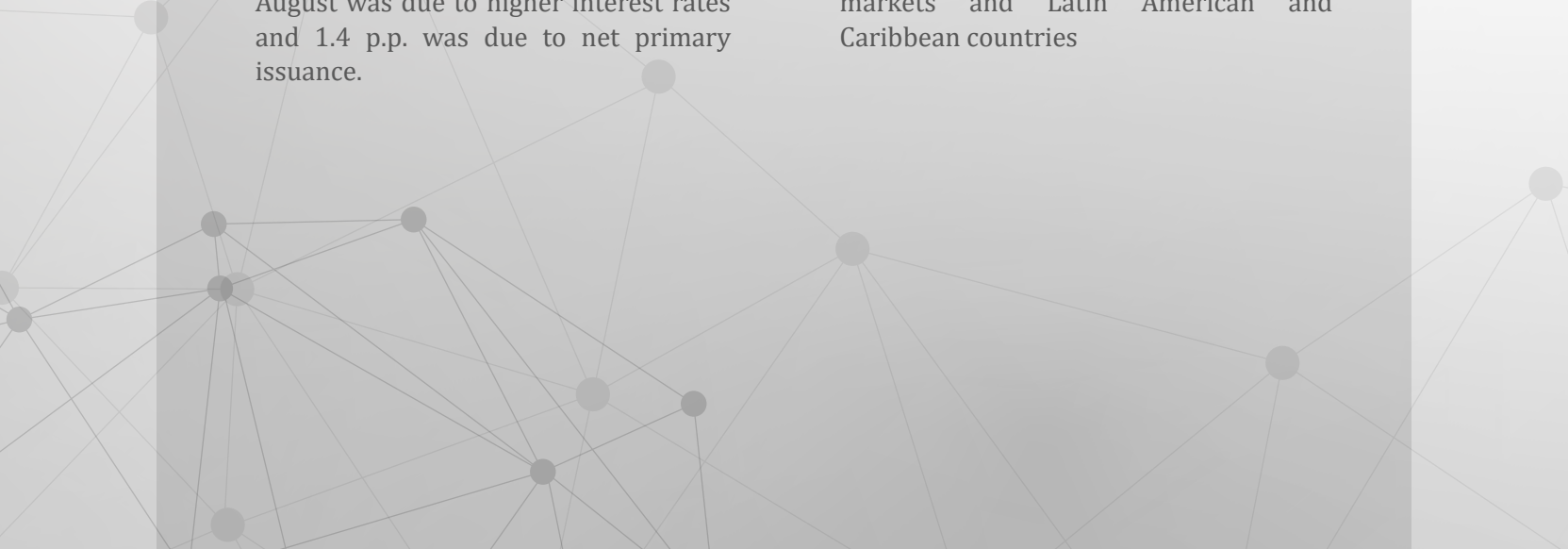


FFFR

Fiscal Follow-Up Report

OCT 17, 2024 • N° 93

HIGHLIGHTS

- Gross Debt reached 78.5% of GDP by August 2024 and is expected to close the year at 80.0%.
 - The Gross General Government Debt-to-GDP ratio has an upward trend and may reach 82.2% in 2025 and 84.1% in 2026.
 - The level of public debt will grow by 12.4 percentage points (p.p.) in the four years of the current presidential term.
 - In December 2022, it reached 71.7% of GDP.
 - The 5.2 p.p. increase in debt up to August was due to higher interest rates and 1.4 p.p. was due to net primary issuance.
 - Moody's Ratings upgraded Brazil's credit rating, but Fitch Ratings and Standard & Poor's did not follow suit in reassessing Brazil's position. Understand the methodological differences and motivations of the three major international credit rating agencies.
 - Fiscal uncertainties make it difficult to achieve investment grade status.
 - Brazil's debt level is on par with the average of Eurozone countries, lower than that of developed G7 nations, but significantly higher than emerging markets and Latin American and Caribbean countries
- 



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Public debt: the main thermometer of fiscal health

The Independent Fiscal Institution (IFI) presents its Fiscal Follow-up Report (RAF), No. 93, for October 2024 [with the acronym RAF kept here in its original form, as well as all acronyms of Brazilian taxes, programs, reports, institutions, etc.].

This month, the focus of our analysis is on the main medium- and long-term fiscal indicator: the ratio between public debt and Gross Domestic Product (GDP), as a thermometer of the country's fiscal health and the sustainability of the debt process.

The IFI initially outlines its methodology for calculating the GDP deflator, a key factor in projecting nominal GDP, which is essential for determining the Debt-to-GDP ratio. The IFI begins with a comparative analysis between the GDP deflator, the Broad Consumer Price Index (IPCA), and the General Price Index – Internal Availability (IGP-DI). This explains minor discrepancies with the projections made by the Secretariat of Economic Policy (SPE) of the Ministry of Finance and the Prisma Fiscal bulletin. **(Page 4)**

The RAF 93 highlights that the Gross General Government Debt (DGBB), calculated by the Central Bank of Brazil, which reflects the indebtedness not only of the Federal Government but also of subnational entities, reached 78.5% of GDP in August 2024. The IFI's projection is that we will close the year with the DGBB/GDP ratio at 80%, with an upward trend for the following years: 82.2% in 2025 and 84.1% in 2026. The debt, which stood at 71.7% of GDP in December 2022, will increase by 12.4 percentage points over the four years of the current presidential term.

The growth in debt, it has been shown, is the result of the failure to generate primary surpluses, higher interest rates and net primary debt issuances by the National Treasury. The debt increase up to August 2024 was driven by a contribution of 5.2 p.p. from rising interest rates and 1.4 p.p. from net issuances. RAF 93 also discusses debt management by the National Treasury Secretariat (STN) and the internal composition of the debt in terms of its linkage to the SELIC rate, price indices, exchange rates, and fixed-rate bonds. **(Page 6)**

Due to the importance of this indicator for assessing fiscal health and the medium- to long-term consistency of economic policy strategies, RAF 93 also analyzes the reasons that led Moody's Ratings, one of the leading international credit rating agencies, to recently upgrade Brazil's credit rating.

The two other major agencies, Fitch Ratings and Standard & Poor's, have already announced that they do not intend to follow Moody's in reclassifying Brazil's credit risk.

RAF 93 delves into the methodological differences between Standard, Fitch and Moody's when assessing a country's risk. It also explores the distinct methods used by the International Monetary Fund (IMF), which guides international comparative series, and by the Brazilian Central Bank in calculating the Debt-to-GDP ratio.

The international comparative series on the public debt-to-GDP ratio show that, although Brazil is on par with the average of Eurozone countries and has a lower debt level than developed G7 nations, its Debt-to-GDP ratio is significantly higher than the average of emerging markets and the countries of Latin America and the Caribbean. This highlights the importance and prominence that the discussion about the sustainability of Brazil's debt accumulation process has gained. **(Page 12)**

Lastly, on behalf of the Independent Fiscal Institution, we would like to express our deepest gratitude for the contribution, competence, and dedication that economist Vilma Pinto has brought to the IFI over the past 38 months. She now leaves our board to take on a significant role in the economic advisory team of the Vice Presidency of the Republic.

Happy reading!

