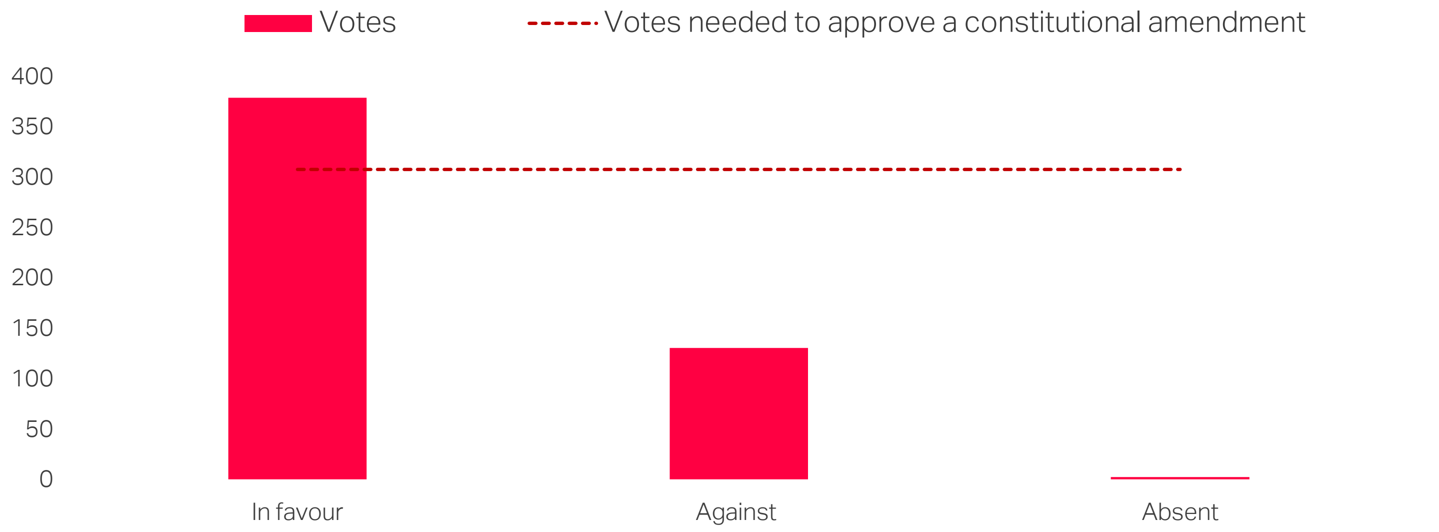
Brazil

PENSION REFORM: THE PATH AHEAD

Elizabeth Johnson / Wilson Ferrarezi

- **Strong support for the pension reform in last week's first floor vote in the Lower House points to a relatively smooth path ahead in the Senate**
- **The Senate plans to present an alternative bill that will include state and municipal government employees in the reform**
- **Despite the failure to complete the second vote on the pension reform in the Lower House, Banco Central is still likely to cut rates this month**
- **Now that the pension reform hurdle has almost been cleared, the economy will be the main risk to monitor**

Result of the first full floor vote for pension reform in the Lower House

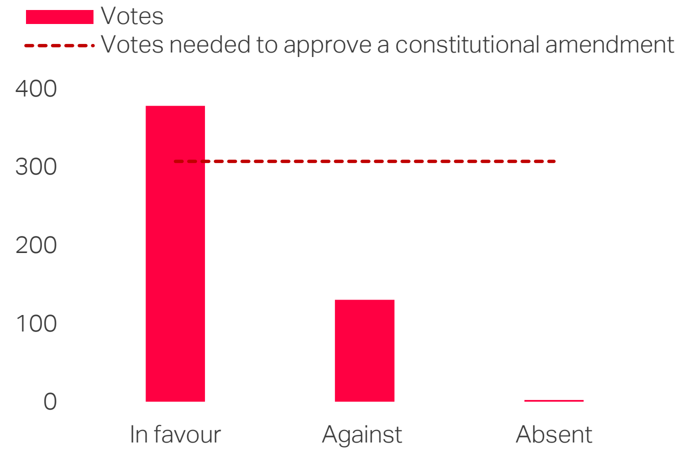


Source: Congress.

