Brazil Macro | February 2023

FISCAL POLICY

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Brief Overview

01

Fiscal Consolidation: Eyeing the Next Steps

- On the fiscal front, the public sector recorded the second consecutive year of primary surplus in 2022. The annual surplus reached BRL126 billion (1.3% of GDP) in December, after peaking at 2.4% of GDP. In 2021, the public sector posted a positive primary fiscal balance of BRL64.7 billion (0.7% of GDP). The Central Government reached the first positive result, after eight year in deficit, favored by temporary cyclical factors (such as the commodity price increase). Gross-debt-to-GDP ended 2022 at its lowest level since 2016, reaching 73.5% of GDP (-4.8 pp for the year).

- After a positive primary result in 2022, we continue to see a worsening budgetary outlook for 2023, considering the fiscal expansion already in the pipeline (~1.9 p.p. of GDP), and the fiscal package to mitigate the deficit. We included the use of ICMS tax credits as a permanent change (raising federal revenues in ~ BRL30 billion in 2023). In this scenario, we slightly reduced our primary deficit estimate to -1.4% of GDP for 2023 (vs. -1.5% of GDP in December and despite a greater-than-expected fiscal waiver).

- Moreover, we continue to foresee a deterioration in the nominal budget results due to heavier debt costs, implying a steeper upward trajectory for government debt in the medium term. Considering the lower level of 2022, we cut our 2023 gross debt/GDP forecast to 78.9% (from 80.2%).

- For the longer term, we continue to see a risky path toward debt stabilization, in a context of elevated pressure for social spending and natural difficulties to raise taxes (given Brazil's tax burden of 33-34% of GDP, much greater than emerging economy peers). The extended commodity cycle could temporally mitigate the increase in outlays, yet the high level of mandatory expenses continues to be a problem that needs urgent fixing, in our view.

Fiscal Consolidation on the Spotlight

Short Term: Measures and Budget Gap

- **2023 Primary Balance**: slightly improvement
  -BRL140 bn (-1.4% GDP) | Dec (e): -1.5% of GDP

  Central Gov.: -BRL145 bn (-1.4% GDP) | -R$10 bn from Dec
  Regional Gov.: +BRL5 bn (0% GDP) | No change

- **Revenues:** more uncertainty after positive results in 2021-22. Some softening is expected.

- **2023 Fiscal Waiver**: BRL170 bn (1.7% of GDP)

- **Gross Debt/GDP:** ended in 73.5% in 22 | **78.9%** in **23**
  Considering the lower level of 2022, we cut our 2023 forecast to 78.9% (from 80.2%). We do not include return of BNDES resources. Voluntary Deposits at 1.0% of GDP.

- **Fiscal rules: main issue in the short-term**
  A new rule to substitute the constitutional spending cap will probably be debated in 1H23. The signs will be important for the fiscal consolidation on revenue and expenditure sides.

Medium Term: Bumpy Road Ahead

- **Risks: Additional rise in Fiscal Stimulus**
  In a scenario with a positive output gap.

- **Unpaid Debt – Judicial Claims**
  We see R$55 bn unpaid by 2023 (not in Fiscal statistics)

- **Higher Nominal Deficit (Selic)**
  Nominal Deficit 2023: above 8.0% of GDP

- **Fiscal adjustment: ~3.0% of GDP**
  In a context of elevated pressure for social spending and natural difficulties to raise taxes

- **Debt-path: on the edge for convergence**
  ~95% of GDP in 2040. Sensitivity with macro structural variables (such as Potential GDP, Neutral Rates, Deflator)

- **Risks for debt convergence**
  Long-term: Neutral interest rate above 5.0%, Potential GDP below 1.5%. Total Expenditures above 19% of GDP.

Fiscal Policy: a return to the primary deficit in 2023

- For 2023, we see a deterioration in the budget gap, especially considering the increase in expenditures (with the welfare program totaling BRL150 bn) and a payback on revenues after several positive shocks (inflation, activity, SOE dividends and commodities prices).
- In Congress, the minimum wage should be BRL1,320 after May (included in our scenario). The increase for public servants should be close to 9%.

2023 - BRL billion	Budget Proposal (PLOA) (a)	% GDP	Santander (b)	% GDP	Δ (b) - (a)
Total Revenue	2,259	21.9%	2,334	22.7%	75
Collected by the Brazilian IRS	1,378	13.4%	1,421	13.8%	43
Net Social Security Revenues	595	5.8%	584	5.7%	-11
Not Collected by the IRS	285	2.8%	330	3.2%	44
Transfers by Revenue Sharing	453	4.4%	469	4.5%	16
Net Revenue	1,806	17.5%	1,865	18.1%	60
Total Expenditure	2,037	19.8%	2,011	19.5%	-27
Social Security Benefits	865	8.4%	877	8.5%	13
Payroll - Public Servants	368	3.6%	364	3.5%	-4
Other Mandatory Expenses	277	2.7%	247	2.4%	-29
Mandatory with Cash Control	329	3.2%	362	3.5%	33
Discretionary Expenses	199	1.9%	160	1.6%	-39
Central Gov. Budget Gap	-231.6	-2.2%	-145.2	-1.4%	86.4

Sources: Ministry of Economy, Santander.

In Congress, the current proposal estimates a BRL231 billion (2.2% of GDP) deficit for 2023. A rise in public servant`s wage of 9%. Bolsa Família outlays should be BRL150 bn. We see the budget leftovers in BRL25 billion.

2023 Proposed Fiscal Measures (BRL bn)	Official Proposal		Santander Estimate	
	BRL bn	% GDP	BRL bn	% GDP
Total Revenue Measures (IV = I+II+III)	192.7	1.9%	100.5	1.0%
Increase in the Budget Revenue Estimate (I)	36.4	0.3%	18.0	0.2%
Permanent Increase in Revenues (II)	83.3	0.8%	59.5	0.6%
Use of ICMS tax credits (PIS/Cofins tax base)	30	0.3%	30	0.3%
PIS/Cofins taxes on companies' financial revenue	4.4	0.0%	4.5	0.0%
Return of PIS/Cofins on fuels	28.9	0.3%	25.0	0.2%
Administrative Judgments ("Carf") - permanent	15	0.1%	-	-
Judicial Measure ("Denúncia espontânea")	5	0.0%	-	-
Extraordinary Revenues (III)	73.0	0.7%	23.0	0.2%
Administrative Judgments ("Carf") - one-off	35	0.3%	-	-
Judicial Measure ("Denúncia espontânea")	15	0.1%	-	-
Unused funds of PIS/Pasep	23	0.2%	23	0.2%
Expenditures Measures (V)	50	0.5%	20	0.2%
Budget 2022 IPCA update (7.2% to 5.8%)	-	-	-24	-0.2%
Contracts Review and Social Programs revision	25	0.2%	19	0.2%
Budget Leftovers	25	0.2%	25	0.2%
Total Impact (IV + V)	243	2.3%	121	1.2%

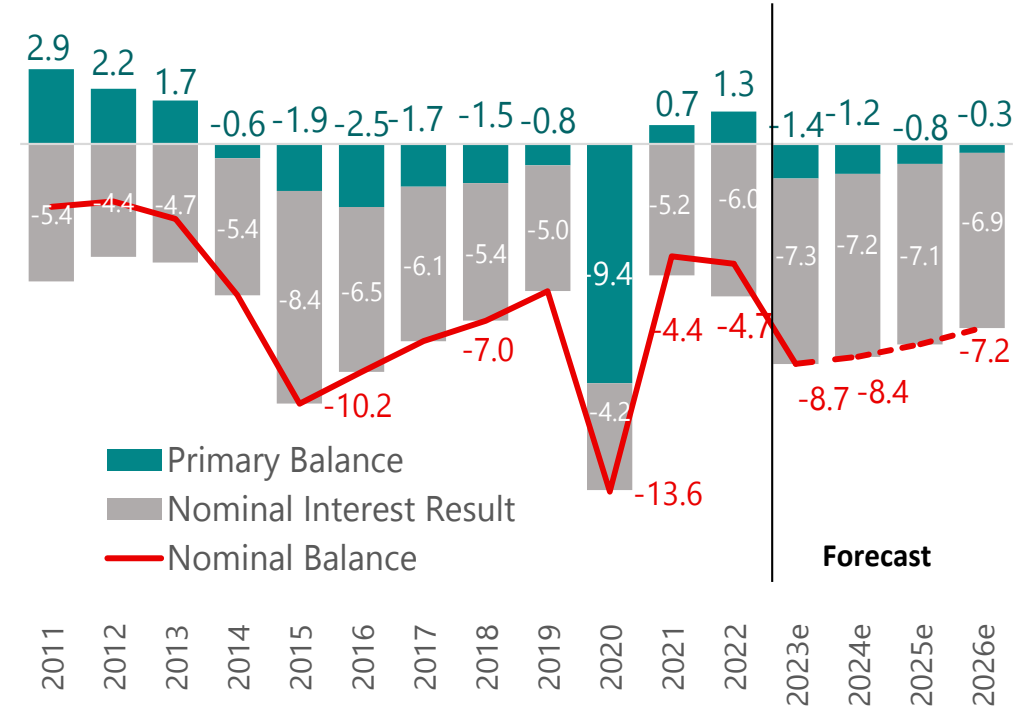
Our estimate considers our parameters and a GDP growth of 0.8% for 2023

Our Scenario included the fiscal package measures with some others estimates.

Fiscal Policy: A higher interest burden to weigh on the debt dynamics

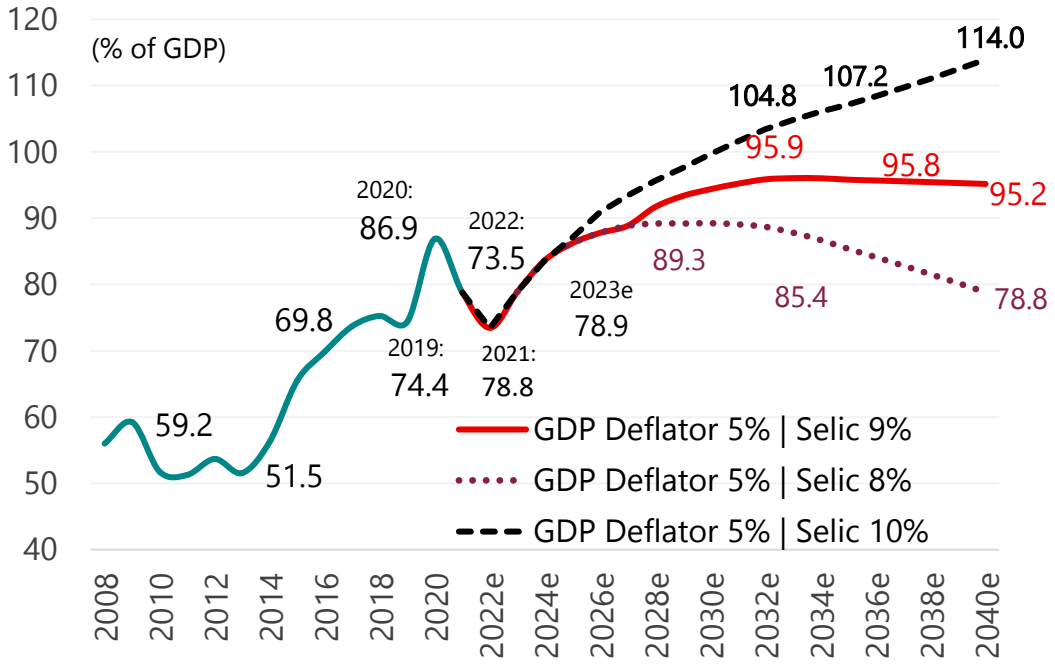
- Interest payments should continue to rise (Selic increase) with the nominal result showing strong deterioration, remaining above 8.0% of GDP in the coming years.
- We simulated scenarios for the debt trajectory: the main debate will be on the structural macroeconomic variables (GDP, Neutral Interest Rate and GDP Deflator).

Public Sector's Financing Needs (% GDP)



Sources: BCB, Santander.

Scenarios - Gross Debt Scenario (% GDP)



Sources: BCB, Santander

Fiscal Stimulus and Measures to mitigate the deficit

- For 2023, we see a deterioration in the budget gap, especially considering the increase in expenditures (with the welfare program totaling BRL150 bn) and a payback on revenues after several positive shocks (inflation, activity, SOE dividends and commodities prices).
- In Congress, the minimum wage should be BRL1,320 after May (included in our scenario). The increase for public servants should be close to 9%.

Size of Some Programs in Debate

	BRL billion	In our scenario?
Housing Program (MCMV)[1]	10	Yes
Real increase in Min. Wage (BRL1,320)[2]	8	Yes
Personnal Income Tax Break[3]	15-30	No
Desenrola Brasil[4]	20	Yes
Welfare Program (Bolsa família)[5]	150	Yes

Sources: National Congress, National Treasury, Santander.

1 MP1,162/23 launched on February 15. Already in the 2023 Budget.

2 Should be announced in May, in the budget was (BRL1,302)

3 Not defined yet. Probably will rise the tax break up to BRL2,640 (could be limited to some group of for all taxpayers). The last proposal would have a BRL7 billion impact in 2023

4 Use of Public Funds – should not have primary effect

5 Already in our scenario with total outlays of BRL150bn of a BRL175 bn budget

Measures not Included in the Budget (LOA)

	BRL billion
IPCA Budget Update (7.2% to 5.8%)*	24
Nursing Wage floor	16
Unpaid Court Ordered Debt	55
States Compensation (2022 ICMS)*	20
Law Aldir Blanc II (Culture benefit)	5
Paulo Gustavo Law (Culture benefit)	3.9
Total	124

Sources: National Congress, Santander

* The spending cap rule considered the IPCA estimate of 7.2%, the official 2022 index that should be used was 5.8%. This means that the fiscal room would be lower.

** Still under debate in the Supreme Court. Most recent negotiations are between BRL24-30 billion, yet the timing and how is going to be paid is still uncertain.

1H23 Expected Agenda

January

24

2022
Federal **Tax Collection**
8.2% YoY real growth

26

PAF 2023 – Financial Needs BRL1.5 tn
More LFT (Floating rate)
Nomination of Prates for Petrobras

27

Central Gov. Primary result (Treasury)
BRL54 bn surplus

31

Public Sector Fiscal Indicators (BCB)
Gross Debt 73.5%
Primary Surplus BRL125 bn

February

01

End of Parliamentary and STF Recess
Election for House Speakers | Lira and Pacheco reelected
Copom 13.75%

02 to 28

Nomination for the Congressional **committees**

? - June

STF – "Coisa Julgada"
FGTS correction
ICMS tax base (TUSD, TUST)

28

Ends the tax break of **PIS/Cofins** on Gasoline

End of **Bruno Serra**'s mandate on **BCB**

March

02

2022 **GDP release**
4Q22: -0.2% 2022: +2.9%

22

Copom Meeting
(e) 13.75%

1st Budget Review

30

2023 Tax Burden estimate release

? - March

Housing Program
*Desenrola Brasil (*indebtness)
Household Income tax exemption (IRPF)

April

April 15

PLDO – 2024 **Budget Guidelines Deadline**

15-20 April

IMF WEO

13 April

Supreme Court analysis of ICMS credit (Difal)

? April

STF: End São Paulo state decision to not pay the debt with Fed. Gov.

1 May

Labor Day - Minimum Wage announcements

3 May

Copom Meeting
(e) 13.75%

22 May

2nd Budget Review

May

- The government should send the new **fiscal** anchor **proposal**
- Supreme Court, **Fed Gov**. and states could debate the **Gasoline ICMS taxation** (not considered essential)
- STF – Ricardo Lewandowski retires

June

01

2023 **GDP release**
1Q23: +0.5% QoQ s.a

21

Copom Meeting
(e) 13.75%

Sources: BCB, STF, National Treasury, BCB, Santander

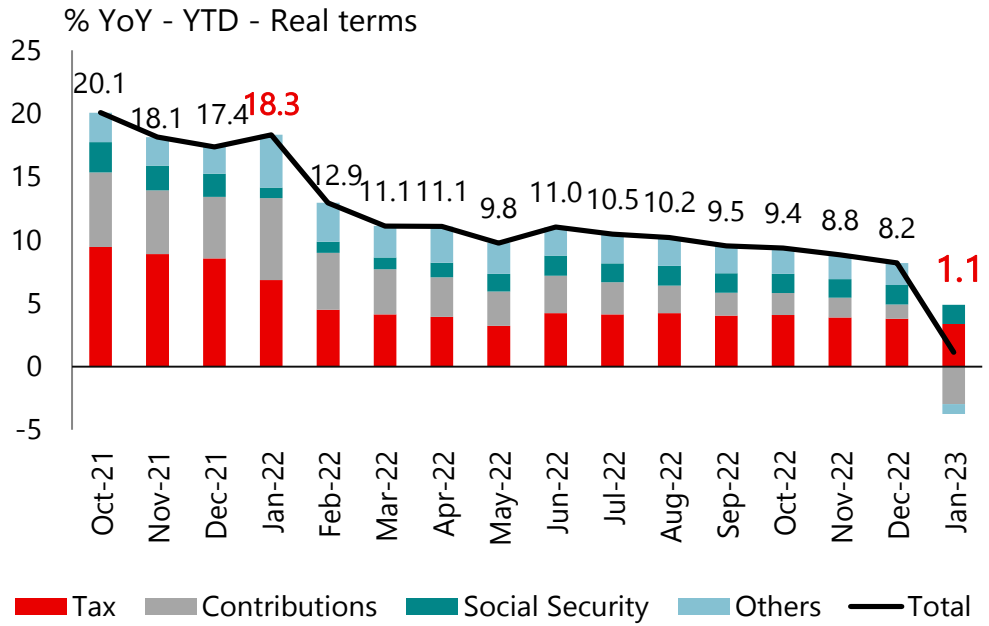
Tax Collection Performance
Two years of good results
Softening expected ahead

02

Revenues Impact – Price Effect + Activity Recovery

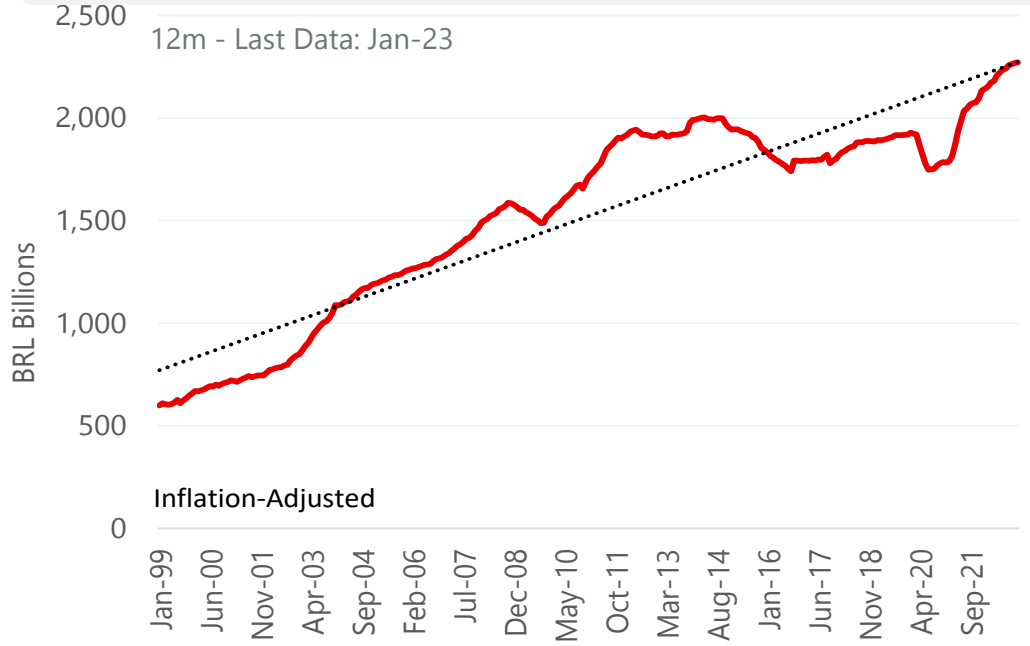
- We see a strong recovery in federal tax collection in recent months, mainly direct taxes linked to the corporate sector, which have posted good results. We can also observe that the increase in tax collection is highly correlated with sectors linked to the commodity boom, especially those related to metals & oil.
- In our view, we expect revenue growth to slow down ahead, for the following reasons: i) Greater basis for comparison; ii) commodity prices losing steam; iii) normalization of the consumption basket - with more services (lower tax collection); iv) activity at a slower pace of growth after the crisis recovery;

Federal Tax Revenue: Year-to-date (%YoY)



Sources: Brazilian IRS, Santander.

