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THE NEW BRAZILIAN ECONOMIC POLICIES

Balanced, Sustainable, Business Friendly

2nd Edition
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of works at regional airports, highways, railways and ports), with expected public investments of BRL 131 billion until 2018. The program also seeks to improve public spending quality and fiscal responsibility, as the unfinished projects generate burdens on the population and public costs.

In February 2018, the government defined a priority agenda of necessary actions for the year to further overcome existing constraints in the Brazilian economy. It includes, among other issues: simplification of Social Contribution taxes; autonomy of the Central Bank; a revised public finance law; privatization of Eletrobras; strengthening of Regulatory Agencies; reduction of the payroll tax break; a recovery program of state-owned companies; and the update of the General Telecommunications Law. ■

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THE NEW BRAZILIAN ECONOMIC POLICIES
Balanced, Sustainable, Business Friendly

Since May 2016, the new Brazilian government adopted an extensive reform agenda, targeting fiscal balance and sustainable growth. The first relevant step was the approval of Constitutional Amendment 95, which created the New Fiscal Regime and established a spending cap for the federal budget.

A set of measures, described ahead, comprises the range of reforms Brazil's government is promoting: mandatory containment of the Federal Government's expenditure; replacement of the Long-term Interest Rate (TJLP) for the market-converging Long-Term Rate (TLP); reform of the labor laws, reform of the pension system, and business friendly measures.

CONTENTS

Additionally, long-term financing in the country will no longer be heavily reliant on low cost public lines, particularly those offered by BNDES and backed by loans from the National Treasury. On 5 September 2017, the Brazilian Congress approved the creation of a new interest rate for BNDES' loans, the Long Term Rate (Taxa de Longo Prazo – TLP in Portuguese), a new market-based rate, replacing the old TJLP. The former rate had a lower value than the cost of the National Treasury's debt, because the National Monetary Council defined the TJLP every three months, reflecting the expected inflation in a year's time and the country risk, while the new TLP will gradually converge to the National Treasury's funding cost.

Starting in 2018, the TLP will be set on a monthly basis by the Central Bank and will vary according to the consumer price index and the yield of the 5-year NTN-B bond (inflation linked Treasury bonds). This measure will make the rates charged on BNDES' loans to be closer to market interest rates. In addition, the new rate will allow for higher predictability of long-term financial operations, positively affecting investment planning, providing a more efficient resource allocation, fostering long-term credit concessions, increasing the monetary policy effectiveness, and reducing public expenditure with interest equalization policies.

Other efforts have to do with improving the governance of state-owned companies, the best example of which is the case of Petrobras. These include: i) mandatory fulfillment of technical requirements to become a director; and ii) increased flexibility in national content regulations. In addition to greater transparency and efficiency for state-owned companies, these efforts will make production chains of key economic sectors more dynamic, with positive impacts on the business environment and the Brazilian economy.

The New Mining Code, in effect by Provisional Measure 790/2017, creates incentives for investments in the research and mining stage (with definition of licensing deadlines) and mining efficiency. Mining royalties, for instance, will be simplified and updated. The rate for iron ore will vary according to international prices up to a ceiling of 4%, while royalties for minerals used in civil construction will be reduced from 2% to 1.5%. The Government expects to increase the mining share in the Brazilian economy, attracting new investments.

The new pre-salt regulatory framework in effect since the end of 2016 ends the compulsory participation of Petrobras in at least 30% of any block contracted under the production-sharing regime, independently of the company's resource availability. The new measure gives the company more autonomy and planning capacity, as it can now decide whether to operate pre-salt exploration blocks. It is expected that the new framework will also attract new investors.

In April 2017, local content requirements on oil and gas exploration were eased. Previously, the requirements could reach up to 60% to 70% during exploration and development stages, with specific percentages defined for several items and sub items. The new model requires 50% during exploration and development on land; if on water, the requirement is 18% during exploration and 25% on oil well construction, 40% on collection and drainage, and 25% on oil platforms, during the development stage.

In November 2017, the Government announced a list of 7,439 stalled works that will be resumed and completed throughout the country. Under the name "Agora, Avançar", the program covers areas ranging from education (including day cares) to housing and infrastructure (with the resumption

Brazil's generation (47GW installed in 239 plants) and 70.3 thousand kilometers of transmission lines (51.7% of the total), with 4.3 million customers. In the distribution segment, Eletrobras currently serves six concession areas in the North and Northeast regions. The privatization of Eletrobras will occur through the issuance of new shares, without new subscription from the public sector, and the privatization of distribution companies will occur through auction of stock control of the companies with a new concession agreement.

Decree 8.874, dated 11 October 2016, established measures that foster the issuance of incentive debentures to finance PPI projects. It assigns priority for all investment projects in infrastructure or in research, development and innovation, related to intensive economic production that are subject of a concession, permit, lease, authorization or Public/Private Partnership (PPP), and that integrate the PPI. Accordingly, the PPI projects do not need approval from the appropriate ministry, when issuing an incentive debenture, which is exempt from personal income tax and tax reduction for corporate entities. In addition, it also authorized the costs incurred with the granting of the infrastructure projects to become part of the investment plan of the prioritized project, and, therefore, can be considered for issuance of debentures.

