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New Brazilian president, same fiscal problems

Regardless of who wins the election, Brazilian growth will slow sharply as the global recession sets in. Moreover, while potential growth would be stronger under Bolsonaro than Lula, neither candidate has a credible fiscal plan.

Key takeaways

- Despite a tightening in the polls, former left-wing president Lula still looks favourite to overcome incumbent Jair Bolsonaro in the race for Brazil's top job, although he is unlikely to secure enough votes in Sunday's first round to avoid a second round run-off (on 30th October).
- With Bolsonaro's market friendly credentials fraying and Lula showing some signs of moderating, the result will not be as polarising for the economy as some had initially assumed.
- Indeed, whoever wins the vote, Brazilian growth looks set to slow over coming years as the global recession hits. Fiscal policy may be loosened, particularly under Lula. But both candidates will be constrained to some extent by a need to maintain credibility in the markets.
- Meanwhile, neither candidate seems to have a strong desire to tamper with the BCB, which looks set to delay interest rate cuts while core inflation remains sticky.
- Looking to the medium term, while potential growth would be stronger under Bolsonaro than Lula, both may struggle to sustain fiscal discipline.
- Indeed, using fiscal policy as a political tool has long been a tactic of Lula and his PT party. But the run-up to this election has revealed Bolsonaro's willingness to do the same.
- Fiscal dominance remains a (tail) risk – particularly under Lula. And without a credible fiscal anchor, risk premia on Brazilian assets is likely to remain high.

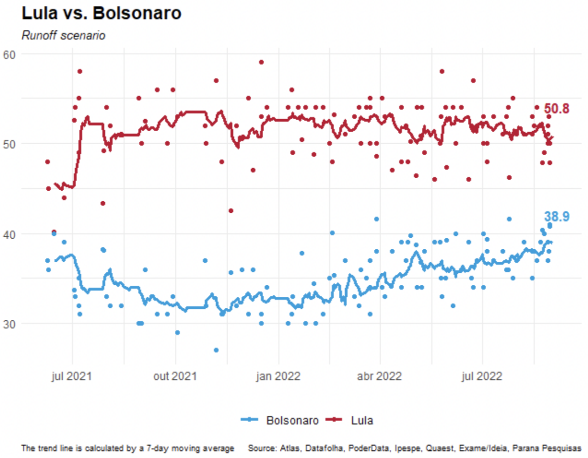
Not black and white, but shades of grey

Markets like a narrative. When ex-president Lula first announced he was going to run, the markets were quick to characterise the election as a very binary affair: Bolsonaro = good, Lula = bad.

It has become clear that this characterisation lacks nuance. Bolsonaro has loosened fiscal policy aggressively prior to the vote, and cast aside the much-vaunted constitutionally mandated spending cap. Meanwhile, Lula has tacked to the centre by appointing well-respected technocrat Geraldo Alckmin as his running mate (there is speculation that he could be made finance minister, although in practice we doubt that Lula would appoint someone he cannot fire).

The state of the race

Figure 1 – The presidential election is still Lula's to lose

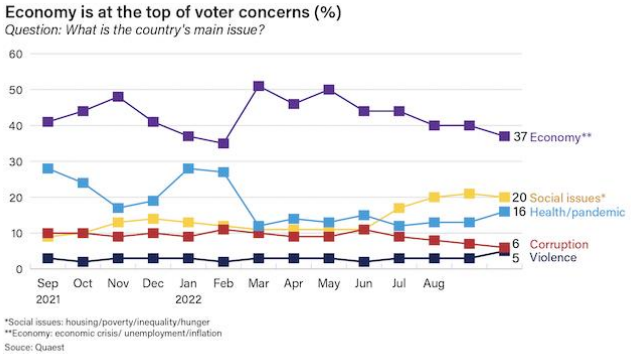


Source: Eurasia, September 2022

Polls suggest that neither Bolsonaro nor Lula will secure enough votes on 2nd October to avoid a second round run-off on 30th October. Polls (and most political experts) predict that Lula will beat Bolsonaro in a run-off (see Figure 1).

Admittedly, Bolsonaro's polling numbers have improved as of late, and may continue to do so as the vote nears. That said, the biggest issues for voters are the economy and unemployment, two areas that play to Lula's strengths. In contrast, issues such as violence and corruption – which propelled Bolsonaro to the presidency in 2018 – have fallen down the pecking order in this election (see Figure 2).

