Santander
Corporate & Investment Banking

ECONOMICS July 12, 2019

Brazil Macro Compass

The Post-Pension Agenda

Luciano Sobral*
lusobral@santander.com.br
+5511 3553 3753

Political Agenda: What's Next?

As widely expected, the core text of the pension reform was approved by a wide margin on the floor of the Lower House this week. As of the closing of voting on the initial text, votes on eight amendments were still pending; these were expected to be concluded by the end of Friday (July 12). In our view, it is likely that the second round of voting will be postponed until after the recess (early August); however, we do not believe a postponement would have a significant impact on expected savings or lead the Central Bank to delay the 25-bp rate cut expected in July.

The changes introduced to the special committee's draft so far subtract around BRL50 billion from fiscal savings in ten years, which still results in a likely positive surprise to our BRL760 billion (net of the tax increases for banks) baseline estimate for that metric. Those figures refer only to the federal government – savings in states and municipalities would add to that amount if the plan of including them back in the reform at the Senate works out.

Markets' attention will now, in our view, turn to growth-promoting policies, whose introduction has been delayed to avoid clogging the congressional pipeline ahead of approval of the pension reform. In our view, there is no fiscal room to increase short-term spending, so any measures would have to tap off-budget resources or attempt to boost productivity. We believe some of the proposals may include[1]:

- **Release resources from mandatory severance funds (PIS/Pasep and FGTS):** a resumption, with some modifications, of policies adopted in the Temer government that allowed certain categories of workers to freely withdraw money from their individual accounts in those two earmarked severance funds. The previous government authorized all shareholders of PIS/Pasep (a fund that is no longer receiving contributions) to claim their shares, as well as holders of inactive (i.e., no longer receiving contributions from employers) FGTS accounts. A new awareness campaign may stimulate more withdrawals from people included in those categories and allow for a fraction of FGTS active accounts also to become available. PIS/Pasep still has around BRL20 billion, but many of its shareholders are deceased (the fund has not been receiving new contributions since 1988), and the government has had difficulty contacting their heirs; withdrawals from FGTS are limited to the fund's liquidity requirements, and, in our view, will probably not exceed the BRL40 billion released in 2017.

- **Tax reform:** the Lower House is working on its own proposal (attempting to consolidate several federal, state, and municipal taxes into a single VAT); the Finance Ministry has a different plan, which includes replacing payroll taxes with a new tax on financial transactions. It is not clear whether there will be a convergence to a single draft, and the inherent political and economic challenges of such broad reforms should extend the discussions for at least several more months, in our view.

- **Privatizations/concessions:** the finance ministry has a goal of raising BRL77 billion this year, of which BRL33.5 billion corresponds to the sales of TAG (a gas transportation company). The pipeline includes sales of two oil refineries, assets from state-owned banks, and concession auctions of ports, rail lines, and airports.

- **Oil (transfer of rights) auction:** the auction is scheduled for November 6; proceeds are estimated at around BRL110 billion.

- **Monetary policy:** in addition to rate cuts, the Central Bank may keep cautiously reducing reserve requirements.

