Brazil Macro | September 2023

FISCAL POLICY

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Brief Overview

All Eyes on Revenue Performance Ahead

1

Fiscal Consolidation: All Eyes on Revenue Performance Ahead

- In this “Scenario Review”, we marginally changed our fiscal forecasts, making only small updates to our debt estimate, based on higher GDP growth for this year. We were considering a positive bias for our primary balance forecast for 2023 (-1.0% of GDP), but the recent decline in federal tax collection has led us to keep our forecasts, in the context of the unimpressive results of the measures already adopted by the government.
- For 2024, we see negative risks for our projection due to the recent tax collection data and uncertainty about the real impact of the measures to raise revenue. In addition, on August 31, the new fiscal framework was enacted, and we continue to see challenges for its full implementation, meaning no significant change to our scenario.
- As for the debt trajectory, while we are lowering our expectation for the gross debt by 0.5 pp to 76.5% of GDP, as we fine tune our forecasts with the team’s new projections for GDP growth for 2023 and a slightly higher GDP deflator estimate for 2023 (3.5% vs. 3.0%), which was an adjustment after the release of the 2Q23 GDP numbers.
- We continue to see rising government debt for the medium term. That implies a difficult path for debt stabilization ahead.

Fiscal Policy – Revenue Measures in the Spotlight

Short Term: All-eyes in Revenues

2023 Primary Res.: No Change | End of Positive Bias
-BRL100 bn (-1.0% GDP)
Central Gov.: -BRL115 bn (-1.1% GDP)
Regional Gov.: +BRL15 bn (0.1% GDP)

Revenues: Timid result of the Measures (So Far)
Only 20% of the package presented in 1H23
Cyclical downturn continue to push down
Federal Tax Collection -0.4% YoY in YTD up to July

2024 Budget: Latent Fiscal Risks
BRL169 billion to close the Budget Gap (60% CARF)
(+) Pressure in outlays (No wage increase, Electoral Fund, Pension outlays underestimated)
Chances of altering the Primary target (4Q23-2Q24)

New Fiscal Framework - no impact to our scenario
Approved. We see challenges to its full implementation. Could maintain outlays at ~19% of GDP

Medium Term: Risks Remain High

Risks: Additional Fiscal + Quasi-Fiscal Stimulus
List of breach to rise the fiscal stimulus
We expect a gradual and limited quasi-stimulus

Judicial Claims stock – Still a problem
We see ~BRL80 bn unpaid by 2023 (not in Fiscal statistics)

Higher Nominal Deficit (Selic)
Nominal Deficit : above 8.0% of GDP ahead
Interest payments is pressuring at the margin

Fiscal adjustment: above 2.0% of GDP
In a context of elevated pressure for social spending and natural difficulties to raise taxes

Debt-path: on the edge for convergence
~91% of GDP in 2040. Sensitivity with macro structural variables (such as Potential GDP, Neutral Rates, Deflator)

Risks for debt convergence
Long-term: Neutral interest rate above 5.0%, Potential GDP below 1.5%. Total Expenditures above 19% of GDP

Fiscal Policy - Looking for 2024: Will the Revenue Measures Being Effective?

- In the short-term we see evenly balanced risks for the primary result. We see positive and negative aspects affecting the revenues.
- Positive Effect: Gov. Measures + Activity Resilience in 1Q23 + Rise in Oil production. Negative: Commodity prices + Cyclical effect

Central Gov. Primary Result

BRL billion	2023 3rd Budget Review (a)	% GDP	PLOA 2024 (b)	% GDP	Santander 2024 (c)	% GDP	Δ (a) - (b)	Δ (c) - (b)
Total Revenue	**2,366**	**22.1%**	**2,709**	**23.7%**	**2,539**	**23.0%**	**-343**	**-170**
Collected by the Brazilian IRS	1,474	13.8%	1,759	15.4%	1,578	14.3%	-284	-181
Net Social Security Revenues	584	5.5%	632	5.5%	622	5.6%	-48	-10
Not Collected by the IRS	308	2.9%	318	2.8%	340	3.1%	-10	22
Transfers by Revenue Sharing	457	4.3%	518	4.5%	476	4.3%	-61	-42
Net Revenue	**1,909**	**17.8%**	**2,191**	**19.2%**	**2,063**	**18.7%**	**-282**	**-128**
Total Expenditure	**2,055**	**19.2%**	**2,188**	**19.1%**	**2,163**	**19.6%**	**-134**	**-25**
Social Security Benefits	867	8.1%	914	8.0%	934	8.5%	-47	20
Payroll - Public Servants	362	3.4%	380	3.3%	382	3.5%	-18	2
Other Mandatory Expenses	301	2.8%	362	3.2%	323	2.9%	-61	-38
Mandatory with Cash Control	330	3.1%	358	3.1%	347	3.1%	-28	-11
Discretionary Expenses	194	1.8%	174	1.5%	177	1.6%	20	2
Central Gov. Budget Gap	-145.3	-1.4%	2.84	0.0%	-100.2	-0.9%	-148	-103
Nominal GDP	10,715		11,420		11,049			

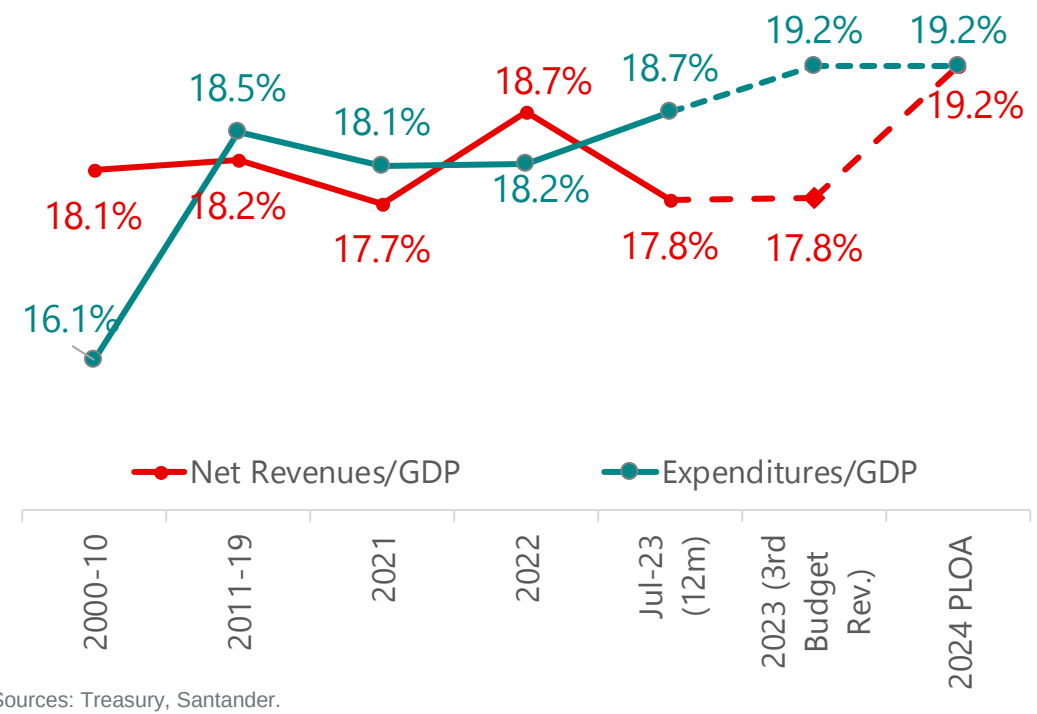
Sources: Finance Ministry, Santander.

Macro Parameters - Gov. Estimate		2024	
	2023	Budget Guidelines (PLDO)	Budget Proposal (PLOA)
Real GDP (%)	2.54	2.3	2.3
Nominal GDP (BRL bn)	10,715	11,502	11,420
Oil Prices (Brent)	78.17	78.06	73.9
Min. Wage (BRL)	1,320	1,389	1,421

Fiscal Policy - The size of the Challenge for 2024

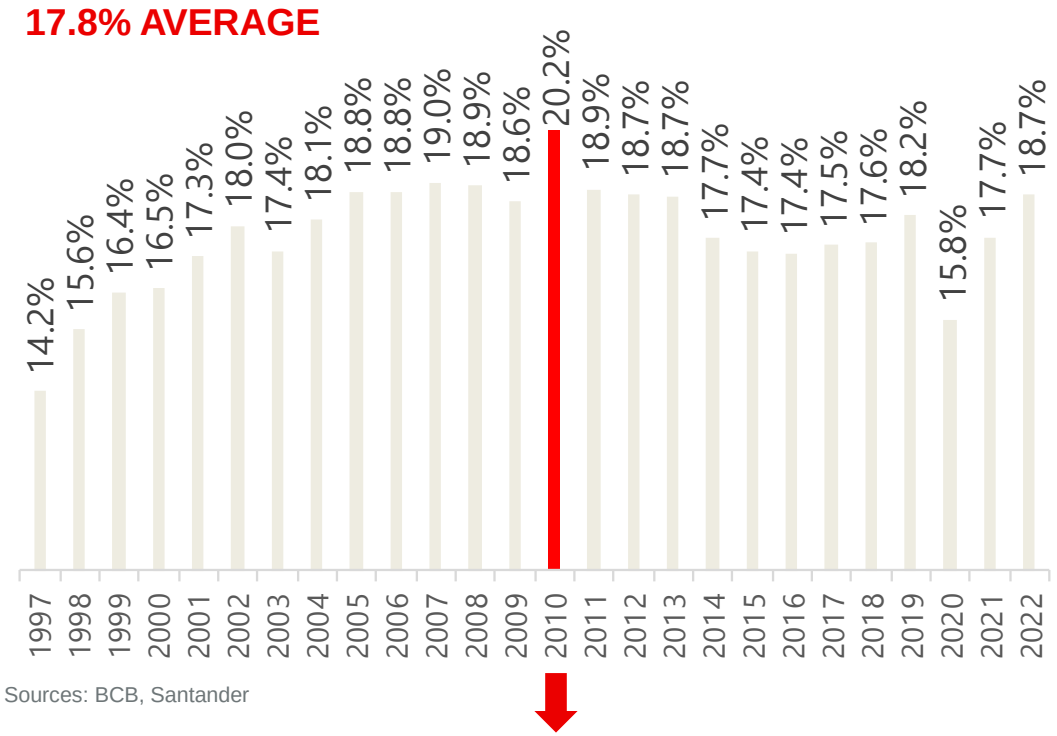
- On August 31, the government also unveiled the 2024 Budget proposal (PLOA), considering the **expenditure limit rising by BRL129 billion and BRL169 billion (1.5% of GDP) in revenues measures to close the budget gap.** We still see challenges in achieving such a large increase in revenues before the budget approval, especially considering the recent cyclical drop.

Gov. Estimates - % GDP



Sources: Treasury, Santander.

Historical Net Revenues - % GDP



Sources: BCB, Santander

The measures to increase revenues are on Tax Breaks and Tax Basis Incentives

Measures BRL bn	Gov. Estimate	In our Scenario	Status
Restrictions in ICMS tax benfits	35	8	MP 1,185 - could face some resistance in Congress. Affects IRPJ, CSLL, PIS/Cofins - Income tax is half shared with subnational entities
CARF/Litigation	97.9	15	Proposed Law 2,394/23 - To be Enacted by the President
Offshore taxation	7	5	Proposed Law 4,173/23 - Under Debate in Lower House
End of IoE (JCP)	10	-	Proposed Law 4,258 - Probably will debated in 4Q23 or 2024
"Exclusive Funds" taxation	13	10	Provisional Measure (MP) 1,184/23
Lottery	0.9	0.9	Proposed Law 3,626/23
Others	4.7	3.1	-
Total Proposed for 2024 Budget	**168.5**	**42**	
Transfer Pricing	23	15	Approved - Law 14.596/23
Tax on sporting bets	15	3	Provisional Measure 1,182/23
Total of Measures	**206.5**	**60**	
PIS/Cofins tax base (no use ICMS Credits)	30	20	Still low, could start rising in next months
Resume of Fuel Taxation (PIS/Cofins)	30	26	Provisional Measures 1,175/23 and 1,178/23
Other Measures Included before	**60**	**46**	

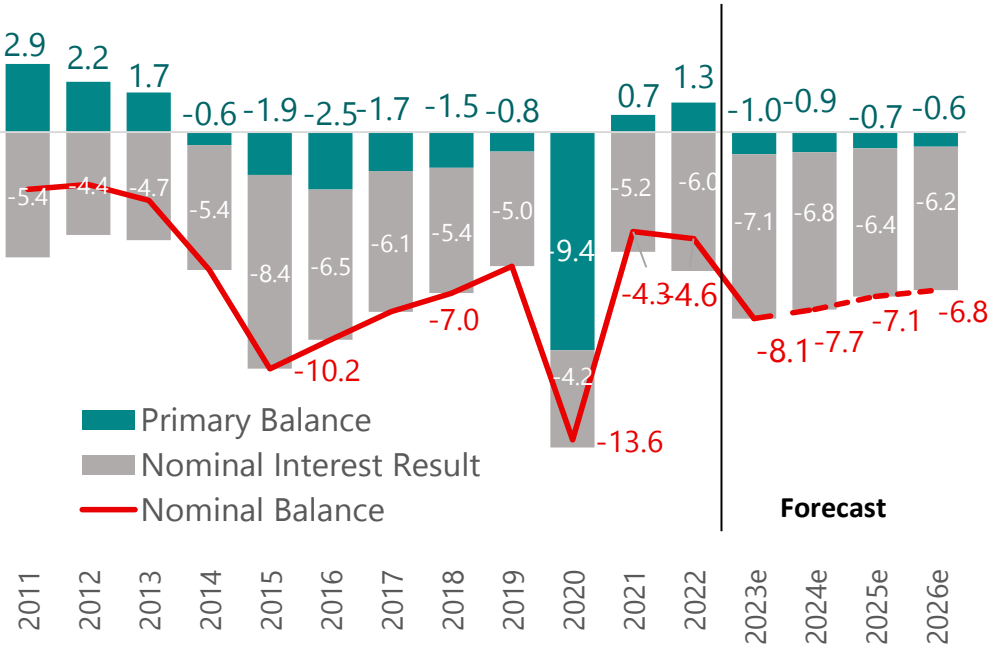
Sources: Finance Ministry, Broadcast, Santander.

Other Measures in the Radar	Gov.	Our estimate	Status
Tax on Dividends (15%)	-	30-35	Should be followed by a reduction in IRPJ (34%). Net Impact will be lower
Legalization of gambling ("Jogos de Azar")	40	35	Could take some time to collect new revenues
Eletronic Games legal framework	12	7	Need to be approved
One-off Oil SOE company - CARF	30	?	?
Total	**82**	**-**	

Fiscal Policy - A higher interest burden to weigh on the debt dynamics

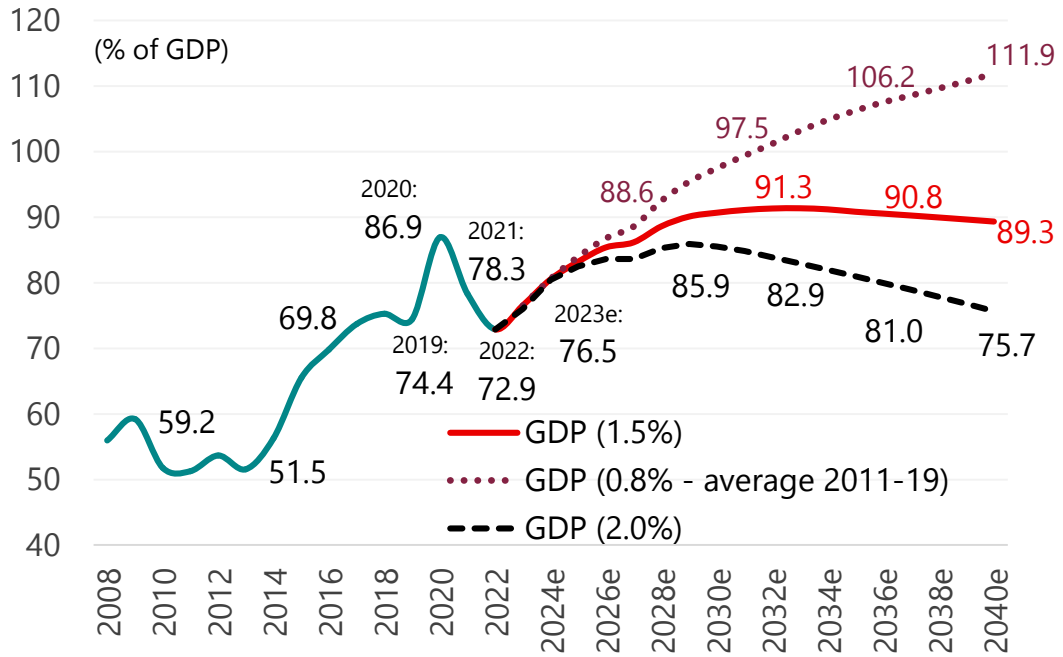
- Interest payments should continue to rise with the nominal result showing strong deterioration, remaining close to 8.0% of GDP in the coming years.
- We simulated scenarios for the debt trajectory: the main debate will be on the structural macroeconomic variables (GDP, Neutral Interest Rate and GDP Deflator).

Public Sector's Financing Needs (% GDP)



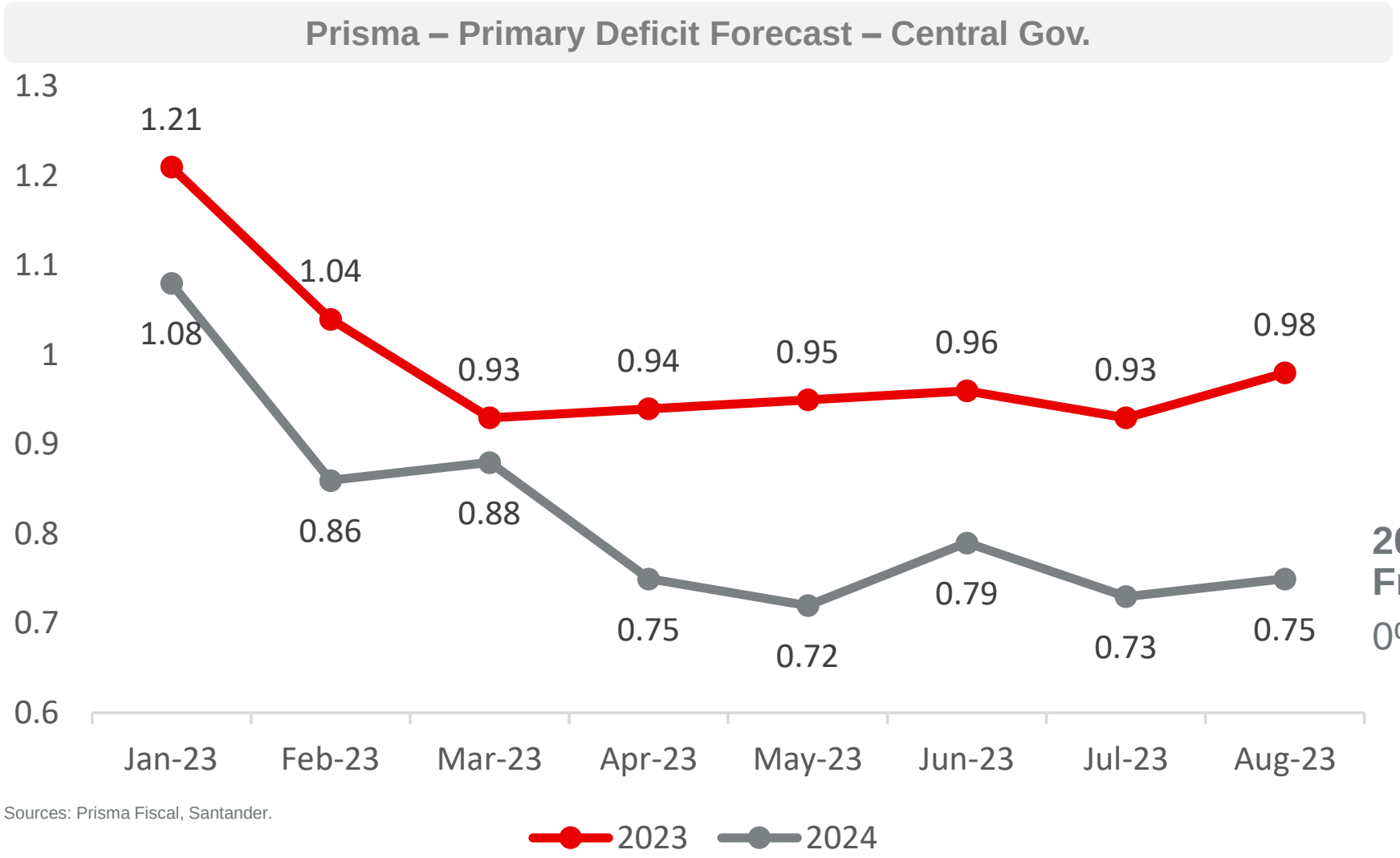
Sources: BCB, Santander.

Scenarios - Gross Debt Scenario (% GDP)



Sources: BCB, Santander

Market Forecasts – Lower estimates for 2024, yet not complying to the target band



2024 New Fiscal Framework Target:

0% +/- 0.25 pp

Sources: Prisma Fiscal, Santander.

Fiscal Background

Calendar, Reforms and Macro Hypothesis

2

Macro Events

June

29
CMN – Setting 2026 Inflation Target
Maintained at 3.0%
End: Calendar-year target

30
TSE Judgment –
Bolsonaro lost his political rights

July

4
Senate – BCB Directors
Gabriel Galípolo for BCB Mon Pol. Director

5-7
Broad Tax Reform (VAT)
Approved in Lower House
Two rounds (>370 votes)

22
3rd 2023 Budget Review
Deficit revised to -1.4% of GDP

August

2
Copom Meeting
13.25% | -50bps

31
Final approval of Fiscal Framework

2024 Budget Proposal
BRL169 bn in revenues to close the Budget Gap

September...