In 2016, Provisional Measure 752, dealing with contract renegotiation of infrastructure concessions, was enacted and later converted into Law 13.488 in June 2017. It aims to provide legal certainty to new investments in existing concessions, as the granting authority has been questioned as to the legitimacy of contractual extension of public concessions. The new provision allows the extension of the contract only once, for a period lesser than or equal to the original term, and the regulatory agency must justify the renegotiation advantages over a new bidding. In addition, it allows the early extension of concessions of highways and railroads by new investments not originally agreed to, provided that the concessionaire is fulfilling contract obligations.

Provisional Measure 800/2017 on road infrastructure extended from five to 14 years the term for concessionaires to carry out the works included in concession contracts. The measure avoids unnecessary investment concentration in the initial period of the contract.

Law 13.499/2017 allowed the payment schedule of signature bonuses on airport partnership contracts, to be made according to the project flow, and not in equal installments as it was the case previously, allowing a higher degree of flexibility to the payments and avoiding unnecessary financial strain in periods of heavy investments and low revenues.

In July 2017, the Government enacted Provisional Measure 786, which authorizes the Federal government to participate in a fund devoted to structuring and developing concession projects and Public Private Partnerships of any federated level (federal government, states, federal district and municipalities). This measure allowed the federal government to overcome the lack of technical capacity to develop and structure projects, especially at the local level. Under the new rule, the financial institution managing the fund should make public calls, organize the demand of the federated institutions and provide studies that attend several projects simultaneously. The federated agencies, in turn, may contract the financial institution directly, by means of a bidding waiver. The fund will mainly work in the sectors of solid waste treatment, sanitation, street lighting, and urban mobility, as well as in smaller projects such as public parking, bus stations, markets, among others.

Since May 2016, the new Brazilian government adopted an extensive reform agenda, targeting fiscal balance and sustainable growth. The first relevant step was the approval of Constitutional Amendment 95, which created the New Fiscal Regime and established a spending cap for the federal budget.

A set of measures, described ahead, comprises the range of reforms Brazil's government is promoting: mandatory containment of the Federal Government's expenditure; replacement of the Long-term Interest Rate (TJLP) for the market-converging Long-Term Rate (TLP); reform of the labor laws, reform of the pension system, and business friendly measures.

1. Addressing the Fiscal Challenge

Fiscal imbalance is the greatest risk factor for the performance of the Brazilian economy. Since the early nineties, Brazil has increased primary expenditure beyond GDP growth. From 1997 to 2015, real primary spending increased at an annual rate of 6%, mainly due to growing costs of the country's social safety net, the expansion of government transfers to the private sector, and accentuated real growth of wages controlled by the government. See Figure 1 below.

Federal Government's Primary Spending (% of GDP)

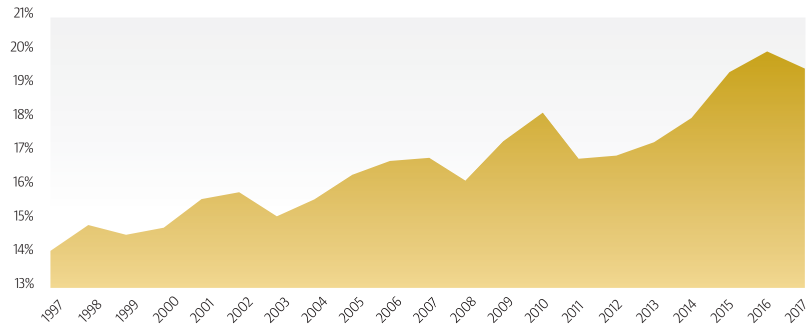

FIGURE 1
Source: Brazil's National Treasury

In recent years, the growing debt created uncertainties regarding the inter-temporal sustainability of public debt. As public finances deteriorated, interest rates and risk perception increased. Brazil lost its coveted investment grade status, assigned by major rating agencies. With inflation and unemployment rising in 2015, households' confidence also crumbled and private consumption slowed down.

To face those challenges, the Brazilian government has proposed a very ambitious set of reforms that represents the biggest overhaul of Brazil's economic governance in decades.

A constitutional amendment imposing strict rules to limit further increases in public spending has been approved. Another constitutional amendment to reform the pension system has been presented to the National Congress. Fiscal consolidation became a priority. Congress has passed new rules aimed at transforming Brazilian labor laws into a more flexible and simplified legislation. Enterprise-crushing regulations are to be lifted. A public-private partnership investment program aims at increasing the participation of the private sector – including foreign investment – in infrastructure projects. Legislative changes to reduce the complexity of the Brazilian tax system are being considered. Brazil is also opening its economy to foreign trade, investment and migration.

As a result, the downward trajectory of the indexes of confidence in the Brazilian economy (Figures 2 and 3) has been reversed. Such reversion reflects changes in the existing expectations, and growing confidence in the future fiscal solvency of the federal Government, after the approval of the spending cap in December 2016.

