Brazil Macro | June 2022

FISCAL POLICY

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Brief Overview

01

Summary – Primary Surplus — New Push from Price Shocks

- We now estimate a primary surplus for 2022 on the heels of stronger activity, higher inflation, and soaring commodities prices. As an upshot, revenues continue to show a positive performance, particularly boosted by proceeds from the oil sector.
- As per the nominal budget balance, we expect a deterioration as a result of a higher Selic rate, with gains from FX swaps (owing to a stronger BRL) partially offsetting the higher interest rate bill in 2022. We estimate gross government debt will continue to see an upward trajectory for the medium term, with a risky path to long-term stabilization, in a context of reduced efficacy of fiscal rules.
- We are also updating our GDP deflator estimate for this year to 10.1% (from 9.5%), reflecting the higher inflation estimates. We lowered our 2022 gross debt forecast 79.0% (from 80.6%), below the level at YE2021 (80.3%).
- We continue to envision a risky path to fiscal consolidation. We expect a rise in expenditures and a reduction in revenue growth ahead as (commodity- and inflation-driven) impulses fade. For the long term, since we assume the commodity cycle will, by definition, not be permanent, we continue to see a risky path toward debt stabilization, given the reduced efficacy of fiscal rules and the social pressures to increase expenditures in a context of higher inflation.
- Despite the breathing room on the fiscal side provided by this extended commodity cycle, the high level of mandatory expenses is a problem that needs fixing as soon as possible (via economic reforms) in order to quell the fiscal risks in the medium to long term. In our view, this implies the necessity for further structural reforms and a more trustworthy anchor.

Fiscal performance led by better activity, higher inflation and new commodity wave

Short Term Surplus: Oil + Activity + Inflation

2022: Primary Surplus: +BRL35 bn (+0.4% GDP)

1. Central Government: -BRL35 bn (-0.4% GDP)
(Higher revenues: +BRL40 bn, 40% Oil)

2. Regional Gov.: +BRL70 bn (+0.8% GDP)
(+BRL30 bn | + Commodities revenue)

Gross Debt: 79.0% of GDP in 2022
2021: 80.3% of GDP
Nominal GDP: +11.4%.
Nominal result increase mitigated by the FX swap profit (close to BRL100 bn YTD or 1.0% of GDP)

Debt Liquidity Reserves Level
Comfortable levels (more than 10 months) to navigate the uncertainties

Pressure to increase Wages
We added 5% in beginning of 2023

Bumpy Road Ahead

Risks: Fiscal Stimulus by drop in revenue
Already BRL60 billion in revenue drop, Diesel (-BRL20 bn), IPI (-BRL15bn). Could add: Income tax breaks (-BRL15 bn)

Fiscal Accounts Unanchored
Inflation-effect: +1.5pp of GDP by 2026. Spending cap there will be BRL45 billion space compared to PLDO 2023

Primary Surplus: 2026-27
Commodities (Revenues) vs. Expenditures inflation payback

Higher Nominal Deficit (Selic)
Nominal Deficit 2023: above 8.0% of GDP, with lower FX profits from Swap operations

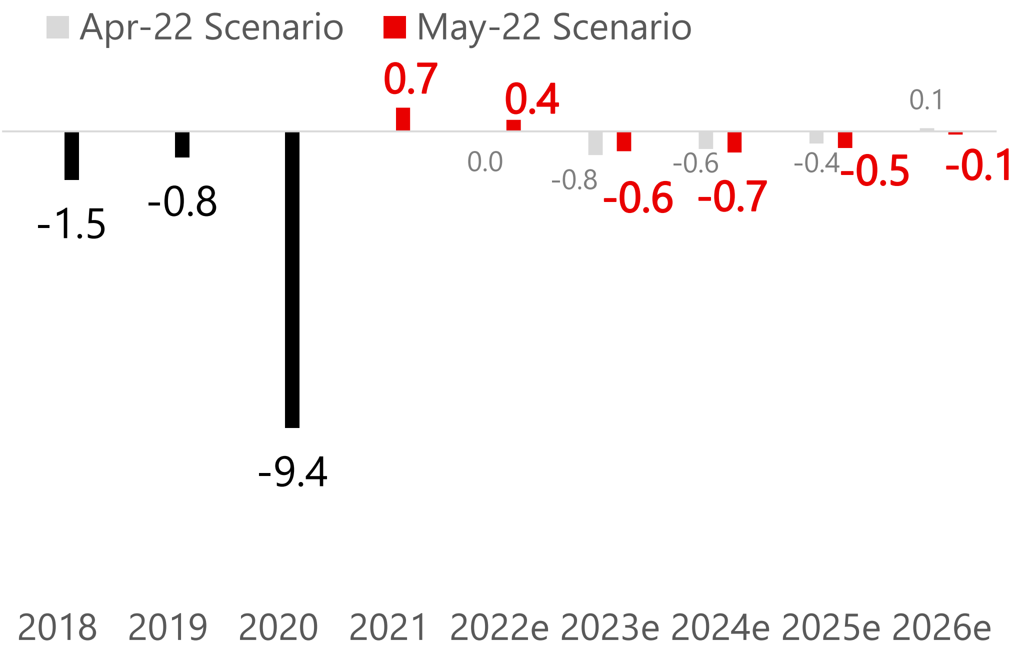
Gross-Debt Peak Estimate – a tad higher
95% of GDP in 2030 (+2.0 pp from Apr-22)

Debt-path: on the edge for convergence
~88% of GDP in 2040

Bumpy road ahead depending on inflation and commodity outlook

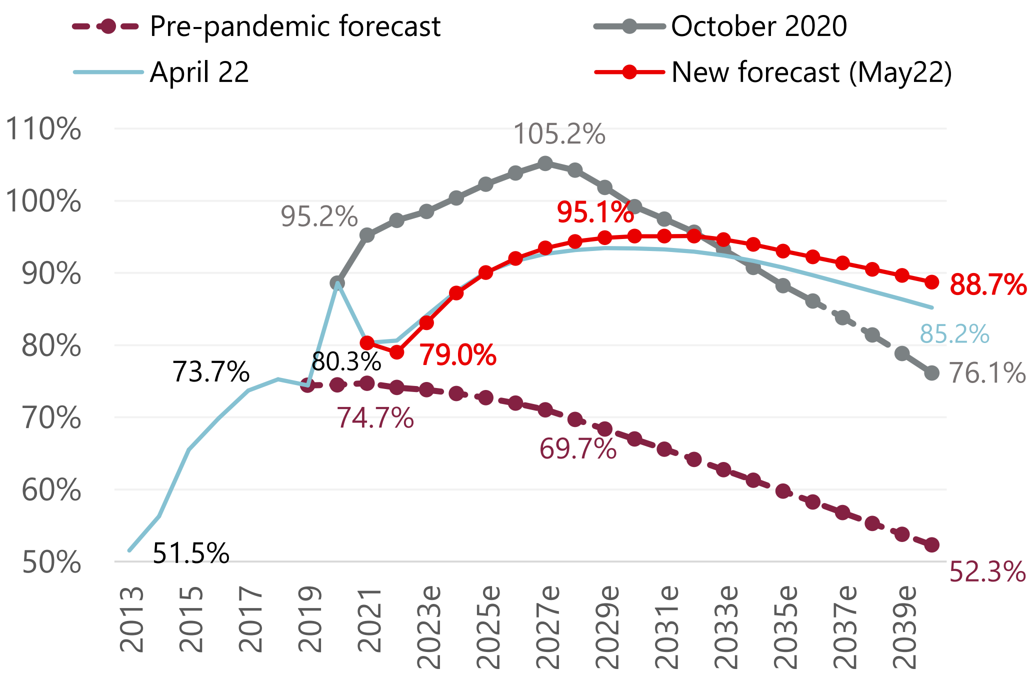
- We now see a primary surplus for 2022 on the heels of higher activity numbers, inflation and the new commodity wave.
- We estimate that federal net revenue will rise by 0.5 pp of GDP per year, due to the positive shock related to terms of trade, depending on the impact and duration of the commodity boom.
- **The inflation shock's impact directly accounts for 3/4 of the improvement (150 bps in 2022; primary and GDP deflator) in the debt-to-GDP.**

Public Sector Primary Result (% GDP)



Sources: BCB, Santander.

Scenarios - Gross Debt Scenario (% GDP)

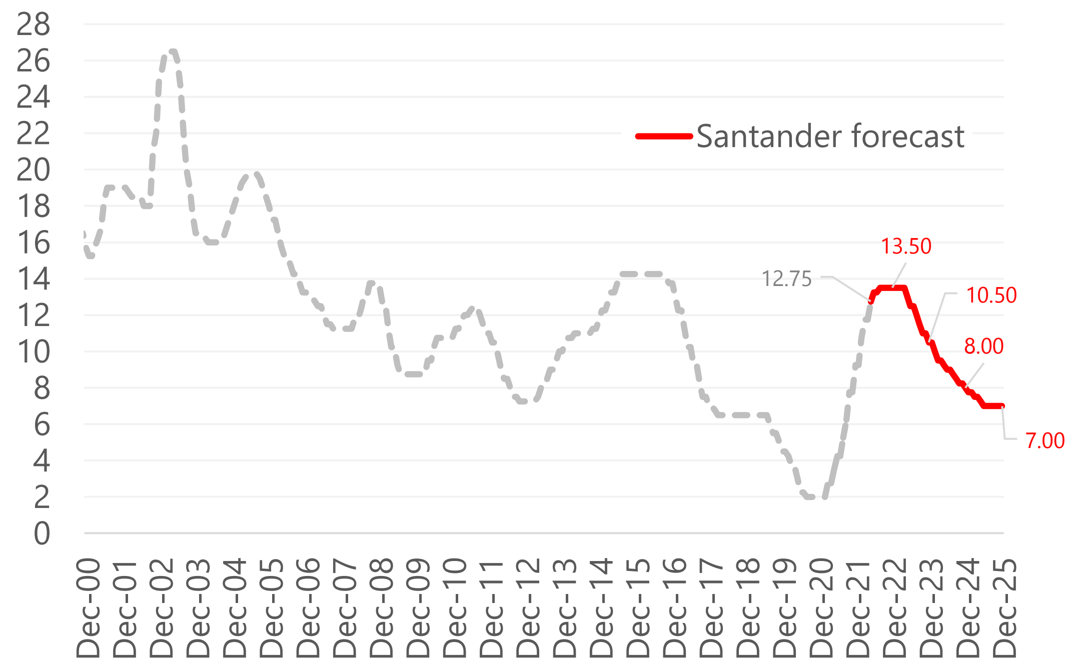


Sources: BCB, Santander

Fiscal – A higher interest burden ahead, deteriorating the debt dynamics

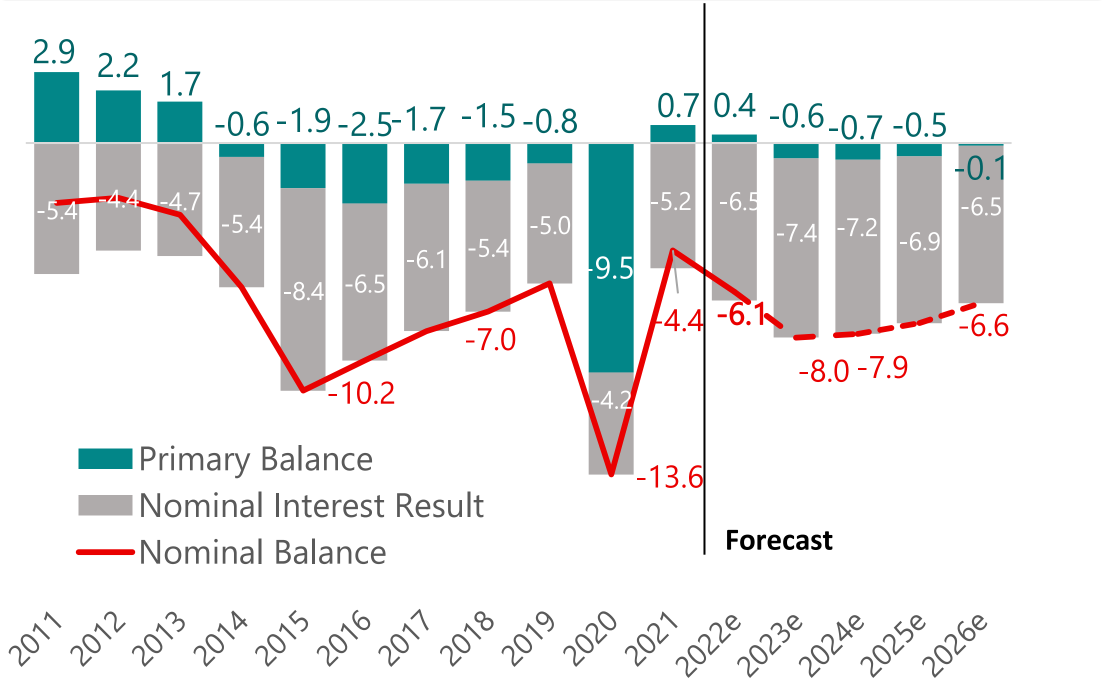
- Our Selic rate forecast is 13.50% in YE2022. Our real interest rate estimate is at 4.0% per year in the long run (7.0% nominal).
- We continue to foresee a deterioration in the nominal (headline) budget results due to higher debt costs (in the Selic rate), implying a still steep upward trajectory for government debt in the medium term. Yet, in the short run, this nominal result will be partially offset by the BCB's profit from FX swaps in 2022 (currently above BRL80 billion), on the heels of the stronger BRL.

Santander Selic Forecast (% pa)



Sources: BCB, Santander

Public Sector's Financing Needs (% GDP)

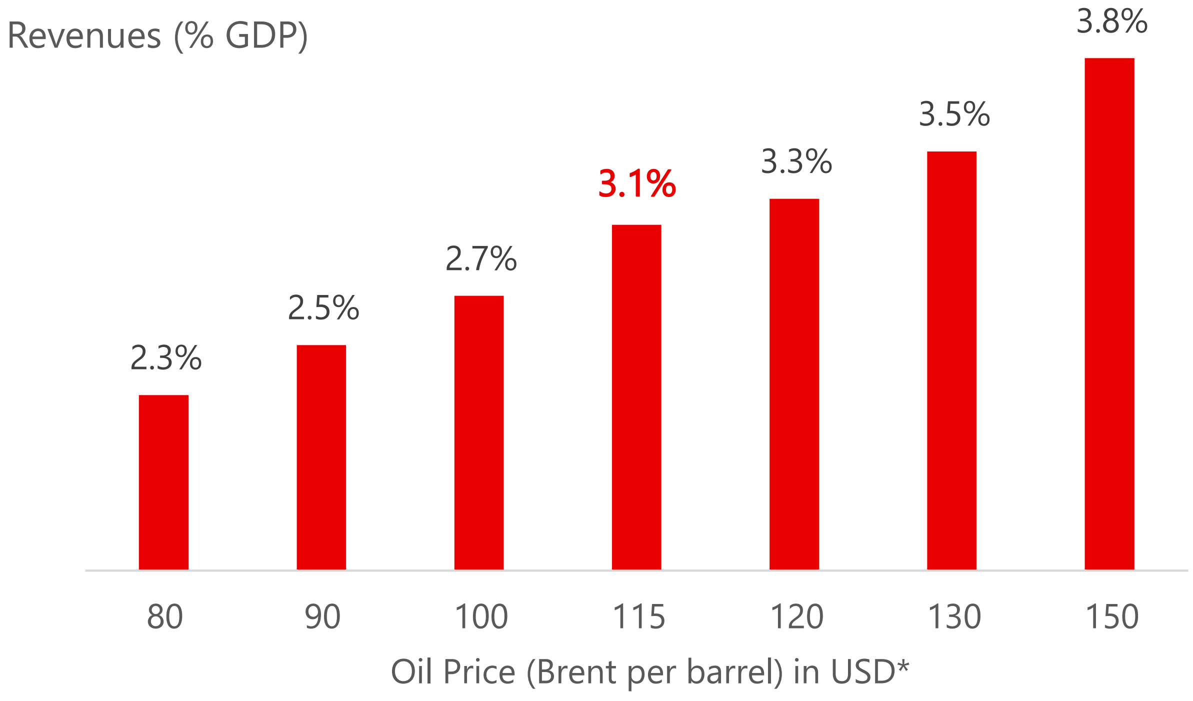


Sources: BCB, Santander.

Background – Oil revenues to help for some time

- We see oil-related direct revenue at around 3.1% of GDP in 2022 considering the consolidated public sector. We estimate oil revenue elasticity by an error correction model at around 0.8. In the Figure below, we explore the different scenarios for international oil prices, keeping the exchange rate at BRL5.05/USD in the average. If oil prices rise further, the fiscal result tends to be even more favorable, with the possibility of recording a primary surplus, as occurred in 2021.

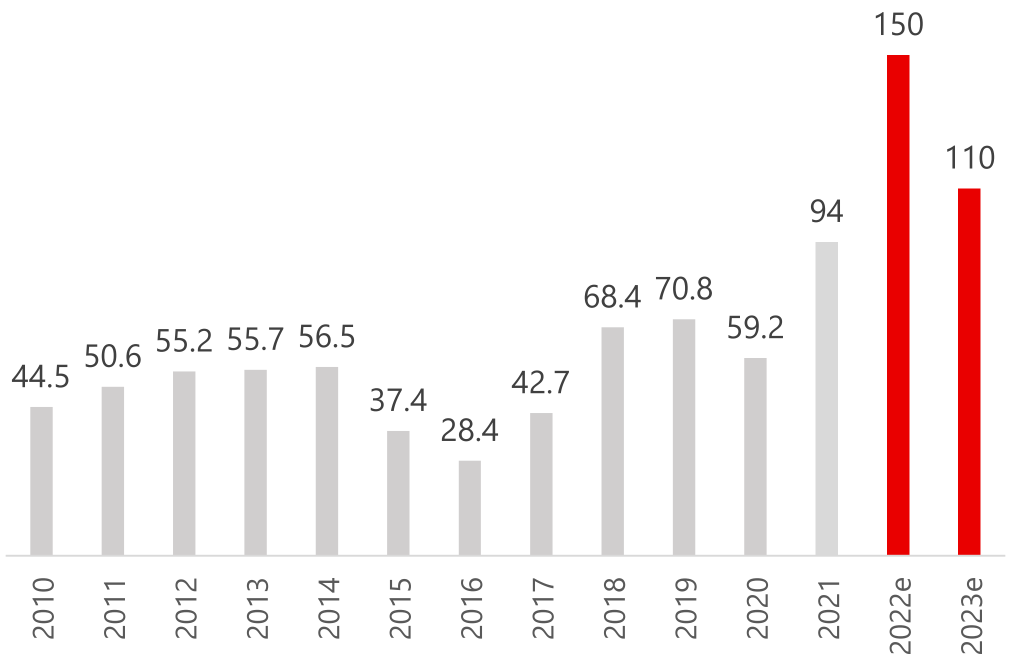
Consolidated Public Sector Oil Revenue – 2022



FX rate maintained at BRL5.05 in the average for 2022

Sources: Confaz, Santander.

