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Brazil – Fiscal Policy

Fiscal Policy During the COVID-19 Crisis:
New Challenges, More Risks and the Same Long-Term Goals

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- **In this report, we focus on the fiscal policy measures adopted by the Brazilian government in order to mitigate the economic hit from the COVID-19 crisis. While acknowledging that professional forecasting is more challenging under current conditions, we provide updated assumptions and expectations for the dynamics of fiscal balance in the medium to long term.**
- **Brazil's government has expanded significantly the scale and scope of emergency relief measures to fight the effects of COVID-19 over the past few weeks. We estimate that the wide set of fiscal measures announced so far amounts to BRL610 billion (8.4% of GDP). With regard to only those initiatives that affect the government's 2020 primary result, we calculate an amount of BRL327 billion (4.5% of GDP), a decent fiscal impulse compared to the average for emerging economies.**
- **Assuming that (i) shelter-in-place policies will be gradually loosened starting in May; and (ii) the domestic economy will be fully operational by the end of 3Q20, we estimate that relief measures will total a primary fiscal expansion of BRL365 billion in 2020 (5.0% of GDP). Less favorable scenarios consider that the magnitude of the shock on economic activity would lead government to postpone the expiration date of some emergency measures or even develop new ones. Thus, we explicitly outline simulations for alternative scenarios in this report, following the methodology applied in our latest forecast review for the Brazilian macroeconomic outlook (see our April 6 report, *COVID-19: The Dominance of Uncertainty – Updating Brazil Forecasts*).**
- **The 2020 public sector's primary fiscal deficit should total around BRL 585 billion (-8% of GDP), according to our updated baseline scenario. For 2021, we calculate a primary fiscal deficit of nearly BRL220 billion (-2.9% of GDP). We note that all of the designed scenarios take on as a crucial assumption: the (massive) fiscal expansion resulting from the public health crisis will be limited to 2020.**
- **Recently, the outlook for Brazilian public debt has changed dramatically. We see the gross public debt-to-GDP ratio climbing nearly 12 p.p. between 2019 and 2020 (from 75.8% to 87.5%%), peaking only in 2022 (at 90.7%). Considering the outcome from the most benign scenario, the gross public debt would peak next year at 88.3% of GDP. Conversely, the indicator would climb to 96.8% of GDP in 2021, peaking only in 2023 (at 98.2% of GDP) if we consider the most unfavorable simulation.**
- **The government's economic team has consistently stated its commitment to ensure that additional emergency spending will be limited to this year. Accordingly, we assume that the broad fiscal expansion will be focused on the core of the problem while preserving the fiscal consolidation framework. We highlight the compliance with the spending cap rule, which is currently the most important anchor for fiscal policy.**
- **In order to support the expenditure ceiling rule, we believe that government will need to speed up the approval of structural reforms in the post-crisis scenario. The challenges are plentiful, as are the risks on the radar. First, we have seen growing concerns about tensions between the executive and legislative branches, which could poison the post-crisis political environment and undermine some reforms. Additionally, we perceive non-negligible risks of lawmakers proposing more fiscal spending next year, as they could face increasing pressure to approve measures to deal with the modest economic growth environment. All in all, while keeping a constructive view on the pursuit of fiscal consolidation in the coming years, we believe that the balance of risks for the execution of the government's reform agenda has worsened in the short term.**

The Turnaround: Invisible Enemy and Inevitable Damage

As the coronavirus pandemic quickly spreads across the globe and governments adopt shelter-in-place policies aimed at containing this outbreak, most economies will face an inevitable recession this year. The crisis has led to an unprecedented lockdown of activities, as political and economic authorities seek to mitigate the potentially substantial impact of the outbreak on households and businesses. In addition to bold actions in the medical and healthcare sectors, authorities have injected fiscal, credit and monetary stimuli into the economy. On the fiscal side, the large packages recently announced around the world (mainly in developed regions) have been rapidly surpassing the easing policies seen during the 2008-09 financial crisis.

In this report, we focus on the fiscal policy measures adopted by the Brazilian government in order to alleviate the economic hit from the coronavirus crisis. While acknowledging that professional forecasting is much more challenging under current conditions, due to the high level of uncertainty in the public health and economic environment, we present updated assumptions and expectations for public account dynamics in the medium to long-term.

Expenditure Side

The government has expanded significantly the scale and scope of emergency relief measures to fight the effects of COVID-19 over the past few weeks. These one-off measures focus on three elements: (i) raising resources for the public health system; (ii) supporting employment and income levels by providing liquidity to businesses; and (iii) protecting the most vulnerable persons by expansion of the social safety net. **As of April 21, we estimate that the wide set of fiscal measures announced by the government totaled BRL610 billion (8.4% of GDP)**, as shown in Figure 1. When we add to that provisions presented by public banks and the Brazilian Central Bank (BCB), the total emergency aid package reaches BRL2.02 trillion (28% of GDP)[1].

Focusing only on the initiatives that affect the government's 2020 primary fiscal result, we calculate a sum of BRL327 billion (4.5% of GDP), a decent fiscal impulse compared to the average for emerging economies (refer to Figure I in the Appendix). Other fiscal measures implemented by the federal government (BRL283 billion, or 3.9% of GDP) aim at providing liquidity to businesses and families over the next few months, without impacting (at least in theory) the public sector's primary fiscal result in the current year. These measures comprise payment of social benefits in advance, postponement of tax payment and reallocation of budget resources. (*Figure II in the Appendix displays al of the federal government's fiscal and quasi-fiscal measures to combat the COVID-19 crisis*).

Figure 1. Economic Measures to Combat the COVID-19 Crisis (as of April 21)

	BRL billion	% GDP
1) Fiscal Measures	**610.0**	**8.4**
1.1 Impact on government's primary result	327.2	4.5
1.2 No impact on government's primary result*	282.8	3.9
2) Public Banks	**248.0**	**3.4**
3) Central Bank of Brazil (*liquidity measures*)**	**1,166.2**	**16.1**
TOTAL (= 1+2+3)	**2,024.2**	**27.9**

* Liquidity fiscal measures - advance payment of social benefits; postponment of tax payment; reallocation of budget resources
** Capital measures are not included.
Sources: Ministry of Economy, BNDES, Caixa Economica Federal, Banco do Brasil, Brazilian Central Bank and Santander.