Pension reform hurdle nearly cleared

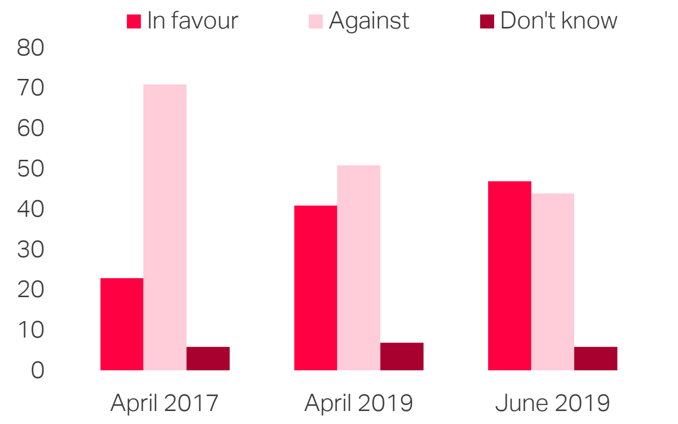
Speaker Maia delivers a historic win for the Congress. After nearly three years of debates, Brazil is on the brink of approving a broad pension reform. The reform, which passed in the first floor vote in the Lower House last week, will fall short of resolving all Brazil's fiscal woes; however, there is little question that it will put the country on a significantly more sustainable fiscal path for the next decade. Support for the reform in the first full floor vote was much stronger than even the most optimistic estimates – 379 deputies voted in favour – highlighting that after years of discussions about the retirement system, there is a strong consensus among both politicians and the general population that the overhaul is necessary. Because all constitutional amendments need to be approved in the Lower House in two full floor votes, the reform will not advance to the Senate until after the July recess. Still, our base case is that, despite the second floor vote being delayed until 6 August, the reform is on track to be approved by the Lower House by a large majority.

Chart 1: Results of first pension reform vote in the Lower House



Source: Congress.

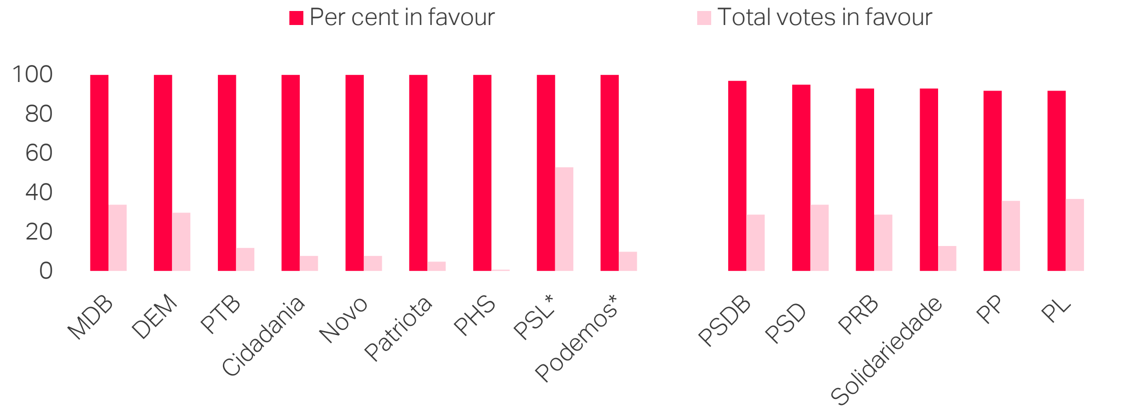
Chart 2: Popular support for the pension reform
%



Source: Datafolha

The vote count is also a result of Lower House Speaker Rodrigo Maia's political skills. Since his re-election in February, Maia has taken ownership of the reform and, in doing so, has succeeded in building a solid coalition to approve the pension reform. In fact, all the members of nine parties in the Lower House, including those from the so-called Centrão ("Big Centre") voted in favour of the reform in the first full floor vote last week, while nearly all the members of another six parties supported the reform. This highlights that, despite Bolsonaro's lack of a support base in the Congress, Maia was able to work with party leaders to build strong support for the pension overhaul. Although there is little question that Social Security Secretary Rogério Marinho and the rapporteur of the reform in the Special Committee of the Lower House, Samuel Moreira, played fundamental roles in this process, too, the reform could easily have floundered in committee for months without Maia's leadership skills.

