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Three Key Questions for the Presidential Elections: Some Initial Answers Expected Soon

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Political Agenda: Decision Time for Outsiders

We believe there are three key questions to be answered before the presidential race officially begins on August 16:

1. **Will the Workers' Party (PT) have its own candidate?** Considering that former president Lula is likely to become unelectable, in our view, after his conviction on corruption charges was upheld by a court of appeals last Monday, the party will have to make an important decision when it is time to replace him (the deadline for the Electoral Court to decide on his candidacy and for parties to change candidates is September 17). Will it follow its traditions (PT has had its own candidate in all the presidential elections since re-democratization, in 1989) or will it decide to support another leftist candidate?
2. **Will the center-right/right remain divided?** Currently, the three largest parties on this side of the political spectrum (MDB, DEM, and PSDB) have their own pre-candidates. Will they continue to endorse individual candidates, contributing to increased fragmentation in the elections, or will they join forces in a coalition?
3. **Will there be any outsiders in the race?** We believe the initial answers to this question could come next week, as April 7 is the deadline for ordinary citizens to join an existing political party if they want to run for office in October (Brazilian law forbids independent candidacies). Thus, by next Saturday we should know if any of the names that the press has been circulating will declare their candidacies in the presidential race, which could significantly change the election campaign, in our opinion. Outsiders have been polling well in popularity rating surveys, and, according to a Datafolha poll (October 1, 2017), 87% of Brazilians believe that it is "very important" that the president they ultimately elect has never been involved in corruption scandals.

April 7 is also the deadline for lawmakers to freely change parties ahead of the October elections. After that date, we will have a better idea of the relative strength of the parties in Congress and how much money they can draw from the public fund that will finance the lion's share of campaign spending this year.

Finally, this week Finance Minister Henrique Meirelles and BNDES CEO Paulo Rabello de Castro announced that they will step down in order to compete in the elections. According to *Valor Econômico* (March 28, 2018), Meirelles is expected to be replaced by Eduardo Guardia, currently his deputy. Dyogo de Oliveira, currently the Minister of Planning, would replace Rabello de Castro at BNDES, with Mansueto Almeida filling his spot. These changes, if confirmed, should not bring any concerns to markets, in our view, as all names are consistent with maintenance of the current economic policy orientation.

We believe other cabinet changes are likely to be announced in the next few days, as ministers are required to resign by next Friday (April 6) to become candidates. We expect to cabinet to keep its current "parliamentarian" profile, with ministers being replaced with members of their own parties.

Upcoming Data: February Industrial Production

Following the Easter holidays, the release agenda next week is very light. We highlight only February industrial production figures: we expect monthly growth at 0.6%, which would imply 3.8% y/y. After the volatile figures released for December and January, February numbers should be closer to the expected trend for manufacturing, in our view.

What's New: A Busy Week at the Central Bank

Brazil Central Bank (BCB) elaborated about its inflation forecasts and monetary policy stance in two documents released this week. The Copom minutes, released on Monday, made clearer what we already expected from reading the statement that followed the March 21 rate decision: **the committee's flight plan is to deliver another rate cut in May (of 25 bps, in our view), as recent downward revisions in inflation expectations added to a risk of "postponing inflation convergence toward its targets"; and it expects to pause in June, as "it needs some time to evaluate how the economy evolves and its reaction to monetary stimulus already implemented"**. The Quarterly Inflation Report showed how BCB expects short-term inflation to evolve: according to its forecasts, CPI inflation from March to June will add to 0.91% (our estimate: 0.96**%). Since our short-term and 2019 estimates do not diverge significantly from BCB's, we reiterate our view that the Selic rate will end the current easing cycle at 6.25%, staying at this level until 2H19.**

BCB, as part of the National Monetary Council, also announced changes in reserve requirement rates (see comment in the "Chart of the Week" below).

On the economic activity front, the unemployment rate (seasonally adjusted) stayed flat in February at 12.4%, slightly above our forecast (12.3%). We maintain our view that the job market recovery will remain slow, keeping the unemployment rate below its "natural" level (around 9.5%, by our estimates) until early 2020 and leaving room for stimulative monetary policy.

