Santander
Macroeconomic Research

Fiscal Accounts: Pandemic Impact, Price Shock Contribution, and Outlook

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- Brazil's fiscal accounts have deteriorated due to the measures to mitigate the economic and public health impact of the COVID-19 pandemic. According to the IMF, Brazilian fiscal stimulus is expected to reach 8.8% of GDP during 2020-2021. In this report we explore the main impacts on the fiscal accounts by analyzing the pandemic's impact and the current favorable price shock effect (inflation and terms of trade), as well as discussing our outlook for the future. In our view, the pandemic shock resulted in a four-year setback in terms of fiscal consolidation.
- For fiscal accounts, the current more persistent and intense inflationary shock and the better terms of trade are acting as a breath of fresh air, in our view, because they have reduced the fiscal risk perception in the short run. The price shock is directly affecting fiscal accounts, resulting in lower debt-to-GDP levels, while boosting revenue at the federal and regional levels. However, we expect several challenges with respect to compliance with the fiscal rule and political pressure for new expenditures ahead.
- Through a higher GDP deflator, the impact of inflation on nominal GDP "eliminated" the risk that the gross debt-to-GDP ratio will reach 100% of GDP, which is regarded by the market as a danger sign. In our current tracking, gross debt has dropped 8 pp, to ~82% of GDP from ~90% of GDP. The inflation shock's impact on the GDP deflator and on federal revenues directly accounts for 65% of the improvement in the fiscal indicator.
- Considering a greater inflation effect on revenue, in our current tracking, the public sector primary deficit improved to -1.9% of GDP in 2021 from -3.0% of GDP, as discussed in our report dated May 20, 2021 (Monetary Stimulus Doomed to End Sooner). In addition, we estimate that federal net revenue will rise by 0.1 pp of GDP per year, due to the positive shock related to terms of trade, depending on the impact and duration of the commodity boom.
- Additionally, based on our forecasts, we see inflation converging to the mid-target only in 2023, and thus, compliance with the constitutional spending cap up to 2026 is now more feasible than before. In our view, an important consequence of the inflationary shock in 2020-2021 is that the spending cap has lost some of its anchoring power, and the fiscal rule is a necessary but not sufficient condition to assure consistent fiscal consolidation. This is especially true if favorable conditions such as terms of trade, convergence of inflation to the target, and lower neutral interest rates are no longer maintained. In a simulation comparing the inflation scenarios during the period 2017-2026, the expenditures subjected to the spending cap rule will be around 3.1% higher (around BRL470 billion in nominal terms) in our inflation scenario compared to a contrafactual simulation, readjusting the fiscal rule with the center of the inflation target. Of this amount, we forecast that 88% will be during the period 2022-26, which means more room for new expenditures ahead. In light of this, we believe the fiscal rule is losing its initial purpose: to make expenditures more efficient through structural reforms, rather than generating further increases in the tax burden.
- In our view, the inflationary shock should provide some time for the country to seek a more structural adjustment in its fiscal accounts, yet this will depend on the duration of the commodity boom and other extraordinary factors, such as the transfer of financial resources from public banks to the Treasury and the possibility of using de-earmarked public funds, among others. However, these quasi-fiscal measures cannot affect the net debt trajectory—and a decline in net debt is essential for achieving long-term fiscal sustainability, in our view.

In this report, we explore the main impact of the pandemic on the fiscal accounts by analyzing the periods before and during the pandemic, along with the current inflationary and terms-of-trade shock, as well as discussing our outlook for the future. In our view, the pandemic shock resulted in a four-year setback in terms of fiscal consolidation. The pandemic had significant consequences, with a sharp increase in the fiscal deficit and government debt. In addition, the shortening of the debt maturity was inevitable, as the value of annual maturities almost doubled in one year. Although at the end of last year we expected a large part of the stimulus to be restricted to 2020, the resurgence of the pandemic (the second wave), even more intense, led the government to maintain fiscal stimulus at around 1.6% of GDP, by our estimates.

On the other hand, both the recent inflationary shock (more intense and persistent than expected) and the positive shock in terms of trade (both of which have had a favorable price effect) acted as a kind of breath of fresh air with respect to short-term fiscal risk, which is highly dependent on the global commodity cycle. The price shock is directly affecting fiscal accounts, whether in terms of reduction of debt-to-GDP ratio or recovery of federal revenue. In addition, the higher inflation numbers will affect the future of the government's compliance with fiscal rules, new expenditures, and debt management. In previous reports[1], we have pointed out that several quasi-fiscal measures, such as the return of BNDES funds to the Treasury and use of public funds for debt management (*PEC Emergencial*), have improved debt management and thus expectations, giving the government some time to pursue fiscal adjustment.

The inflationary shock also helped the government comply with the constitutional spending cap rule (by increasing the readjustment index) and helped produce a short-term revenue recovery, which is highly correlated with the commodity cycle. In our observation, the increase in terms of trade has been almost instantaneously captured by federal revenue. The main question that remains is whether or not this effect will last; for our part, we see it as temporary during the economic recovery following the pandemic. If the positive impact of terms of trade and tax collection lasts longer, however, it could result in upside risk to our forecasts.

Despite that, in our view, the long-term debt trajectory is in a borderline situation, since any additional negative shock that raises the neutral interest rate or reduces potential GDP growth could derail the expected debt convergence. We believe that the slower the fiscal consolidation, the higher the idiosyncratic country risk.

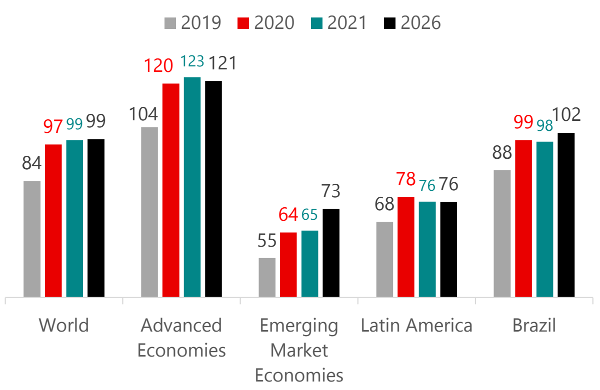
We have divided this report into eight sections. In the first, we discuss the fiscal context from before the pandemic to the present. In the second, we explore the pandemic's impact on the debt situation. The third section examines the impact on the primary result, and the fourth discusses the federal government's revenues. The fifth section is a discussion of regional governments, which have also been affected by the pandemic and government transfers. In the sixth section, we explore the impact of the spending cap rule, and in the seventh we examine the impact on debt management. Finally, our closing remarks are found in the eighth section.

1. Fiscal Accounts: A Context

Since March 2020, the government's finances have been facing an unexpected and unprecedented deterioration due to the government's measures to mitigate the economic and public health effects of the pandemic. According to data from the IMF, in both 2020 and 2021 Brazil's fiscal stimulus reached 8.8% of GDP, higher than the 4.0% of GDP that is the average for emerging economies (EM). Considering IMF data, Brazil still has one of the highest debt-to-GDP ratios among EM, around 30 pp above this group of countries. Among the largest EM countries, it is behind only Argentina and Angola. In short, the fiscal outlook presented by the IMF reinforces the importance of reforms to secure the credibility of the fiscal consolidation. The IMF figures could slightly improve in upcoming releases, in our view, given the current favorable price shock.

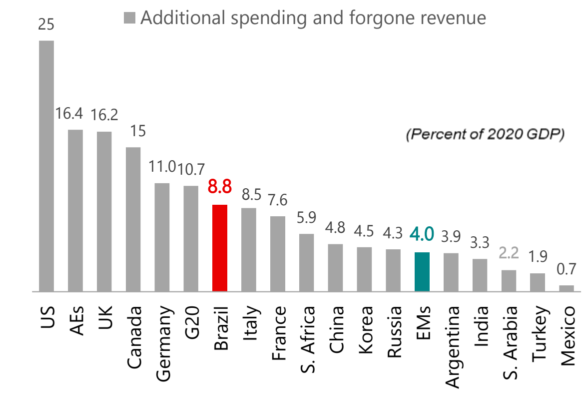
[1] **Santander Brazil - Macroeconomic Scenario:** ***"Monetary Stimulus Doomed to End Sooner"*** **–** May 20, 2021- Available on: http://bit.ly/Std-scr-review-may21

Figure 1.A – IMF Gross Debt Forecasts (% GDP)



Sources: IMF, Santander

Figure 1.B – Fiscal Stimulus in 2020-21



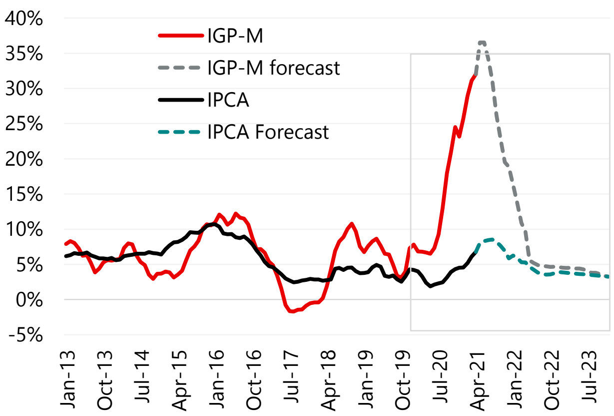
Sources: IMF, Santander

The most recent global inflationary shock also played a significant role for public accounts. The outbreak of this inflationary shock can be attributed to the robust fiscal and financial stimuli introduced by governments to mitigate the effects of COVID-19 on economies, both abroad and in Brazil. The initial demand shock affected households and businesses. On the household side, the consumption basket suddenly changed, with higher consumption of goods and lower consumption of services, considering measures to reduce social mobility in an effort to limit viral contagion. On the business (and government) side, demand has accelerated for technology goods and services, as families and individuals needed to adapt to work-from-home policies, remote learning, and increased delivery or online services. Furthermore, there has been a supply shock due to a break in global supply chains. Thus, our consumer inflation annual forecast (IPCA) for 2021 increased to 5.9% as of May from 3.6% in February. Meanwhile, our wholesale price annual forecast (IGP-M) jumped from 7.0% to 18% on the same basis of comparison.

