

Brazil: Lula 3.0 – Good news for climate and biodiversity?

What Lula's victory means for Brazil's environment

Macroeconomic Research



Luis Lopez Vivas
Emerging Market Economist
Macro Research – Core Investments

Key points

- The Amazon rainforest occupies half of Brazil, making it a key global player in the fight against climate change and the preservation of biodiversity
- Deforestation reached record levels under former President Bolsonaro but Lula's track record suggests this could be a turning point for Brazil's environmental policy
- Lula has promised to reach net-zero deforestation by 2030 and also to reach net-zero emissions in electricity generation
- But deep political polarisation will make legislative changes more difficult
- Cattle ranching and soybean production are the primary forces behind deforestation but are also key contributors to Brazil's economy
- Longer term, increasing sustainability in the commodity and resource sectors of Brazil's economy could potentially lead to higher levels of international investment

Encompassing seven million square kilometres, the Amazon rainforest is the world's largest forest formation, occupying around half of Brazil's territory. According to the United Nations Environment Programme (UNEP), Brazil is the world's most biodiverse country. Estimates show it hosts between 15% and 20% of the world's total biodiversity. In addition, Brazil has by far the largest fresh surface water reserves in the world, which power the country's hydropower system. Since democracy was restored in the 1980s, the state has taken measures to protect the country's vast natural resources. Particularly emblematic was the introduction of the national system of conservation units in 2000. These so-called 'protected areas' cover about 15% of Brazil's land area.

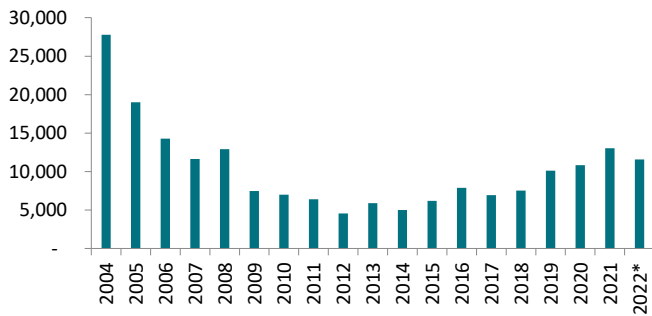
Despite legislative efforts, 8% of the Amazon - an area larger than Spain - has been destroyed since 2000. Soy production, cattle ranching and illegal logging are the biggest drivers of deforestation. Unfortunately, forest clearance has picked up in recent years under former President Jair Bolsonaro's administration. During his four-year tenure (2019-2022), Brazil lost 45,000 square kilometres of rainforest, an astonishing 60% increase over the four previous years (Exhibit 1). If this trend continues, the Amazon could soon reach a critical point of 'dieback', where the forest dries out and turns into a savannah. This would have far-reaching implications for biodiversity and climate change.

But there are hopes the re-election of Luiz Inácio Lula da Silva (known as Lula) as Brazil's President can help to once again

reverse the significant clearances and biodiversity losses in Brazil.

Exhibit 1: Deforestation measured via satellite images

Deforestation in Brazil
(Square kilometers)



Source: Instituto Nacional de Pesquisas Espaciais (INPE)

Lula’s recent victory was greeted with relief by climate activists worldwide as the left-wing leader pledged to protect the Amazon and roll back some of his predecessor’s policies. During Lula’s previous two terms as President (2003-2010), there was a steep decline in forest loss and an increase in the number of protected areas. However, it remains to be seen if Lula will be able to deliver on his promises given the vastly different political and economic backdrop. Unlike before, left-wing parties do not hold a majority in the nation’s fragmented Congress. Moreover, as the economy continues to slow, it creates additional incentives for land clearing.

Bolsonaro’s policy wrecking ball

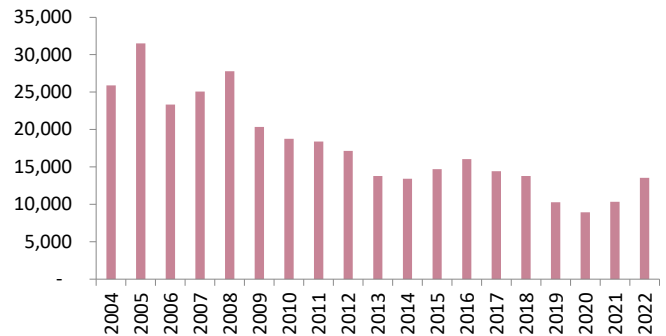
Since he first ran for President in 2018, Jair Bolsonaro made it clear that he considered environmental policies to be obstacles to economic development and pledged to eliminate the Ministry of the Environment. Although unable to fulfil his promise due to public backlash, he implemented measures to weaken its powers. For example, despite increased deforestation and fires, Bolsonaro slashed the Ministry’s budget, severely curtailing its ability to enforce environmental laws and outsourced the Amazon’s protection to the military. As a result, the number of fines issued for environmental infractions fell significantly (Exhibit 2).

