Newsletter: February, 2023

There shines a star... a falling star?

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The great rulers, which “shaped” their eras throughout history, were forged less so by their own personal characteristics and more so by having experienced the calm inbetween great inflationary waves that struck societies throughout the centuries.

In this newsletter, we have once again called upon David Hackett Fischer’s “The Great Wave,” from where we surf on the idea that the most potent variable for contextualizing history are the great inflationary waves.

Starting with this idea, which deals with the environment outlined by inflation, we have dug into the current Brazilian political setting and the existing political/economic restrictions to Lula III.

One of the paramount virtues of a good politician is being able to recognize the environment surrounding them, to perceive its restrictions, and to reach, credibly and effectively, the best way toward their objective.

We understand that President Lula’s main objective is to end his third term with an approval rating closer to the levels he enjoyed at his second term ending in 2010, around 80%, which prompted then-president Obama’s reference to him as “the man” at a G20 meeting.

Why would Lula, as a seasoned president, not reach this approval rating this time?

This newsletter will examine how the existing environment boundaries in the President’s third term go differs from 2003’s, and how we expect Lula to react to the restrictions imposed on him.

Our focus is set on how the President will face the dilemma of whether or not to accept the necessary economic downtrend to curb inflation and weather out the inherent negative impacts of this strategy over his popularity in the short term. This trade-off plays out in a context in which an additional opposing force amplifies the traditional Workers' Party (*PT*) intolerance towards an economic downturn, threatening its political stability.

The Backdrop

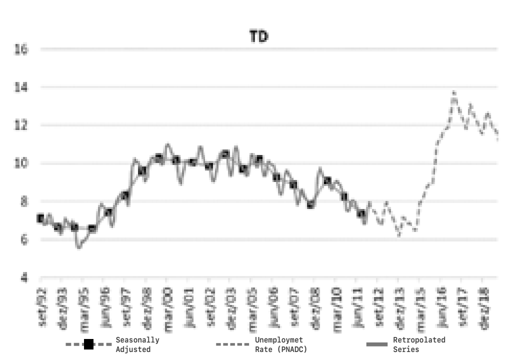
In 2002, Lula was elected in the second-round run-off voting with 61.3% of the votes. He was handed the presidential sash by a center-left president, Fernando Henrique Cardoso, who implemented deep structural reforms and experienced several economic crises during his eight years in power, at home and abroad. At the 2002 election's final stretch, Cardoso was met with an economic crisis when forced to decree a mandatory electric power rationing.

The combination of (i) accumulating structural reforms with (ii) back-to-back crises[1], which forced the output gap to open and raised the unemployment rate, and (iii) the demographic bonus onset, in which active age population growth accounted for a potential GDP growth of at least 2.1% a year, outlined the political/economic backdrop for the new president in office (Figures 1 and 2). This environment made it possible for strong economic growth and social spending expansion with minute consequences to inflation rise in the following years.

Figure 1:

Unemployment rate between 1992-2019

% of workforce

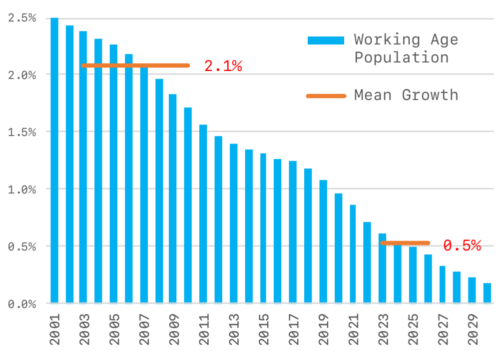


Source: *IBGE* (Brazilian Institute of Geography and Statistics), Vaz and Barreira (2021), Mar Asset Management

Figure 2:

Population growth, ages 20-64

%, annual



Source: Ministry of Health, Mar Asset Management

1 E.g., the Asian Financial Crisis in 1997, the Russia crisis in 1998, the Argentina crisis in 1999, and Power rationing in 2001.

