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SPECIAL REPORT – FISCAL POLICY

2023 Fiscal Accounts: Room for Adjustments

Ítalo Franca*
Italo.franca@santander.com.br
+5511 3553 5235

- In the 2023 budget (LOA) approved in December, the federal government's estimated primary deficit was BRL232 billion (2.2% of GDP). The Congressional approval of the Transition PEC allowed for an increase in budget expenditures that were BRL170 billion above the spending cap limit. The new administration is currently debating ways to reduce this deficit estimate, either by reducing expenditures or increasing revenue. In our view, the government is most likely to reducing the primary deficit by BRL83 billion (0.8% of GDP). This BRL83 billion number considers a reduction in expenditures of BRL23 billion (0.2% of GDP), with remaining BRL60 billion (0.6% of GDP) coming from an increase in revenue wrought by the end of the tax breaks that were implemented in 2022. Nonetheless, we believe the task of reducing the deficit will be challenging, due to significant trade-offs, especially revenue-related ones (with the increase in taxes or ending tax breaks) and the impact of these on inflation.
- In addition, we believe that another way to affect the primary deficit result could also come from surprises related to the parameters used to estimate the budget. First, the government's inflation estimate used as a budgetary assumption (IPCA of 7.2%) is higher than that of consensus (5.6%). The 2022 IPCA result used to adjust the constitutional spending cap for 2023: if the inflation forecast were updated using the consensus number, this would represent less BRL27 billion in the spending cap limit for 2023. Affecting revenue, the budget considered that GDP growth will be 2.5% in 2023 (our estimate is 0.8%).
- In our view, the 2023 fiscal adjustment will be important for the new administration's four-year term, which ends in 2026. The high level of mandatory expenses remains a problem that urgently needs to be fixed (via economic reforms to both curb expenses and boost potential GDP). We see the importance of the approval of reforms with significant cost savings, reducing budgetary rigidity and idiosyncratic risk. However, we believe that the reforms under debate would have a more fragmented fiscal impact, being relatively difficult to approve in Congress and/or implementing those.
- On the revenue side, another possibility is to increase other taxes or create new ones. For zeroing the central government deficit by 2026 with GDP growing at an average of 1.5% per year, it would be necessary to increase the tax burden by ~2p.p. of GDP, and by ~4p.p of GDP to achieve a primary result (2.0% of GDP) that is enough to stabilize the gross debt, in our view. It is worth noting that the total tax burden is already about a third of GDP, making it more challenging for Congress to approve an increase in taxes. In addition, raising taxes on financial operations (such as IOF) could make it more difficult for the country to join the OECD group.
- In a scenario of adjustments in the fiscal accounts in 2023, we expect to see politicians and policymakers focusing on overhauling fiscal rules. The transition PEC determined that the new fiscal anchor may be approved by August 31 (the deadline for presenting the 2024 budget proposal) through supplementary legislation, which requires an absolute majority—instead of the 60% of votes necessary for the approval of a constitutional amendment. This new fiscal framework will be debated in Congress, which should be key to anchoring expectations regarding fiscal consolidation ahead. In this context, our gross debt to GDP estimate is a rise of 5p.p in 2023, potentially ending 2026 at close to 90% of GDP. In the end, this year fiscal adjustment would be crucial for the credibility to the adjustment and anchoring process for the medium-term debt convergence.

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1. Introduction

After approval of the Transition PEC, which could lead to an expansion of federal expenditures by around BRL170 billion, the approved Annual Budget Law (LOA, acronym in Portuguese) pointed to a deficit of BRL231.5 billion (2.2% of GDP) for the federal government, in contrast to the deficit of BRL 63.7 billion (0.6% of GDP) anticipated in the Executive branch's original proposal (PLOA, acronym in Portuguese) that was sent to Congress at the end of August of 2022.

The new administration is currently debating ways to reduce this value, either by reducing costs or increasing revenue. In this report, we explore the possible ways to reduce the deficit estimate. In our view, the government is most likely to reducing the primary deficit by BRL83 billion (0.8% of GDP). This BRL83 billion number considers a reduction in expenditures of BRL23 billion (0.2% of GDP), with remaining BRL60 billion (0.6% of GDP) coming from an increase in revenue wrought by the end of the tax breaks that were implemented in 2022. Another possible way to reduce the expenditures in the year is via the budget execution control by the government, which could increase the budget leftovers. In other words, without the full budget execution of all foreseeable programs, we see this value reaching ~BRL25 billion (0.2% of GDP) in 2023. In our view, usually the non-use of all expenditures estimated are those related to the increase in public investments that should take some time to be fully used.

