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FLASH NOTE

Nº 14.2019 | 20 Dec 2019

Fiscal consolidation efforts kept steady in 2020 Budget

Conservative Brent assumptions should allow for better than expected execution

A. DESCRIPTION

1|The State Budget (OGE) for 2020, approved last Thursday at the Angolan parliament, expects a revenue of AOA 8,611 billion (Bn) and expenditure of AOA 8,092 Bn. As a percentage of GDP, revenue would amount to 20.4%, while spending would total 19.2%. In Dollars, according to our calculations, expenditure would be USD 14.6 Bn[1], while revenue would total USD 15.5 Bn (see Annex for a copy of the table below in USD).

State Budget	2019		2020		
(AOA Billion)	Budget*	Execution	Budget	BFA	20/19
Revenue	**5,986**	**6,774**	**8,611**	**8,965**	**27.1%**
Current Revenue	5,986	6,774	8,611	8,965	27.1%
Taxes	5,564	6,283	8,097	8,426	28.9%
Oil Taxes	3,568	4,288	5,581	5,920	30.2%
Non-oil Taxes	1,996	1,995	2,517	2,506	26.1%
Social Contributions	181	250	281	307	12.5%
Donations	-	-	0	0	-
Other current revenue	241	241	232	232	-3.8%
Capital Revenue	-	-	-	-	-
Expenditure	**5,980**	**5,954**	**8,092**	**8,084**	**35.9%**
Current Expenditure	4,956	4,840	6,761	6,753	39.7%
Wages	1,793	1,654	2,218	2,034	34.1%
Goods & Services	847	829	1,200	1,203	44.7%
Interest	1,599	1,712	2,474	2,474	44.5%
External	858	938	1,405	1,405	49.8%
Internal	742	774	1,069	1,069	38.1%
Current Transfers	717	645	870	1,043	34.8%
Capital Expenditure	1,024	1,113	1,331	1,331	19.5%
Current Balance	**1,030**	**1,934**	**1,850**	**2,212**	**(84)**
Primary Balance	1,605	2,532	2,993	3,355	461
in % of GDP	5.2%	7.8%	7.1%	8.1%	(0.7)
Non-oil Primary Balance	**(1,962)**	**(1,755)**	**(2,587)**	**(2,565)**	**(832)**
in % of non-oil GDP	-8.5%	-7.7%	-9.0%	-9.1%	(1.3)
Budget Balance	**6**	**820**	**519**	**881**	**(301)**
in % of GDP	0.0%	2.5%	1.2%	2.1%	(1.3)

Source: Min. Fin., BFA calc.
*Revised 2019 Budget

[1] Our estimates point towards a Budget planned with an implicit average exchange rate ranging between USD/AOA 554-565.

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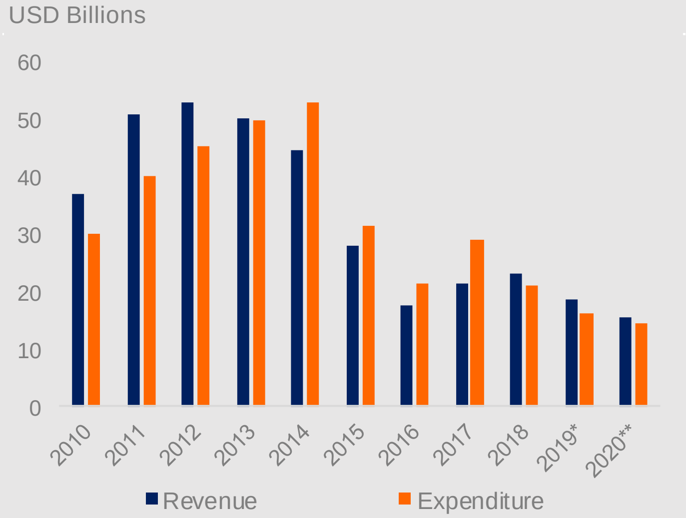
2|On the revenue side, we calculate that these numbers point to a 26.7% increase against expected revenue in 2019[2], a hike of around AOA 1,837 Bn. As a share of GDP, revenue should fall from 20.8% in 2019 to 20.4% in 2020; for the sake of comparison, in 2011 revenue was 45.5% of GDP. In USD, we estimate a revenue of USD 15.6 Bn (-15.6% yoy), the lowest in recent years (it had peaked at USD 53.0 Bn in 2012).