1
2Q23 GDP release
0.9% QoQ | +3.4% YoY

20
Copom Meeting
(e) 12.75% | -50bps

22
4th 2023 Budget Review
Will the primary estimate improve?

...

25-30
Lula's Hip replacement surgery

25-30
Desenrola- 2nd and most important phase of the program, aimed at those with an income of two minimum (R$ 2,640). BRL7 bn in Treasury guarantee.

October

11
IPCA September
Base effect: YoY >5%

17-19
IMF – World Economic Outlook

?
STF – Weber`s Retirement
Lula will indicate a new name to the Court

Conab 23/24 Harvest Estimate

November

1
Copom Meeting
(e) 12.25% | -50bps

9
IBGE 2024 Harvest Estimate

22
5th 2023 Budget Review

4Q23
Senate could approve the Broad tax reform

2H23
2022 Census Data

December?
Approval of 2024 Budget

December

5
3Q23 GDP release
-0.3% QoQ | +1.7% YoY
Expected series revision

13
Copom Meeting
(e) 11.75% | -50bps

22
Treasury Report – Debt Forecasts

20...
Year-end Recess Congress and Judiciary

31
End of two BCB directors' mandates
Mauricio Moura
Fernanda Guardado

Additional Revenue Measures
Could be announced to comply to the new fiscal framework

January 24

25-31
2023 Official fiscal numbers

31
Copom Meeting
(e) 11.25% | -50bps

February 24

1
End of Congressional YE Recess

Sources: BCB, STF, National Treasury, BCB, Santander

National Congress – Current New Legislation in Debate

Proposal	Summary	Status
New Fiscal Framework (PLP 93)	**The administration must approved a proposal to replace the constitutional spending cap for 2024**	**Sanctioned with two Presidential vetoes***
VAT reform (PEC 45/2019, PEC 110/2019)	**Unifies federal, state, and city taxes, changing collection from production to consumption. The reform will feature an extended transition period and temporarily compensate subnational governments for revenue losses to give companies, states, and cities time to adapt to the new model.**	**Approved in Lower House. To be approved in Senate during 4Q23**
Income tax reform	Expected to be proposed by the Lula administration in the second half of 2023, it updates income tax brackets, reducing taxation on low-income individuals . It will also modify corporate taxes, imposing dividends taxes while lowering corporate profits tariffs.	Awaits submission to Congress
Taxation of offshore income (MP 1171)	Raises the exemption threshold of personal income tax (IRPF) and rise the tax on wealthiest	Awaits dispatch from the lower houser speaker
Update on income tax rules (MP 1172)	Sets the new minimum wage for 2023, increases the exemption threshold to workers who earn up to twice the minimum wage and modifies taxes levied on Brazilian investments held abroad to meet OECD standards.	Awaits a lower house floor deliberation
Taxation of exclusive funds (MP 1184)	Mandates periodic taxation of 15%-20% of earnings on exclusive funds instead of levying only at redemption.	Awaits submission to Congress
Regulation of court ruling on IRPJ and CSLL exemption on tax benefits (MP 1185)	Regulates a court ruling limiting the use of state tax benefits to reduce the calculation basis of the federal IRPJ and CSLL taxes.	Awaits joint committee
Reduction of tax benefits on interest on net equity (IOE) (PL 4258)	Repeals the provision allowing companies to distribute profits to shareholders, which reduced the calculation base for corporate income tax (IRPF) and the federal contribution CSLL.	Awaits dispatch from the lower house speaker
Carbon Credit Market Framework (PL 412)	Creates the legal framework for the Brazilian Carbon Market, which regulates the purchase and sale of carbon credits.	Awaits a vote on the recommendations from rapporteur Leila Barros in the senate's environmental committee

Sources: Eurasia, Santander

* It will be important to monitor the debate in Congress.

Commodities - Idiosyncratic factors playing out in cooling commodity prices

- We see the continued geopolitical shock from Eastern Europe as a risk that could once again create supply-demand imbalances in some commodities (e.g., grains, fuels, fertilizers). However, we still expect monetary tightening promoted by the main central banks to cause a deceleration in global activity, and fundamentals continue to point to a gradual drop in global materials costs in the coming years, as aggregate supply gradually catches up.
- We still see: (i) record grain output in key producing countries; **(ii) Brent oil prices at USD85/bbl for YE2023 and USD95/bbl for YE2024**; and (iii) fiscal and monetary stimulus from the Chinese government having a short-lived impact on metals prices. As a result, we are maintaining our aggregate commodity index forecast for YE2023 and for YE2024.

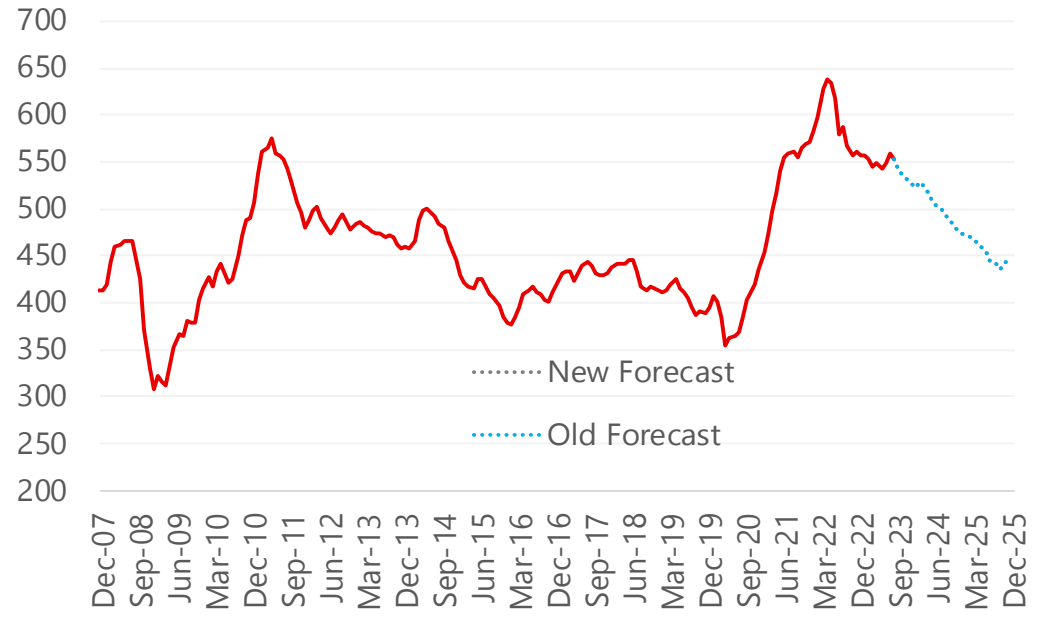
Our Forecasts for CRB Index – End of Period

YE	2021	2022	2023e	2024e	2025e
CRB Food	483	539	453 ➡	395 ➡	371 ➡
CRB Energy	1521	2078	1761 ➡	1724 ➡	1619 ➡
CRB Metal	1259	1010	1113 ➡	977 ➡	918 ➡
CRB	**571**	**558**	**528** ➡	**474** ➡	**445** ➡

YE YoY	2021	2022	2023e	2024e	2025e
CRB Food	36%	12%	-16%	-13%	-6%
CRB Energy	31%	37%	-15%	-2%	-6%
CRB Metal	42%	-20%	10%	-12%	-6%
CRB	**29%**	**-2%**	**-5%**	**-10%**	**-6%**

Sources: Santander.

Our Forecasts for CRB Index – Monthly Averages

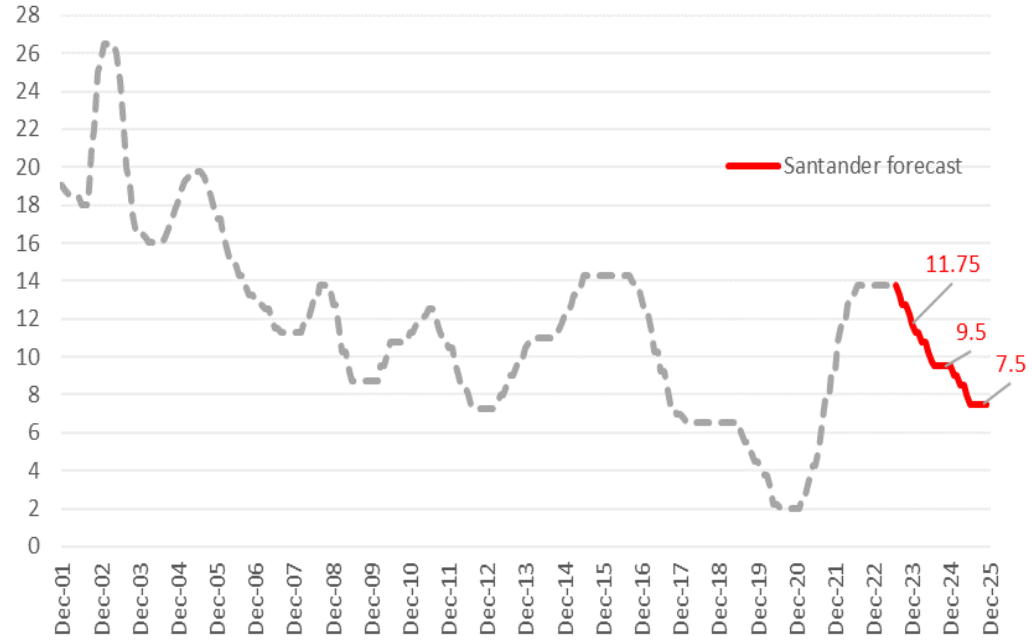


Sources: Bloomberg, Santander.

Macro Background – A reduction in Selic Rate and higher growth for 2023

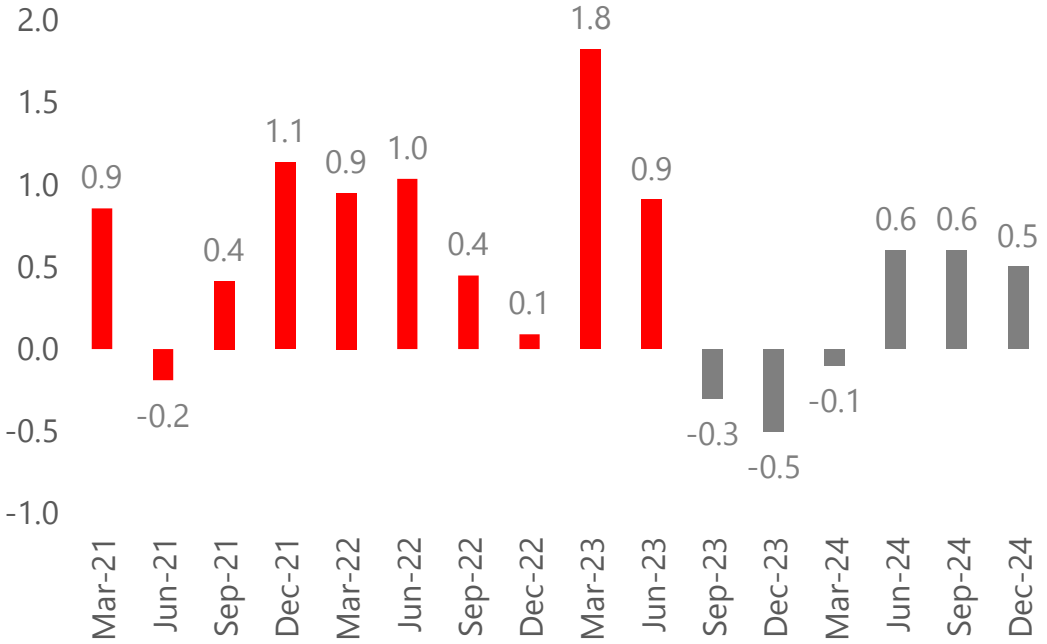
- Better growth forecast in 2023 will help in the Nominal GDP forecast. Yet, we still see a deceleration at the margin.
- The small change for 2024 reflects our perception that the room for a continued easing of monetary policy is limited. In addition to the domestic issues discussed, we believe most central banks worldwide are likely to maintain contractionary monetary policies as well. These points mean that the room for lowering the Selic rate in 2024 is limited, in our view.

Selic Rate (%)



Sources: Brazilian Central Bank, Santander.

GDP Growth (% QoQ-sa)

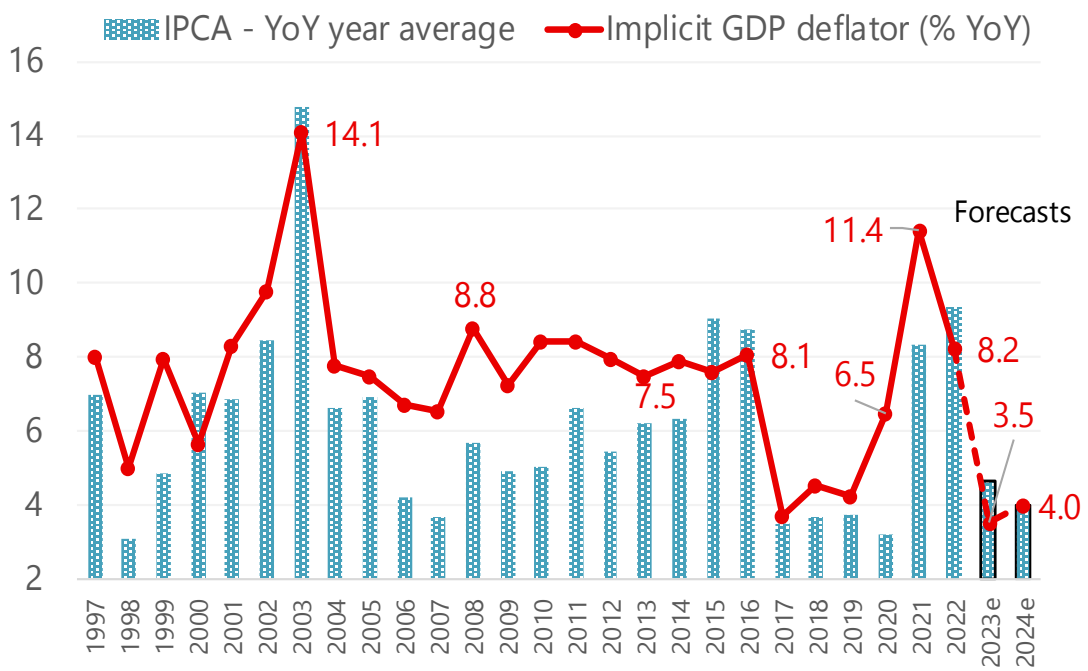


Sources: IBGE, Santander

GDP Deflator Impact – Downward effect in 2023 on lower IGP-M average

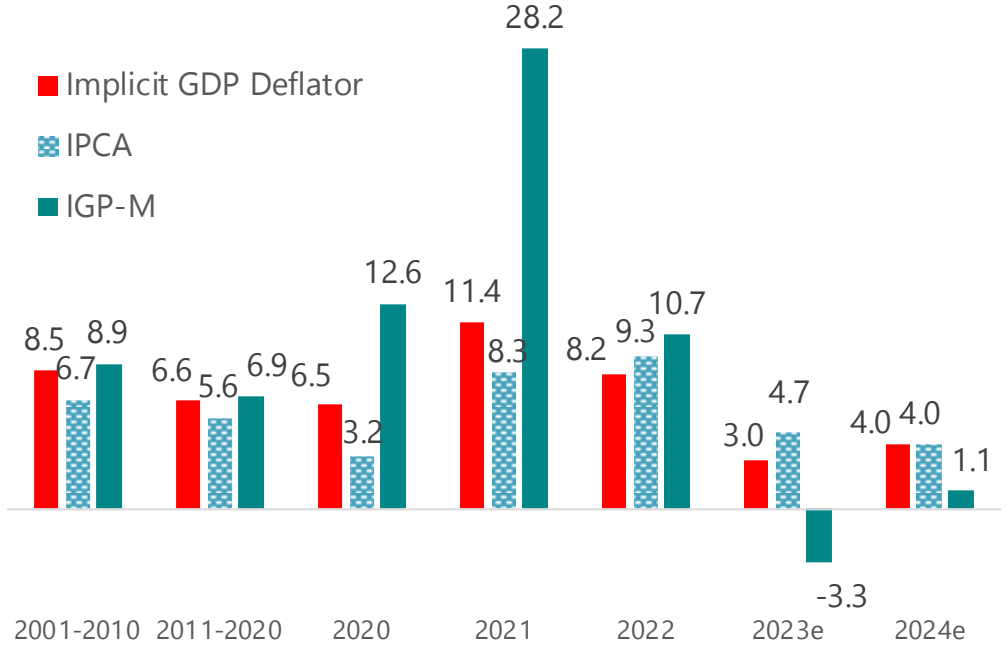
- After helping the increase in Nominal GDP, we estimate that the GDP Deflator will be lower than the IPCA numbers.
- We now estimate a slightly higher GDP deflator estimate for 2023 (3.5% vs. 3.0%), which was an adjustment after the release of the 2Q23 GDP numbers. For 2024, we downward risks for our estimate of 4.0%.

IPCA and GDP Deflator



Sources: IBGE, Santander.

IPCA, IGP-DI and GDP Deflator



Sources: IBGE, FGV, Santander.

New Fiscal Framework

We see challenges to its full implementation

3

Fiscal Policy - New Fiscal Framework Government Proposal Proposal

New Fiscal Framework Guidelines

1. **Primary Balance Target - % GPD** (bands of +/- 0.25pp)
2023: -0.5% | 2024: 0% | 2025: +0.5% | 2026: 1.0%

2. **Commitment** to the target bands up to 2026. Target will be set each year in the Budget Guidelines (LDO). That will be tested next year.

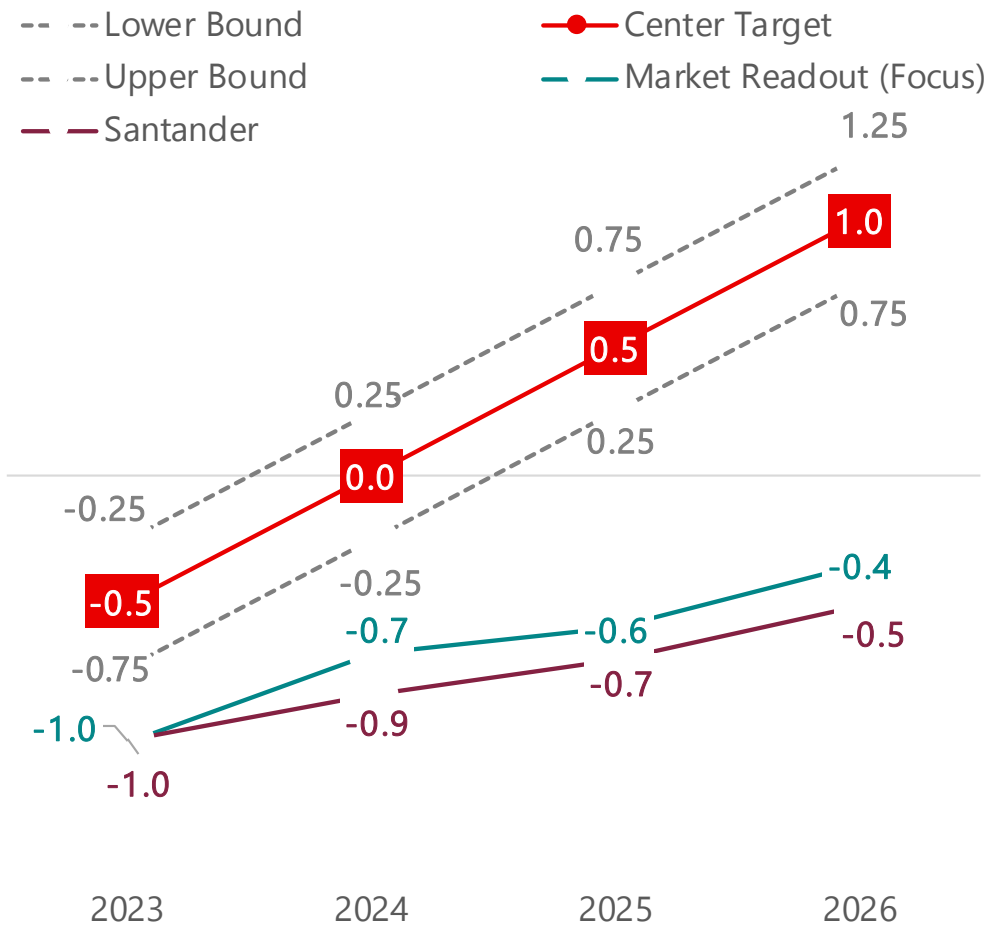
3. **Outlays in the Spending Ceiling Real Limit between:**
Update: IPCA + Real update of [0.6%-2.5%]
FCDF not included into the outlays limit

4. Annual growth within the **expenditure growth range limited to 70% of the adjusted primary revenue** (without SOE Dividends, Concessions and Natural Resources) change in the last 12m

5. Not compliance to the target: a drop in expenditure growth to 50% of revenue growth (t+2)

6. **Investment outlays lower bound – 0.6% of GDP**. Extra-bonus (limited to 0.25% of GDP) of the value above the ceiling of the primary target band

Primary Result - Target and Scenarios % GDP



Sources: Finance Ministry, Santander

New Fiscal Framework - Efficacy Will Depend Largely on Revenue Performance

Main Aspects of the New Framework

Federal tax collection will be a key factor
- Dependency of Macro Parameters
- Cyclical Payback (?) and Commodities Prices

