Instituição Fiscal Independente

SENADO FEDERAL

Fiscal Follow-up Report

January 2019

Full report here (portuguese)

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Executive Director

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Summary

- The IBC-Br, Index of Economic Activity of the Central Bank, was stable in October at seasonally adjusted monthly comparison. The stability shown in the last three disclosures suggest gradual recovery of the economy. In 2018, industrial production has suffered the effects of the thuckers' strike and the downturn in manufactured exports.

- Credit recovery, in the last 18 months, tends to continue in line with the expected economic growth. The resumption of the credit is due to the reduction of indebtedness of agents, sustained mainly by better conditions on loans. Nevertheless, the characteristic informality of the incipient economic recovery constrains the resumption of credit.

- The General Government Gross Debt reached 77.3% of GDP in November 2018. Since May 2018, the indicator remains at the same level, never exceeding 78%, momentarily ceasing the ascendant trajectory observed in recent years. However, the participation of selic indexed public bonds grew in total debt.

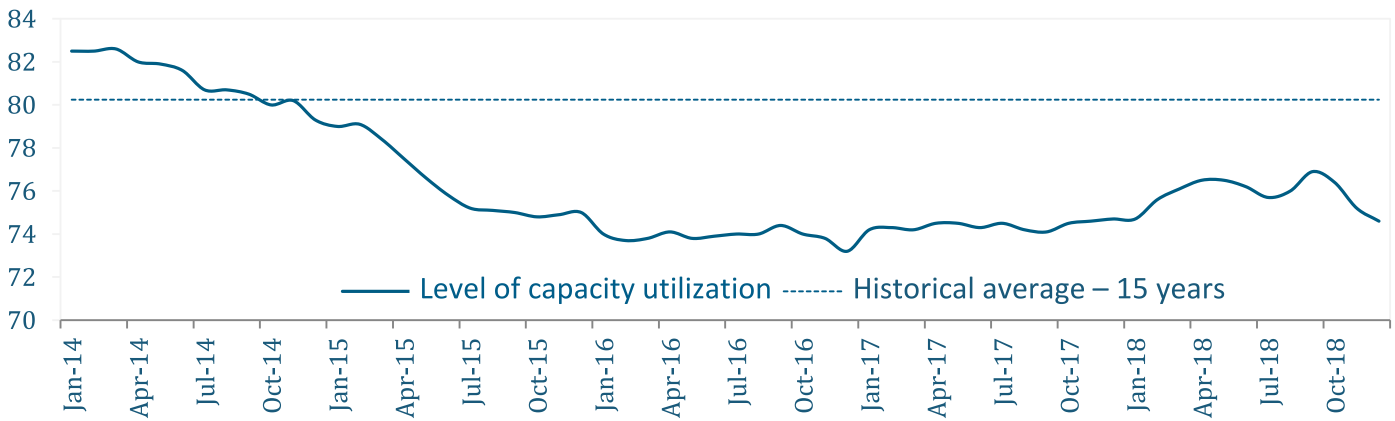
- In December, the National Congress approved the Budget Law of the Union for 2019. This year, the budget assumes GDP growth of 2.5% and inflation measured by the IPCA of 4.3%. The primary balance target is a deficit of BRL 132.0 billion (1.8% of GDP) for the consolidated public sector, being BRL 139.0 billion to the central government, BRL 3.5 billion to the state-owned companies and a surplus of BRL 10.5 billion to states and municipalities.

- The budget contains an excess of credit operations in relation to capital expenditures of BRL 248.9 billion, which violates the constitutional rule. As a solution, a portion of the estimated expenditure in the same amount of the excess, can only be executed if it is approved by Congress by an absolute majority. This portion focuses basically on social security benefits and social assistance. For these expenses, the portion not subject to the approval of the legislature should be sufficient only for the first six months of the year.

Macroeconomic Context

- The resumption of economic activity, based on the IBC-Br, remains gradual. The index grew 3.1% in comparision to October 2017 and 1.5% in the last 12 months.
- On the supply side, sectorial indicators point an accommodation trend. Out of the five segments of the Monthly Services Research, only two (information and communication services and other services) contributed to the increase in the monthly comparison.
- The national industry follows operating with a high level of economic slack. As a consequence of the low dynamism of production, the capacity utilization of industry is still well bellow historical average (80.3%). Between November and December, in the seasonally adjusted series, the index retreated 0.6 percentage point, reaching 74.6%.

LEVEL OF CAPACITY UTILIZATION (%)



Source: FGV. Elaboration: IFI.

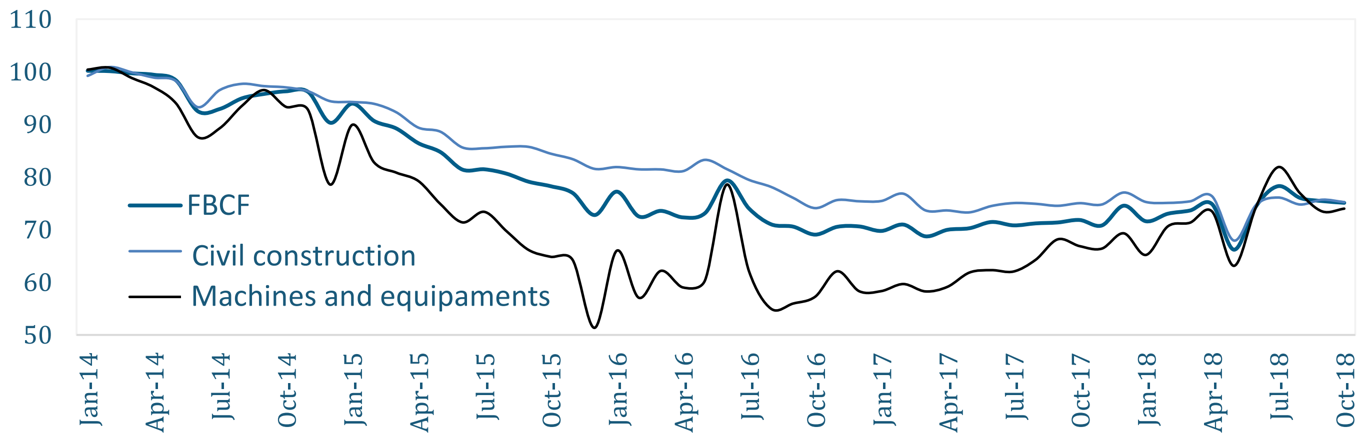
Macroeconomic Context

- On the demand side, the high level of economic slack in industry should limit the reaction of investments in the short term. On investments, the Ipea Indicator of Gross Fixed Capital Formation retreated 0.4% between September and October, in the seasonally adjusted series. In annual comparison, the index advanced 5.0%, accumulating 4.2% in 12 months ended in October.