Marcus Pestana
IFI Executive Director

Alexandre Andrade
IFI Director

Evolution and outlook of the GDP deflator

Rafael Bacciotti

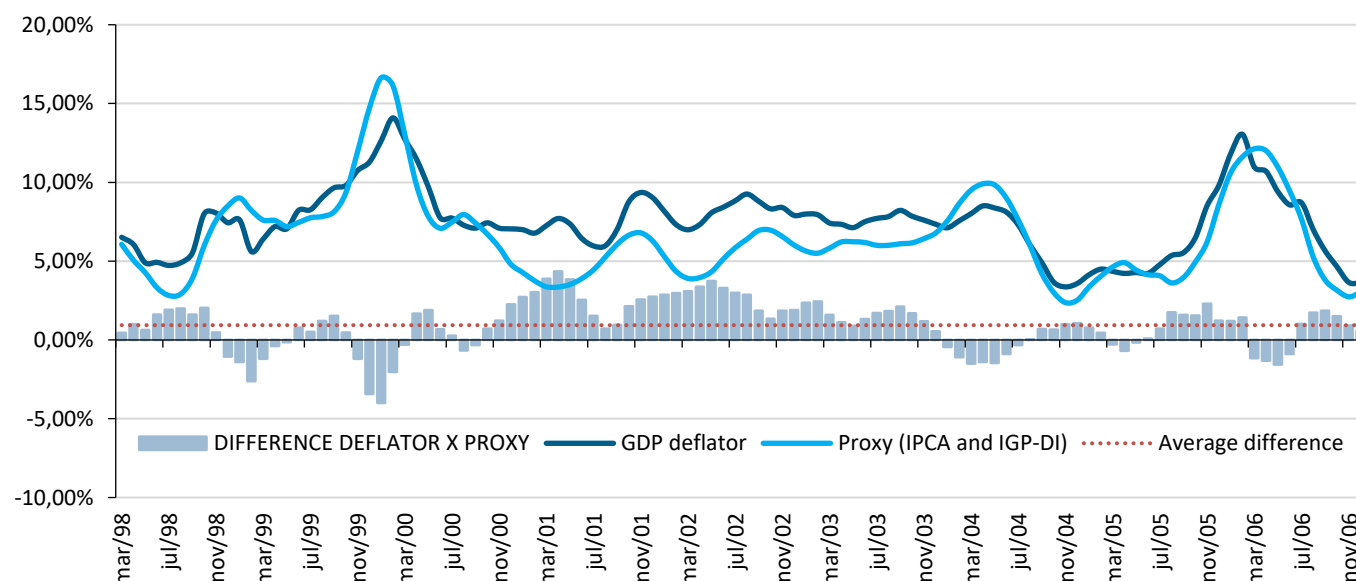
This text examines the recent evolution of the GDP deflator, presents the assumptions underlying the IFI's projections for 2024 and 2025, and provides comparisons between the IFI's nominal GDP projections, those of the Secretariat for Economic Policy (SPE) and the Fiscal Prisma Report.

The release of the Quarterly National Accounts by the Brazilian Institute of Geography and Statistics (IBGE) indicated that the gross domestic product (GDP) reached BRL 2.888 trillion in current values, totaling BRL 11.174 trillion over the four quarters ending in June 2024. Compared to the same period last year, nominal GDP, which reflects the monetary value of domestic production, increased by 6.2%. In the same comparison, real GDP (in volume) and the implicit deflator showed variations of 2.5% and 3.6%, respectively.

The GDP deflator, calculated by the ratio between nominal GDP (or GDP at current prices) and real GDP (or GDP at constant prices), implicitly measures price changes in goods and services produced in the country. Tracking the evolution of the GDP deflator is important for developing nominal GDP projections¹ and for assessing fiscal indicators expressed as a proportion of nominal GDP, such as public debt.

The IFI's short-term projection for the GDP deflator is conducted through a comparative analysis between the GDP deflator, the Broad Consumer Price Index (IPCA), and the General Price Index – Internal Availability (IGP-DI). The Graph 1 shows the evolution of the GDP deflator in comparison with the *proxy* constructed using a weighted average² of the changes in the IPCA and the IGP-DI.

GRAPH 1. PRICE INDICES: AVERAGE VARIATION (4 QUARTERS COMPARED TO THE PREVIOUS 4 QUARTERS)



Prepared by: IFI, based on IBGE data

1 According to the equation: $\text{Nominal GDP}_t = \text{Nominal GDP}_{t-1} * (1 + \Delta\% \text{ GDP in volume}_t) * (1 + \Delta\% \text{ GDP Deflator}_t)$, where $\Delta\%$ indicates the percentage variation.

2 The weights of the IPCA and IGP-DI were estimated by the IFI through a regression analysis, using the average variations of the implicit GDP deflator, the IPCA, and the IGP-DI.

The IPCA, which reflects the increase in the cost of living from the consumers' perspective, shows a strong correlation with the GDP deflator, as household consumption accounts for a significant portion of GDP from the expenditure perspective (63% in the second quarter of 2024). The IGP-DI, in turn, was chosen because of its wider scope, since it measures price variations in wholesale (including agricultural and industrial products), retail (considering the cost of living for families) and construction (materials, labor and services).

Historically, the GDP deflator shows higher rates than the IPCA, for reasons discussed in IFI Technical Note No. 18³. Between 1997 and 2023, the GDP deflator's average annual growth rate was 7.5%, exceeding the IPCA by 1.3 percentage points (p.p.).

In the same period, the difference between the GDP deflator and the variable constructed from the IPCA and IGP-DI was slightly smaller, at 1.0 percentage point (p.p.). It is worth noting that in the second quarter of 2024, this difference was 0.6 p.p., lower than in previous quarters: first quarter of 2024 (0.9 p.p.), fourth quarter of 2023 (1.5 p.p.), third quarter of 2023 (1.8 p.p.), second quarter of 2023 (1.7 p.p.), and first quarter of 2023 (1.0 p.p.).

The projection for the GDP deflator presented in the September RAF⁴ indicates a variation of 3.7% in 2024 and 3.9% in 2025. Let's imagine that, on this horizon, the difference between the GDP deflator and the weighted average of the IPCA and the IGP-DI will continue to decrease, in line with the trend observed in previous quarters. Thus, for 2024 and 2025, the GDP deflator should evolve in line with the price indices.

Table 1 presents IFI's projections for nominal GDP (in billions of reais) and growth rates (nominal GDP, real GDP, and the deflator), compared with the latest figures from the Secretariat of Economic Policy (SPE)⁵ and the Prisma Fiscal Report⁶, produced by SPE to monitor market expectations regarding fiscal metrics.

TABLE 1. PROJECTIONS FOR NOMINAL GDP: IFI, SPE AND PRISMA FISCAL

	2024	2025	2024	2025	2024	2025
	IFI		SPE		Prisma Fiscal	
Nominal GDP (BRL billion)	11.579	12.249	11.618	12.492	11.607	12.361
Nominal GDP - variation. (%)	6,7%	5,8%	7,0%	7,5%	6,9%	6,5%
Real GDP - Var (%)	2,8%	1,8%	3,2%	2,5%	2,4%	1,8%
GDP Deflator - Var. (%)	3,7%	3,9%	3,7%	4,9%	4,4%	4,6%
IPCA - var. (%)	4,4%	3,7%	4,3%	3,4%	-	-
IGP-DI - Var. (%)	4,5%	4,0%	3,8%	3,8%	-	-

Source: IFI and STN.

It can be seen that the projections for the level of nominal GDP in 2024 are relatively close, with greater divergences appearing in 2025. The difference between the Prisma figures and the IFI is mainly due to the deflator. Comparing the SPE with the IFI, the discrepancies stem from both real GDP growth and the deflator.

³ In general, the growth rate of the household consumption deflator—calculated from a more limited basket than GDP—tends to exceed the rate recorded by the IPCA by approximately 1.0 p.p. Although these indices are conceptually similar, a significant portion of the historical difference between the household consumption deflator and the IPCA is due to a scope effect, particularly related to items such as imputed rent and financial intermediation services indirectly measured. These items cause the consumption structure in the National Accounts to differ from that observed in the Household Budget Survey (POF) and the IPCA, which only account for actual rent costs and bank service fees. For more information, see Technical Note No. 18: <https://tinyurl.com/4arw5r48>.

⁴ Available at: <https://tinyurl.com/4ptvy5um>.

⁵ Available at: <https://tinyurl.com/mam8fvxm>.

⁶ Available at: <https://tinyurl.com/4bj2v2wp>.

Considerations on the recent trajectory of gross debt and its drivers

Alexandre Andrade

The Gross General Government Debt (DBGG) reversed the downward trend observed until the end of 2022 and began to rise in 2023, reaching 78.5% of GDP in August 2024. According to the drivers of gross debt, this increase in indebtedness occurred primarily due to (i) lower contributions from nominal GDP, (ii) the behavior of interest expenses, and (iii) net debt issuances. The prospect of public sector fiscal deficits in the coming years, along with the real interest rate being kept at a relatively high level, will contribute to the continued upward trend in debt.

Initial considerations

The aim of this text is to discuss the recent evolution of the Gross General Government Debt (DBGG)⁷, calculated by the Central Bank, which is the debt indicator most used by analysts to assess the sustainability of public accounts. In September⁸, the IFI revised its projection for the indicator in the short term. The new estimates for DBGG in 2024, 2025 and 2026 are 80.0% of GDP, 82.2% of GDP and 84.1% of GDP respectively.

In the accumulated period of 2024 up to August, the DBGG recorded an increase of 4.1 p.p. of GDP, reaching 78.5% of GDP. This increase occurred primarily due to the rise in financing needs, especially the payment of nominal interest. This expense, in turn, is related to the accumulation of recurring fiscal deficits in the public sector, particularly within the central government, which includes the National Treasury, the Social Security, and the Central Bank.