Concerning the measures that will impact primary spending this year (please refer to Figure 2), we highlight:

a. **Coronavoucher.** This is an income transfer (BRL600/month) to informal workers, microentrepreneurs, self-employed and low-income workers for three months. The emergency aid cannot be received with other stipends (namely social security benefits, *Bolsa Família* entitlements, continuous cash benefit [BPC in Portuguese] and unemployment insurance). At least 24 million people in vulnerable conditions will benefit from this measure. We calculate the fiscal impact at around BRL110 billion in 2020.
b. **Employment and Income Maintenance Emergency Program.** This program allows companies to proportionally reduce their employees' workload and wages by 25%, 50% or 70% for up to three months. The federal government

[1] Our estimates for Brazilian Central Bank's measures do not consider the bond-buying program included in the constitutional amendment proposal known as "War Budget" (PEC 10/2020), which creates a temporary separate budget regime to allocate the fiscal spending aimed at mitigating the impact from the COVID-19 outbreak in Brazil and to suspend fiscal restrictions in 2020 (such as the so-called "Golden Rule"). In addition, the proposal allows the Brazilian Central Bank to purchase public bonds and private financial assets in order to stabilize financial markets. (*Figure III in the Appendix displays the measures announced by public banks and Central Bank of Brazil aimed at alleviating the economic impact from COVID-19 crisis*).

provides an unemployment insurance benefit in advance that is proportional to the reduction in employee's workload and wages. For workers who earn up to one minimum wage, full earnings will be assured. Additionally, the measure authorizes temporary suspension of employment contract for three months, granting up to the full unemployment insurance; 54 million formal workers could benefit from this program. We calculate a fiscal impact of slightly above BRL50 billion in 2020.

c. **Emergency credit line for small and medium-sized companies to finance their payrolls for two months.** Credit operations will be limited to two minimum wages per worker, with a six-month grace period and a maximum payment term of three years. Companies that join the program will not be able to dismiss their employees during the validity period. The interest rate applied to this credit line will be 3.75% p.a., the current level of the Selic target rate (that is, no spread). The lifeline program will be funded by resources from both the National Treasury (85% of total resources or BRL34 billion) and private banks (15% of total resources or BRL6 billion), while the BCB will be responsible for its supervision and BNDES (The National Bank for Economic and Social Development) will be in charge of its operation. According to the federal government, the measure could benefit 12 million workers and 1.4 million companies. We calculate a fiscal impact of BRL34 billion in 2020.

d. **Securing level of tax collection with ICMS (for states) and ISS (municipalities).** While the federal government's economic team sought to transfer a fixed amount of resources to the subnational entities over the next three months (up to BRL40 billion), the Lower House recently approved (on April 13) a bill proposal with a financial compensation for the next six months tied to tax collection levels (i.e., assuring that states and municipalities will receive the same amount of tax revenue registered in the same period of 2019). According to rapporteur's estimates, this provision would cost federal coffers approximately BRL80 billion, a much higher level than originally proposed by the federal administration. We use this estimate to calculate the total fiscal impact of the measures already announced (see Figure 2), but we emphasize that the amount may be different after Congress finishes processing the bill that provides emergency financial aid to states and municipalities. The federal government expects senators to change this provision during the coming deliberations in the Upper House, thus leaving the size of its fiscal impact undefined.

The four measures detailed above account for more than 80% of the total primary fiscal impact resulting from the emergency relief package announced so far. **Most lifeline provisions have been designed by the Brazilian government to alleviate the pain of the pandemic on the public health system and the economic environment over the next three months**, based on assumptions for the extension of lockdown (social distancing) measures and, as intrinsically related, the dynamic of economic activity. In fact, if the COVID-19 crisis proves to be more acute than previously expected, many measures could be extended beyond the next few months (e.g., emergency aid for informal workers and low-income households, tax exemptions, extraordinary funds for the public health system, among others), thereby widening the fiscal gap this year.

Figure 2. Fiscal Measures with Impact on Government's Primary Fiscal Result (until April 21)

	BRL billion	% GDP
Emergency aid for informal and intermittent workers, self-employed, microenterpreneurs and low-income workers	110.0	1.52
Securing level of tax collection with ICMS (states) and ISS (municipalities) - preserving the same (nominal) levels as 2019	80.0	1.10
Compensation payments for workers with suspended or reduced empolyment contracts (reduction in worload and wages)	51.2	0.71
Emergency credit line for small and medium-sized companies to finance their payroll for two months	34.0	0.47
Securing level of transfers through state and municipal participation funds	16.0	0.22
Resource transfers to the subnational health systems	8.0	0.11
Extraordinary funds for the Ministry of Health	7.7	0.11
Temporary exemption of IOF (Financial Transactions Tax) for credit operations	7.1	0.10
Addition of 1.2 million households to the *Bolsa Familia* entitlement program	3.1	0.04
Zero import tariffs for medical, hospital and healthcare products	2.2	0.03
Resource transfers for social assistance expenditures in subnational governments	2.0	0.03
Emergency resources to philantropic hospitals, to be used in the purchase of medicines and healthcare equipment	2.0	0.03
Extraordinary funds for the Citizenship Ministry (Specialized Reference Centers for Social Assistance - CREAs)	2.0	0.03
Emergency resources to fund low-income households electricity bill for 3 months	0.9	0.01
Temporary exemption of IPI (Tax on Industrial Products) for domestic and imported medical, hospital and healthcare products	0.6	0.01
Extraordinary funds for the Ministries of Defense, Foreign Affairs and Science	0.4	0.01
TOTAL	**327.2**	**4.51**

Sources: Ministry of Economy, BNDES and Santander.

