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# Modest acceleration of growth

- **Approval of pension reform is important milestone**
- **Inflation fell below 3%, giving room for further monetary relaxation**
- **Q3 points to some acceleration of growth**
- **Still, overall growth outlook remains subdued**
- **We maintain our 2019 and 2020 growth forecasts at 1% and 2%**

**Pension reform approved without much resistance**

In late October, the pension reform passed the final hurdle in the senate. This was a major victory for the right-wing president Jair Bolsonaro and his pro-business economic team, who took office on 1 January 2019. What was also important was that there seems to be a rather strong consensus that some kind of pension reform was needed. Protests or other forms of social resistance were therefore limited, making Brazil suddenly look like a beacon of stability in a currently turbulent continent. Still, all is certainly not quiet on the political front. Political infighting within president Bolsonaro's PSL party continues, with some members recently forced to leave their positions. The most prominent case was the resignation of the congressional leader of the PSL Delegado Waldir, who was replaced by Bolsonaro's son Eduardo. Rumours are further that Bolsonaro plans to resign from the PSL and start a new party. With municipal elections scheduled for next October, political infighting is likely to intensify. This will also make it hard to get approval for any unpopular measures in an already strongly divided parliament. In addition, it remains to be seen whether the release of former president Lula from prison will result in a stronger mobilisation of opposition forces.

**Reform is an important milestone, but fiscal situation remains precarious**

After some further adjustments by congress and the senate, the final savings expected to be achieved by the pension reform in the coming ten years amount to BRL 800 mln, down from the original proposal of BRL 1.2 bn. This exceeds the estimated savings of the pension bill presented by the former interim government of president Temer and is probably sufficient to avoid the threat of downgrades of the country's creditworthiness. However, it will take time for the reform to lead to a reduction in fiscal spending and government debt levels, which now stand around 80% of GDP. An important element of the fiscal problems is that around 90% of the expenditures are earmarked in the constitution, while the tax burden of over 30% makes it difficult to increase revenues. This will not change overnight, and more measures are needed to reduce the spending cap. While a tax reform seems to have been removed from the table for the moment, President Bolsonaro and his economic minister Paulo Guedes used the momentum created by the approval of the pension reform to present three so-called PECs (proposals to amend the constitution) to the senate. These include measures to reduce the size of the state, curb public sector wage rises in the event of a so-called fiscal emergency and decentralise government funds. Approval of these more administrative reforms will not be a fast and easy process. As was the case with the pension reform, these proposals require unin both the senate and congress and a 60% majority. Privatisation of state enterprises and deregulation of infrastructure investments are other important additional measures aimed at improving the fiscal situation and boosting (foreign) investment. The government has targeted around 130 companies, 17 of which are given priority, including Eletrobras and the Correios postal service. But here, too, expectations are that it will be a slow process, with little achieved before the municipal elections in 2020.

**Inflation clearly down**


Source: Bloomberg

**Interest rates at historic low**


Source: Bloomberg

**Reforms create room for further interest rates cuts**

The pension reform and adherence to the spending cap rule clearly diminish the risks of a downgrade of the sovereign credit ratings. These changes, together with a strong external position, a favourable inflation picture and lower global rates also create room for a further extension of the easing cycle which started end-2016. Inflation fell to 2.9% yoy in September, helped by a stronger currency. This is close to the lower bound of the inflation target range for 2019 of 2.75% to 5.75%, with a central target of 4.25%. While inflation might pick up in the coming months, we expect it to remain at or below target. Producer prices even fell in September by 1.2% yoy. This provides scope for a further rate cut in December this year, to a new historic low of 4.5%. When the monetary expansion cycle started at the end of 2016, the Selic rate stood at 14.25%

**Strong acceleration of growth unlikely**

Unfortunately, approval of the pension reform and lower interest rates have increasingly become a necessity to stop a further deterioration of the economy rather than a condition to kickstart it. During the year we have lowered our growth forecast for 2019 several times, from an initial 2.5% at the start of the year to 1% currently. For the moment, we are sticking to our 1% growth forecast for 2019 and 2% for 2020. This means that we expect some growth acceleration in the second half, which will continue in 2020. This acceleration should come from slightly stronger consumption and investment growth, thanks to lower interest rates and some improvement in confidence levels. Still, as long as confidence fails to improve significantly, a more pronounced revival of depressed investments is not expected. Fiscal austerity will continue to hamper a stronger growth recovery, as will structural weaknesses such as low savings, low productivity and inadequate infrastructure. Given a variety of global uncertainties and domestic issues, risks still remain tilted to the downside.

**Business confidence up…**

Index (CNI)


Source: Bloomberg

**…and industrial production is slowly stabilising**

% yoy 3mma


Source: Bloomberg

**Gradual pick-up in growth continues in Q3**

Economic figures available for the third quarter and beyond indeed point to a modest acceleration of growth in line with our forecast. For some months now, the forward-looking PMI indicator has pointed to a recovery. The manufacturing PMI rose from 49.9 in July to 52.5 in October, with 50 the threshold between growth and contraction. Consumer credit has been growing by over 10% yoy since November 2018 and rose by 15% in July. Private consumption will profit from this and from some improvement in employment figures. Retail sales increased by 2.6% in the third quarter compared to a year earlier In the first half of the year, the increase was only 0.7% yoy. While a rise in industrial confidence following the election of president Bolsonaro last year led to some revival of investments, industrial production only recently started to pick up. In September, industrial production moved back to positive territory compared to a year earlier. There were various factors behind the contraction in industrial production in the first half of 2019. The crisis in Argentina was negative for the automotive industry, while iron production was disrupted due to the collapse of an important dam. Although the recent pick-up in investments is encouraging, it will take a while to compensate for the accumulated decline of over 30% in the period between 2014 and 2017. The third quarter GDP figures will be published in early December and will provide more clarity about the extent of the recovery.

See also our recent report: [BRICS: An Emerging Commodity Coalition is here to stay.]()

**Key forecasts for the economy of Brazil**

| | 2016 | 2017 | 2018 | 2019e | 2020e |
|---|---|---|---|---|---|
| GDP (% yoy) | -3.3 | 1.1 | 1.1 | 1.0 | 2.0 |
| CPI inflation (% yoy) | 8.7 | 3.4 | 3.7 | 3.8 | 3.6 |
| CPI Inflation (% eoy) | 6.3 | 2.9 | 3.7 | 3.7 | 3.8 |
| | | | | | |
| Budget balance (% GDP) | -7.5 | -8.9 | -6.9 | -6.0 | -4.5 |
| Government debt (% GDP) | 70 | 74 | 77 | 82 | 83 |
| Current account (% GDP) | -1.3 | -0.4 | -0.8 | -1.0 | -1.5 |
| | | | | | |
| Gross fixed investment (% GDP) | 16 | 15 | 16 | 16 | 17 |
| Gross national savings (% GDP) | 14 | 15 | 15 | 15 | 15 |
| | | | | | |
| USD/BRL (eop) | 3.26 | 3.31 | 3.87 | 4.0 | 4.3 |
| EUR/BRL (eop) | 3.44 | 3.97 | 4.44 | 4.5 | 4.9 |

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