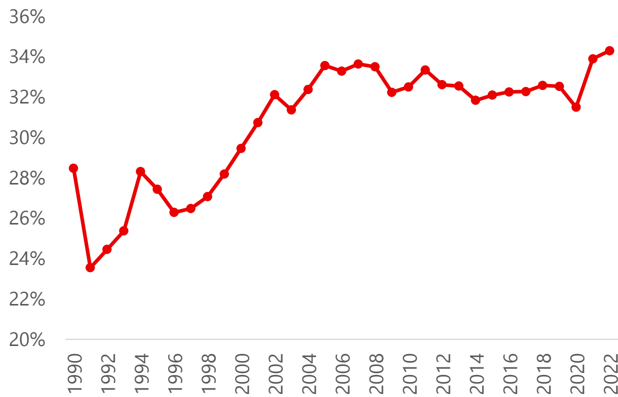
We explore the breakdown of the measures below. Nonetheless, we believe the task of reducing the deficit will be challenging, due to significant trade-offs, especially revenue-related ones (with the increase in taxes or ending tax breaks) and its impact on inflation. In addition, rising taxes in financial operations (such as IOF) could make more difficult for the country to join the OECD countries group.

Structurally, fiscal adjustments are always an onerous task. And in Brazil, fiscal adjustments on both the revenue and expenditure fronts will involve complex political decisions. The government may choose to increase the tax burden to gain more flexibility in spending growth and seek to ensure that public debt will converge in the long-term. In our view, the measures would have to start with the removal of tax benefits (with the endorsement of Congress), as increasing and/or creating new taxes would be much more complex.

For zeroing the central government deficit by 2026, with GDP growing at an average of 1.5% per year, it would be necessary to increase the tax burden by ~2p.p. of GDP, and by ~4p.p of GDP to achieve a primary result (2.0% of GDP) that is adequate enough to stabilize the gross debt at 90% of GDP by the end of the decade, with the help of an oil revenue increase from pre-salt production and the positive effects of pension reform. It is worth noting that increasing the tax burden (especially income taxes) would imply the necessity to share the tax collection with states and municipalities, which would have to be imposed via Brazilian legislation (for example: the option of increasing income taxes on profits and dividends). Under Brazilian law, the collection of this tax must be distributed to municipalities (25%) and states (22%). Another important aspect of fiscal adjustment is that the total tax burden is already of about a third of GDP, making it more challenging for Congress to approve a tax increase, even a temporary one (e.g., the CPMF tax, which has been implemented in the past).

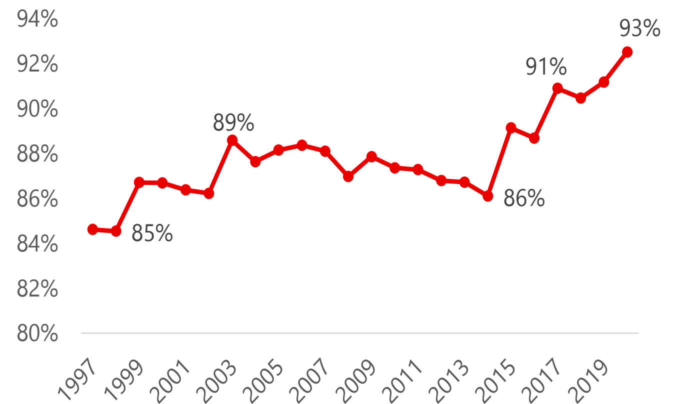
In addition, as an example, even if the increase in the taxation of company's dividends were approved (currently in debate in Congress), due to legislative issues *(Principio da Anterioridade*), such an increase would only be valid for 2024. On expenditures, recent signs from the recent legislations (e.g Transition PEC) approved point to expansion of expenditures, that could cause an increase in mandatory outlays ahead. We estimate 92% of mandatory expenses for 2023 (~93% in 2022), reinforcing the low margin for adjustments. The high level of mandatory expenses continues to be a problem that needs to be fixed (via economic reforms to both curb expenses and boost potential GDP). Therefore, just as we were surprised in 2022, these factors (macro parameters and commodity prices) will be important for the fiscal result at the end of this year.

Figure 1. Tax Burden (% GDP) – Is it possible to raise taxes?