Total Federal Tax Collection –



Sources: Brazilian IRS, Santander.

Federal Tax Collection slowing down at the margin

Federal Tax Collection							
	Weight[1]	Month[2]				Year-to-date	
		Jan-22	Dec-22	Jan-23	YoY %	Jan-23	YoY %
Total	100	248,918	211,305	251,745	1.1	251,745	1.1
Taxes	**40.7**	**107,507**	**82,383**	**115,875**	**7.8**	**115,875**	**7.8**
Foreign Trade	2.6	5,663	4,703	4,921	-13.1	4,921	-13.1
Industrialized Products (IPI)	2.8	7,162	5,358	5,500	-23.2	5,500	-23.2
Income Tax	32.5	89,724	66,941	100,063	11.5	100,063	11.5
Households	2.6	2,864	3,853	2,265	-20.9	2,265	-20.9
Companies	14.4	55,271	17,322	57,931	4.8	57,931	4.8
Withholding income tax	15.5	31,589	45,767	39,867	26.2	39,867	26.2
Financial Operations (IOF)	2.7	4,908	5,206	5,347	9.0	5,347	9.0
Rural land property	0.1	50	175	44	-13.1	44	-13.1
Contributions	**27.0**	**75,806**	**46,705**	**68,416**	**-9.7**	**68,416**	**-9.7**
Social Security (COFINS)	14.0	30,113	26,557	28,661	-4.8	28,661	-4.8
Social contribution (PIS/Pasep)	3.9	8,440	7,391	8,180	-3.1	8,180	-3.1
Net profit (CSLL)	7.2	33,765	9,267	28,718	-14.9	28,718	-14.9
Other Contrib.	1.8	3,488	3,490	2,857	-18.1	2,857	-18.1
Pension	**25.2**	**44,143**	**73,775**	**47,951**	**8.6**	**47,951**	**8.6**
Others Revenue	**7.2**	**21,462**	**8,442**	**19,503**	**-9.1**	**19,503**	**-9.1**

1 - average in 12 months

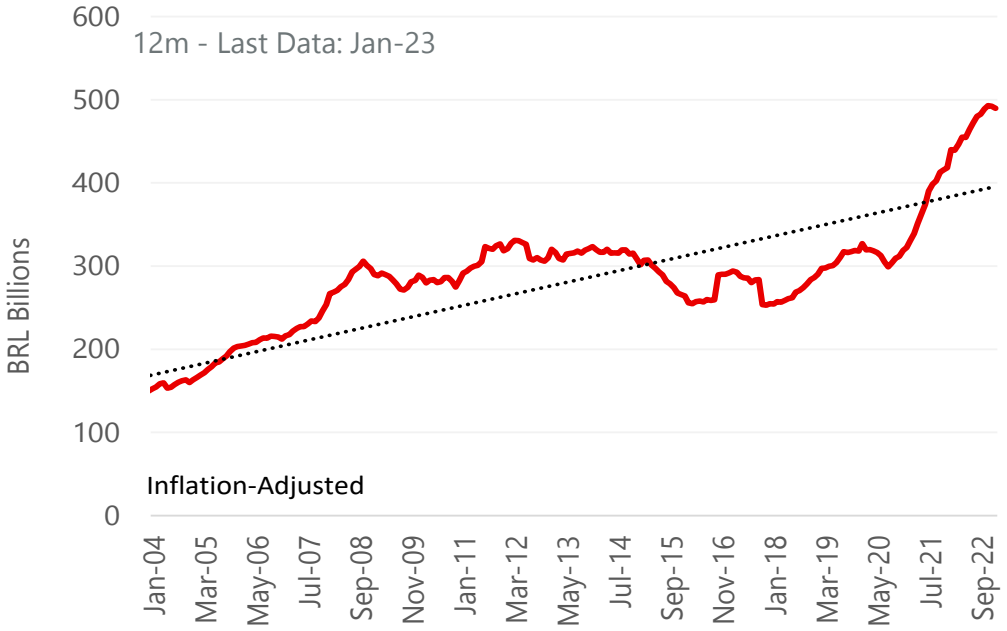
2- real terms

Source: Brazilian Revenue Service and Santander

Performance pushed by Corporate Revenues and Labor Market Recovery

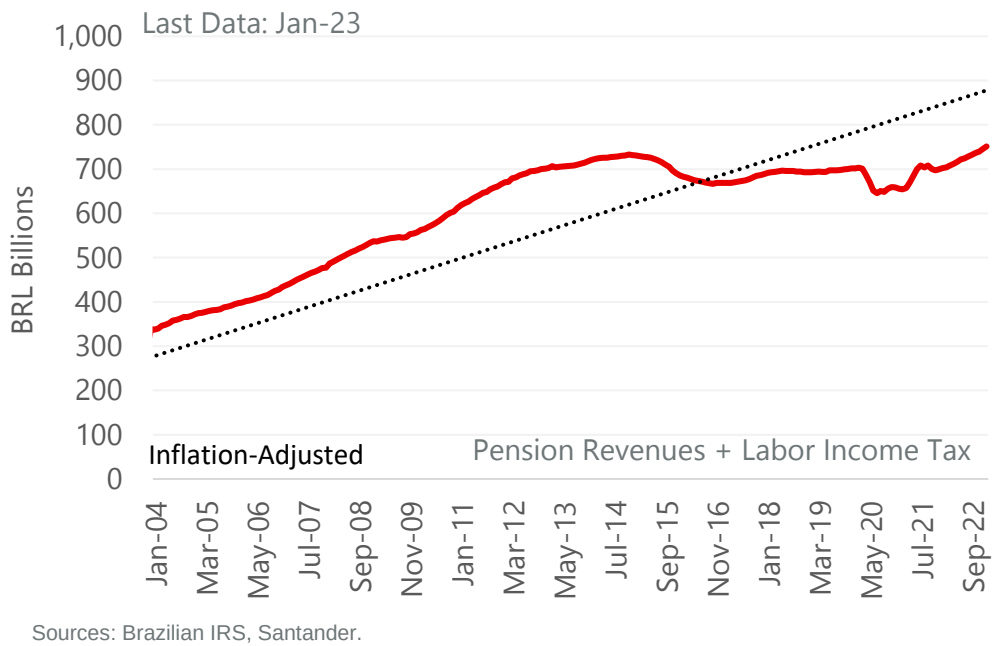
- The main contribution to the federal tax collection result was the increase in tax collection related to corporate revenues, in a context of activity recovery, years of deleveraging (reducing the costs) and the price shock. Oil proceeds also helped the result
- Labor market also showed some recovery during 2022. We envision a tight labor market until 3Q23 (we see the NAIRU stabilizing around 10%)
- Both should continue with a positive performance, yet losing steam

Federal Tax Revenue: Corporate (IRPJ/CSLL)



Sources: Brazilian IRS, Santander.

Labor-related Federal Tax Collection

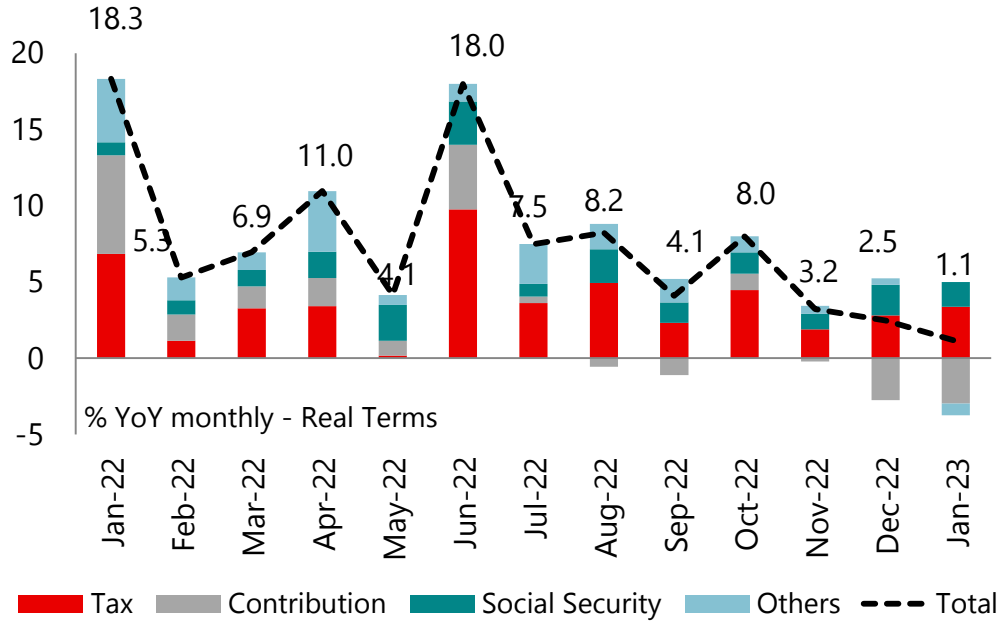


Sources: Brazilian IRS, Santander.

Now, federal tax collection is showing signs of losing steam

- In the January, Federal Tax Collection reached BRL251.7 bn, a tad lower than our forecast (BRL253.5 bn) and slightly higher than the market median (BRL250.4 bn). January's result was the first negative surprise to our forecast since Feb-22. The monthly result represents a 1.4% YoY real increase, the best value for the month since 1995. The core measure of Tax Collection (not considering extraordinary revenues) rose 9.0% YoY (considering that Jan-22 there was BRL12 bn in atypical revenues, compared to BRL3 bn this year),

Federal Tax Revenue: Monthly (%YoY)



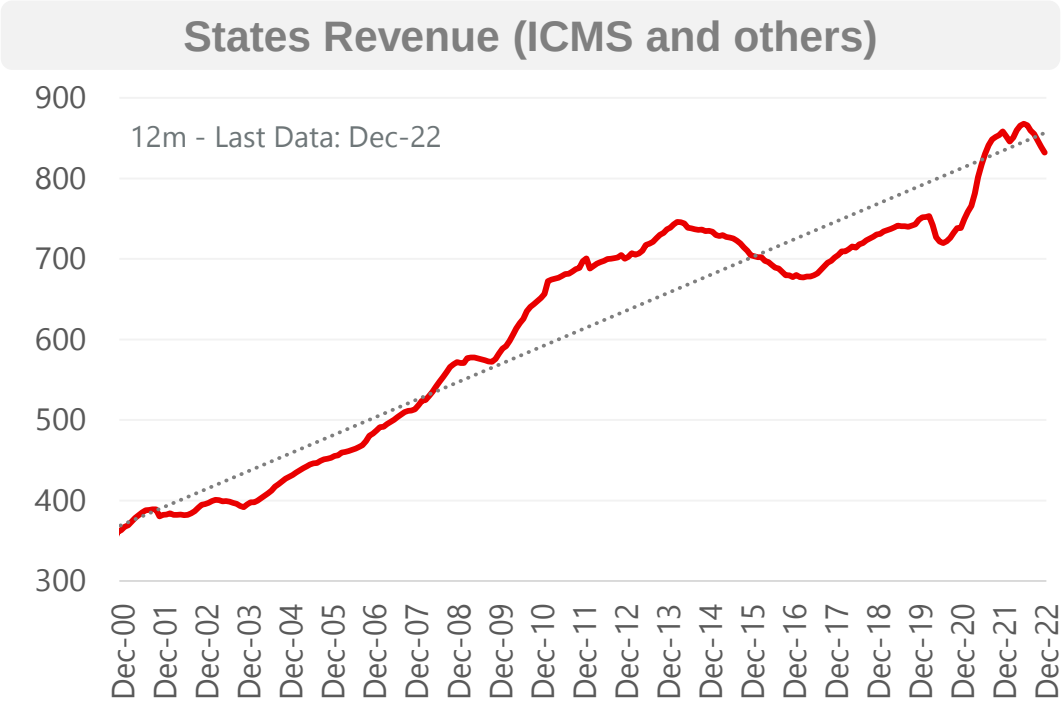
Sources: Brazilian IRS, Santander.

Federal Tax Collection

Sources: Brazilian IRS, Santander.

Regional gov. also is losing steam at the margin with the cap on ICMS

- The fiscal result of regional gov. registered a drop in revenue due to legislation that limited ICMS (VAT) tax on essential goods.
- The states revenue registered a real increase of 16% YoY in 2021. In 2022, it ended at -3.0% YoY with a -10.7% YoY in the 4Q22.



Sources: Confaz, Santander.

Fiscal Impact of Measures	2022		Full-Year	
	BRL bn	% GDP	BRL bn	% GDP
LC194 ICMS Cap (Impact)	**45**	**0.4%**	**95**	**0.9%**
1. Fuels ICMS Cap 17-18%	20	0.2%	44	0.4%
Gasoline	14	0.1%	32	0.3%
Diesel	5	0.0%	10	0.1%
Ethanol	1	0.0%	2	0.0%
2. Telecom cap	5	0.0%	11	0.1%
3. Eletricity	20	0.2%	40	0.4%
ICMS cap to 17-18%	5	0.0%	10	0.1%
Changing the ICMS base (TUSD/TUST)	15	0.1%	30	0.3%
Total Impact	**45**	**0.4%**	**95**	**0.9%**

Sources: Congress, Santander.

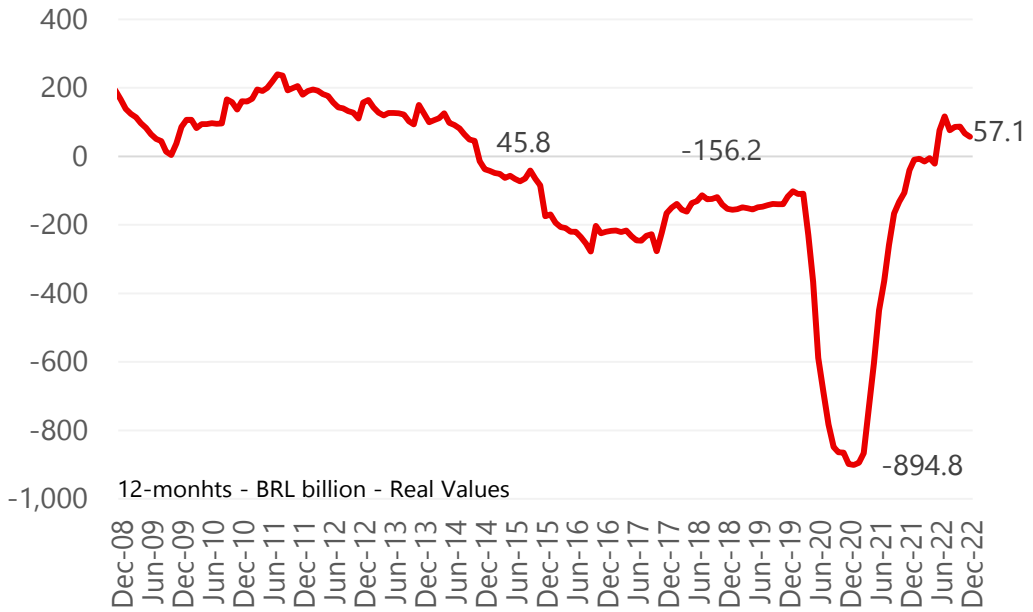
Primary Result and Debt Central Gov. and Public Sector

03

Central Gov: Fleeting Glimpse – A Surplus After Eight Years

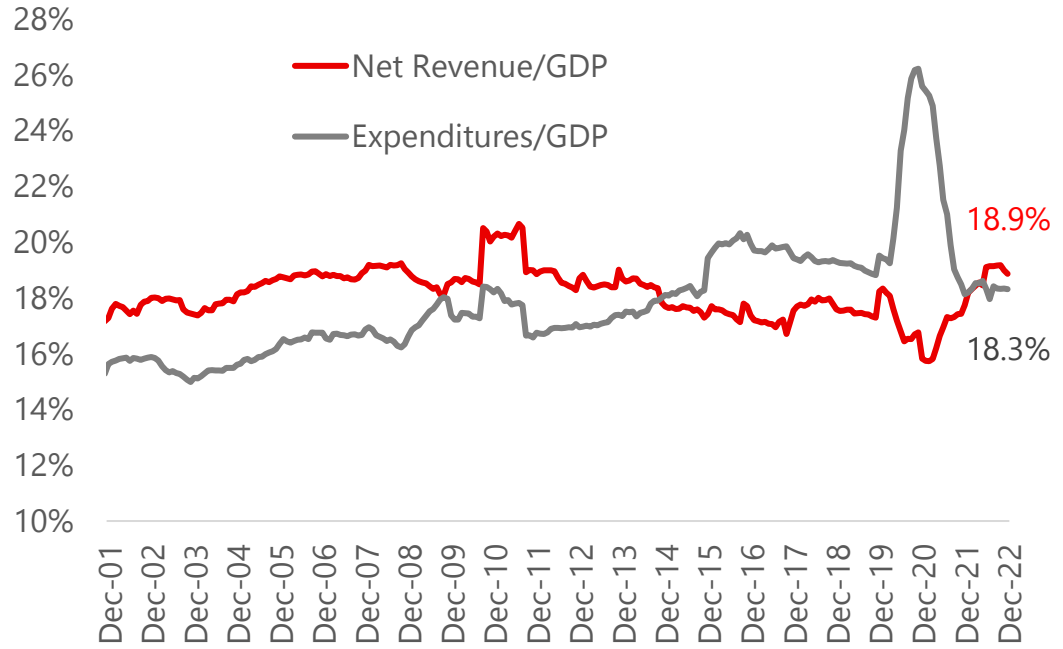
- In 2022, the Central Gov. registered a primary surplus of BRL54 bn (0.5% of GDP), compared to a deficit of BRL35 bn (-0.4% of GDP) in 2021. This was the first positive result after eight years registering primary deficits. The result was lower than our last official forecast for the year of BRL65 billion (0.7% of GDP). The main difference was on 'Net Revenues', especially with higher 'Transfers by Revenue Sharing' reducing its value.

