ECONOMICS **November 23, 2018**

Brazil Macro Compass

Subnational Finances, National Problems

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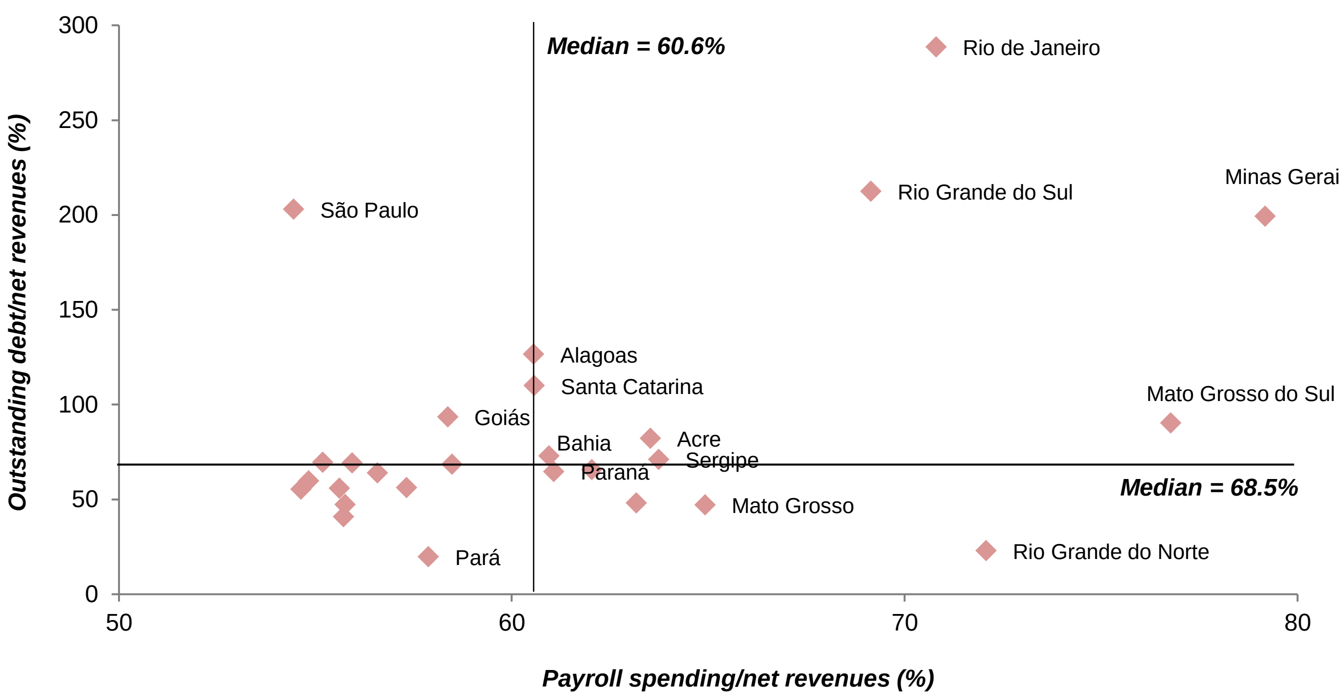
Chart of the Week: Subnational Finances, National Problems

On November 13, the Brazilian National Treasury released a comprehensive *Bulletin of Finances of Subnational Entities*, providing a plethora of data on the fiscal health of the country's states and municipalities. Our Chart of the Week compares two dimensions of the states' accounts: debt and payroll spending. Three of the largest Brazilian states (Rio de Janeiro, Rio Grande do Sul, and Minas Gerais), which account for almost a quarter of the country's population, are in the high debt/high payroll spending quadrant. According to the report, Rio de Janeiro state more than doubled payroll spending (including pensions) in real terms between 2011 and 2017. São Paulo, the most populous state (22% of Brazil's population), has the lowest payroll burden among all the states (54%, with virtually no growth between 2011 and 2017), but one of the highest debt levels.

Renegotiating debt payments and other transfers with the subnational entities will be one of the first challenges of the newly elected president in 2019, as the newly elected governors are likely to line up in Brasília to extend their lifelines with the federal government, currently subject to a refinancing program announced by the Temer government in June 2016 and accepted by 24 of the 27 states. Several states are not meeting the conditions implied in the program, which include keeping the payroll spending/net revenue ratio below 60%.

Brazil States – Outstanding Debt and Payroll Spending as Share of Net Revenues (2017)



Sources: National Treasury, Santander.

Political Agenda: *Cessão Onerosa* Needs an Agreement

According to Eunício Oliveira, the president of the Senate, the voting on the transfer of oil rights (*cessão onerosa*) will not happen until the government finalizes an agreement to share auction revenue with states and municipalities. If an agreement is reached, though, the approval by Congress should be easier, in our view, as lawmakers will have something to offer to their constituencies to attenuate the current fiscal hardship. Discussions are expected to continue into next week.

