Brazil Watch

Group Economics
Emerging Markets Research

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Positive mood, but slower growth

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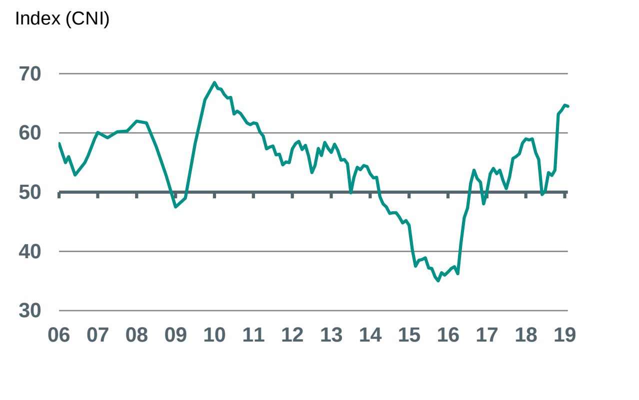
- **Pension reform proposal well received by markets**
- **Still uncertain how much savings will ultimately be achieved**
- **Approval of pension reform not expected before September**
- **Investors will remain cautious at least until then**
- **We revise our 2019 growth forecast downwards to 2% from 2.5%**

Lower growth forecast for 2019

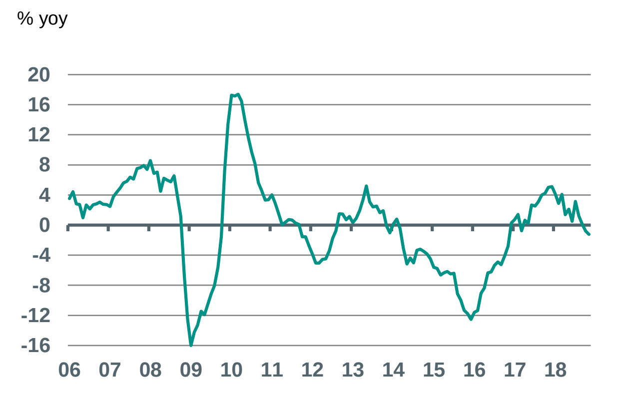
Markets reacted favourably to the election of the right-wing Bolsonaro in October and his pro-market economic agenda. However, this has not yet led to an significant revival of investments. The fear that the reform process will move very slowly is probably an important reason behind the limited revival of investments. Investors seem to be waiting for more clarity about the progress of the approval process surrounding social security reform. Given subdued investments and weaker-than-expected growth levels in the last two quarters of 2018, we have lowered our growth forecast for 2019 from 2.5% to 2%. Meanwhile, we are currently maintaining our 2.5% forecast for 2020. Risks are still tilted to the downside. If confidence does not improve significantly, this will continue to hamper a revival of depressed investments and hurt our growth outlook.

Strong rise in business confidence ...



Source: Bloomberg

..but industrial production back in negative territory



Source: Bloomberg

First tests for President Bolsonaro

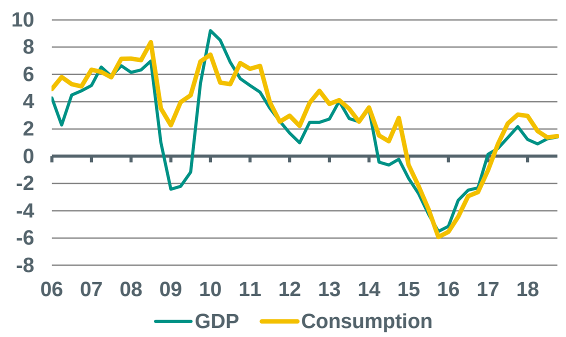
Now that the elections are behind us, political uncertainty has clearly diminished. Still, these remain interesting times. In mid-February, President Bolsonaro, who was inaugurated the first of January, experienced his first political crisis. Campaign funding irregularities and a clash with Bolsonaro's sons led to the dismissal of

Gustavo Bebianno, secretary general of the president's office and member of Bolsonaro's right-wing Social Liberal Party. One of the president's sons, the recently elected senator Flavio Bolsonaro, is under attack himself because of supposed links to a paramilitary group in Rio and allegations of illegal financing.