In this context, on the activity front, following the fourth quarter's solid results, we observed resilient GDP growth at the start of 2021. The GDP headline index ended 1Q21 by climbing 1.2% QoQ-sa (1.0% YoY), whereas the market consensus was at 0.8% (our call: 0.9%). Besides the substantial change in relative prices, the surprisingly positive activity releases for 1Q21 showed the resilience of the Brazilian economy even amid the withdrawal of fiscal stimuli and the resurgence of the pandemic, culminating in this quarterly growth.

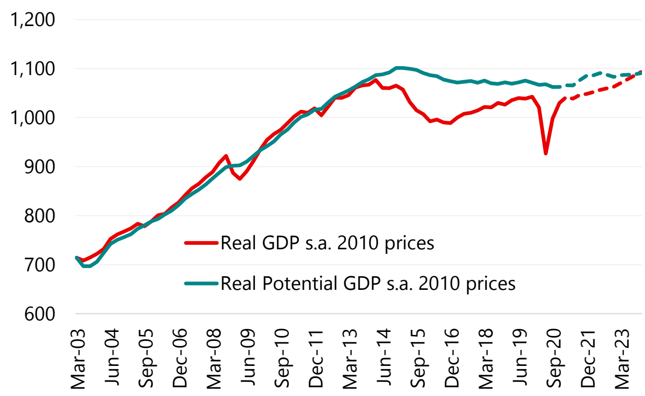
In the following sections, we will discuss the impact of the pandemic shock and the current inflationary cyclical recovery on each aspect of the fiscal accounts (debt level, primary result, fiscal rules, and debt management).

Figure 2.A – %YoY Inflation – IGP and IPCA



Sources: IBGE, FGV, Santander

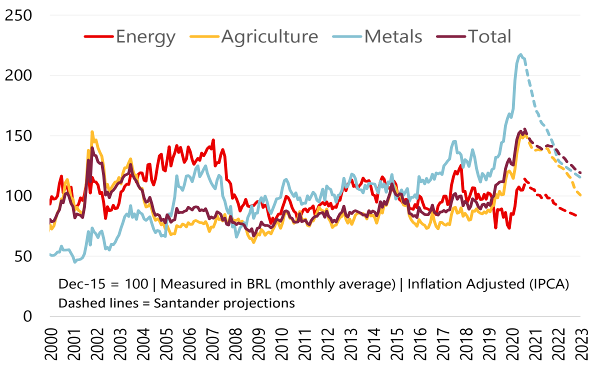
Figure 2.B – Brazilian GDP s.a.



Sources: IBGE, Santander

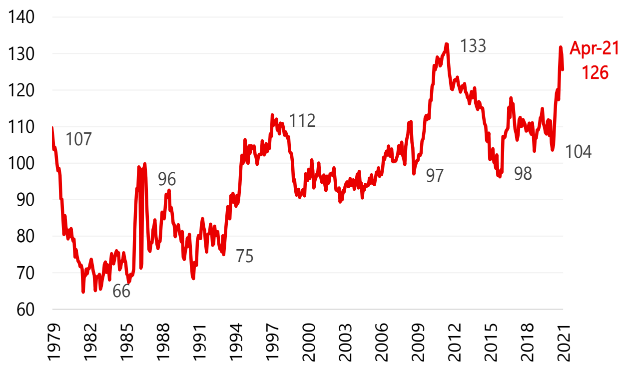
In Figures 3.A and 3.B, we show two factors that have affected inflation and, consequently, the fiscal accounts. Figure 3.A shows the Central Bank of Brazil commodity indices (all are in BRL terms). We can see a strong recent rise, driven by the global recovery and also by the weaker exchange rate. Figure 3.B shows the gains in terms of trade in recent periods. The fact that the greater gain in terms of trade accompanies higher commodity prices helps to increase revenue for the largest companies related to the sector. It is important to emphasize that Brazilian GDP has a strong positive correlation with the commodity cycle, so the duration of this commodity cycle will be a key factor to observe. In our view, it will tend to cool down until 2023, which gives the government time to promote structural changes on the fiscal front.

Figure 3.A – CRB Commodity Index



Sources: Bloomberg, Santander.

Figure 3.B – Terms-of-Trade Index



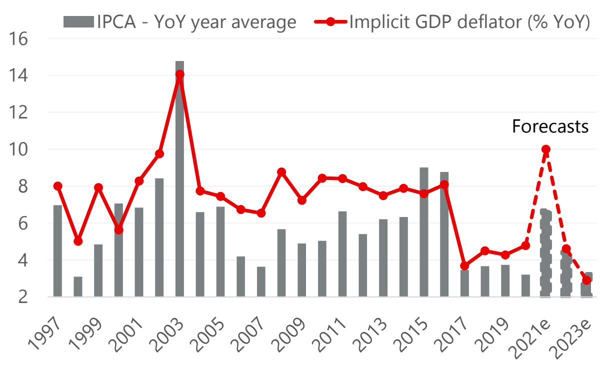
Sources: FUNCEX, Santander.

2. Impact on the Debt Situation

One of the main effects of both higher inflation and activity recovery is higher nominal GDP, which consequently affects the debt-to-GDP ratio. At the beginning of the year, we estimated that nominal GDP would increase by 7% in 2021; our latest tracking points to a ~15% increase. The main effect was on the GDP deflator, which went from 4.0% to 10.0%, closely related to the commodity shock and an increase in the IPCA projection from 3.6% (February) to 5.9% (May). We ran several models for the GDP deflator, considering the IPCA, IGP-M (wholesale prices), terms of trade, and commodities. We found that the deflator has great inertia, even with the mini commodity cycle cooling down until the end of 2023, according to our hypotheses. In addition, we attempted to find the optimal weight of the GDP deflator weighting based on both the IPCA and the IGP-M. In the mean square error minimization method, the optimal weighting was 90% of the IPCA index and 10% of the IGP-M index, which was consistent with the econometric models. (See Figure 4.B for our projections.)

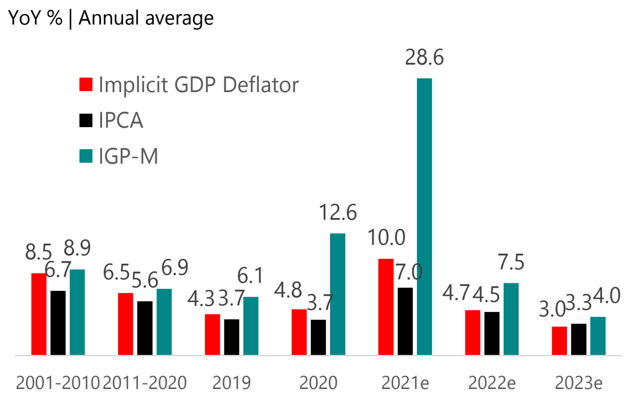
Given the uncertainty regarding the duration of the commodity cycle, we created a simulation with a steeper price drop in agricultural and industrial wholesale prices, after they accumulated significant increases in recent months. In a contrafactual scenario considering a more intense drop in commodity prices, we estimate that the following two subcomponents of the IGP index would fall as follows: the agricultural wholesale index (IPA-agriculture) by 15% and the industrial wholesale index (IPA-industry, which includes raw materials) by 10%. As a consequence, we would instead see disinflation, an 8.8% IGP deflation in 2023. In this case, IGP would reach -8.8%, and the GDP deflator would be below 2.0% in 2023. Thus, any benefit to the debt-to-GDP ratio caused by higher nominal GDP during a certain year could have the opposite effect later on the debt-GDP ratio in a scenario with deflation in the IGP index, because the GDP deflator would be lower than the IPCA index. In addition, in our view, it is likely that federal tax collection will decrease in view of companies' lower profits. This is not our base scenario, but it is a significant risk to the fiscal outlook.

Figure 4.A – IPCA and GDP Deflator



Sources: IBGE, Santander.

Figure 4.B – IPCA, IGP-DI and GDP Deflator



Sources: IBGE, FGV, Santander.

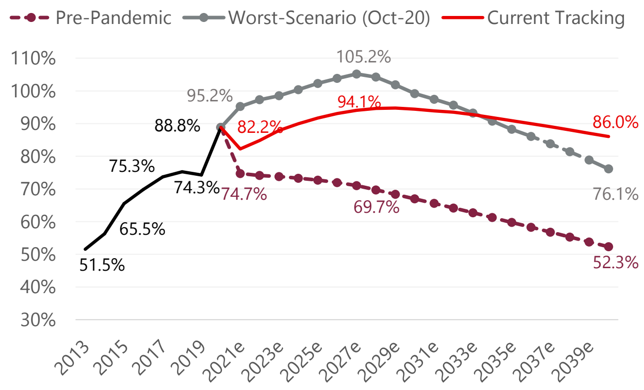
In Figures 5.A and 5.B, we compare gross debt scenarios in three different periods. It can be seen that we had a more positive outlook for debt in the pre-pandemic scenario, with debt converging to the level of other emerging countries, especially after the 2019 approval of pension reform, which was projected to save over BRL800 billion in 10 years and leave the main government expenditures (Social Security Benefits) relatively stable as a proportion of GDP. The pandemic led to the need for massive fiscal stimulus, which pushed the expected trajectory to above 105% of GDP at its peak. It is worth remembering that we thought that the primary deficit would reach above 12% of GDP with the extension of emergency aid until the end of the year. However, the execution of the so-called "war budget"[2] came in lower than expected, with greater government control of the fiscal stimulus. In addition, economic activity showed a better-than-expected recovery in 4Q20. This led to an improvement in the debt outlook, with the primary deficit ending 2020 at around 9.4% of GDP. For the February projection, there were some uncertainties concerning the progress of the economic agenda, which was deadlocked in Congress due to disagreements over some of its provisions. We and others doubted whether the economy would grow more strongly, and the pandemic was already in a second wave, even more intense than that of 2020. In addition, the budget for 2021 had not been approved either.

