ECONOMICS March 1, 2019

Brazil Macro Compass

After Carnival

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Political Agenda: After Carnival

After Carnival I'm going to come to my senses,
It's been a while since I need to regenerate,
Drop the guitar, look for a job,
I urgently need,
To stabilize myself.

From "Depois do Carnaval" (*After the Carnival*), a popular song by Beto Scala and São Beto released by the great samba singer Jair Rodrigues in 1974.

The government will also have much to deal with after Carnival, and start working to get the pension reform proposal through Congress without too much watering down (we believe the reform could potentially yield BRL800 billion in savings over 10 years – see our report *It's Show Time: The Battle for Social Security Reform*, February 20, 2019). In a press conference this Thursday, President Bolsonaro indicated that the opposite could happen, suggesting that the government would be willing to reduce the proposed minimum retirement age for women. In our view, the main current obstacle is the government's own political coordination, as the opposition has been relatively quiet and does not have enough seats (around 27% of Lower House seats) to block the reform in either Congressional house. More specifically, the government needs to assure support of approximately 80% of the representatives from center-right/right parties to get to the three-fifths of total seats required to amend the Constitution. This week (on February 25), House Speaker Rodrigo Maia indicated that this process has only just began, mentioning that if called to a vote on that day, the government's proposal would be defeated at the Constitutional Committee (CCJ) level, the first to examine the Executive's proposal. Speaker Maia further added that, "Today I say that the government has the PSL *[Bolsonaro's party]* in its coalition and no other party. The government's coordination needs to improve[1]."

The delay in the formation of Lower House committees (initially expected for this Tuesday) is, in our view, evidence of the still-developing relationship between the Executive Branch and Congress: the quicker these committees are formed, the earlier pension reform can be ready (after passing through the CCJ and a specially designated committee) for a floor vote. Maia now expects House representatives to be ready to vote on the reform by the beginning of June or the first half of July (in January, his declared estimate was May), with the CCJ starting to work on the reform only by the second half of March. Expediting the committees' works, however, is of little use if the government cannot rely on a solid coalition, and this, in our view, will be the main job for the government's political core after Carnival, as Brazil really needs a broad pension reform to fiscally stabilize itself.

Minas Gerais, Brazil's third largest state in terms of GDP, was declared to be in "selective default" by S&P Global, after missing debt service payments to local banks and multilateral institutions on February 16. According to S&P, the rating embeds a belief that future payments related to other loans are likely not to be missed. This, in our view, is evidence of fiscal risk for the federal government, as most states' debt is guaranteed by the National Treasury. Recent estimates from Vilma Pinto, a fiscal policy expert at the Getúlio Vargas Foundation in Rio de Janeiro, show that between 2012 and 2014 the National Treasury authorized states to add BRL140 billion (around 2% of GDP) to their outstanding debts. The default also adds to the necessity of moving forward in the negotiations of a bailout package for bankrupt states, which, in our view, is likely to be conditioned upon measures such as selling of state assets and payroll reductions (the latter still pending a Supreme Court decision and further changes in the current tenure legislation). States should also be important actors in the pension reform discussions, as retirement payments to teachers, police forces, and other public servants are poised to grow strongly in the next few years.

[1] "Discurso antipolítica de Bolsonaro emperra aprovação da reforma, diz Maia," Folha de S. Paulo, February 26, 2019.

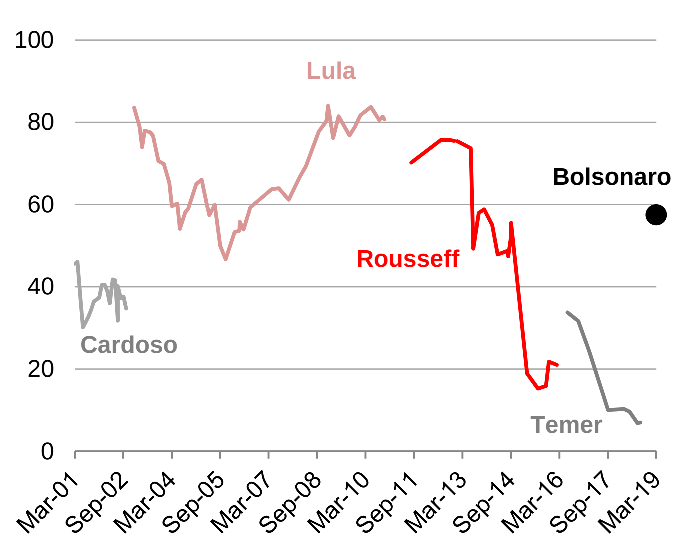
The National Council of Energy Policy (CNPE) scheduled for October 28 the transfer of rights (*cessão onerosa*) oil auction, which could bring around BRL100 billion in fiscal revenue to the federal government this year (total proceeds are likely to be shared with states and municipalities), according to National Treasury's preliminary estimates. This revenue is still not accounted for in the budget and, consequentially, in the primary deficit official target.

Roberto Campos Neto was inaugurated as Central Bank governor, following Senate approval. The hearings were uneventful — Campos Neto repeated the tone used in the last monetary policy committee statement ("caution, serenity, and perseverance"), which, in our view, suggests continuity in the monetary policy stance, at least in the short term. The next Copom meeting is scheduled for March 20.

