

BRAZIL

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CONSTRAINED BUT NOT CORNERED, THE STATE'S OPTIONS FOR NAVIGATING THE SLOWDOWN

As a result of monetary tightening, Brazil's economic growth has been losing momentum over the last two quarters. Nevertheless, the slowdown in domestic demand is facilitating the disinflationary process, which is further bolstered by decreasing food and oil prices, along with the appreciation of the real. Despite highly restrictive monetary conditions, labour and credit markets continue to exhibit areas of resilience within the economy. The impact of trade tensions with the United States are currently limited, as lost exports find alternative destinations. Diplomatic efforts, combined with Brazil's geostrategic position, point to a possible easing of tensions ahead. With general elections a year away, fiscal leeway to stimulate growth is limited – hampered by institutional, political and financial constraints. However, extra-budgetary channels still provide mechanisms to support growth. These measures will need to be carefully calibrated to avoid undermining the monetary easing anticipated by markets in Q1 2026.

ECONOMIC ACTIVITY: LOSING MOMENTUM

Economic growth has experienced a decline in momentum over the last two quarters. In Q2, GDP increased by 0.4% q/q, compared with 1.3% q/q in Q1, as domestic demand weakened. Household consumption grew by just 0.5% q/q, which is half the rate observed in Q1, while investment spending – which had bolstered growth in the previous quarter – fell by 2.2% q/q. In Q3, survey data confirmed the signs of a slowdown in economic activity. In September, the services PMI recorded its sixth consecutive monthly decline, while manufacturing output saw its sharpest contraction in almost two and a half years (46.5). At the same time, confidence in industry deteriorated – weighed down by trade tensions with the United States and the Brazilian Central Bank's (BCB) highly restrictive monetary policy (the real policy rate is nearly double the neutral rate, estimated at 5%). So far, the slowdown in activity has not completely permeated the labour and credit markets, although signs of softening have begun to appear in recent months. GDP growth is projected to reach 2.3% in 2025 (after 3.6% in 2024) before slowing to 1.6% in 2026.

MONETARY POLICY: END OF THE HIKING CYCLE, TRANSMISSION INERTIA

After accelerating at the beginning of the year, inflation has been falling since April, on the back of the economic slowdown and a favorable external environment (lower oil and food prices and a 13% appreciation of the real against the dollar since January). That said, disinflation is progressing slowly. The IPCA index even recorded a slight rebound in September from 5.13% to 5.17% y/y due to a catch-up effect linked to an exceptional discount on electricity bills in August (the *Itaipu bonus*). However, encouraging signs have emerged in recent months. The core component of the IPCA index is retreating, while inflationary pressures in the services sector are easing. These favourable developments prompted the BCB to halt its tightening cycle in June, after a cumulative 450 basis points (bps) of rate hikes between September 2024 and June 2025, which raised the SELIC rate to 15%. Markets continue to anticipate rate cuts in Q1 2026 with a total easing of 275 bps anticipated over the course of the year.

Credit growth has remained relatively resilient, especially in light of the BCB's stringent monetary stance (+11.5% year-on-year at the end of 2024; +10.15% at the beginning of September 2025). An IMF study¹ attributes this resilience to three key factors: 1/ A somewhat muted monetary transmission mechanism, which requires a 140 bps increase in the key policy rate by the BCB to achieve a 100 bps rise in average lending rates across the economy. This is due to the structure of the banking sector, where approximately 40% of loans are state-directed (earmarked loans), making them less sensitive to changes in the benchmark rate; 2/ the emergence of fintechs has broadened access

¹ Xu, R., & Leigh, D. (2025). Monetary policy transmission to lending rates: Evidence from Brazil. IMF Working Papers, 2025(152), 10-5089.