The intense political pressure in Brazil to create a new and permanent welfare program has receded, especially with respect to alternatives without fiscal counterparts or introduced through a possible change in the spending cap rule through a constitutional amendment. For 2021, the pandemic's resurgence has generated the political conditions for the coexistence of the fiscal rules with emergency measures, such as temporary income transfers, upon approval of extraordinary budget spending (*crédito extraordinário*), which is not restricted by the spending cap limit. As a consequence, during the pandemic we have seen the continual extension of emergency aid, which may last until the end of 3Q21. However, the possibility of a new permanent welfare program is still an important issue for the upcoming budget discussions. This is especially the case considering the slow recovery of the labor market (although it is gradually improving in the short term) and given that the pandemic has exacerbated economic inequality.

In our most recent scenario, the impact of the inflationary shock is assumed to be more persistent and lasting than we initially expected. With that, tax collection grew and, especially, the projection of the GDP deflator rose significantly. The scenario became more positive, but there was still no structural change that would justify a reversal in the expectation of a deteriorating trend, unless the positive terms-of-trade shock is more lasting than we expect. As already mentioned, the approval of the Fiscal Constitutional Amendment (*PEC Emergencial*) brought certain improvements to fiscal management, but its dilution during the approval process left it with reduced fiscal power.

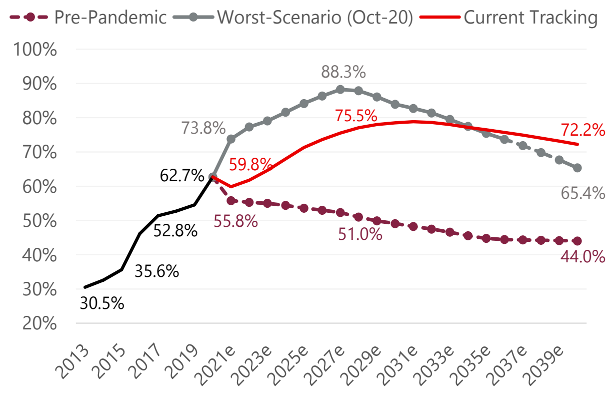
[2] Brazil's lower house of Congress approved a constitutional amendment for a "war budget" to separate coronavirus-related spending from the government's main budget. All the expenditures in this war budget were not subject to the constitutional spending cap rule.

Figure 5.A – Gross Public Debt (% GDP)



Sources: BCB, Santander.

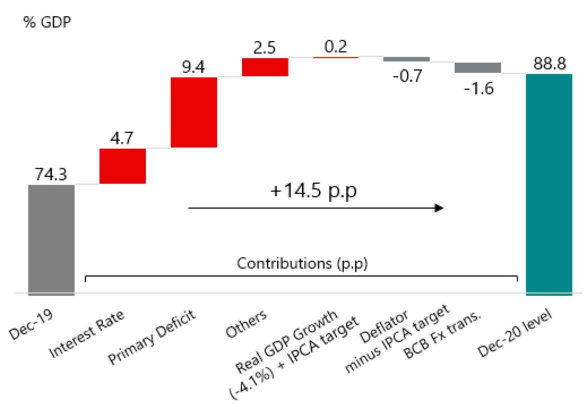
Figure 5.B – Net Public Debt (% GDP)



Sources: BCB, Santander.

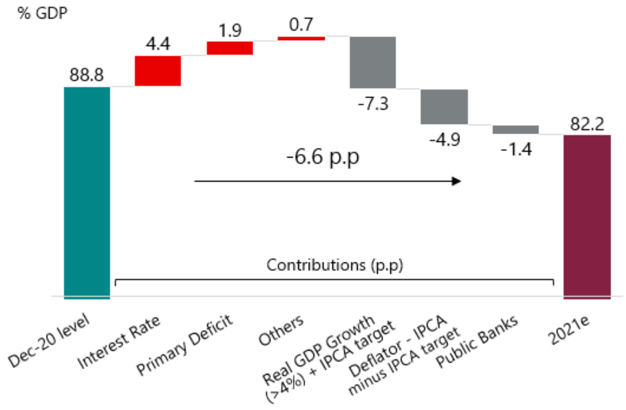
We have attempted to deconstruct the effect of the pandemic on debt. Debt increased 14.5 pp in 2020. It is worth noting that the increase in inflation in 2H20 and the revision of 2019 GDP by the IBGE removed 2.2 pp from the level of debt, with higher nominal GDP—which left the debt-to-GDP ratio lower. For 2021, we expect debt to fall to 82.2% of GDP, with a faster cyclical recovery in activity and a stronger impact from the GDP deflator (again, due to higher inflation).

Figure 6.A – Gross Public Debt (Pandemic Effect)



Sources: BCB, National Treasury, Santander.

Figure 6.B – Gross Public Debt (Current Forecast)



Sources: BCB, Santander.

In order to get an idea of how the inflation shock affected our debt-to-GDP forecast, in Figure 7 we explore the main changes in macroeconomic assumptions. The rise in the GDP deflator corresponds to more than 65% of the expected debt adjustment. In our assumptions, we consider that practically all the improvement in the primary result also comes from higher revenue, driven by inflation and the change in relative prices—that is, the price effect, more than the quantity effect. In addition, the impact on net revenue from the primary result of inflation and the more positive terms of trade corresponded to about 17% of the improvement in the debt-to-GDP ratio. The impact of the higher Selic is still not likely to prove significant in the short term, in our view, because the cost of new issuances is still below the average cost of the total debt stock. We also believe that the rise in the Selic rate, along with higher debt, will exert more pressure on debt management from 2023 onward.

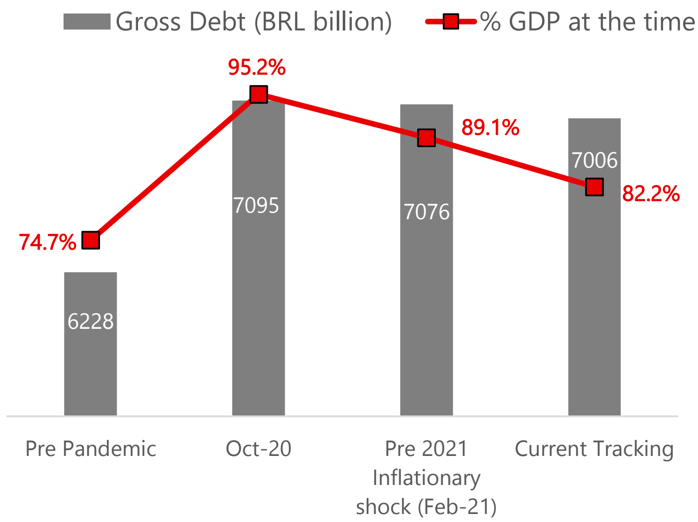
Figure 7 – Santander Gross Debt Forecast (% GDP)

2021 Gross Debt (% GDP) Scenario			
Feb-21 Macro Hypotheses			
GDP: +2.9% | IPCA: 3.6% | Selic: 4.0% | Primary Deficit: -3.1% of GDP | GDP deflator: 4.1%			
Current Macro Hypotheses (tracking)			
GDP: +4.8% | IPCA: 5.9% | Selic: 6.5% | Primary Deficit: -1.9% of GDP | GDP deflator: 10%			
The effect on the forecast of changing the parameters			
Feb-21 Gross Debt Forecast		89.1	
	New Value	Impact	% Total
+ Current GDP tracking: 4.8%	87.8	-1.3	18%
+ GDP Deflator: 10%	83.2	-4.6	65%
+ Primary Deficit: -1.9% of GDP	82.0	-1.2	17%
+ Selic rate 6.5% year end	82.5	0.5	-7%
+ Others	82.0	-0.5	7%
Current tracking for 2021 gross debt: 82.2% of GDP			

Sources: Santander.

There was a clear improvement in our forecast for debt, with an increase in revenue. Yet, as we mentioned, a large part of this is due to the increase in nominal GDP, which has been affected by the commodity shock since 4Q20. Our projection of debt-to-GDP has fallen by 13 pp since the worst-case scenario in October 2020, when we believed the 2020 stimulus would be higher than what actually materialized. On the other hand, when we look at the debt in nominal terms, it jumped by more than BRL700 billion during the pandemic, compared to our current tracking. Following the pandemic shock, there has been a smaller difference in nominal values; there was an improvement, but the amount of debt in billions remained quite high, as shown in Figure 8. This difference in nominal GDP consequently alters the debt-to-GDP trajectories we have been showing, making the psychological danger level of 100% of GDP more distant. Although this is an improvement in the debt statistic due to higher nominal GDP, the structural debt trajectory continues upward. More structural improvements are still needed to change this scenario, in our view, and the more volatile commodity cycle could have a positive impact on the revenue side (an upside risk).

Figure 8 – Santander Gross Debt Forecast for 2021

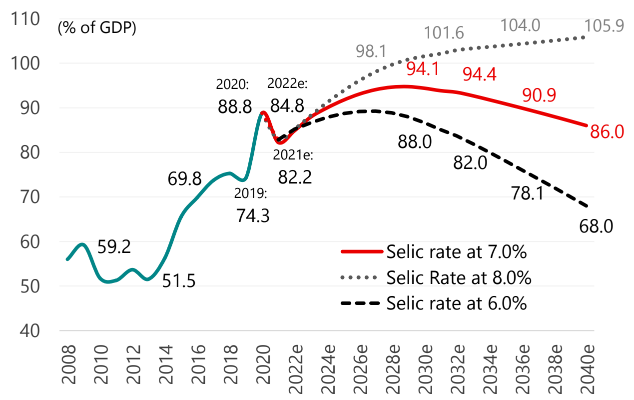


Sources: BCB, Santander.

All in all, although we forecast an improvement in the short term (due to the inflation shock), the challenge on the fiscal front is still quite significant and has worsened in the wake of the pandemic. In our view, two of the biggest factors to be assessed are the Brazilian neutral interest rate, potential GDP growth, and GDP deflator. As shown in Figures 9.A, 9.B and 9.C, hypotheses about these three factors are highly significant for the country's indebtedness trajectory.

