMS (state consumption tax) legal framework:

- **Expected broad terms of the proposal:** We believe the proposal currently being studied in Congress would unify the legal framework and significantly reduce the number of different tax rates for the same product, depending on the state.
- **Fiscal impact:** May be negative for some states, in our opinion.
- **Instrument:** Senate bill (simple majority in a single round, only in the Senate) and presidential decrees (simple majority in a single round, in both houses), setting up compensation accounts for the states.
- **Probability:** Can only be approved if bundled with the state debt renegotiation (see below).

4. **State debt renegotiation (and financial relief):**

- **Expected broad terms of the proposal:** We believe the proposal would include a two-year grace period (interruption in interest and amortization payments). We believe it is important to require from the states (i) a commitment to improve fiscal management over the medium and long term; (ii) approval of fiscal responsibility laws at the state level; (iii) raising social security contributions from inactive workers; (iv) privatization of public companies; (v) limits to payroll spending; (vi) closing loopholes for hiring third-part providers to avoid spending limits; and (vii) support of the ICMS reform (see above).
- **Fiscal impact**: -0.6% per year in the primary balance, according to our projections. No immediate impact on the outstanding debt stock, in our opinion.
- **Probability:** High, in our view.

VI. Measures to improve business environment and macroeconomic stability

Other measures that could also be addressed, in order to improve the business environment and help to boost confidence and economic growth are listed below:

1. Privatizations, concessions, and public-private partnerships (PPPs)

- **Expected broad terms of the proposal:** We believe the proposal will include unlocking concessions for ports and airports already planned, with expected investments of BRL30 billion, according to our forecast; we also anticipate the creation of a government agency linked to the presidency and improvements in regulation, with professional management of the regulatory agencies.
- **Fiscal impact:** We estimate the proposal could double annual revenue from concessions (BRL5 billion in 2015), generating new revenue of 0.1% of GDP.
- **Probability:** High, in our view.

2. Oil sector—changes in the model of production-sharing agreements:

- **Expected broad terms of the proposal**: We believe the proposal will include resumption of the concession model and a review of the requirement for national suppliers.
- **Fiscal impact:** We estimate the proposal could double annual revenue from concessions (BRL5 billion in 2015), generating new revenue of 0.1% of GDP.
- **Instrument**: Supplementary Law.
- **Probability:** High, in our view.

3. Central Bank formal autonomy:

- **Expected broad terms of the proposal:** We expect the proposal to include a fixed term for the Central Bank governor and members of the board, mismatched with the presidential term.
- **Instrument**: Supplementary Law.
- **Probability:** Moderate, in our opinion.

4. BNDES:

- **Expected broad terms of the proposal:** We believe the proposal will include a reduction in subsidies (tightening the spread between TJLP and Selic) and redirecting the banks' operations, focusing on credit to long-term investment enterprises (a shift from the current emphasis on working capital and retail financing).

- **Fiscal impact:** We forecast no impact on the primary balance, but we believe the proposal could improve the nominal balance and public debt dynamics — a 100-bp compression in the TJLP-Selic spread (currently at almost 700 bps) diminishes the nominal deficit by BRL5 billion and reduces the implied interest over public debt, according to our estimates.
- **Probability:** High, in our view.

5. Labor law reforms:

- **Expected broad terms of the proposal**: We expect the proposal to include changes in the current Consolidated Labor Laws (CLT), allowing free bargaining between employers and employees to prevail over the laws (similar to the German model); we also expect reform or extinction of FGTS (the compulsory savings fund for registered workers).
- **Probability:** Low, in our opinion.

VII. Expected Impact on Main Macro Variables

1. Primary balance (% of GDP)

The fiscal approach is extremely important over the short term, in our view. We believe the government should present targets that are both ambitious and realistic, making it clear how it intends to achieve them. The optimism cycle that we expect wholly depends on the credibility of this plan.