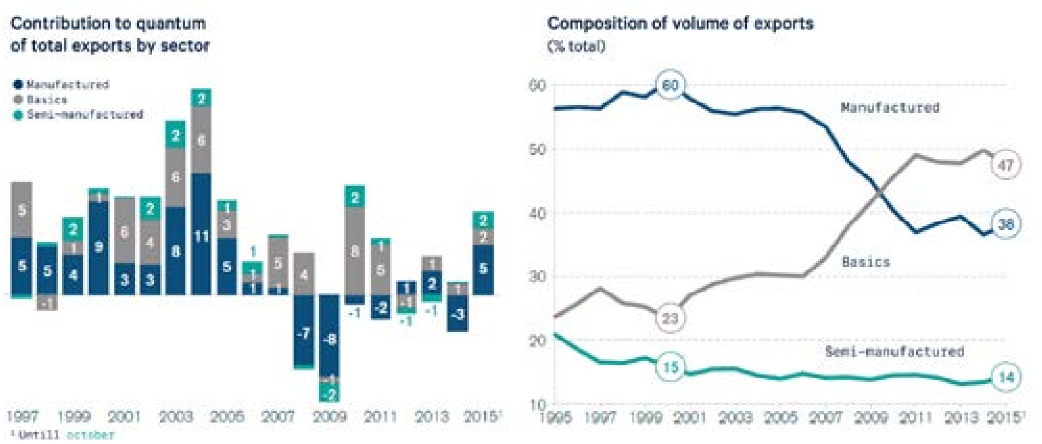
The domestic economic cycle was favorable during Lula I and II. In addition, the foreign environment after the consecutive 1990s crisis became extremely positive for emerging economies in the early 2000s.

China, recently on board the World Trade Organization, would start growing robustly and demanding agricultural and metallic commodities, which doubly benefitted Brazil. Either by a direct impact, through greater demand for Brazilian commodities, or by its indirect effect, fomenting our continental neighbors' growth and, thus, Brazilian manufactured goods exports.

Especially, Brazil reaped positive externalities from strong exports to Argentina, which was then leaving its greatest economic crisis, thus strengthening the Mercosur trade bloc.

In the first years of Lula I, the greatest contribution to growth from the international market came from exports of manufactured goods. With LATAM's recovery, factory-made goods exports rose plenty in volume up to 2005. From 2007 on, Brazilian exports turned to primary goods (Figure 3).

Figure 3:
Brazilian exports growth and make-up
%



Source: Credit Suisse, Mar Asset Management

In 2006, halfway through Lula I, South American countries accounted for 19% of Brazilian exports, while China, a little less than 8%. Fast forward to 2020, the slice imported by our neighbors fell to 11%, while China secured 32%.

From a political viewpoint, in 2003, Lula was still wary of the establishment and the markets. In addition to a greater fear of policy mistakes, the president was surrounded by an experienced political group from *PT*, which had been formed decades earlier. Lula had a personal economic adviser, the medical doctor Antônio Palocci, who surprisingly learned economics with enormous celerity.

Lula´s ideas were very up-to-date back in his time. His campaign centered on sharing wealth by strengthening income distribution policies. Although these policies were already in place, they were still modest and not focal for the previous administration. While his predecessor invested political capital into a macro agenda relative to economic and legal structural changes, Lula brought the income distribution/economic growth agenda to the table, which was compatible with the changing environment.

President Lula was successful in winning over the minds and hearts of Brazilian society by effectively delivering, in a tangible manner, his campaign promises. He did so while maintaining economic foundations solidity, keeping with and strengthening the macroeconomic tripod. Monetary policy was well directed by Meirelles, and the fiscal results were steadily positive throughout his whole term due to economic growth.

That is how he became the most popular President in Brazilian history.

Lula repeatedly says that his previous administrations attest to his fiscal responsibility.

So, why are financial markets currently suspicious of Lula not being fiscally and monetarily responsible now?