Sources: National Treasury, Santander

Figure 2. Mandatory Outlays / Total Expenses

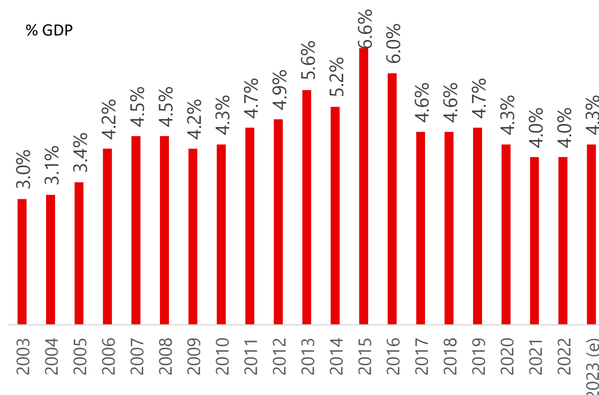


Sources: National Treasury, Santander

Since 2015, we have seen federal administrations more willing to reduce tax waivers to help fiscal adjustment by seeking to achieve a better primary balance result. According to official government numbers, tax waivers granted by the federal government to certain segments of society should reach BRL456 billion in 2023, or 4.3% of GDP. This value exemplifies the difficulty in reaching the goal of constitutional amendment No109 (approved in 2021), which sets to determine the reduction of tax incentives to 2% of GDP by 2028. However, the biggest benefits are: (i) *Simples Nacional* (19.4%); and (ii) *Zona Franca de Manaus* (12.2%); but these two are outside the mandatory reduction of the constitutional amendment. Most of these incentives already had proposals to be reduced or eliminated and were not approved by Congress. In other words, this type of adjustment is not in the consensus in the Brazilian society and policy makers. As was the case with pension reform, it takes time to form a consensus on reforms and tax break removals.

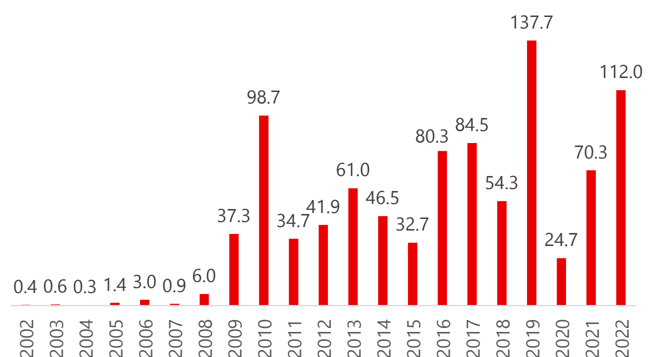
Another way that could help create a temporary fiscal adjustment is through extraordinary revenue. However, a good portion of this revenue comes from oil auctions (as in 2019) or the sale of SOE companies, as was the case last year. The level of extraordinary revenue from corporate taxes (atypical IRPJ/CSLL) linked to corporate restructuring should remain at between BR35-40 billion in 2023, per our estimate, yet higher revenue needs one-off events (e.g. oil auctions, SOE privatization, etc.).

Figure 3. Total Tax Waiver (% GDP)



Sources: Brazilian IRS, TCU, Santander

Figure 4. Extraordinary Revenues (BRL billion)



Sources: National Treasury, Brazilian IRS, Santander

2. Fiscal Adjustment I - Budget Parameters and Cyclical Issues

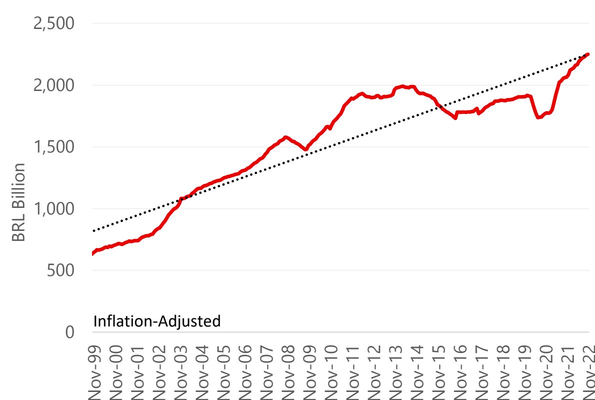
Returning to the attempt to reduce the 2023 deficit estimate, the first issue is that the possible fiscal adjustment also could happen due to changes in the parameters used to estimate the budget, which are subject to potential positive or negative shocks. The inflation estimate used as a budgetary assumption (IPCA of 7.2%) is much higher than the consensus figure (5.6%), and that is the index used to adjust the constitutional spending cap next year: if the inflation forecast were updated with the consensus number, this would represent less BRL27 billion in spending cap limit for 2023. Affecting revenue, the budget considered that GDP growth will be 2.5%

in 2023 (our estimate is 0.8%). Another key aspect for the revenue result will be commodity prices (especially brent oil prices (estimated at USD93/barrel in LOA)), which bolstered2022's positive result.