Most of the increase referred above (70.4%) is caused by the increase in oil tax revenues measured in national currency, by AOA 1,293 Bn (+30.2%). According to our calculations, oil tax revenue is expected to fall measured in Dollars to USD 10.1 Bn (-13.6% yoy); however, the depreciation from October onwards meant that, from now on, these same revenues will turn into a much larger amount in Kwanzas. These taxes will represent 13.2% of GDP in 2020 (equal to 2019) - they represented 36.4% of GDP in 2011.

Revenue and expenditure will keep reducing when measured in dollars, far below 2012-14



*BFA estimate **2020 Budget Source: Min. Fin., BFA calc.

On the other hand, non-oil taxes would total AOA 2,517 Bn, an increase of AOA 522 Bn (+26.1%) compared to the expected amount collected in 2019. In this case, in addition to the impact of inflation, some tax changes (notably in Personal Income Tax) will likely have a positive effect on tax revenue. In Dollars, non-oil tax revenue will be 16.2% lower than in 2019. As a percentage of GDP, non-oil tax collection is expected to represent 6.0% - non-oil taxes yielded a high of 8.2% of GDP in 2015.

3 | On spending, our estimates point to a 36.0% increase from effective execution in 2019, by around AOA 2,143 Bn. As a percentage of GDP, there is an increase from 18.3% in 2019 (the recent historical low) to 19.2% in 2020. In USD, spending will be the lowest in recent years, USD 14.6 Bn (-9.7% yoy), well below the USD 53.1 Bn peak in 2014.

More than 1/3 of the increase in expenditure is due to interest expenses, which are expected to increase by 44.9% to AOA 2,473 Bn, representing 31% of total spending. Accumulated debt in previous years, together with the effect of depreciation, have brought interest payments to about 5.9% of GDP in 2020 – it was less than 1% of GDP until 2013; expenditure on interest payments will surpass spending on public wages. Nevertheless, interest payments will decrease slightly when measured in USD, from USD 4.6 Bn to USD 4.5 Bn, a slightly positive sign.

One should note the 34.1% increase in wages, above inflation (prices are expected to increase 21-22%, on average, 25% in the end of the year); however, this may be a result of our assumption actual spending in 2019, which may be more optimistic than that of the government: if the we consider a more pessimistic (higher) spending in wages in 2019 than BFA estimates, the 2020 prediction would represent a smaller increase (+23.7% if we consider the 2019 Revised Budget numbers).

[2] Notice that we are presenting changes in comparison to the 2019 execution forecast by BFA (which is presented later in this Note); in previous Budgets, the Finance Ministry provided a projection for the execution of the present year, a fact which has not occurred in this exercise; given that fact, and considering that, for multiple factors (namely the depreciation), the execution will widely diverge from the Revised Budget, we choose to compare 2020 Budget values with our forecast for execution in 2019.

On the other hand, spending on goods & services, which are expected to post a low of 2.5% of GDP in 2019, should increase significantly in 2020 (+44.7%); also, investment will represent only 3.2% of GDP, a new historic low, increasing well below inflation (+19.5%).

The Budget predicts a surplus of AOA 519 Bn, about 1.2% of GDP, below our forecasted surplus for 2019. Similarly, 2020 will likely be the third consecutive year with a primary surplus[3], forecast at AOA 2,993 Bn (7.1% of GDP) - AOA 461 Bn more than in 2019. On the other hand, the non-oil primary deficit is expected to widen to AOA 5,061 Bn (AOA 3,462 Bn in 2019).

Box 1 – 2019 Budget Execution

1|According to our estimates, budget execution will exceed expectations in 2019, particularly on the revenue side. We expect a total revenue of AOA 6,774 Bn (+788 Bn vs. Budget), and total spending of AOA 5,949 Bn (-32 Bn than planned).

2|Revenue was higher mainly due to an additional AOA 720 Bn in oil tax collection. Our calculations point to a positive impact of a higher-than-expected Brent price, of about AOA 663 Bn – the Budget assumed USD 55, while Angolan exports sold for around USD 63, on average; a more depreciated exchange rate also had a positive impact (AOA 355 Bn), while a lower than expected production (AOA 188 Bn) and negative combined effects (AOA 110 Bn) contributed negatively for oil taxes. These figures speak to the importance of prices on oil tax revenue: in 2019, for every extra Dollar in the price, oil taxes saw an increase of about AOA 87 Bn – around 10% of budgeted expenditure in 2019 for goods & services.

