June 07, 2019

Economics Group

Special Commentary

Brazil—Economic Update and Outlook

Executive Summary

- Pension reform remains the most critical issue in Brazil, with the sustainability of the government’s debt burden likely to be primarily influenced by the progress and outcome of the current pension reform bill.

- We believe the pension reform bill will be implemented; however, given a fragmented Congress and the unpopular nature of pension reform, the final approval may be delayed until April 2020, while final savings may not be enough to make government debt more sustainable.

- Brazil’s economy is struggling to gain traction and is likely to remain subdued for now. While we do not believe the Central Bank of Brazil (BCB) will cut policy rates at this time, the motivation for the BCB to pursue higher interest rates has been significantly reduced.

- We believe the recent thawing of political tensions will only be temporary and contentious political dynamics are likely to continue for the foreseeable future. Key policymakers have also been linked to new scandals, which, if proven credible, can create renewed negative sentiment towards Brazilian assets.

Pension Reform Update: Where Do We Currently Stand?

The primary issue still impacting Brazil’s debt trajectory and currency is the country’s pension system. Over time, social security and other forms of retirement obligations guaranteed by the state have weighed heavily on government finances. As Brazil’s population has aged, these obligations have increased significantly, forcing the government to borrow heavily in order to fund its commitments. As a result, the government’s debt burden has increased materially over time, while forecasts suggest that without meaningful reform to the pension system, it could become unsustainable and even lead to default. Multiple presidential administrations have attempted to reform the country’s pension system; however, for numerous reasons, they have failed to implement any sort of material change.

Following the election of the reform-minded Jair Bolsonaro in late 2018, market participants have had renewed optimism for pension reform. This optimism carried into 2019, when Bolsonaro submitted his much anticipated pension reform proposal to Congress in February. In aggregate, Bolsonaro’s plan is estimated to save the government about 1.2T reais (USD$310B) over the next ten years, approximately 9% of GDP, and is a much more aggressive plan than previous administrations have introduced.

While aggressive pension reform is needed, the process for the actual implementation of the bill is rather complex, with multiple votes taking place throughout the Lower House of Congress (Chamber of Deputies) as well as in the Senate. Since February, limited progress has been made, with only the first step of the process being completed. After multiple delays, the Lower House Constitution and Justice Committee (CCJ) voted in April that pension reform, as well as Bolsonaro’s specific bill, are constitutional under Brazilian law and further debate over the details of the bill can proceed. Despite making it through the CCJ, the delays were largely a reflection of how unpopular pension reform is and how fragmented Brazilian Congress is.
At the current juncture, the bill is with the Lower House Special Commission, a group of 40 policymakers from the Chamber of Deputies, mandated to meet at least 11 times to discuss the details of the bill and introduce potential changes. As of now, the Special Commission has met 14 times, with at least one more meeting scheduled, which gives a sense of just how contentious these meetings have been. Assuming the commission completes its mandate, the bill will move to the full Chamber of Deputies on June 15, where additional debates will be held. This is likely to be a lengthy process as well, which in our view, will not be completed until at least July.

**Pension Reform Outlook: What’s the Timeframe for Final Implementation?**

Table 1 shows each step the pension reform bill will need to go through in order to be approved, and an expected time frame for when we think each stage will be completed. Given how contentious policymakers have been in regard to pension reform, we expect the final approval process to last longer than government officials suggest. Recent commentary from Lower House speaker Rodrigo Maia suggested the bill will make its way completely through the Lower House by the end of June. We believe that estimate is extremely ambitious and think the bill will move through the Lower House by November, ultimately going through the Senate and being implemented in April 2020.

<table>
<thead>
<tr>
<th>Stage</th>
<th>Purpose</th>
<th>Votes</th>
<th>Expected Date</th>
</tr>
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<tbody>
<tr>
<td>Lower House CCJ</td>
<td>Decide if pension reform bill is constitutional</td>
<td>Simple Majority</td>
<td>Completed - April 23</td>
</tr>
<tr>
<td>Special Commission</td>
<td>Chamber of Deputies introduces changes to bill</td>
<td>Simple Majority</td>
<td>July 2019</td>
</tr>
<tr>
<td>Lower House Floor Vote 1</td>
<td>Introduce new changes to the bill</td>
<td>3/5ths' Majority Needed (308 out of 513)</td>
<td>October 2019</td>
</tr>
<tr>
<td>Lower House Floor Vote 2</td>
<td>Introduce new changes to the bill</td>
<td>3/5ths' Majority Needed (308 out of 513)</td>
<td>November 2019</td>
</tr>
<tr>
<td>Senate CCJ</td>
<td>Decide if pension reform bill is constitutional</td>
<td>Simple Majority</td>
<td>January 2020</td>
</tr>
<tr>
<td>Senate Floor Vote 1</td>
<td>Introduce new changes to the bill</td>
<td>3/5ths' Majority Needed (49 out of 81)</td>
<td>March 2020</td>
</tr>
<tr>
<td>Senate Floor Vote 2</td>
<td>Introduce new changes to the bill</td>
<td>3/5ths' Majority Needed (49 out of 81)</td>
<td>April 2020</td>
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1. Any changes in the Senate will require Lower House approval as well

**Pension Bill Amendments are Crucial**

One of our primary concerns regarding the pension reform process is the potential for multiple policymakers to propose and make changes to the current bill. Throughout the entire seven stage process, there are five stages where amendments can be proposed. Amendments can be pursued in both the Lower House as well as in the Senate, a concern as significant changes to the bill would likely dilute total government savings to a point where pension reform may not have a material impact on the government’s debt trajectory and sustainability.