On the revenue side, we see more uncertainty with regards to the 2023 result. Revenue from dividends of state-owned companies, corporate profits tax collection and other proceeds from resource exploration account that boosted 2022's revenue result will be key factors in 2023. We expect some softening after several positive shocks last year, thanks to the jump in commodity prices.

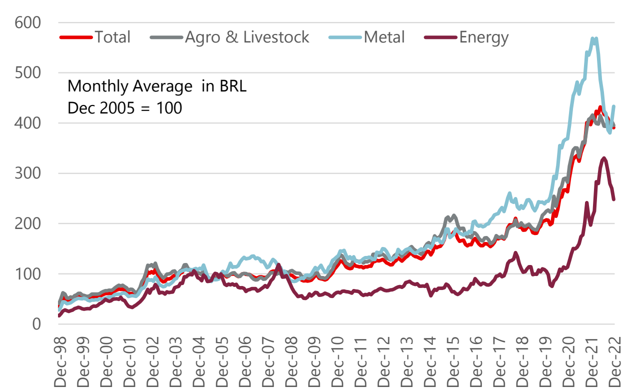
That is, the current improvement in public accounts could be temporary due to cyclical factors, meaning that revenue could be affected by the persistence of higher prices, although we expect softening prices. While supply issues — such as low inventories, underinvestment, and geopolitical conflict — continue to support prices, we acknowledge that markets have priced in a slowdown in global economic growth and, consequently, declining demand for raw materials, against a backdrop of rising global interest rates. As a result, we have recently downgraded our aggregate commodity indexes forecast for the same period. We still look for a gradual drop in global material costs in the coming years, as global demand softens and aggregate supply gradually catches up.

Figure 5. Federal Tax Collection (12-months)



Sources: Brazilian IRS, Santander

Figure 6. Commodities Prices (IC-Br)



Sources: BCB, Santander

3. Fiscal Adjustment II - Revenue and Expenditures

In this section, we move to the direct actions that the government could decide or implement to reduce the BRL232 billion deficit estimated for 2023. For 2023, according to the LOA estimate, federal spending could reach around 19.2% of GDP, from 18.4% of GDP in 2022, according to the last official 2022 budget review (we estimate the total expenditure of 18.2% of GDP). The revenue estimated in the 2023 budget (BRL2,257 billion or 21.8% of GDP) are significantly lower than the result expected in the last 2022 Budget Review (BRL2,325 billion or 23.4% of GDP). This implies upside risk for the official revenue forecast. Even with a lower GDP estimate, we expect BRL2,305 billion (22.1% of GDP), assuming the complete end of fuel tax break.

Figure 7. Main Fiscal Numbers for 2023

Federal Gov. Outlook for 2023					
		2023 (E)			
	2022 (E)	PLOA	LOA (a)	Santander (b)	(a) - (b)
Net Revenue (BRL bn)	1.870	1.805	1.805	1.842	-37
Total Expenditures (BRL bn)	1.805	1.868	2.037	1.997	40
Discretionary Outlays (BRL bn)	125*	99	160**	140	20
Primary Balance (BRL bn)	65	-63	-231,5	-155	-77
Net Revenue (% GDP)	18,9%	17,0%	17,0%	17,7%	-0,7%
Total Expenditures (% GDP)	18,2%	18,1%	19,2%	19,2%	0,0%
Discretionary Outlays (% GDP)	1,3%	0,9%	1,5%	1,3%	0,2%
GDP Growth (%)	3,0%	2,5%	2,5%	0,8%	1,7%
Nominal GDP (BRL Bn)	9.917	10.629	10.629	10.407	222

Note: PLOA is the Budget Proposal. LOA is the official Budget
* Without Campo de Marte (BRL24 bn) - expenditures from the agreement between São Paulo City Hall and the federal government that ended the dispute over the management of the Campo de Marte region. The latter led to the cancellation of the municipality's debts.
** Our estimate

Sources: National Treasury, National Congress, Santander.

