

## Brazil: A momentous reform

The positive momentum favouring the imminent passage of the Social Security Reform continues, with the goal to conclude the Lower House approval by the weekend. Such an impressive result should trigger a BRL rally, but the rally would be limited by the central bank's willingness to cut rates, by as much as 150bp, which has reduced the currency's appeal



### We are nearly there

After years of negotiations, and much political turmoil, it finally appears that we are days away from the approval of the social security reform by the Brazilian Congress. The pro-reform momentum improved sharply last week, with the approval of the reform by a wide margin in the Lower House's Special Committee, and with Speaker Rodrigo Maia standing out for his leadership and savvy command of the House.

In fact, congressional leaders aim to fast-track the debate and have the reform fully approved by the Lower House, which requires a 3/5 majority support in two rounds of the vote, by the weekend. Such an impressive result would consolidate Maia's reputation and would bode well for the ambitious post-reform agenda advocated by the Speaker, which is broadly consistent with the agenda of the Bolsonaro administration, and includes the tax reform and the formal independence of the central bank.

There remains some uncertainty about the timing and the content of the draft that the House should eventually approve. Passage of the proposal already approved by the Special Committee last week would be a favourable outcome.

But the text could be improved with an amendment to, at least, facilitate the extension of the reform to states and municipalities, or it could worsen with, for instance, the easing of the retirement rules for police workers, as advocated by Bolsonaro.

As it stands, the reform could generate savings of about BRL 0.9-1 trillion in 10 years, which is far higher than initial investor expectations and reflects a very mild dilution in the fiscal savings initially proposed by the Bolsonaro administration (BRL 1.1 trillion).

This result would go a long way towards ensuring the long-term sustainability of Brazil's fiscal accounts and should be enough to prompt a reassessment of the near-term credit ratings trajectory for Brazil. But actual upgrades may take a while longer and should depend, in our view, on the evidence of a stronger recovery in economic activity, which is expected to pick up pace in the second half of the year.

## Reform approval would green-light the monetary easing process

The approval of the reform should have an invigorating impact on the outlook for economic activity, but the reform should also have a benign impact on the inflation outlook. As a result, the reform's approval should not prevent the central bank from adding to the monetary stimulus that is already in place.

In fact, given the (1) ongoing improvement in current inflation trends, as illustrated by falling and fully-anchored inflation expectations, (2) the expected post-reform appreciating bias for the BRL and (3) the dovish shift seen in central banks across the world, we believe the balance of risks favours a larger, more frontloaded and more lasting cycle than currently priced in the local curve.

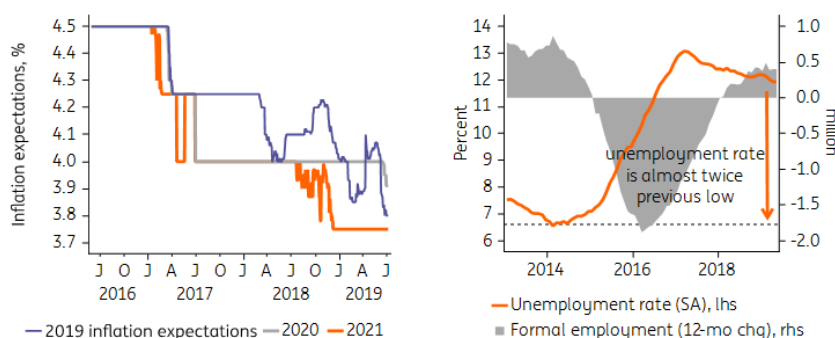
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*The balance of risks favours a larger, more frontloaded and more lasting rate-cutting cycle than currently priced in the local curve*

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Central bank officials have been on the defensive in their effort to justify their reluctance to ease monetary policy, despite the poor economic activity data and high unemployment. Inaction was generally justified by the lingering uncertainties regarding the passage of the social security reform. But with the reform approved and the yearly rate trending considerably below-target, at around 3-3.5% throughout 2H19, the central bank's ability to justify inaction should weaken materially.

## Fully anchored inflation expectations and ample spare capacity



Source: Macrobond

### The BRL could lag other local assets

With the reform approved, political uncertainties related to the sustainability of fiscal accounts should ease materially and prompt an improvement in the outlook for economic activity and for local assets in general.

The Brazilian Real should also rally, but the extent of that rally should be limited by the central bank's willingness to cut rates (by as much as 150bp), which should reduce the currency's appeal. Lower rates should also incentivize the use of the USDBRL as a (relatively cheap) hedge to external risks, such as trade wars, as other local assets such as equities and rates are seen as more appealing.

In addition, as indicated by central bank officials recently, the lower cost of financing in BRLs has also reduced the inflow of USDs in Brazil this year. And this shift could intensify post-reform, as the SELIC policy rate is further reduced and the local debt capital markets deepen further. As a result, we now believe that the post-reform trajectory for the USDBRL may bottom at a higher level, closer to 3.6 than 3.4.

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In any case, with the reform approved this week or next, we would expect the Brazilian central bank to be able to launch the easing cycle in its 31 July meeting, possibly with a 50bp cut. This would bring the SELIC rate to a fresh record-low of 6.0%, from 6.5% now. Consecutive 50bp cuts would bring the SELIC rate to 5.0% by the end of October, but a shallower or less-frontloaded cycle should not be ruled out.

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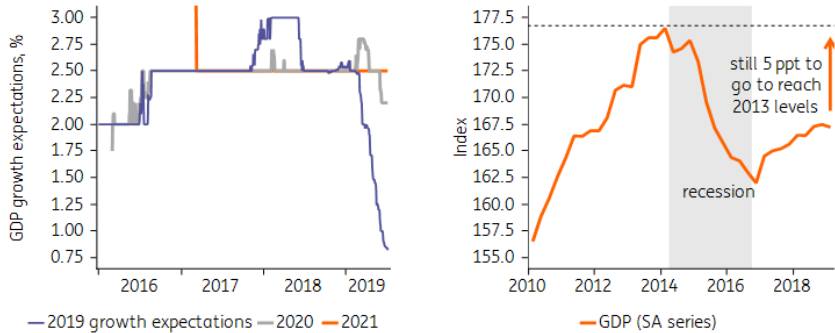
*Consecutive 50bp cuts would bring the SELIC rate to 5.0% by the end of October, from 6.5% now*

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A more frontloaded cycle would be amply justified as a catch-up measure needed to help address

the paralysis in economic activity seen in recent quarters. The central bank's own projection for 2019 GDP growth collapsed recently, moving from 2.0% as of the end of 1Q19 to just 0.8% as of the end of 2Q. And, as the chart below illustrates, Brazil's GDP remains 5.5ppts below the peak seen in 2013.

## Disappointing economic activity and a long way to go to full recovery



Source: Macrobond