Order and Progress?
Brazil's post-election outlook

A report by The Economist Intelligence Unit

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Introduction

A radical shift to the right is under way in Brazilian politics: Jair Bolsonaro of the Partido Social Liberal (PSL), a far-right former army captain, is the favourite to win the October 28th presidential run-off against Fernando Haddad of the left-wing Partido dos Trabalhadores (PT) party.

The political and policymaking challenges for the next president of Brazil are huge. He will need to tame an unruly Congress and address major pending policy issues. Most significantly, these include consolidation of the public finances, and structural and business environment reforms needed to lift Brazil's weak economic growth rates. Without such measures, Brazil's growth potential will remain lacklustre at best; at worst, the country could be headed back into fiscal crisis. Improving public security is another key issue.

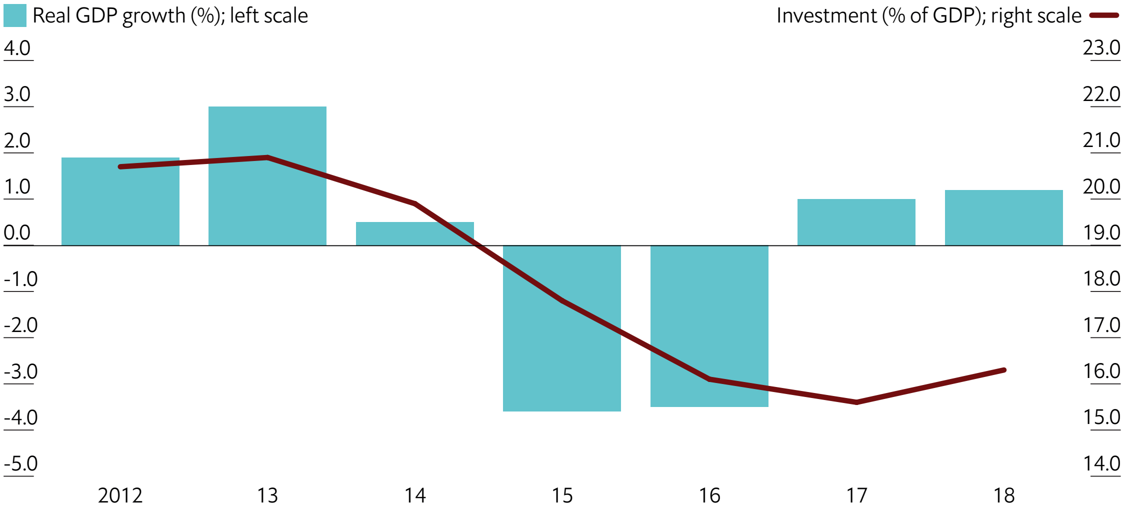
Pension reform, as well as other spending and revenue-raising adjustment measures, will be at the top of the to-do list. Otherwise, a landmark public spending cap set in 2016—a rule designed to stabilise a high (and rising) public debt/GDP ratio (77% currently)—will be exceeded, causing debt sustainability stresses and higher inflation to return. The prospects for pension reform under either candidate are cloudy, but The Economist Intelligence Unit assumes that economic realities will prevail and that a reform of sorts will pass.

Mr Bolsonaro has chosen a free-market economist, Paulo Guedes, as his would-be finance minister, but uncertainty hangs over the implementation of Mr Guede's radical policies of privatisation and state sector downsizing given expected pushback from vested interests in Congress. Moreover, there is a risk that policymaking would be erratic, sapping investor confidence. Mr Bolsonaro has espoused nationalist rhetoric in the past, criticising Chinese investments in agriculture and energy, for example. Conversely, relations with the US would be warmer. A Bolsonaro win would send shockwaves around Latin America, particularly in leftist countries such as Venezuela, Cuba and Bolivia, with which bilateral tension would grow.

Mr Haddad is a moderate, but he would face calls from PT hardliners to shift back to the failed economic policies of the PT's years in power (2003-16), including more state intervention, fiscal laxity and a public bank lending binge to stimulate growth. He also wants the central bank to target employment, not just inflation, which would lift inflationary expectations. Ultimately, if Mr Haddad wins we might see another "Br-exit" as investors sell off Brazil.

In this report, The Economist Intelligence Unit provides analysis of the upcoming election in Brazil, examining the candidates, their manifestos and highlighting the key issues and challenges the winner will face during their 2019-22 term. The analysis provides a snapshot of the in-depth political and economic analysis included in our Brazil Country Report.

