Annual Federal Public Debt Report 2017

TESOURO NACIONAL

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Convento da Penha e vista aérea da cidade de Vila Velha, ES

National Treasury Message

The National Treasury has advanced in its institutional mission to ensure public accounts balance and public debt sustainability by fostering transparency, fiscal discipline and debate over public choices. In this context, we present in the 15th edition of the Annual Debt Report (ADR), which displays the results and main achievements of the Federal Public Debt (FPD) management in 2017.

FPD is currently characterized by healthy profile, with low exposure to exchange rate, and low concentration of short-term maturities, besides having a diversified investor base for its funding. These factors, in line with the guidelines that drive FPD strategies, contribute to mitigating the inherent debt management risks and should be weighed in the analysis of the intertemporal debt sustainability.

Presenting an evaluation of 2017, we highlight the reduction of the average cost of financing the FPD, which are explained by inflation decline and consequent interest rate decline throughout the year. Regarding the External Federal Public Debt, two successful operations in the international market pointed to investor confidence in the soundness and low risk of the Brazilian indebtedness profile.

This edition presents, in Chapter 1, the developments of macroeconomic expectations throughout the year. Next, Chapter 2 concerns the main outcomes achieved for the FPD, with an emphasis on main statistics evolution, external debt management, investors' base, and guarantees granted. Finally, Chapter 3 summarizes the accomplishments and developing topics including the Golden Rule for fiscal policy, the relationship with the Central Bank, communication efforts with society, and Tesouro Direto public bonds retail program, among others.

The results presented here corroborate that FPD management follows the commitment to reduce debt funding costs and maintain debt risk at prudent levels, seeking, in addition, to contribute to the proper functioning of the Brazilian public bonds market. This report is also part of the National Treasury efforts to actively give transparency to its management and strengthen communication channels with society.

National Treasury Staff

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1 Brazilian and International Economy Developments in 2017

At the beginning of 2017, domestic economic activity displayed a slow and gradual recovery emerging from two years of significant recession (-3.5% GDP growth both in 2015 and 2016). Markets forecasted GDP growth of around 0.5% for the year[1]. In the first quarter, GDP growth rate of 1.3%, after eight consecutive quarters of negative results, positively surprised the market. On the one hand, statistical breakdown revealed that GDP growth was driven by agricultural and specific industry and services sectors, respectively capital goods and transport. On the other hand, the lack of recovery on demand components (consumption and investment) reinforced the scenario that the economic recovery was still underway.

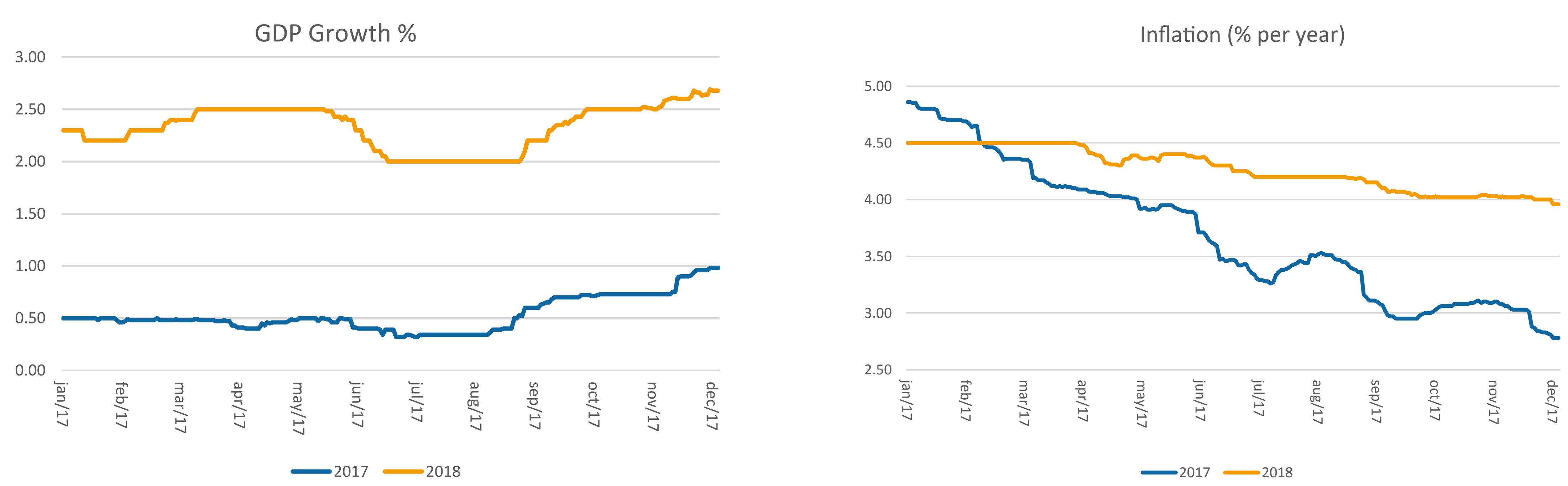
Inflation expectations are well anchored

The weakened activity of previous years impacted prices more significantly. After meeting inflation target in 2016 (6.3%), the outlook was of a continuing Broad Consumer Price Index (IPCA, acronym in Portuguese) deceleration in 2017 to a value closer to the center of the target (4.5%). Besides, there was a sharp fall in food prices resulting from a favorable harvest in the period. This positive scenario started impacting inflation projections for the coming years, which supported National Monetary Council's (CMN, acronym in Portuguese) decision to lower inflation targets for 2019 (4.25%) and 2020 (4.0%)[2]. This strengthened monetary policy's ability to anchor long-run inflation expectations and initiating a process of convergence to international standards. Chart 1 reflects the evolution of market expectations for GDP and inflation over the course of 2017, with a significant improvement in the economic agents' perception on the perspective of economic growth and inflation for 2017 and 2018.

[1] Central Bank Focus Market Readout of 01/26/2017: http://www.bcb.gov.br/pec/gci/ingl/Readout/R20180126.pdf

[2] Until 2016, the inflation target of 4.5% considered a 2 p.p. upwards and downwards tolerance interval relative to the midpoint target. Therefore, the target's upper limit l was of 6.5%. Starting in 2017, the tolerance interval was reduced to 1.5 pp.

Chart 1. Evolution of Market Expectations for GDP and Inflation



Source: Central Bank (Focus Market Readout)

On the fiscal sphere, the 2017 Budgetary Guidelines Law (LDO, acronym in Portuguese) estimated a deficit of BRL 143.1 billion for the public sector. In the first months of the year, median market forecasts projected a BRL 144.4 billion (or 2.2% of GDP) public sector deficit and non-compliance with the fiscal result target. On August 15, the government announced a fiscal target revision to BRL 163.1 billion. Despite the target change, tax collection in the last months of the year was more favorable than anticipated, contributing to the fiscal result in the year.

This scenario, which was accompanied by exchange rate stability, provided room for the monetary policy to continue the monetary easing initiated at the end of 2016. At its first meeting of the year, the Monetary Policy Committee (Copom, acronym in Portuguese) intensified Selic overnight interest rate cuts pace from 0.25 percentage points (p.p.) to 0.75 p.p. and then 1 p.p. This pace allowed the interest rates to drop from a level of 13.75% at the end of 2016 to 7.0% at the end of 2017. Reflecting expectations of Selic cuts in the short term, short-term interest rates dropped, which contributed to the reduction of public debt rollover cost. This can be observed in the following chart:

Short-term interest rates have plunged. Long-term interest rates, in turn, persisted at higher levels.

Chart 2. Yield Curve – % p.a.

Source: Bloomberg

On the other hand, long-term interest rates did not fall to the same extent as short-term rates. Long-term yield curves reflect concerns over adjustments considered necessary to the Brazilian economy, such as uncertainties related to the delay of the Social Security Reform voting and the 2018 elections. Long-term yield curves also follow prospects for political support to the executive's reform agenda.

The chart also displays interest rates peaks in May. During this month, uncertainties over the political environment have risen significantly, causing a strong increase in risk premium and worsening market financial conditions. On May 16 alone, the 10-year interest rate rose from 10.2% to 12.1% while the exchange rate went from BRL/USD 3.14 on May 18 to BRL/USD 3.38. The 5-year CDS[3] rose from about 330 in early May to above 360 by the end of the month. Such movements were temporary for most variables, but long-term interest rates have since then responded less to Selic rate declines. National Treasury interventions in the interest rate and the Central Bank in the exchange rate during the month helped to stabilize these indices.

Despite risk aversion caused by political instability, GDP surprised positively once more in the second quarter (+ 0.7% QoQ). The result was driven by services and household consumption; it was a recovery based on sectors different from those

[3] The Credit Default Swap (CDS) acts as an insurance (hedge) against default, in which one of the parties to the contract assumes the risk of having to pay the "insured" amount in the event of default and, for that, charges/receives for this risk. In theory, the higher the value charged, the greater the sovereign risk of a country.

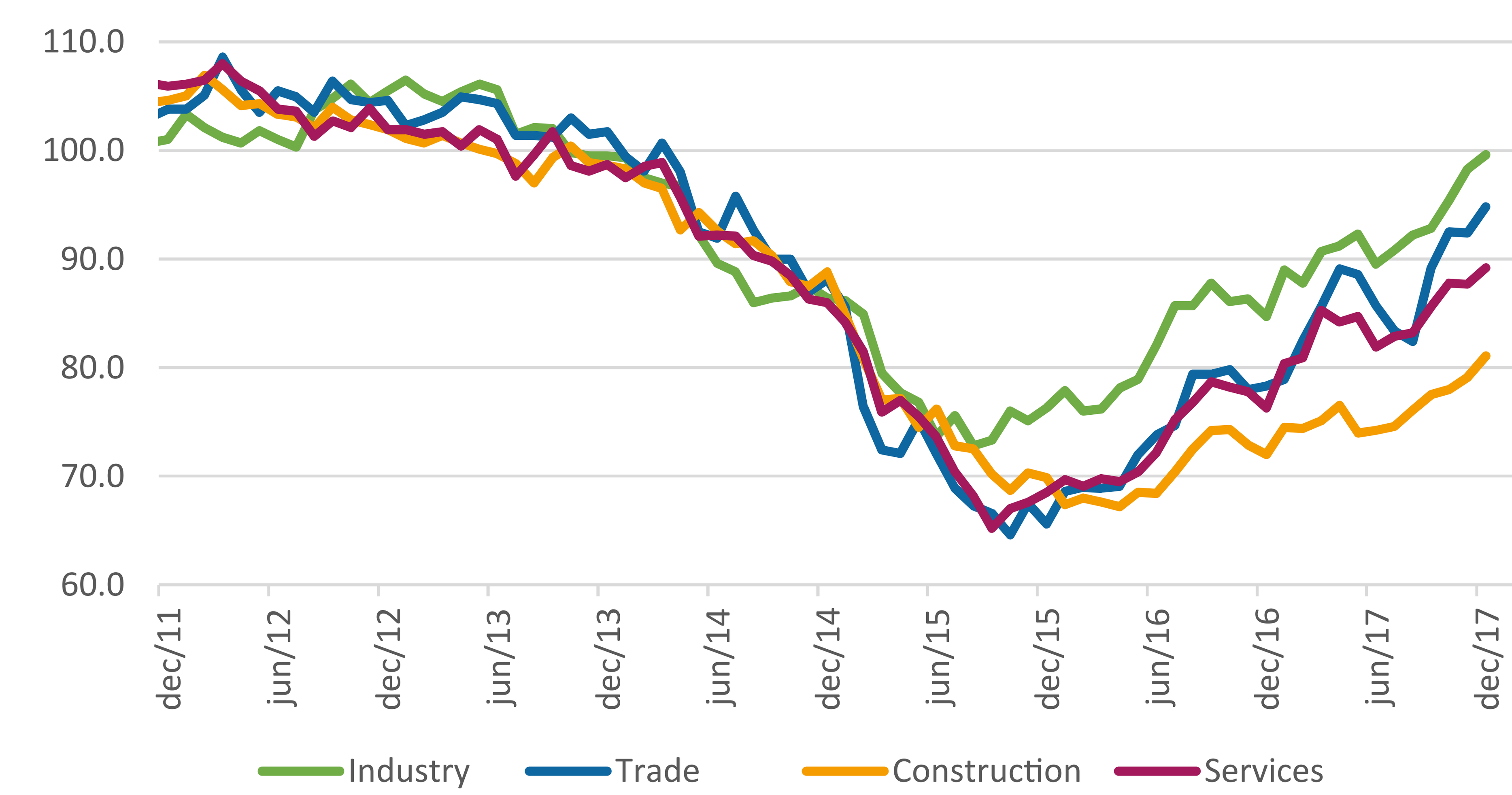
that positively reacted in the first quarter and were considered more crucial for GDP growth resumption (services sector accounts for almost 70% of GDP). Household consumption recovery after nine consecutive quarters of contraction benefitted from positive effects of authorization to withdrawal from inactive Worker's Fund[4] accounts, despite labor market modest recovery.

Economic activity presents recovering signs and confidence indices are increasing in all the sectors.

The second half of the year was marked by major reforms such as the creation of a new long-term interest rate (TLP, acronym in Portuguese), BNDES early settlement resulting in a gross debt decline, approval of labor reform, and Fies[5] modification, opening an agenda of long-term fiscal adjustment combined with improvement in business environment[6].

By the end of 2017, economic activity showed clear signs that the most severe part of the crisis had been overcome. Confidence indeces showed a recovery throughout the year. Industry confidence index reached its peak in December/17, the highest record since January/14. Services sector's confidence also reached its peak during the same period, since September/14. The negative impacts generated by the troubled political scenario throughout the first half of the year were not enough to deteriorate the performance of the economy, ratifying the perception that economic activity registered a moderate recovery path. In the third quarter, the GDP registered a positive result (+ 0.1%) driven fundamentally by demand components (consumption and investment). Investment measured by Gross Fixed Capital Formation (GFCF) registered in 3Q17 a positive result (+1.6%) for the first time after 15 quarters. At the end of 2017, market projections (chart 1) were indicating a 1.00% growth for the year and 2.70% for 2018. The IPCA also surprised positively throughout the year, ending 2017 at 2.95%, below the lower limit of the inflation target for the year. Combined with the fall in interest rates, low inflation helped reduce federal public debt management costs.

Chart 3. Confidence Indeces



Source: FGV

The main challenges of the domestic economy remain on the fiscal side. Throughout the year, in spite of one-off revenue inflows, recurring tax revenues loss led the government to issue financial scheduling decrees containing strict freezing until November. Over the last two months of the year, government revenues' performance surprised positively. However, mandatory expenses rose above inflation throughout the year, demanding a strict control of discretionary expenditures financial disbursements, mainly investments. For the next years, the reform agenda will be paramount in ensuring a fiscal performance capable of generating primary surpluses that will ensure long-term public debt sustainability.

