Santander

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Economic Scenario

Some Theses for 2016

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- **Fiscal uncertainty will persist, in our view, with primary fiscal result still in deficit and debt still rising.**
- **Nevertheless, we believe that the BRL should not face additional, structural depreciation . . .**
- **. . . as external financing should suffice for declining external needs.**
- **In the absence of sustained BRL weakening, we see relevant disinflation ahead . . .**
- **. . . limiting the probability, and the need, of a substantial monetary tightening.**
- **Economic downturn will lose strength over 2016 . . .**
- **. . . but labor market should continue to deteriorate through year-end, in our view.**
- **Delinquency levels will face some limited deterioration.**
- **Risks to our view: What to monitor in the year ahead? Policy response to the difficult environment can be a trigger to change in the economic outlook.**

INTRODUCTION: WHAT DO WE KNOW AND WHAT WE DO NOT KNOW ABOUT 2016

In recent decades, few years have started out as uncertain for the Brazilian economy as 2016. Although doubts about the international scenario seem to be lower than in many years, there is limited visibility on many local variables, be them political, policy-related or purely economic.

In this context, debating the scenario for the year ahead is a difficult, yet necessary (and hopefully useful) exercise. More than simply laying out some forecasts, in this piece we attempt to outline some trends while pointing out key events or risks to monitor that could turn the scenario one way or the other. While politics will certainly play an important role in this dynamic, we try to keep politics aside in this exercise. In our scenario, we simply assume continued political turmoil, with little support toward legislative initiatives proposed by the President and persistently high popular dissatisfaction with the government, at least for most of 2016. In this sense, specific political events that eventually occur during the course of 2016 would only be drivers for a change in economic outlook if they imply significant changes on popular or Congressional support to the government.

Considering the limited visibility, it seems risky to insist on out-of-consensus calls. Nevertheless, our scenario departs from the prevailing consensus in a few aspects. First, we do not envisage reasons for new rounds of sustained, substantial BRL weakness, although high volatility should be the tonic for the new year once again. As a consequence, unlike many analysts, we do expect some disinflation, and because of that we are more cautious than most in the market when it comes to new rounds of monetary tightening. Perhaps some additional tightening could be useful to tame inflation expectations, but a shock seems unnecessary. With no harsh monetary tightening in our scenario, we do expect the economic activity to stabilize in mid-2016, but it is worth noting the very negative carry-over that harms GDP growth this year. Once again, as a consequence of these premises, we are less worried than many analysts regarding the prospects for delinquency levels, which should deteriorate but only to a limited extent, in our view.

All these calls rely on premises, and because of that it is important to point out what they are and what the risks are to these views. The basic premise here is that economic policy will not change materially over the course of this year. This means that neither we will see a substantial improvement on the fiscal area nor will we see a shift toward heterodox options. Specifically, we are assuming that the government will not rely on new rounds of quasi-fiscal stimuli, will fight inflation (even if somewhat reluctantly), and will not prevent the BRL from floating, be it through the use of reserves or any other type of controls. These assumptions can be questioned, and are the main sources of risk to our scenario. We discuss these risks in greater detail and point out variables to keep in the radar so to monitor potential shifts in the scenario.

FISCAL POLICY: FISCAL UNCERTAINTY WILL PERSIST, WITH PRIMARY DEFICIT AND RISING DEBT

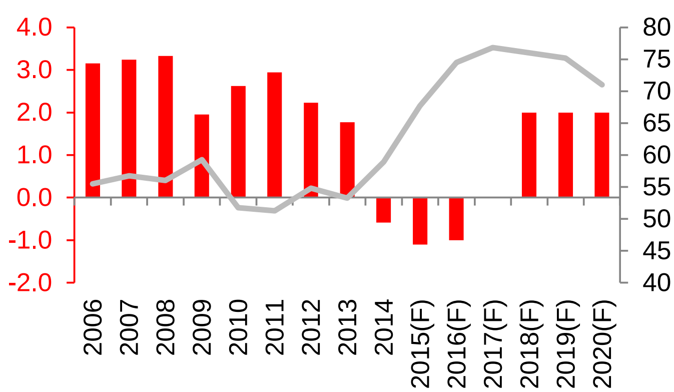
Politics aside, fiscal policy should remain the main concern of Brazil observers. With the country likely to stay in “stagflation mode” for most of 2016, we believe two of the main drivers of the debt/GDP dynamics will remain under intense pressure: tax revenue will probably keep disappointing, in our view, and interest rates (and hence debt service) should remain high (and probably rising, although our base-case scenario is still of stability). This would require a strong (higher than 3% of GDP) primary surplus to lead the debt trajectory to a flat path, which we think is extremely difficult to reach given macroeconomic conditions and the weak support for any spending cut/raising revenue measures that depend on the Congress. We forecast a primary deficit of 1% of GDP (the government, therefore, will miss significantly the 0.5% of GDP surplus target—already cut, in December, from 0.7% of GDP), lifting the gross debt/GDP ratio to 74.5%.

However, we believe most of this deterioration in fiscal accounts is already priced in, so this weakening in fiscal indicators should not trigger disruption. As per the last 2015 Central Bank poll of forecasts, the median expectation for the primary balance in 2016 is a deficit of 0.95% of GDP. This pessimism is also reflected in the long end of the BRL yield curve, with markets asking for real rates above 7% to finance government debt, more than 100 bps higher than a year ago.

Most economists in Brazil agree that the short-term debt trajectory is quite negative, but there is also a consensus that something—namely, social security reforms, a revision in the correction mechanisms of the minimum wage, some tax increase, and eliminating frauds and distortions in social programs—will be done as soon as the political crises stabilize (the government is already preparing a proposal of social security reform, to be sent to Congress as soon as possible) or, the latest, after 2018 presidential elections. In any case, economists expect little more than the bare minimum for 2016, and to most observers, risks are on the downside. Finance Minister Nelson Barbosa seems to have exhausted most of his discretionary options, in our view, and, as we said, significant new relevant measures depend on willingness and on political skills we see neither in the executive nor in the Congress. For example, government’s plan to reach the 0.5% of GDP target includes raising tax revenues by re-enacting tributes such as CPMF, a tax on financial transactions that, in official budget estimates, could bring BRL32 billion (around 0.5% of GDP) to Treasury’s coffers. On the spending side, there has been strong pressure from some sectors of the ruling party to add stimulus to credit through state-owned banks—the same kind of policy that explains the widening gap between net and gross debt since 2011 and would probably add to market participants’ and rating agencies’ concerns.

