Brazil

TENUOUS TRUCE

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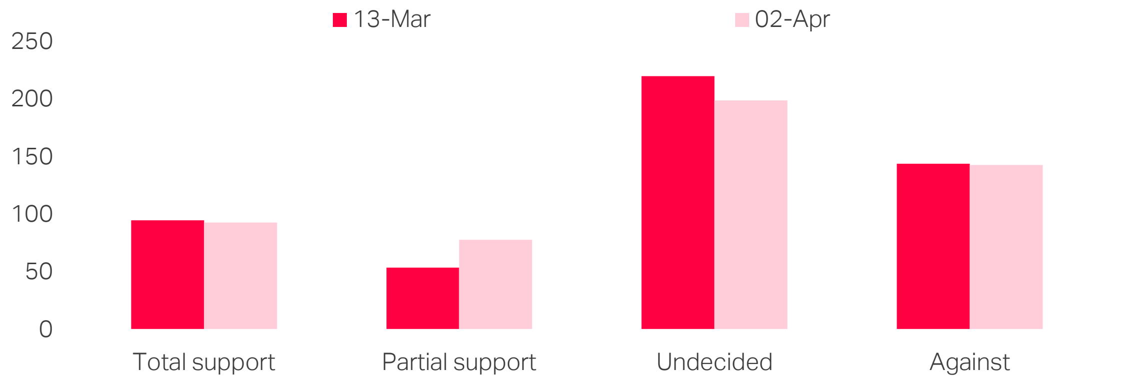
- **Bolsonaro and Lower House Speaker Maia reached a deal to salvage the pension reform after tensions reached a boiling point last week**
- **While Bolsonaro will support the reform more vocally, Economy Minister Paulo Guedes will actively negotiate with the Congress**
- **Bolsonaro also agreed to meet with party leaders, but other changes to his political team are needed for the reform to gain traction**
- **Following today's committee hearing, it is likely that changes to rural pensions and to disability payments for the elderly will be eliminated from the reform**
- **The approval in both houses of a constitutional amendment reducing budget flexibility was a clear warning signal to the government**

Lower House support for pension reform

No. of votes

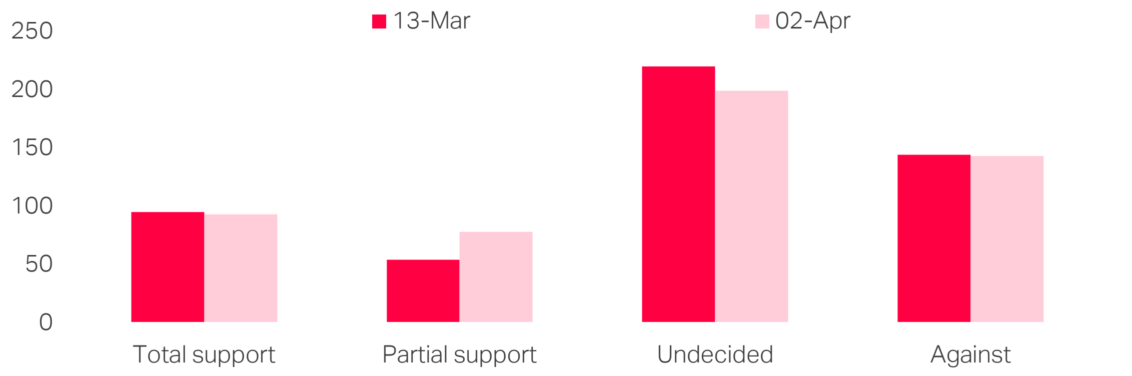


Source: Atlas Político.

Pension reform in focus as tensions ease

Nearly six weeks after the Bolsonaro administration presented its pension reform proposal to the Congress, the government is finally starting to show some small signs of progress towards gaining support for its proposal. Following the crescendo of political noise last week as President Bolsonaro and Lower House Speaker Rodrigo Maia traded insults, the environment in Brasilia has become slightly more harmonious in the past few days. This has helped the government make some progress towards getting the 308 votes necessary for approval. According to the most recent Atlas Político survey, the government has 171 votes in favour of the reform, which is up from 149 on 13 March (see Chart 1 below). The largest increase came among members of the Lower House who said they would support the reform with changes. The number of votes against the reform fell by one vote, while 199 members of the Lower House remain undecided, down from 220 in March. Although this highlights the long path ahead to approval of the reform, the government is at long last starting to head in the right direction.