Central Gov. Primary Balance – 12m % GDP



Sources: National Treasury, Santander.

Revenue and Expenditures (%GDP)

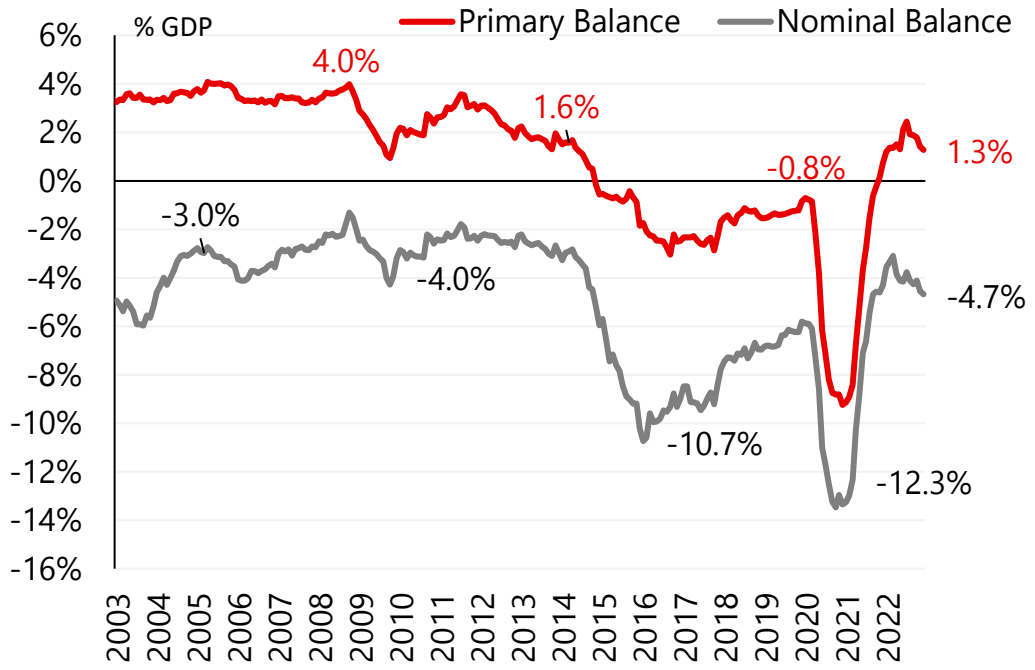


Sources: National Treasury, Santander.

Public Sector Primary Result Improving with the Price-effect

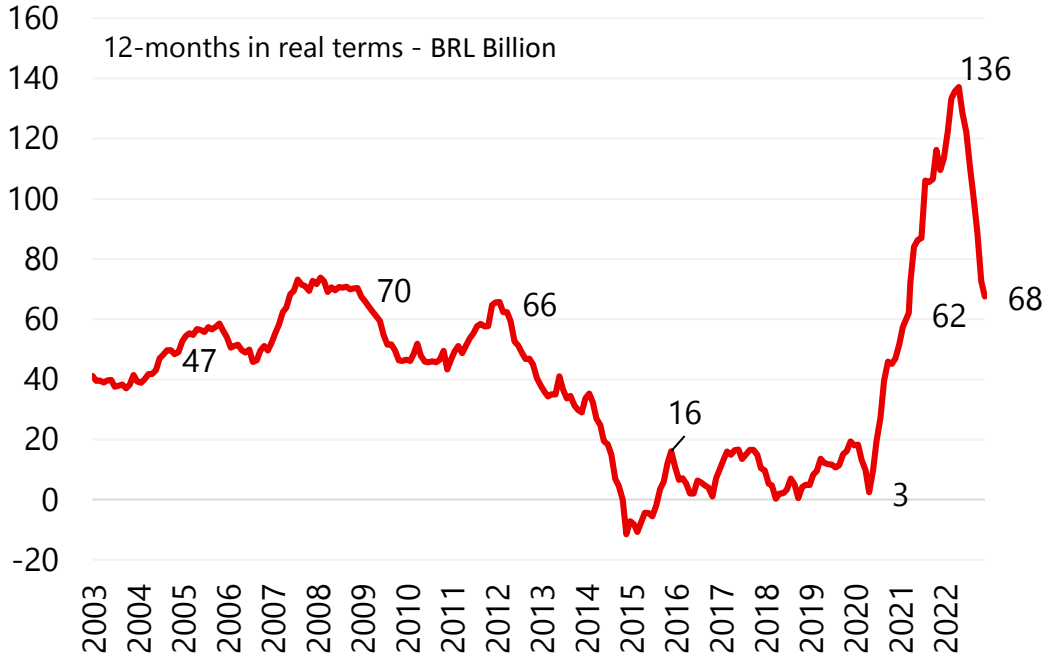
- On January, the Brazil Central Bank (BCB) released the consolidated public sector's fiscal balance for December. For the month, the public sector posted a primary deficit of BRL11.8 billion, in line with our forecast (-BRL12.1 billion). Regional governments registered a deficit of BRL18.6 billion (close to our call of BRL17.5 billion), due to the impact of reduced revenue, after legislation capped the VAT (ICMS) tax on essential goods and an unfavorable seasonal month with higher outlays. In nominal terms, the state's revenue dropped 6.8% YoY in the month.

Public Sector – 12m % GDP



Sources: Brazilian Central Bank, Santander.

Regional Gov. – Primary Result



Sources: Brazilian Central Bank, Santander.

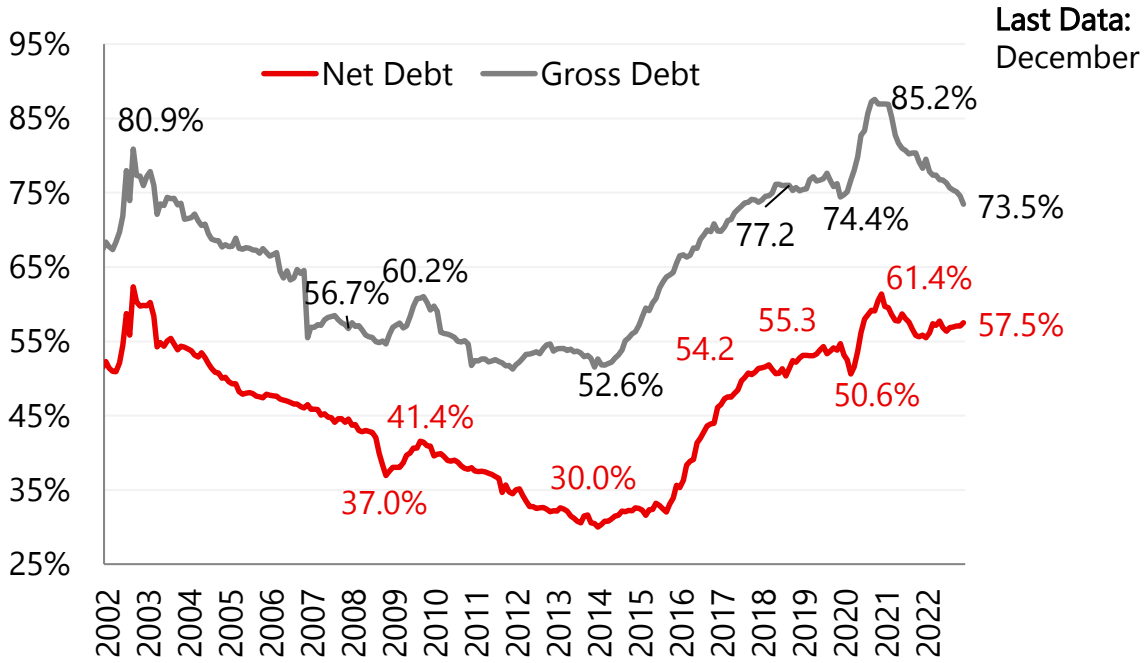
Increase in Interest Payments should pressure the debt ahead

- In 2022, the nominal result totaled -BRL460 billion (4.7% of GDP), compared to -BRL383.7 billion (4.3% of GDP) in 2021. For 2023, we expect an increase in the cost of debt, owing to the more elevated Selic rate. Thus, we expect the nominal result to reach close to 8.5% of GDP this year
- Debt registered mixed results in 2022. Gross debt fell to 73.5% of GDP (-4.8 in the year), with an increased nominal GDP (-7.5pp impact in the year). Gross debt is at its lowest level since 2016. Net debt ended the year at 57.5% of GDP (+1.7 in the year). Voluntary deposits in the BCB (not included in debt statistics) shrank 0.1pp, to 0.8% of GDP.

Nominal Interest Result – BRL billion

Sources: Brazilian Central Bank, Santander.

Public Sector Debt (12m % GDP)



Sources: Brazilian Central Bank, Santander.

Fiscal – Short-term relief with price shock, challenges ahead

Central Gov. Primary Balance																
Fiscal Items (% of GDP)	2017	2018	2019	2020	2021	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e	Δ 26-17	Δ 30-17
Total Revenue	21.0	21.3	22.1	19.3	21.7	23.5	22.7	22.8	22.8	23.0	22.8	22.7	22.6	22.5	2.0	1.5
Revenues Collected by the IRS (1)	12.7	12.9	12.8	11.8	13.4	14.1	13.8	13.7	13.7	13.8	13.7	13.6	13.5	13.4	1.1	0.7
Net Social Security Revenues (2)	5.7	5.6	5.6	5.3	5.2	5.4	5.7	5.7	5.6	5.7	5.7	5.7	5.6	5.6	0.0	-0.1
Revenues Not Collected by the IRS (3)	2.7	2.8	3.7	2.2	3.1	3.9	3.2	3.5	3.5	3.5	3.5	3.5	3.5	3.5	0.8	0.8
Transfers by Revenue Sharing	3.5	3.7	3.9	3.5	4.0	4.6	4.5	4.5	4.4	4.3	4.2	4.2	4.1	4.0	0.8	0.5
Net Revenue	17.5	17.6	18.2	15.8	17.7	18.9	18.1	18.3	18.5	18.7	18.6	18.6	18.5	18.5	1.1	0.9
Total Expenditure	19.4	19.3	19.5	25.6	18.1	18.3	19.5	19.5	19.3	19.0	18.8	18.6	18.2	18.0	-0.4	-1.5
Social Security Benefits (4)	8.5	8.4	8.5	8.7	8.0	8.1	8.5	8.6	8.6	8.6	8.5	8.5	8.4	8.4	0.1	-0.1
Payroll (5)	4.3	4.3	4.2	4.2	3.7	3.4	3.5	3.6	3.6	3.6	3.6	3.6	3.5	3.4	-0.7	-0.9
Other Mandatory Expenses (6)	3.0	2.9	2.6	9.5	3.4	3.0	2.4	2.5	2.4	2.3	2.2	2.2	2.1	2.1	-0.7	-0.9
Expenses with Cash Control (7)	1.9	2.0	1.9	1.8	1.6	2.2	3.5	3.3	3.2	3.1	3.0	2.9	2.8	2.8	1.2	0.9
Discretionary Expenses (8)	1.8	1.8	2.2	1.4	1.4	1.5	1.6	1.5	1.5	1.5	1.5	1.4	1.4	1.4	-0.3	-0.4
Central Gov. Primary Balance	-1.9	-1.7	-1.3	-9.8	-0.4	0.5	-1.4	-1.2	-0.8	-0.4	-0.2	0.0	0.3	0.5	1.5	2.4
Public Sector Primary Balance	-1.7	-1.5	-0.8	-9.4	0.7	1.3	-1.4	-1.2	-0.8	-0.3	-0.1	0.1	0.3	0.6	1.3	2.2
Nominal GDP (BRL billion)	6,585	7,004	7,389	7,610	8,899	9,836	10,301	10,819	11,530	12,288	13,096	13,957	14,875	15,853	5,703	9,268

Notes and Hypothesis

(1) Elasticity: Revenues-GDP 2021: 1.7 | 2022: 1.3 | Long-term: 1.05. We see a slowdown in extraordinary revenues from 2023 onwards. Potential GDP: 1.5%. Inflation: 4.0%, GDP deflator 5.0. (2) Faster recovery in the formal labor market and earnings (better short-term numbers), expected some softening ahead. (3) Oil revenues will increase with greater federal share in pre-salt, the reduction in prices in medium-term will be compensated with more production. 4) A permanent fiscal waiver of BRL170 billion in 2023 onwards. We assume a fiscal rule that incorporates the waiver for 2023 as a permanent shift in the constitutional spending cap, which remains indexed to IPCA inflation up to 2026 (before the new fiscal anchor proposal). Expenditures limited to ~19% of GDP (close to the level before enactment of the spending cap law). Real minimum wage increase (IPCA + average of last 5 years of GDP growth). The government will mitigate the impact of real gains in minimum wage by a tighter rule for the welfare program. Pension Reform approved in 2019 will stabilize the expenditures as % of GDP in the long-term (even with the rapid aging of the population). In the short-run we eliminate the queue (repressed by the pandemic). (5) Gradual increase in admissions (faster than the previous scenario, 70% instead of 55%) to the federal workforce ("normalization"). In the short-term (2024-25) decomposition of 80%, We included the 9% increase in 2023 and 2024, after that is decreasing gradually to 4% in Medium-term. Long-term: digitalization effects contain the increase. (6) Includes: higher payments in Court-ordered debt budget (sub-cap) – better management with a reduction in long-term, rise in federal contribution to Fundeb (Educational Fund), BPC (pension benefit). Court-ordered debts to accumulate to 1.6% of GDP by 2026, with the government negotiating future payments. (7) The main change was the increase in the welfare program (*Auxílio Brasil*). 2022 budget: BRL90 billion (from BRL35 bn of the former Bolsa Família). For 2023 onwards a more efficient and focalized welfare program with a total of BRL150 bn (gradual reduction in outlays after 2024). (8) Discretionary Expenses maintained at ~1.5% - a level that we consider enough to avoid a partial shutdown of public services, with and increase in investment with the reforms. (9) Not consider an increase in Tax exemption from 2023 onwards.

Public Debt Scenario and Simulations

04

Fiscal Accounts: Trajectories for the Brazilian Government Debt

- Public sector's primary balance (% GDP) required for the stabilization of the gross public debt-to-GDP ratio at **80%**
- We see the neutral interest rate hypothesis at 5.0%, this implies a larger primary surplus needed to stabilize the debt.
- Not considering the effects of the cyclical recovery, the long-term outlook will require a remaining 3.0p.p. of GDP primary fiscal adjustment, just to stabilize the ratio debt-to-GDP around the level of ~80% of GDP.

- **Current situation:**

. Real interest rate (ex-ante) 1-year: ~8%,
. GDP: 2.9% in 2022 and 0.8% in 2023

Liquidity reserves close to 8 months of debt maturities

Increase in debt cost (Selic + IPCA)

- **Steady-state:**

According to our hypothesis:
. Real interest rate at +5.0%
. Potential GDP at +1.5%,

. The primary surplus must reach >2% of GDP to maintain the gross debt stable.

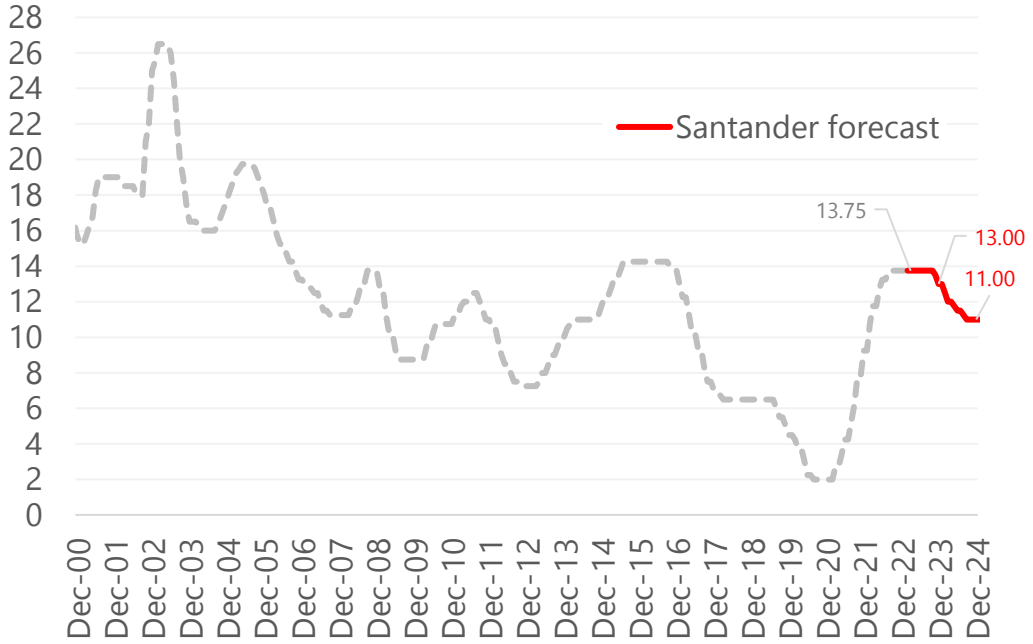
		Real Interest Rate						
		1.0%	*2.0%*	*3.0%*	*4.0%*	*5.0%*	*6.0%*	*7.0%*
GDP Growth	*0.0%*	0.8	1.6	2.4	3.2	4.0	4.8	5.6
	1.0%	0.0	0.8	1.6	2.4	3.2	4.0	4.8
	1.5%	-0.4	0.4	1.2	2.0	2.8	3.5	4.3
	1.8%	-0.6	0.2	0.9	1.7	2.5	3.3	4.1
	2.0%	-0.8	0.0	0.8	1.6	2.4	3.1	3.9
	2.5%	-1.2	-0.4	0.4	1.2	2.0	2.7	3.5

Sources: BCB, Santander.

