Fiscal Follow-up Report

September 2018

Full report here (portuguese)

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Summary

- The output gap, difference (percentage) between observed and potential output, which reached the lowest value of the time series (-8.5%) at the end of 2016, shows slow recovery. The estimate for the second quarter of 2018 indicates output 6.4 p.p. below potential, with a plausibility interval between 6.4% and -4.1%.

- The General Government gross debt ("DBGG" in Portuguese) reached BRL 5.2 trillion in July 2018, BRL 21.1 billion greater than June 2018. Despite the increase, the DBGG as a percent of GDP fell from 77.16% to 77.02%. Unlike the DBGG, the Public Sector Net Debt ("DLSP" in Portuguese) grew from 51.40% to 52.03% of GDP.

- The Federal Government Budget Proposal for 2019 projects primary deficit of BRL 132.0 billion to the consolidated public sector, sixth consecutive year of negative result. According to the proposal, the primary expenditure is expected to reach the ceiling for 2019. In addition, in order to meet the golden rule, part of social security and assistance benefits will be subject to the approval of the Congress in 2019.

- Inequalities in local collection and low redistributive impact of intergovernmental transfers result in large differences in the disposable revenue that finance public policies of local Governments: the State of Maranhão, which has the second smallest HDI of the country, has BRL 3,357 per citizen, which is about a third of the BRL 9,966 disposable revenue for the State with the highest HDI, the Federal District.

- Federal Government Balance Sheets show assets and liabilities rather high, 74% and 111% of GDP, respectively, resulting in a net worth (the difference between assets and liabilities) strongly negative, 37% of GDP. The net worth is expected to fall even more in the coming years, due to the generation of new deficits in the federal Government accounts.

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Macroeconomic Context

o Economic activity remains at a slow pace. GDP growth slightly accelerated in the second quarter of 2018 to 0.2% (0.1% in the first three months of the year, considering the seasonally adjusted series);

o Our estimates for the output gap indicate that the Brazilian economy in the second quarter is 6.4 percentage points below potential, with a plausibility interval between 6.4% and -4.1%.

o The recession which took place in Brazil from 2014 to 2016 and the slow recovery of the activity still have significant implications on the labour market: reduction of formal contracts, high permanence in unemployment and people exiting workforce, in the last case discouraged by the lack of opportunities.

Macroeconomic Context

○ Domestic absorption contributed 1.7 percentage point to the GDP growth (1.4%). External demand exerted negative influence (of -0.3 p.p.).
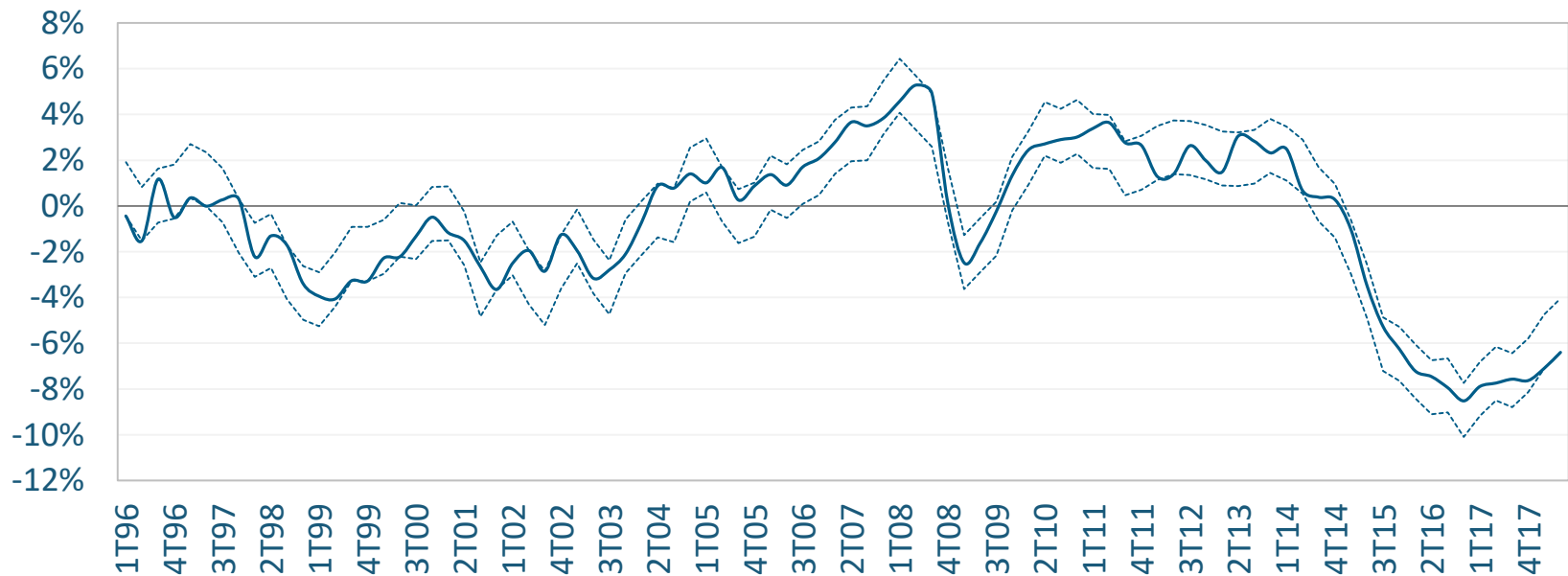
EVOLUÇÃO DO PIB TRIMESTRAL