Finally, we would like to call attention to a somewhat counter-intuitive result: an alternative scenario of financial market stress may lead to marginally better debt indicators. Brazil is a net creditor in foreign currency, so another leg of strong currency depreciation would translate into profits from international reserves. Furthermore, accelerating inflation would lead to lower ex-post real interest rates and falling liability costs. In a stress scenario (in which annual inflation rises to 20% by 2018, nominal rates reach 22%, GDP falls 4% this year and remains stable in 2017 and 2018, and BRL weakens to 6.0 to the USD), gross and net debt/GDP ratios would be, respectively, 8 and 12 percentage points lower than in a “convergence” scenario of stable exchange rates and inflation falling to 5%. In other words, scenarios in which all the most relevant macro variables (including fiscal indicators) turn sour may be internally inconsistent, and, conversely, a relief in the ongoing crisis may, in the short term, further deteriorate the debt/GDP path. This also shows that financial repression may be an effective strategy to reduce the debt burden, a fact that could keep policymakers tempted and bondholders worried.

Figure 1. Gross Public Sector Debt and Primary Balance (GDP %)



Sources: Brazil Central Bank and Santander estimates.

Figure 2. Primary Fiscal Results Forecasts (GDP %)

2014 primary balance	**-0.6**
Non-recurring revenues	-0.1
Economic cycle impact	-1.4
Spending growth	-1.4
Fiscal measures	2.4
2015 primary balance	**-1.1**
Economic cycle impact	-0.5
Spending growth	-0.7
Fiscal measures	1.3
2016 primary balance	**-1.0**

Source: Santander estimates.

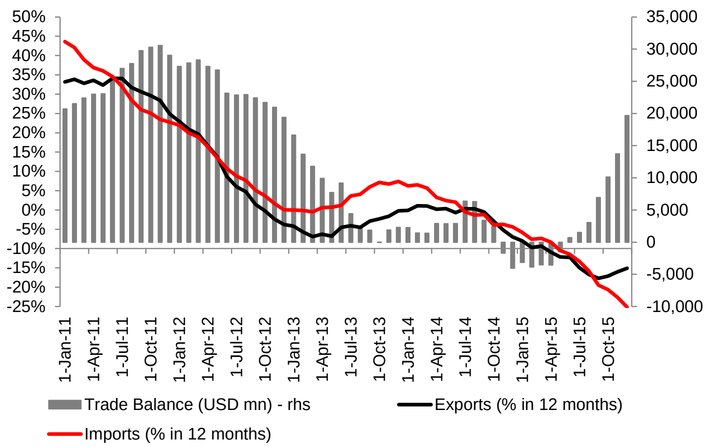
BRL: NO NEW ROUND OF ADJUSTMENT (BUT A LOT OF VOLATILITY)

The Brazilian macroeconomic outlook remains difficult. Among a wide range of factors, fiscal uncertainties and GDP contraction remain the primary sources of concern from the point of view of financial markets. That said, we do not expect meaningful improvement in risk premiums and asset prices in 2016. In our view, the current and substantial political uncertainties will not abate in 1H16, and the market consensus for 2016 fiscal primary results will continue in the deficit side rather than in the fiscal target side (a surplus of 0.5% of GDP), and GDP growth forecast will be further revised for the worst. These uncertainties ending up in a pessimistic scenario will promote a lot of volatility for asset prices, especially for BRL.

We expect the news flow to essentially remain negative. We expect economic activity to continue to disappoint, as well as increasing social tensions, with the global environment unlikely to provide any source of joy. We foresee five-year sovereign CDS hovering around 350 bps, close to the level registered throughout 2015. Consequently, commodities prices and country risk being the main drivers for BRL behavior, there is no room for exchange rate appreciation; we see BRL surpassing 4.0/USD mark in 2016 with high volatility.

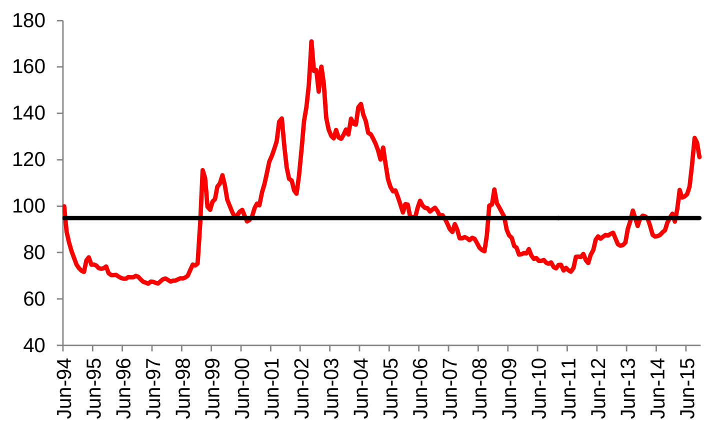
Nevertheless, we also believe that the necessary adjustment in the real exchange rate to reduce the current account deficit and to promote trade balance surpluses is complete. We highlight some indications that the Brazilian real may currently be weaker than its long-term equilibrium. Figure 4 shows the real exchange rate far above the average of the last 20 years. Another indication that the currency may have surpassed its long-term equilibrium is the performance of external accounts, particularly the trade balance. Although economic activity has played an important role for the trade surplus of USD19.7 billion in 2015, we believe that the BRL level also had a significant influence on this outcome. In 4Q15, exports started to present some recovery, decelerating the path of the reduction in 12 months from 17% to 15%. We find it highly likely that the current account deficit will approach 2% of GDP (its historical average) by 2017. That said, we foresee the exchange rate should keep depreciating, adjusting for the inflation differential. Our BRL/USD forecast is 4.10/USD for 2016 and 4.20/USD in 2017.

Figure 3. Trade Balance



Source: MDIC.