In our view, the most likely possibility of reducing the primary deficit with direct government decisions totals BRL83 billion (0.8% of GDP). This number is composed by the reduction in expenditures of BRL23 billion (0.2% of GDP) and BRL60 billion (0.6% of GDP) by increasing the revenues thought the end of tax breaks make in 2022.On the revenue side, the main adjustment could come from a reversal of the tax waivers made in 2022, which, in our view, could contribute around BRL60 billion in revenue and reduce the deficit by 0.6% of GDP. The main measure was the reintroduction of PIS/Cofins and Cide on fuels, with an estimated revenue of BRL30 billion. In addition, the reduction of import taxes by 10% (BRL3 billion) and the end of the 35% reduction in the IPI rates on more than 4,000 industrialized goods (BRL27 billion). These measures do not depend on Congress approval. However, the return of these measures would probably lead to an increase in inflation (IPCA) above 1pp, with an increase in the prices of fuel and goods. **Last year we published a report exploring some of the impacts of tax breaks and inflation**[1]**.**

Figure 8. Possible Fiscal Adjustments in 2023

REVENUES	
Tax Breaks	BRL billion
Rise of IPI federal tax (reduced by 35%)	27
Return of PIS/Cofins on Fuels	30
End of import tax rates drop by 10%	3
More Likely	60
Extension of payroll tax exemption*	7
Soccer specific tax regime (TEF)	3.5
Extension of PCD benefit (IPI Autos)	2.5
ZPE expansion	1.5
IOF reduction for credit support programs	1.5
IRRF reduction on aircraft leasing	1
Others	3
Total	80

* 2Q onwards

EXPENDITURES	
	BRL billion
Welfare Program (Eliminating loopholes)	-18
Extra BRL150 Child benefit (excess budget)	-5
More Likely	-23
Ammendments reduction (=2022)	-10
Wage Bonus *(Abono Salarial)*	-12
Total	-45
No Included in Budget	BRL billion
IPCA Correction (7.2% to 5.6%)	27
Nursing Wage floor	15
Court-Ordered Debt	55
States Compensation (2022 ICMS cap)	12
Total	109

Sources: National Treasury, National Congress, Santander.

To illustrate the difficulties in raising these taxes, recently the government decided to extend the tax break on fuels with Provisional Measure No 1157 (60 days for gasoline and ethanol, and one year for diesel and LNG), with a fiscal impact of BRL25 billion (Figure 9). On revenues, the LOA also did not include the BRL52 billion with the return of taxation of PIS/Cofins federal taxation. In our deficit estimate of BRL155 billion (1.5% of GDP) we included most of the revenue (BRL50 billion), the recent extension in the tax break adds a downward pressure to our estimate.

Figure 9. Impact of the Provisional Measure that extended the Fuel Tax Break

Revenue Impact (BRL billion) - PIS/Cofins Tax Break		
Measure	Year-Impact	MP 1157
Gasoline	31	5
Diesel	18	18
Ethanol	5	1
LPG*	1	1
Total	55	25

MP 1157 is the Provisional Measure that extended the Tax Breaks for Gasoline and Ethanol for 60 days and Diesel and LPG for one year.

Sources: National Congress, Santander

Figure 10. Primary Deficit Estimate vs. Tax Collection with Fuels

Primary Deficit estimate for 2023 (% GDP)							
		2023 GDP Growth					
	BRL bn	0%	0.5%	0.8%	1.5%	2.0%	2.5%
Federal Fuel Taxes	55	-1.7%	-1.6%	-1.5%	-1.4%	-1.3%	-1.1%
	30	-1.9%	-1.8%	-1.7%	-1.6%	-1.5%	-1.3%
	15	-2.0%	-1.9%	-1.8%	-1.7%	-1.6%	-1.4%
	0	-2.1%	-2.0%	-1.9%	-1.8%	-1.7%	-1.5%

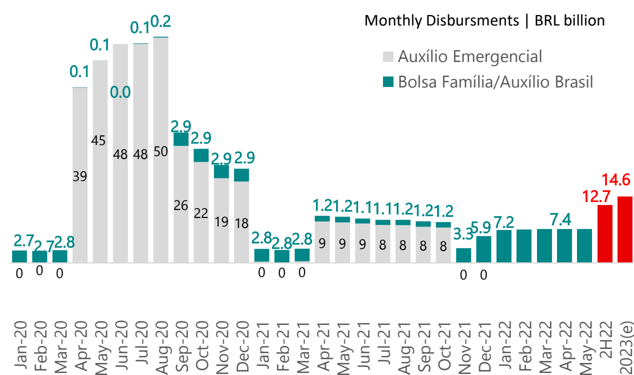
Sources: Santander

On the expenses side, the LOA for 2023 opened room for an increase of BRL170 billion. In our view, there is a possibility of weaker execution of the *Bolsa Família* budget (estimated at BRL175 billion) by around BRL23 billion, out of which BRL18 billion would result from closing loopholes. We see the possibility of a redesign of the program reducing the number of single-person families in the program and consequently reducing the

