The Costs of the Current Political Turmoil on the Brazilian Economy

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Overview

The recent political scandal involving President Temer will not come cheap for Brazil, an already very weak/vulnerable economy.

As a result of the current political situation, there are two likely scenarios regarding the way forward: 1) If the allegations against the president are confirmed, the president could be impeached or political pressure could force him to resign, bringing a new person to power. It is not yet clear who would replace Temer if this were to happen, which results in this scenario carrying a wide range of uncertainties. 2) Even if the allegations are not true, Temer's already low popularity among Brazilians will make governing more difficult and possibly affect his relationship with congress. It is expected that as a result of the current political turmoil, Temer's popularity will continue to go down and is unlikely to recover as a result of his portrayal as a corrupt person (even if he is not) and there is little time left to recover the people's trust.

In any case, both scenarios result in a very weak government that would likely struggle with the basic tasks of governing, making any new policy proposals or reforms unlikely in the short term. This means that pension reform would most likely not be approved in 2017 and raises the possibility that irrespective of the outcome of the current scandal, Brazil could enter into a period of uncertainty that will last until the next election in 2018.

A potential delay in the approval of the pension reform would negatively affect the deteriorated fiscal balance. In 2016, Brazil recorded a primary deficit of 2.5% of GDP, and without pension reform, it is projected that the primary deficit would more than double (as % of GDP) by 2030.

The largest economy in Latin America was hit yet again by a corruption scandal[1], this time involving the current president, Michel Temer, just 9 months after the impeachment of the former president, Dilma Rousseff. This scandal could have severe consequences for the Brazilian economy and will likely delay (or potentially lead to the abandonment of) important policy reforms recently proposed by President Temer. The scandal is causing many uncertainties, regarding both the Brazilian economy and government, and presents a range of downside risks.

1. Current Economic Conditions

Brazil has been in recession since 2015 and a very modest recovery is forecast for 2017 (0.5% YoY[2]), pulling Brazil out of the current recession. The economy is still very weak and any political turmoil could destabilize the economy and prolong the recession.

Real GDP continues to register negative growth (-0.4% YoY) during Q1 2017, where the sectors of construction, transportation and commerce struggled the most to regain any momentum. Household consumption continued to be lackluster (-1.9% YoY) during Q1 2017, however, it showed a modest improvement when compared to Q4 2016 (-2.9% YoY). And unemployment rate (13.7%, Q1 2017) is currently at its highest level at least since Q1 2002.

2. Potential Negative Effects of Corruption Scandal

In December 2016, Brazil passed a 20 year public spending ceiling to control a ballooning budget deficit. To complement the spending cap, the current administration proposed reforms to the pension system[3], a key piece to restore the fiscal balance. In addition, President Temer has proposed labor reforms[4] to combat the record high unemployment rate.

The pension system reform is far more important for the long term stability of the Brazilian economy and while this reform had significant opposition among certain segments of the Brazilian congress and population, prior to the current scandal, it was expected that the reform would be approved during 2017.

[1] On May 17th, the Brazilian newspaper O Globo, said that the Brazilian President endorsed a JBS (largest meat processing company with headquarter in Sao Paulo) executive's payment of hush money to a powerful politician jailed for corruption. Also said that Temer directed the executive to pay a lawmaker to help resolve a problem at a company plant. The recording was part of a plea bargain that the JBS's owners made with prosecutors.

[2] MUFG's forecast

[3] Please see Box 1

[4] Among the main changes, the proposed bill contained the following items: 1) The measure would alter the rules for temporary workers with an increase in contract duration as well as same salaries, benefits and overtime pay as a permanent worker, the only difference being that a temporary worker would not receive a severance payment. 2) It would regularize to a maximum of 12 hours per work day, extending the maximum work hours per week from 44 hours to 48 hours. 3) It would introduce guarantees for outsourced work, and 4) It would allow collective bargaining agreements between unions and employers to override some rules of the labor code.

