How Brazil’s Economic and Political Realities Will Shape the Plans of the Bolsonaro Administration

On Tuesday, November 13th, the Brazil Institute hosted a half-day conference on what Brazil’s undeniable economic and political realities mean for President-elect Jair Bolsonaro, his administration, and the country.

In the first session, the International Monetary Fund discussed its finding from the latest Article IV consultation with Brazil and the prospects for economic and fiscal reform. The second session took a broader look at the current challenges facing the Brazilian economy, including an analysis of its structural characteristics and key sectors, with editors and contributors of the Oxford Handbook of the Brazilian Economy (2018). In the third and final session, panelists discussed the capacity of the new administration to navigate Brazil’s changing political landscape.

Session I: IMF Outlook for Brazil and the Political Economy of Reform
Antonio Spilimbergo, Assistant Director and Mission Chief for Brazil, IMF
Damiano Sandri, Senior Economist, IMF
Iza Karpowicz, Senior Economist, IMF

Session II: Key Sectors of the Brazilian Economy, with the editors of the Oxford Handbook of the Brazilian Economy
Edmund Amman, Professor of Brazilian Studies, Leiden University
Carlos Azzoni, Professor of Economics, University of São Paulo (USP)
Geraldo Martha, Researcher, Brazilian Agricultural Research Corporation (Embrapa)

Session III: Navigating Brazil’s Changing Political Landscape
Paulo Sotero, Director, Brazil Institute
David Fleischer, Professor Emeritus, University of Brasilia
Christopher Garman, Managing Director for the Americas, Eurasia Group
Antonio Spilimbergo, International Monetary Fund (IMF) Assistant Director and Mission Chief for Brazil, gave an overview of Brazil’s recent economic history and trajectory, detailing key problems impeding growth. Spilimbergo identified three main economic challenges facing Brazil at the moment: historically disappointing growth, weak recovery from the deepest recession in the country’s history, and adverse debt dynamics with strong institutional constraints. Since 1986, the Brazilian economy has grown at an average rate of 2.6 percent annually. However, growth fell significantly over the past five years and is currently projected to continue at a lower rate (GDP growth in 2018 is expected to have been just 1.2 percent). Compared to its neighbors and other emerging markets, Brazil—the largest economy in Latin America—has produced some of the lowest rates of economic growth. This is due largely to productivity stagnation and low levels of investment relative to GDP.

Additionally, recovery from the 2014-2017 economic recession has been much slower than typically expected. The traditional assumption in economics is that a “big drop” in GDP during a recession will be followed by a “big bounce back” once the economy moves into an expansionary phase. Brazil, however, has seen a particularly sluggish return to growth. Causes include a fall in consumer confidence and consumption (triggered by the recession) and a similar fall in private and public investment, as investor confidence plummeted during the long economic contraction. Low investment and negative growth during the recession significantly increased unemployment, which hit a record 13.6 percent in 2017 and still remains far above pre-recession levels. These challenges have proven difficult to overcome.

Spilimbergo next turned to an analysis of Brazil's “problematic” debt dynamics. He noted that the IMF projects Brazilian gross public debt will continue to rise, as the fiscal deficit rises. The IMF predicts that gross debt will reach 90 percent of GDP by the end of 2019, and could hit almost 100 percent by 2023—a point at which “usually emerging markets have some problems.” Spilimbergo argued that, despite frequent public debate on the issue in recent years, there has been little progress toward much-needed stronger fiscal consolidation.

Fiscal consolidation is expected to be a priority for the incoming Bolsonaro government. Based on IMF estimates for the next five years, Brazil will need to rein in spending and increase revenue to a tune of about 3.4 percent of GDP, even after accounting for increased growth. Spilimbergo argued that reform of a single area of expenditure, such as the pension system, will not provide enough fiscal room to reach this point. Instead, multiple expenditure areas and potentially even revenue areas must be addressed with vigor. The good news, Spilimbergo argued, is that Brazil has stabilized inflation. Because most public debt is domestic, stable inflation means that public expenditure on interest can be gradually reduced. Spilimbergo closed by highlighting the high profit margins banks make on interest rates, which reduce economic efficiency and discourage investors from investing.