Monetary Policy: No Change in Outlook for Now; Risks Skewed to the Upside

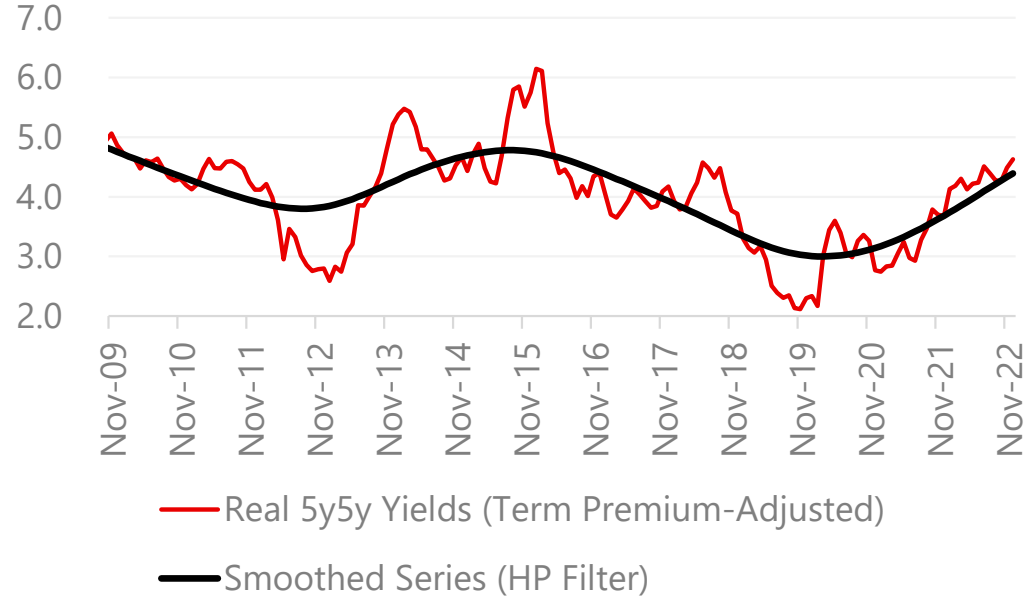
- The gap between 18-month ahead IPCA forecasts and the calendar-adjusted target remains high, running above 100bps.
- Our asset-based proxy for the neutral level of real interest rate is moving towards 5%.

Selic path Forecast



Sources: Brazilian Central Bank, Santander.

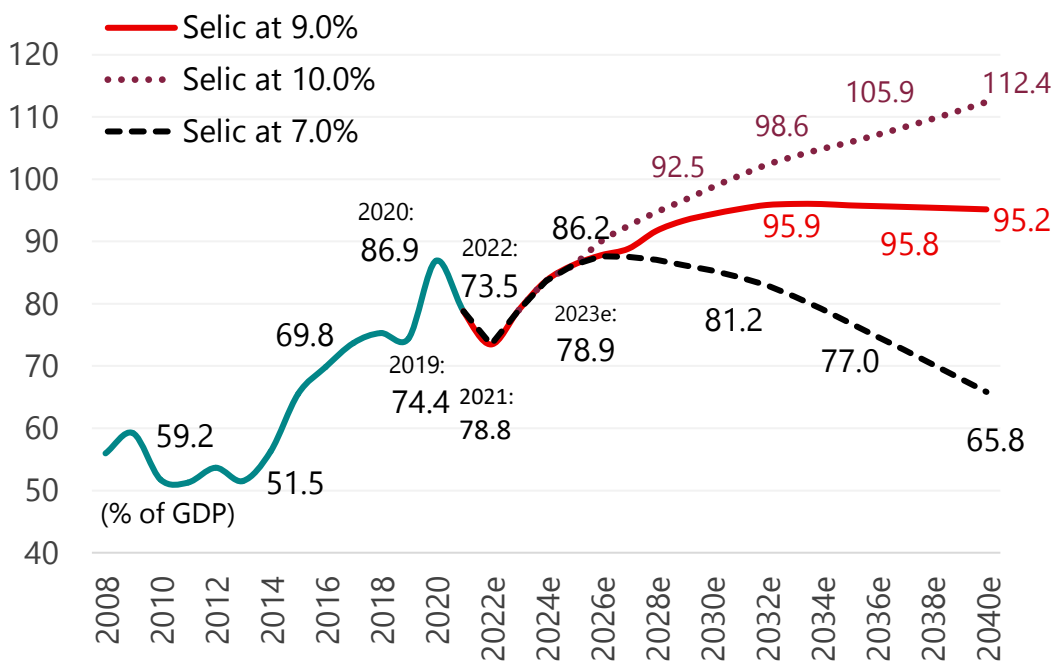
Neutral Rates Could Be Rising Further



Sources: Brazilian Central Bank, Anbima, Santander.

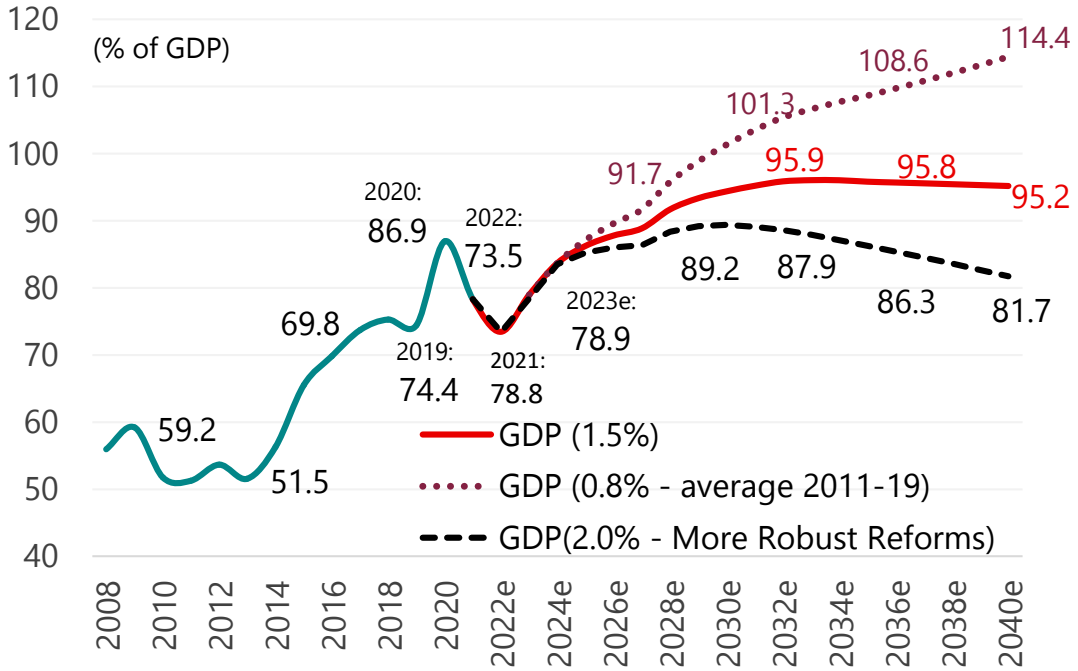
Debt Scenarios: Sensitivity to Changes in the Long Run Macro-outlook

Government Debt – Simulations for Selic Rate Hypotheses



Sources: BCB, Santander

Government Debt– Simulating for Trend GDP Hypotheses



Sources: BCB, Santander.

Notes: Debt issuances: we added a spread of + 1.0 pp in addition to the Selic rate in the models.
2023 GDP Deflator: 3.9% | GDP: 0.8% | Selic Rate (avg): 13.7% | BNDES zero | Voluntary Deposits 1.0% of GDP
2023-40: GDP deflator: 5.0% | Potential GDP: 1.5% | Neutral Selic Rate: 5.0%

Debt Management – Debt cost on the rise, liquidity reserves to navigate uncertainties

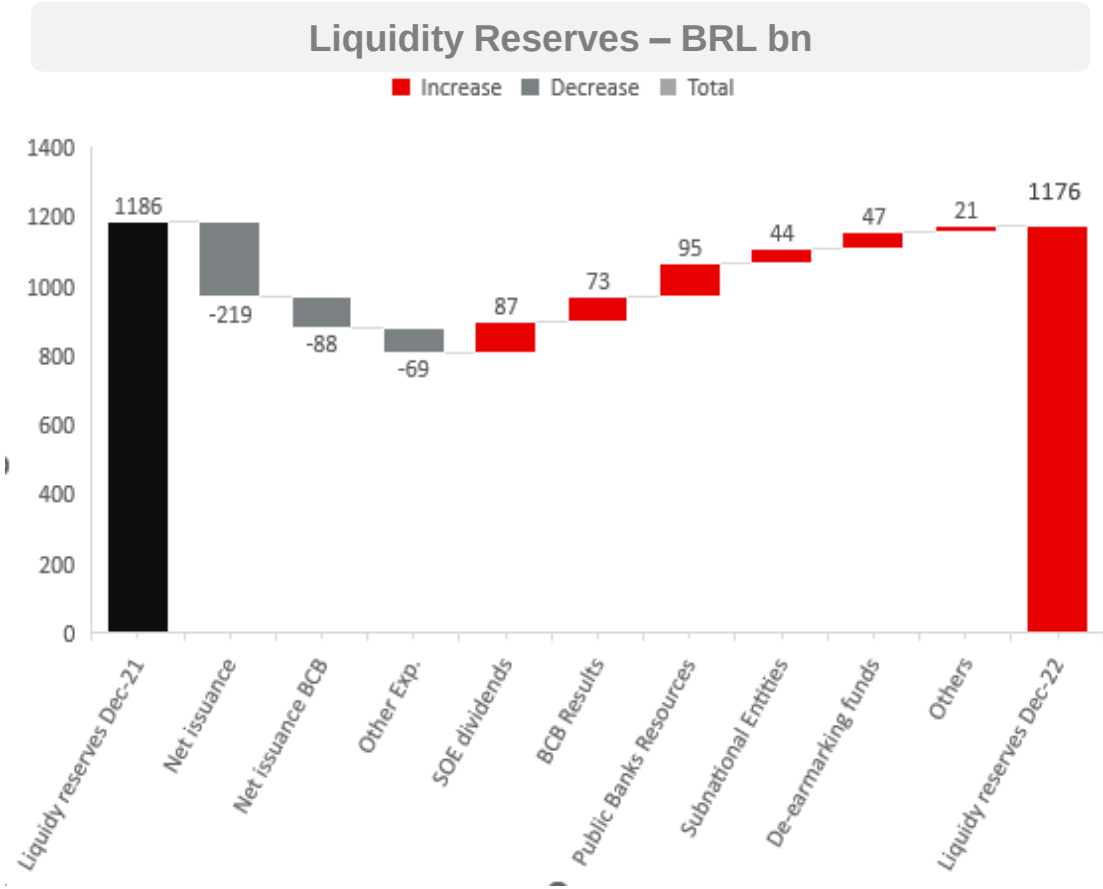
05

Annual Borrowing Plan (PAF) 2023

- On January 25, the National Treasury published the monthly debt report for December and the Annual Borrowing Plan (PAF, in Portuguese) for 2023. Regarding the PAF, net borrowing requirements rose to BRL1,488 billion for 2023, slightly higher than our forecast (BRL1,415 billion) — compared to BRL1,235 billion in 2022. Weekly issuances to keep liquidity reserves constant should be around BRL28 billion (in our calculus), compared to BRL22 billion last year. So far this year this value was at BRL17 billion per week in January.

INDICATORS		PAF 2022		Dec-22	PAF 2023	
		Min	Max	-	Min	Max
Outstanding Debt (BRL bn)		6,000	6,400	5951	6,400	6,800
Average Maturity (years)		3.8	4.2	3.9	3.8	4.2
% Maturing in 12m		19	23	22.1	19	23
Debt Profile (%)	Fixed-rate (LTN)	24	28	27.0	23	27
	Inflation-Linked (NTN-B)	27	31	30.3	29	33
	Floating rate (LFT)	38	42	38.3	38	42
	FX	3	7	4.4	3	7

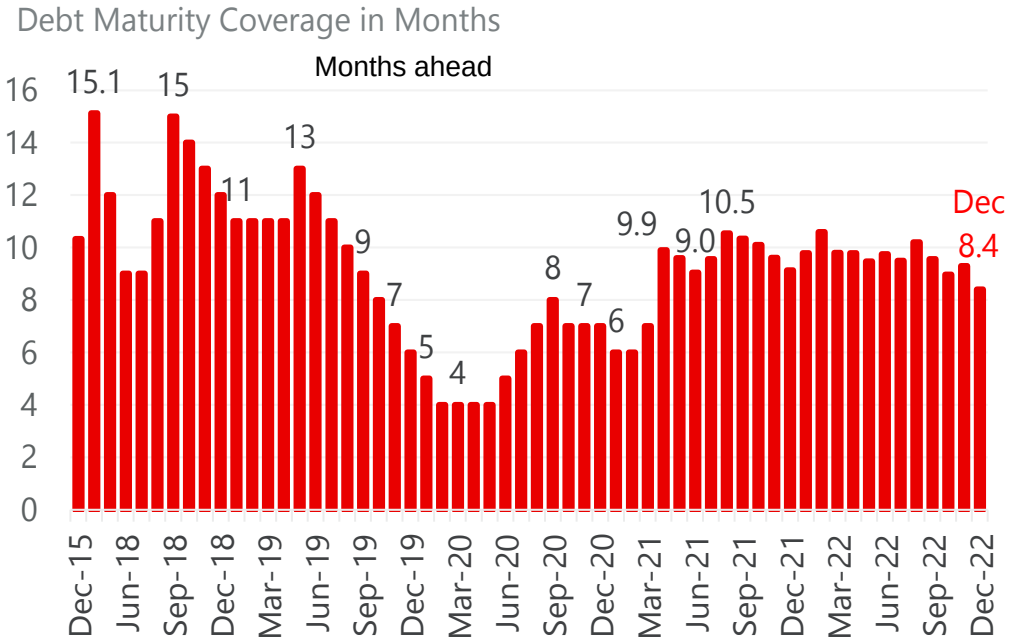
PAF - Annual Borrowing Plan



Treasury's Cash Position at comfortable level to navigate the uncertainties

- Public debt liquidity reserves rose BRL34 billion in December (+3% MoM in nominal terms), reaching BRL1,175 billion and reflecting net issuances in the month. This level of liquidity reserves covers close to 8.4 months of debt maturities (from 9.3 in November).

Liquidity cushion coverage of domestic debt



Sources: National Treasury, Santander.

Debt - Weekly issuances

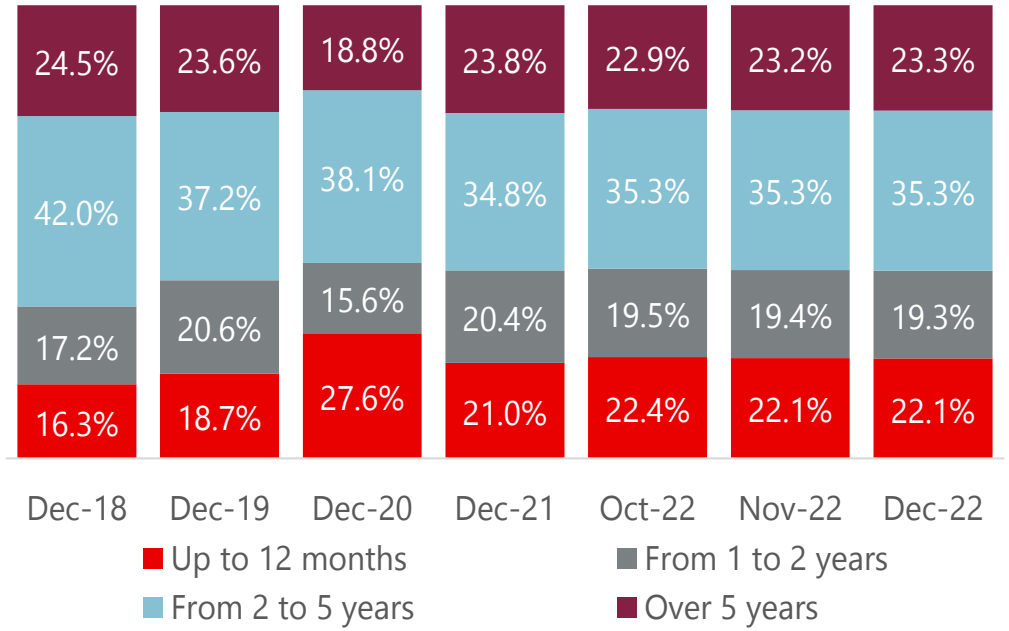
Sources: National Treasury, Santander.

2023 is the level that we estimate to keep the liquidity cushion constant. Other factors, such as the reduction in budget gap and other sources of finance could reduce this amount.

Debt Profile and Maturity

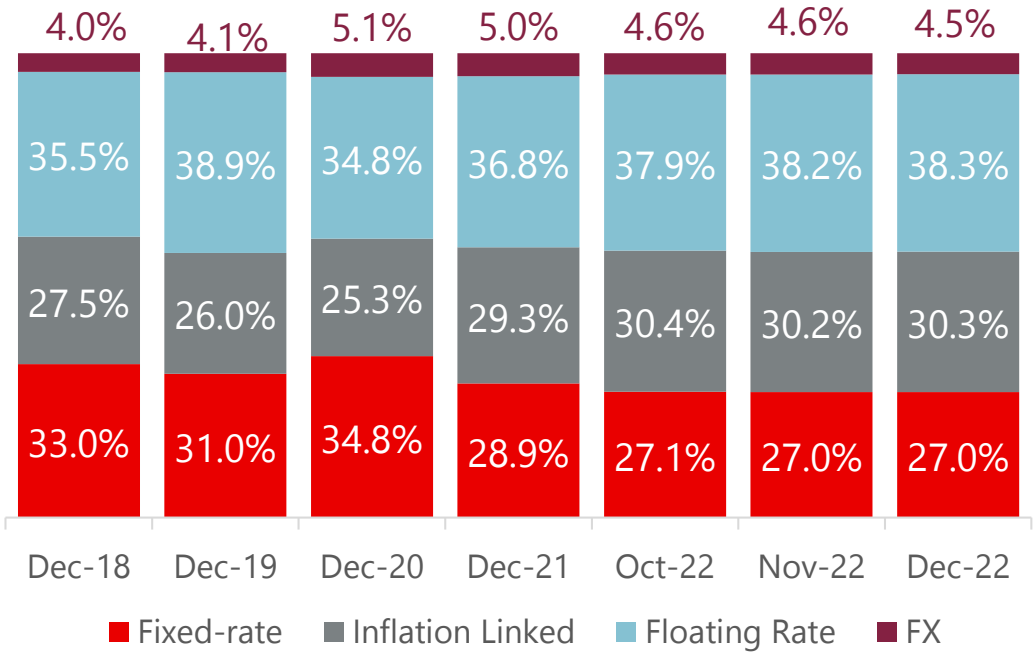
- “The share of fixed-rate FPD securities decreased their share from 27.03% in November to 27.01% in December. Share of inflation-linked securities increased from 30.20% to 30.26%. At the same time, the share of floating-rate securities increased from 38.18% in November to 38.25% in December.“
- The volume of DFPD securities maturing in up to 12 months shifted from 22.69% in November to 22.61% in December. Fixed-rate securities accounted for 41.52% of this total, followed by floating-rate securities with share of 36.90% of the total.