Revenue from social security contributions should also surpass expectations, at around AOA 69 Bn by our estimates. Regarding non-oil revenues, we expect execution to hit near the mark; figures from H1 2019 would point to higher-than-expected revenues, but the implementation of VAT will have led to lower revenue when compared to what would have been collected through Consumption Tax (which VAT replaced); this effect may offset other more positive trends.

3|On the expenditure side, the effects will be varied - we expect positive surprises on wages, goods & services and transfers, and higher-than-expected spending on interest and capital expenditures. On wages, the statistical record indicates that the execution of these expenses has always been below budgeted (since 2011) – a similar performance would indicate an expected positive gap of AOA 139 Bn compared to foreseen budget. A similar trend has occurred in the last few years with spending on goods & services; however, depreciation may play a negative role here, as some of these purchases might be imported – the positive gap is expected to be marginal, estimated by BFA at AOA 18 Bn.

Interest spending is expected to be negatively affected by depreciation in the last quarter, adding an estimated AOA 180 Bn to planned expenses; finally, public investment may also suffer from similar effects, so we estimate higher-than-expected expenditure, by AOA 90 Bn.

4| As a result of this execution, we expect a significant surplus around AOA 826 Bn, 2.5% of GDP, which would be slightly higher than the positive balance achieved in 2018. The primary balance should also increase from AOA 1,753 Bn in 2018 to AOA 2,532 Bn this year, about 7.8% of GDP. The success of the fiscal consolidation effort is demonstrated in particular by the fall in the non-oil primary deficit, which excludes both interest spending and oil tax revenues: the State still

[3] The Primary Budget Balance is the difference between fiscal revenue and expenditure, excluding interest payments.

spends more than it collects, but this deficit will be around AOA 1,755 Bn, accounting for 7.7% of non-oil GDP – it stood at 55.5% of non-oil GDP in 2012.

B. ANALYSIS

1|Overall, we find the Budget to be relatively conservative, and feasible. In particular, the assumed Brent hypothesis at USD 55 is prudent, given that most forecasts point to an average above level around USD 60 by 2020: Bloomberg's composite forecast is USD 62.

2|On the contrary, the oil production volume expectation seems optimistic, as it seemed for 2019. The Finance Ministry expects production to rise to 1.44 million barrels per day (mbd) in 2020 from 1.39 mbd in 2019. However, according to our estimates, which take into account investments expected to occur and the natural rate of decline in mature projects, point to a lower level of production, around 1.38 mbd.

3|In this sense, the Executive expects a 1.5% growth in the oil economy, while BFA anticipates a further fall of about 1.0%. On the non-oil economy, the Executive expects a 1.9% increase in activity; our expectation is slightly more optimistic at 2.6%. **In the whole economy, the Executive anticipates 1.8% increase in GDP, while BFA expects a more moderate rise at 1.5%.**

Forecast Scenario	Budget	BFA
Hypotheses		
Brent (USD/barrel)	55.0	59.6
Oil Production (mbd)	1.44	1.38
GDP Growth (%)	1.8	1.5
Forecast		
AOA Billion		
Revenue	**8,611**	**8,965**
Oil Taxes	5,581	5,920
Non-Oil Taxes	1,714	1,715
Expenditure	**8,092**	**8,084**
Budget Balance	**519**	**881**
in % of GDP	1.2	2.1

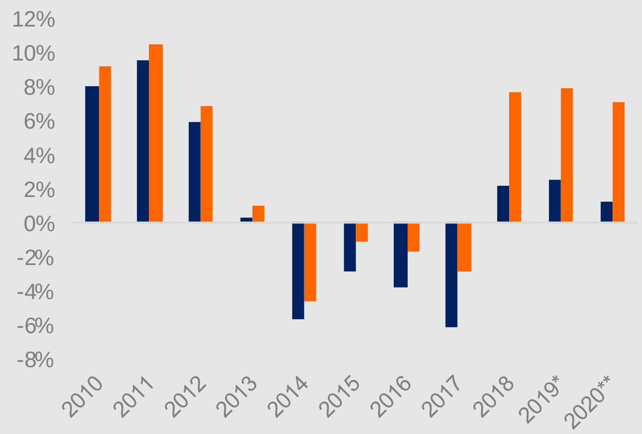
Source: Min. Fin., BFA calc.

