Brazil's Presidential Election: Familiar names for an uncertain future

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Key points

- On 2 October, Brazilians will vote to elect a new President for the 2023-2027 term. If no candidate secures more than 50% of the vote, a runoff election will be held on 30 October. Voters will also elect members of Congress, state Governors and state Legislative Assemblies
- Polls show a clear two-horse race between former President Luiz Inácio Lula da Silva and the incumbent Jair Bolsonaro. While Lula still holds a sizeable lead, Bolsonaro has however been able to narrow the gap in recent weeks
- While both candidates sit at opposite ends of the political spectrum, they would likely pursue similar fiscal policies which favour populism over much-needed structural reform
- The next president will face a highly fragmented Congress, which will impede both a radical policy shift to the left in the case of Lula's victory, but also structural reforms needed to jumpstart economic growth and ensure fiscal sustainability

A two-horse race

On 2 October, Brazilians will go to the polls to cast their votes in the country's massive general election. Nationwide, voters will elect a new President, all 513 Federal Deputies and one-third of Senators. Voters will also elect new state Governors and state Legislative Assemblies. If no presidential or gubernatorial candidate reaches 50% of the votes, runoffs will take place on 30 October.

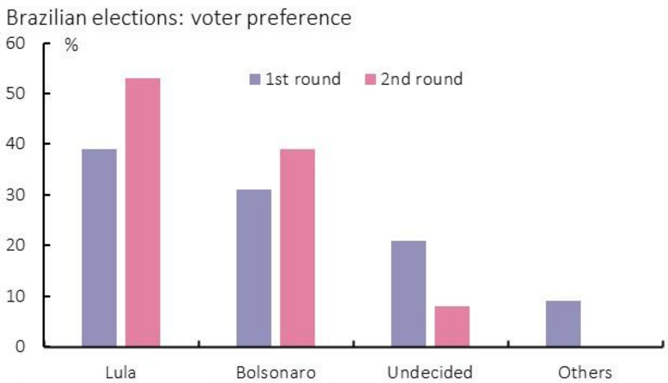
Brazil is currently dealing with several economic challenges. While the recent upswing in commodity prices has given Brazil's economy an additional push this year, the country's post-pandemic recovery has been patchy as a result of extreme weather conditions, high interest rates and soaring consumer prices. Annual inflation peaked at 12.1% in April, the highest in 19 years, which prompted the central bank to take the policy rate to 13.25%, one of the highest across emerging markets. As a result, Bolsonaro's approval ratings have steadily declined since the start of his term. Meanwhile, investors remain focused on Brazil's troubled public finances and its sustainability following the elections.

The presidential contest is a decidedly two-horse race between former president Luiz Inácio Lula da Silva – known simply as Lula – and the incumbent president Jair Bolsonaro. According to the latest Datafolha poll, all other candidates together account for just 9% of the vote. Meanwhile, Lula continues to comfortably lead the race with 39% of voting intentions over

Bolsonaro's 31% (Exhibit 1). Unlike Bolsonaro, Lula was widely popular in his previous two terms as President (2003-2010) and left office with an approval rating above 80%.

However, a Lula victory is not a foregone conclusion. The gap between the two has been closing in recent weeks as Bolsonaro has ramped up cash transfers to poor families and cut taxes on fuel in a last-minute attempt to bolster his chances in the upcoming elections. His bet seems to be working, as Lula's lead has fallen to eight percentage points from 16 points in May. Providing a further boost to Bolsonaro's campaign, GDP growth accelerated in Q2, surpassing market expectations. The question remains whether Bolsonaro will be able to catch up before the potential runoff elections in late October. For now, pollster Datafolha estimates Lula to have 53% of the vote versus Bolsonaro's 39% in the event of a second round. Undecided voters make up 9% of the electorate.

Exhibit 1: A two-horse race



Source: Datafolha poll and AXA IM Research, 9 September 2022

Lula 2.0: Radical or a pragmatist?

