Viewpoints

Brazil – The Moment of Truth

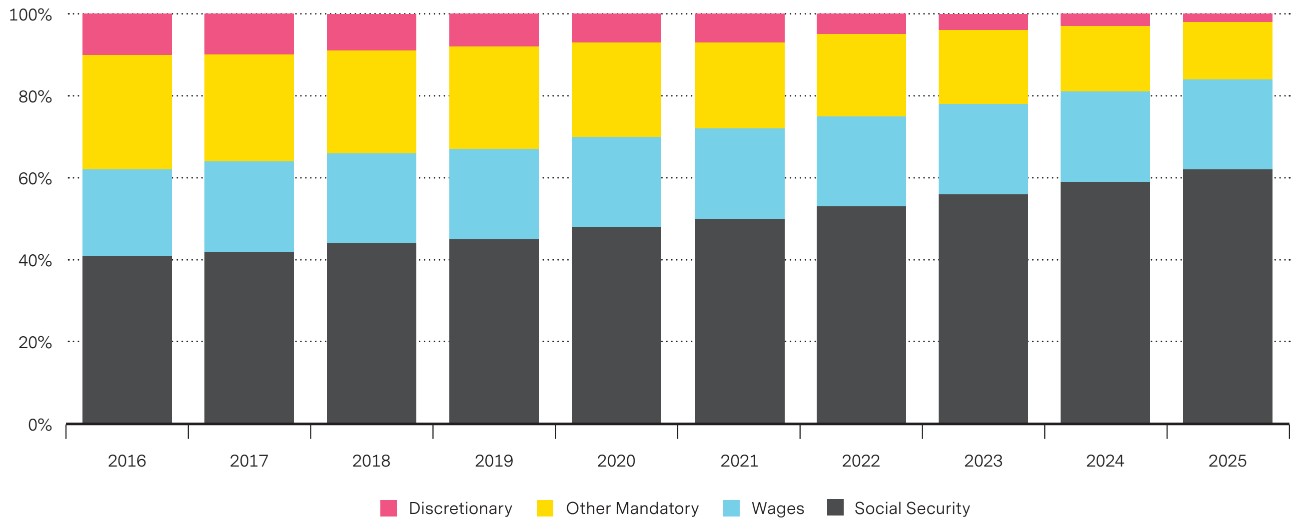
Brazil's equity market and currency have been weak this year as investors worry about the upcoming presidential election, the lack of social security reform, and emerging markets in general. We believe the current bout of hand wringing once again underestimates the stability of Brazil's institutions. Brazil is a vibrant democracy backed by an independent judicial system that was created to correct the difficulties the country inherited from poor stewardship during the previous administration. In this paper, we outline the challenges the new government will face and why we believe it has little choice but to follow economic reform, which is what its people want and need.

This October, Brazil will arguably hold its most important presidential election in the last 30 years. At stake is the economic stability Brazil has battled to achieve since the introduction of the Plano Real in 1994. It is hard to believe that just four years ago the government ran a surplus, public debt was declining, and Brazil's sovereign credit rating was investment grade. Today, under the mocking shadow of Operation Car Wash, the country's biggest corruption investigation ever, Brazil's public finances are a mess. Gross mismanagement by the past administration is partly to blame. But more damaging going forward is an overly generous social security system, whose mounting obligations are eroding the country's balance sheet. If the system is not reformed, public debt as a percent of GDP will rise near the point of no return — printing money, which will lead to stagflation.

There is little room for Brazil to balance its budget without reform. The government cannot realistically raise taxes. Any increase will choke economic growth and potentially spark social unrest. Public taxes as a percent of GDP have increased from 24% in 1998 to 34% today, the highest of any Latin American country. Eduardo Gianetti, an economist and author of several books, summarizes well the situation: "40% of the GDP flows through the public sector today. And yet half of the households do not have access to basic sewage infrastructure. How is this possible? Bolsa Familia (income transfer program) accounts for just 0.5% of GDP. It is a crumb that falls from the table. But it has a giant impact in the life of millions of families. There is something deeply wrong with public finances in Brazil."

On the expense side, there are no easy answers, either. Discretionary expenditures represent just 9% of the federal budget. And another 25% goes to hard-to-cut services, like health, education, and the very popular Bolsa Familia program.