Industry Confidence Index
(seasonally adjusted)

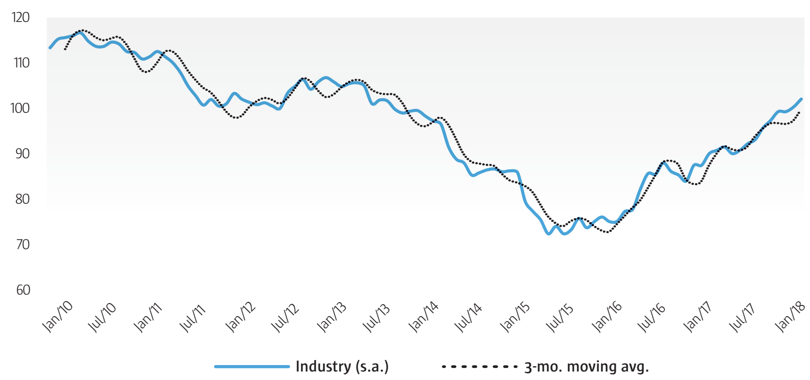

FIGURE 2
Source: FGV

6. Regulatory framework for investment in infrastructure

Besides achieving fiscal balance, the new Brazilian economic policies aim to establish economic growth in a gradual and sustainable manner, by increasing the investment rate, capital intensity per worker, and productivity. To this end, the Government has expanded and improved the concessions program and thus established an additional boost to growth. The Program for Investment Partnership (PPI) addresses viable private investments in infrastructure and other projects considered as priorities by the Federal government. The PPI also picks public assets for sale, in order to reduce public expenditure on current spending and to ensure a more efficient asset management.

The PPI provides partnership contracts with more transparency and legal certainty, and expedites the administrative process for granting concessions, in an effort to increase cooperation with the private sector. Its overall objectives include expanding investment, creating jobs, stimulating technological and industrial development, improving the quality of public infrastructure, and promoting competition and legal certainty in establishing partnerships with the private sector. The expected investments of the Program as a whole amount to over USD 80 billion.

Eletrobras is the largest holding in the electric sector in Latin America, the 16th largest energy company in the world and, one of the world's 5 largest hydroelectric generators in installed capacity

By the end of March 2018, 70 of a total of 175 PPI projects were already auctioned or renewed.

The set of 105 still ongoing projects comprise a wide range of sectors that will significantly improve the country's infrastructure. These include logistics projects that will promote interconnection between important poles and cargo flow, and upgrade transportation services; power generation and distribution projects to amplify energy efficiency; and projects on key sectors that are strong economic drivers, such as oil and gas.

Among the many ongoing projects of interest that stand out is the privatization of Eletrobras and of six subsidiaries, aiming to ensure the expansion of Brazil's power supply and improve the distribution services in a sustainable manner at the lowest prices possible.

Eletrobras is the largest holding in the electric sector in Latin America, the 16th largest energy company in the world, and one of the world's 5 largest hydroelectric generators in installed capacity. It is traded on the São Paulo, Madrid and New York stock exchanges, and holds 30.7% of

5. Labor reform

Brazilian labor laws were modernized in 2017. Law 13.467, enacted on July 13, represents a major step in introducing provisions that are more consistent with current practices in the labor market. The labor reform will bring more flexibility to labor relations, strengthening collective agreements, reducing costs, and favoring the offer of new jobs.

One of its most important innovations is the reinforcement of collective labor agreements, which will prevail over the law with regard to working hours, career plans and productivity remuneration. Collective agreements cannot be reversed by a judicial decision anymore, which will increase legal certainty. As the previous regulation for labor market was quite rigid, any agreement between employers and employees could be disputed, so there was a significant instability in labor relations. Unions sometimes encouraged workers to sue their employers rather than promoting negotiation.

Other changes ensure a higher level of flexibility for the labor market. For instance, it is now possible to fraction vacation periods and negotiate over working days, overtime and banked hours. In addition, union contributions are no longer compulsory. These items followed a very rigid regulation, which made quite difficult for employers and employees to negotiate more suitable conditions according to their specific needs.

With regard to outsourcing, Law 13.429, ratified on 31 March 2017, is also important. It allows employers to hire employees of another company to carry out core activities, while previous regulation allowed employers to hire other companies only for complimentary duties, prohibiting outsourcing of core activities. It was approved with the purpose of filling a legal gap and providing legal certainty to companies contracting outsourced services, as this modality of contracting has become vital to bring more agility, competitiveness and efficiency, thus ensuring better conditions for workers. It should be noted that this provision reaches at least 12.7 million outsourced workers and will impact a large portion of the labor force, formerly working in the informal economy. Informal workers will be able to enter the formal labor force, resulting in more productivity and competitiveness for companies and the whole economy.

In addition, hourly contracts were formalized, allowing the worker to sign with more than one service provider, receive proportional payments to the Employment Security Fund (known as FGTS)[3], enjoy proportional vacation time, and receive the thirteenth salary. This provision will simplify the payment of social security contributions and taxes, consolidating social rights for workers and providing easier conditions for companies. This innovation helps employers to overcome the complex bureaucracy related to social contributions and taxes under the old legislation, which had remained almost unchanged for the last 70 years.

Another innovation introduced by the new law is the part-time work contract. It allows working hours up to 30 hours per week, without the possibility of overtime, or working hours of up to 26 hours per week, allowing up to 6 extra hours. Overtime will be paid with an increase of 50%, paid vacation will be the same as in full-time regime, and overtime compensations will be possible until the immediately following week.

3 - See note 2.

