Brazil: Macro Reforms Are Critical – But Micro Reforms Are Too

- **Fiscal challenges will only be partially addressed, and markets are vulnerable to reform-delivery-driven disappointment in 19H2.**
- **We expect reform uncertainty to hit BRL in 19H2, meaning we are skeptical that the BCB will be able to deliver further monetary policy easing.**
- **Not all is bleak; the growth outlook is improving, although private investment outlook may not remain as rosy as it seems in 19H2.**
- **There is material room for "micro reform" progress—much of which Bolsonaro could be able to deliver. Will he? A concern is what happens if the economy is "opened to global competition" without addressing micro level competitiveness issues.**

MACRO CHALLENGES – WILL THEY BE ADDRESSED?

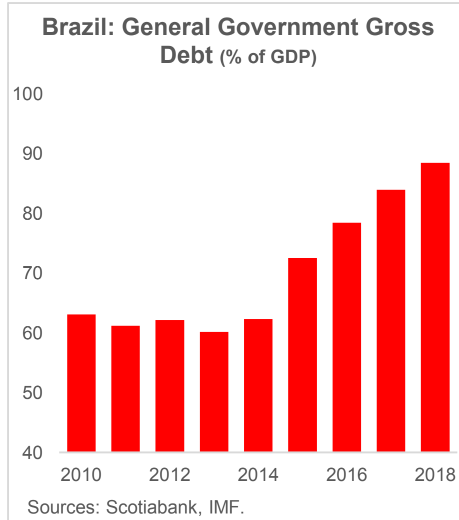
A lot of focus has been placed on Brazil's new government, its market-friendly tone, and pledges to undertake critical reforms that include: 1) pensions, 2) BCB independence, 3) privatizations, and 4) fiscal simplification—and business sector tax cuts. We agree with the urgency of these reforms, and the country has little time to address them to improve its currently disastrous fiscal path. Over the past 5 years, Brazil's gross public debt has risen from around 60% of GDP to almost 90% of GDP (see graph below) and, without reform, the country's fiscal deficit should remain consistently north of 5% of GDP. Hence, markets' reaction to reform talk has been positive, just as we believe that under-delivery relative to expectations should provide a negative shock—potentially as soon as the second half of 2019 (more on this later).

Even though Brazil's gross general government fiscal deficit fell from 10% of GDP in 2015, to roughly 8.0% of GDP in 2018, it remains deeply concerning, and could spike higher once again if rates are forced higher. On the positive side, as the loan portfolio of BNDEs matures, reduced pressure from the subsidizing of loan costs could be supportive for the country's fiscal stance. However, we think the pressures on the "negative side" are greater. Of Brazil's total debt only 1/3 is fixed rate in local currency, with the rest being linked to inflation, the policy rate, or the BRL, meaning that changes in financial variables could lead to relevant fiscal hits. In addition, the average maturity of Brazil's debt is 4.1 years which, being relatively short, means higher rates would quickly hit the fiscal balance. Our main source of concern—on which we've been wrong so far—has been the possibility that the BRL could come under pressure, potentially due to reform delivery disappointment. If that happens, the BCB could be forced to hike rates from what we see as a currently lax monetary stance—given we see neutral real rates somewhere in the 3.5%–4.5% range (we assume the neutral rate dropped 100bps, with the de-segmentation of the credit markets the TJLP should gradually drive). With roughly 30% of the public debt being inflation-linked, and 40% being floating rate or FX linked, this can quickly become a problem.

CONTACTS

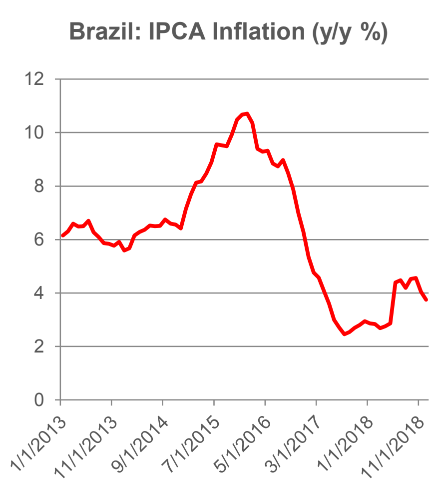
Eduardo Suárez, VP, Latin America Economics
52.55.9179.5174 (Mexico)
Scotiabank Economics
eduardo.suarez@scotiabank.com

Chart 1



Sources: Scotiabank, IMF.

Chart 2



Source: Bloomberg.

The Brazilian government projects a gradual improvement in the fiscal stance, which we believe will be slower given we expect a) more volatile and less favorable domestic financial variables, as well as b) progress on pension and fiscal reform will not be as supportive as government assumptions suggest. The government's projections of the fiscal consolidation are in the table below, but we think the pace of consolidation will be about half that amount, with progress on the nominal deficit's reduction being about 1 point of GDP by 2020, as opposed to 2 percentage points.