Debt Maturity - %



Sources: National Treasury, Santander.

Debt Profile - %

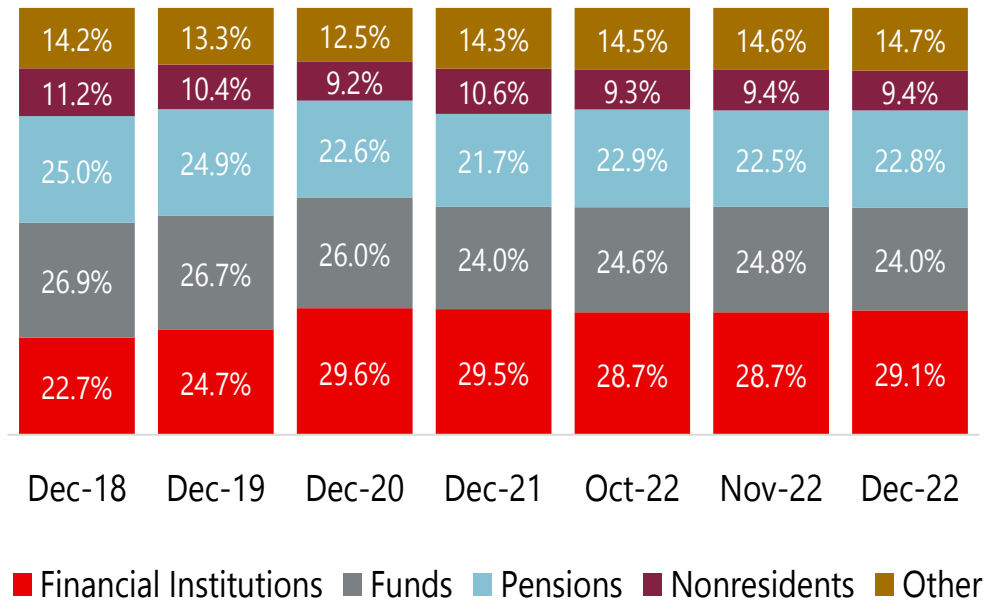


Sources: National Treasury, Santander.

Fiscal – Debt Holders

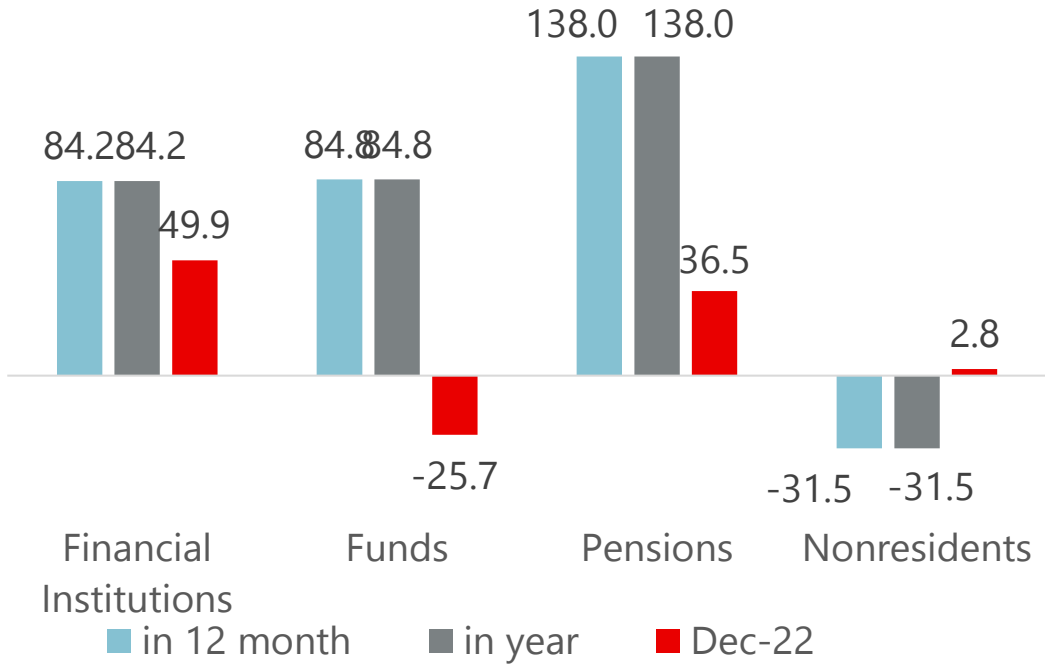
- Non-residents registered a positive flow of BRL2.8 billion in December, with a negative flow of BRL31.5 billion in 2022. The percentage of non-resident debt holders was 9.4% in December vs. 9.2% in September and compared to 10.6% in December 2021, 9.2% in December 2020, and 10.4% in December 2019. Financial institutions continue to be the main debt holders, at 29.1%.

Debt Holders - (% Total Debt)



Sources: National Treasury, Santander

Debt Holders Change

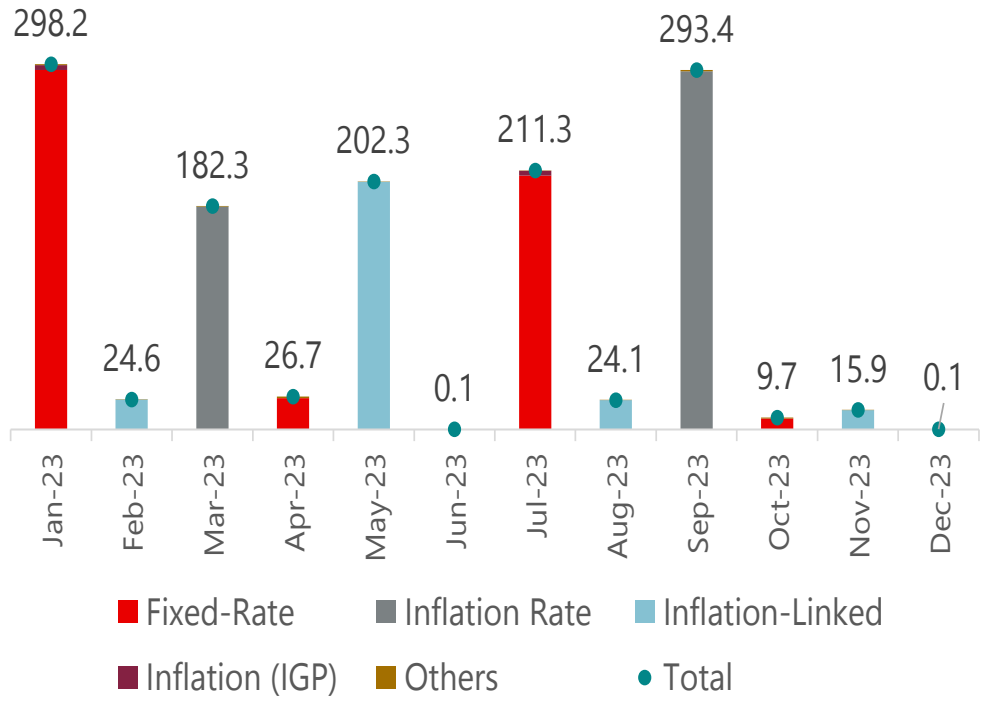


Sources: National Treasury, Santander.

Fiscal – The debt is at a higher level it will be important to reach a larger maturity

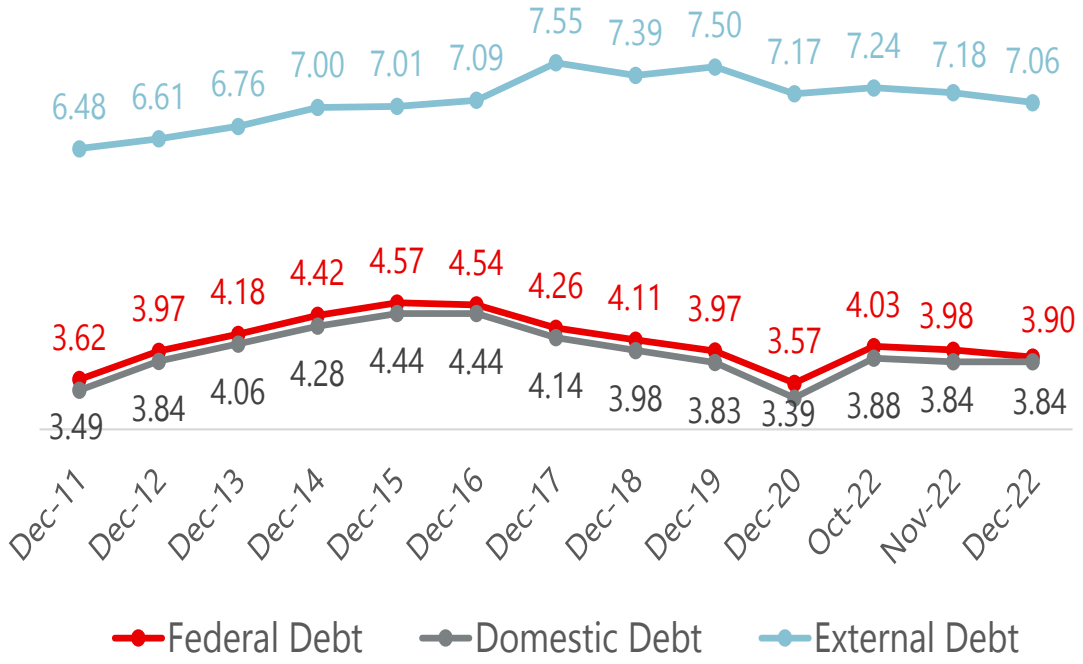
- Despite the increase in liquidity reserves the debt maturity level is still challenging. Structural reforms will help to increase debt maturity and reach a sustainable primary surplus.

Debt maturity - (BRL billion)



Sources: National Treasury, Santander

Average Maturity (years)

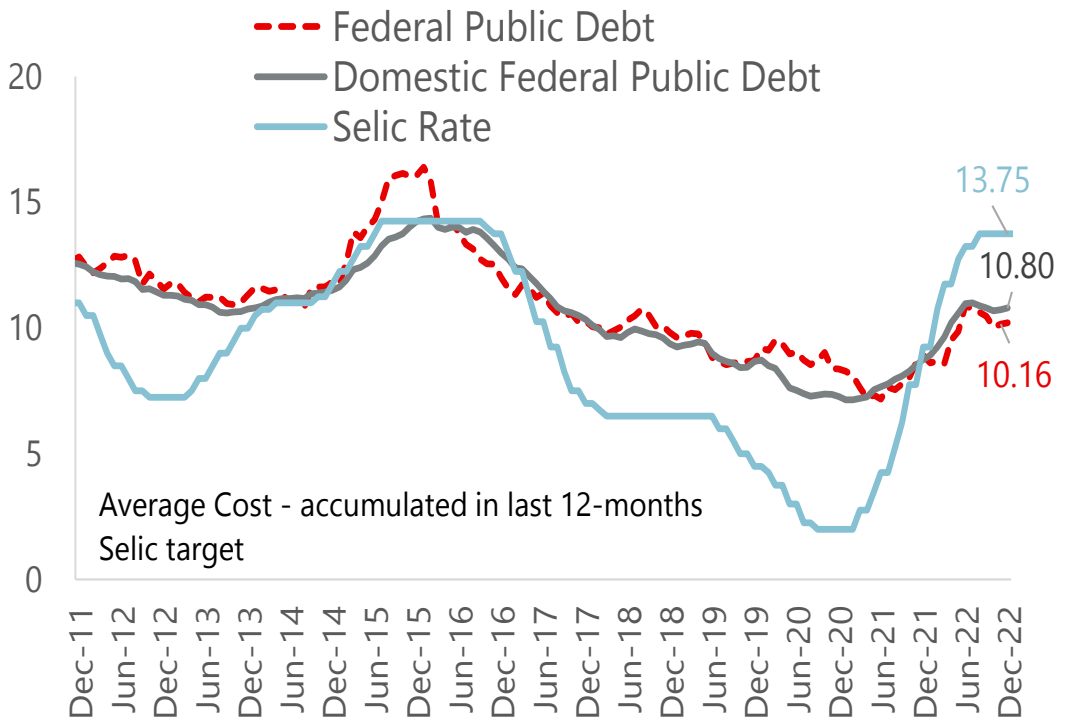


Sources: National Treasury, Santander.

Fiscal – Debt Cost on the rise with the increase in Selic Rate

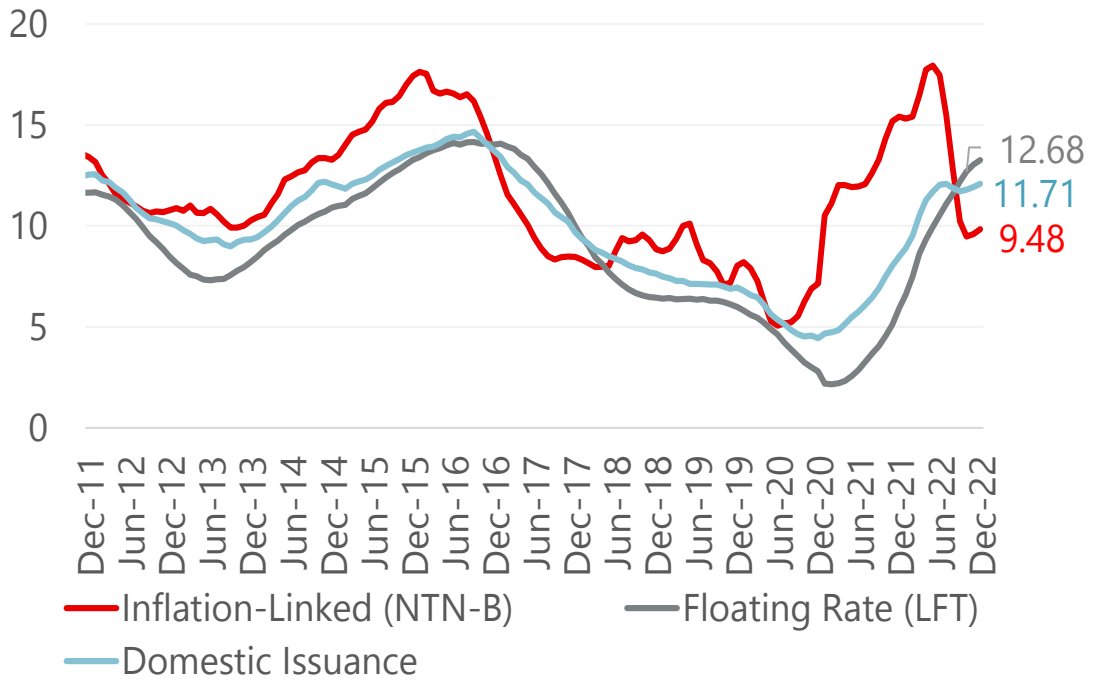
- The cost of new domestic issuances rose slightly to 12.1% p.a. in December vs. 11.9% p.a. in November. The debt cost of LFT bonds accumulated in the last 12 months increased to 12.5% (from 11.2% in November and 4.5% in December 2021), and the recent rise in the Selic rate (currently at 13.25%) could create additional pressure on debt costs in the coming months, in our view. Debt maturing in 2023 totals BRL1,288 billion. We highlight the large maturity in January (BRL293 billion, mainly in LTN bonds).

Debt Cost - %



Sources: National Treasury, Santander

Debt Cost of New Issuances - %



Sources: National Treasury, Santander.