Chart 1: Federal Government Expenditures – Social Security Will Explode Without Reform



Source: Treasury, Bradesco

Social Security Reform: Difficult But Not Impossible
That leaves social security, which saps almost half of Brazil's budget. It is one of the most generous systems in the world. Workers retire at an average age of 55. Government workers, a fraction of beneficiaries, receive the highest monthly payouts, retiring at nearly full pay that can be 50 times higher than those of retired rural workers. They receive a third of social security expenditures, yet only represent one tenth of the retirees. Indeed, expenditures are rising three times faster than the population is aging, according to Brazilian economist and pension analyst Paulo Tafner. In addition to the visible fiscal imbalance, he notes, the system has the hidden negative effects of lowering savings rates and productivity, where Brazil ranks second to last in South America, one notch above Venezuela. "Thank God there are Chavez and Maduro," Tafner quips.

Generosity is one side of the equation that makes Brazil's social security system unsustainable. The other is that Brazil's population is relatively young and aging quickly as population growth slows. Only 10% of Brazil's population is over 60. But the country now spends nearly 12% of GDP on social security. A look at Japan illustrates where that percentage is heading as Brazil's population ages. Japan spends the same percentage of GDP on social security as Brazil does now, but its population over 60 is three times larger (see Chart 2). The IMF predicts that Brazil's retirement expenditures as a percent of GDP will rise by 14% around 2021 and continue to climb exponentially if changes are not implemented. *The Economist* calls the brewing crisis "an economic cluster bomb."

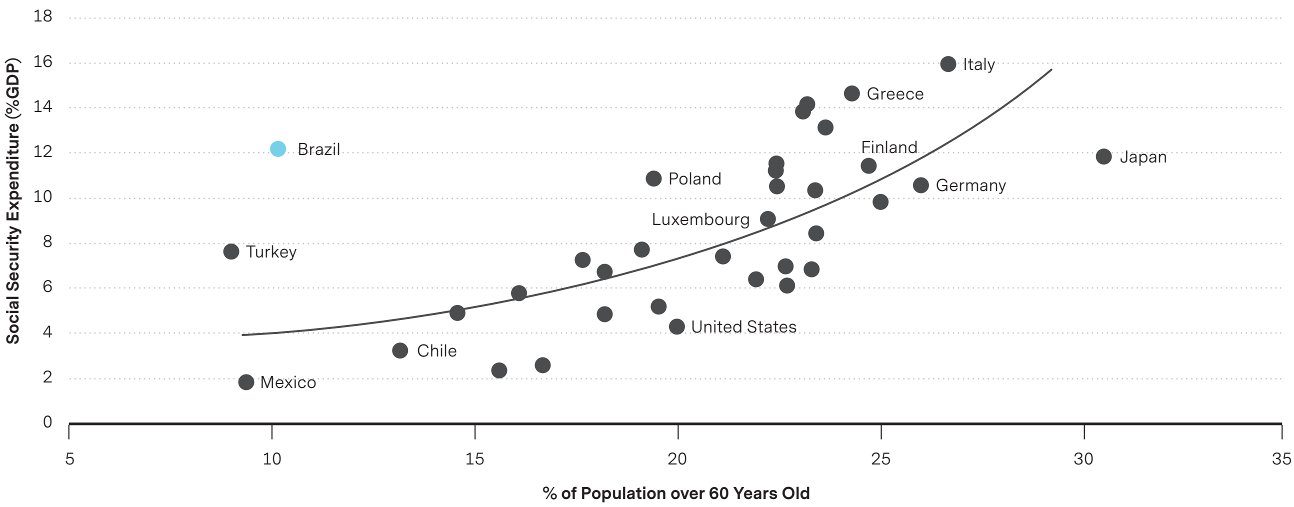
Social security reform is not easy. It faces strong opposition from the government employees who benefit most from the system. It requires a constitutional amendment, which takes three-fifths of congressional support in both houses. It isn't impossible, though. The administration of President Michel Temer came close in May 2017, with proposals that included increasing retirement ages to 65 for men and 62 for women. But the vote fell apart after audio tapes leaked of Temer discussing bribes with a businessman.

Fortunately, many Brazilians understand the urgency of reform. A recent poll by FenaPrevi, a Brazilian private pension association, found that 43% of the population understands the need for social security reform and 49% believe the issue needs to be addressed by the next president. But Edson Franco, the association's president, says support is still a major marketing challenge because nearly as many Brazilians oppose reform as those who favor it. This raises a larger question – who will lead new reforms?

As President Temer was drawn into the Car Wash investigation, he lost the political capital to push even weaker versions of reform. The recent truck driver's strike, which paralyzed the country for two weeks over higher petrol prices, underscores his government's lack of credibility. Brazil is in a state of limbo until the end of this year. Any chance of reform will hinge on October's presidential election.