General Government Fiscal Stance – Brazilian government projections

(% of GDP)	2016	2017	2018	2019F	2020F	2021F
Primary balance	-2.5	-1.7	-2.3	-1.8	-1.3	-0.7
Nominal balance	-9.0	-7.8	-7.3	-6.9	-6.8	-6.4

Source: Fazenda.

Our base case is that the BCB won't be able to cut rates, with the main obstacle to easing being market disappointment over lack of reform delivery, triggering pressure on BRL, which in turn hits inflation. That means that the more positive expectation of fiscal adjustment, where: 1) lower rates helps the fiscal stance, 2) the rollover of development bank loans provides a boost to the country's fiscal position, and 3) a steady BRL and inflation also support fiscal consolidation, loses two of its three pillars (of the three, only the development bank loan rollover in a reformed TJLP economy actually delivers fiscal support). To compound the problem, the fiscal savings that the government is estimating will come from fiscal reform will only see a fraction of the projections materialize.

HOW MUCH PROGRESS ON STRUCTURAL REFORMS?

As we have argued for some time, our base case in terms of "reform delivery" is that the Bolsonaro administration may be able to: approve a formal BCB independence bill (good news, and may help compress Brazil's long-term interest rates), as well as a watered-down version of the pension bill—probably including reforming pensions for the military, as well as future entrants into the public sector. We assume that would trim the savings to about $^{1}/_{5}$–¼ of the government's projections listed in the table below.

Brazil's projected savings from the pension reform proposal (BRL bn, 2019 PV)

	4yrs time	10yrs time
New rules for private sector (RGPS)	83	715
New rules for public sector (RPPS)	34	174
Change in private contribution rate (RGPS)	-10	-28
Change in public contribution rate (RPPS)	14	29
Change in social benefits (wage, BPC, etc.)	41	182
Total savings from amendments	161	1072
Military system	28	92
Total	189	1165

Sources: Scotiabank, Brazilian FinMin.

Our take is that with that pension bill likely disappointing, a lot of work will remain for the fiscal authorities to solve the country's problematic fiscal situation, as we discussed above. Also, without a pension bill, and given we don't expect the fiscal deficit will materially improve, we think business tax-cuts are likely off the table—or should be.

BCB POLICY

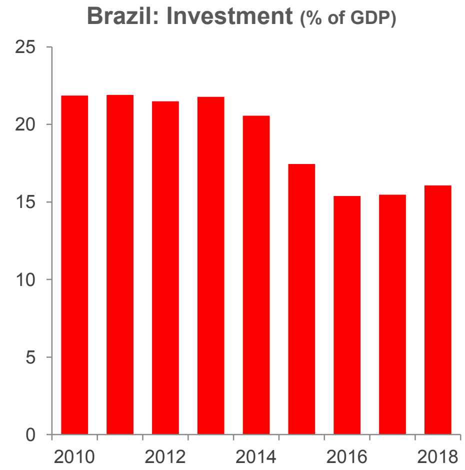
The DI curve is pricing the central bank will remain on hold for the remainder of the year, before kicking-off a gradual tightening cycle at the start of 2020 (150bps in total during 2020). We're expecting an earlier start of the tightening cycle (19Q3), with our 2020 path being similar to the market's. For us, the timing of the cycle will depend on whether reforms are delivered, which will in turn determine whether the BRL remains anchored. The reason why we think the reform delivery is the key is twofold: 1) without reforms, the BCB will need to tighten the monetary policy to offset loose fiscal policy, and 2) Brazil has a relatively high FX-inflation pass-through of between 20-30%. Given that, as we argued earlier, we don't expect much progress on reforms, we don't believe the BCB will be able to remain as patient as the DI-rates curve is pricing in.

THE GROWTH OUTLOOK LOOKS BETTER

Similar to the new Brazilian government's estimates of potential GDP at 2.3%, we foresee the country's growth somewhere in the 2.0% to 2.5% range. The government's estimate is the result of using an average 3.3% annual growth for the past 20 years, with changes in China's demographic structure and slower global growth subtracting 100bps from past potential. We see the drag on growth being domestic—and related to the country's low investment rate (hovering in the 15–20% of GDP range) and structurally high nominal interest rates, which are among the drivers of that low investment rate. Another drag on investment is lack of progress on micro reforms, as well as a high cost of doing business in the country, which we discuss later. One sign of light at the end of the tunnel is that two factors seem likely to contribute to a moderate but relevant bounce in investment: 1) since the departure of the PT from government, industrial and business confidence seems to be recovering, and 2) even though we think interest rates look set to rise, they will nonetheless remain below their previous highs. These factors should contribute to a gradual improvement in Brazil's growth rate.