FORECASTS

	2022	2023	2024	2025e	2026e
Real GDP growth, %	3.1	3.2	3.6	2.3	1.6
Inflation, CPI, year average, %	9.3	4.6	4.4	5.0	3.8
Public sector fiscal balance / GDP, %	-4.6	-8.8	-8.5	-8.3	-7.5
Gross public debt / GDP, %	72	74	77	80	83
Current account balance / GDP, %	-2.9	-1.3	-2.5	-3.4	-2.7
External debt / GDP, %	35	33	33	36	34
Forex reserves, USD bn	324	355	329	348	352
Forex reserves, in months of imports	11	13	10	10	10

e: ESTIMATES & FORECASTS

SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TABLE 1

BRAZIL: CREDIT GROWTH AND SHARE OF EARMARKED CREDIT

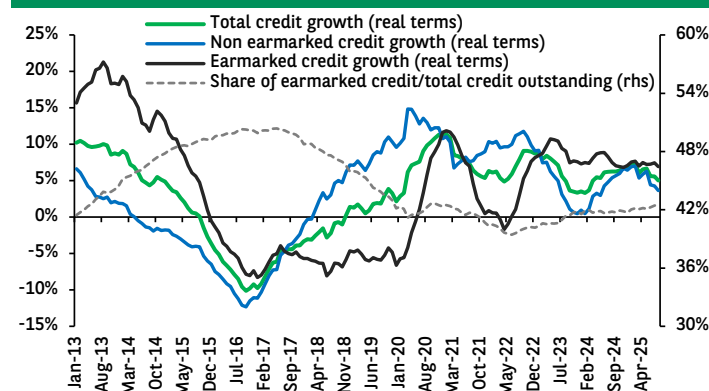


CHART 1

SOURCE: BCB BNP PARIBAS

to credit and helped sustain credit supply amid tightening conditions. According to the study, in 2024, digital banks and other fintech lenders accounted for a quarter of the credit card market and over 10% of non-payroll personal loans; 3/ Sustained growth in household income, driven by minimum wage increases, social transfers, and a strong labour market. The rise in household incomes has bolstered borrower solvency, thereby enhancing credit demand. In real terms, outstanding credit (up 5% y/y at the end of August) continued to grow at nearly double the rate of economic activity. However, since May, clearer signs of a credit slowdown have emerged, particularly in the corporate segment.



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EXTERNAL ACCOUNTS: TIME FOR DIVERSIFICATION?

The impact of the US tariff measures announced this summer on Brazil's economic performance is expected to remain limited. The 50% tariff was applied to only about 36% of Brazilian exports to the US² (with 45% of exports being exempt and subject only to the 10% tariff³). Since the announcement, exports to the United States have fallen by just over 15% (cumulative from August to September), with the most affected sectors being meat, timber, coffee, and metal products. This decline has been partially offset by a rise in exports to other markets, including China (which has granted export licences to over 183 Brazilian coffee companies affected by the tariffs). In response to the US announcements, Brazil did not take any retaliatory measures. Instead, it relaxed its fiscal rule to support the sectors most affected by the US measures⁴. At the same time, Brazil has been actively pursuing the diversification of its trading partners while accelerating the ratification of free trade agreements within Mercosur⁵. Politically, the US measures have had the opposite effect of what was intended: rather than protecting Jair Bolsonaro, they have enhanced the popularity of President Lula (79), who has since confirmed his intention to seek re-election in 2026. After several attempts at a *rapprochement*, bilateral relations between the United States and Brazil may improve in the short term. Brazil is home to 17% of the world's rare earth reserves – second only to China (37%) – providing it with considerable geo-economic leverage in the so-called «critical» value chains, an area of growing strategic focus for the United States.

HOW MUCH FISCAL CAPACITY TO SUPPORT THE ECONOMY?

In the short term, the fiscal (budgetary) channel is unlikely to be a significant driver of cyclical support. At the federal level, fiscal stimulus typically comes in the form of social transfers and regulatory changes⁶. Public consumption contributes only marginally to growth, while federal investment – already low at less than 1% of GDP – is often regarded as an adjustment variable during periods of strain on public finances. Although social transfers may increase ahead of the 2026 elections, any increase is expected to be limited. The Fiscal Responsibility Law and electoral rules impose strict limits on public spending in pre-electoral periods. Also, while the new fiscal framework allows for countercyclical expenditures, any increase in spending can only be modest (+0.6% above inflation, with an overall tolerance margin of +/- 0.25% of GDP around the deficit target). In addition to adhering to fiscal rules, the government must also contend with significant financial constraints: (i) a high (and increasing) public debt ratio (76.5% of GDP at the end of 2024), (ii) a rigid spending structure, (iii) a substantial interest burden (6.3% of GDP at the end of 2024) (iv) immediate market reactions that translate into higher long-term rates when fiscal balances deteriorate. Political constraints further exacerbate these institutional and financial challenges. In early October, the government failed to pass its proposed revenue-raising measures, thereby constricting its ability to implement fiscal stimulus and meet its primary surplus target for 2026 (0.25% of GDP).