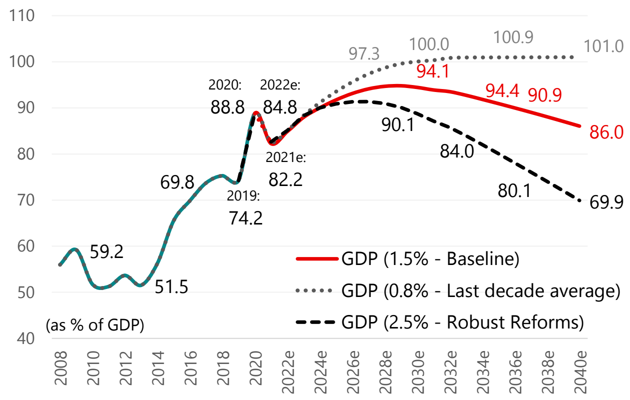
Our main hypotheses in the simulations shown in the figures are as follows: *Debt issuances cost:* we added a spread of + 1.0 pp in addition to the Selic rate in the models; *PEC Emergencial:* Funds (+BRL150 billion for liquidity cushion in 2021)[3]; *2021 GDP Deflator:* 10%—due to the inflationary shock. *2022 hypotheses:* 4.7% YoY of GDP deflator. *FX reserves:* (BRL50 billion) + BNDES and Public Banks (totaling BRL65 billion); *2023:* the GDP deflator considered was 3.0% YoY. *2024-40:* we used the average of long-term GDP deflators of 4.0%, which is the inflation target + 0.8% (average difference between IPCA and GDP deflator over the last decade); Finally, the *exchange rate* is evolving, according to PPP.

Figure 9.A – Government Debt – Simulations for Selic Rate Hypotheses



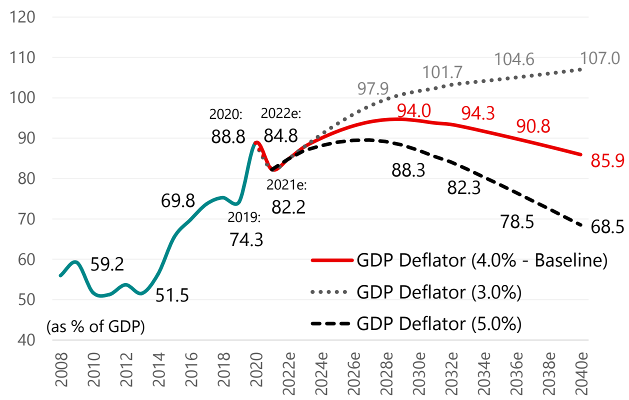
Sources: BCB, Santander.

Figure 9.B – Government Debt– Simulating for Trend GDP Hypotheses



Sources: BCB, Santander.

Figure 9.C – Government Debt – Simulating for Trend GDP Deflator Hypotheses



Sources: BCB, Santander.

3. Impact on the Primary Result

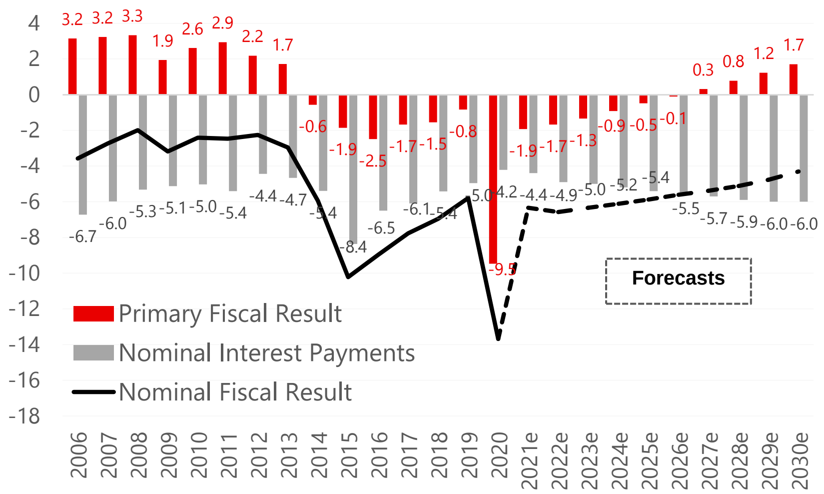
In this section, we explore the main effects of the pandemic on the primary result, and especially the impact of the recent inflation shock on revenues. In Figure 10 we show the financing needs of the public sector. Despite the improvement in the primary result in 2021, our scenario is still a gradual adjustment of public accounts. Recently, we revised our nominal Selic rate to 7.0% in 2022 (from 4.0% in our February scenario) (the neutral interest rate is now at 4.0% per year). This higher Selic rate will contribute to increasing the nominal deficit, especially after 2023. As can be seen, the nominal deficit is expected to remain close to 6.0% of GDP in the medium and long term. In our scenario, the long-term nominal deficit level will stand near the last decade's average (without considering the pandemic)—although the current structural interest rates are lower than those prevailing in previous crises, as the debt and its financing needs have increased.

If the revenue recovery outlook improves, and the government maintains expenditure control under the spending cap, it is possible that the primary surplus will be reached before 2028 (our scenario). However, we

[3] A constitutional amendment (*PEC Emergencial*) was approved, setting up the conditions and rules for an emergency fiscal regime. The law allowed the government to de-earmark public funds to increase its liquidity reserves, which meant an improvement in debt management conditions.

still see a cyclical revenue recovery of around 1.5 pp of GDP as more likely in the medium term. For this recovery to be achieved, important reforms are needed, especially those that increase potential GDP. It is important to point out that revenue rises in periods of accelerating inflation and terms-of-trade positive shock, but when inflation starts to converge toward the target (2023 in our scenario), this effect is likely to be limited.

Figure 10 – Public Sector's Financing Needs (% GDP)



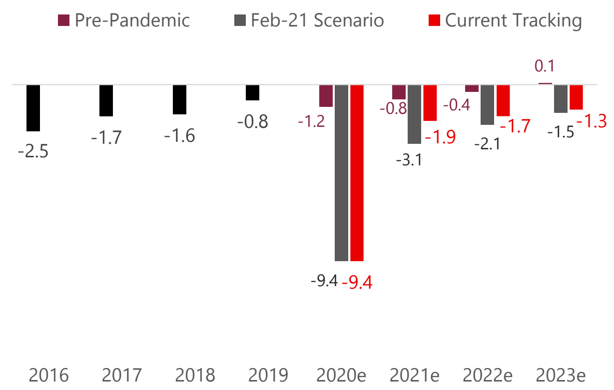
Sources: BCB, Santander.

In 2020 alone, the pandemic accounted for a drop of about BRL167 billion in revenue and an increase of BRL505 billion in expenses. With that, the primary deficit—which before the pandemic was expected to end 2020 close to BRL100 billion—ended up seven times larger; in other words, Brazil had seven years of deficit in just one. In 2021, the reduction in spending was less than expected due to the resurgence of the pandemic (the second wave being even worse than 2020), but the stimulus was lower.

On the expenditure side, this year the country is facing a reduction in its ability to make spending disbursements due to the mismatch of inflation rates last year. Furthermore, the budget was only approved at the end of April. Both factors have driven discretionary expenses to the lowest level in the historical series. There are still risks of occasional shutdowns in some public services, given the need to comply with the spending cap. This year the government will have to freeze spending to meet the spending cap, whereas spending freezes typically have been used to meet the primary target. The consolidated government's primary target for the year is currently at BRL250 billion (3.0% of GDP), which in our view will be easily met. However, we think it is important to note that ~BRL70 billion in expenses will not be considered in the official calculation of the primary target for the central government result, as is legally permitted by recently approved laws (*PEC Emergencial* and PLN2/2021).

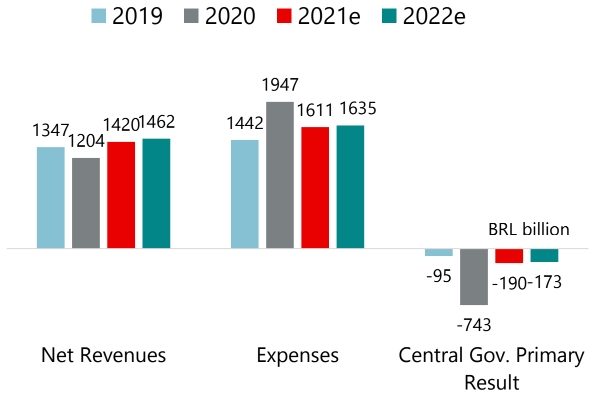
The highlight has been the faster-than-expected cyclical recovery and its impact on revenue, which was boosted by the commodities and inflation shocks. This will contribute to improve the primary deficit results by 1.1 pp of GDP in 2021, according to our projections, improving the post-pandemic fiscal consolidation somewhat. Nevertheless, even assuming that the primary surplus required to stabilize the public debt will be reached a couple of years earlier (i.e., in 2031), assuming this short-term improvement, achieving this stabilization level will take at least four years longer than was expected pre-pandemic. Discounting the effects of the cyclical recovery, the long-term outlook will require a remaining 3.5% of GDP primary fiscal adjustment, just to stabilize the ratio debt-to-GDP around the higher post-pandemic level of 95%. **In other words, the pandemic shock has meant a four-year setback in terms of fiscal consolidation.**

Figure 11.A – Primary Result (% GDP)



Sources: BCB, Santander.

Figure 11.B – Primary Result Current Tracking



Sources: National Treasury, Santander.

