Fiscal Follow-up Report

November 2018

Full report here (portuguese)

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Summary

- In the base scenario, the Brazilian economic slack is reverted gradually, so that the output gap would close only at the end of 2021, when the GDP growth converges to its potential rate (estimated at 2.2%).

- The BRL 12.8 bi gain in foreign exchange swap operations in September contrasts with the BRL 28.6 bi loss in August. If the first amount is added to the preliminary gains related to October, already announced by the Central Bank, BRL 19.5 bi, we can see that the losses in August were completely reversed, under the influence of the appreciation of the real against the dollar over the past two months.

- One-off revenues and the expenditure “puddling" contribute to a lower primary deficit in the short term, despite the performance of recurring revenue and the mandatory spending in a lower level also make an important contribution. Reversal of primary deficit to a surplus occurs only in 2022, in the optimistic scenario.

- The update of the basic, optimistic and pessimistic scenarios for the gross debt incorporates the effects of the anticipated amortization of Treasury loans by the BNDES and indicates an improvement in the three trajectories. In the base scenario, considered the most likely, the debt will reach the peak of 82.7% of GDP by 2023 and will fall from 2025. But fiscal adjustment remains urgent and a combination of measures will be required to satisfy it.

- The payment of expenses below the financial limit granted to Executive ministries, or expenditure “puddling”, contributes to that primary expenditure and consequently the 2018 primary deficit to stay below the official projections. According to the Treasury, the “puddling” was at BRL 12.2 bi by September. The IFI estimates that this value has reached some BRL 14.1 bi at the end of October.

Macroeconomic Context

- The IFI updates its projections for macroeconomic and fiscal variables on a quarterly basis, publishing them in the Fiscal Follow-up Report (RAF). During this period, latest data are incorporated and the assumptions and models are reevaluated.

- In this edition, the trajectories of the main variables in the medium and long-term horizon didn't suffer substantial changes, standing next of those presented in the August edition. Some adjustments were made in the short term though.

- In the base scenario, the risk premium is maintained, by assumption, at the current level of 250 points throughout the projection horizon. The Brazilian economic slack is reverted gradually, so that the output gap would close only at the end of 2021, when the GDP growth converges to its potential rate (maintained at 2.2%).

Macroeconomic Context

- Compared to the last update, the IMF began to design a framework of less vigorous growth for the global GDP due, in part, to the effects of trade tensions between the United States and China on the volume of international trade. There was also a substantial review of the of Argentinean performance, Brazil's major trading partner.

- Taking into account the slowdown of the world economy as well as the recent movement of important indicators of economic activity such as industrial production, we revised slightly downward the projection for GDP growth in the base scenario from 1.6% to 1.4% in 2018 and from 2.4% to 2.3% in 2019.

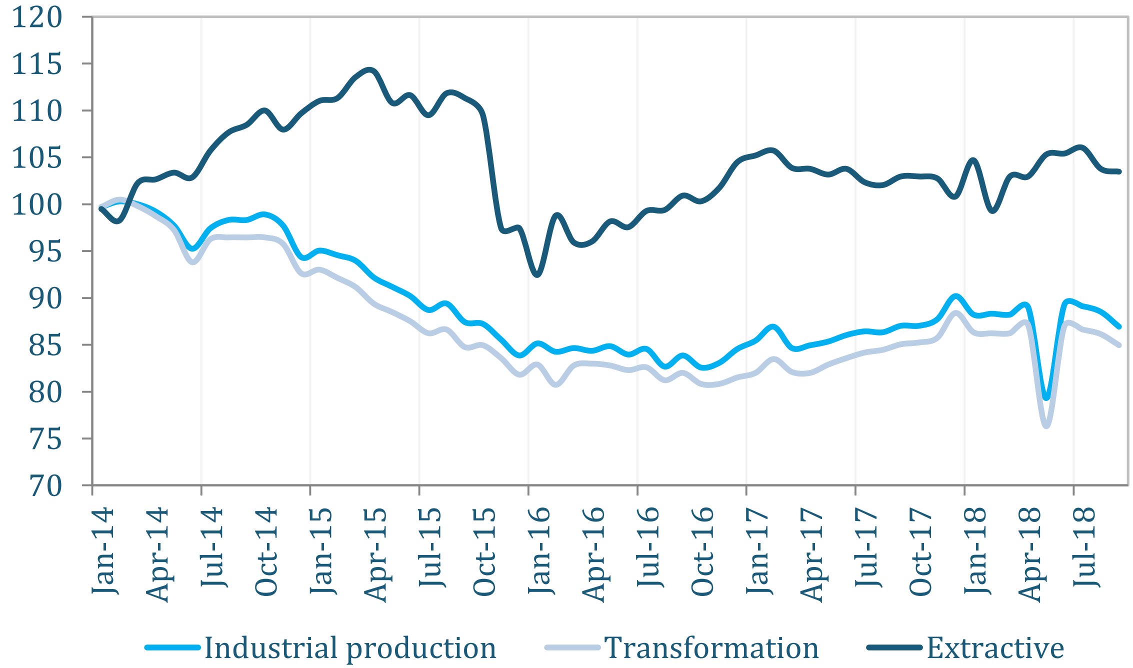
				Base scenario			Optimistic scenario			Pessimistic scenario		
Current	**2015**	**2016**	**2017**	**2018**	**2019**	**2020-2030**	**2018**	**2019**	**2020-2030**	**2018**	**2019**	**2020-2030**
GDP real - Percent change	-3,5	-3,5	1,0	1,4	2,3	2,2	1,7	2,9	3,4	1,0	1,1	1,4
Total wages - Percent change	0,5	-3,4	2,3	2,0	2,4	2,3	2,5	3,6	3,0	1,9	1,5	1,5
Consumer prices (IPCA, end of period)	10,67	6,29	2,95	4,40	4,25	3,91	4,09	3,65	3,65	4,71	5,23	5,79
Exchange rate R$/US$ (end of period)	3,90	3,26	3,31	3,70	3,69	4,07	3,54	3,36	3,58	3,80	3,92	4,83
Selic - final de período	14,25	13,75	7,00	6,50	8,00	8,50	6,50	7,00	7,00	6,50	9,50	11,86
Real interest rate	3,23	7,02	3,94	2,0	3,6	4,4	2,0	3,6	3,2	1,7	4,1	5,7
Last version	**2015**	**2016**	**2017**	**2018**	**2019**	**2020-2030**	**2018**	**2019**	**2020-2030**	**2018**	**2019**	**2020-2030**
GDP real - Percent change	-3,5	-3,5	1,0	1,6	2,4	2,2	1,8	2,9	3,4	1,4	1,3	1,4
Total wages - Percent change	0,5	-3,4	2,3	2,2	2,8	2,1	2,4	4,1	2,9	1,9	1,8	1,7
Consumer prices (IPCA, end of period)	10,67	6,29	2,95	4,00	4,11	4,04	3,69	3,38	3,71	4,27	4,72	5,74
Exchange rate R$/US$ (end of period)	3,90	3,26	3,31	3,69	3,61	4,02	3,5	3,3	3,6	3,73	3,76	4,56
Selic (end of period)	14,25	13,75	7,00	6,50	8,00	8,50	6,5	7,0	7,0	7,5	9,5	11,9
Real interest rate	3,23	7,02	3,94	2,4	3,7	4,3	2,4	3,7	3,2	3,1	4,6	5,8

Macroeconomic Context

- Industrial activity had an all-around decline in September, piling up a loss of 2.7% between July and September.
- The current level of production is 2.3% lower than that of April (the month that preceded the strike of truck drivers).