Consumers Confidence Index
(seasonally adjusted)

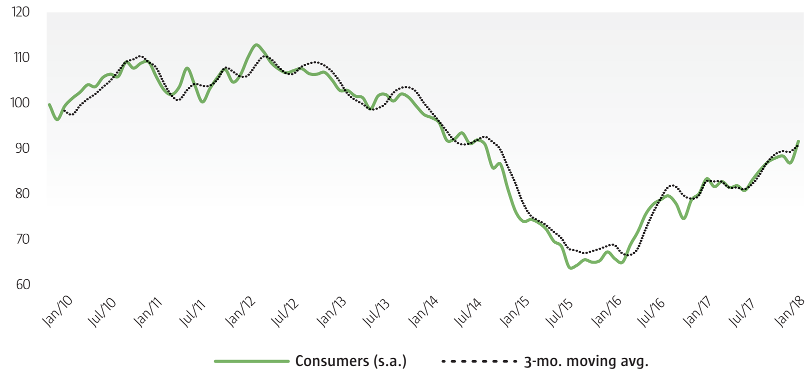

FIGURE 3
Source: FGV

In stopping the growth of primary expenditures, the spending cap makes clear the need for reforms in mandatory expenditure, so that the public sector may achieve primary surpluses once again.

> As a result of the reforms, the downward trajectory of the indexes of confidence in the Brazilian economy has been reversed since 2016

Despite the federal Government's non-mandatory spending having registered a declining trajectory over the past two years, as can be seen in Figure 4, the dynamics of mandatory spending still keeps overall expenditures increasing. With the limit to public spending already in force, at the end of 2017, the projections indicate that the level of non-mandatory expenditure will return to the same level of 2010.

Federal Government's Expenditure*
Total Yearly Expenditure (BRL bn February 2018)

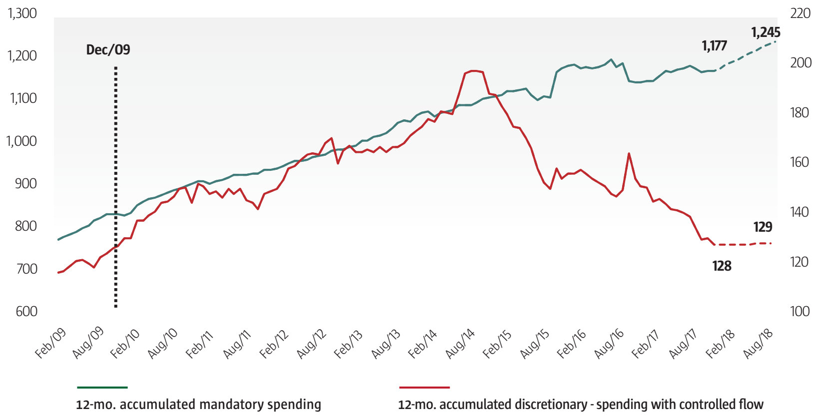

FIGURE 4
Source: Brazil's National Treasury

* These expenditures do not include Petrobras´capitalization held in September 2010

Besides, the whole mandatory expenditure regime has been intensively debated in Brazil, including the restructuring of personnel expenditure and the reduction of costs associated with various programs financed by the Federal government. One such program is the Student Financing Fund (Fies), a subsided student credit loan program that responds for approximately half of the enrollment in Brazil's private higher education. Originally established in 1999, the program was subjected to evaluations that led to a revision in 2017, through Law 13.530. Known as "new FIES", the program aims at broadening the access to higher education, greater transparency for students and society, and improved governance and financial sustainability. It is divided into three different modalities, defining a scale of funding that varies according to the family income of the candidate.

The new administration has also developed a new approach for the Brazilian Development Bank (BNDES), which has played a fundamental role in stimulating the expansion of industry and infrastructure in Brazil. In recent years, though, long-term financing in the country has been heavily reliant on public lines, particularly those offered by BNDES. As of January 2017, BNDES had accumulated a passive of over BRL 532 billion with the National Treasury — with a mirroring surge in Brazil's national debt.

On September 5 2017, the Brazilian Congress approved the creation of a new interest rate for BNDES' loans, the New Market-Based Rate (TLP, in Portuguese), replacing the old TJLP. While the former rate had a lower value than the cost of the National Treasury's debt – which would, sometimes, be even lower than the inflation rate –, the new TLP will gradually converge to the National Treasury's funding cost.

Starting in 2018, the TLP will be set on a monthly basis by the Central Bank and will vary according to the consumer price index and the prefixed

The project of Electronic Invoice for Services (NFS-e) was adopted to establish a national standard for electronic invoice emission – including on mobile devices – in accordance with the protocol of cooperation signed within the framework of the National Conference of Fiscal Administrators (Enat). Its goal is to simplify procedures, reduce compliance costs and thereby increase the competitiveness of Brazilian companies through the rationalization of ancillary obligations.

The project benefits taxpayers and fiscal administrations by standardizing and improving the quality of information, rationalizing government costs and generating greater efficiency in fiscal activity.

4. Single Foreign Trade Window – Centralized Payment

The Single Foreign Trade Window is a platform that rationalizes the work of agencies involved in Foreign Trade.

Establishing a single point of entry for the input of documents or data required to import, export or transport goods, it simplifies and integrates customs clearance. Once it has been implemented, Brazil shall have what has been internationally dubbed a single window for foreign trade, with a predicted reduction of 38% on export time and 41% on the time to import goods. The full deployment is expected for December 2018.

DECREASE IN THE CUMULATIVE NATURE OF TAXATION AND SIMPLIFICATION OF CREDIT USE

Among the fiscal measures under consideration is the simplification of two of the largest social contributions levied on the gross revenues of companies: PIS/Pasep and Cofins[2].