Assuming that (i) shelter-in-place policies will be gradually loosened from May onwards and (ii) the domestic economy will be fully operational again by the end of 3Q20, we estimate that relief measures will amount to a primary fiscal expansion of BRL365 billion in 2020 (5.0% of GDP). (For details of our baseline scenario, please see our April 6 report, *COVID-19: The Dominance of Uncertainty – Updating Brazil Forecasts*). From this total fiscal impulse, we calculate that BRL335 billion (4.6% of GDP) is directly related to higher federal government's primary spending, while some BRL30 billion (0.4% of GDP) refers to temporary tax exemptions (e.g., tax exemptions for medical, hospital and healthcare products) and additional postponement of tax payments. Regarding the latter, we note that the federal administration has granted a significant deferral of tax collection for the next three months (amounting to more than BRL100 billion), labeled as liquidity fiscal measures in Figure 1. This provision allows the payment of some taxes to be shifted from the first to the second semester of this year (e.g., the deferred collection of employer contribution to social security system and taxes levied on small and medium-sized companies), meaning a neutral primary fiscal impact in 2020 in principle. Nonetheless, we believe that a portion of this amount may actually be paid next year.

As already mentioned, more damaging scenarios concerning the virus outbreak across the country and the magnitude of the shock on economic activity could lead the government to postpone the expiration date of some emergency relief measures or even create new ones, intensifying the fiscal deterioration in the current year—we explicitly outline simulations for alternative scenarios in upcoming sections of this report.

Revenue Side

In addition to the sharp expansion in public spending, public revenue will deteriorate significantly in 2020, in our view. The main reasons behind this worsening are (in descending order of importance): (i) lower GDP growth; (ii) an abrupt decline in international oil prices; and (iii) lower dividend payments by state-owned companies (mainly public banks) to the federal government.

In this report, we adopt a methodological approach similar to that applied in our latest forecast review for Brazil's macroeconomic outlook (April 6, 2020 *COVID-19: The Dominance of Uncertainty – Updating Brazil Forecasts*). In short, our forecasts for the main fiscal policy indicators were developed for alternative scenarios, given different assumptions and hypotheses for the economic activity (GDP growth), the size and scope of the government's emergency package aimed at fighting the COVID-19 crisis, among other factors. Accordingly, **Figure 3 summarizes the foremost drivers of the government's primary revenue and our estimates for five different scenarios**, including our baseline before the COVID-19 crisis (when we were expecting Brazil's GDP to grow 2% in 2020 and 2.5% in 2021) and our updated baseline (Brazil's GDP is expected to fall 2.2% this year and to expand 1.7% next year).

Regarding the impact of economic activity on public coffers, we estimate that a 1 p.p. decline in real GDP growth implies a reduction of some BRL14 billion in recurring tax revenue. In addition to the direct impact of lower aggregate income on tax collection, we also consider the effect from tax exemptions and deferral of tax payments granted by the federal government aimed at relieving the economic hit from the pandemic outbreak. Of course, the deeper the (inevitable) economic recession this year and the slower the GDP recovery next year, the higher the likelihood of longer-lasting temporary tax exemptions. The same logical reasoning can be applied to the amount of dividend payments from state-owned companies to the National Treasury—before the virus spread in Brazil, we were forecasting a total payment of BRL 22.5 billion in 2020, whereas the updated baseline scenario anticipates less than BRL10 billion (especially due to the likely lower profitability of public banks, which have announced several measures to provide liquidity to businesses under atypical funding conditions). Last but not least, our projections take into consideration the impact of tumbling crude oil prices on international markets, as this harshly affects the government revenue from oil royalties. Our projections for the crude oil price plunged from USD60/barrel in 2020 and 2021 (annual average) to USD30/barrel and USD45/barrel, respectively. Hence, we calculate that the payment of oil royalties to the federal government will fall by ~BRL16 billion this year and BRL8.5 billion next year, already discounting the effect (favorable, in this case) from the exchange-rate depreciation in the period. If the annual average price of crude oil plunges to half of what we expect (i.e., USD15/barrel in 2020 and USD22.5/barrel in 2021), we calculate additional losses of ~BRL9.0 billion this year and BRL13.5 billion next year to federal public coffers.

In our new baseline scenario, the government's primary revenue will amount to BRL1,520 trillion in 2020, implying a loss of ~BRL115 billion compared to the pre-coronavirus outlook. For 2021, our estimate points to a reduction of BRL130 billion in comparison to the amount previously anticipated (Figure 3). When it comes to the more pessimistic scenario (GDP variation of -6% this year and +2.8% next year), revenue losses total approximately BRL205 billion in 2020 and BRL195 billion in 2021. While reiterating the high uncertainty related to the harm of the COVID-19 crisis on Brazilian economic activity, we acknowledge that our base-case forecast for 2020 GDP growth may seem a bit optimistic in light of recent developments and revisions carried out by multilateral bodies. In other words, we reckon it fair to assign a downward bias to our current expectation.

Figure 3. Drivers of Government's Primary Revenue

Central Government's Primary Revenue - Simulations for Alternative Scenarios*							
Real GDP growth (%)		Tax exemptions (BRL bn)**		Dividend payment (BRL bn)		Total Primary Revenue (BRL bn)	
2020	2021	2020	2021	2020	2021	2020	2021
+2.0	+2.5	-	-	22.5	15.0	**1,636**	**1,747**
-2.2	+1.7	-30	+20	8.5	10.4	**1,520**	**1,615**
-3.6	+2.1	-40	+25	7.3	10.7	**1,490**	**1,597**
-4.0	+6.0	-40	+40	7.0	18.5	**1,484**	**1,680**
-6.0	+2.8	-65	+30	5.2	7.5	**1,430**	**1,552**

Source: The National Treasury Secretariat, Central Bank of Brazil and Santander.

* International oil price (Brent barrel) for all scenarios: USD 30/barrel in 2020 and USD 45/barrel in 2021 (annual average).
** It includes explicit tax exemptions (e.g. temporary exemption of Tax on Industrial Products and Import Tariffs on medical and healthcare goods; temporary exemption of Financial Transaction Tax for credit operations) and additional postponement of tax payment with primary fiscal impact (-) in 2020, followed by full or partial return (+) in 2021.

