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Flash Note

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Revised Budget erases surplus, cuts purchases, investment

2018 saw a budget surplus of 3.0% of GDP

A| Description

1| Last week, the proposal for the Revised State Budget for 2019 (OGE 2019 R) was submitted to Parliament). This proposal should be discussed and approved on May 24. According to the accompanying Budget Report, this revision is due to a change in assumptions, namely a lower level of oil production and a lower price of Brent on international markets, at USD 55.

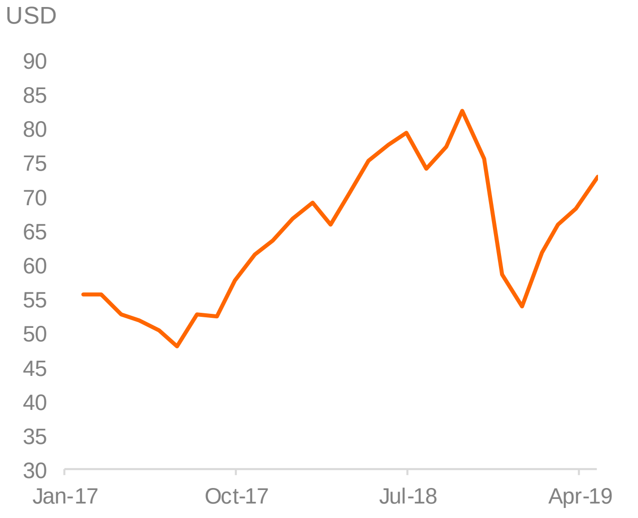
2| **As a result of these two factors, oil revenues will be substantially lower than originally expected on the first OGE (-32.9%) - total revenue is expected to be 19.4% lower.** Thus, the Executive's option was to allow a zero budget balance (0% of GDP), instead of the previously estimated surplus of 1.5% of GDP. On the other hand, there should be a lower than expected amount in expenditure (by 13.6%). In particular, purchases of goods and services will be 39.5% lower, and investment will be 21.0% below the initial forecast.

3| **It is also worth noting the performance of budget execution for 2018, with the first budget surplus (3.0% of GDP) since 2012 – the surplus had been 4.1% of GDP in that year.** The primary balance (excluding interest expenditure) was 7.4% of GDP, the highest since the 2011 (8.1% of GDP).

B| Analysis

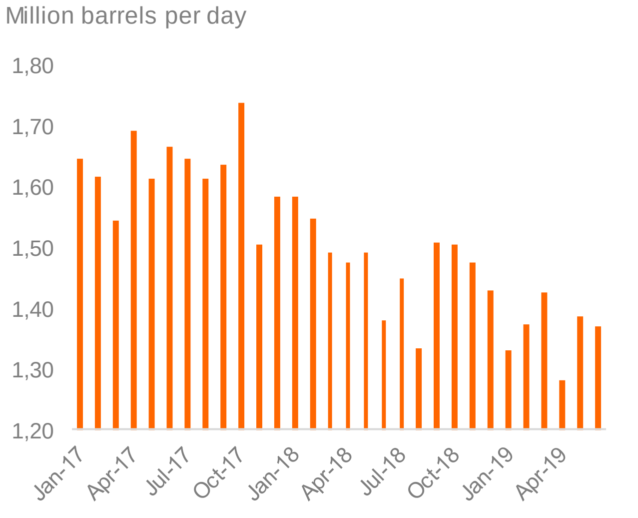
1| Looking at the assumptions of the Revised OGE, and beginning with oil production, the Government now has a much more pessimistic outlook than a few months ago. The forecast is set for 1.435 million barrels per day in Crude production: this is a 3.5% reduction compared to the 2018 output; it should be noted that if the initial forecast of 1.571 mbd in 2019 was met, there would be an increase in production of 5.7%. The numbers posted since the beginning of the year confirm this downward trend; however, due to changes in data availability, it is difficult to fully grasp the whole scenario. There are reports of maintenance occurring in some Crude streams, but it is possible that there is a larger than expected drop in the output of mature blocks; alternatively, it is also

Brent prices fell steeply in the end of 2018, recovering in 2019



Source: Bloomberg

Exports are falling persistently, according to Bloomberg Crude loadings



Source: Bloomberg

possible that some production ramp-ups (in Block 15/06 and Block 32) are facing more obstacles than anticipated. **According to the Government, this lower expectation of production translates into a 3.5% fall in oil, similar to the size of the production drop.**