The current law of PIS/Pasep is extremely complex, with problems such as limitations to the right to verify claims; cumulative incidence of contributions; competitive asymmetry, and a high amount of special taxation regimes. The goal is to simplify PIS/Pasep calculation, to tax the added value of each economic operation, to promote equality in the treatment of small enterprises and to adjust the different regimes, avoiding distortions.

The biggest change of this proposed reform is to extend credit. Everything that a company acquires for production or consumption – including, for example, electricity bills, office supplies – can be discounted from the tribute being paid. In addition to making the calculation of the tribute simpler for enterprises, the reform should reduce tax litigation due to calculation or interpretation mistakes. The calculation of the contribution will also facilitate compliance with ancillary obligations, because the credits that may be deducted from the amount to be paid will be highlighted in the E-Invoice.

SIMPLIFICATION OF ANCILLARY OBLIGATIONS

Ancillary obligations are positive or negative requirements of taxpayers' shares for complying with the fiscal legislation. With their simplification, the Brazilian government hopes to create a better business environment for companies, through actions that aims at integrating the Fiscal Administrations on its three levels (federal, state and municipal), by simplifying the tax system and reducing costs associated with the provision of information to the fiscal authorities.

NEW PHASE OF THE PUBLIC SYSTEM OF DIGITAL BOOKKEEPING (SPED)

"Sped" was established in January 2007 and unifies the delivery and custody of tax information, facilitating the relationship between fiscal and regulatory authorities, companies and society. In addition to tax documents, the system also encompasses bookkeeping for the whole Brazilian taxes. Fiscal administrations in the federal, regional and local governments are committed to rationalize the provision of information and to develop integration functionalities.

The business environment in Brazil still has to cope with more than 30 regional declaration forms, with a high level of redundancy regarding the information provided to the Public System of Digital Bookkeeping (Sped). Sped intends to replace the existing declarations and forms of the 27 states with a single declaration and, thus, avoid duplication and redundancy in their filling.

This will reduce the amount of information required and the number of hours spent filling forms, bringing the Brazilian standards to the same level as that of countries with a dynamic economic environment.

ELECTRONIC INVOICING FOR SERVICES PROVIDERS

Currently, around 5,570 regulatory laws and invoices for different types of services coexist, one for each municipality.

2 - Cofins is funded by mandatory contributions from employers to provide social security policies such as public health etc.

rate of five-year inflation-linked bonds (NTN-Bs, currently at approximately 5%). This measure will make the rates charged on BNDES' loans to be closer to market interest rates. The full transition to this new rate will be completed in five years.

To get an idea of the importance of this reform, it should be highlighted that the subsidies directly affected by the TJLP represented 44% (or BRL 218.6 billion) of subsidies paid by the federal Government over the last five years. Another positive aspect of the implementation of TLP are the gains obtained by higher predictability of long-term operations in the financial market, with a positive impact on investments planning.

Through a comprehensive reform agenda and specific economic measures for 2017 and 2018, the Brazilian government reaffirms its commitment to create an environment favorable for the consolidation of a new cycle of economic growth, prioritizing:

Sustainability of the public deficit and modernization of the State;

Promotion of investments in infrastructure, contributing to the elimination of growth bottlenecks;

Increase of capital and labor productivity by improving the business environment, encouraging innovation and professional qualification; and

Reduction of the long-term interest rate of the economy and the cost of capital and investment.

2. New Fiscal Regime (NFR)

Due to the risks associated to the growing trends of the gross debt, a crucial measure adopted by the current administration was the creation of a New Fiscal Regime, approved through Constitutional Amendment 95 (EC 95) in December 2016. The NFR established a spending cap to limit the growth of primary expenditures until 2036.

It established a period of at least 10 years during which federal government annual primary spending can increase by no more than the previous year's rate of inflation – as measured by the Consumers Price Index (IPCA). Under the NFR, there will be no growth in real terms for the federal budget. In the subsequent 10 years, each president will be able to propose to Congress a new maximum to limit increases in primary spending for the following four years.

The spending cap ensures that the government will be able to restore balance to the fiscal accounts and reduce the ratio of debt and expenditures to GDP.

Before EC 95 was enacted, the estimates made in the Amendment's Explanatory Memorandum clearly pointed to the necessity of adopting the proposal for reasons of fiscal discipline.

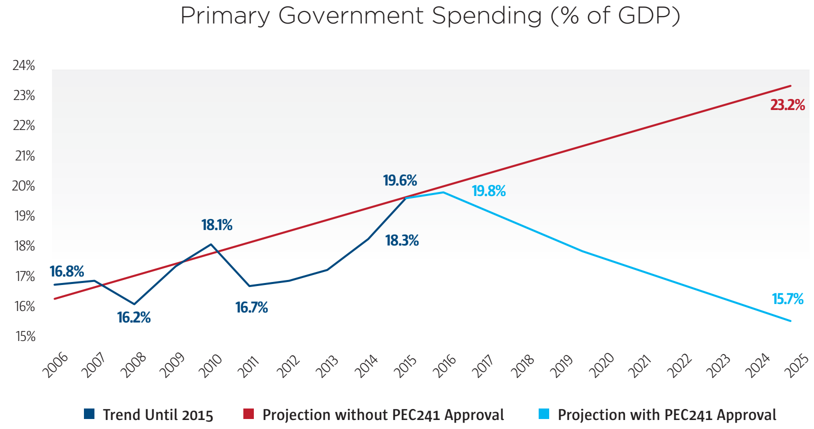

FIGURE 5
Source: Brazil's National Treasury

The NFR marks the beginning of a new model for the government's performance, based on the efficiency of federal public expenditures, greater transparency of decisions on budget allocation, and inter-temporal sustainability in the public debt, contributing to expectations that are more positive.