INDUSTRIAL PRODUCTION

(INDEX NUMBER: 1Q/14=100)



Source: IBGE.

Macroeconomic Context

- The reduction of unemployment still reflects the expansion of the informal sector, which has functioned as a escape valve in an environment marked by a slow resumption of economic growth.

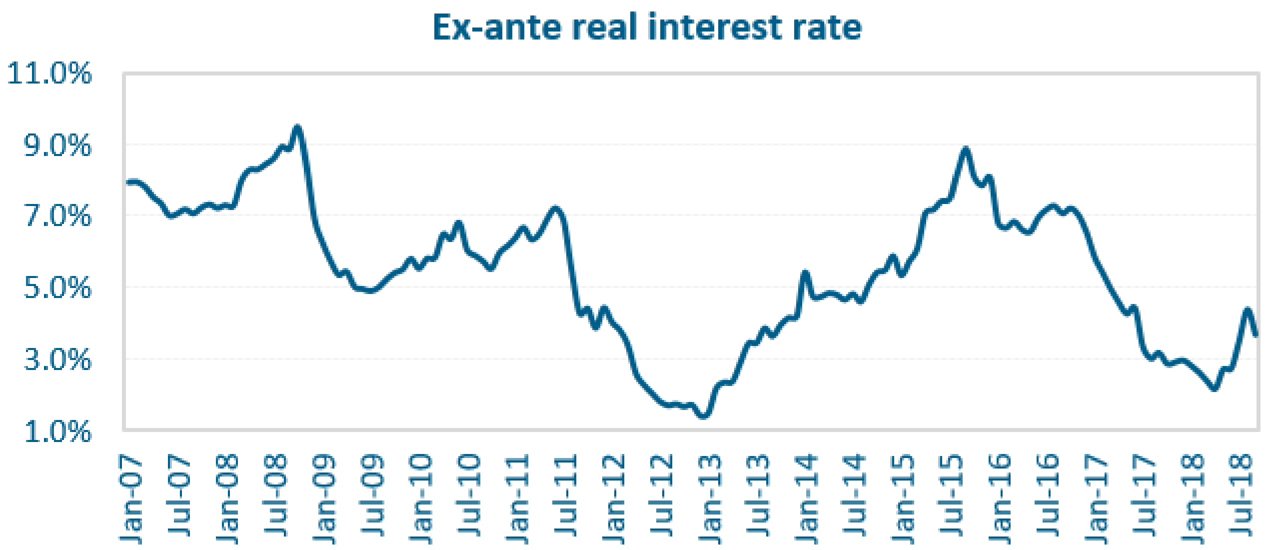
Employment indicators	Percentage in relation to employed population			QoQ			Accumulated in 12 months		
	jul/18	ago/18	set/18	jul/18	ago/18	set/18	jul/18	ago/18	set/18
Occupied population	**100.0%**	**100.0%**	**100.0%**	**1.1%**	**1.1%**	**1.5%**	**1.7%**	**1.6%**	**1.6%**
Private sector: registered	36.0%	35.8%	35.6%	-1.1%	-1.3%	-1.0%	-1.6%	-1.8%	-1.5%
Private sector: non-registered	12.1%	12.2%	12.4%	3.4%	4.0%	5.5%	5.3%	5.4%	5.0%
Domestic worker	6.8%	6.8%	6.8%	3.2%	3.1%	1.3%	2.6%	2.9%	2.5%
Public sector	12.7%	12.7%	12.7%	1.9%	2.3%	2.1%	2.3%	2.4%	2.5%
Employer	4.8%	4.8%	4.8%	4.0%	5.2%	4.3%	4.6%	5.5%	5.1%
Self-employed	25.2%	25.3%	25.4%	2.1%	1.9%	2.6%	3.9%	3.5%	3.4%
Percentage of workers that cntribute to social security	**63.7%**	**63.4%**	**63.0%**	**0.5%**	**0.1%**	**0.2%**	**-0.3%**	**-0.3%**	**-0.1%**

Source: IBGE.

Macroeconomic Context

- The context of favorable current inflation, recovering activity level and anchored inflation expectations allows the Central Bank to sustain the Selic rate at historically low levels (6.5%).

- The main risk for an upward move in the inflation scenario and, therefore, for the movement of interest rates, concerns the frustration of expectations about relevant measures to the balance of public accounts and debt sustainability - risk is amplified in a more challenging international environment for emerging economies, in the face of rising interest rates in the U.S. economy.

