BRAZIL

LOOKING FOR BALANCE

Brazil's macro-financial portrait is one of striking contrasts: on the one hand, unemployment is at an all-time low, external accounts exhibit a notable resilience, and economic growth continues to outperform expectations as it draws on multiple levers ; On the other hand, the currency has continued to weaken, residents have increased their holdings abroad, and risk premiums have widened – as defiant markets call for additional measures to curb public spending. The Central Bank – bucking the global trend – has initiated a phase of monetary tightening in response to rising inflation. The latter has witnessed upward pressures on both the supply and demand side in recent months. Looking forward, the trade-off between fiscal consolidation and social support will be undoubtedly difficult for authorities, especially as growth is set to slow in 2025. Economic policy is indeed anticipated to be less supportive, and the projected softening of Chinese demand should affect Brazil through various channels. For the government, the results of the last municipal elections highlight the low political dividends associated with an overall favourable economic record.

ECONOMIC GROWTH: A MULTIPLICITY OF LEVERS

The Brazilian economy continues to defy expectations. Economic growth picked up speed in Q2 2024, rising by 1.4% q/q despite initial concerns of significant output losses due to flooding in southern parts of the country in April and May. Q1 growth prints were meanwhile revised upwards (1% q/q vs. 0.8% previously). Despite some signs of slowing down in both July and August, activity indicators available for the second half of the year have overall displayed positive tilts. Agricultural output is also anticipated to hold up better than initially expected. Although credit growth in real terms has been slowing since the summer, it still outpaces the rate of growth of the economy (+5.8% on average in Q3). Real GDP is expected to grow by just over 3% this year – in line with its annual average since the beginning of 2022, but well above potential growth estimates (1.5% to 2%).

The economy has benefitted from a diverse range of growth drivers over the past couple of years: industry in Q2, services in Q1 and agriculture in 2023 – when looking at the supply side of the economy; on the demand side, investment (including changes in inventories) drove growth in Q2 (vs private consumption in Q1) ; in 2023, external demand fueled the economy. The multiplicity of growth sources enhances the economy's resilience to sectoral fluctuations and to slowdowns in Brazil's main export markets (China, the United States, the EU, Argentina).

FORECASTS

	2021	2022	2023	2024e	2025e
Real GDP growth, %	5.1	3.1	2.9	3.1	2.0
Inflation, CPI, year average, %	8.3	9.3	4.6	4.4	4.2
Fiscal balance / GDP, %	-4.3	-4.6	-8.9	-7.2	-7.6
Gross public debt / GDP, %	77	72	74	79	81
Current account balance / GDP, %	-2.8	-2.9	-1.3	-2.2	-2.0
External debt / GDP, %	42	36	34	36	37
Forex reserves, USD bn	362	324	355	360	362
Forex reserves, in months of imports	14	11	12	11	12

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL : LABOR MARKET DYNAMICS

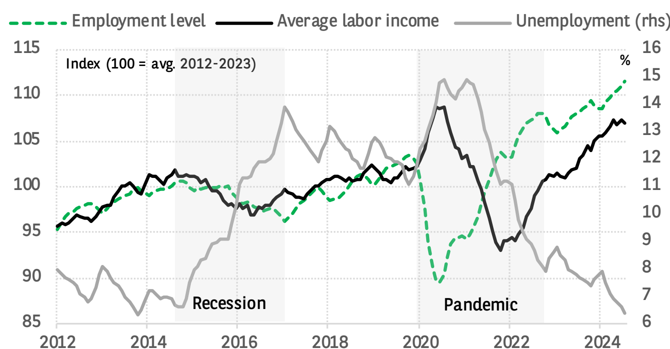

CHART 1 SOURCE: IBGE, BNP PARIBAS

MONETARY POLICY: GOING AGAINST THE GRAIN

In addition to the appointment of Gabriel Galipolo as the new Central Bank governor, set to take office on January 1st, 2025, September was primarily marked by the BCB's monetary policy U-turn. The authorities tightened policy – a first in two years – hiking rates twice by 25 bps and 50 bps, bringing the SELIC policy rate back up to 11.25%. This decision – which diverges from the global trend and contributes to keeping Brazilian monetary policy in restrictive territory[1] – followed the rise of inflation in recent months closer to the upper limit of the target (3% +/- 1.5 pp). Several determinants have contributed to the resurgence of inflation since April: i/ macro-financial pressures (record low unemployment, fiscal stimulus, currency depreciation, drift in inflation expectations), ii/ regulatory changes (increase in gasoline prices controlled by Petrobras) and iii/ climatic events (severe droughts in northern and central-western regions[2] impacted electricity production, while fires and floods in southern regions disrupted agricultural output and supply chains).

A positive output gap and tensions in the labour market continue to be important points of attention for the BCB (unemployment reached a historical low in September at 6.4% and strong labour demand is driving wage growth upward). In the absence of labour productivity gains, rising wages risk feeding into consumer prices through higher production costs. The rise of the US dollar, following the election of Donald Trump, is also a source of concern for authorities.

1 The *ex-ante* real rate (adjusted by 12-months inflation expectations) is close to 7.2%, above the BCB's neutral rate estimate of 4.75%.
2 The country's energy matrix relies on hydroelectric power for about 65% of its electricity generation. While a strength from an energy transition perspective, it can be a source of vulnerability from the perspective of inflation as dam reserves tend to be highly sensitive to droughts, with adverse consequences on electricity prices.

In its communications, the BCB has not provided clear guidance on the pace of monetary tightening it envisions. Initially, markets expected an aggressive tightening cycle, betting on nearly 275 basis points of cumulative rate hikes by May 2025. These expectations, however, have since been tempered.