Public Sector's Primary Result

In this section, we combine all estimates regarding the impact of deteriorating economic activity and fiscal measures to combat the COVID-19 crisis (among other drivers) on the government's revenue and spending. For the sake of simplification, we treat transfers from the federal government to regional governments (states and municipalities) as primary spending in Figure 4, although such operations are deducted from the federal government's total primary revenue to gauge its net primary revenue, as established in the National Treasury's methodological framework.

As highlighted in Figure 4, **we now expect the Brazilian central government to register a primary deficit of BRL556 billion in 2020 (-7.6% of GDP)**, whereas regional governments (states and municipalities) and state-owned companies should record a combined negative balance of BRL30.5 billion in the period (-0.4% of GDP). Thus, **2020 public sector's primary fiscal deficit will total BRL583 billion (-8% of GDP), according to our updated baseline scenario.** For 2021, we calculate a primary fiscal deficit of BRL218.5 billion (-2.9% of GDP) for the consolidated public sector.

On the one hand, these forecasts are worse than what was provided in our previous revision of fiscal policy indicators (April 6 report, *COVID-19: The Dominance of Uncertainty – Updating Brazil Forecasts*), since the size of the emergency aid package to mitigate the economic impact from the COVID-19 outbreak has proved to be larger than our previous forecast for 2020 public sector's primary fiscal result: BRL452.5 billion (-6.2% of GDP), also displayed in Figure 4. On the other hand, **we reiterate that the balance of risks for this year's economic growth outlook is tilted to the downside** (i.e., more pronounced decline in Brazil's GDP), which explains our choice for presenting in this report alternative scenarios that contemplate more significant economic recession and, consequently, higher primary fiscal deficits. In this sense, we call attention to two simulated scenarios: (i) after falling 4% in 2020, GDP recovers quickly and expands 6% in 2021; and (ii) GDP plunges 6% this year and grows at a slow pace next year (+2.8%). Regarding the former, public sector's primary fiscal deficit would reach BRL661 billion in the current year (-9.3% of GDP), declining next year to BRL140 billion (-1.8% of GDP). As for the most pessimistic scenario, nevertheless, the public sector's primary fiscal deficit would be nearly BRL750 billion (-11% of GDP) in 2020 and BRL290 billion (-4% of GDP) in 2021, more than four times the negative balance expected before the COVID-19 outbreak (-BRL68 billion or -0.8% of GDP).

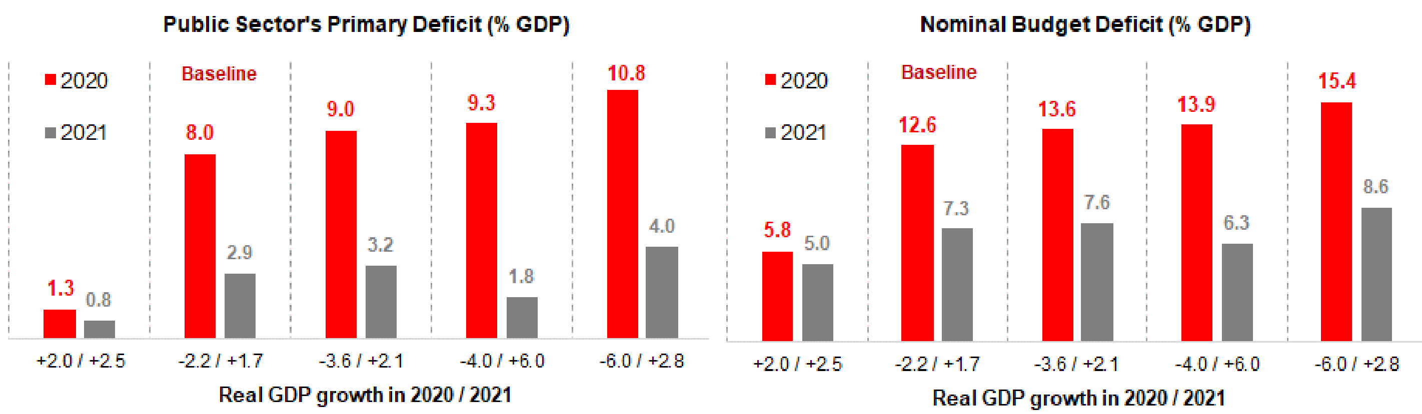
It is worth noting that all scenarios designed in this study take as a crucial assumption that the (massive) fiscal expansion resulting from the public health crisis will be limited to 2020. That is, there will be no significant increase in public expenditure (or persistent tax exemptions) in the coming years. The federal government's economic team has reiterated its pursuit of long-term fiscal consolidation once the COVID-19 crisis has ended, and congressional representatives had supported this agenda until recently. Scenarios contrasting with this framework (e.g., expansion of permanent spending) would probably widen the already enormous public sector's primary deficit we estimate for 2021, in addition to making it difficult to achieve primary fiscal surpluses on the foreseeable horizon. **In our baseline scenario, the primary fiscal balance will return to the positive territory in 2024** (please refer to Figure IV in the Appendix). Risks of disruption in the economic policy framework that has been adopted since late 2016—fiscal austerity and structural reform agenda—will be analyzed in the last section of this report.

Figure 4 – Forecasts for the Public Sector's Primary Result in 2020 and 2021

Primary Fiscal Result in 2020 and 2021 - Simulations for Alternative Scenarios											
Real GDP growth (%)		Primary Revenue Losses (BRL bn)*		Expansion in Primary Spending (BRL bn)*		Central Government's Primary Result (BRL bn)		Regional Govts & State-Owned Companies' Primary Result (BRL bn)		Public Sector's Primary Result (BRL bn)	
2020	2021	2020	2021	2020	2021	2020	2021	2020	2021	2020	2021
+2.0	+2.5	-	-	-	-	-105.0	-76.5	-2.3	4.2	-98.5	-68.0
-2.2**	+1.7	96	112	260	5	-431.0	-149.5	-24.8	-2.9	-452.5	-148.3
-2.2	+1.7	116	132	335	5	-556.2	-213.3	-30.5	-9.0	**-582.8**	**-218.5**
-3.6	+2.1	147	150	360	5	-611.8	-231.2	-35.0	-11.0	-643.0	-238.4
-4.0	+6.0	153	67	370	5	-627.7	-148.4	-37.2	4.0	-661.2	-140.6
-6.0	+2.8	206	195	395	5	-706.2	-281.5	-45.0	-17.5	-747.4	-290.2

Source: The National Treasury Secretariat, Central Bank of Brazil and Santander.
* Central government's revenue and spending.
** Previous baseline scenario (published on April 06, 2020).