Reform agenda progress in Congress will be paramount to meeting fiscal challenges.

From 2014, public debt started to grow more substantially in a context of primary fiscal deficits, economic recession, and rising interest rates. These conditions contributed to the GGGD (General Government Gross Debt) reaching 74.4% of GDP in November/17. However, the set of economic measures recently adopted, as well as the expectations regarding the approval of the new reforms, can contribute to the improvement of fiscal and debt projections. The outlook for GGGD is very sensitive to the reforms currently being debated in National Congress and the degree to which its original proposals could be dried out. Considering the risk

[4] Government Severance Indemnity Fund

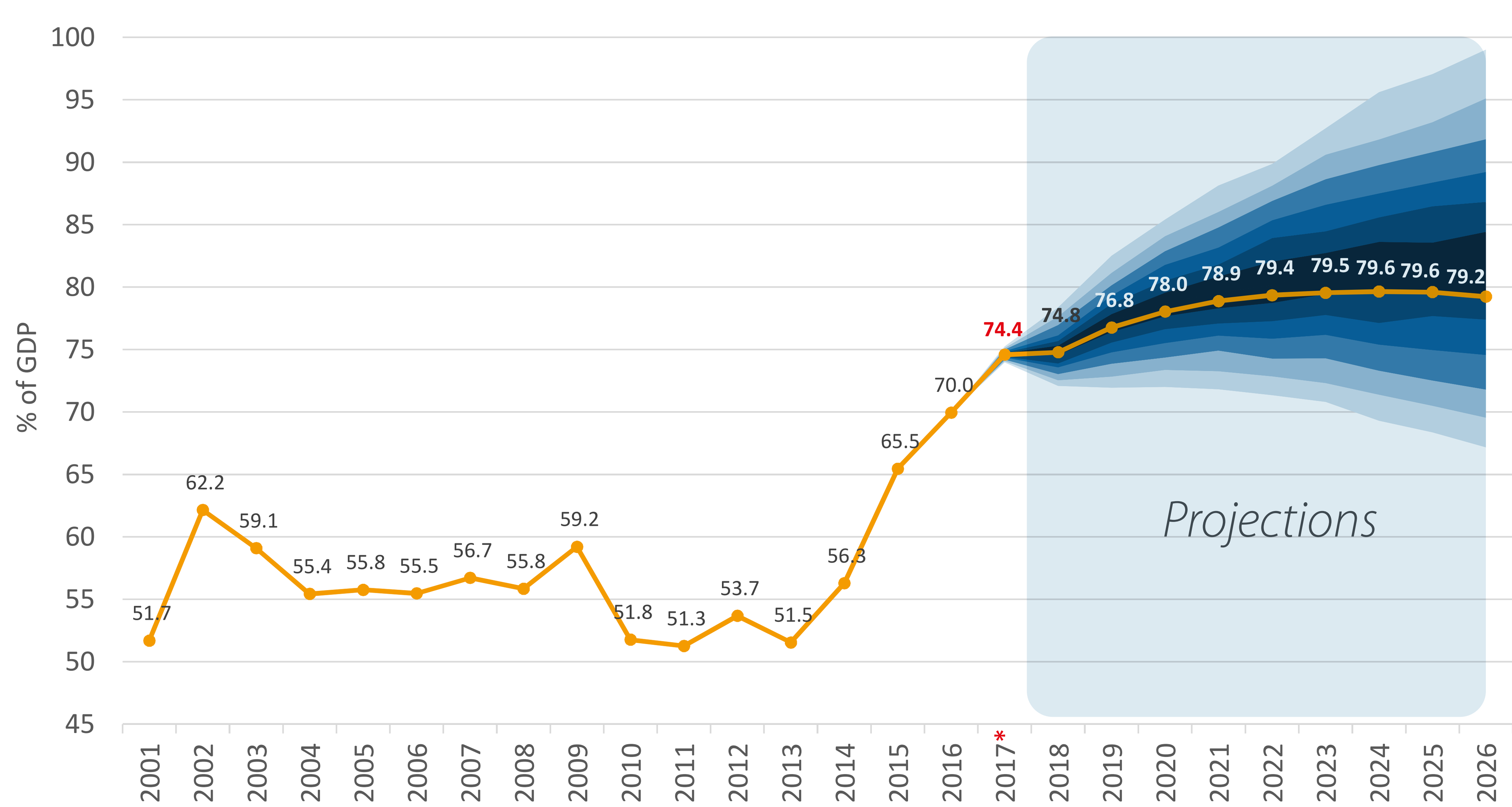
[5] Student Financing Fund which provides low interest loans to pay tuition at private universities.

[6] Reforms authorized by Law No.13,483, dated 09/21/2017; Law No. 13,496, dated 10/24/2017; Law No. 13,467, dated 07/13/2017; and Law No. 13,254, dated 01/13/2017, respectively.

spectrum, scenario analysis shows that GGGD stabilizes around 80% of GDP in central cases, which baseline scenario includes as premises the fulfillment of the spending ceiling and the macroeconomic parameters disclosed by the Secretariat of Economic Policy. On one hand, in scenarios where reforms are fully implemented, GGGD follows a stable path. On the other hand, the absence of fiscal consolidation reforms could result in more adverse scenarios, in which GGGD could exceed 90% of GDP.

For more information, see The public debt solvency and sustainability report[7]

Chart 4. GGGD central forecast and probability intervals



Source: Central Bank and STN forecasts

** Position as of November 2017.*

In addition, the year was marked by the persistence of a strong external sector adjustment, initiated in 2015, and driven mainly by a strong trade balance performance. In the financial account, the inflow of foreign direct investments kept substantially high so that the financing of balance of payments remained comfortable throughout the year.

International scenario benefitted from favorable global financial conditions. In the United States, the year was characterized by Federal Reserve phasing out of the quantitative easing policy and President Trump's reform agenda setback such that gradual fed funds rate increase did not significantly affect emerging economies. In the Eurozone, European Central Bank continued to implement a monetary easing policy to tackle low inflation and volatility stemming from the distressed political arena, with elections in major countries. In China, despite concerns over high economic indebtedness and high idle capacity in the industrial sector, growth remained stable, confirming a favorable scenario for international economic activity.

[7] The National Treasury published in November 2017 a report called "Public Debt Solvency and Sustainability Analysis.

2 Achievements

Turbinas eólicas, RN

This section intends to present the achievements of debt management in the fulfillment of its legal mandate and includes the monitoring of borrowing requirements, domestic and external issuance strategy execution, as well as main results achieved.

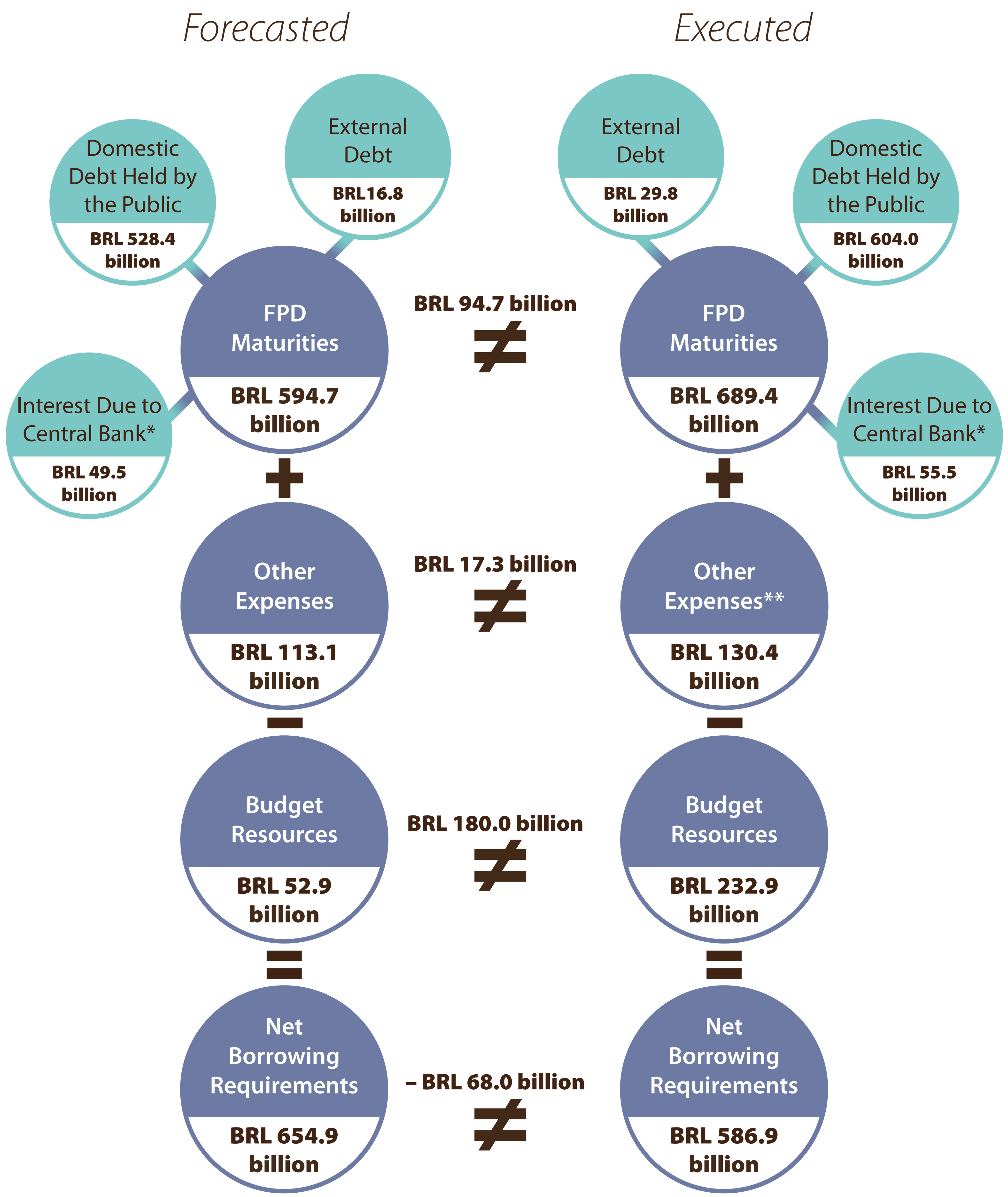
2.1 Borrowing Requirements

The gross borrowing requirements to be covered through public debt comprises as follows: FPD maturities in the market, which include maturities of domestic and external debts; interests on the public securities portfolio held by the Central Bank; and other budgetary expenditures to be paid with public bond issuance revenues, typical in a context of primary fiscal deficits. To reach the net borrowing requirements, the budgetary resources used to pay the debt are written off from this result. These budgetary resources are not originated from bond issuances. Chart 5 below compares the borrowing requirements forecasted by ABP 2017, at the beginning of the year, with borrowing requirements registered at the end of the year.

Net Borrowing Requirement reached BRL 586.9 billion in 2017, BRL 68 billion lower than the forecasted value. A significant share of this difference can be explained by the increase in budgetary sources related to the BRL 150 billion BNDES' early settlement, BRL 100 billion at the end of 2016 and BRL 50 billion in 2017, besides Central Bank positive balance (source 152). This effect was partially offset by FPD maturities BRL 94.7 billion higher than previously forecasted, most of which refer to issuances maturing in the fiscal year (BRL 25 billion) and the share of BNDES 2017 early settlement in bonds (BRL 15 billion).

Concerning external debt, the BRL 13 billion difference can be attributed to the redemption of securities throughout the year, through a liability management operation, the early redemption program, and the first make-whole call, as detailed in the following section. Other expenses had an impact of R $ 17.3 billion, mostly attributed to social security spending.

Chart 5. National Treasury Borrowing Requirements



(*) Under article 39 of the Fiscal Responsibility Law (Supplementary Law No. 101/2000), the real interest of the Central Bank's portfolio cannot be refinanced by means of payments with STN bonds directly to the BCB.

(**) [Other Expenses] Only expenditure committed, according to art. 34 Law 4320/64, the expenses actually paid reached BRL 117.4 billion, remaining to be paid BRL 13.4 billion.

Source: National Treasury

2.2 Strategy and its accomplishment

Before assessing the results of public debt management, it is necessary to recollect the FPD strategy performance during the year, which is defined by the profile of issuances and redemptions according to bond type (inflation-linked, floating, fixed rate), terms, and the maturities profile. Despite fiscal challenges, debt management benefited from inflation control, interest rates decline, as well as resumption of confidence indeces and economic growth.

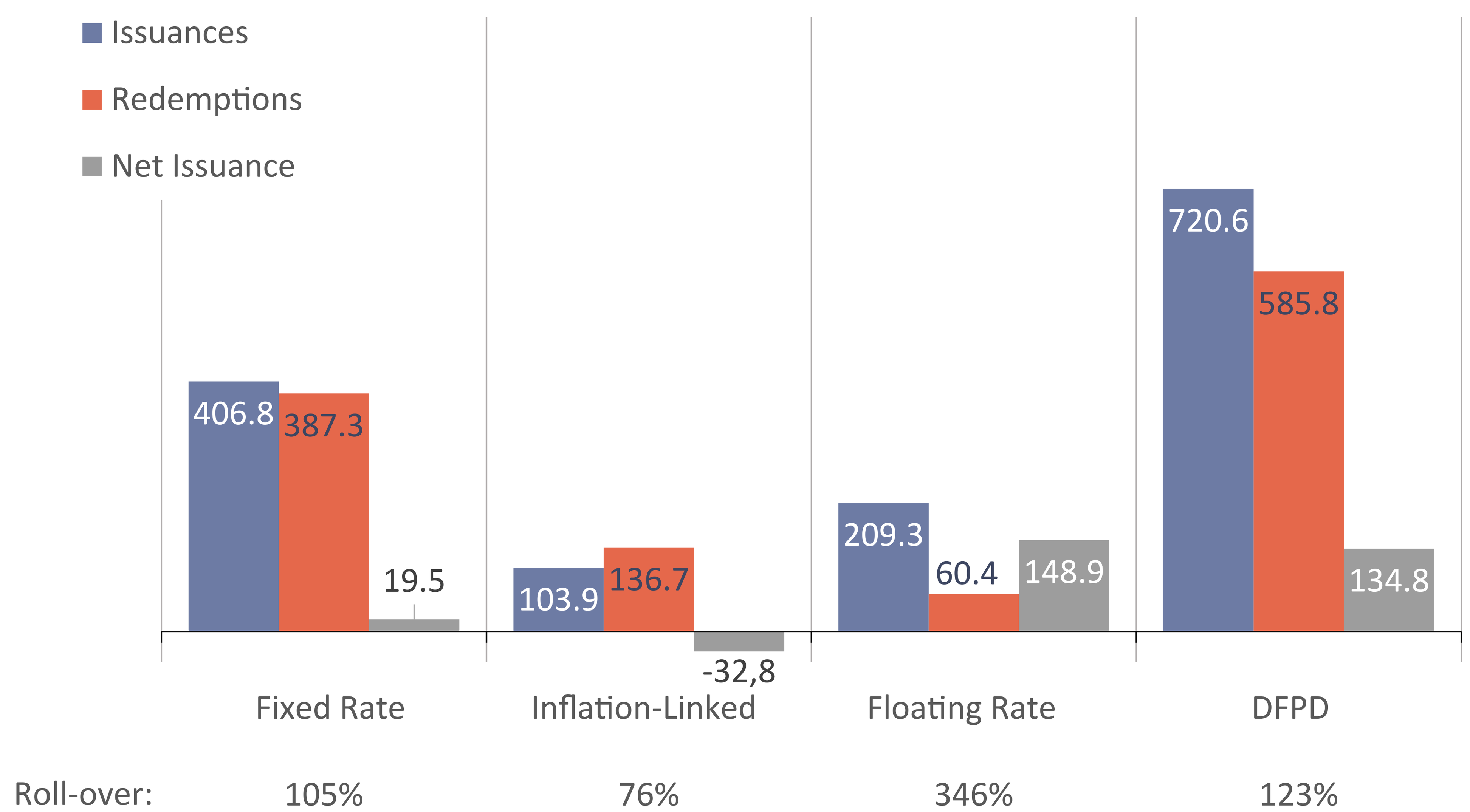
Inflation control and interest rates decline benefited Debt management.