Revenues from Exploitation of Natural Resources (~85% oil-related)



Sources: National Treasury, Santander.

Background – Surfing a extended commodity wave

- Commodity prices to remain relatively high until 2025, supporting government revenue for this period. The plentiful extraordinary revenue from corporate restructurings in 2021 will drop to the average of recent years
- Low inventories for most raw materials, coupled with idiosyncratic factors (e.g., adverse weather, past underinvestment, and high cost of production), have been feeding the commodity rally in 2022. The ongoing geopolitical shock coming from Eastern Europe aggravates further what was already materializing as supply-demand imbalances.

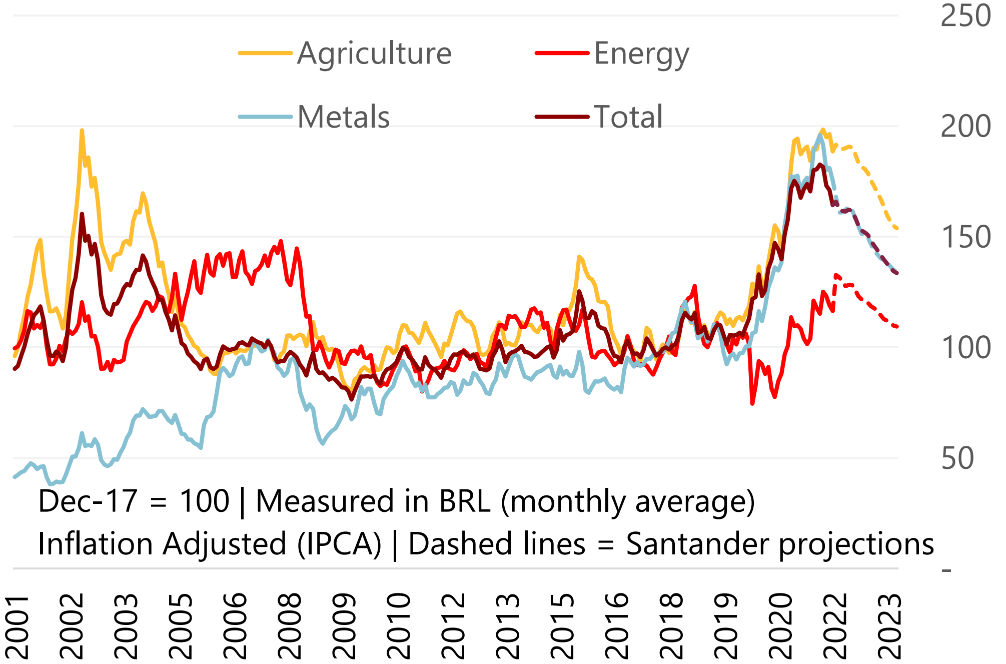
CBR Commodity Prices

YE	2019	2020	2021	2022e	2023e
CRB Food	331	355	483	542	488
CRB Energy	1647	1161	1521	1850	1809
CRB Metal	749	887	1259	1294	1165
CRB	401	444	571	596	561

YE YoY	2019	2020	2021	2022e	2023e
CRB Food	1%	7%	36%	12%	-10%
CRB Energy	2%	-30%	31%	22%	-2%
CRB Metal	-11%	18%	42%	3%	-10%
CRB	-3%	11%	29%	4%	-6%

Sources: BBG, Santander.

CBR Commodity Prices



Sources: BBG, Santander.

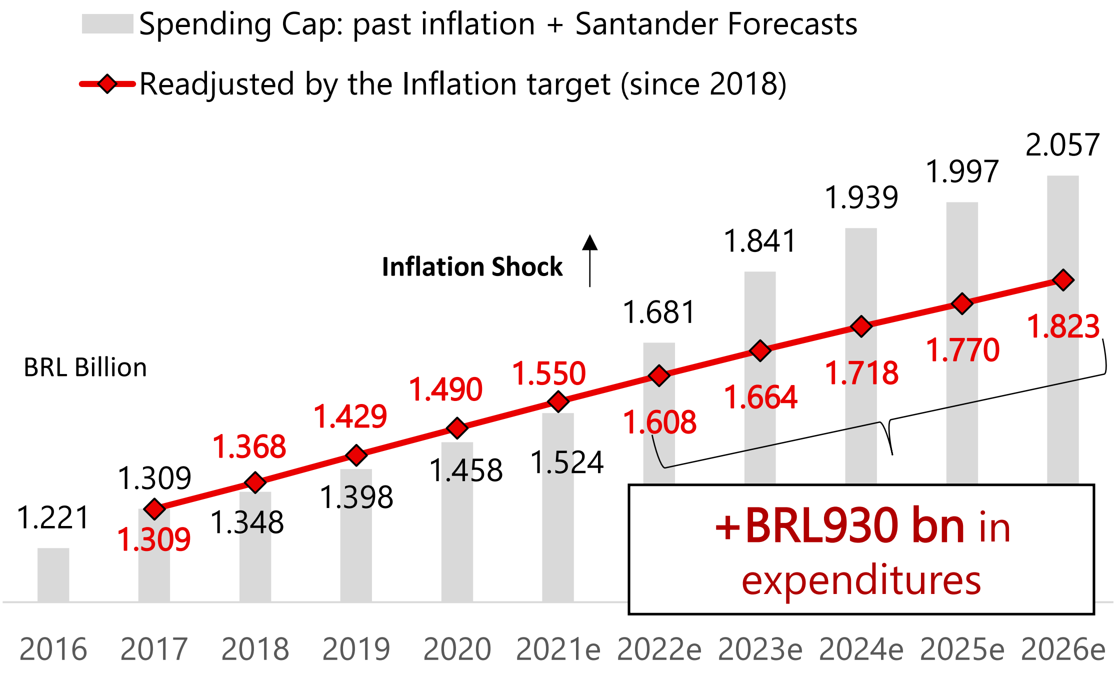
Spending Cap Rule – Lost part of its anchoring power

02

Fiscal – Spending cap rule was affected by the inflationary shock

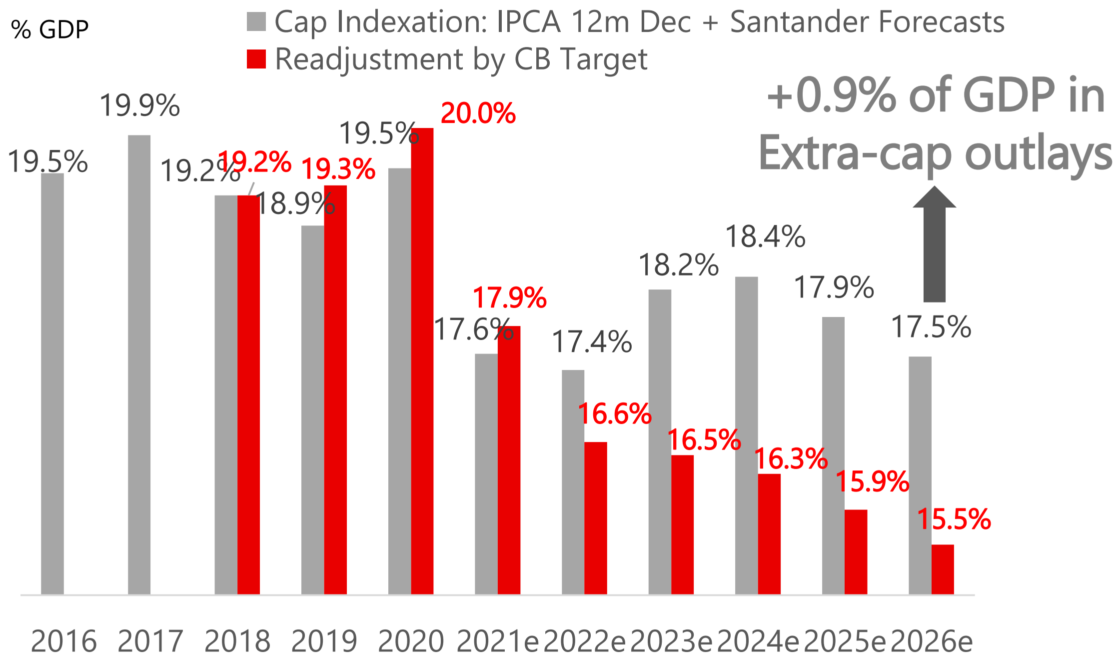
- We believe that the main fiscal anchor lost part of its anchoring power. We calculated more than BRL930 billion in expenditures, compared to the scenario that the spending cap rule is readjusted by the inflation target.
- Recent revision added more 0.5pp in the expenditure in 2026.

Spending Cap Max. Total Limit



Sources: BCB, Santander.

Change in the index of Spending Cap Rule

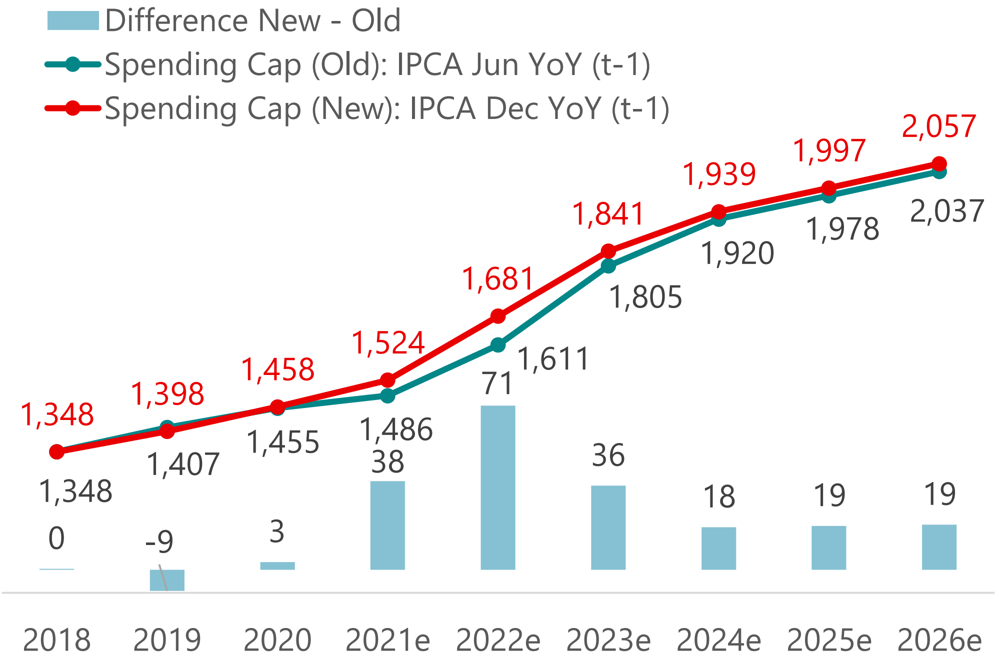


Sources: Ministry of Economy, IBGE, Santander

Fiscal – *PEC dos Precatórios* was the legal vehicle for the new welfare program

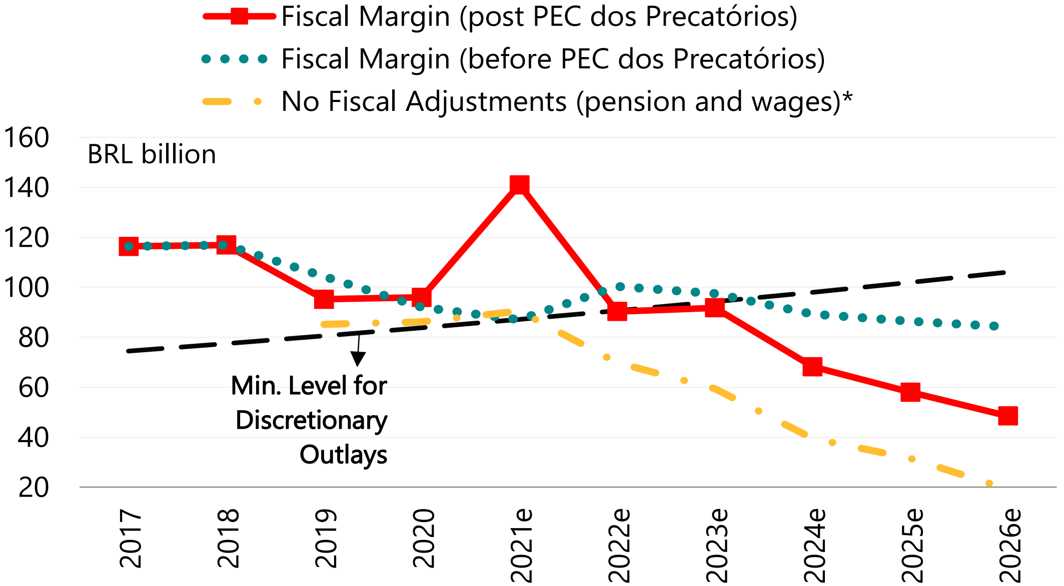
- PEC *dos Precatórios* created a margin of BRL113 bn in the spending cap rule (BRL46 bn through court-ordered debt cap + BRL67 bn by changing the spending cap indexation rule).
- Compared to April 2022 Scenario the annual rise of the spending cap limit rose by BRL50 billion per year, considering the increase in inflation forecasts. In relation to January the increase is BRL100 billion per year.

Change in the index of Spending Cap Rule



Sources: Ministry of Economy, IBGE, Santander

Fiscal Margin – BRL billion



Fiscal Margin = Spending cap Max limit - Mandatory Outlays

* Simulation **WITHOUT** the approval of the PENSION REFORM and WITH PUBLIC SERVANTS WAGES readjusted by inflation

Sources: National Treasury, Santander

Court-ordered Debt – *Precatórios* on the rise

03

National Treasury report - The provisions of court-debt orders liabilities

- In a report published on 10/06/2021, it included the provisions for judicial and administrative losses reported by the Attorney General of Brazil, totaling BRL307 billion. These are the official provisions published in the Treasury's "General Budget Report".

Provisions (BRL billion)	2021	2020	% total (2021)
Fundef	132.5	137.5	43.1
Minimum Income Program (Law10,834/2004)	54	-	17.6
Action possessive	50	50	16.3
Compensation to the sugar and alcohol sector	8.4	-	2.7
Prescription of Reimbursement to the Treasury – TCU	7.3	7.3	2.4
Fiscal Auditors – 28.9% readjustment	7.1	7.1	2.3
Indemnity for material damage	7.0	10.5	2.3
Wage Differences	5.8	5.3	1.9
Performance Bonus – RAV	4.3	4.3	1.4
Correction of inflationary purges	3.8	3.8	1.2
Indemnity related to readjustment, damages and loss of profits	-	32.6	-
Others	27.3	18.7	8.9
Total	307.5	277.0	100

Sources: National Treasury, Ministry of Economy, Santander

Fundef: is the discussion about lower transfers on the Fund for the Preservation, Development and Valorization of Primary Education in the States (Fundef), a skeleton belonging to the government of Fernando Henrique Cardoso. Expenses related to this liability increased by R$16 billion to a total court-ordered account in 2022

Outlook – Judicial Claims official estimate soared, the risks remains high

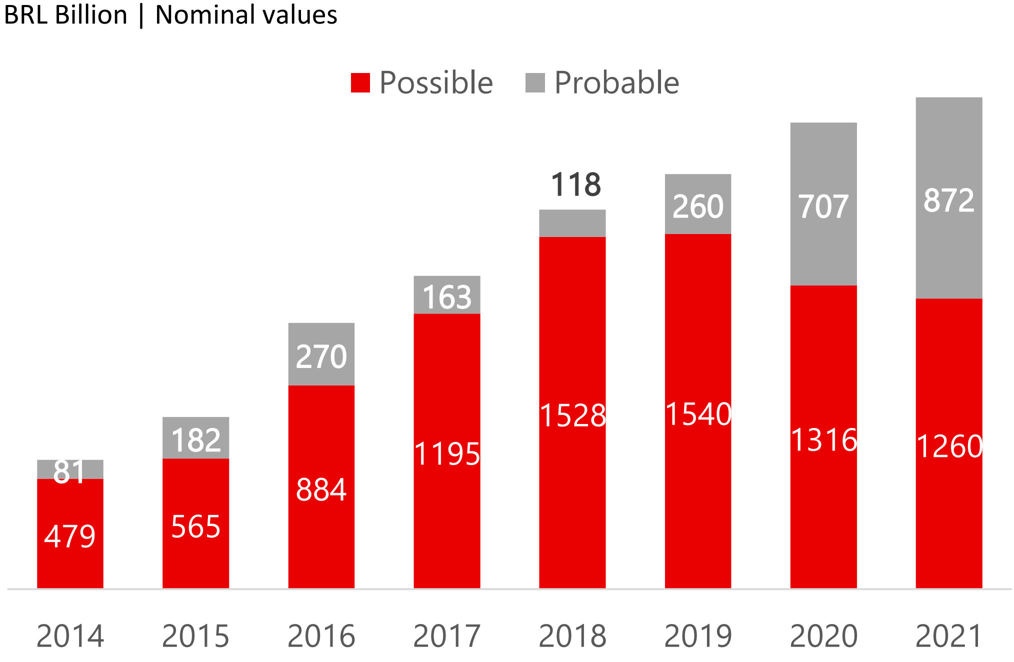
- Regarding probable judicial claims, the amount increased from BRL707.2 billion in 2020 to BRL871.9 billion in 2021, an increase of 23.3%. Claims of a tax nature correspond to 66.9% of the possible risk and 70.4% of the probable risk.

Judicial Claims Increase – BRL billion

BRL Billions	2021	2022
Personnel	**10.5**	**13.7**
Judicial Claims	7.3	10.5
RPVs (small value requisitions	2.1	1.9
Others	1.1	1.3
Pension Benefits	**22.6**	**30**
Judicial Claims	10.5	15.7
RPVs (small value requisitions	12.1	14.3
Continuing Benefits	**1.4**	**1.6**
Judicial Claims	0.2	0.3
RPVs (small value requisitions	1.2	1.4
Other cost capital expenses	**20.8**	**43.7**
Judicial Claims	17.7	40.3
RPVs (small value requisitions	1.9	2.3
Others	1.3	1.1
Total	**55.4**	**89.1**

Sources: National Treasury, MCM, Santander

LDO Judicial Claims: Probable and Possible Risk



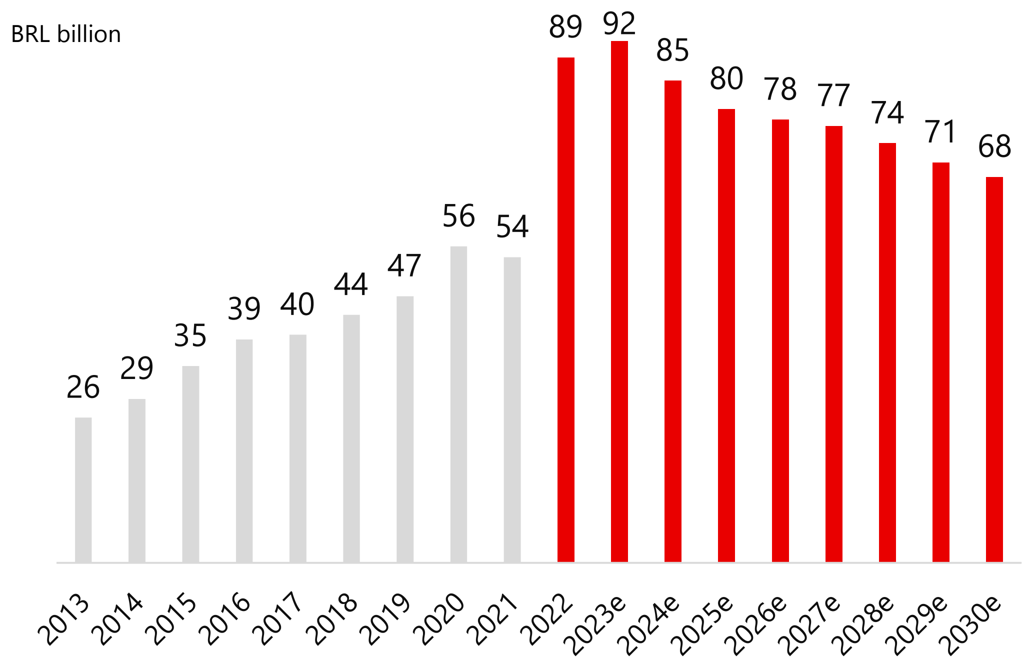
Sources: AGU, LDO 2020, Santander.

