Brazil: Can Bolsonaro Deliver on Reforms?

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Brazil's economic prospects have brightened following a tumultuous five years. This included the impeachment of President Dilma Rousseff in August 2016 and an extended period of policy paralysis, which contributed to a steep, prolonged recession, a significant increase in public debt and multiple downgrades to its sovereign rating. While growth has partially recovered, stocks have surged, and interest rates have tumbled, the country is not completely out of the woods yet. The long-term strength of the economy and, in tandem, the ability to stabilize its public finances will ultimately depend on the pace of structural reforms.

Still Stagnant

Although we expect Brazil's modest recovery to continue, this is largely because the economy is operating with a high degree of slack. Real GDP grew by an average of 1.1% in 2017-18 (*Chart 1*), which leaves it roughly 5% below its pre-crisis level in 2014. Meanwhile, the unemployment rate remains elevated, standing at 12.4% in February, though this is below the recent peak of 13.7% in March 2017.

This stagnant economic backdrop explains why investors, both domestic and foreign, remain focussed on the prospect of structural reforms. The importance is reflected in the wide range of estimates of Brazil's medium-term potential growth rate, from as high as 4.0% (assuming the implementation of a fiscal adjustment that stabilizes public debt and microeconomic reforms that improve the investment climate) to as low as 1.5% (without any adjustments).

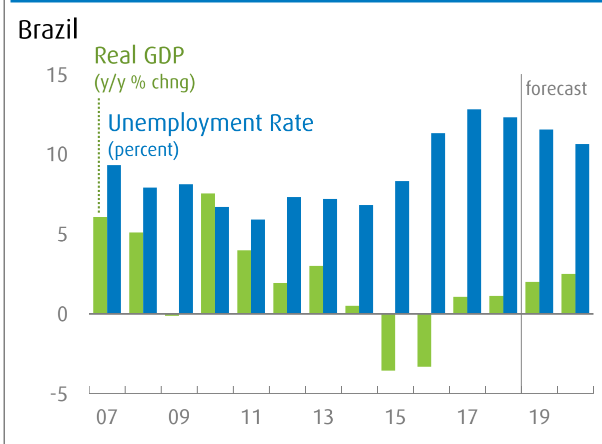
Bolsonaro has a Tough Road Ahead

The election of a centrist/market-friendly president may not be enough to revive Brazil's economic fortunes. President Jair Bolsonaro and his Partido Social Liberal (PSL) party simply do not have enough seats and/or support in the lower house—the Chamber of Deputies—to implement new legislation. The PSL holds just 52 of the lower house's 513 seats, which are distributed among 30 parties. Bolsonaro needs at least three-fifths of the lower house to approve major bills, such as pension reform. Further complicating matters, Bolsonaro has chosen not to engage in the traditional 'horse-trading' tactics of his predecessors (e.g., distributing key cabinet positions to other parties to build alliances).

Pension Reform Badly Needed...

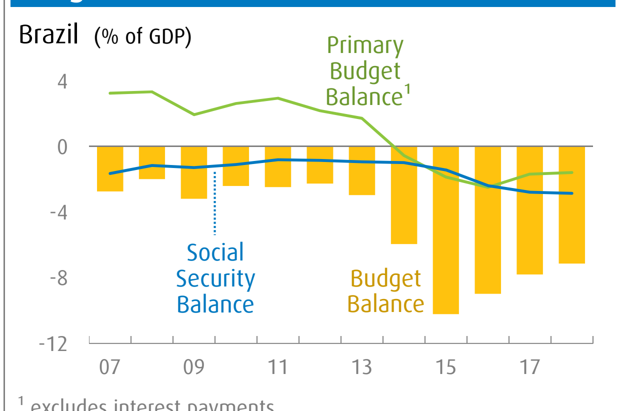
It appears that there is a consensus, even among Brazil's most hardened centre-left politicians, that the government's social security costs must be reduced, but to what degree and under what conditions remain uncertain. As it stands, the social security system is financially unsustainable as it pays high replacement rates—pensions relative to working-age incomes—and at a relatively

Chart 1
Modest Economic Recovery Forecast



Sources: BMO Economics, Haver Analytics

Chart 2
Fiscal Reform Needed to Correct Primary Budget Deficit



[1] excludes interest payments
Sources: BMO Economics, Haver Analytics

young age (53 years for women and 56 years for men). In 2018, social security spending accounted for 8.6% of GDP (vs 6.8% in 2014), which pushed the social security deficit to 2.9% of GDP (vs 1.0% in 2014) (*Chart 2*).

