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Brazil Macro Compass

The Long-Awaited Pension Reform Proposal

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In-Depth Research: Pension Reform

President Bolsonaro's final pension reform proposal was presented to Congress on February 20. The proposal's contents did not diverge much from previous leaked drafts and market expectations. If fully implemented, the changes would yield nearly BRL1.2 trillion in savings over 10 years (see the "Chart of the Week" on page 2 of this report). According to our preliminary calculations, around 60% of those expected savings are derived from two key elements in the reform proposal: (i) the introduction of minimum retirement ages (62 for women, 65 for men for both private sector workers and civil servants, including categories such as teachers, civil police forces, and rural workers); and (ii) a relatively short (12 years) transition period. Members of the military (including military police, a heavy burden on states' budgets) were not included in the proposal; a separate draft changing their retirement eligibility is expected within a month.

In our view, Congress is likely to substantially water down the proposal. The previous government's attempt at reform started with a draft that would deliver BRL845 billion in savings over 10 years; the version that emerged from Lower House committees and was ready for a floor vote projected BRL550 billion in savings for the same period. Applying that same "watering down rate" to the current proposal, we believe the approved reform could imply approximately BRL800 billion in savings over 10 years. Given that the expected increase in benefit payments in this period is projected at approximately BRL1.5 trillion, it is going to be crucial, in our view, to keep expected savings not close to BRL1 trillion.

The main risk for the reform, in our view, is the government's ability to amass a coalition, especially in the Lower House, to approve the reform relatively fast. Bolsonaro's party, PSL, controls little more than 10% of Lower House seats, and a three-fifths majority is needed in both houses to pass the required constitutional amendment. The coalition building process is likely to take many months and is the real binding constraint on the approval — house committee procedures, although lengthy, can be expedited if the government is strong enough to overrule the opposition's attempts to filibuster. Bear in mind that the Temer government, supported by a broad coalition based on a semi-parliamentarian cabinet (i.e., the cabinet composition closely replicated the share of Congressional seats), spent more than four months to pass the reform through the two required committees (constitutional and a specially designated one) and ready it for a first floor voting. We expect the current reform to be submitted to a first Lower House floor vote by September-October this year.

The next step requires the Lower House to create a Constitutional Committee (CCJ); currently, this is being negotiated among the parties. The informal agreement that elected Rodrigo Maia as Speaker of the House grants control of that Committee to PSL; this week Maia said that he plans to kick off the Committee on February 26. Once that happens, the Committee needs to verify, within a deadline of five legislative sessions, if the proposal meets constitutionality requirements; only after that can the Special Committee be designated (this is likely to happen only after the Carnival holiday, in the second week of March).

For more details on the pension reform proposal, see our report *It's Show Time: The Battle for Social Security Reform* (February 20, 2019).

Political Agenda: Slow Week Ahead of Carnival

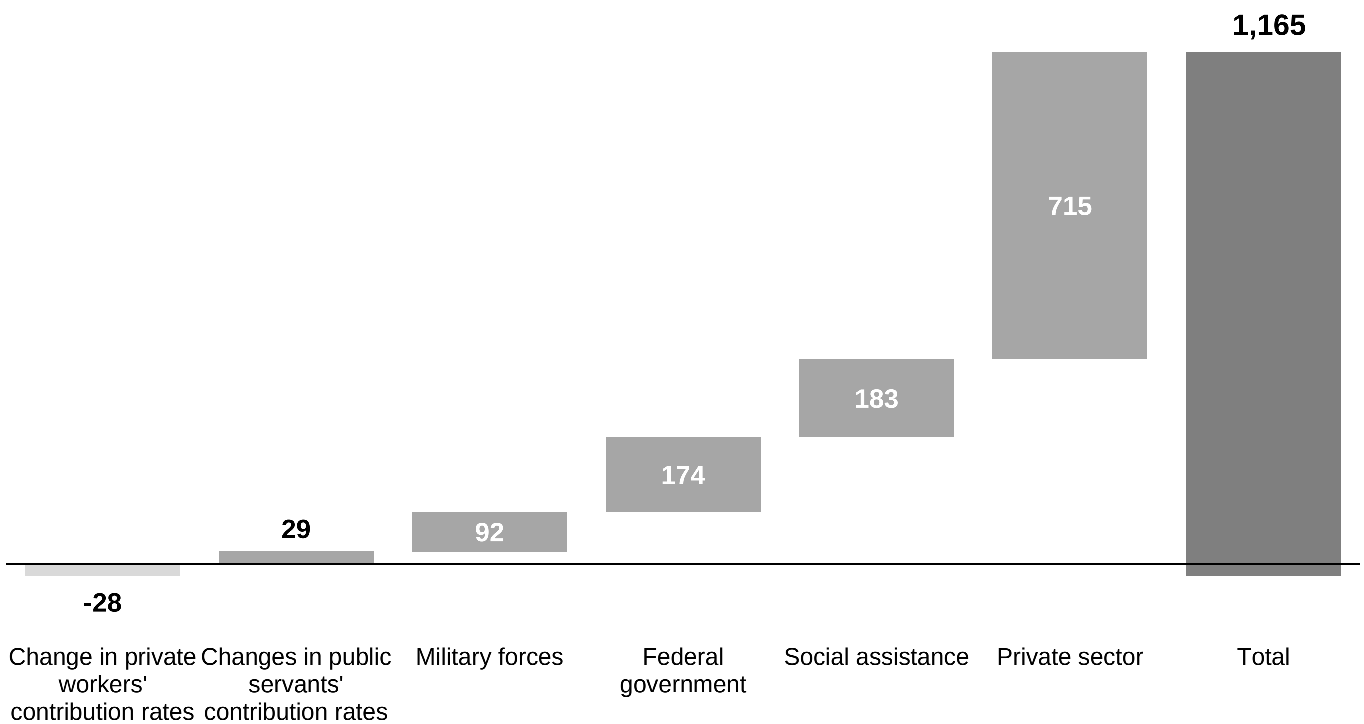
The bill that makes the creation of a comprehensive credit bureau and a credit score system (*cadastro positivo*) possible was approved in the Lower House this week. The Temer government's proposal aimed to reduce information asymmetries in the credit system, which can lead to a reduction in credit spreads. Senate voting is still pending before the bill can be signed into law by the president.