Figure 4. Real Effective Exchange Rate Index (at Constant November 2015 Prices)



Source: BCB.

BALANCE OF PAYMENTS: EXTERNAL FINANCING SHOULD SUFFICE FOR DECLINING NEEDS

The current account balance has undergone a sharp adjustment over the course of the last year, representing probably the most positive piece of economic news of that period. Indeed, the current account is likely to have closed 2015 with a deficit below USD60 billion, retreating to less than 3.5% of GDP, after having peaked at USD104 billion at the end of the previous year. Slightly more than half of this improvement came from the turnaround in trade balance, which swung from a deficit of USD6 billion in 2014 to a surplus of USD19.7 billion last year (despite the lower commodity prices), thanks to the weaker BRL and the shrinking domestic demand. These factors also drove a substantial improvement in two other items of the current account: the deficit in international travel, which probably shrank to USD11.5 billion from the peak of USD19 billion earlier last year, and net remittance of profits and dividends, which retreated to around USD20 billion after closing 2014 at USD31billion.

Looking ahead, we see a new round of reduction in the current account deficit in 2016. Once again, the trade balance will likely be the main driver. We anticipate a surplus nearly twice as large as the one seen last year, assuming a less intense decline in commodity prices, some lagged response of manufactured exports to the weaker currency, and the additional contraction in domestic demand. International travel may also show some moderate improvement, with (modest) support from the Olympic Games in Rio. As a result, we expect to see a current account deficit of USD37.3 billion, or 2.4% of GDP, a figure that falls within the range that we see as sustainable, from the point of view of external liabilities dynamics.

Adding to the USD60 billion in medium- and long-term external debt amortizations, Brazil will need to find financing for a little less than USD100 billion. About half of that will likely come from foreign direct investments, which have been very resilient, due to new investment opportunities emerging in light of favorable valuation. The question on whether the external financing will suffice, therefore, lies in three aspects:

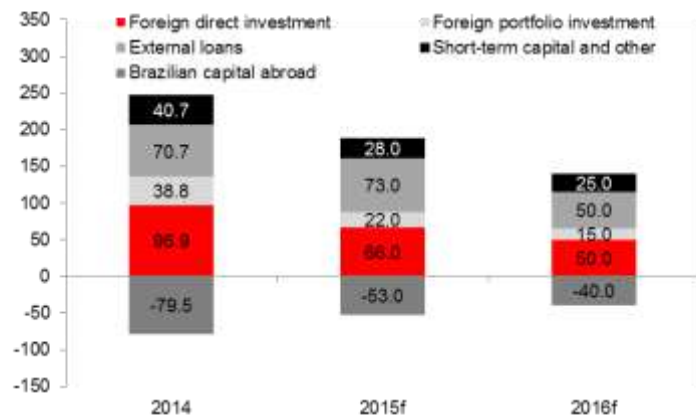
- **Will corporates be able to roll over their maturing external debt?** Until last November, rollover ratios had been above 100% on average, although with some change in the profile of debt instruments, which has become more biased toward direct loans rather than credit market operations. We assume some decline in the rollover ratio to a little above 80%, meaning an expected inflow of USD50 billion in such type of financing.
- **Will there be outflows of portfolio investment?** An inspection of recent history shows that such flows have only become negative, on a 12-month basis, in extreme occasions (1999 and 2008). In the absence of a major deterioration in market sentiment toward Brazil, we do not expect an outflow of portfolio investment. We assume some USD15 billion net inflow, lower than the flows seen in 2015 (somewhere north of USD20 billion) even in midst of market turbulence.
- **Will Brazilians increase their investment abroad?** Once again, in the absence of a major deterioration in sentiment, we do not envisage an increase in net remittance of Brazilian investment abroad. We expect about USD40 billion in such remittances (in net terms).

Commercial credit and short-term capital should bring further USD25-30 billion in external funds. Adding up these factors, we see a balance between external financing needs and sources of external financing under our conservative assumptions for our base-case scenario. However, in the event of a substantial deterioration in market sentiment, a combination of lower rollover of external debt, foreign portfolio outflows and more intense remittance of investments abroad could create a gap in the USD market, and under those extreme assumptions we could see a new round of BRL weakness. In such event, the reaction of economic policymakers will be critical to determine the magnitude and persistence of such weakness. (See Risks to Our View.)

Figure 5. Current Account Deficit: Selected Items

Sources: BCB and Santander.

Figure 6. External Financing: Selected Items



Sources: BCB and Santander.

INFLATION: WITH THE BRL STABLE, WE SEE DISINFLATION AHEAD

Regulated prices set the tone of the inflation scenario in 2015. The adjustments of electricity tariff, fuel prices, water tariff and urban transportation fares led the way to inflation of 10.7% last year. Clearly, in our view, the 47% BRL depreciation also accounts for a significant share of price acceleration, although the current economic contraction might have hampered (and should continue to do) the pass-through from weaker exchange rate to prices.

In the absence of a new round of strong BRL depreciation, we expect a reasonable disinflation process to take place in 2016. The electricity tariff is unlikely to show another 50% adjustment this year (we forecast a 6.5% variation) while gasoline prices should have a more timid hike of around 10% in the period. The risks to these two assumptions are on opposite sides. On one hand, we believe the priority of the federal government will be to raise taxes in order to improve revenues, and to raise taxes on fuel prices can be done by decree (does not require Congressional approval). Because of that, we forecast a hike of 10% in gasoline prices as a result of the hike in CIDE (tax charge on gasoline); the risk to this forecast is on the upside, because the company may need to equalize the domestic price to an eventually higher international price in R$, due to either further exchange rate depreciation or an increase in the international gasoline price. On the other, the risk of electricity tariffs is on the downside. A weaker summer (weaker consumption) or much better hydrology (rainfall above 100% of the average in the southeast region) could mean an electricity tariff adjustment at 2.0% on average in 2016 (smaller than our base-line forecast of 6.5%), with the adoption of a green flag (meaning a lower price band, as set by regulatory agency depending on weather condition) in the beginning of 2Q16.