Chart 3: Party support in the first-round vote in the Lower House
% and votes

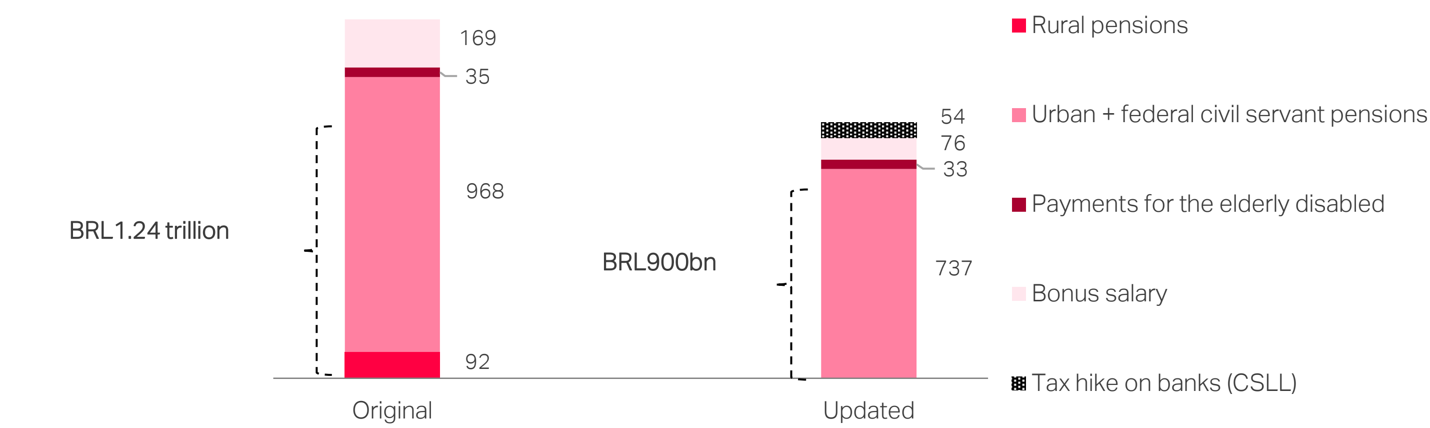


Source: Congress.

*One member was absent on voting day.

Although Maia was forced to postpone the second floor vote until 6 August to vote amendments to the reform, he was able to limit significant changes to the reform during the first round of voting last week. Estimates of the savings from the reform over the next decade range from BRL750bn to BRL900bn, compared with the estimated BRL1.2 trillion from the government's original proposal. As a result, the savings from the reform will likely be above market estimates and higher than the projections in the Temer proposal in May 2018. The reform, coupled with the anti-fraud legislation approved in early June, means that savings are in line with Economy Minister Paulo Guedes' target of BRL1trillion over the next 10 years.

Chart 4: Estimated savings from pension reform
BRLbn over 10 years



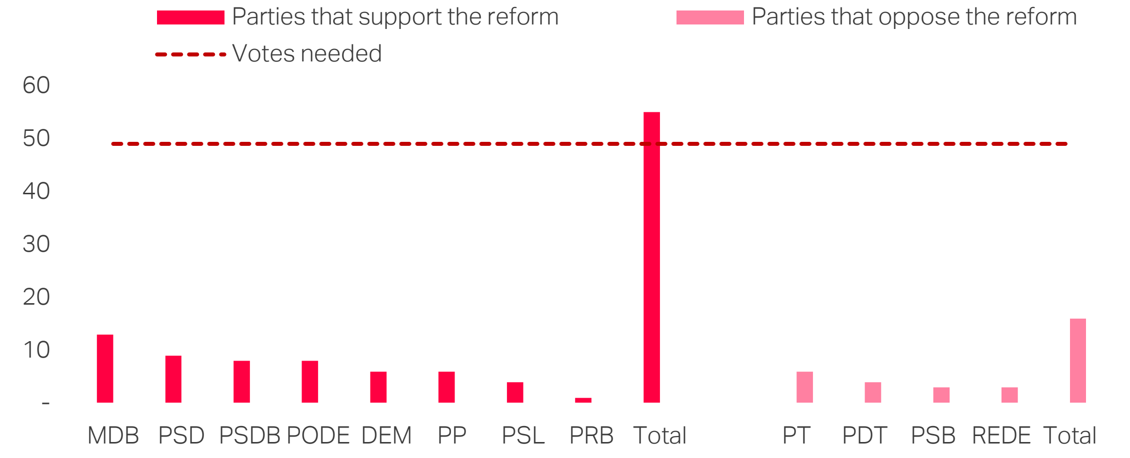
Sources: Economy Ministry, Congress.