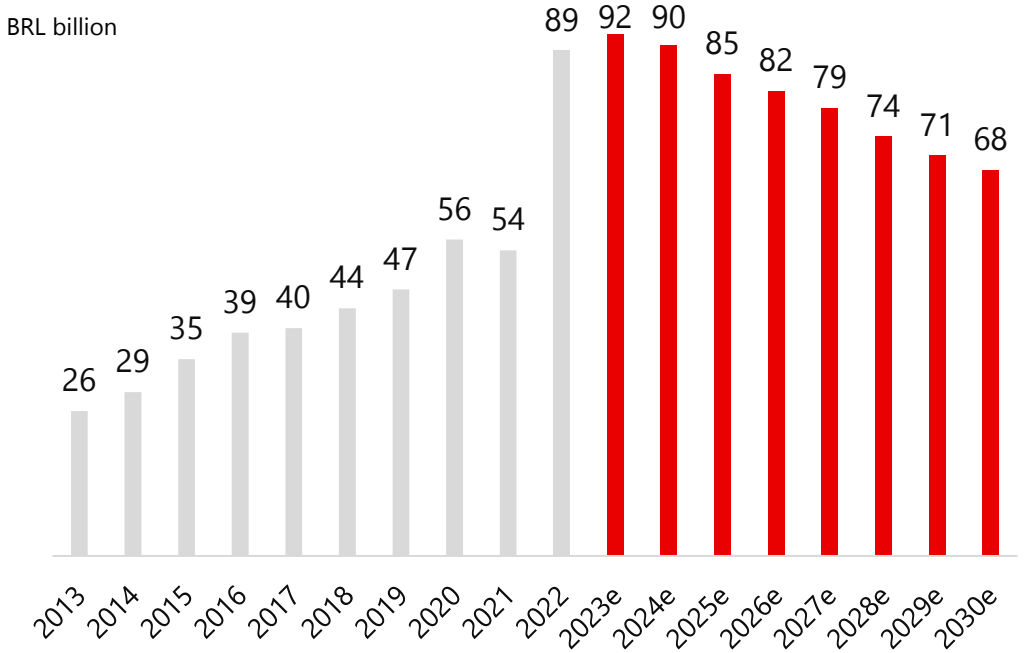
Court-ordered Debt – *Precatórios* on the rise

06

We estimate an increase in judicial claims over the next years

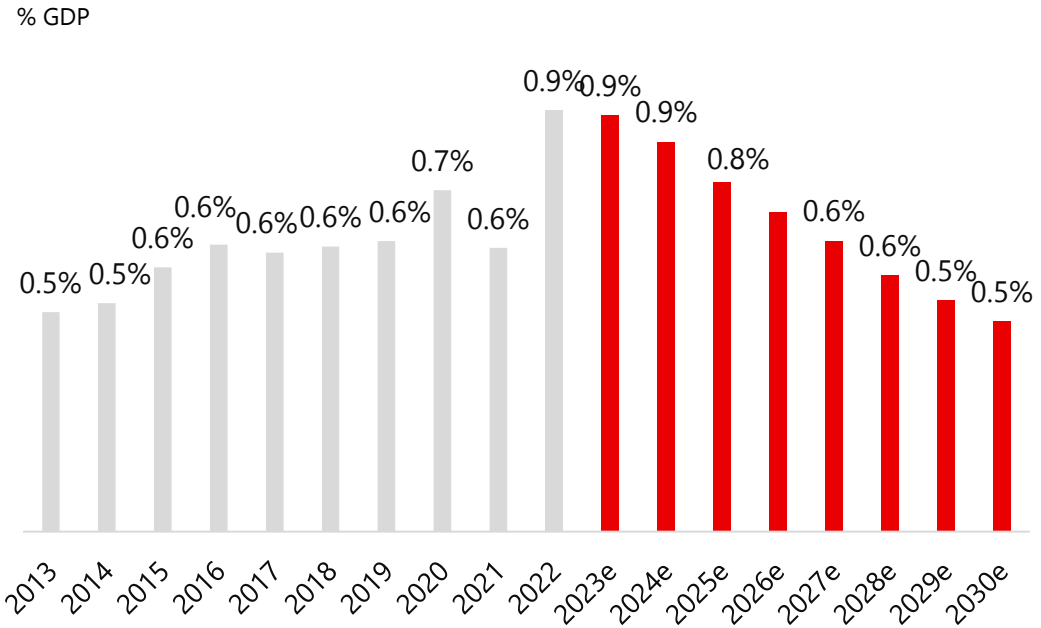
- We constructed a forecast based on the Budget Guidelines (LDO) probable judicial claim for next the years. In the short-run we see more pressure from the Fundef (educational fund) and those related to pension payments.
- Our preliminary estimate is only a preliminary "educated-guess" in view of the difficulty in estimating and the uncertainties related to the legal process. Either way, it has a relevant fiscal risk and requires a fiscal discipline in management to this increase.

Our Preliminary Estimates for judicial claims budget



Sources: LDO 2023, Santander

Judicial claims estimates



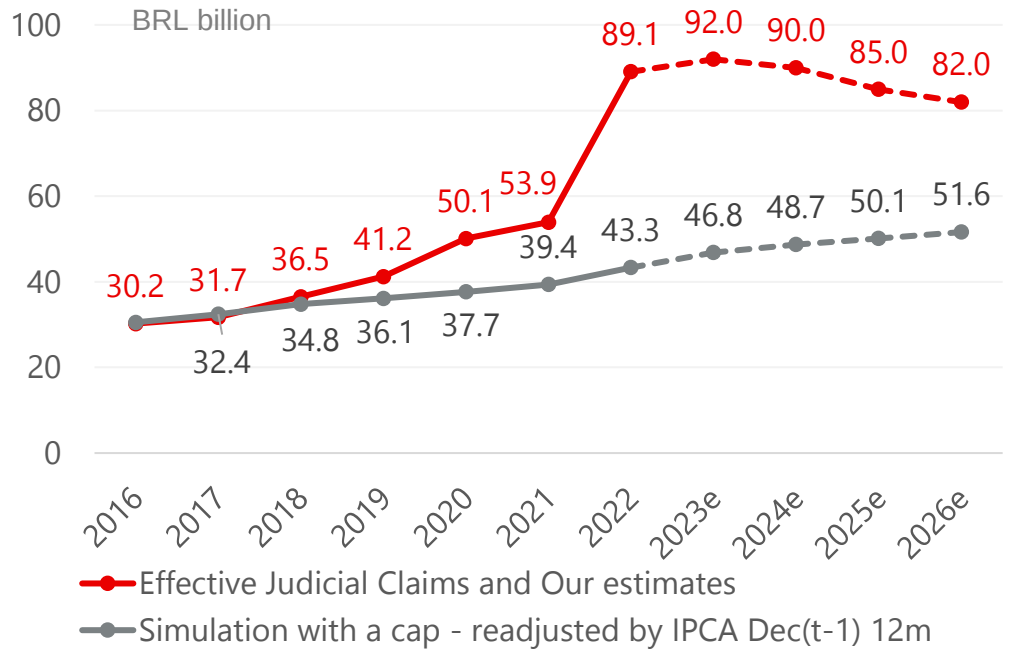
Sources: LDO 2023, Santander

Based on the PLDO 2023

Simulation – effects of creating a cap for the court ordered debt payment

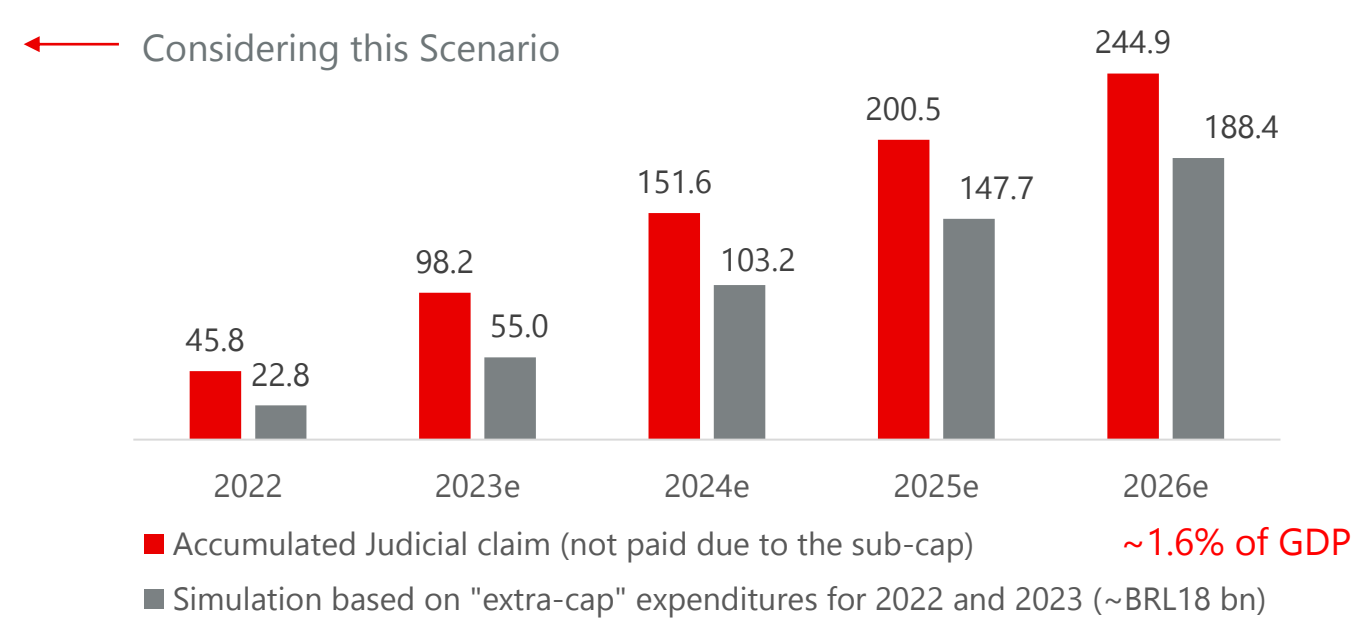
- In order to reduce the judicial claims payments, the government proposed to create a ceiling for these liabilities and postponing the remaining for the next few years (or paying outside the spending cap limit).
- Creating a cap since 2016 would reduce the judicial claim payments in 2022 to close to BRL43 billion, from the BRL89.1 billion official number. We believe that ~BRL55 billion will be accumulated for being paid in the future. If not paid the court-ordered debt could reach a total of 1.6% of GDP in 2026

Simulation - A limit for Judicial Claims payments



Sources: National Treasury, BCB and Santander.

Simulation with a cap – Accumulated judicial claims



Sources National Treasury, BCB and Santander.

The Supreme Court (STF) decided on December 1 that the so-called "life revision" for some pensioners is constitutional. Based on this mechanism, all social security contributions made to the INSS by workers before July 1994 will be accounted for in the calculation of some pensions, increasing their payments. In our view, this will bring a fiscal impact of BRL50 billion in 10 years. While that may not affect our primary balance estimates, we calculate that the amount of unpaid court-ordered debt (the so-called *precatórios*) should increase to ~1.6% of GDP by 2026 (from 1.3% of GDP).

National Treasury estimates

- The National Treasury unveiled a report to explain the judicial claims payments for 2022,
- There is a risk of accumulating this expenditures over time, and with the increase in Selic rate this amount could be even higher.

Estimated Payments - Judicial Claims 2022

	Value BRL bn
Limit for payment of Judical Claims	19.9
RPVs	24.4
Other Sentences - Considered in the Expenditure Ceiling	2.7
Recomposition of canceled court documents - Law 13,463/17	0.5
Monetary Update of the claims to be paid with the limit	2.4
Claims in installments (with correction) - art. 100, §20, ADCT	4.2
Fundef judicial claims (rule 40% + 30% + 30%)	7.9
Total	**62.0**

Sources: National Treasury, Santander

Estimated without *"Encontro de Contas"* (debt cancelations)

Item	2022	2023
Expected Judicial Claims	89.1	92.1
Subcap (PEC Precatórios)	40.5	43.1
Payments in the year	62.0	61.6
Precatórios unpaid (accumulated)	22.9	55.4

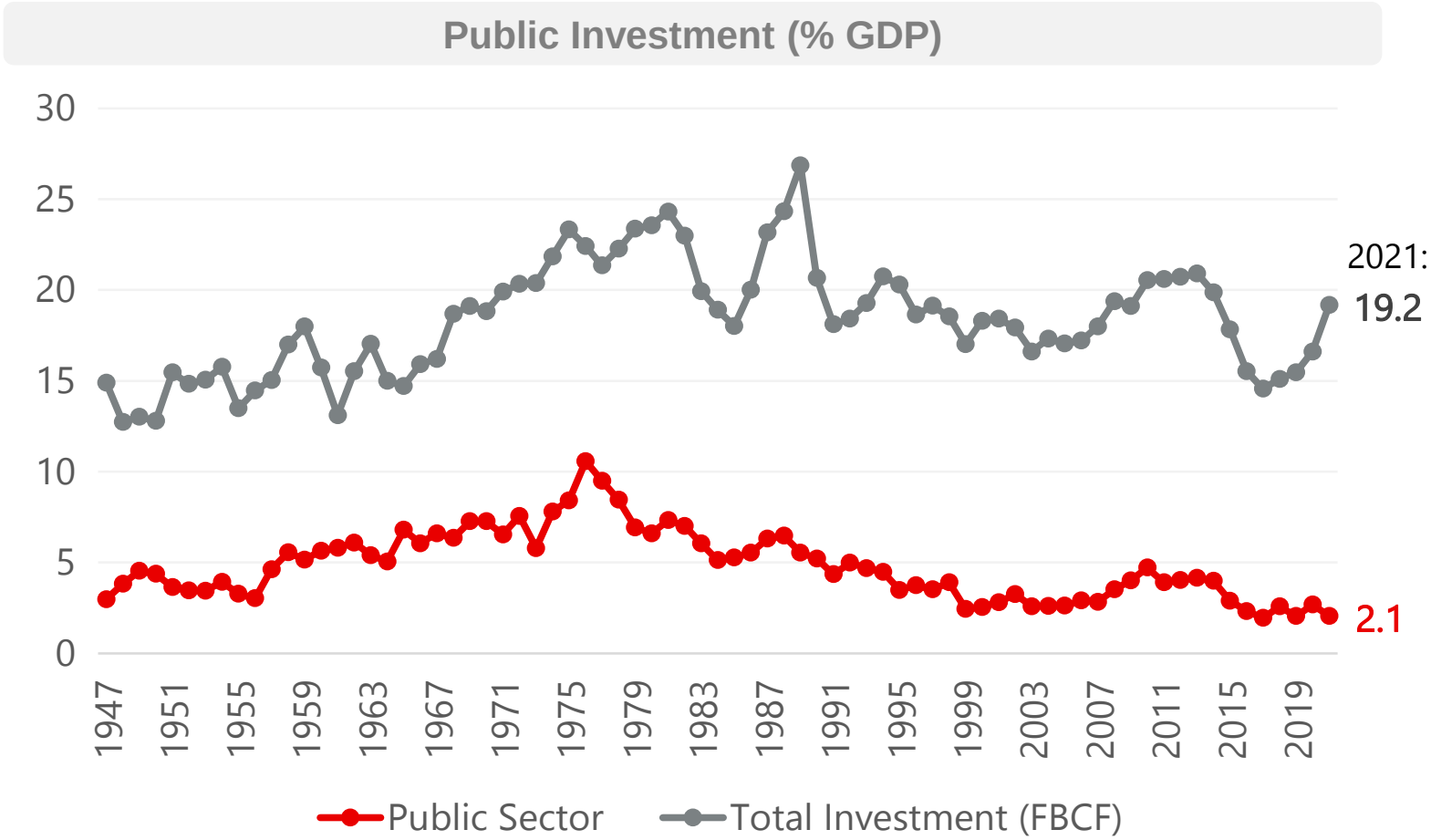
Sources: National Treasury, Santander

Others

07

Public Investment at low levels

- Part of the recent fiscal adjustment was made by a reduction on discretionary expenditures, mainly public investments.

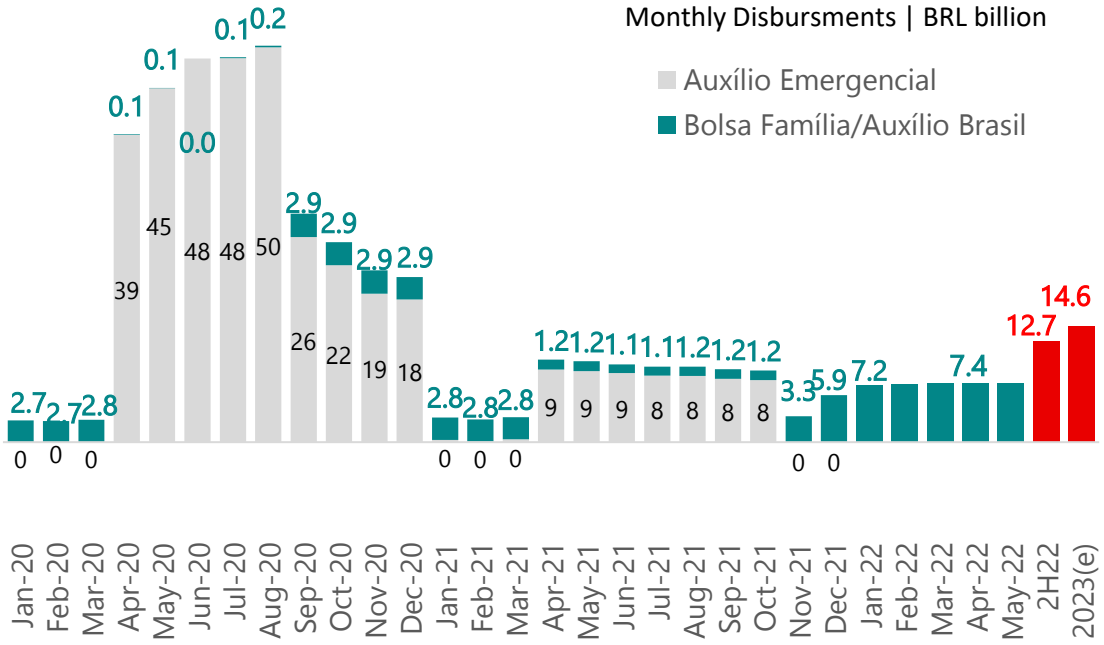


Sources: IBRE, National Treasury, BCB and Santander.

Fiscal Policy: increase in the welfare program outlays

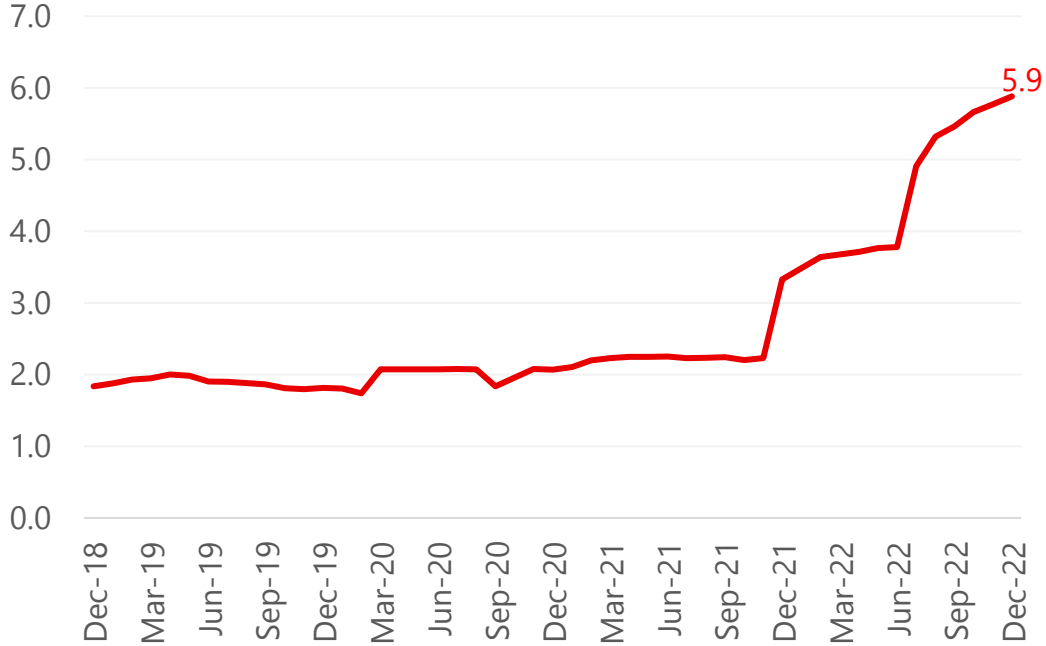
- The monthly disbursements with welfare program could reach closer to BRL14 billion, with a yearly total budget of BRL175 billion.
- In our view, the total program cost will come to BRL150 billion in 2023, already accounting for some tightening in the rules for families to access the program.