Necessity of increase in Net Revenues

In total revenue this amount could double if we observe a rise in taxes of which part is shared by subnational entities

Dependency of Macro Parameters:

Gov. Parameters: (permanent) increase in federal net revenue of 1.2% of GDP in 2024

Our scenario: it would be necessary for net revenue to increase by 2.3% of GDP in 2024

No increase: deficits of
-1.2% in 2023, -1.8% of GDP in 2024, -1.6% in 2025, -1.3% in 2026

Details and Global Overview

Uncertainty about the details:
- Transition – new lower bound Education and Health
- Court-ordered debt extra-cap payment
- The primary target will be set only in LDO (biding for 1 year)?
- Analysis of the Presidential Vetoes

Some important aspects:
- Pursuit of reaching a primary surplus (Very Important)
- No new exceptions to the spending limit
- Use of past revenues (not using estimates)
- Reducing the size of outlays with a drop in revenues

Challenges:
- Diminish the adjustment by tax increase (outlays are linked)
- Floor for investments (corrected by inflation)
- Gradual drop in expenditures, with necessity to cut discretionary
- Congressional approval of tax burden adjustments
- Less enforcement for the approval of reforms
- Debt Convergency – depending on parameters

Fiscal Policy - Triggers enacted in (t+1) and 50% rise in outlays in (t+2)

Expenditures – Gradual Decline

GDP	Net Revenue	Total Expenditure % YoY		Expenditures (% GDP) - 2023:18.9%	
		50%	70%	50%	70%
0.0%	0.0%	0.6%	0.6%	-0.1%	-0.1%
1.0%	1.0%	0.6%	0.7%	-0.3%	-0.2%
2.0%	2.0%	1.0%	1.4%	-0.4%	-0.3%
2.5%	2.5%	1.3%	1.8%	-0.4%	-0.3%
3.0%	3.0%	1.5%	2.1%	-0.5%	-0.4%
4.0%	4.0%	2.0%	2.5%	-0.6%	-0.5%

Nominal GDP = f(REAL GDP, IPCA + 1.0%)

Sources: Finance Ministry, Santander

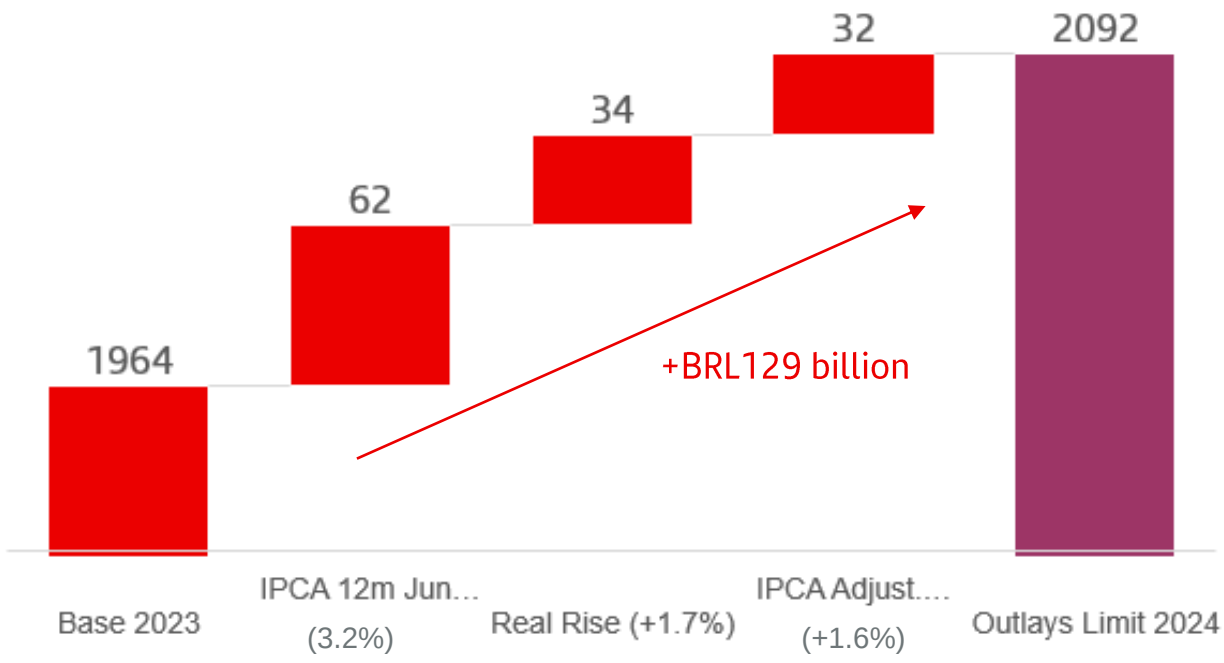
Triggers - Non-compliance with the Primary Target

Failure to meet fiscal goal	Triggers
1st year - not meeting the goal	• The creation of new public jobs that entail expenditure growth, • The restructuring of public careers that entail expenditure growth, • The creation of new assistance programs, • The creation of new mandatory expenditures, • The readjustment of current mandatory expenditures, • The increase of tax benefits.
Two consecutive years	• Government can't increase salaries nor hire new public workers, in addition to previous penalties

Sources: Finance Ministry, Santander

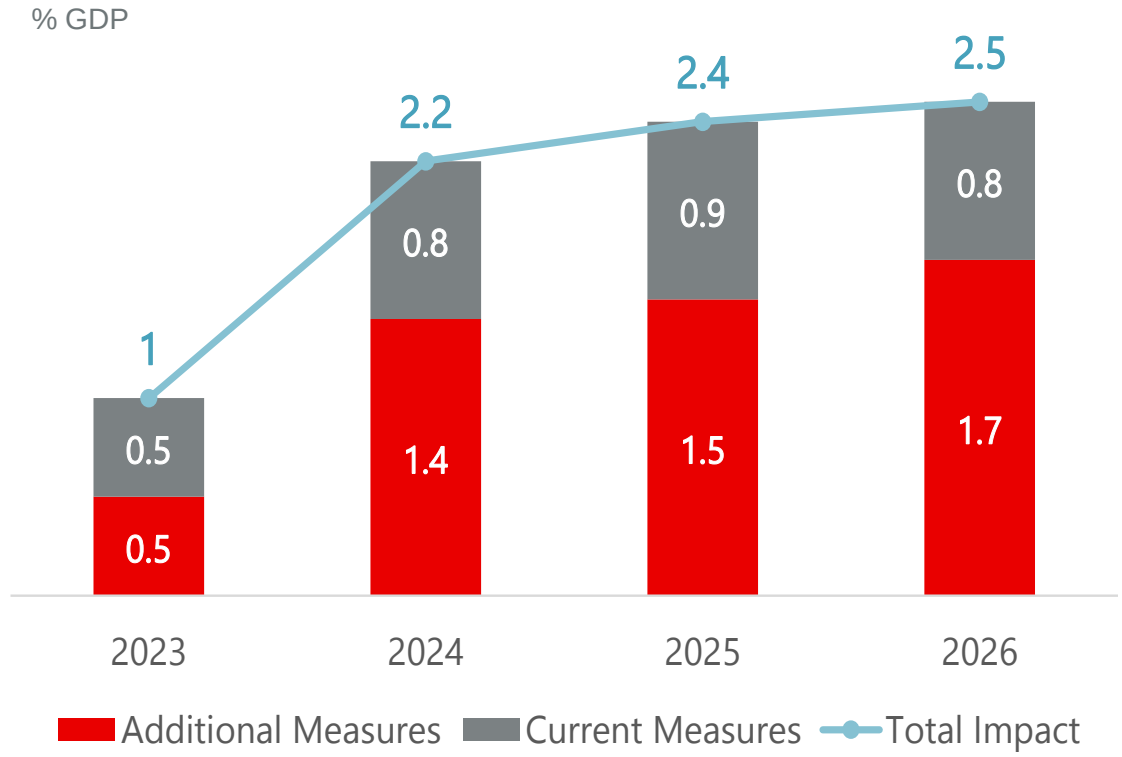
Fiscal Policy - New Fiscal Framework Proposal

Expenditure Limit for 2024 – BRL bn



Sources: National Treasury, Santander.

Net Revenues – Treasury`s estimate to comply to the primary center target

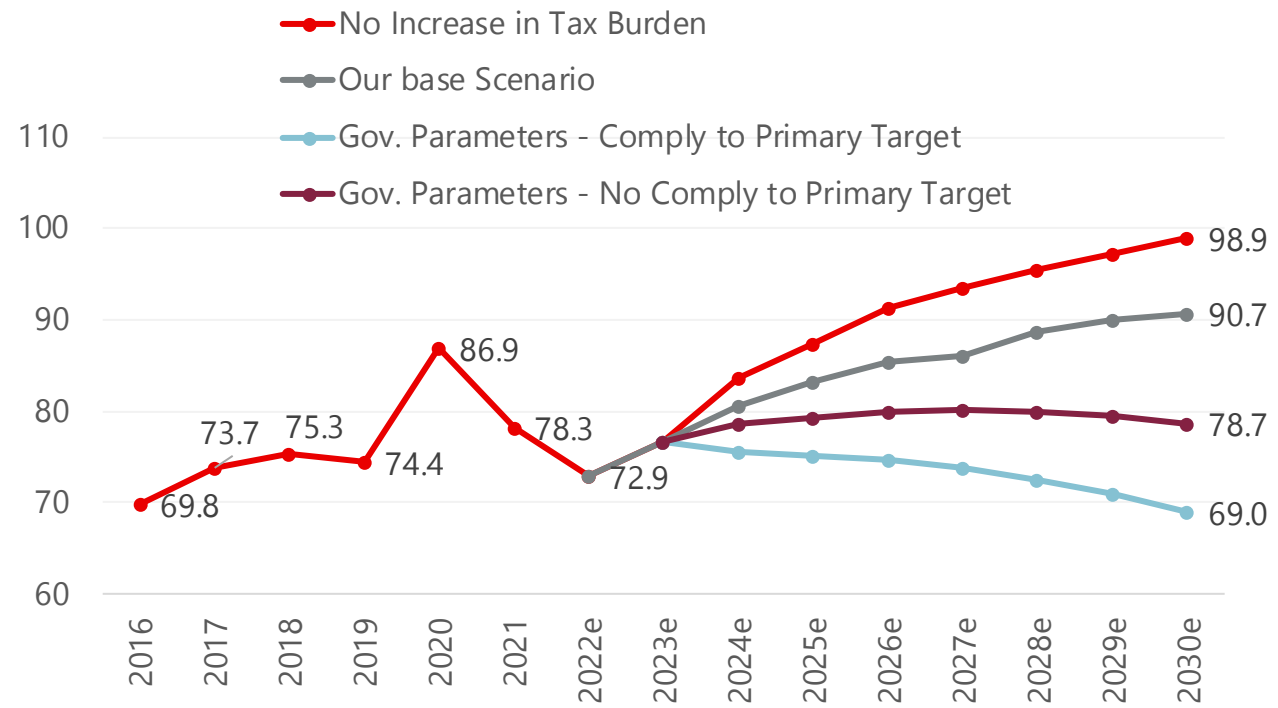


Sources: National Treasury, Santander.

Fiscal Policy - New framework will depend on revenues and short-term results

- The gross debt trajectory depends on the parameters and increase in revenues
- In the short-term, the effect of positive shocks observed in recent year will lose steam

Government Debt Simulation – The new framework will not guarantee the debt stabilization



Sources: BCB, Santander.

Notes: Debt issuances: we added a spread of +1.0 pp in addition to the Selic rate in the models.
2023 GDP Deflator: 3.5% | GDP: 2.5% | Selic Rate (avg): 13.3% | BNDES zero | Voluntary Deposits 1.0% of GDP
2023-40: GDP deflator: 5.0% | Potential GDP: 1.5% | Neutral Selic Rate: 5.0%

Primary Target - Historical Series of Compliance to the Primary Target

Year	Primary Target		Changed Target		Final Result		Deduction Made by Gov.	Observations
	BRL bn	% GDP	BRL bn	% GDP	BRL bn	% GDP	R$	
2001	32.3	2.6%	28.1	2.3%	22.0	1.7%	0.0	The target was met with compensation with the excess primary of federal state companies.
2002	26.4	2.0%	29.2	2.3%	31.9	2.1%	0.0	The primary target was accomplished.
2003	32.0	2.3%	39.1	2.4%	38.7	2.3%	0.0	The primary target was accomplished.
2004	43.3	2.5%	43.3	2.5%	52.4	2.7%	0.0	The primary target was accomplished.
2005	44.5	2.4%	44.5	2.4%	55.7	2.6%	0.0	The primary target was accomplished.
2006	53.0	2.5%	53.0	2.5%	51.4	2.1%	2.8	The target was met with deductions.
2007	56.2	2.4%	53.0	2.1%	59.4	2.2%	5.1	The target was met with deductions.
2008	60.8	2.2%	60.8	2.2%	71.3	2.3%	7.8	The primary target was accomplished.
2009	68.5	2.2%	43.3	1.4%	42.4	1.3%	17.9	The target was met due to the economic crisis of 2008-09. Complied with the deduction.
2010	72.6	2.1%	76.3	2.1%	78.7	2.0%	22.1	The primary target was accomplished.
2011	81.8	2.1%	81.8	2.1%	93.0	2.1%	28.0	The primary target was accomplished.
2012	97.0	2.1%	91.0	2.1%	86.1	1.8%	39.3	The target was met with deductions.
2013	108.1	2.2%	108.1	2.2%	75.3	1.4%	35.1	The target was met with deductions.
2014	116.1	2.1%	116.1	2.1%	-20.5	-0.4%	161.7	The target was met with deductions.
2015	55.3	1.0%	-51.8	-0.9%	-116.7	-1.9%	66.9	The goal was met with compensation from federal state-owned companies and deduction.
2016	24.0	0.4%	-170.5	-2.8%	-159.5	-2.5%	0.0	The primary target was accomplished.
2017	-139.0	-2.0%	-159.0	-2.4%	-118.4	-1.8%	0.0	The primary target was accomplished.
2018	-129.0	-1.8%	-159.0	-2.2%	-116.2	-1.7%	0.0	The primary target was accomplished.
2019	-139.0	-1.8%	-139.0	-1.8%	-88.9	-1.2%	0.0	The primary target was accomplished.
2020	-124.1	-1.6%	-124.1	-1.6%	-745.3	-9.8%	0.0	The target was suspended due to the pandemic.
2021	-247.1	-3.2%	-247.1	-3.2%	-35.9	-0.4%	79.4	The primary target was accomplished.
2022	-170.5	-1.9%	-170.5	-1.9%	54.9	0.6%	40.5	The primary target was accomplished.

Sources: IFI, Santander.

Tax Collection

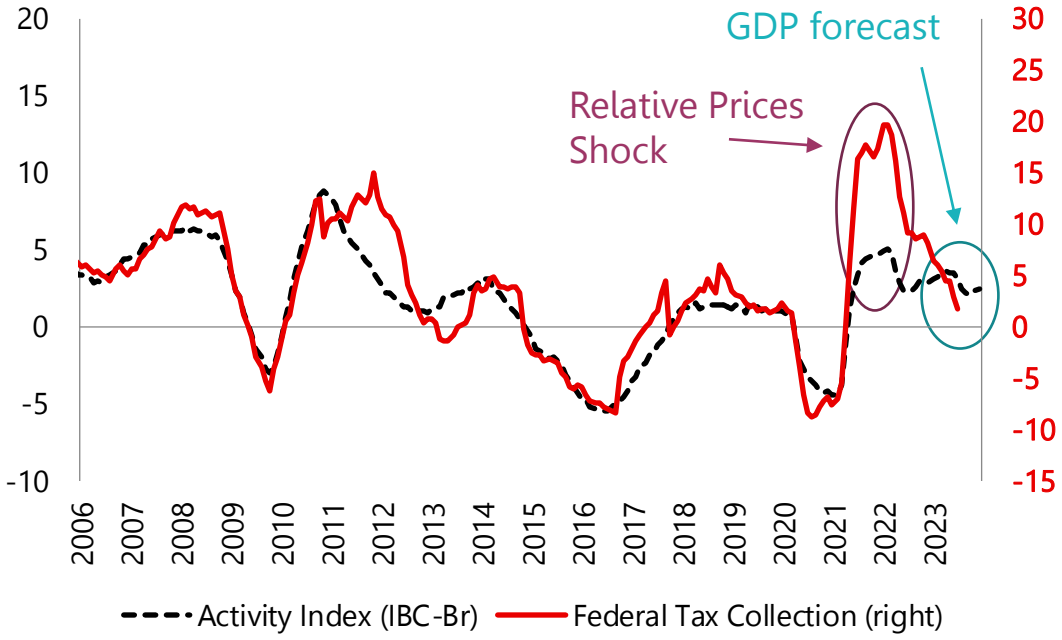
Losing steam with cyclical effects

4

Revenues – Cyclical reduction vs. Gov. Measures and Activity Resilience

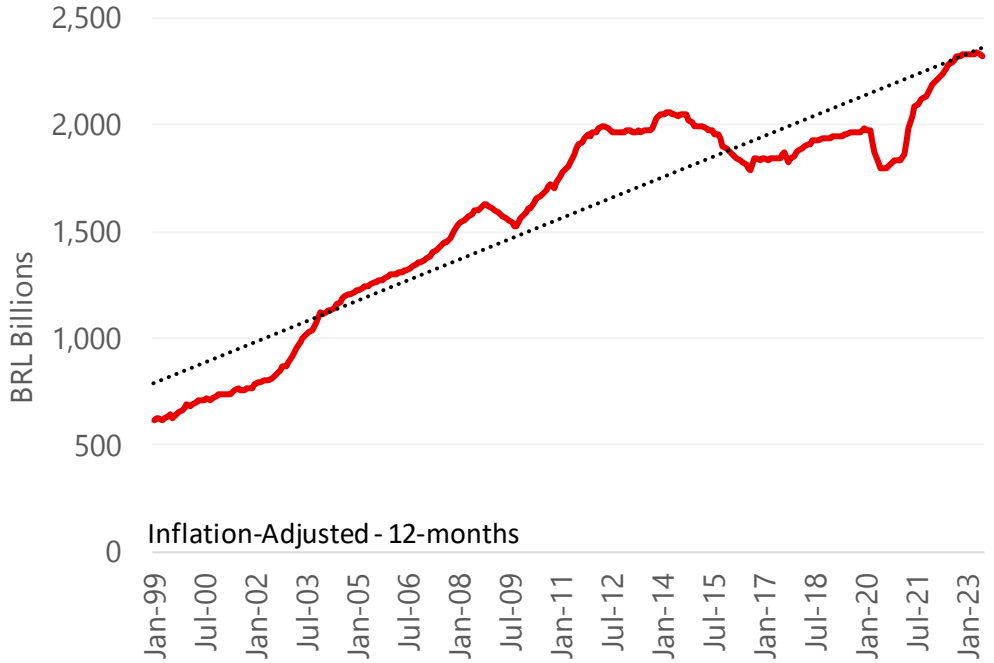
- We expect some softening in the federal tax collection growth ahead with the reduction in domestic activity and lower wholesale prices, the revenue result will be a key-element to the fiscal consolidation ahead, in context of expanding the outlays.

Activity and Tax Collection (12m - % YoY)



Sources: Brazilian IRS, BCB, Santander.

Federal Tax Collection – Recently Flat

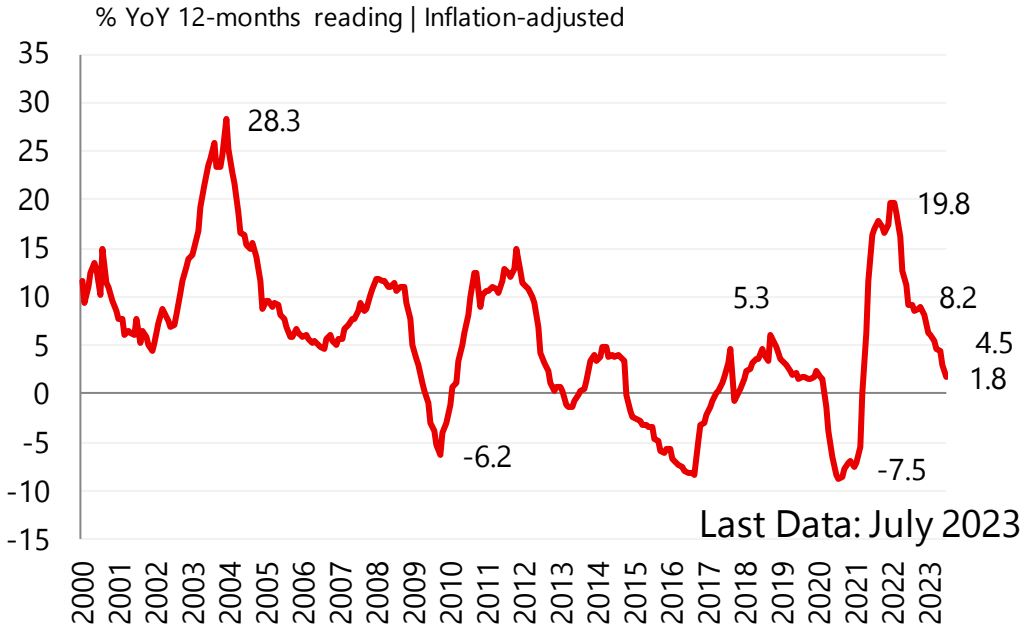


Sources: Brazilian IRS, Santander

Revenues Impact – Price Effect + Activity Recovery

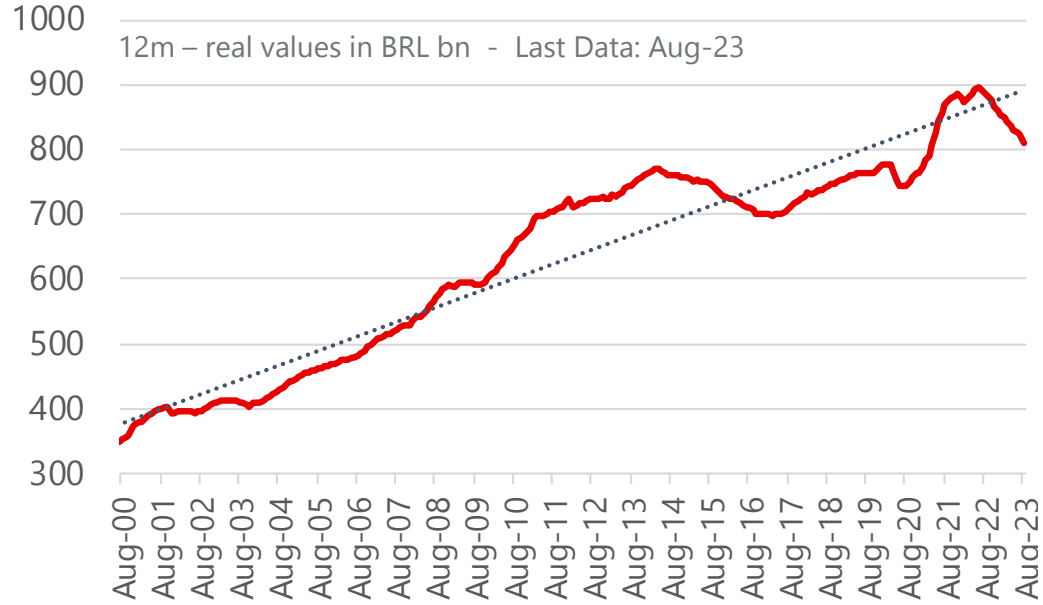
- We see a strong recovery in federal tax collection in recent months, mainly direct taxes linked to the corporate sector, which have posted good results. We can also observe that the increase in tax collection is highly correlated with sectors linked to the commodity boom, especially those related to metals & oil revenues.
- In our view, we expect revenue growth to slowdown ahead, for the following reasons: i) Greater basis for comparison; ii) commodity prices losing steam; iii) normalization of the consumption basket - with more services (lower tax collection); iv) activity at a slower pace of growth.

