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Brazil Narrowly Elected Lula: What's Next?

By: Emerging Markets Debt | November 16, 2022

Boston - Elections in Brazil are over, with Luiz Inacio Lula da Silva, known as "Lula," emerging the victor by a narrow margin — in line with poll predictions and the EMD team's expectations. After a few days of uncertainty, the succession process appears to be on track, with Bolsonaro giving a short speech where he did not technically concede, but said he would respect the transition of power.

With the elections now over, markets and politicians are focused on potential Cabinet appointments and policy announcements. So far, Lula hasn't given many details on either, but we offer the following observations:

A right-leaning Congress will serve as a check on Lula's agenda.

In the first-round elections, which took place October 2, Bolsonaro gained a strong foothold in the lower chamber of Congress. The Senate (81 seats) saw the same rightward shift. Currently, Lula's coalition controls about 123 seats in the lower chamber and 27 in the upper chamber, well short of the number required to pass legislation (257 votes in Congress and 41 in the Senate). Lula may be able to piece together a Petro-like coalition to get simple majorities, but that will require both political tact and resources. To the latter point, Lula's government could dole out Cabinet positions to potential allies, or pursue the same strategy as Bolsonaro did, using a "secret budget" to entice ideologically fluid centrist parties (centrão) to support his administration. The legality of the "secret budget" is currently under review by the Supreme Court.

Fiscal announcements are likely to be made relatively quickly, even prior to Lula's actual inauguration (scheduled for January 1, 2023).

Lula's priority will be to extend the social welfare program Auxilio Brasil (BRL600/month) into next year, at an extra fiscal cost of BRL50bn, as well as to increase the minimum wage and provide tax benefits. The total cost of such policies could exceed BRL200bn — more than 2% of Brazil's GDP and double initial projections. The markets are likely to respond negatively to these announcements if they are not accompanied by potential funding sources. Furthermore, implementation of these measures will require delicate political maneuvering to circumvent a constitutionally mandated spending cap, which limits public expenditure growth to the past year's inflation. Beyond fiscal policy, Lula's administration will focus heavily on environmental issues, primarily on reversing the deforestation of the Amazon, which was supported by Bolsonaro.

Markets will react positively to an orthodox pick for Minister of Finance.

Lula has sent mixed messages to markets, vowing to increase the role of the state in the economy and expand social welfare, while simultaneously maintaining a free market economy and fiscal prudence. Therefore, his choice of Finance Minister will be a critical indication of which sentiment will dominate, and a signal to ensure market support for his administration's plans.

One market-friendly option could be Henrique Meirelles, who has a good mix of political as well as technocratic experience. He was previously head of the central bank during Lula's first and second terms, and is seen as pretty orthodox. He also hails from the more centrist, right-leaning side of the bench, which could be a plus for Lula. One drawback is that Lula has previously pledged to do away with the fiscal spending cap, a rule that Meirelles helped to author. Other technocratic alternatives, though more of a long shot, could come from VP-elect Alckmin's economic team of advisors.

Other potential names in the hat include Fernando Haddad and Alexandre Padilha — both of whom are PT (Workers' Party) members. These two have more political than economic experience, which could benefit Lula, because he will definitely need someone who knows how to work with Congress to garner support for the government's reform proposals. In recent days, Padilha has taken to Twitter with very ministerial-sounding tweets.

President-elect Lula faces a different set of domestic and geopolitical conditions than he did when he became president for the first time 20 years ago.

He will likely be constrained by these starting circumstances, which we believe is a positive, and, if prudent, will pick an orthodox Finance Minister and conduct his government in a pragmatic fashion. Otherwise, Lula risks facing deteriorating market sentiment and a floundering government agenda before he gets out of the gate. We saw a hint of this in the recent, sharp sell-off in Brazilian assets, which reacted to Lula's statements signaling fiscal irresponsibility, as well as a few market-unfriendly appointments to his transition team.

Bottom line: The EMD team will continue to monitor ongoing developments for clues about just what kind of Lula administration we will see this time around. Despite ongoing uncertainties, we think Lula's government will eventually strike a balance between his pre-election promises and fiscal rectitude, given challenging initial conditions, his party's weak representation in a right-leaning Congress and a vigilant

market that will punish deviations toward a more radical agenda.

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