According to *Observatório do Clima*, a local coalition of environmental organisations, Bolsonaro also pushed for wholesale environmental deregulation using presidential decrees to bypass Congress. In 2020, the federal government approved nearly 600 regulatory changes related to the environment. These included a softening of controls over suspicious timber exports; attempts to allow oil exploration in sensitive offshore areas; packing environmental agencies with military officers; and legalising artisanal and

small-scale mining in protected areas. Unsurprisingly, in 2021, Brazil’s greenhouse gas emissions hit their highest since 2005.

Exhibit 2: Weak enforcement

Number of environmental fines issued by IBAMA



Source: Instituto Brasileiro do Meio Ambiente e dos Recursos Naturais Renováveis (IBAMA)

At an international level, Bolsonaro weakened Brazil’s leadership in environmental diplomacy. Upon assuming office, he eliminated the steering committee of the Amazon Fund, effectively freezing its operations. The billion-dollar fund had been created in 2008 to receive donations from international organisations and governments to finance the conservation of the Amazon. Similarly, the Foreign Ministry eliminated its Climate Change Division which coordinated efforts with the United Nations, while the government threatened to pull Brazil out of the landmark Paris climate agreement.

Fresh start – a greener future?

"Brazil is ready to resume its role as leader in the fight against the climate crisis", asserted Lula in his inaugural speech. Just a few days into office, the left-wing leader made sweeping changes such as unfreezing the Amazon Fund, repealing Bolsonaro’s small-scale mining decree and drawing up new guidelines for the National Environment Council.

For his third term, Lula has pledged to achieve net-zero deforestation of the Amazon by 2030. Likewise, he has promised to reach zero greenhouse gas emissions in the electricity matrix. Historically, Brazil has relied heavily on hydropower to generate electricity but its share in energy production has declined over the years. For example, Lula has indicated that he wants Petrobras, the state-owned oil company, to take a more active approach in developing low-carbon energy. Lula has also announced that Brazil will re-engage with international actors to raise funds to pay for environmental conservation. However as yet, the government has yet to provide specific plans for the mining industry.

He also reappointed Marina Silva as his environment minister, which provided a credibility boost to Lula’s environmental

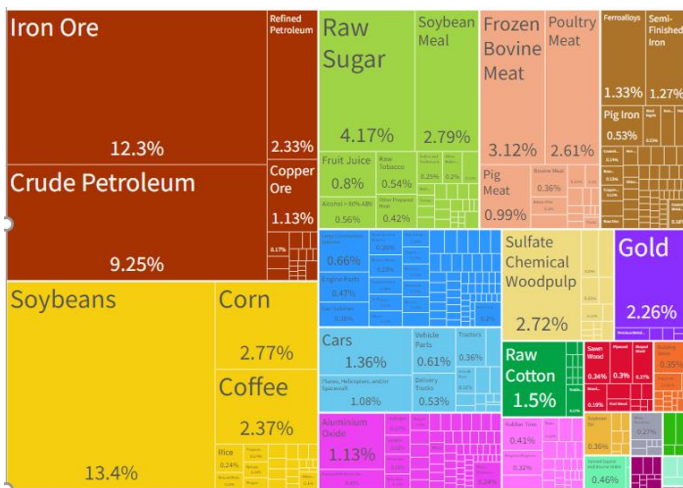
plans. In her previous stint as Minister, Silva oversaw the creation of dozens of new protected areas and developed a comprehensive plan to combat deforestation, using advanced satellite surveillance, and tackling environmental crimes.

Speed bumps ahead

While Lula’s plans for the environment are lauded by international organisations and foreign governments, the reality is very different at home. It will be hard for the executive to implement environmental policies which require congressional approval. Centre-right parties hold a majority in Brazil’s fragmented legislature and many are aligned with the powerful agribusiness lobby. Going forward, Lula’s policies could also face resistance from the public as he is not the hugely popular figure he once was.

The country’s slowing economy could also throw a wrench in this administration’s plans for the environment. GDP growth is expected to decelerate to 1.0% in 2023 from 2.9% last year. To keep the economy afloat, the government may prioritise economic growth over environmental concerns; ultimately, agriculture and cattle ranching still play a pivotal role in Brazil’s economy (Exhibit 3). The country is the world’s largest exporter of soybeans and beef. Likewise, with public coffers already under pressure, it will be challenging to finance a significant expansion in the monitoring and enforcement of conservation policies.