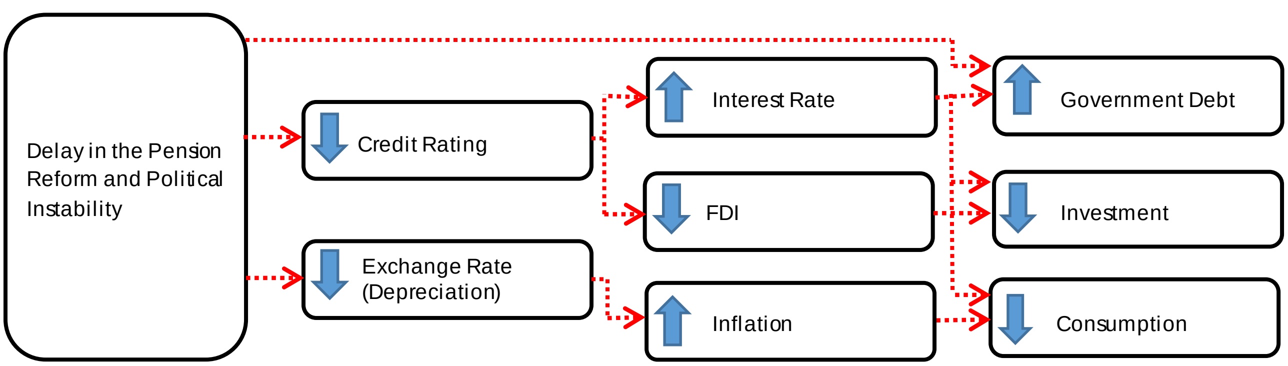
As a result of the current political situation, there are two likely scenarios regarding the way forward: 1) If the allegations against the president are confirmed, the president could be impeached or political pressure could force him to resign, bringing a new person to power. It is not yet clear who would replace Temer if this were to happen, which results in this scenario carrying a wide range of uncertainties. 2) Even if the allegations are not true, Temer's already low popularity[5] among Brazilians will make governing more difficult and possibly affect his relationship with congress. It is expected that as a result of the current political turmoil, Temer's popularity will continue to go down and is unlikely to recover as a result of his portrayal as a corrupt person (even if he is not) and there is little time left to recover the people's trust.

In any case, both scenarios result in a very weak government that would likely struggle with the basic tasks of governing, making any new policy proposals or reforms unlikely in the short term. This means that pension reform would most likely not be approved in 2017 and raises the possibility that irrespective of the outcome of the current scandal, Brazil could enter into a period of uncertainty that will last until the next election in 2018. A delay of the pension reform would be accompanied by increased political instability; both could trigger another set of negative effects (Figure 1).

The delay in the implementation of the pension reform could lead to a downgrade of the credit rating, correspondingly leading to an increase in interest rates. This would impact government debt, making it more expensive to borrow money, and further deteriorating the fiscal balance due to increased debt payments.

A downgrade of Brazil's credit rating could also potentially affect foreign direct investment (FDI). FDI is an important component of the Brazilian economy and is highly sensitive to the various economic shocks. A reduction in FDI could also lead to a deceleration of the Brazilian economy.

Figure 1: Potential negative effects of corruption scandal



Source: MUFG

[5] After a year in power, Temer's popularity among the Brazilian population continues to fall with 61% of Brazilians disapproving of his presidency, almost doubling the disapproval rate since he assumed power (31%), this makes Temer the second least popular democratically elected president in the history of Brazil. Datafolha, Survey Institute.

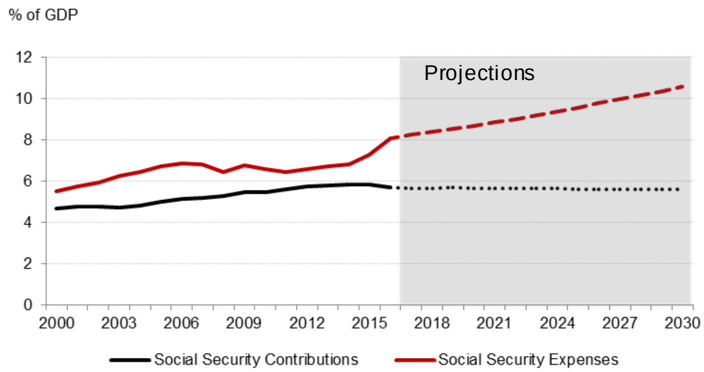
The political instability surrounding Brazil is likely to further depress the economy and has already led to a depreciation in the currency. Further depreciations in the Brazilian Real could lead to a spike in inflation. If inflation starts to accelerate, this will likely affect the pace of rate cuts the Central Bank currently is implementing, halting the already weak economic growth.

3. Impact of pension reform's delay

Pension reform is crucial in order to restore public finances. A projection[6] on how social security contributions and expenditures will develop over the time was made by the Brazilian government in order to show politicians and the Brazilian population that the current pension system is no longer sustainable and will greatly hurt the economy.