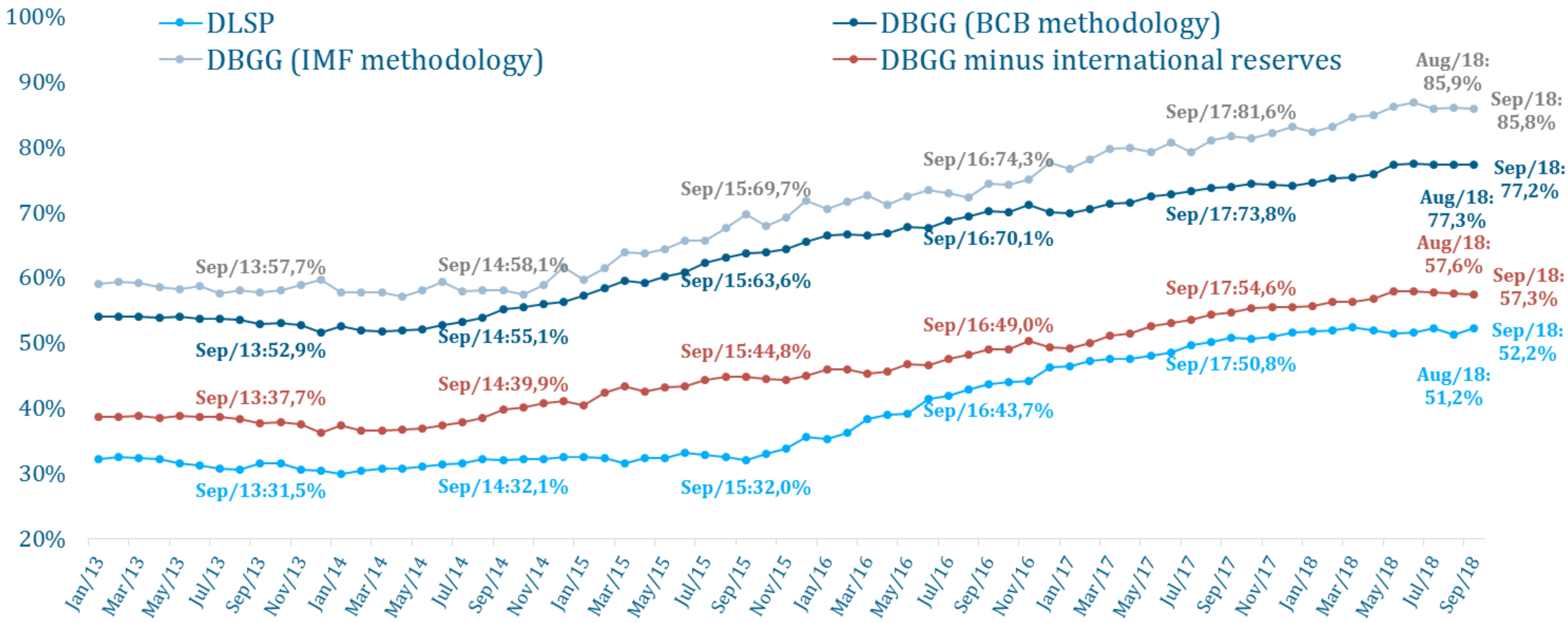


Source: BM&F and Central Bank.

Fiscal Context

- General Government Gross Debt (DBGG, BCB methodology) fell to 77.22% of GDP, between Aug/18 and Sep/18, but increased by BRL 22.7 bi, as a consequence of a BRL 32 bi increase in internal debt.
- Contrarily to the DBGG, the Public Sector Net Debt (DLSP) rose, from 51.20% of GDP in Aug/18 to 52.15% in Sep/18.

PUBLIC DEBT OVER TIME (% OF GDP)

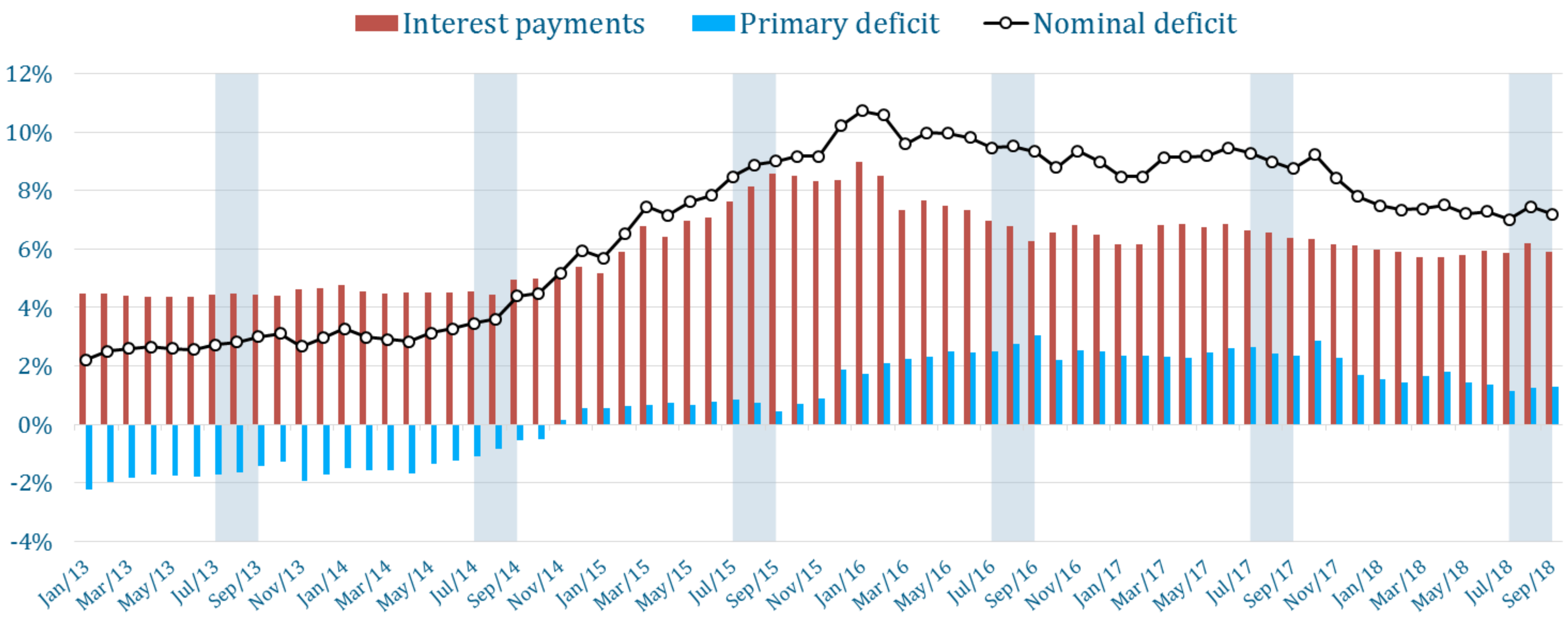


Source: Central Bank of Brazil. Elaboration: IFI.

Fiscal Context

- Despite the increase in the primary deficit in Sep/18, to 1.29% of GDP, it remains below the level of 2016/2017.
- Interest payments fell in Sep/18, mainly due to gains of BRL 12.8 bi from FX swap operations.

PUBLIC SECTOR BORROWING REQUIREMENTS (% OF GDP)