Damiano Sandri, Senior Economist at the IMF, discussed which reforms Brazil should prioritize to increase lasting growth and address its economic
woes. Though there is a “long list of potential reforms” for authorities to choose from, he argued that attempting multiple reforms simultaneously is unworkable: major structural reforms typically generate strong political opposition by interest groups that benefit from the status quo and the full focus of public administration may be needed to effectively shape and implement reforms. Thus, the administration will need to prioritize.

In general, economists and policymakers have tended to push for whichever reform is estimated to produce the greatest economic benefit. However, this approach ignores political constraints. Therefore, the ideal formula would balance high economic impact with low political resistance.

The first step is to assess areas of economic need and economic potential. This can be done by estimating the effects of reforms on total factor productivity through panel regressions and measuring the structural reform gaps between Brazil and advanced economies. Sandri indicated that, according to this type of analysis, reforming the banking sector (by minimizing state intervention) would increase general economic productivity and have the largest impact of the list of reforms.

The second step is to assess political resistance, which analysts can do using a combination of public opinion polls and past precedent. According to Latinobarómetro—a regional polling organization—support for free market and structural reforms is highest in times of high economic growth, a paradoxical statistic considering that these reforms are most urgently needed during a recession. For policymakers, this means that reforms should be done proactively during times of economic growth.

Sandri also noted that this type of economic-political analysis of reform efforts should incorporate legislative and fiscal considerations. For example, reforms that do not require congressional approval—that can be done through executive action alone—are much easier to enact. Moreover, implementing new reforms requires at least some financial resources—bureaucratic costs, subsidies to minimize economic pain during the transition period, etc.—which policymakers should weigh against the anticipated gains.

Banking reform notably requires neither congressional approval nor significant funding to implement, and would likely produce positive economic gains for Brazil. Sandri also argued that popular support in Brazil for greater “innovation and productivity” can be interpreted as support for banking reform, given that banks facilitate innovation through investment, and greater banking efficiency should therefore advance innovation and product markets. Given how well banking reform scores using the method described above, Sandri recommended it be the top economic priority for the Bolsonaro government.
Sandri contended that the privatization of the Brazilian financial sector is also likely to spur economic growth. Globally, there has been a positive correlation between economic growth and private sector participation in the financial sector. Moreover, countries with more public banks in the credit market, such as Brazil, tend to see lower economic growth and lower productivity.

Sandri also argued that any time the public sector intervenes in financial markets, it is offering lines of credit to non-preferential borrowers and thus forcing the market to operate at an inefficient equilibrium. The Brazilian state has a significant presence in the market, through its public banks and a broad range of state-administered credit programs. At the peak of the Brazilian economic crisis, up to half of all available credit was allocated through state-mandated programs. Sandri stressed that credit is allocated more productively when banks can choose independently which borrowers offer the best investment opportunities.

*Iza Karpowicz*, Senior Economist at the IMF, argued that policymakers must address long-term fiscal stability pressures at their roots and opt for truly effective reforms, not just superficial fixes. This applies not only to the federal government (which already instituted a spending cap in a noteworthy step towards fiscal efficiency), but also to state and municipal governments, which are experiencing their own fiscal problems.

Karpowicz identified an oft-ignored but urgently needed economic reform: the amount the government spends on public sector wages. She estimated that government payroll expenses—at 13 percent of GDP—are second only to the pension system as the highest public expenditure in Brazil. She noted that roughly a quarter of employee compensation is tied to the pension system, so fully addressing the public sector wage issue will also require pension reform.

Nonetheless, Brazil’s public sector wage expenditures are very high, relative to its peers. The 13 percent of GDP spent on public sector wages contrasts greatly with the meager 2 percent of GDP spent on public investment, including investment in infrastructure, sanitation, and other public goods. Public sector employees are also paid significantly higher wages than their private sector counterparts, even when controlling for differences in education attainment between the two groups. According to the IMF’s calculations, the Brazilian public sector holds a 30 percent average wage premium over the private sector, which rises to 50 percent at lower skill and education levels. Public sector workers are disproportionately represented among top earners in Brazil. Karpowicz noted that the Brazilian Congress’s decision to increase judicial salaries will set a new benchmark for the rest of the public sector, causing wage growth to “trickle-down” to the states and municipalities.