4|Given the above assumptions, we expect the Government to again exceed its planned performance. We anticipate higher-than-expected oil tax revenues, of about AOA 339 Bn. Despite the negative effect of a lower than budgeted production (-235 Bn), and a slightly less depreciated exchange rate than the Finance Ministry is expecting (-54 Bn), the price effect should broadly offset these impacts (+621 Bn), with a slight increase due to combined effects (+7 Bn). Thus, we expect a positive budget balance of AOA 881 Bn, about 2.1% of GDP.

5|2020 will be a year of continued fiscal consolidation, indicated by various metrics. The Executive expects a budget surplus at 1.2% of GDP in 2020, less than our estimates for 2019 (2.5%); however, our expectation is that the higher-than-expected oil price will raise this to 2.1% of GDP. Excluding interest expenditure – not due to current policy decisions – the Executive expects to save 7.1% of GDP, also slightly below our expectations for the primary surplus in 2019 (7.8%); we expect the figure to be 8.1% (which would be a high since 2011). If, on the other hand, we take interest spending and oil tax revenue, the State will spends more than what it collects: in 2020, the non-oil primary deficit would amount to 9.0% of GDP; this is an increase compared to the 7.7% forecast by BFA for 2019; however, these figures are much lower than in 2011 and 2012, when the rate exceeded 50% - that is, the Government spent over 150% of its collected revenue other than oil taxes.

Primary balance and budget balance will be slightly smaller but positive...

Percentage of GDP

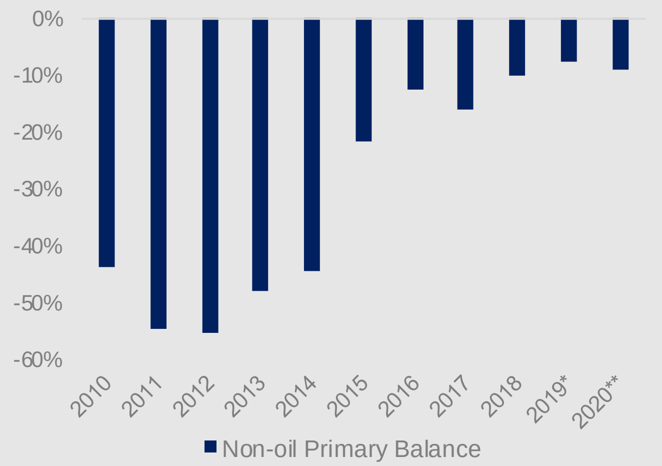


*BFA estimate **2020 Budget

Source: Min. Fin., BFA calc.

... while the non-oil deficit will also worsen slightly

Percentage of non-oil GDP



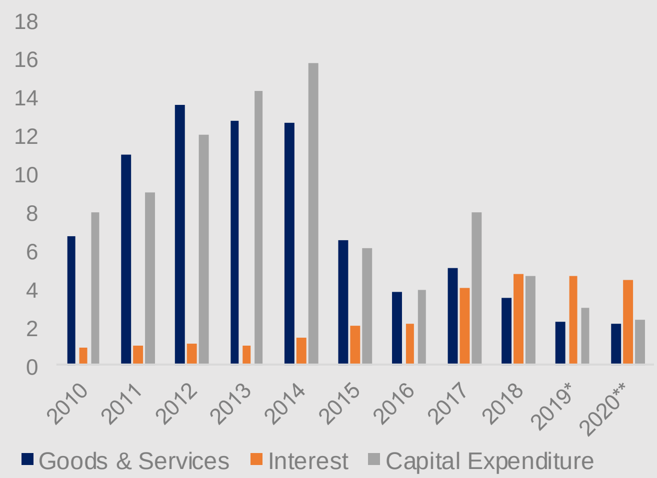
*BFA estimate **2020 Budget

Source: Min. Fin., BFA calc.

6|It is worth noticing the very significant decline in expenditure on both investment and purchases of goods & services, which has been taking place since 2014. Dollar figures point to a sharp reduction: in 2020, Government spending on goods & services will be only 17,0% of spending in 2014; on the other hand, investment spending will only be a fraction (15.2%) of expenditure in 2014. Part of this effect comes from depreciation in the period; still, as a percentage of GDP, the Executive is expected to spend only 2.8% of GDP on purchases of goods and services (1/3 of the percentage in 2014), and only 3.2% of GDP on capital expenditure (less than 1/3 of the percentage in 2014). This reduction was deemed necessary in the context of fiscal consolidation, but maintaining this low level of investment spending will be detrimental to the country's development; considering that there is little room for further consolidation in the other expenditure components, mobilizing additional non-oil revenues (through the ongoing effort to broaden the tax base) will be essential.