The failure to include state and municipal government employees is the main shortcoming of the reform. Despite Speaker Maia's considerable efforts, he was unable to reach an agreement to have state and municipal government employees included in the reform. This is largely because a handful of governors in Brazil's northeastern region refused to come out in favour of the reform. Still, it is worth highlighting that there are elements in the reform passed in the Lower House this week that will increase pressure on state and municipal governments to overhaul their pension systems. For example, the reform requires state and municipal governments to limit the deficits of their pension systems and bring them into line with the system for private-sector workers. This aspect of the reform, which is being compared to the Fiscal Responsibility Law, will require those governments to take steps to reform their pension systems.

The Senate has promised to address the issue of state and local government pension systems. After Speaker Maia had thrown in the towel with respect to the inclusion of state and local government employees in the reform, Senate President Davi Alcolumbre promised to address the issue without compromising the broader reform. One solution that is looking increasingly likely is to present a separate constitutional amendment in the Senate that would run parallel to the broader pension reform. Approval of this legislation could be less challenging in the Senate, where the opposition holds fewer seats. Furthermore, many Senators are former governors and, as such, are keenly aware of the fiscal challenges of state and local governments. Presenting a "parallel" bill would allow the Senate to pass the broader pension reform without modifications, which would mean it would not need to return to the Lower House for another round of votes. Only the legislation that deals with state and municipal government employees would need to be approved by the Lower House.

Chart 5: Parties in favour/against the pension reform in the Senate

No. of Senators



Source: Senate.

There is still some hope that state and municipal government employees will be included in the reform. Because of the larger-than-expected number of votes in favour of the reform in the Lower House last week, there is a growing sense among politicians that the political cost of voting for the reform could be lower than assumed. Still, electoral politics at the state and municipal level continue to influence the debate, and it will be up to the Senate to try to reconcile all the opposing interests when the reform advances to the Senate next month. Still, failure to include state and municipal government employees in the reform would be a significant failure on the part of the legislature. It would leave many state and local governments with no capacity to invest and also means that the federal government may be forced to offer financial support to these governments in the near term.

Support from some leftist politicians has put critics of the reform on the defensive. Although the far-left parties, including the Workers' Party (PT), voted unanimously against the reform, 19 members of the centre-left Brazilian Socialist Party (PSB) and Democratic Workers' Party (PDT) – or nearly one-third of their total number of representatives – voted in favour of it. Leaders of the PSB and PDT are now threatening to expel these representatives from their parties for failure to follow party directives. The most high-profile case has been that of PDT Congresswoman Tabata Amaral, who voted for the reform. Former Ceará Governor Ciro Gomes is now calling on Tabata Amaral – a rising star in Brazilian politics – to resign from the party. While the anti-reform discourse plays well among core supporters of far-left parties, the public demonization of Tabata and other left-leaning politicians could ultimately backfire on far-left parties, which have failed to present a viable alternative for Brazil's fiscal woes.

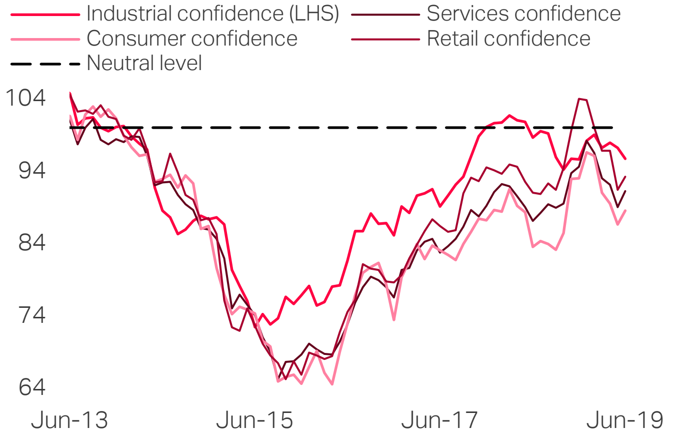
The final vote count in the second floor vote in the Lower House will be key to monitor. Because approval of the additional amendments extended for two days, the second floor vote in the Lower House has been postponed until 6 August. While this has contributed to market jitters, we expect a similar vote count in the final vote. Any changes – either on the upside or the downside – will be key to monitor. Although Maia has hoped to conclude the vote, many Congressmen who supported the reform in the Lower House will use the extra time to pressure the Bolsonaro administration to release additional funding for their pet projects. This is particularly important after Bolsonaro decided to reduce the powers of his Chief-of-Staff, Onyx Lorenzoni, in the recent cabinet shuffle. Many members of pro-reform parties are concerned that the Bolsonaro administration will not fulfil its promise to release those funds once the pension reform has been approved.