4. Impact on Federal Revenue

A phenomenon that has occurred on the revenue front in recent months has improved the perception of short-term fiscal risk. Higher inflation (allowing margin recovery for companies), higher commodities prices, and FX depreciation (higher revenue for commodity-exporting companies and higher amount of import-related taxes) also helped the fiscal statistics from the standpoint of revenue. This phenomenon led the government to revise its 2021 revenue estimate by BRL108 billion in its latest bimonthly report released on May 21, with an increase of BRL85 billion in revenue administered by the Brazilian Internal Revenue Service (IRS), most of which was related to corporate taxes. There were also increases of BRL13 billion in revenue not managed by the Internal Revenue Service, around BRL3 billion related to concessions for airports, and BRL4.4 billion from the exploitation of natural resources (related to revenues from royalties). The possible capitalization of a state energy company this year is also a positive risk for our revenue scenario, yet it could generate more expenses (not included in the budget) in the future. The estimated grant in the 2019 budget was around BRL12 billion, and we estimate that it could reach close to BRL20 billion for 2021 or 2022, which would improve the government's primary result. We still think, however, that the full extrapolation of the latest federal tax collection results to the year-end account requires caution.

Our projections also improved, as shown in Figure 12. However, we still see still uncertainty about the pace of recovery in industry (which generates greater revenue) and the impact of an even weaker job market. In addition, the recent decision by the Supreme Court (STF) to remove the state tax (ICMS) from the PIS/Cofins calculation basis may accelerate the use of tax credits and lead to a more substantial resumption of revenue collection—this is an uncertainty that will need to be monitored in the release of the next federal tax collection data. See details in the link[4]. It is worth noting that since the recovery of activity is linked to the formal part of the economy, there is also an increase in transfers to states and municipalities by constitutional funds, which causes net income to increase more slowly.

[4] **Santander Brazil – Fiscal Policy:** ***"Supreme Court Decision on Tax Methodology: A Middle Ground"*** – May 20, 2021- Available on: http://bit.ly/Std-special-icms

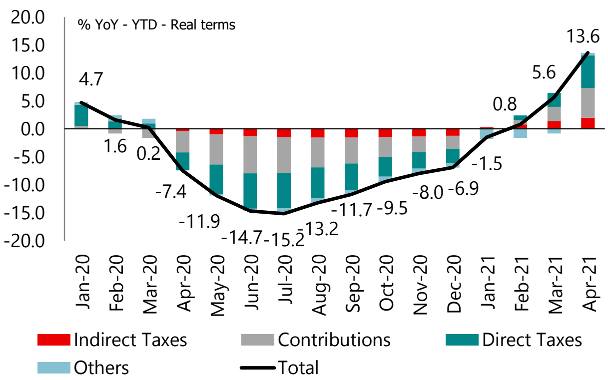
Figure 12 – Revenue Forecasts – Government and Santander

2021 forecasts	Total Revenues (BRL bn)	Net Revenues (BRL bn)	GDP	IGP-DI
Budget Guidelines (PLDO)	1671.0	1380.5	3.3	4.0
Budget Bill (PLOA 2021)	1560.1	1283.2	3.2	4.1
1st Bymonthly report	1643.6	1345.0	3.2	5.1
2021 Budget (LOA 2021)	1595.4	1302.1	3.2	4.1
April extra report	1643.6	1345.0	3.2	5.1
2nd Bymonthly report	1752.1	1433.3	3.5	10.2
Santander May Forecast	1652.5	1363.3	3.6	18.9
Santander Tracking	1738.0	1420.0	4.8	18.9

Sources: National Treasury, Santander.

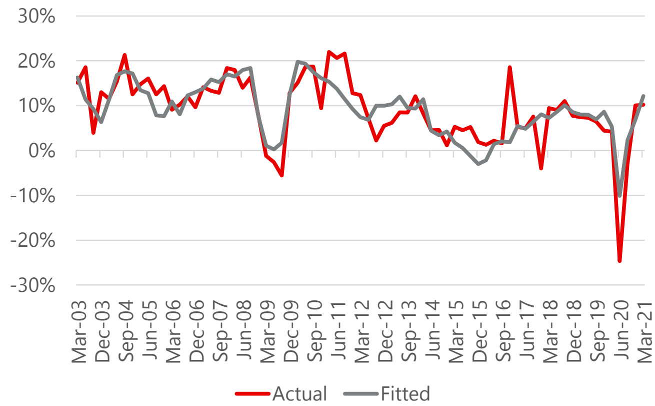
Figure 13.A shows a strong recovery in federal tax collection in recent months, mainly direct taxes linked to the business sector, which have posted good results recently. We ran a revenue model (Figure 13.B) showing the relationship between the recovery of activity and the effect of inflation; the projection based on this model is consistent with our tracking shown in Figure 12.

Figure 13.A – Federal Tax Revenue



Sources: Brazilian IRS, Santander.

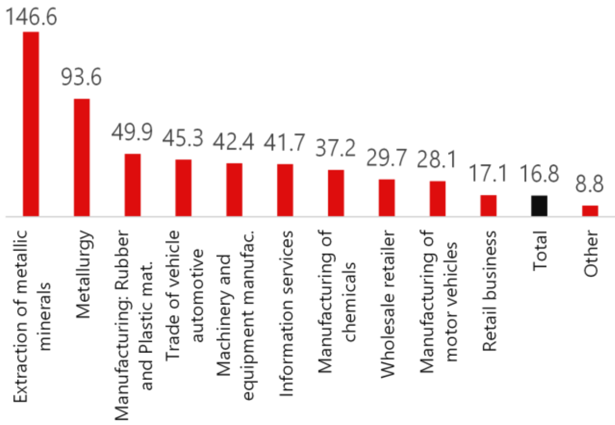
Figure 13.B – Model – Tax Revenue – GDP and Inflation



Sources: IBGE, FGV, Santander.

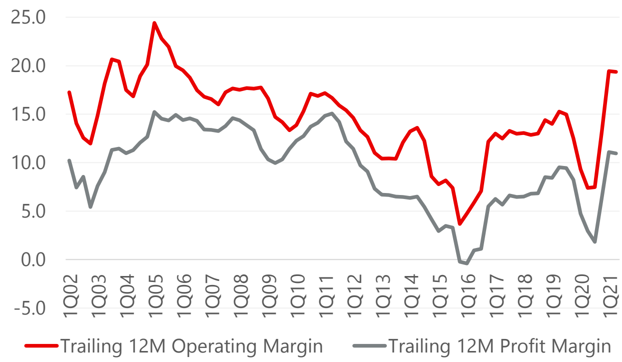
Figures 14.A and 14.B show that most of the recovery is coming from the corporate and formal sectors. In Figure 14.A, it can be seen that substantial amount of tax revenue is related to the recent commodity boom, closely tied to the global recovery, especially in China. With high ore prices and a depreciated exchange rate, the commodity sector's revenue increased significantly. In Figure 14.B, it can be seen that companies in the IBX index on the stock exchange (comprised of 100 companies) have had a significant margin recovery since 4Q20. The effect of inflation, with wholesale prices posting inflation rates above 30% over 12 months, led companies to pass on costs as much as possible. This is in the context of the massive fiscal stimulus of the economy since 2020, as well as companies' greater adaptation to social mobility restrictions. There are also increased debt services payments (with the increase in the Selic rate), which are likely to pressure corporate margins ahead, in our view, reinforcing the increase in pass-through owing to higher input/raw materials costs.

Figure 14.A – Federal Tax Revenue by Sector YTD (%YoY)



Sources: Brazilian IRS, Santander.

Figure 14.B – Corporate Margin Recovery – Brazilian Companies IBX Index



Sources: Bloomberg, Santander

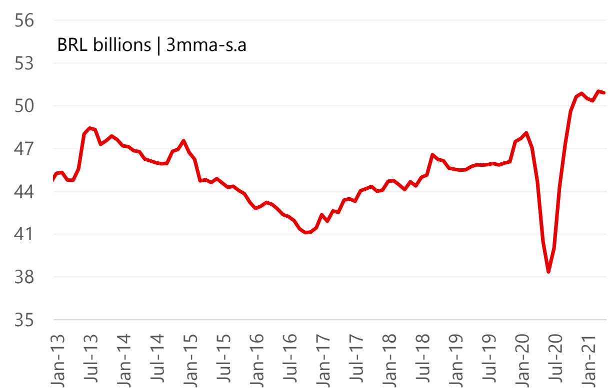
5. Impact on Regional Governments

The same impact on the recovery of revenue has been seen among regional governments. In YTD data (January to April), the surpluses of regional governments reached an all-time high. In April, regional governments' results were positive (+BRL7.0 billion compared to a deficit of BRL1.9 billion in April 2020), probably affected by the lagged effects of the 2020-2021 fiscal stimulus on local economies, added to the impact of the inflation shock on tax collection, the activity recovery, and the resurgence of e-commerce in the last few months. In the YTD reading, regional governments posted a primary fiscal surplus of BRL33.7 billion, on average (1.3% of GDP)—the best result in real terms for the first four months of the year since 2019. In our view, the subnational entities should continue to achieve positive results in the short run. However, we expect the positive fiscal result to be partially reversed ahead. This is because spending should increase as regional governments begin to have larger current expenditures with the normalization of activity after the pandemic (such as expenditures on health and education).These positive results are highly related to a series of recent events: (i) Cessão Onerosa/Oil Transfer of Rights from the federal government (BRL11.7 billion in 2019); (ii) the federal government disbursement to cover state debt Treasury guarantees, which was BRL13.3 billion in 2020; (iii) more transfers by educational fund-FUNDEB (which may imply higher spending on public employees' wages); (iv) lack of harmonized fiscal rules for the subnational entities (improved with the approval of *PEC Emergencial*); (v) structural reforms undertaken by some states (pension and administrative reforms, for example); (vi) state court orders with the national government (such as FUNDEF); and (vii) transfers from the Kandir law (BRL4 billion a year). In addition, the direct fiscal transfers of BRL78 billion (not considering those related to health measures) from the federal government to the regional governments in the so-called "war budget" (EC 106/20) have improved the regional governments' fiscal result.