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

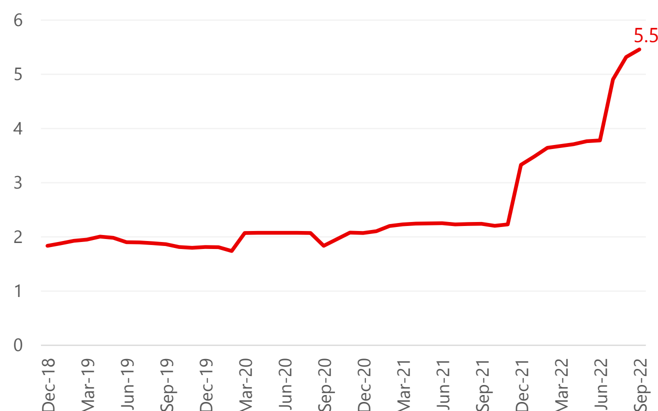
number of beneficiaries in the program. We believe the final cost of the program will be around BRL150 billion in 2023. In addition, the extra benefit of BRL150 per month (budgeted close to BRL20 billion) for children up to six years old may be lower than expected. In addition, for each month that the children extra benefit is not implemented (takes some time to implement it) would imply in fiscal saving of ~BRL1.5 billion per month. All in all, changes in the welfare program are more likely, in our view.

Figure 11. Welfare Program Outlays



Sources: National Treasury, Santander

Figure 12. Welfare Program - Single Person Families



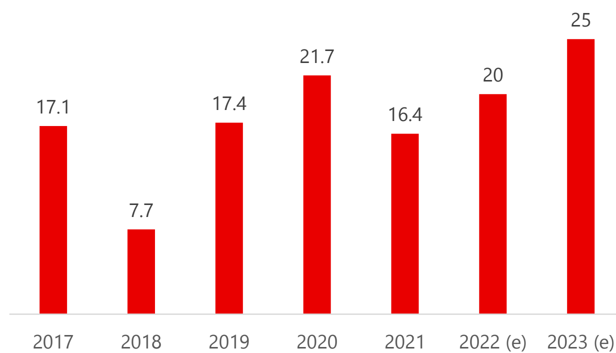
Sources: *Ministério da Cidadania*, Santander

In addition, it would be possible to have savings of BRL10 billion with weaker execution of amendments (we note that this value is closer to the value of 2022). In this context, eventual, more moderate execution of primary expenditures could lead to an improvement in the result of 0.3% of GDP, per our estimate. Another possible and more complex political measure would be to end salary bonuses (*Abono Salarial*), which could bring savings of BRL12 billion. However, previous initiatives to shrink this program already have been rejected by Congress during pension reform voting.

Another relevant point will be the budget leftovers (unused resources from the budget – *empoçamento* in Portuguese). For 2022, we see this value close to BRL20 billion (see Figure 13), this fiscal savings would probably help the federal government in achieving a more positive result in 2022. For 2023, we estimate a value close to BRL25 billion. With the transition PEC and the increase in investment, it is possible that it will not be possible to execute all expenses throughout the year. The government's ability to handle expenditures could be important: with a lower execution of outlays included in the budget, the government could save some resources to mitigate the deficit.

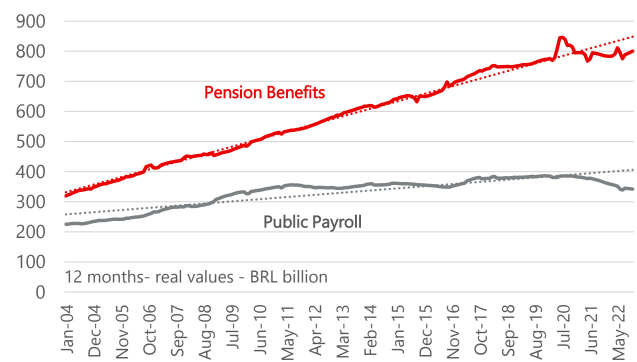
In turn, the evolution of pension and personnel expenses will also be important. Pension outlays in 2022 are set to reach BRL20 billion above the official budget, due to the increase in the concession of benefits and the effects of inflation. This year, with the real increase in the minimum wage and the expected reduction in the queue for granting benefits, both could pressure government estimates of the highest primary expenditure. We see a possible BRL10 billion increase in pension outlays above the one considered in LOA this year. Personnel expenses are more contained with a lower number of hires and salary freezes, with an expected increase of 8%, per our estimate. For these expenses it will be important to check how these accounts will perform in 2023 (with possible new hirings).