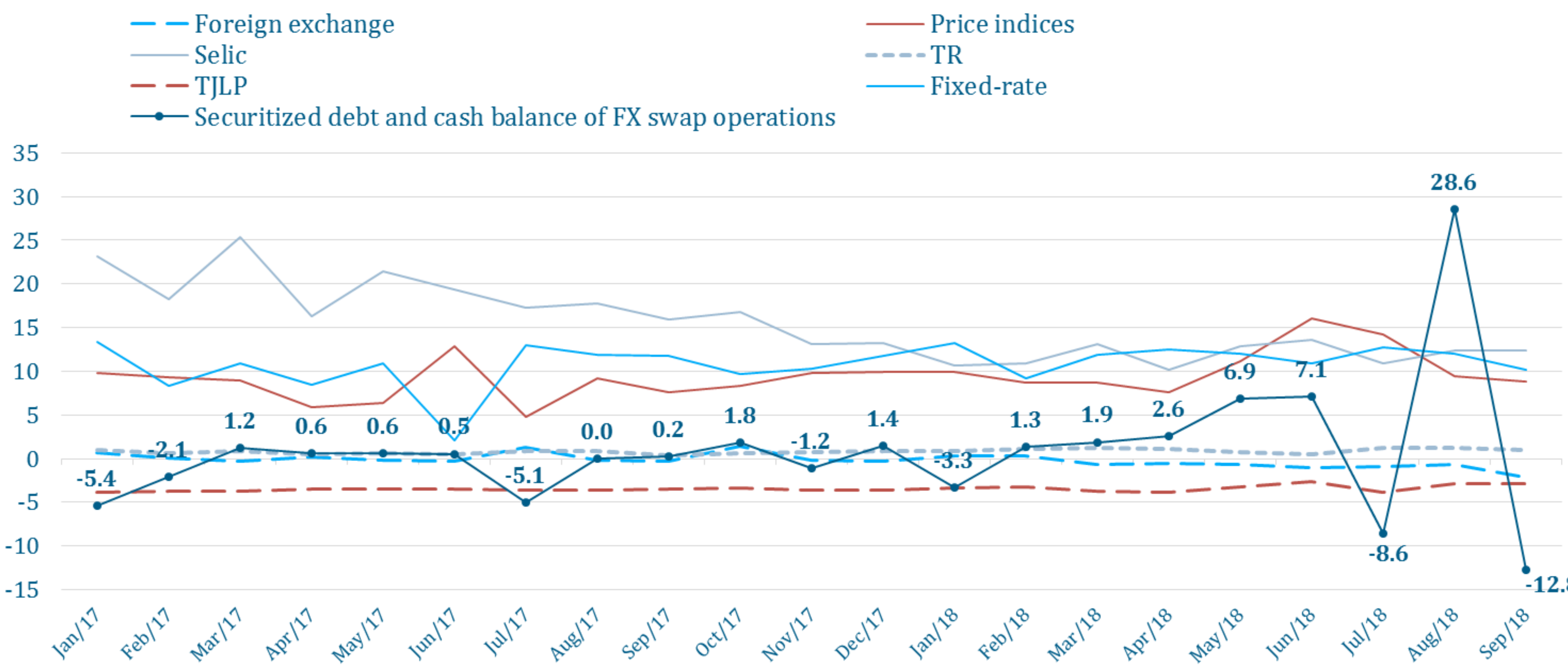


Source: Central Bank of Brazil. Elaboration: IFI. Each series equals the 12-month deficit at current prices, divided by the 12-month GDP at current prices. Positive values indicate deficits; negative values indicate surpluses.

Fiscal Context

- Gains of BRL 12.8 bi from FX swaps in Sep/18 led interest payments to reach their lowest real value since Mar/16.
- The loss from FX swaps in Aug/18, of BRL 28.6 bi, has been offset by accumulated gains in Sep/18 and Oct/18.

INTEREST PAYMENTS BY INDEXING FACTOR (BRL BILLION, PRICES OF SEPTEMBER 2018, IPCA)



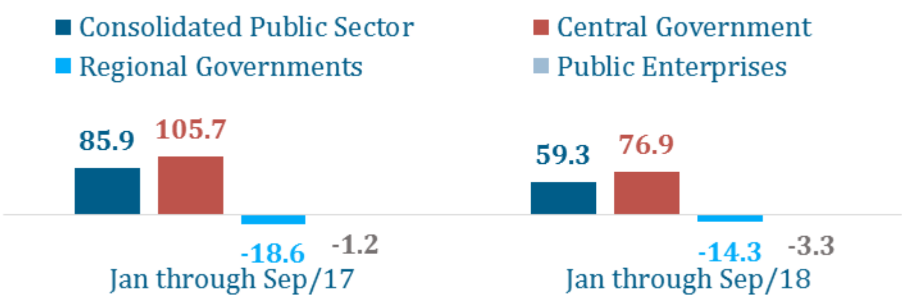
Source: Central Bank of Brazil. Elaboration: IFI. Positive values indicate losses; negative values indicate gains.

Fiscal Context

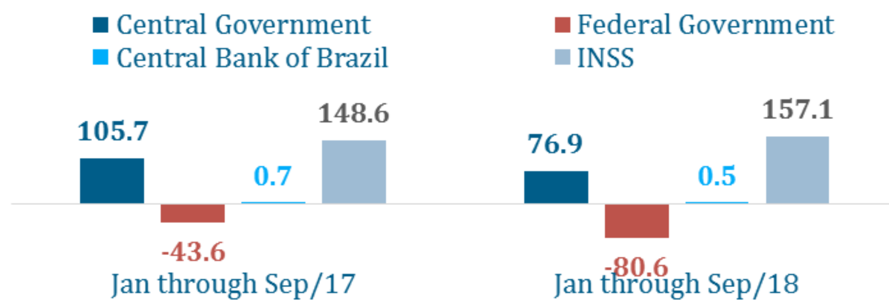
- The primary deficit of the consolidated public sector reached BRL 24.6 bi in Sep/18.
- The primary deficit accumulated over Jan-Sep/18 reached BRL 59.3 bi, smaller than the Jan-Sep/17 value (BRL 85.9 bi), in real terms. The main contribution for such decline came from the Federal Government's balance.

DECOMPOSITION OF THE JAN-SEP ACCUMULATED PRIMARY DEFICIT (BRL BILLION, PRICES OF SEP/18)

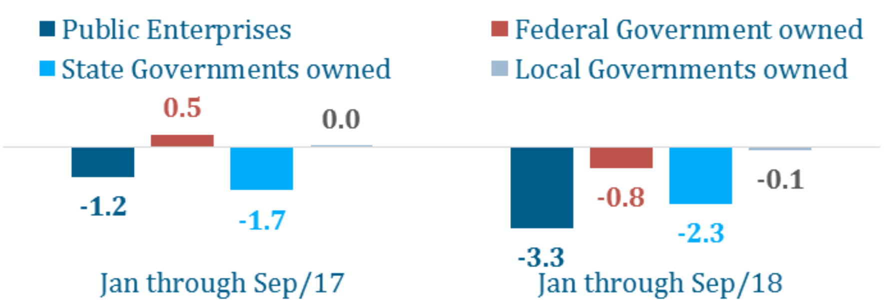
CONSOLIDATED PUBLIC SECTOR PRIMARY DEFICIT DECOMPOSITION



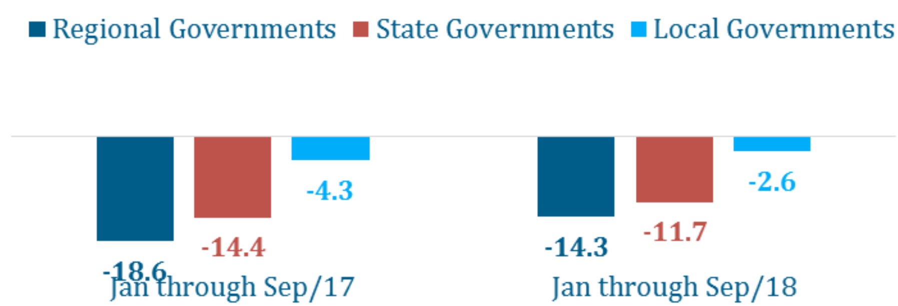
CENTRAL GOVERNMENT PRIMARY DEFICIT DECOMPOSITION



PUBLIC ENTERPRISES PRIMARY DEFICIT DECOMPOSITION



REGIONAL GOVERNMENTS PRIMARY DEFICIT DECOMPOSITION



Source: Central Bank of Brazil. Elaboration: IFI. Positive values indicate deficits; negative values indicate surpluses.

