Daily Note

BRAZIL: ELECTION OPENS DOOR FOR FURTHER REFORM

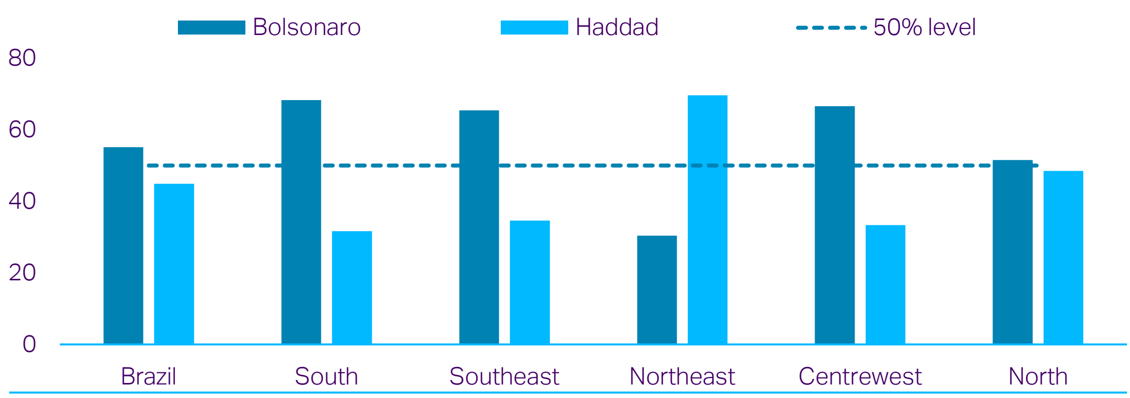
Elizabeth Johnson / Grace Fan

- **Far-right candidate Jair Bolsonaro wins runoff by a solid margin**
- **Bolsonaro must push an ambitious reform agenda – notably pension and tax reforms, plus privatizations – to put the economy back on track**
- **He is likely to benefit from stronger growth and revenues in 2019**

Bolsonaro handily beats his leftist opponent. Brazilian voters handed the far-right presidential candidate a solid victory in Sunday's ballot, as the population continued to reject the political status quo. Bolsonaro's anti-establishment and anti-corruption stance were decisive for his 10pp victory over former São Paulo mayor Fernando Haddad of the Workers' Party (PT) amid myriad corruption scandals. The far-right legislator's win is part of a broader trend which swept out traditional political leaders from all levels of government. Although Bolsonaro's once tiny political party, the Social Liberal Party (PSL), will now be the second largest in the Lower House, it also means that the new leader will face an even more fragmented legislature than past leaders.

The new administration has promised an ambitious reform agenda. Although Bolsonaro has offered only vague details of his economic programme, his economic team has vowed to prioritize key reforms, notably pension reform. Speaking briefly to the press after the candidate's runoff triumph, Bolsonaro's chief economic adviser and future Economy Minister Paulo Guedes reiterated the importance of controlling government spending, adding that pension reform would be the top priority. He also promised to speed up privatizations, to "simplify and reduce taxes" and to slowly open up the economy while prioritizing trade outside the Mercosur bloc.

Chart 1: Second-round presidential results by region
% of valid votes



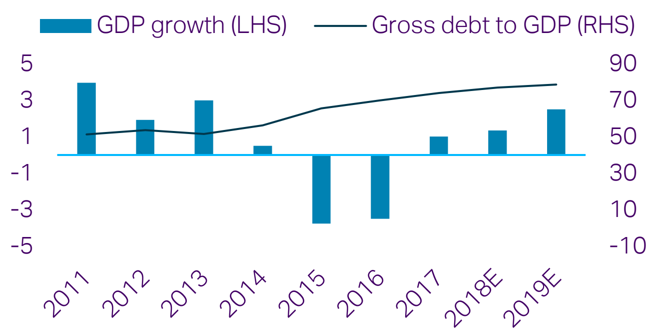
Source: TSE.

But Bolsonaro needs to deliver on his promise to outsource economic decisions to Guedes. Although the market has been willing to give Bolsonaro the benefit of the doubt in recent months, the continued rally will hinge on his willingness to allow Guedes to take the lead on economic issues. This is largely because the President-elect's own economic views are a legitimate cause for concern. During the campaign, Bolsonaro slammed Chinese investment in Brazil and flip-flopped about whether to allow privatizations in "strategic sectors", such as energy, mining and agriculture. Bolsonaro also contradicted Guedes with respect to tax policy, ultimately forcing his economic guru to spend most of the last month avoiding the press.

Central Bank independence will be a key test for the new administration. While both Guedes and Bolsonaro agree that the current president of the Banco Central (BC) Ilan Goldfajn should be invited to remain in the post and that the institution should be given "formal" independence, the details of these negotiations will be key to watch. The market was left perplexed after Bolsonaro said in a Friday interview (published Saturday) that while he supported granting the BC autonomy, it should be "within parameters" and that currency and inflation targets should also be "fixed". Although this was likely yet another example of Bolsonaro's poor understanding of the economy, the upcoming debate on this issue will show the extent to which Bolsonaro is truly willing to outsource key economic decisions to Guedes. Additionally, because Guedes has no experience in government, any signs that other members of Temer's economic team would stay on in the new administration would be highly positive as they would be able to shepherd important reforms through the legislature. Conversely, a mass exodus would be a bad sign, as it will slow down the transition and create ruptures where continuity is preferable.

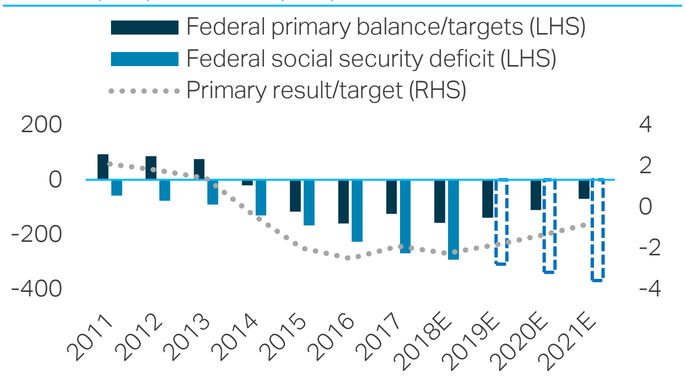
The improved growth outlook will ease some of the fiscal burden on Bolsonaro, but reform is paramount. The good news is that after two years of weak economic growth, we expect the recovery to finally pick up in 2019, thanks to improved confidence and an end to electoral uncertainty, which will lead to an increase in investment. This will be aided by the expectation of another record harvest and the strong pipeline of infrastructure projects left by the Temer administration. Furthermore, additional revenues in 2019 – notably from the continuation of oil & gas tenders, including a planned mega-tender of Petrobras pre-salt blocks – will help reduce the primary deficit. But the challenges of getting Brazil's worsening fiscal accounts back on track should not be underestimated. For this reason, it is essential that the new government work quickly to pass unpopular reforms early in Bolsonaro's term in office. Failure to take advantage of the honeymoon period could prove fatal for the new government, because the window to pass reforms will slam shut at the end of 2019.

Chart 2: GDP growth vs gross debt to GDP ratio
%



Source: Brazilian Treasury.

Chart 3: Brazil's primary balance, targets and social security deficit
BRL bn (LHS) / % of GDP (RHS)



Source: Finance Ministry.

Authors

Elizabeth Johnson
Managing Director, Brazil Research

Grace Fan
Senior Director, Latin America Research