2| As for the Brent price, the Executive is now working with an hypothesis of USD 55 per barrel, rather than the previous USD 68. This should be understood as a measure of caution on the part of the Government. At the time when the Budget was drawn up, the forecast appeared to be adequate and somewhat conservative, as most international agencies were expecting average prices above USD 70. However, Angola's dependence on the oil sector and price volatility suggest a higher degree of cautiousness than the one adopted. Thus, the Government planned for the revised Budget with Brent at USD 55, below, for example, the average Bloomberg forecast, now at USD 68.5. In the first four months of the year, average prices stood around USD 66. There is another positive factor, albeit with less impact: some types of oil sold by Angola are similar to the ones faltering in the market, from Venezuela and Iran, so these streams have lately been sold at a premium over Brent, instead of which happens normally, the sale at a discount. It should be noted, however, that these differences from the benchmark do not usually exceed USD 2.

State Budget	2018		2019			
(AKZ Billions)	OGE	Execution	OGE	OGE R	Revision	19/18
Revenue	4404	5929	7424	5986	-19,4%	1,0%
Current Revenues	4404	5929	7424	5986	-19,4%	1,0%
Taxes	4139	5478	7033	5564	-20,9%	1,6%
Oil tax	2399	3785	5319	3568	-32,9%	-5,7%
Non-oil Tax	1740	1693	1714	1996	16,5%	17,9%
Social Contributions	173	194	181	181	0,0%	-6,8%
Donations	0	2	0	0	-	-
Other Current Revenues	92	255	210	241	14,9%	-5,5%
Capital Revenue	0	0	0	0	-	-
Expenses	5209	5123	6919	5980	-13,6%	16,7%
Current Expenses	4230	3950	5624	4956	-11,9%	25,5%
Public wages	1690	1539	1793	1793	0,0%	16,5%
Goods and Services	972	749	1400	847	-39,5%	13,1%
Interest	968	1212	1627	1599	-1,7%	31,9%
External	517	592	808	858	6,2%	44,9%
Internal	451	620	819	742	-9,5%	19,5%
Transfers	600	450	805	717	-10,9%	59,4%
Capital Expenditures	979	1173	1296	1024	-21,0%	-12,8%
Current Balance	174	1980	1800	1030		
Primary Balance	164	2019	2131	1605		
in % of GDP	0,7%	7,4%	6,1%	5,2%		
Non-oil Primary Balance	-2235	-1767	-3188	-1962		
in % of non-oil GDP	-11,3%	-9,2%	-13,8%	-8,5%		
Overal Budget Balance	-805	806	505	6		
in % of GDP	-3,4%	3,0%	1,5%	0,0%		

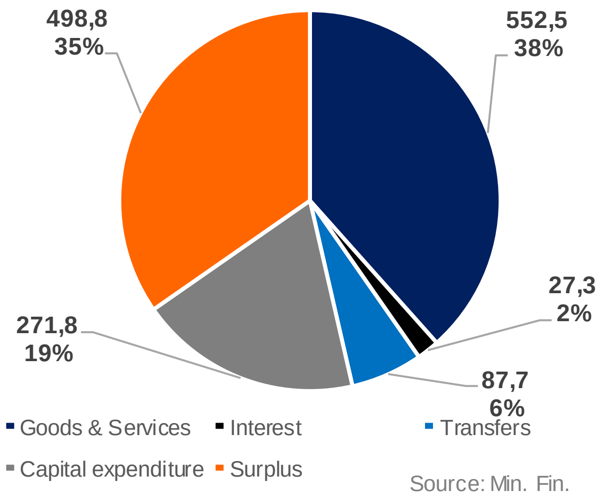
Source: Min. Fin.

3| **This price effect, coupled with lower production, will naturally have an effect on the non-oil economy, with fewer resources to spend on the part of the private and public sector (detailed later in the piece), so the government expects the non-oil economy to grow by only 1.6% (2.6% previously).** Overall, the Executive expects economic activity to practically stagnate (+ 0.3%), instead of the previously expected growth of 2.8%. At this point, we believe this is an optimistic prospect: if Brent's average price is around USD 55, the performance of the non-oil economy will be lower than expected, certainly below 1.0%. **As a result, if this price environment were to occur, there should be a further decline in GDP in 2019.**

4| The main effect of this change in assumptions is a decrease in oil tax revenues by 32.9% from AOA 5.32 trillion to AOA 3.57 trillion. According to our calculations, about ¼ of the decrease is due to lower production, while the remainder is due to the lower price assumed. At the outset, one would also expect a decrease in expectations for the collection of non-oil taxes. However, this does not happen: these surpass the original OGE forecast in 16.5%. This adds up to a total of AOA 2.00 trillion. In total, the expected revenue changes from AOA 7.42 trillion to AOA 5.99 trillion. **Thus, there is a gap of AOA 1.44 trillion which needs to be offset.**

Not having a budget surplus compensates for 35% of the AOA 1,44 trillion gap

AOA billion; percentage



Source: Min. Fin.