Domestic Debt

In the context of the DFPD, this macroeconomic scenario favored a greater debt rollover, of 123%, as shown in Chart 6. Issuance superior to redemptions in the year allowed reinforcing the liquidity reserve (liquidity cushion) as well as contributed to the guideline to reduce market excess liquidity. DFPD rollover was achieved largely by a higher issuance of fixed-rate and floating-rate bonds, greater investor base, and redemptions profile diversification. On the other hand, there was a lower demand for inflation-linked bonds, which became less attractive in the context of inflation control.

The net issuance of fixed-rate bonds is considered favorable, as it took the share of these bonds close to the upper limit defined in the ABP 2017. Greater demand from pension funds favored good placements of this bond. As shown by debt indicators, detailed in the following section, the strategy adopted in 2017 proved to be effective in taking advantage of the sharp fall of the issuance cost without affecting risk indicators in the same proportion.

Chart 6. Net Issuance (BRL bn) and Debt Rollover Rate – Comparative by index of DFPD



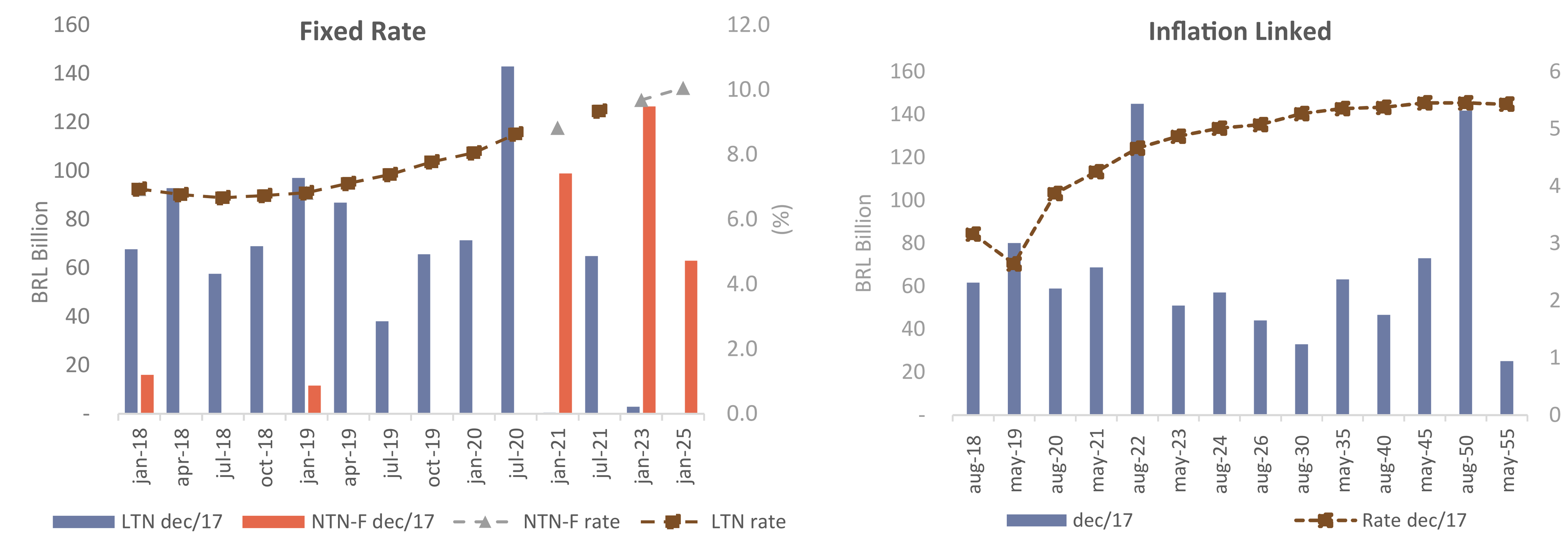
Source: National Treasury

The fixed rate bonds yield curve was built by the primary offering of four LTN benchmarks: six, twelve, twenty four, and forty eight months, which represent the short- and medium-term fixed-rate benchmarks. The long-term benchmarks, between six and ten years, were represented by two NTN-F benchmarks: January 2023 and January 2027. Rollover rate (ratio between issuances and redemptions) for these bonds was of 105%, well above that of 2016, which was 79%.

Regarding inflation-linked bonds, NTN-B issuances followed a fortnightly basis offer strategy, in two benchmark groups, defined according to the bonds' maturities. Group I NTN-B benchmarks maturities were August 2022 and August 2026, while Group II maturities were May 2035 and May 2055. Compared to 2016, only the shortest-term benchmark was changed, which used to be due May 2021. The other three benchmarks remained the same as the previous year.

In December 2017, outstanding fixed-rate and inflation-linked bonds and their yield curves were as represented in Chart 7:

Chart 7. Outstanding Debt and Yields of Fixed-Rate and Inflation-Linked Bonds



Source: National Treasury and Anbima.

The low volume of LFT redemptions in 2017 contributed to enlarge the share of floating-rate bonds in FPD profile, which reduced debt costs, considering short-term interests decline in the year. LFTs were issued fortnightly with benchmarks of March and September 2023. Thus, the average maturity of these bonds was close to six years, remaining at a level higher than of outstanding FPD average maturity.

Additionally, to traditional public bond offerings, the National Treasury also held quarterly early redemption auctions for NTN-B maturing between 2035 and 2055 and NTN-F maturing in 2025 and 2027. Market participants showed low interest in these auctions, demonstrating the good depth of the secondary market for these bonds. NTN-B exchange auctions' frequency was reduced from monthly (as in previous years) to quarterly, aiming to foster secondary market negotiations. The purpose of exchange auctions is to replace shorter-term bonds with longer-term one, which favors debt maturity profile.

The strategy execution presented good results from the cost and risk perspectives

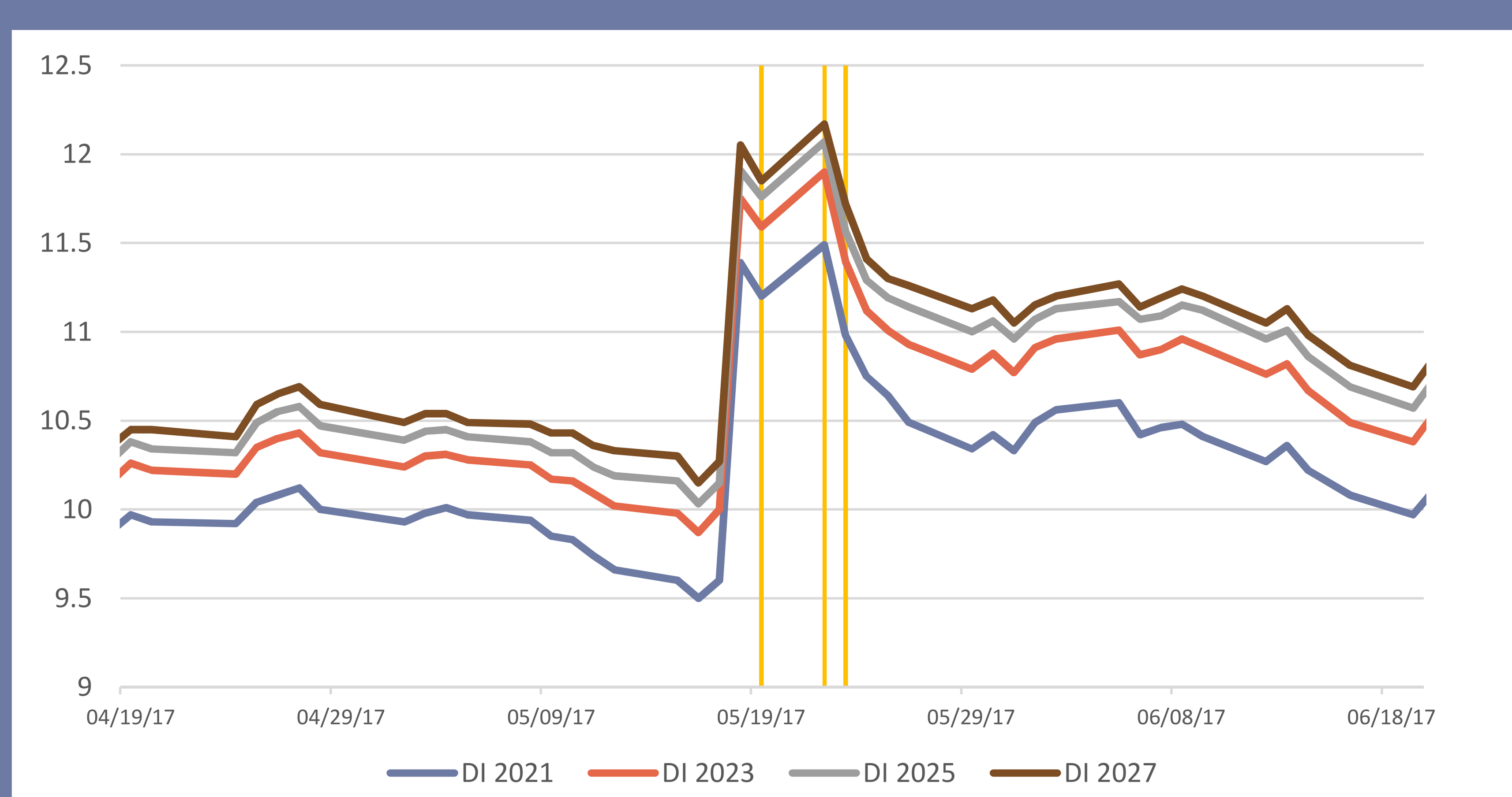
Box 1. Non-scheduled Auctions

The National Treasury constantly monitors market conditions, seeking to ensure proper functioning of the public bonds market and other related financial markets. Proper functioning conditions are characterized by an efficient public bonds yield curve with well-defined and liquid benchmarks. During high volatility periods in the financial market, the National Treasury is backed by the Annual Financing Plan to conduct non-scheduled auctions, which involves changes in the auctions schedule, to provide support for the proper functioning of public bonds market. The National Treasury exercised this strategy in the context of the political turmoil scenario in 2017.

The National Treasury intervened a few times in the auctions schedule during May 2017, revoking LTN and LFT auctions scheduled for May 18 and LTN and NTN-F auctions planned for May 25, in addition to conducting non-scheduled auctions for repurchase and issuance of LTN, NTN-F, and NTN-B on May 19, 22, and 23. There was a net redemption of approximately BRL 2.1 billion. The impact of the interventions in each bond can be checked here.

The following chart shows the behavior of the rates of some domestic bonds offered in operations, with emphasis on the impact of the action of the National Treasury. The vertical lines represent the days of execution of non-scheduled auctions. The National Treasury does not seek to change the bond prices trends but to avoid sharp short-term fluctuations that may hinder good performance securities markets and other related markets.

Chart 8. Impact of Non-scheduled Auctions on the Yield Curve



Source: National Treasury

External Debt Management

The sharp reduction in risk premium, as measured by the CDS, reflects the improvement in investors' perception of the country

In 2017, the National Treasury followed the policy of improving the external yield curve, seeking to mitigate refinancing risks, as well as providing more appropriate price references through qualitative issuances and the early redemption of securities. In this sense, two operations were carried out in the international markets, in a context of positive external environment for issuers of emerging markets, with high international liquidity, and an improvement in investors' feeling in relation to Brazil, reflected in the trend observed in the Credit Default Swap throughout the year (Chart 9).

Chart 9. Brazil 5-year CDS rate

Source: Bloomberg

In early March, aiming to promote greater liquidity, the 10-year benchmark bond, called Global 2026 bonus, was reopened, and it amounted to USD 1.0 billion. The bond was issued at a yield rate of 5.00% per year for investors and 112.5 basis points lower than the original placement. The issuance was carried out with a spread of 248.4 basis points above the US Treasury bond for the same maturity.

See here more details on the reopening of the Global 2026:

The second external issuance took place on October 3, as a liability management operation, when some bonds with shorter terms or interest coupons considered high, with maturities up to 2030, were withdrawn from the market.

The Global 2028 is issued as a liability management operation

Check out the details of the liability management operation here:

The operation consisted of the issuance of a new 10-year benchmark bond of the yield curve in dollars, called Global 2028 with a more attractive rate to the Republic (4.675% per annum), amounting to USD 3.0 billion and with a spread of 235 basis points above the US Treasury bond. Of the total issued, USD 1.16 billion was used for the preferred repurchase, in which the investor has priority in the repurchase by indicating interest in the new Global 2028 and USD 420 million for the non-preferential repurchase. The operation final net proceeds were used to pay part of the Global 2019 Call Option (make-whole-call) with interest coupons of 5.875% per year, as detailed in the Early Redemption section.

The two issuance operations totaled BRL 12.9 billion. However, due to their maturities and early redemptions, EFPD presented net redemption of BRL 15.8 billion in 2017.