Fiscal Scenarios

- Fiscal scenarios update did not bring substantial changes in the medium and long-term projections, although some important adjustments in the short term were made.

- Reversal of primary deficit to a surplus still occurs only in 2022, 2023 and 2024, respectively, in the optimistic, base and pessimistic scenarios, if and only if the constitutional expenditure ceiling is met.

- Our projections remain pointing out the possibility of meeting the expenditure ceiling in the first two years of the next presidential term.

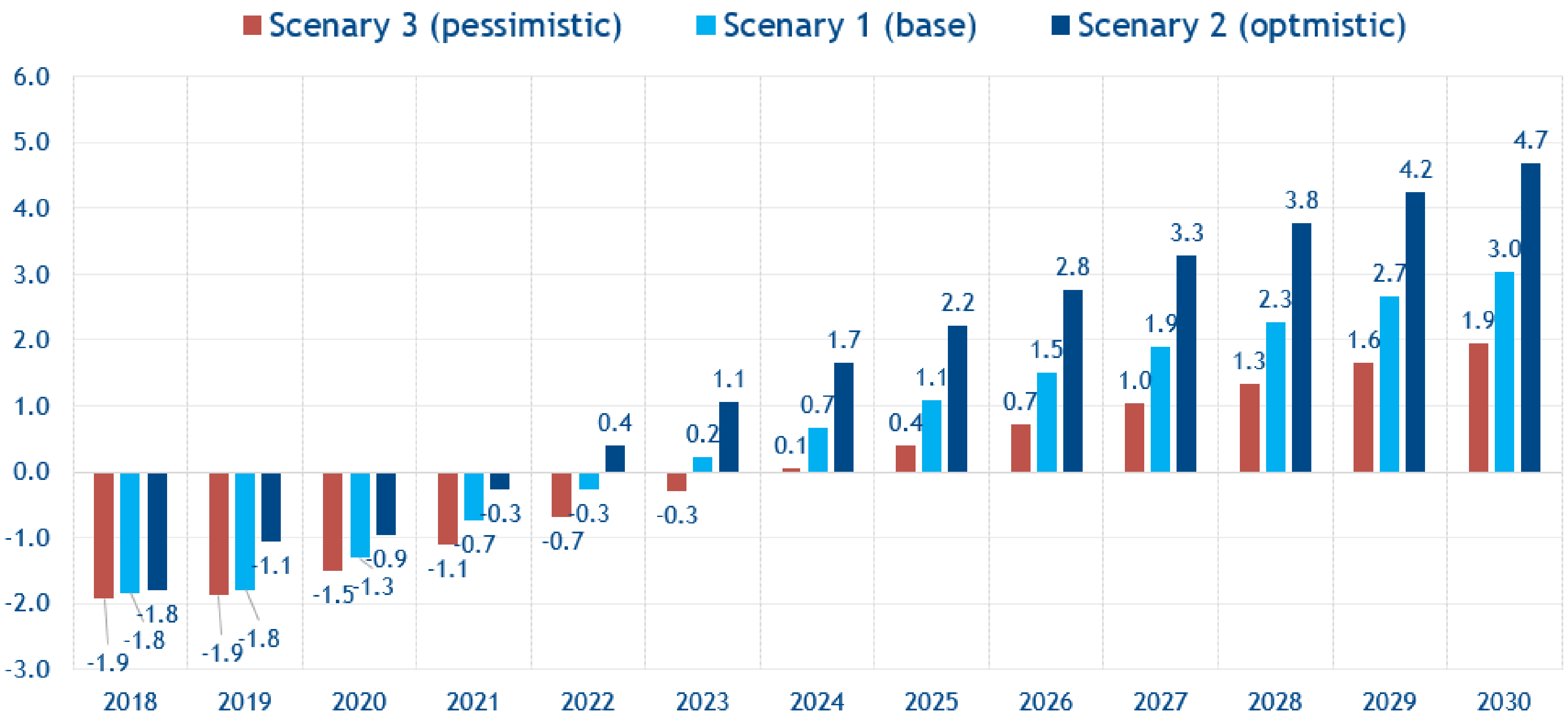
- One-off revenues and the expenditure "puddling" contribute to a lower primary deficit in the short term, but the performance of recurring revenue and the mandatory spending in a lower level also make an important contribution. In the base scenario, central government primary deficit should reach in end of the year BRL 137.5 bi, below the target of BRL 159.0 bi.

- For the consolidated public sector, we project a primary deficit of BRL 128.9 bi, below the target of BRL 161.3 bi (central government: deficit of BRL 137.5 bi; subnational governments: surplus of BRL 8.5 bi; and federal state-owned enterprises: surplus of BRL 0.15 bi).

Fiscal Scenarios

- In the best case scenario, reversal of primary deficit occurs only in 2022.

CONSOLIDATED PRIMARY BALANCE (% GDP)



Source: Federal Revenue Office, National Treasury and Central Bank.

Public Debt Scenarios

- Gross debt remains in its upward trajectory, after relative stability in recent months.

- Key factors of this evolution are the poor performance of the economy and the high fiscal deficits.

- The improvement of primary balance and interest payments should be highlighted, but is not sufficient, for now, to stabilize the debt-to-GDP ratio.