- GDP should grow 2.3% in 2019. The preliminary set of information available on the state of economic activity in the fourth quarter of 2018 suggests that GDP growth in the year should be materialize a little bellow what is currently expected by IFI (1.4%).

GROSS FIXED CAPITAL FORMATION

(SERIES WITH SEASONAL ADJUSTMENT – 1°Q/14=100)



Source: Ipea. Elaboration: IFI.

Macroeconomic Context

- Unemployment retreated 0.5 p.p. in November. The growth of occupation occurs in non-registered positions or self-employed, showing relative weakness in the recovery of the job market.
- The increase of formal employment in the Brazilian economy should occur only when entrepreneurs invest again in expansion of production capacity. For a new investment cycle, the government need to persist in macroeconomic imbalances correction, in particular, the disarrangement in the public accounts of the federated entities.
- Salary mass is driven by income growth and influences household consumption. Indeed, the growth is more robust in the sales of nondurable goods.

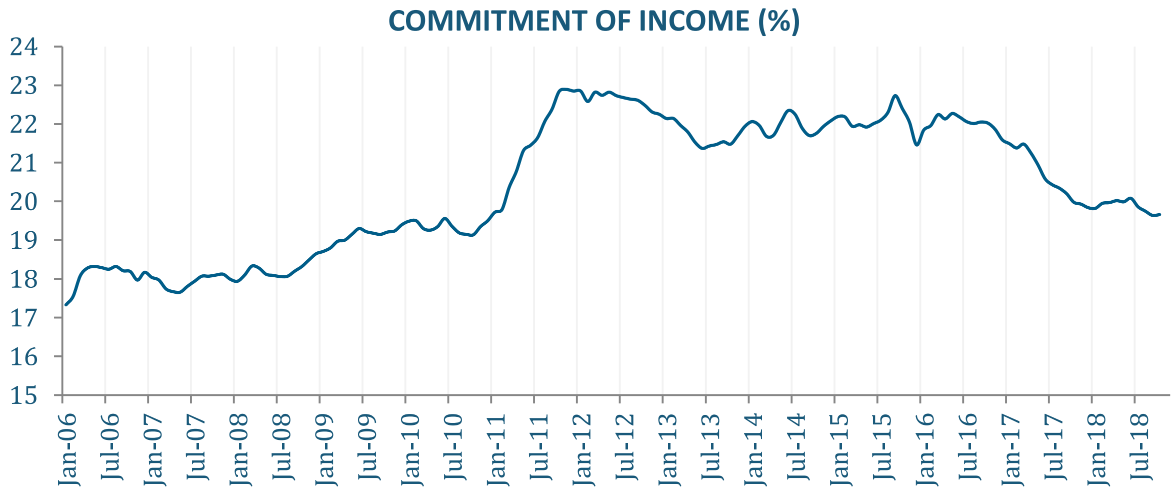
POPULATION OCCUPIED BY POSITION

	Absolute values (in thousands)			Accumulated variation in 12 months			Percentage in relation to total of occupied		
	Sept/18	Oct/18	Nov/18	Sept/18	Oct/18	Nov/18	Sept/18	Oct/18	Nov/18
Occupied population	**92,622**	**92,901**	**93,189**	**1.6%**	**1.6%**	**1.4%**	**100.0%**	**100.0%**	**100.0%**
Private sector: registered	32,972	32,923	32,962	-1.5%	-1.4%	-1.3%	35.6%	35.4%	35.4%
Private sector: non-registered	11,511	11,628	11,689	5.0%	5.3%	4.8%	12.4%	12.5%	12.5%
Domestic worker	6,259	6,264	6,262	2.5%	2.1%	1.5%	6.8%	6.7%	6.7%
Public sector	11,732	11,713	11,769	2.5%	2.4%	2.6%	12.7%	12.6%	12.6%
Employer	4,429	4,514	4,480	5.1%	4.7%	4.4%	4.8%	4.9%	4.8%
Self-employed	23,496	23,610	23,811	3.4%	3.2%	3.0%	25.4%	25.4%	25.6%
Percentage of workers who contribute to social security	**58,398**	**58,488**	**58,664**	**-0.1%**	**0.0%**	**0.1%**	**63.0%**	**63.0%**	**63.0%**

Source: IBGE. Elaboration: IFI.

Macroeconomic Context

- The recent growth of credit (4.4%) was possible due to deleveraging held by families and businesses. To a large extent, the reduction in the commitment of income index occurred due to the drop in the basic interest economy rate (Selic), which relieved the expenditure of households with bank debts service.
- Credit can grow more with increasing formalization. The confrontation of the credit market information with data regarding the labor Market suggests that the resumption of credit may be more robust if the recovery in employment occurs with increased formalization of labor. The relatively fragile conditions in the labor Market, which registers further expansion of the occupation without officially registered or their own, constrain the expansion of credit in the economy.