Next week's highlights include the definition of the Lower House's Constitutional Committee (see "In-Depth Research" on page 1 above), a meeting of the National Committee of Energy Police (on February 28) that may schedule and define the rules of the transfer of rights (*cessão onerosa*) oil auction, and Roberto Campos Neto's Senate confirmation hearings (on February 26).

Chart of the Week: Pension Reform Savings

Our "Chart of the Week" shows the estimated fiscal impact of several features of the pension reform proposal presented this week, as estimated by the Ministry of Economy. The bulk of expected savings (more than 60%) should come from new rules (including a minimum retirement age) for private sector workers. An interesting consequence of the reform is the effect of proposed changes in the contribution rates of private sector and federal public servants — if the reform is approved, an aggregate reduction in contributions from the private sector (mostly from lower rates to low wages) is to be offset by higher contributions from public servants with high wages.

Expected Savings in 10 Years from Bolsonaro's Pension Reform Proposal (BRL billions)



Source: Ministry of Economy

What's New: Inflation Still Subdued

February IPCA-15 came in at 0.34% m/m, slightly below our forecast (0.37% m/m). 12-month inflation moved to 3.73% (from 3.77% in the previous month). School tuition fees, the usual main driver of February inflation, rose less than we anticipated (+4.3% versus +5.0%) and were the main contribution to the surprise. Our estimate for core inflation at the margin is still running around 2.5% y/y, which reinforces our view of well-behaved inflation until the end of the year (we expect 12-month inflation at 3.7% by year-end).

Upcoming Data: 2018 GDP

4Q18 GDP data will be released on February 28. We expect a weak overall economic performance in that quarter: quarterly GDP should stay flat relative to 3Q18, with year-on-year growth at 1.2%. From a supply perspective, a strong contraction in industrial activity (-1.1% q/q) should have canceled out growth in services (+0.5% q/q) and agriculture (+2% q/q). On the demand side, a 2.5% q/q plunge in investments is expected to offset a 1.2% q/q growth in net exports. Private and government consumption should have had negligible changes in the period.

If our quarterly forecast is confirmed, 2018 GDP growth stayed at 1.1%, repeating the 2017 rate and frustrating most of the expectations from one year ago (of at least 2% growth).

Looking ahead, we expect growth to accelerate in 2019, with the economic reform agenda keeping business and consumer confidence in an uptrend, a necessary condition for a robust recovery. Low and stable inflation, historically low interest rates and robust external accounts should also contribute to a stronger growth. There are relevant risks both in the external (global growth deceleration, trade wars, etc.) and in the domestic (uncertainty regarding the approval of reforms) environments, but the positive factors, in our view, should prevail and contribute to a stronger expansion.

Number of the Week

BRL 1.16 tn

The Ministry of Economy estimates that the pension reform proposal presented this week would save BRL 1.16 trillion over 10 years if fully implemented (see also the "Chart of the Week" on page 2 of this report).

Quote of the Week

"*The pension reform is a kind of Brumadinho dam in each one's house.*"

— **Representative Margarida Salomão**, from the Workers' Party (PT), in her Facebook page (February 20, 2019).

What We've Been Reading

- "Optimism or Wishful Thinking? Brazil's Recovery Has Bit of Both," by David Biller (*Bloomberg*, February 19, 2019). The gap between consumer expectations and consumers' economic conditions has never been wider.
- "If Your Emerging Markets Fund Looks Great, Thank Brazil," by Kenneth Rapoza (*Forbes*, February 15, 2019). After years of lackluster performance, Brazil has been leading the asset class.
- "Palace intrigue in Brasília hampers Bolsonaro's agenda," by Ryan C. Berg (*AEIdeas*, February 14, 2019). The government may be its own worst enemy in the implementation of the economic reform agenda, argues Berg.
- "Brazil's Bolsonaro Plays Catch-Up With His Cabinet," by Mac Margolis (*Bloomberg*, February 15, 2019). Government's military faction has been playing a moderating role, argues Margolis.
- "2019 Latin American political landscape: The good, the bad, and the ugly," by John Price (*Global Americans*, February 21, 2019). Optimism with Brazil contrasts with more gloomy views on Mexico and Venezuela.

Recent Publications (Available on Our Website)

- *It's Show Time: The Battle for Social Security Reform* (February 20, 2019)
- *Economic Activity: Economic Derby – Rivals or Teammates?* (February 19, 2019)
- *Brazilian Asset Prices: How Much "Over" Has the Performance Been?* (January 31, 2019)
- *Substantial Challenges and Risks in the Global Outlook: How Do They Affect Brazil* (January 29, 2019)
- *Brazil Macro Scenario: 10 Macro Propositions for 2019* (January 7, 2019)

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