Real GDP growth and investment



Note: 2018 figures are estimates.
Sources: IBGE; The Economist Intelligence Unit.

Key players

Bolsonaro rising

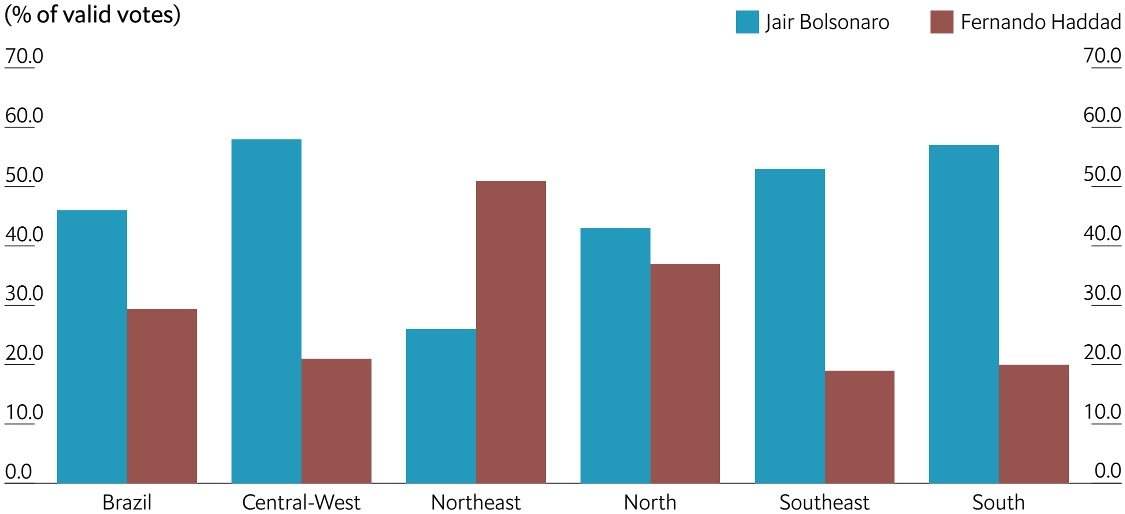
Mr Bolsonaro is set to be the first politician to break the hold that the PT and the Partido da Social Democracia Brasileira (PSDB) have had on power since the mid-1990s. His would be a divisive presidency, however, as his government will serve to deepen—rather than heal—the political and social divisions that have emerged around the PT's dismal performance towards the end of its time in office.

Mr Bolsonaro, regarded as a loose cannon by his fellow legislators, passed mostly unnoticed during his 28 years in Congress until 2016, when he surged to notoriety by casting his vote to impeach the then-president, Dilma Rousseff, taunting her by dedicating his vote to the military official who tortured Ms Rousseff during Brazil's military dictatorship (1964-85). Mr Bolsonaro began toying with a run for the presidency in 2015 as anti-PT sentiment grew amid economic problems and widespread corruption. Lacking much of a party structure he—and his campaigners—used social media to great effect. He courted controversy through controversial statements, but has ridden a popular wave of anti-establishment sentiment and clamour for a hardline response to a violent crime wave.

His populism and nostalgia for the dictatorship—and the fact that his cabinet is likely to contain retired and active military officials—has raised concerns over whether he would potentially trample over Brazil's young democratic institutions. He has said that he will defend the constitution, but a drift towards authoritarianism cannot be ruled out altogether. Feeling the lack of an effective and large-enough police force, most Brazilians would want the armed forces to be more visible on the streets to fight lawlessness in places like Rio de Janeiro—not as a replacement for democratic rule.

Perhaps of greater immediate concern will be Mr Bolsonaro's ability to run a government, and to build and manage a working coalition (let alone build a three-fifths majority needed for constitutional reforms) in order to advance his agenda. He lacks experience of management in government, and a lot of credibility is being put on the shoulders of Mr Guedes, a free-marketeer. The latter has no experience of the rough and tumble of congressional politics. If legislators resist Mr Guedes' policies (for example on privatisation) he might not hang around too long in the government, potentially putting the credibility of the Bolsonaro administration on the line.

First round election results by region
(% of valid votes)



Source: Tribunal Superior Eleitoral.