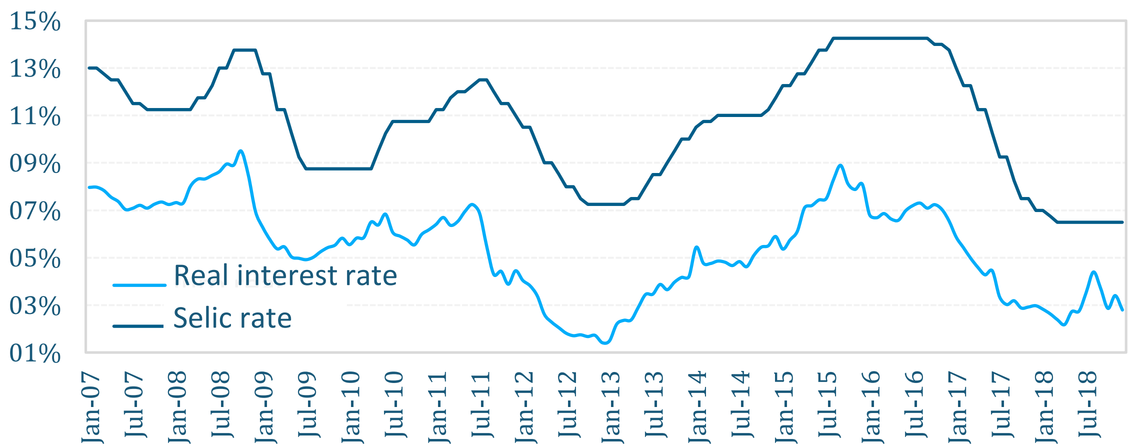
Source: Central Bank of Brazil. Elaboration: IFI.

Macroeconomic Context

- Good scenario for inflation, which was 0.75 p.p. below the goal, assures the permanence of interest rates at historically low levels. The current inflation in comfortable level, the slow reaction of economic activity and inflation expectations anchored – aligned to the inflation goal for the next years, as indicated in the Focus Market Readout – are factors that allow the Central Bank to support the Selic rate ate the current level of 6.5% per year.

- The process of monetary easing leading to ex ante real interest rate (measured by the futures contract rate deflated by inflation expectations for the next 12 months) to low in historical terms. Such a reduction, to raise the cost of credit, helps boost the level of activity and employment. A risk around the inflation scenario and, therefore, the path of interest rates, involves the frustration of the expectations regarding the challenge of reducing the primary deficit and ensure the sustainability of public debt.

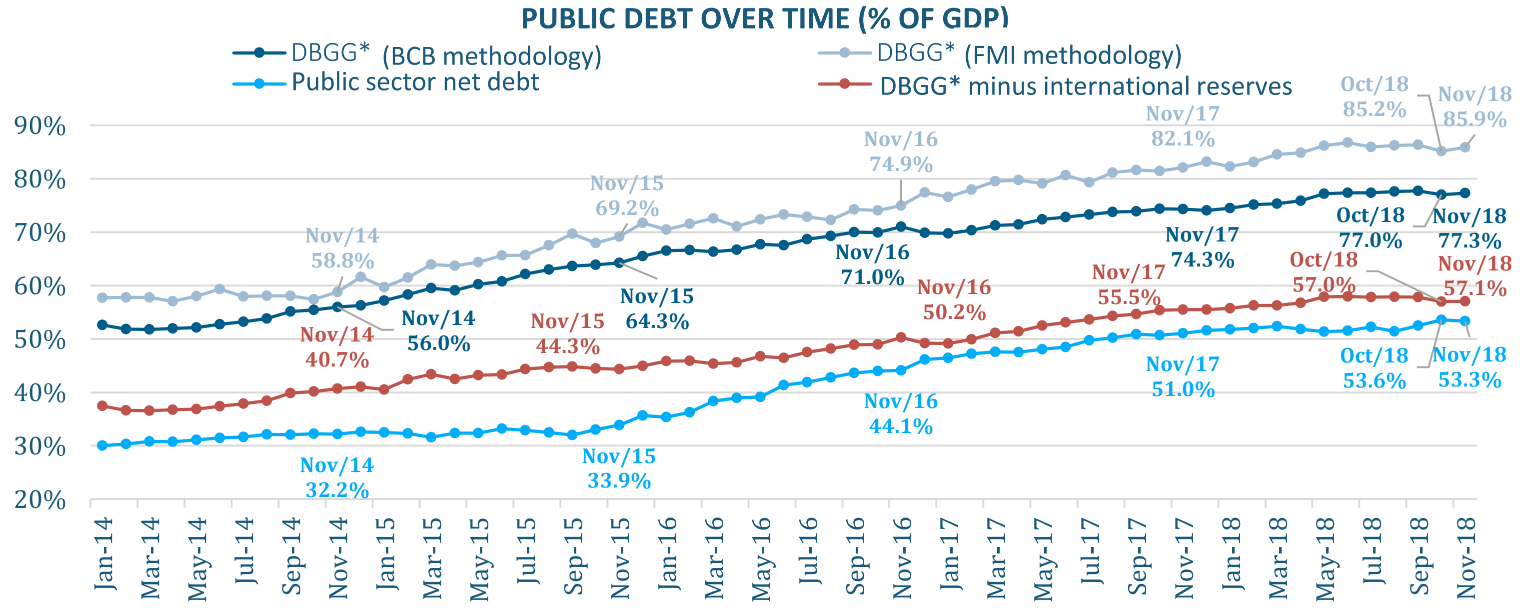
EX-ANTE **NOMINAL AND REAL INTEREST RATE**



Source: BM&F e Central Bank of Brazil. Elaboration: IFI.

Fiscal Context

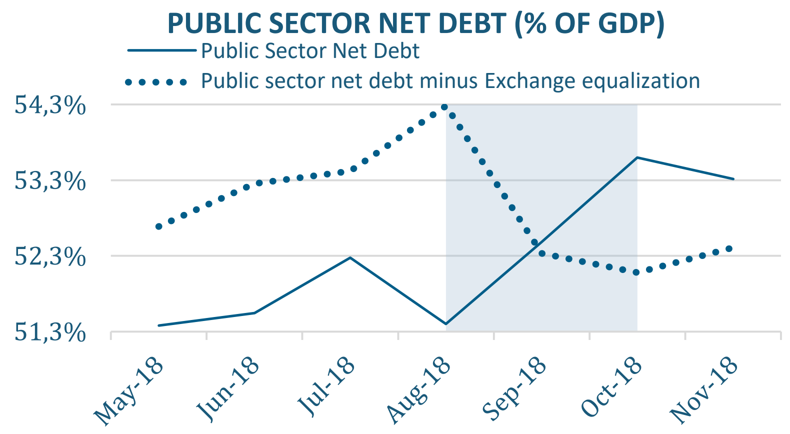
- The Gross Debt of General Government (DBGG) reached 77.3% of GDP in November 2018, compared with 77% in October and 74.3% in November of 2017. Despite these variations, since may 2018 the DBGG has remained relatively stable at this level, never exceeding 78% of GDP, thus interrupting the growth trajectory observed in recent years.
- From the point of view of indexers of DBGG, however, grew the involvement of titles indexed by Selic: Advanced to 45.7% in May to 48.3% of the total public debt in November, an expansion of 2.6 percentage points.