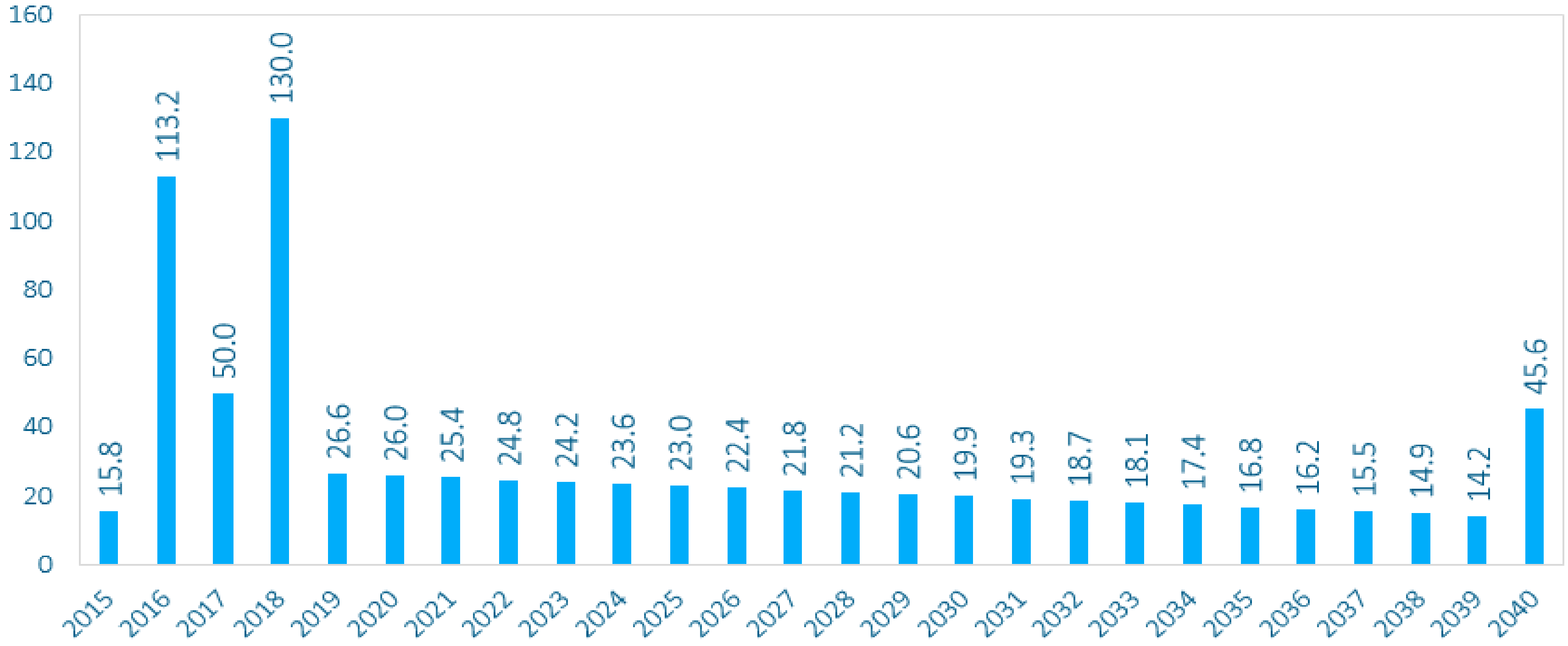
- Another important factor in 2018 is the anticipated amortization of Treasury loans by the BNDES. This flow should persist over medium and long term, albeit in lesser intensity.

- The General Government Gross Debt (DBGG) reached 77.2% of GDP in September 2018, while remaining relatively stable in the very short term, mainly because of the BNDES returns (BRL 130 bi this year).

Public Debt Scenarios

- According to the BNDES, between 2015 and 2018, BRL 309 bi have been returned to the Treasury.
- From 2019 to 2040, there will be an annual flow of returns, which will begin at BRL 26.6 bi and decrease until it reaches BRL 14.2 bi in 2039. In 2040, there should be a final payment of BRL 45.6 bi.

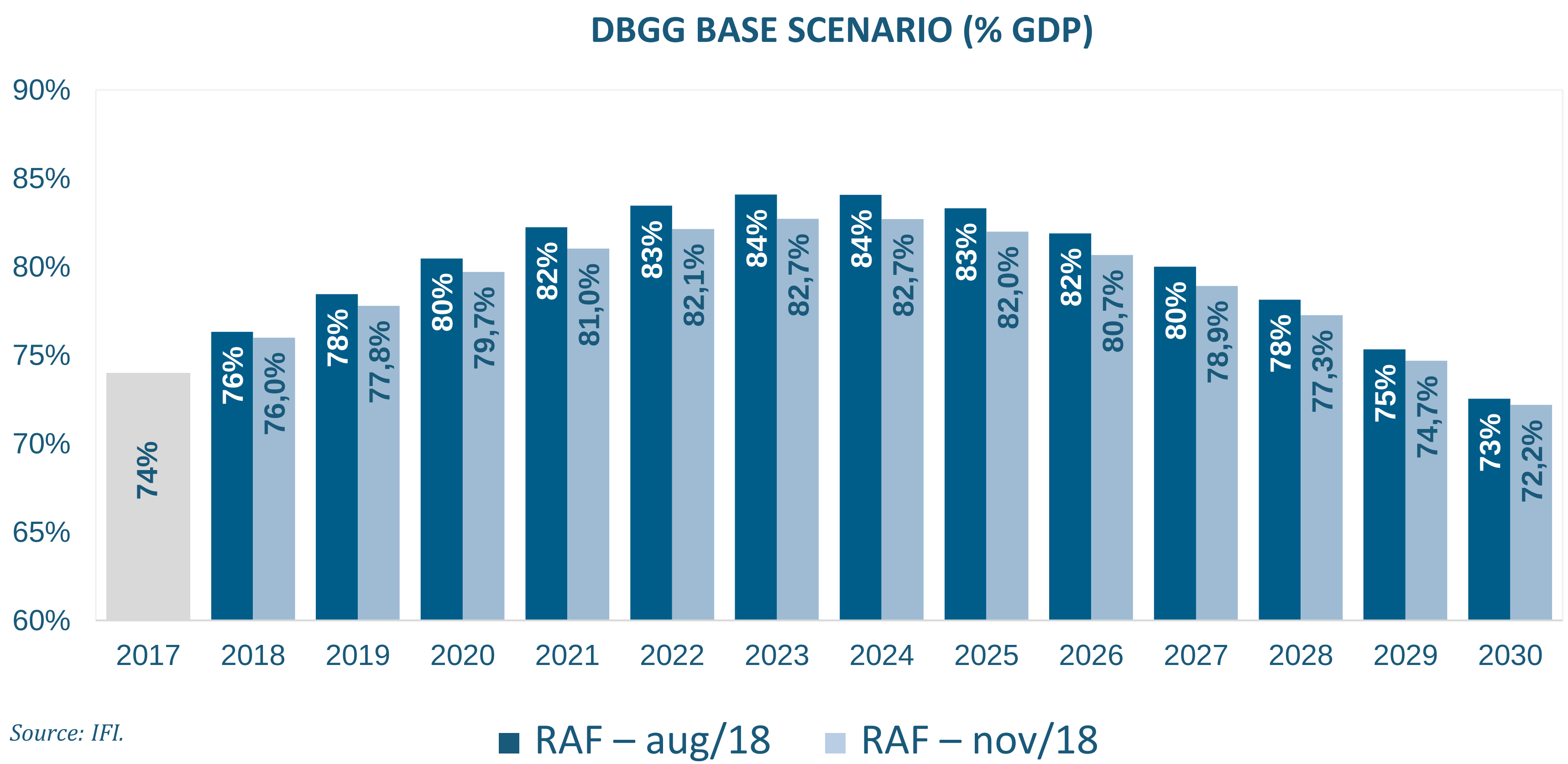
BNDES RETURNS TO THE TREASURY (BRL BILLION)



Source: BNDES.