Chart 1: Support for the pension reform in the Lower House
No. of votes



Source: Atlas Político.

The most concrete sign of progress was the appointment of a rapporteur for the Constitution and Justice Committee (CCJ) last week. The rapporteur, Delegado Marcelo Freitas of Bolsonaro's Liberal Social Party (PSL), promised to submit his report on the constitutionality of the reform to the CCJ committee by 9 April but noted that the report could be presented sooner. He estimates that the committee will vote on the reform by 17 April, just ahead of the Easter holiday. While the progress in the CCJ committee is positive, it is worth highlighting that the Temer reform was able to clear this hurdle in just seven days, whereas the Bolsonaro reform has wallowed in the committee for more than a month now.

Changes to the reform will likely begin in the special committee. In yet another small victory for the administration, the rapporteur of the CCJ has promised to focus only on analysing whether the reform is constitutional. That announcement came after growing pressure from some members of the Congress to start changing the basic text of the reform in the CCJ committee. Key members of the committee argued that it would be a "dangerous precedent" to start analysing the merits of the reform at this stage in the process. Still, labour unions representing public employees have increased pressure on committee members to make changes to the text of the reform, so it will be important to monitor what happens over the next two weeks.

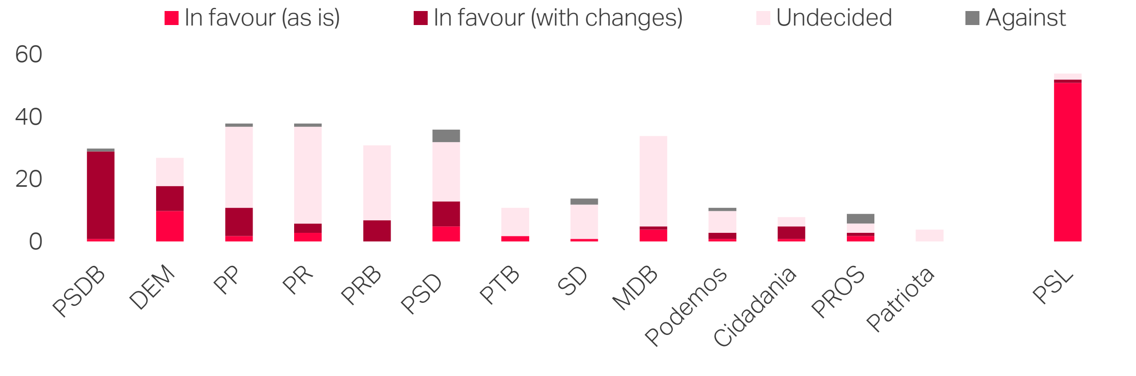
Perhaps more important, the administration appears to have reached an agreement on a path forward to gain support for the approval of the reform. After the market sell-off last week, key members of the government got a taste of the importance of the reform. Following the tremors in Brasilia, Lower House Speaker Maia and Economy Minister Paulo Guedes agreed to work closely together to persuade undecided members of the Congress to support the reform. Under the agreement, Guedes will be meeting with members of the Congress on a daily basis to discuss the reform, explain its importance and, not least, give them the opportunity to air their concerns.

The first phase of this plan involves meeting with the Social Democratic Party (PSD). On Tuesday, Minister Guedes and Social Security Minister Rogério Marinho met with 13 representatives from the party, which is the fifth-largest party in the Lower House with 36 seats. Guedes is scheduled hold talks with the remaining PSD members later this week. Guedes met with a total of 50 members of the Congress on 2 April, including members of the Liberal Social Party (PSL) and the Brazilian Republican Party (PRB). Meetings with representatives of other parties are expected to take place in the coming weeks.

The administration will likely focus on the 13 parties that have announced their support for the reform if the government agrees to make some changes. Leaders of these parties, which together have 291 members or more than 56% of the seats in the Lower House, signed a document in support of the reform on 26 March (see Chart 2 below). With the support of these parties and that of Bolsonaro's PSL party, the government would have enough support to pass the reform. The issues cited in the document include disability payments to the elderly and rural pensions, as we highlighted in our 15 March note. Other issues include the proposal that future changes to the pension system would not require a constitutional amendment as well as the introduction of a Chilean-style capitalization system. These issues were also the main points of contention among members of the Constitution and Justice Committee, which grilled Minister Guedes for over six hours on Wednesday.

Chart 2: Support for pension reform among key political parties

No. of votes



Source: Atlas Politico.