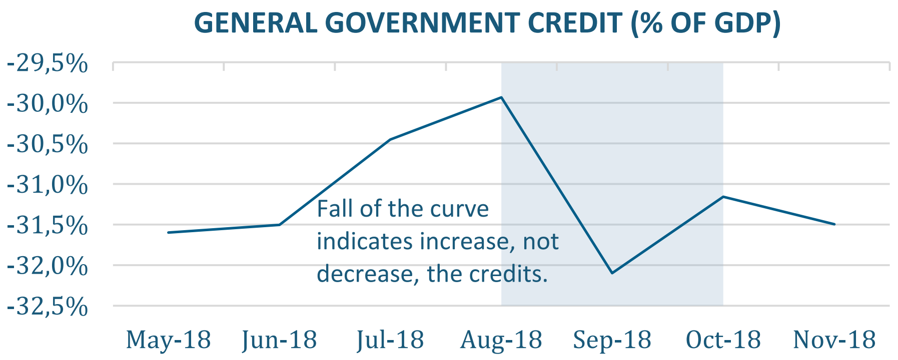


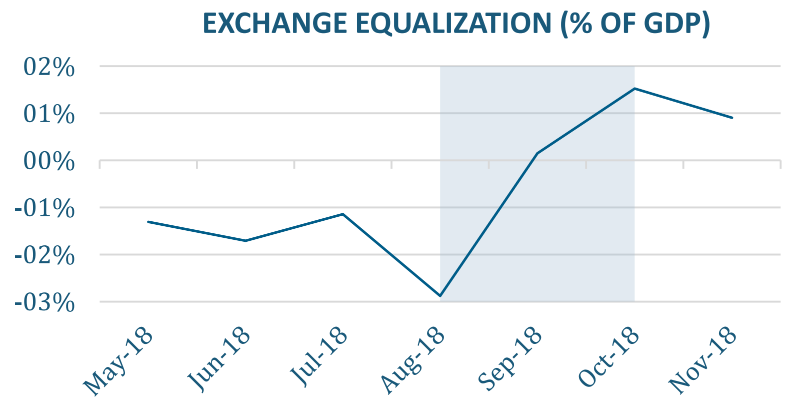
*Source: Central Bank of Brazil. Elaboration: IFI. *Gross Debt of General Government. Each historical series is equal to the debt stock in the indicated month, divided by the GDP accumulated in the twelve months up to (and including) the indicated month.*

Fiscal Context

- The Public Sector Net Debt reached 53.3% of GDP in November 2018, compared to 53.6% in October and 51% in November 2017, having advanced more than the DBGG in recent months mainly due to the foreign exchange equalization. In addition, the stock of free titles in the portfolio of the Central Bank remained little changed in recent months, which is why the gross indebtedness at the discretion of IMF, which sum these titles to DBGG, has remained stable, in line with other measures of indebtedness.





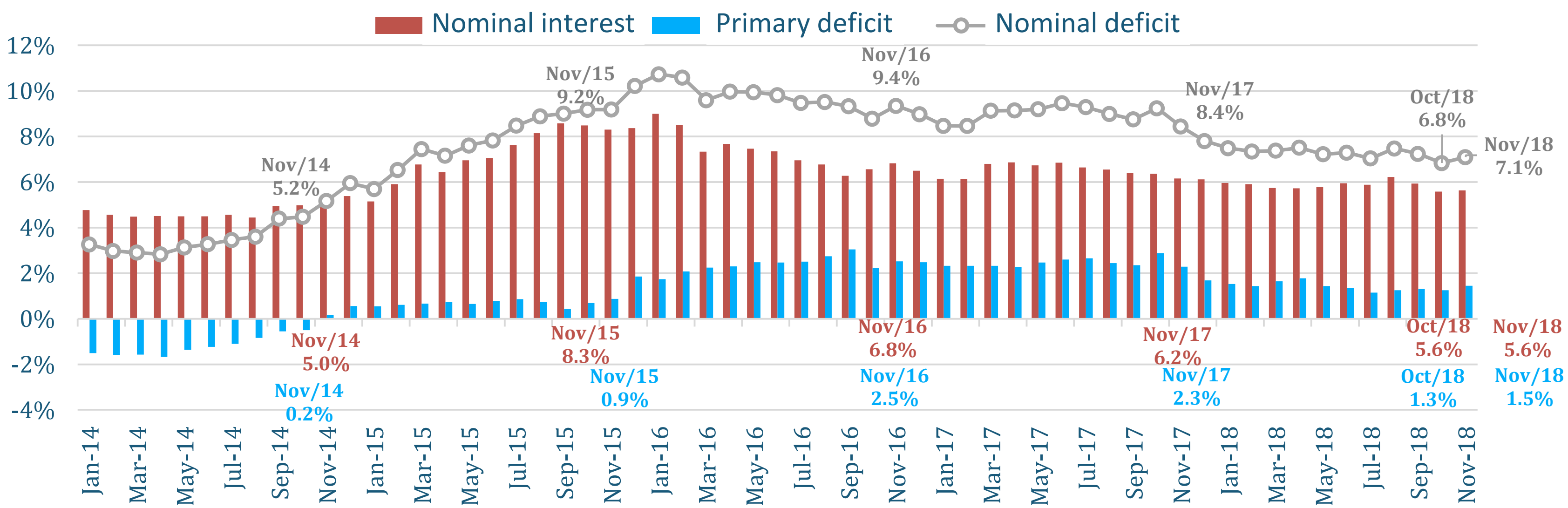


Source: Central Bank of Brazil. Elaboration: IFI.

