- The extreme polarization in the political environment and the events underlying it due to the feeling of injustice of the election results generates an atmosphere of conflict in Brazilian society. We observe a Brazil divided by two very popular presidents, where Da Silva generates fiscal uncertainty due to large administrative expenses to come and Bolsonaro fuels the opposition movement.
- The delicate dilemma of the government's choice to set the short-term interest rate at 13.75% to contain inflation should be handled with great caution, since together with the rising cost of living and oil prices it dictates a population with low consumer demand.
- Weak global demand is expected to limit export growth in Brazil, although the reopening of China and a good soybean harvest will probably offset some of that weakness. This implies that the external sector will continue to be a key factor for the country's economic recovery, but also that it will face challenges and risks in the international context.

Brazil	2021	2022	2023	
			Target	Estimated
GDP	4.6%	2.3%	2.1%	1.0%
Median Inflation	9.3%	5.7%	3.3%	5.5%
Dec/Dec Inflation	10.1%	5.8%	3.3%	5.6%
Avg Exchange Rate	5.4	5.2	4.7	5.4
Avg Exchange Rate End Y	5.7	5.2	4.8	5.5
Pasive Avg Ex. Rate	3.4%	9.9%	8.9%	8.3%
CB Avg Ex. Rate	5.6%	12.5%	11.3%	10.5%

Consensus Forecast (Mar 2023)

Brazil	2022	2023	2024
GDP (%)	2.30	1.20	1.4
Median Inflation (%)	5.70	5.60	4.20
Avg Echange Rate	5.17	5.48	5.38

Interest Debt

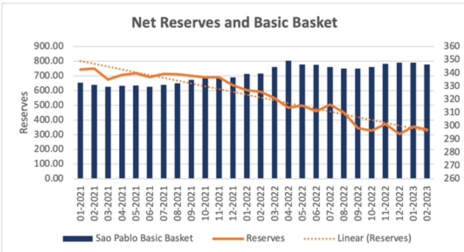
According to internal calculations (with data from 2021), the interest rate on Brazilian debt is estimated to be 11.5%. The Selic interest rate is fixed as of August 2022 by the Central Bank of Brazil at 13.75%, which allows the government to manage the growing debt adequately.

Political Context

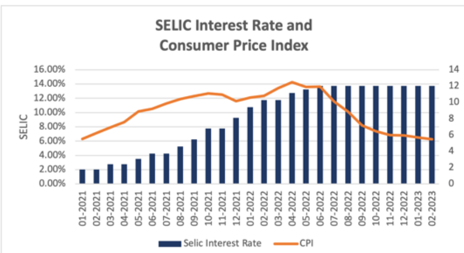
The four years of Jair Bolsonaro's extreme right-wing presidency left Brazil with great political polarization, culminating in a coup attempt after the closest presidential election the country has had since the return to democracy, where 77-year-old leftist and former president Lula da Silva won the presidency after serving 19 months of his 12-year prison sentence for corruption. Da Silva left the presidency of Brazil in 2010 with an approval rate of 90%. However, 4 years later he was found guilty during the largest corruption investigation in Brazil's history, Operation Lava Jato. In early 2021 the conviction was overturned due to procedural defects, and not more than a year and a half later Da Silva ran for president. The controversial figure of Lula and the deep polarization of left and right that has developed in the last decade in Brazil presents a complex political management for the future, where a great opposition force will be present during the term of office due to the majority presence of the right-wing party in Congress and the strong presence of 'Bolsonaristas'. Demonstrations and protests in Brazil continue, compromising political stability and fueling uncertainty, which will be reflected in market sentiment.

