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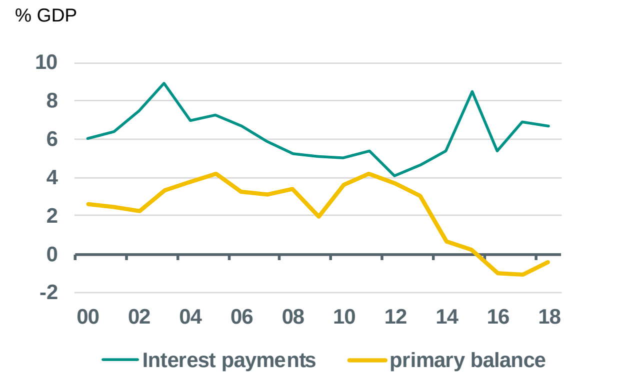
Brazil: First hurdle cleared

- **Pension reform can finally proceed in congress, but fiscal situation remains dire**
- **Economic activity still weak, while inflation picks up**
- **No room for further interest rate cuts, also given fiscal situation**

1. First hurdle for pension reform cleared, 6 more left

On February 20 the long awaited pension reform proposal was presented to congress. The reform, which envisages savings of over BRL 1 trillion in the coming ten years, was received well by the markets, but It took till April 23 to pass its first hurdle in congress. The Lower House Constitution and Justice Committee then finally concluded with a sufficient majority that the pension reform proposal is constitutional and can proceed in Congress. This is only the first step in passing the pension reform. A day later Rodrigo Maia, the speaker of the Lower House, set up a Lower House special committee that will analyze the bill. This committee needs to vote on the bill as well. After approval, two other voting rounds with a two-thirds majority are necessary in the lower house. After this, the same procedure continues in the Senate, bringing the total voting rounds to 6. We still expect that in the second half of the year a watered-down version of the pension reform will be approved, but it will remain a difficult battle in congress. Getting reforms approved will become more difficult next year. With municipal elections scheduled in October 2020, fewer and fewer congress members want to be associated with unpopular proposals.

Fiscal situation improves only slowly

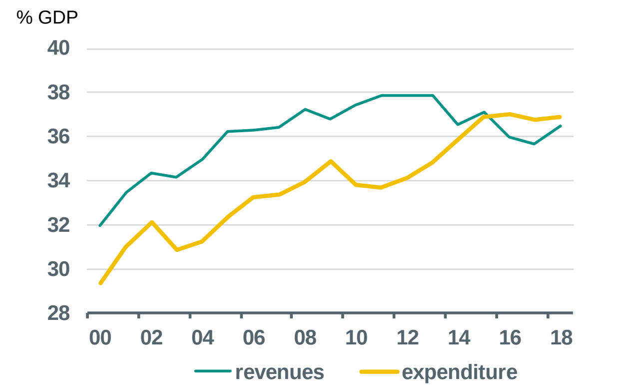


Source: EIU

2. Fiscal situation remains Achilles heel

Even with the pension reform approved, it will take many years to improve the dire fiscal situation and to reverse the rising trend of government debt rations. Gross government debt levels rose above 80% of GDP by the end of 2018. The primary deficit is slowly moving to a surplus. Together with lower interest expenditure, this puts the fiscal deficit on a declining trend, but it remains far too high, falling from 8% in 2017 to 7.1% in 2018, and to an expected 5% in 2019/20. Primary budget expenditure (without interest payments) have risen from 30% of GDP in 2000, to a peak of 38% in 2014, and it remains high at almost 37% now. Mandatory spending amounts to around 90% of the total and unless the pension reforms and other reforms are approved, this leaves little room for expenditure cuts, other than public investment. Room to increase taxes is also limited, as taxation levels are already relatively high.

Primary budget revenue and expenditure

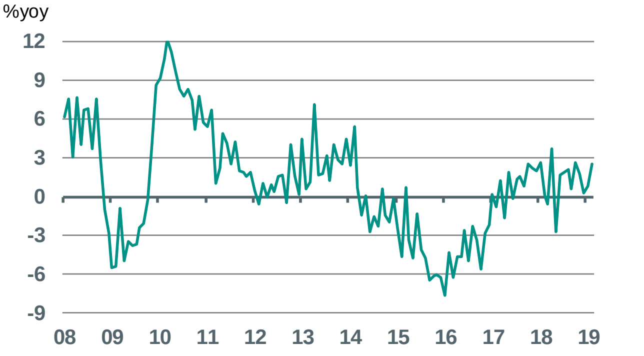


Source: EIU

3. February shows some uptick in economic activity

The recent economic data still points to a bleak economic picture. the economic activity index fell 0.7% mom in February, after -0.3% mom in January. Compared to a year earlier, however, economic activity rose 2.5% yoy, though the three month moving average remains weak at 1.2%. After lower than expected growth in Q4, Q1 GDP is expected to remain weak as well. Forward looking indicators show a mixed picture. The manufacturing and services PMIs remain in expansionary territory. The composite PMI rose from 52.6 in February to 53.1 in March. On the other hand, both consumer and business confidence indicators dropped in March. The overall soft economic activity data continue to point to a subdued recovery. The median of market expectations published by the Central Bank of Brazil shows that growth forecasts for 2019 fell from 2% a month ago to 1.7% now. For the moment we stick to our forecast of 2% growth in 2019, but downside risks have clearly risen.

Economic activity very slowly picking up

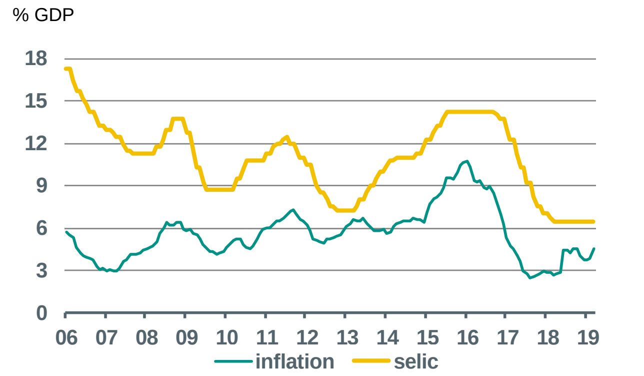


Source: Bloomberg

4. Inflation picks up

While risks have risen that growth disappoints again this year, inflation could end the year a little higher than expected. Inflation rose from 3.9% in February to 4.6% in March, just above the current central target of 4.5%. Given the rise in inflation and limited progress on the fiscal front, we expect the central bank to keep the Selic rate on hold for the remainder of the year at 6.5%. The central bank will continue to act prudently in order not to jeopardize the well anchored inflation expectations. If progress on the pension reforms disappoints, and this triggers a new wave of currency weakness, interest rates could even be hiked. If reforms progress more quickly, the opposite holds. Given this, we expect inflation in the coming two years to hover around the gradually declining central inflation target. Real interest rates will remain relatively high, with a stronger decline only likely if pension reforms get approved and an improvement of the fiscal situation becomes within reach.

Inflation on the rise, Selic on hold



Source: Bloomberg