Spending on goods & services and investment is far below the period up to 2014...

USD Billions

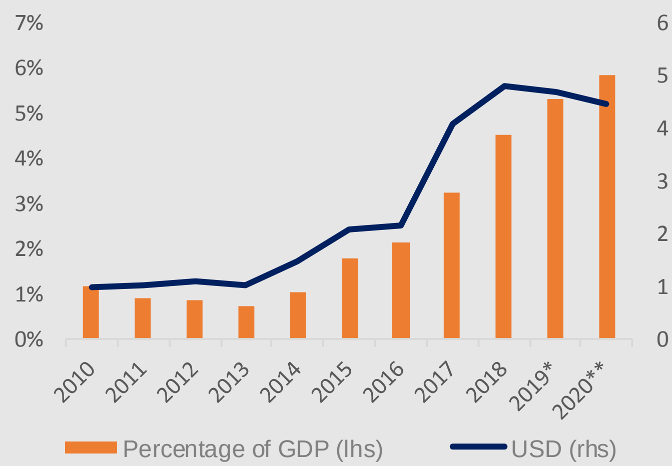


*BFA estimate **2020 Budget

Source: Min. Fin., BFA calc.

... while interest expenses became much higher, although stabilizing in 2019 and 2020

Percentage of GDP; USD Billion



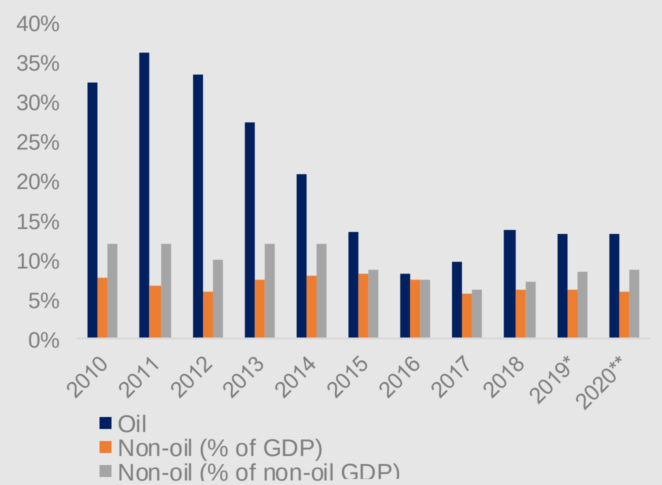
*BFA Estimate **2020 Budget

Source: Min. Fin., BFA calc.

7|In that sense, one should expect changes to tax laws already in the beginning of 2020. According to our estimates, discounting the effects of inflation and the possible non-oil economy growth, the Executive is counting on tax changes to yield an additional revenue in non-oil tax revenue of about 0.1-0.2% of GDP; this is a conservative estimate, but a negative impact from VAT implementation is likely being taken into account, as it could have a negative effect in the short term, in net terms. Among other taxes, marginal changes are expected in Profit Tax, a reform of tax benefits policy, further harmonization of the Urban Property Tax, and a reformulation of vehicle taxation; however, the largest change should be the adjustment of the Personal Income Tax rate schedule - the IMF hypothesized in July the creation of a top income bracket with a 37% tax rate; no specific details were given by the Government, but at the end of November the Cabinet's Economic Commission approved a proposal to "allow for lower income tax relief, maintaining the tax burden for middle-income individuals and including progressivity on higher incomes".

Non-oil tax revenue still represents a small percentage of GDP

Percentage of PIB; percentage of non-oil GDP



*BFA Estimate **2020 Budget Source: Min. Fin., BFA calc.

8|Another part of the Budget which seems underfunded are the social transfers for families (part of transfers), which are incipient in Angola. These should amount to AOA 565 Bn, +15.3% compared to the Revised 2019 Budget, below inflation. In detail, the only component that will keep up with inflation are retirement pensions (72.1% of spending in social transfers), up 24.4%.