Economic Enviornment

Brazil's government remains optimistic and projects the country's economic growth for 2023 at 2.1%, however, market specialists point to a growth below 1% due to the adverse global economic situation and the effect of the high U.S. interest rates in the global market. The relatively strict monetary policy of the Central Bank of Brazil and its low hesitation to increase the Selic



Graph 1



Graph 2

Analysis Graphs 1 and 2

A clear inverse correlation (since 2021, around -.8) between the reserves of the Brazilian authority and the basic basket of the country can be observed through graph 1. Both trends (downward reserves and upward basket) can be partly explained by the interest rate hike (graph 2). A worrisome fiscal scenario is presented, where the cost of living increases while the government struggles to balance the use of the interest rate to curb inflation.

rate (which increased from 2% in February 2021 to 13.75% and remains fixed at present) favors the control of inflation, together with the subsidies granted during the pandemic. However, the greatest risk to an increase in inflation rates in the country lies in high fiscal expenditures. The Brazilian government is at a crossroads, where it can either maintain the fuel subsidies introduced during the pandemic, which have allowed inflation reduction, or let them expire and make way for strengthening the strained finances, with an effect of increasing energy costs (which are expected to continue to rise due to the high demand for oil in China and the Russian sanctions that limit the supply of its oil in the market) and in turn increase inflationary expectations. A pass-through effect of 44% at 5 months and 55% at 8 months is estimated, so inflation is expected to have already reached its ceiling and to hover between 5-6% if a strict monetary policy is maintained and there is a limit on public spending by the new administration (which indicates it has other plans).

Stimulus from last year's presidential elections have been debilitating factors for Brazil's fiscal position. The new administration's plans are aggressively increasing government spending, with Congress already approving additional spending of USD 33 billion, which will be used to fund public health programs; wage increases for public workers; and increased cash transfers to the poor. This extra spending will result in a budget deficit at almost 2% of the nation's GDP in 2023 and is reflected with an immediate forward effect on 10-year government bonds, which had a sudden jump in yield from 12% just before the election to over 13% afterwards. Strong wage growth, which has increased by 14% y-o-y to November 2022 and 7.3% inflation-adjusted, along with tightness in the labor market are also indicators that inflation is unlikely to decline to the central bank's target (3%). This increase in wages has managed to balance to some extent the rapid increase in Brazil's basic food basket prices, but a gradual decline in overall consumer spending is expected once wage growth stabilizes, combined with the prospect of rising oil prices.

Moreover, while the global economic slowdown has affected export prospects in most countries and points to a decline in demand for goods worldwide, an optimistic scenario is foreseen for Brazil in the agricultural sector. As the leading

Effect of unemployment on Brazil's Inflation

The Philips curve represents a negative slope empirical curve relating the inflation rate and the unemployment rate, interpreted using the following formula:

$$\pi - \pi^* = f\alpha + \beta(u - u^*)$$

A model is proposed using the annual data for the period 1992-2021 with the OLS (linear least squares) regression method. The model manages to explain only 23.5% of inflation (using the R2 metric). This may be due to a number of external factors, from the nairu (non-accelerating rate of unemployment) and expected inflation used for regression development, to the influence of other variables in predicting future inflation. However, the difference between unemployment and nairu has a significant effect on inflation (p-value = 0.007), with a coefficient of -117.89. That is, one unit higher unemployment reduces inflation by about 1.17%.

Unemployment has been rising since November 2022, after a prolonged period of decline. According to the Philips curve theory, if unemployment continues to rise as it has in recent months, a decline in inflation would be expected. However, as could be observed in the model, the effect is not guaranteed due to external variables that influence inflation behavior.

exporter of soybeans globally, a record crop of 16.6% increase compared to last season is expected. Combined with the reopening of China (its largest importer of soybeans, which has recently decreased the import of this product from the United States) and a price increase of this product of 10% in the last months, it is expected to have an alleviating effect that offsets part of this slowdown in global export growth, especially for a country with a trade surplus such as Brazil.

Clearly the Brazilian economy is slowing down. Brazil's government and monetary authority must manage economic support to the population due to the high cost of living growth and the global economic context with great moderation, in order to avoid a spike in inflation. This balance will largely dictate the country's economic trajectory over the next few years.