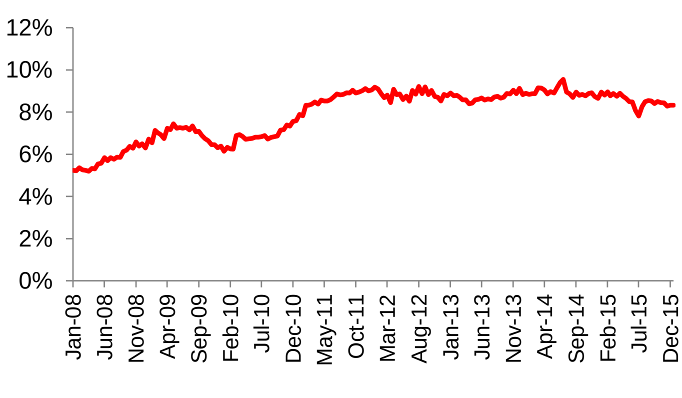
Additionally, other regulated prices, such as urban transportation and water tariff, are expected to have a lower readjustment in 2016. With this, and already accounting for the recently announced bus tariff hike in some important cities, we forecast 7.3% for regulated prices inflation, significantly below the regulated prices inflation of 18% registered in 2015.

Regarding foodstuff inflation, BCB stated in the last Inflation Report (IR 4Q14) that the prices of *in-natura* items should be affected by a change in weather pattern (*El Niño*). Because of this weather event, foodstuff inflation is expected to increase above the seasonal pattern, with most of the deviation concentrated in the first half of the year. Consequently, food-related services as restaurants (food out of home) are likely to show lagged inflation acceleration.

Regarding other service prices, generally known to be linked to the past inflation (inertia), we do expect some (but not intense) relief due to the economic recession expected for 2016. The uptrend unemployment rate and sharp economic contraction have been limiting wages readjustments. Real income fell more than 5% in the last months of 2015, and this movement is already playing an important role in minimizing the inflationary impacts. The exception should be flight tickets, which posted 15% deflation in 2015 in the wake of the strong fall in oil prices, and should post a hike in prices this year as the deflationary effects of fuel start to fade and no longer offset the increase of costs due to BRL depreciation.

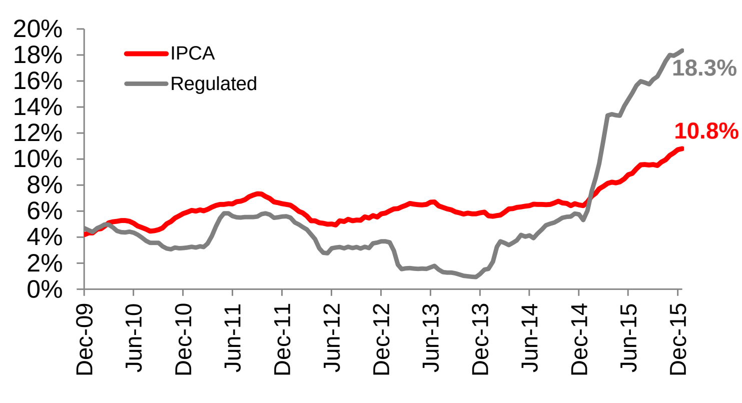
Summarizing, we forecast 2016 year-end inflation of 7%, which means a disinflation of almost 4 percentage points from last year. The turning point of inflation year over year should happen throughout 1Q15: in March we expect the inflation to be back to single digit. It seems that BCB will have to hope for a lot of rain in order to not break the target ceiling of inflation for the second year in a row.

Figure 7. Core Services* Inflation



*Services excluding food out home and airline tickets.
Sources: IBGE and Santander estimates.

Figure 8. IPCA and Regulated Prices Inflation



Source: IBGE.

MONETARY POLICY: LIMITED PROBABILITY, AND NEED, OF FURTHER TIGHTENING

Our base-line assumption is that there will be an important disinflation process throughout 2016 coupled with the current economic recession. Of particular importance is the unusually wide output gap and accelerated pace of unemployment increase.

However, the recent statements of the monetary authority indicate that it intends to tighten monetary policy further; we see no compelling reason to believe it will substantially amplify the process of disinflation that we believe is already on the way.

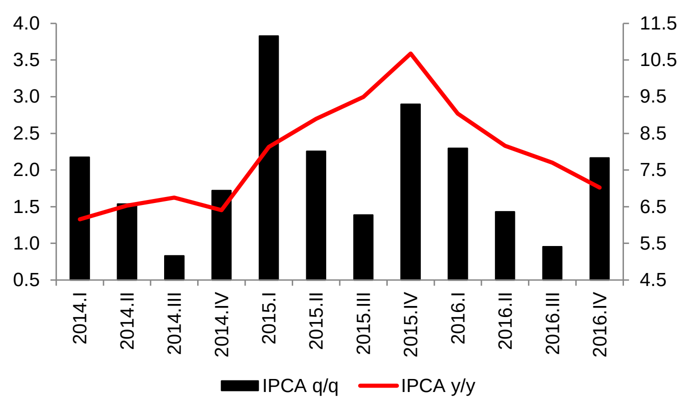
We agree that monetary policy should still be guided by the prescriptions of the inflation targeting regime, which means interest rates should be managed to anchor expectations. Therefore, the easier the fiscal stance, the tighter monetary policy would have to be. Or, the higher inflation expectation deviation from the target for the upcoming years, the tighter monetary would have to be. In this sense, both of them (fiscal guidance and inflation expectations) point toward a tighter monetary policy. For instance, inflation expectations for 2016 increased from 5.5% to 6.9% in the last six months, and inflation expectations for 2017 increased from 4.5% to 5.0%.

On the other hand, (1) the real ex-ante interest rate is higher than the neutral level forecast by the market consensus and ourselves (5.5-6.5%), which clearly shows the monetary tightening stance (see Figure 10); (2) we should see relevant inflation deceleration in 1H16; and (3) also a relevant rise in the unemployment rate as a result of the ongoing economic recession backdrop, which shows no additional monetary tightening needs. In this case, additional monetary policy tightening will be more an instrument to restore the credibility eroded by the recent poor performance in terms of complying with the target for inflation than an efficient way of changing the current inflation trend. And, as widely understood, credibility takes time to build (although it can be destroyed in an instant).