Haddad: "mission impossible"

Mr Haddad is a moderate, middle-class academic (a lawyer and an economist), who is not well liked by the rank and file working-class and more radical, leftist PT members. He was handpicked by a former PT president, Luiz Inácio Lula da Silva (who is in prison on a conviction for corruption), to run in his place. Further back, Lula groomed him as his education minister in 2005-12 and sought to build his career by launching him as a candidate for the mayoralty of São Paulo in 2012, which Mr Haddad won. His mayoral administration was marked by efforts to increase infrastructure through public private-partnerships, demonstrating his economic pragmatism. The city achieved investment grade status during his term. But he failed to gain re-election in 2016 after being resoundingly defeated on a national anti-PT wave, and because of an otherwise patchy record in office.

In the first round of the 2018 presidential election Mr Haddad campaigned as Lula's "representative", but he is now trying to pivot and present as a more moderate figure in order to attract centrist voters. For example, he has discarded earlier proposals to introduce a new constitution. But overturning Mr Bolsonaro's lead is beginning to look like a "mission impossible".

A fragmented—and polarised—Congress

Building and managing a coalition of parties in Congress will be a key test for the incoming president—and a challenge in the context of a deeply fragmented legislature. In the next Congress there will be 30 parties in the lower house and 21 in the Senate. On top of the sheer number of parties in Congress, the new president will have to grapple with shifts in the legislative balance of power. The new Congress heralds a renewal of sorts. On October 7th an anti-establishment wave swept out many legislators associated with the traditional parties and corruption cases, including many (but not all) of those implicated in the *Lava Jato* (car wash) investigations. The advance of less experienced politicians will complicate the legislative process.

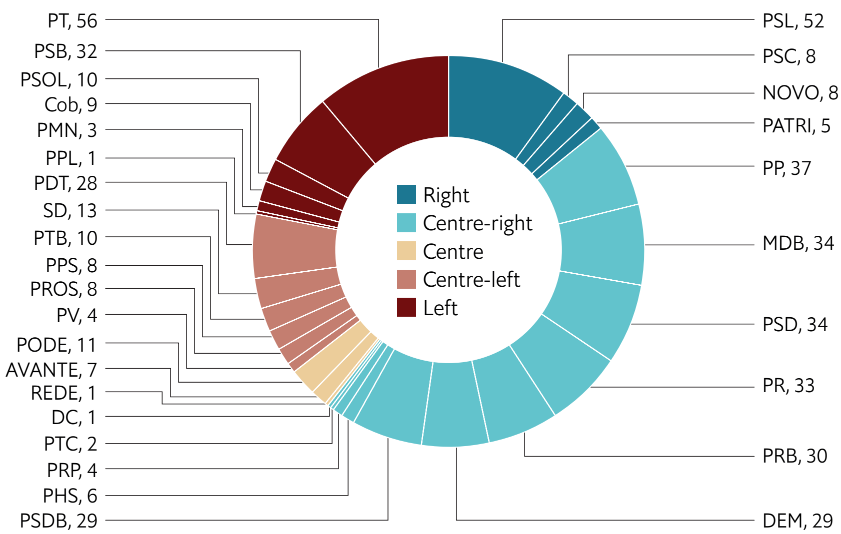
Politics will be divisive. The right and left wings will be vociferously opposed to one another. The right-wing PSL and the left-wing PT will be the biggest parties in Congress, but both with only around 10% of seats in the lower house. Traditional parties (Movimento Democrático Brasileiro and Democratas) accustomed to holding the balance of power have been weakened. The PSDB will be a shadow of its former self, after its presidential candidate's humiliating loss in the first round of the presidential election (Geraldo Alckmin came fourth). The *Centrão*—a group of centrist forces—will be influential, and whoever wins the presidency will need to bring some of these parties on board if they want to advance reforms.

Mr Bolsonaro has cross-party support from three leading groups represented in Congress, known locally as the *"Bancada BBB"* (the *"bala, boi, biblia"*, or "bullets, beef and bible" caucus), which includes law-and-order conservatives, socially conservative evangelical Christians (a growing demographic in Brazil) and agriculture-sector interests (who are seeking to expand the production frontier, putting into question Brazil's stewardship of the Amazon under its climate change commitments).

In total, Mr Bolsonaro boasts around 300 deputies—a working majority, but nonetheless short of the three-fifths needed for constitutional amendments, such as pension reforms. Nor will these 300 or so deputies be aligned behind all of Mr Bolsonaro's economic policies by any means. Vested interests are pervasive in Congress, and many will resist a mooted privatisation drive or any efforts to dial back tax breaks for businesses.