This deterioration in gross indebtedness over the past two years, along with the prospect of further worsening in the coming years, somewhat contradicts the rationale presented by the credit rating agency Moody's in a report⁹ published on October 1st, in which it upgraded Brazil's sovereign credit rating and maintained a positive outlook.

Recent evolution of gross debt and its drivers

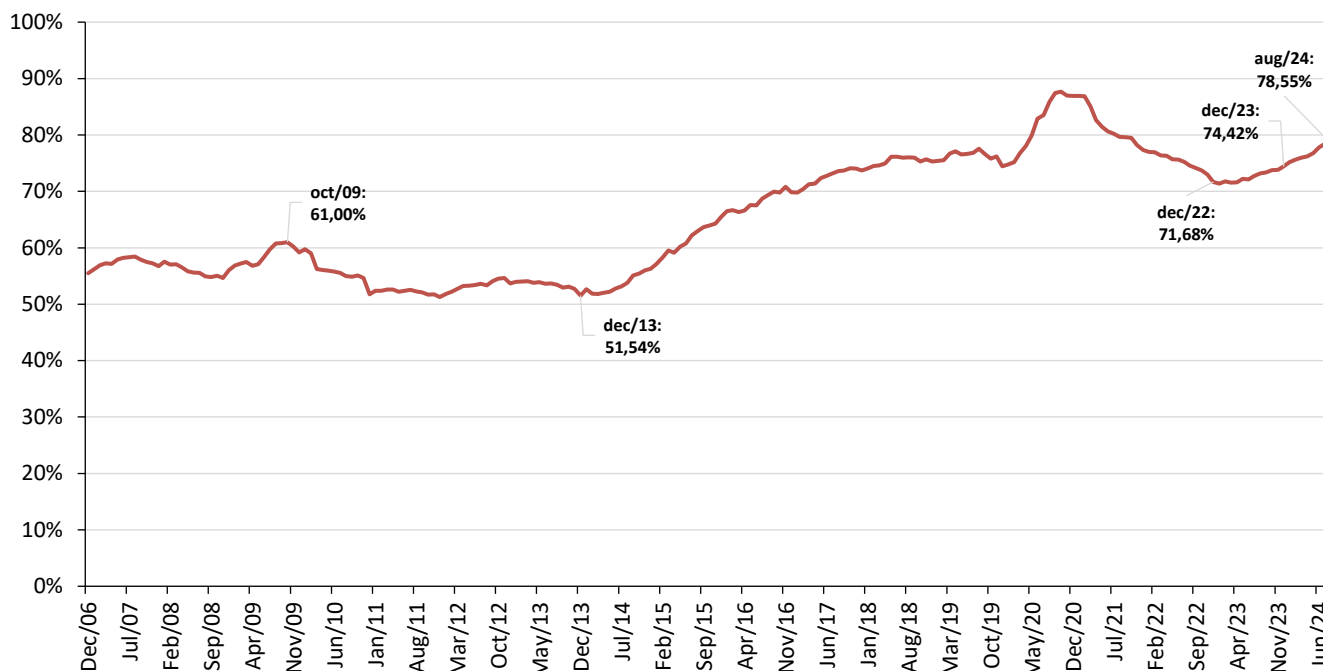
Graph 2 shows the recent evolution of the DBGG as a proportion of GDP. The figure shows the indicator rising from 2023 onwards. The debt went from 71.7% of GDP in December 2022 to 74.4% of GDP in December 2023, and rose to 78.5% of GDP in August 2024, the latest data available. From December 2022 to August 2024 the DBGG rose by 6.9 p.p. of GDP.

⁷ For a better explanation of the indicator, see Special Study (EE) No. 7, from October 2018, available at: <https://tinyurl.com/27t26wvz>.

⁸ See RAF No. 92, from September 2024, available at: <https://tinyurl.com/ifi-raf92-set24>.

⁹ Link to news published on the website of the Ministry of Finance: <https://tinyurl.com/3za22mdf>. Here is the link to Moody's report, in English: <https://tinyurl.com/muyn9xfz>.

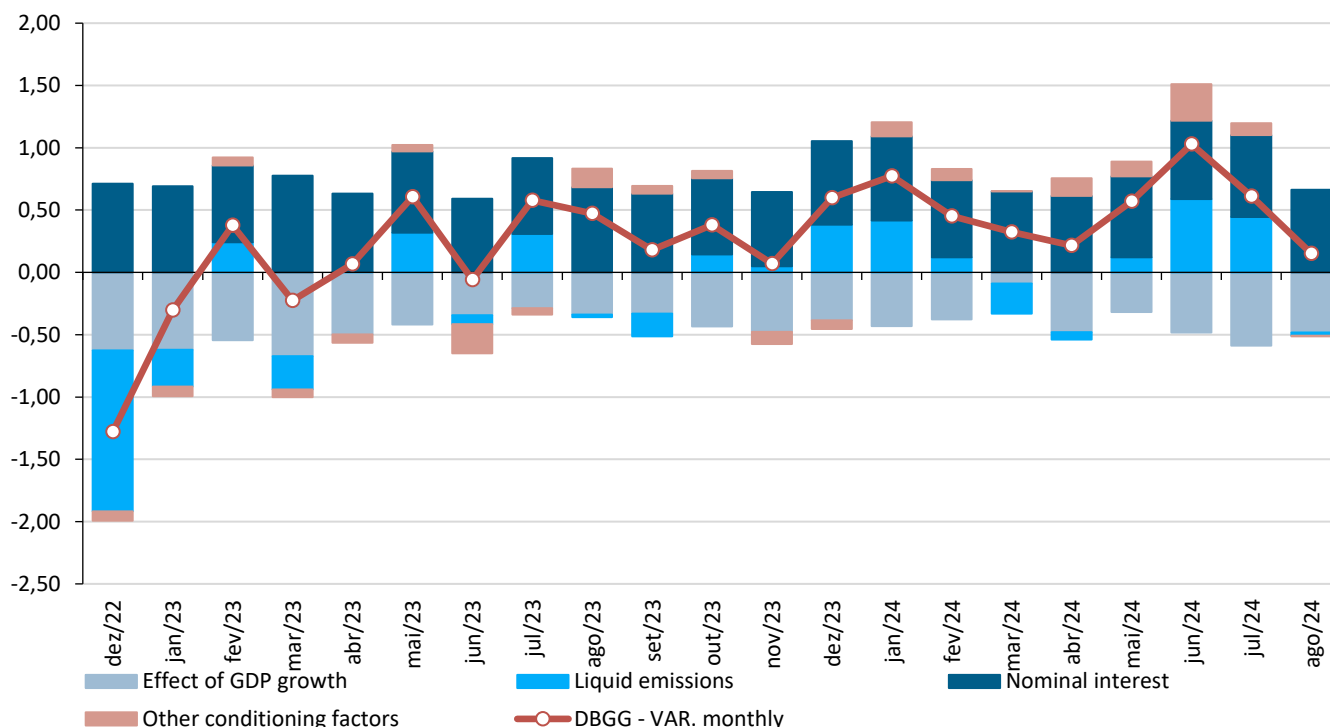
GRAPH 2. GENERAL GOVERNMENT GROSS DEBT (% OF GDP)



Source: Central Bank. Prepared by: IFI.

Graph 3, which shows the monthly evolution of the main drivers of the DBGG, in percentage points (p.p.) of GDP, helps to explain the upward trajectory of the indicator over the past two years. Although this fact is not shown in the figure, the reduction observed in the DBGG in 2021 and 2022 was primarily due to the effect of the increase in nominal GDP, which contributed negatively by 13.5 p.p. of GDP and 8.2 p.p. of GDP in those years, respectively.

GRAPH 3. MONTHLY EVOLUTION OF DBGG DRIVERS (P.P. OF GDP)



Source: Central Bank. Prepared by: IFI.

In 2023 and 2024, the effect of nominal GDP growth continued to be negative, i.e. the evolution of GDP reduced the DBGG, although the rates fell. In 2023, the effect of GDP growth on the DBGG was negative by 5.1 p.p. of GDP. In 2024, in the eight months to date, this effect was negative by 3.2 p.p. of GDP (monthly effects in Graph 3).

In addition to a smaller contribution from GDP growth, the DBGG was further pressured in 2023 and 2024 primarily by the evolution of financing needs and, to a lesser extent, by other driving factors, especially exchange rate adjustments. Interest expenditure, which had contributed to an increase of 5.5 p.p. of GDP in 2021 and 7.3 p.p. in 2022, increased its contribution to 7.5 p.p. in 2023 and, in the accumulated eight months of 2024, has already had an impact of 5.2 p.p. of GDP on gross debt. In turn, net debt issuance, which made negative contributions in 2021 and 2022, and a positive 0.6 p.p. of GDP in 2023, already contributed 1.4 p.p. to the rise in the DBGG between January and August this year.