We believe that additional monetary tightening in the current economic environment of a profound recession would deteriorate the fiscal backdrop rather than compensate its poor performance. In our view, more than managing short-term interest rates under the current adverse economic conditions, any attempt to rebuild credibility would be more efficient through institutional changes. These should be aimed at providing increased autonomy to the Central Bank (rather than indications that it will be even more subject to political pressures), in our view, and through mechanisms tying its own hands to the inflation-targeting regime (such as a more transparent inflation forecast targeting official intermediate objectives for inflation and known reaction functions).

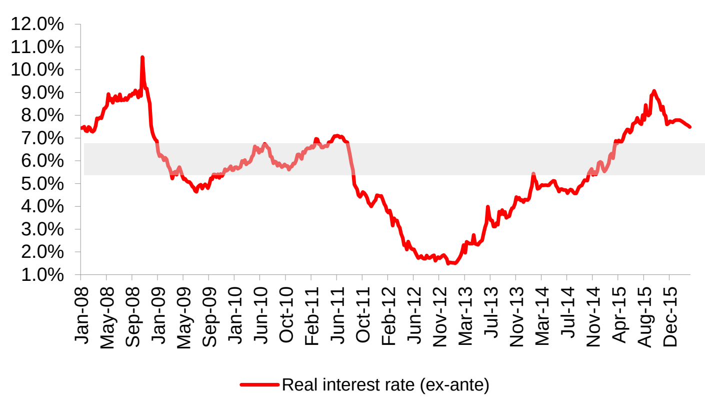
Our year-end Selic forecast is 13% in 2016 and 11.5% in 2017. We expect the BCB will assign considerable weight to the current deep recession and disinflation process from 2Q16 onward. We foresee the BCB moving the relevant horizon for monetary policymaking to 2018 in some moment in 2H16 (considering the very lagged effect of monetary policy on inflation) which, combined with inflation downward trend will, in our view, open room to start a monetary easing cycle in 4Q16.

Figure 9. IPCA (Year over Year)



Source: IBGE.

Figure 10. Real Ex-Ante Interest Rate



Sources: Bloomberg and BCB.

ECONOMIC ACTIVITY: ECONOMIC DOWNTURN WILL LOSE STRENGTH OVER 2016 . . .

As we said, there are no signs of a consistent and widespread recovery of economic activity in the coming quarters. The further deterioration in consumption and investment fundamentals, combined with the political turmoil and its impacts on the risk perception about the macroeconomic environment, will prevent a negative path of activity variables until late 2Q16, at least, in our view.

We believe that business and consumer confidence play a major role, as the improvement of these indicators usually precedes the reversal of a downward trend in investments, industrial production and durable goods sales. We reiterate that the ability and willingness of government to persist with the commitment to rebalance its accounts are crucial to raise the confidence indexes and untie the knot of economic activity.

Looking at the GDP breakdown, it is very unlikely to see resumption in household consumption this year. Indeed, the labor market should continue to deteriorate through year-end. For example, considering the PNAD—National Household Sample Survey—data, we estimate the unemployment rate will climb from 9.7% in 2015 to 12.0% in 2016 (end of period), driven by the sharp decline in the working population and more significant growth in the labor force, in-line with the weakening household income. Furthermore, the credit market conditions should get even tighter, reflecting the rising individual NPLs and environment full of uncertainties.

Similarly, there is no doubt that investments will shrink once again. High real interest rates, low levels of business confidence and negative outlook for large sectors such as oil & gas and civil construction will keep the Gross Fixed Capital Formation (GFCF) on a downward path. Nevertheless, investment dynamics are quite sensitive to the degree of risk perception, and the little visibility on the ongoing fiscal adjustment and politics makes it difficult to forecast the magnitude of shrinkage. Our base scenario points to a 10% contraction in GFCF in 2016, but the probability of a result as bad as (or worse) in 2015 are not negligible (below -15%).

On the positive side, we highlight that the external sector will be very important for Brazil's economy in 2016, preventing a wider contraction of the activity. We calculate an increase in exports and steep decline in imports will contribute around 1.5 p.p. to GDP this year, in the wake of BRL depreciation and lower domestic income, which should limit the potential downside for the economy. We believe most of the decrease of imports will be led by the worsening economic activity, but the positive impact from the drop in the import penetration ratio is also noteworthy: we estimate nearly 0.25 p.p.

Considering the aggregate sectors, only agriculture and livestock will increase in 2016, in our opinion. Despite the falling trend of international commodity prices, FX exchange and increased productivity for many crops should raise the agricultural income. On the other hand, the industrial sector is likely to continue to contract this year, mainly due to the sharp decline of domestic demand (forecast of around -4%) and, consequently, excessive inventories in several, and large, activities (e.g., automotive; machinery and equipment), and political and economic uncertainties that keep business confidence at very low levels. According to our estimates, industrial production will drop 5.2% in 2016, mainly due to the dismal performance of capital goods and durable goods categories, following a fall of about 8% in 2015.

However, the most favorable conditions of the external sector will mitigate the negative effect of the adverse environment faced by the Brazilian industry, implying a declining trend at a more moderate pace. In the absence of a positive influence from abroad—expansion of manufactured goods and import substitution, albeit at a gradual step—industrial output would register a worse result than in last year, in our view.

Moreover, we think that civil construction will remain on a grueling path throughout 2016, reflecting tighter funding conditions, stoppage (or slowness) of large infrastructure investments (highlighting the public projects), high inventories in important regions, among other factors. The recovery of this sector will take much longer than in others, based on our estimates.

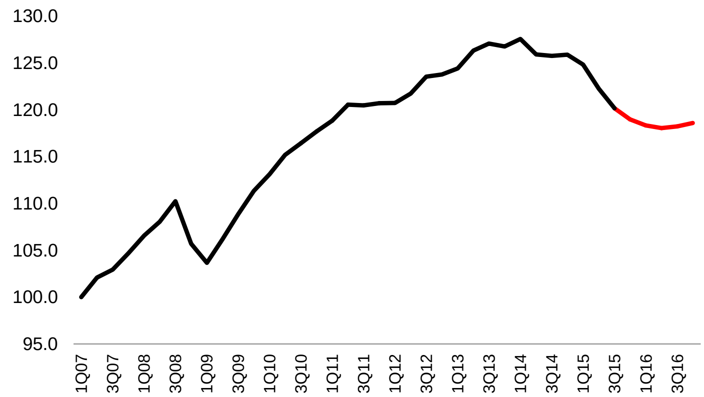
In turn, the weakening of the services sector is likely to continue in the current year, especially driven by the poor performance of commerce (forecast of 5.5% contraction in real retail sales, broad index) and activities closely linked to industry, such as transportation and storage, and services provided to companies. Even the less sensitive activities showed a significant slowdown in 2H15, signaling that the deterioration in the services sector will be widespread and persistent.