This impacts all levels of government. Some two-thirds of public sector payroll spending takes place at the sub-national level in states and municipalities, which is common in centralized economies. Educators and police, for example, are often paid at the municipal and state level. Northern and Northeastern states in Brazil, which have fewer economic resources to begin with, tend to spend a higher percentage of their budget on public employment. For example, São Paulo’s public sector wage expenditure is only 5 percent of the state’s GDP; in Roraima, which has a much smaller population and a less dynamic economy, the wage bill rises to 20 percent. Karpowicz acknowledged that little can be done to address these disparities between states.

Even within the federal government, however, there are significant differences across the more than 130 different career tracks and their corresponding pay grades. A clerk in the Ministry of Mines and Energy, for example, earns significantly more than a clerk in the Ministry of Foreign Relations. The rigidity of the civil service career paths, however, make it difficult for employees to switch tracks—to move from Foreign Relations to Mines and Energy, for instance—regardless of overlapping skillsets. Moreover, the structural nature of pay raises rewards seniority rather than performance, which, combined with constitutional restrictions on firing employees in Brazil, creates a perverse incentive for public sector employees to work at a sub-ideal level of productivity, while earning more with each passing year—creating an ever-increasing wage bill.

To find a solution, IMF economists ran a variety of simulations and determined that a decline in real wages plus a hiring freeze could achieve the needed 1 percent decrease in payroll expenditures in the short run. Some of the proposals Karpowicz presented to achieve this include: an agreement between the government and its employees to keep pay increases beneath inflation, a review of “allowances” (payments outside of the base wage), and the introduction of performance-based pay increases in the short run. In the long run, she recommended that the government simplify the numerous civil servant wage grids (merging them...
where there are wage structure overlaps), realign public sector wages with those in the private sector, reduce seniority-based pay raises in favor of performance-based increases, control the use of allowances, and reshape the workforce to reflect demographic developments.

Q&A Session

Q: Is there any hope for the financial sector if the high real interest rates charged to those not selected for BNDES loans are not lowered?

Sandri: The real interest rate is still problematically high, but the Central Bank has achieved significant decreases over the past few years. Net interest rates, or the margins banks earn on interest payments, are still very high and contribute to financial and economic inefficiency. The IMF has concluded that some of the state credit operations that force banks to provide subsidized credit to unprofitable portions of the market actually cause overall increases in real interest rates. It is also likely that real interest rates would decrease if the state reduces its market interventions, thereby reducing the resulting market distortions.

Spilimbergo: There are three components to inefficiency in the financial sector: distorting financial subsidies, high operational costs, and the highly concentrated market structure. The first component is, as the panelists discussed, a result of overly interventionist policy and a large number of public banks. The second revolves around problems in the legal system that add costs to banking operations, such as difficulties in seizing owed debts. The third is that certain banks exert very strong market pressures in their sector which warp incentives and credit flows. The three factors together create an inefficient system.

Q: Regarding the wage bill, which two reform possibilities should the government prioritize?

Karpowicz: In the short term, during an economic crisis for example, governments can freeze hiring and wages to find some saving. However, this is not an organized or sustainable way of dealing with the wage bill. After several years, market pressures will reemerge and break the freezes.

The most urgent problem for the government—and also the most complex one—is the rigid wage grid. The current system prevents lateral movement between the various ministries. When offices end up without employees performing certain needed functions due to retirement or funding cuts, for example, capable employees from other agencies cannot be reallocated to fill the openings. Additionally, restructuring the promotion system to reward performance rather than seniority could limit wage bill growth (especially during times of economic difficulty) and would also encourage higher levels of productivity.

Q: How do socio-economic concerns and Brazil’s drastic income inequality play into these reforms and, more broadly, into Brazil’s long-term development?