Federal Tax Revenue – Losing Steam



Sources: Brazilian IRS, Santander.

States – Tax Collection

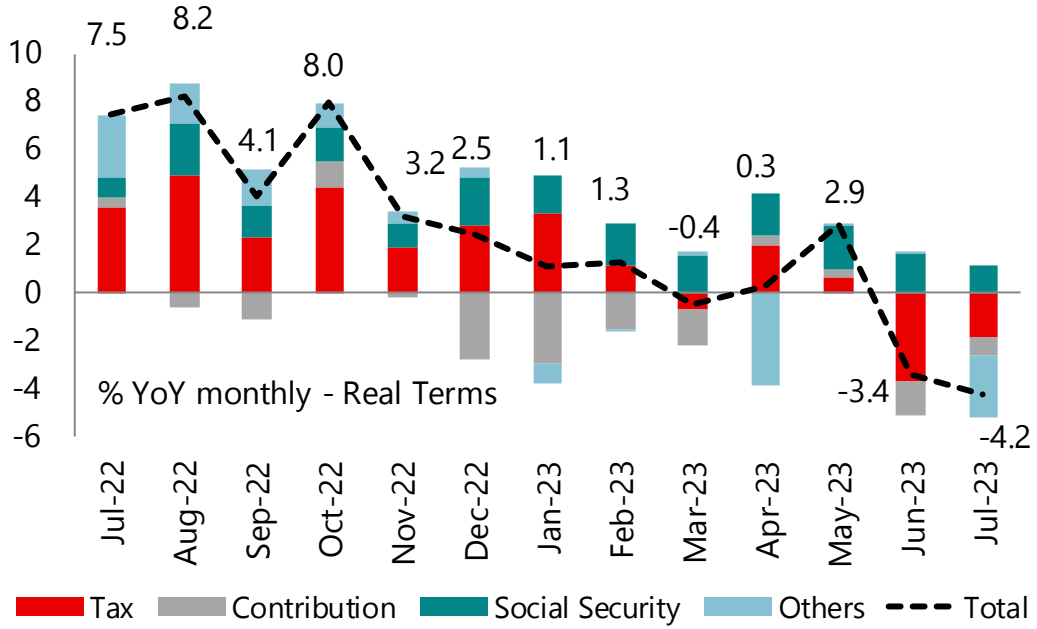


Sources: Confaz, Santander.

Now, federal tax collection is showing signs of losing steam

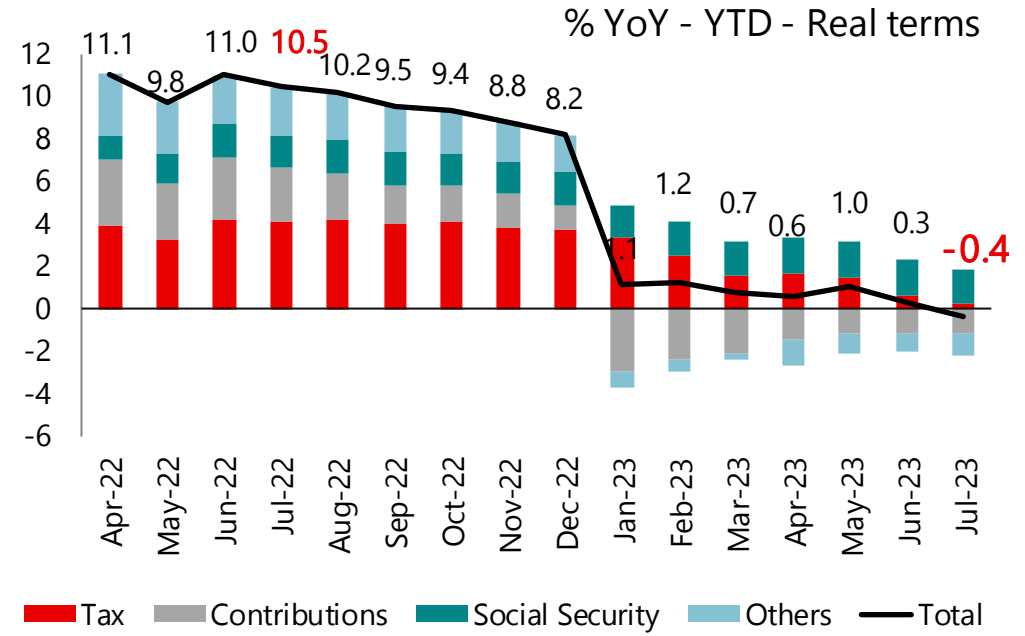
- Last month, the Brazilian IRS unveiled the federal tax collection data for July, which continued to show a *weak performance*, with a second consecutive strong decline in YoY basis. In YTD terms, the tax collection is now in the negative territory: -0.4% YoY in July, from 0.3% in June

Federal Tax Revenue: Monthly (%YoY)



Sources: Brazilian IRS, Santander.

Federal Tax Revenue: YTD (%YoY)

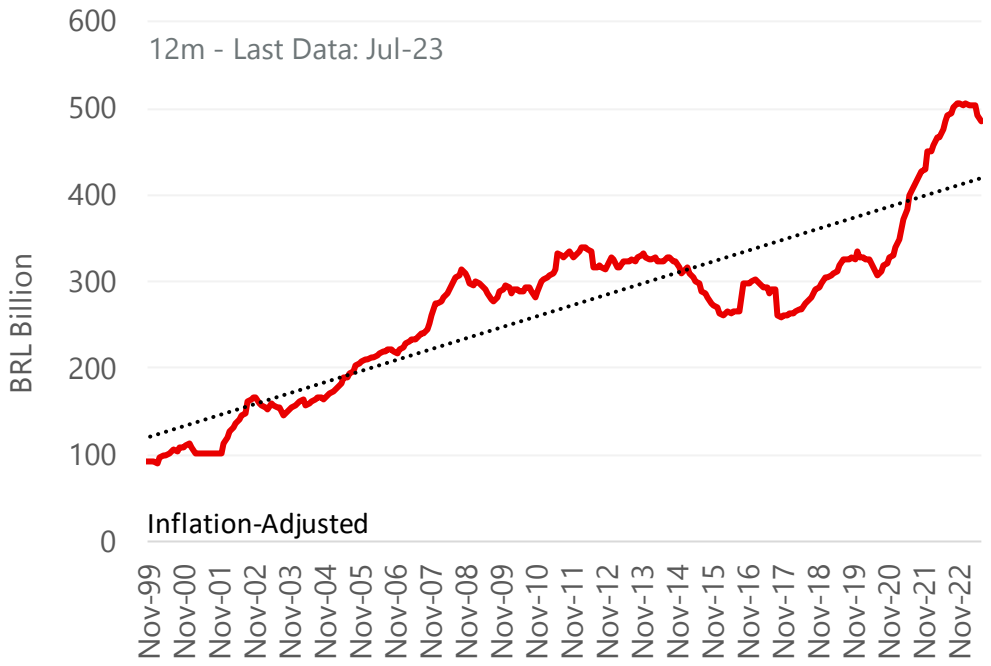


Sources: Brazilian IRS, Santander.

Labor Market - Still resilient and tax revenues presenting a good performance

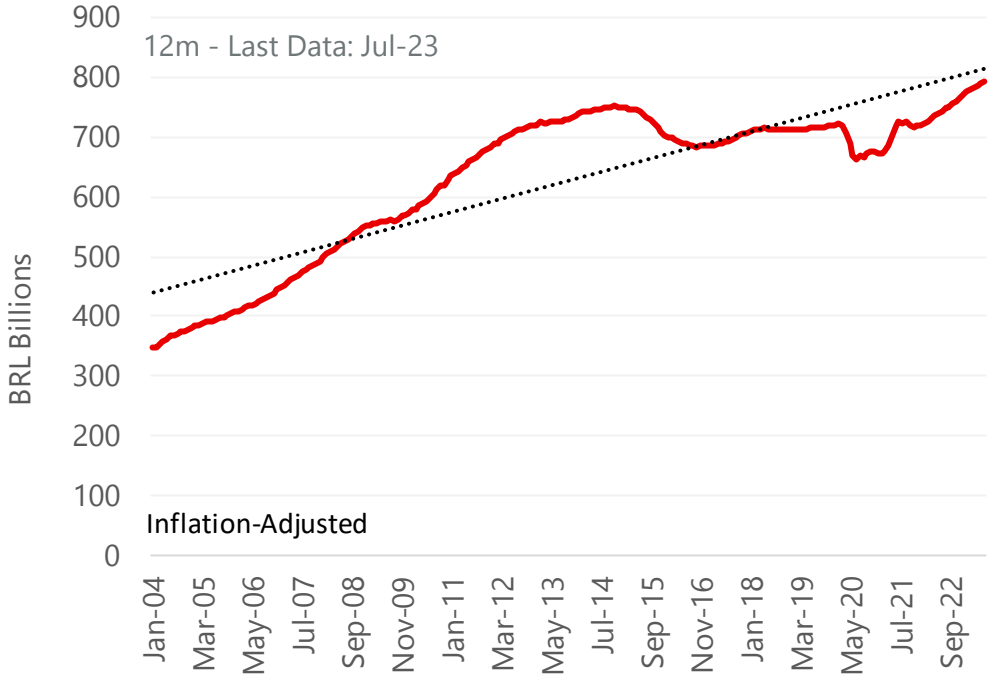
- As expected, we continued to observe a reduction in revenues linked to corporate profits (IRPJ/CSLL); the decrease was 8.2% YoY, removing the BRL4 billion atypical of July 2022. We continue to expect a weak result due to excellent results in 2022, boosted by commodity prices and activity recovery. On the other hand, we still have robust Social Security contributions (+4.7% YoY) with the real wage bill rising, yet with a deceleration at the margin. We expect positive numbers related to the labor market ahead, yet for the year we continue to forecast a slowdown in domestic demand and in cyclical components.

Tax Collection linked to Corporate Profits



Sources: Brazilian IRS, Santander.

Tax Collection linked to Labor Market



Sources: Brazilian IRS, Santander.

Primary Result and Debt

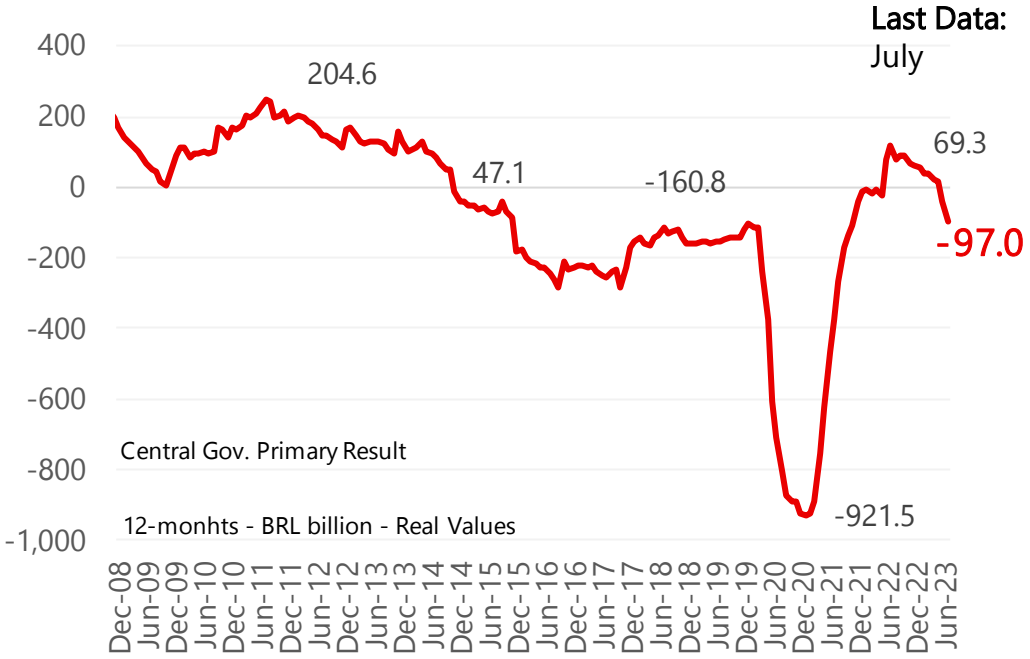
Back to a Primary Deficit in 12-months

5

Central Gov - Return to the Deficit Territory

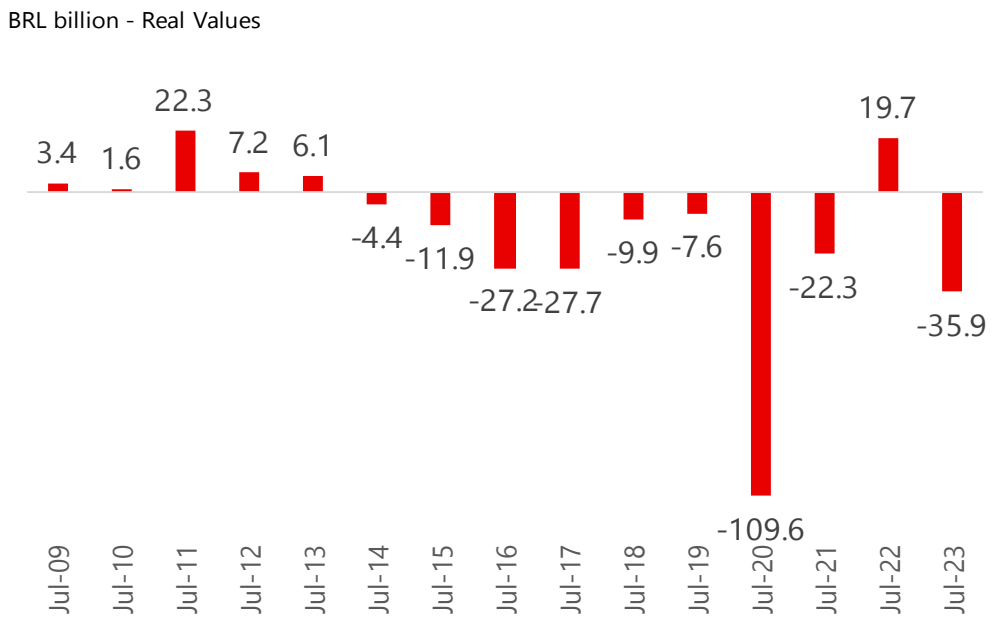
- In 12-month reading, the Central Government registered a *primary deficit* of BRL97 billion (0.95% of GDP), down from a deficit of BRL41.5 billion (0.4% of GDP) registered in June and surplus of +BRL18.2 billion (0.2% of GDP) in May and +BRL56.4 billion (0.5% of GDP) in January. For 2023, our forecast remains at -BRL 115 billion (-1.1% of GDP).

Central Gov. Primary Balance – 12m



Sources: National Treasury, Santander.

Central Gov. Result – BRL bn

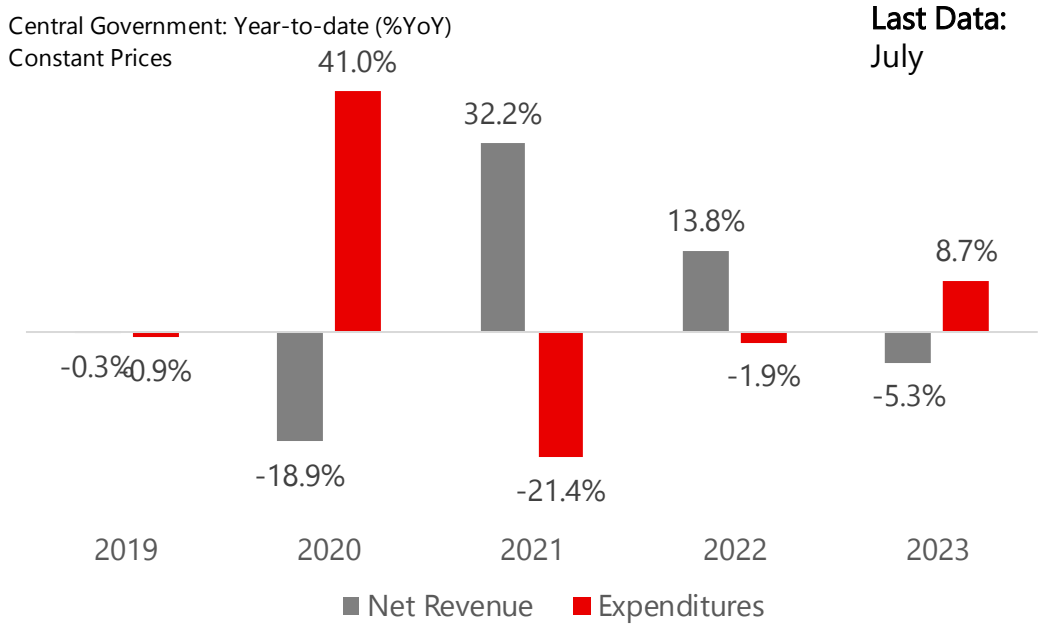


Sources: National Treasury, Santander.

Central Gov - Return to the Deficit Territory

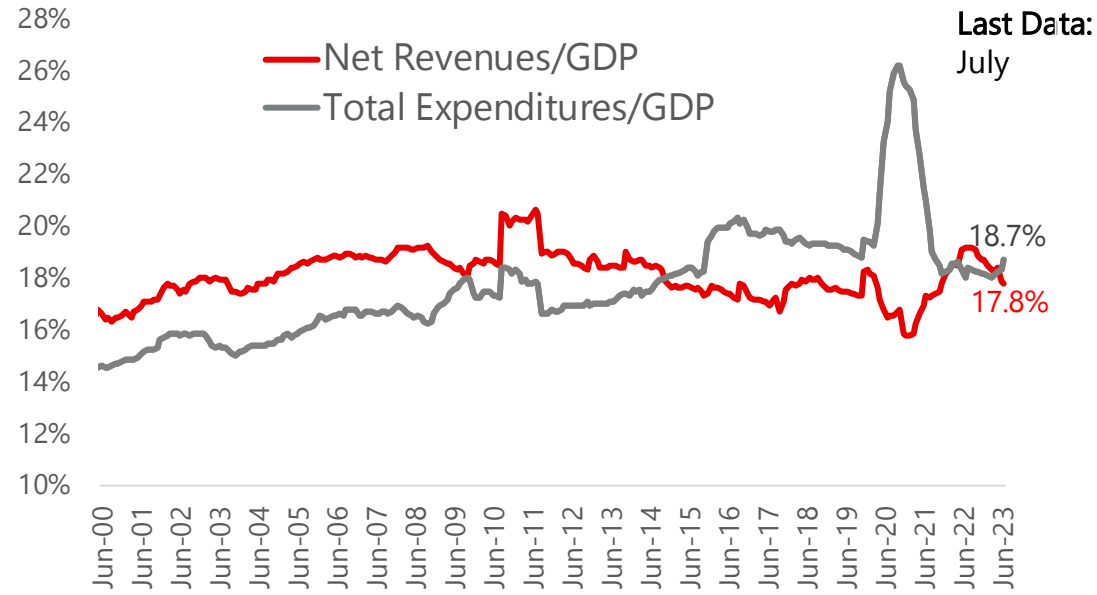
- In YTD data, net revenues had a real drop of -5.3% YoY. The result was affected by the lower level of federal tax collection performance, especially with a reduction in revenues related to commodity prices. On *Expenditure side*, we observed a rise of 8.7% YoY real, pushed by the rise in Mandatory Outlays with cash control (+39% YoY), which is mainly driven by the rise in the welfare program.
- We continue to believe that the monthly result will lose steam ahead with the increase in expenses (already in the pipeline) and with a more modest increase in revenues (some measures starting to being more effective). We believe that the tax collection performance will be a key thermometer for the fiscal result this year, and it is highly correlated to the commodities prices.