—— PIB em volume - Média de 1995 = 100
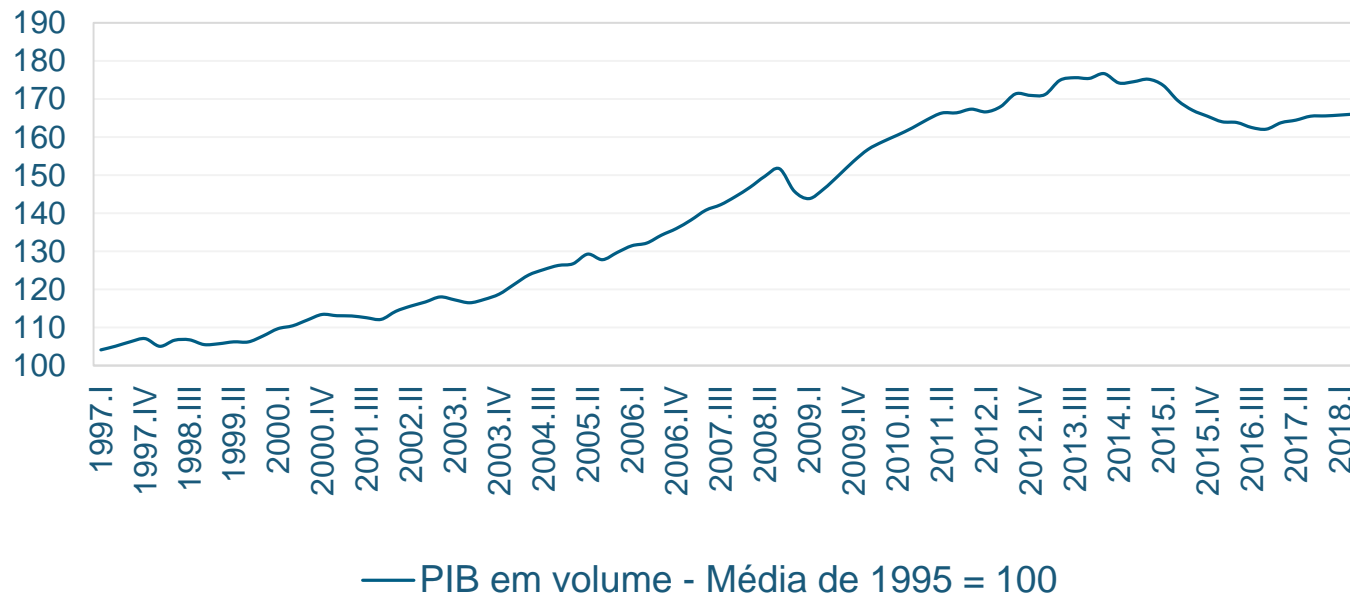
Fonte: IBGE.

Macroeconomic Context

o The economy operates with a high degree of slack. Gap is estimated at 6.4 percentage points below potential, with a plausibility interval between 6.4% and -4.1%.
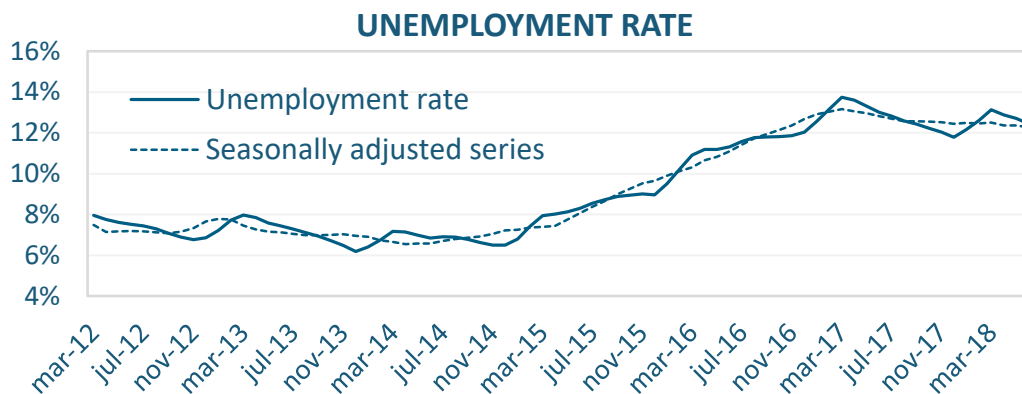
OUTPUT GAP AND PLAUSIBILITY INTERVAL

Source: IFI.

Macroeconomic Context

o The unemployment rate is at 12.3% and has been dropping moderately since March 2017.

UNEMPLOYMENT RATE

Source: IBGE and IFI.

EMPLOYED POPULATION BY POSITION

Employment indicators	Percentage in relation to employed population			QoQ			Accumulated in 12 months		
	mai/18	jun/18	jul/18	mai/18	jun/18	jul/18	mai/18	jun/18	jul/18
Employed population	100,0%	100,0%	100,0%	1,3%	1,1%	1,1%	1,6%	1,7%	1,7%
Private sector: formal	36,1%	36,0%	36,0%	-1,5%	-1,5%	-1,1%	-2,0%	-1,8%	-1,6%
Private sector: informal	12,2%	12,0%	12,1%	5,7%	3,4%	3,4%	5,7%	5,1%	5,3%
Domestic worker	6,8%	6,8%	6,8%	0,1%	2,1%	3,2%	2,0%	2,4%	2,6%
Public sector	12,6%	12,7%	12,7%	2,9%	2,7%	1,9%	2,1%	2,3%	2,3%
Employer	4,8%	4,8%	4,8%	5,6%	4,2%	4,0%	5,9%	5,1%	4,6%
Self-employed	25,2%	25,3%	25,2%	2,5%	2,5%	2,1%	3,7%	4,0%	3,9%
Percentage of workers that contribute to social security	63,6%	63,7%	63,7%	0,2%	0,2%	0,5%	-0,6%	-0,5%	-0,3%

Source: IBGE.