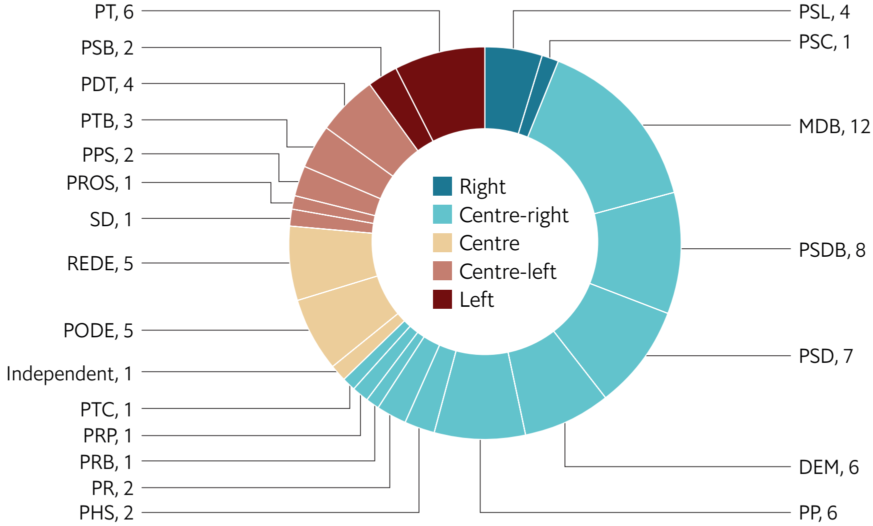
The fragmentation of Congress, and Mr Haddad's low chances of winning after a poor showing in the first round (29%), reduces the PT's chances of building a "democratic front" against Mr Bolsonaro. Among the PT's allies in Congress are smaller parties like the left-wing Partido Comunista do Brasil (the party of Mr Haddad's vice-presidential candidate, Manuela D'Ávila), and the Partido Republicano da Ordem Social (also left wing). In the unlikely scenario of a Haddad victory, even assuming that other amenable, centrist parties would fall into Mr Haddad's gravitational orbit of power, this would probably give him fewer than 200 deputies, which would be insufficient to approve any major legislative initiatives. Governability would, in this environment, be weaker under a Haddad administration.

Brazil Chamber of Deputies political parties, 2018
(number of seats; total 513)



Source: Lower house of Congress.

Senate political parties, 2018
(number of seats; total 81)



Source: Senate.

Key issues

Monetary policy and credit: central bank independence or public credit binge?

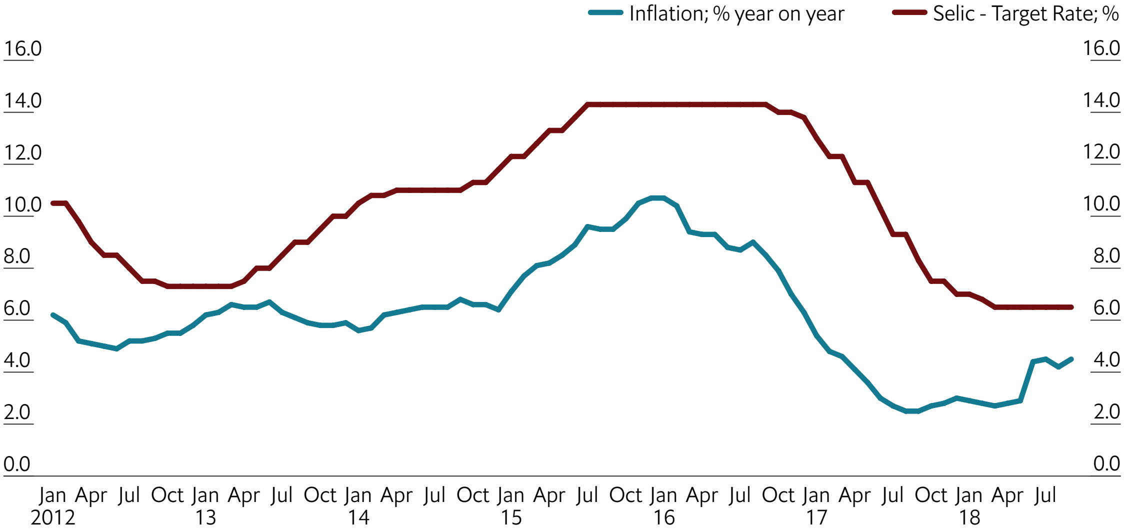
Although fiscal policy has grabbed headlines as a result of the urgency of reforms, the next administration's stance on other key elements of the macroeconomic framework, including inflation targeting and the floating exchange rate, is just as important—and in this area, the two second-round candidates hold clearly divergent views. As part of his stated drive to reduce political party appointments in Brazil's large number of state companies, Mr Bolsonaro wants to give the Banco Central do Brasil (BCB, the central bank) formal independence. The current president, Michel Temer, has been trying to approve such a measure in Congress, with no success so far.