Fiscal Context

- The nominal monthly deficit of public sector reached BRL 50.6 billion in November 2018. The value rolling 12-month was BRL 485 billion, equivalent to 7.1% of GDP, compared with 6.8% in October. The increase of 0.3 p.p. occurred due to the expansion in net interest appropriation and primary deficit (+0.1 and +0.2 p.p. Of GDP, respectively).
- As for the primary deficit, which reached 1.5% of GDP in November 2018, it is the highest value since May 2018, although is below the levels observed in 2016 and 2017.

PUBLIC SECTOR BORROWING REQUIREMENTS (% OF GDP)

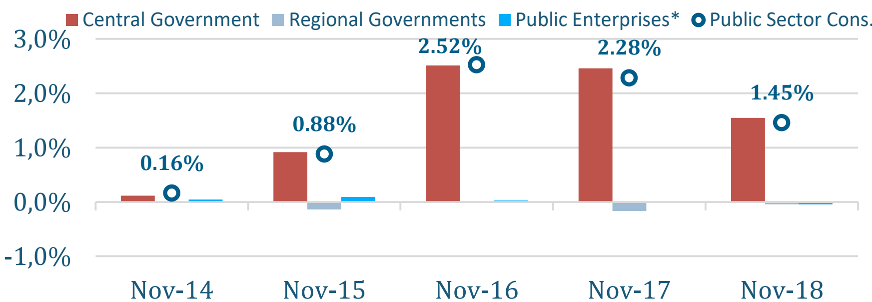


Source: Central Bank of Brazil. Elaboration: IFI. Positive values indicate deficit; negative values surplus. Each historical series corresponds to the accumulated in the twelve months up to (and including) the month, divided by the accumulated PIB in the same 12 months.

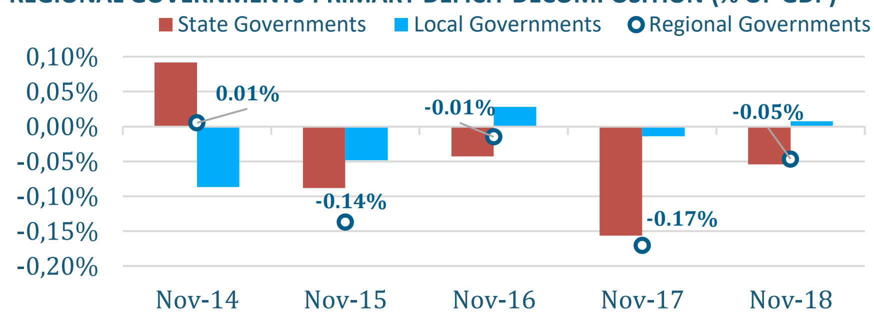
Fiscal Context

- The surplus of regional governments and public enterprises was small, not enough to significantly affect the total deficit. Decomposing the Central Government deficit in November 2018, this received important contribution of federal government’s surplus, which was greater than that observed in the same period of previous years. Such surplus was enough to avoid, at least momentarily, the prevalence of social security deficit, which has been growing.

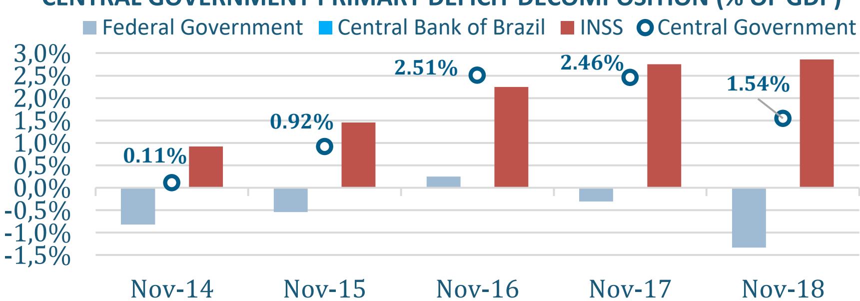
CONSOLIDATED PUBLIC SECTOR PRIMARY DEFICIT DECOMPOSITION (% OF GDP)



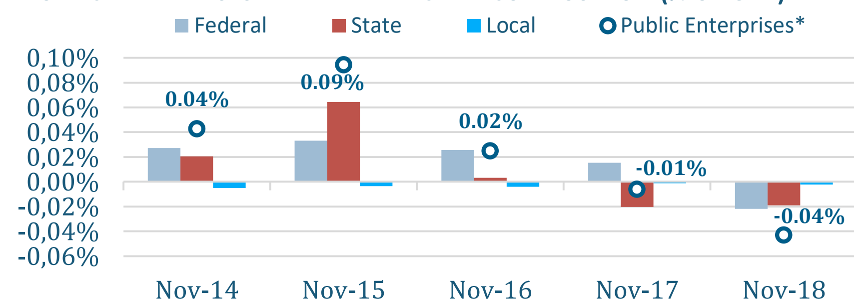
REGIONAL GOVERNMENTS PRIMARY DEFICIT DECOMPOSITION (% OF GDP)



CENTRAL GOVERNMENT PRIMARY DEFICIT DECOMPOSITION (% OF GDP)



PUBLIC ENTERPRISES PRIMARY DEFICIT DECOMPOSITION (% OF GDP)

