Narrow window of opportunity for Brazil

Atradius Economic Research – October 2018

Summary

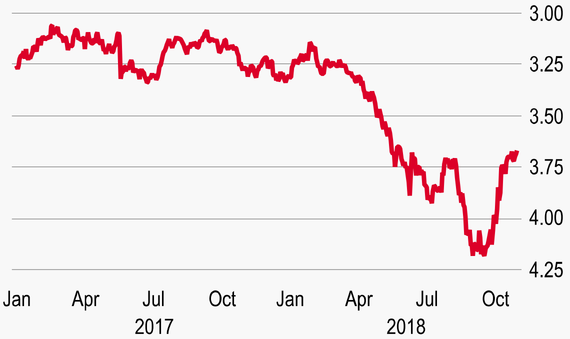
- The election of Brazil's new president ends a long period of political uncertainty. The new administration is expected to continue much-needed economic reforms.
- Policymaking will be challenged by a highly fragmented, polarised, and relatively inexperienced congress.
- The window of opportunity for reform, especially of fragile public finances, is very narrow. Failure to deliver would result in a loss of confidence, renewed real depreciation, inflation, worsening financing conditions and slower economic growth.

The election of Jair Bolsonaro puts an end to a long period of political uncertainty in Brazil, which has negatively affected investor sentiment, and economic growth in Latin America's largest economy. However, whether Mr Bolsonaro will be able to implement critical, time-sensitive reforms in a highly challenging environment remains to be seen.

A ten-day truckers strike in May brought the country to a standstill, underlining the growing frustration with the political establishment and high corruption and crime rates. Investor confidence in the continuity of the more market-friendly agenda started under the outgoing Temer government began to waver, resulting in a sharp (25%) depreciation of the real. With the election of Jair Bolsonaro and his choice of free-market economist, Paolo Guedes, as finance minister, hopes in continuity of economic reforms have grown, but challenges abound.

Prospects of Bolsonaro victory reversed real's slide

Real per USD, reverse axis



Sources: Macrobond, Atradius

On the political front, the new administration is confronted with a deeply fragmented, highly polarised and less experienced Congress. In the new Congress, there will be 30 parties in the lower house and 21 in the Senate. The right and centre-right parties have a combined majority in the lower house of 60%, just enough for the three-fifths needed for constitutional amendments. But not all of these deputies will be aligned behind all of Mr Bolsonaro's policies, in part due to pervasive vested interests. Mr Bolsonaro is also a highly controversial figure and many Brazilians are concerned about human rights, civil liberties and freedom of speech under his presidency. Whether he will be able to build and manage working coalitions to push through much-needed reforms, particularly those requiring constitutional majorities, is thus an open question.

On the economic front, the main challenges are putting government finances on a sustainable track, raising potential GDP growth rates, and keeping inflation in check. Brazil's fiscal deficit remains high at 7.5% of GDP as of August compared to 7.8% of GDP in 2017, lifting the public-debt-to-GDP ratio to 77% from 74% in 2017. By far the most urgent fiscal measure will be the pension reform, put on hold by Mr Temer earlier this year. Otherwise, a landmark public spending cap set in 2016 will be exceeded and the public-debt-to-GDP ratio will continue to rise. Absent these reforms, inflation pressures will also return.

Inflation has surprised to the upside in the past months, reaching 4.5% in September, largely due to energy prices and currency depreciation ahead of the elections.

We expect real GDP to slowly begin recovering with 1.1% growth in 2018 and 2.3% in 2019. Economic growth has stalled following the truckers' strike in May. Recent indicators suggest that the economy is slowly recovering on the back of improving business and consumer sentiment. This recovery will remain weak, as unemployment remains high at 12% and as exports fall due to the economic problems in neighboring Argentina, its third largest export market.

The fragility of public finances leaves no room for policy mistakes though. If the new government fails to deliver the pension reform and other needed fiscal measures in the first year, the outlook will quickly deteriorate. The window of opportunity is very narrow given the high unpopularity of these measures and sensitivity of investor confidence. Investor sentiment will sour, the real will depreciate and current record low interest rates will have to be raised, which will be detrimental to economic growth. That said, the shock absorbing capacity of the Brazilian economy remains strong, underpinned by a flexible exchange rate, a sound banking sector, and very high official reserves.

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