BRAZIL

NEW PRIORITIES

Luiz Inacio Lula da Silva started his third term as President of Brazil amidst a tense socio-political climate and more benign economic environment. Despite the many obstacles lying ahead of him, Lula bolsters ambitious social and environmental objectives. Their realisation will rely, amongst other, on an increase in public spending and a more interventionist credit policy. In the absence of a credible redefinition of the fiscal framework, market participants and the Central Bank fear that the use of these policies will come at the expense of greater macroeconomic imbalances.

A TENSE HANDOVER OF POWER

The handover of power between Jair Bolsonaro and Lula da Silva at the head of the Presidency of Brazil was – in many respects – historic : absence of Jair Bolsonaro at the inauguration (a first for an outgoing head of state), storming of Congress, the Supreme Court and the Presidential Palace by pro-Bolsonaro rioters a week only after the inauguration. In the last few months, the latter have contested the legitimacy of the presidential election and have been calling on the army to take power. Lula's first measures in office did not help to appease them (signing of decrees affecting gun ownership and mining laws in indigenous and protected areas of the rainforest; revocation of ordinances affecting abortion; creation of new supervisory bodies to fight disinformation).

PUBLIC POLICIES: GRAND MANEUVERING IN THE WORKS ?

Unlike his predecessor, Lula wants to put the state back at the centre of the growth equation with the aim of reducing poverty and accelerating the transition to a more sustainable growth model. Ten million Brazilians have fallen into poverty since the pandemic and around 33 million (15% of the population) are currently in a state of food insecurity in a country which is the world's third largest food producer and the world's leading exporter of meat. To act quickly against poverty (in particular tackle hunger) Lula intends to lean on transfers. To that end, he will rely on i/ his flagship conditional cash-transfer programme – *Bolsa familia*, ii/ increase the minimum wage (above inflation), iii/ relaunch programmes to allow better access to housing and iv/ deploy an action programme against hunger. This part of his agenda will initially be financed by debt and then by a tax reform. The latter will also be aimed at tackling a complex and regressive taxation system (strongly based on consumption rather than income). However, this reform is unlikely to get approved prior to the revision of the country's fiscal rules, which Lula wants to make more flexible in order to allow the government to spend more freely on the poor and the energy transition. Public banks will also be more heavily leaned on to provide subsidized credit. Petrobras, the country's largest energy company, could also suffer a change in its pricing policy at the pump. The company – whose refining capacity will also be expanded under Lula – could see its prices become more decorrelated from international prices to better protect the most vulnerables in the event of shocks.

However, Lula will not be able to act sustainably against poverty and inequality with anaemic growth. He therefore intends to complement his policy of transfers and subsidies with public policies destined to stimulate investment and productivity – two important determinants of potential growth. The latter has been muzzled in recent years by stagnating productivity, the slowdown in the growth rate of the working population (a consequence of the country's demographic transition) and the erosion of investment (a consequence, in part, of fiscal adjustments since 2016). Lula would like to reactivate public investment in infrastructure in collaboration with the States. He is expected to continue to rely in part on concession contracts but projects to expand the use of public-private partnerships (PPP) and encourage more Environmental, Social and Governance (ESG) considerations in projects. The development bank, BNDES, will play a key role in the government's plans. It will be mobilized, in particular, to i/ finance green infrastructure (wind farms, solar power plants) ii/ support investment by SMEs and start-ups and iii/ help reinvigorate the country's industrial policy (industrial production has shrunk by 1/5th in 10 years.) Internationally, by taking a stronger position on the environment, Lula hopes to activate i/ financial levers (bolster official contributions to the Amazon protection fund ; capture international investors' appetite for ESG

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth, %	-3,3	5,0	3,0	0,5	1,2
Inflation, CPI, year average, %	3,2	8,3	9,4	4,8	4,8
Fiscal balance / GDP, %	-13,3	-4,3	-5,3	-8,7	-6,6
Gross public debt / GDP, %	88	82	78	83	85
Current account balance / GDP, %	-1,9	-2,8	-3,0	-2,3	-2,0
External debt / GDP, %	44	42	39	40	43
Forex reserves, USD bn	356	362	324	335	340
Forex reserves, in months of imports	19	15	13	14	13

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL: AVERAGE COST OF THE FEDERAL DEBT (%, OVER PAST 12 MONTHS)

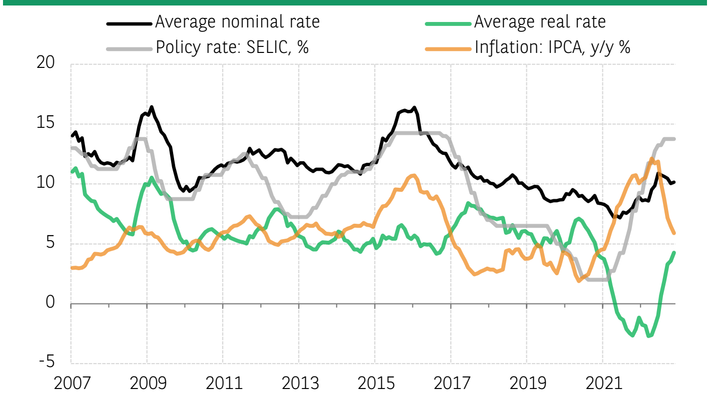

CHART 1 SOURCE: NATIONAL TREASURY, BNP PARIBAS

investments in a country where ¾ of the energy mix comes from renewable energies) as well as ii/ commercial levers (resumption of the free trade agreement between the EU and Mercosur – suspended since 2019 due to the country's low commitment to environmental protection). Greater trade openness would enable technology transfers that would ultimately lead to significant productivity gains for the country.