This judicial claims are included in the Budget Guidelines (LDO) as a potential and probable fiscal risks. Differently from the previous table from the “General Budget Report”, this numbers are the potential of liabilities in the Supreme Court judgments.

We estimate an increase in judicial claims over the next years

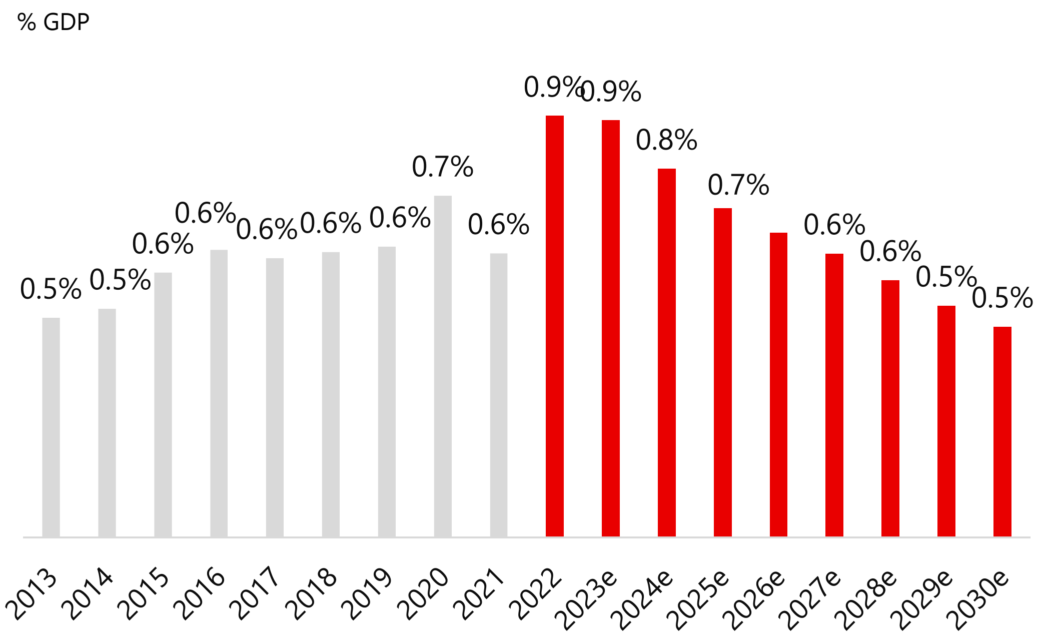
- We constructed a forecast based on the Budget Guidelines (LDO) probable judicial claim for next the years. In the short-run we see more pressure from the Fundef (educational fund) and those related to pension payments.
- Our preliminary estimate is only a preliminary "educated-guess" in view of the 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

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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**

Estimated without “Encontro de Contas” (debt cancelations)

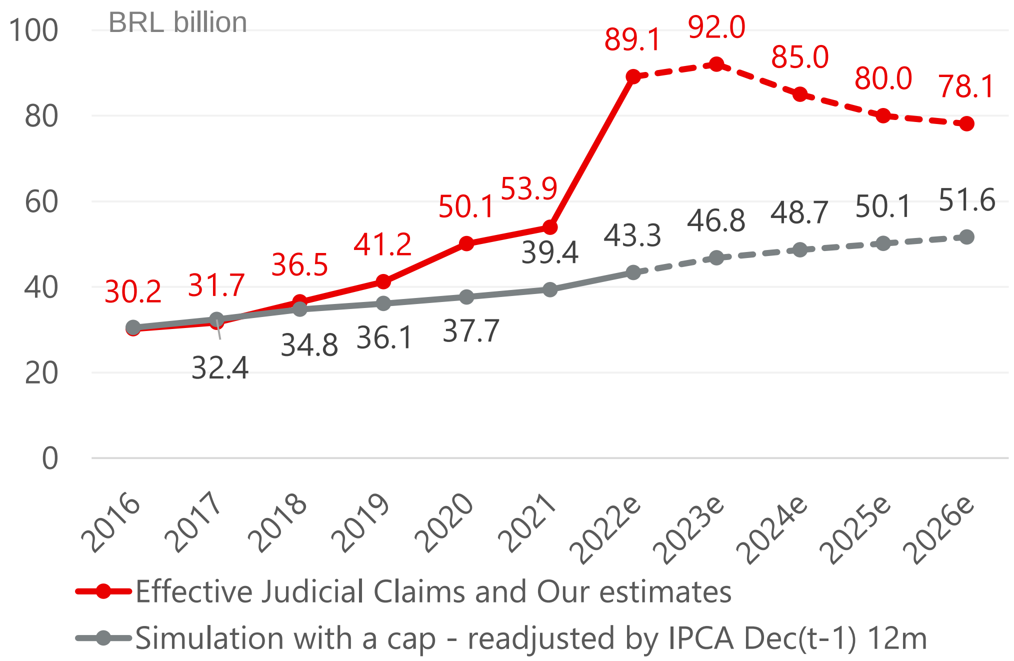
Item	2022	2023
Expected Judicial Claims	89.1	92.1
Subcap (PEC Precatórios)	40.5	43.1
Payments in the year	62.0	61.6
Precatórios unpaid (accumulated)	22.9	57.6

Sources: National Treasury, Santander

Simulation – effects of creating a cap for the payment

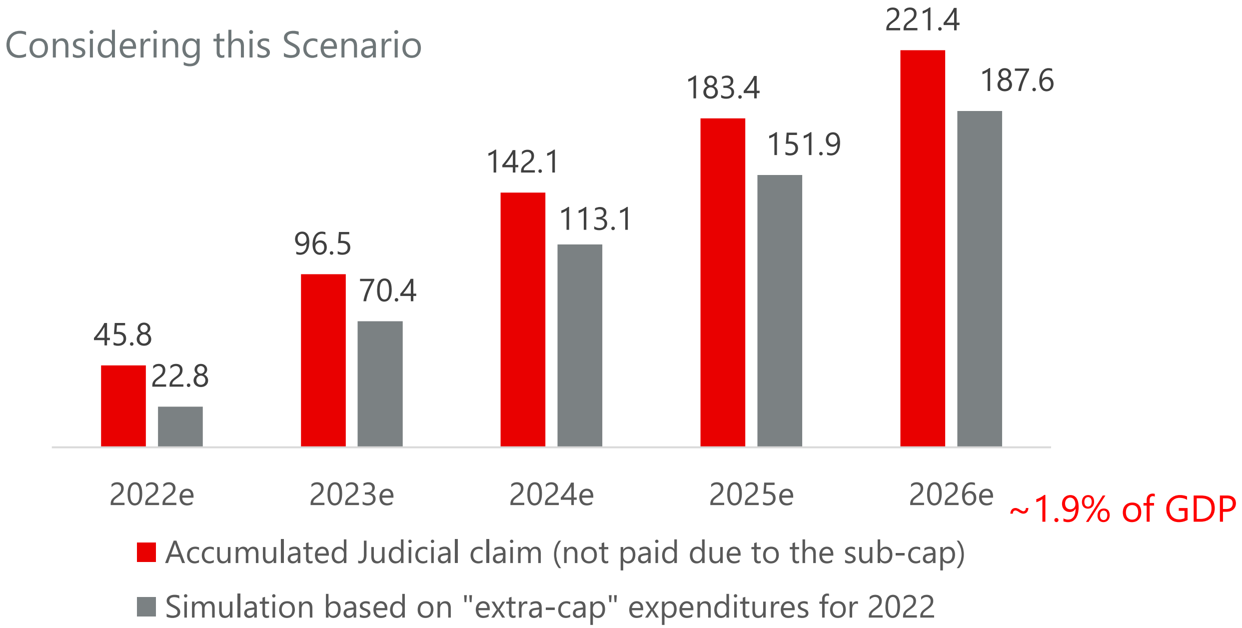
- In order to reduce the judicial claims payments, the government proposed to create a ceiling for these liabilities and postponing the remaining for the next few years (or paying outside the spending cap limit).
- Creating a cap since 2016 would reduce the judicial claim payments in 2022 to close to BRL43 billion, from the BRL89.1 billion official number.

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.

Oil, Inflation and Impact on Fiscal Scenario

04

Outlook – Legislation to Curb the increase in Fuel Prices

- The administration proposed two a constitutional amendments to curb the increase in fuel prices. The first would authorize direct federal transfers to compensate states that reduce taxation on diesel further than PLP18/22 17-18% rate. The other would implement new taxation rules for ethanol to keep its prices competitive against gasoline.

PLP 18/22

(Approved in Lower House, Currently in Senate)

- ❑ Aims at permanently capping the VAT tax (ICMS state tax) on fuel, electricity, telecom and transportation, which are levied at the state level.
- ❑ Allows the federal gov. (without compliance to the Fiscal Responsibility Law) to remove the PIS/Cofins federal tax from gasoline (temporary in 2022) and ethanol (by 2027).

PEC Fuels

(Only a draft in Senate)

- ❑ Federal gov. to compensate the states that reduce the ICMS tax (on Diesel, LGN) to below 17% by the end of the year (Ethanol until 12%),
- ❑ Exempting this from the fiscal rules (constitutional spending cap and Fiscal Responsibility Law, LRF).

PLP1143/21

(Heads to Presidential sanction)

- ❑ Speeds up the use of tax credits in electricity (“Bonus Tarifário”). Could reduce federal gov. revenues in 2022.

PEC Biofuels

(Only a draft in Senate)

- ❑ providing for a "favored tax regime for biofuels in the form of a complementary law, guaranteeing lower taxation than fossil fuels, encouraging their use"

For more details:

Santander Brazil – Special Report: “*Measures to Curb the Rise in Prices*” – June 09, 2022 – Available on: https://bit.ly/Std-special-060922

Legislations - Summary of the Impact of the Proposals

- . We believe that the total impact, if all the measures are approved, would be BRL89 billion (0.9% of GDP) in 2022. This would lead to a primary deficit of close to BRL50 billion (0.5% of GDP), according to our calculations. There is uncertainty as to which measures will be approved. Thus, the timing and the overall impact are still unclear. For now, the constitutional amendment (PEC Fuel) will be limited to 2022, totaling BRL28 billion (0.3% of GDP) of impact. Considering the full year impact (if the measure is extended for next year), it would be BRL88 billion (0.9% of GDP). It is important to note that if the PEC is approved, the downward reduction in inflation would pressure the numbers for 2023. This could add more impetus for new fiscal stimulus ahead.

Impacts on Fiscal (BRL bn)

Potential Impact on Fiscal				
	2022		Full-Year	
	BRL bn	% GDP	BRL bn	% GDP
I. PLP 18/22 ICMS Cap (Impact)	**65**	**0.7%**	**129**	1.3%
1. Fuels ICMS Cap 17-18%	20	0.2%	40	0.4%
Gasoline	14	0.1%	28	0.3%
Diesel	5	0.1%	10	0.1%
Ethanol	1	0.0%	2	0.0%
2. Telecom cap	5	0.1%	10	0.1%
3. Eletricity	20	0.2%	40	0.4%
ICMS cap to 17-18%	5	0.1%	10	0.1%
Changing the ICMS base (TUSD/TUST)	15	0.2%	30	0.3%
4. Zeroing PIS/Cofins and CIDE Gasoline**	16	0.2%	32	0.3%
5. Zeroing PIS/Cofins Ethanol**	3.5	0.0%	7	0.1%
II. PEC Fuel (Compensation)	**28**	**0.3%**	**56**	0.6%
Zeroing ICMS Diesel*	23	0.2%	46	0.5%
Zeroing ICMS LPG*	3	0.0%	6	0.1%
Reducing ICMS Ethanol to 12%*	2	0.0%	4	0.0%
Total Impact (I + II)	**93**	**1.0%**	**185**	**1.9%**

* Revenue loss for States

** Revenue loss for federal government (without Compliance with the Fiscal Responsibility Law)

Sources: National Congress, Santander.

Legislations - Summary of the Impact of the Proposals

- Therefore, we believe a more reasonable scenario is to assume that (i) PLP 18 (state tax ICMS cut to 17% and PIS/Cofins federal tax cut) will cover fuel only for the short term (leaving electricity and telecom only for 2024), (ii) the PEC could take a while to be approved, and even so it is unlikely that states will zero the ICMS tax on fuel, and (iii) Aneel will accelerate the use of the tax credits. Moreover, we also assume that the pass-through to consumers of the tax cuts on fuel will be only 70%. In that scenario we envision a 136-bp fall in the IPCA index in 2022, but followed by a +45-bp rebound in 2023, from the resumption of federal taxes on fuel, and +10 bps from the acceleration in the use of tax credits.

Impacts on Inflation (p.p)

Inflation Scenarios	2022			2023
	Full	Most likely	Low effect	Most likely
I. PLP 18/22 ICMS Cap (Impact)	**-253**	**-104**	**-2**	**45**
Fuels ICMS Cap 17-18%	-85	-59	-2	0
Gasoline	*-80*	*-56*	*0*	*0*
Diesel	*-2*	*-2*	*-2*	*0*
Ethanol	*-3*	*-1*	*0*	*0*
Zeroing PIS-Cofins and CIDE Gasoline	-64	-45	0	45
Telecom cap	-30	0	0	0
Electricity	-74	0	0	0
ICMS cap to 17-18%	*-40*	*0*	*0*	*0*
Changing the ICMS base (TUSD/TUST)	*-34*	*0*	*0*	*0*
II. PEC Fuel (Compensation)	**-25**	**0**	**0**	**0**
Zeroing ICMS Diesel	-4	0	0	0
Zeroing ICMS LPG	-17	0	0	0
Reducing ICMS Ethanol to 12%	-4	0	0	0
III. Tax Credits	**-32**	**-32**	**-32**	**10**
Electricity	-32	-32	-32	10
Total Impact (I + II + III)	-310	-136	-34	55
IPCA	6.4	8.1	9.2	5.9

Sources: National Congress, Santander.

Impacts on Fiscal (BRL bn)

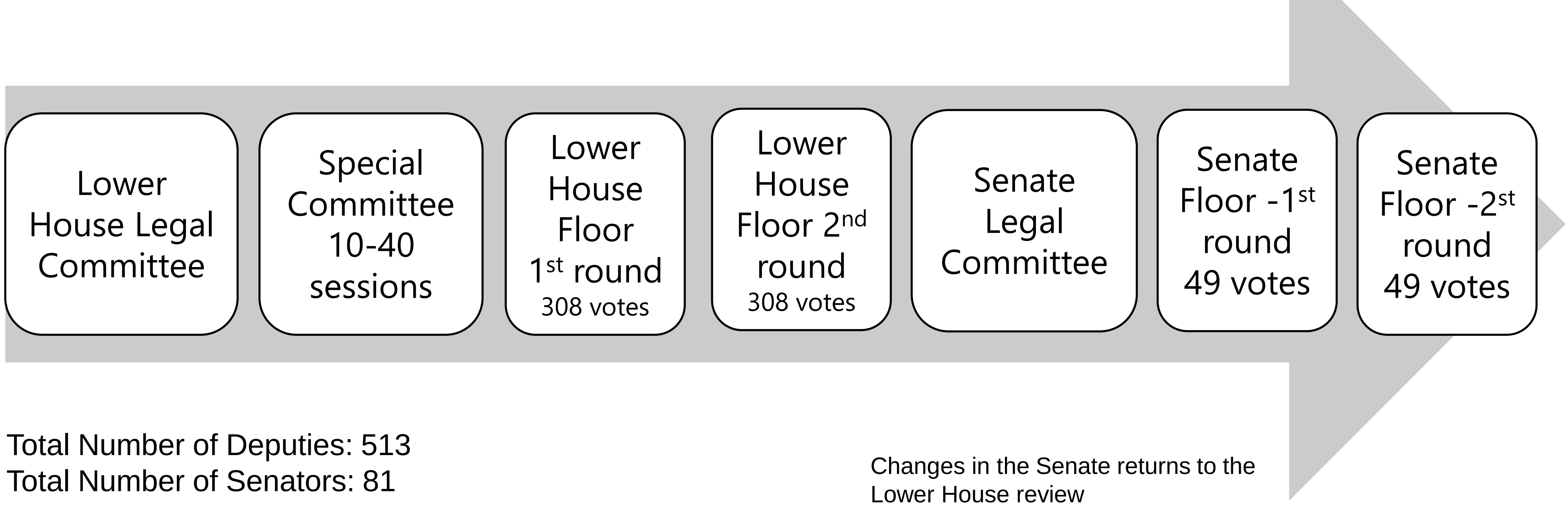
Fiscal Scenarios	2022			2023
	Full	Most Likely	Low effect	Most Likely
I. PLP 18/22 ICMS Cap (Impact)	**65**	**35**	**13**	**37**
1. Fuels ICMS Cap 17-18%	20	16	5	30
Gasoline	14	10	0	20
Diesel	5	5	5	10
Ethanol	1	1	0	2
2. Telecom cap	5	0	0	0
3. Electricity	20	0	0	0
ICMS cap to 17-18%	5	0	0	0
Changing the ICMS base (TUSD/TUST)	15	0	0	0
4. Zeroing PIS/Cofins and CIDE Gasoline	16	16	8	0
5. Zeroing PIS/Cofins Ethanol	4	3	0	7
II. PEC Fuel (Compensation)	**28**	**0**	**0**	**0**
Zeroing ICMS Diesel	23	0	0	0
Zeroing ICMS LPG	3	0	0	0
Reducing ICMS Ethanol to 12%	2	0	0	0
Total Impact (I + II)	93	35	13	37
Primary Balance Public Sector (BRL bn)	-58	0	22	-85

Sources: National Congress, Santander.

Outlook – Legislation to Curb the increase in Fuel Prices

- The administration proposed two a constitutional amendments to curb the increase in fuel prices. The first would authorize direct federal transfers to compensate states that reduce taxation on diesel further than PLP18/22 17-18% rate. The other would implement new taxation rules for ethanol to keep its prices competitive against gasoline.