External Debt Bonds Early Redemption

For the constant improvement of the external yield curve, the National Treasury removes less efficient securities from the market, with less liquidity and repurchase prices attractive to the Republic. The repurchase of securities that no longer adequately represent the country's credit minimizes possible distortions in the yield curve and increases its efficiency, benefiting the funding of Brazilian companies in the long term, which now have more appropriate price references. In this sense, as for the Buyback Program for external debt, which began January 2006, USD 502.25 million in face value of dollar-denominated securities were redeemed. This value was equivalent to USD 578.79 million in financial value.

Additionally, on November 14, the National Treasury exercised the Global 2019 Call option, with interest coupon of 5.875% per year, which fully withdrew the dollar-denominated bond from the market. Issued in January 2009, the bond was one of the first to have the option called Make-Whole Call.

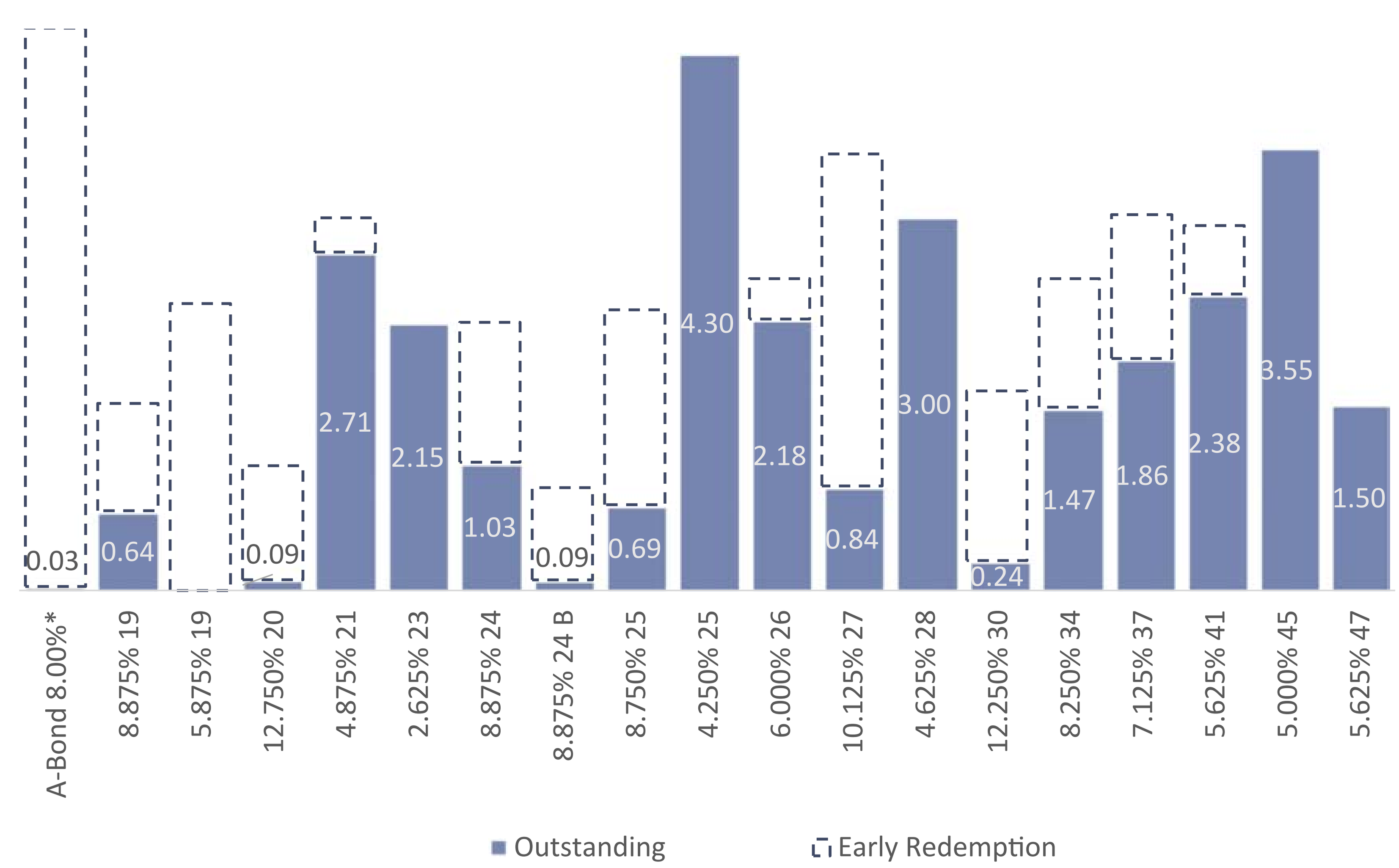
Check out the following resource to understand Make-Whole-Call

This was the first time that the mechanism called Make-Whole-Call was used by the Republic, a decision that depends on the economic benefits for the country. The financial value of the operation amounted to approximately USD 1.8 billion, of which USD 33.2 million related to accrued interest, thus significantly reducing the short-term maturities of the EFPD, which minimizes the financing risk.

The Republic used for the first time the mechanism called Make-Whole Call.

Finally, Chart 10 summarizes the National Treasury performance in its dollar yield curve, reflecting not only the issuances of securities, but also the repurchases, both within the Buyback Program, as well as in the scope of liability management operations and exercise of call options.

Chart 10. Result of the National Treasury Performance in the Dollar Yield Curve – In USD Billion



Source: National Treasury.
Note: The redemptions include the buyback program, liability management and exercise of call options.
(*) In the case of A-Bond, repayments are also taken into account.

The complete history of the issuance made in the external market can be accessed here:

2.3 **FPD statistics and risk management**

FPD statistics in 2017 showed adherence to the reference limits defined in the ABP, as presented in Table 1.

Table 1. Main Results for the Federal Public Debt

INDICATORS	DEC/2016	DEC/2017	LIMITS FOR 2017	
			MINIMUM	MAXIMUM
Outstanding (BRL billion)				
FPD	3,112.9	3,559.3	3,450.00	3,650.00
Composition(%)				
Fixed Rate	35.7	35.3	32.0	36.0
Inflation Linked	31.8	29.6	29.0	33.0
Floating Rate	28.2	31.5	29.0	33.0
Exchange Rate	4.2	3.6	3.0	7.0
Maturity Profile				
% Matiruing in 12 months	16.8	16.9	16.0	19.0
Average Maturity (years)	4.5	4.3	4.2	4.4

Source: National Treasury

Outstanding FPD

The outstanding FPD ended 2017 at BRL 3,539.3 billion, within the ABP limits. The growth relative to the previous year was 14.3%, in nominal terms, surpassing the 2016 growth (11.5%). The growth can be justified by net issuance of BRL 118.2 billion and by interest appropriation of BRL 328.1 billion, as shown in Table 2. Redemptions include BNDES bonds' early settlement with an impact on outstanding debt, as detailed in Box 2.

Table 2. FPD Fluctuation Factors – BRL Billion

INDICATORS	OUTSTANDING		CHANGE	CHANGE DRIVERS			
				ISSUANCES	REDEMPTIONS	NET ISSUANCES	ACCRUED INTEREST
	2016	2017	(a+b+c)	(a)	(b)	(a-b)	(c)
FPD	3,112.9	3,559.3	446.3	736.5	-618.3	118.2	328.1
DFPD	2,986.4	3,435.5	449.1	720.6	-586.6*	134.0	315.1
EFPD	126.5	123.8	-2.7	15.9	-31.7	-15.8	13.0

(*) Includes the portfolio transfer between the market and the central bank in the amount of BRL 818.1 million, as explained in table 2.9 of the MDR.
Source: National Treasury

Box 2. BNDES prepayment to the National Treasury

In 2017, new early settlements of loans granted between 2008 and 2014 by the National Treasury to the Brazilian Development Bank (BNDES, acronym in Portuguese) were negotiated. The parties agreed to an early settlement of BRL 50 billion in two installments. The first part was executed on September 28 and totaled BRL 33 billion, of which BRL 17.9 billion in cash and BRL 15.1 billion in securities. The payment of the remaining BRL 17 billion occurred on October 27, fully in cash. The total amount of BRL 50 billion represented 10.8% of the BRL 462.5 billion of BNDES' liabilities towards STN, in October 31, 2017 values.

Both the proceeds received in cash and obtained by the redemption of prepaid bonds were destined exclusively to public debt payment. In addition, in 2017, the proceeds from the 2016 prepayment of BRL 100 billion were also used for debt relief. The table below summarizes FPD payments in 2017 provided with BNDES prepayment proceeds.

Table 3. BNDES prepayment proceeds

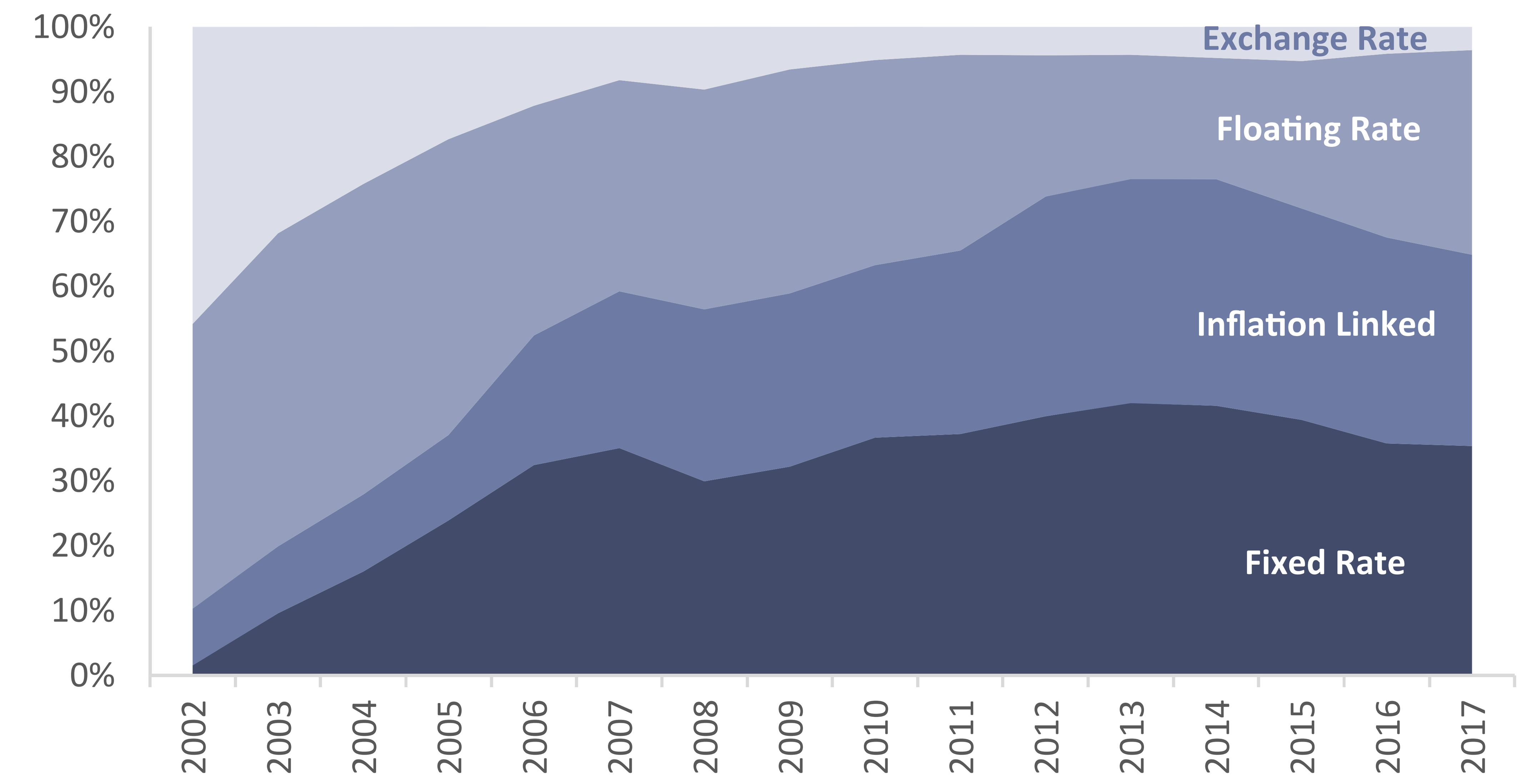
Prepayment Date	Prepayment (BRL Billion)	Date of DFPD Deduction	Value Used for Deduction (BRL Billion)
23/12/2016	100.0	03/07/2017 08/09/2017 02/10/2017	61.6 28.3 10.2
28/09/2017	33.0	02/10/2017	33.0
27/10/2017	17.0	16/11/2017	10.4*

(*) The total repayment on 11/16/2017 was less than the amount received from BNDES on 10/27/2017 due to the non-maturity of public debt securities in the period of November and December 2017 sufficient for the full use of the funds received. The difference will be used for the deduction of the DFPD in 2018.

The prepayments in bonds reduce FPD directly through bonds cancellation. Prepayments in cash imply a reduction in financial system surplus liquidity, consequently reducing Central Bank repos, once the cash enters National Treasury Single Account. In both cases, the GGGD decreases by the exact amount of the operations.

Regarding Public Sector Net Debt (PSND), these operations do not have an immediate effect, since there is a proportional offset between assets and liabilities' positions of the public institutions involved. However, the prospected PSND path will benefit from savings with implicit subsidies. These subsidies arise from the difference between the cost of STN funding and rates offered by BNDES loans to its clients. It is estimated that the total prepayment (BRL 150 billion) will save subsidies of about BRL 39.7 billion in present value.

Chart 11. FPD profile by bond type



Source: National Treasury; position in December, 31 of 2017.

FPD Profile

Regarding FPD profile, the share of floating bonds rose by 3.3 percentage points from the end of 2017, from 28.2% to 31.5%. This growth represents a slowdown compared to 2016, when the share of these bonds rose 5.5 p.p. In 2017, the increase in the proportion of floating-rate bonds was offset by the fall in the share of inflation-linked securities (from 31.8% to 29.6%), fixed-rate bonds (from 35.7% to 35.3%), and exchange-rate-linked debt (from 4.2% to 3.6%).