Figure 5. Primary and Nominal Budget Balance



Sources: The National Treasury Secretariat, Brazilian Central Bank and Santander.

Public Debt Escalation

The outlook for Brazilian public debt has changed dramatically in the recent period. For instance, the gross public debt-to-GDP ratio reached 75.8% at YE2019, the first annual decrease since 2013. Moreover, we were expecting its downward trajectory to continue this year and in the coming ones, due to such factors as: (i) a significant decline in interest rates, reducing the cost of public debt rollover; (ii) higher GDP growth; (iii) BNDES payments in advance to the National Treasury; and (iv) lower primary fiscal deficits, albeit at a gradual declining pace (for details, see our December 13, 2019 report, *Better Outlook*). Nonetheless, this outlook no longer exists: **according to our updated forecasts, the public sector's nominal budget deficit will jump to 12.6% in 2020 from 5.9% of GDP in 2019**, almost 7 p.p. of GDP above the level we expected a few months ago (before the COVID-19 crisis). The most stressed scenario points to a nominal fiscal balance of 15.4% of GDP in the current year (see Figure 5).

Therefore, we now see the gross public debt-to-GDP ratio climbing nearly 12 p.p. (from 75.8% to 87.5%) from 2019 to 2020 and peaking only in 2022 at 90.7%. More importantly, we expect the indicator to reach 83% in 2030, implying a difference of 16 p.p. of GDP compared to the pre-coronavirus outlook. Regarding the net public debt-to-GDP ratio, we foresee an increase from 55.7% in 2019 to 66.2% in 2020 and a peak at 70.2% in 2024 (new baseline scenario, as shown in Figure 6). Of course, the degree of uncertainty surrounding this type of forecast is high, since it combines the predicted dynamics for several macroeconomic variables (e.g., GDP growth, inflation, interest rates, exchange rate, primary fiscal balance, etc.); however, this exercise pointedly clarifies the massive fiscal effort required to substantially reduce Brazilian public debt in the current context.

Considering the outcome from the most benign scenario (where GDP expands 6% in 2021, following a contraction of 4% in 2020), the gross public debt would peak next year at 88.3% of GDP, while the end-point level of our simulations (2030) would be 78.2% of GDP. Conversely, the indicator would climb to 96.8% of GDP in 2021, peaking only in 2023 (at 98.2% of GDP) if we consider the most pessimistic simulation (GDP diving 6% this year). **It never hurts to reiterate that all scenarios do not foresee an explosive trajectory in Brazilian public debt (e.g., continuously rising levels above**

100% of GDP) because of our fundamental hypothesis that the government and Congress will remain credibly committed to the fiscal consolidation agenda. Hence, risk premiums—embedded in the yield curve—related to the perception of fiscal deterioration will not return to levels observed in the period prior to the adoption of the first fiscal adjustment measures in Brazil (particularly in the period from 2013 to 2016), in our view, although we have already seen some increase in fiscal risk perception recently.

Figure 6 – Forecasts for Brazilian Public Debt (Gross and Net Measures)

Public Debt - Simulations for Alternative Scenarios											
Real GDP growth (%)		Public Sector's Primary Result (% GDP)		Gross Public Debt (% GDP)				Net Public Debt (% GDP)			
2020	2021	2020	2021	2020	2021	Peak	2030	2020	2021	Peak	2030
+2.0	+2.5	-1.3	-0.8	75.5	74.7	75.8 (2019)	67.0	57.2	57.5	57.7 (2022)	50.4
-2.2	+1.7	-6.2	-1.9	83.9	84.8	84.8 (2021)	77.2	63.5	64.9	66.5 (2024)	58.2
-2.2	+1.7	-8.0	-2.9	87.5	90.1	90.7 (2022)	83.0	66.2	68.5	70.2 (2024)	63.2
-3.6	+2.1	-9.0	-3.2	89.4	92.0	92.6 (2022)	85.2	68.1	70.4	72.3 (2024)	65.6
-4.0	+6.0	-9.3	-1.8	90.1	88.3	88.3 (2021)	78.2	68.6	68.2	68.2 (2022)	60.3
-6.0	+2.8	-10.8	-4.0	94.0	96.8	98.2 (2023)	91.0	72.2	75.2	77.4 (2025)	71.8

Sources: The National Treasury Secretariat, Central Bank of Brazil, IBGE and Santander.
Note: Gross Public Debt in 2019 = 75.8% of GDP ; Net Public Debt in 2019 = 55.7% of GDP.

Other important assumptions used to simulate scenarios for public debt follow:

Real GDP growth: 2.8% in 2022; 2.6% in 2023; 2.3% in 2024; 2.2% (potential GDP growth) from 2025 onward.

Inflation: 2.2% in 2020; 3.1% in 2021; 3.5% in 2022; 3.00% from 2023 onward.

Interest rate (average cost of rolling over public debt): 4.9% in 2020; 5.1% in 2021; 6.4% in 2022; 7% from 2023 onward.