Legislative Process – Constitutional Amendment (PEC)



Total Number of Deputies: 513
Total Number of Senators: 81

PLP approval: 50% +1

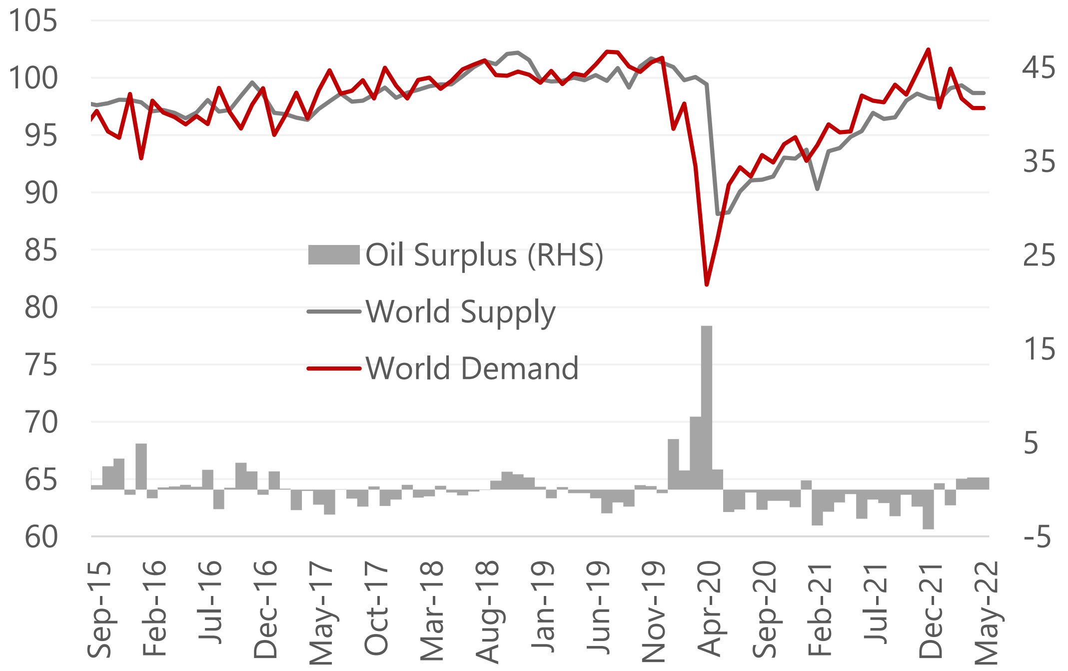
For more details:

Santander Brazil – Special Report: “*Measures to Curb the Rise in Prices*” – June 09, 2022 – Available on: https://bit.ly/Std-special-060922

Oil Balance - Global market deficit

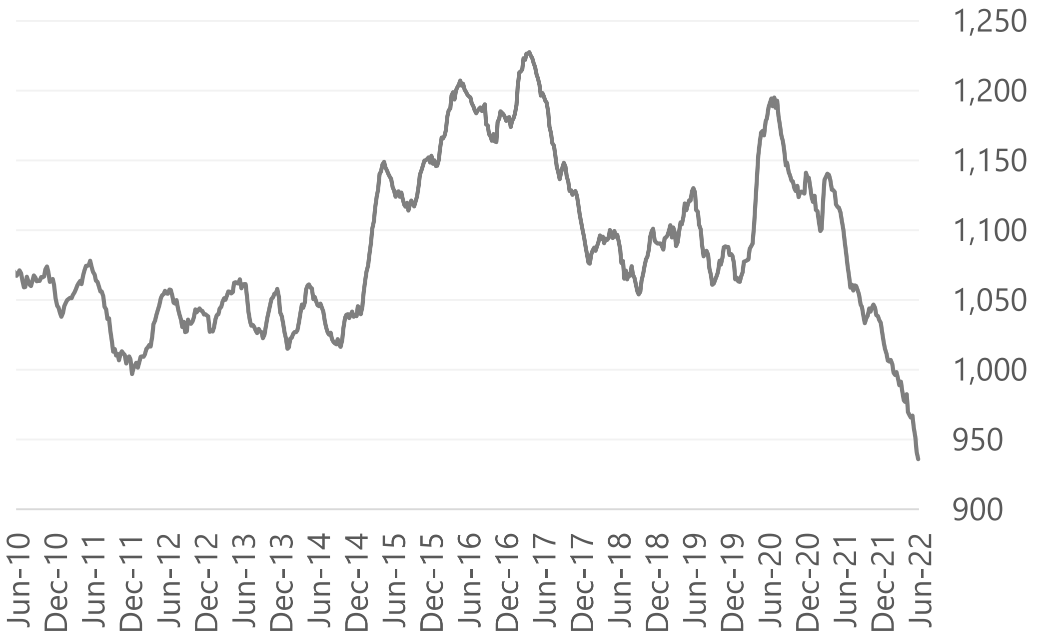
- As the economy recovers from the coronavirus pandemic and as major oil producers' output falls, the global balance of supply and demand for oil has been consistently running at a deficit. As a result, global inventories are the tightest in at least seven years: U.S. crude inventories are already below 2011-15 levels, when Brent crude oil stayed above US$100/bbl. Similarly, US inventories are the low levels

World Oil Supply x Demand (mbd)



Sources: Bloomberg, Santander.

US Total Oil Crude Stocks (strategic reserve + commercial stocks)

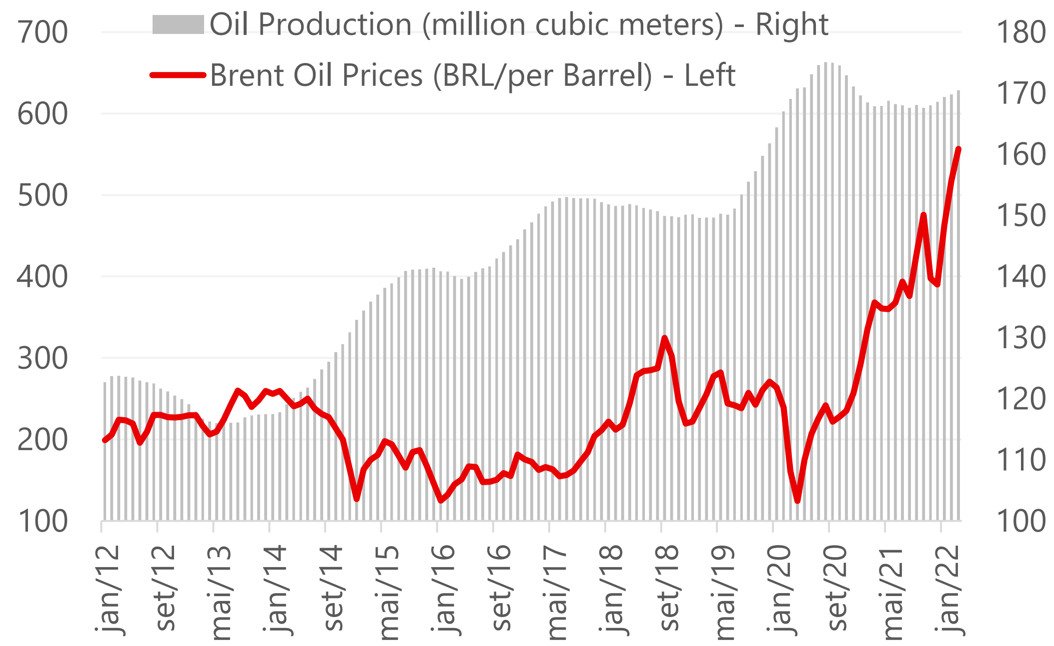


Sources Bloomberg, Santander.

Oil and Fiscal – Higher production and the jump in revenues

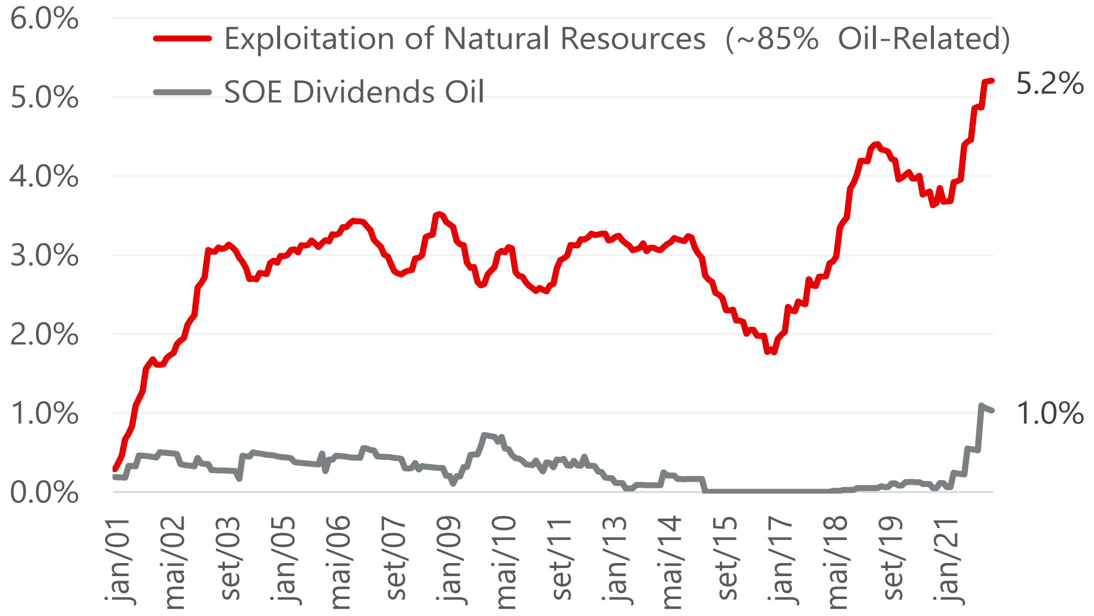
- For public accounts, oil revenues have been a notably positive factor, especially in 2021, and we expect this revenue to continue to help government revenue. As shown in Figure below, oil production in Brazil has been increasing, especially pre-salt oil production. In 2021, a depreciated FX rate coupled with higher international oil prices (Brent) led to a robust revenue increase. For 2022, owing to the factors mentioned above, we expect revenue from oil to continue to be strong, leading to better primary balance numbers.

Brazilian Oil Prices and Production



Sources: MCM, ANP, Bloomberg, Santander.

Federal Tax Revenues (% of total Revenues)



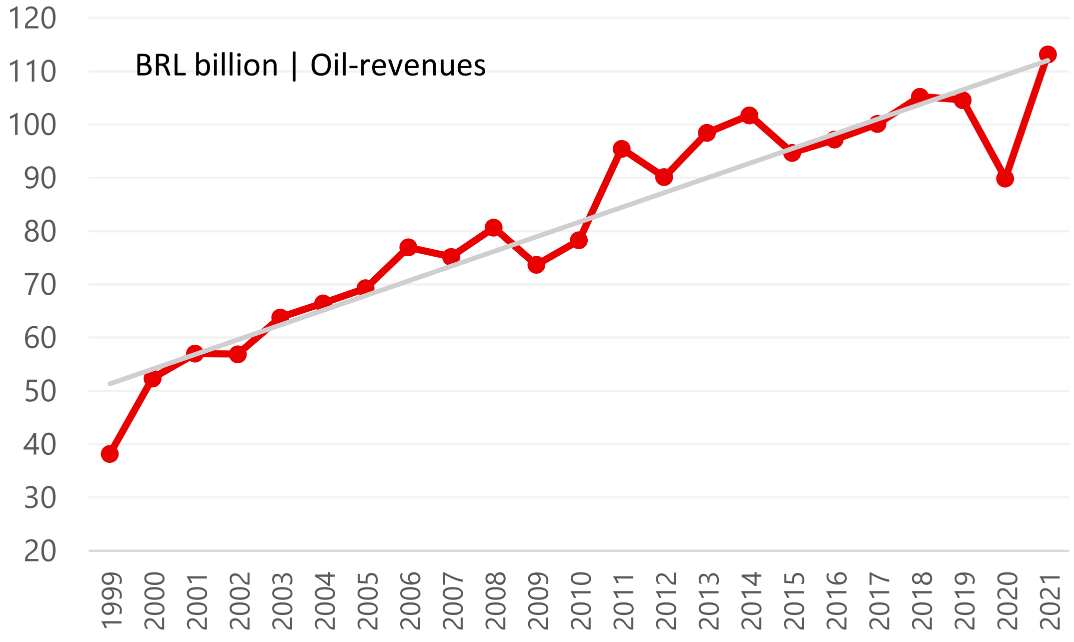
Sources National Treasury, Santander.

Santander

Oil and Fiscal – Regional Governments revenue increase

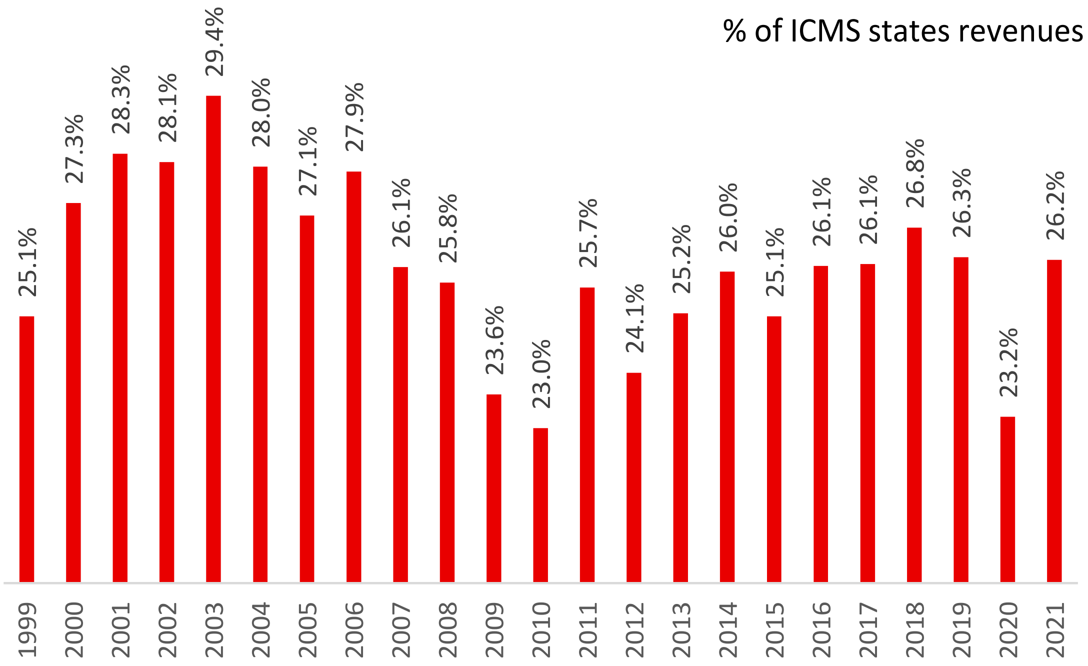
- The evolution of oil prices was a key element of this improvement in the public accounts of regional governments. ICMS tax collections related to oil were up 26% in 2021, in real terms. In other words, the states registered a strong recovery after the loss of revenue in 2020. We highlight that oil revenue corresponds to more than 20% of total ICMS, historically.

Brazilian Oil Prices and Production



Sources: Confaz, Santander.

Regional Governments – Oil as % total

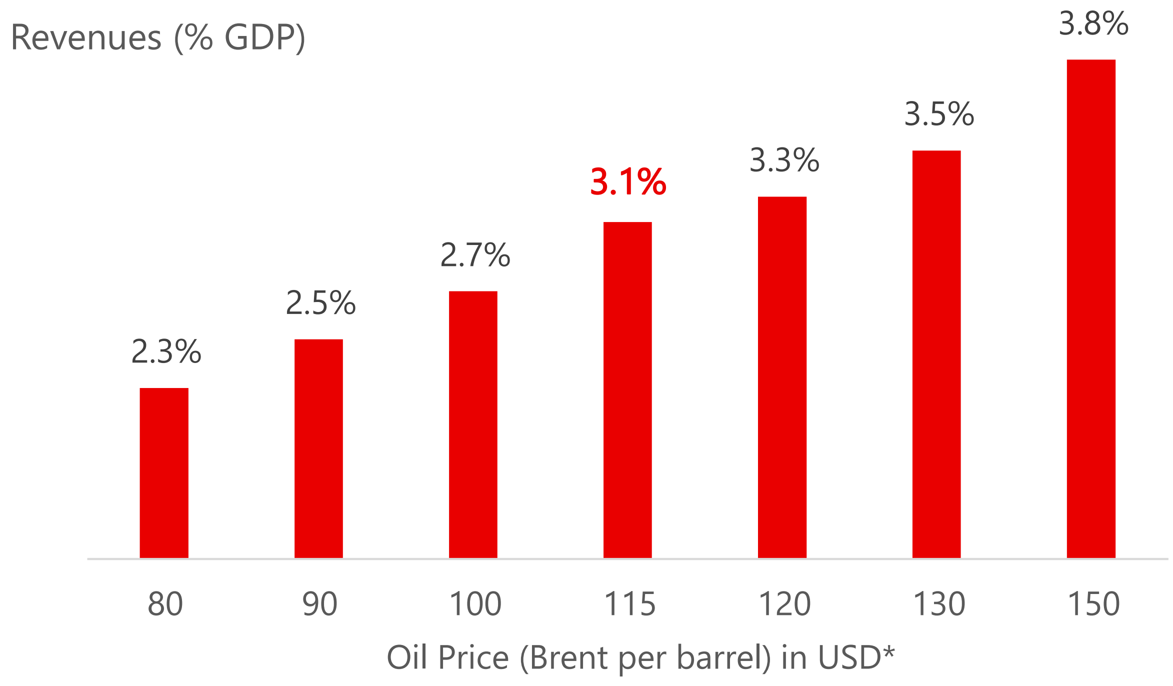


Sources National Treasury, Santander.

Oil and Fiscal – Total impact

- we see oil-related direct revenue at around 3.1% of GDP in 2022 considering the consolidated public sector. We estimate oil revenue elasticity by an error correction model at around 0.8. In the Figure below, we explore the different scenarios for international oil prices, keeping the exchange rate at BRL5.00/USD. If oil prices rise further, the fiscal result tends to be even more favorable, with the possibility of recording a primary surplus, as occurred in 2021.

Consolidated Public Sector Oil Revenue – 2022



FX rate maintained at BRL5.05 in the average for 2022

Sources: Confaz, Santander.