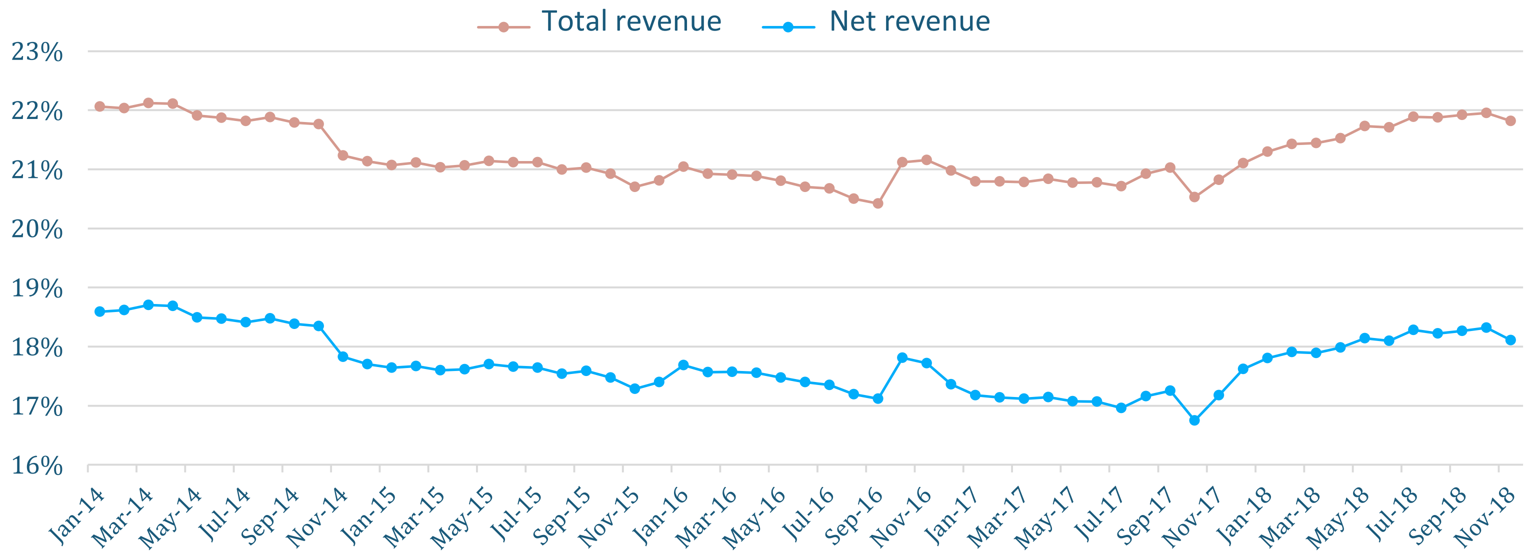


*Source: Central Bank of Brazil. Elaboration: IFI. Positive values indicate deficit; negative values surplus. *Except Petrobras and Eletrobras. Each historical serie correspond to the sum of the preceding 12 months divided by the sum of the monthly GDP of the same 12 months.*

Fiscal Context

- The primary total revenue of Central Government in November 2018 was BRL 124.2 billion, equivalent to the recoil of 4.3% (in real terms) in relation to the same period last year. The recovery of total revenue between October 2017 and August 2018 mainly due to movement of the collection with Import Tax (+0,09 p.p.), IPI (+0,12 p.p.), Cofins (+0,71 p.p.), PIS-PASEP (+0,18 p.p.) and revenues not administered by RFB (0,65 p.p.).

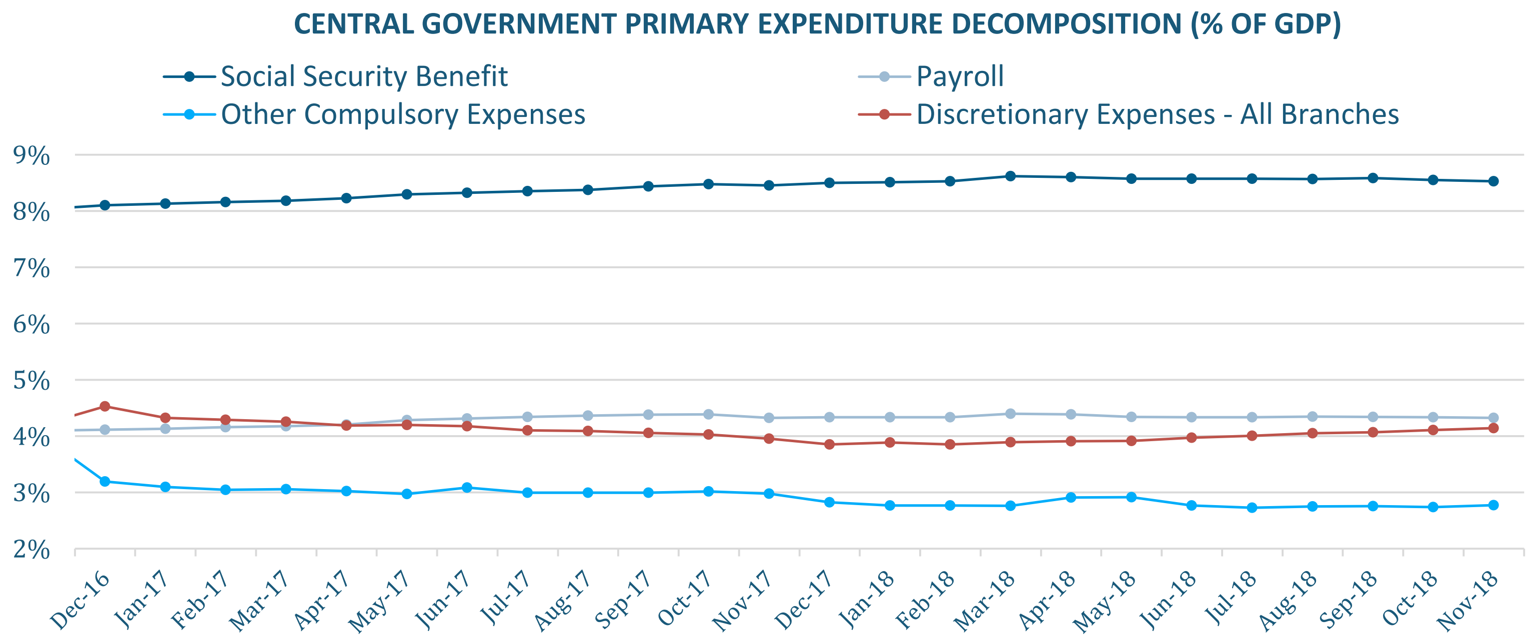
PRIMARY TOTAL REVENUE OF CENTRAL GOVERNMENT (% OF GDP)



Source: National Treasury and Central Bank of Brazil. Elaboration: IFI. Each historical serie corresponds to the accumulated in the 12 months up to (and including) the month, divided by the cumulative GDP in the same twelve months.