Mr Haddad, however, wants a "dual mandate" for the BCB, so that it targets not just inflation but also employment levels when setting the interest rate. This may well work in developed markets such as the US, but in Brazil's case would further erode confidence in policymaking. Inflation and interest rates would be higher.

Helping to mitigate exposure to adverse external conditions, the central bank has a huge cushion of reserves (US$380bn). But Mr Haddad wants to use a portion of these to fund infrastructure—a measure that would rattle markets. Mr Haddad also wants to put pressure on private banks to reduce commercial rates by taxing them more heavily if they don't. Such heavy-handed efforts under previous PT administrations failed to bring about a sustained reduction in commercial rates. Mr Haddad would probably also oversee renewed growth in lending by public banks.

Mr Bolsonaro's administration would continue with the more market-oriented policies in place since 2016 under the outgoing Temer government. These have included dialling back BNDES lending, which surged after the global financial crisis, and lowering the subsidised interest rates extended to selected companies. These are sensible policies to develop Brazil's capital markets.

Inflation and interest rates



Source: Haver.

Fiscal policy and pensions: the time for dallying on reform is over

Brazil's burgeoning fiscal deficit and public debt are on an unsustainable trajectory. Since 2016 investors have given Brazil the benefit of the doubt as a reformist government under Mr Temer pursued a gradual fiscal adjustment. But ahead of the elections Congress baulked at pension reforms that are crucial for fiscal consolidation. If the new government fails to deliver the measures in its first year—the only window of opportunity for unpopular reforms—investor sentiment will sour.

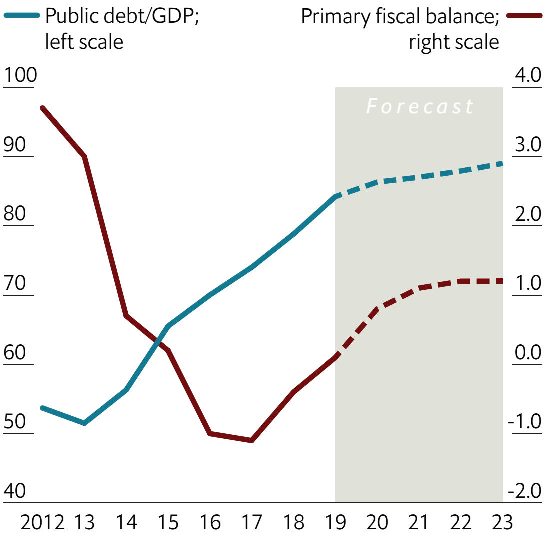
One possibility is for the outgoing Congress to begin approving the Temer proposals after the run-off election and before year-end, specifically raising the minimum retirement age and bringing the public-and private-sector schemes in line.

Instead, both candidates have talked more about their own plans, including introducing individual capitalisation accounts. But the transitional costs would be huge and are unfunded. So, although we expect some piecemeal progress (more so under Mr Bolsonaro), uncertainty over this crucial issue will be high until the winner's plans become clearer—and until it becomes clear that Congress will eventually approve them.

On fiscal policy more broadly, Mr Bolsonaro's team wants to reduce the primary fiscal balance (before interest payments) to zero in 2019 and run a surplus in 2020. But that goal is unrealistic and hinges on proceeds from a huge privatisation sell-off, which will run into obstacles in Congress. Other tax plans include raising the income tax threshold for poorer people (Mr Haddad also proposes this, and wants to fund it by taxing the rich) and eventually replacing four or five sales taxes with a single value-added tax (VAT). The tax would be revenue neutral and serve to simplify Brazil's tax system, which is ridiculously complex, and expensive for businesses to comply with.