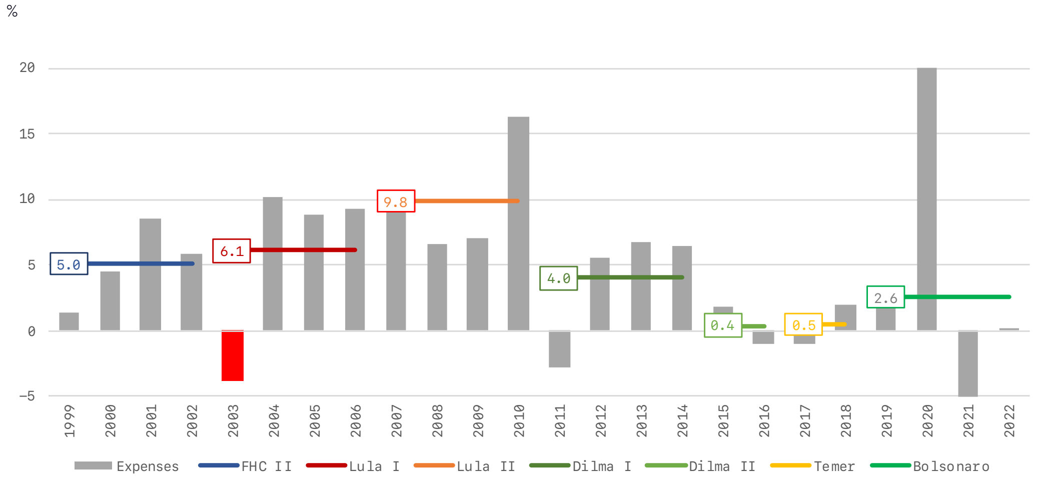
Our premise to define a responsible government is that it must effectively abide by fiscal and monetary restrictions when they present themselves. Was that case during Lula I?

This is exactly what we attempted to answer in our newsletter/study "Lula from a fiscal policy perspective."[2] We observed that in 2003 when the government pushed hard on a contractionary fiscal policy to augment the GDP's primary surplus by 0.5%, this was achieved by slashing 1% of GDP from investments and raising 0.5% of GDP in social spending.

Starting in 2004, government spending expanded drastically, resulting in an annual 8% GDP average spending during Lula I and II (Figure 4). In other words, despite a consistent primary surplus, President Lula never really faced fiscal restriction.

Figure 4:

Yearly primary expenses real growth



Source: National Treasury of Brazil, Mar Asset Management

Even so, given his successful experiences in previous terms, his diagnosis for the situation today is that, should he apply the economics guidelines from his previous terms to Lula III, the economic results will be the same.

In our view, this diagnosis is inaccurate, for it shows incongruence with the current political/economic scenario, which differs significantly from that of 2003.

2 See our website (link).

Will Lula be a replay of Dilma's errors?

Lula is not Dilma!

There is an abyssal difference between the two. Lula is a traditional politician, forged within the trade union negotiations in the 1980s, when he emerged as a major political leader, thanks to his own negotiation and liaison skills.

Lula's relationship with Congress has always been, in all his terms, very different from Dilma's political approach.

In a recent interview with journalist Kennedy Alencar[3], he confirmed his diagnosis that Dilma's impeachment was solely political, especially due to her conflicting relationship with Congress. A mistake that, according to him, will not happen once more.

To illustrate his approach, Lula insists on the expression "the Administration needs Congress more than Congress needs the Administration" as a means of portraying his political openness and willingness to negotiate with Congress.

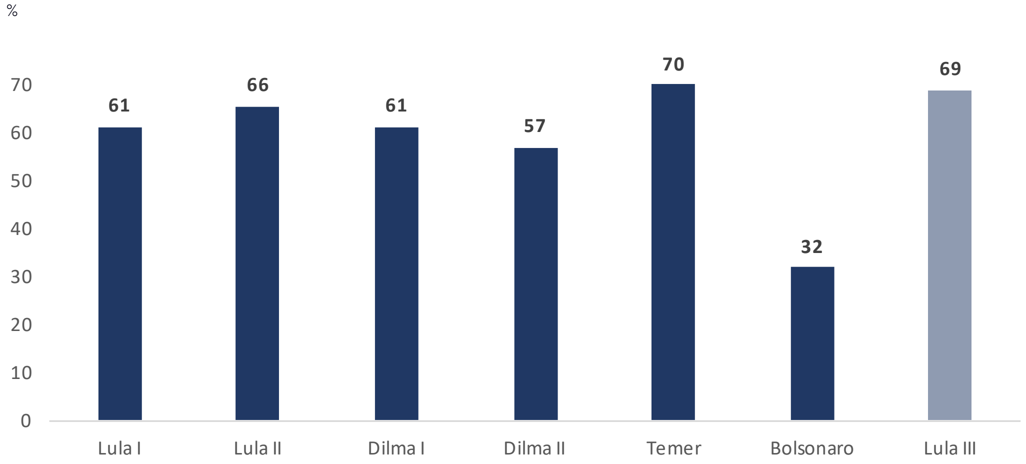
In January 2023, we disclosed the "Governance under Lula III" newsletter/study, in which we calculated his current term's coalescence index[4]. Such an index measures the partisan distribution proportion of his congressional base (Figure 5). The closer to one, the more similar the distribution of a ministry to his allies is.