2017 Primary Result

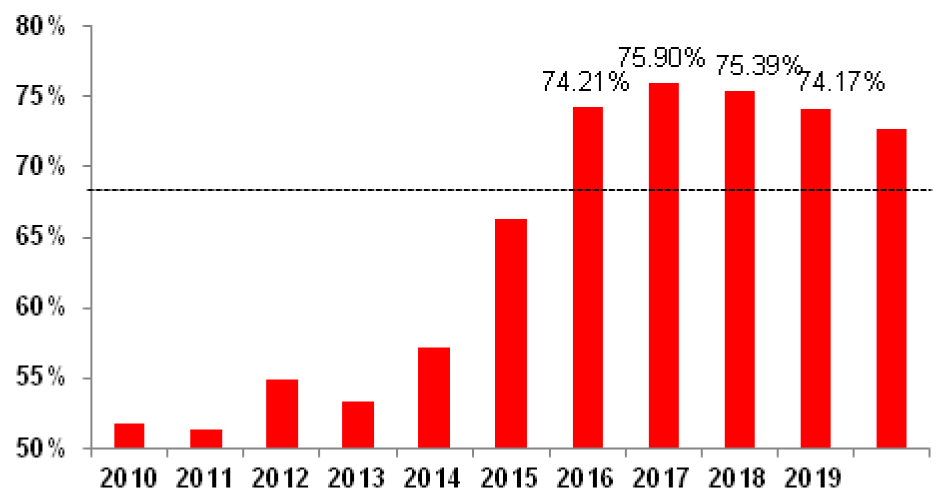
2015 Primary Surplus	(1.9)
Non Recurring revenues and expeditures	1.6
Impact of the Economic Cycle	(1.9)
Spending Growth	(0.8)
2015 Fiscal Package (remnant effect)	0.5
New Fiscal Package	0.7
2016 Primary Surplus	(1.8)
Non Recurring revenues and expeditures	0.5
Impact of the Economic Cycle	0.6
Spending Growth	0.6
New Fiscal Package	0.8
2017 Primary Surplus	0.7

Source: Santander estimates based on National Treasury Secretariat data.

2. Gross Debt (% of GDP)

We project that a significant (3 pp of GDP) primary balance adjustment in 2016-17 should reduce substantially the debt growth trajectory over the next few years. Debt/GDP stabilization will likely require further adjustments—more feasible after 2018, in our view.

Gross Public Sector Debt (% of GDP)

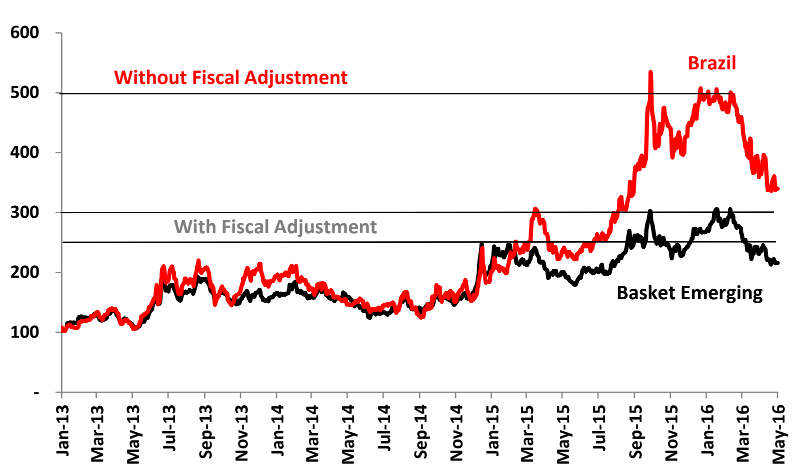


Sources: Brazilian Central Bank and Santander estimates.

3. Country Risk

The charts above show two very different dynamics for the debt path, which suggest substantial variations in what we should expect for country risk. Instead of a five-year CDS spread at 500 bps, we believe the new scenario as we outline it in this report could translate into spreads of 275-300 bps at the top of the optimism cycle, and probably above 300 bps thereafter.

Country Risk – 5-Year CDS



Basket (weighted by GDP): Bulgaria, Chile, Colombia, Hungary, Indonesia, Malaysia, Mexico, Peru, Philippines, Poland, Russia, South Africa and Turkey.

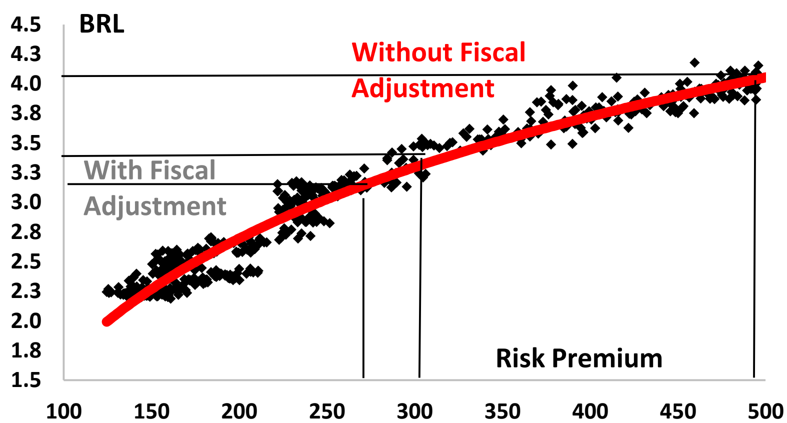
Sources: Brazil Central Bank and Santander estimates.