Figure 15.A – Regional Gov. Primary Result (% GDP)

Sources: BCB, Santander

Figure 15.B – ICMS Tax Collection (States)



Sources: Ministry of Economy, MCM, Santander

Because of this recovery of revenue and the suspension of some expenditures during the pandemic (on health, education, etc.), the pressure for new expenditures in the future will be high, in our view. **Regional governments will face the challenge of reestablishing fiscal balance in the medium term after the end of fiscal and monetary stimuli, mainly, in our view, because of pressure to increase mandatory expenditures in the next year (for example, pressure to increase public servants' wages, after years without a nominal increase).** It is worth noting that a substantial part of regional government expenditures is linked to revenue growth, but with a lag, and should only appear in the future. In addition, debt payments to the federal government were suspended during the pandemic (BRL35.6 billion from July 2020 to December 2020), which meant that the size of the regional governments' debt expanded during that period.

6. Impact on the Spending Cap Rule (Expenditures)

On the expenses front, we need to comment on the spending cap constitutional rule. Last year, due to the pandemic, the government approved legislation that created a "parallel budget" ("war budget") that was not subject to the spending cap and served to mitigate the effects of the pandemic. Figure 16.A shows that total expenditures in 2020 amounted to BRL524 billion. This year, with the worsening of the pandemic, the government is already expected to spend around BRL135 billion on measures to mitigate the effects of the pandemic, and it remains at risk of requiring further increases in its allocation (already considering the possibility of extending the emergency until October). In short, these were the main legacies of the pandemic with respect to fiscal accounts.

Figure 16.A– 2020 "War Budget" (BRL billion)

In BRL billion - Accumulated	Dec-20	Total Budget	Executed
Bem - Employment program (MP 935)	33.5	51.5	65.0%
Expansion of Bolsa Família (MP 929)	0.4	0.4	100.0%
Emergency Aid (MP 937)	**293.1**	**322.0**	**91.0%**
Transfers to regional governments (MP 939)	78.3	79.2	98.8%
Credit for payroll (MP 943)	6.8	6.8	100.0%
Energy Sector (MP 950)	0.9	0.9	100.0%
Ministry of Health and others	42.7	50.8	84.0%
Guarantees for credit measures (MP 977)	**58.1**	**58.1**	**100.0%**
Financing of Tourism Infrastructure (MP 963)	3.1	5.0	61.6%
Emergency Credit Program - "Maquininhas"	5.0	10.0	50.0%
Vaccine Acquisition	2.2	20.0	11.1%
Accumulated Total	524.0	604.7	86.7%

Updated until 10/02/2021

Sources: National Treasury, Santander.

Figure 16.B – Expected "Extra-Cap" Expenditure 2021

Covid related expenditures - 2021	BRL billion
Emeregency Aid (*PEC Emergencial*)	45
Extension of the Aid until October (3 months)	20
Vaccine Acquisition (2020 Leftovers)	22
Health Expenditures	20
2020 War Budget Leftovers	13
Pronampe 2021 (credit support for SMEs)	5
BEm 2021 (formal job suport program)	10
TOTAL	135
Estimate of final execution in 2021 (85%)	115

Sources: National Treasury, Santander.

Since our February scenario revision, a constitutional amendment (*PEC Emergencial*) was approved, setting up the conditions and rules for an emergency fiscal regime. The law allowed the implementation of a new round of emergency aid for four months, with a total budget limit of BRL44 billion, and also created "fiscal triggers" that may favor compliance with the spending cap for the medium term. However, the final text saw a watering down of the economic team's proposal, meaning less potential for fiscal savings, which we believe was a way to avoid even greater setback of the reform. Although substantial, this reform will not ensure fiscal consolidation, and the debate in Congress concerning its approval showed the difficulty of approving tougher fiscal measures.

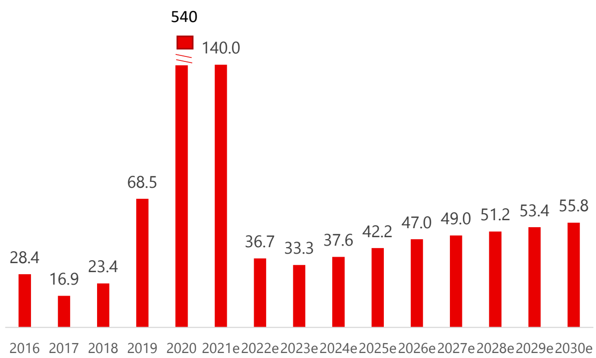
Another key aspect of this issue is that, because of the inflationary shocks in 2020-2022, the constitutional spending cap has lost part of its anchoring power. This is due to the inflation mismatch between the price index used to readjust the spending cap limit and the index used to correct the minimum wage (important index for pensions) and other mandatory outlays. The fiscal rule remains important, but it is no longer sufficient to lead to consistent fiscal consolidation. In addition, after 2026, there is the possibility of a change in the spending cap readjustment index (which is IPCA 12-months to June of the previous year), which could open up even more room for new expenditures.

In our scenario, the constitutional spending cap gross margin will rise by as much as BRL120 billion in 2022 (considering readjustment index: IPCA 12-months to June 2021: 8.3%). Considering the increase in mandatory outlays (indexed on the minimum wage correction by inflation), the net margin will be ~BRL70 billion. This means expenditures can increase by BRL70 billion compared to the counterfactual scenario, with inflation (IPCA) at the 2021 inflation target (3.75%). Consequently, even with a real increase in mandatory expenses next year, we believe compliance with the spending cap by 2026 is more feasible than it was before the current inflationary shock.

Another key aspect of the fiscal outlook that we want to emphasize is that the higher margin (BRL120 billion in 2020) will probably open room for an increase in future mandatory outlays. Figure 17.A shows that the transfers from the federal government to regional governments will increase on the heels of the approval of the new FUNDEB[5] (education fund)—that is, the spending not subjected to the spending cap will grow over time, apart from that already authorized for pandemic spending in 2020-2021.

We expect the new welfare program (“Extended Bolsa Família”) to have its budget increased. The debate will not take place until 4Q21, yet we are already considering an increase of BRL7 billion in our scenario. This means that the budget for the welfare program will jump from BRL35 billion this year (2021) to almost BRL42 billion annually in the coming years (there is significant political pressure for a higher budget for the program). Additionally, we forecast that next year the government will grant a 5.0% salary increase to public servants, considering the inflationary shock pressure, the legislative authorization for this increase in the 2022 budget guidelines, and the fact that public servants have gone two years without nominal adjustments. These two expenses (“Extended Bolsa Família” and the salary increase for public servants) are likely to prevent the return of a positive primary result in the coming years. However, if these expenditures are contained or more limited, it would be a positive risk to our fiscal scenario.

Figure 17.A – Extra-Cap Expenditure (BRL billion)



Sources: National Treasury, Santander.

Figure 17.B – Santander Forecast - Expected Use of Spending Cap Margin in 2022

Use of BRL120 billion in 2022	BRL billion	%
Social Security Benefits	47.4	39.3%
Payroll - Public Servants	24.8	20.6%
Other social benefits (BPC)	4	3.3%
2021 Wage Bonus payment	7.4	6.1%
Extra Budget for the new Bolsa Familia (totaling BRL42 billion)	7	5.8%
Recomposition of discretionary expenses	20	16.6%
Federal Gov. normalization of "current spending" flow	10	8.3%
TOTAL	120.6	100.0%

Sources: National Treasury, Santander.

As shown in Figure 18.A, we explored the impact of higher inflation on the spending cap, comparing it to the scenario in which the fiscal rule would only be readjusted by the inflation target for the year. We note that the budgetary impact became more unfavorable only in 2021, considering the disinflationary effect of the pandemic. The mismatch of the inflation numbers has affected the fiscal rules since the emergence of the pandemic. During the 2017-2026 period, we project that expenditures will be +3.1% higher than in the scenario that considers only the adjustment to the target, or around ~BRL470 billion in nominal terms, with 88% of this effect occurring in the period 2022-26.

This greater "legal space" to spend more, but within the limits of the fiscal rule, leads us to believe that the spending cap has lost part of its anchoring power. In light of this, we believe that the fiscal rule is losing its initial purpose: to make expenditures more efficient through structural reforms rather than by further increasing

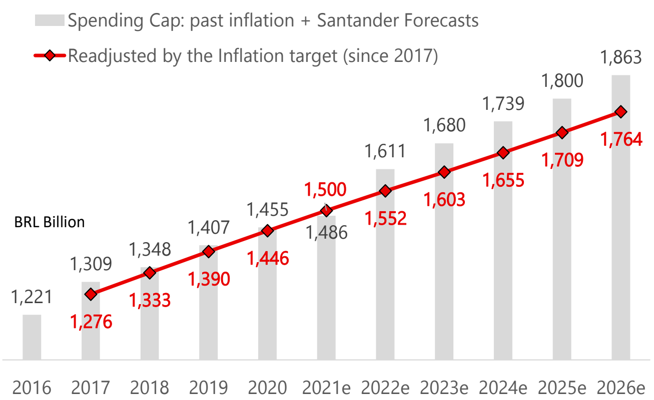
[5] Last year bills were approved by Congress that order the government to gradually increase the federal contributions to the fund to 23%, from 10% in 2020. FUNDEB’s resources are excluded from the spending cap.

the tax burden. Another way to compare the increase in expenditures is that the possible growth in expenditures due to the effect of inflation from 2022 to 2026 is equivalent to 122% of the expected savings from the pension reform (BRL335 billion) approved in 2019, considering the same period and government estimates.

For the medium-term scenario, it is important to remember that 2026 will be the end of the first phase of the spending cap, and in that year, there will be a review of the fiscal rule readjustment index for the next 10 years. If an indicator greater than the June IPCA YoY of the previous year is chosen, the room to spend will be even greater in the future, hampering the fiscal consolidation process that is intended by the reduction in expenditures.