3 Read the full interview from 2/02/23 at UOL (link).

4 See link.

Figure 5:

Coalescence Rate within the Chamber at each Term's onset



Source: National Congress, Mar Asset Management

Lula III shows a similar index to Temer's administration, the highest ever in Brazil and the most parliamentary-based presidency.

This demonstrates Lula's effort to avoid Dilma's political mistake.

Lula fails to acknowledge Dilma's wrongdoings in the economic domain by stating that her impeachment was strictly political. In our view, the fatal blow had its origins in not respecting the economic cycle and not accepting the necessary economic deceleration.

After Lula's two terms in office, with strong GDP growth and relevant unemployment reduction, inflation was persistently high during Dilma I. High inflation was not perceived by her administration as an economic troubling sign after so many years of intense growth but rather as an obstacle to her 2014 reelection bid.

High inflation and economic downturn, deriving from exhausted production capacity, were confronted with even more government-led growth stimulus. After all, the previous *PT* administrations managed to obtain GDP expansion, minimum wage growth, and unemployment reduction. Anything different from this would be considered a failure and could jeopardize reelection.

However, a demand boost in an economy already running above its capacity does not generate growth. Actually, it only generates more inflation.

Then, this inflation must be fought with even a stronger recession and unemployment hike. That is exactly what we observed in 2015-16.

Economic analysts at the time pointed clearly to this diagnosis mistake, but the government deemed political restrictions more important than economic ones. Heterodox measures were adopted to reduce inflation: interventions on administered prices – notably the reduction, via executive act, of electric power price – together with the expansion of public banks' balance sheets with interest rates lower than the market's and pressure on the Central Bank, which led to the premature interest rate cuts. All this to reignite an economy that had already shown signs of exhaustion.

In spite of the extensive literature on Dilma's economic policy mistakes, when Lula diagnoses that period exclusively in political terms, we suspect there might be room for a repetition of the economic policy mistakes undertaken by his successor.

The current scenario

In 2023, the surrounding environment is quite different from 20 years ago.

The global economic cycle has been extremely synchronized since the pandemic. After the successful reaction from global economic policy, with a swift recovery of job shortage due to social distancing, the economic challenge morphed into global inflation, its main side effect.

Central Banks the world over have been facing more hardships than expected to slow down their economies and bring inflation back to its target. We understand that the strong stimuli supply during the pandemic is still present, intensifying the national Central Banks' battle and demanding even higher interest rates than imagined before throughout the cycle[5].

Likewise, in Brazil, the Central Bank has been maintaining the Selic (base interest rate) at high levels to deflate the economy. Nonetheless, while

5 See, for example, our newsletters from June and August 2022 (link and link).

fiscal stimuli have been steadily revoked around the world to aid monetary authorities in the fight against inflation, the new government has recently approved a fiscal expansion close to 2pp. of the GDP for 2023.

So again, we see ourselves under a *PT* administration in a cycle that demands economic slowdown and some unemployment increase to curb inflation.

Even though the previous government left some sectors unattended, the Brazilian economy behaved in a coherent manner during the pandemic and now shows a rather low unemployment rate compared to our historical patterns (Figure 6). The Brazilian economy's recovery in the last years was stronger than expected, as were new job openings.

The surprise is the economy's resilience to the strong monetary tightening. Even though there is consensus among economists in relation to GDP slowdown and unemployment increase, what we saw in the recent quarters was the consolidation of a growth rate beyond its potential, with an unemployment rate close to its lowest historical levels.

Therefore, we believe the current risk derives less from excessive monetary tightening but rather from an activity level so strong that it would maintain further pressure on inflation.