Bolsonaro is scheduled to meet with party leaders tomorrow, in a significant departure from his original political strategy. Having previously argued that he had already "done his part" by presenting the pension reform to the Congress, Bolsonaro has finally agreed to take a more active role in securing approval for the reform. He decided to cut his trip to Israel short, albeit by just a few hours, in order to meet with party leaders this Thursday. Bolsonaro is currently scheduled to meet with the Presidents of key parties, including Romero Jucá (MDB), Gilberto Kassab (PSD), Antônio Carlos Magalhães Neto (DEM), Ciro Nogueira (PP), Geraldo Alckmin (PSDB) and Marcos Pereira (PRB). Next week, he is expected to meet with the president of his own PSL party along with the leaders of the Republican Party (PR) and Podemos. The results of these meetings will be key to monitor, as they represent a significant departure from the President's previous stance.

In addition to these meetings, Bolsonaro has promised to dedicate half his day to holding talks with members of the Congress. If he keeps these promises, it will be a sign that he is starting to realize that the reform will fail unless he gets involved in political negotiations. Still, the President clearly wants to try to distance himself from "old-style politics": he has vowed not to meet privately with party leaders who have been implicated in corruption scandals in an effort to protect himself from future corruption allegations.

In an indication that Bolsonaro's decision to focus on political caucuses rather than parties could, in fact, bear some fruit, the pension reform has also received support from two important rural groups. The Parliamentary Agriculture Front (FPA) and the National Agricultural Confederation (CNA) announced their support for the reform this week. But in the case of the FPA, which has 225 members, the support of many of its members hinges on changes to the reform. The FPA has scheduled a meeting with Guedes and Agriculture Minister Tereza Cristina for next week to discuss the reform. These negotiations will be key to follow, as other caucuses could follow suit and announce that they, too, will support the reform.

Maia adopts a more amenable stance too. After more than a week of verbal sparring with Bolsonaro, Maia has decided to adopt a more peace-and-love approach to dealing with the administration. Not only has he been meeting regularly with Guedes; he also held a meeting last Friday with Justice Minister Sergio Moro and promised to help push ahead with the anti-corruption legislation. Just one week earlier, Maia had criticized Moro and called his anti-corruption legislation a "cut-and-paste" version of a similar bill presented by Supreme Court Justice Alexandre de Moraes.

Meanwhile, changes to Bolsonaro's political team remain key to monitor. While Bolsonaro's new approach to the political negotiations are welcome, it has become increasingly clear that other members of the team could be doing more to support the reform. The government leader in the Congress, Major Vitor Hugo, has been a liability to the administration. In an interview with the São Paulo daily *Folha de São Paulo*, the leader of the Progressive Party (PP) in the Lower House Arthur Lira said that none of the party leaders are willing to speak with Vitor Hugo. At the same time, there are rumours that General Carlos Alberto Santos Cruz, who is the Government Secretary, could be replaced by Congresswoman Joice Hasselmann. Santos Cruz would become the President's Secretary General, taking over from General Floriano Peixoto. For now, Bolsonaro has not publicly mentioned replacing his Chief-of-Staff, Onyx Lorenzoni, but the latter has been criticized for likewise failing to negotiate with the Congress. Any changes on this front could be supportive of the market, since the lack of political coordination has been the main obstacle to building support for the reform.

Although the mood has improved, the relationship between the Congress and the administration remains strained. The dust has settled in Brasilia, but the Congress remains cautious with respect to the Bolsonaro administration and continues to strongly support Maia. As we highlighted in February, Maia has taken a leadership position with respect to the reform since he was re-elected Speaker of the Lower House. He has also fulfilled his promise to represent the interests of the legislature and to maintain its independence from the executive branch. In a clarion example of his strong support across the political spectrum, Maia was able to pass a constitutional amendment that further limits the executive branch's ability to allocate budget last week. The proposal was passed in record time and received support from 448 members of the Lower House. The approval of the legislation not only showed that Maia has support from across the political spectrum, but also that the legislature has the power to sabotage the government's agenda.

The bill will increase the amount of compulsory spending in the government budget to roughly 97% of total primary spending, compared with 93% today. Not only would this legislation go in the opposite direction than that which Guedes is currently advocating; it would also make it more difficult for the government to comply with the spending cap. Under the bill, it would be compulsory for the administration to fund amendments included in the annual budget. The current rules stipulate that the government decides whether funds for those amendments are released; and sometimes it uses them as bargaining chips in negotiations for support. While Bolsonaro and other high-rank government members insist on downplaying the approval of the bill in the Lower House, the government has clearly been dealt a defeat. The bill is estimated to have a BRL7.3bn impact on government spending between 2020 and 2022 – BRL1.7bn in 2020 – according to the Senate's Independent Fiscal Office (IFI).