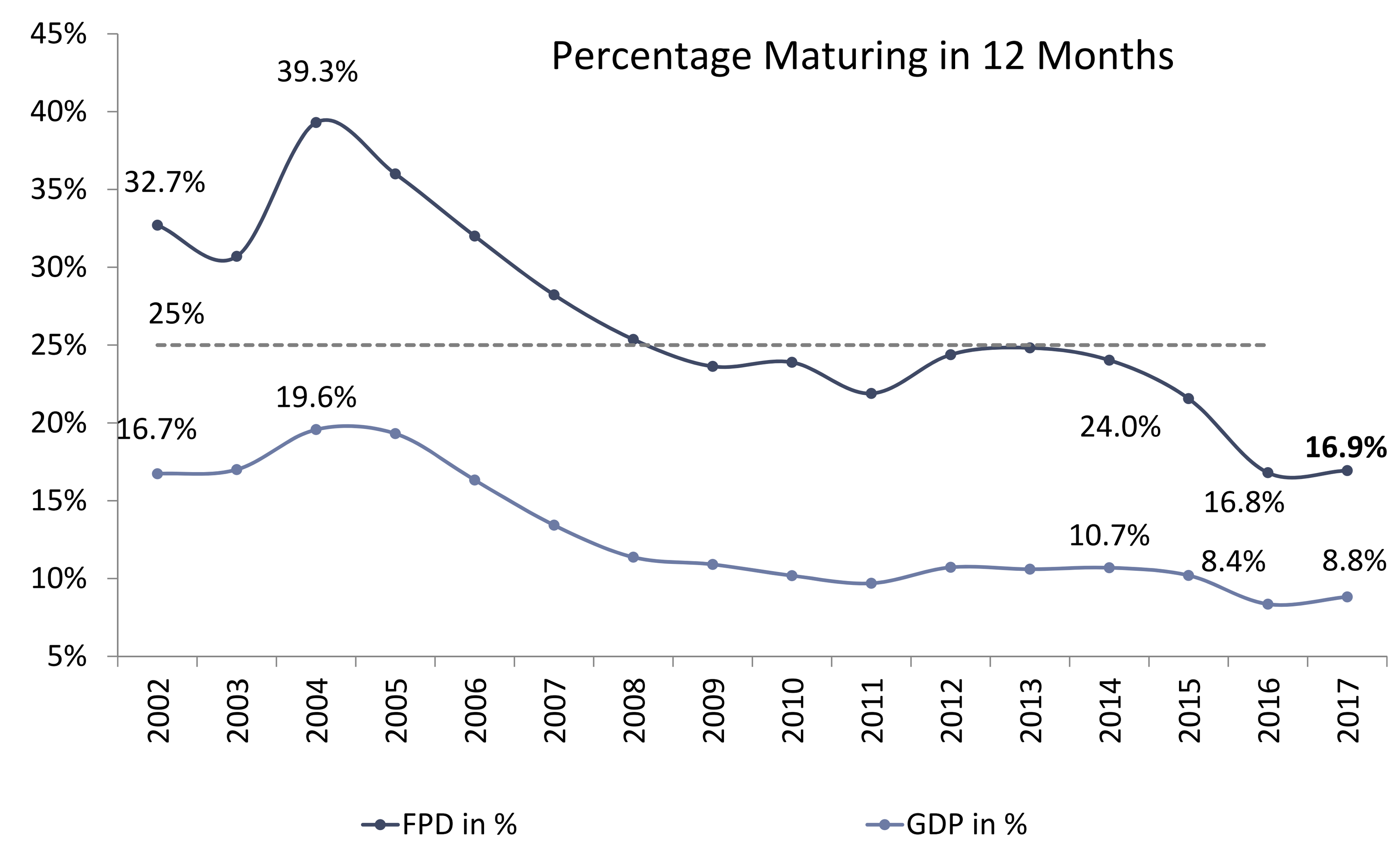
Although at a slower pace than in 2016, the share of floating-rate bonds increased in the FPD profile

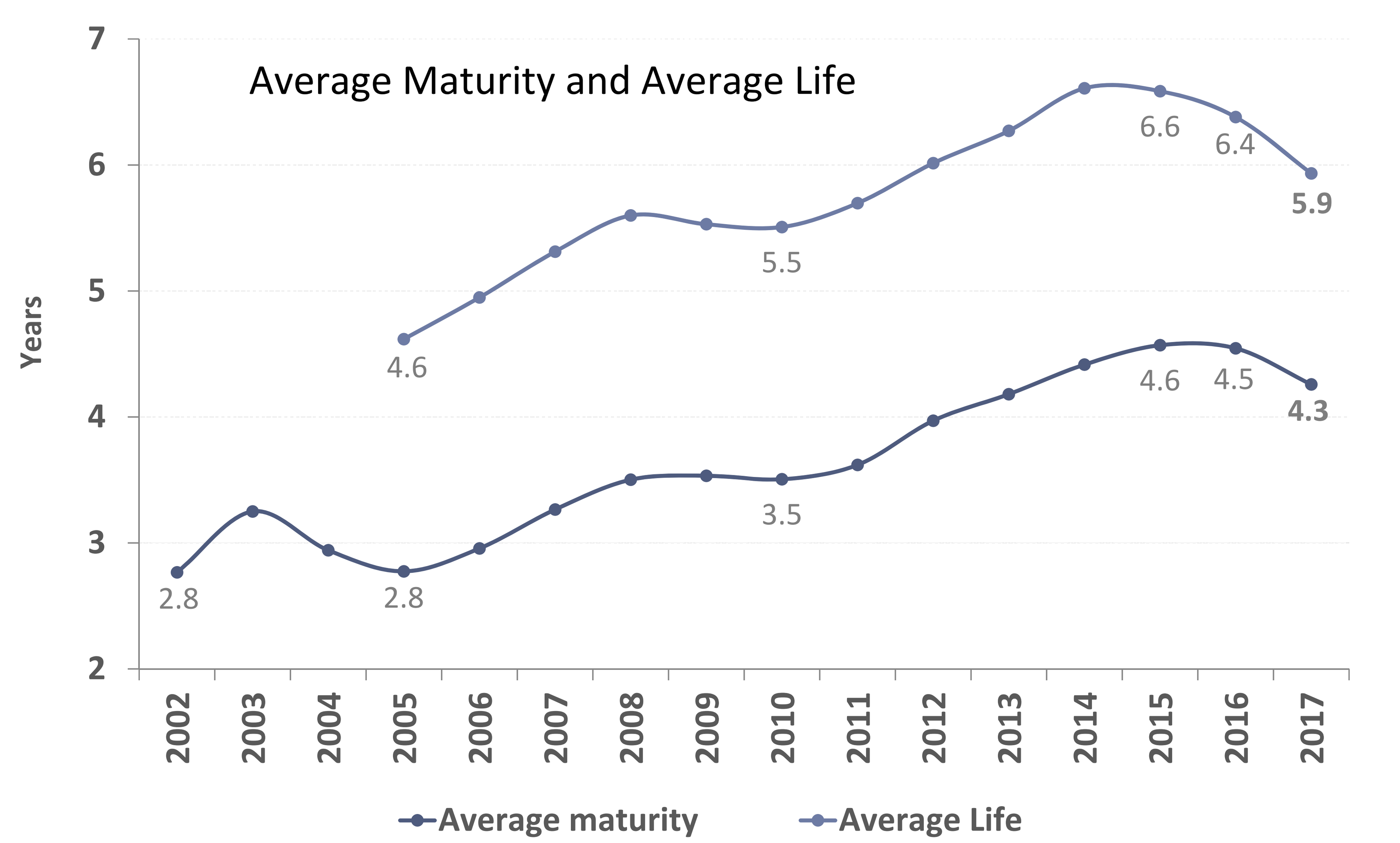
The current economic environment challenges the public debt management with a growing outstanding FPD volume, which may lead to a temporary deviation from the debt path convergence to FPD guidelines. The increase in floating rate bonds' share results mainly from the strategy of rollover of at least 100% of the FPD in a period when there are low maturities of floating-rate bonds. Despite these changes in the FPD profile, the National Treasury maintains its long-term guideline of replacing gradually floating-rate bonds with fixed-rate or inflation-linked.

Maturity Structure and Rollover Risk

The main statistics used to monitor FPD maturity structure performance are a share of debt maturing in twelve months and average maturity. The first shows the share of debt that will mature in the short term, while the latter captures the average time remaining before debt payments, weighted by the present value of principal and interest flows.

Chart 12. FPD Maturity Structure





Source: National Treasury

The aforementioned changes in FPD profile influence these statistics. The average maturity decline, for example, reflects the lower share of inflation-linked bonds, which are predominantly long-term instruments. The share of securities maturing in 12 months is close to its historical low, favored by STN strategy to reduce very short-term (up to one year) securities issuances.

The share of securities maturing in 12 months at historically low levels and liquidity reserve indicate low rollover risk

Although showing a slight reversal in 2017, these statistics remain close to their historical records, indicating that rollover risk is well managed. In addition, the National Treasury maintains a reserve liquidity in domestic and foreign currency, also referred as "liquidity cushion" to foresee periods of higher maturities concentration, following the policy of maintaining this reserve in an amount equivalent to at least three months of outstanding FPD service. The cushion guarantees the National Treasury conditions to continue operating amidst adverse circumstances without the need to raise funds to roll over the FPD for a period corresponding to the one allowed by the cushion, without adding pressure to the debt cost.

Cost of Public Debt

Debt average cost reached the lowest level in seven years

The monetary policy easing had an impact on the debt cost, which maintained a downward path in 2017, as can be seen in Chart 13. During the year, the 12-month accumulated debt average cost fell by 1.73 percentage points and reached in November the lowest value in the last seven years. The average debt cost was below the Selic rate throughout the year, even at times of higher volatility. This effect is explained by the rapid decline of inflation, with an immediate impact on the inflation-linked bonds, while Selic follows the regular COPOM meetings.

With an even steeper decline, the average issuance cost, which measures market access conditions in the last twelve months, decreased by 4.03 percentage points, closing the year at 9.69%. This drop is also observed at the individual type of bond level, especially the cost of inflation-linked securities, which reached a historic low of 8.34% p.a. in September.

Chart 13. Cost of Debt Performance (accrued in 12 months)

Source: National Treasury

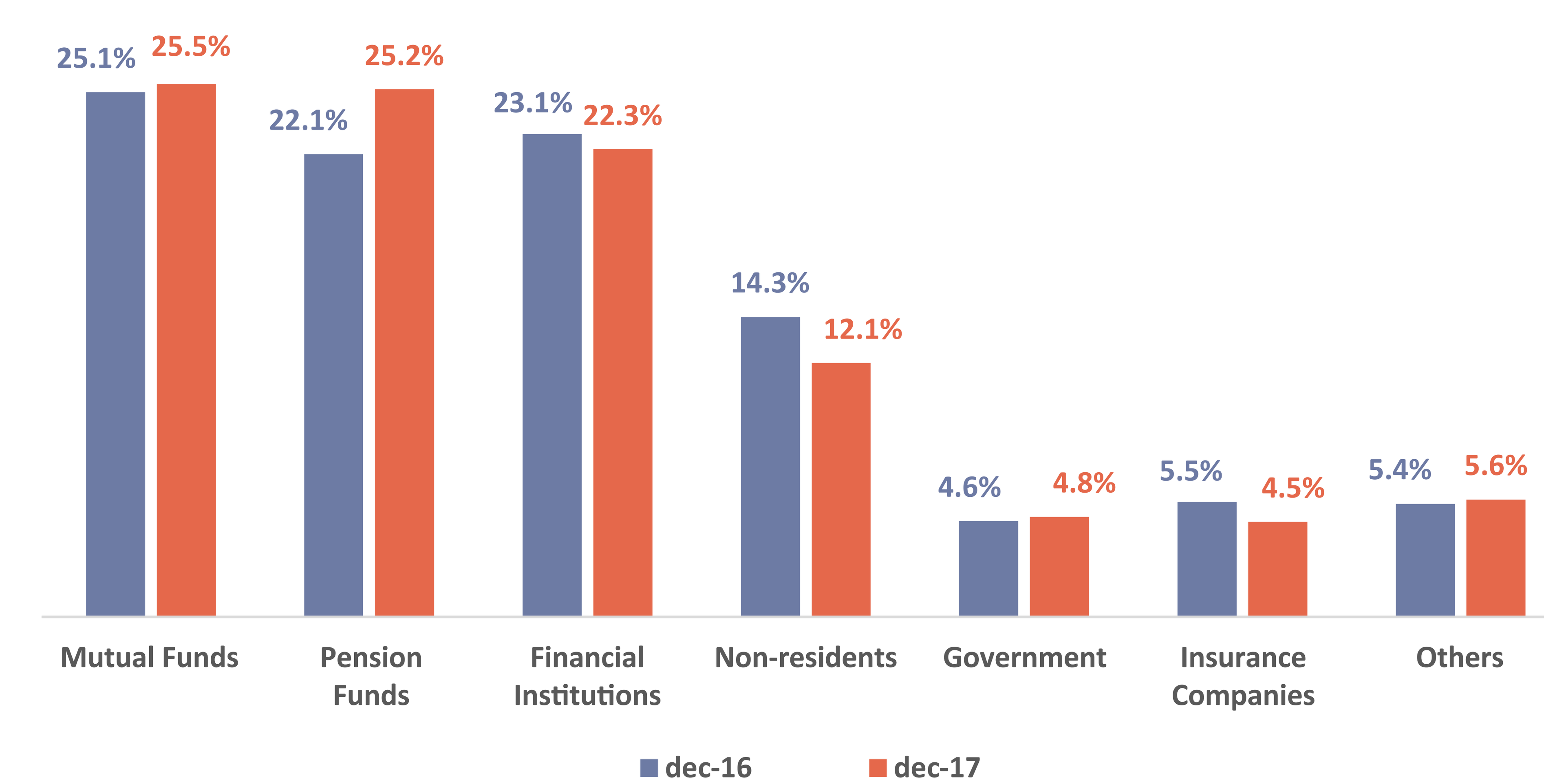
2.4 **Investors Base**

Among the guidelines that drive the development of the strategies of FPD financing is the expansion of the bondholder base. The existence of investors with different risk profiles and investment horizons contribute to efficiently manage the FPD, minimizing possible effects of the behavior of a particular group of bondholders on the prices and rates of government securities, increasing liquidity and avoiding excessive volatility. The diversity of the investor base, especially in the financing of domestic debt, has been a contributing factor to risk mitigation of Brazil's public debt.