As part of the "counter-reforms" to the Temer government, Mr Haddad wants to lift the public spending cap and increase spending to stimulate the economy. Doing so, without putting in place a credible medium-term fiscal framework, would scare the markets and eventually lead to higher indebtedness and inflation; and potentially a "made in Brazil" crisis. Amid trickier times for emerging markets, bad policies are likely to be punished more severely.

Public debt and primary fiscal balance
(% of GDP)



Note: 2018 figures are estimates; 2019-2023 are forecast.
Source: The Economist Intelligence Unit.

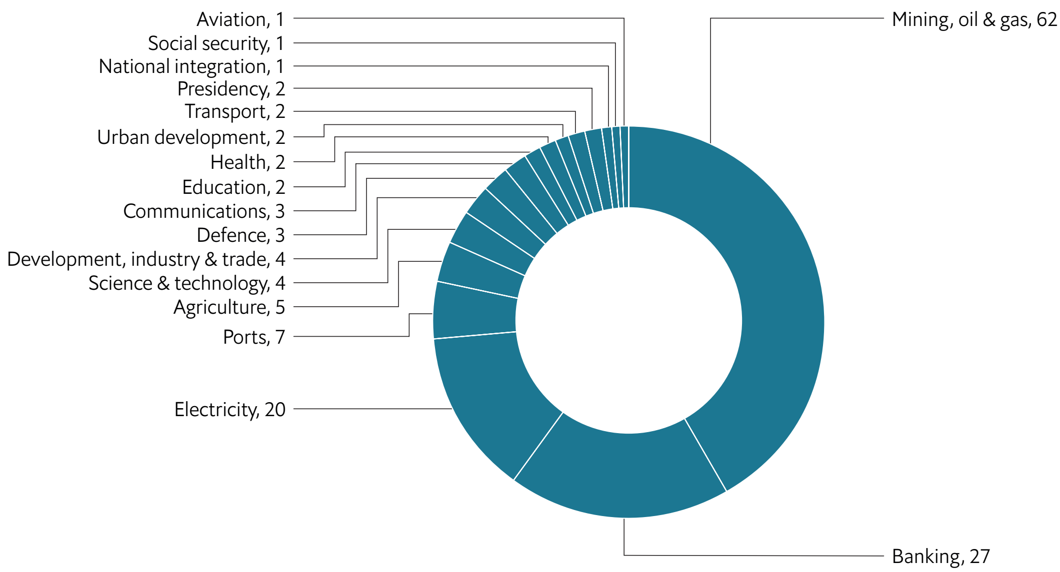
State involvement in the economy: more or less?

For many years Mr Bolsonaro was a statist, nationalist figure of the ilk nostalgic for the dirigisme of the military dictatorships. But partly in reaction to the disastrous economic record of the PT government, he has changed tack and adopted more free-market views under the guidance of his economic adviser, Mr Guedes. Given Mr Bolsonaro's past, it is uncertain how strongly he holds these free-market views and whether he has adopted them mostly from a politically tactical perspective. If Mr Guedes were to become disillusioned with the probable push back to his privatisation plans he may not even last a full four years in government.

Mr Guedes is proposing a sweeping privatisation programme, which aligns with Mr Bolsonaro's rhetoric of removing political appointees (which in many cases led to mismanagement and corruption). There are a huge number of state enterprises operating at both the federal and the state level, suggesting that there are many potential targets for privatisation. However, Mr Bolsonaro has taken some steps back and indicated, for example, that Banco do Brasil and Caixa (two large retail banks) operate efficiently enough to be spared privatisation. He has also pledged to retain the core operations of Petrobras, the state oil company, but some of its refineries and distribution arms could come under the hammer. National content rules would be relaxed, spurring foreign investment in oil and gas. But other than these strategic state assets, there are scores of companies that could face a sell-off. One early test of Mr Bolsonaro's privatising credentials will be the part-privatisation of Eletrobras, the state-owned electricity company, which got under way earlier this year but continues to face obstacles.

Mr Haddad, on the contrary, would re-instate the dominant role that Petrobras enjoyed in pre-salt auctions and re-enforce national content rules as part of a return to the state-led industrialisation policies pursued by past PT governments. Weaker investment and economic outcomes would follow.