Public Debt Scenarios

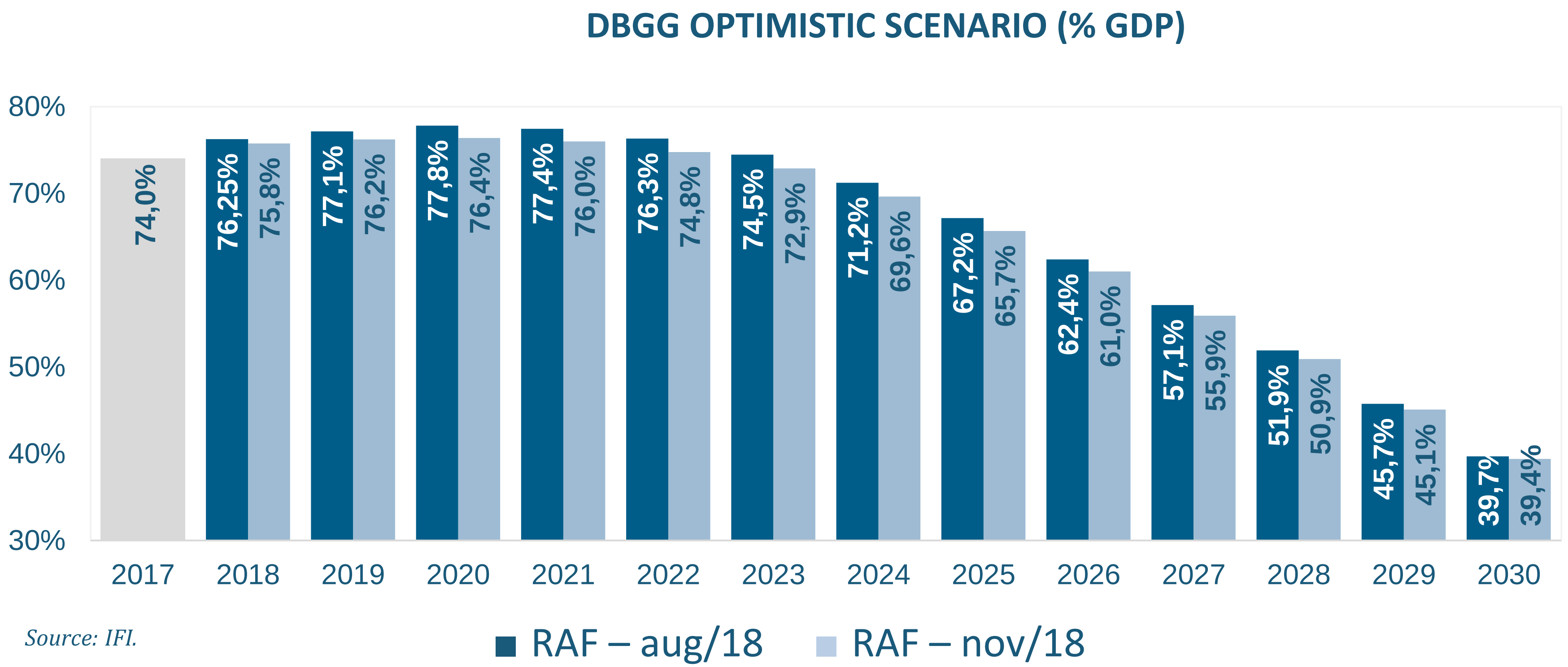
- Base scenario for the gross debt is better than projected in the August report.
- The debt remains reaching its peak in 2023, but on the level of 82.7% of GDP, lower than the previous peak of 84.1% of GDP.



Source: IFI.

Public Debt Scenarios

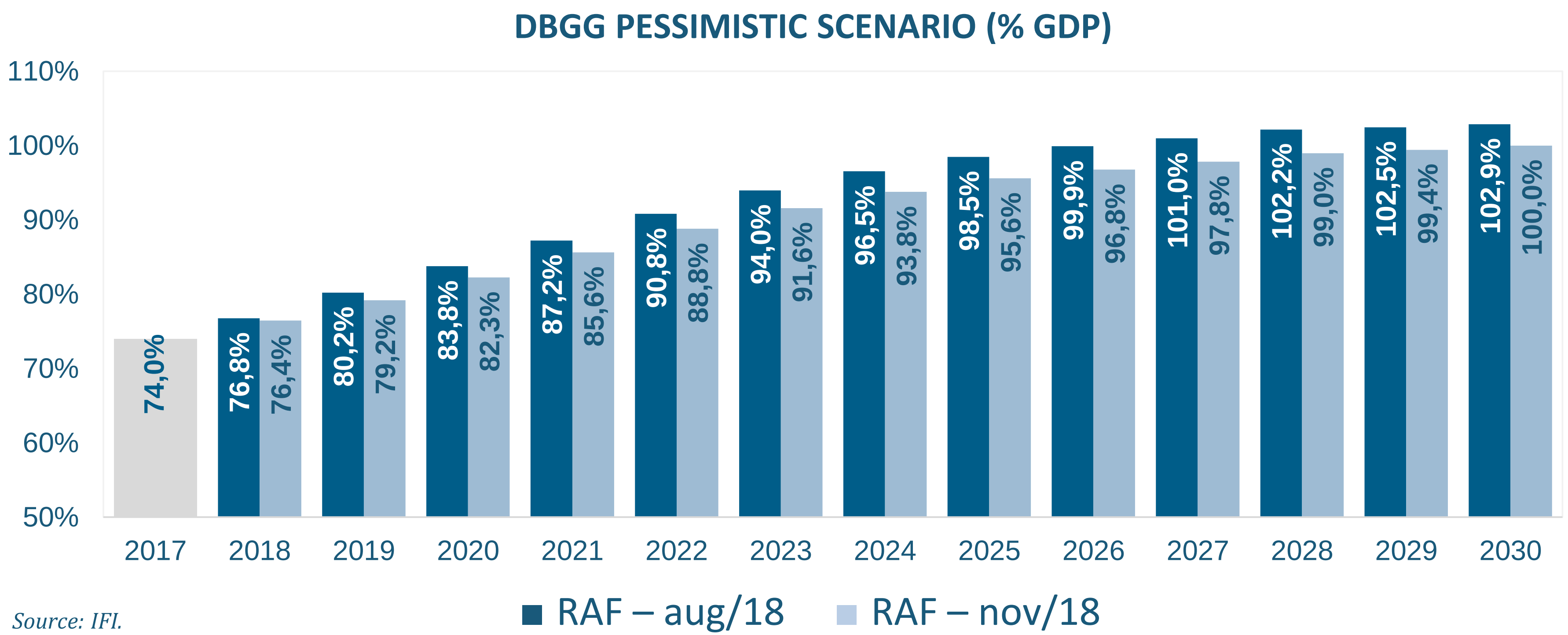
- In the optimistic scenario, the debt stabilizes between 2019 and 2020. New scenario is better than the previous. Debt should reach 76.4% of GDP in 2020, below the previous maximum value.
- BNDES returns and increase in nominal GDP projection explain much of the improvement in the curve. For 2018, also contributes the relevant improvement in our projection for the primary deficit.