Senate President Davi Alcolumbre has promised to hold a vote on the reform in the Senate within 45 days. Although the delay in concluding the second vote in the Lower House will push back the start date for debates to begin in the Senate, the rapporteur of the reform in the Senate, Tasso Jereissati, said that the process is expected to move much more quickly in the Senate than in the Lower House. Because support for the reform is already stronger in the Senate than in the Lower House, we believe it is possible that the reform could be signed into law by early October. The main sticking point in the Senate, as highlighted above, remains the inclusion of state and municipal government employees in the reform.

The approval of the pension reform will boost confidence. Overall sentiment levels have been on a steady downward trend since peaking at the beginning of this year amid all the political uncertainty. We expect the approval of the reform to lift the dark cloud that has been hanging over the country since late 2016. Indeed, the improved outlook for the pension reform in recent weeks helped confidence levels to improve at the margin last month. Confidence in the industrial sector, retail sales, services and among consumers as measured by Fundação Getulio Vargas (FGV) posted an average 1.3% mom/sa increase, following the 3.2% decline in May. This was the first aggregate increase since January.

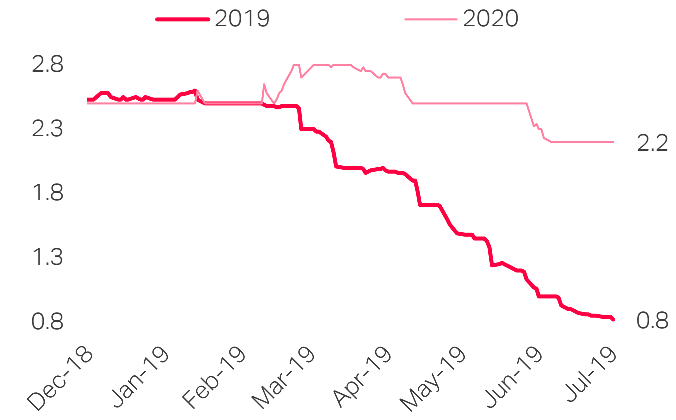
But concrete economic improvements are not expected to be felt until 2020. In the meantime, economic activity will likely remain lacklustre throughout the remainder of 2019 amid a stubbornly high, double-digit unemployment rate, which means subdued consumer spending. While unemployment declined 20bps in May to 12.3% compared with the previous month, there are still 13mn unemployed people, versus just 6.4mn back in 2014 and the 9.7mn average since the IBGE monthly job survey was launched in the early 2012. The weak labour market in Brazil and the resulting low capacity utilization levels have kept the output gap wide. Because of the rigidity of the Brazilian job market, these weak dynamics are set to continue throughout the coming months before the economy recovery begins in earnest.

Chart 6: FGV sector confidence levels
Avg. between Jun/10 to Jul/15 = 100



Source: FGV. Note: Neutral here means sentiment tilted to positive.

Chart 7: Market GDP growth expectations
%



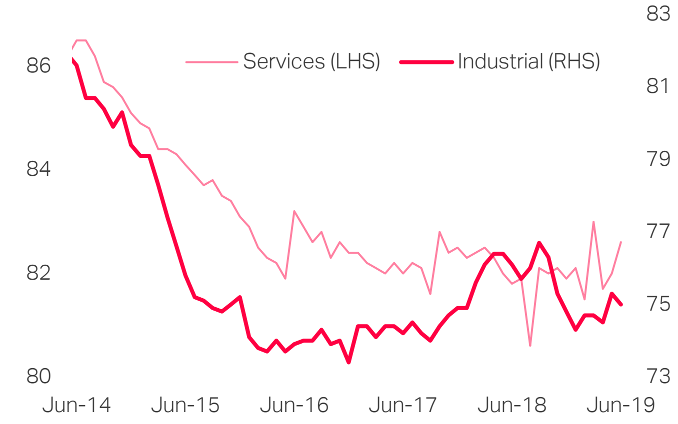
Source: Banco Central.