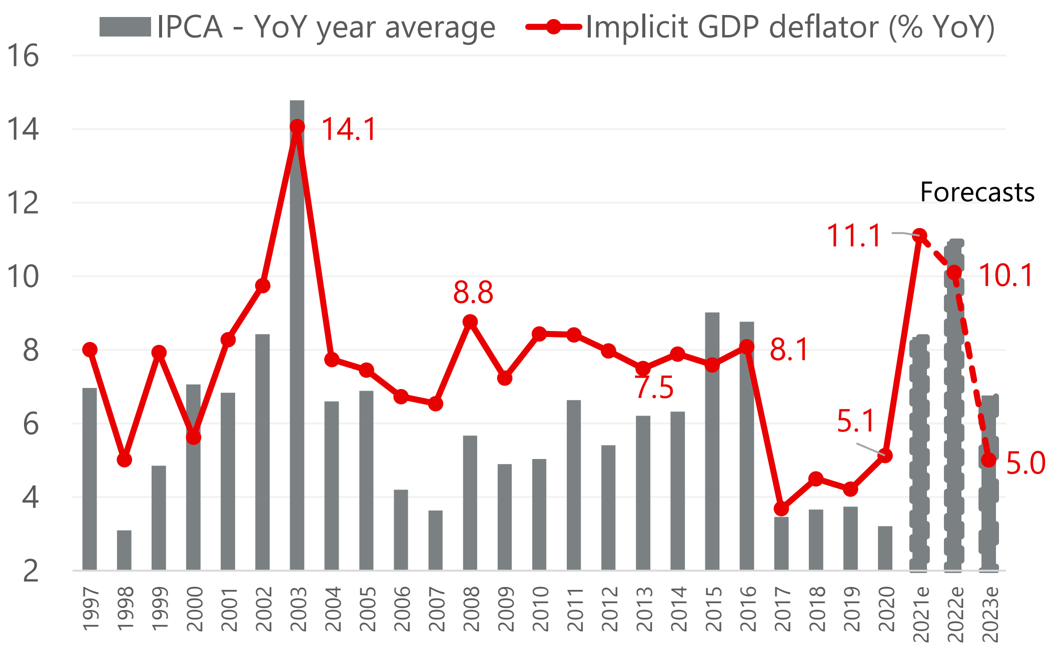
05

Fiscal Baseline Scenario – Primary Result and Simulations

GDP Deflator Impact – Terms-of-Trade and Inflation Shock Effect

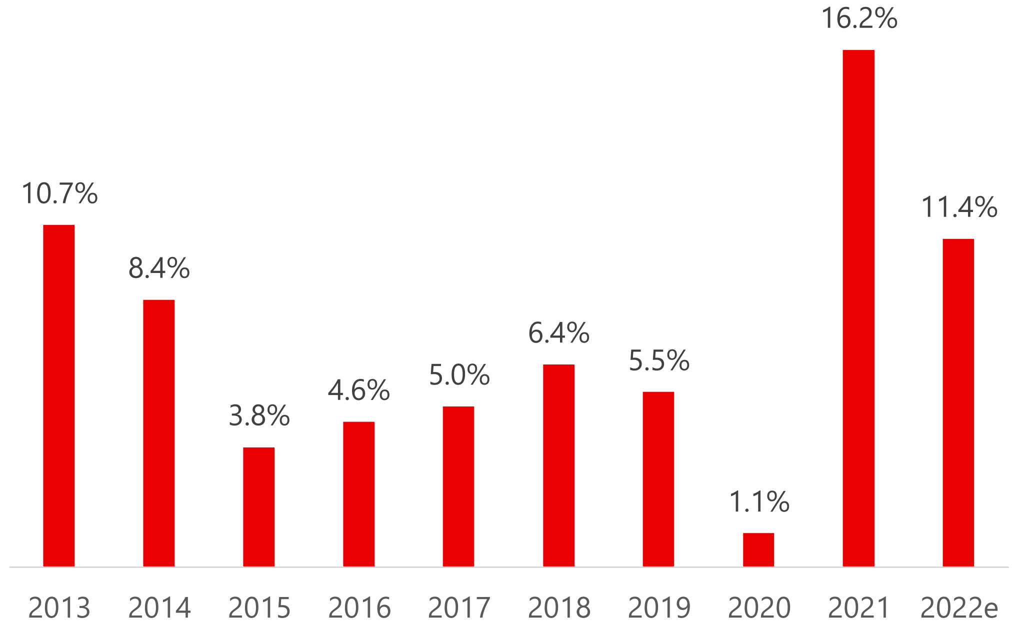
- Inflation played a significant role in improving public accounts in the short run. For 2021, in Mar-21 we estimated nominal GDP at 7%, but it ended the year with a 16.2% increase. The effect of the massive increase in the GDP deflator affected the fiscal-statistics-to-GDP ratio. For 2022, we also revised upwards due to a more intense inflationary shock, we rose the estimate for 2022 GDP deflator from 9.5% to 10.1%. As a consequence the nominal GDP should rise 11.4%, according to our numbers.

IPCA and GDP Deflator



Sources: IBGE, Santander.

Nominal GDP Increase YoY

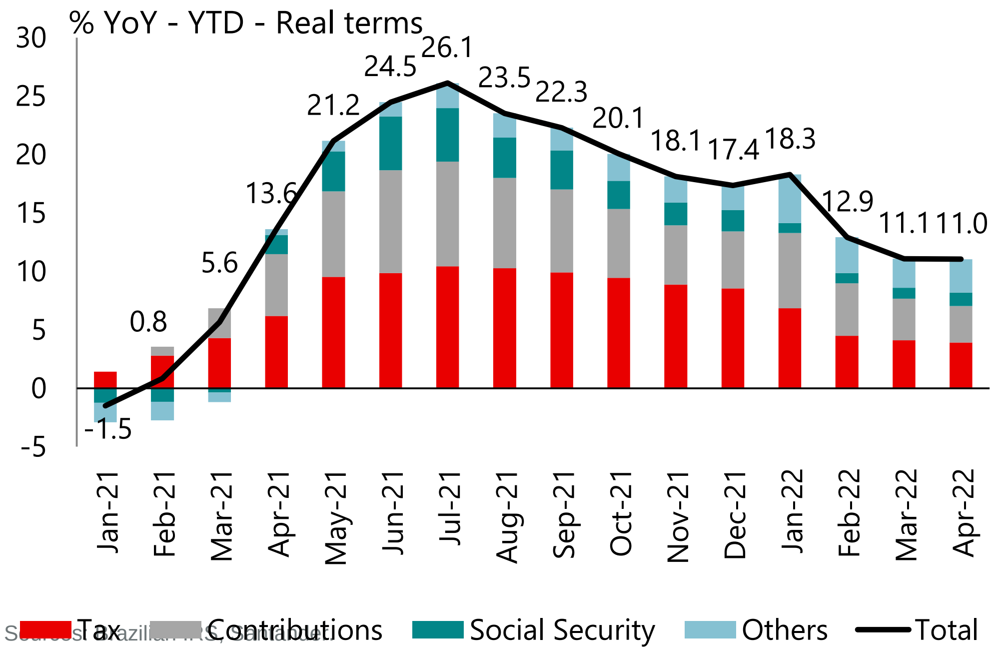


Sources: IBGE, FGV, Santander.

Revenues Impact – Inflation is Boosting Tax Collection in Federal and Regional Terms

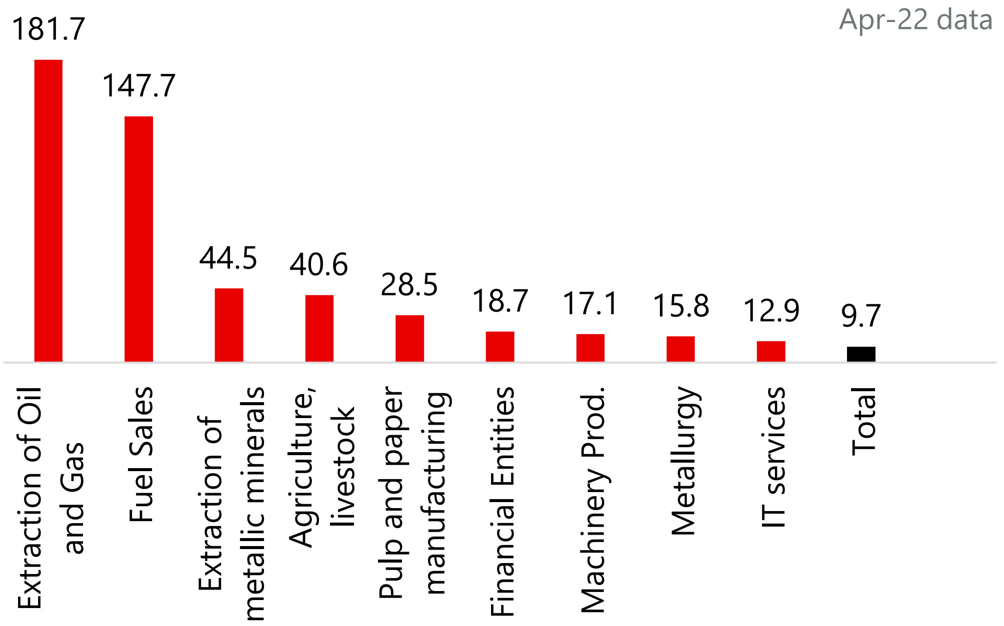
- We see a strong recovery in federal tax collection in recent months, mainly direct taxes linked to the corporate sector, which have posted good results. We can also observe that the increase in tax collection is highly correlated with sectors linked to the commodity boom, especially those related to metals.
- In our view, we expect revenue growth to slow down in 2H22 (still positive), 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; v) Oil prices impulse with Russian-Ukraine conflict

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



Sources: Brazilian IRS, Santander.

Federal Tax Revenue by sectors (%YoY)

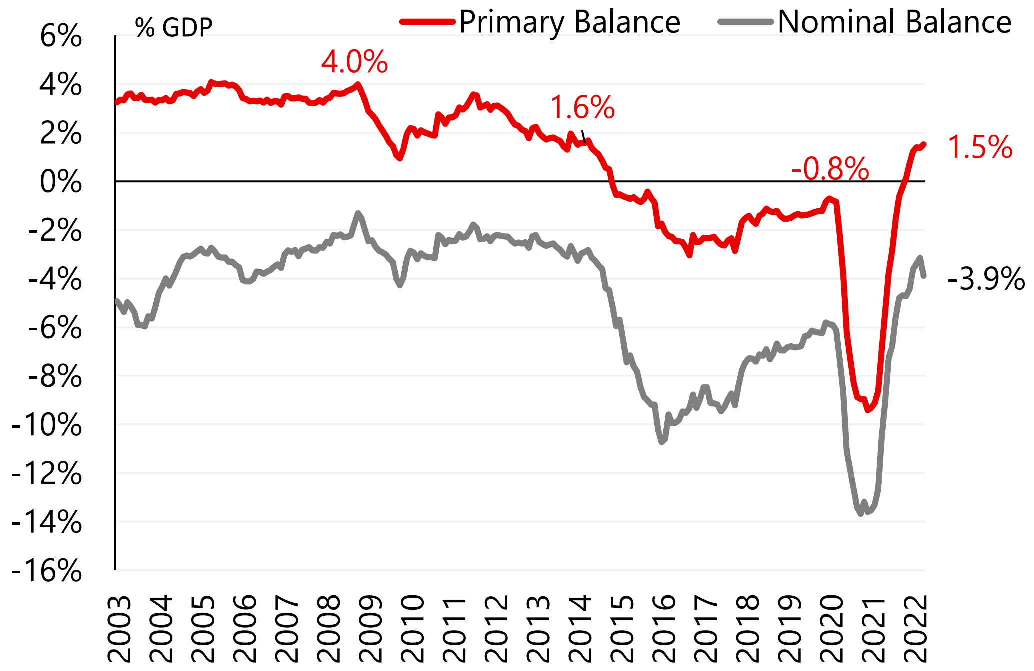


Sources: Brazilian IRS, Santander.

Public Sector Primary Result Improving with the Price-effect

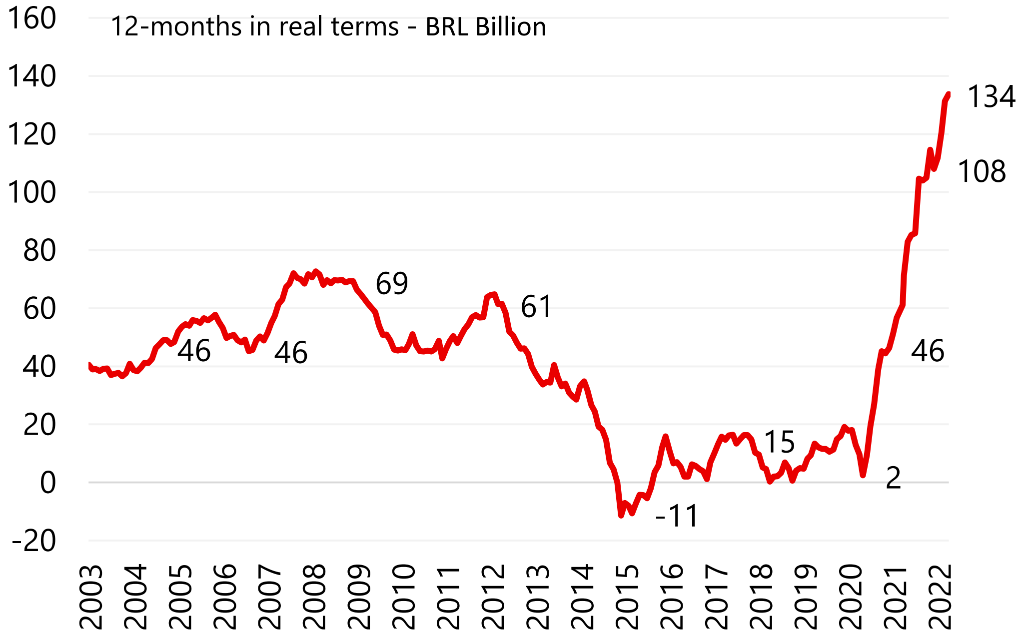
- According to BCB data published today, the consolidated public sector posted a hefty primary surplus of BRL38.9 billion in April, close to our forecast (BRL40 billion) and better than the market's median estimate (BRL30.1 billion). This was the best result for the month in the historical series. In 12 months, the public sector reached a primary surplus of BRL137.4 billion (1.5% of GDP), compared to BRL122.8 billion (1.4% of GDP) in March and BRL64.7 billion (0.75% of GDP) in December 2021.

Public Sector – 12m % GDP



Sources: Brazilian Central Bank, Santander.

Regional Gov. – Primary Result

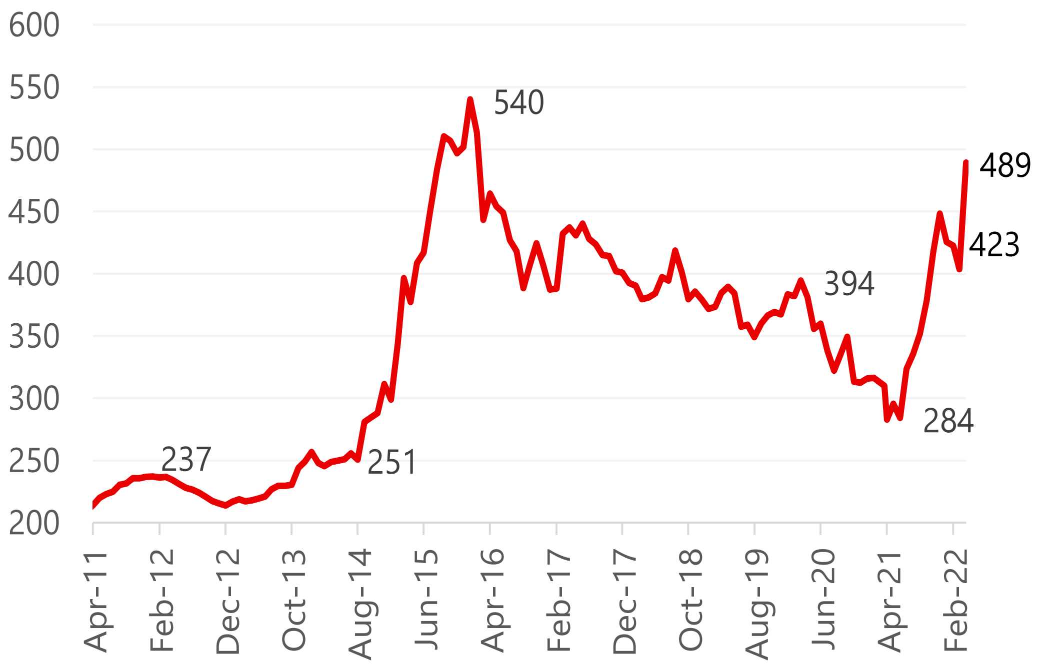


Sources: Brazilian Central Bank, Santander.

Public Sector Primary Result Improving with the Price-effect

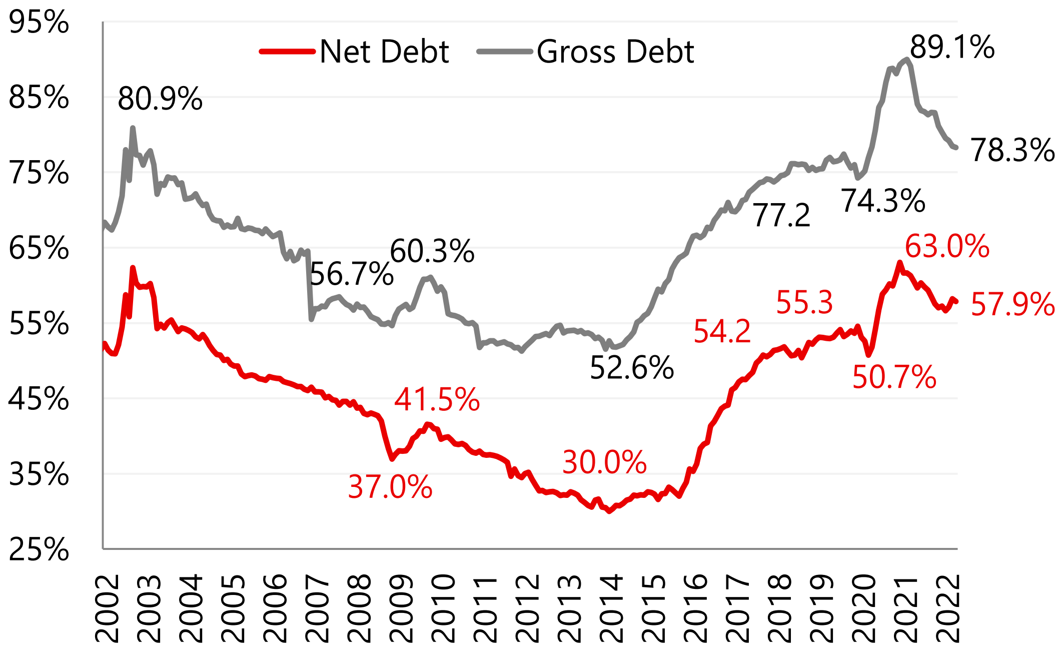
- In April, interest payments soared and reached BRL79.9 billion, compared to -BRL5.7 billion in April 2021. The result of FX swap operations in the period contributed to this result (loss of BRL15.4 billion in the month compared to a gain of BRL30.4 billion in April 2021). It was the first month of the year in which the result was lower than last year. In the 12-month reading, the nominal budget balance reached BRL352 billion (3.9% of GDP), compared with BRL383 billion (4.4% of GDP) in December 2021.

