Brazil: The bumpy road to reform

Over the past couple of months, it's become clear that political risk remains high in Brazil, and that the approval of the fiscal consolidation agenda should not be taken for granted. Caution about Brazil's medium-term outlook suggests, meanwhile, persistent volatility in local financial markets and stagnation on the economic activity front

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Bolsonaro's tentative hold over Congress keeps uncertainty high

Every day seems to end with a new political cliffhanger in Brasília these days. The suspense reflects primarily the fact that President Bolsonaro's support base in Congress remains deeply unstable.

Congressional party leaders appear to remain dissatisfied with Bolsonaro and, as a result, they have yet to provide him with a solid Congressional base and to commit to the federal government's legislative agenda. This has resulted in frequent conflicts and heightened uncertainty regarding legislative outcomes.

The pre-Easter week has ended on a sour note, amid the delay of the conclusion of the first stage of the social security reform's debate in Congress, at the Constitutional Commission (CCJ). The failure is on two fronts. The first is, clearly, the delay on the pre-established timeline for the reform's approval. The second is the apparent leadership agreement to alter the draft of the reform already at this early stage of the debate process.

The episode illustrates the political difficulties the administration continues to face in Congress. There's a broad consensus that the reform is needed, and we suspect political resistance is not towards the reform per se. Resistance, we believe, reflects the fact that Congress is still dissatisfied with the terms of power-sharing Bolsonaro is willing to provide. And that dissatisfaction is manifested in their resistance to the reform, which is vital to the success of the Bolsonaro administration.

The large number of parties in the Brazilian Congress, with a large presence of inexperienced legislators and diffuse power structure, is another difficulty, which illustrates the importance of having savvy and experienced negotiators representing the government's interests.

The episode contrasts with the optimism demonstrated by government leaders in public statements. However, it confirms our view that even though the reform is eventually likely to be approved, the road to reform approval will be quite bumpy.

Financial market volatility and standstill on the activity front

The Brazilian Real has corrected and now incorporates a less positive outlook for the pension reform approval, after the initial optimism proved to be excessive. We expect the USD/BRL to trade within a near-term range of 3.8-4.0, with the BRL underperforming its EM peers so long as uncertainty vis-à-vis the reform remains high.

Local assets would rally sharply once the reform approval becomes clearer. In our base-case scenario, this would suggest a sharp BRL rally, towards 3.3-3.4, during 3Q. But that timing remains deeply uncertain, chiefly dependent on political considerations that are still too hard to assess.

The successful passage of the reform in its first committee debate (the CCJ) next week should bring some relief, but any relief is likely to be temporary. As the reform moves to the Special Committee, it enters a much more delicate territory. It will be in this committee that the proposal is expected to be altered in material ways. A firm hand and savvy political negotiations will be even more crucial here to avoid drastic changes to the proposal.

The speed of the debate will continue to be monitored but investors should be more focused now on the depth of the fiscal adjustment the reform will generate. Any adjustment lawmakers make to the text will be compared to the benchmark BRL1,100bn in projected savings (over 10 years) estimated for the government's initial proposal.

The original proposal is ambitious enough to accommodate moderate watering-down by lawmakers, with local investor consensus projecting savings closer to BRL700bn. Any material divergence from this figure should trigger a market reaction.

The latest activity data indicators suggest that lingering concerns regarding Brazil's challenging fiscal outlook has taken a significant toll on economic activity, which remains broadly weak. GDP growth likely decelerated further in 1Q19, with a likelihood of a negative result increasing of late. A seasonally-adjusted contraction in 1Q would be the first in more than 2 years.

The central bank consensus survey also suggests that the outlook for economic activity has deteriorated, with expectations for GDP growth for both 2019 and 2020 falling in recent weeks. The consensus growth forecast for 2019 is now slightly lower than 2%, which we still consider optimistic relative to our own 1.4%.

Overall, we maintain our constructive medium-term outlook for Brazil, based on the assumption that the Bolsonaro administration should eventually be able to secure the support of a solid majority in Congress. The opposition isn't large enough to block the government's agenda, but a majority of lawmakers continue to signal that they won't rubber stamp government proposals. Their support must be negotiated and the government has yet to find an appropriate and mutually satisfactory power-sharing structure to accommodate lawmakers' demands.