Karpowicz: The wage bill is closely connected to questions of inequality. The IMF noticed a decline in inequality levels between 2004 and 2014 and believe it is mostly due to increases in schooling and social programs such as Bolsa Família. The growth in public sector wages, however, seems to have counteracted the decreases in inequality created by the social programs. Concern with socio-economic inequality is therefore one of the reasons the IMF is pushing for reforming the wage bill, not only through public sector employment but also through wage levels.
Edmund Amman, Professor of Brazilian Studies at Leiden University, opened the second panel by explaining the need that he and other editors and contributors to the Oxford Handbook of the Brazilian Economy (2018) saw to create a volume covering multiple aspects of the Brazilian economy—historical, contemporary, international—to help experts and non-experts alike gain a broader view of one of the world’s most important economies. The book’s core objectives are to describe the Brazilian economy’s evolution over time and explain Brazil’s broader place in the global economy, as well as consider the ways in which Brazil’s role has changed and will continue to change in the coming years.

Amman noted that, despite periods of rapid progress and high growth, Brazil’s economic history has been marked by failure to sustain growth, repeated crises, regional inequalities, and external disequilibrium. Amman also commented on the historically prominent role of the state in the economy, especially problematic government-business relationships, which expanded between 2002 and 2016.

On a more positive note, Brazil has developed strong technological capabilities in certain sectors such as agriculture, aerospace, and information technology. Amman likened these areas of global excellence to islands surrounded by mediocrity, and stressed the need for Brazil to broaden its economic base and become more competitive overall.

Amman then presented a graph mapping the decline of poverty and interpersonal inequality rates in Brazil from 1992 to 2014. However, that trend has now reversed—with poverty and inequality once again on the rise. Amman argued this reversal will certainly present a challenge to the new administration.

Other challenges include the nature and scale of Brazilian trade. Amman noted that Brazil has increased its reliance on commodities in recent decades. Brazil had a fairly diversified export base in the 1960s, but now concentrates on mineral and agricultural exports. Moreover, Brazil is not an export-intensive country, in contrast to other middle-income and Latin American economies. Amman argued that the closed nature of the Brazilian economy hinders growth. He questioned whether the new administration, which has expressed a desire for greater economic openness, will be able to move the needle on these metrics.

Another unaddressed economic challenge is labor productivity. Amman cited poor education, low infrastructure quality, corruption, and fiscal restraints.
as key factors contributing to higher poverty rates and low levels of overall productivity.

Amman predicted that Brazil will likely maintain fiscal orthodoxy, but he also expects pension reform could create room for an expansion of growth-facilitating discretionary spending. He theorized that privatization could expand the scope for private infrastructure investment, which liberalized environmental regulations could also facilitate. However, Amman expressed little hope for improvements in Brazil’s educational or social programs, as the incoming government has not indicated it will prioritize these areas. Instead, the next four years will most likely be characterized by market reforms, perhaps similar to the Collor administration (although without the macroeconomic crisis of that period). Under the Bolsonaro administration, the role of the state in tackling structural challenges will likely diminish as business becomes more privatized. Amman argued this would be a desirable shift, but he also emphasized that the state will need to continue to play a role in critical fields such as education, science, and technology.

Geraldo Martha, a researcher at the Brazilian Agricultural Research Corporation (Embrapa), began his remarks by providing a brief overview of the evolution of the agricultural sector in Brazil. Until the late 1960s, Brazil relied on the food donations it received from USAID; yet today it is second only to the United States in agriculture exports. Martha attributed this rapid transformation to the revolutionary development of a modern agriculture sector based on science and technology—a transformation associated with the establishment of Embrapa in 1973.

Since its founding, Embrapa’s primary mission has been to search for science-based solutions to the dynamic issues facing Brazil’s agricultural sector. One of the ways it achieves this mission is through international cooperation, including sending researchers abroad to learn and collaborate.