4. Exchange rate

A new level of country risk results, in the short term, in a more appreciated currency. According to our estimates, a simple, very short-term relationship suggests that a 250-300-bp CDS range could be associated with an exchange rate between BRL3.20/USD and BRL3.40/USD in the short term.

Our new year-end forecasts for 2016 and 2017 (respectively R$3.65/USD and R$3.95/USD) take into account, besides risk premium, other variables such as commodity prices and the U.S. dollar's value against other currencies, which tends to result in a weaker level for the BRL (than the BRL3.20/USD mentioned above).

Country Risk and BRL (Jan 2014-Apr 2016)

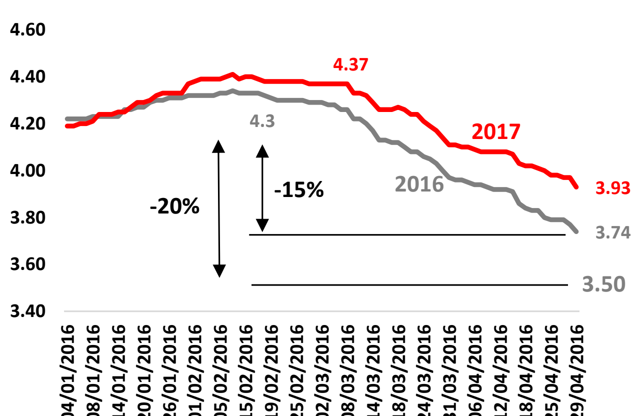


Sources: Brazil Central Bank and Bloomberg.

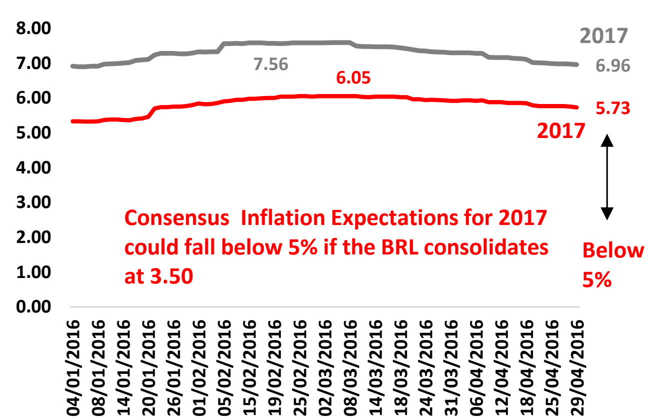
5. Inflation

Our inflation forecasts already incorporated a widening output gap stemming from the recession. This factor has been more widely incorporated in market consensus after more benign monthly inflation readings in March and April. Two factors have led to a sharper decrease of inflation in 2017 than previously expected: (i) a stronger BRL, and (ii) a faster short-term fiscal consolidation. For this reason, we are revising downward our forecast for the IPCA in 2017 from 6% to 5.2%.

Focus - Consensus Forecasts for Year End BRL / USD



Focus - Consensus Forecasts for Inflation (IPCA)

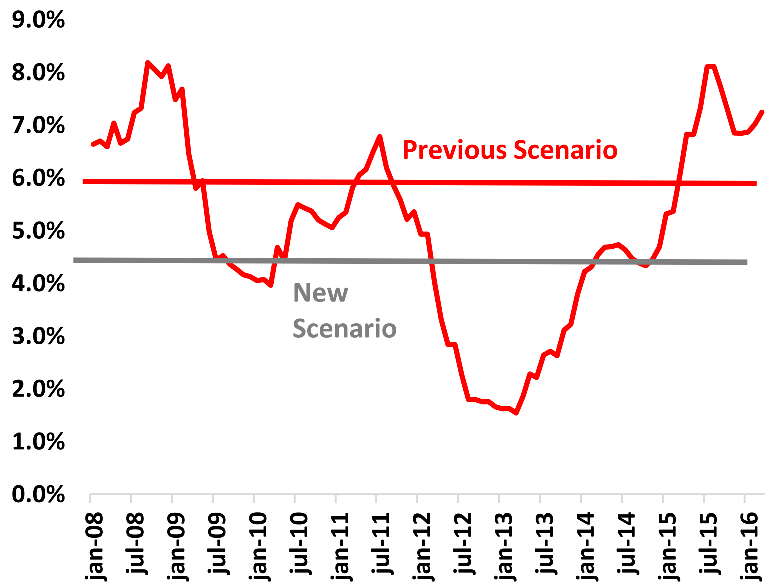


Source: Brazilian Central Bank.