In short, the upward trajectory of the DBGG as a proportion of GDP between 2023 and 2024¹⁰ can be explained by: (i) the reduced effect of GDP growth on the debt; (ii) the increase in financing needs (interest payments and net debt issuances); and (iii) exchange rate adjustments.

Also contributing to debt dynamics are (i) the average maturity of bonds and (ii) the average cost of debt. Ideally, the government seeks to extend the maturity of the debt to facilitate the management of these obligations. In the opposite situation, that is, if the debt consists of obligations maturing in a few months, the government becomes more exposed to uncontrolled variables, such as the international environment, should it need to roll over the debt. For example, in 2020, there was a sharp increase in the issuance of short-term bonds (maturing within a year) due to the higher risk premiums demanded by market participants during Treasury auctions. The uncertainties in the economy associated with the pandemic have contributed to this. Starting in the second half of 2021, the Treasury gradually managed to extend the average maturity of the bonds issued.

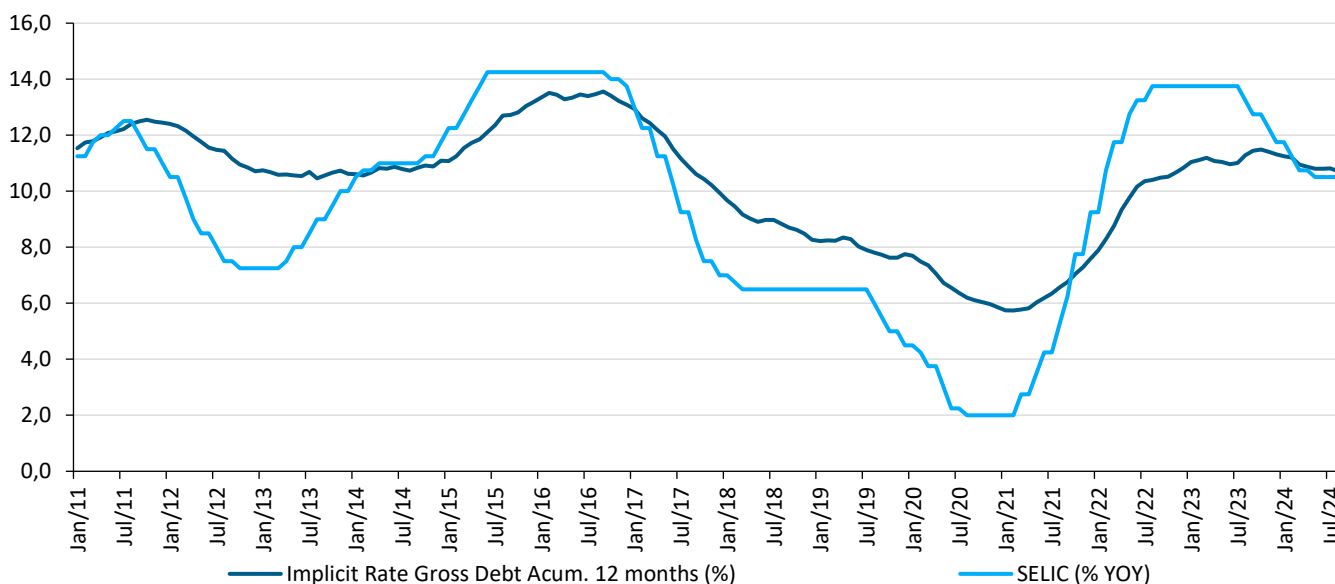
In 2021 and 2022, the Treasury was able to manage the debt without relying on a large volume of issuances due to several factors. For instance, the liquidity reserve was used to reduce the volume of issuances, thanks to the inflow of exclusive budgetary revenues for public debt repayment, such as dividend and concession revenues, the Central Bank's operational results, the unbinding of public funds, and the return of credit operations. Some of these revenues were made possible due to the more favorable international environment. In 2021 and 2022, there was a "mini commodity boom" that boosted domestic economic activity and government revenues, including dividends and natural resource exploration revenues.

The average cost of debt is another relevant variable for fiscal sustainability. This refers to the average annual amount the government pays to roll over its debt, including interest and amortizations. The Central Bank calculates and publishes the implicit gross debt rate, which is influenced by the composition of the debt stock, the behavior of domestic and international interest rates, inflation, and the risk perception of bondholders.

Graph 4 shows the implicit gross debt rate accumulated over 12 months and the Selic rate (target) for the year. It can be seen that the two curves run close together. The implicit DBGG rate was 10.71% p.a. in August, compared to 10.81% p.a. in July. With the start of a Selic rate hike cycle in September, the implicit debt rate will probably rise in the coming months. This perception is reinforced by the recent composition of public debt.

¹⁰ For more details, see Table 8 of the aforementioned RAF no. 92, from September 2024.

GRAPH 4. IMPLICIT GROSS DEBT RATE ACCUMULATED OVER 12 MONTHS (%) AND SELIC RATE - TARGET (% PER YEAR)

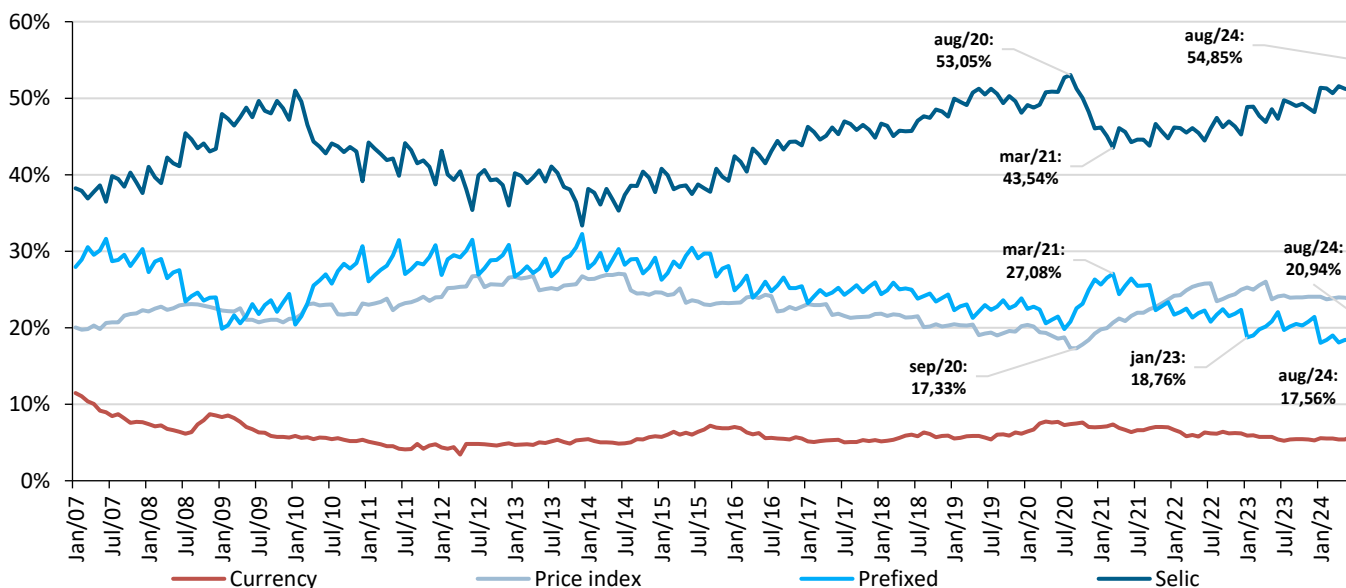


Source: National Treasury Secretariat. Prepared by: IFI.

According to Central Bank data on the composition of bonds (differentiated by indexer) in the DBGG, the proportion of floating-rate bonds (indexed to the Selic rate) has been on an upward trend since 2021, while fixed-rate bonds have lost significance during the same period. Bonds indexed to price indices have remained stable at around 24% of the DBGG. It is worth noting that in August, this share declined to 20.9% due to the redemption of a large volume of bonds maturing in the same month in 2024. This information can be seen in Graph 5.

The increase in the relative share of bonds indexed to the Selic rate in the composition of the DBGG reflects investors' preference for liquidity. The context of rising base interest rates (Selic) and increasing uncertainties in the economic environment leads investors to prefer floating-rate bonds in Treasury auctions

GRAPH 5. IMPLICIT GROSS DEBT RATE ACCUMULATED OVER 12 MONTHS (%) AND SELIC RATE - TARGET (% PER YEAR)



Source: Brazilian Central Bank. Prepared by IFI.