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 Government's Primary Balance															
Fiscal Items (% of GDP)	2018	2019	2020	2021	2022e	2023e	2024e	2025e	2026e	2027e	2028e	2029e	2030e	Δ 26-17	Δ 30-17
Total Revenue	21.2	22.1	19.7	22.3	22.6	22.5	22.8	22.8	22.9	23.0	23.0	23.0	23.0	1.9	2.0
Revenues Collected by the IRS (1)	12.9	12.8	12.0	13.8	13.6	13.3	13.4	13.4	13.4	13.4	13.4	13.4	13.4	0.7	0.7
Net Social Security Revenues (2)	5.6	5.6	5.4	5.3	5.4	5.5	5.6	5.6	5.6	5.6	5.7	5.7	5.7	-0.1	0.0
Revenues Not Collected by the IRS (3)	2.7	3.7	2.2	3.2	3.5	3.7	3.8	3.9	3.9	3.9	3.9	4.0	4.0	1.2	1.3
Transfers by Revenue Sharing	3.7	3.9	3.5	4.0	4.7	4.6	4.6	4.6	4.6	4.6	4.6	4.5	4.4	1.2	1.0
Net Revenue	17.6	18.2	16.1	18.2	17.9	17.9	18.2	18.2	18.3	18.4	18.4	18.5	18.6	0.7	1.0
Total Expenditure	19.3	19.5	26.1	18.6	18.2	18.7	19.0	18.8	18.4	18.2	18.0	17.8	17.6	-1.1	-1.9
Social Security Benefits (4)	8.4	8.5	8.9	8.2	8.1	8.5	8.6	8.6	8.6	8.6	8.5	8.4	8.4	0.1	-0.1
Payroll (5)	4.3	4.2	4.3	3.8	3.6	3.8	3.9	3.8	3.8	3.8	3.8	3.7	3.7	-0.5	-0.7
Other Mandatory Expenses (6)	2.9	2.6	9.6	3.5	2.8	2.9	3.1	3.1	2.9	2.9	2.8	2.8	2.7	-0.1	-0.3
Expenses with Cash Control (7)	2.0	1.9	1.8	1.7	2.4	2.3	2.2	2.1	2.0	1.9	1.9	1.8	1.8	0.1	-0.1
Discretionary Expenses (8)	1.8	2.2	1.4	1.4	1.3	1.2	1.1	1.1	1.1	1.1	1.1	1.1	1.1	-0.6	-0.7
Central Gov. Primary Balance	-1.7	-1.3	-10.0	-0.4	-0.4	-0.8	-0.8	-0.6	-0.1	0.1	0.4	0.7	1.0	1.8	2.9
Public Sector Primary Balance	-1.5	-0.8	-9.4	0.7	0.4	-0.6	-0.7	-0.5	-0.1	0.1	0.4	0.7	1.0	1.6	2.7
Nominal GDP (BRL billion)	7,004	7,389	7,468	8,679	9,671	10,093	10,550	11,125	11,733	12,410	13,152	13,938	14,771	5,147	8,186

Notes and Hypothesis

(1) Elasticity: Revenues-GDP 2021: 1.7 | 2022: 1.1 | Long-term: 1.06. We see a slowdown in extraordinary revenues from 2023 onwards. Approval of CBS (VAT) tax reform, modest increase of efficiency (0.2% of GDP). Potential GDP: 1.5% (until 2026), 2.0% (after 2026). Inflation: Center target (3.0%), GDP deflator (4.9%).
(2) Gradual recovery in the formal labor market and earnings. In 2022, we anticipate a more intense increase in informal jobs (post-pandemic).
(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. We see more revenues from Concessions.
(4) 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 5% increase in 2023, after that is decreasing gradually to 2% in Medium-term. Long-term: digitalization effects contain the increase.
(6) Includes: higher payments in Court-ordered debt budget (including in the fiscal rule) – better management with a reduction in long-term, rise in federal contribution to Fundeb (Educational Fund), BPC (pension benefit).
(7) The main change was the increase in the new welfare program (*Auxílio Brasil*). 2022 budget: BRL90 billion (from BRL35 bn of the former Bolsa Família program). For 2023 onwards a more efficient and focalized welfare program (gradual reduction in outlays).
(8) Discretionary Expenses maintained close to 1.1% - 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 (currently in Debate) from 2022 onwards.

Fiscal Risks – Income tax break and legislations

- We see a higher probability of fiscal stimulus via tax breaks ahead (with BRL60 billion already granted for 2022, in our estimates), with the increase in the income threshold of tax brackets for personal income tax expected to add to the amount of revenue losses.
- The legislations in Congress is also an relevant risk that could add more than BRL30 billion in new stimulus,
- There is also the debate regarding the increase in public servants wages. For each 1% it represents ~BRL5 billion in expenditures

Fiscal Stimulus by Revenue Reduction

Tax waiver measures already in place in 2022	BRL billion	% GDP
Reduction of IPI federal tax by 35%	23.4	0.2%
Reduction of PIS/Cofins of Diesel, kerosene and LPG	14.9	0.2%
Extension of payroll tax exemption	9.2	0.1%
Reduction of import tax rates by 10%	6.0	0.1%
Soccer specific tax regime (TEC)	2.3	0.0%
Extension of PCD benefit	1.3	0.0%
ZPE expansion	1.2	0.0%
IOF reduction for credit support programs	0.8	0.0%
IRRF reduction on aircraft leasing	0.4	0.0%
Others	1.3	0.0%
Total	**60.8**	**0.6%**

Sources: Ministry of Economy, Santander.

Fiscal Measures and its impacts

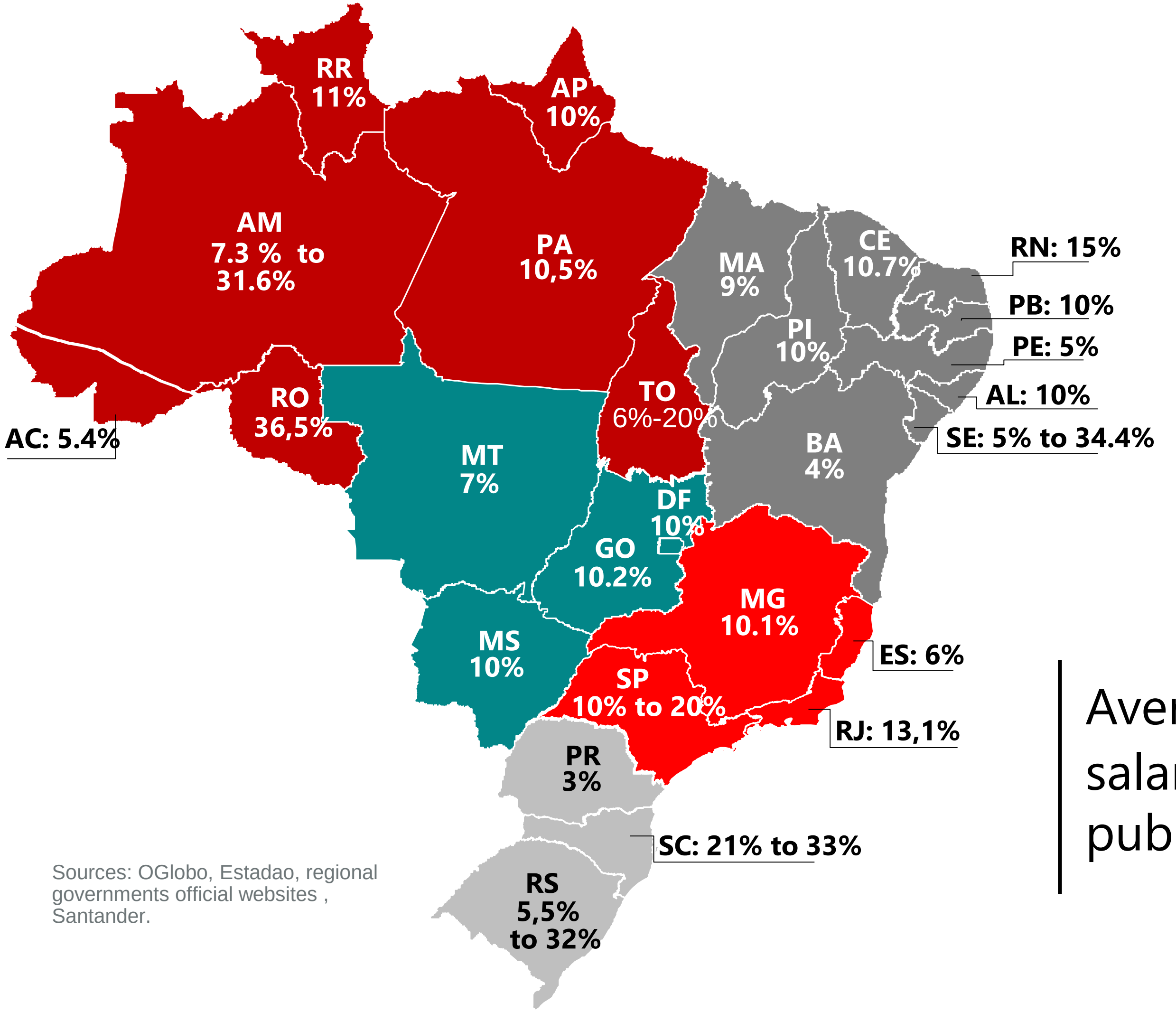
Measures	Fiscal Impact (BRL bn)
Subsidy for municipal public transport	5.0
Paulo Gustavo Law - Support for cultural sector	4.0
Salary floor community health workers	4.0
Aldir Blanc Law - Support for cultural sector	3.0
Assis Carvalho Law - aid to family farmers	3.0
Transfer to beneficiaries of the event sector emergency program (perse)	2.5
Financial aid to Santas Casa (Health)	2.0
PEC judicial quinquennium readjustments	3.7
1pp increase in public servants wages	2.7
Salary floor to nurses	0.5

Sources: Estadao, Marcos Mendes, Santander.

Fiscal Risks – Inflationary measures would represent higher expenditures ahead

- This year the regional governments started raising the public servants wages that would represent higher expenditures.

Regional governments wages increase by states in 2022



Sources: OGlobo, Estadao, regional governments official websites , Santander.

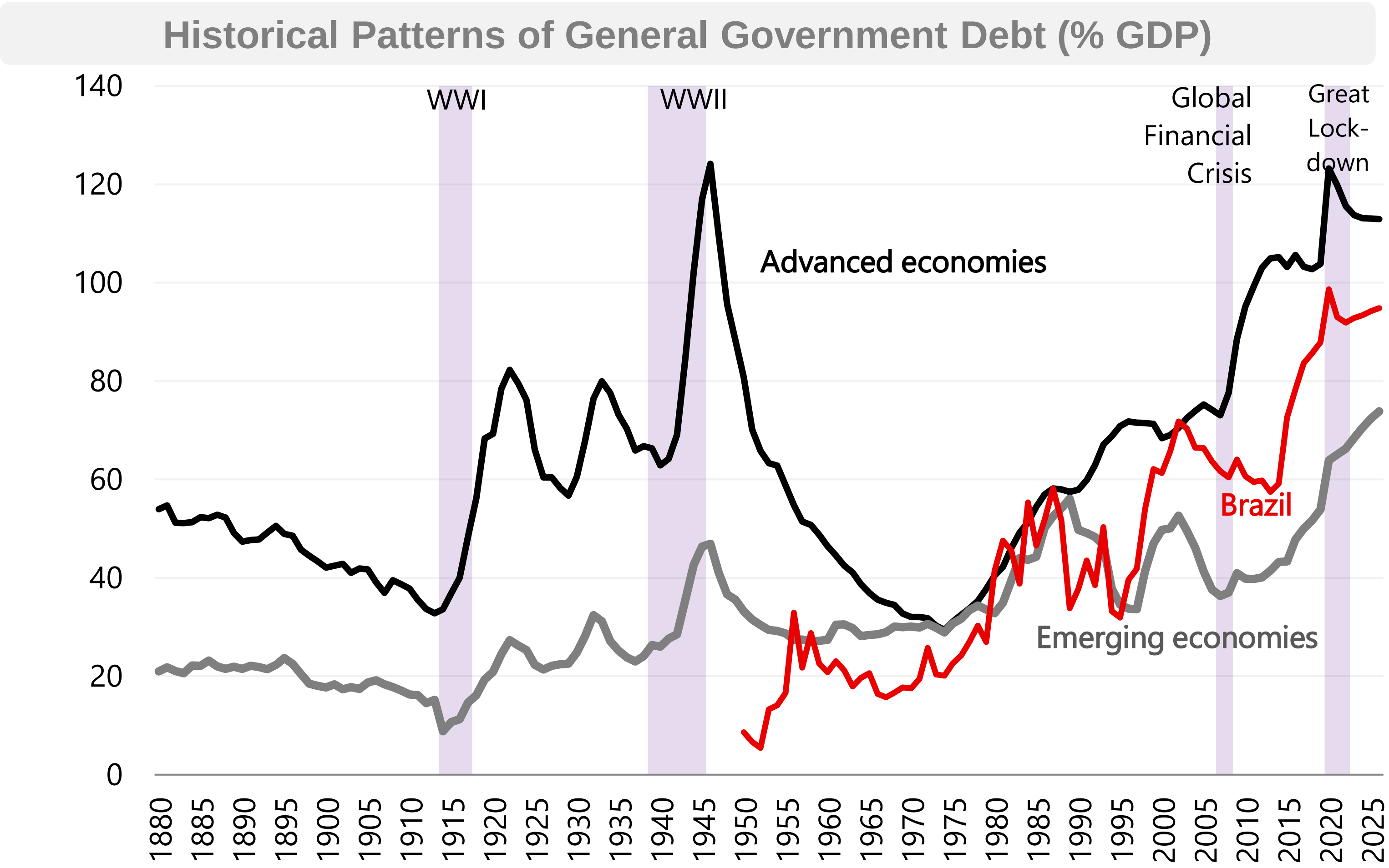
Average of **11.7%** of salary readjustments of public servants wages

06

Public Debt Scenario and Simulations

Brazilian gross debt approaches the level of advanced countries – International Comparison

- Brazilian government finances registered an unprecedented deterioration in 2020, affected by the government's measures to mitigate the economic and health effects of the pandemic.



Sources: IMF, Santander.

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 **90%**
- We see the neutral interest rate hypothesis at 4.0%, 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 2.0-2.5pp of GDP primary fiscal adjustment, just to stabilize the ratio debt-to-GDP around the level of ~90% of GDP.

- **Current situation:**

. Real interest rate (ex-ante) 1-year: ~7.1%,
. GDP: 1.2% in 2022 and -0.6% in 2023

Liquidity reserves up to 10 months of debt maturities

Increase in debt cost (Selic + IPCA)

- **Steady-state:**

According to our hypothesis:
. Real interest rate at +4.0%
. Potential GDP at +1.5%,

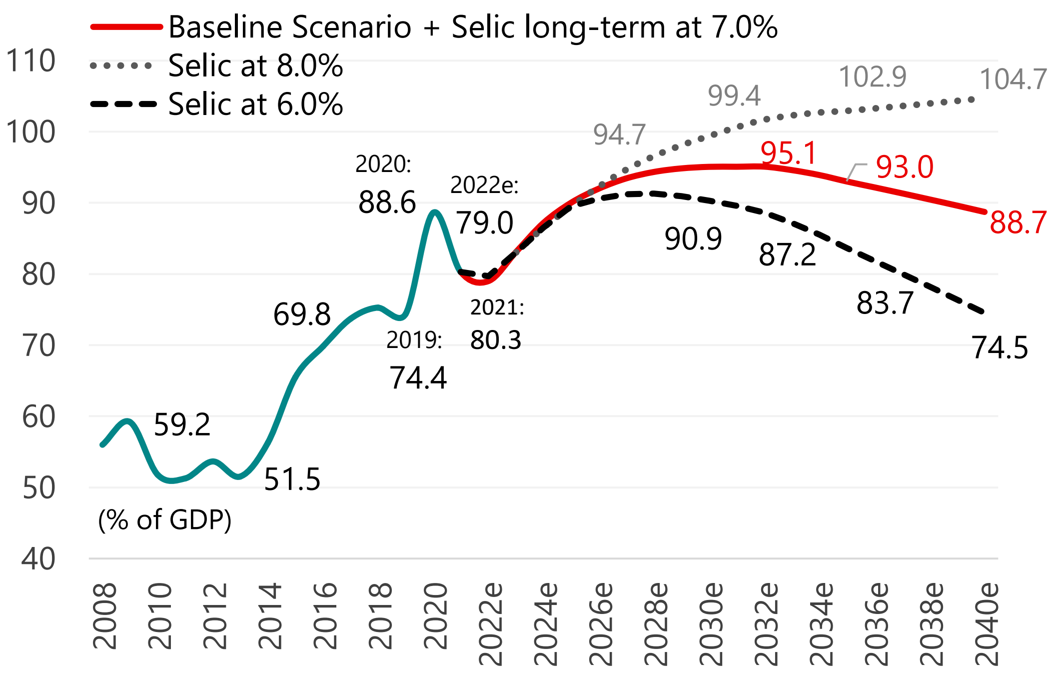
. The primary surplus must reach 1.8-2.2% of GDP to maintain the gross debt stable.

		Real Interest Rate						
		0.0%	*1.0%*	*2.0%*	*2.5%*	*3.0%*	*4.0%*	*5.0%*
GDP Growth	*0.0%*	0.0	0.9	1.8	2.2	2.7	3.6	4.5
	1.0%	-0.9	0.0	0.9	1.3	1.8	2.7	3.6
	1.5%	-1.3	-0.4	0.4	0.9	1.3	2.2	3.1
	2.0%	-1.8	-0.9	0.0	0.4	0.9	1.8	2.6
	2.5%	-2.2	-1.3	-0.4	0.0	0.4	1.3	2.2

Sources: BCB, Santander.

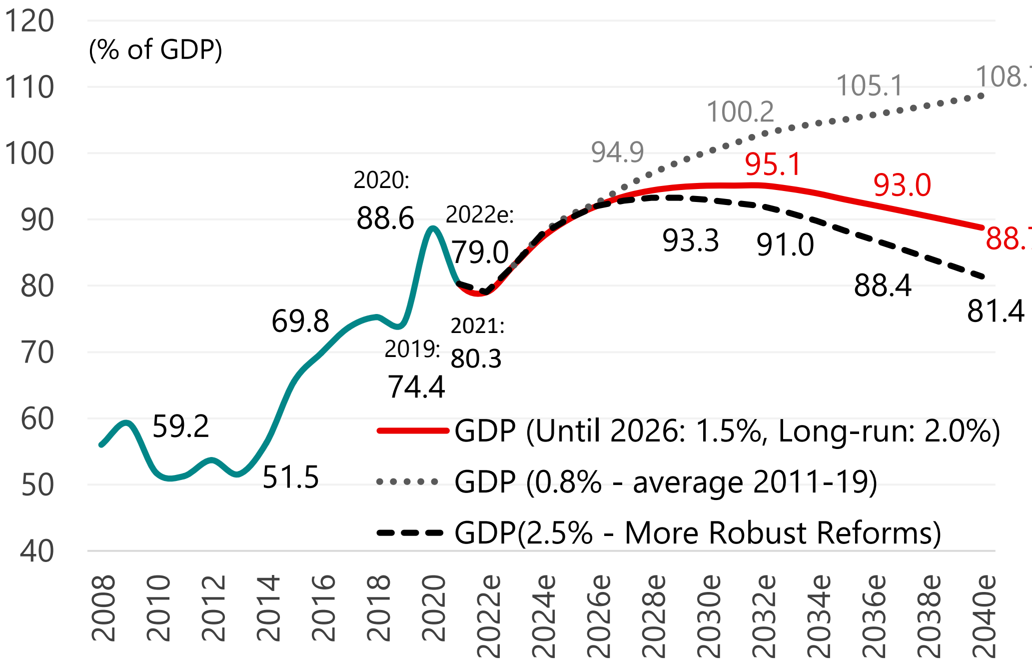
Debt Scenarios: Sensitivity to Changes in the Long Run Macro-outlook

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.

