



Daily Note

IS BRAZIL THE NEXT ARGENTINA?

Elizabeth Johnson/Larry Brainard

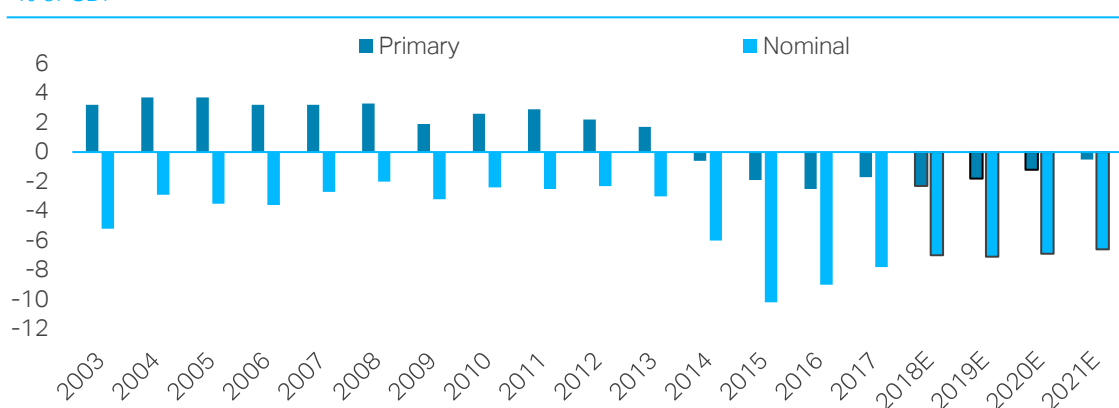
- **Fiscal solvency requires both a reform-minded president and Congress**
- **The leading presidential candidate supports needed reforms but has not demonstrated the political skills to get them through Congress**
- **Candidates on the left are proposing a return to populist policies**

Delaying fiscal adjustment is no longer an option. Despite efforts by the Temer administration to cut discretionary spending, Brazil remains firmly stuck on a fiscally unsustainable path; its fiscal deficit is roughly twice that of Argentina, though financed mostly domestically. This year, Brazil is on track to post its fifth consecutive primary deficit, as we recently [highlighted](#). To make matters worse, current government projections see the primary deficit continuing until at least 2021, when the nominal deficit is projected to reach 6.6% (see Chart 1 below). The fiscal erosion has contributed to a sharp rise in Brazil's debt-to-GDP ratio, which is expected to reach 82% by 2021, up from 50% five years ago.

Growth and investment continue to disappoint. To make matters worse, the economic recovery that the market had expected in 2018 has yet to materialize. The economy expanded by just 0.2% qoq in the second quarter, after the 11-day truckers' strike acted as a drag on growth. Moreover, looking beyond short-term factors, the economy still does not have any significant growth drivers. The biggest disappointment over Q2/18 growth was the lack of investment, which has progressively weakened since Q4/17 (see Chart 2 below). Although investment as a percentage of GDP increased to 16% in Q2/18 compared with 15.3% in Q2/2017, it remains well below the 20% reached in Q2/2011. Unfortunately, political uncertainty triggered by the upcoming presidential election means that investment will remain on hold until after the final round of the presidential election on 28 October.

Chart 1: Brazil's primary and nominal fiscal balance

% of GDP



Source: Brazilian Treasury.

Pension reform is more urgent than ever. Currently, Brazil spends nearly 8% of GDP on pensions, roughly equivalent to pension expenditures in Germany, despite the fact that just 9.2% of Brazil's population is over 65. Without reform, pension spending as a percentage of GDP is expected to reach 10% by 2030. The urgency of this reform prompted Finance Minister Eduardo Guardia to urge candidates to try to pass the pension overhaul before the end of 2018. He warned that otherwise, Brazil risks following the same path as Argentina.

Former São Paulo Governor Geraldo Alckmin is best equipped to pass reform. While all of the [main candidates](#) have paid lip service to pension reform, the candidate with the best chance of quickly negotiating pension reform is Geraldo Alckmin. He has put together an economic team that includes the architects of the 1994 Real Plan, which ended hyperinflation, and has a large coalition in the legislature. Unfortunately, he has been slow to rise in the polls.

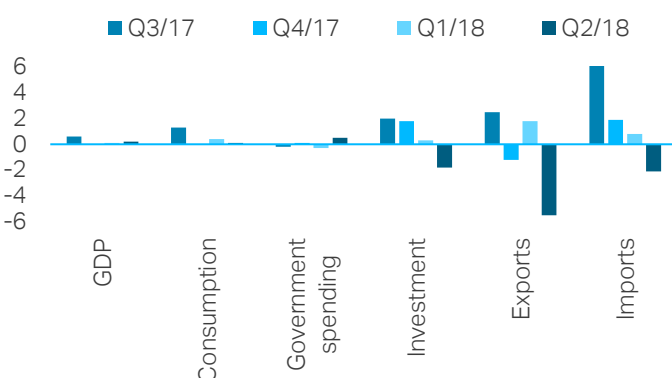
Far-right candidate Jair Bolsonaro has a respected economic adviser, but limited political skills. The market is currently giving Bolsonaro the benefit of the doubt, because his economic adviser, Paulo Guedes, is a highly respected, reform-minded economist. Guedes supports aggressive privatizations, but it will be a huge challenge to get the new Congress to support such radical moves. And while Bolsonaro has been in Congress for nearly three decades, he has shown no interest in passing legislation and could face difficult challenges in building support for them. Despite his high rejection rates, Bolsonaro leads in the polls (see Chart 3) could advance to the runoff, especially because Alckmin has been forced to roll back his negative ads targeting Bolsonaro after the latter was stabbed last week while campaigning.

Candidates on the left are offering populist solutions. Meanwhile, candidates on the left appear do not appear to have learned any lessons from the recent economic crisis. Former Ceará Governor Ciro Gomes has promised to use public banks to bail out indebted consumers, while the the Workers' Party (PT) economist believes that fiscal problems be magically resolved by stronger growth. As we highlighted in our [EM Strategy monthly](#), we expect significant volatility to erupt if no reform-minded candidate advances to the runoff; this would shock markets out of their current complacency about the fiscal challenges ahead.

The current global environment will make it harder for the next government. Although the next administration will be taking office with historically low inflation and interest rates, the new president is going to have to make tough political decisions. Because of the recent shift in sentiment towards emerging markets, Brazil will no longer be given the benefit of the doubt. This means that unless the new administration moves quickly to pass a credible fiscal programme, Brazil runs the risk of following down the same path as Argentina and Turkey.

Chart 2: Brazil's GDP

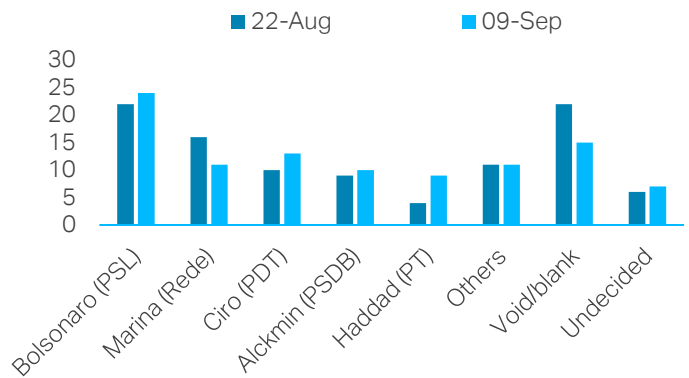
% change, qoq/sa



Source: IBGE.

Chart 3: First round voter intentions

%



Source: Datafolha.