The preference of public debt investors for bonds linked to the Selic rate led the Treasury to revise the 2024 Annual Financing Plan (PAF 2024) last August, setting new reference limits for the composition of the Federal Public Debt (DPF)¹¹. It is important to note that there are methodological differences between the calculation of the Federal Public Debt (DPF), as determined and published by the National Treasury Secretariat (STN), and the computation of the Gross General Government Debt (DBGG), calculated by the Central Bank¹². In other words, the new reference limits set in the PAF 2024 indicate the Treasury's expectation of a continued increase in the share of bonds indexed to the Selic rate in the DPF (the DBGG encompasses, in addition to the DPF, state and municipal debts, banking debts of entities, among other components).

Considerations on Moody's report

In general terms, the report released on October 1st by Moody's improved Brazil's sovereign credit rating and maintained a positive outlook. Thus, Brazil is now one level away from achieving investment grade status with this credit rating agency.

In RAF No. 92 from September 2024, the IFI revised the short-term macroeconomic and fiscal scenarios. In the macroeconomic environment, the growth estimate for the Brazilian economy in 2024 was adjusted from 2.0% to 2.8%, although the projections for growth in 2025 and 2026 remained largely unchanged due to the impact of higher interest rates on domestic economic activity. In the medium term (2026 to 2034), the IFI estimates that average real growth will be 2.2%, considering the potential of the Brazilian economy.

That RAF also incorporated into the scenario the Selic rate hike cycle started by the Central Bank in September, which will raise real interest rates this year and next, having an effect on the gross debt trajectory. This slight increase in the real interest rate and the new estimates for the primary balance of the consolidated public sector led to a deterioration in IFI's projections for the DBGG this year and in the following two years. By the end of 2024, DBGG should stand at 80.0% of GDP.

In Moody's report, the agency justified the upgrade of Brazil's credit rating based on: (i) the more robust growth performance in the recent period; and (ii) the implementation of economic and fiscal reforms in recent years, which have brought resilience to the country's credit risk profile. The agency also pointed out that the credibility of the fiscal framework, introduced in 2023, is still moderate.

As a limiting factor for Brazil's sovereign credit rating, Moody's mentioned risks related to meeting fiscal targets, due to budgetary rigidity and the growth of mandatory expenditures outside the framework rule.

Although Brazil's real economic growth has been robust since 2021 (4.8% in 2021, 3.0% in 2022, and 2.9% in 2023), this performance was driven by high commodity prices, resulting in an improvement in Brazil's terms of trade. These growth rates recorded in recent years are above the potential growth of the economy, estimated by the IFI (2.2%).

Furthermore, as discussed in RAF No. 92, despite the positive performance of primary revenues in 2024, the growth rate of primary expenditures is outpacing that of revenues, particularly (i) for expenditure groups affected by the new minimum wage adjustment rule, and (ii) for other groups linked to the behavior of net current revenue and the Federal Government's net tax revenue. It is therefore becoming difficult for the Executive to meet the fiscal targets set out in the budget guidelines. The IFI's projections for the short term, revised and presented in RAF No. 92, indicate primary deficits for the central government this year, in 2025 and 2026.

The IFI's revised projections for the DBGG indicate further increases in the indicator over the coming years due to the prospect of primary deficits in the public sector, particularly in the central government. Considering, moreover, the IFI's most recent projections for the medium-term fiscal scenario, presented in RAF No. 89¹³, from June 2024, gross debt will continue to rise over the next few years in the baseline scenario. This estimated trajectory for indebtedness indicates the challenges associated with the sustainability of public accounts in the medium term.

¹¹For more information, see the Monthly Debt Report for July 2024, available at: <https://tinyurl.com/stn-rmd-ago24>.

¹²For a more detailed explanation, please refer to the previously mentioned Special Study (EE) No. 7, of October 2018.

¹³Page to access the document: <https://tinyurl.com/ifiraf89jun24>.

Fiscal policy inconsistency remains an obstacle to achieving investment grade status

Eduardo Nogueira

Credit rating agencies view Brazil as capable of absorbing external shocks and maintaining moderate economic growth in the short term, but they warn of the need to address fiscal challenges to ensure sustainability in the medium and long term. The IFI emphasizes that the lack of clear limits on indebtedness affects the implementation of a sustainable fiscal policy, keeping the country at a high level of indebtedness. Additionally, the IFI highlights that both economic theory and empirical evidence show that indebtedness cannot grow indefinitely, requiring a reversal of fiscal imbalances to avoid risks to debt repayment capacity.

The revision of the country's sovereign rating reinforces the discussion on the management of fiscal policy

On October 1, 2024, Moody's Ratings (Moody's) upgraded¹⁴ Brazil's sovereign credit rating¹⁵. The decision came one week after the meeting¹⁶ between the President of the Republic, members of the federal government's economic team, and representatives from the major credit rating agencies.

With Moody's decision to upgrade Brazil's rating from Ba2 to Ba1, while maintaining a positive outlook, Brazil is now one level below investment grade according to the agency's criteria. Thus, given the positive outlook, it is possible to foresee the country regaining its investment grade rating in the short term (on average, within 12 to 18 months), a position it has not held since February 24, 2016.

This upgrade took place five months after the previous review, carried out on May 1, 2024, which maintained the credit rating¹⁷, but revised the outlook to positive, already signaling a potential improvement in the credit score in the short-term horizon. Thus, although the improvement in the evaluation could have been expected, the short time span between evaluations may have surprised economic agents.

The rating upgrade caused some friction between analysts¹⁸, who disagree with Moody's assessment, and the federal government's economic team, which agrees with the agency's evaluation¹⁹. Other major agencies such as Fitch Ratings²⁰(Fitch) and Standard & Poor's²¹(S&P) have already issued statements indicating that they do not foresee a rating change in the short term.

Despite the discussions about "who is right," which are not the focus of this analysis, other relevant points regarding the management of fiscal policy, aimed at achieving investment grade status, can be explored.

Considerations on the methodologies adopted by major credit rating agencies

First of all, it should be noted that the sovereign credit assessment methodology of the three major rating agencies (Moody's Ratings²², Fitch Ratings²³ and Standard & Poor's²⁴) is public and available on the internet.

¹⁴ Available at: <https://tinyurl.com/52reb4f6>.

¹⁵ According to the National Treasury Secretariat, a sovereign credit rating is the grade assigned by institutions specialized in credit analysis, known as credit rating agencies, to a debt-issuing country. These agencies assess a country's ability and willingness to honor its debt payments fully and on time. The rating is a relevant tool for investors, as it provides an independent opinion on the credit risk of the debt of the country being analyzed. Available at: <https://tinyurl.com/56vd2ksn>.

¹⁶ Available at: <https://tinyurl.com/4mwwdd2w>.

¹⁷ Available at: <https://tinyurl.com/bdeay2bc>.

¹⁸ See, for example: <https://tinyurl.com/2s4xbtn4>.

¹⁹ The position of the economic team can be seen, for example, during the presentation meeting of the National Treasury Report for August Available at: <https://tinyurl.com/57bb2p3j>.

²⁰ Available at: <https://tinyurl.com/5e5x7ca4>.

²¹ Available at: <https://tinyurl.com/5fpujxmn>.

²² Available at: <https://tinyurl.com/yk825nzc>.

²³ Available at: <https://tinyurl.com/2p985fdv>.

²⁴ Available at: <https://tinyurl.com/mpac87j5>.

Although there are significant differences between the methodologies adopted by these agencies, as a rule, the evaluation considers quantitative and qualitative factors and adopts a forward-looking perspective. In this case, it is future-oriented, considering past factors, particularly those related to the failure to meet previous commitments (“defaults”).

Another commonality between the methodologies is the assessment of political and economic factors, both structural and cyclical, as well as the possibility of additional adjustments after applying the standard model. Thus, the result obtained from the mere application of the model's factors can be subsequently adjusted based on the final assessment of the experts involved in the process.

As a first point of attention, and using a didactic classification that may not correspond exactly to each agency's specific structure, it is possible to observe that the analysis of factors is based on five major areas of evaluation: institutional performance, economic performance, monetary policy, fiscal policy, and external accounts.

The agencies consider the impact of institutions and public governance on the country's macroeconomic policies, along with public transparency, political accountability, the culture of debt repayment, and both geopolitical and security risks, internal and external.

Economic performance is another key factor, highlighting the country's income level and its growth prospects, economic diversification and resilience to external shocks as elements that influence the government's debt capacity.