Exhibit 3: Exporting the Amazon



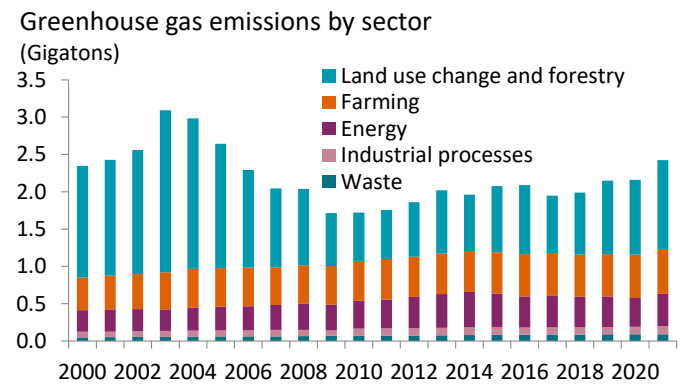
Source: The Observatory of Economic Complexity (OEC), 2020 data

Green versus Growth

Although Lula’s plans for net-zero deforestation by 2030 may sound too ambitious, a recent study by Oxford University suggests deforestation could fall by 89% over the next decade if his administration follows through on its pledge to crack down on illegal activities. Significantly reducing forest clearance

would have a big impact on Brazil’s carbon emissions and climate change on a global level. Brazil is responsible for 3% of global greenhouse emissions, ranking sixth in the world. According to the Greenhouse Gas Emission and Removal Estimating System, forest clearance accounts for almost half of Brazil’s annual share of carbon emissions. Moreover, reducing deforestation would be a major step towards strengthening biodiversity, helping to preserve important habitats for a wide range of plant and animal species, many of which are found nowhere else on Earth.

Exhibit 4: Forest lost, climate cost



Source: The Greenhouse Gas Emission and Removal Estimating System (SEEG)

Inevitably, implementing stricter environmental regulations and protections will have some economic costs, such as decreased profits for industries that rely on environmentally-harmful practices, or increased expenses for companies to comply with new regulations, which could be potentially exacerbated by any related job losses in those industries. On the other hand, there could be longer-term economic benefits from protecting the environment such as increased tourism, improved public health and the ability to tap into new markets for eco-friendly products. Brazil may also be able to continue to raise funds from overseas to contribute to its conservation – a new form of foreign direct investment. It also worth considering that Lula’s environmental policies could have a positive impact on Brazil’s image and reputation in the international arena.

The next phase

Lula’s recent victory will likely be a turning point for Brazil’s environment policies after four years of degradation of climate protection measures during the Bolsonaro administration that led to significant environmental damage. Lula’s commitment to achieving net-zero deforestation and eliminating gas emissions from electricity generation will have a significant impact on the Amazon, and as a result, on the global fight against climate change and the preservation of biodiversity.

Yet, Brazil’s economic and political realities pose a major threat to realising these goals. Lula will have to work with a right-

leaning Congress at a time of deep political polarisation. Silva's credibility among the public should help the government but Lula should not over-rely on her to push his agenda. Similarly, he will face a complex challenge of balancing environmental policy with economic growth. The country has committed to implementing environmentally-friendly policies but its economy relies heavily on industries that contribute to environmental degradation. Given Brazil's decelerating economy, it only adds to the difficulty of finding solutions that satisfy both goals.

A more investable future?

Looking longer term, increasing sustainability in the commodity and resource sectors of Brazil's economy, given its dependence on them, could potentially lead to higher levels of international investment.

Overall, Brazil's potential for environmental sustainability and clean energy, combined with its vibrant democracy and free press, could make it an appealing destination for investors seeking environmental, social and governance (ESG)-friendly opportunities. However, investors will need to pay close attention to a potentially uncertain regulatory framework around ESG policies in Brazil as the Lula presidency gets underway.

Our Research is available online: www.axa-im.com/investment-institute



DISCLAIMER

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date.

All information in this document is established on data made public by official providers of economic and market statistics. AXA Investment Managers disclaims any and all liability relating to a decision based on or for reliance on this document. All exhibits included in this document, unless stated otherwise, are as of the publication date of this document.

Furthermore, due to the subjective nature of these opinions and analysis, these data, projections, forecasts, anticipations, hypothesis, etc. are not necessary used or followed by AXA IM's portfolio management teams or its affiliates, who may act based on their own opinions. Any reproduction of this information, in whole or in part is, unless otherwise authorised by AXA IM, prohibited.

Issued in the UK by AXA Investment Managers UK Limited, which is authorised and regulated by the Financial Conduct Authority in the UK. Registered in England and Wales No: 01431068. Registered Office: 22 Bishopsgate London EC2N 4BQ.

In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.

© AXA Investment Managers 2023. All rights reserved

AXA Investment Managers SA

Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826