It's no wonder investors are nervous. There is little clarity at this point on the race. After three years of deep recession – and almost daily revelations of corruption by public officials from the Car Wash scandal – voters are angry and anti-establishment. This has opened the field to non-traditional candidates. At the present, Jair Bolsonaro seems to be the only candidate with a shot at a runoff. Bolsonaro is a polarizing figure with a platform based on national security. His views on economic reform are not yet clear. Geraldo Alckmin, the current governor of Sao Paulo, is the most pro-market candidate, but he carries the liability of being an establishment politician.

Chart 2: Social Security and Demography



Source: UN, Bradesco, OECD. Data as of 2015 or latest available.

Three Powerful Drivers of Social Security Reform
We can't claim any special insight on who will win the election. But we do see three important catalysts that can steer the next president towards social security reform:

1. **Political.** The fragmentation of political parties requires a president to form a wide coalition to govern. As the two recent administrations (Dilma Rouseff's and Temer's) underscore, presidents need popular support to build such coalitions. The recent democratic history in Brazil shows that presidents are popular as long as they improve the economy. There were four presidents elected since 1990, the first direct election for president after the end of the dictatorship regime. Two of the presidents were from the right and two were from the left. Two from each side were re-elected (Fernando Henrique Cardoso and Lula da Silva) and two were impeached (Fernando Collor de Mello and Dilma Rousseff). The two presidents who were re-elected delivered low inflation and economic prosperity, respectively. The two who were impeached left the economy in recession. Today, the prescription for a prosperous economy starts with balancing the budget. And to balance the budget, some level of social security reform is necessary.

2. **Legal.** The next president will have to work around three fiscal laws (fiscal responsibility, golden rule and budget ceiling), each with a different angle on expense management but ultimately with the same goal – to force the government to be fiscally responsible. Like it or not, the next president will need to walk a fine line between his/her policy preferences and the restrictions of these laws. Again, some form of social security reform will be required for the next president to stay compliant with the law and to avoid the risk of being impeached.

3. **Market.** It is true that the next president may try to change the constitution in order to expand the budget beyond the ceiling. But the market will not wait. If he/she tries to move in that direction, Brazil's currency will depreciate and interest rates will increase, which would result in higher inflation and unemployment rates – negatively impacting the real economy. If politicians are not sensitive to economic arguments, they are sensitive to the voices of the street. This also makes it unlikely that the next president can ignore reform.

The Road to Recovery
Although the outlook for Brazil continues to be positive, it is easily forgotten when the country goes through its ups and downs. Brazil does not face the challenges of Argentina or Turkey, which both rely on foreign capital to finance their public debt. Brazil is actually a net creditor in dollars, adjusting for foreign reserves of US$380 billion. Brazil is also running a small current deficit of 0.4% of GDP. (For more information on Brazil's fiscal deficit, access our Viewpoints paper: Turning the Corner – Emerging Market Currencies Take a Knock.)

The country has considerable capacity and will not require significant capital expenditure to lift its economic performance. Reform would give the economy the shot of confidence it needs to step the nascent, but fragile recovery into a higher gear. After a steep GDP contraction of 7% and unemployment spiking to 13%, the economy is operating with excess capacity. Manufacturing, for example, is at 74% of capacity utilization compared to 84% in 2010. Consequently, higher investment is not a significant hurdle to attain faster growth.

We expect the Brazilian market to continue to be volatile until the end of the year – when investors will have more clarity on the next president and his/her fiscal approach. We have sought high quality companies there that we expect to outperform regardless of how Brazil's story unfolds. In fact, we maintain an overweight to Brazil in our emerging markets portfolios because we find the country offers a rich pond to fish in. We look for powerful companies that are able to defend their businesses and grow, even in a weak economic environment. Some examples are:

- *Ambev*, the largest brewery in the country, has well-established brands, a difficult-to-duplicate distribution network and pricing power.

- *Ultrapar*, one of the largest fuel distribution companies, still has room to grow through consolidation.

- *Cielo*, the largest payment system operator, likely to continue to benefit in the shift from cash to electronic transactions.

- *Lojas Renner*, the largest domestic fast fashion company, has tremendous room to take share from rival department stores and smaller boutiques.

The dominant message from the recent crisis in Brazil is that its political and legal institutions are active and strong. This gives us confidence that the next president will steer the right course.

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