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Fiscal Context

- Gross debt (BCB Method.) falled in July for the first time since December 2017, to 77% of the GDP.
- Contrarily to the gross debt, between June and July the net debt has increased: from 51.40% to 52.03% of the GDP.
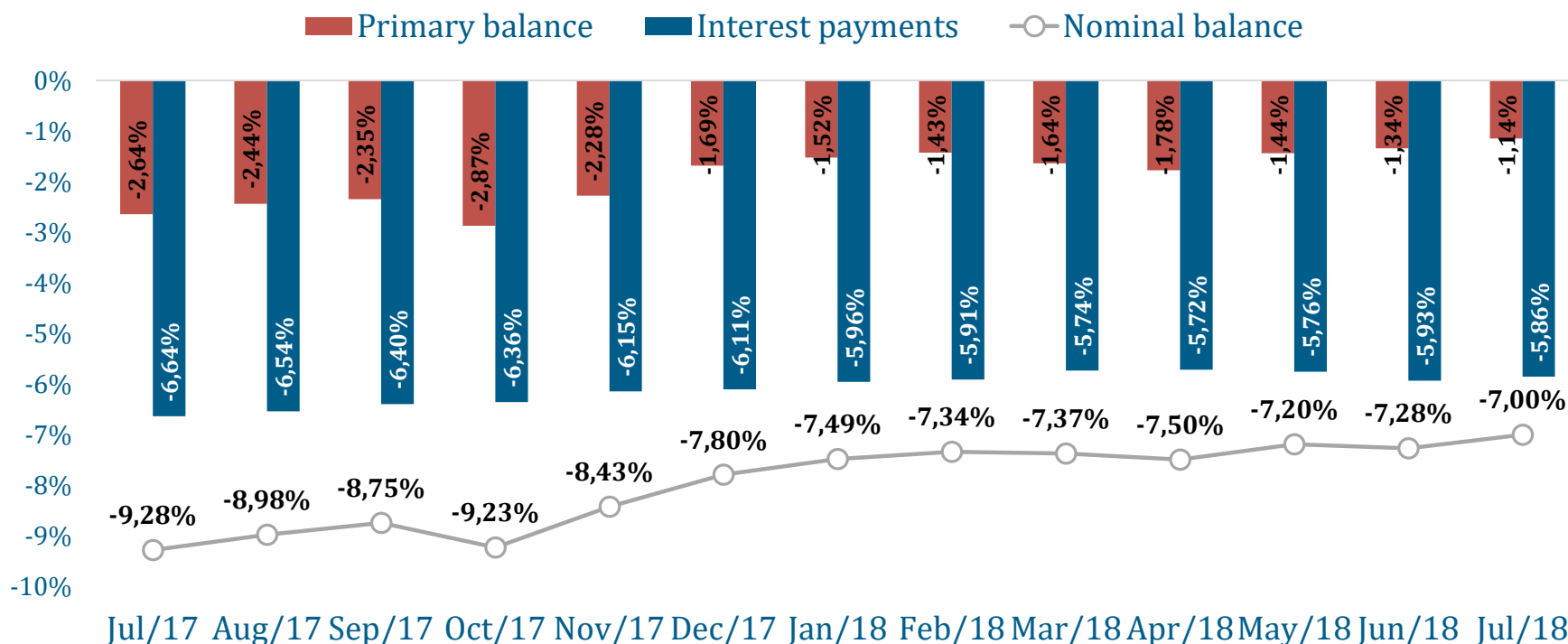
PUBLIC DEBT OVER TIME (% OF GDP)
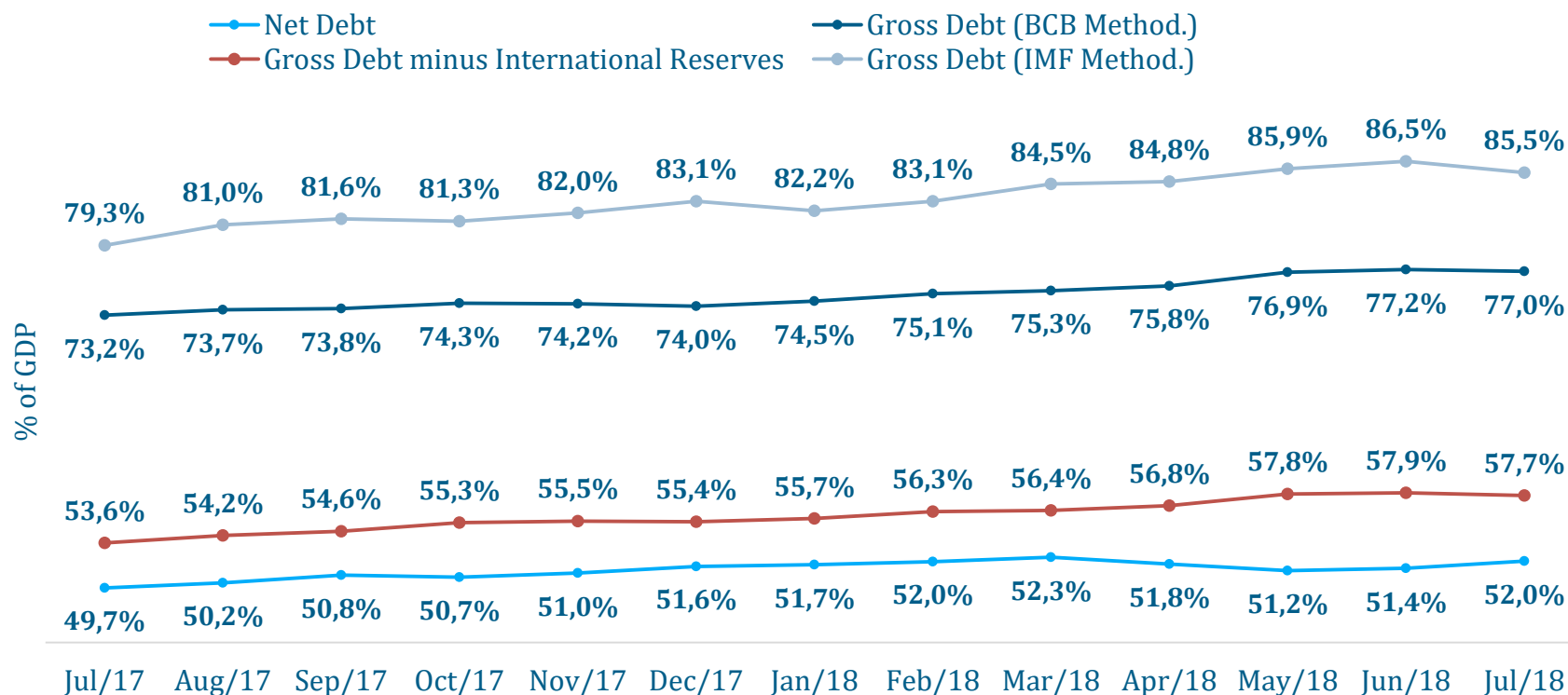
Source: Central Bank of Brazil. Elaboration: IFI. Values are percentage points of 12-month GDP.

Fiscal Context

- Nominal deficit in July is the lowest since March 2015.
- Primary deficit in July is the lowest since December 2015.

PUBLIC SECTOR BORROWING REQUIREMENTS (% OF GDP)

Source: Central Bank of Brazil. Elaboration: IFI. Values are in percentage points of 12-month GDP. Negative values are deficits.

Fiscal Context

○ Total revenue (% of GDP) has been persistently larger in 2018 as compared to 2017.
○ Such differece is not due to social security revenues, but to tax and contributions revenues.