In short, we think that economic activity will continue to weaken throughout 1H16, as the effects of cloudy environment will not fade fast. Our base scenario contemplates the economic sentiment will bottom out in late 2Q16 and show a slow improvement thereafter, led by factors such as lower inflation, some reduction of risk perception (albeit not enough to bring it to levels observed before 2015), lower volatility of financial markets and more industrial sectors responding positively to the favorable conditions of external sector. Then, we acknowledge increasing risks for our current forecast that GDP will drop 2.0% in 2016, following a plunge of 3.8% in 2015.

Indeed, as previously mentioned, depending on the dynamics of ongoing fiscal adjustment and uncertainties in the political front, the risk perception and confidence indicators could remain on a deteriorating trend through year-end, at

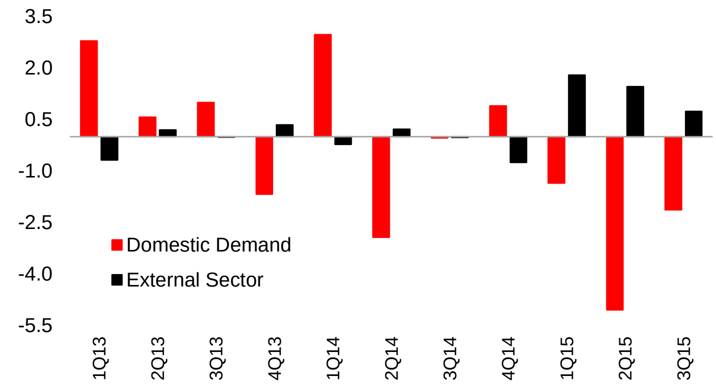
least (e.g., low commitment to the improvement of the gross debt trajectory and drastic changes in economy policy). In this case, our estimates indicate that GDP performance would be even worse than in 2015, mostly driven by a deeper contraction in investments and industrial production.

Figure 11. GDP – Level, Seasonally Adjusted Series



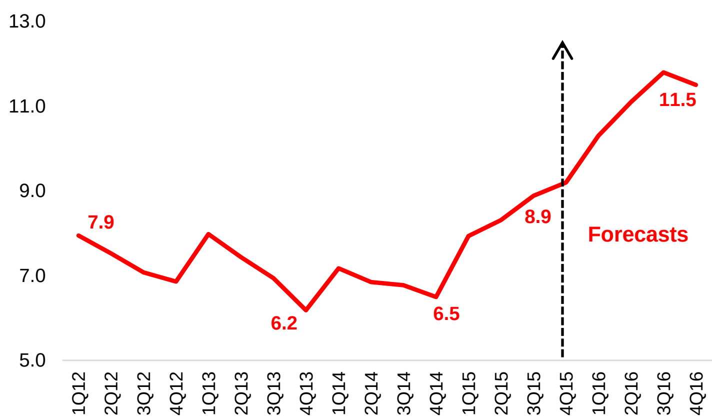
Source: IBGE – National Accounts.

Figure 12. Domestic Demand and External Sector (Contribution in Percentage Points)



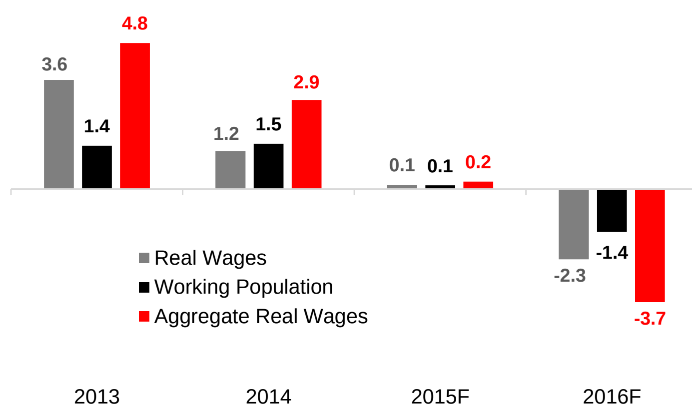
Source: IBGE – National Accounts.

Figure 13. Unemployment Rate—Quarterly Average (%)



Source: IBGE – PNAD.

Figure 14. Labor Market Indicators (Annual Change, %)



Source: IBGE – PNAD.

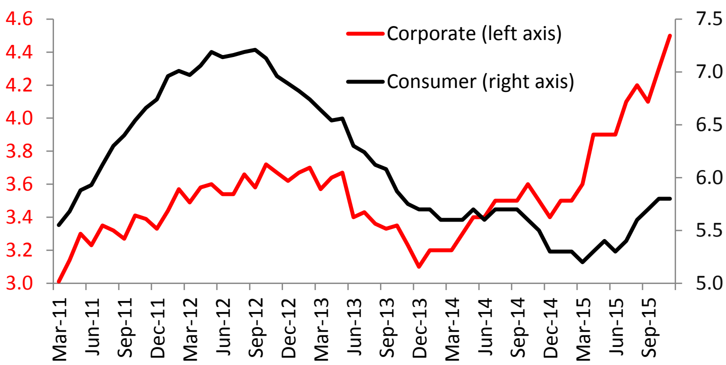
CREDIT: LIMITED DETERIORATION IN DELINQUENCY LEVELS

With regard to the credit market, the delinquency rate will probably repeat the upward trend observed in 2015, but with a new composition. Last year, the rise resulted mainly from the corporate sector. Consumer NPL was relatively under control for the most part of the year. This poor credit behavior of the companies at the beginning of the downturn cycle was expected for two reasons: (1) revenues are more sensitive to economic cycles than are wages and (2) companies depend more on credit than consumers. (Families use credit to increase the consumption, while companies use credit to survive, so in a tight credit context, companies suffer more than families.) Additionally, social security and compensations paid to the employees when dismissed create a lag between the increase in unemployment rate and the increase in consumer delinquency. We believe that this lag is already past. Thus, consumers' NPL will start to increase faster. The high burden income level, derived from the increase in interest rates, will reinforce this trend.

