Brazil: Strike weakens, but fiscal worries deepen

Brazil's chief challenge is its unsustainable fiscal trajectory, which can only be addressed with the election of a new administration committed to fiscal austerity, and with considerable political capital to approve much-needed but unpopular initiatives

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The truckers' strike appears to be winding down amid mounting economic losses and growing questions about its legitimacy. The deterioration in economic activity and inflation should be short-lived, while domestic financial assets should stabilise with the support of market intervention by the Treasury and the Central Bank. But the fiscal impact should be lasting, complicating Brazil's already challenging fiscal and political outlook.

Strike reveals the weakness of the political establishment

The truckers' strike that has paralyzed Brazil for more than one week now is not over yet, but it is winding down, with the more energetic police presence helping decrease the number of roadblocks. Domestic trade normalization may take a while to normalize however, amid mounting losses across many sectors in the economy, notably perishables and livestock.

Higher prices and weaker economic activity indicators should be the most noticeable near-term impact of the strike. Any inflationary spike should be short-lived but the weakness in economic activity could linger, as the full impact of the extensive monetary easing seen in recent quarters should be partially compromised by the rise in risk premium levels and the greater caution on the part of borrowers and lenders.

The greater volatility in local markets also stood out, with the Brazilian Real and local debt trading under considerable pressure. But continued central bank intervention in the FX market, with US$750m in FX swaps (net) being offered daily, and Treasury debt buybacks have helped stabilize local markets.

The most lasting impact of the strike is, however, fiscal and political in nature.

On the fiscal side, the government agreed to provide fiscal support to truckers in the form of tax cuts and subsidies on diesel prices, among other benefits for the sector. The fiscal cost is estimated at more than BRL13bn until year-end, or almost 0.5% of GDP annually, if the program remains in place permanently. That cost is expected to be partially covered by an effective increase in payroll taxes, affecting some sectors in the economy that currently benefit from a lower tax rate.

In political terms, the surprising resilience of the strike, which was clearly underestimated in Brasília, also vividly illustrated the political weakness of the administration, with barely veiled calls among the strikers and in social media for the president to step down and for the military to take over. Fears of an institutional crisis, along with the heavy economic losses, have helped intensify calls for the end of the strike, amid growing questions about its legitimacy, following the considerable concessions already granted by the government. But it is undeniable that the Temer administration, and Congress, should emerge from this crisis further diminished.

The strike, the October elections and beyond

The combination of a politically weak government, a discredited political class, still-high unemployment and widespread social dissatisfaction should continue to pose considerable challenges for Brazil's macro outlook.

In fact, we believe the strike has been highly instructive for the two key dynamics that will define Brazil's medium-term outlook: the October presidential election, and the fiscal policy adopted by the new administration in 2019.

Regarding the elections, what stood out from the strike was the deeply felt popular disapproval of the political class and the strong anti-establishment sentiment, which confirms what opinion electoral polls already suggest: Presidential candidates not seen as part of the establishment should have a considerable advantage over candidates seen as part of the establishment, not unlike electoral dynamics seen in Colombia and, especially, in Mexico.

Regarding fiscal policy, the truckers' demands and the resulting action by Congress and the Temer administration plainly illustrated the conflicts of fiscal redistribution that will mark 2019.

> *The new administration will take over facing considerable fiscal challenges.*

Difficult decisions regarding the compensation of public sector employees, retirees, and benefits accruing to other special interest groups, suggest a high number of conflicts, that only a highly committed and politically able new administration would be able to navigate without giving up on a commitment to re-anchor fiscal accounts.

In addition, the episode also revealed that despite the impressive improvement seen over the past couple of years, and the introduction of important shields protecting the governance structure of state-owned enterprises and Petrobras (including the *Lei das Estatais* and the *TCU* court), these companies remain vulnerable to political interference, further raising the stakes for the upcoming presidential election.

Overall, the current fiscal framework is unlikely to survive intact, which could cause much market volatility next year. The so-called "gold rule", which limits the ability of the Treasury to issue debt and creates the possibility of a public sector shutdown, is likely to be effectively abandoned by Congress, due to the extreme difficulties of meeting it next year.

The spending ceiling, which is the most important aspect of the fiscal framework, can survive 2019, but with considerable difficulty. The current assessment is that Congress would need to cut mandatory spending by about BRL40bn, in order to keep discretionary spending at current levels (at about BRL120bn annually), which is seen as the minimum necessary to keep most government activities functioning adequately.

Intense market focus on how congress changes the fiscal framework suggests that market volatility could stay high throughout 1H19. In order to ensure the sustainability of the spending ceiling, the new administration will take power having to ably navigate opposing interests by several powerful special interest groups. The need to implement a change in the way the minimum wage is calculated, limiting annual adjustments to inflation, by mid-April 2019, and the urgency to approve a robust social security reform could be particularly controversial.

BRL sell-off is unlikely to trigger rate hikes, for now

Despite the strike-induced rise in inflation and the weaker BRL, Brazil's inflation outlook remains broadly benign, trending near the target until 2019. Central bank officials have, as a result, signalled a preference for keeping the SELIC policy rate stable at 6.5% in the foreseeable future, while also signalling a resistance to raising the policy rate in an effort to stabilize FX dynamics. The bank is likely to continue to consider direct FX market intervention as the optimal tool to address excessive FX market instability.

The central bank continues to have considerable ammunition to intervene through direct spot USD sales, the auction of FX credit lines and/or FX swaps. But we still believe that the relatively cheap cost of hedging (due to the relatively low interest rate differential vs the USD) along with exacerbated political risks has made the BRL vulnerable. As a result, despite the existence of considerable ammunition to intervene (eg, at least about USD 80bn in FX swaps), we suspect the current monetary policy guidance underestimates the eventual need to tighten the SELIC rate a bit sooner than expected, in large part to support of the BRL.

> *Even though we had recently adjusted our BRL forecast path to incorporate a weaker path for the currency ahead of the October elections, reaching an average of 3.70 during 3Q, that trajectory now seems conservative.*

We continue to expect the BRL sell-off to be orderly, thanks in large part to more aggressive FX intervention by the central bank and robust external trade inflows, but should current electoral trends consolidate over the next couple of months, demand for hedge should intensify while asset prices should gradually incorporate a high likelihood of stress scenarios, with the BRL weakening towards all-time highs, near 4.0.

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