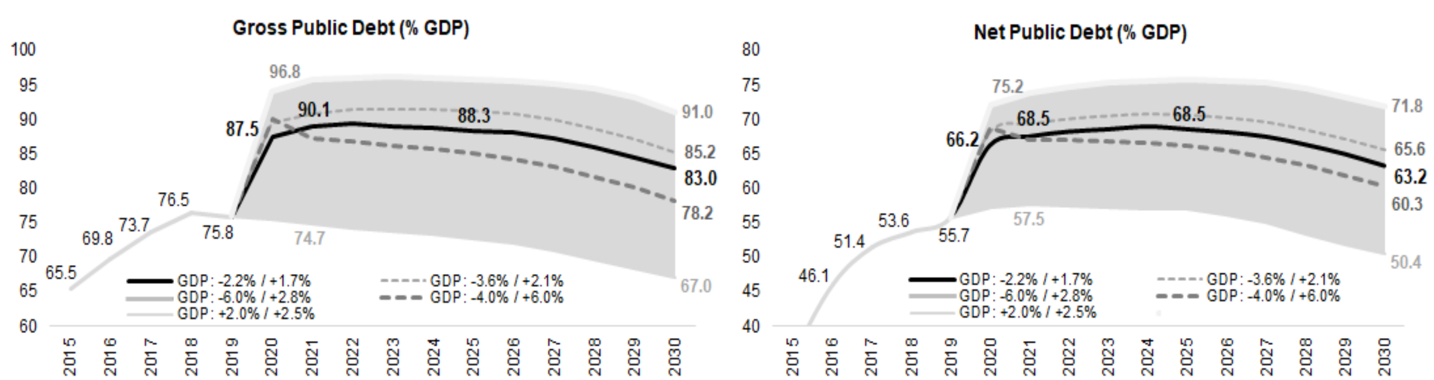
Exchange rate (BRL/USD - annual average): 5.09 in 2020; 4.33 in 2021; 4.07 in 2022; 4.10 in 2023; 0.5% increase from 2024 onward.

Net sales of **international reserves**: USD25 billion in 2020 (-1.7 p.p. of GDP) and USD10 billion in 2021 (-0.6 p.p. of GDP).

Return of **BNDES funds** to the National Treasury: no payment in 2020; BRL40 billion in 2021 (-0.5 p.p. of GDP); BRL60 billion in 2022 (-0.7 p.p. of GDP); USD20 billion in 2023 (-0.2 p.p. of GDP); USD20 billion in 2024 (-0.2 p.p. of GDP).

Temporary reduction of **reserve requirements** (announced by Brazilian Central Bank): BRL118 billion in 2020 (+1.6 p.p. of GDP).

Figure 7 – Projected Trajectory of Brazilian Public Debt over Next 10 Years



Sources: Brazilian Central Bank and Santander.

As mentioned above, our simulations consider a potential GDP growth (long-term equilibrium) of 2.2%, which reflects the assumption of continuity of the government's reformist agenda; consequently, the expansion in Brazilian economy's productivity and investment rate over time. If this agenda is significantly weakened or even abandoned, the fiscal outlook will be much more dramatic, in our opinion. For example, we estimated again the alternative scenarios presented in this report with a vital difference: potential GDP growth of 1% instead of 2.2%. In summary, Brazilian public debt would rise continuously throughout our simulation interval for all scenarios. In the baseline case, the gross public debt-to-GDP ratio would climb to 115% of GDP in 2030. This simple exercise did not consider indirect effects (obviously negative, in this case) on other macroeconomic variables such as the yield curve, which would likely further worsen the results.

Walking the Tightrope: Facing New Challenges and Preserving Past Achievements

Most emerging countries are badly positioned to tackle the current health crisis, since their ability to mitigate the economic impact of the (necessary) social isolation measures seem to be much lower compared to developed regions, especially regarding the leeway of fiscal and monetary policies. In spite of this, we note that after tepid responses at the pandemic's onset in Brazil, the federal government and the Congress have announced a decent package of emergency measures. The financial aid for off-the-books workers and compensation payments for formal workers with reduced or suspended employment contracts are good examples of the size and scope of the relief package.

No one knows the extent of the epidemiological crisis in the country, nor of the magnitude of its hit on the economy. However, we know that the unprecedented fiscal expansion related to combating COVID-19 will impose high costs for the country. The economic damage would be even worse if we had not observed meaningful fiscal and parafiscal adjustment measures and reforms over the past few years, which greatly contributed to anchoring expectations and improving the macroeconomic environment (e.g. tame inflation and historically low interest rates). While helping substantially, this does not brighten the horizon, especially when we remember that Brazilian fiscal consolidation had not been achieved prior to the outbreak.

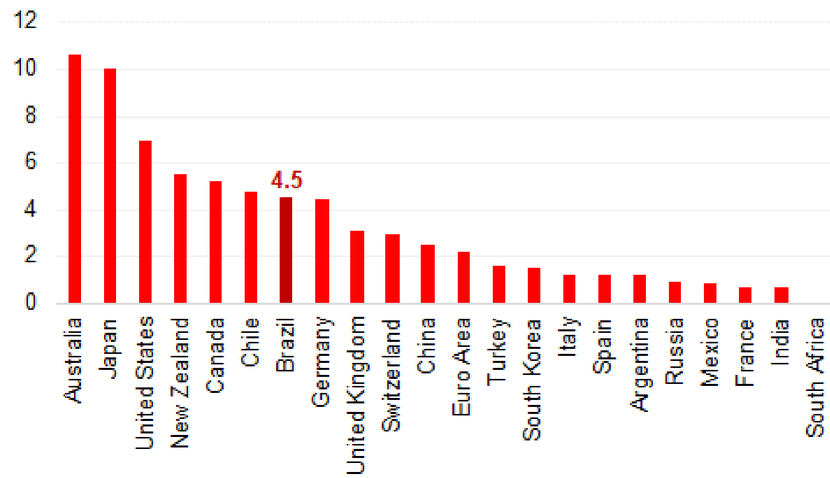
The government's economic team has consistently stated its commitment to ensuring that additional emergency spending is limited to this year, a view that seems to be shared by some key party leaders in Congress. As already discussed in this report, we assume that the robust fiscal expansion will be temporary and focused on the core of the problem, preserving the fiscal consolidation framework. In our opinion, the more intact this framework, the greater the likelihood of a more consistent recovery of the economy after the pandemic subsides. In this sense, we highlight the compliance with the spending cap rule, which is currently the most important anchor of fiscal policy and the economy, in our view. The compliance with this constitutional rule in 2021 will be challenging, since the difference between the expenditure ceiling and the amount of mandatory outlays, combined with a minimum level of discretionary outlays to prevent the shutdown of public services, is slightly above BRL10 billion, according to our estimates. In other words, any increase in permanent expenditures larger than this amount would impose a high risk to the maintenance of the fiscal anchor, which reinforces the need for limiting to 2020 the (inevitable) expansion in primary spending aimed at combating the COVID-19 crisis. Furthermore, the stability of public servants' wages in nominal terms, added to the stability of minimum wage in real terms (as set out in the 2020 public budget), should be important elements providing some relief—in compliance with the constitutional spending cap rule in 2021.