The dynamics of the bondholder base have shown positive results, with a more steady and diversified base. In 2017, there was an increase in the share of both pension and investment funds and a relative position loss of financial institutions and non-residents. This movement points toward a more steady and diversified base. As shown in Chart 14, the pension funds group kept the leadership in 2017, with a slight increase of its share (0.4 percentage points), closing the year with 25.5% total share. Investment funds increased its relative share by 3.1 percentage points and became the second main FPD holder in 2017, with a total share of 25.2%

The DFPD bondholder base is diversified, with the largest holdings in investment and pension funds

Chart 14. DFPD Bondholder Base Evolution

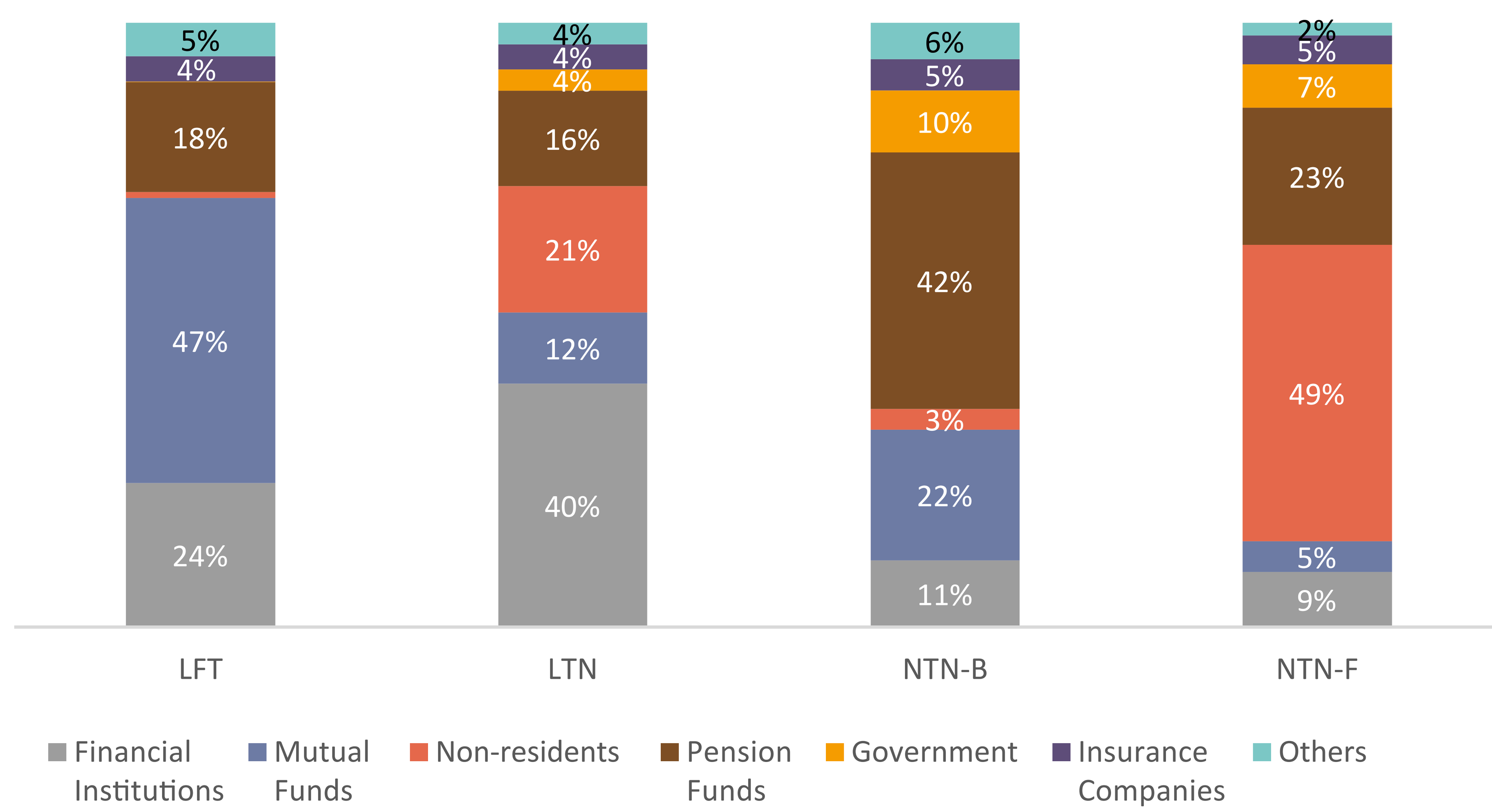


Source: National Treasury and Selic

The financial institutions' group, despite having reduced its relative share by 0.8 percentage points, increased its position by BRL 78.29 billion. Non-residents group, on its turn, reduced its share by 2.2 percentage points and reduced its position by BRL 11.5 billion, ending the year of 2017 at BRL 416.3 billion.

As shown in Chart 15, despite reducing their position, non-residents have stood out as the largest investors in long-term fixed-rate securities, NTN-Fs. Investment funds, however, remain with their preference for floating rate securities, LFTs.

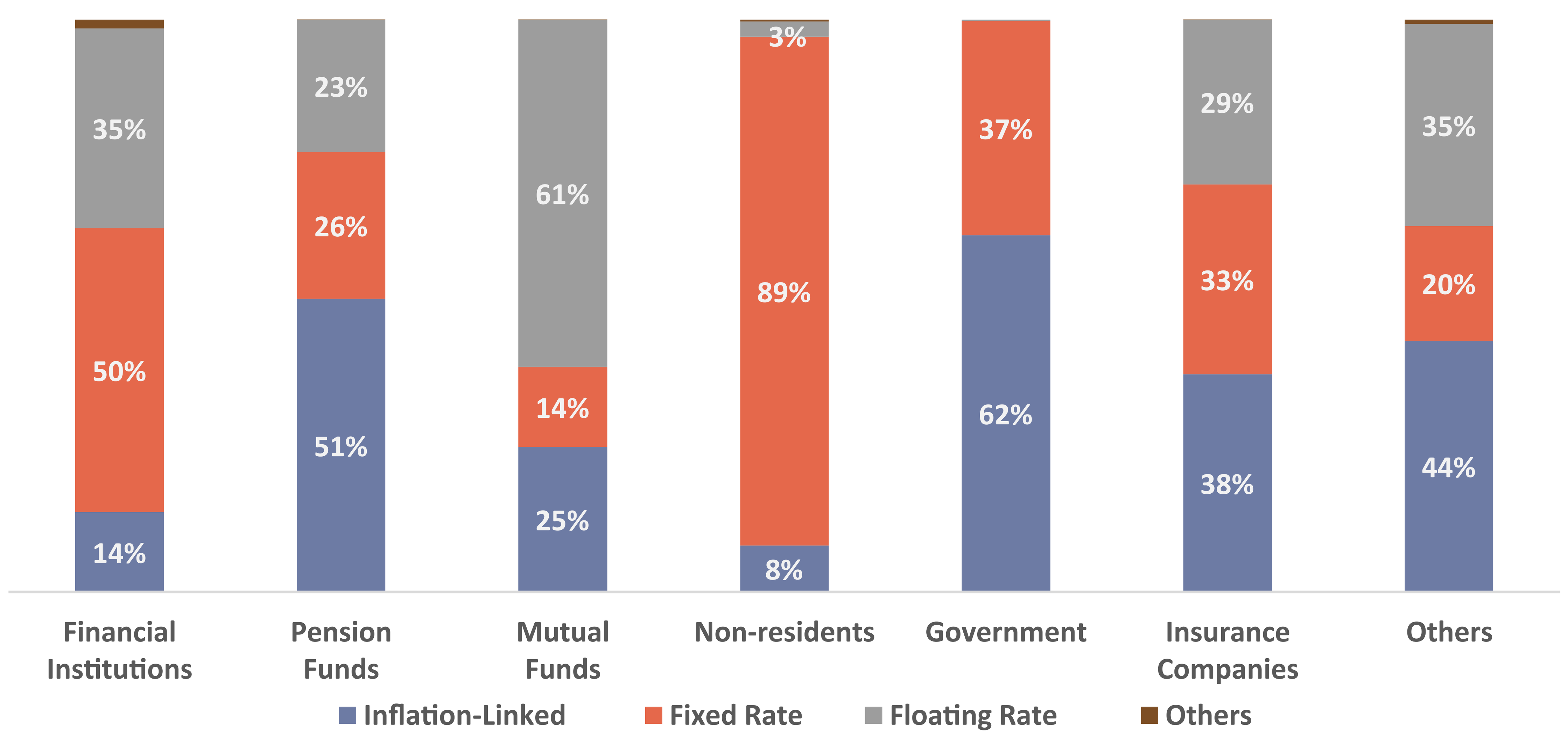
Chart 15. Distribution of Bondholder by Securities Type



Source: National Treasury and Selic

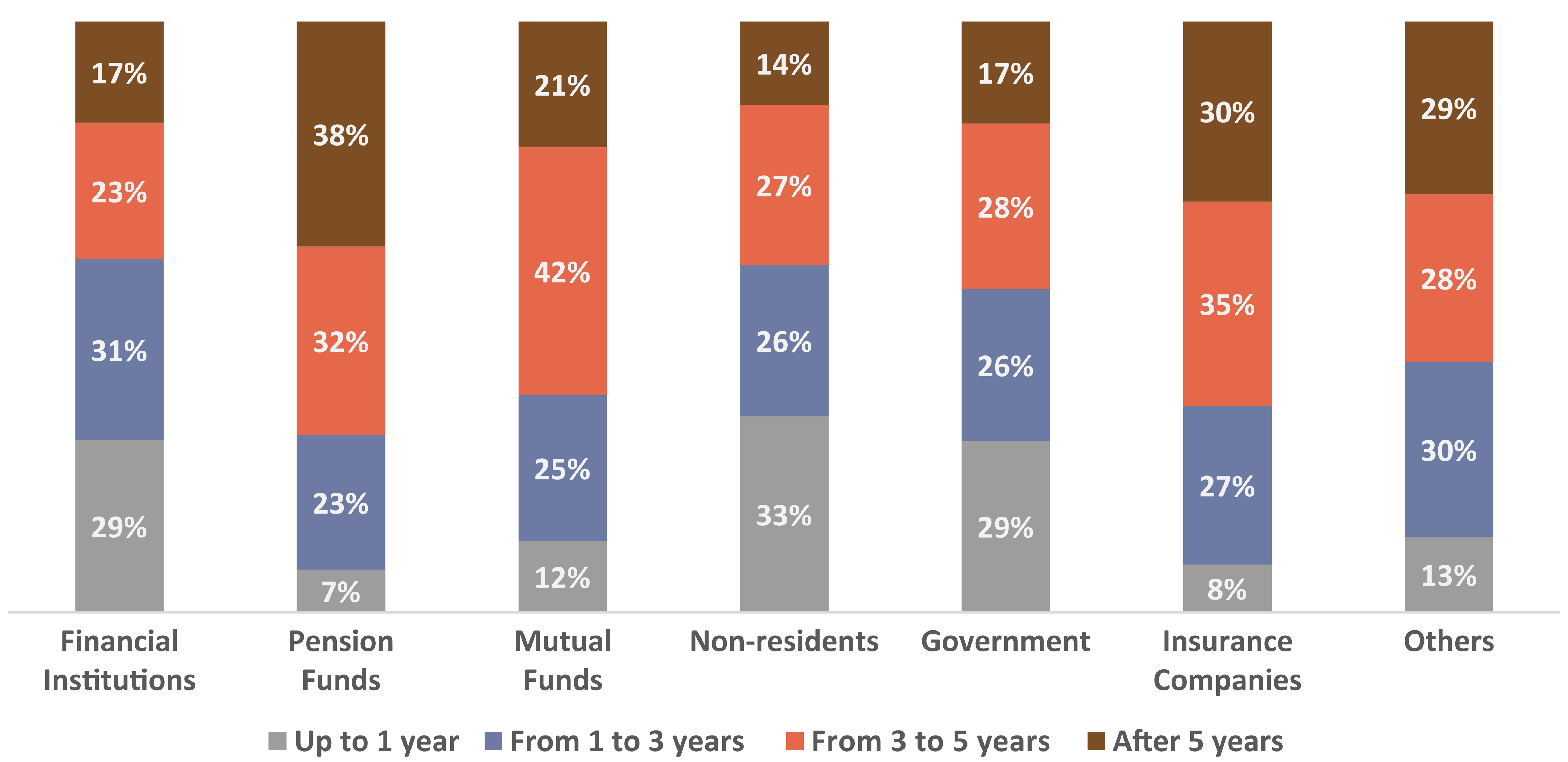
The portfolio composition and public debt tranches distributed by term of the main groups of holders are shown in Charts 16 and 17 below. The pension funds' group continues to maintain a high share of bonds with maturity over five years, which is in line with its preference for inflation-linked and longer-term bonds.

Chart 16. Distribution of Securities Type by Bondholder



Source: National Treasury and Selic

Chart 17. Distribution of Maturity Terms by Bondholder



Source: National Treasury and Selic

2.5 **Guarantees Granted by the Federal Government**

By grating loan guarantees, the National Treasury contributes to reduce borrower's credit risk by making it possible to raise credit at lower costs than it is in the absence of such guarantees. Among the beneficiaries of the guarantees are sub-national entities, state-controlled entities, funds, banks, and state-owned enterprises. Among the creditors of these guaranteed credit operations, multilateral organizations and federal banks are the highlights.

The federal government paid guarantees amounting to BRL 4.06 billion in 2017

The guarantees granted by the federal government for credit and operations have gained importance in the context of public debt control, especially in light of the growing balance of guaranteed debt and recurrent payment by the federal government of liabilities incurred by regional governments. In 2017, the federal government paid a total of BRL 4.1 billion in liabilities, incurred by states and municipalities, representing a growth of 70.8% compared to 2016 (BRL 2.4 billion). The payments related state of Rio de Janeiro defaults amounted to BRL 4.0 billion of the total paid by the federal government.

The outstanding balance of credit operations guarantees granted by the National Treasury amounted to BRL 233.4 billion in 2017. Domestic guarantees' balance totaled BRL 111.50 billion in credit operations. External guarantees balance reached BRL 121.9 billion.

Complementary Law No. 101 of 2000 (Fiscal Responsibility Law – LRF) establishes that the total outstanding balance of obligations guaranteed by the federal government may not exceed the limit established by the Senate, i.e. the amount defined in Resolution No. 48/2007, equivalent to 60% of Current Net Revenue (CNR). The total balance of guarantees by the federal government is also taken into account in calculating the established limit. As of December 31, 2017, the balance of guarantees, including funds was BRL 301.0 billion representing 41.4% of CNR.

Throughout 2017, the state of Rio de Janeiro ratified its entry into the fiscal recovery regime, established by Complementary Law Nº 159/2017. Because of that, the Federal Government is not allowed to execute a counter-guarantee provided by the credit operations contracts of the state of Rio de Janeiro during the term of the regime. The amount of defaulted tranches by the state of Rio de Janeiro will be recovered in accordance with the provisions of article 17 of the aforementioned law.

Finally, in November 2017, the Ministry of Finance Administrative Decree nº 501/2017 was published, whose article 13 prohibits the concession of guarantees from the federal government for new financing contracts to regional governments that have incurred in need to guarantee in the last twelve months or have incurred three delays in the last twenty four months. These restrictions are removed after complying for twelve months in the case of honor of guarantee and six months in the case of delays. These penalties were established to discourage default by entities guaranteed by the federal government.