Figure 2 – Voter concerns play to Lula's strengths



Source: Eurasia, September 2022

Politics won't change the 12-18m course of economy

We won't go into detail on every aspect of each candidate's policy platform here, not least because some details are vague and pre-election pledges can often differ wildly from what is delivered in office. Instead, we will touch on what we think are the key similarities and differences from a macro perspective – both on a 12-18m and medium-term horizon.

Perhaps the first important point to note here is that neither candidate will prevent the economy from entering recession next year. While Lula in particular may respond to economic weakness with fiscal loosening, we doubt that any support would be large enough to significantly cushion the economy.

In particular, we suspect that both candidates in the early part of their term will pledge and practice fiscal rectitude in order to try to get markets on-side and prevent undue financial market stress.

While inflation is likely to decline regardless of the election result, the drop in inflation may be quicker under Lula if his economic team is more active in regulated price markets.

However, looser fiscal policy under Lula could support demand and force the BCB to keep policy tighter for longer. Perceptions of fiscal largesse under Lula and a higher country risk premium may also see the BCB judge that Brazil's neutral real interest rate to be higher under him.

Potential growth would be stronger under Bolsonaro

Looking to the medium term impacts, both Lula and Bolsonaro have pledged a consumption tax reform – a recognition of Brazil's chaotic framework of multiple consumption taxes, which creates economic distortions and a large administrative compliance burden.

The problem is that successive governments over decades have tried and failed to overhaul the consumption tax framework. With Congress likely to remain fragmented, we are sceptical that a wide-reaching consumption tax reform will be implemented by the new president.

Even so, Bolsonaro would likely have some success in continuing his privatisation agenda. Bolsonaro's government has so far privatised more than 100 state assets. Most notably, the president in June finally cut the government's stake in Electrobras from 72% to 45%. Bolsonaro would likely continue his privatisation agenda in a second term, although selling down the government's 36% stake in "national champion" Petrobras would be politically challenging.

Studies tend to find a strong relationship between privatisation and growth. It's possible that privatisations are serving as a proxy in such regressions for one or more missing variables that may broadly be characterised as a favourable regime change. Even so, when combined with the structural reforms to labour and credit markets over the past 4-5 years, four more years of Bolsonaro's reform agenda could boost potential growth up to around 2.25%.

In contrast, under Lula potential growth could weaken from its current rate of around 2% if he unwinds some of the structural reforms recently implemented. In particular, there may be incentives to intervene in credit markets again via subsidised BNDES lending as the economy enters recession. By artificially juicing activity, this could risk entrenching high inflation. It could also reawaken moral hazard and weaken the monetary transmission mechanism.

Fiscal discipline may be difficult to sustain

Finally on the fiscal side, it is difficult to see a medium-term structural fiscal improvement under Lula in particular, and perhaps Bolsonaro too.

Lula has a very ambitious medium-term spending agenda, and does not seem to be proposing significant offsetting revenue-raising measures.

Meanwhile, Bolsonaro's casting aside of the spending cap and recent loosening has arguably weakened his fiscal credentials. While this is largely a function of the electoral cycle, it's still concerning and underscores that he is not afraid to use fiscal policy for political gain – a tactic long-used by Lula and his PT party.

Both candidates have suggested that they would seek to amend the spending cap. But in practice, the spirit (and credibility) of the cap has now been lost. While a new disciplining device is needed, neither candidate has put forward a credible alternative. Without a strong anchor, political influences on fiscal policy will remain.

Against that backdrop, it is worth highlighting that fiscal dominance remains a (tail) risk – particularly under Lula.

The current makeup of the BCB is steadfast in its commitment to keep monetary policy tight, to the detriment of the public debt position in the near-term given the large share of Selic-linked debt. While this is the antithesis of fiscal dominance, the appointment of a new central bank governor by the president in 2024 could yet usher in a different approach.

Investment implications

Several investment implications stand out from all this. First, regardless of the election result, the outlook for Brazilian assets will be challenged by the global recession and fall in commodity prices that we expect. That said, if the central bank keeps real interest rates high, this could help Brazilian bonds and the BRL to outperform on a relative basis.

Second, without a fiscal anchor, markets may demand a higher political risk premium on Brazilian assets. And third, while the installation of a credible economic team could help to assuage market fears in the initial aftermath of the vote, policy uncertainty will stay high for a prolonged period, particularly under Lula.

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