Figure 13. Budget Leftovers (BRL billion)



Sources: National Treasury, Santander

Figure 14. Federal Gov. Outlays



Sources: National Treasury, Santander

Another counterpoint, some expenses that were not considered in the LOA could add even greater pressure (for example, the payment of the cost of the "nursing wage floor" by the federal government, which can add up to BRL15 billion). In addition, currently in analysis in the Supreme Court (STF), the decision about the federal compensation for states for the drop in ICMS (VAT) revenue with the cap imposed on essential goods (fuels, electricity, and telecommunications) could reach more than BRL10 billion more in federal outlays. Finally, there is approximately BRL55 billion in court-ordered debt that is not expected to be paid this year (BRL22 billion accumulated in 2022). Another important aspect of the 2023 budget is that the inflation estimate used as a budgetary assumption (IPCA of 7.2%) is much higher than the consensus figure (5.6%), and that is the index used to adjust the constitutional spending cap next year. If the inflation forecast were updated with the consensus number, it could mean a reduction of BRL27 billion in the constitutional spending limit in 2023. All in all, it will be important to monitor the new administration's decision to curb expenditures or mitigate the increase in outlays with a rise in revenue.

In our view, the 2023 fiscal adjustment will be important for the new administration's four-year term, which ends in 2026. The high level of mandatory expenses remains a problem that urgently needs addressing (via economic reforms to both curb expenses and boost potential GDP). We see the importance of the approval of reforms with significant cost savings, reducing budgetary rigidity and idiosyncratic risk. However, we see the reforms under debate with a more fragmented fiscal impact and a relevant difficulty to approve in Congress or implement. Some examples of possible measures to be adopted are: (i) curbs in public sector payroll spending; (ii) ending the wage bonus (*Abono salarial*); (iii) de-linking social expenses from inflation; (iv) reducing discretionary expenses and parliamentary amendments; and (v) the extinguishing or selling non-profitable SOE companies. In our view, all these examples need an intense debate in Congress to be implemented.

4. Fiscal Rules and Gross Debt

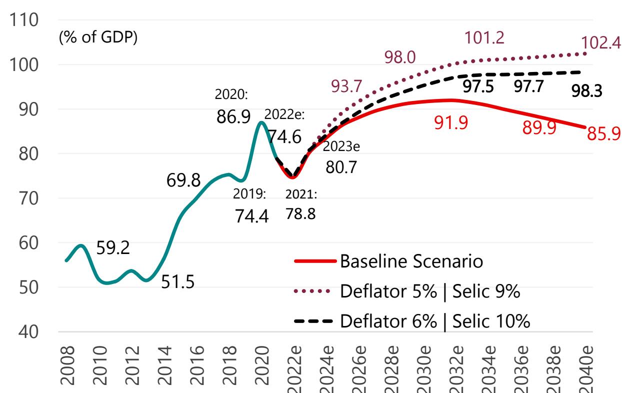
In a scenario of adjustments in the fiscal accounts in 2023, we expect to see politicians and policymakers focusing on overhauling fiscal rules. The transition PEC determined that the new fiscal anchor may be approved by August 31 (the deadline for presenting the 2024 budget proposal), through supplementary legislation, which requires an absolute majority—instead of the 60% of votes necessary for the approval of a constitutional amendment. This overhaul will be a critical factor for the fiscal consolidation ahead. A new fiscal framework will be debated in Congress, which should be key to anchoring expectations regarding fiscal consolidation ahead. The new fiscal framework will probably incorporate the outlays and the adjustments expected for this year. Without measures to curb mandatory outlays, any fiscal rule will not assure a credible fiscal consolidation, meaning more expenditures ahead.

For now, we are assuming the implicit fiscal rule considering the fiscal waiver to be approved (on a permanent basis) this year and adjusted by inflation in the future. We adopt the hypothesis of real minimum wage increase (IPCA + average of last five years of GDP growth). The government will mitigate the impact of real gains in minimum wage by a tighter rule for the welfare program.