Source: IFI.

Public Debt Scenarios

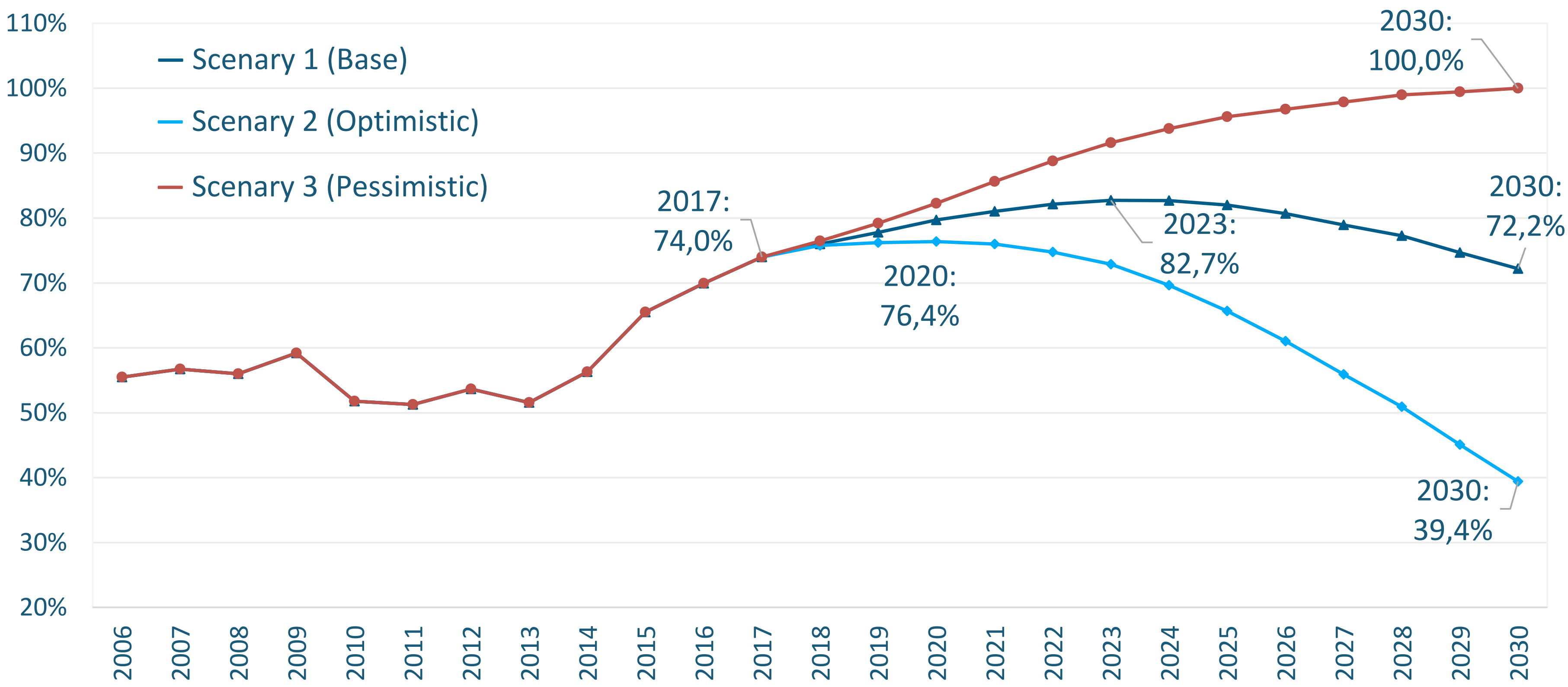
- Pessimistic scenario remains pointing to an uninterrupted growth of DBGG-to-GDP ratio until 2030.
- New pessimistic scenario is also more favorable than the previous: debt would reach 100% of GDP in 2030, while in August, this level would be reached between 2026 and 2027.
- BNDES returns and projections for nominal GDP explain, as in other scenarios, a major part of the improvement along the curve.



Source: IFI.

Public Debt Scenarios

BASE, OPTIMISTIC AND PESSIMISTIC SCENARIOS FOR THE DBGG – NOVEMBER 2018 (% GDP)



Source: IFI.

Budget 2018

- In this RAF, we analyze the expenditure "puddling": payments below the limit granted to Executive ministries.
- The "puddling" occurs only in the share of expenditure subject to financial planning, i.e. all discretionary spending and part of mandatory spending
- It is one of the factors that will contribute to the 2018 primary deficit to stay below the official projections.
- For the Treasury, expenditure "puddling" was BRL 12 bi until September. We estimate it has reached BRL 14bi in Oct.
- The most affected ministries have been Health and Defence.

EXPENDITURE "PUDDLING" BY MINISTRY AND ON PARLIAMENTARY AMENDMENTS (BRL BILLION)

Breakdown	Until june	Until july	Until august	Until september	Until october*
Parliamentary amendments	2,4	2,4	2,6	2,4	3,1
Ministry of Health	1,9	2,1	2,0	2,5	2,7
Ministry of Defense	1,8	2,2	1,5	1,6	2,0
Ministry of Justice	1,0	1,1	1,4	1,3	2,1
Ministry of Education	1,4	1,4	1,0	0,8	1,2
Financial obligations of the Central Government	1,8	1,8	0,9	0,8	0,6
Other	2,3	3,4	3,4	2,9	2,4
Total	**12,6**	**14,4**	**12,8**	**12,3**	**14,1**

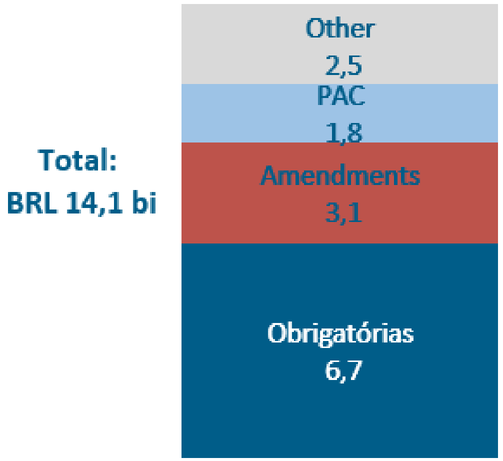
Source: National Treasury Fiscal Balance and "Siga Brasil" (Federal Senate).

** IFI estimates. Official data should be publish in the October National Treasury Fiscal Balance.*

Budget 2018

- Of the total calculated by the IFI until October, some BRL 6.7 bi, or 48%, are related to mandatory spending with “cash-flow control" (left chart). These expenses, though mandatory, are subjected to Executive’s financial planning.
- Other BRL 3.1 bi (22% of the total) are parliamentary amendments, where the “puddling” is the largest in relative terms: it represents 29% of the available limit for payments of these expenses (right chart).

Expenditure "puddling" until October (BRL Billion)



Source: "Siga Brasil" (Federal Senate).

Expenditure "puddling" until October - % of payment limit