Looking at the Dollar amounts, in 2020 we estimate a prediction of about USD 1,020 million spent, about USD 32 per inhabitant. Moreover, 83.9% of this expenditure is concentrated between retirement pensions and former combatant pensions; child allowance spending would total only USD 1.5 million, while USD 78.4 million will be spent on scholarships, USD 16.3 million in subsidies to traditional authorities, and USD 68 million for other social transfers; knowing that the overwhelming majority of the population is under 60, one should note that, excluding pension spending (retirement and former combatants), social benefits will amount to only USD 5 per inhabitant.

The World Bank and the Government are known to be preparing a pilot program to be launched in the first half of 2020, with direct money transfers to low-income citizens; this program is directly funded for 3 years by the World Bank for a total of USD 320 million, so the amounts are not included in the Budget. However, this Program is a pilot, to be further expanded throughout the 3-year period; given the country's serious economic situation, it would likely by prudent to allocate a higher priority to this matter, conditional on the country's financial means.

Looking at the functional distribution of expenditure, the Executive expects to spend AOA 2,554 Bn in the social sector (education, health, social protection, housing, culture and environmental protection), a 27.6% growth compared to the Revised State Budget 2019; this represents 31.6% of total expenditure, down from the budgeted 33.5% for 2019; however, if we look at this expenditure as a percentage of primary expenditure (excluding interest), the figure would be 45.5% in 2020, only marginally (-0.2 pp) lower than planned in 2019.

9|With regard to financing, 2020 will be a particularly challenging year, with repayments (principal and interest) totalling over USD 16.0 Bn, slightly above budgeted for 2019 (USD

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14.8 Bn) and well above currently scheduled repayments for 2021 (USD 10.3 Bn) - the amount to be repaid in 2021 is not expected to increase substantially as short-term debt is currently below USD 2.0 Bn.

The Executive expects to repay principal in the amount of AOA 7,226 Bn, 56% of which is in domestic debt (AOA 4,082 Bn) and 44% in external debt (AOA 3,144 Bn, about USD 5.6 Bn). To this end, despite the expected budget surplus of AOA 519 Bn, the Executive expects to issue AOA 7,348 Bn in debt: 2/3 in external debt (AOA 4,867 Bn, about USD 8.7 Bn), and 1/3 in domestic debt (AOA 2,481 Bn). This net funding of AOA 122 Bn, together with budget savings (AOA 519 Bn) will amount to AOA 641 Bn net increase in Government assets, including deposits, acquisition cost of holdings, other capital transfers and the payment of commercial debt to Sonangol.

It is particularly relevant to consider planned external disbursements of around USD 8.7 Bn. Part of this amount is multilateral financing from the IMF, World Bank and AfDB (USD 1.9 Bn); on the other hand, according to the last Eurobond prospectus, at 31 December 2018 there was an amount of USD 15.7 Bn available for disbursement, in financing lines already in use by the Angolan State - in all probability the amount budgeted for investment (about USD 2.4 Bn) will be funded by amounts of this type of lines. Excluding these two amounts, the remaining USD 4.4 Bn could be partly financed by a new Eurobond in 2020, other multilateral, bilateral or commercial bank financing: the publication of the 2020 Annual Debt Plan should shed some light on the matter.

Box 2 – End of November Eurobonds Emission

1|In the end of November, Angola issued over USD 3.0 Bn in Eurobonds, divided into 10 and 30-year tranches, supported by Deutsche Bank, ICBC and Standard Chartered Bank. The issue met a demand of over USD 8.4 Bn, with yield of 8% on the 10 year bond (USD 1.75 Bn) and 9.125% on the 30 year bond (USD 1.25 Bn). Both rates were 0.25 pp below the issuance in 2018, making the cost of financing slightly cheaper in comparison.

2|Despite this decline, the spread paid on the issue - compared to similar US debt maturities - increased, indicating a rise in the implicit risk of Angolan debt. On the 10-year, Angola agreed to pay 623 basis points (bp) above the US yield, when it had agreed to pay an additional 529 bp in 2018; on the 30-year, the spread went from 624 bp to 691 bp. This followed the trend already taking place in the secondary market.

3|On the shorter maturity, Angola has paid the 4th highest rate among sub-Saharan African countries; on the longer tenor, it is the 2nd highest rate; however, it is important to stress that only 6 countries in the region have 30-year issues, and only 16 countries in the region have Eurobonds of any maturity. Other relevant issues in 2019 were from South Africa (4.85% at 10 years and 5.75% at 30 years) and Ghana (8.125% at 12 years and 8.95% at 31 years).