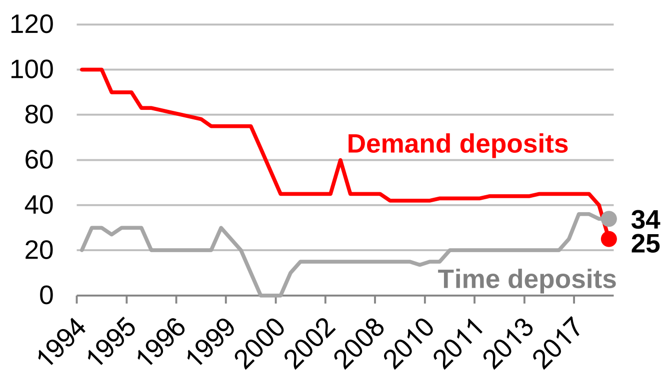
February primary fiscal balance was in-line with consensus, at BRL 17.4 billion, confirming, in our view, that the government should not have difficulty in meeting this year's primary deficit target (BRL 159 billion). We expect a 2018 full year primary deficit of BRL 140 billion (2% of GDP).

Chart of the Week: Reserve Requirements

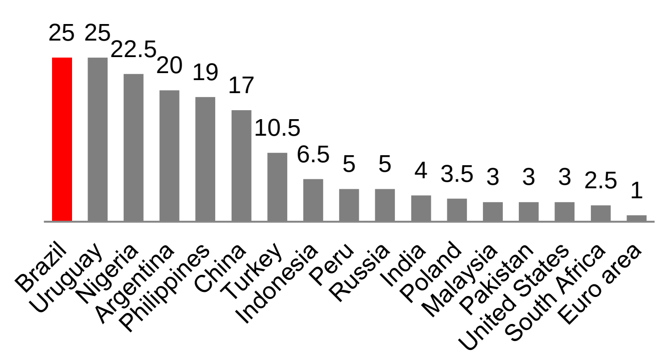
Brazil's National Monetary Council announced on Thursday a cut in reserve requirement rates for demand deposits (to 25%, from 40%) and saving accounts (to 20% for both rural and other savings, from 21% and 24.5%, respectively). Reserve requirement rates for demand deposits in Brazil are now at the lowest level since inflation stabilized in 1994, and ceased to be an absolute outlier compared with other countries (although such rates are still among the highest in the world).

However, we believe the measure should have smaller effects on credit and economic activity than meets the eye. First, we think the impact of the reduction in demand deposits should be mitigated by new measurements on what can be included in the requirement calculations. Second, we believe most of the liquidity injection (BRL 25.7 billion, according to Brazil Central Bank – about 0.8% of the current total credit outstanding) is likely to be directed to Caixa, the state-owned savings bank, which has been restricting lending because of capital constraints. **Net/net, we foresee a negligible impact on economic activity and monetary policy this year.**

Brazil – reserve requirement rates (%)



Reserve requirement rates for demand deposits (%)



Sources: Brazil Central Bank, Central Bank News, and Santander.

In-Depth Research: Explaining BRL Weakness and Improving NPLs

In *Falling Interest Rates Leading to BRL Weakness* (March 28, 2018), we analyze the recent BRL underperformance versus the USD and other high-yield currencies. We conclude that the ongoing monetary easing has been the main driver for the Brazilian currency, reducing the attractiveness of the carry trade and cheapening hedging costs for companies. We reaffirm our BRL/USD year-end forecast at 3.50.

In NPLs Improving More Than Meets the Eye (March 26, 2018), we argue that financial conditions, especially for companies, have been improving at a fast pace, which should contribute to the credit recovery expected for this year. We believe privately owned banks' market share could increase to 50% by year-end, from 45.9% at the end of 2017.

Number of the Week

32.4%

32.4% of GDP is the official National Treasury estimate for Brazil's overall tax burden in 2017, flat from 2016. This indicator peaked at 33.7% of GDP in 2007.

Quote of the Week

It would be cowardice not to be a candidate.

— **President Michel Temer**, making his reelection plans explicit, despite record low popularity ratings. Quoted from *Isto É* (March 23, 2018).

What We've Been Reading

- "Judges in Brazil Get Plush Perks. Is the Jig Up?", by Vinod Sreeharsha (*Americas Quarterly*). Brazil's judiciary consumes 1.2% of GDP, compared to 0.13% in Argentina and 0.14% in the United States.
- "On Labor Mobility, Economic Growth, and Targeted Programs", by Lant Pritchett (*Center for Global Development*). The NPV per person lost in Brazil's "lost decade" (from 1980) amounts to $61,353, according to Pritchett's estimates.
- "Ronaldinho Explains How Close He Came to Choosing Man United Over Barcelona" (*Sports Illustrated*). An interesting counterfactual to think about.

Recent Publications (Available on Our Website)

- *Falling Interest Rates Leading to BRL Weakness* (March 28, 2018)
- *NPLs Improving More Than Meets the Eye* (March 26, 2018)
- *TJLP: Less Discretion, More Volatility?* (March 19, 2018)
- *Food (Inflation) for Thought (2): Forecasts* (March 9, 2018)
- *Food (Inflation) for Thought: Relative Prices* (March 7, 2018)

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