Contrary to Brazil’s low productivity elsewhere, Martha stressed the agricultural sector’s strong productivity gains in recent decades. The total factor productivity of Brazilian agriculture in the 1960s was estimated at 0.17 percent; over the last fifteen years, however, it has risen to 3.15 percent—the fastest growing total factor of agricultural productivity in the world. This huge growth in productivity generated an extensive land-saving effect. Two-thirds of Brazil is still covered with native vegetation, 20 percent of which is preserved through privately owned farms. Furthermore, Martha argued that this agricultural boom reduced prices for consumers, helping to alleviate inflationary pressures and generating an “income effect” primarily benefitting the poor. However, if agricultural production does not keep pace with demand moving forward, prices will increase again—and technology is critical to this effort.

According to Martha, technology accounts for 68 percent of agricultural growth in Brazil, while labor accounts for 20 percent and land just 10 percent. However, technology is unevenly used among Brazilian farmers. In part, this is due to market imperfection, which alters relative prices for farmers and thus their return on investment in technology. Due to relatively low domestic incentives for Brazilian agriculture—the producer support estimate (PSE) in Brazil is approximately 1.6 percent, compared to the United States, European Union, and China at 13 percent, 27.2 percent, and 14.5 percent respectively—farmers in Brazil respond more strongly to market signals and will adopt technologies based on individual benefit-cost analysis. Low human capital has also severely restricted production capacity and the use of technology in agriculture, making investment in human capital essential going forward. Martha argued that future breakthroughs will only come from the greater dissemination and effective implementation of modern technologies by a significant number of farmers in Brazil.

Carlos Azzoni, Professor of Economics at the University of São Paulo, discussed the regional aspects of Brazil’s economy. He began by displaying a graph showing the economic center of gravity in Brazil over time, which mapped the
regional movement of economic growth in Brazil from 1939 to 2013. Despite the need, economic growth did not begin to shift towards the northeast region of Brazil—one of the poorest regions in the country—until the early 2000s.

Breaking down the graph by sector, Azzoni noted that in terms of gross value added, only the commerce and services sectors shifted towards the Northeast. The region receives the highest amount of government aid, in forms such as pensions and Bolsa Família’s conditional cash transfers, and is also in the lowest income percentile in Brazil. Prior to the most recent economic crisis, the Northeast was an area heavily influenced by low wages and government welfare programs.

Azzoni argued, however, that income alone does not tell the full story of regional inequality in Brazil. Although the average income in São Paulo is higher than in Campina Grande in Paraíba, the wage gap becomes far less significant once you adjust for the cost of living. More tellingly, inequality is evident in the geographical concentration of scientific investment and infrastructure, which together create economic opportunity and the conditions for economic growth. Science and scientific collaboration tends to flow between the larger cities of Brazil, primarily located in the southeast; these areas are also where infrastructure investment is concentrated.

Azzoni offered recommendations for ways to lessen socio-economic regional inequality, such as offering subsidies to firms, improving human capital through better education, and strengthening social welfare programs. Bolsa Família in particular has proven highly efficient in terms of decreasing regional income inequality, but the issue has lost attention in Brasilia. Azzoni predicted that Bolsonaro will favor comparative advantage, a sort of laissez-faire approach in which the market would be allowed to do as it likes, and argued that economic growth will shift back south to the metropolitan city centers in the coming years.

Q&A Session

Q: Why is it that this wonderful example of agricultural growth in Brazil cannot be transposed to the industrial sector?

Amman listed three lessons industry could learn from the agricultural sector. First, Brazilian agriculture has shown that if market incentives are used correctly, people will respond accordingly. Second, the right sort of publicly sponsored innovation, based on the needs of a sector, can work exceedingly well—one example of this working in industry is the case of Embraer. Third, Amman pointed out that Brazil has an enormous comparative advantage in the agricultural sector, underscoring the importance of circumstance and opportunity. For example, the agricultural sector has been positively impacted by increases in food demand from growing countries such as China, the amount of land that is available in Brazil, and a large amount of human capital that was already invested into the agricultural sector.