WILL LULA HAVE THE MEANS TO ACHIEVE HIS AMBITIONS?

Lula has an ambitious programme. But the fragility of the political and macroeconomic situation calls into question his ability to carry out his project. Firstly, the conditions under which he will exercise power won't be favourable to him : i/ high rejection rate in society, ii/ reinforced opposition in Congress and at the state level, iii/ more diluted power of his party, the PT, within the governing coalition and iv/ stronger opposition from conservative segments of civil society which are better organised and highly active. As such, it will be difficult to backtrack on the pension reform (2019), the labour market reform (2016) and the privatisation of Electrobras (2022), which members of his party contest. Recent experience in Latin America (Chile, Colombia, Argentina, etc.) also shows that it is increasingly difficult to govern in the region. Political cycles and "honeymoon" periods are becoming shorter with a very low rate of government renewal and a rapid erosion in popularity for newly elected presidents (except Mexico and El Salvador). This situation tends to constrain the influence that Presidents have on the legislature, potentially hindering the progress of reforms.

Secondly, his fiscal leeway will be very limited. Lula is starting his term in office in the midst a benign economic environment. Growth has been slowing down for several months and this trend is expected to continue this year. This environment will weigh on public revenues, further accentuating an already elevated interest burden (22% of revenues, 5.6% of GDP) and whose weight in real terms has increased sharply since the summer of 2022 (on the back of significant disinflation). The government is also facing considerable refinancing needs due to significant short-term debt (23% of the debt matures over the next 12 months). Furthermore, while the price of certain commodities should remain favourable in the short term, public finances will not be able to count on a prolonged boom in the price of commodities (as in 2003-2010) to finance social programmes – all the more so as a larger part of the oil windfall will be gradually passed on to the States. The Federal State, whose spending structure is very rigid, is also more indebted than during Lula's previous mandate (+25 points of GDP in 10 years). Nor will it be able to count on exceptional revenues from privatisations, since Lula is opposed to the sale of public assets. In addition to the constraint arising from the country's fiscal rules[1] , the economy's weak growth potential (estimated at some 1.5-2%) could also limit public action. An economy fuelled by public spending that operates persistently above its growth potential (positive output gap) would very quickly generate imbalances and feed inflation –a situation most prejudicial to the poorest segments of society.

ONE FOOT ON THE GAS AND THE OTHER ON THE BRAKE?

Despite the many obstacles that lie ahead to govern effectively, Lula is still expected to gain ground on many issues (a scenario which worries market participants, in particular locally). The allocation of 8 of his 37 ministerial portfolios to centre and centre-right parties (+6 to centre-left parties) has already enabled him to execute a large amendment to the budget (some BRL 145 bn, or 1.7% of GDP) to finance social spending in 2023. Lula also extended for two months the reduction in oil taxes, a measure at the origin of the rapid disinflation over H2-2022 (the IPCA reached 5.78% in December compared to 11.9% in June). Market participants are worried that prolonged fiscal easing and the roll-out of subsidized loans by public banks will keep inflation and interest rates at high levels (the SELIC has been at 13.75% since August). The minutes from the Central Bank in December also point to these concerns. The risk is that the economy finds itself caught between an expansionary fiscal policy and a restrictive monetary policy, fuelling a vicious cycle between inflation and interest rates at the expense of growth and debt dynamics. Despite these concerns, Brazil remains attractive from the perspective of international investors, especially when compared to other major emerging markets (e.g. Türkiye, China, Russia, Argentina and South Africa). In addition to its positive real yields, and the absence of foreign exchange controls, its now more positive stance on the environment, multilateralism, and the defence of democratic institutions have become new factors of appeal. Its low current account deficit, large foreign exchange reserves, the independence of its Central Bank and the absence of systemic fragilities across the banking and real estate sectors are also important assets.

BRAZIL: RATE OF CHANGE OF CAPITAL STOCK ACCUMULATION

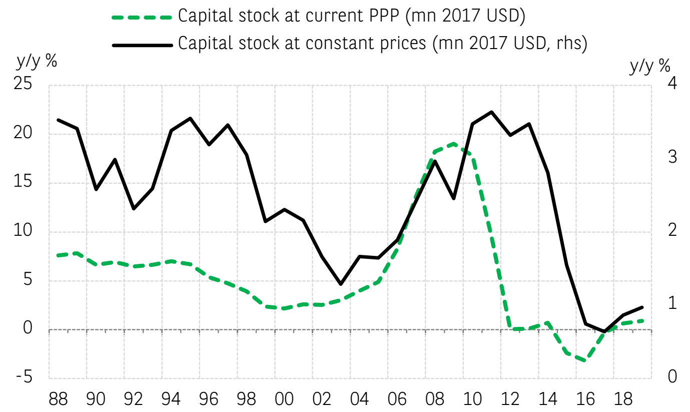

CHART 2 SOURCE: PENN WORLD TABLES, BNP PARIBAS

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1 The country has put in place a "spending cap" (2016) to prevent primary spending from growing faster than inflation. The "Golden Rule" (1988) prohibits the state from contracting debt to cover current expenses. The "Fiscal Responsibility Act" (1999), which applies at all levels of government, prohibits new expenditures from becoming permanent if financed by revenues, which are temporary in nature. The "Electoral Budget Law" prohibits new expenditures or tax exemptions in an electoral year. While these rules have been largely circumvented in recent years due to the pandemic and the war in the Ukraine, they will (even if amended) represent an additional constraint on public action. A prolonged disregard for the fiscal framework would meanwhile generate significant market reaction.