Welfare Program Outlays



Sources: Ministry of Economy, Santander

Welfare Program - Single Person Families



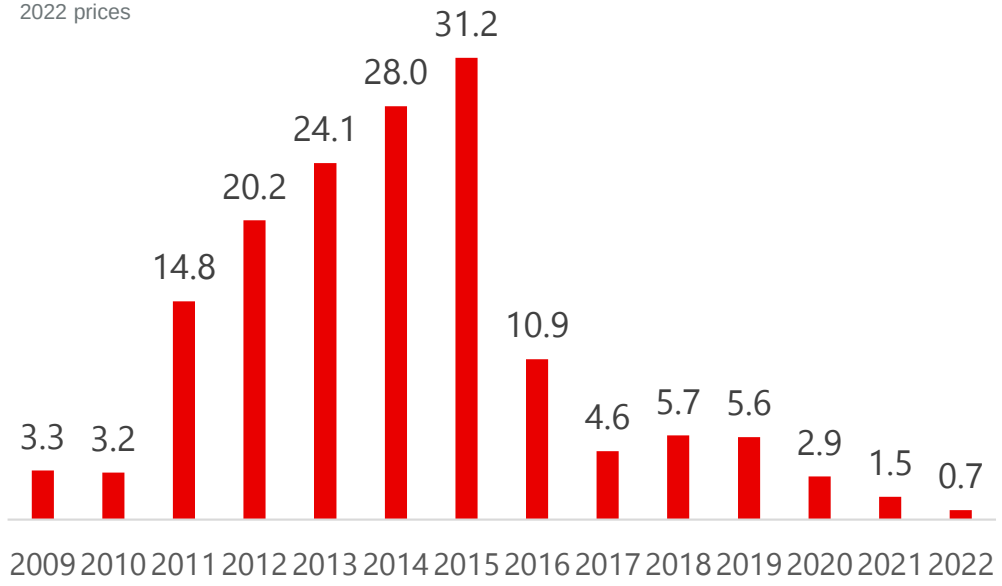
Sources: *Ministério da Cidadania,* Santander

Fiscal – Former Programs that could be increased

- Considering the increase in the 2023 we could see an increase in Housing Program and rise in public investment.
- The Housing program budget for 2023 is BRL10 billion.

Housing Program – BRL billion

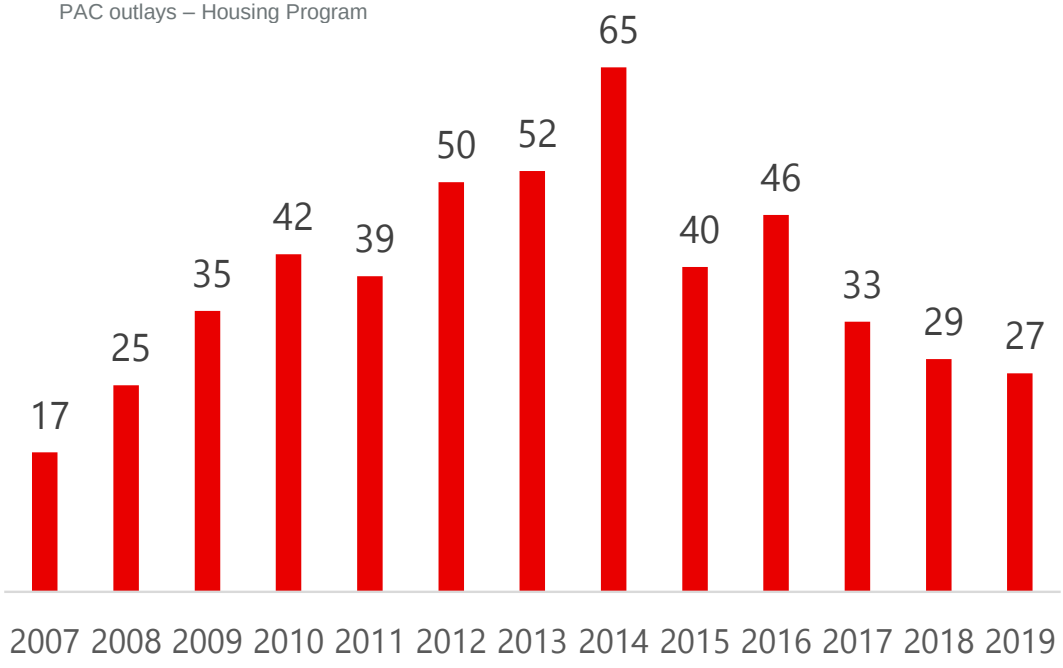
Minha Casa, Minha Vida (2009-2020)
Casa Verde Amarela (2021-)
2022 prices



Sources: National Treasury, Santander

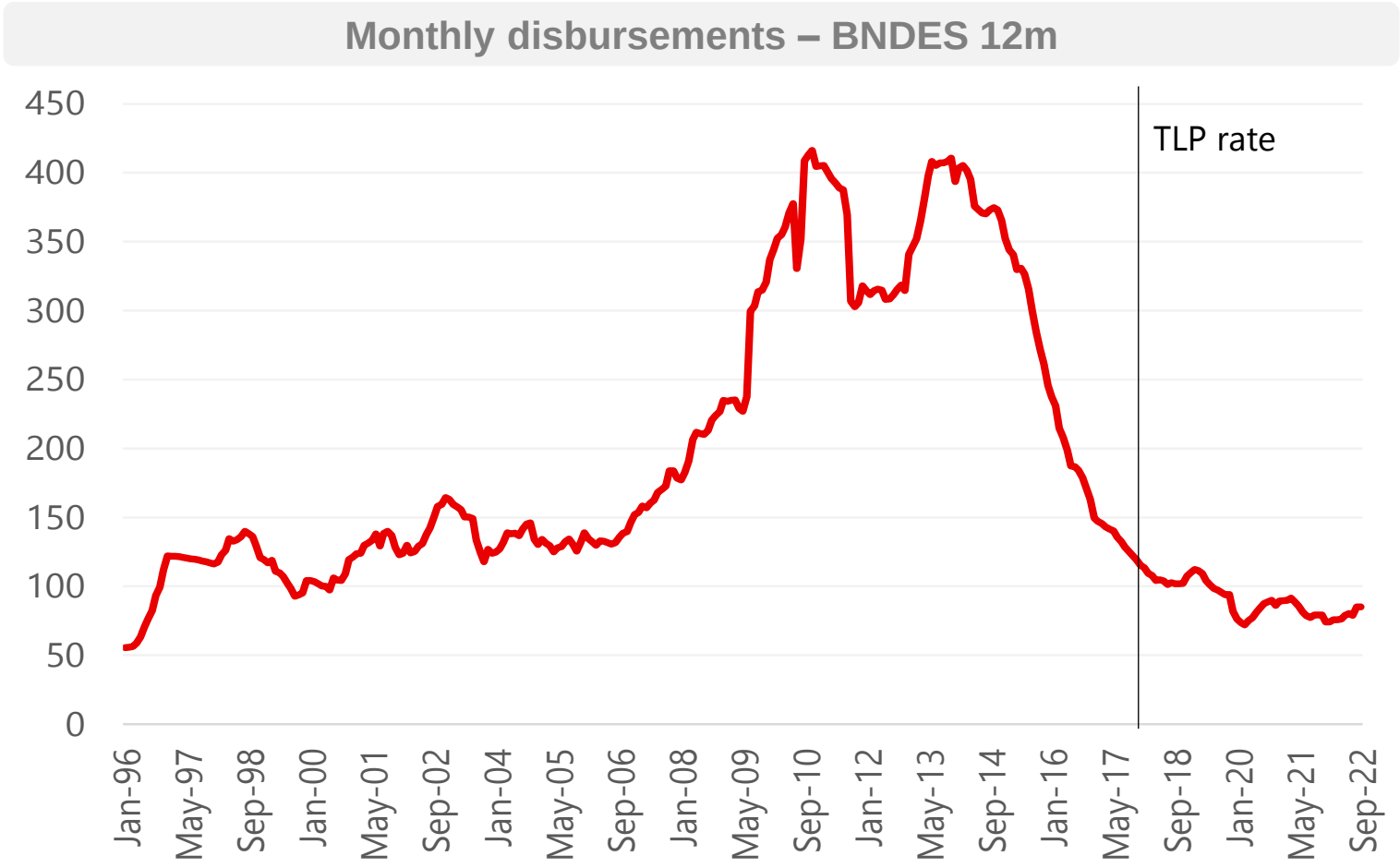
Investment Plan (PAC) – not considering Housing

PAC outlays – Housing Program



Sources: National Treasury, Santander

BNDES – Public Bank

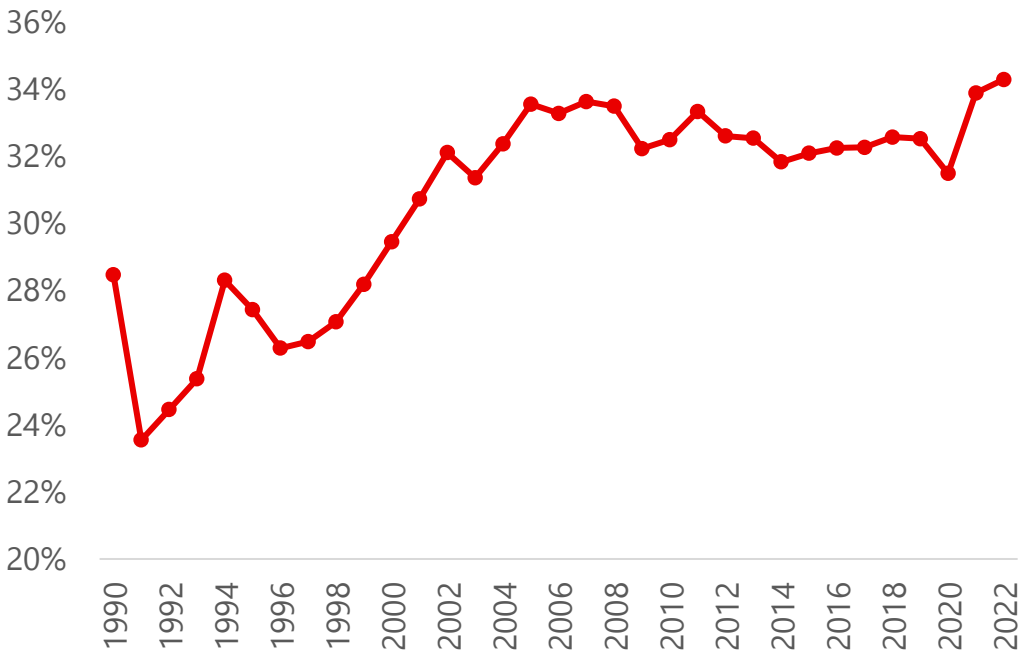


Sources: BNDES, Santander.

Difficulty in the Fiscal Adjustment - Expenses or Revenues?

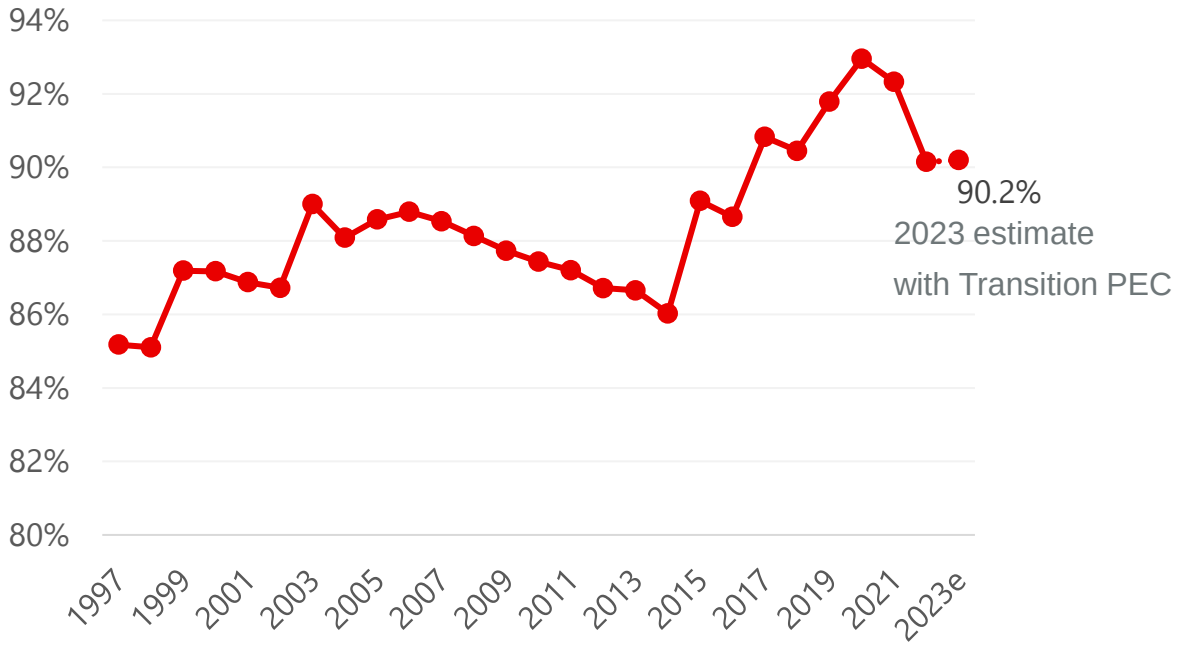
- There is a limit to increase taxes and to reduce the discretionary expenses.

Tax Burden (% GDP) – Is it possible to raise taxes?



Sources: IBRE, National Treasury, BCB and Santander.

Mandatory Outlays / Total Expenses



Before 2008 there is no classification of discretionary expenses, we maintained the historical pattern among the expenses with flow control

Tax Reform: An Overview on the Current Proposals

- We believe that one of the priorities of the new federal administration should be the reform of taxes on goods and services.

In his inaugural post-elections speeches, new Finance Minister Fernando Haddad has emphasized the need for tax reform in Brazil. Moreover, the appointment of Bernard Appy as the new Special Secretary of the Finance Ministry suggests that tax reform is likely to be a top priority for 2023. Appy helped to draft *PEC 45/2019*, a constitutional amendment that has already received some support in the Lower House. In this PEC, it is proposed to streamline the tax code in Brazil by combining five different taxes into a single VAT tax (IBS - *Imposto sobre Bens e Serviços*), with positive effects in productivity and potential GDP.

The Senate is concurrently debating a reform proposal, called *PEC 110/2019*. In this case, the proposal involves the creation of two VAT-type taxes: (i) *CBS* (*Contribuição sobre Bens e Serviços*), replacing the federal taxes *IPI*, *PIS* and *Cofins*; and (ii) *IBS*, replacing *ICMS* (state tax) and *ISS* (municipal tax).

Main Differences between PEC 45 and PEC 110

	PEC 45 / 2019	***PEC 110 / 2019***
Who´s Leading?	Lower House; Approved by the CCJ in May 2019.	Senate; Still not approved by the CCJ.
Main Proposal	Replacement of *IPI* + *PIS* + *Cofins* + *ICMS* + *ISS* by ***IBS*** and create a **selective tax**	Replacement of *IPI* + *Cofins* + *PIS* by ***CBS***, replacement of *ICMS* + *ISS* by ***IBS***, and create a **selective tax**
Tax Rates	Uniform rate for all goods and services, but tax rate could differ between states and municipalities	
Fiscal Benefits	No tax benefits are predicted. The eventual inclusion of tax benefits must be evaluated technically.	Eliminate most tax benefits, except Simples and Zona Franca. New benefits may be created by complementary legislation.
Tax Burden	No increase	

Sources: *CCiF and Pra Ser Justo*.

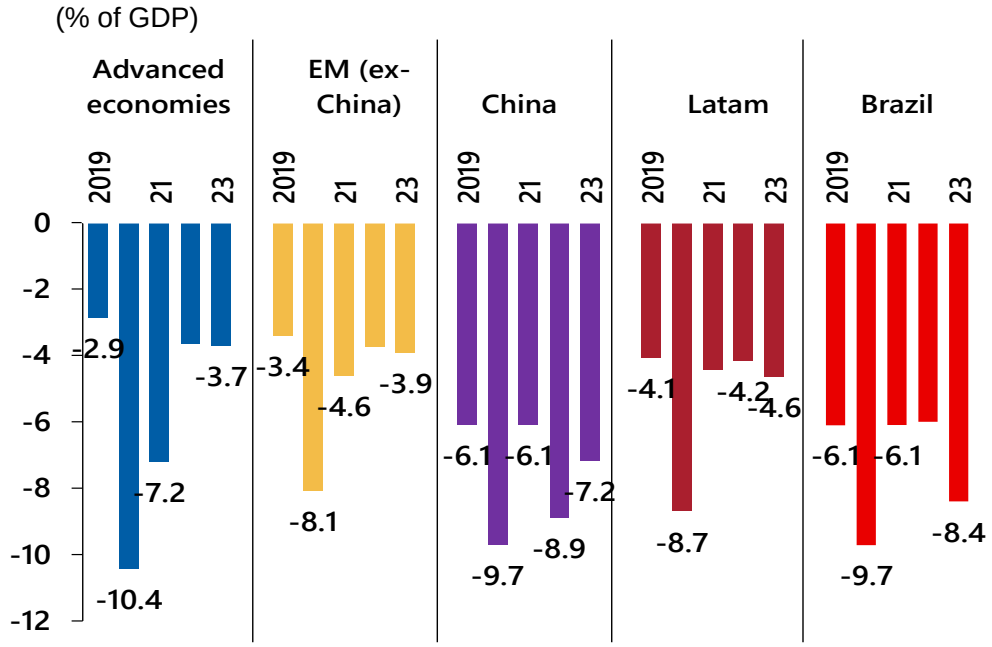
International Comparison

08

International Comparison – Increase in interest rates

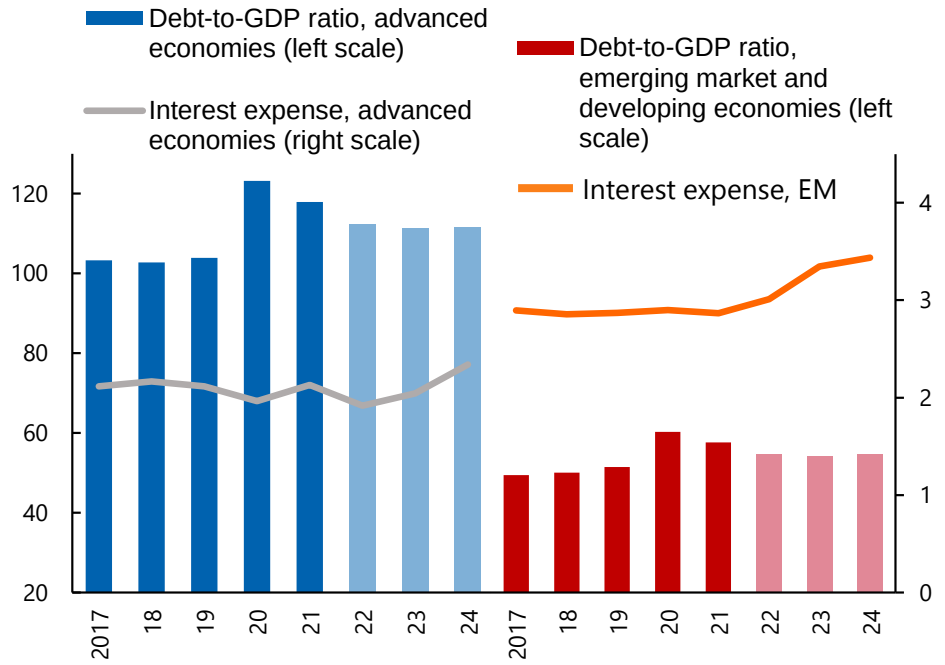
- The effect of current monetary tightening on fiscal accounts

National Budget Balances by Income Group



Sources: IMF, Santander.