In this context, the gross debt in relation to GDP could rise 5p.p, with the return to the primary deficit and the increase in the cost of debt with the increase in the Selic rate. This in a context of inflation gradually converging

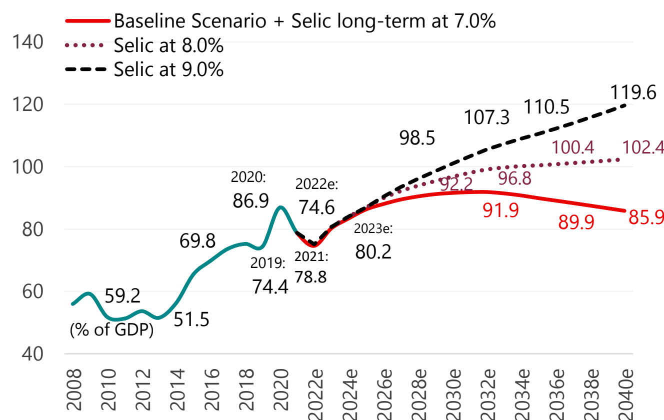
to the center target in the medium term. In addition, one-off factors such as BNDES returns to the Treasury tend to decrease. In 2022, the payments made to the Treasury by the BNDES was BRL81.4 billion (0.8% of GDP). For the next year, there is a forecast to settle the remaining debt (BRL 24.1 billion) by November 30, 2023, we do not include this in our scenario. In addition, voluntary deposits in the BCB (not included in debt statistics) should remain hovering 1% of GDP. Sensitivity to long-term macro parameters also becomes a key issue.

Figure 15. Government Debt – Simulations for Deflator and Selic



Sources: BCB, Santander

Figure 16. Government Debt – Simulations for Selic Rate Hypotheses



Sources: BCB, Santander

We believe there is no sustained fiscal consolidation without structural reforms to reign in government spending (via a wide-ranging review of social assistance for greater effectiveness, with the end of ineffective programs; untying and de-indexing of mandatory spending) and gains in the productivity of the economy (tax reform that promotes greater potential growth). In our view, it will be crucial to achieve a re-anchoring in the fiscal accounts estimates and the adopt economic policy that seeks debt sustainability, with the approval of reforms to boost sustained GDP growth (from the supply side) and keep the neutral interest rate at low levels. For the longer term, since we still assume the commodity cycle will gradually fade, we continue to see a risky path toward debt stabilization, in a context of reduced efficacy of the fiscal rules, elevated social pressures to increase spending and natural difficulties to raise taxes.

CONTACTS / IMPORTANT DISCLOSURES

Brazil Macro Research

Ana Paula Vescovi*	Chief Economist	anavescovi@santander.com.br	5511-3553-8567
Mauricio Oreng*	Head of Macro Research	mauricio.oreng@santander.com.br	5511-3553-5404
Jankiel Santos*	Economist – External Sector	jankiel.santos@santander.com.br	5511-3012-5726
Ítalo Franca*	Economist – Fiscal Policy	italo.franca@santander.com.br	5511-3553-5235
Daniel Karp Vasquez*	Economist – Inflation	daniel.karp@santander.com.br	5511-3553-9828
Tomas Urani*	Economist – Global Economics	tomas.urani@santander.com.br	5511-3553-9520
Lucas Maynard*	Economist – Economic Activity	lucas.maynard.da.silva@santander.com.br	5511-3553-7495
Felipe Kotinda*	Economist – Commodities	felipe.kotinda@santander.com.br	5511-3553-8071
Gabriel Couto*	Economist – Special Projects	gabriel.couto@santander.com.br	5511-3553-8487
Fabiana Moreira*	Economist – Credit	fabiana.de.oliveira@santander.com.br	5511-3553-6120
Gilmar Lima*	Economist – Modeling	gilmar.lima@santander.com.br	5511-3553-6327

Global Macro Research

Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Rodrigo Park *	Economist – Argentina	rpark@santander.com.ar	54-11-4341-1272
Ana Paula Vescovi*	Economist – Brazil	anavescovi@santander.com.br	5511-3553-8567
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888
Mike Moran	Head of Macro Research, US	mike.moran@santander.us	212-350-3500

Fixed Income Research

Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Mauricio Oreng*	Senior Economist/Strategist – Brazil	mauricio.oreng@santander.com.br	5511-3553-5404
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778

Equity Research

Miguel Machado*	Head Equity Research Americas	mmachado@santander.com.mx	5255 5269 2228
Alan Alanis*	Head, Mexico	aalanis@santander.com.mx	5552-5269-2103
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Mariana Cahen Margulies*	Head, Brazil	mmargulies@santander.com.br	5511-3553-1684

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