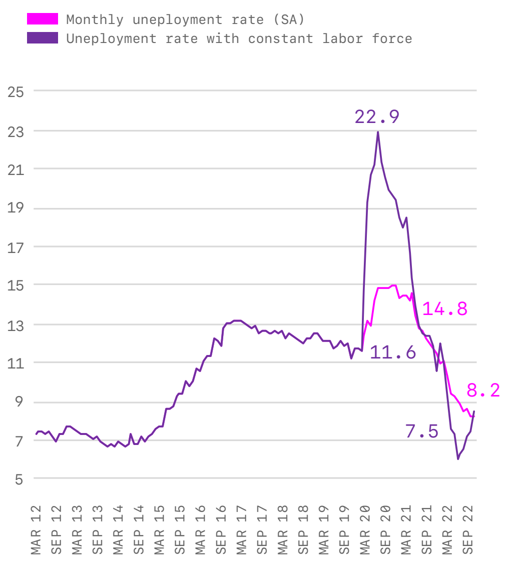
We expect GDP to grow above 2% in 2023, despite real interest rates being decisively high. The one-year ex-ante interest rate has topped 6% for more than 12 months and topped 8% for more than six months. Maintaining growth above the potential will keep inflation above the target for the third year in a row[6] (Figure 7).

6 See our newsletter/study "Will there be room for monetary loosening in 2023?" from September 2022 (link).

Figure 6:

Monthly unemployment rate with seasonal adjustment – headline with constant workforce in pre-pandemic level

% of the workforce

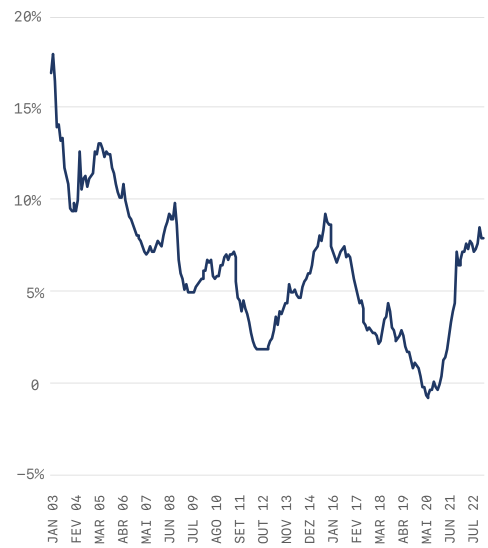


Source: *IBGE* (Brazilian Institute of Geography and Statistics), Mar Asset Management

Figure 7:

One-year ex-ante real interest rate

% , annual



Source: *IBGE* (Brazilian Institute of Geography and Statistics). *BCB* (Brazilian Central Bank), Mar Asset Management

In other words, the standing economic cycle demands the slowing of activity, which explains the BCB's high interest rates but goes against the growth goal of this novel administration.

At this point in the cycle, more economic growth is bad news, for it pressures already high inflation to even higher levels. The more time inflation remains high, the greater the unanchoring of expectations will be, thus the greater the future cost to control it.

If Dilma's lessons are well-known, why would Lula insist on the same mistakes?

Popular political knowledge bears a simple recipe for four-year presidential terms. In the first two years in office, one should put things in order, approving more challenging bills and cutting expenses so that, in the remaining two years, they are able to spend more and finish off with a good economic scenario.

If Lula is the most successful politician in Brazil's history, we ask ourselves why such a politician would make an obvious mistake. Why would he not follow the two-year slowdown and then two-year expansion rule of thumb?

Although impossible, we tried to trade places with him, going back to the reflection that economic policy must comply with the economic cycle stage, but in the political agent's view, economic policy must also consider the political cycle.

The current political atmosphere is very different from 2003. Bolsonaro's administration revealed a structural slice of the Brazilian population with right-wing inclination, which before had partially identified with PSDB (Brazilian Social-Democracy Party) governments[7].

Once they found the political platform that best suited their wishes, this part of society mobilized behind these ideas representing a popular, permanent, organized, and noisy conservative opposition.