Negative as that is, the weak economy will keep inflationary pressures low. The weak dynamics in consumption mean that inflation will remain at tempered levels throughout the remainder of the year. Recent inflation numbers reinforce this view. The June CPI (IPCA) slowed to 0.01% mom, down from 0.13% in May, its lowest level since November 2018, bringing the 12-month rolling rate to 3.4% yoy in June compared with 4.7% in May. The sharp yoy decline is related to the dissipation of the base effect from the 1.3% spike in inflation following the May truckers' strike last year. While low inflation in June reflected falling food and fuel prices and lower electricity inflation, services inflation highlights the lack of demand pressures on prices. And while 12-month rolling services inflation rose 8bps to 3.95% yoy, it remains comfortably below the 4.25% inflation target for this year. In addition, underlying services inflation, which is used by Banco Central as a proxy for core services inflation, fell 20bps to 3.66% yoy, reinforcing the view that weak activity will keep a lid on inflationary pressures through the remainder of this year.

The stars remain aligned for a rate cut this month. As we highlighted last week, conditions are ripe for a cut in the monetary policy rate. The benign inflation scenario, coupled with the perception of stagnant economy in Q2/19 and the strong approval of the reform in the first vote in the Lower House, reinforces our view of rate cuts in the 30-31 July rate decision. As a result, we expect Banco Central to cut rates by as much as 50bp at the end of this month.

Chart 8: Capacity utilization levels

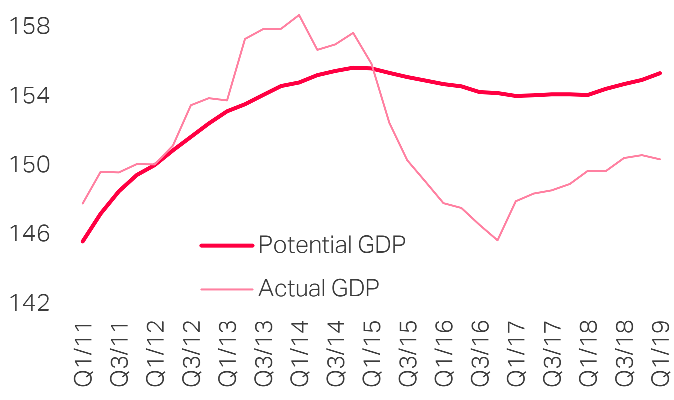
%



Source: FGV.

Chart 9: Potential vs actual GDP

2000 actual GDP = 100, seasonally adjusted



Sources: IPEA, IBGE.

Lower interest rates and an improved fiscal outlook will pave the way for increased investment. Although the impact of the pension reform will not be felt immediately, there is little doubt that its approval will help to boost investment. As we highlighted recently, lending has been slow to respond to the low interest rate environment, in part because of the uncertainty related to pension reform. Once this final hurdle has been cleared, we expect companies to slowly resume investments that have been on hold. This means that the economy has the potential to enter a more virtuous cycle starting in 2020.

Conclusion

Even though the dark clouds over Brasilia are dissipating, we do not expect blue skies ahead. It is true that the solid support for the pension reform in the first of two floor votes in the Lower House helped boost optimism; however, markets will fully price in the pension reform only when the reform has cleared both the Lower House and the Senate. And while approval of the pension reform in the Congress is paramount for sustained improvement in sentiment levels, only the continuation of a broader reform agenda will put the country on track. This means that politicians in Brasilia need to take advantage of the pro-reform sentiment in the legislature to continue to push ahead with other legislation aimed at improving productivity.

Speaker Maia and Minister Guedes share many goals with regards to the economic reform agenda. Despite recent disagreements between Maia and Guedes, we expect them to work together to push ahead with a joint economic agenda in coming months. As we highlighted last week, the tax reform debate will be key to monitor, since there are several versions of that reform currently in the works. Maia has already stated that he plans to work closely with the Economy Ministry to reach a consensus on tax reform, which is arguably as politically challenging as pension reform.

The pace of the economic recovery will be key to monitor. This is because politicians – including President Bolsonaro – have promised that the approval of the pension reform will help jump-start the economy. And while there is little doubt that once the pension overhaul is signed into law, a huge weight will be lifted from the economy, the country still needs to transition away from its consumption-led growth model. Furthermore, although many of the pieces are already in place for investment to resume, it will take time for lower unemployment and higher growth to follow. This poses the risk of President Bolsonaro losing his patience and beginning to flirt with economic populism. While this is not a short-term risk, Bolsonaro has already made it clear that he plans to run for re-election in 2022 and his success in that bid will be directly linked to the economic recovery.