Martha attributed the success of Embrapa, in large part, to the support and commitment of the Brazilian government, which understood the long-term perspective necessary to develop research. Embrapa was given the space and time necessary to adapt many agricultural techniques from temperate climates, without pressure for immediate tropical agriculture deliverables. Martha also highlighted the way Embrapa looks for practical solutions to agricultural issues, as well as its close working relationship with local farmers. In addition, the success of the Brazilian agricultural sector has not been solely due to the work of Embrapa, but also that of many other governmental and non-governmental organizations.
Panel II: Navigating Brazil’s Changing Political Landscape

Paulo Sotero, Director of the Brazil Institute, provided context for the current landscape of Brazilian politics, and argued that the common narrative in U.S. and European press that the election of Jair Bolsonaro could plunge Brazil back under military rule was overblown. Brazilian democracy, while under stress, is not facing existential danger. Sotero contended instead that the press should question the new government’s commitment to liberal economic policies, and how it intended to make good on its campaign promises in that area. The Brazilian economy, Sotero stated—paraphrasing an earlier speaker—“looks like the EKG of a dead person.”

Economic renewal will require cooperation between the new administration and the Brazilian National Congress. Sotero noted that Bolsonaro knows Congress well, having served for twenty-eight years as a federal deputy, but also cautioned that this knowledge might not translate to the successful passage of economic reform.

Another arena where the possibility of renewal exists is in the realm of Brazil-U.S. relations. Both Bolsonaro and Donald Trump are populists, and many have remarked on their similar political styles. Sotero recognized that some observers are worried about a shared emphasis on results over process, and photo-ops over substance. But with some energy (especially on the part of Brazil) long-prepared but not yet realized possibilities, such as a Boeing–Embraer partnership, could come together.

David Fleischer, professor emeritus at the University of Brasilia, explained the unexpected emergence of Jair Bolsonaro as the frontrunner in the 2018 elections. He observed that there were two large public opinion waves: on one hand, the anti-PT/anti-Lula movement; and, on the other, a sense of alienation and disgust with corrupt political systems—the “I won’t vote to reelect anyone” ideology. Fleischer attributed the success of Jair Bolsonaro to his ability to incorporate both of these public opinion waves into his campaign, thus making him the ideal “anti-system” candidate.

Bolsonaro was aided in this effort by several unusual factors. First, the 2018 election lacked a strong centrist candidate. Until 2018, every presidential election since 1994 had been polarized between two of Brazil’s largest political parties: the leftist PT and the center-right PSDB. However, Fleischer argued that in the 2018 elections the PSDB—and, for that matter, the political center itself—disappeared, resulting in a stark left-right polarization: the PT vs. Bolsonaro.

Second, Lula’s imprisonment, combined with his subsequent insistence on staying in the race, became a major strategic problem for the PT, as it limited eventual PT candidate Fernando Haddad’s national campaign to fewer than 30 days in the first round.

Third, the knife attack on Bolsonaro at a campaign rally in September helped the candidate to gain support, and allowed him to avoid official televised debates. Instead, Bolsonaro effectively used social media to reach voters and define his candidacy—a key factor in his success.

Fleischer also noted that the election was highly “regionalized.” In total, Haddad won eleven states, nine of which were in the Northeast. Bolsonaro won in sixteen states, with his support concentrated in the South, Central-West, and Southwest.

The 2018 elections also caused considerable turnover in Brazil’s National Congress. Of the thirty-two senators running for reelection, only ten were successful, producing a turnover rate of 81.5 percent. Many prominent senators were defeated, several due to corruption accusations. The Chamber of Deputies had a 52 percent turnover rate, as well as a 15 percent increase in female representation. Moreover, traditionally strong parties, such as MDB, PSDB, PT, DEM and others, saw their share of seats decline. Less traditional parties, including Rede and Bolsonaro’s PSL saw their numbers increase.

Fleischer expressed some concern over the fact that Bolsonaro, the “anti-system” candidate, will now need to operate and govern within the system. In his first 100 days in office, Bolsonaro will need to organize his new government and address a number of urgent challenges.

In terms of foreign affairs, Bolsonaro has spoken negatively of China, which has been increasingly investing in electricity generation and land in Brazil.
In fact, Bolsonaro has already upset Chinese officials by visiting Taiwan during his campaign, but not China. Another possible international upset, Fleischer explained, could occur if Bolsonaro follows through with plans to transfer the Brazilian Embassy to Israel from Tel Aviv to Jerusalem, which could prompt a negative response from Arab nations.