Hence, in order to support the constitutional spending cap framework, we believe that the government would need to speed up the approval of structural reforms in the post-crisis scenario. Furthermore, efforts to boost privatizations and concession plans could help pave the way for more robust economic growth, in our view. In short, we see ample challenges, as well as risks on the radar. First, we have seen growing concerns that tensions between the executive and legislative branches could poison the post-crisis political environment and undermine some reforms. Regarding the proposed constitutional amendments already announced, we still expect tax reforms and the fiscal emergency package to resonate in Congress next year, in the wake of pleas from (a large part of) the population for measures that increase overall economic productivity—such as the simplification of tax regime—and for cuts in public servants' salaries, which is specifically important in a scenario where private sector workers see their wages and positions slashed owing to the COVID-19 crisis. Other reforms (e.g., the Federal Fiscal Pact) appear, nevertheless, to have lost ground recently, in our view.

In addition to the turbulent political scenario, we see non-negligible risks of lawmakers proposing more fiscal spending next year, as they will face increasing pressure to approve measures to deal with the modest economic growth environment. Bear in mind that last month Congress overturned a presidential veto on the expansion of eligibility criteria for welfare benefits under the Continuous Cash Payment (BPC, acronym in Portuguese) program, which increases the amount of mandatory expenditure from 2021 onward and makes the compliance to the spending cap rule more challenging. This event can be understood as a sign of times to come, in our view, particularly if employment and income levels do not recover quickly and the populace pushes lawmakers for more social spending (e.g., the maintenance of some emergency relief measures implemented this year and/or conception of new provisions). All in all, while keeping a constructive view on the pursuit for fiscal consolidation in the coming years, we recognize that the balance of risks for the execution of the government's reform agenda has worsened in the short term.

APPENDIX

Figure I – Global Fiscal Impulse by Country (% GDP)



Sources: International Monetary Fund (IMF) and Santander.

Figure II – Fiscal and Quasi-Fiscal Measures Announced by Federal Government (as of April 21)

	BRL billion	% GDP	Does the measure affect primary result?
1) Postponment of tax payment (from 1H20 to 2H20)	**132.2**	**1.82**	
1.1 - Deferred collection of payroll levies (on FGTS accounts) for 3 months	30.0	0.41	N
1.2 - Deferred collection of taxes on small and medium-sized companies (*Simples*) for 3 months	22.2	0.31	N
1.3 - Deferred colection of social contributions for 2 months (PIS/PASEP, COFINS and employer contribution to social security)	80.0	1.10	N
2) Advance payment of social benefits (from 2H20 to 1H20)	**58.8**	**0.81**	
2.1 - Early disbursement of year-end bonuses paid to retirees (1st installment in April and 2nd installment in May)	46.0	0.63	N
2.2 - Early disbursement of year-end bonuses payments to formal workers (from December to June)	12.8	0.18	N
3) Tax exemptions	**12.1**	**0.17**	
3.1 - Lower collection (-50%) to finance the Autonomous Social Services (*Sistema S*) for 3 months	2.2	0.03	N
3.2 - Temporary exemption of IPI (Tax on Industrial Products) for domestic and imported medical, hospital and healthcare products	0.6	0.01	Y
3.3 - Zero import tariffs for medical, hospital and healthcare products	2.2	0.03	Y
3.4 - Temporary exemption of IOF (Financial Transactions Tax) for credit operations	7.1	0.10	Y
4) Resource reallocation	**28.3**	**0.39**	
4.1 - Allowance for individuals to withdraw more resources from FGTS accounts (mandatory savings) - destination of PIS/PASEP funds	21.5	0.30	N
4.2 - Destination of the Insurance for Traffic Accidents fund - DPVAT, acronym in Portuguese - to the public health system	4.5	0.06	N
4.3 - Reallocation of Census resources to the Ministry of Health	2.3	0.03	N
5) New Spending	**211.3**	**2.91**	
5.1 - Addition of 1.2 million households to the *Bolsa Família* entitlement program	3.1	0.04	Y
5.2 - Emergency aid for informal and intermittent workers, self-employed, microenterpreneurs and low-income workers for 3 months	110.0	1.52	Y
5.3 - Extraordinary funds for the Ministry of Health	7.7	0.11	Y
5.4 - Compensation payments for workers with suspended or reduced empolyment contracts (reduction in worload and wages)*	51.2	0.71	Y
5.5 - Emergency resources to philantropic hospitals, to be used in the purchase of medicines and healthcare equipment	2.0	0.03	Y
5.6 - Extraordinary funds for the Ministries of Defense, Foreign Affairs and Science	0.4	0.01	Y
5.7 - Extraordinary funds for the Citizenship Ministry (Specialized Reference Centers for Social Assistance - CREAs, in Portuguese)	2.0	0.03	Y
5.8 - Emergency credit line for small and medium-sized companies to finance their payroll for two months**	34.0	0.47	Y
5.9 - Emergency resources to fund low-income households electricity bill for 3 months, benefiting 9.4 million poor families	0.9	0.01	Y
6) Financial Aid to States and Municipalities	**167.3**	**2.31**	
6.1 - Securing level of transfers through state and municipal participation funds - preserving the same levels as 2019	16.0	0.22	Y
6.2 - Resource transfers to the subnational health systems	8.0	0.11	Y
6.3 - Resource transfers for social assistance expenditures in subnational governments	2.0	0.03	Y
6.4 - Temporary suspension (for 6 months) of debt service payments with the federal government	22.6	0.31	N
6.5 - Temporary suspension of debt service payments with public banks (BNDES and Caixa Econômica Federal) - valid for 2020	14.8	0.20	N
6.6 - Debt securitization guaranteed by the federal government	20.0	0.28	N
6.7 - Deferred collection of social contributions for 2 months (PASEP and contribution to social security)	3.9	0.05	N
6.8 - Securing level of tax collection with ICMS (states) and ISS (municipalities) - preserving the same (nominal) levels as 2019***	80.0	1.10	Y
Impact on central government's primary result	**327.2**	**4.51**	
TOTAL (= 1+ 2 + 3 + 4 + 5 + 6)	**610.0**	**8.41**	

Sources: Ministry of Economy, BNDES and Santander.