Central Gov. Primary Balance



Sources: National Treasury, Santander

Revenue and Expenditures (%GDP)

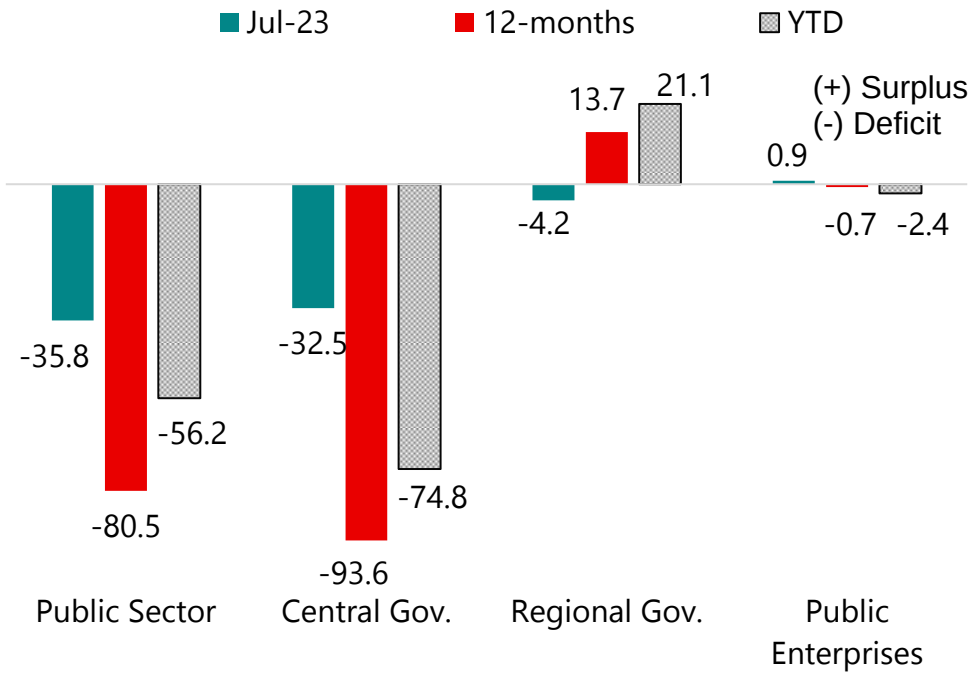


Sources: National Treasury, Santander

Public Sector Primary Result - Back to Negative Territory

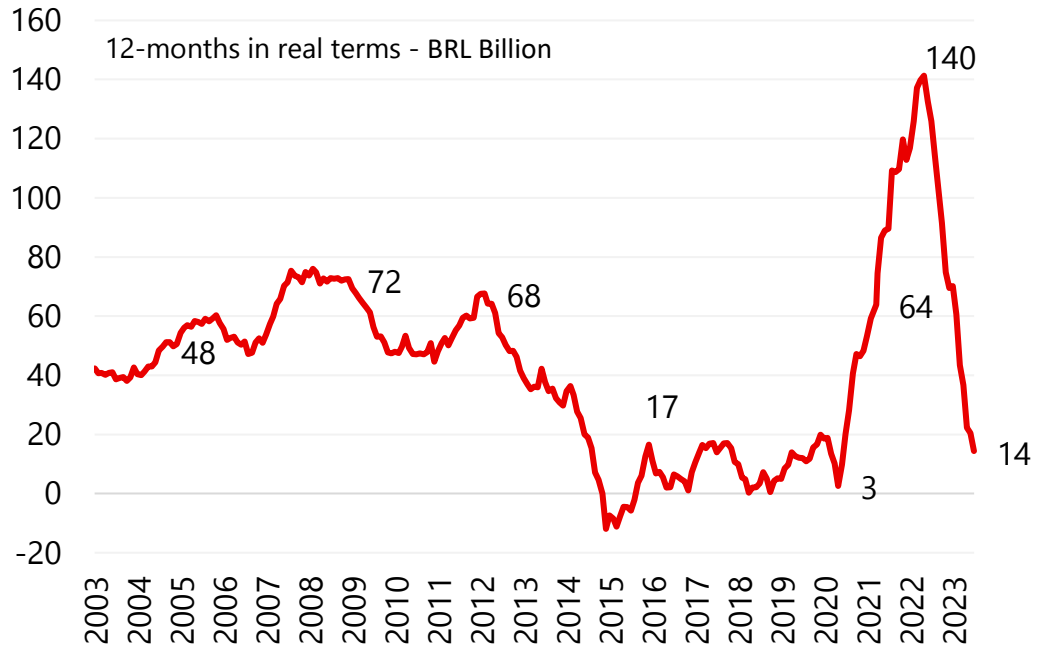
- In the 12-month reading, the public sector's primary deficit fell deeper into the negative territory, reaching a primary deficit of BRL80.5 billion (0.8% of GDP) in July, vs. -BRL24.2 billion (0.4% of GDP) in June, and after peaking at 2.4% of GDP (surplus) in July 2022. Regional governments reached a surplus of BRL13.7 billion (0.1% of GDP), vs. the peak registered in May 2022 (BRL128.7 billion, or 1.4% of GDP). Despite the solid recent performance, we believe that fiscal expansion already in the pipeline (~2.0 p.p. of GDP), in the context of softening commodity prices and real activity, will drive the primary deficit to BRL100 billion, or 1.0% of GDP, by the end of 2023.

Public Sector – Primary Result – BRL bn



Sources: Brazilian Central Bank, Santander.

Regional Gov. – Primary Result

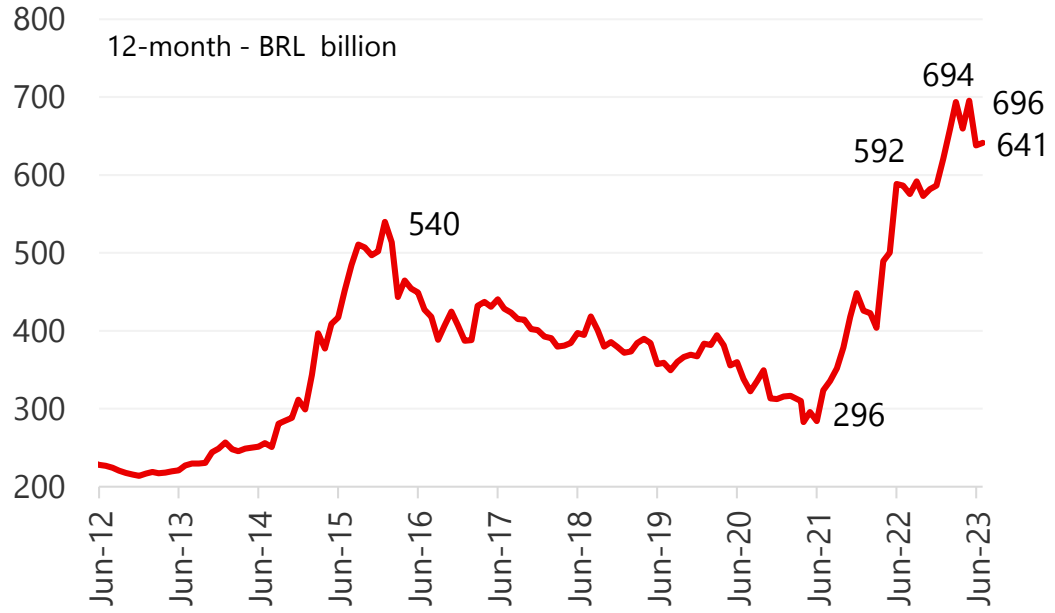


Sources: Brazilian Central Bank, Santander.

Increase in Interest Payments should pressure the debt ahead

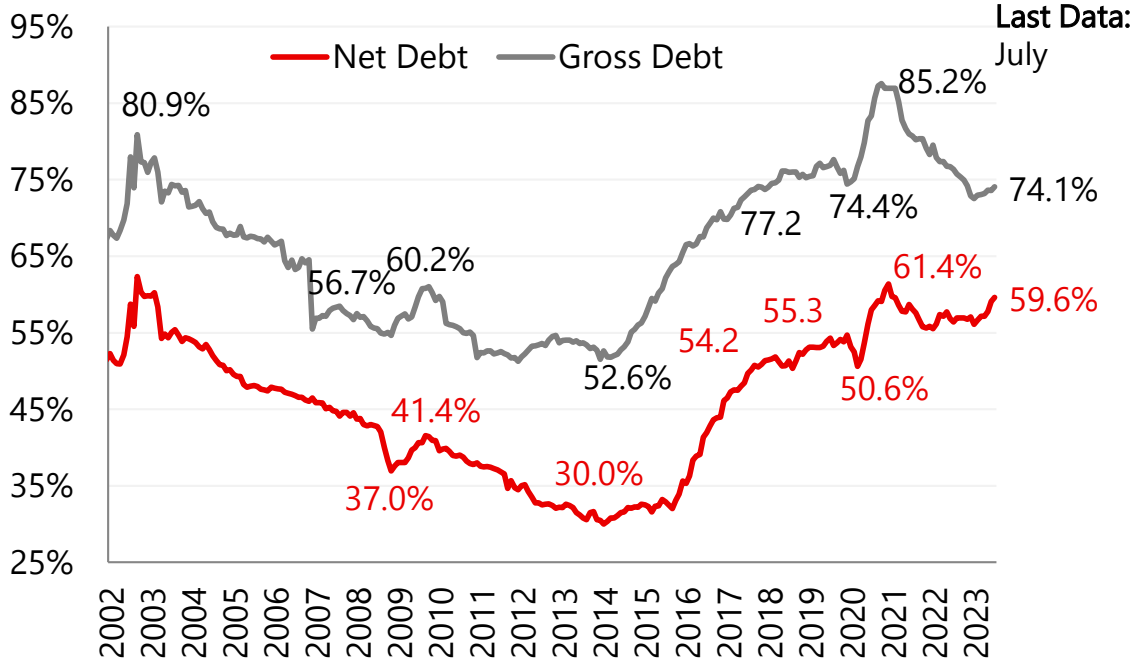
- Interest payments totaled BRL46 billion in July, compared to BRL43 billion in July 2022. In the 12-month reading, the nominal deficit totaled BRL722 billion (7% of GDP), +0.54 p.p. compared to the June 2023 result and up from the BRL460 billion (4.6% of GDP) reported in December 2022. We believe that interest payments will end the year slightly above 8% of GDP.
- In July, debt rose compared to June. Gross debt increased to 74.1% of GDP (+0.5 p.p.). Net debt went up to 59.6% of GDP (+0.6 p.p. in the month), on the heels of interest accrual (+0.4 p.p.) and the primary deficit result (+0.3 p.p.). Voluntary deposits into the Central Bank (not included in debt statistics) declined slightly, to 0.9% of GDP (-0.2 p.p.).

Nominal Interest Result – BRL billion



Sources: Brazilian Central Bank, Santander.

Public Sector Debt (12m % GDP)

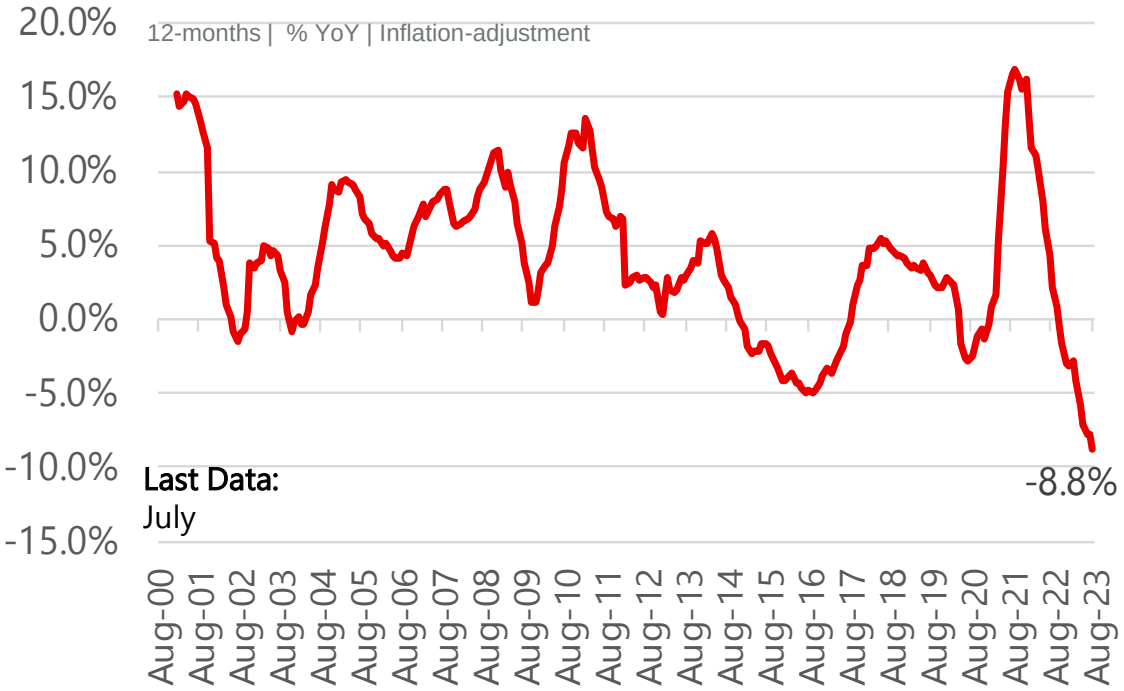


Sources: Brazilian Central Bank, Santander.

Fiscal Policy - Regional Government

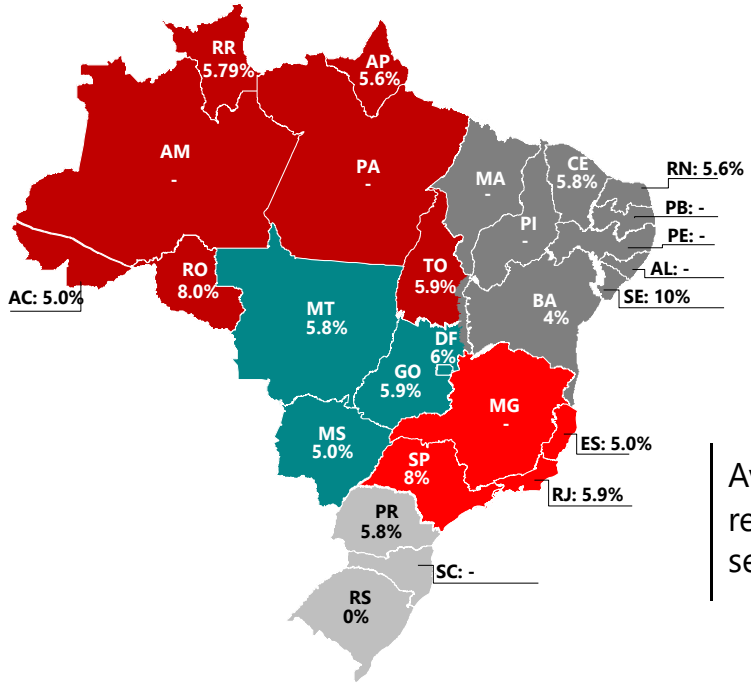
- The revenues of regional governments is reducing at the margin, we are seeing a drop of -8.8% YoY in real terms.
- We are observing the public servants' wages readjustment ~6% in the states, after increasing 11% in 2022. We also see pressure of the teacher's wage floor that was increased by 15% in the begging of the year.

Regional Gov. Revenues



Sources: Confaz , Santander.

Regional Gov. – Increases in Wages



Average of **6%** of salary readjustments of public servants' wages

Sources: Brazilian States, Santander.

Fiscal Policy: Challenging Path to Reach A Sustainable Primary Surplus

Central Gov. Primary Balance																
Fiscal Items (% of GDP)	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023e**	**2024e**	**2025e**	**2026e**	**2027e**	**2028e**	**2029e**	**2030e**	**Δ 26-17**	**Δ 30-17**
Total Revenue	21.0	21.3	22.1	19.3	21.7	23.3	22.5	23.0	23.1	23.3	23.5	23.7	23.7	23.6	2.3	2.6
Revenues Collected by the IRS (1)	12.7	12.9	12.8	11.8	13.4	14.0	13.9	14.2	14.2	14.2	14.3	14.3	14.2	14.0	1.5	1.3
Net Social Security Revenues (2)	5.7	5.6	5.6	5.3	5.2	5.4	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6	-0.1	-0.1
Revenues Not Collected by the IRS (3)	2.7	2.8	3.7	2.2	3.1	3.9	3.0	3.2	3.3	3.4	3.6	3.8	3.9	4.0	0.8	1.3
Transfers by Revenue Sharing	3.5	3.7	3.9	3.5	4.0	4.6	4.4	4.3	4.2	4.2	4.1	4.0	4.0	3.9	0.7	0.4
Net Revenue	17.5	17.6	18.2	15.8	17.7	18.7	18.1	18.7	18.9	19.1	19.4	19.7	19.7	19.7	1.6	2.1
Total Expenditure	19.4	19.3	19.5	25.6	18.1	18.2	19.2	19.6	19.7	19.8	19.5	19.3	19.1	18.9	0.4	-0.5
Social Security Benefits (4)	8.5	8.4	8.5	8.7	8.0	8.0	8.3	8.5	8.5	8.5	8.6	8.7	8.8	8.8	0.1	0.3
Payroll (5)	4.3	4.3	4.2	4.2	3.7	3.4	3.5	3.5	3.5	3.6	3.6	3.6	3.6	3.5	-0.7	-0.8
Other Mandatory Expenses (6)	3.0	2.9	2.6	9.5	3.4	3.0	2.7	2.9	2.9	2.8	2.7	2.6	2.5	2.5	-0.2	-0.5
Expenses with Cash Control (7)	1.9	2.0	1.9	1.8	1.6	2.2	3.1	3.1	3.1	3.1	3.0	2.9	2.8	2.7	1.2	0.8
Discretionary Expenses (8)	1.8	1.8	2.2	1.4	1.4	1.5	1.7	1.6	1.6	1.7	1.6	1.6	1.5	1.5	0.0	-0.3
Central Gov. Primary Balance	-1.9	-1.7	-1.3	-9.8	-0.4	0.5	-1.1	-0.9	-0.7	-0.7	-0.1	0.4	0.6	0.8	1.2	2.7
Public Sector Primary Balance	-1.7	-1.5	-0.8	-9.4	0.7	1.3	-1.0	-0.9	-0.7	-0.6	0.0	0.4	0.6	0.8	1.0	2.5
Nominal GDP (BRL billion)	6,585	7,004	7,389	7,610	8,899	9,915	10,519	11,049	11,798	12,634	13,464	14,349	15,293	16,298	6,048	9,713

Notes and Hypothesis: Elasticity: Revenues-GDP 2021: 1.7 | 2022: 1.3 | 2023:0.9 | Long-term: 1.03. We see a slowdown in extraordinary revenues from 2023 onwards. Potential GDP: 1.5%. Inflation: 4.0%, GDP deflator 5.0%. (2) Recovery in the formal labor market and earnings (better short-term numbers), expected some softening ahead. (3) Oil revenues will increase with greater federal share in pre-salt, the reduction in prices in medium-term will be compensated with more production—one of the key aspects to reach a sustainable primary surplus by the end of the decade. 4) A permanent fiscal waiver of BRL170 billion in 2023 onwards. We assume a fiscal rule that incorporates the waiver for 2023 as a permanent shift in expenditure limit (new fiscal framework). New rule will maintain expenditures limited to ~19% of GDP (close to the level before enactment of the former spending cap law). Real minimum wage increase (IPCA + average of last 2 years of GDP growth). Pension Reform approved in 2019 will stabilize the expenditures as % of GDP in the long-term (even with the rapid aging of the population, pressuring more after the end of the decade). In the short-run, the queue of the new pension benefits will be gradually reduced. (5) Gradual increase in admissions (70%) to the federal workforce ("normalization"). In the short-term (2024-25) decomposition of 80%, We included the +9% increase in 2023 and 2024, after that is decreasing gradually to 5% in Medium-term. Long-term: digitalization effects contain the increase (higher productivity). (6) Includes: higher payments in Court-ordered debt budget (sub-cap) – better management with a reduction in long-term, rise in federal contribution to Fundeb (Educational Fund), BPC (pension benefit). Court-ordered debts to accumulate to 1.6% of GDP by 2026, with the government negotiating future payments. (7) The main change was the increase in the welfare program (*Auxílio Brasil*). 2022 budget: BRL90 billion (from BRL35 bn of the former Bolsa Família). For 2023 onwards a more efficient and focalized welfare program with a total of BRL165 bn (gradual reduction in outlays after 2024). (8) Discretionary Expenses maintained at ~1.6% - a level that we consider enough to avoid a partial shutdown of public services, with and increase in investment. The new fiscal framework will not be biding for a drastic cut after 2025. 2026 we should observe a rise in the discretionary outlays, with a containment only in 2027. (9) Not consider a relevant increase in Tax exemption from 2023 onwards.

Public Debt and Simulations

A risky path toward debt stabilization

Lower GDP deflator in the short-term

6

Fiscal Accounts: Trajectories for the Brazilian Government Debt

- Public sector's primary balance (% GDP) required for the stabilization of the gross public debt-to-GDP ratio at **80%**
- We see the neutral interest rate hypothesis at 5.0%, this implies a larger primary surplus needed to stabilize the debt.
- Not considering the effects of the cyclical recovery, the long-term outlook will require a remaining 2.5p.p. of GDP primary fiscal adjustment, just to stabilize the ratio debt-to-GDP around the level of ~80% of GDP (in cyclical estimate). In the structural estimate, the adjustment is closer to 2p.p..