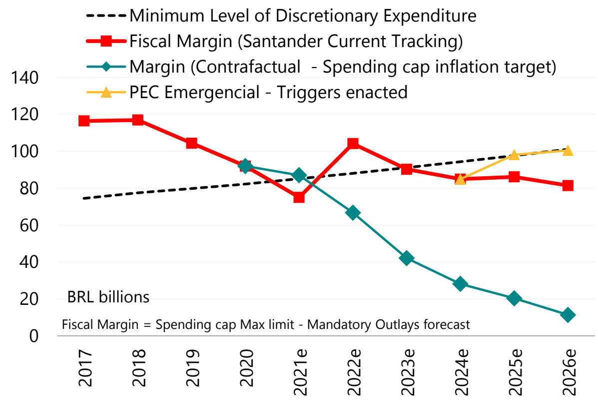
Figure 18.B shows the fiscal margin (spending cap maximum limit – mandatory outlays). We can see that compliance with the fiscal rule becomes much more feasible (as does the use of the fiscal triggers approved in *PEC Emergencial*), and even more so with the impact of lifting the ceiling. If only corrected by the target, discretionary expenses would be reduced almost to zero by 2026, in order to comply with the spending cap rule and in the absence of a review of mandatory spending.

Figure 18.A – Spending Cap Max. Total Limit



Sources: National Treasury, Santander.

Figure 18.B – Simulation Discretionary Outlays

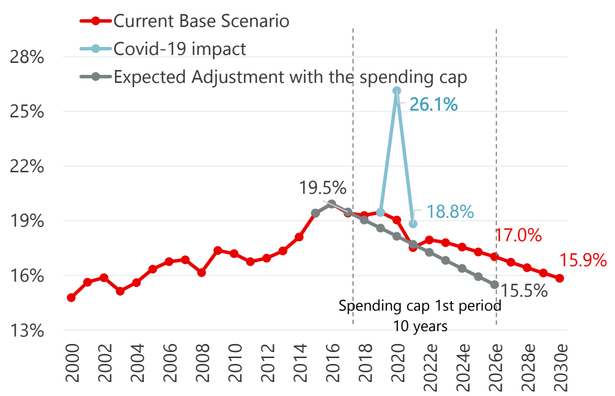


Sources: National Treasury, Santander.

Finally, we show the total expenditures and revenues as a percentage of GDP. As shown in Figures 19.A and 19.B, the pandemic led to significantly higher spending in 2020-2021 as part of the temporary fiscal stimulus. According to our forecast, the first phase of the spending cap will be 1.5 pp of GDP higher than initially expected when the cap was implemented, especially because of lower GDP growth. It is worth noting that when the spending cap was proposed, the expected potential GDP was around 2.5% per year. Even so, we expect a gradual decline in expenditures, which reinforces the importance of the spending cap constitutional rule, yet this will no longer be enough to lead to a more consistent return to the primary surplus. On the revenue side, we see a 1.5 pp cyclical recovery. The longer duration of the commodity cycle, along with the approval of reforms that improve potential GDP, could help create a more favorable outlook for government revenue, in our view.

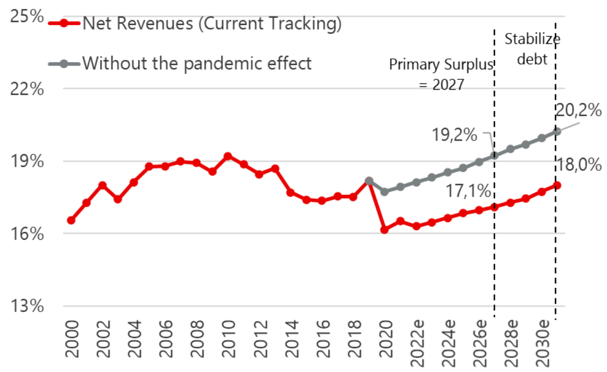
In addition, we estimate that federal net revenue will rise by 0.1 pp of GDP per year, due to the terms-of-trade positive shock, depending on the impact of the commodity boom. Considering the total effect up to 2030, net revenue is 1.0 pp of GDP above our projection at the beginning of the year. If the commodity shock is even stronger and more persistent, there is an upside risk to our forecasts. However, we acknowledge the possibility that this effect will subside at the end of the global recovery from the pandemic and with the normalization of production chains.

Figure 19.A – Expenditures (%GDP)



Sources: National Treasury, Santander.

Figure 19.B – Net Revenues (% GDP)



Sources: National Treasury, Santander.

One of the main challenges in reaching a primary surplus (after seven years of deficit through 2020) will be the path of revenue recovery. We have more favorable forecasts, as discussed in the previous sections, and this improved outlook could become more permanent depending on the maintenance of favorable terms of trade. In this regard, we ran some simulations to analyze in which year the primary surplus would be reached (see Figure 20). In this simulation, we use our expenditures scenario, and our hypothesis is that the government complies with the spending cap rule and maintains the level of discretionary spending at around 1.4% of GDP, which we believe is a necessary level in order not to result in a partial shutdown of public services.

For revenue, we use the expected amount of net revenue estimated by the government for 2021 in its second bimonthly report of the year (if the inflation and terms-of-trade shock is more intense than we expect; see Figure 12). We note that if there is greater elasticity of revenue to GDP and higher growth, the primary surplus can be reached sooner than we currently expect. We maintain GDP growth close to 1.5% after 2023, a GDP deflator of 4.0%, and elasticity close to 1.1.

Figure 20 – Simulation - Year When the Primary Surplus Will Be Reached

		GDP Growth			
		1.0%	1.5%	2.5%	3.0%
Elasticity: GDP-Revenues	0.9	2038	2032	2029	2027
	1	2031	2028	2027	2026
	1.1	2028	2027	2026	2025
	1.2	2027	2026	2025	2024
	1.3	2026	2025	2024	2024

Assumptions: GDP deflator: 4.0% after 2023; Net revenue from the 2nd bimonthly government report; Santander expenses scenario.

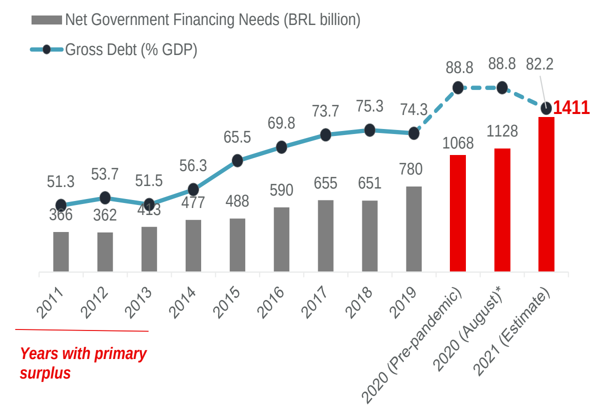
Source: Santander.

7. Impact on Debt Management

The pandemic also increased the need for government funding, nearly doubling that of the previous period. Last year there was a transfer of BRL325 billion from the Brazilian Central Bank to the Treasury, approved according to the law. For 2021, approval of *PEC Emergencial* helped to de-earmark BRL150 billion of public funds, in addition to the return of BRL115 billion to the Treasury by public banks. Next year, we expect public banks to return the remaining BRL70 billion. All these factors significantly helped with debt management, which reduced the need for financing.

In our view, the outlook for debt management remains challenging in the medium term and dependent on maintaining the current fiscal framework, the level of the liquidity reserve, and favorable market conditions.

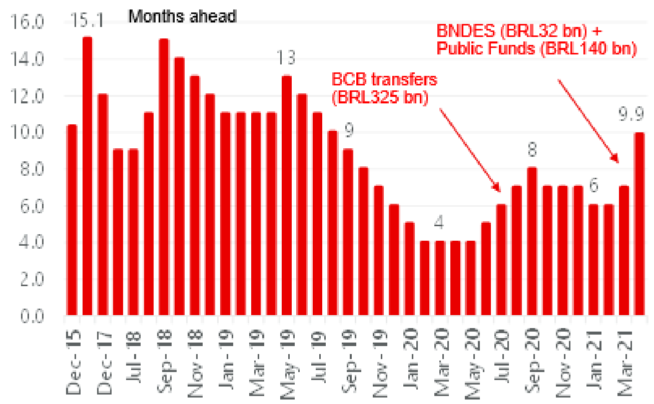
Figure 21.A – Financial Needs



* It includes BRL325 billion from the transfer from BCB to the Treasury, allowed by law nº 13,820/2019

Sources: National Treasury, Santander.

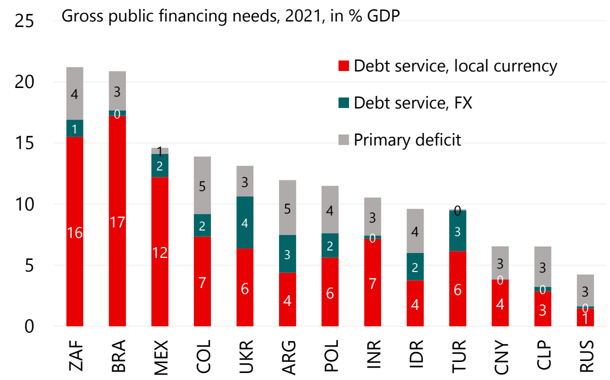
Figure 21.B – Liquidity Cushion Coverage of Domestic Debt



Sources: National Treasury, Santander.

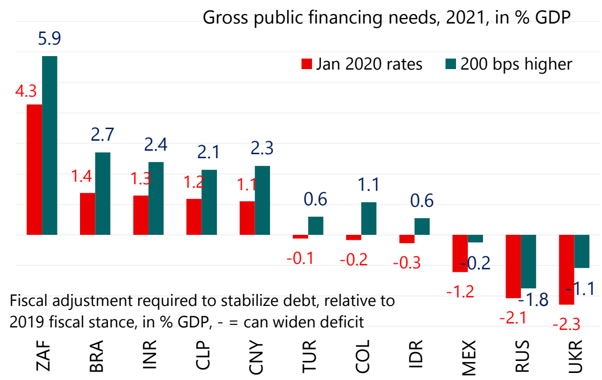
According to Institute of International Finance (IIF) estimates, compared to the main emerging countries, Brazil is the second largest in gross financing needs as a percentage of GDP, behind only South Africa (Figure 22.A). In addition, monetary normalization should also affect public accounts, according to the same IIF report (see Figure 22.B).