Brazil's 148 federal state-owned enterprises
(number)



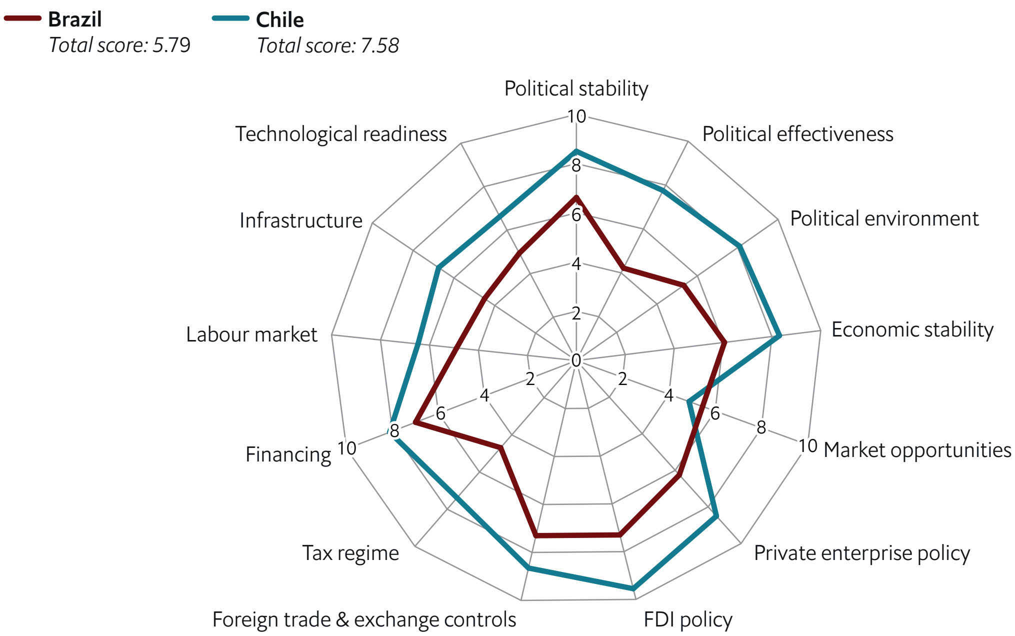
Note: Does not include state-level enterprises and agencies.
Sources: Ministry of Planning, Development and Management; The Economist Intelligence Unit.

Fixing the "custo Brasil"

The size of Brazil's market continues to attract foreign investment, but overseas businesses want to see faster growth and a better environment for doing business. Reducing bureaucracy and lowering the "custo Brasil" (the additional cost of doing business in Brazil compared with other emerging markets, stemming from the high regulatory and tax burden) should, after fiscal consolidation, feature on the new government's to-do list. But these are decades-old problems, and the big question is whether the Bolsonaro government could really fix them. Key areas for reform include:

- Labour reforms: reforms in 2017 introduced a degree of flexibility in the country's byzantine rules, but more needs to be done.
- Tax simplification: this would deliver a tangible boost, particularly for small and medium-sized enterprises that can't afford to hire legions of staff to comply with the complicated tax regulations.
- Increasing the efficiency of the banking sector to address its high levels of directed lending and the dominance of public banks: according to a recent IMF paper, reforms could deliver productivity gains of over 1%.
- Trade liberalisation: the latter is high up on the agenda of Mr Bolsonaro's free-market economic team, and would oblige Brazil's cosseted industries to become more competitive. The idea is also to get manufacturing more integrated into global value chains, as is the case in Mexico.
- "Rightsizing" the public sector: reforms here would help to free up resources for public works, which have fallen below 1% of GDP. Mr Bolsonaro favours a slimmer state, but will be up against powerful civil servants' unions.

Business Environment Rankings (2014-18)



Source: The Economist Intelligence Unit.

On top of these key areas, advances could be made in reducing red tape, easing regulations to open (and close) businesses, and strengthening competition rules. Mr Bolsonaro has not made any ambitious infrastructure promises, and instead he plans to finish incomplete works, of which there is no shortage.

Aligning the ducks could provide a confidence-boost and kick start investment growth. Coupled with fiscal and pension reforms, this could even lead to a period of GDP growth of 3% or more. But right now, that seems more than investors are willing to bet on.

Our own business environment rankings (see graph) show the scale of the challenge. In key areas including tax policy, the labour market, infrastructure, technological readiness and policy towards private enterprise, Brazil lags behind other emerging markets--including Chile, the best scoring Latin American country in our rankings. The policymaking task is clearly huge, and the next administration will see stubbornly weak growth if it does not take up the challenge.

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