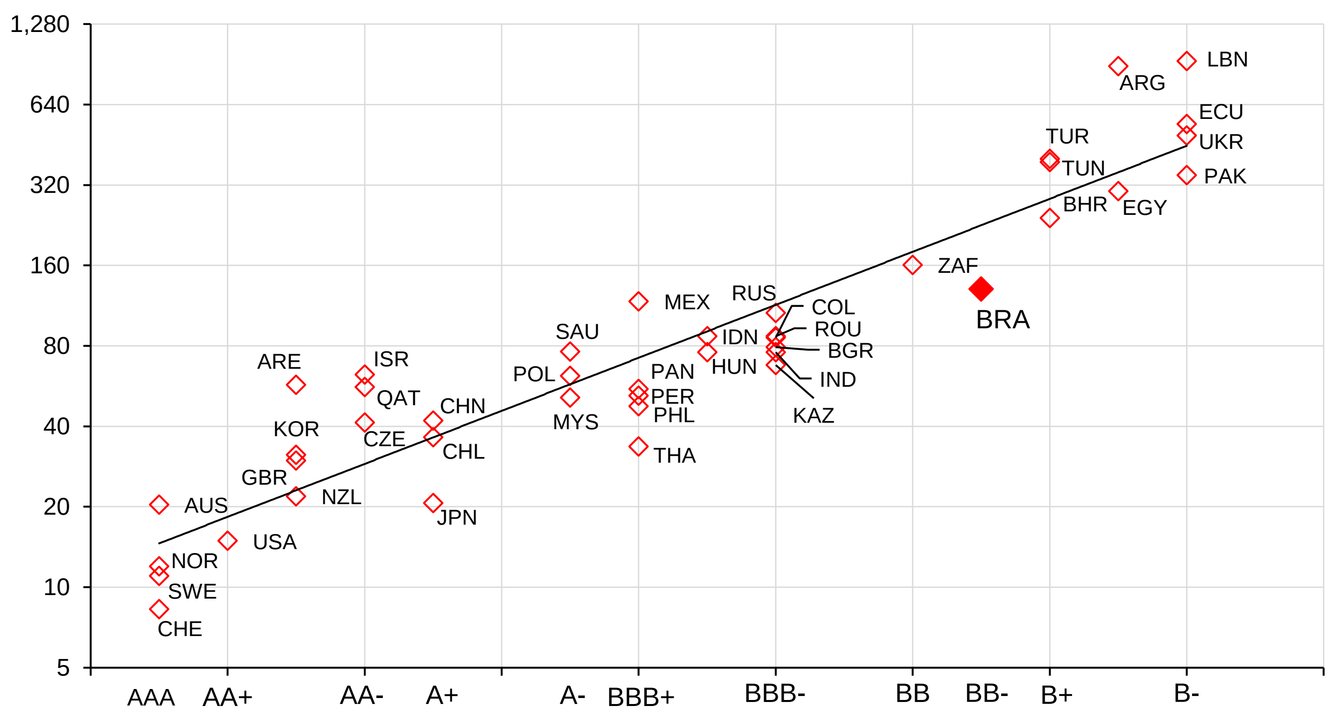
[1] For a good reference, see "Depois da Previdência," by Helio Gurovitz (*Época*, July 5, 2019).

All in all, we believe that the forthcoming measures, although all in the pro-market direction, should have incremental effects on productivity, with no "big-boom" effect on short-term growth. The recent easing in financial conditions, partially driven by a risk repricing following the strides that have been made in achieving the pension reform, should result in accelerating growth in 3Q19 and 4Q19, but we still expect full year growth at only 0.8%. The effects of a still ongoing deleveraging cycle and the unfeasibility of short-term fiscal stimulus should, in our view, continue to weigh on economic activity, reducing the probability of a strong cyclical recovery. The challenges involved in gaining congressional approval of some of the aforementioned measures only add to our view that any strong boost in optimism about this year's growth based on the "economic package" is likely to be disappointed.

Chart of the Week: CDS Spreads Are Pricing In Rating Upgrades

Our "Chart of the Week" looks at the relationship between sovereign credit risk (measured by the price of five-year CDS contracts) and credit ratings. As we can observe, there is a tight exponential relationship between credit spreads and a linear scale of ratings – roughly, spreads double for every two notches in the rating order. The recent rally in Brazil's credit spread put it deep inside the line of best fit. At 130 bps, the country's CDS trades almost 100 bps below the estimated price, given its BB- rating, and very close to the trend line for BBB-, the lowest notch in the investment-grade space (Russia's spread, the highest among current BBB- countries, is at around 110 bps). In other words, the market is already pricing in almost three credit rating upgrades for Brazil. Although we believe the ultimate passage of the pension reform and commitment to further short-term adjustment will indeed lead to rating upgrades, in our view it is still too early to forecast that Brazil will regain investment-grade status in the next few years. As we showed in our recent research (see *Fiscal Policy: Climbing the Cliffs in Bad Weather*, June 18, 2019), debt sustainability is still conditional upon several additional years of austerity – we expect Brazil to post is first primary surplus since 2013 only by 2023, and the gross debt/GDP ratio will, in our view, continue to rise until 2025, topping out at 82.8% of GDP. We do not believe external solvency will be an issue anytime soon (which may also be part of the explanation for why Brazil's external debt yields less than that of other countries with better overall fiscal fundamentals), but the growth of domestic debt will continue to be an important concern for investors.