The bill was approved by the Senate today, but will need to return to the Lower House, because of changes made to the legislation by the Senate. With the changes, the percentage of obligatory spending rises gradually, which would reduce the short-term fiscal impact. The bill now needs to return to the Lower House for a second vote.

If approved, the budget bill would increase the risk of breaking spending cap rule in 2020. While the estimated impact for 2020 might appear small at first glance when compared with the government's annual spending of roughly BRL1.4 trillion, it could be the last straw in terms of noncompliance with the spending cap rule. In the situation of an already rigid budget, which makes it harder for the government to provide adequate fiscal adjustment, the approval of this bill would clearly be negative as it further reduces the government's ability to manage the budget. In practical terms, the approval of the bill in the Senate would anticipate the risk of the government not being able to comply with the spending cap rule – a scenario that would almost certainly materialize in 2021, if not in 2020. In a bid to offset the eventual effects of the budget bill, the Economy Ministry has increased the amount of the funds that are blocked in this year's budget to BRL35bn – BRL5.4bn higher than the previous amount – in order to reach its BRL139bn primary deficit target for 2019.

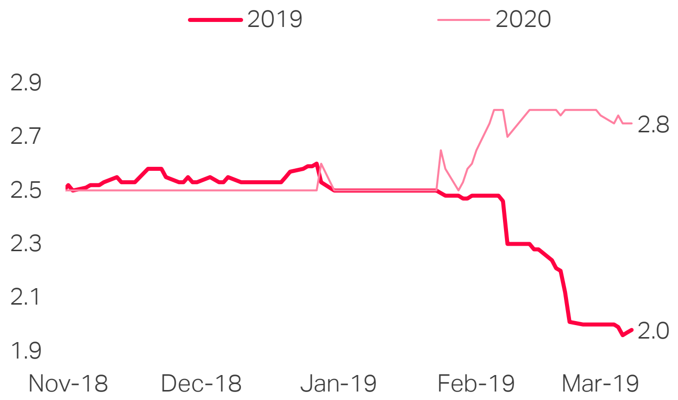
All eyes on the economy

The weak economic recovery is a growing concern for the President and his economic team, even if the success of the Bolsonaro administration is intrinsically linked to the approval of pension reform. The unemployment rate rose 40bps in February to 12.4% owing to seasonal factors and despite the rise in formal job creation. The poor result prompted Bolsonaro to question the quality of the government's official unemployment data, which, in turn, led to an outpouring of support from economists and the specialized news media for the official statistics agency, the IBGE. Still, the legions of unemployed Brazilians are undoubtedly cause for concern among members of the economic team and highlight the challenges ahead.

Market expectations for GDP in 2019 fell 0.5pp to 2% in March and are likely to keep falling amid weak Q1/19 data. As the outlook for a stronger recovery continues to dim, there are growing concerns that the mediocre results of 2018, when the economy expanded by just 1.1%, will be repeated this year. In its bimonthly budget report, the Economy Ministry revised down its GDP growth forecast for this year to 2.2% from 2.5% owing to the lacklustre pace of the recovery. And in its Quarterly Inflation Report, the Banco Central, too, revised down its 2019 growth forecast from 2.4% in December to just 2.0%. The revision was in part because of the lower statistical carryover from the weaker-than-expected growth last year. But it also recognized that the decline in iron-ore output following the breach of the mining giant Vale's tailings dam in January will weigh on industrial production.

Chart 3: GDP growth expectations for 2019 and 2020

%



Source: Banco Central.

Chart 4: Business confidence index

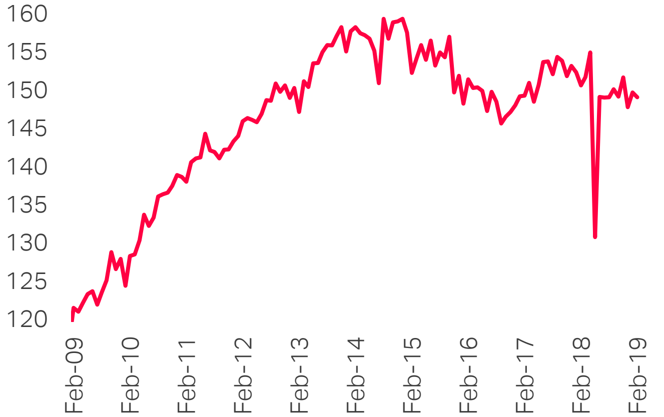
Avg. for Jun/10 to Jul/15 = 100

Source: FGV.