Figure 22.A – Gross Financing Needs Have Risen



Sources: IIF, Santander.
Jonathan and Sergi (2021)
IIF: Economic Views – EM Fiscal Vulnerability (Mar 09, 2021)

Figure 22.B – Higher Rates Would Wipe Out Fiscal Space



Sources: IIF, Santander.
Jonathan and Sergi (2021)
IIF: Economic Views – EM Fiscal Vulnerability (Mar 09, 2021)

On May 26 the National Treasury released a revision of the PAF 2021. According to the debt profile, the fiscal authority intends to expand the total share of LFT (floating rates) and NTN-B (inflation-linked) securities in the composition of debt, in line with the current demand profile for bonds, in view of the rise in both inflation and the Selic rate. In contrast, the value expected for fixed-rate securities has decreased (see Figure 23.A). The estimate for average maturity showed a slight improvement, due to the new composition of debt issuances predicted by the Treasury (NTN-B has greater average maturity).

In addition, the total level of the outstanding debt dropped by BRL100 billion, on the heels of a record issuance until April (BRL672 billion) and the BNDES repaying the Treasury BRL100 billion in 2021 (through April it totaled

BRL38 billion), as well as the possibility of using de-earmarked public funds (allowed by the PEC Emergencial), which increased liquidity reserves (+BRL140 billion so far) and improved debt management.

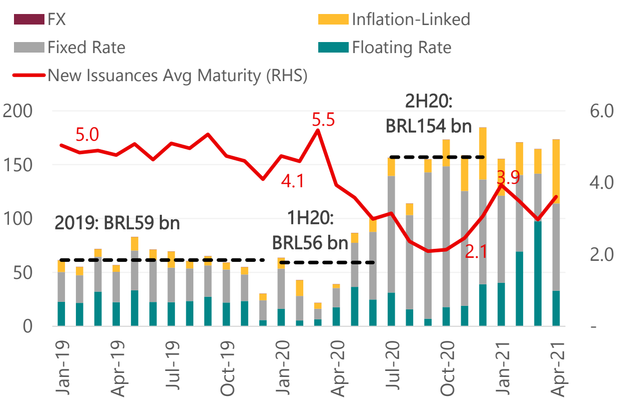
Figure 23.A – Annual Borrowing Plan (PAF) 2021

Indicators	2020	PAF 2021 ranges Min	PAF 2021 ranges Max	PAF 2021 revised Min	PAF 2021 revised Max
Outstanding Debt (BRL billion)	5009	5600	5900	5500	5800
Composition (% of Debt)					
Fixed-rate	34.8	38.0	42.0	31.0	35.0
Inflation-linked	25.3	24.0	28.0	26.0	30.0
Floating-rate	3.8	28.0	32.0	33.0	37.0
FX	5.1	3.0	7.0	3.0	7.0
Maturity Structure					
% maturing in 12 months	27.6	24.0	29.0	22.0	27.0
Average maturity	3.6	3.2	3.6	3.4	3.8

PAF = Annual Borrowing Plan.

Sources: National Treasury, Santander.

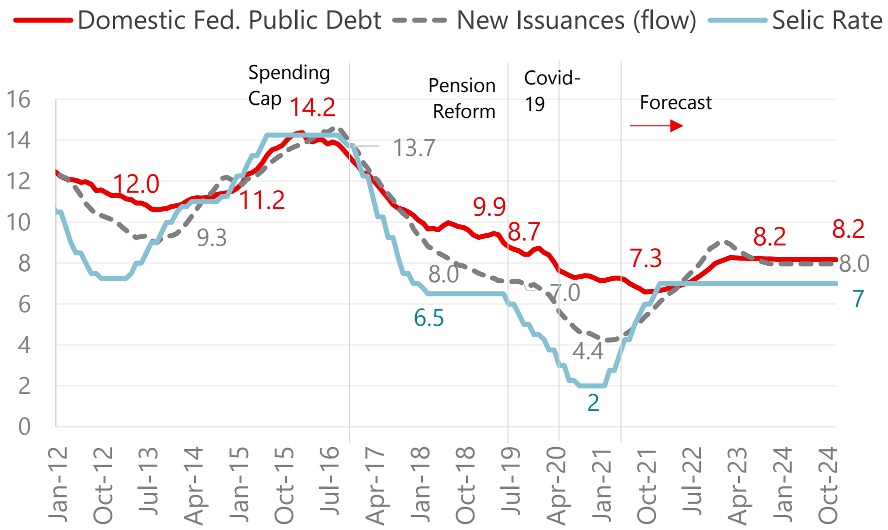
Figure 23.B – Treasury Issuances



Sources: National Treasury, Santander.

In addition, the cost of new issues is below the total debt stock, as we have already mentioned. As the Selic rises, and with a higher debt level, we expect the pressure on debt cost to increase beginning in 2023.

Figure 24 – Average Cost of Federal Debt - 12 Months – (%)



Sources: National Treasury, Santander.

8. Final Considerations

All in all, the COVID-19 pandemic represented a temporary shock to global activity, likely to last about three years (according to our current outlook), with heterogeneous impacts among sectors: goods and services; formal and informal; domestic and external. The pandemic caused temporary changes in relative prices and led to a break in global supply chains. Likewise, we expect the recovery to be as heterogeneous as the combinations of stimuli (fiscal and monetary) and public policies adopted among nations.

It is important to note that this temporary economic shock due to the pandemic directly affected the Brazilian fiscal outlook. Obviously, the pandemic will also leave its side effects on the future structural outlook (productivity and potential GDP, neutral interest rates). Although that is not the focus of this report, we have presented some hypotheses and have run sensitivities concerning the fiscal accounts.

In specific terms, we can see that the pandemic has aggravated the situation of public accounts, leaving their structural outlook still quite challenging. According to data from the IMF, in both 2020 and 2021, Brazil's fiscal stimulus reached 8.8% of GDP, higher than the average of 4.0% of GDP for the emerging economies (EM). In light of this, there was an increase in the debt-to-GDP ratio of 14.5 pp during 2019 and 2020. The pandemic also increased the need for government funding, nearly doubling that of the period before the pandemic.

The recovery of activity, and the effect of inflation and higher commodities prices on federal and subnational tax collection, improved short-term conditions and helped Brazil's debt avoid reaching the psychological danger level of 100% of GDP, in our view. Higher inflation (allowing margin recovery for companies) and FX depreciation (higher revenue for commodity-exporting companies and a higher amount of import-related taxes) also helped the fiscal statistics from the standpoint of revenue. In our current tracking, the public sector primary deficit forecast improved to -1.9% of GDP in 2021, compared to -3.0% of GDP in our previous scenario. **An important effect of inflation on the primary result comes from the time mismatch (at least one year) between its impact on revenue and its impact on expenditures (indexed and linked).**

In addition, considering inflation's effect on nominal GDP, through the higher GDP deflator, in our current tracking, gross debt has dropped 8 pp from ~90% of GDP to ~82% of GDP. The inflation shock's impact on the GDP deflator and federal tax collection directly account for 65% of the improvement in the fiscal indicator.

On the other hand, in our view, the spending cap's anchoring power has loosened with the recent inflation shock and inflation's convergence toward the center of the Central Bank's target (in 2023, according to our expectations). Furthermore, amid the pandemic the government has found ways to accommodate some extra spending that is not subject to the spending cap (i.e., breaches of the cap).

In the end, this only reinforces that the country has time to adjust until several risks materialize. We list some of them in Figure 25.

Figure 25 – Main Risks to the Fiscal Outlook

Main Risks to the Fiscal Outlook
Change in the spending cap readjustment indicator after 2026 onward - postponing the fiscal consolidation
Possibility of a water/energy crisis affecting the domestic economy recovery
Earlier end of the mini current commodity cycle
Disinflation effect on federal and regional tax collection
Changes in the structure of income tax without compensation for federal revenues (neutral)
Monetary normalization of advanced countries and pressure over debt rollover cost
Inequality and greater pressure for additional social expenses
Complacency with reforms to decrease budget rigidity and improve its composition
Stagnation of domestic productivity (lower Potential GDP)

Source: Santander.

We believe that the inflation shock, in addition to other important factors, has given the country time to seek a more structural adjustment of its fiscal accounts. We consider as an upside risk to our scenario the approval of reforms with a significant fiscal impact, reducing the idiosyncratic risk and potentially boosting GDP. A partial reduction in tax exemptions (currently around 4% of GDP) could improve the level of revenue and shorten fiscal consolidation by at least two years, according to our projections. Additionally, we think the most lasting likely effect of a terms-of-trade shock is structurally raising revenue. Finally, we believe a high level of fiscal discipline will be important to continue the adjustment on the expenditure side, since approving tougher fiscal measures seems increasingly difficult politically, in our view.

We still believe that the long-term debt trajectory is in a borderline situation, since any additional shock that raises the neutral interest rate or reduces potential GDP growth could derail the expected debt convergence. Furthermore, it is likely that advanced economies will begin to remove stimuli (both fiscal and monetary) once they have observed a consistent recovery from the pandemic. In this scenario, the commodity boom could decelerate, as we have shown, which could reduce government revenue and also possibly affect the cost of rolling over debt.

Finally, it is important to highlight that the economic recovery from the pandemic is likely to be heterogeneous. On the one hand, the inflationary shock improved revenue recovery, yet on the other hand, we think it may increase the pressure for more spending (especially for social programs), in a context of more inflation and more inequality. In our opinion, the softening of the current cycle, to a lesser extent, may have an effect similar to that of the post-commodity super-cycle (from 2013 onward), when revenue growth led to an increase in permanent and in revenue-linked expenses, reinforced inflation inertia, and increased fiscal fragility.

In other words, we believe it is essential that Brazil remains committed to seeking structural reforms and maintaining the fiscal discipline to curb the pressure for an increase in mandatory outlays, especially considering the impact of this positive shock on revenues due to inflation and terms of trade.

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