While the NFR is in force, the National Congress will act more decisively to select priorities for public expenditures, pointing out which specific areas should receive more or fewer resources, without increasing overall spending.

Health and education, however, have a secured mandated funding floor under the NFR. The government is constitutionally mandated to spend a share of total primary revenues in health and education. While this floor will be adjusted by the previous year's rate of inflation, it will no longer be linked to central government's fiscal revenues, which can oscillate from year to year.

EC 95 was also accompanied by the approval of the Delinked Federal Revenues Law (DRU). It granted the Executive – until 2023 – the free implementation of 30% of federal revenues, which were previously assigned to specific expenditures by the Federal Constitution.

> According to Figure 5, without the adoption of a spending cap, primary expenditures could reach 25% of the GDP in 2025. With the spending cap, it is estimated that the total value of primary expenditures will reach 15.7% of the GDP in the same period

Financial markets indicators reflect the recognition that the Brazilian economy is reaching a favorable momentum. For instance, 5-year CDS reached, in March 2018, levels comparable to the investment grade period, while the main stock exchange index, Ibovespa, gained around 126% since its lowest 2016 level. See Figures 11 and 12.

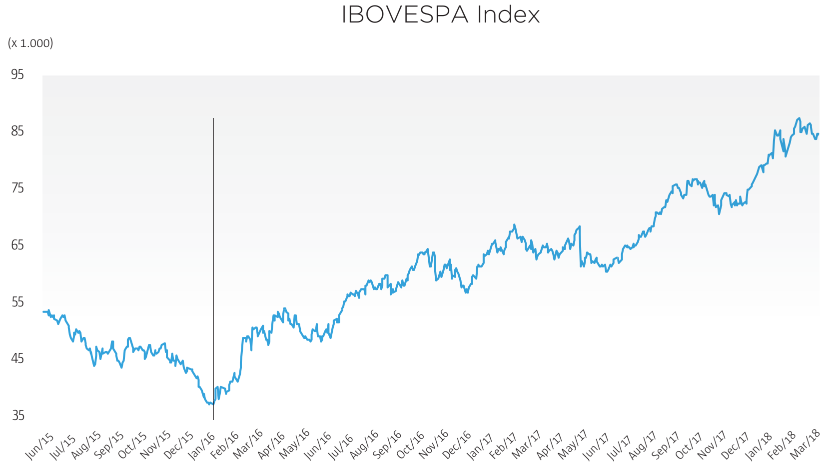

FIGURE 12
Source: Bloomberg

3. Tax system improvements

The Brazilian tax burden amounts to 36% of the GDP - in line with advanced economies, as the federal budget traditionally subsidizes the relevant part of Social Security, the entire national health system, and other social expenditures of re-distributive character. Although the Brazilian fiscal situation makes it difficult to reduce taxes in the short term, the Federal government is working on measures to simplify compliance through secondary obligations by reducing its cost and lowering the cumulative effect of some of the primary federal taxes.

Another objective of the tax system revision is the digitalization of documents and facilitation of compliance with fiscal liabilities, such as changes in ancillary obligations.

These measures aim at reducing redundancies and inefficiencies, contributing to reduce compliance costs and to improve the business environment.

The floating exchange rate regime ensures quick adjustments in Brazil's balance of payments, such as trade in goods and services, travels, and transfers of profits and dividends. The current account deficit has declined consistently, from USD 104 billion in 2014 (4.24% of GDP) to USD 7.8 billion in February 2018 (0.4% of GDP), and the trade balance is at its record highs. At the same time, direct investment in the country remains steady, at levels that allow for a consistent flow of funding to the current account. Finally, high foreign reserve levels guarantee the sustainability of foreign accounts – Brazil is today a net creditor, with a level of reserves that surpasses its total external debt.

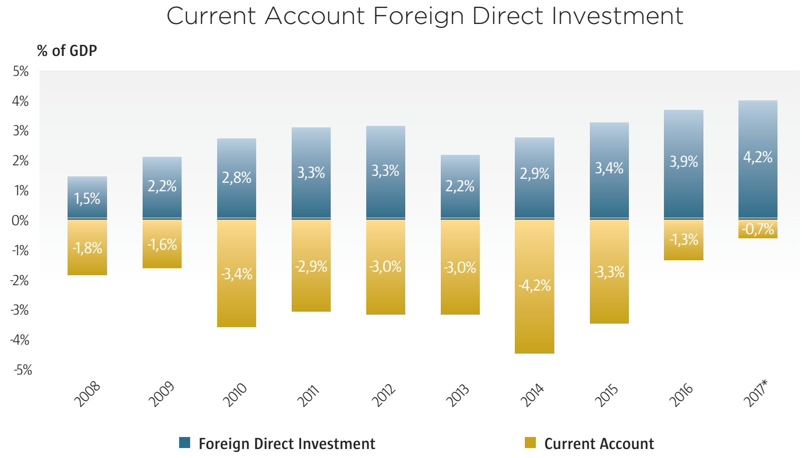

FIGURE 10
Source: Brazilian Central Bank-BCB
*12-mo. accumulated mandatory spending