## TOTAL REVENUE (% OF GDP, JANUARY THROUGH MONTH)
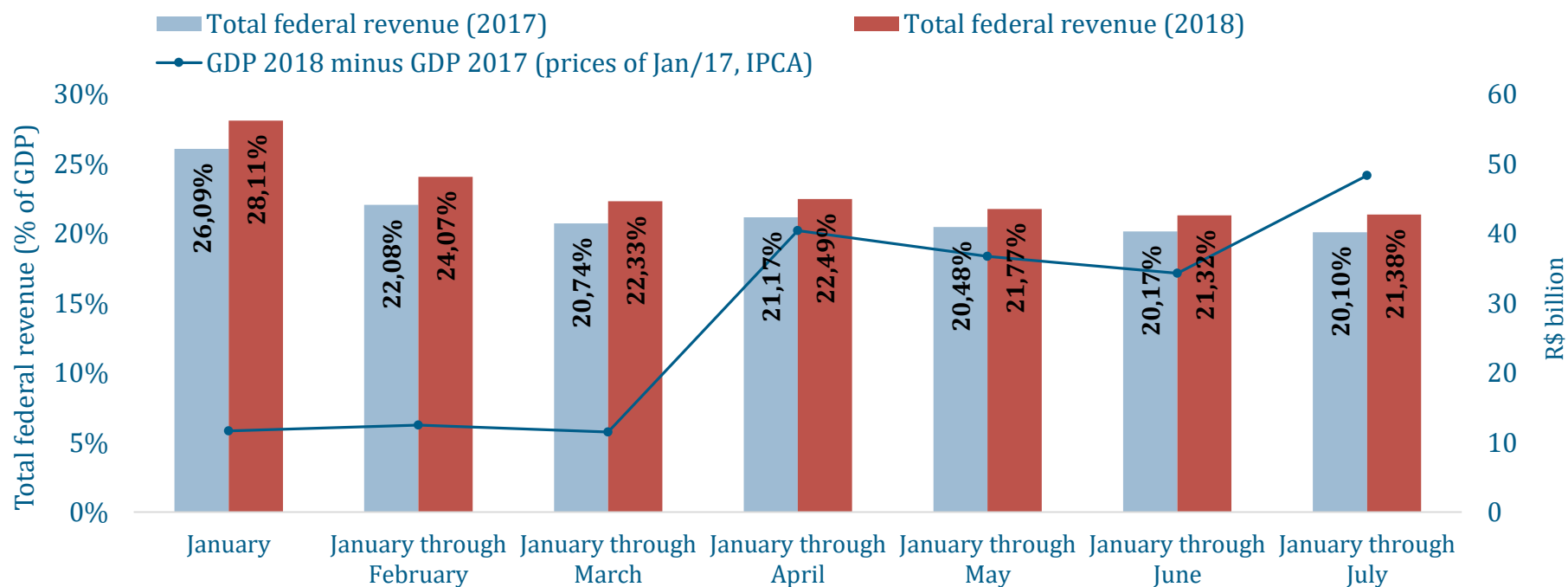
Source: Federal Revenue Office and Central Bank of Brazil. Elaboration: IFI. Values are in percentage points of GDP from January through each month. For example, the value for 2018 and "January through April" equals the sum of monthly revenues in current prices, from January through April, divided by the sum of the corresponding monthly GDP values in current prices.

Fiscal Context

- Total expenditure accumulated since January (as % of GDP) in 2018 was smaller as compared to 2017 by the beginning of the year. Since then, this pattern has inverted.
- The series initially diverged, and then converged by July. This was mainly determined by the dynamics of payroll expenditures, income transfers and discretionary expenditures.

TOTAL EXPENDITURE (% OF GDP, JANUARY THROUGH MONTH)
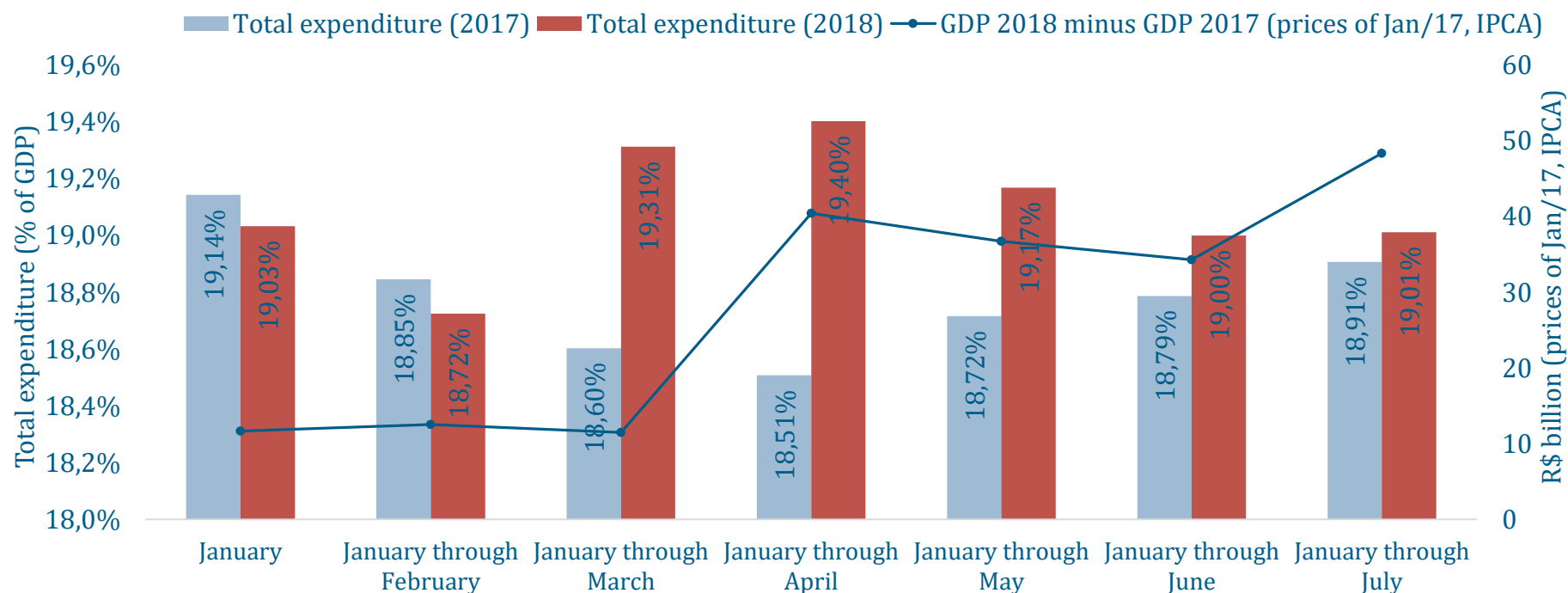
Source: National Treasury and Central Bank of Brazil. Elaboration: IFI.

2019 BUDGET

o The Federal Government Budget Proposal for 2019 expects GDP growth of 2.5% GDP and inflation of 4.3% (CPI)
o For 2019, Government and other agents project a rise in the Selic rate and a fall in the exchange rate.

MAIN MACROECONOMIC INDICATORS

Indicator	2018				2019			
	Gov	IFI (RAF 19)	Market (Focus)[1]	IMF[2]	Gov	IFI	Market (Focus)[1]	IMF[2]
GDP real growth (%)	1.6	1.6	1.4	1.8	2.5	2.4	2.5	2.5
IPCA acum (%)	4.2	4,0	4.1	3.5	4.25	4.1	4.1	4.2
Average overnight SELIC rate (%)	6.5	6.8	6.5	-	7.17	7.3	7.31	-
Average exchange rate (BRL / USD)	3.6	3.5	3.7	-	3.62	3.6	3.7	-
Average oil price (USD/barrel)	74.7	74.1	-	70.2	74,0	82.5	-	69.0
Salary mass nominal growth (%)	4.2	6.3	-	-	7.54	7,0	-	-

Source: Ministry of Planning, Central Bank, IMF and IFI. [1]Central Bank's Market Readout from 9/6/2018. [2]World Economic Outlook, July Update.