PEC Emergencial: Funds (+BRL150 billion for liquidity cushion in 2021 + BRL30 billion in 2022)

2022 GDP Deflator: 10.1% | GDP: 1.2% | Selic Rate: 13.5%

2023-40: GDP deflator: 3.9%, which is Inflation target + 0.9%
(close to the average difference of the last decade between IPCA and GDP deflator)

Santander

07

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

Annual Borrowing Plan 2022

- The National Treasury released (on January 26) the Annual Borrowing Plan (Portuguese acronym: PAF) for 2022. The total outstanding debt reached ~BRL5.75 trillion in March 2022 and could reach BRL6 trillion this year, according to the fiscal authority's plan. The average maturity is expected to remain close to 4.0 years, according to the PAF. In the debt profile, the National Treasury stated that it intends to increase the floating-rate total relative to fixed-rate bonds.

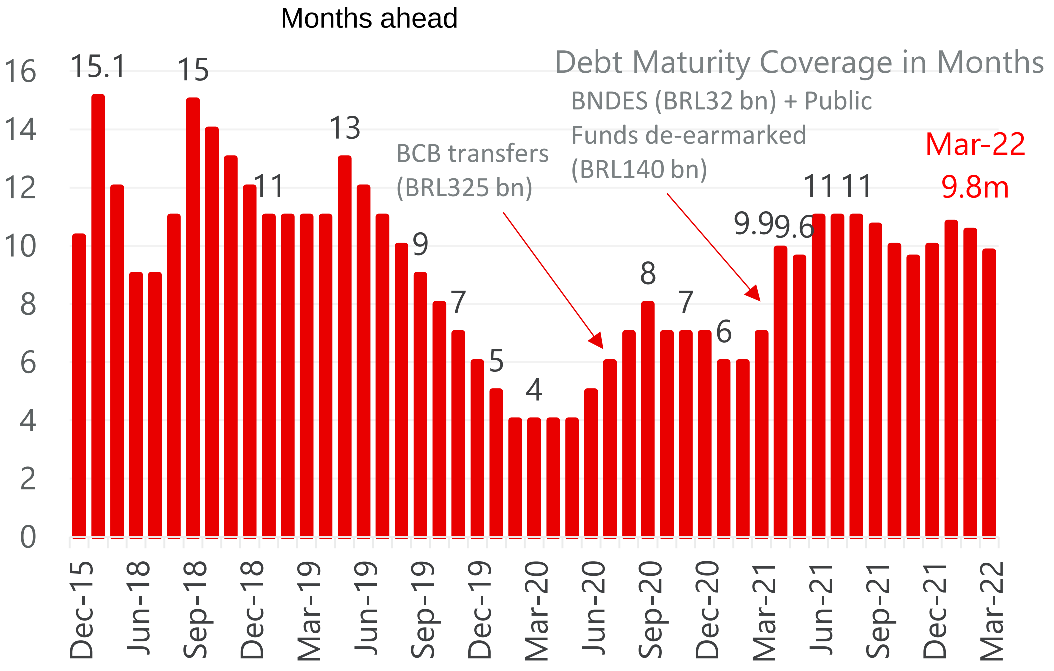
Annual Borrowing Plan (PAF 2022)										
	2020	2021	Feb-22	Mar-22	PAF 2022 range		PAF 2021 Revised (May21)		PAF 2021 (Jan-21)	
Outstanding volume (BRL billion)					Min	Max	Min	Max	Min	Max
Federal Public Debt	5,010	5,614	5,730	5,565	6,000	6,400	5,500	5,800	5,600	5,900
Composition (%)										
Fixed-rate	34.8	28.9	26.9	28.3	24	28	31	35	38	42
Inflation-linked	25.3	29.3	29.6	31.3	27	31	26	30	24	28
Floating-rate	34.8	36.8	39.1	36.2	38	42	33	37	28	32
FX	5.1	5.0	4.4	4.2	3	7	3	7	3	7
Maturity Structure										
% maturing in 12 months	27.6	21	23.4	22.4	19	23	22	27	24	29
Average maturity (years)	3.6	3.8	3.9	4.0	3.8	4.2	3.4	3.8	3.2	3.6

Sources: National Treasury; Santander

Treasury's Cash Position Improved in the Last Few Months with Larger Auctions

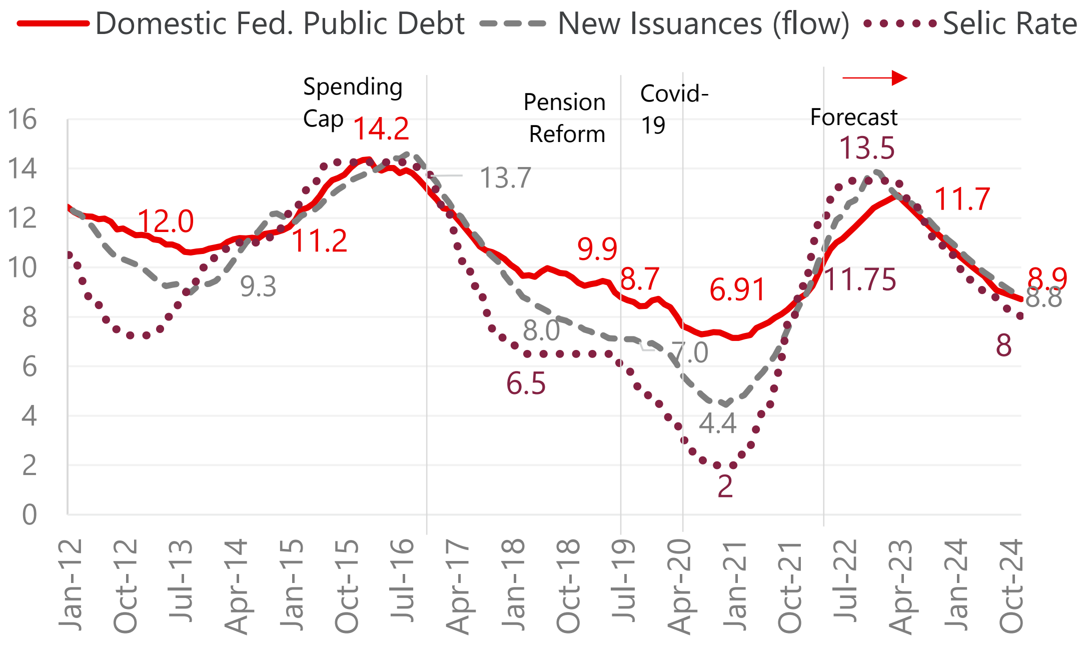
- With debt shortening it is important to keep the level of the liquidity cushion at comfortable levels.
- The domestic debt cost continued to rise, due to both inflation and Selic increase
- Debt liquidity cushion reduced in March (-BRL205 bn | Totaling BRL1,073 bn), equivalent of ~10 months of debt maturities.

Liquidity cushion coverage of domestic debt



Sources: National Treasury, Santander.

Average cost of Federal Debt - 12 months – (%)

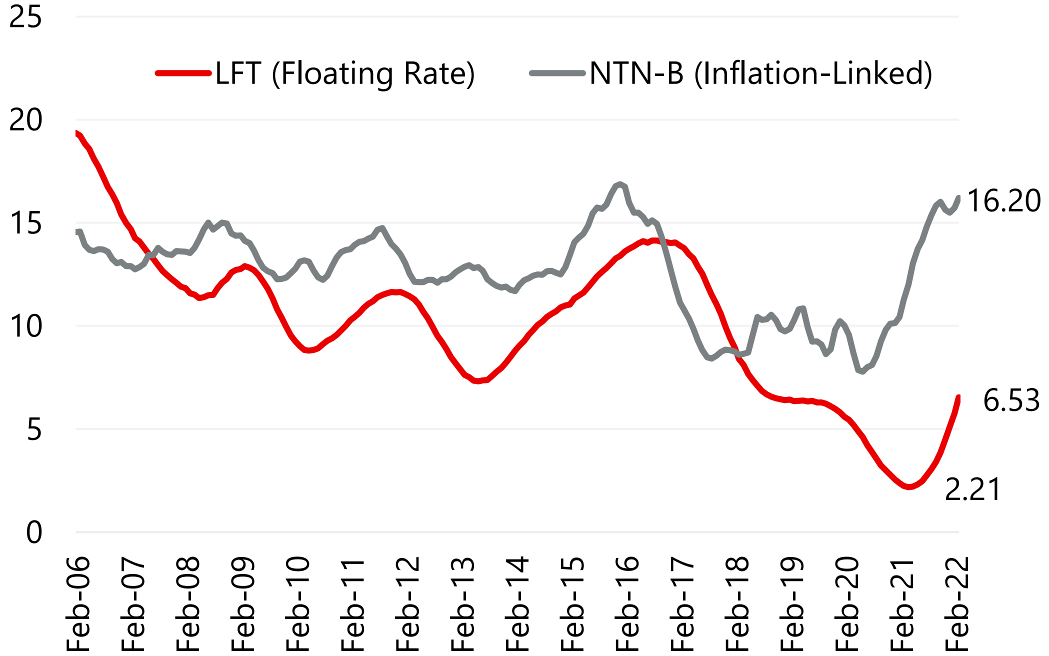


Sources: National Treasury, Santander.

At the margin there is a increase in debt cost related to Selic and Inflation

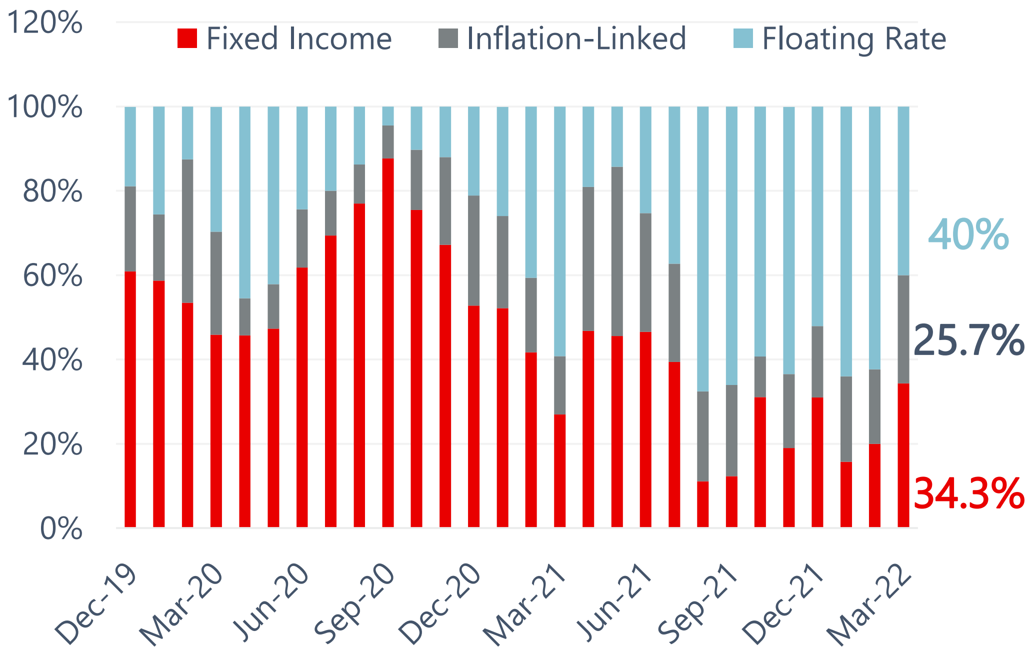
- The average cost of the outstanding debt accumulated in 12m reduced to 8.6% (from 8.7% in Feb-22). The NTN-B (inflation-linked bonds) cost in the last 12m reached 16.2% p.y. The cost of LFT (floating rate) in 12m increased to 6.5% (from 5.8% in Feb-22 and 4.5% in Dec-21), the Selic increase (currently at 12.75%) will add an additional pressure in debt costs in coming months.

Average Debt Cost in the last 12 M (Accum.)



Sources: National Treasury, Santander.

Participation in total issuances (%)

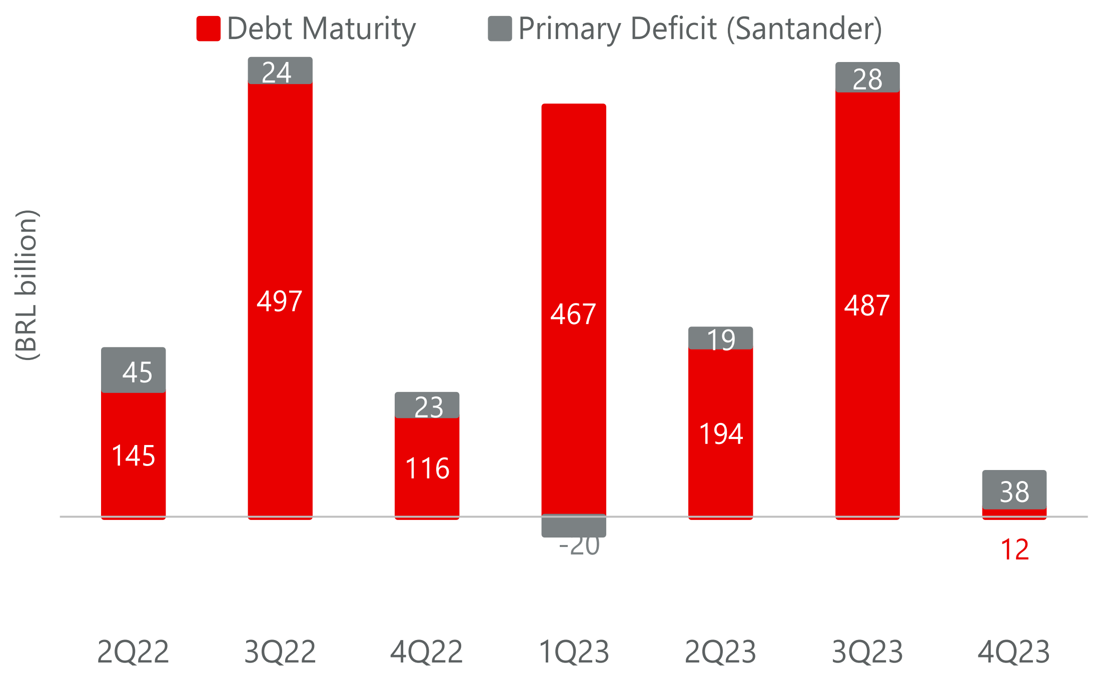


Sources: National Treasury, Santander.

Fiscal – The debt is at a higher level and with a shorter maturity

- Despite the increase in liquidity reserves the debt maturity level is still challenging. Structural reforms will help to increase debt maturity and reduce the primary deficit.

Debt maturity - (BRL billion)



Sources: National Treasury, Santander

Profile by categories - (BRL billion)

Quarter	Fixed Rate	Floating Rate (selic)	Inflation-Linked	FX-Exchange	Other	Total
2Q22	126.2	-	17.4	-	1.3	**144.8**
3Q22	130.5	172.8	188.2	4.0	1.2	**496.7**
4Q22	95.9	-	17.0	-	3.0	**115.8**
1Q23	275.1	166.2	21.6	3.8	0.7	**467.4**
2Q23	5.9	0.0	187.2	0.0	1.4	**194.4**
3Q23	194.8	266.1	21.1	3.6	1.4	**487.0**
4Q23	0.0	0.0	11.2	0.0	0.8	**12.0**

Sources: National Treasury, Santander.

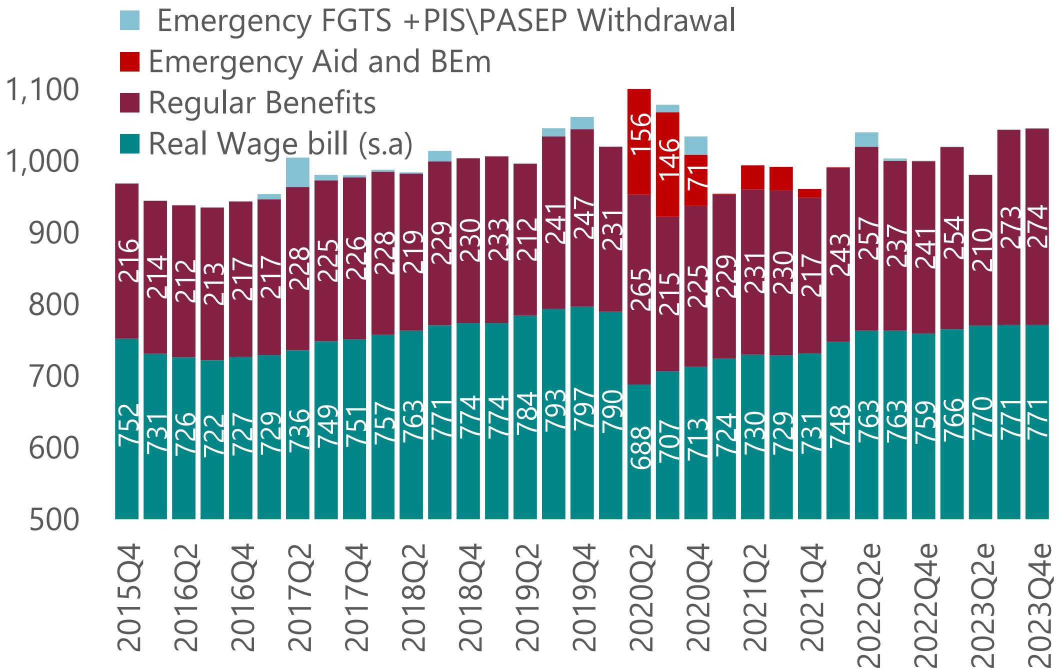
Special Report – Real Wage Bill: Update And Inflation Effect

08

“Expanded” Real Wage Bill Largely Impacted by Inflation

- As for the “expanded” real wage bill scenario (labor income added with government transfers and social programs), our forecasts had only minor changes, as the higher expected level of employment was offset by the upward revisions in our inflation scenario. We project that the “expanded” real wage bill will grow 3.1%, 0.8%, and 1.2% in 2022, 2023, and 2024, respectively (we previously estimated gain of 3.2%, 1.1%, and 1.8%, respectively).

“Expanded” Real Wage Bill (BRL billion)



Sources: National Treasury, IBGE, Ministry of Economy, Santander.

	2021	2022(E)	2023(E)	2024(E)
Real Wage Bill	+0.6%	+4.1%	+1.5%	+1.8%
Real Wage Bill (With Government Transfers)	-8.0%	+3.1%	+0.8%	+1.2%

Sources: National Treasury, IBGE, Ministry of Economy, Santander.