On the other hand, banks have been conservative in the supply of new loans just as consumers have been conservative in their demand for credit, which prevent the borrowers' rating mix to deteriorate as fast as the economic scenario, limiting delinquency growth. Additionally, bank provisions are well above (70%) observed delinquencies, so, the solvency of the banks does not seem to be a relevant issue in the short to medium term. This does not mean that the scenario is not challenging for the banks.

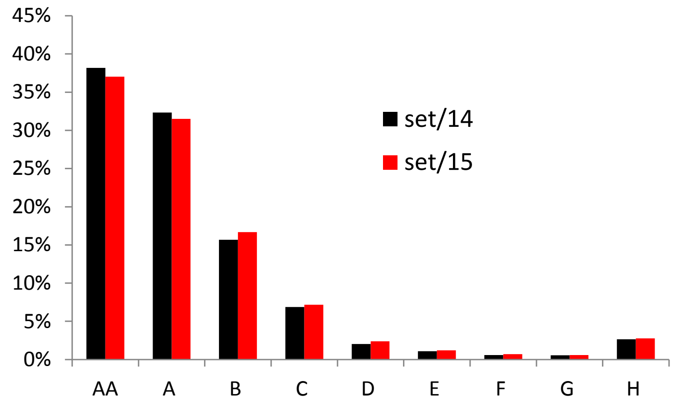
Costs are increasing due to delinquency and funding; and new concessions are decreasing because of the conservative behavior and the high interest rates. Therefore, profits are expected to increase much less than in the recent past.

Figure 15. Delinquencies



Source: Central Bank.

Figure 16. Borrowers Rating Mix



Source: Central Bank.

RISKS TO OUR VIEW: WHAT TO MONITOR IN 2016

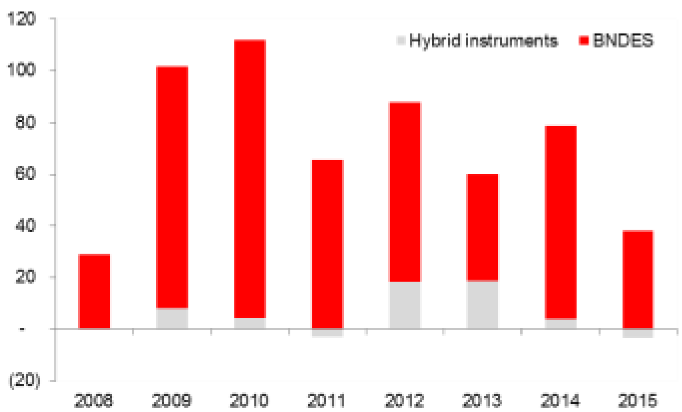
While the view expressed in the previous sections represents our base-case scenario, we do acknowledge there are substantial risks to our view, associated primarily with the assumptions we make for economic policymaking. As mentioned, we expect no major departure from the economic policy guidelines seen in 2015. Therefore, we point out the following aspects as risks worth monitoring:

- **Will quasi fiscal policy come back to center stage?**

  Political pressures, particularly from within the government coalition, have been mounting for the provision of stimulus to growth and of some relief to financially distressed local governments. With regard to stimulus to growth, there is no room in the budget for tax breaks, but there is a (nonprevailing) risk that the government resorts yet again to quasi-fiscal stimuli, either by new injection of funds in state-owned federal banks or by the widening of the gap between the Selic and the long-term interest rate (TJLP, benchmark for most of BNDES' operations). If the economic team does cave in to these pressures, the negative message would be twofold: (1) It would imply an even more negative trend for gross public debt and for its cost. (2) Also, it would increase the pressure on monetary policy, elevating the required interest rate to offset the expansionist effects of such policy. We see this is a limited but relevant risk. We see it as limited because these banks have recently seen their lending capacity restored after the federal government regularized the so-called "pedaladas," which means that they can (modestly) expand their credit without requiring fresh funds from the National Treasury, and this should suffice to cater to these political pressures unless the political and economic scenario deteriorates significantly. However, *we see it as a relevant risk because of its potential implications in terms of confidence in the economic team and of market perception toward public debt dynamics.*

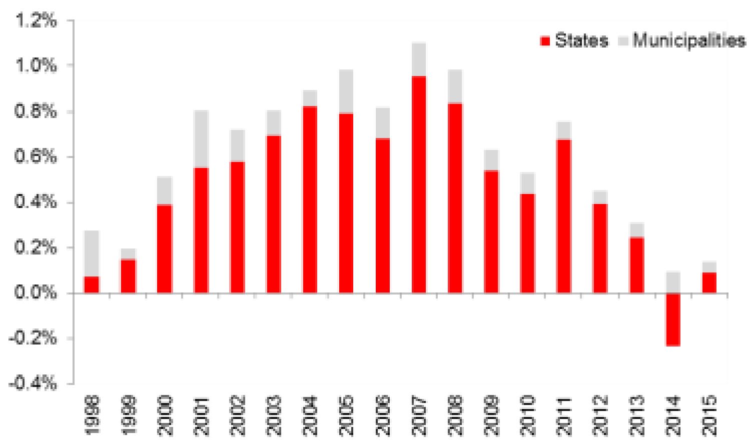
  Regarding the financially strained states and municipalities, the government has nodded to governors and mayors with the application of a change in debt correction indexes that had been approved in 2014 but not implemented until recently. This, however, may not be sufficient for some states that are facing difficulties to honor even payroll expenditures. While many governors are enthusiastically supporting the return of CPMF with hopes of seizing part of its revenue, the fact remains that, should CPMF be restored, it will probably only bring revenues from 4Q 2016 on. In the meantime, the federal government may face significant political pressure to provide some kind of relief to these entities, be it by increasing transfers, relaxing indebtedness limits or waiving the monthly payments of debt renegotiation agreements settled in the end-1990s/early 2000s. The first would have a direct impact on the primary budget of the federal government; the second would lead to deterioration in the primary performance of these entities; and the latter would represent a crack in the fiscal responsibility framework. *Considering the prevailing political background and the financial situation of some important states, we see this risk as moderate, particularly regarding the second and third options (relaxing indebtedness levels or waiving monthly payments of renegotiated debt).*

Figure 17. Loans to Federal State-Owned Banks



Annual change in outstanding loans and hybrid instruments to state-owned federal banks (for 2015, Jan-Nov), in BRL billion. Source: Central Bank.