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2019 BUDGET

o Public sector primary deficit target was set in BRL132.0bn, BRL139.0 billion of which related to the central government, BRL3.5bn to federal enterprises and a surplus of BRL0.5bn to States and municipalities.
o According to the government, in 2019 primary expenditure will reach the constitutional expenditure ceiling.
o Budget proposal does not include revenues from the extra oil in onerous transfer contracts with Petrobras..
o Expenses include salary increases within the Executive, which subsequently were suspended by the Provisional Measure 849/2018.

CENTRAL GOVERNMENT PRIMARY BALANCE

Breakdown	2018				2019			
	Government		IFI		Government		IFI	
	BRL Billion	% GDP[1]	BRL Billion	% GDP[1]	BRL Billion	% GDP[1]	BRL Billion	% GDP[1]
I, TOTAL REVENUE	1,482.2	21.3	1,468.9	21.1	1,574.90	21.1	1,567.3	21.0
II, TRANSFERS BY REVENUE SHARING	256.1	3.7	250.5	3.6	275.2	3.7	273.2	3.7
III, NET REVENUE (I-II)	1,226.1	17.6	1,218.4	17.5	1,299.70	17.4	1,294.1	17.3
IV, TOTAL EXPENDITURE	1,385.1	19.9	1,374.4	19.7	1,438.70	19.3	1,435.9	19.2
V, CENTRAL GOVERNMENT PRIMARY BALANCE	-159.0	-2.3	-156.0	-2.2	-139	-1.9	-141.8	-1.9
V,1 Treasury Balance	42.6	0.6	37.7	0.5	79	1.1	69.1	0.9
V,2 Social Security Balance	-201.6	-2.9	-193.6	-2.8	-218	-2.9	-210.8	-2.8

Source: Ministry of Planning and IFI. [1]Percentage calculated considering nominal GDP estimated by the IFI. Our macroeconomic forecasts are avaiable at: https://www12.senado.leg.br/ifi/dados/arquivos/projecoes-ifi/view.

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2019 BUDGET

o In 2019, Government projects that loans will be higher than capital expenditure, which violates the Golden Rule.
o Therefore, part of budget expenses will be subject to the approval of the Congress by absolute majority.
o Such expenses are concentrated on social security benefits and social assistance programs.

GOLDEN RULE – EXPENSES SUBJECT TO THE CONGRESS APPROVAL

Budget Proposal	BRL Billion
Credit operations revenue	1,424.0
Capital expenditure	1,165.9
Golden rule insufficiency	**258.2**

Expenses subject to Congress approval	Authorized	Conditioned	Total
Social security benefits ("RGPS" system)	436.1	201.7	637.9
Assistance benefits ("LOAS/RMV")	30.2	30.0	60.2
Bolsa Família program	15.0	15.0	30.0
Subsidies and grants	9.7	9.0	18.7
Compensation to the "RGPS" system	7.5	2.5	10.0
TOTAL	**498.6**	**258.2**	**756.8**

Source: Ministry of Planning.

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2019 BUDGET

o Public investment projection is only BRL27bn, reinforcing recent downward trajectory.
o This amount is the lowest since 2006 and is 71% below the projected amount in the 2013 budget proposal.
o Realized data show that this year investments may have slight growth in comparison to 2017.
o Even so spending should remain in historically low level, about 50% of the 2010-2014 average.

**FEDERAL PUBLIC INVESTIMENTS (BRL BILLION, PRICES OF JULY/18)**
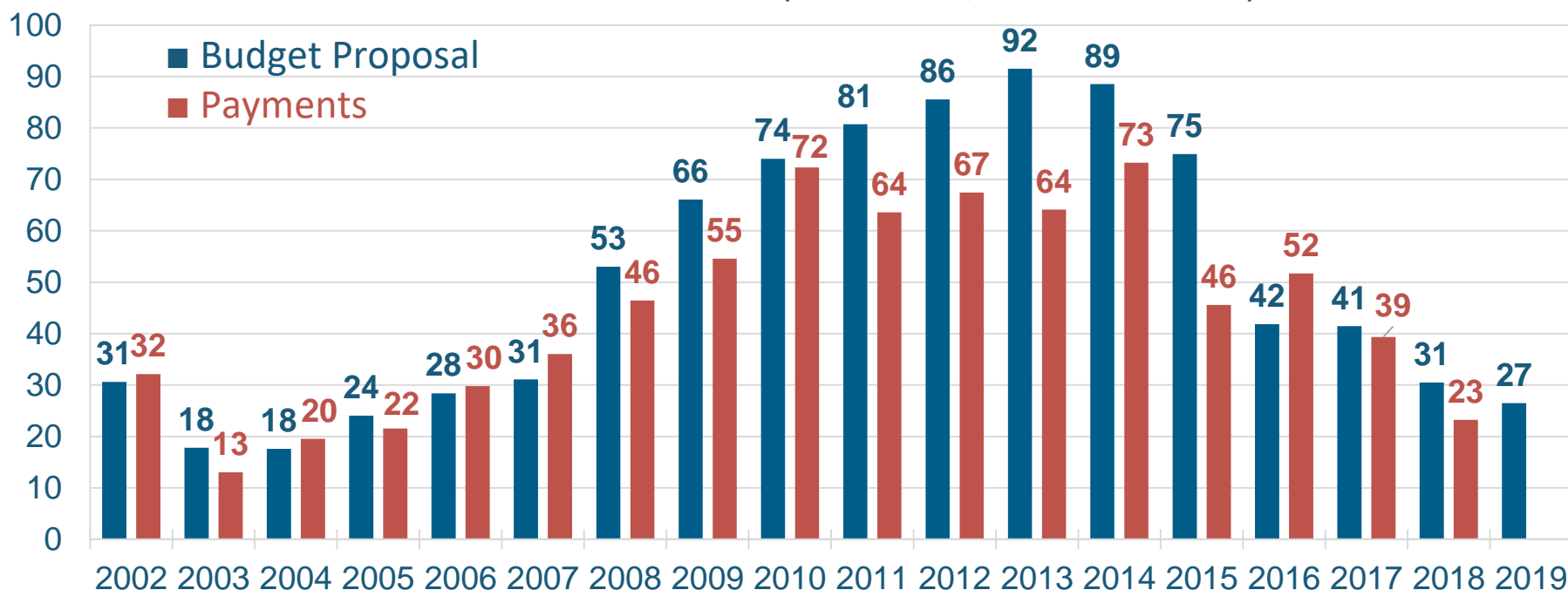
Source: Senate ("Siga Brasil").