6. Interest Rates (Selic)

The expected fiscal adjustment and anchored inflation could lead to a faster reduction in the real equilibrium interest rate of at least 2 pp, in our view, as a result of (i) a lower risk premium, and (ii) reduced inflation uncertainty. In the case of inflation expectations not far from 5% and real equilibrium rates around 4%-5%, we believe it would be possible to observe nominal interest rates (Selic) converging toward 10% as early as 2017.

Ex ante Selic Rate (Selic minus inflation expectations)

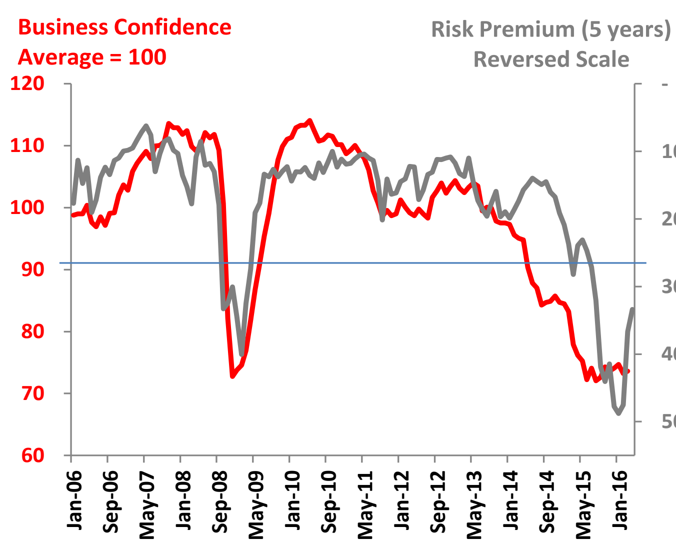


Source: Santander estimate based on Bloomberg and Central bank data.

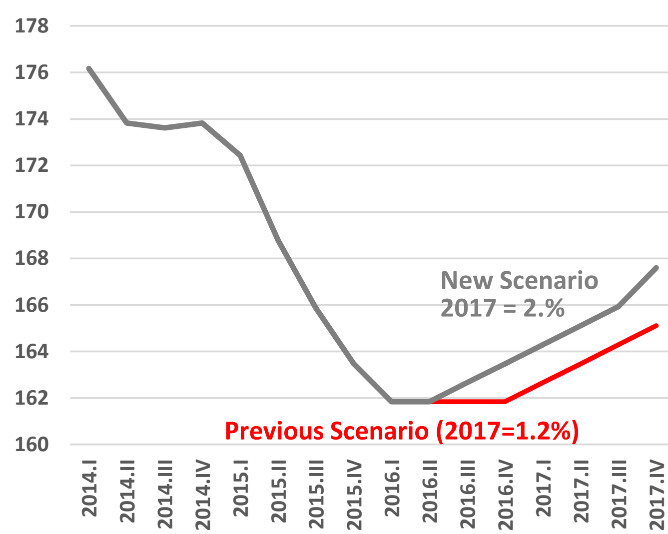
7. GDP

The optimistic cycle we expect for the markets could spill over to consumers and business people, leading to a recovery in confidence indexes and GDP.

Business Confidence and Risk Premium



GDP (1995=100)



Sources: FGV, IBGE and Santander estimates.

The stronger recovery in confidence that we expect, added to the prospect of lower interest rates, could trigger an early and more robust recovery in economic activity, in our view. However, we think ongoing deleveraging among consumers and companies, still high inventories in the construction sector, and lagged recession effects in the job market should prevent strong growth acceleration.

VIII. Risks and Challenges

1. Negative agenda in Congress

- We expect the Senate to be focused on the impeachment trials for at least three to six more months.
- The Lower House is involved in corruption investigations and is preparing for the municipal elections in October.

2. "Pauta Bomba" (measures that would increase government spending and undermine the fiscal adjustment)

- Wage increases for the judiciary of between 16% and 41% are possible, in our view. Fiscal impact of BRL1.1 billion in 2016, according to market estimates (however, the bill was vetoed by President Rousseff last year).
- Increase in *Bolsa Família* stipend, announced on May 1, 2016.
- Adjustments in income tax brackets, also announced on May 1, 2016.

3. "Car wash" investigations

- Risk of further corruption charges against additional politicians/ministers.