Several leading activity indicators suggest weak growth in Q1/19, which will add to the sluggish recovery this year. Cardboard sales, which are a leading indicator of both industry and consumer spending, posted marginal growth only at 0.2% mom/sa in February, compared with a decline of 1.0% in January. Leading indicators for retail followed the same weak dynamics. Consumer credit demand, as measured by the credit bureau Serasa Experian, slowed in February to 0.6% mom/sa, compared with a 1.9% increase in January. The flow of vehicles on toll roads, as measured by the Brazilian Toll Road Concession Holders' Association (ABCR) – a key leading indicator for the industrial sector – fell 0.4% mom/sa in February, after increasing by 1.3% in January.

The overall weak preliminary activity data for February, together with the increased perception of the lack of progress on pension reform, continue to weigh increasingly on sentiment. The Getúlio Vargas Foundation's (FGV) business confidence index, which aggregates industrial, retail, services and construction sentiment and was rising steadily until the end of last year, fell 2.8% mom/sa in February, following a 0.8% decline in January (see Chart 4 above). Overall sentiment is likely to remain under pressure amid the lack of growth drivers in the short term.

Chart 5: Toll road activity index
Index 100=1999



Source: ABCR.

Chart 6: Cardboard sales
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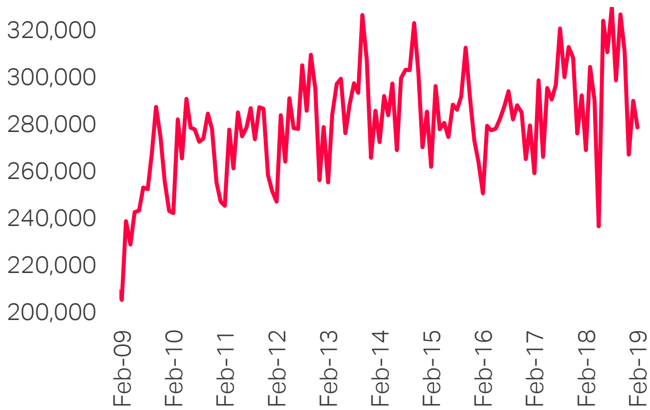

Source: ABPO.

Conclusion

There is still a risk that the administration will not be able to pass any pension reform, although our base case remains that a watered-down reform will be passed. As the crisis in Brasilia escalated last week, it was clear that key opinion-makers understand what is at stake. For example, a group of leading businessmen announced that they would be opening an office in Brasilia to help lobby for the pension reform. Likewise, governors and mayors from across the political spectrum continue to support the reform. As a result, it is possible that the reform could pass despite the President, rather than because of his strong support for the reform.

Although the mood has improved over the past week, there are concerns that tensions could flare again at any moment. While Bolsonaro and his sons have exercised more constraint with their Twitter accounts and have even been sharing content about pension reform, there is no guarantee that they will continue to do so. It is also clear that the administration recognizes that it needs to improve its communications. Last week, the administration replaced one of Eduardo Bolsonaro's long-time allies, Floriano Barbosa, with a new communications strategist, Fábio Wajngarten. Wajngarten will be responsible for the publicity campaigns for pension reform, which should become more frequent once the bill reaches the special committee.

Meanwhile, Bolsonaro's continued missteps in other areas continues to weaken the administration. This has been most evident at the Education Ministry, which is headed by Ricardo Vélez, one of the most fiercely ideological members of the cabinet. Not only have there been almost daily reports about the gross mismanagement of the ministry; Vélez himself has been forced to back track on many of his key decisions. Similarly, Bolsonaro's recent denial that the military regime (1964-1985) was a brutal dictatorship has further polarized the population and opened up the government to criticism at a time when it needs all the popular support it can muster. Finally, the President's decision to establish a business office in Jerusalem, despite protests by important Middle Eastern trading partners, threatens to alienate key domestic allies, including those in the agricultural sector. And while some of these mistakes can be blamed on lack of political experience, Bolsonaro needs to understand in all humility that if his administration fails to pass pension reform, it will be remembered as one of the worst in modern Brazilian history. Likewise, if the economy deteriorates further because the reform does not pass, it is also possible that Bolsonaro could face impeachment in the future.