5| Part of this gap is compensated for by the previously existing budget surplus, of about AOA 0.50 trillion – 1.5% of GDP. On the other hand, the primary balance (excluding interest payments) changes from 6.1% of GDP to 5.2% of GDP.

6| The remainder of the gap is obtained through more contained expenses, a reduction of AOA 0.94 trillion compared to the initially estimated (-13.6%). The main changes occur in the purchase of goods and services (AOA -0.55 trillion versus the estimated) and investment (AOA -0.27 trillion), respectively, decreases of 39.5% and 21.0%. As can be seen in the table, there is also a -10.9% change in current transfers, and an interest expense 1.7% below expectations; on the other hand, the expenditure on wages is practically unchanged.

7| Finally, with regard to financing, the AOA 0.50 billion in savings that do not occur will have to be financed in addition to what was foreseen in the previous Budget. Specifically, the Government plans to resort to AOA 2.59 trillion in external financing this year, compared to the previously planned AOA 2.00 trillion; in terms of domestic financing, there are around AOA 0.11 trillion that will cease to occur, compared to the initial OGE.

8| Considering the assumptions, production and Brent prices, the forecasts of the OGE are realistic, as far as revenue is concerned. Oil revenues correspond to the expected scenario, and are consistent with a slight depreciation, such as that which is occurring during 2019. However, the expectation for nominal GDP is somewhat optimistic, due to the real growth of non-oil GDP. As a result, the estimate of non-oil tax collections may be above the reasonable level: nevertheless, the expectation is of an increase of 17.1% against 2018, in line with the expected average inflation for 2019.

9| On the expenditure side, two issues need to be addressed. The more "rigid" expenditure (in the sense that it depends less on the Executive's present options), in wages, and in interest, seems reasonable - interest rates continue to rise substantially as a result of the increase in the level of debt, and wage expenditure rises 16.5% compared to 2018, slightly below inflation. It should be noted, however, that there have been wage increases for public servants, which have taken place since April: unfortunately, we cannot at this time estimate whether the overall effect of the increases (some above, others below average inflation in 2019) is correctly reflected in this forecast. In the case of expenditure on Goods & Services, Transfers, and Capital Expenditures (investment), the Government has more leeway to adjust expenditures. And it is precisely what it does with the purchase of goods and services and investment; in our view, it is possible to meet the forecasts in these areas, although the almost 40% fall in the purchase of goods and services (compared with the initial Budget) might not be fully achieved. In particular, as a percentage of GDP, these expenditures are at the lows of recent years, and this may be unsustainable in practice.

10| Our perspective for the performance of this year's Budget assumes different hypotheses: we expect a level of production slightly below Government predictions, taking into account the performance of exports in the first semester; also, we expect a Brent price of USD 68.5, taking into account the latest composite forecasts from Bloomberg. The main effects are manifested in a revenue well above what the Executive expects, due to the price effect; in particular, AOA 1.02 trillion more in oil taxes. If the expenditure is carried out with the "cautious spirit" inscribed in this Budget revision (with adjustments to usual implementation trends), this scenario corresponds to a surplus of about 3.3% of GDP, slightly above the 3.0% achieved in 2018. Moreover, if the expenditure on Goods & Services and Investment foreseen in the initial OGE were accommodated, there would still be a surplus of 0.6%. **That is, if the Brent price level remains high (at least consistently above USD 65 for the rest of the year), the Executive is likely to have a reasonable positive gap in its accounts.** It remains to be seen whether the Government will choose to use this gap to pay off debt to suppliers, redeem more internal debt (or issue less debt, external or internal), or spend more on goods & services/investment. It will probably be a mixed approach, but there is a publicly stated willingness to accelerate payments of debts to suppliers, provided that this debt is certified.

Forecast Scenario	OGE	OGE R	BFA*
Hypotheses			
Brent (USD)	68	55	68,5
Oil Production (mbd)	1,57	1,43	1,42
GDP Growth (%)	2,8	0,3	0,1
Predictions			
AOA Billions			
Revenue	7424	5986	6996
Oil Tax	5319	3568	4591
Non-oil tax	1714	1996	1983
Expenditure	6919	5980	5933
Budget Balance	506	6	1063
in % of GDP	1,5	0,0	3,3

*This scenario assumes that the Executive will not use the budget surplus in expenditure, and instead will use all the margin to repay debt, in securities or to suppliers.

