ECONOMICS

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Brazil Macro Compass

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It ain't over till it's over

- **Contrary to market expectations, the Senate's first round of voting on the pension reform bill was more contentious, shaving off a projected ~R$80 billion in savings over the next 10 years. More importantly, we believe that this result was a signal that this process might not conclude on October 10, as formerly suggested by the Speaker of the Senate.**
- **In our view, the setback, among other reasons, stemmed from the stalemate between senators and representatives regarding how subnational governments will share future proceeds from the auction of transfers of oil rights that the federal administration expects to come into effect on November 6.**
- **While we believe that noise on the political front is likely to increase investor concerns on progress in the domestic fiscal agenda, economic figures slated to be released next week could, in our view, provide further evidence of a gradual recovery in tandem with a quite comfortable inflationary environment.**
- **On the one hand, we expect the IPCA to have barely moved in September: we forecast a 0.03% MoM change, implying 3.0% inflation in 12-month-to-date terms and thus indicating that the YoY IPCA change would be running below the target — even for 2022 (3.5%).**
- **On the other hand, we expect August retail sales and services sector surveys (the PMC and PMS, respectively) to show expansion: we forecast MoM changes of 0.2% and 0.5% changes sa terms, respectively—still not enough to lead us to change our 2019 GDP forecast.**

Pension Reform: When the Pension Reform bill landed in the Senate on August 8, the market expected its approval to come from a smooth process that would conclude on October 10—as indicated by the Speaker of the Senate, Senator Davi Alcolumbre—without significant changes that could erode the volume of savings proposed by the Lower House and with the extension of the new rules to states and municipalities. Fast forward nearly two months and only the latter has materialized, as the approval process is now not expected to be concluded next Thursday due to concerns that have surfaced recently, leading to an erosion of R$133 billion in the amount of savings over the next 10 years implied by the bill approved in the Lower House–out of which approximately R$80 billion came during a tense first round vote in the Senate that took place last Wednesday. Why? The government failed to fulfill its promises, political coordination was lacking, and senators and representatives entered an eleventh-hour standoff on the sharing of future proceeds from the auction of transfer of oil rights (see the following section for more details). However, as we do not see these challenges as insurmountable, we expect the pension reform bill still could be concluded until the end of October, without extra savings dilution.

Senators vs Representatives: After having found an ingenious way to ensure the realization of the auction of transfers of oil rights on November 6 (for details see last week's Macro Compass, *A Little Box of Surprises*), which could generate revenues of R$106 billion according to the federal government's estimates, senators and representatives came to a stalemate as to the sharing of these proceeds between states and municipalities. As a reminder, Petrobras will get nearly R$34 billion in compensation owing to the federal government breaking its past contract, and 30% of the remainder will go to states and municipalities. In order for the auction to happen, senators agreed with the government that the subnational amount would be equally split between states and municipalities (i.e., each group would get 15% of net proceeds). However, representatives (who are the ones assessing the bill that defines the sharing) have suggested a different break down, with municipalities getting 20% of net proceeds and states 10%, as they believe cities fiscal balances are more critical than those of states. Senators were not warm to this suggestion and warned the federal government that they could retaliate and break the agreement, by either voting against the pension reform bill in the second round vote or introducing new changes that could further trim the volume of savings. Hence, the decision to not hold the second round vote in the next week.

In an attempt to try to overcome this gridlock, the government stated that it would propose a third alternative: splitting the 30% of net proceeds into 3 parts: 10% for states, 10% for municipalities and 10% for parliamentary suggested projects. In this case, senators and representatives would be able to please governors and mayors, according to their preferences. Apparently, lawmakers liked the idea and are debating how to come to an agreement that could both guarantee a beneficial division of net proceeds for their interests and avoid jeopardizing the conclusion of the pension reform bill in the Senate.

Inflation: On the back of lower inflation in electricity tariffs, we expect the IPCA to have shown a 0.03% MoM change in September 2019—or 3.0% in YoY terms—which would confirm Brazil's currently soothing inflation environment. Not even the marginal review that we have in the annual projection for 2019—to 3.5% from 3.3% due to costlier average electricity fares and fuel prices as compared to 2018—changed the perception that core inflation measures continue to point toward an accommodation around 3.0%, which means that prices dynamics are already in line with the target set for 2022—let alone 2020, 2021.

Economic Activity: Industrial production in August 2019 has positively surprised market participants and provided some support to the view that an economic recovery has gained traction. In that sense, surveys of retail sales and services segment are also likely to go in the same direction of a gradual recovery under way. We expect core retail sales expansion of 0.2% MoM sa in August 2019, while the broader gage—which factors in the contribution of building material stores and vehicles and auto-parts' dealers—is likely to deliver an even brighter outcome (1.1% MoM sa) in the period, per our projections. As for the services segment, we expect the survey to unveil a 0.5% MoM sa increase, thus suggesting a positive result for the services sector as a whole in 3Q19 and, consequently, for the GDP. All in all, we have become increasingly confident with respect to our 2019 GDP projection of 0.8%.

Number of the Week

R$133B Dilution promoted by senators in the amount of savings within the next 10 years implied by the pension reform bill approved in the Lower House.

Quote of the Week

The Senate writes an important page of the Congress history by approving the pension reform. Brazil has guaranteed its future.

— **Roberto Rocha**, Brazilian senator, about the assessment of the pension reform bill in the Senate Constitutional, Citizenship and Justice Commission, before the first round vote.

Recent Publications (Available on Our Website)

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- *Economic Activity and Credit: Highway to Heaven?* (June 7, 2019)
- *Is It Time to Upgrade Core Inflation Measures?* (May 21, 2019)
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