5-Year CDS Spreads (bps, log scale) vs. S&P Credit Rating



Sources: Bloomberg, Santander. Market data as of July 11, 2019.

What's New: June Inflation, May Economic Activity Data

June CPI inflation came in at 0.01%, slightly above our forecast (-0.02%). Twelve-month inflation plunged to 3.37% from 4.66% in May, mostly because of the effects of last year's truckers' strike dropping from the comparison. Falling fuel and electricity prices contributed to the decelerating inflation in the month. Core measures remain at around 3.0% y/y, comfortably below the Central Bank's target midpoint. We expect monthly July and August inflation at 0.19% and 0.18%, respectively, compatible with our year-end forecast of 3.9% y/y.

May core retail sales dropped 0.1% m/m (+1.0% y/y), below market consensus (+0.1% m/m). In the same month, the volume of services rose 4.8% y/y (flat m/m). Both releases are in line with our GDP growth estimate for this year (0.8%).

Upcoming Data: May IBC-Br

The Central Bank releases its monthly GDP proxy next week. We expect 4.8% y/y growth (+1.0% m/m). The yearly comparison is inflated by the base effect from last year's May truckers' strike. With that result, we expect the indicator to contract 0.1% q/q in 2Q19, still attesting to the fragility of the recovery in the first half of 2019.

Number of the Week

379

379 Lower House representatives voted in favor of the core text of the pension reform, almost three quarters of the total of 513 representatives.

Quote of the Week

"Centrão *is that thing that nobody knows what it is, but 'it's evil'. But it's* Centrão *that's making the pension reform, those parties that call themselves* Centrão."

— **Rodrigo Maia,** Speaker of the Lower House, after the landmark floor vote on the pension reform (July 10, 2019).

What We've Been Reading

- "For Wall Street, Brazil Is Back, Baby!" by Kenneth Rapoza (*Forbes*, July 10, 2019). Summing up the recent bullish wave.
- "The swashbuckling meat tycoons who nearly brought down a government," by Dom Philllips (*The Guardian*, July 2, 2019). A retelling of the story of one of Brazil's biggest "national champions."
- "An evening with João Gilberto, the bright wallflower of bossa nova," by Ted Gioia (*The Guardian*, July 7, 2019). One of the best of the many eulogies that followed the death of the great singer/guitarist.

Recent Publications (Available on Our Website)

- *Fiscal Policy: Climbing the Cliffs in Bad Weather* (June 18, 2019)
- *Economic Activity and Credit: Highway to Heaven?* (June 7, 2019)
- *Is It Time to Upgrade Core Inflation Measures?* (May 21, 2019)
- *Inflation—Year of the Pig: Good Fortune?* (April 30, 2019)
- *Economic Activity: No News Is Bad News* (April 22, 2019)

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Sergio Galván*	Economist – Argentina	sgalvan@santanderrio.com.ar	54-11-4341-1728
Maurício Molan*	Economist – Brazil	mmolan@santander.com.br	5511-3012-5724
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	598-1747-6805
Fixed Income Research			
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Aaron Holsberg	Head of Credit Research	aholsberg@santander.us	212-407-0978
Equity Research			
Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Cecilia Jimenez*	Head, Mexico	mcjimenez@santander.com.mx	5255-5269-2228

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