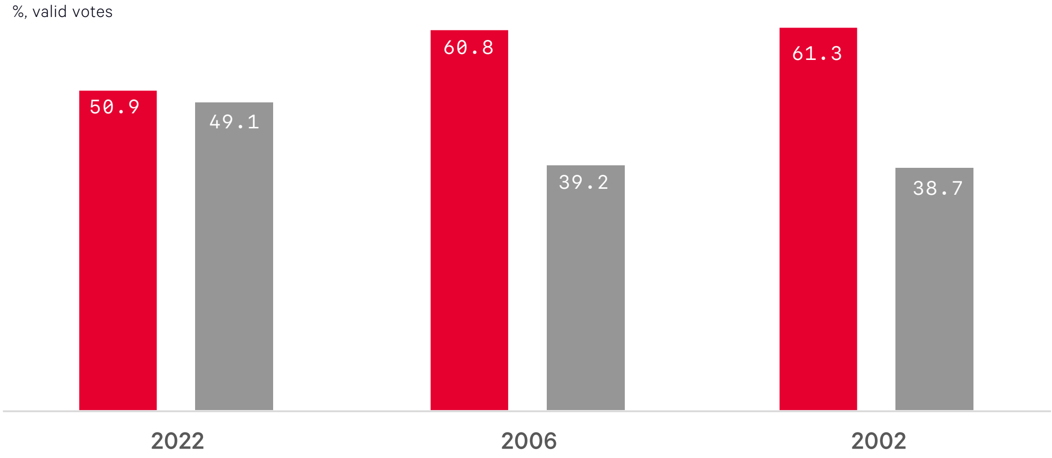
This is unprecedented for President Lula, who had always governed alongside a low-key popular opposition.

The 2022 election result, contrasting with 2002, was a virtual tie, demonstrating relevant rejection to both sides.

A victory in the run-off voting with 50.8% of valid votes (Figure 8), which effectively means support from only 38% of the population, combined with a permanent threat of organized popular opposition, produces an unstable political environment and presents itself as a serious restriction to unemployment increase, demanded by the economic cycle.

7 See our "The Bolsonaro Paradox" newsletter from October 2021(link).

Figure 8:
Results from run-off presidential elections won by Lula (red)



Source: *TSE* (Superior Electoral Court), Mar Asset Management

PT administrations are traditionally averse to slow economic activity, and an unemployment increase could catalyze the political threat from the far right.

A relevant drop in popularity due to unemployment rising in the short term could lead Lula's own government base to charge him with electoral embezzlement. Meanwhile, maintaining economic stimuli drive inflation, producing a recession and even higher unemployment moving forward.

This is the not-so-trivial dilemma Lula III has to face. Up until this moment, the president's public statement is that the political risk outweighs the economic cycle risk.

Such a decision is promoted by an erroneous diagnosis of the economic cycle, minimizing the risk of public debt unsustainability and unmanageable inflation, thus maximizing the political risk.

Therefore, this administration's economic modus operandi would be very much like Dilma's. Namely, the use of public banks for subsided credit, government primary expenses expansion, government payroll, minimum wage increase, and lastly, intervention in the Central Bank's role, pushing for an interest rate reduction.

All this is for the sake of GDP growth and unemployment decrease.

The debate on fiscal dominance is closing in at a rapid speed.

This does not mean Brazil will become an Argentina-like State. We see structural differences in the political-social organization, in the economic establishment interrelation, and in the political leaderships, as well as in institutions' maturity level.

The 2022 Brazilian election result alone is the best measure for observing that the current government lacks wiggle room. The risk of an approval rating drop real and, should Lula not find a practical solution, the political realm will swiftly respond by reducing the Executive Branch's effective power, gradually transferring major decisions to the Congress.

Even if we do not count on extreme scenarios, market prices would fluctuate at very different levels than we see today.

Markets and economic model deconstruction

At first, we understand upward interest rates will constitute adjustment variables. This will strengthen the BRL and protect its value. However, if, at some point, the Central Bank's freedom of action is limited, the adjustment variable will become the exchange rate, and capital offshoring will be the natural consequence.

Lula has consistently attacked two pillars of the well-known macroeconomic tripod, which consists of primary surplus, inflation targeting, and floating exchange rate.