Ministry of Finance Administrative Decree nº 501, of 2017, prohibits the federal government to grant guarantees to loans of regional governments in default.

Colheita de trigo, PR

3 Innovation and Topics in Development

3.1 **Relationship between the National Treasury and the Central Bank**

The National Congress is discussing Bill No. 9,283 of 2017, which represents an important improvement in the relationship between the National Treasury Secretariat and the Central Bank of Brazil (BCB), aligning the Brazilian institutional structure with the best international practices regarding management of monetary, fiscal, and debt management policies.

International reserves accumulation, especially after 2006, contributed to strengthen the Brazilian economy. However, the greater volume of foreign currency assets in the BCB brought volatility to the institution's balance sheet results. In times of exchange rate devaluation, BCB has high positive results, the opposite occurring in moments of exchange rate appreciation. It is in this context that an update of the regulation is necessary because the current institutional framework provides for the transfer of Central Bank's positive result to the Treasury in cash or, otherwise, the coverage of the negative result through public bonds' issuance by the Treasury.

The changes proposed by Bill No. 9,283/17 are intended to reduce the frequency and magnitude of the transfer flows between the two institutions, since the positive exchange results will constitute a reserve in the balance sheet of the BCB when it registers a positive result with foreign exchange operations. This reserve will be used later to cover any negative results. If the reserve is depleted and there are still negative results to be covered, this will be done by reducing the BCB's net equity until it reaches 1.5% of the bank's assets. If there is still a negative result to be covered, National Treasury will issue securities in favor of BCB.

As a consequence of this new legal framework, there will be lower payments exchange between TN and BCB, and a more transparent coverage system of negative BCB results, reflecting less pressure on public indebtedness.

In addition to updating the rules governing BCB balance, Bill 9,283/17 contributes to the improvement of inflation control management.

The BCB has a portfolio of public securities under the responsibility of the National Treasury that is used as a collateral in open market operations, also known as repo operations. The purpose of these operations is to manage economy liquidity and thus keep inflation under control. The current system of guaranteeing a minimum amount of these securities is regulated by the Ministry of Finance, through Ordinance MF Nº 241/2009, which requires TN to issue securities in favor of BCB, with no financial contribution, whenever BCB non-earmarked portfolio reaches less than BRL 20 billion.

In this regard, Bill No. 9,283/17 strengthens the institutional framework to ensure that BCB has the necessary instruments for an efficient monetary policy execution, by setting a minimum threshold for the share of available securities for sale (non-earmarked portfolio), below which STN must issue new securities for the bank, with no financial contribution. This measure ensures that the BCB will always have a sufficient amount of bonds for the proper execution of the monetary policy. Under specific conditions, securities issued for this purpose may be canceled in the future.

Bill 9,283/17 also represents an improvement of public debt, by promoting the reduction of the issuance volume of Treasury bonds to BCB. As already mentioned, such reduction will occur due to the creation of a reserve with the positive result of foreign exchange operations, which may be used later to cover eventual BCB negative results. Therefore, BCB's securities portfolio will no longer grow due to balance sheet's negative results coverage. Consequently, the Treasury tends to spend less on BCB's portfolio interest payments in the future.

3.2 **The Golden Rule**

The golden rule is one of the best-known fiscal rules of public finances and, in essence, aims to ensure that public debt is only issued to finance capital spending and not to cover current spending. The rule assumes that current spending should be limited to the current tax collection volume and is intended to ensure fiscal solvency over time and balance between different generations. This prevents the government from postponing for future generations the burden of paying for activities that only benefit current generation.

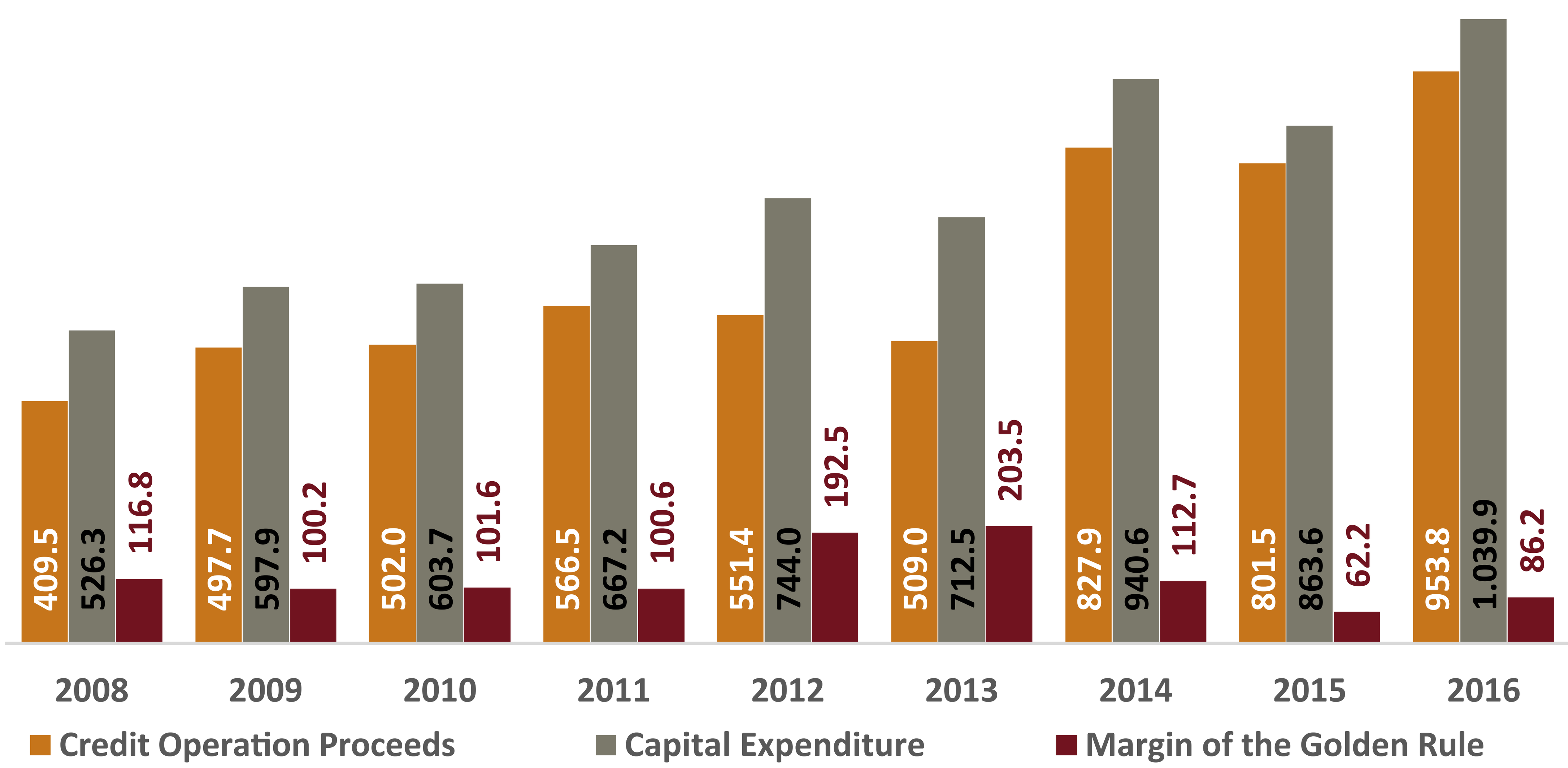
The golden rule is provided in the Brazilian legal framework in the Federal Constitution article 167, which prohibits credit operations from in excess of capital spending , including investments, financial acquisition, and debt payments. The Fiscal Responsibility Law (article 32) establishes that the calculation as determined by the golden rule must be carried out at the end of the fiscal year. Bond issuance proceeds will only be considered during the fiscal year in which they are used to pay expenses, as regulated by Senate Resolution No. 48, of 2007. Senate resolution proves to be fundamental because it brings more flexibility to public debt management, allowing more efficient liquidity and cash management without preventing compliance with the golden rule.

In this sense, the difference between current and capital public spending must be highlighted. Current spending is used to support and maintain the activities of public administration bodies, such as personnel spending, consumer goods purchase, third-party services, equipment maintenance, water, energy, and telephone consumption, among others. A particularly important item of current spending is public debt interests.

Capital spending represents two types of expenditures: (1) investments and financial acquisition (acquisition of equipment, machinery, construction, companies shareholdings acquisition, real estate acquisition, loans to investment), which normally concern capital asset formation and expansion of the public administration body activities; and (2) debt payment, which includes payment of principal and monetary restatement of credit operations performed to cover expenses in the past.

Chart 18 below shows that, historically, the golden rule has been fulfilled by the Federal Government; in other words, the amount of credit operations performed within the management of the federal public debt minus the fluctuation of the Public Debt sub-account of the National Treasury Single Account each year was lower than the capital spending amount.

Chart 18. Evolution of the Golden Rule Limit



Source: National Treasury

As the chart shows, the golden rule is under pressure due to decreases in sources of funds for public debt payments. The country's current fiscal situation urges for an adjustment through current spending cut or revenue increase. If this question is not addressed, the pressure to cut investments or to finance current spending embedded in the budget deficit through debt issuance will be greater. Both measures make it harder to comply with the golden rule.

Golden rule's margin is becoming increasingly narrow, which can be attributed to recurrent negative fiscal balances.

3.3 The Dealers System

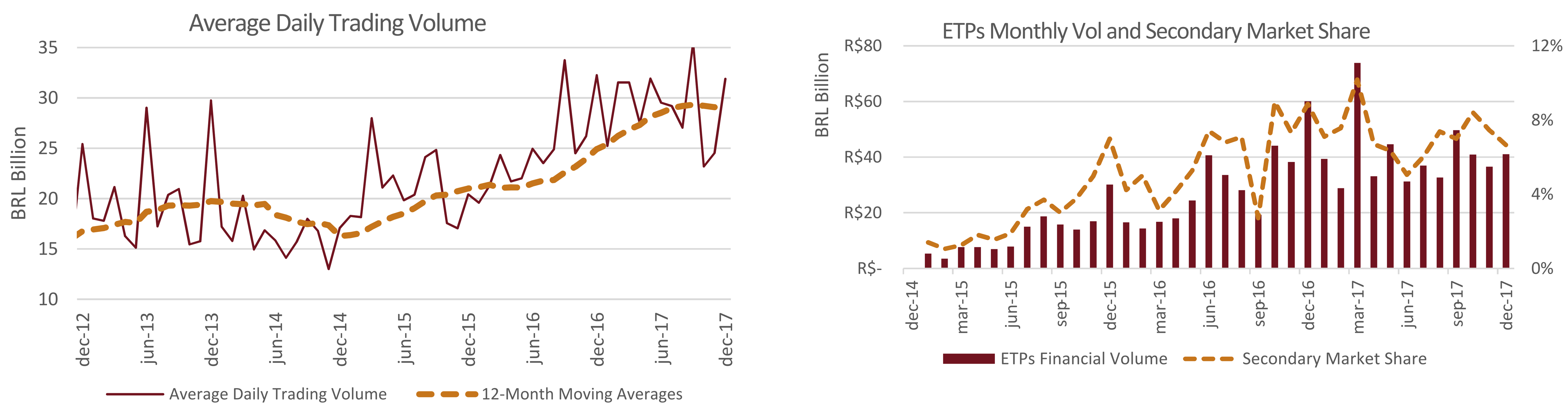
The dealers' system allows the National Treasury to monitor more efficiently the secondary market

The National Treasury accredits financial institutions with the purpose of promoting the development of public bonds primary and secondary markets. Known as "dealers", these institutions operate on primary issuances of public bonds and the public bonds secondary market through distribution and market formation. The dealers' system allows the National Treasury a more efficient monitoring of public bonds' secondary market performance and the unfolding of the industry in which these institutions are inserted. In this context, the dealers' system's rules are regularly improved. The most recent change was STN Ordinance No. 29, dated January 17, 2017, which changed, among other parameters, the distribution of the number of accredited institutions.

Due to recent developments in the banking market concentration and in order to maintain competitiveness within the system, the number of institutions belonging to banking conglomerates has been reduced from ten to nine. In contrast, the number of independent institutions (not belonging to banks) was increased from two to three, since the competitiveness observed in previous periods indicated that the system could include one more institution in this segment. In addition, following the new system profile, adjustments were made in the dealers' set of targets and obligations in the primary and secondary markets to carry out special operations with the National Treasury.

To illustrate the rising trend in the volume traded, since Central Bank and National Treasury dealers' systems were separated, Chart 19 explains the historical series of average daily trading volume in the secondary market in the last five years. This volume, which was approximately R$ 18 billion per day in January 2015, reached R$ 32 billion in December 2017. Through the dealers' system, the National Treasury also seeks to encourage electronic trading platforms (ETPs) for public securities in order to advance liquidity and price transparency. As shown in Chart 19, the progress of this segment has been positive in recent years, increasing from about R$ 5 billion in volume traded in electronic platforms in January 2015 to about R$ 41 billion per month in December 2017.

Chart 19. Secondary Market



Source: National Treasury

3.4 Budget forecast recommendation to bond issuances

The Working Group on Public Debt (GT DIV, acronym in Portuguese), instituted by STN Ordinance No. 38, of January 22, 2016, aimed at evaluating the budgetary, financial, and equity procedures related to the issuance and payment of federal government bonds under the National Treasury responsibility and at proposing possible improvements. The work undertaken promoted a comprehensive review of the processes of federal public bonds' issuance and payment, and an expansion of the dialogue on public debt. GT DIV's main results can be aggregated into three groups: (1) accounting adjustments, in order to better reflect the nature of public issuances and redemption operations; (2) processes improvement to provide efficiency gains; and (3) inclusion of a budget forecast for bonds direct issuance, in order to provide greater transparency and publicity to these operations.

The last set of recommendations, to include budget forecasts for direct issuances, offers particular potential to promote greater control of spending and better accountability of government's activity, in accordance with the budget universality principle. Direct issuances are earmarked for governmental programs and structured operations, such as securitizations and issuances to the monetary authority in order to adjust the balance sheet. Two of these issuances were already included in the 2017–2018 budget process: debt securitization issuances from the Compensation Fund for Salary Fluctuation (FCVS, acronym in Portuguese) and the Program for Stimulating Restructuring and Strengthening Higher Education Institutions (Proies, acronym in Portuguese).

Also it is worth noting that Senate Bill No. 351/2013, which amends the Fiscal Responsibility Law and establishes that all bonds issuances, except issuances of bonds for the Central Bank non-earmarked portfolio, should be part of the Annual Budgetary Law (LOA, acronym in Portuguese), turning concrete GT DIV recommendations into law. This is a legislative innovation that provides fiscal and regulatory security to operations, preventing a public indebtedness increase without a proper budget forecast. This point shows the proactive nature of the GT DIV, since the requirement for budget forecasting for these public bond issuances meets the most recent recommendations of bodies of control, such as the Federal Audit Court (TCU, acronym in Portuguese).