On the more fundamental question of whether Bolsonaro poses a threat to Brazilian democracy, Fleischer referenced Bolsonaro’s defense of torture while a federal deputy, but noted Bolsonaro’s commitment to upholding the 1988 Constitution and promises to work with public prosecutors. Fleischer also highlighted connections between the international press and the Brazilian left, which he suggested has colored some of the reporting. He concluded that the president-elect did not likely pose a threat to Brazilian democracy, at least “not for the time being.”

Christopher Garman, Managing Director for the Americas at Eurasia Group, articulated a broadly positive outlook, despite the “large tail risk” of an “unorthodox candidate” transforming into an “unorthodox administration.” He echoed Sotero and Fleischer in stating he was not worried for the quality of Brazil’s democracy. Recent slides into soft authoritarianism, in Turkey and Russia for example, occurred under a certain set of conditions. These conditions usually included benign economic conditions combined with high public approval of the president, which in turn allowed the president to consolidate and centralize power, often through public referenda. These are, however, not the conditions at play in Brazil, which has highly decentralized institutions, an independent judiciary, and a legislature which recently impeached a president—not to mention a current “difficult public opinion climate.” Garman predicted a “short honeymoon period” for the incoming administration.

Garman admitted that Bolsonaro’s record on economic issues as a federal deputy is not encouraging. Bolsonaro voted against the privatization of state enterprises and did not support previous attempts at pension reform. However, Garman opposed the theory that Bolsonaro hired Paulo Guedes—a true believer in economic liberalism—merely to gain credibility, and would soon jettison him and revert to a more economically nationalist outlook. Garman noted that Bolsonaro had decided to shift to an economically liberal platform well before he brought on Guedes, not vice versa, which suggested that the platform would survive even if Guedes were to depart.

Garman also addressed the theory that there are two factions in the Bolsonaro camp: the statist generals and the liberal economists. He argued the idea that the Brazilian military was in favor of state-led development was outdated, and that there was no such deep division or ambivalence over the pro-trade outlook. He expressed a positive outlook on trade and on the potential for relations with the United States.
Garman predicted some progress on the pension front, but at the same time expressed concerns about the tractability of the Brazilian Congress and governability in general. Economic recovery depends on the government “tackling the fiscal hole,” which means progress on pensions. If the administration could make progress, a virtuous cycle might be inaugurated; free trade, streamlining of licensing and other breakthroughs could follow. Yet, if pension reform fails, the reverse could happen. The Brazilian real could hit R$4.50 to the dollar, investment could dry up, and an environment of distrust might stymie progress on other fronts.

In particular, Garman drew attention to Bolsonaro’s promise to not nominate cabinet ministers based on congressional patronage, which would violate the “grand bargain of Brazilian democracy”: that legislators approve unpopular measures in exchange for patronage (high-level government jobs for themselves and/or their parties) and pork (earmarks for pet projects to help them get reelected). Questioning how Bolsonaro would get things done without “pork,” Garman predicted that he will have to use patronage, despite his campaign promise to change the way politics work in Brasilia. Further complicating the situation, the majority of legislators who voted for pension reform lost their seats, while the majority of those who voted against pension reform won reelection. Instead of negotiating with the parties, Bolsonaro wants to negotiate with the various caucuses (such as the evangelical caucus, the agricultural caucus, the security caucus, and other loose groupings). However, Garman doubted that this will work, since there is little discipline among the ranks of these groups and no real mechanism for enforcement. Garman advised the administration to go for a quick but less ambitious win that can be sold to the public. Otherwise, the government will soon face declining approval rates, which could cause a whole host of negative consequences.

In closing, Garman argued the prevailing narrative in the press should not be about a threat to democracy (which he believed to be mostly fictional), but instead about the prospects of a great experiment in Brazilian democracy: the attempt to govern without distributing pork.

Q&A Session

Q: Failed bids for pension reform in 2016 and 2017 didn’t really spook the markets. Are these reforms truly critical?