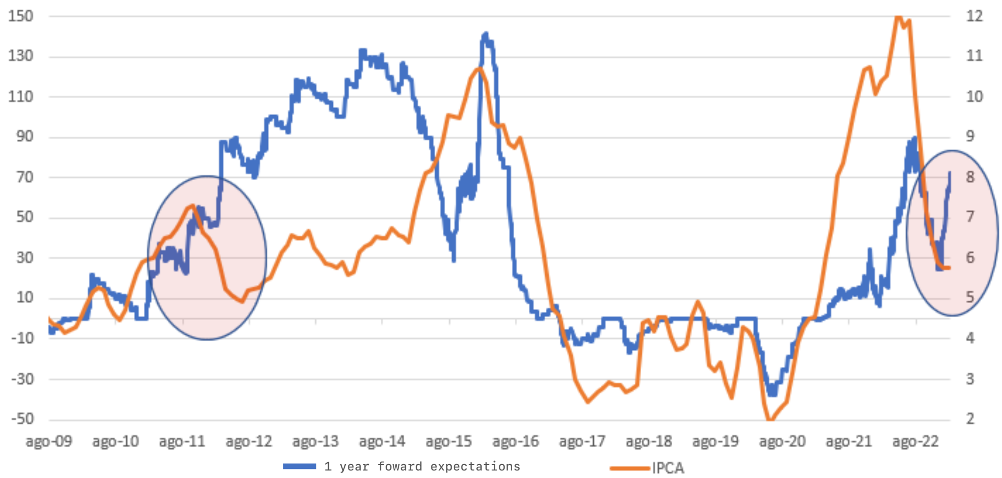
The spending cap fiscal policy that seemed secure, for it is enshrined in the Constitution, was deconstructed via Transition PEC (Constitution Amendment Bill) prior to Lula's swearing-in office. The inflation-targeting set of rules, which was enhanced with the Central Banks' legal independence, has been under constant fire. Finally, an occasional capital evasion with BRL's depreciation would lead to some kind of exchange rate pegging.

Thus, fulfilling the attempted deconstruction of the current economic model.

The market has already foreseen the risk of this to-be scenario. Inflation expectations, more sensitive to the possibility of a disturbed environment, have already gone higher since Lula first signaled the adoption of his expansionist strategy. This is occurring despite current inflation showing a much more positive movement than expected a few months ago. In other words, we are observing a scenario in which inflation expectations are being unanchored at the same time current inflation is falling. Since early this century, such a phenomenon had only been seen in 2011, during the Tombini/Dilma administration.

Figure 9:
Inflation Expectations Deviations in Relation to Target (bps) vs *IPCA (%, yoy)**

**IPCA* (Broad Consumer Price Index)
%, untill 12 months



Source: *IBGE* (Brazilian Institute of Geography and Statistics), *BCB* (Brazilian Central Bank), Mar Asset Management

What would make Lula change his mind?

We understand Lula's new term faces important restrictions, both political and economic. However, the correct diagnosis of the economic cycle point Brazil and the world are in seems necessary to make the correct policy decisions..

The President's meager dialogue with the establishment, as well as his closest political group´s opinion, consolidated the diagnosis that the need for political risk reduction via immediate expansionist measures' delivery outweighs the fiscal and monetary austerity that the economic cycle demands.

These very same decisions will deepen the economic problem, elevating inflation, affecting asset prices, and, eventually, the presidential approval rating.

The variable we believe will make the president reassess his strategy is the drop in his approval rating. This could be brought on by the BRL depreciation and inflation increase.

Even so, in such a case, would Lula back down from his initial strategy or double it? Lula, for instance, could intensify expansionist fiscal and monetary policies - via BNDES (The National Bank for Economic and Social Development).

What is the effect of such great political/economic space restrictions on a successful former president, now at 77 years of age and after 580 days in jail?

His long and successful political run will take him to a careful and thorough assessment of the situation ahead, understanding that he has to tread on "thin ice," or will his confidence, or impatience, lead him to oversimplify problems, blaming imaginary elements and proposing timely mismatched solutions, that did work in the past and so should work once again?

While in the US, President Biden and Chairman Powell root for a "soft landing," inflation drop with growth slowdown, but without a recession (flat Phillips curve), in Brazil, the current government demands an anti-inflationary process coupled with economic activity reheating and even greater unemployment decrease.

Is it possible for, as Lula's first campaign jingle in 1989 put it, his star to shine again?

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