Fiscal Context

- The Central Government primary total expenditure in November 2018 was BRL 115.6 billion, equivalent to the advanced of 5.4% (in real terms) as compared to the same period last year. In rolling 12-month, the expenditure has fluctuated between 19.5% and 20% of GDP, and since May 2018 it was even more stable. Such trajectory is derived from the stability of four main components of total expenditure: social security benefits, payroll, discretionary expenditure and other compulsory expenditures.



Source: National Treasury and Central Bank of Brazil. Elaboration: IFI. Each historical serie corresponds to the accumulated in the 12 months up to (and including) the month, divided by the cumulative GDP in the same twelve months.

Budget 2019

- The Annual Budget Law 2019 (LOA 2019) was approved by the National Congress in December. The Budget considers GDP growth of 2.5% in 2019 and inflation measured by the IPCA of 4.3%. The primary result goal is a deficit of BRL 132 billion (1.8% of GDP) for the public sector consolidated, being BRL 139 billion for central government, BRL 3.5 billion for federal enterprises and a surplus of BRL 10.5 billion of states and municipalities.
- The expected movement by the IFIs and other economic agents is of moderate elevation of the Selic and relative stability of exchange rate in relation to current levels.

MAIN MACROECONOMIC PARAMETERS OF BUDGET 2019

Parameters	Government (LOA 2019)	IFI (RAF 22)	Market (Focus)	IMF (WEO)
Real GDP (%)	2.50	2.30	2.53	2.37
IPCA (%)	4.25	4.25	4.11	4.15
Selic (média - %)	7.10	7.25	7.13	-
Exchange rate (average - BRL / US$)	3.70	3.70	3.82	-

Source: Focus Market Readout (Market expectations of 11/30/2018), IMF (World Economic Outlook, in October – WEO of 2018), Deputies Chamber (Final Opinion of the Joint Committee on Plans, Public Budgets and Monitoring of the National Congress on the PLOA 2019) and IFI (RAF of November 2018).

Budget 2019

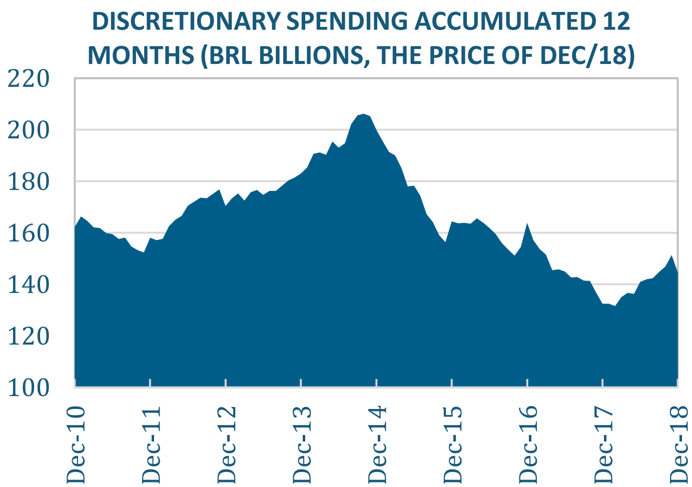
- The primary revenue from Union Budget don't include the resources from the auctioning of surplus oil from the onerous transfer to Petrobras. These resources, according to the Ministry of Mines and Energy, can get the BRL 100 billion, being part of which can be passed on to subnational governments, reducing the revenue available to the Union.

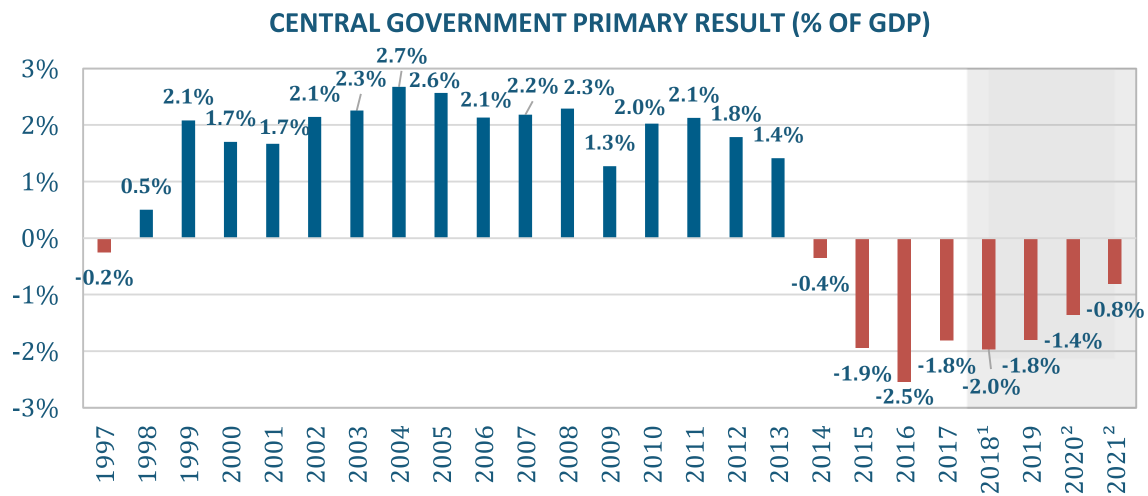
- The Budget doesn't consider the potential revenue income tax levied on revenue from investments funds, which can reach about BRL 10.7 billion (according to the Federal Revenue Office). The budget included, however, the revenue from grants by the new concession contracts of the plants of Eletrobras, estimated at BRL 12.2 billion (regime change depends on the approval by the Congress).

- The Budget of 2019 includes spending on salary adjustments of about 370 thousands active and inactive servers. These adjustments had been postponed by Provisional Measure no. 849, of August 31 2018. However, in December, the MP was suspended by the Supreme Court and the adjustments are back. According to the Statement of Motivates that accompanies the Measure, the postponement would represent an economy of BRL 4.7 billion in 2019.