National Gross Debt and Interest Expense by Income Group

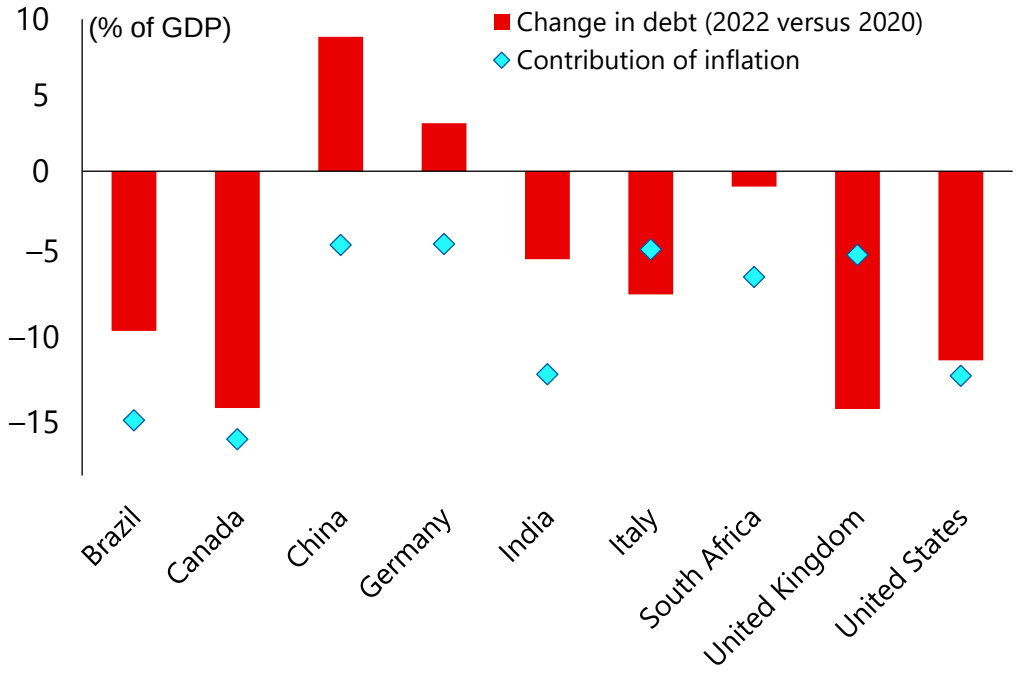


Sources: IMF, World Economic Outlook; IMF staff calculations. Note: China is excluded. Bars for 2022–24 are projected data.

International Comparison – Inflation impact on Fiscal

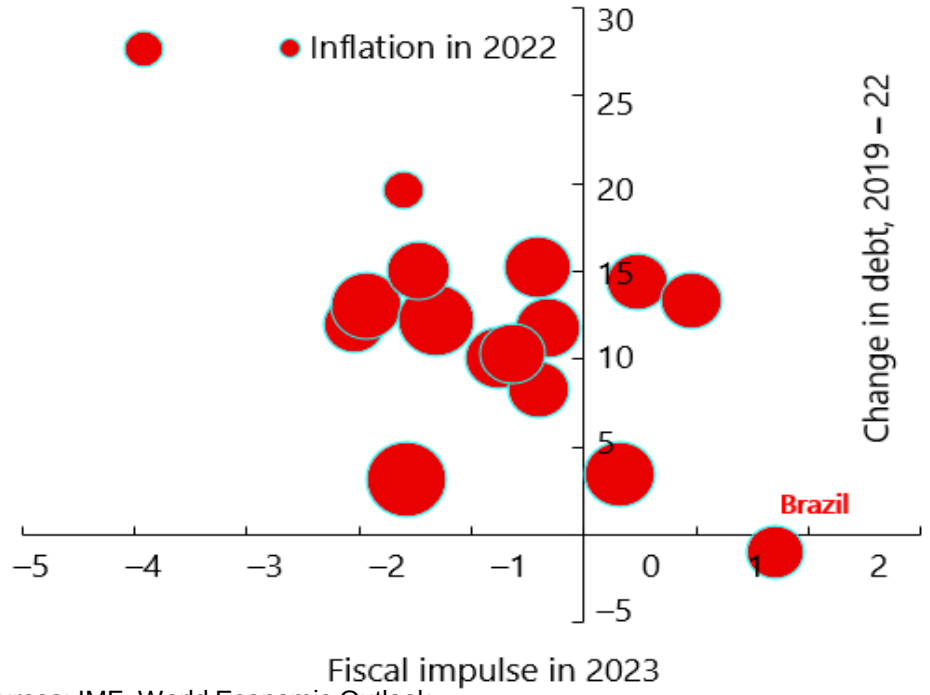
- Inflation had an effect on fiscal accounts.

Effect of Inflation Shock on the Debt Ratio



Sources: IMF, Santander.

Fiscal Impulse, Inflation, and Debt for G20 Countries

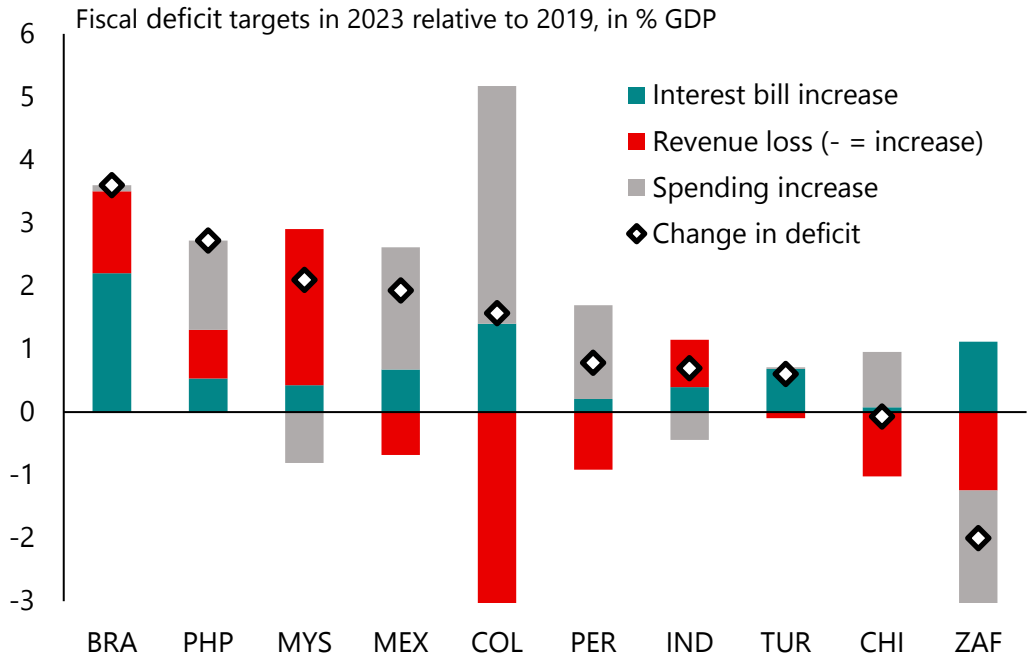


Sources: IMF, World Economic Outlook.
Note: Includes Spain; excludes Argentina, Russia, Saudi Arabia, and Tűrkiye. Fiscal impulse is measured by the change in the cyclically-adjusted primary balance. The size of the bubble reflects the inflation rate.

International Comparison – The EM Fiscal Outlook in 2023

- Change in EM fiscal accounts for 2023

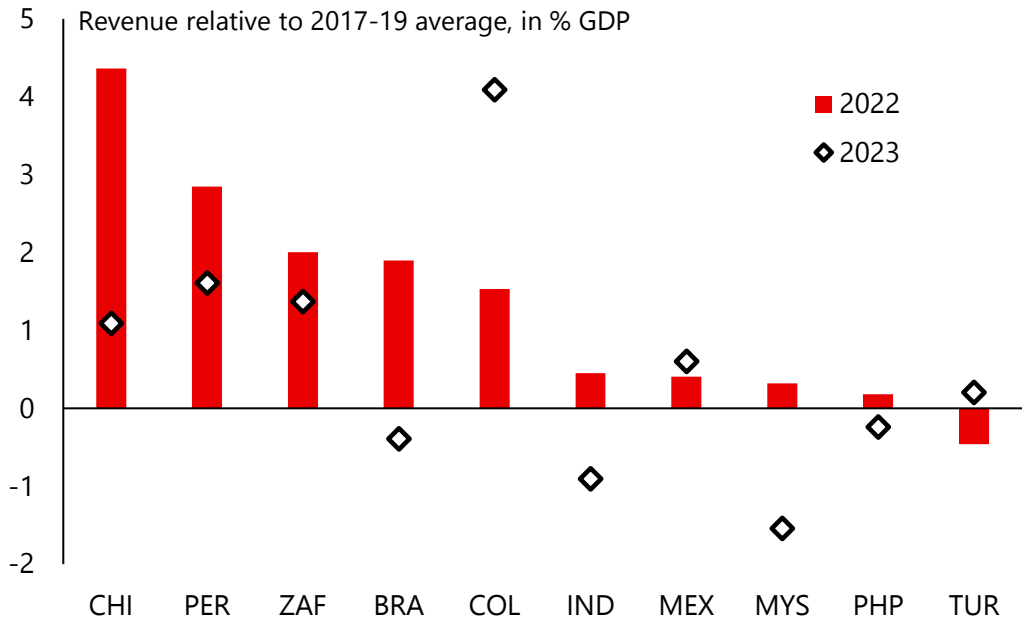
Larger Fiscal Deficits in 2023



Sources: Haver, IIF, Santander

For Brazil: Our estimate.

EM Revenues: favorable winds from *commodities*



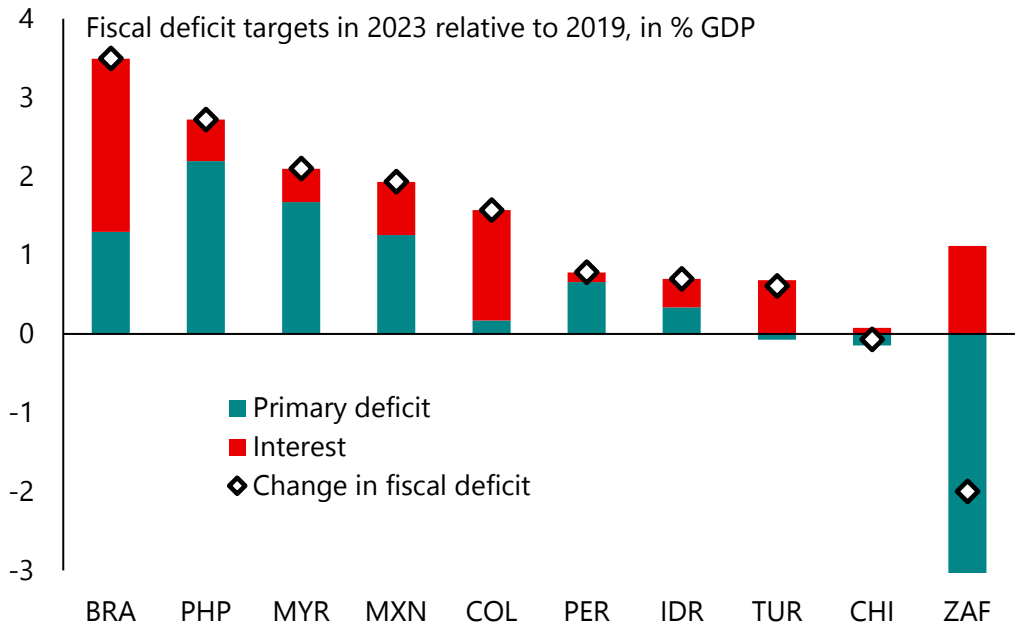
Sources: Haver, IIF, Santander

For Brazil: Our estimate.

International Comparison – The EM Fiscal Outlook in 2023

- Change in EM fiscal accounts for 2023

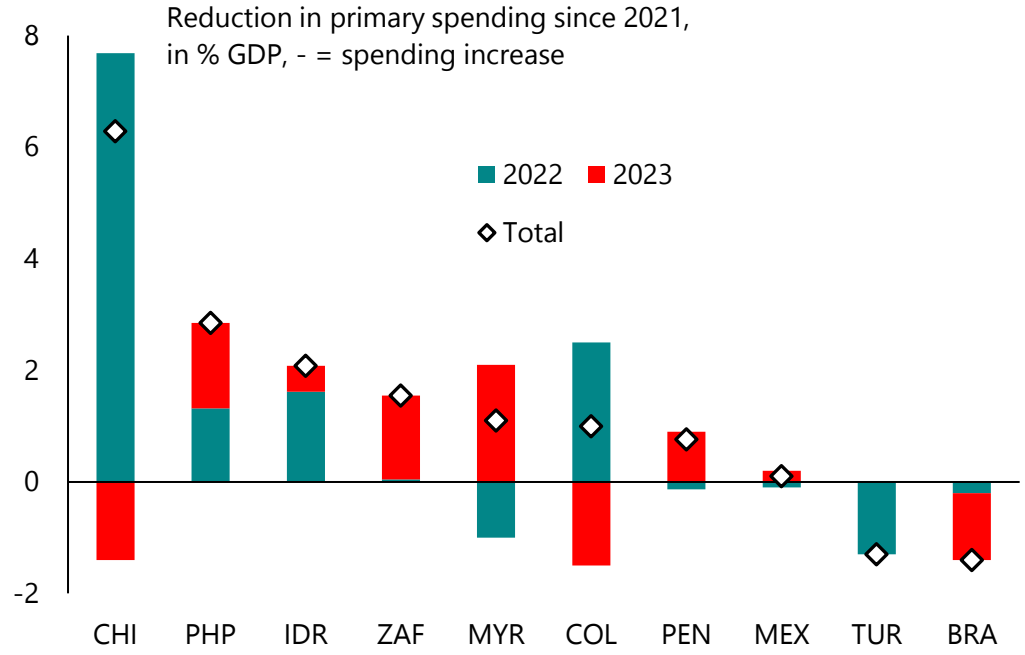
Changes in Fiscal Deficit Target



Sources: Haver, IIF, Santander

For Brazil: Our estimate.

EM Revenues: favorable winds from *commodities*



Sources: Haver, IIF, Santander

For Brazil: Our estimate.

Tables - Forecasts

09

MACRO SCENARIO: Forecasts

Macroeconomic Variables		Previous		Current
GDP (%)	2022E	3.0	↓	2.9
	2023E	0.8	→	0.8
	2024E	0.5	→	0.5
	2025E	1.5	→	1.5
IPCA (%)	2022	-		5.8
	2023E	5.4	↑	5.9
	2024E	3.5	↑	3.7
	2025E	3.0	↑	4.0
Selic Rate (% end of period)	2022	-		13.75
	2023E	12.00	↑	13.00
	2024E	9.00	↑	11.00
	2025E	7.00	↑	8.00
FX Rate - USDBRL (end of period)	2022	-		5.22
	2023E	5.40	→	5.40
	2024E	5.50	→	5.50
	2025E	5.55	→	5.55
Current Account Balance (% of GDP)	2022	-		-2.9
	2023E	-3.1	→	-3.1
	2024E	-3.1	↓	-3.4
	2025E	-3.4	↑	-3.1
Primary Fiscal Balance (% of GDP)	2022	-		1.3
	2023E	-1.5	↑	-1.4
	2024E	-1.2	→	-1.2
	2025E	-0.7	↓	-0.8
Gross Public Debt (% of GDP)	2022	-		73.5
	2023E	80.2	↓	78.8
	2024E	83.5	↓	83.4
	2025E	86.4	↑	86.7

The forecasts refers to our latest Scenario Update

"More Persistent Inflation, Higher Interest Rate"
(sent on February 09, 2023)

For the full report click on the link:

https://bit.ly/Std-scenupdate-feb23

Sources: IBGE, The National Treasury, BCB and Santander.

MACRO SCENARIO: Santander Brazil's Global Macro Assumptions – Summary

Global Macro Scenario										
	2018	2019	2020	2021	2022	2023E		2024E		2025E
Global GDP (%)	3.5	2.8	-3.5	5.9	3.4	2.3	↑	2.3	↑	2.6
China GDP (%)	6.7	6.0	2.3	8.1	3.0	5.8	↑	5.5	↑	5.0
US GDP (%)	3.0	2.2	-3.5	5.7	2.1	0.4	→	0.7	→	1.5
US Inflation (Core PCE, %)	2.1	1.6	1.5	4.9	5.0	3.4	→	2.3	→	2.0
US Interest Rate (FFR, %)	2.50	1.75	0.25	0.25	4.50	5.25	↑	3.75	↑	2.50
US Interest Rate (UST10y, %)	2.7	1.9	0.8	1.8	3.9	4.0	→	3.2	↑	3.0
Dollar Index - DXY	96	96	90	96	104	102	↓	100	→	100
Commodity Prices - CRB	409	401	444	571	558	524	↑	474	↑	445

Source: Bloomberg, Santander. Note: The arrows denote the direction of changes since our previous scenario publication (as of December 9, 2022)

The forecasts refers to our latest Scenario Update

"More Persistent Inflation, Higher Interest Rate"
(sent on February 09, 2023)

For the full report click on the link:

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Thank you.

Our purpose is to help people and businesses prosper.

Our culture is based on believing that everything we do should be:

Simple Personal Fair

Santander

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