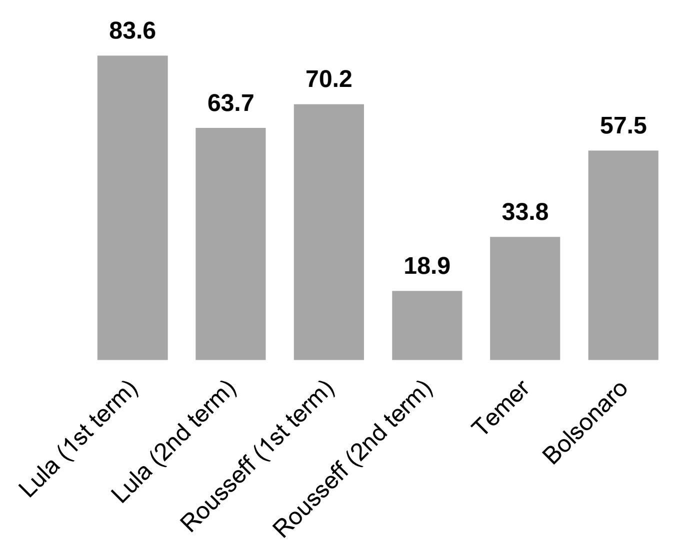
Chart of the Week: Presidential Approval Ratings

CNT/MDA released this week its first popularity survey on the new president and his government. Our "Chart of the Week" shows how presidential approval ratings have been evolving in Brazil since 2001, highlighting each president's popularity at the beginning of their respective terms. Bolsonaro is off to a more favorable start than the last two presidents, but far from the level of popularity enjoyed by both presidents from the Workers' Party (Lula and Rousseff) when they took office for the first time (CNT started collecting data in 2001, the middle of Cardoso's second term).

Presidential Approval Ratings (%)



First Presidential Approval Ratings of Each Term (%)



Source: CNT, MCM Consultores.

What's New: 2018 GDP

4Q18 GDP growth came in at 0.1% q/q, adding to a 1.1% annual growth in 2018, 20 bps lower than the median forecast at the last central bank Focus survey of last year. On the demand side, household consumption and capital formation expanded 1.9% and 4.1%, respectively, in 2018. A strong growth in imports (+8.5%) and flat government consumption led to the lower headline growth. From a supply perspective, a weak quarter for the industry (-0.3% q/q) led to 0.6% annual growth. Construction diverged from the overall (though slow) recovery, contracting 2.5% in 2018, which suggests that the inventory cycle in that sector has not bottomed out yet. We revised our 2019 growth estimate to 2.3% (from 3.0%) – see "In-Depth Research" below for more details.

In-Depth Research: Lower Growth and Inflation Forecasts

In *Is The Glass Half Empty or Half Full?* (February 27, 2019), we updated our GDP growth forecast for 2019. We cut our estimate to 2.3% (from 3.0%), on the back of a lower-than-expected carry-over effect from 2018 (estimated from the 4Q18 release at 0.4%), a more challenging global growth backdrop, the recession in Argentina, and less favorable dynamics in mining and agricultural activities. We expect domestic demand to continue to be led by household consumption (2.2% expected growth), with a smaller contribution from investments (4.5% growth), flat government consumption and a negative contribution from the external sector. We expect the approval on the pension reform on 2H19 to boost confidence and accelerate the pace of growth to 3.0% in 2020.

In *Lower Inflation Forecast for 2019* (February 28, 2019), we revised our 2018 annual CPI inflation forecast to 3.5% (from 3.7%). Our bottom-up models point toward falling inflation in regulated prices (mostly due to slowly rising fuel prices) and foodstuff. The persistent negative output gap should continue to contribute to low core inflation, which, in our view, will continue running in the 3.0%-3.5% y/y range throughout the rest of this year. Despite lower inflation, we still believe the Central Bank will hold the policy rate at 6.5% until 2020, as inflation is likely to accelerate on 2H19 and into 2020 assuming growth gaining momentum after the favorable resolution of the pension reform process.

Number of the Week

57.5%

According to the latest Sensus/CNT poll, released this week, Jair Bolsonaro is starting his presidential term with an approval rating of 57.5% (see also the “Chart of the Week” above).

Quote of the Week

“*Fiscal stability is key to reducing uncertainties, increasing confidence and investment, and the consequent long-term growth of the economy. I am sure we will advance in this direction.*”

— **Roberto Campos Neto**, incoming Central Bank Governor, during his confirmation hearings at the Senate (February 26, 2019).

What We’ve Been Reading

- “LatAm in Focus: Can Bolsonaro Get What He Wants From Brazil’s Congress?,” by Luisa Leme (*AS/COA Online*, February 26, 2019). A conversation with Carlos Pereira, one of Brazil’s top political scientists, on the government’s ability to build a stable coalition in Congress.
- “Latin America’s Right Turn Could Draw Its Economies Closer,” by Shannon K. O’Neil (*Bloomberg*, February 25, 2019). O’Neil sees ideological alignment in South America as an opportunity for deepening regional integration and boosting external trade.
- *Legitimacy in Criminal Governance: Managing a Drug Empire from Behind Bars*, by Benjamin Lessing and Graham Denyer Willis (*American Political Science Review*, February 22, 2019). Weber meets Marcola: how Brazil’s most powerful prison gang manages its empire.

Recent Publications (Available on Our Website)

- *Lower Inflation Forecast for 2019* (February 28, 2019)
- *Economic Activity: Is The Glass Half Empty or Half Full?* (February 27, 2019)
- *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)

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