Concerns are also rising over the social and environmental agenda. A temporary decree issued by Bolsonaro on his first day in office gives the government far-reaching and restrictive powers over non-governmental organizations working in Brazil. In addition, the move to shift responsibility for indigenous territories from the Justice Ministry to the Agriculture Ministry was also seen by some as an attack on indigenous rights. It remains to be seen whether the president – who was elected on the combination of a law and order program and a neo-liberal economic agenda – will get all his proposed legislative changes approved. The decrees issued need to be confirmed by Congress. It became clear that this was not a forgone conclusion one day after the firing of Bebianno. The lower house voted to suspend an executive order by the Bolsonaro government that is aimed at altering Brazil's freedom of information law.

GDP growth stagnates

% GDP



Source: Bloomberg

Very weak Q4 growth figures

The economy came to a near standstill in the fourth quarter of 2018 with GDP growth of just 0.1% qoq. Compared to the previous year, growth slowed from 1.3% in Q3 to 1.1%. Average annual growth for 2018 came in at 1.2%. This is only marginally higher than last year's growth figure of 1.1% and much lower than expected at the start of last year. Growth in the agricultural sector and industry was just 0.6%. In the agri sector, growth started the year on a weak footing but accelerated in the second half. In industry, and especially in manufacturing, the opposite occurred, due in large part to the recession in Argentina. On the demand side, both consumption and investments picked up compared to 2017, with a growth rate of 1.9% and 4.1% respectively. The growth in investments sounds quite strong but comes after an accumulated 28% decline in the three previous years. The negative contribution of the external sector to growth increased, with exports growing by 4.3% and imports up 8.5%. For 2019, we expect private consumption to remain the most important growth engine, while investment growth will remain subdued.

Pension reform presented to Congress

On 20 February, the long-awaited pension reform proposal was presented to Congress. The proposed measures, which envisage savings of over BRL 1 trillion in the coming ten years, were tougher than those presented by former President Temer and were well received by the markets. The sense of urgency for some type of pension reform has become a more common. Still, it is not yet clear how much savings will remain after the negotiations in Congress. An outcome around BRL 600 to 700 billion is probably acceptable. Anything above that range would be seen as positive. Alternatively, should savings fall below that level, worries over a return to a more sustainable fiscal position in the foreseeable future would likely increase. Negotiations will be tough and lengthy, and it seems unlikely that the reform scheme will be approved before September. We therefore think that, while the odds seem to be in favour of approval, investors will maintain a wait-and-see attitude for the moment.

Structural issues will continue to restrain growth

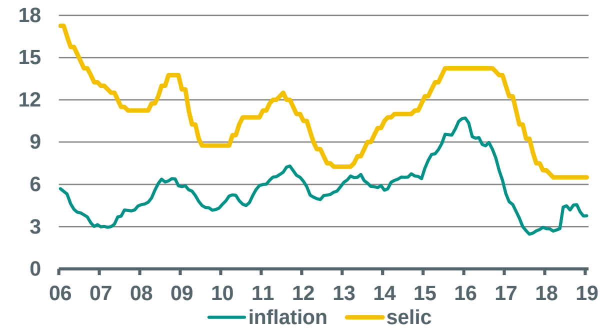
To improve the investment climate, President Bolsonaro stated in his speech at the World Economic Forum (WEF) in Davos that he wants to push Brazil into the top 50 of the WEF's Global Competitiveness Index by the end of this presidential term. This seems overly ambitious. Brazil is currently ranked 80 out of 137 countries. Chile, Costa Rica and Panama are the only Latin American countries in the top 50. Besides political uncertainty there are various other factors that are holding back investment growth. One is the high level of idle capacity in the economy, but even more important are several structural issues that will not improve overnight. Savings remain extremely low and it will take several years after approval of the pension reforms to improve this. The same applies to the necessary improvement of infrastructure and low productivity. The government's neo-liberal agenda might eventually result in improved competiveness, but it will take many years to reduce the structural shortcomings. Meanwhile, without approval of the pension reforms, investment might not pick up and the economy would most likely return to a recessionary state. And it is by no means certain that approval will lead to a strong upswing.

Inflation is under control, but does that mean more rate cuts?