* Income compensation through proportional unemployment insurance. Reduction of workload and equivalent wages in 25%, 50% or 70% up to 3 months. The benefit could reach 54 million formal workers.

** Resources from the federal government (National Treasury, 85% of total resources or BRL34 billion) and private banks (15%), supervision by the Central Bank of Brazil and operationalization by the BNDES. Financing up to 2 minimum wages per worker with a 6-month grace period and a total payment term of up to 3 years.

*** Estimated impact of the bill proposal approved by the Lower House on April 13 (still awaiting a vote in the Senate). Furthermore, the federal government has proposed an alternative bill with lower fiscal impact.

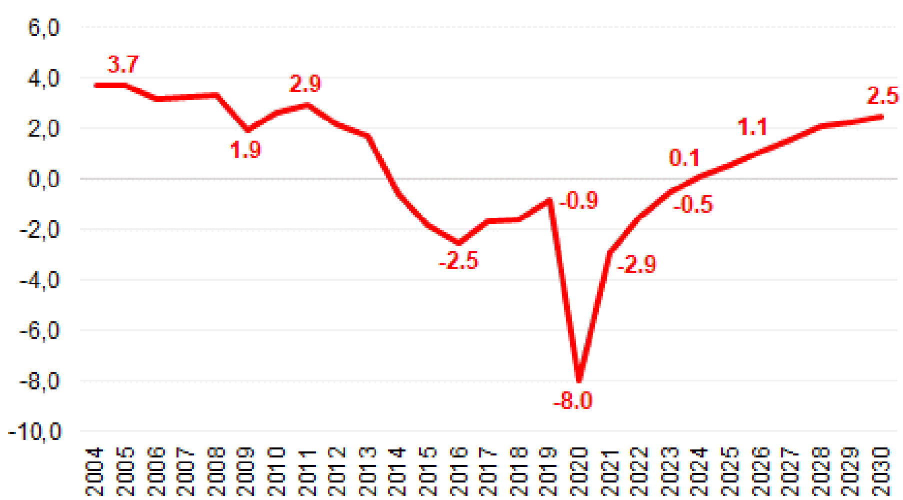
Figure III – Measures Announced by Public Banks and the BCB (as of April 21)

	BRL billion	% GDP
1) BNDES - The National Bank for Economic and Social Development	**37.0**	**0.51**
1.1 - Postponment of debt service payments (standstill) for direct credit operations - valid for 6 months	19.0	0.26
1.2 - Postponment of debt service payments (standstill) for indirect credit operations - valid for 6 months	11.0	0.15
1.3 - Expansion of credit lines to micro and small businesses (PROGER), limited to BRL 70mn *per* customer	5.0	0.07
1.4 - Emergency credit lines for production, import and/or commercialization of medical, hospital and health products	2.0	0.03
1.5 - Allowance for regulated fintechs to transfer funds from BNDES to small and medium-sized companies	-	-
2) Caixa Econômica Federal	**111.0**	**1.53**
2.1 - Emergency credit (working capital lines) for micro and small companies	60.0	0.83
2.2 - Purchase of vehicle loan and payroll-backed portfolios from small and medium-sized banks	40.0	0.55
2.3 - Further agricultural credit to finance the 2020/2021 harvest	6.0	0.08
2.4 - Emergency resources to philantropic hospitals that provide services to the public health system (SUS, acronym in Portuguese)	5.0	0.07
2.5 - Lower interest rates on emergency credit lines and possible suspension of debt service payments for up to 3 months	-	-
2.6 - Larger volume of loans to states and municipalities	-	-
3) Banco do Brasil	**100.0**	**1.38**
3.1 - Strenghtening emergency credit lines (working capital, investments) and prepayment of companies' receivables	48.0	0.66
3.2 - Expansion of agricultural credit	25.0	0.34
3.3 - Expansion of household credit	24.0	0.33
3.4 - Emergency credit lines for states and municipalities to finance investments and equipment purchases related to health systems	3.0	0.04
SUBTOTAL - Public Banks (1+2+3)	**248.0**	**3.42**
4) Central Bank of Brazil*	**1,166.2**	**16.1**
4.1 - Reduction in reserve requirements of time deposits (from 31% to 25%)	50.0	0.69
4.2 - Further reduction in reserve requirements on time deposits (from 25% to 17%, up to December 2020)	68.0	0.94
4.3 - Expansion of credit concession through new term deposit with special guarantees (NDPGE, acronym in Portuguese)	200.0	2.76
4.4 - Easing the short-term liquidity rules (LCR, acronym in Portuguese), diminishing the required level of high-quality illiquid assets	85.0	1.17
4.5 - New loans backed by debentures	91.0	1.25
4.6 - Easing rules for Agribusiness Credit Bills (LCA, acronym in Portuguese), potentially expanding the credit lending	2.2	0.03
4.7 - New loans backed by Financial Bills (LF, acronym in Portuguese) guaranteed by credit operations, aiming at providing liquidity	670.0	9.23
TOTAL - Public Banks and Central Bank of Brazil (1+2+3+4)	**1,414.2**	**19.49**

Sources: Ministry of Economy, Central Bank of Brazil, BNDES, Caixa Econômica Federal, Banco do Brasil and Santander.

* Capital measures are not included.

Figure IV – Public Sector's Primary Result (% GDP) from 2004 to 2030 – Baseline Scenario



Sources: Brazilian Central Bank and Santander.

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