Representative Celso Maldaner (MDB-SC), the overseer of the Central Bank's independence bill in the Lower House, stated in an interview with *O Globo* (November 21, 2018) that an urgency request for the bill could come to a vote next week. The request approval is necessary before the bill can be submitted to a floor vote this year. The schedule for that is tight: there are only four weeks left until Congress enters summer recess, on December 22.

What's New: Payroll; Inflation

The Ministry of Labor announced the net creation of 57.7k formal jobs in October, a slower pace compared to the previous two months and probably inflated by the postponement of hiring decisions following strikes in the transport sector in 2Q18. We believe this pace will be maintained in November and December, leading up to net creation of 350k formal jobs throughout 2018. This will be a disappointment compared to our estimates at the beginning of the year (around 1 million jobs), but a relief from the pessimism that dominated the pre-electoral period.

November's CPI inflation preview (IPCA-15) came in at 0.19% m/m, slightly above our forecast (-0.03% m/m) but below market consensus (+0.24% m/m). The recent fall in wholesale gasoline prices still did not translate into better consumer prices, which were almost flat (+0.05%) in the month covered by the indicator. On the other hand, electricity tariffs fell 1.46% m/m, on the back of a lower surcharge in the flag system. 12-month inflation fell to 4.39% (from 4.56% on October IPCA), with the average of BCB core measures at 2.94% y/y (+1 bp above October IPCA). We believe the next inflation readings will show a relief on fuel prices, contributing to a deceleration to 4.0% y/y by year-end. We believe the Central Bank will stay on hold at its next monetary policy meeting, scheduled for December 12.

Upcoming Data: 3Q18 GDP; October Unemployment and Budget Deficit

On November 30,IBGE will release data on Brazil's national accounts for 3Q18. We expect GDP growth at 0.8% q/q (1.6% y/y). We believe all the supply-side components (agriculture, industry, and services) contributed to the expansion. On the demand side, both domestic demand (+0.5% q/q) and the external sector (+0.4% q/q) grew, according to our forecasts. One caveat to the apparently robust numbers is a strong base effect from the disappointing 2Q18 (+0.2% q/q), influenced by the truckers strike in May. Looking ahead, we see several reasons to believe that economic activity is accelerating: the recent improvement in financial conditions, low inflation, and recovering credit and job markets should, in our view, boost growth in 2019 to 3.2%.

October unemployment rate will be released on November 29. We expect the seasonally adjusted unemployment rate to stay at 12.0% (flat from September and -60 bps year-to-date). For 2019 we expect a clearer downtrend for that variable, which, according to our forecast, should reach 10.9% at that year-end.

Finally, also on November 29, October fiscal indicators will be published. We expect a monthly central government primary surplus of BRL1.3 billion. For the whole of 2018, we forecast a BRL126 billion primary deficit, below the BRL159 billion target, thanks to improving tax revenue.

Number of the Week

79.2%

According to the National Treasury, Minas Gerais state spent 79.2% of its net revenue in 2017 to pay wages and pensions, the most among Brazilian states. See the "Chart of the Week" on page 1.

Quote of the Week

"I will not miss anything."

— **President Michel Temer,** in an interview with *Época* (November 23, 2018).

What We’ve Been Reading

- *How Brazil’s Economic and Political Realities Will Shape the Plans of the Bolsonaro Administration* (seminar at the Wilson Center Brazil Institute, November 13, 2018). Presentations from the event, with IMF officials and political scientists, are available online.

- “Understanding Brazil’s Latest Depression” and “What Triggered Brazil’s Crisis,” by Matthew C. Klein (*Barron’s*, November 16 and 21, 2018). According to Klein, the root cause of the crisis was the combination of excessive leverage and limited scope for countercyclical economic policy.

- *Is Inflation Domestic or Global? Evidence from Emerging Markets*, by Rudolf Bems, Francesca G. Caselli, Francesco Grigoli, Bertrand Gruss, and Weicheng Lian (IMF Working Paper No. 18/241, November 8, 2018). Domestic factors (such as inflation expectations and output gap) are the main determinants of inflation in a sample of 19 emerging countries (including Brazil).

- “Why Bolsonaro Should Pursue Free Trade with the U.S.,” by Colin Grabow and Juan Carlos Hidalgo (*Americas Quarterly*, November 14 2018). The case for a free trade agreement between Brazil and the United States.

- “Jair Bolsonaro’s inner circle: who’s who,” by Andres Schipani (*Financial Times*, November 22, 2018). A useful guide for the new faces in Brasília.

Recent Publications (Available on Our Website)

- *Risks for the Selic in 2019 Expected to Become Even Less Asymmetric* (November 6, 2018)
- *20 Charts that Explain Brazil’s New Political Power Structure* (October 29, 2018)
- *Brazil Post Elections: Honeymoon and Marriage* (October 25, 2018)
- *Brazil – Risk Premium: Apples and Oranges* (October 9, 2018)
- *BRL: Between Common and Idiosyncratic Factors* (September 26, 2018)

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