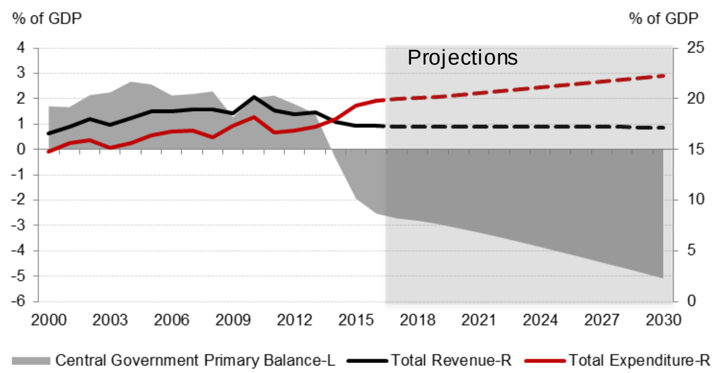
In 2016, Brazil recorded a primary deficit of 2.5% of GDP. Social security expenditures currently represent almost half of total public spending (8.1% of GDP in 2016). As figures 2 and 3 show, if there is no reform by 2030, social security expenditures will be more than 10% of GDP while the contributions will remain around 6.0% of GDP (these results are mainly driven by the rapidly aging population in Brazil[7], a consequence of declining fertility rates and increases in life expectancy), leading to a growing central government primary deficit that will more than double (as a % of GDP) over the next 14 years.

Figure 2: Social Security Contributions and Expenses



Note: Projections were made by the Ministry of Treasury
Source: Ministry of Treasury, MUFG

Figure 3: Brazils Central Government Fiscal Balance



Note: The primary balance projections were calculated taking the government's social security projections and assuming everything else remains constant (this assumption was based on historical tendencies).
Source: Ministry of Treasury, MUFG

[6] This projection is very optimistic and close to a lower range impact. Other organizations such as the IMF had estimated the expenditures to be more around the 17% of GDP by 2030 which put the government finances in a more complicate scenario.
[7] According to IBGE, by 2030 as the share of youth and working age population declines, old age (above 65) population is expected to be close to 19% as a share of population ages from 15 to 64.

Box 1: Brazil's pension system

Brazil's Current Pension System Structure

	General Social Security Regime (RGPS)-Pay-as-you-go (PAYG) system	The Pension Regimes for Government Workers (RPPS)	The Private Pension Regime (RPC)
Beneficiary	- Private sector employed workers - Self-employed professionals - Elected civil servants	Public-sector employees	Occupational and personal pensions are provided on a voluntary basis
Monthly Pension	Monthly pension is calculated based on the mean of the salaries registered from July 1994 to the date of retirement (excluding the lowest 20% of salaries during that period). This value is inflation adjusted and multiplied by a factor that considers the age, life expectancy and the years of contribution of the retiree. The value of the monthly pension cannot be lower than the minimum wage 880 Brazilian Reals or higher than the ceiling of 5,189.82 Brazilian Reals[8].	The monthly benefit calculation is the same as for the RGPS. In addition, public sector employees have a complementary pension made up of voluntary contributions (Under the Complementary Fund for Civil Workers- Funpresp, approved since 2003).	
Financed by	- Payroll taxes - Revenues from sales taxes - Federal transfers that cover shortfalls of the system	Pay-as-you-go basis with the employee paying a percentage of their salary	
Age of retirement	**Urban Areas** - Full retirement - at least 15 years (Y) of contributions – 65 Y-Men, 60Y-Women. - Full retirement after 35 Y of contribution irrespective of the retiree's age (55Y-Men, 50Y-Women). **Rural Areas** - Eligible for pension (without having contributed to the system) People aged over 60Y and poor citizens over 65Y.	- Full retirement (Members who joined after 2003) - 10Y of work within the government are required 60Y – Men, 55Y - Women. - Full retirement (Members who were already employed in the public sector) Men- 53Y, Women -48Y.	
Other benefits	Families inherit pensions in their entirety Paid maternity leave benefits, sickness benefits, unemployment insurance and disability pension, among other.		

Brazil's Pension Reform Plan includes the following[9]:

- Set a minimum age of retirement at 65 years, for both men and women.
- For rural areas, the minimum age to apply for the benefit will increase to 70 years.
- Raise social security contributions by civil servants. Require a minimum of 25 years of contributions in order to qualify for pension benefits.
- Reduce death pension benefits. These will be reduced to 50%, plus 10% per dependent. In addition, it will be disconnected from the minimum wage readjustment, which currently allows for real gains in pension payments.

[8] The minimum wage is around 252USD and the ceiling is around 1,487USD (both figures are calculated using 2016 annual average exchange rate). These numbers are based on the latest publication of ABRAPP (Brazilian Association of Complementary Pension Plans Entities).

[9] Based on the original proposal the government sent to Congress. It is expected this proposal will have several changes before its approval.