4. Contingent liabilities: public banks and Petrobras

- Collateralized loans to Petrobras to insure debt payments until 2019: 1% of GDP, according to our estimates.
- Writing off bad loans, provisioning, and capital injection at Caixa Econômica Federal: 0.3% of GDP, according to our estimates.

Appendix—The Fiscal Adjustment

The following measures are likely to be proposed, in our view. "Fiscal impact" is according to our projections. "Probability" is our estimate of the likelihood of passage and implementation.

1) Revenue

1.1) Income tax: 35% rate for wages above BRL 10k

Fiscal impact: Current rate is 27.5%. Additional revenue of 0.1% of GDP or a little more if deduction allowances are reduced.

Instrument: Supplementary law – simple majority (50% + 1 of representatives).

Probability: High.

1.2) Tax on dividends

Fiscal impact: 0.6% of GDP.

Instrument: Supplementary law – simple majority (50% + 1 of representatives).

Probability: High.

1.3) Unification of PIS/Cofins under a new (higher) rate

Fiscal impact: 0.8% of GDP.

Instrument: Constitutional amendment (3/5 of representatives).

Probability: Moderate in 2017.

1.4) Increase in CIDE (from BRL0.2 to BRL0.5), implying 10% higher fuel prices, according to our estimates.

Fiscal impact: 0.2% of GDP.

Instrument: Presidential decree.

Probability: High.

1.5) Increase in IOF (from 3.0% to 4.5%)

Fiscal impact: 0.1% of GDP (last year IOF rose from 1.5% to 3.0%).

Instrument: Presidential decree.

Probability: High.

1.6) Reverse tax cuts (currently amounting to 4% of GDP), including reinstating labor taxes (some sectors were spared in 2015)

Fiscal impact: 0.4% of GDP.

Instrument: Supplementary law—simple majority (50% + 1 of representatives)

Probability: High.

1.7) Tax on interest paid on equity—18% rate

Fiscal impact: 0.3% of GDP.

Instrument: Supplementary law – simple majority (50% + 1 of representatives)

Probability: Low–we expect the focus to be a tax on dividends

1.8) Privatizations, concessions, and public-private partnerships

Fiscal impact: should double revenue from concessions in 2016 and 2017 (was BRL5 billion in 2015)—0.1% of GDP.

Probability: High.

1.9) CPMF

Fiscal impact: 0.2% rate translates into 0.6% of GDP in revenue.

Instrument: Constitutional amendment (3/5 of representatives).

Probability: High.

2) Spending

2.1) Removing revenue earmarks

Following the Social Emergency Fund created in 1994 with the Real Plan—at that time, unlocked 20% of several revenue sources. Removing earmarks is not enough, in our view; mandatory spending cuts would be necessary for long-term fiscal consolidation.

Fiscal impact: 0.3% of GDP.

Instrument: Supplementary law—simple majority (50% + 1 of representatives)

Probability: High, with potential fiscal gains beginning in 2017.

2.2) Public payroll spending. wage freeze, voluntary resignation plan, reduction in direct appointments

Fiscal impact: 0.5% of GDP.

Instrument: Presidential decree.

Probability: High.

2.3) Cuts in discretionary spending

Fiscal impact: 0.2% of GDP.

Instrument: Presidential decree.

Probability: High.

2.4) Zero-base budgeting

Continuing evaluation of social programs by a special purpose agency—at the time of every budget definition, government and Congress would choose programs to continue or shut down.

Fiscal impact: unknown.

Instrument: Supplementary law—simple majority (50% + 1 of representatives).

Probability: Very low.

2.5) Remove indexation of social programs to the minimum wage

These programs include bonus wages, unemployment insurance, LOAS (Organic Law of Social Security), and Bolsa Família. The proposal would change indexation from the minimum wage to CPI inflation.

Fiscal impact: no impact in 2017, minimum wage correction will probably be below CPI.

Instrument: Supplementary law—simple majority (50% + 1 of representatives).

Probability: Low.

2.6) Change minimum wage correction rule or remove indexation from social security payments

Fiscal impact: no impact in 2017, minimum wage correction will probably be below CPI.

Instrument: Supplementary law—simple majority (50% + 1 of representatives).

Probability: Low.

2.7) Reduction in the number of cabinet positions

Fiscal impact: negligible.

Instrument: Presidential decree.

2.8) Elimination of the Bonus Wage (one additional minimum wage paid to workers gaining up a maximum of two minimum wages)

Fiscal impact: 0.3% of GDP.

Instrument: Supplementary law—simple majority (50% + 1 of representatives).

Probability: Very low.

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