Inflation ended 2018 at 3.8% yoy, up from 3% at end 2017, but clearly below the central inflation target for 2018 of 4.5%. Given the turbulence in emerging markets last year and the resulting depreciation of the real, this was still a remarkable achievement. It also showed that inflation expectations are much better anchored now than in the past. As a consequence, the central bank was able to further reduce the Selic rate, from 7% at the start of 2018 to 6.5% in March 2018, after which rates were kept on hold. The inflation target for this year is 4.25%, 4% for 2020 and 3.75% for 2021. June 2019, the target for 2022 will be unveiled. This is important as it relates to the question of what will happen to monetary policy. With inflation expectations for the coming years hovering around 4%, the prospect of a lower central target of, say, 3.5% in three to four years could imply that the central bank is not inclined to lower rates further, even though economic growth has not yet picked up.

Stable inflation, stable interest rates

%yoy/%



Source: Bloomberg

Real rates low from a historic perspective

% (Selic minus inflation)

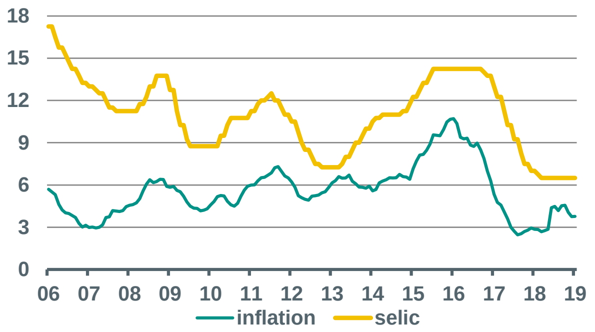
Source: Bloomberg

Reforms critical to achieve lower (real) interest rates in the future

In real terms (just simply subtracting the current Selic rate from the current inflation rate), interest rates are at historically low levels. Real rates only temporarily fell below 2.5% in 2012. Still, compared to other countries, the current interest rate of 6.5% is high – not just in nominal terms but also in real terms. This is entirely due to the poor state of Brazil's public finances. We therefore think that with only slow progress expected in the pension reform approval process, there is not much room to lower rates, even if growth continues to disappoint. This could change if the reform process moves faster and the reduction in the savings is lower than expected. On the other hand, should Congress not approve the reform scheme, the risk of a credit rating downgrade will continue to lurk in the background. This would very probably spark a further currency depreciation, causing interest rates to rise further. The approval of the social security reforms and a subsequent improvement in the fiscal situation is therefore pivotal to achieve a more supportive monetary policy.

Stable inflation, stable interest rates

% yoy/%



Source: EIU

Less upside on the real

We still expect the real to outperform the US dollar in 2019 and 2020 but less so than we originally had expected. There are several reasons for this. First, we are of the view that the Fed is done hiking rates and the US Treasury yields will decline at a modest pace this year and next. This is supportive for the Brazilian real. However, the decline in Fed's excess reserves will provide some support to the US dollar across the board. As a result, US dollar weakness will be less substantial versus the real than we originally had. Second, as discussed above the are now less optimistic about the Brazilian economy and we expect that there are quite some hurdles to take before the pension reforms are approved. This will dampen the upside in the real. Third, we see limited upside for commodity prices and we think that investor sentiment is less constructive than we originally had expected. These factors also dampen the upside in the real. As a result our new year-end forecasts for USD/BRL are 3.6 end of 2019 (3.4 previously) and 3.4 end of 2020 (3.2 previously).

Key forecasts for the economy of Brazil

	2016	**2017**	**2018e**	**2019e**	**2020e**
GDP (% yoy)	-3.5	1.0	1.2	2.0	2.5
CPI inflation (% yoy)	8.7	3.4	3.7	4.4	3.9
CPI Inflation (% eoy)	6.3	2.9	3.8	4.0	3.8
Budget balance (% GDP)	-6.5	-8.0	-7.1	-6.0	-5.0
Government debt (% GDP)	70	74	80	84	84
Current account (% GDP)	-1.3	-0.5	-0.7	-1.0	-1.0
Gross fixed investment (% GDP)	16	16	16	17	18
Gross national savings (% GDP)	14	15	15	15	15
USD/BRL (eop)	3.26	3.31	3.88	3.6	3.4
EUR/BRL (eop)	3.44	3.97	4.44	4.2	4.3

Economic growth, budget balance, current account balance for 2019 and 2020 are rounded figures
Source: EIU, ABN AMRO Group Economics