Encouraging signs for growth? Yes, but we'd also highlight that the country's growth rate is still capped by chronic under-investment, and although the recent recession left some idle capacity, there is the risk that idle capacity decayed due to the length of the recession (the longest in the country's history). Our base case is that growth will continue to gain moderate traction, but will settle around 2% for the next couple of years.

Chart 3



Sources: Scotiabank, IMF.

Chart 4

Sources: Scotiabank, Bloomberg.

Brazilian's FinMin estimates of potential growth w/ & w/o reforms:

Scenario	(% of GDP)
Growth over past 20 yrs.	3.3
Demographic and world growth effect (China)	-1.0
Potential GDP w/o reforms	2.3
Micro reforms	+
Private sector crowding in	+
Potential GDP with reforms	3.5 – 4.0

Sources: Scotiabank, Brazilian FinMin.

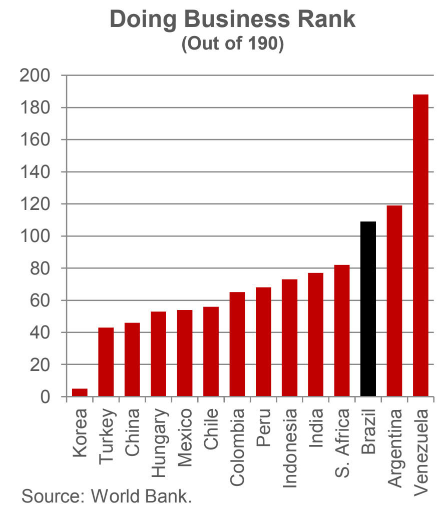
We're skeptical that, without a major external positive shock, enough progress will be achieved to reach potential growth above 3.0%. However, after a long period of stagnation / recession, some idle capacity likely remains (the FGV Capacity Utilization estimates place it at 78.0%, compared with an average 80.4% for the past 10 years). With this, we see potential for a temporary bounce in growth above 3%, if private sector confidence continues to strengthen. However, to sustainably grow above 2.5%, we think the Brazilian economy needs to increase the domestic savings rate, and at the same time, deliver "micro reforms" which we discuss below.

THE MICRO MATTERS TOO

However, besides these very important "macro" changes, there are also a lot of positives the government can deliver focusing on micro improvements. Based on the World Bank's Doing Business data, Brazil's business environment is a major problem for the country—the country's business environment ranks in the bottom 1/3 of the economies tracked by the Doing Business index. The problem of these reforms is that they are not the kind of headline grabbing reforms markets react to—and it could be argued they won't provide as much of a short-term confidence boost to investment. There may also be issues implementing micro reforms on some fronts, related to the restrictiveness of the Mercosur agreement—and also Brazil's bloated state bureaucracy. The second of these two last problems could create some political battles, even if they are not legislative ones.

Deregulation, and dealing with micro-inefficiency can present low-hanging fruit if the new government can focus on execution. However, they are also important risks for Brazilian businesses if the new government is too quick and ambitious in opening the country to competition, without addressing the country's ability to compete internationally. To address this issue, the government is expected to announce a set of measures aimed at boosting productivity through micro reforms, which will be called "More Brazil, less Brasilia".

Chart 5



Source: World Bank.

One of the constant questions we end up discussing with investors when talking about Brazil is: "*Why has FDI into Brazil been as strong as it has, if the country is not competitive from a global perspective*?" Our take is there are two major reasons for this: 1) the size of the Brazilian market, and 2) how costly it is to access a Mercosur economy from the outside of it. This explains a fundamental difference in the type of investment we see into Mexico (where global firms see the country as a global export platform) and Brazil—where investment is focused on satisfying the Brazil and Mercosur market. At the end of the day, Mercosur is a market of close to 300mn people, with an income per capita of around US$10,000. It's also a market that is tough to access from outside the bloc, due to the restrictiveness of the agreement. Hence, given that within the agreement Brazil is arguably the friendliest jurisdiction in which to base a business, FDI into the bloc should continue, as long as it's seen as a large and attractive market. Adding to this logic, is the vast natural resource potential that for obvious reasons cannot be tapped from abroad.

Scotiabank's main projections:

	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4
USD/BRL	3.82	3.91	3.97	4.18	4.08	4.11	4.07	4.18
SELIC	6.50%	6.50%	6.75%	7.25%	7.75%	8.25%	8.50%	8.50%
GDP	1.47%	1.72%	2.11%	2.18%	2.73%	2.46%	1.87%	1.79%
IPCA	3.73%	3.79%	3.83%	3.92%	4.23%	4.18%	4.43%	4.87%