BRAZIL: SOCIAL TRANSFERS TO HOUSEHOLDS BY THE FEDERAL GOVERNMENT

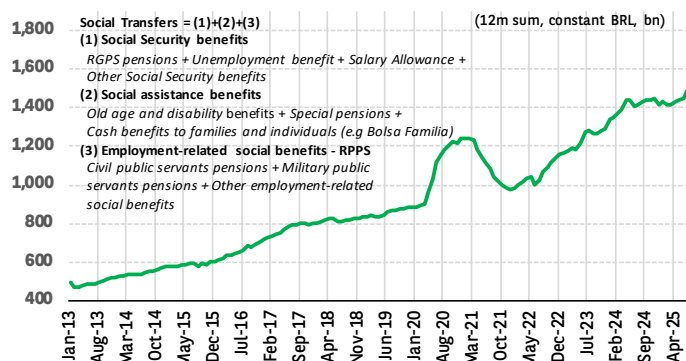


CHART 2

SOURCE: NATIONAL TREASURY, BNP PARIBAS

However, subnational governments may provide some support to the economy. States and municipalities tend to significantly draw down fiscal surpluses in election years.

Beyond the confines of the federal budget perimeter, the authorities have other levers to stimulate GDP growth. First, the monetary channel remains active (albeit less so than in the past), particularly through the Novo PAC investment program⁷. It operates on two levels: a) via public credit, with the majority of funding sourced from major public banks such as BNDES, Banco do Brasil, and Caixa Federal; b) through the expansion of public guarantee schemes to bolster concessions and public-private partnerships (PPPs).

Second, the impact of the monetary channel is amplified by the regulatory channel. For example, the government recently introduced changes to the savings and credit system for real estate financing. This new system aims to increase the resources available for mortgage financing and to promote home ownership among the middle class. This demographic will also benefit from the recently adopted income tax reform, which exempts workers earning less than BRL 5,000 (~ EUR 800) per month from income tax, affecting around 15 million people. The reform, set to take effect in January 2026, is expected to stimulate consumption among the middle class.

Third, quasi-fiscal channels offer another means to enhance investment projects by large public companies. However, their effectiveness has been inconsistent. In 2024, President Lula faced a strong market backlash when his government urged Petrobras and Vale to redirect dividend distributions towards investment spending.

In the current context, fiscal authorities face complex trade-offs: if domestic support measures stoke inflation (or inflation expectations), any potential growth gains may be mitigated – or even negated – by a delay in the anticipated monetary easing cycle.

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Salim Hammad

salim.hammad@bnpparibas.com

² Representing 12% of total exports, just under 2% of GDP, with commodities accounting for nearly half.

³ Key exports – crude oil, aircraft and other aerospace components, orange juice, iron ore, and pulp – were exempt from the additional tariff.

⁴ Congress approved an exemption from the federal spending cap to allow the government to roll out targeted support measures. These fall into three categories: (1) credit lines for affected sectors; (2) export guarantees for SMEs; and (3) public purchases of perishable food stocks to supply school canteens.

⁵ The Mercosur-EU trade agreement has gained new momentum, following the signing in July of a free trade agreement between Mercosur and EFTA (Switzerland, Norway, Iceland, Liechtenstein) after eight years of negotiations.

⁶ By raising the minimum wage at a rate higher than inflation, the Lula administration has automatically increased the volume of social transfers. The minimum wage is used as the basis for calculating pensions, conditional cash transfers (e.g., Bolsa Familia), and unconditional benefits for the elderly, the most disadvantaged, and people with disabilities.

⁷ The (new) Growth Acceleration Plan, relaunched by President Lula in 2023, amounts to some BRL 1.3 trillion (USD 242 bn). So far, some 23% of the planned projects have been delivered.



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