- **Current situation:**

. Real interest rate (ex-ante) 1-year: ~6.3%,
. GDP: 2.5% in 2023 and 1% in 2024

Liquidity reserves close to ~9 months of debt maturities

Increase in debt cost (Selic + IPCA)

- **Steady-state:**

According to our hypothesis:
. Real interest rate at ~5.0%
. Potential GDP at +1.5%,

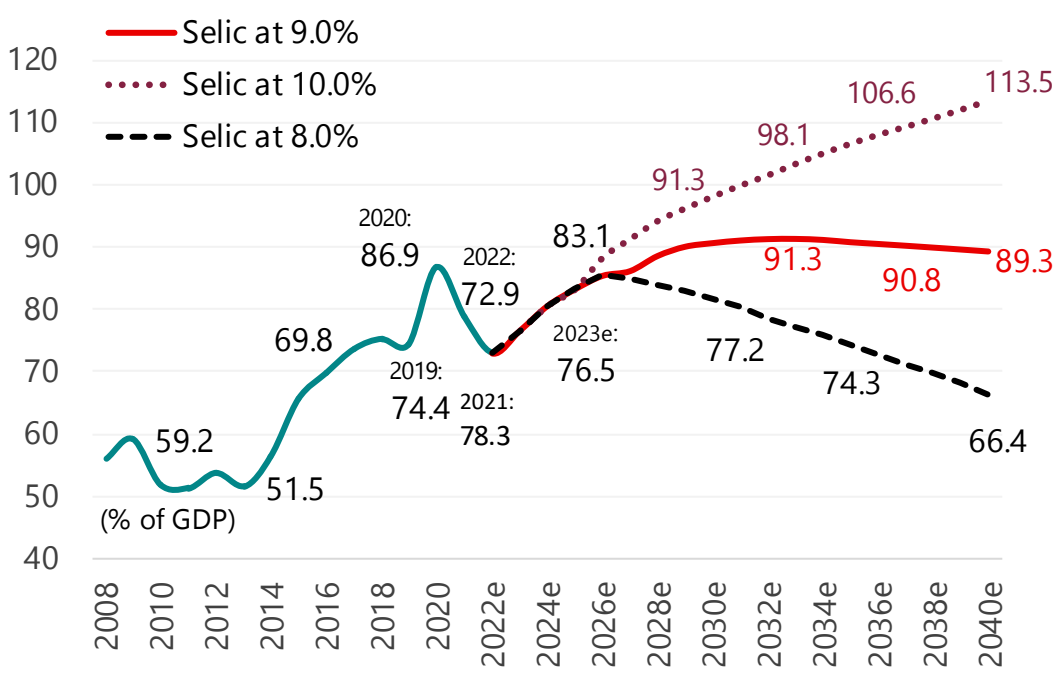
. The primary surplus must reach >2% of GDP to maintain the gross debt stable.

		Real Interest Rate						
		1.0%	*2.0%*	*3.0%*	*4.0%*	*5.0%*	*6.0%*	*7.0%*
GDP Growth	*0.0%*	0.8	1.6	2.4	3.2	4.0	4.8	5.6
	1.0%	0.0	0.8	1.6	2.4	3.2	4.0	4.8
	1.5%	-0.4	0.4	1.2	2.0	2.8	3.5	4.3
	1.8%	-0.6	0.2	0.9	1.7	2.5	3.3	4.1
	2.0%	-0.8	0.0	0.8	1.6	2.4	3.1	3.9
	2.5%	-1.2	-0.4	0.4	1.2	2.0	2.7	3.5

Sources: BCB, Santander.

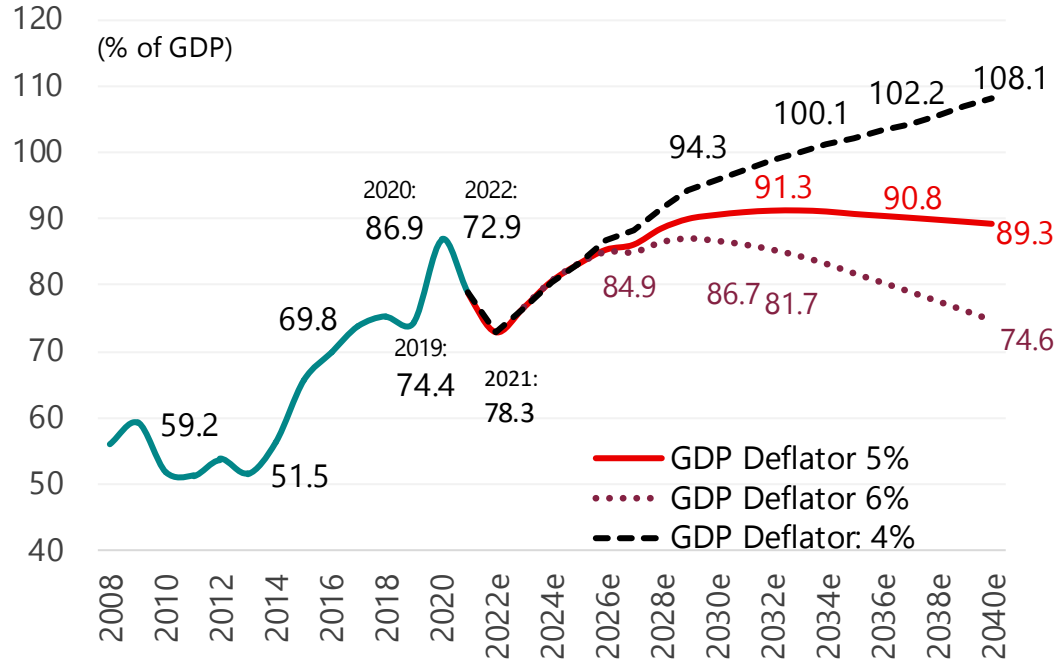
Debt Scenarios - Sensitivity to Changes in the Long Run Macro-outlook

Government Debt – Simulations for Selic Rate Hypotheses



Sources: BCB, Santander

Government Debt– Simulating for GDP Deflator Hypotheses



Sources: BCB, Santander.

Notes: Debt issuances: we added a spread of +1.0 pp in addition to the Selic rate in the models.
2023 GDP Deflator: 3.5% | GDP: 2.5% | Selic Rate (avg): 13.3% | BNDES zero | Voluntary Deposits 1.0% of GDP
2023-40: GDP deflator: 5.0% | Potential GDP: 1.5% | Neutral Selic Rate: 5.0%

Debt Management

Weekly issuance slightly above the level to keep the liquidity reserves up to July

7

Annual Borrowing Plan 2023

- On August 29, the National Treasury published its monthly debt report for July. The report showed a steady pace of debt issuance over the last few months. Debt issuance totaled BRL134.4 billion in July, compared to an average of BRL123 billion/month over the year. A variety of bonds were issued although floating rate bonds accounted for the largest portion (44%). Weekly bond issuances reached BRL28.9 billion in July, rising from BRL28 billion in June. This was the fourth consecutive month in which weekly bond issuances was above the level needed to keep liquidity reserves stable until the end of the year. For the rest of 2023, we estimate that ~BRL24 billion in issuances per week will be required.

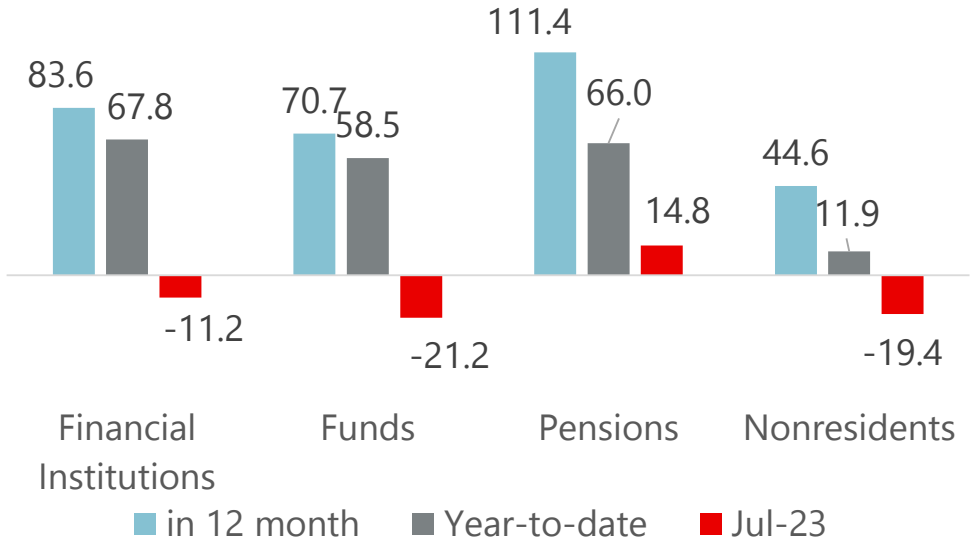
Annual Borrowing Plan (PAF 2023)									
	2020	2021	2022	Jun-23	Jul-23	PAF 2023 range		PAF 2022 range	
Outstanding volume (BRL billion)						Min	Max	Min	Max
Federal Public Debt	5,010	5,614	5,951	6,192	6,142	6,400	6,800	6000	6400
Composition (%)									
Fixed-rate	34.8	28.9	27.0	27.0	24.7	23	27	24	28
Inflation-linked	25.3	29.3	30.3	29.5	30.2	29	33	27	31
Floating-rate	34.8	36.8	38.3	39.5	41.2	38	42	38	42
FX	5.1	5.0	4.4	4.0	3.9	3.0	7.0	3	7
Maturity Structure									
% maturing in 12 months	27.6	21	22.1	19.7	18.2	19	23	19	23
Average maturity (years)	3.6	3.8	3.0	4.0	4.1	3.8	4.2	3.8	4.2

Sources: National Treasury; Santander

Debt Holders June's data

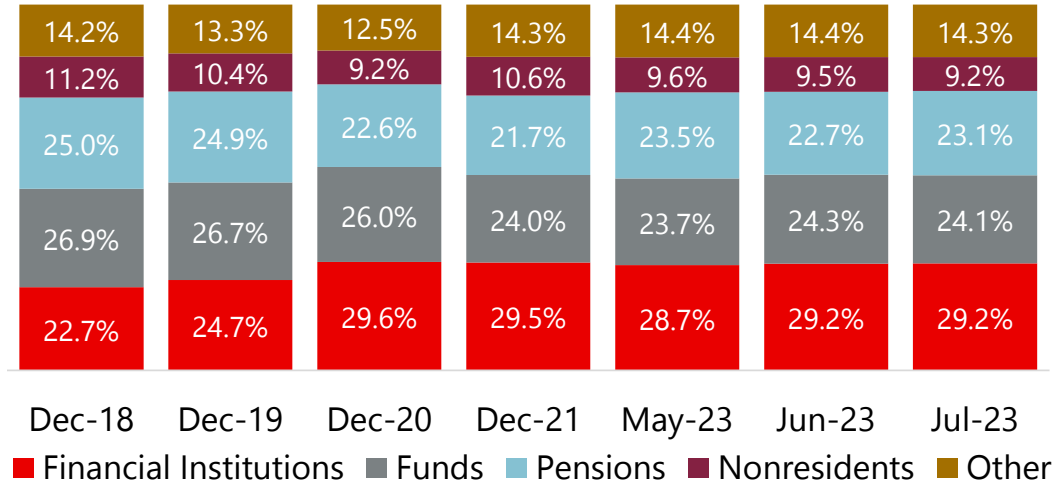
- Non-resident debt holders reduced their investments by BRL19.4 billion in July bringing total net investment flows to BRL11.9 billion in 2023 and BRL44.6 billion in the last 12 months. The percentage of debt held by non-residents fell to 9.2% in July vs. 9.4% in December 2022 and 10.6% in December 2021. Financial institutions continue to be the main holders (29.2%, flat MoM).

Change in Holders Debt Stock (BRL bn)



Sources: National Treasury, Santander.

Debt Holders - %

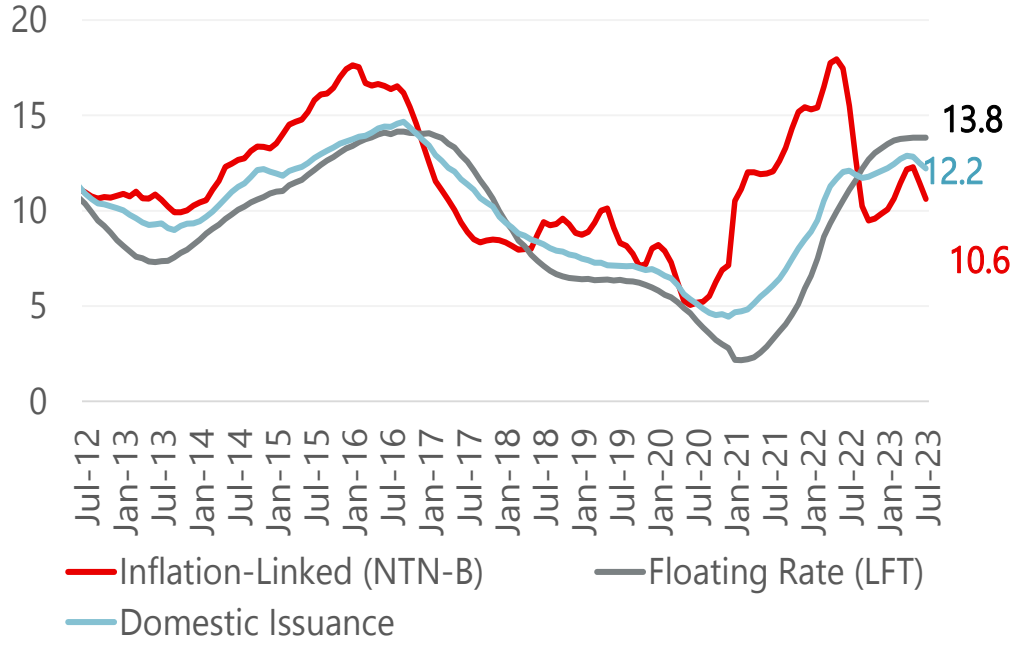


Sources: National Treasury, Santander.

Debt Cost of New Issuances - %

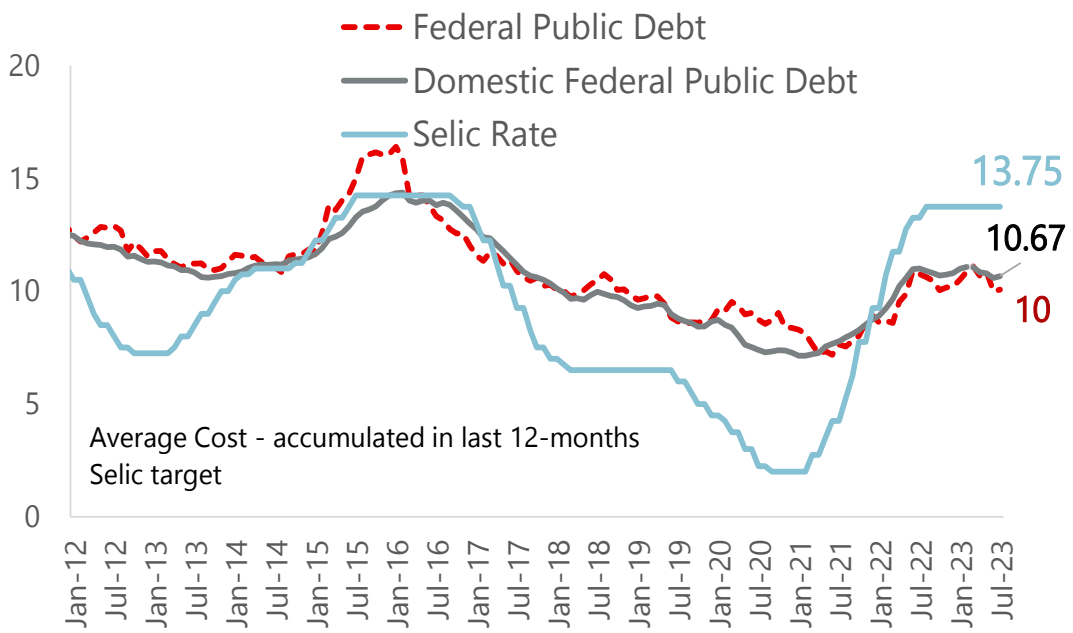
- Despite the start of the easing cycle the debt cost should continue at high level for a while

Liquidity cushion coverage of domestic debt



Sources: National Treasury, Santander.

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

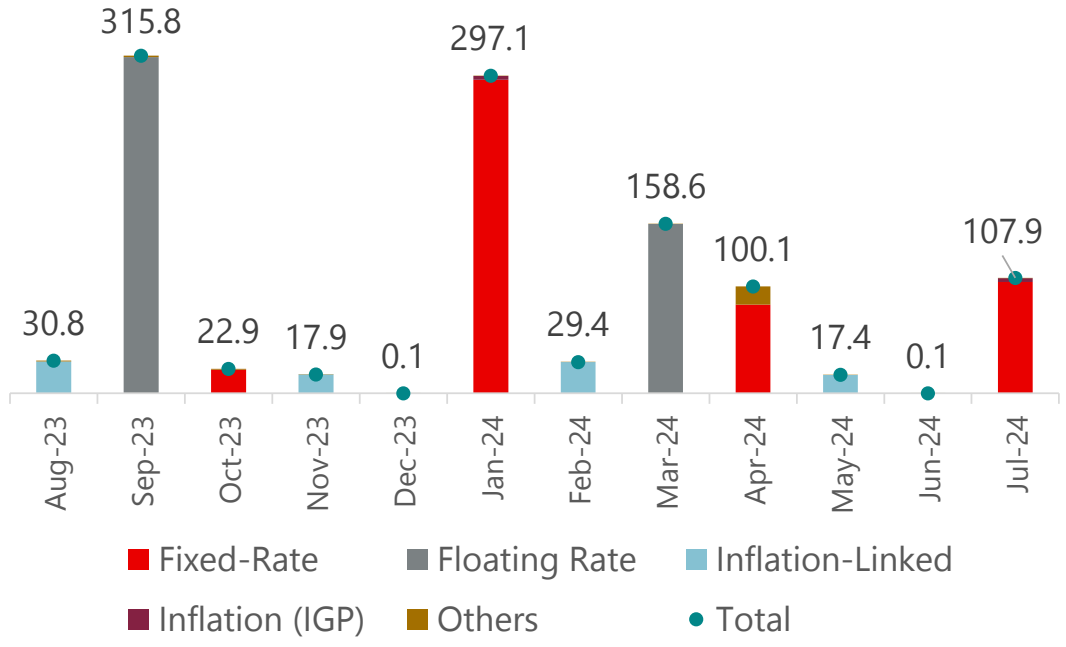


Sources: National Treasury, Santander.

Treasury's Cash Position at comfortable level to navigate the uncertainties

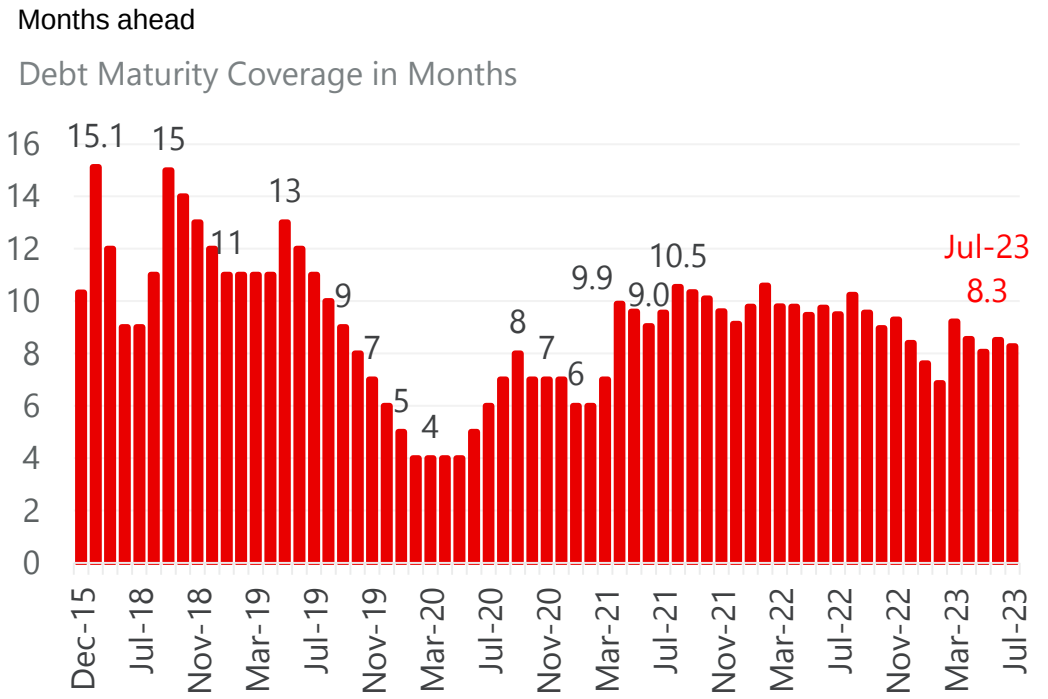
- Despite the increase in liquidity reserves the debt maturity level is still challenging. Structural reforms will help to increase debt maturity and reach a sustainable primary surplus.

Debt maturity - (BRL billion)



Sources: National Treasury, Santander

Liquidity cushion coverage of domestic debt



Sources: National Treasury, Santander.