Monetary policy analysis examines the independence and ability of the monetary authority to sustain money power and economic growth, as well as mitigate economic or financial shocks. This assessment is based on the exchange rate regime, the credibility of monetary policy (as measured by inflation trends and the achievement of targets), and the ability of market mechanisms to influence the real economy.

The assessment of fiscal policy looks at the sustainability of fiscal deficits and the country's debt burden. This analysis takes into account budgetary and fiscal performance and flexibility, fiscal risks, the debt burden, the debt structure, the capacity to generate revenue and control expenditures, and access to public debt financing.

The analysis of external accounts focuses on the transactions and positions of the country's residents in relation to the rest of the world. It includes the country's international reserves position and external liquidity, the ability to generate foreign currency to meet its current external obligations and the status of the country's currency in international transactions.

The methodological differences lie mainly in the way these factors are weighted and organized. Fitch, for example, gives greater weight to economic structure and vulnerability to shocks, using a multiple regression model to generate its ratings.

Moody's, in turn, uses a scorecard approach, where economic resilience is calculated with equal weights for economic and governance factors, while fiscal strength is given variable weighting depending on the context.

Standard & Poor's, on the other hand, distributes its qualitative analysis across five distinct pillars, emphasizing factors such as the quality of institutions, economic diversity, and monetary policy, with a detailed focus on the government's ability to adapt to internal and external shocks.

Another relevant divergence is in the consideration of risk events. All agencies assess susceptibility to crises, but Moody's and S&P highlight this factor as an explicit component in their methodologies, assigning significant weight to it in the final evaluation.

Finally, the way in which the agencies deal with monetary policy also varies. S&P includes a specific assessment of the exchange rate regime and the credibility of monetary policy, while Fitch and Moody's integrate this factor within other factors.

A second important point for understanding the agencies' methodology is to check which are the main indicators used to measure each of the factors. A straightforward approach would be to review the methodologies published by the agencies and check the weights assigned to each factor, as well as the weights of each indicator within each factor.

Another approach is to consult empirical studies²⁵ that seek to understand, in practice, which factors are the key determinants for sovereign credit rating evaluations of countries. Although there are differences in the results, GDP per capita growth, real GDP growth, public debt, and the public deficit are generally identified as the main short-term indicators in a country's credit rating.

On the other hand, according to these studies, the country's institutional performance, the level of external debt, the level of foreign reserves and the history of past defaults are important determinants of the long-term credit rating.

Comparing the results of the studies with the methodologies published by the agencies, it is possible to observe a strong alignment between the key indicators. Some studies even achieve accurate predictions of the agencies' ratings based on these indicators²⁶. This leads us to believe that, in fact, the methodology is mostly followed by the agencies, with small occasional and expected deviations.

The third important point to highlight in the methodology is that the agencies assess the ability to repay debts issued in local and foreign currency with different weightings. The three major credit rating agencies share some commonalities when assessing sovereign debt issued in local currency (LC) and foreign currency (FC). They all agree that in many cases, especially for investment-grade countries, LC and FC ratings tend to be equal or very close.

This similarity is based on the understanding that, in these cases, the countries have both the capacity and the willingness to honor their debts in both currencies.

In fact, by reviewing the historical record of debt ratings²⁷ available on the National Treasury Secretariat (STN) website, we can observe that, most of the time, the rating for local currency-denominated debt simply followed the rating for foreign currency-denominated debt. Most of the discrepancies are found in older assessments, primarily in the early 2000s, when different criteria were applied, as the agencies' methodologies are continuously revised.

In addition, the country did not have a high level of international reserves, which grew significantly between mid-2006 and 2012²⁸. It is worth noting that the level of international reserves is a highly relevant factor, especially for foreign currency-denominated debt, but also for local currency-denominated debt²⁹.

Another point of convergence is the recognition that a sovereign's ability to control its own currency and domestic financial system can provide additional support to the local currency (LC) rating. These powers allow sovereign governments to issue their own currency and regulate the financial system, providing greater flexibility to meet their obligations in local currency.

In this way, the inability of countries, especially emerging economies, to develop a domestic debt market is seen in specialized literature as the "original sin"³⁰, as this situation makes these countries highly vulnerable to external shocks.

Furthermore, all agencies agree that in cases of monetary unions or the use of foreign currency, where the government loses control over monetary policy, LC and FC ratings tend to be the same, as the country no longer controls the issuance of its currency.

On the other hand, there are important differences in the way the three agencies treat LC and FC. Moody's rarely differentiates between LC and FC, except in cases where there are severe external liquidity restrictions or capital mobility limitations. When differentiation occurs, it rarely exceeds two levels, and Moody's may choose not to apply this distinction if there are expectations of an improvement in the country's external position.

²⁵ See, for example: <https://tinyurl.com/4a2whcxj>, <https://tinyurl.com/5xfike7t>, <https://tinyurl.com/34raya52>, <https://tinyurl.com/59hrdez5>, <https://tinyurl.com/5n8z4m66>, and <https://tinyurl.com/4aapes4v>.

²⁶ See, for example: <https://tinyurl.com/ycry44ny>.

²⁷ Available at: <https://tinyurl.com/3spdxsuj>.

²⁸ See, for example, IFI's Special Study No. 1 of 2017. Available at: <https://tinyurl.com/mtakcy9r>.

²⁹ See, for example: <https://tinyurl.com/5n6t69ys>.

³⁰ See, for example: <https://tinyurl.com/3npm82wk>.

Fitch, on the other hand, is more flexible, allowing for greater differences, especially for countries below investment grade or in situations of financial stress. The agency considers factors such as the strength of public finances compared to external finances, preferential treatment of creditors, and the depth of the local capital market to determine whether the LC rating can be up to two levels higher than the FC rating, or, in rare cases, whether the FC rating can be higher than the LC rating.

S&P is the most restrictive of the three agencies, allowing a maximum of one level of difference between LC and FC, arguing that sovereign powers over the local currency justify a limited adjustment. When a country has no control over its currency (for example, in a monetary union), S&P considers that LC and FC should have the same rating.

Thus, while the three agencies share the view that countries with control over their local currency may have additional support for debt issued in LC, they differ in the magnitude and conditions that justify such a differentiation. These variations reflect the different analytical approaches that each agency adopts when assessing sovereign risk in local and foreign currency.

Local currency debt does not guarantee immunity from debt restructuring

Although some economists disagree³¹, another interesting point for the debate is to note that local currency debt is not immune to default³² and high levels of local currency indebtedness can lead to a fiscal crisis, especially if the economy is exposed to adverse shocks.

In fact, according to S&P, 2023 was the first year since 1999 in which defaults in local currency exceeded those in foreign currency³³. However, other studies³⁴, with broader datasets, show that between 1995 and 2016, local currency restructurings outpaced foreign currency ones, with a growing trend of local currency defaults.

Fitch, on the other hand, highlights in its methodology that most sovereign governments, through the central bank, have ultimate control over the domestic money supply and, in theory, could print money to finance themselves, although not indefinitely and at the cost of high inflation.

According to the credit rating agency, while many countries have preferential access to domestic capital markets, which can be a more reliable source of financing than international capital markets, especially during times of crisis, it remains entirely feasible for sovereign debts to default in local currency. The agency highlights numerous examples of such defaults in the past two decades³⁵.

This happens because, even as investors demand increasingly higher interest rates to roll over the debt, anticipating the inflationary impacts of monetary expansion, there comes a point when economic agents may lose faith in the government's ability and willingness to fully honor its debts. This occurs when the financial cost of fulfilling contracts becomes higher than the financial and reputational cost of defaulting on those commitments.

Thus, facing difficulties in rolling over its debt in the local market and collecting less than enough to cover its expenses, it is possible that the government could enter a fiscal crisis and be forced to default and impose a "haircut," that is, enforce a restructuring (default), with a reduction in the amounts owed, even if denominated in local currency.

In this regard, it is worth noting that the International Monetary Fund (IMF) published an extensive study³⁶ in December 2021 on the restructuring of sovereign debts denominated in both local and foreign currencies, in which it states that the majority of public debt restructuring events were preceded by economic and fiscal pressures, triggered or exacerbated by real or financial shocks, both domestic and external.

³¹ See, for example: <https://tinyurl.com/ywd5rk9p>.

³² If this were true, all debts denominated in local currency would be classified as "triple A", i.e. the lowest level of risk.

³³ Available at: <https://tinyurl.com/5essm29y>.

³⁴ See, for example: <https://tinyurl.com/3ts6s3ak> e <https://tinyurl.com/bdf5e62x>.