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2019 BUDGET

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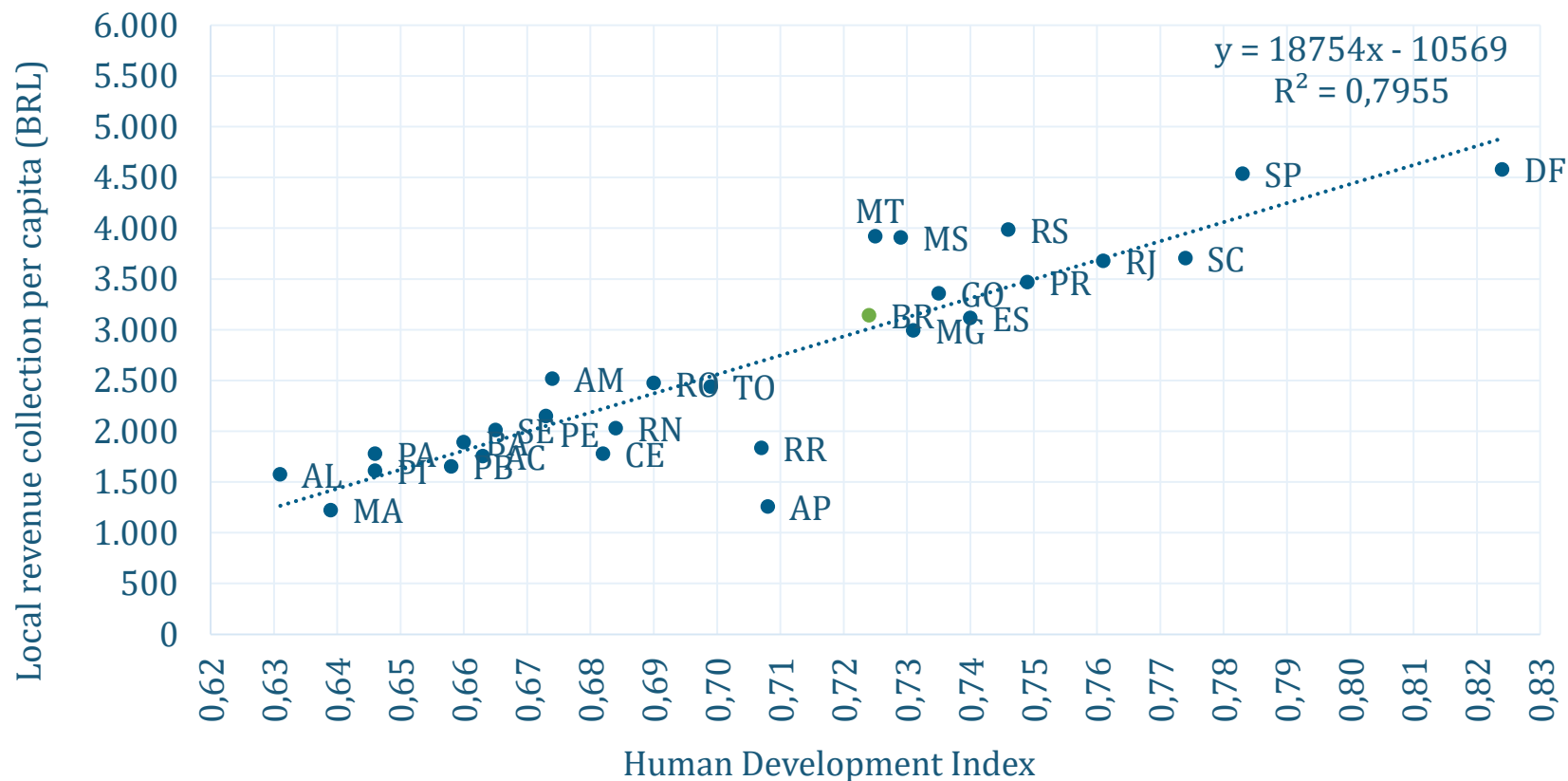