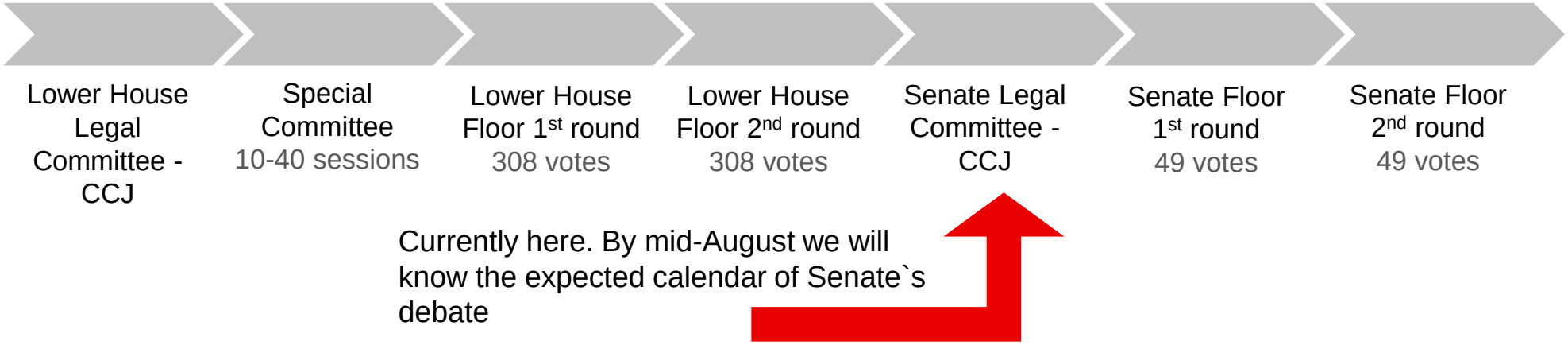
Tax Reform (VAT)

Currently in debate in Senate

8

Tax Reform - General Proposals

Legislative Process – Constitutional Amendment (PEC)



For Approval (3/5 of votes):

Total Number of Deputies: 513 (3/5 for the proposals to be approved; 308 votes)
Total Number of Senators: 81 (3/5 for the proposals to be approved; 49 votes)

Changes in the Senate return to the Lower House for a final review
There is no presidential veto for a PEC approved by Congress

Tax Reform - General Proposals

Consumption tax – How does it work currently?

	PIS/Cofins	IPI	ICMS	ISS
	Prog. Integração Social *Contr. Finan. Seguridade Social*	*Imposto sobre Produto Industrializado*	*Imposto sobre Circulação de Mercadorias e Serviços*	*Imposto sobre Serviços*
Who pays?	All goods and services	Industrialized goods	All goods and some services	Most services
Who charges?	Federal Government	Federal Government	States	Municipalities
Problems	1. Cumulative and non-cumulative systems operating together; 2. Subjectivity in interpreting what generates taxable credit; 3. Taxes benefits that are not clear.	1. Numerous categories and subcategories; 2. Lack of definitional parameters for the different rates. 3. Length of exemptions	1. 27 different laws, each with rates-related specifications; 2. Taxes benefits that are not clear; 3. Incentivizes competition between states.	1. More than 5,000 municipalities regulating the same tax; 2. Conflicts between municipalities and states.

Source: CCiF, OECD, Poder 360; Santander.

The Process of Changing the Tax System in Brazil

Brazil's Consumption Tax Is Highly Complex

In Brazil, there are 5 major consumption taxes, but most countries only use one: the goods and services tax, or VAT tax;

Federal government, states, and municipalities make their own laws to regulate taxation;

There is separation between taxes on goods (pay ICMS) and taxes on services (pay ISS), which encourages legal disputes;

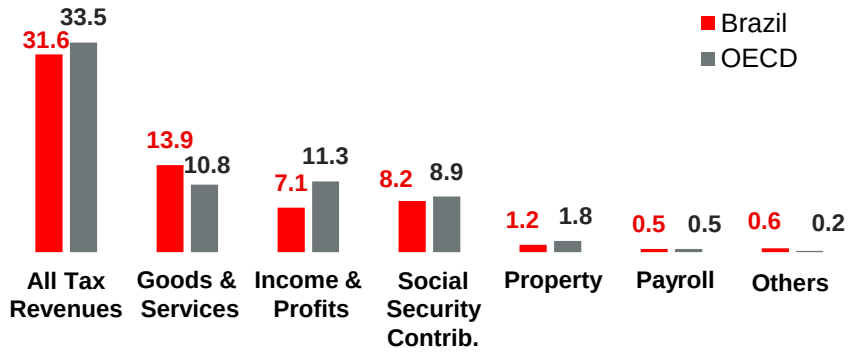
There are many tax exemptions and benefits;

There is cascading taxation and complexity in relation to tax credits generated.

Goods & Services Taxes Being Considered in Tax Reform

Tax	Federation	R$ billion	GDP %
ICMS	State	660	7.6
Cofins	Federal	270	3.1
ISS	Municipal	87	1.0
IPI	Federal	70	0.8
PIS	Federal	57	0.7
Total	**-**	**1144**	**13.2**

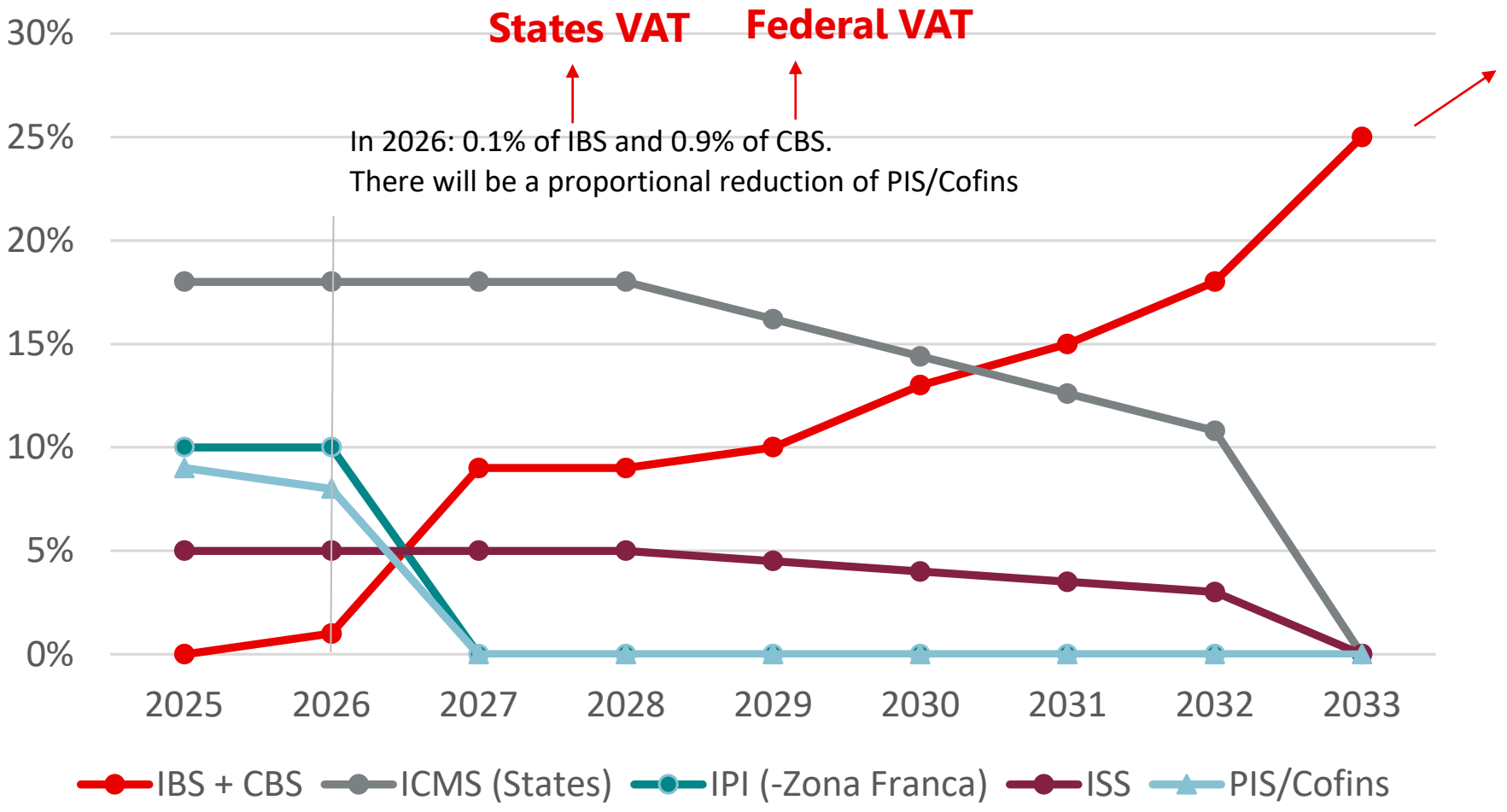
Share of Total Tax Revenue (2020)



Source: CCiF, OECD, Poder 360; Santander.

Tax Reform - General Proposals

Transition Period – Tax System to a *dual* VAT – 8 Year Transition



The final value will depend on the exemptions and will be known only in next decade

In the end, depending on the exemption could be between 24-27%

Sources: National Congress, Santander

Finance Ministry Simulations On Tax Rates in Brazil

- Table below presents the “inside” and “outside” rates for a good or service subject to the collection of ICMS at the standard modal rate and the normal tax regime of PIS/Cofins. The situation described in the table corresponds to the usual taxation of electricity or of a typical industrial product, not subject to the collection of IPI.

Base rate in the current tax regime

	Value	Rate	
		"Inside"	"Outside"
A. Price with taxes	100		
B. ICMS (18% of A)	18.0	18.0%	24.2%
C. PIS/Cofins (9.25% of A-B)	7.6	9.25%	10.2%
D. Net Prices - no taxes (A-B-C)	74.4		
Total rate		27.25%	34.4%

Sources: Finance Ministry

For the official release (in Portuguese), access here:
https://bit.ly/Tax-Reform-MF

Finance Ministry Simulations On Tax Rates in Brazil

- Simulation of the rate in several scenarios considering changes in the exemptions and reduced rates for some

Estimated base VAT rates based on the text approved by the Lower House (%)

Scenario	Description	Feasible scenario			Conservative scenario		
		CBS	IBS	Total	CBS	IBS	Total
A	Base VAT rate	6.95	13.78	20.73	7.38	14.64	22.02
B	Scenario A+ Reduced rate of 50% for agriculture and basic food basket	7.51	14.89	22.39	7.98	15.83	23.81
C	Scenario B+ Reduced rate of 50% for private education and services	7.61	15.1	22.71	8.09	16.05	24.14
D	Scenario C+ Reduced rate of 50% for private health and services	7.82	15.51	23.33	8.3	16.47	24.77
E	Scenario D+ Reduced rate of 50% for other goods and services	7.95	15.76	23.7	8.43	16.72	25.15
F	Scenario E + Reduced rate of 40% of the base rate	8.19	16.24	24.43	8.69	17.23	25.92
G	Scenario F + Zero rate for half of the basic food basket	8.41	16.69	25.1	8.92	17.7	26.62
H	Scenario G + Other exemptions	8.53	16.92	25.45	9.05	17.95	27.00

Sources: Finance Ministry

For the official release (in Portuguese), access here:
https://bit.ly/Tax-Reform-MF

The Process of Changing the Tax System in Brazil

- First, the constitutional amendment must be approved; after that, Complementary Laws must be approved (is expected four), with the VAT tax value and definition of specifics of the new system. Complementary laws: IBS Regulation; Federative Council (governance), Clearing (credits and debts), Regional Development Fund.

Possible implementation schedule

Approval of Broad Tax Reform (PEC)
2023

Complementary Laws: defining the tax value & others
2024

First Year of Implementation the VAT Federal System
2026

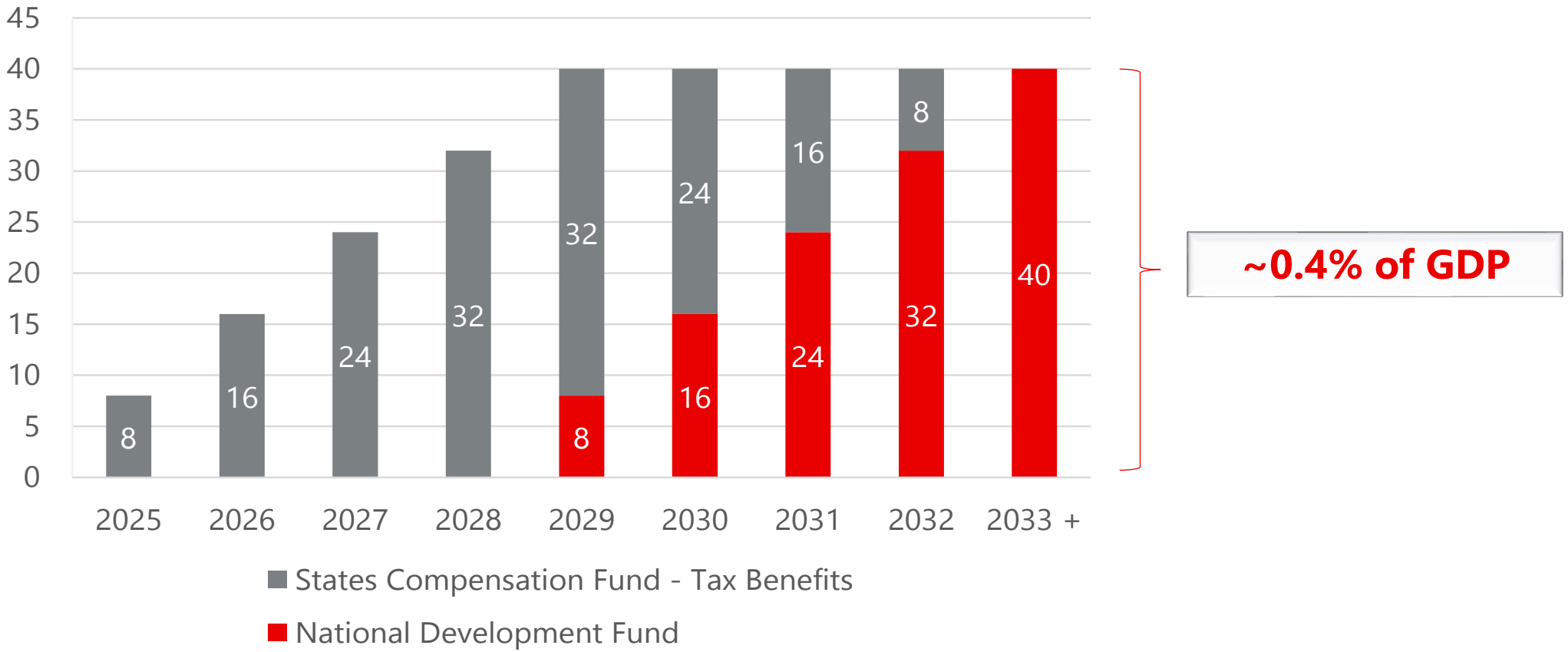
Change in Subnational Entitles
2029

New Tax System Fully Operational
2033

Tax Reform - Compensation Fund

- Creation of two funds financed by central government to compensate existing tax benefits (up to BRL40 billion or 0.4% of GDP annually, during and after transition). This value could increase during the Senate debate.

Federal Government will make the contributions to the Funds – BRL bn



Sources: National Congress, Santander

Probably will not be subjected to the new fiscal framework expenditure limit

Special Report - BRAZILIAN SOVEREIGN RATING AND COMPARISON WITH PEERS

9

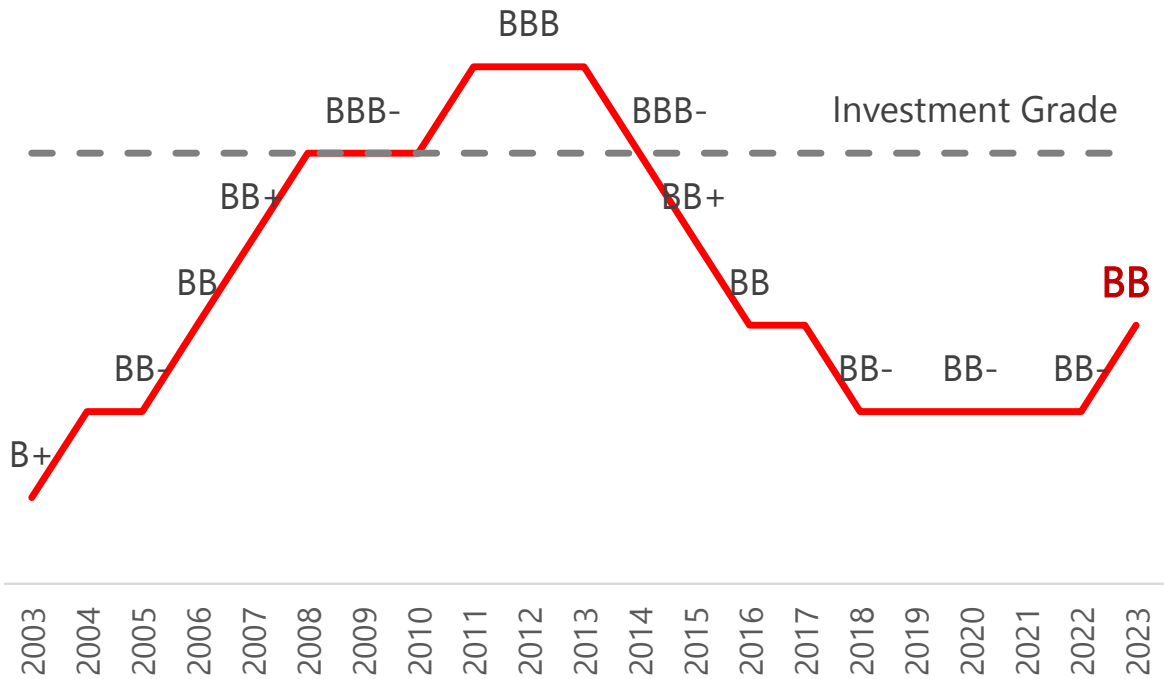
Brazilian Rating – Recently S&P upgraded the outlook to positive and Fitch rose to BB

S&P	Fitch	Moody's		Rating Grade Description
AAA	AAA	Aaa	Investment Grade	Highest Grade Credit
AA+	AA+	Aa1		Very High Grade Credit
AA	AA	Aa2		
AA-	AA-	Aa3		
A+	A+	A1		High Grade Credit
A	A	A2		
A-	A-	A3		
BBB+	BBB+	Baa1		Good Credit Grade
BBB	BBB	Baa2		
BBB-	BBB-	Baa3		
BB+	BB+	Ba1	Speculative Grade	Speculative Grade Credit
BB	BB	Ba2		
BB-	BB-	Ba3		
B+	B+	B1		Very Speculative Grade Credit
B	B	B2		
B-	B-	B3		
CCC+	CCC+	Caa1		Substantial Risks - In Default
CCC	CCC	Caa2		
CCC-	CCC-	Caa3		
CC	CC	Ca		
C	C			
SD	DDD	C		
D	DD			
	D			

BRAZIL

- On Wednesday (July 26), Fitch Ratings upgraded Brazil's credit rating to BB from BB- with a stable outlook. The country is still two notches below investment grade level. In the release, Fitch expects compliance with the primary target band proposed in the new fiscal framework. We still see challenges to achieve these targets due to the necessity for the government to take in more than 1.5% of GDP (at least) in permanent net revenue in the near future.

Fitch Rating – Historical of Brazilian Credit Rating



Sources: Fitch Rating, Santander.

Santander

International Comparison – Main Economic Data

2022										
	BBB+	BBB	BBB-	BB+	BB	BB-	Brazil	B+	B	B-
Government Finance	(Investment Grade)						(BB-)			
General government gross debt (%GDP)	53.6	55.2	66.5	48.1	41.5	52.7	88.2	79.0	65.5	66.2
General government net debt (%GDP)	14.6	40.0	41.0	61.7	25.4	56.1	58.4	81.6	53.9	86.1
General government primary net lending/borrowing (%GDP)	-2.5	-1.2	-4.7	1.9	0.8	-1.3	0.8	-2.2	-1.6	0.2
General government net lending/borrowing (%GDP)	-3.8	-3.5	-8.1	0.2	-0.8	-4.2	-5.8	-5.3	-4.7	-1.8
General government revenue (%GDP)	29.8	26.7	25.1	29.3	26.9	21.0	31.8	23.6	25.6	23.6
General government total expenditure (%GDP)	33.7	30.3	33.2	29.1	27.7	25.1	37.6	28.9	30.3	25.4
External Sector										
Current account balance (%GDP)	-0.2	-1.1	-6.0	5.6	-1.6	-2.1	-1.5	-7.1	-7.3	1.5
Total reserves minus gold (Billions US$)*	91.1	72.4	320.1	52.4	11.1	83.0	354.6	3.6	17.5	10.8
Economic Activity										
GDP, constant prices (% Change)	4.8	4.1	5.8	4.8	4.5	4.2	2.8	5.4	4.6	4.9
Inflation, end of period consumer prices (% Change)	8.4	10.3	10.6	8.5	6.3	8.4	6.0	6.3	15.8	9.2
Gross national savings (%GDP)	25.1	22.8	24.4	30.1	20.8	23.4	17.3	20.6	17.1	21.4
Total investment (%GDP)	25.3	24.3	30.3	24.7	22.4	25.7	18.8	26.7	24.9	22.6
Social										
GDP per capita, current prices (PPP)	22,052	28,172	23,195	14,756	25,156	13,075	17,684	15,732	15,879	8,108

Santander Sources: IMF, World Bank, Santander.

