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Challenges to the Brazilian Economy in an Election Year

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Election years are full of uncertainty. Tax hikes or cuts, special tax regimes, increasing expenditure, pay rises, sectoral policies, targeted and subsidized credit and changes in industrial relations law are issues that always return during election campaigns and have relevant implications for the dynamics of economic growth and productivity in the short, medium and long term, especially considering the way in which they are implemented.

The 2022 campaign has so far provided little space for in-depth discussion of these issues, and all the signs are that the debate will focus on what many political analysts are calling a war of narratives. Despite scant knowledge of the candidates' economic agendas, the styles and ideas of the leaders of the presidential race according to all the polls, Lula and Bolsonaro, are well-known from their time in office, and they have offered some clues as to what to expect if they win.

The indications from Lula's campaign are that public spending will expand, with the extra money coming largely from tax hikes. Both Lula himself and close allies have expressed a clear intention of altering the spending cap (by exempting investment, for example), awarding pay rises to government employees, raising the minimum wage, and adjusting the 2017 labor law reform.

On the side of Bolsonaro's campaign, the incumbent administration has to deal with all the economic problems of the fallout from the pandemic, especially galloping inflation, which erodes purchasing power and hurts its approval ratings. In response, a number of measures entailing foregone revenue are being implemented, including a reduction in sales tax (ICMS) on electricity and telecommunications, redefined as essential goods or services that merit low rates. While such measures may lead to lower inflation, their fiscal impact will be significant, not just for the federal government but also for the states, for which ICMS is a major source of revenue.

Figure 1 - Fiscal Impact of Measures under Discussion

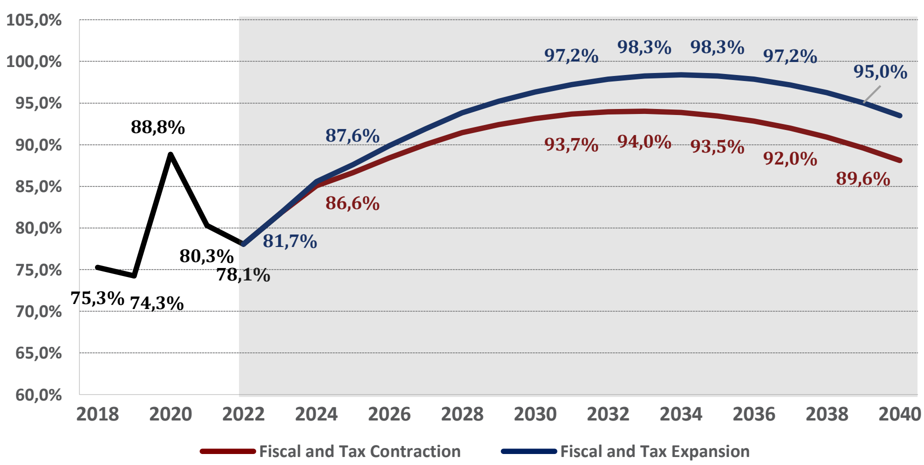
Description	Stage	Impact 2022 (BRL Billion)
Revenues		**31,7**
Gasoline Exemption	Approved	15,1
Diesel Exemption	Approved	16,6
Expenses		**41,25**
ICMS 17% fuel, eletric energy and communications*.	Approved	-
Expansion of Alimenta Brasil Program*	Sent to Chamber of Deputies	0,5
Subsidy for free public transportation*	Sent to Chamber of Deputies	2,5
Ethanol Subsidy*	Sent to Chamber of Deputies	3,8
Expansion of the gas voucher*	Sent to Chamber of Deputies	1,05
Aid for truck drivers*	Sent to Chamber of Deputies	5,4
Expansion of Auxílio Brasil and zeroing of the waiting line*	Sent to Chamber of Deputies	26
Aid for taxi drivers*	Sent to Chamber of Deputies	2
Total		**72,9**

*Indicates that values are estimates from National Congress/Federal Government

Source: BOCOM BBM, Federal Government, Federal Congress

Several other expansionary proposals are also being debated in both houses of Congress, involving subsidies for truckers and taxi drivers, as well as consumers in the form of a cooking gas allowance and a hike in the Auxílio Brasil cash transfer benefit (Figure 1). These would be temporary measures, but history shows that this kind of spending is politically very hard to reverse and often becomes permanent.

Figure 2 - Debt to GDP Ratio - Contraction vs Fiscal and Tax Expansion



Source: BOCOM BBM

Both candidates' proposals raise concerns regarding the sustainability of Brazil's public debt, either via higher net fiscal expansion than the rules currently allow (although they have been repeatedly broken by means of constitutional amendments), or via reformulation or even abandonment of the existing fiscal framework (Figure 2). The scenarios of fiscal and tax expansion/contraction above suppose that the change in tax revenue is offset by the change in expenditure. It is also assumed that the lower taxation and expenditure are more efficient, causing long term growth to be higher.

The negative effects of fiscal deterioration are evidenced by several financial and economic indicators. The increase in risk suggests a higher neutral interest rate (the one that balances supply and demand in the long term), raising the financial cost of the debt and therefore increasing the difficulty of driving the indicator down in the long run. The exchange rate, that has pro-appreciation fundamentals, remains under pressure from the risks and uncertainties of the domestic outlook. And tax collection, responsible for the government's excellent results in terms of the primary surplus in 2021, is set to decelerate in response to higher interest rates and weaker economic activity.

The external outlook is also challenging. Central banks in the developed economies have shown strong concern over the dynamics of inflation, indicating that rate hikes will continue and may even intensify. The 75 bps hike announced by the US Federal Reserve in June was the highest for 30 years, and the Fed has signaled a series of additional hikes to reach a terminal rate of 3.8%.

Our current projections are shown below. We now forecast inflation of 7.2% in 2022 and 5.6% in 2023, taking into account the expected drop in taxes. We also project economic growth of 1.4% in 2022 and 0.5% in 2023. The CPI, at 11.7%, continues at a very high level and displays worrisome readings, with groups characterized by their persistence accelerating. To control inflation, we believe the Central Bank of Brazil will have to raise its policy rate to 13.75% and hold it there for a long period.

ECONOMIC FORECASTS	2019	2020	2021	2022F	2023F
GDP Growth (%)	1,1%	-3,9%	4,6%	1,4%	0,5%
Inflation (%)	4,3%	4,5%	10,1%	7,2%	5,6%
Unemployment Rate (eoy ,%)	11,7%	13,9%	11,1%	9,8%	10,3%
Policy Rate (eoy, %)	4,5%	2,0%	9,3%	13,75%	11,75%
External Accounts					
Trade Balance (US$ bn)	48	32	36	68	45
Current Account Balance (US$ bn)	-65	-24	-28	-14	-40
Current Account Balance (% of GDP)	-2,8%	-0,9%	-1,8%	-0,8%	-2,6%
Fiscal Policy					
Central Government Primary Balance (% of GDP)	-1,2%	-10,0%	-0,4%	-0,3%	-0,5%
Government Gross Debt (% of GDP)	74,3%	88,8%	80,3%	78,1%	81,7%