Garman: Goalposts do move: Temer’s government failed to deliver pension reform, but due in part to a benign global backdrop, Brazil escaped serious consequences in the market. But the global backdrop is worsening, meaning the longer the government delays, the larger the price in terms of an eventual crisis of confidence. Without traditional pork arrangements, public approval means more than usual for Bolsonaro. Thus, he needs to sell pension reform effectively to the public; and ought to aim for a minimal approach to get something passed, rather than going for an ambitious reform such as the capitalization scheme.

Fleischer: Brazil’s pension problem is like a tsunami, with the deficit dramatically increasing each year. Many countries implemented fiscal reforms after the 2008 crisis, often beginning with pension reform. For Brazil to conduct even a moderate pension reform would send an important positive signal to investors, which is key to the health of the Brazilian economy, especially for jobs creation. Guedes’ desire is for the eventual implementation of a capitalization plan for pensions, but this need not happen right away.

Sotero: Brazil is the “country of the future,” and the capitalization scheme belongs to that future Brazil; what is essential in the present is basic pension reform.

Q: What about environmental protection in the Amazon under the new administration, and the problem of illegal deforestation?

Fleischer: We’ve had examples of this challenge in the final days of the Temer administration, with cases of environmentalists and IBAMA agents who are going after illegal loggers and others cutting down the Amazon. The environmental protection agents and activists have been physically attacked, and IBAMA vehicles burned. They’ve had to ask for protection from the Armed Forces and the National Public Security Force. So there are already strong challenges to the environmental protection regime from those engaged in illegal deforestation. It’s unclear whether Bolsonaro will continue providing this support.

Garman: Constitutional provisions are likely to prevent the administration from eliminating protected swaths of the Amazon. Less funding for enforcement could...
harm environmental protection efforts, although it may not be a radical change. Sensationalism in the press is unhelpful to discerning the incoming administration’s position. There are reasons to support its agenda of streamlining of environmental licensing, if it is done without threatening environmental preserves.

Sotero: Bolsonaro’s expressed desire to leave the Paris accord gives global context to the environmental issue, as do Brazil’s substantial agricultural exports. Embrapa and the military will both play a role in environmental protection, and are not as opposed to environmental protections and the protection of indigenous communities as is often supposed.

**Q: What is your outlook for political fractionalization in Brazil?**

Fleischer: There are so many parties in Brazil’s legislature: thirty-one in the lower chamber. But this may change going forward: seven or eight may disappear due to a clause passed last year which will strip funding and TV spots from parties that received less than 1.5 percent of the vote nationally. Stripping money and free publicity will “kill almost any party.” The parties slated to lose these privileges are already looking at mergers with larger parties. This should contribute to political consolidation going forward.

Brazil, like many countries, has a proportional representation (PR) system of voting; but unlike other countries with PR, voters have influence over which candidates are elected from each party list. This has the effect that people often vote for individuals but later forget who they voted for. One possible reform that could spur political consolidation would be to have voters choose parties rather than candidates.

**Q: Will the occasional intractability of Brazil’s Foreign Service prevent breakthroughs in the U.S.–Brazil relationship?**

Fleischer: There is speculation that the foreign affairs portfolio will be held by a seasoned bureaucrat, but Bolsonaro has also claimed that ideology will no longer prevail over Brazil’s foreign policy, left or right.

Sotero: There are reasons to be optimistic about the future of the bilateral relationship. There is a parallel with the Clinton–Cardoso relationship, in that there are ideological and personal synergies between the two presidents. The Embraer–Boeing deal is also a potential coup for the relationship, and perhaps even the Alcântara agreement will be dusted off as a possible show of goodwill, a chance to make good on the “unrealized love affair” between the two countries—but this would take real leadership.

Fleischer: Alcântara is of particular interest to the U.S. space program due to its proximity to the equator.

**Q: Will Bolsonaro’s negative press coverage affect the global economic outlook on his administration?**

Garman: There may be some effect, but not very great. International economic organizations are used to working with governments of various different political colors and stripes. Polarization will remain, because Bolsonaro has every reason to believe his rhetoric is effective; but it is not likely to reach the point where it would negatively impact growth.