Box – 2018 Budget performance

The budget execution in 2018 resulted in a 3.0% surplus of GDP, which stemmed from a much higher-than-expected collection of oil taxes: in fact, the State obtained AOA 3.79 trillion in oil taxes, 58% above the forecasted amount (AOA 2.40 trillion). As a result, total revenue reached AOA 5.93 trillion (35% higher than expected). On the other hand, expenses were slightly lower than expected, in a total of AOA 5.12 trillion (OGE had AOA 5.21 trillion). This was mainly due to below-expected performance of wages (-9%), goods & services (-23%) and transfers (-25%). On the other hand, interest expenditure was 25% higher than expected and investment spending was 20% higher than expected.

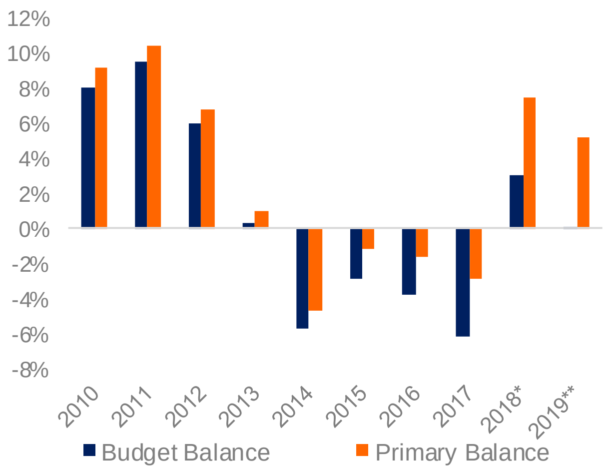
It should be noted that in 2018 a primary balance of 7.4% of GDP was obtained, the largest since 2011 and return to a positive primary balance. On the other hand, the non-oil primary balance (as a% of non-oil GDP) will have posted the smallest deficit in the recent period in Angola, at -9.2%.

Looking at the numbers in Dollars, for an analysis that takes into account the massive depreciation in 2018: there was a 10% increase in revenues, returning to the highest levels of 2014, standing at USD 23.5 billion; a 24% increase in oil taxes, and a 7% drop in non-oil taxes; on the other hand, there was a 30% drop in expenditure to USD 20.3 billion, well below the 2014 (USD 53.1 billion) levels; in terms of spending, we highlight a 42% drop in spending on goods and services (as well as in capital expenditure), and an 18% increase in interest expenses. **Evaluated in USD, purchases of goods & services represent 21% of their value in 2012.**

Finally, as a percentage of GDP, revenues and expenditures are far below normal in the years leading to 2014. Moreover, one should notice the permanent difficulty in increasing non-oil tax revenue: in 2018 they accounted for only 6.2% of GDP (13.9% % of GDP in oil taxes) and 7.3% of non-oil GDP. It is hoped that the introduction of VAT will contribute to an improvement in this area. It should also be noted that there is an expenditure of 4.5% of GDP (which is expected to rise above 5% in 2019) in interest, when this category accounted for only around 1% between 2010-2014. In summary, 2018 was a year of prudent fiscal management, where spending was kept under control, and higher than expected revenue allowed for a strong start of a fiscal consolidation process.

Budget balance will be null but the primary balance will remain positive

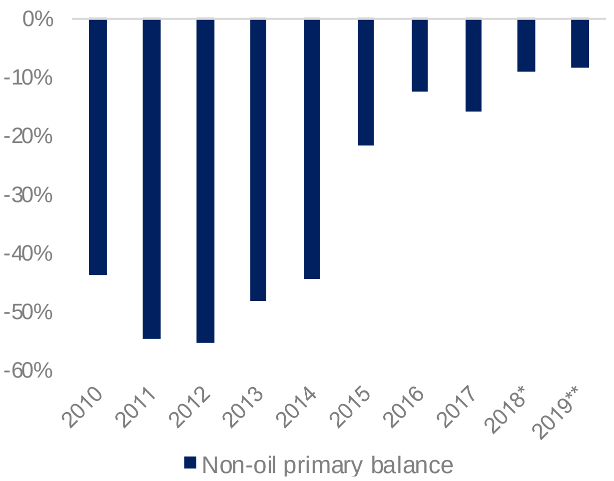
Percentage of GDP



*Preliminary **Forecast Source: Min. Fin.