Fiscal Risks – Size Of The Fiscal Stimulus And Leftovers

- The larger part of the worsening of the recent fiscal result was the massive stimulus ("extra-cap" spending) related to Covid-19, which totaled 7.0% of GDP in 2020 and 1.4% in 2021. The trend is for the stimulus to decrease as the effects of the pandemic fade, yet Brazil has changed the fiscal framework to open up more space for spending.

Fiscal Stimulus Measures (BRL billion)

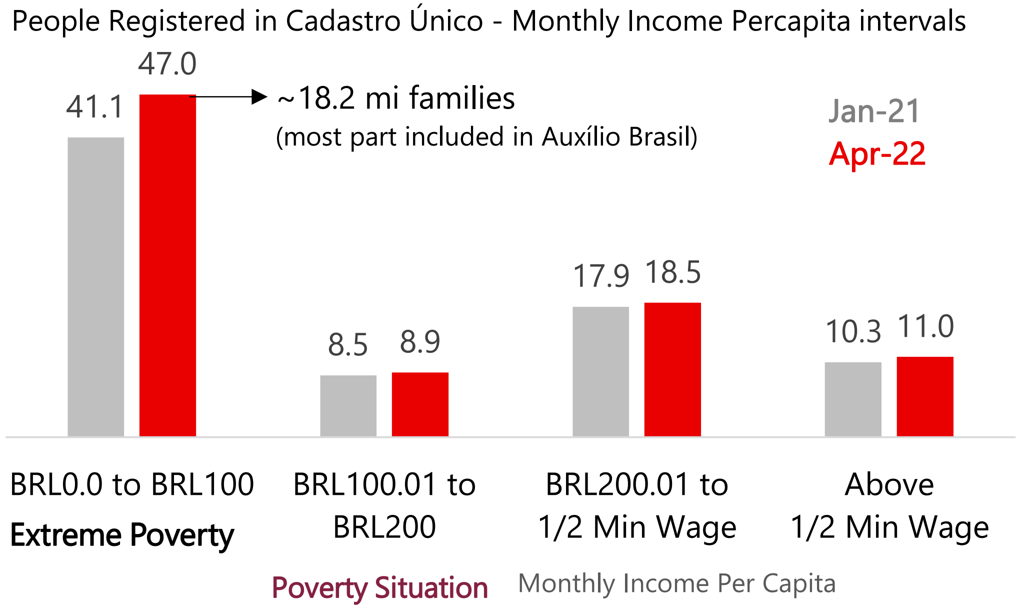
	2020			2021			2022		
In BRL billion - Accumulated	Dec-20	Total Budget	Executed	Dec-21	Total Budget	Executed	May-22	Total Budget	Executed
Bem - Employment program (MP 935)	33.5	51.5	65.0%	7.7	10.7	71.5%	0.0	0.2	0.0%
Expansion of Bolsa Família (MP 929)	0.4	0.4	100.0%	-	-	-	-	-	-
Emergency Aid (MP 937)	293.1	322.0	91.0%	60.7	63.9	94.9%	3.1	5.7	54.3%
Transfers to regional governments (MP 939)	78.3	79.2	98.8%	-	-	-	-	-	-
Credit for payroll (MP 943)	6.8	6.8	100.0%	-	-	-	-	-	-
Energy Sector (MP 950)	0.9	0.9	100.0%	-	-	-	-	-	-
Ministry of Health and others	42.7	50.8	84.0%	25.8	43.2	59.7%	7.7	10.5	73.5%
Guarantees for credit measures for SME (MP 977)	58.1	58.1	100.0%	5.0	5.0	100.0%	-	-	-
Financing of Tourism Infrastructure (MP 963)	3.1	5.0	61.6%	0.6	1.3	42.3%	-	0.7	-
Emergency Credit Program - "Maquininhas"	5.0	10.0	50.0%	-	-	-	-	-	-
Vaccine Acquisition	2.2	20.0	11.1%	21.8	26.2	83.4%	4.5	10	44.3%
Accumulated Total	524.0	604.7	86.7%	121.4	150.2	80.8%	15.3	27.1	56.3%

Updated until 6/10/2022
Sources: National Treasury, Santander.

New welfare program – *Auxílio Brasil*

- Regarding the fiscal transfers, the emergency aid program ended in October. The new welfare program *Auxílio Brasil* started in November, with the BRL400 benefit payments starting in December (post *PEC dos Precatórios*). The government stated that in 2022 Budget there will be ~BRL90 billion for the program.
- The current monthly average benefit of the welfare program is BRL 408, reaching 18 million families.

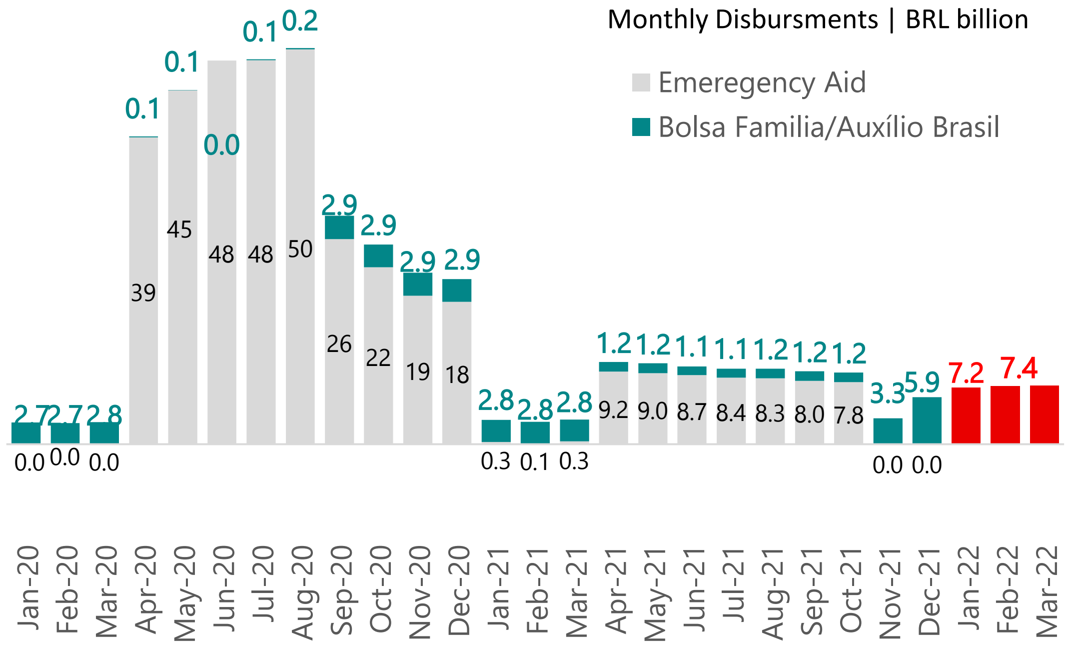
Cadastro Único – Gov. Database



Monthly income breackets to classify poverty situation were updated in Nov-21 by presidential decree in ~12%.

Sources: Ministerio da Cidadania, Santander

Welfare program – BRL billion



Sources: National Treasury, Santander.

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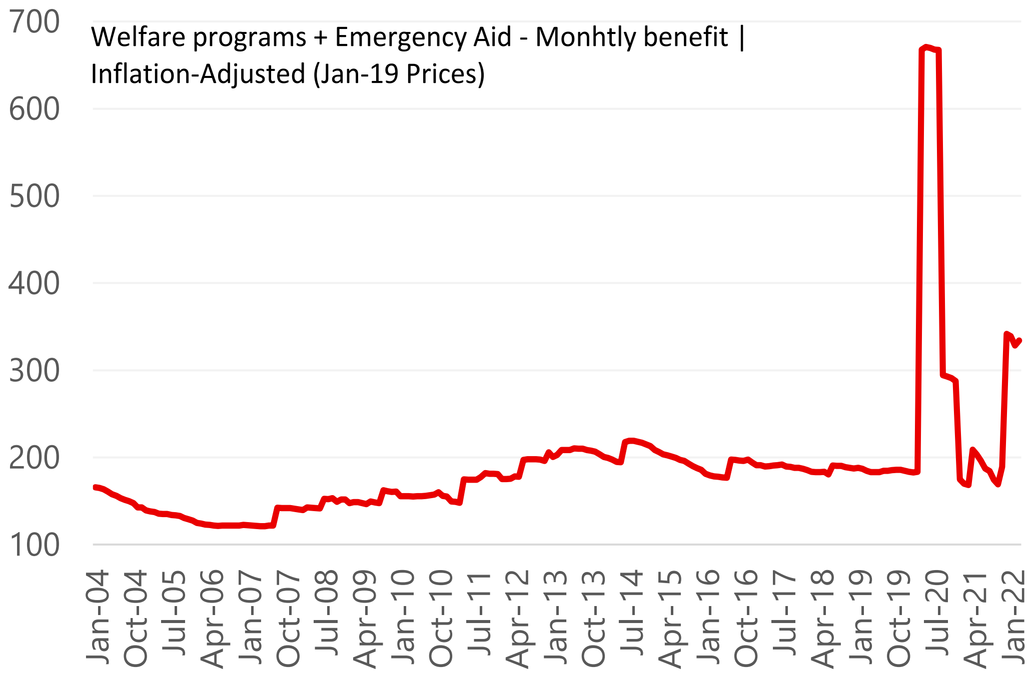
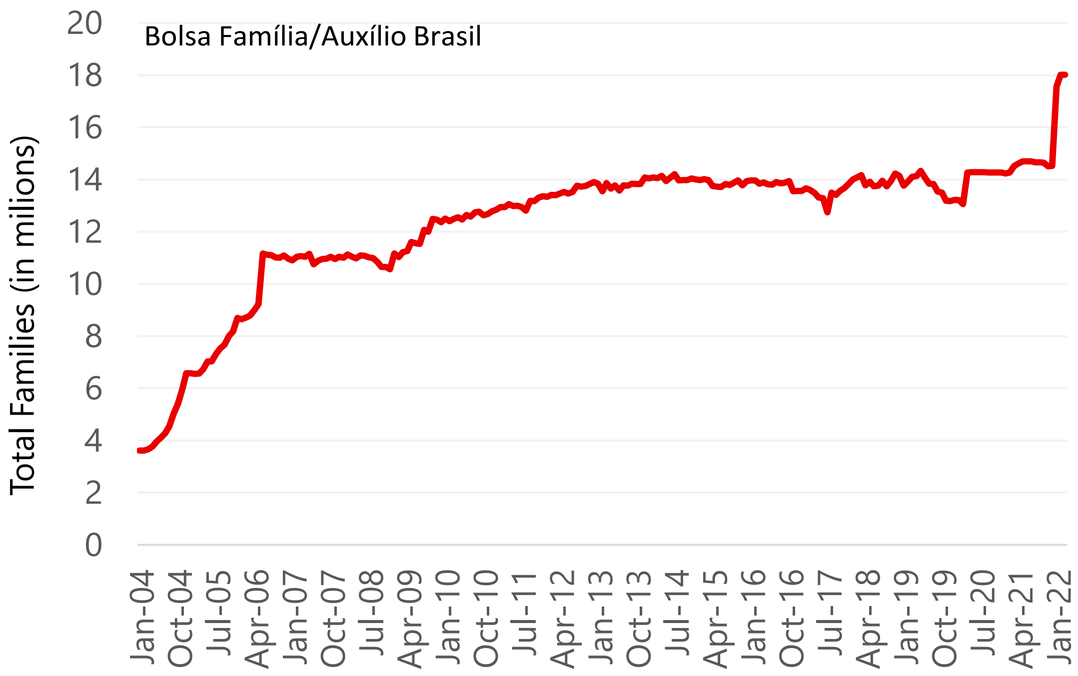
Monthly Benefit Real Value



Sources: Ministerio da Cidadania, Santander

Number of Families – Welfare Program

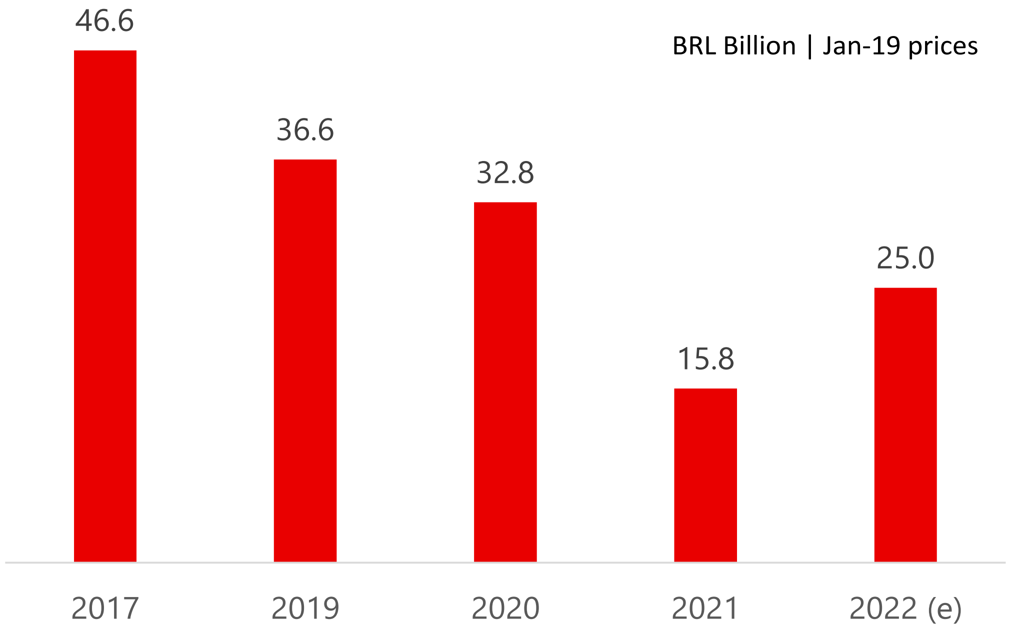


Sources: National Treasury, Santander.

New welfare program – *Auxílio Brasil*

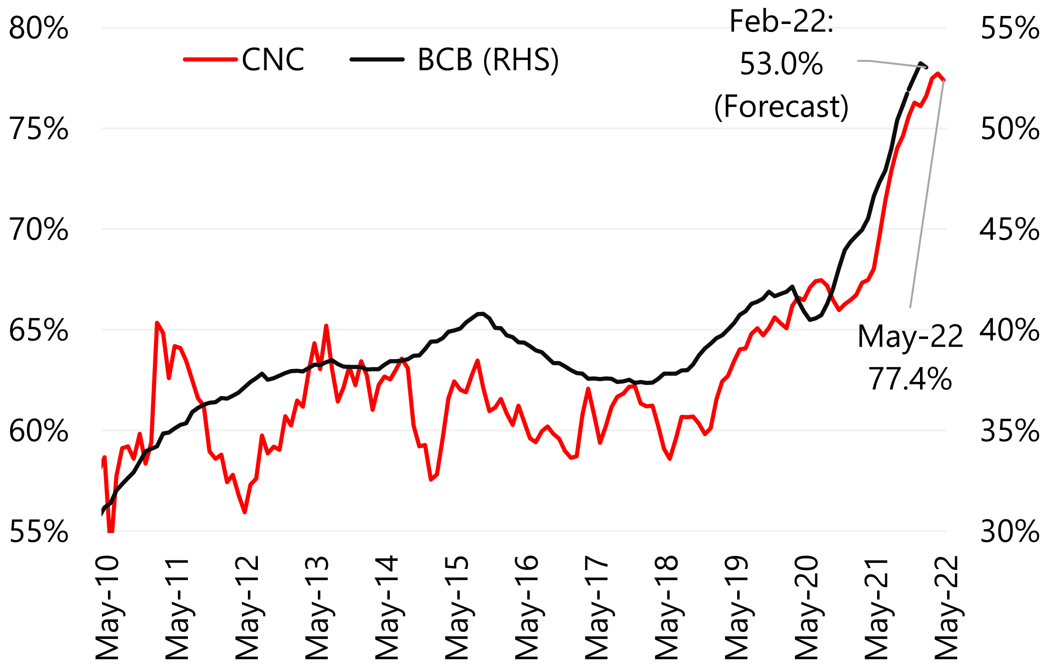
- We estimate that FGTS withdrawals will add 0.6 p.p. to the growth of the "expanded" real wage bill. However, compared to our last projection of 3.3% growth for the real wage bill, the increase in our inflation forecast from 6.0% to 7.8% practically nullified the expected growth from FGTS withdrawals. In other words, the 1.5 p.p. increase in inflation should offset the effect of the fiscal stimulus.

FGTS funds workers withdrawn



Sources: Caixa, MCM, Santander

Extended household Indebtedness (%)



Sources: National Treasury, Santander.

Tables - Forecasts

09

MACRO SCENARIO: Forecasts

Macroeconomic Variables		Previous		Current
GDP (%)	2022E	0.7	↑	1.2
	2023E	-0.3	↓	-0.6
	2024E	1.5	↓	0.5
IPCA (%)	2022E	7.9	↑	9.5
	2023E	4.0	↑	5.3
	2024E	3.0	→	3.0
Selic Rate (% end of period)	2022E	13.25	↑	13.50
	2023E	10.00	↑	10.50
	2024E	7.00	↑	8.00
FX Rate - USDBRL (end of period)	2022E	5.00	↑	5.15
	2023E	4.80	↑	5.00
	2024E	4.70	↑	5.10
Current Account Balance (% of GDP)	2022E	-1.2	↓	-1.4
	2023E	-1.0	↓	-1.2
	2024E	-2.0	→	-2.0
Primary Fiscal Balance (% of GDP)	2022E	0.0	↑	0.4
	2023E	-0.8	↑	-0.6
	2024E	-0.6	↓	-0.7
Gross Public Debt (% of GDP)	2022E	80.6	↓	79.0
	2023E	84.1	↓	83.1
	2024E	87.5	↓	87.2

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

- **The forecasts refers to our latest Scenario Review**

"A BITTERSWEET SCENARIO"
(sent on June 02, 2022)

- **For the full report click on the link:**

https://bit.ly/Std-scenreview-jun22

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

Global Scenario (Baseline) - May 2022										
	2018	2019	2020	2021	2022E		2023E		2024E	
Global GDP (%)	3.5	2.8	-3.5	5.9	2.8	↓	2.5	↓	2.0	↓
China GDP (%)	6.7	6.0	2.3	8.1	4.8	↓	5.5	↑	5.0	⇨
US GDP (%)	3.0	2.2	-3.5	5.7	2.6	↓	1.6	↓	-0.3	↓
US Inflation (Core PCE, %)	2.1	1.6	1.5	4.9	4.2		3.0		2.1	
US Interest Rate (FFR, %)	2.50	1.75	0.25	0.25	3.50	↑	4.50	↑	3.50	⇨
US Interest Rate (UST10y, %)	2.7	1.9	0.8	1.8	3.5	↑	4.0	↑	3.0	⇨
Dollar Index - DXY	96	96	90	96	107	↑	106	↑	100	⇨
Commodity Prices - CRB	409	401	444	571	596	↓	561	↓	495	↓

Sources: Bloomberg, Santander

- The forecasts refers to our latest Scenario Review

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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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