In the last few years, Latin America has seen a spate of left-wing politicians come to power, which has created market turmoil and fear among investors. However, despite his left-wing credentials and calls for a bigger state, Lula's strong position in the polls has not caused panic for two main reasons. First, Bolsonaro's government has failed to deliver structural reforms and has, in fact, leaned towards fiscal populism. But more importantly, Lula's previous presidency (2003-2010) was relatively market-friendly and fiscally responsible, while funding poverty eradication programmes. For example, government debt fell from 73% of GDP in 2003 to 63% in 2010; the central bank retained its autonomy; and Brazilian equities rallied during Lula's government, outperforming the emerging market equity average (Exhibit 2).

However, Lula's success was aided in large part by high global commodity prices, of which Brazil is a major exporter. In the absence of a sustained commodity boom, Lula will have a hard time increasing social spending without putting government finances at risk. Government debt reached 93% of GDP[1] at the end of 2021, while the fiscal deficit is expected to widen to 6.6% this year. Should he win, it's unclear whether Brazil will get the pragmatic Lula of yore or a more populist figure resembling the likes of former Presidents Rafael Correa (Ecuador) and Cristina Fernández (Argentina).

Exhibit 2: Brazilian equities outperformed during Lula's presidency

Source: Refinitiv, Datastream and AXA IM Research, 19 September 2022

Policy proposals

Bolsonaro's and Lula's policy positions differ, particularly on the fiscal regime to be implemented in the coming years. Broadly speaking, Lula's platform calls for a large role for the state, increased social spending and more redistributive taxation. But Bolsonaro's plans indicate a continuation of his current economic agenda such as more privatisation, a smaller state and a continuation of the fiscal adjustment, although he has yet to specify how he will do this.

Given Brazil's fiscal woes, potential changes to the public spending cap and the tax system will be critical for the country's debt sustainability. On this aspect, Lula's programme proposes to remove the spending ceiling, which has served as an anchor for fiscal credibility since its inception in 2016. A Lula administration plans to offset increased spending by overhauling the tax system. This tax reform would focus on a more progressive income tax regime, the introduction of a tax on corporate dividends and a simplification of the tax code. While not planning to scrap it altogether, Bolsonaro has also vowed to adjust the cap to allow for more spending. In fact, the President has continuously found ways to circumvent the rule during his tenure. From the revenue side, Bolsonaro plans to reduce taxes at the state and federal level as well as simplifying the tax system to make it competitively neutral. Bolsonaro also claims he will remain committed to fiscal consolidation, but it is still unclear how his government would achieve this adjustment.

[1] IMF definition of Brazil's debt burden. Official national statistics differ because of conceptual differences.

The two contenders are also diametrically opposed in their views of labour market regulations and privatisation. Bolsonaro wants to continue his liberalisation agenda by privatizing Petrobras and the Correios, the national postal service. In contrast, Lula wants to halt all privatisation plans, use state-owned banks to foster economic growth and to renationalise Eletrobras, the country's largest electricity provider. On the labour front, Bolsonaro wants to further simplify labour legislation and to formalise informal workers. A Lula administration would dismantle the previous labour reform (2016) and grant more social protection measures to workers.

Congressional elections

The outcome of Congressional elections will also be a key factor for Brazil's future. Unlike other countries in the region, Brazil's Congress is relatively autonomous and powerful, and thus will dictate the viability of the next President's agenda.

According to polling data, the composition of Congress is expected to remain fragmented and politically centrist. For example, the Senate is currently comprised of 15 different political parties. Lula's and Bolsonaro's respective political parties —The Workers' Party and the Liberal Party— have less than 10% of seats each in the Senate, a share that will likely remain stable after the general elections. Therefore, the next President will depend on political alliances to enact any meaningful reforms.