GT DIV recommended, as general rule, budget forecast for debt issuances

3.5 Tesouro Direto Retail Program

To reinforce its role as a promoter of financial education, in September 2017, the National Treasury, in partnership with B3, launched the #TransformationThroughKnowledge campaign. The campaign brought as a novelty the Tesouro Direto Retail Program Financial Planner, a tool that materializes the necessary knowledge so that the investor can buy public bonds with greater autonomy and confidence. Initiated in 2015, the project aims at assisting the investor in choosing the most suitable bond for his/her financial objective, comparing the yield of the suggested bond with the main fixed-income alternatives available in the market: savings, certificates of deposit, interbank deposits, mortgage bills, and agribusiness credit bills. In the context of the campaign, the Treasury also offered to the public, in partnership with the School of Finance Administration (ESAF), eight thousand new vacancies of the free Tesouro Direto Retail Program course.

Tesouro Direto Retail Program launches financial planner and offers eight thousand vacancies on its free course.

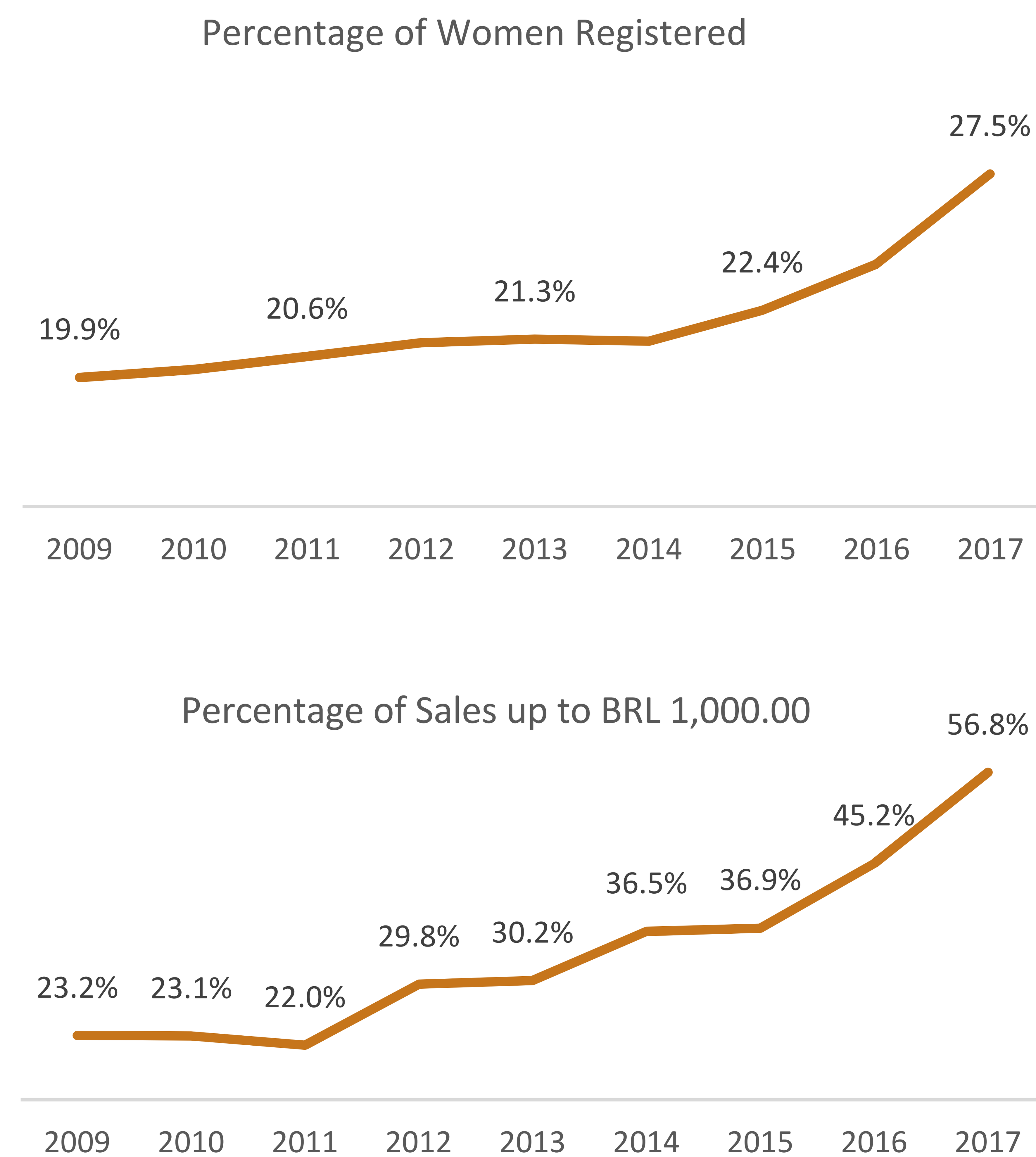
TesouroDireto Simulator

TD Simulator

The various marketing pieces created for the #TransformationThroughKnowledge campaign, including videos, banners, and infographics, were released on all major social media platforms. In addition, for the first time, the TD program team met with the main national promoters of finance-related topics, including bloggers, journalists, experts, and financial institutions' representatives, for a trial of the new tool.

The program democratization growth in 2017 delivers the largest highlight presented by Tesouro Direto Retail Program statistics. In 2017, there was an increase of 164 thousand active investors, those that effectively have investments, totaling 565 thousand active investors. This number represents 40.8% more investors than in 2016. The proportion of investments up to R$ 1 thousand rose from 45.2% at the end of 2016 to 56.8% in December 2017. The share of women also showed strong growth, rising from 24.1% at the end of 2016 to 27.5% at the end of 2017.

Chart 20. Changing in Tesouro Direto Retail Program Investor's Profile



Source: National Treasury

The total invested volume increased from R$ 41.1 billion at the end of 2016 to R$ 48.5 billion at the end of 2017, an increase of 18.1%. However, net sales amounted to R$ 2.9 billion at the end of 2017, down from the R$ 11.4 billion registered at the end of the previous year. Gross sales totaled R$ 19.4 billion, compared to R$ 19.0 billion at the end of 2016. The number of sales on its turn reached the mark of 2.2 million sales, increasing by 425 thousand compared to the end of the previous year.

The program democratization, with more presence of women and small investors.

3.6 Efforts in Communicating with Society

In 2017, the National Treasury Secretariat centered its efforts on communicating with society. In the Treasury's strategic planning, communication was defined by the institution as a protagonist element to strengthen the Treasury's image, improve transparency, and consolidate STN as a source of management information on accounting and fiscal data of the Brazilian public sector. For this reason, throughout the year, the National Treasury and, in particular, public debt management reinforced and innovated communication initiatives by introducing new channels, formats, and language levels for official publications.

Debt in Videos

Aiming for greater inclusion and citizens participation in discussions and relevant matters to the country, the Treasury launched the "Debt in Videos" space with its first series: "Knowing the Public Debt". The series was composed of a presentation video and six other short videos, with a simple and educational language addressing the most frequent doubts of Brazilians: "What is public debt?", "Where does it come from?", "How much does it cost?", "Who pays for it?""How is it payed?", and "Who manages it? ". A supporting text accompanied each video with detailed information about the topic addressed. In addition to the Treasury website, the videos were shared on Facebook, Twitter and YouTube.

This first series resulted from a joint effort by the National Treasury and ESAF. The videos were published on the main social media channels, and their impact was enhanced by transforming the National Treasury page on Facebook into an active and official channel of communication. This strategy offered good results, with some of the videos reaching around 26 thousand people.

1st International Workshop on Public Debt

The 1st International Workshop on Public Debt-Debt Management and its interaction with Macroeconomic Policy was opened to the general public and held by the National Treasury Secretariat on November 9 and 10, 2017, in Brasília - DF, in partnership with the School of Finance Administration (ESAF).

The event had a live broadcast, whose full recording and material presented can be accessed here.

The workshop’s purpose was to foster the improvement and generation of knowledge related to the interaction between public debt management and fiscal policy, monetary policy, financial market development, and real economy. For this discussion, more than 20 renowned experts participated, as speakers and mediators, from the government, financial market, academia, consultancies, and multilateral organizations.

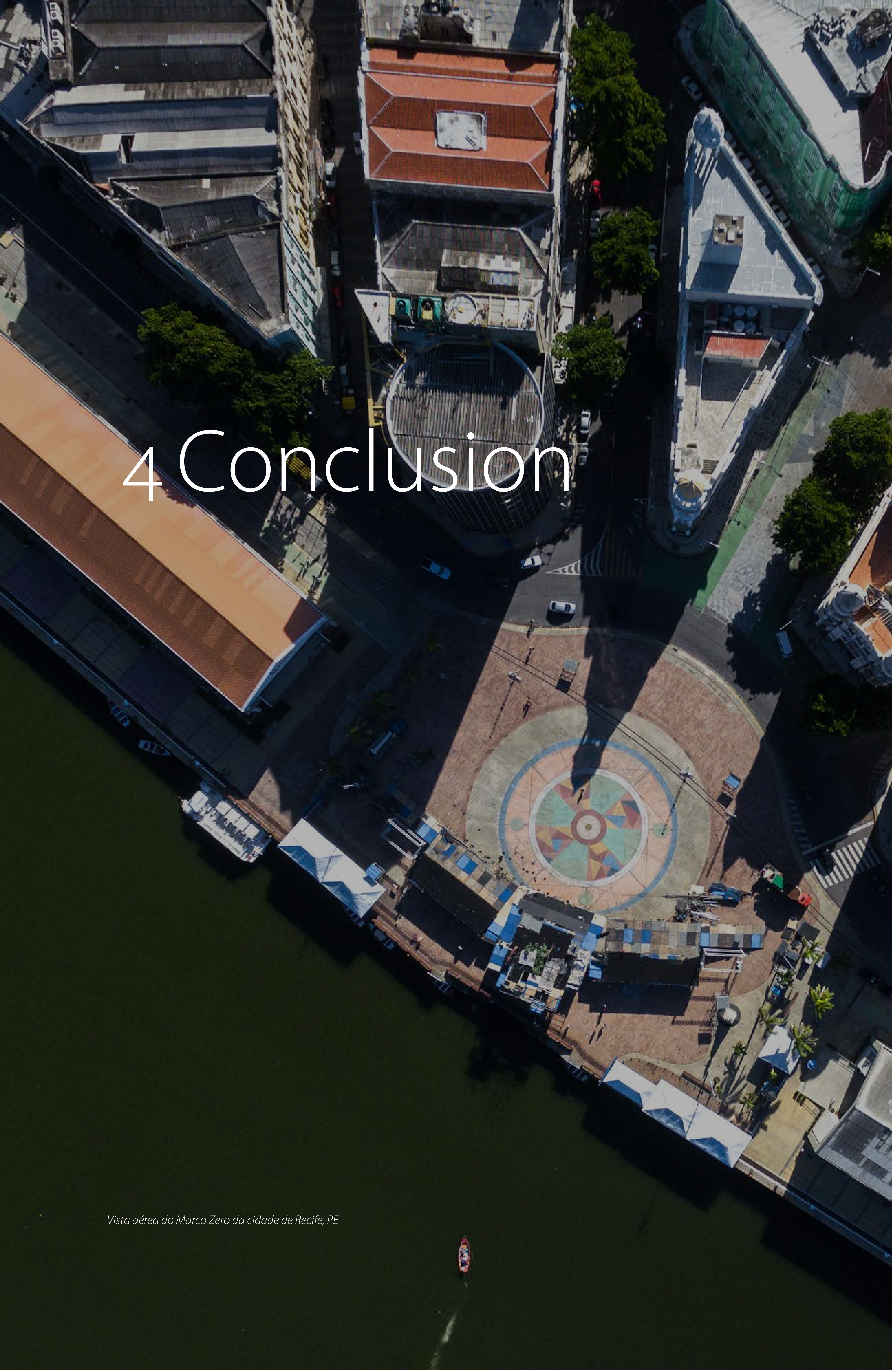
Other initiatives

Looking to establish a broader dialogue with society, the Treasury began to publish quarterly a report, "Inside the Accounts", with the evolution of the government budget in a more accessible and visual language to the general audience. In addition, the National Treasury continued to disclose its traditional publications, such as the 2017 Annual Borrowing Plan (ABP), the Monthly Debt Reports (MDR), and the Annual Debt Report (ADR). Monthly Reports alone, for example, had more than 35,000 downloads in 2017.

The National Treasury also expanded space for dialogue with the academy through the Papo Tesouro program – Research Support and Guidance by the National Treasury. This is a first initiative to create a channel for knowledge exchange and collaboration in studies related to public finances, as well as promote graduate studies and research related to public finances. The gains should materialize more significantly in the medium term and are expected to be as follows: receiving research and lectures from studies developed by researchers, establishing technical cooperation agreements to develop studies that benefit both STN and the academy, and invitations to present studies developed by STN.

Adding to the mission of managing public debt in an efficient, transparent and sustainable way, since the June 2017 edition, the National Treasury has started to use the information and statistics extracted from the Integrated Debt System to prepare the Monthly Debt Report. The internal production of information and its use to publish reports ratifies the Treasury´s role as the primary producer of public debt information and statistics. This development was made possible by unifying the calculation criteria adopted by the National Treasury and by the Central Bank, which also improved information accuracy.

4 Conclusion



Vista aérea do Marco Zero da cidade de Recife, PE

The 2017 economic scenario was favorable for debt management, with statistics remaining within limits defined by ABP 2017. On the positive side, the main highlight was the cost statistics, which are close to historical lows. However, there are still recurrent negative fiscal balances, which, together with the strategy to achieve a minimum percentage debt rollover of 100% of the FPD, made it important to increase the issuance of floating-rate bonds. This additional volume of LFTs in a period with low maturities of these securities increased the share of floating-rate bonds in the FPD profile without necessarily having a lower placement of fixed-rate bonds. Even with debt profile change, FPD risk statistics remain close to the best historical levels, especially with the stabilization of the share of securities maturing in twelve months below 20%.

In 2017, the Treasury continued its efforts to strengthen FPD management institutional framework. In this context, the institution continued developing the public bonds secondary market and also actively participated in discussions with officials of the economic team, the Central Bank, and Congress with the purpose of proposing an update of the regulatory framework that governs the Treasury's relationship with the Central Bank. The 2017 Annual Debt Report also showed several initiatives to increase debt management transparency and improve communication channels with society.


Vitórias-régias, AM