Recent Changes in Brazilian Rating

Figure 20. Key Credit Factors – S&P

Key credit factors	Evaluation	Background
Institutional	4	Brazil has a stable and solid democracy, with solid checks and balances, along with a robust private sector and an active press. At the same time, it has shown slow and unequal progress in addressing fiscal and economic imbalances. Data dissemination is widespread and timely, and such data is analyzed by the federal accounting agency for irregularities after release.
Economic	5	The trend of weighted average GDP per capita growth over a 10-year period is 1.2%, below the trend of sovereign governments in the same GDP category.
External	2	Considering the large stock of foreign direct investment in Brazil, the country is vulnerable to a possible significant change in international financing conditions.
Fiscal: flexibility and performance	6	Based on change in general government net debt (% of GDP) : **2022**: 1.3 / **2023 E**: 8.0 / **2024 E**: 6.0 / **2025 E**: 5.7 / **2026 E**: 5.6
Fiscal: debt burden	6	Based on general government net debt (% of GDP) and general government interest expenditure (% of general government revenue). **Net debt/GDP: 2022**: 52.3 / **2023 E**: 56.9 / **2024 E**: 59.8 / **2025 E**: 62.2 / **2026 E**: 64.5 **Interest/revenue: 2022**: 10.8 / **2023 E**: 13.1 / **2024 E**: 12.9 / **2025 E**: 13.3 / **2026 E**: 13.7 Banking sector exposure above 20% of assets. The number of lawsuits against the government is significant, which adds to long-term pressures on fiscal accounts.
Monetary	3	The BRL is a floating exchange rate currency, and the Central Bank intervenes occasionally. The Central Bank has a history of independence, and acquired legal independence in 2021. It also has the capacity to act as lender of last resort.

Sources: S&P, Santander

Recent Changes in Brazilian Rating

Figure 21. Key Rating Drivers - Fitch

Key Rating Drivers	
Reform Progress	Brazil has achieved important policy breakthroughs, including pension reform and central bank independence. Key fiscal reforms are still pending final approval but have seen important progress.
Resilient Growth	Economic momentum continues in 2023 after a healthy post-pandemic rebound, supported by a bumper agricultural harvest. Consumption has cooled on tight monetary policy, but it remains supported by a strong labor market, fiscal spending, and continued credit growth.
Upside from Economic Agenda	The consumption tax reform offers the most upside, as it addresses one of Brazil's greatest competitiveness bottlenecks.
Prudent Monetary Policy	The central bank (BCB) has maintained prudent and proactive monetary policy during the recent inflation shock.
New Fiscal Rule Takes Shape	Fiscal outturns in coming years will be guided by a new fiscal framework to replace a spending cap, which imposes a looser limit on spending set as a function of past revenue growth, targets gradually improved primary balances and includes contingency measures (ex ante and ex post) to prevent and correct for target noncompliance.
Better Debt Trajectory	Fitch expects weaker primary balances and high real interest rates to lift debt to 75% in 2023 and gradually thereafter, but at a slower pace and much better starting point than we previously expected.
Robust External Position	Brazil is on track to achieve a record trade surplus in 2023, supported by strong agricultural output and lower import costs. Fitch projects this will reduce the current account deficit.

Sources: Fitch, Santander

IMF forecasts for Brazilian Economy

Figure 22. Comparison Between Macro Variables in 2008 and 2023F-2026F

Brazil	2008	2023 F	2024 F	2025 F	2026 F
Government Finance					
Government gross debt (%GDP)	62.3	88.4	91.5	93.7	95.2
Government net debt (%GDP)	37.6	61.2	65.3	68.4	70.6
Government primary net lending/borrowing (%GDP)	3.3	-2.0	-1.0	-0.5	0.2
Government net lending/borrowing (%GDP)	-2.0	-8.8	-8.2	-6.6	-5.5
Government revenue (%GDP)	35.8	35.8	35.5	35.4	35.3
Government total expenditure (%GDP)	37.8	44.6	43.7	42.0	40.8
External Sector					
Current account balance (%GDP)	-2.1	-2.7	-2.7	-2.6	-2.6
Total reserves minus gold (Billions US$)*	192.8	317.1			
Economic Activity					
Gross domestic product, constant prices (% change)	5.1	0.9**	1.5	1.9	2.0
Inflation, end of period consumer prices (% change)	5.9	5.4	4.1	3.0	3.0
Total investment (%GDP)	21.6	18.3	18.1	18.1	18.0
Gross national savings (%GDP)	19.5	15.5	15.5	15.4	15.4
Social					
Gross domestic product per capita, current prices (PPP)	13,397	18,686	19,277	19,916	20,583

Sources: IMF (World Economic Outlook 2023), World Bank, Santander

* Total reserves minus gold data have been collected from the World Bank up to the year 2021.
** Updated to 2.1% in July 2023.

Long path to Recover the Investment Grade

- On average, the countries took 6-7 years to recover the investment grade status.

Country	Downgrade year	Year the investment grade was regained	Outlook when country regained investment grade
Uruguay	2002	2013	• Uruguay's five-year average GDP growth at 5.6% is well above the 'BBB' median and its medium-term prospects remain favorable. • Social and political stability, strong institutions and relatively high per capita income are characteristics that are fully in line with investment-grade sovereigns. • Prudent fiscal management has led to a decline in government indebtedness and a significant improvement in debt composition in recent years.
Colombia	2000	2011	• Track record of prudent economic policies demonstrated resilience to external and domestic shocks, as well as the improvement in its external credit metrics. • Colombia's five-year average growth is expected to equal 4.2% in 2011, above the 3.1% of the 'BBB' median. • Colombia is also likely to maintain broad macroeconomic stability with inflation slightly above 3% in 2011 and 2012.
Indonesia	1997	2011	• Indonesia's cyclical resilience to large external shocks points to sustainably high trend growth over the medium term. • A more favorable assessment of Indonesia's economic strength is underpinned by gains in investment spending, improved prospects for infrastructure development following key policy reforms, and a well-managed financial system.
Romania	2008	2011	• The upgrade reflects Romania's progress in recovering from the effects of the financial crisis, evident in a return of GDP growth, a strong export performance, narrowing in the current account deficit and reduction in its budget deficit

Sources: S&P, Santander

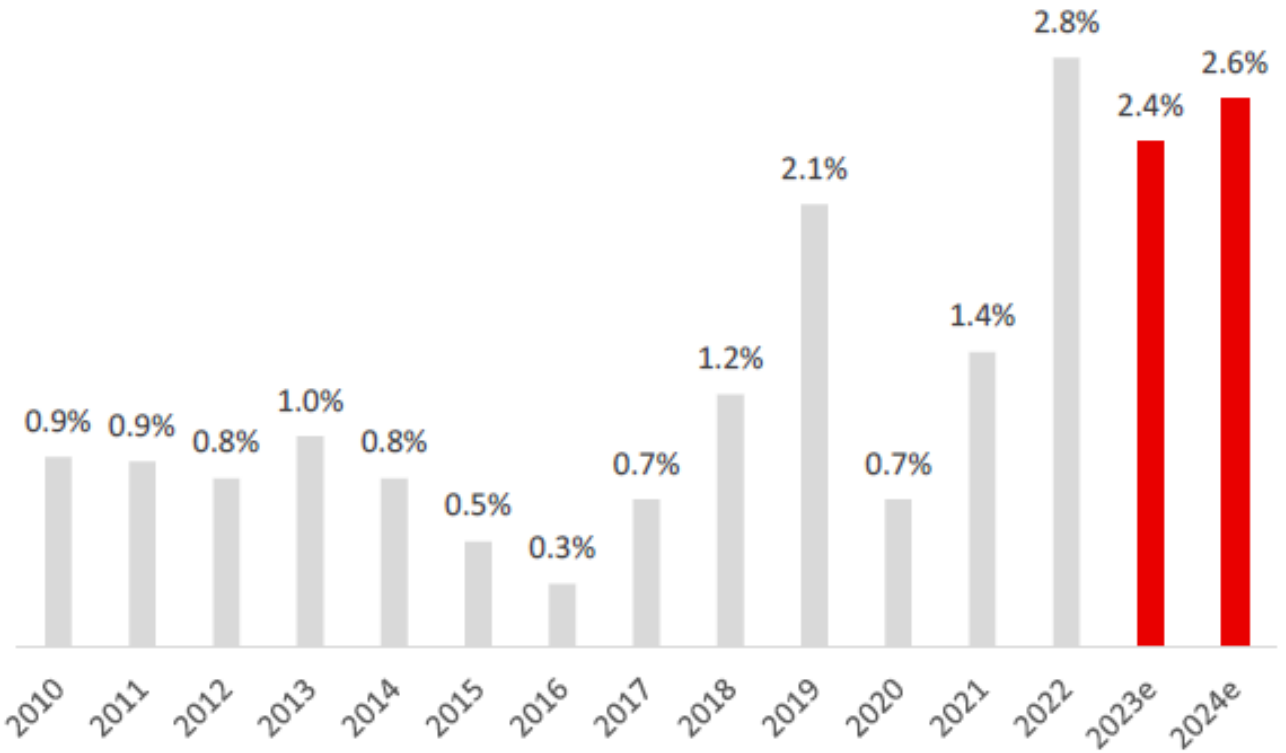
Special Report - GLOBAL OIL BALANCE AND ITS EFFECTS ON ACTIVITY AND FISCAL ACCOUNTS

10

Fiscal Policy – Oil Revenues "helped" the fiscal accounts

- For public accounts, oil revenues have been a notably positive factor, especially in 2021-22, and we expect this revenue to continue to support government revenue ahead, especially with the increase in oil production in the pre-salt area. For the short-term, we observed oil procedures playing an important role in public accounts. Last year, we had a BRL200 billion revenue surprise in our initial estimate for January 2022, compared to the final result. About 62% of this surprise was due to the increase in oil prices. We calculate that of the total rise of BRL380 billion in total revenues for the central government, about ~40% was from the jump in oil prices. We can observe in the Figure 21 that the oil sector revenues reached 2.8% of GDP in 2022, compared to an average of 0.9% of GDP between 2011-19.

Figure 21 – Central Gov. Primary Revenues Related to Oil Sector

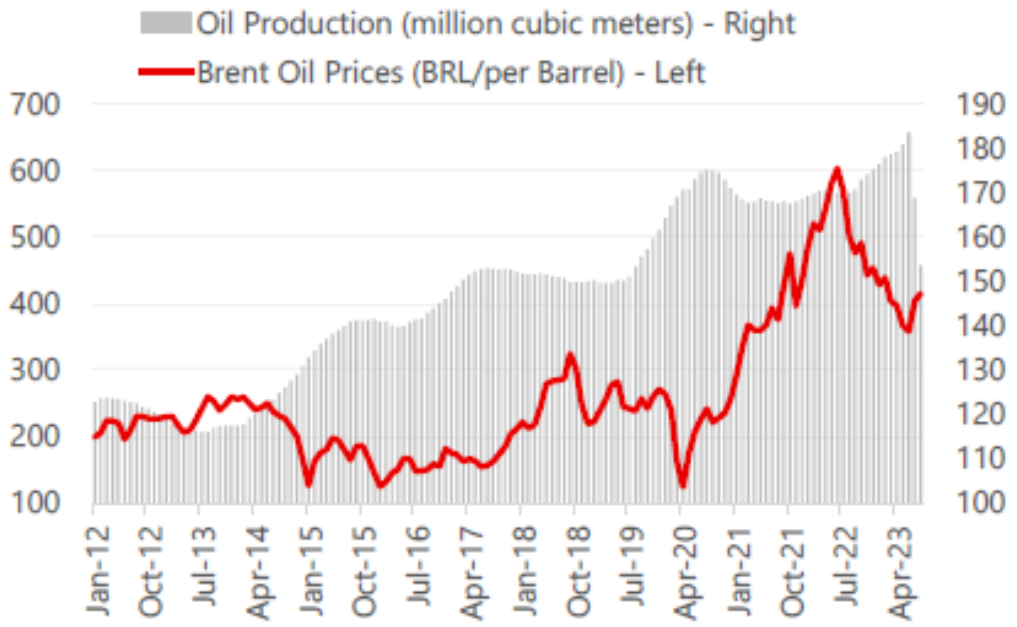


Sources: National Treasury, Brazilian IRS, Santander.

Fiscal Policy – Oil Revenues "helped" the fiscal accounts

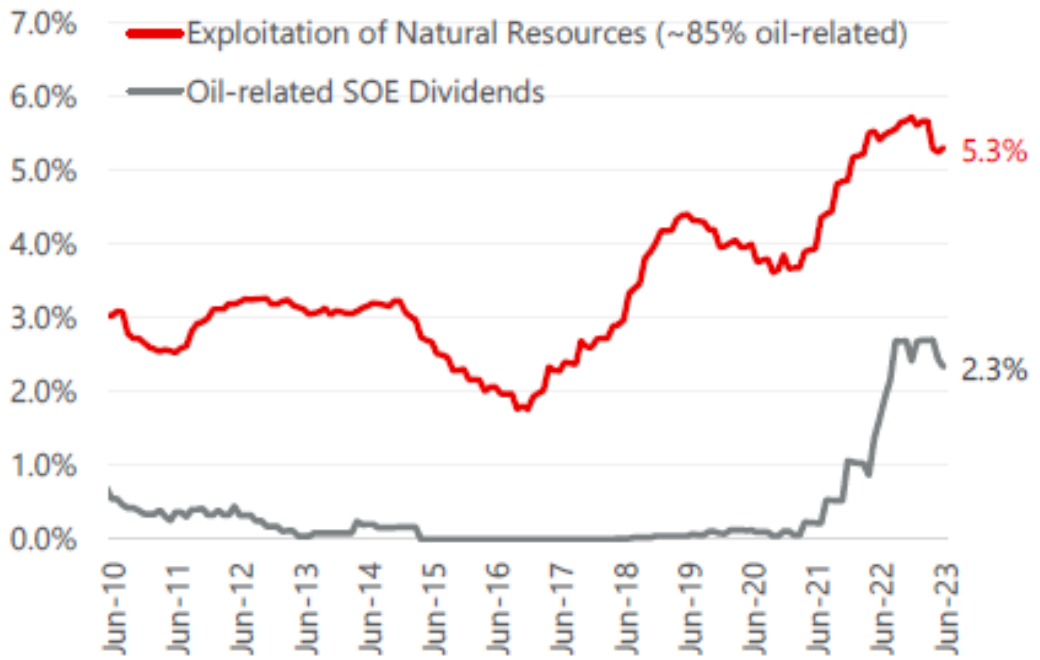
- As we already pointed out last year the fiscal result was better than expected due to the price effect (inflation, commodities, and terms of trade). Figure 23 shows that revenue related to the exploitation of natural resources is close to an all-time high (5.73% registered in December 2022), with a share of 5.3% of total revenue by June 2023, rising more than the total revenues. In addition, the government began to receive more dividends from state-owned companies, and a good part of this was from industries associated with the oil sector.

Figure 22 – Brazilian Oil Prices and Production



Sources: MCM, ANP, Bloomberg, Santander.

Figure 23 – Federal Tax Revenues (% of total Revenues)

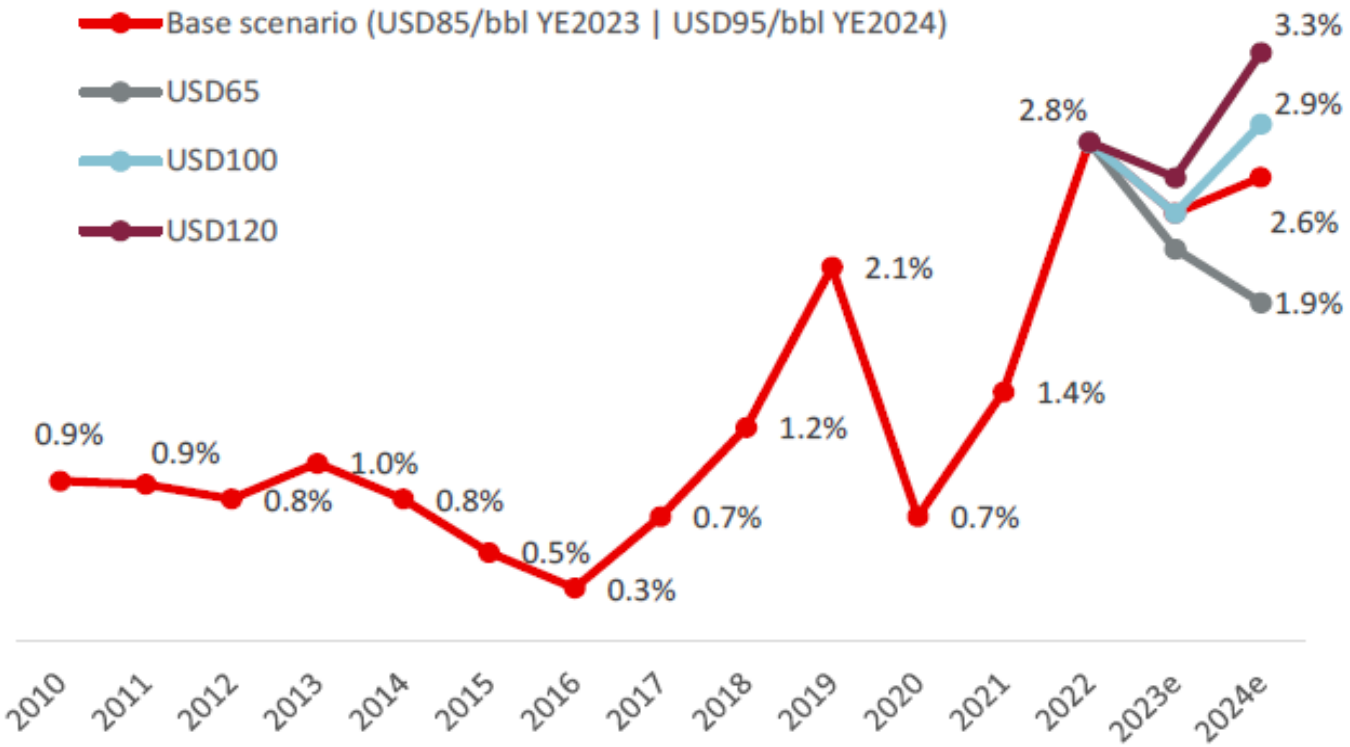


Sources: National Treasury, Santander.

Fiscal Policy – Oil Revenues "helped" the fiscal accounts

- In Figure 24, we ran a sensitivity analysis of the oil prices and its impact on the Central Government's primary revenues. As we can observe, if the oil prices drop to USD65 per barrel, despite the increase in production the revenues could drop by 0.7% of GDP. We believe that the oil prices could be an important parameter to observe in the next few years, special considering that the government needs at least 1.5% of GDP in new revenues to comply to the new fiscal framework primary targets.

Figure 24 – Central Gov. Primary Revenues Related to Oil Sector



Sources: National Treasury, Santander.

Tables – Forecasts

SCENARIO REVIEW - Adjustments to Reflect Past Surprises; Same Trends Continuing Ahead

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Macro Scenario - Forecasts

Macroeconomic Variables		Previous		Current
GDP (%)	2023E	1.9	↑	2.5
	2024E	1.0	→	1.0
	2025E	1.5	→	1.5
IPCA (%)	2023E	4.9	↓	4.7
	2024E	3.9	↓	3.8
	2025E	4.5	→	4.5
Selic Rate (% end of period)	2023E	11.75	→	11.75
	2024E	10.00	↓	9.50
	2025E	7.50	→	7.50
FX Rate - USDBRL (end of period)	2023E	5.20	↓	5.10
	2024E	5.35	↓	5.25
	2025E	5.40	↓	5.30
Current Account Balance (% of GDP)	2023E	-2.5	→	-2.5
	2024E	-2.7	→	-2.7
	2025E	-2.7	→	-2.7
Primary Fiscal Balance (% of GDP)	2023E	-1.0	→	-1.0
	2024E	-0.9	→	-0.9
	2025E	-0.7	→	-0.7
Gross Public Debt (% of GDP)	2023E	77.0	↓	76.5
	2024E	81.1	↓	80.5
	2025E	83.9	↓	83.2

Note: Our previous forecasts date from August 4, 2023 (Scenario Update: "Better Growth Outlook in 2024 Given a Less Contractionary Monetary Policy" – Available on: https://tinyurl.com/Std-scenreview-aug23).

The forecasts refers to our latest Scenario Review

"Adjustments to Reflect Past Surprises; Same Trends Continuing Ahead"
(sent on September 15, 2023)

For the full report click on the link:

https://bit.ly/std-sce-review-Sep23

Macro Scenario - Santander Brazil's Global Macro Assumptions – Summary

Global Macro Scenario												
	2018	2019	2020	2021	2022	2023E		2024E		2025E		
Global GDP (%)	3.5	2.8	-3.5	5.9	3.4	2.4	→	2.2	→	2.8	→	
China GDP (%)	6.7	6.0	2.3	8.1	3.0	5.2	↓	5.1	→	5.0	→	
US GDP (%)	3.0	2.2	-3.5	5.7	2.1	2.1	↑	0.1	↑	1.8	→	
US Inflation (Core PCE, %)	2.1	1.6	1.5	4.9	5.0	4.0	↑	2.5	→	2.0	→	
US Interest Rate (FFR, %)	2.50	1.75	0.25	0.25	4.50	5.50	→	4.00	→	2.50	→	
US Interest Rate (UST10y, %)	2.7	1.9	0.8	1.8	3.9	4.0	↑	3.5	↑	3.0	→	
Dollar Index - DXY	96	96	90	96	104	103	↑	100	→	100	→	
Commodity Prices - CRB	409	401	444	571	558	528	→	474	→	445	→	

*Core PCE is referred to the y/y variation for Q4.

Source: Santander

The forecasts refers to our latest Scenario Review

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Thank you.

Our purpose is to help people and businesses prosper.

Our culture is based on believing that everything we do should be:

Simple Personal Fair

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