Budget 2019

- The Budget Guidelines Law for 2019 designs for 2020 and 201 primary result negative, but shows trend of deficit reduction.
- This reduction will come mostly from primary expenditure restraint. The discretionary portion of the expenditure of the Union is in a historically low level, even having shown improvement in 2018 compared to 2017.
- The vision of the central government, as well as the base scenario of the IFI, shows deficit for a few more years, but projected primary surplus in 2023, thus completing nine years of negative result (2014 to 2022). The short-term trajectory of the primary result, however, can be changed significantly as a function of potential revenue from the onerous transfer of Petrobras or any advancement in the federal government's privatization agenda.





Source: Siga Brasil (Senado Federal).

Source: Câmara dos Deputados (Parecer Final da Comissão Mista de Planos, Orçamentos Públicos e Fiscalização do Congresso Nacional sobre o PLOA 2019), Lei 13.707, de 2018 (LDO 2019) e IFI (RAF de novembro de 2018). [1] Projeção da IFI. [2] Projeção da LDO 2019.

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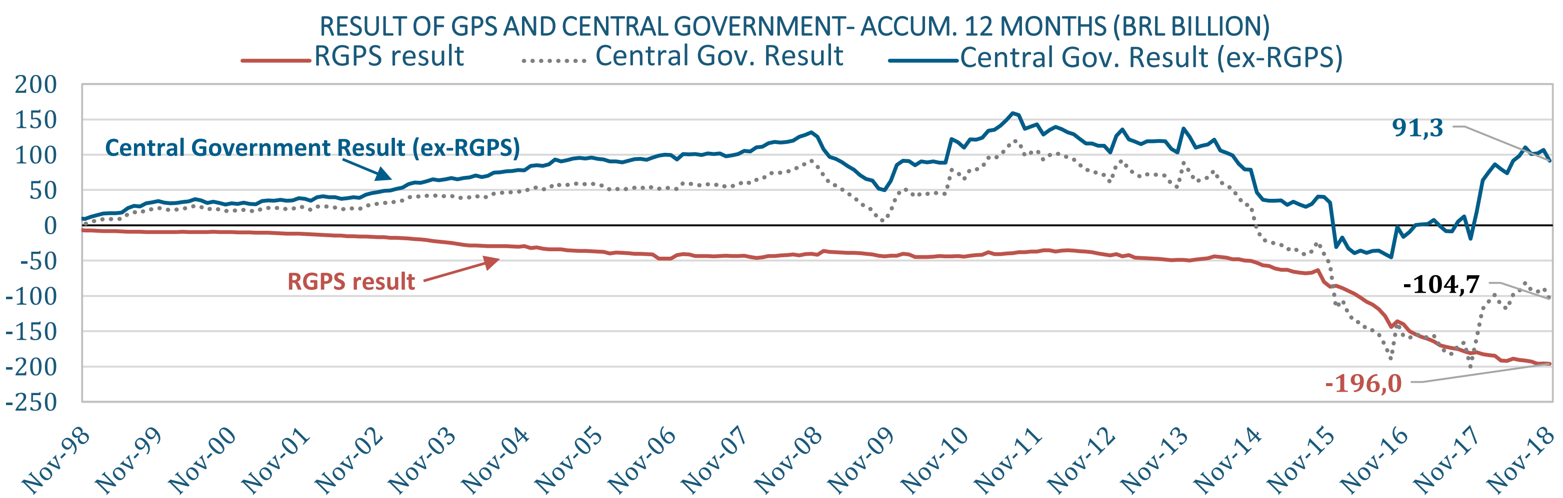
Budget 2019

- The Union Budget for 2019 previsses a déficit of BRL 218 billions (2.9% of GDP) in the General Social Welfare Policy (RGPS). If the forecast for 2019 is confirmed, it will be an increase close to 11% in just one year.
- Without the result of RGPS, the national treasure would be found. Until November 2018, revenue and primary expenditure, except the linked to Social Security, presents surplus BRL 91.3 billion, or 1.3% of GDP. This result, although it can be influenced by atypical recipes, is a better measure of recovery of the result of the national treasure in the most recent period.
- The social security deficit, totaling the RGPS and own schemes, will be BRL 305.6 billion in 2019, about 4.2% of GDP. This is the bill being funded by non-social security income, making it impossible for the use in your other essential public services, in addition to hindering the search tremendously public accounts balance.



Source: National Treasury.

Budget 2019

- Some potential events impact on the fulfilment of the main tax rules applied to the Union. But, there are distinctive traits relevant among them.

EVENTS WITH RELEVANT FISCAL IMPACT

Event	Primary result goal	Golden rule	Potential impact
Revenue from auction of surplus oil from the onerous transfer to Petrobras	It's a primary revenue and therefore helps in fulfilling the primary result goal.	It isn't foreseen in Budget of 2019. If used to pay expenditures, reduces the need for contracting of credit operations and, therefore, the insufficiency of the golden rule.	According to Ministry of Mines and Energy, it can reach BRL 100 billion, but part may be passed on to the subnational governments, reducing the revenue available to the Union.
Revenue from privatizations of public enterprises	It's a primary revenue but isn't considered for effect of verification of fulfilling the primary result goal.	It isn't foreseen in Budget of 2019. If used to pay expenditures, reduces the need for contracting of credit operations and, therefore, the insufficiency of the golden rule.	It will depend on the assets sold and the terms of negotiation.
Revenue from devolution BNDES to Treasure	It's financial revenue. It doesn't impact the primary result.	It is foreseen in BRL 20 billion in Budget of 2019. If used to pay expenditures, reduces the need for contracting of credit operations and, therefore, would reduce the insufficiency of the golden rule.	It could reach much higher as the reported BRL 100 billion reported in 2019. The BNDES's debt with the Union currently is BRL 260 billion.
Positive result of Central Bank	It's financial revenue. It doesn't impact the primary result.	It is foreseen in BRL 26.4 billion in Budget of 2019. If used to pay expenditures (linked to the payment of the debt and services), reduces the need for contracting of credit operations and, therefore, the insufficiency of the golden rule.	The unused balance of result of 2018 is about BRL 140 billion.