³⁵ See, for example: <https://tinyurl.com/ym7x6tac>.

³⁶ Available at: <https://tinyurl.com/35yuv76j>.

The study also highlights that public debt levels before restructuring were relatively high in all the cases analyzed. The median public debt-to-GDP levels prior to restructuring were 70% for debt restructuring events under domestic law (DDR), 79% for external debt restructuring events (EDR), and 88% for external debt restructuring accompanied by domestic law debt restructuring events (EDR/DDR).

The IMF study also highlights that the share of domestic public debt in relation to total indebtedness matters as well, given that the median share of domestic debt in total public debt prior to restructuring was notably higher for DDR (37%) than for EDR (27%). This indicates that a larger stock of domestic debt makes its inclusion in a restructuring more likely.

The share of external public debt held by private creditors, that is, the profile of debt holders³⁷, also matters. External public debt held by private creditors was very low before the DDR (9% of total public debt), compared to 28% for EDR and 65% for EDR/DDR. This suggests that countries may have opted for isolated DDR because external debt restructuring would not result in significant debt relief, while imposing higher reputational costs.

Another important point is the availability of domestic bank credit to the private sector. In countries that underwent DDR, the level of financial deepening and the private sector's dependence on domestic bank credit were much lower compared to cases of EDR or EDR/DDR. This could mean that countries choose DDR when the ability of the banking system to transmit shocks to the broader economy (in the event that banks have to absorb losses due to the restructuring) is limited, making the domestic costs of restructuring relatively small compared to the external costs.

Finally, the IMF study warns that restructurings of sovereign debt issued under domestic law may become more frequent in the future. This is because, before the mid-1990s, with underdeveloped financial markets and widespread capital controls, debt crises in emerging market and developing economies (EMDE) were often resolved through inflation, financial repression³⁸, and, when necessary, external debt restructuring.

Since then, the proportion of domestic debt in EMDEs has been growing, with a more noticeable increase recently due to the COVID-19 pandemic. With many countries³⁹ at risk of a debt crisis as a result of the pandemic, domestic debt restructurings may be necessary more often due to the lack of sustainability of sovereign debts.

It is important to mention that the IMF has been issuing warnings⁴⁰ not only for emerging and developing countries, considering that the post-pandemic reality is one of higher real interest rates in the long term, lower growth, and increased public indebtedness—factors that will pressure medium-term fiscal trends and financial stability for most countries.

Thus, both empirical data and economic theory show that it is impossible to increase public debt indefinitely, even if it is denominated in local currency. Furthermore, although there is no absolute number or limit, the higher the debt level, the greater the risk that a critical event could unfold in the form of a real, monetary, or fiscal crisis, potentially triggering a public debt crisis—especially in emerging and developing countries with high levels of public debt, such as Brazil.

International comparisons are not favorable to Brazil

As you can see, the level of public debt is an important factor in a country's sovereign credit rating. Moreover, there is an inverse, albeit non-linear and heterogeneous⁴¹, relationship between these variables. In other words, higher indebtedness generally reduces the chances of obtaining (or maintaining) investment grade status. It is not possible to directly compare Brazil's debt level with that of developed countries that have widely accepted currencies and hold investment grade ratings, for example.

³⁷ In the same vein, see also: <https://tinyurl.com/23k6tmb7>.

³⁸ Measures such as controlling capital outflows, for example.

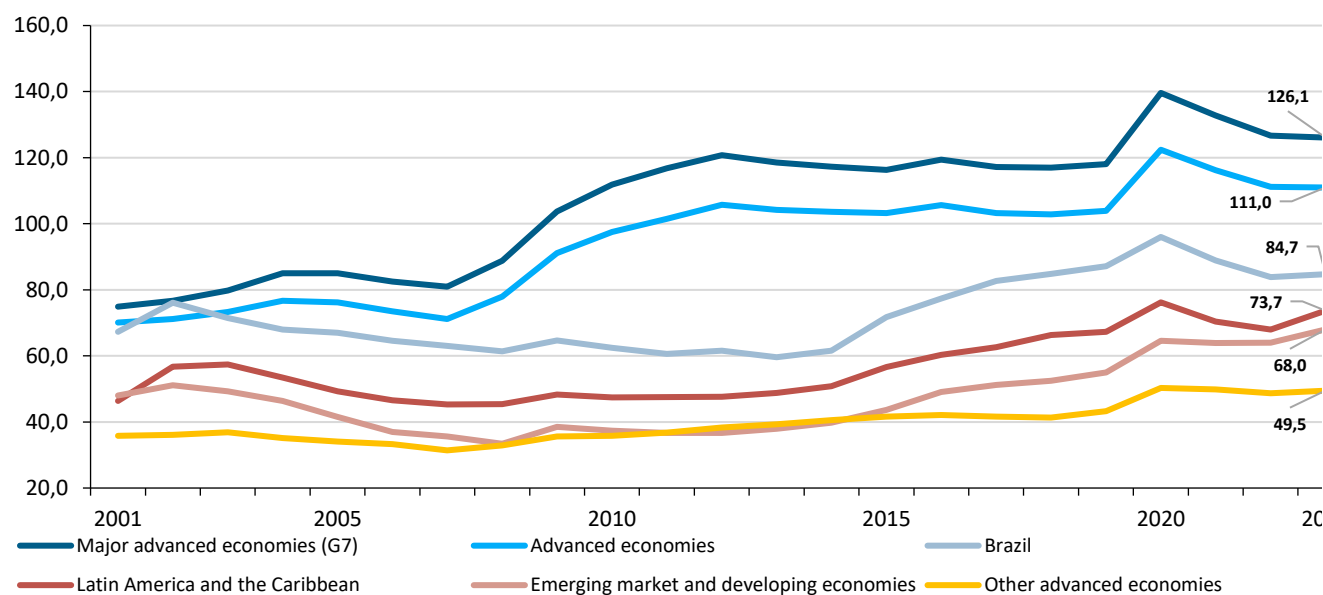
³⁹ According to the World Bank, no fewer than 68 low-income countries are at risk of defaulting on their debts, representing more than one-third of the world's countries. The monitor does not track the risk for high- and middle-income countries, so the overall situation could be even worse. Available at: <https://tinyurl.com/2f648r7y>.

⁴⁰ See, for example: <https://tinyurl.com/fv3nc7tk>.

⁴¹ See, for example: <https://tinyurl.com/fwmy8jkc>.

Thus, although the country's gross debt, according to the IMF's criteria⁴²—which is relevant for international comparisons⁴³—is lower than the average for developed countries in general, and particularly the more advanced economies in the world (G7⁴⁴), our debt levels are higher than those of Latin American and Caribbean economies, as well as the average for emerging and developing countries. In fact, even the average of the other advanced economies⁴⁵, with the exception of the G7 and Eurozone countries⁴⁶, is lower than Brazil's, as can be seen in Graph 6 below.

GRAPH 6. EVOLUTION OF GROSS DEBT (IMF CRITERIA. % OF GDP)



Source: IMF. Prepared by: IFI.

In addition, gross debt of 84.7% of GDP, according to IMF criteria, places Brazil in line with the Eurozone's indebtedness, which stood at 88.7% of GDP at the end of 2023. This figure indicates that the country is vulnerable to shocks, according to IMF studies seen earlier, which show that countries that renegotiate their debt had an average gross debt of between 70% and 88% of GDP at the time of the restructurings.

Although Brazil has established a sustainable fiscal regime that, in theory⁴⁷, provides for a trajectory of public debt convergence, evidenced by the level of fiscal results consistent with stabilizing debt relative to GDP, the measure may lose effectiveness in terms of debt sustainability for two main reasons.

First, because the limits for federal securities debt and the Federal Government's consolidated public debt, as provided for in Article 48, XIV and Article 52, VI of the Federal Constitution, have not yet been established. This allows the debt trajectory to be continuously shifted forward and upward with each new projection, forecasting stabilization at increasingly higher levels and always at the end of the medium-term horizon (10 years).

Second, because even if debt stabilization occurs at current levels, it may be insufficient to eliminate fiscal risks, as it is already at a high level in relation to comparable countries. The Eurozone, for example, is working on a gradual plan to reduce public debt from almost 90% today to 60% of GDP by 2070⁴⁸. This effort requires primary surplus measures of 1.4% of GDP just to stabilize the debt and an additional 0.6% of GDP for long-term debt reduction.

⁴² Available at: <https://tinyurl.com/47nmkj4t>.

⁴³ See, for example: <https://tinyurl.com/jb54hma6>.