Figure 18. States and Municipalities: Primary Surplus



12-month flows, as % of GDP. Source: Central Bank.

- **Will quasi-sovereign debt pose a problem?**

  Some large state-owned entities with heavy external debt amortizations due this year and the next may represent a contingent risk for the public debt dynamics. So far the government has not made any open remarks regarding their approach toward such debt, so we work with the assumption that the government will not help these entities with either loans or equity. Should they face severe difficulties to roll over their debt on their own, however, the government may feel pressured to rescue, and in that case, a substantial upward shift in the public debt should be expected. *As of now, we see this risk as low.*

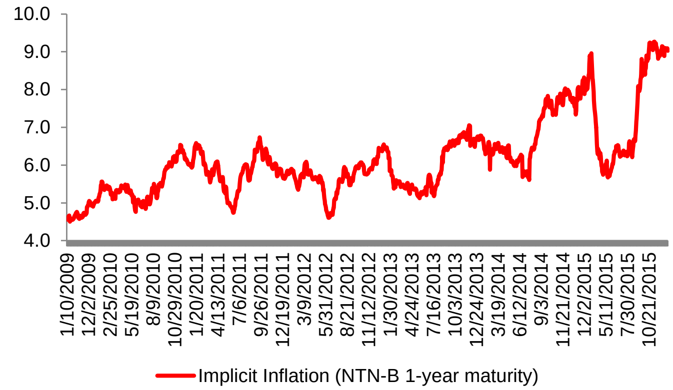
- **How will monetary policy react to the recession-inflation dilemma?**

  According to the latest monetary authority communication, there is high probability that an additional monetary tightening cycle takes place in 1Q16, albeit a short cycle. In our opinion, the BCB reaction function will be very sensitive to news on the fiscal front regarding any fiscal expansion and BRL further depreciation. Fiscal policy and BRL behavior should have more weight in the BCB's decision in the short term, than should the economic activity figures.

- **Will inflation remain in double-digit zone?**

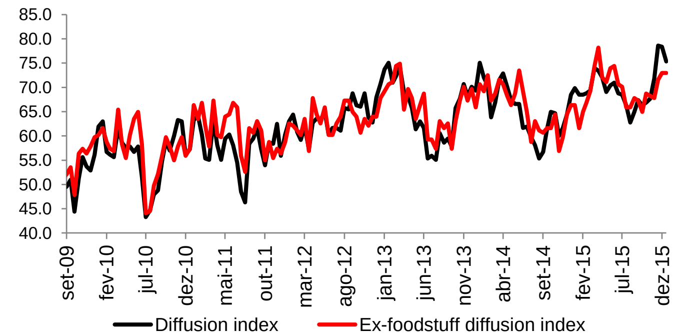
  Despite the current IPCA dispersion at 75% is pointing to a core inflation running in double-digit zone, and the FI market expectations priced in one-year maturity NTN-Bs 8% of implicit inflation, we do not see a high probability of double-digit inflation in 2016. However, there are some relevant risks that remain in the scenario that might increase the resilience of inflation and should be monitored. The most relevant among them is the fiscal accounts performance. The adoption of a loose fiscal policy by credit expansion of state-owned banks or current spending expansion will contribute to inertia, and also will promote further BRL depreciation, which will pressure tradable and regulated prices inflation.

Figure 19. Implicit Inflation in Public Bond Yields



Source: Anbima.

Figure 20. IPCA: Dispersion



Sources: IBGE and Santander estimate.

- **How will the economic team react to pressures on the currency?**

  Last, but not least, the question of the economic team's attitude toward BRL weakness remains relevant. *So far, all public statements from the new economic team have pointed to a pro-floating approach, and no change in FX policy was made since the new team took office despite the relevant pressure seen in some moments.* However, it cannot be entirely ruled out that the administration gives in to temptation of using reserves to fight an eventual new, substantial wave of currency weakness, driven by international conditions and/or heightened local uncertainties. The idea is particularly tempting because it would (in theory) ease potential inflationary pressures stemming from a new currency depreciation, and because (also in theory) it reduces the gross debt and its cost (given the high cost of carrying reserves).

  In our view, however, such a move could be devastating on many grounds: (1) lower reserves mean a higher external vulnerability, and could trigger a new round of sovereign downgrades; (2) the government already acts in the derivatives and forward markets so to limit FX volatility, so adding to that toolbox the FX sales in the spot market could (and likely would) be interpreted as an attempt to influence not only volatility but the level of the currency itself, weakening one important driver of external sustainability; (3) we see a high risk that, once the government decides to sell USD spot, the market will perceive that there is a certain FX level that triggers such action and would test which levels could drive more action. In other words, the use of reserves could create an implicit rule for the exchange rate against which the market could speculate. We see it as very likely that the economy would be left more vulnerable without even reaping the "benefit" of a stronger exchange rate. *So far, all indications are that this risk is limited, but it is contingent on the trend for the BRL, which is driven by forces not entirely controlled by the economic team.*

Figure 21. Macroeconomic Forecasts: Selected Variables

Forecasts	2015(E)	2016(F)	2017(F)
Exchange Rate (BRL / USD)	4.00	4.10	4.20
Risk Premium (5 yr CDS eop)	495	350	300
GDP (%)	-3.8%	-2.0%	2.0%
Inflation (IPCA %)	10.7%	7.0%	6.0%
Selic (% p.a.)	14.25%	13.0%	11.5%

Sources: IBGE, Brazilian Central Bank and Santander estimates.

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