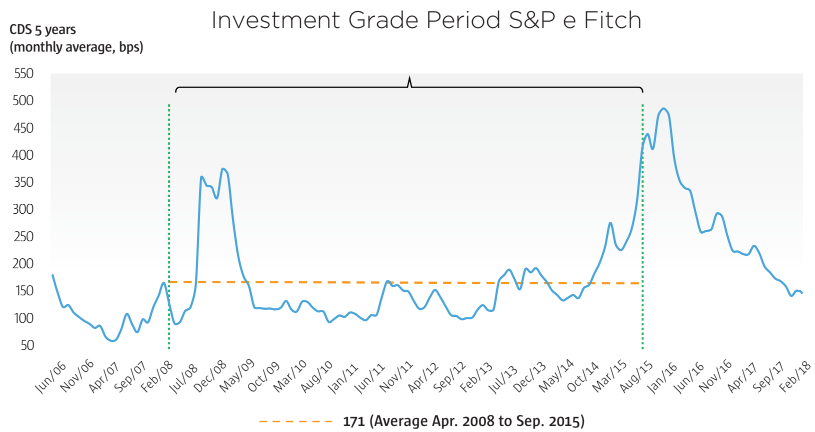

FIGURE 11
Source: Bloomberg

The new fiscal regime aims at reducing primary expenditure as a share of GDP for the first time in recent history, and is expected to lead to lower deficits as soon as growth and tax revenues rebound.

In fact, in the short period since its implementation, the NFR has already reversed the trajectory of the federal government's public expenditures. The spending cap has confirmed expectations and led to a greater control of primary expenditures. In the long run, the new guidelines for fiscal policies, combined with reduced government debt, will increase the Brazilian government's effectiveness in the provision of essential public services – especially health, education and security. The NFR will also increase efficiency in the management of public spending, reverse negative expectations, and establish the basis for a virtuous cycle of sustained growth in Brazil.

The path to the New Fiscal Regime was paved by other important actions, such as the adoption, early in 2016, of a credible primary deficit target, and the extension of the Delinked Federal Revenues Law until 2023.

On top of that, the current administration presented a comprehensive and ambitious agenda to restore short and medium-term confidence in the Brazilian economy, and provide the necessary foundation to increase its growth potential over the medium- and long-term, enabling the country to take full advantage of its economic and social potentials, and bringing Brazil closer to fulfilling its development goals. This included proposals for additional reforms, administrative measures allowing for efficiency gains and modernization of the State and the public policies, and changes to the regulatory and infrastructure legal frameworks. Underlining these initiatives is the view that an effective and sustainable recovery can only be brought about through a series of structural reforms that inject dynamism into the economy, expand productivity, and reduce dependence on state-run stimulus measures.

These actions proved successful to boost confidence in the economy. The first results under the NFR proved the economy was in the right path. Not only the central government complied, with good margin, with the primary result target in 2016, registering a deficit of BRL 154 billion against the expected BRL 163 billion, but also the main macroeconomic indicators improved from the second half of 2016 on.

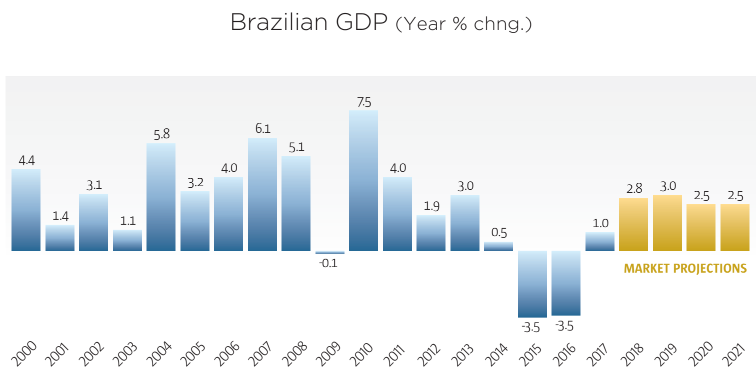

FIGURE 6
Source: IBGE and BCB (market expectations BCB Focus Report of 23 March 2018)

The year of 2017 represented the end of one of the deepest recessions ever recorded in Brazilian history. Although 2016 ended with a fall of 3.5% of GDP, following the fall of equally 3.5% in 2015, the numbers of 2017 registered a clear recovery. In the year, GDP increased by 1.0%, recording positive changes in each quarter. More important than the result was its composition: as of the second quarter, the two main components of demand, Investment (expressed as Gross Fixed Capital Formation) and Household Consumption, recorded positive quarterly changes. Investment, in particular, advanced in every quarter.

The year of 2017 also marked the beginning of the labor market recovery. The employed population increased by 3 million people, in contrast to the job loss in the same period of the previous two years. Although the unemployment rate is still high – 12.6% of the labor force in February 2018 – it is below the March 2017 figure of 13.7%. Households' total real income and average real income are also on the rise – reaching +2.8% and +1.0% respectively in the 12 months ending in February 2018 in comparison to the preceding period.