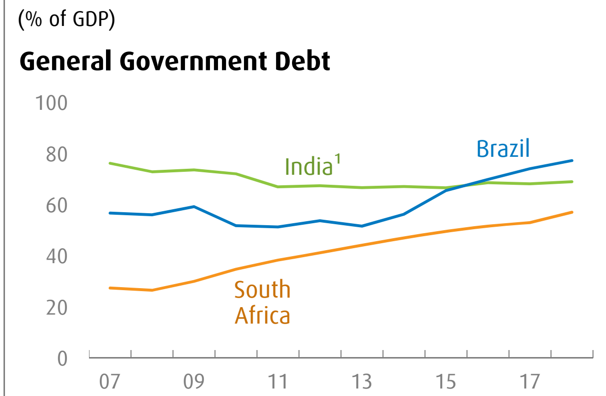
Bolsonaro has proposed an ambitious pension reform plan, which if implemented, should help lower/stabilize future budget deficits. According to the government's estimates, the proposal, which includes raising the retirement age (to 62 for women and 65 for men), increasing contributions paid by higher-income workers and limiting the ability of pensioners to collect more than one benefit, would provide savings of BRL1.2 trillion in the first 10 years after approval, equivalent to 17% of nominal 2018 GDP.

...but Likely to be Watered Down

But recent debate in Congress suggests that the odds of Bolsonaro's proposal being approved in its current form are slim, and, thus, it will likely be watered down. Most private-sector analysts expect it to be diluted to BRL600-800 bln, which may still be an acceptable outcome. If the proposed pension bill is watered down significantly, say to under BRL500 bln of savings, then it will eventually begin to impact the government's ability to spend on other essential services, due in large part to the 20-year public spending cap (introduced in 2016), which limits the rise in federal non-interest spending to the previous year's inflation rate.

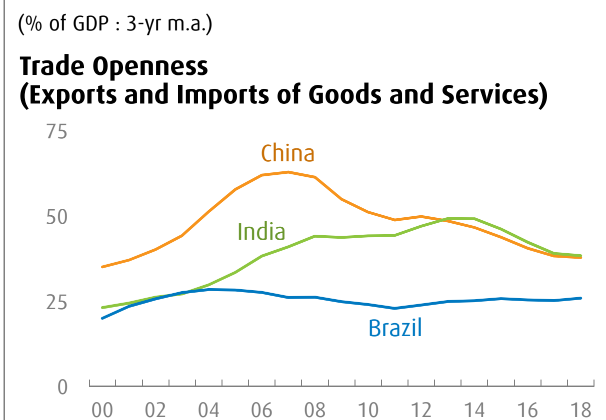
The public spending cap is not necessarily a 'hard budget constraint', which means that, without a significant cut in social security spending or other major fiscal savings measures, the prospect of the cap being breached cannot be fully discounted. This could lead to an unsustainable rise in general government debt (*Chart 3*).

Chart 3
Public Debt Approaching Unsustainable Levels



[1] based on the financial year-end (end-March)
Sources: BMO Economics, Haver Analytics, Reserve Bank of India

Chart 4
A Closed Market by Emerging Market Standards



Sources: BMO Economics, Haver Analytics

Improving Competitiveness on the Backburner

We doubt that Bolsonaro will be able to focus on revamping Brazil's economic model—where the legacy of import-substitution and protectionist policies implemented as far back as the 1950s continues to stifle potential growth—until pension reform has been resolved. Even then, reforming the financial sector and labour market, or opening Brazil's closed economy to more competition by reducing both tariff and non-tariff trade barriers, will face stiff opposition, given deeply rooted vested interests (*Chart 4*).

Key Takeaways

History has proven that implementing major structural reforms in Brazil is not easy. Nonetheless, we think that Bolsonaro will be able to obtain enough support to push through a pension reform bill that is able to move the country's public finances in the right direction and keep the credit rating agencies at bay. Or put another way, Brazil's politicians—no matter where they sit on the political spectrum—have reached a point where they can no longer 'kick the can down the road'.