As such, a divided and centrist Congress is a double-edge sword. On one hand, it will impede any radical reforms which could push government policy to the left in the case of Lula's victory. For instance, the approval of constitutional amendments requires two-thirds of votes in both houses. Bills of supplemental law need approval of an absolute majority of all members of Congress. But political fragmentation also means even if Bolsonaro chooses to pursue a more market-friendly and fiscally responsible agenda in a second term, its implementation will be slow and difficult.

Future fiscal fiasco?

Just how bad is Brazil's fiscal situation? There are two sides to this issue. First, it has a high debt-to-GDP ratio – significantly above its ratings peers (sovereigns with a BB- rating) and the regional average for Latin America. Likewise, the International Monetary Fund (IMF) expects the fiscal deficit to remain upwards of 4.4% of GDP until at least 2027. Just as important is Brazil's low potential economic growth, standing at some 2% annually. In the absence of productivity-enhancing investment, this is expected to drop further as Brazil's favourable demographics start to reverse.

Below we conduct a post-election analysis for the trajectory of the debt ratio under three different scenarios. In a bearish case, we assume a delay in the delivery of structural reforms and below-potential GDP growth, leading to further fiscal deterioration.

For our base scenario, we set GDP growth to rebound to its potential along with a slightly larger primary deficit. Finally, in the bull case, we consider higher potential GDP growth along with a long-term primary surplus resulting from fiscal consolidation.

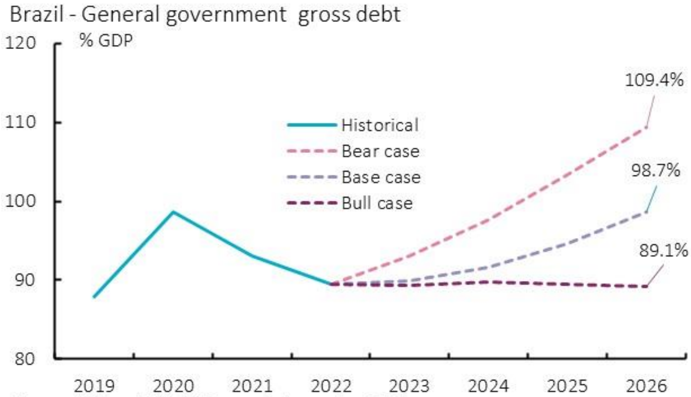
Exhibit 3: Scenario analysis for Brazil

In %	2022e*	Long-term trend by scenario		
		Bear	Baseline	Bull
Nominal GDP growth	11.5	3.5	4.5	4.6
Real GDP growth	1.5	0.5	1.5	2.0
Inflation	10.0	3.0	3.0	2.5
Primary balance (%GDP)	-0.1	-1.5	-0.9	2.0

Source: IMF and AXA IM Research, September 2022 **estimate*

Under these different assumptions, only the bullish scenario allows for a stabilisation of government debt (Exhibit 4) i.e. the next administration will have to pass fiscal reforms to contain public spending and enact measures which can lift Brazil's dismal potential GDP growth. Failure to pass these reforms either due to ideological positions or a fragmented Congress could result in debt approaching 100% of GDP by 2026.

Exhibit 4: Debt trajectory



Source: IMF and AXA IM Research, September 2022

Outlook

The next administration will inherit a stagnant economy and a difficult fiscal situation. Unfortunately, Brazil's divided Congress will likely hinder any meaningful attempts at addressing this. Furthermore, neither candidate seems interested in delivering fiscal reforms that would stabilise the country's debt. More positively, based on his track record and the aforementioned Congressional fragmentation, it's unlikely a Lula victory would translate into a hard turn to the left.

While the economy has been more resilient than expected through the first half of 2022, it will nevertheless slow significantly to 1.5% this year (2021: 4.6%) as the post-COVID-19 rebound effect dissipates. We expect investment to contract reflecting higher interest rates and soft business sentiment, while growth in private consumption will be limited by high inflation. High commodity prices should provide a growth cushion.

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