Federal public investiments (BRL Billion, constant prices - jul/18)
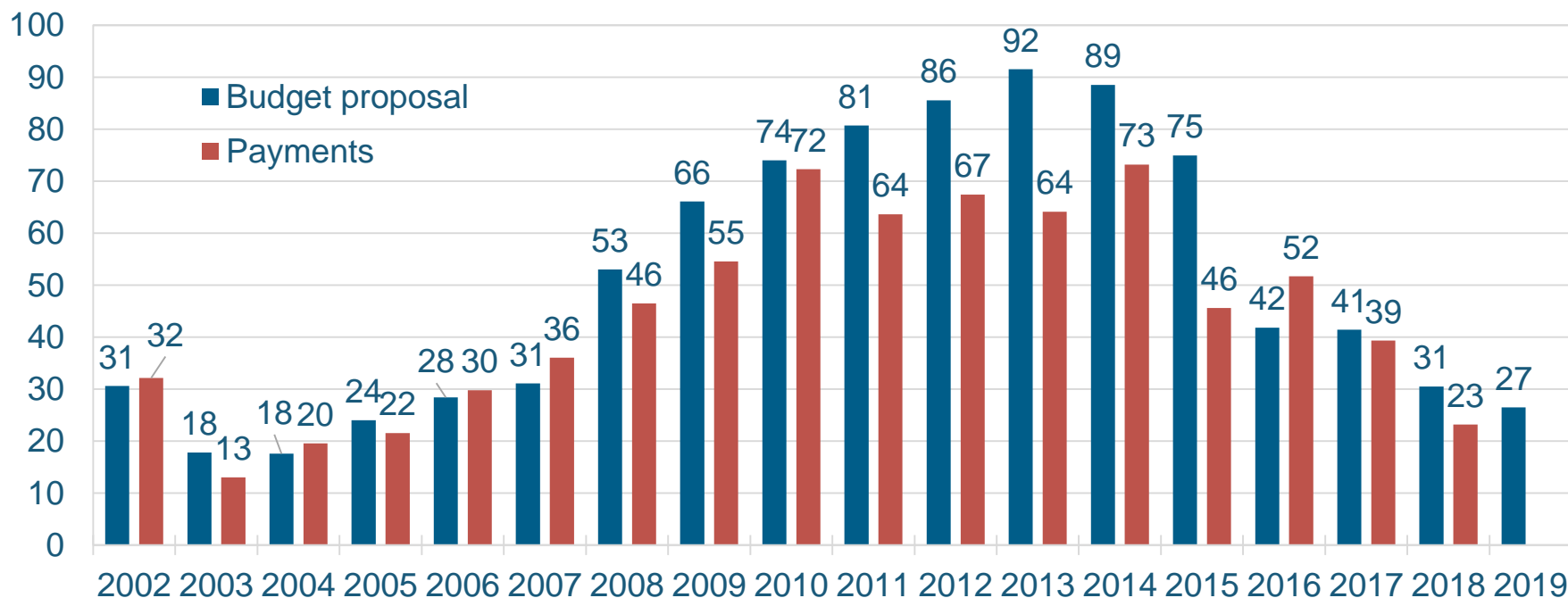
Source: Federal Senate ("Siga Brasil").
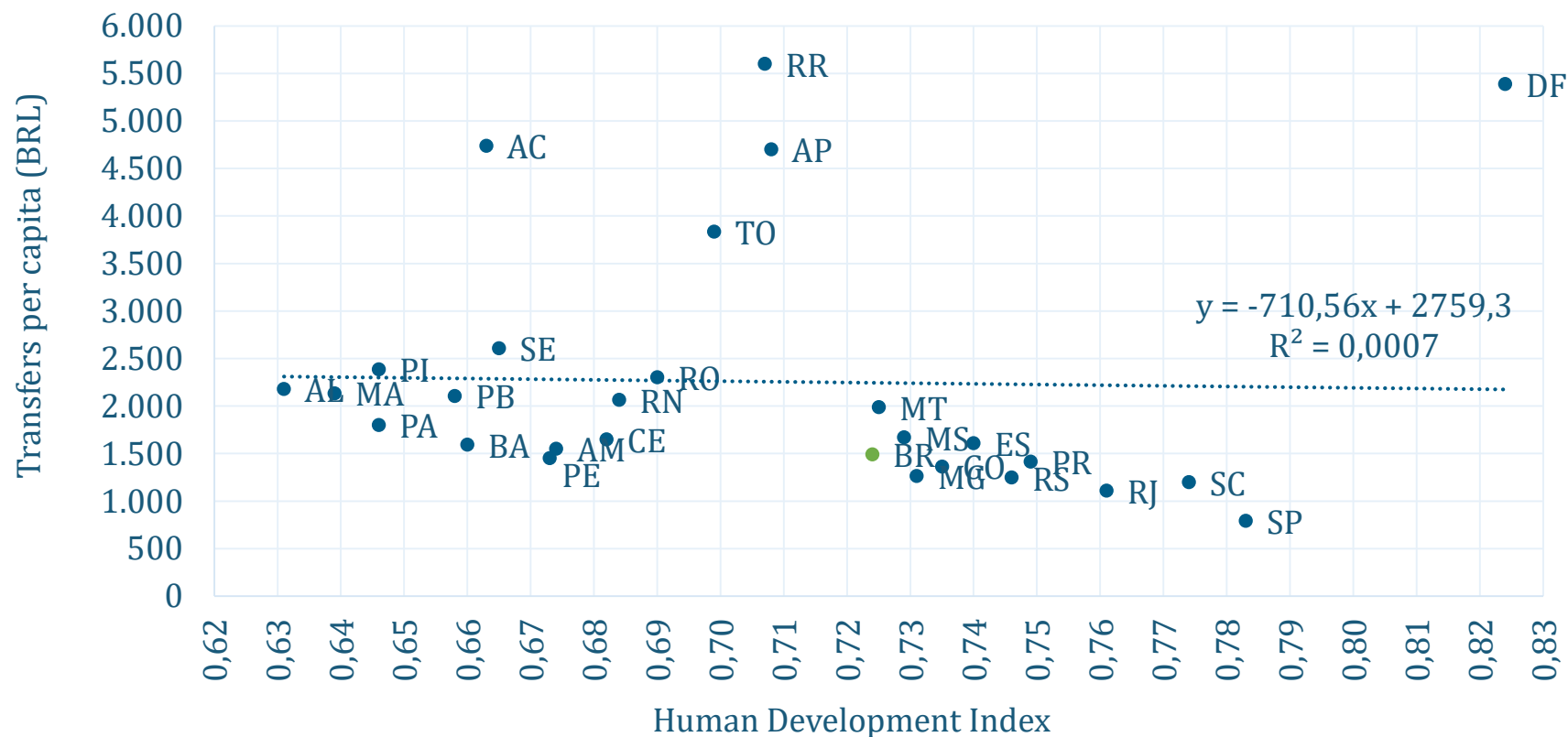
Disposable Revenue by State

o Local government revenue collection (without intergovernamental transfers) per capita in 2016.

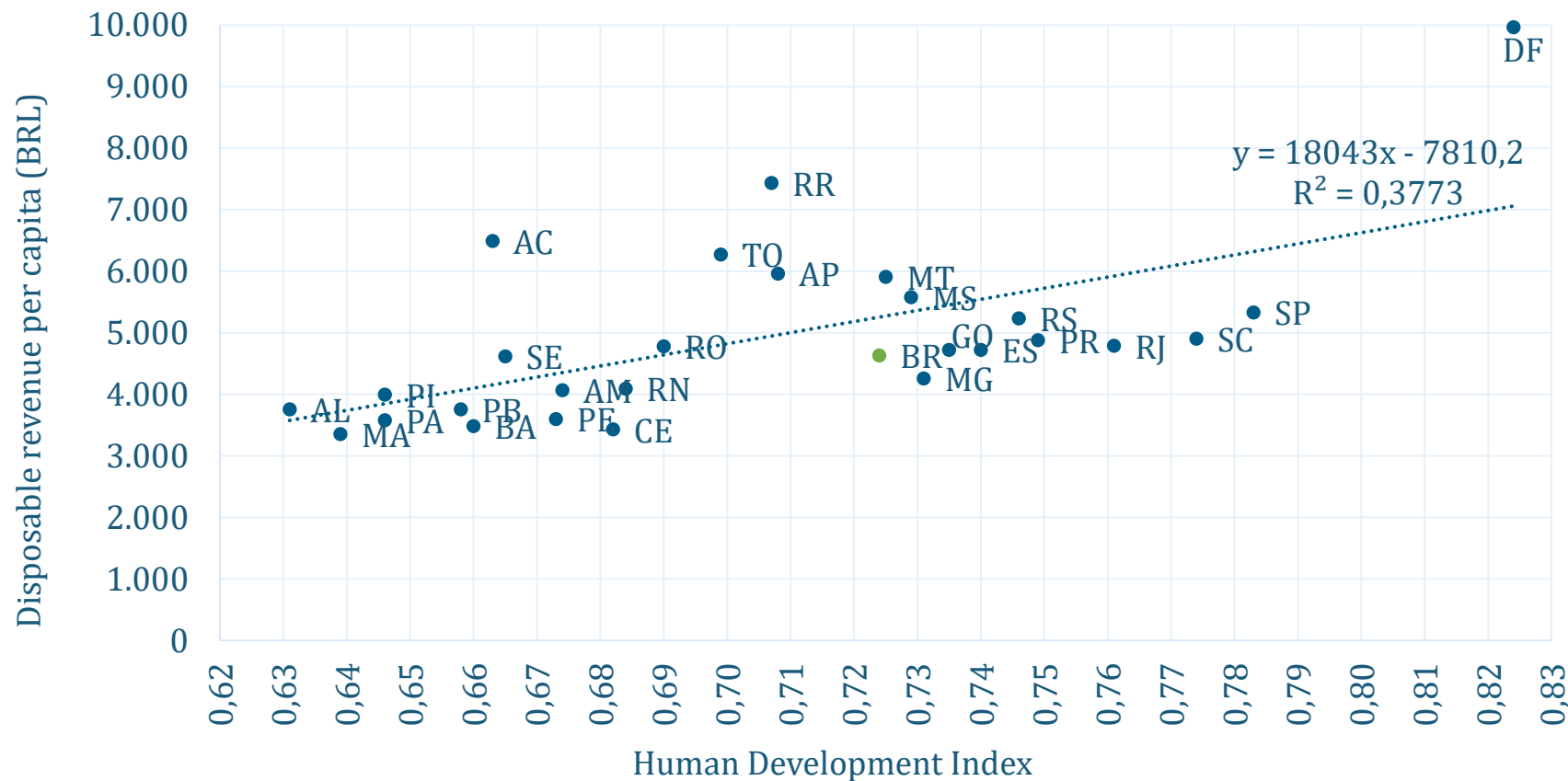Source: IFI.