Angolan 10-year Eurobond (2025) risk has increased compared to the USA (2025) and Nigeria (2023)

Basis Points

Source: Bloomberg

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4 | The Eurobond issue was thus moderately successful, especially given the high amount obtained and the continued lengthening of the yield curve with the 30-year bond; on the other hand, one should take notice of a widened risk perception by the market. Angolan debt remains desirable in a yield-seeking environment (with low interest rates on international markets), but it is noteworthy that, according to market participants, investors stressed that Angola should be given "the benefit of doubt, for now". This perception stresses the need to hasten the pace and show results on the economic front, while continuing the effort already shown on the fiscal front.

C. CONCLUSION

1|This is a relatively conservative Budget, despite the overly optimistic expectation for oil production, as the Brent assumption more than compensates for this effect; it is also a Budget that maintains the results achieved by fiscal consolidation in previous years, and will likely be the third consecutive year with a positive budget balance.

2|Budget execution could exceed expectations, as it did last year via oil revenues, given the conservative oil price assumption. Non-oil taxes will continue to make a rather moderate contribution to tax revenue, with the Budget pointing to 6.0% of GDP, similar to the 2012 low. Nevertheless, part of this will be due to the initial implementation of VAT, which should impact negatively on tax collection; conversely, changes in the Personal Income Tax rate schedule may bring a positive surprise along the year.

3|Interest expenses represent an increasing share of GDP (already 5.9% in 2020), higher than the wages of civil servants. Still, according to our estimates, 2020 could be the second consecutive year of declining interest spending when measured in USD.

4|The robust reduction in goods & services and investment spending been impressive so far and should progress throughout 2020; however, public investment spending will now be significantly below what would be desirable (3.2% of GDP by 2020), and should be raised in the medium-term as far as fiscal consolidation efforts allow.

5|Expenditure on social transfers still represents a tiny amount, about USD 34 per capita, concentrated on retirement pensions and former combatant pensions, with no significant direct social support to populations other than the existing public services. The World Bank and the Government will start a pilot program of cash transfers for the poor, to be extended in the medium term; however, the country's very difficult social situation would require a much higher priority for this project.

6|The financing of the Angolan State in 2020 will be very demanding, with repayments (between principal and interest) above USD 16.0 Bn; however, we consider the Angolan authorities to be up for the challenge; 2021 will bring significant relief in this perspective.

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D. ANNEX

State Budget	2019		2020		
USD Billion)	Budget*	Execution	Budget	BFA	20/19
Revenue	**17,93**	**18,56**	**15,54**	**16,46**	**-16,3%**
Current Revenue	17,93	18,56	15,54	16,46	-16,3%
Taxes	16,67	17,21	14,61	15,47	-15,1%
Oil Taxes	10,69	11,75	10,07	10,87	-14,3%
Non-oil Taxes	5,98	5,47	4,54	4,60	-16,9%
Social Contributions	0,54	0,68	0,51	0,56	-25,9%
Donations	-	-	0,00	0,00	-
Other current revenue	0,72	0,66	0,42	0,43	-36,6%
Capital Revenue	-	-	-	-	-
Expenditure	**17,92**	**16,31**	**14,60**	**14,84**	**-10,5%**
Current Expenditure	14,85	13,26	12,20	12,40	-8,0%
Wages	5,37	4,53	4,00	3,73	-11,7%
Goods & Services	2,54	2,27	2,16	2,21	-4,7%
Interest	4,79	4,69	4,46	4,54	-4,8%
External	2,57	2,57	2,54	2,58	-1,3%
Internal	2,22	2,12	1,93	1,96	-9,0%
Current Transfers	2,15	1,77	1,57	1,91	-11,2%
Capital Expenditure	3,07	3,05	2,40	2,44	-21,3%
Current Balance	**3,08**	**5,30**	**3,34**	**4,06**	**(1,96)**
Primary Balance	4,81	6,94	5,40	6,16	(0,22)
in % of GDP	5,2%	7,8%	7,1%	8,1%	(0,7)
Non-oil Primary Balance	**(5,88)**	**(4,81)**	**(4,67)**	**(4,71)**	**0,14**
in % of non-oil GDP	-8,5%	-7,7%	-9,0%	-9,1%	(1,3)
Budget Balance	**0,02**	**2,25**	**0,94**	**1,62**	**(1,31)**
in % of GDP	0,0%	2,5%	1,2%	2,1%	(1,3)

Source: Min. Fin., BFA calc.

*Revised 2019 Budget

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