...while the non-oil primary deficit has been reducing since 2015

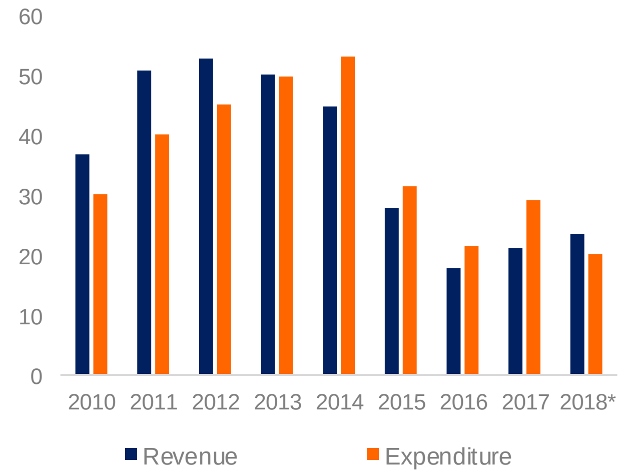
Percentage of Non-oil GDP



*Preliminary **Forecast Source: Min. Fin.

Revenue and expenditure are well below previosuly normal levels

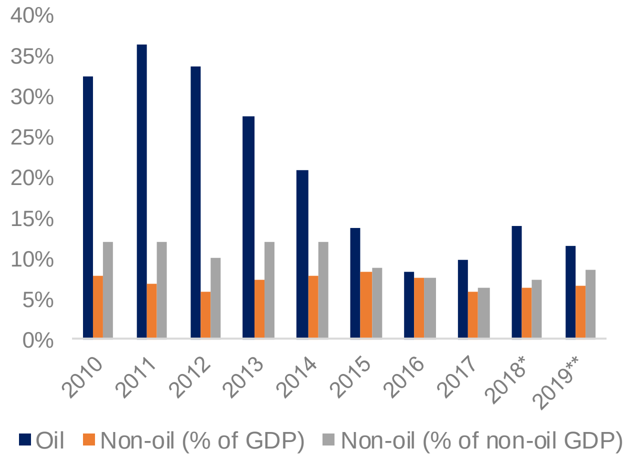
USD billion



*Preliminary Source: Min. Fin.

Non-oil taxes still represent a small share of the Angolan GDP

Percentage of GDP



*Preliminary **Forecast Source: Min. Fin.

C| Conclusion

1| This revised Budget is a responsible exercise, with an early assumption of the reduction (not expected until a few months ago) in oil production. However, there is some lack of clarity about the reason for this weaker than expected performance, so it is difficult for us to see beyond the figures for the first semester, which are even weaker than the average forecast for annual production. **On the other hand, it is also prudent because it assumes a conservative assumption in relation to the Brent price, thus adjusting the expenditure to a level which is not vulnerable to the possible price decline for the rest of 2019.**

2| The forecasts for growth are not consistent with the assumptions, according to our calculations, in particular as regards non-oil GDP growth, which would be clearly below 1% if average Brent prices were around USD 55. However, the budget forecasts are not terribly affected by this (in particular non-oil tax revenues), as they are relatively conservative**.**

3| In the BFA analysis, with different and more adequate assumptions (a higher Brent price and a slightly lower production level), assuming an expenditure control as is implied in this revised Budget, there would

be a surplus equal or higher than in 2018. In other words, it would afford, for example, to carry out faster payments of certified debt to suppliers, to pay off internal debt, or to meet the investment levels foreseen in the initial OGE. **It should be noted, however, that this analysis, and Angolan budget execution in general, is completely dependent on the behavior of the international oil market**. A consistent fall in prices to levels below USD 60-65 is detrimental to this gap, and a tougher implementation of this budget exercise is, at that point, essential.

4| We also note that the current fiscal discipline control is what allows for lower funding needs of the state and, as a consequence, the current decline in domestic treasury interest rates (in BTs), which should continue, and extend to longer-term rates (in OTs). This reversal of a previous crowding out by the State - leading to greater liquidity for the banking system - will bring about a downward trend in the LUIBOR rates, which in turn will affect interest rates on loans. It should be a slow process, but it is starting, and a responsible budget management is the sine qua non condition for it to continue.

5| Finally, we highlight the importance of fiscal discipline execution in building confidence in the market: a first year of actual decline in the government debt-to-GDP ratio (expected to occur in 2019) will be important for a better investment perspective from foreign investors and for national entrepreneurs (and consumers) to be confident that additional budgetary efforts (in the form of new taxes or a faster-than-expected withdrawal of fuel price subsidies, among others) will not be required.

BFA