⁴⁴ According to the IMF: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

⁴⁵ According to the IMF: Andorra, Australia, Czech Republic, Denmark, Hong Kong, Iceland, Israel, South Korea, Macao, New Zealand, Norway, Puerto Rico, San Marino, Singapore, Sweden, Switzerland and Taiwan.

⁴⁶ According to the IMF: Austria, Belgium, Croatia, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, the Slovak Republic, Slovenia and Spain.

⁴⁷ In accordance with item III, § 5, Article 4 of the Fiscal Responsibility Law. Available at: <https://tinyurl.com/ye88v28n>.

⁴⁸ Available at: <https://tinyurl.com/5n6w3u4a>.

Thus, even advanced economies, which historically benefit from more favorable macroeconomic conditions than Brazil, have gross debt levels that are either lower or in line with those observed in Brazil (with the exception of G7 countries). Moreover, they have plans for the gradual reduction of their debt stock, while the national framework aims merely to stabilize debt levels, a goal that has not yet been achieved.

Converging and diverging views among risk assessment agencies

Given all of the above, it is possible to have a better-informed view of the main convergences and divergences of the recent assessments presented by the main rating agencies. During the term of the current fiscal framework, in addition to the two evaluations carried out by Moody's, mentioned above, another two evaluations were carried out by S&P, in June⁴⁹ and December 2023⁵⁰, and another two by Fitch, in July⁵¹ and December⁵² 2023, as well as an additional commentary in September 2024⁵³.

All three agencies acknowledge the institutional strengthening of Brazil and highlight the pragmatism in the implementation of public policies, despite the challenges in the political sphere. Moody's highlights a progressive improvement in institutional effectiveness due to structural reforms and the presence of "institutional safeguards" that mitigate uncertainties, which was considered a positive factor in its assessments, with an improvement noted between May and October 2024.

S&P, on the other hand, considers that the institutional framework is complex, and that Brazil is slow to implement reforms, although it sees positive signs of political stability, which has led to an increase in the outlook between June and December 2023. Fitch also highlights the pragmatism of the federal government in its political approach, but recognizes the limitations imposed by the National Congress, with little change in its vision between July 2023 and September 2024. In general, the three agencies recognize a growing institutional resilience, but with constant political challenges.

As for economic growth, there have been improvements in the evaluations of the three agencies over time. Moody's revised its growth forecasts upward, highlighting stronger performance in 2024, driven by structural reforms and investments in sectors such as clean energy.

S&P, on the other hand, noted higher-than-expected economic growth, revising its forecasts and attributing this performance to the agribusiness sector and a strong labor market. Similarly, Fitch has successively revised its growth estimates, rising from 2.3% to 3.0% in 2023 and to 2.8% in 2024. However, all agencies remain cautious about the long term growth potential, which is still seen as limited by structural factors such as the low level of investment and the need for additional reforms.

In terms of monetary policy, the agencies acknowledge the Central Bank's effectiveness in controlling inflation, but the trajectory of high interest rates is viewed with caution due to its fiscal impact. Moody's highlighted the Central Bank's independence and effectiveness in conducting monetary policy, which contributed to the anchoring of inflation expectations, with no significant changes in its assessment between May and October 2024.

S&P also saw the restrictive monetary policy as effective in containing inflation, which helped stabilize expectations in 2023. The agency expected the easing to continue until 2024 (which had to be reversed due to rising inflation), which could have a negative impact on future ratings.

Fitch also acknowledged the role of the Central Bank, but in September 2024, it highlighted the new cycle of monetary tightening with the increase of the interest rate to 10.75%, suggesting that the interest costs of public debt could intensify in the future. In summary, all agencies maintain a positive view on the conduct of monetary policy, with some concerns regarding the side effects of high interest costs.

⁴⁹ Available at: <https://tinyurl.com/nnu7wvzt>.

⁵⁰ Available at: <https://tinyurl.com/bde586hb>.

⁵¹ Available at: <https://tinyurl.com/4npr4dze>.

⁵² Available at: <https://tinyurl.com/5n94j6vv>.

⁵³ Available at: <https://tinyurl.com/55yw76mv>.

The fiscal issue is where the agencies show the most concern. Moody's was relatively optimistic throughout 2024, mentioning that fiscal consolidation could be gradual, but dependent on revenue growth and mandatory spending control. However, it continued to highlight the limitations imposed by high debt costs and mandatory expenditure.

S&P shared this concern, highlighting that although tax reform was a positive step, fiscal rigidity and the high deficit still limit the quality of Brazil's sovereign credit. There was only a modest improvement in the rating between June and December 2023.

Fitch was the most cautious, predicting a significant fiscal deterioration in 2023 and difficulties in consolidating public accounts in 2024 and beyond. In September 2024, the agency worsened its primary deficit expectations, raising it to 1% of GDP in 2025, well above the limit set by the new fiscal rule, which highlights the weaknesses in Brazil's fiscal policies. It also raised its debt projections for 2024 (77.8% of GDP) and 2026 (83.9% of GDP), pointing out that these figures are much higher than those observed by the countries classified as "BB", which have an average gross debt of 55% of GDP.

Regarding external accounts, all three agencies view Brazil's position as a strength, with record trade surpluses driven, among other factors, by agribusiness and oil production. Moody's maintained a positive outlook on the robustness of the balance of payments and international reserves, which help mitigate external risks, with no notable changes between May and October 2024.

S&P also praised Brazil's external position, positively revising its assessment for 2023, highlighting that the low external debt and high inflows of foreign direct investment are resilience factors. In September 2024, Fitch reinforced its positive view on Brazil's record trade surplus and its ability to structurally improve its external position in the coming years, noting that international reserves cover nine months of external payments—one of the highest among countries rated in the "BB" category.

Conclusion

In general, credit rating agencies consider similar factors when assessing the solvency of sovereign governments, although their methodologies differ in terms of emphasis and approach. Among the common factors is the assessment of the government's ability and willingness to honor its short and long-term financial obligations in a timely and complete manner.

These similarities and differences show that although the agencies share a common basis for evaluation, each one brings nuances to its methods, reflecting distinct priorities and specific analytical approaches. The three agencies agree that Brazil has shown economic and institutional resilience, driven by reforms, an effective monetary policy and a favorable external position.

However, fiscal weaknesses are the main point of divergence and concern, with all the agencies warning of the uncertainties surrounding fiscal consolidation. While Moody's shows some improvement in its overall assessments of Brazil in terms of growth and institutional policy, S&P and Fitch are more cautious regarding fiscal developments, particularly from 2025 onwards.

In summary, from the agencies' perspective, Brazil is seen as having a good capacity to absorb external shocks and maintain moderate economic growth in the short term, but with an urgent need to address fiscal challenges to ensure sustainability in the medium and long term.

The IFI, in turn, adds that the lack of clear limits on Brazilian debt undermines the achievement of targets necessary for conducting a sustainable fiscal policy, contributing to the perpetuation of the country's uncomfortable level of indebtedness when viewed from an international perspective.

Finally, the IFI warns that economic theory and empirical evidence show that it is not possible to expand debt indefinitely, even when denominated in local currency, and that it is necessary to reverse the current trend of persistent imbalances before a shock jeopardizes the country's ability to meet its obligations.

IFI projections

SHORT TERM

IFI projections	2024			2025		
	Sep/24	Oct/24	Comparison	Sep/24	Oct/24	Comparison
GDP - real growth (% p.a.)	2,81	2,81	=	1,80	1,80	=
GDP - nominal (BRL billion)	11.578,66	11.578,66	=	12.249,07	12.249,07	=
IPCA - accumulated (% in the year)	4,42	4,42	=	3,66	3,66	=
Exchange rate - end of period (BRL/US\$)	5,40	5,40	=	5,47	5,47	=
Employment - (%) growth	2,50	2,50	=	1,20	1,20	=
Payroll - (%) growth	7,01	7,01	=	2,41	2,41	=
Selic - end of period (% p.a.)	11,50	11,50	=	10,00	10,00	=
Ex-ante real interest rate (% p.a.)	6,17	6,17	=	5,48	5,48	=
Consolidated Public Sector Primary Balance (% of GDP)	-0,83	-0,83	=	-1,10	-1,10	=
of which Central Government	-0,83	-0,83	=	-1,20	-1,20	=
Net Nominal Interest (% of GDP)	8,08	8,08	=	7,48	7,48	=
Nominal Balance (% of GDP)	-8,90	-8,90	=	-8,58	-8,58	=
Dívida Bruta do Governo Geral (% do PIB)	80,01	80,01	=	82,21	82,21	=

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