Part of the gain in household purchasing power was due to the sharp drop in inflation, which closed 2017 at 2.95% (the lowest year level for the Inflation Target Regime period, which started in 1999) and reached, in February 2018, 2.84% in 12 months (as measured by the official Consumer Price Index, IPCA). These results are below the tolerance margins defined by the National Monetary Council to meet the inflation target.

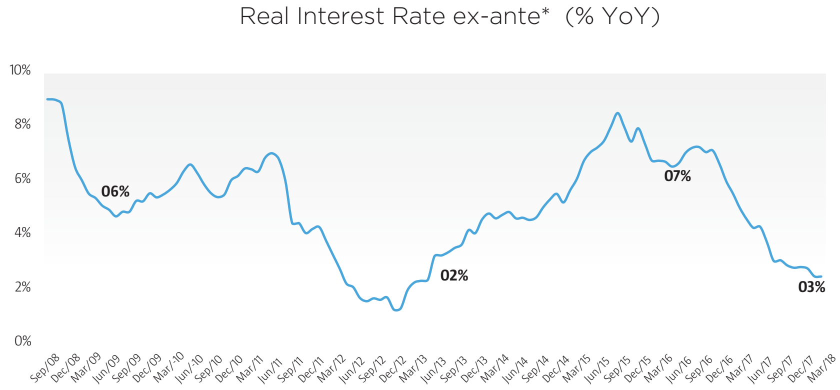

FIGURE 7
Source: Brazilian Central Bank-BCB

** Swap DI-Pre of 360 days over expected IPCA inflation in 12 months*

The "disinflation process" reflects the monetary policy, which managed to realign inflationary expectations. In line with these results, the Central Bank of Brazil started, in October 2016, a cycle of interest rate cuts, promoting the first reduction in four years. In February 2018, the Selic target rate was at 6.5%, contributing to the sharp reduction in ex-ante real interest rates (which reached 2.6% per annum) – an important indicator of capital costs for investment decisions.

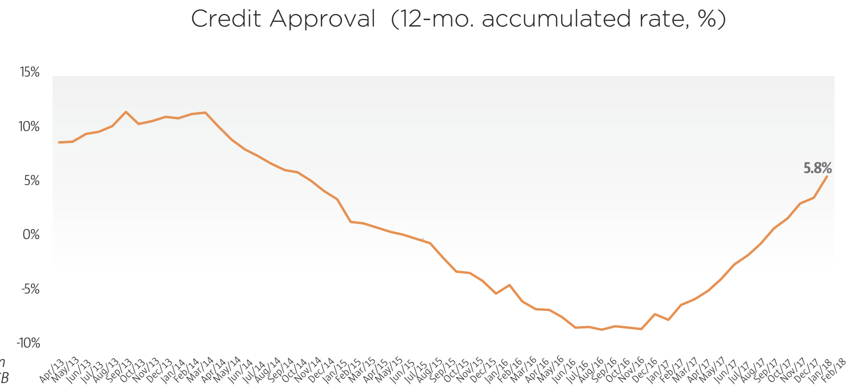

FIGURE 8
Source: Brazilian Central Bank-BCB

Household indebtedness has undergone an adjustment process, reverting the steady pace of increase registered until 2014. Credit conditions, which remained adverse in 2016, are now improving significantly. By February 2018, credit approvals grew 5.8% over the previous year, while spreads on loans and delinquency rates are in a downward trend from their peaks (reached in October 2016 and May 2017, respectively).

In addition, measures such as the withdrawal of the inactive FGTS accounts[1], which injected BRL 44 billion in the economy, have allowed for the reshaping of the financial capacity of households.

Over this background, it is worth noting that the Brazilian economy is now – in contrast to past crises – far more resilient and able to withstand turbulence.

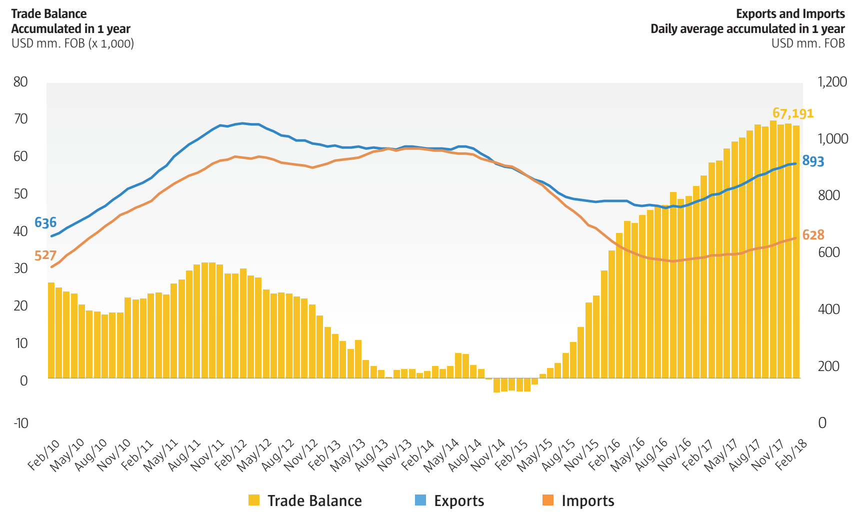

FIGURE 9
Source: MDIC

1 - FGTS accounts are mandatory deposits funded by employers to provide indemnities proportional to employees' seniority in the job, which can be withdrawn in cases of dismissal, retirement and other special conditions.