In our view, the current Special Commission stage is very important, as it represents the first opportunity policymakers have to make changes to the bill. We believe the Lower House Special Commission stage could be a key indicator for how well received the bill will be in the later stages of Congress. If the Special Commission proposes material changes, it could be a signal that the bill will get watered down and the final bill may not change the debt dynamics of the government.

Despite pension reform, we estimate debt levels will still increase to over 100% of GDP in the next ten years.

The initial version of the bill targets savings of 1.2T reais, which our estimates show would likely place Brazil’s debt burden on a downward trajectory and sustainable path. However, given policymakers ability to make amendments, we believe it is very unlikely the government will reap the full benefits of the current pension reform bill. Given this view, we believe the final implemented version of the pension reform bill will save the government 700B reais over the next ten years. These savings should help limit the increase in government debt, but we estimate debt levels will still increase to over 100% of GDP in the next ten years.
Brazil’s Economy is Still a Concern

Brazil’s economy has underperformed expectations for some time now, with economic indicators relatively subdued since the second half of 2018. This sluggish momentum has carried into this year as well, culminating in a contraction in Q1 GDP of 0.2% quarter-over-quarter.

High frequency indicators of economic activity have also failed to show signs of recovering in Q2, as industrial output contracted 3.9% year-over-year in April and retail sales are expected to remain subdued in April following a 4.5% year-over-year contraction in March. Sentiment data also remains relatively downbeat, as the manufacturing PMI has declined sharply this year, falling to 50.2 in May from 53.4 in February, while the services PMI has once again, fallen into contractionary territory. In response to the contraction in Q1 as well as underwhelming sentiment and activity indicators, consensus GDP forecasts for 2019 have been revised down significantly. At the end of 2018, consensus forecasts suggested GDP could grow around 2.6% in 2019. The most recent update now indicates analysts have a much more cautious view on the economy, with 2019 GDP expectations now at only 1.1%.

Policymakers in Brazil have taken notice of the sharp deceleration in the economy. In the latest meeting of the monetary policy committee, the Central Bank of Brazil (BCB) held policy rates steady, although it noted how softening data observed in 2018 has carried into 2019. The BCB also mentioned how the global macroeconomic backdrop remains challenging and that current conditions are still conducive to stimulative monetary policy. Financial markets seem to share an opinion similar to the BCB, as implied policy rates have re-priced dramatically since September.

Before Brazil’s economic slowdown took form, markets were expecting the BCB to raise interest rates almost 600 bps as the economy recovered from its recession a few years earlier. As economic activity continues to slow, markets have completely priced out any hikes from the BCB, now currently pricing in almost 50 bps of rate cuts over the next twelve months.

At this time, we do not expect the BCB to cut policy rates within the next twelve months, although the incentive for Brazil’s central bank to raise rates has likely diminished. With the economy struggling to gain traction, and inflation well within the target range, the primary impetus for the BCB to raise rates would be a swift pension reform approval that saves the government more than expected. However, given our view for a delayed pension reform that lacks an adequate amount of savings, we believe the BCB’s bias will start to tilt towards more dovish monetary policy, with rate cuts a possibility especially if the economy continues to soften.
Since the beginning of Bolsonaro’s presidency, tensions built between President Bolsonaro and Lower House speaker Rodrigo Maia, an important policymaker in Congress. In addition, opposition political parties fought hard to disrupt Bolsonaro’s pension reform bill and his broader plans for reforming Brazil’s economy. However, over the past few weeks, headlines suggest political tensions may be starting to ease. Bolsonaro has become more active in voicing his views on pension reform and other policy decisions in Congress, while he has also met directly with Maia and other policymakers to engage in constructive dialogue.

We believe the recent thawing of political tensions will only be temporary. Given our view for delays in the approval process for the current pension reform bill, this is likely to renew contentious political dynamics and potentially create new stresses within Congress. Government corruption is also a very sensitive topic in Brazil and is widely viewed as a contributing factor to the severe recession a few years ago. Although charges cannot be filed given immunity status as members of Brazil’s Congress, President Bolsonaro’s son has been implicated in a corruption scandal, while Maia himself has also been linked to a bribery scandal. Should these accusations be proven credible, or additional government officials be implicated, we would expect sentiment towards Brazilian assets to turn negative, while the currency would likely sell-off quite sharply.