Disposable Revenue by State

○ Legal and constitutional transfers for State governments per capita in 2016 (BRL)

Source: IFI.

Disposable Revenue by State

o State government disposable revenue per capita in 2016.

Source: IFI.

Federal Government Balance Sheets

o Balance Sheet:

- The balance sheet contains all the rights and obligations of the Federal Government. The rights are listed in the assets; the obligations appear in the liabilities

- Its figures reflect public policy options taken in the present and in the past, as well as other economic events that impact net worth.

- Are included in the balance sheet the funds, autarchies, foundations and federal dependent enterprises. The Central Bank and non-dependent enterprises are not included.

- The difference between assets and liabilities corresponds to the called net worth, a measure of the net wealth of the Federal Government. The net worth can be negative, which means obligations exceed rights.

Federal Government Balance Sheets

o   Composition of Federal Government assets and liabilities:

- In the assets side (Table 1), BRL 4.8 trillion in 2017, the main item are loans granted, which represent 32% of the total, almost entirely long term receivables. Next in value, the Treasury operating account and real estate assets, 22% of the total each, although the measurement of these figures is still incomplete.

- As for the liabilities (Table 2), BRL 7.3 trillion in 2017, the concentration is even greater than the observed in the assets. 72% of liabilities refer to loans taken, basically loans based on the issuance of government bonds in the domestic market (held by the public and the Central Bank). Next in value, the provisions with 24% of the total, especially the called social security maths that are nothing more than the actuarial evaluation of the federal public servants retirement system ("RPPS" in Portuguese).

Federal Government Balance Sheets

o Assets: loans granted, Treasury operating account and fixed assets

TABLE 1. FEDERAL GOVERNMENT BALANCE SHEET – ASSETS

	2017		2016	
	(BRL billion)	Share %	(BRL billion)	Share %
ASSETS	**4,839**	**100**	**4,672**	**100**
1. CASH AND CASH EQUIVALENTS	**1,140**	**24**	**1,108**	**24**
Treasury operating account	1,041	22	1,005	22
Other	99	2	103	2
2. LOANS AND FINANCING	**1,545**	**32**	**1,526**	**33**
Short-term	42	1	77	2
Long-term	1,503	31	1,449	31
3. RECEIVABLES ("DÍVIDA ATIVA") AND TAX CREDITS	**583**	**12**	**552**	**11**
Receivables ("Dívida Ativa")	407	8	364	8
Long-term	407	8	364	8
Tax credits	176	4	188	4
Short-term	34	1	34	1
Long-term	143	3	155	3
4. INVESTIMENTS	**309**	**6**	**302**	**6**
Permanent shares	308	6	299	6
Other investiments	2	0	3	0
5. FIXED ASSETS	**1,143**	**24**	**927**	**20**
Movable goods	93	2	88	2
Real Estate	1,050	22	839	18
6. OTHER	**118**	**2**	**257**	**6**
Other receivable credits*	81	2	220	5
Short-term	51	1	191	4
Long-term	31	1	29	1
Other accounts**	37	1	37	1
Short-term	22	0	24	1
Long-term	16	0	13	0

Source: Union Balance Sheet.

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Federal Government Balance Sheets

o   High concentration in liabilities: debt and social security

TABLE 2. FEDERAL GOVERNMENT BALANCE SHEET – LIABILITIES AND NET WORTH

	2017 (BRL billion)	Share %	2016 (BRL billion)	Share %
LIABILITIES	**7,265**	**100**	**6,695**	**100**
1. LOANS AND FINANCING	**5,246**	**72**	**4,664**	**70**
Short-term	789	11	656	10
Long-term	4,456	61	4,008	60
2. PROVISIONS	**1,710**	**24**	**1,597**	**24**
Short-term	56	1	41	1
Long-term	1,655	23	1,556	23
Social Security maths	1,199	17	1,365	20
Judicial and administrative losses	250	3	106	2
Military pensions granted	119	2	0	0
Other	87	1	50	1
3. OTHER LIABILITIES*	**309**	**4**	**433**	**6**
Short-term	284	4	368	5
Long-term	25	0	65	1
NET WORTH (Assets minus liabilities)	**-2,425**		**-2,021**	

Source: Union Balance Sheet.

*The main itens in the balance sheet are the costs of foreign exchange operations and reserves (negative balance of the Central Bank) and liabilities in the process of recognition and regularization (basically the salary variation compensation fund – "Fundo de Compensação de Variações Salariais – FCVS", in portuguese, according to the National Treasury).

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o   Main features of the balance sheet:

- Apart from the composition of assets and liabilities, both trademarks of the Federal Government balance sheet: net worth strongly negative and assets/liabilities rather high.

- At the end of 2017, the net worth was BRL 2.4 trillion negative. The persistence of public deficits in the coming years will deteriorate even more the net worth, indicating the unsustainability of public policies reflected in the balance sheet.

- High values for assets (BRL 4.9 trillion) and liabilities (BRL 7.3 trillion) are a problem, since the return of the assets is less than the cost of the liabilities and the assets cannot be easily used to rescue liabilities for a number of reasons (liquidity, conflict of objectives and predetermined use).