PUBLIC ACCOUNTS: DEALING WITH DEFIANT MARKETS

The solid economic performance in the first half of the year alongside Moody's upgrade of Brazil's sovereign credit rating (now just one notch below investment grade) were insufficient to quell market concerns about fiscal risks. Local investors, who hold 90% of the government's debt stock, have shown increased unease with the debt trajectory which reached 78.5% of GDP in August – an increase of 7 percentage points since January 2023. Markets have also cast doubt over the government's ability to even achieve the targets it revised downwards last April: in 2025, the government will have to achieve a balanced primary balance (excluding interests) with a tolerance of 0.25 points of GDP, or, at worst, a deficit of around BRL 30 bn[3]. To meet this target, the government will need to freeze over BRL 15 bn in spending.

The growing worries of local investors has been reflected in tensions in the bond market. The Treasury has experienced more difficulties placing fixed-rate or inflation-linked bonds owing to the rising preference for floating-rate instruments. The share of debt instruments indexed to the SELIC rate has, as a result, increased rapidly, adversely affecting the composition of public debt – shortening maturities, and increasing the debt's sensitivity to interest rate fluctuations. The rise in the yields required to hold public debt (12.9% in November for 10-year bonds compared to 10.3% at the end of 2023), the weakening of the currency (-18.6% against the USD since January) and the accumulation of assets by residents abroad (USD 9.2 bn in the first nine months of the year compared to USD 4.5 bn for the whole of 2023) have underscored the prevailing pessimism amongst local investors.

To regain investor confidence and eventually lower debt costs (the effective interest rate on sovereign debt stood at 11% while interest expenses represented some 7% of GDP over 12 months in Q3), the government has announced it was negotiating new measures to lower spending. These announcements have come on the heels of municipal elections marked by the weakening of Lula's PT party and the concurrent strengthening of both the center-right bloc (the Centrão) as well as some right-wing groups – a sign of continued resilience of *Bolsonarismo* in the country. More strikingly, the election – which was seen as a sort of mid-term test for Lula – underscored the growing disconnect between economic performance and public opinion, mirroring trends observed in other countries.

2025 OUTLOOK: THE CHINESE UNCERTAINTY

In 2025, economic activity is expected to slow down. Domestic demand is likely to suffer from a less supportive policy mix (monetary tightening, reduction of fiscal support for households and businesses). Real GDP is projected to grow around 2%, with nearly one percentage point coming from the carryover effect from 2024.

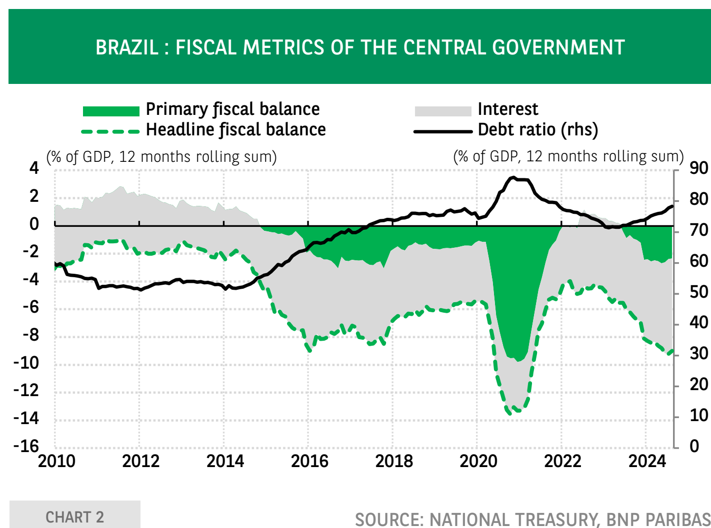

CHART 2 SOURCE: NATIONAL TREASURY, BNP PARIBAS

Uncertainties surrounding the strength of Chinese demand[4] pose a downside risk to growth due to close trade ties between the two countries[5]. Simulations using the NIGEM model suggest that a 1% reduction in Chinese demand (via a -3.3% shock on private consumption over two years) would typically lead to a 0.25% decline in Brazilian activity after one year, all else being equal. In addition to its impact on external trade and the stock market (with commodities playing a sizeable role in the Bovespa index), a slowdown in China would also affect domestic demand via the investment channel (lower sales/turnover of Brazilian companies due to falling commodity prices and reduced export volumes). A Chinese slowdown could also prompt Brazil to tighten its tariffs – as it did back in April, when the country doubled down on its steel import duties up to 25% to help insulate its industry from the influx of cheap Chinese steel (competition channel)[6].

The slowdown in foreign direct investment (FDI) flows from China to Brazil, on the other hand, appears less certain, given China's current industrial policy[7]. China is seeking to expand markets for its solar and wind energy producers as well as electric vehicle manufacturers; it is also trying to secure access to essential minerals for its EV battery supply chain. Despite Brazil's recent decision not to join the "Belt and Road Initiative", the country has expressed desire to continue collaborating with Chinese investors (a topic that will likely fuel discussions between Presidents Lula and Xi Jinping during the latter's official visit on November 20 in the wake of the G20 in Rio de Janeiro). Between 2020-2023, Brazil captured just over a third of Chinese direct investment flows to Latin America.

Salim Hammad
salim.hammad@bnpparibas.com

3 The initial target was a primary surplus of 0.5% of GDP.
4 Despite the support measures announced by the Chinese authorities since September, the economy is projected to slow down in 2025. In addition, Donald Trump's return to the United States presidency reinforces the scenario of a strengthening of American protectionist measures, with likely adverse effects on Chinese exports (in the worst-case scenario, an increase in customs duties to 60% for goods from China, compared to an average of nearly 20% in 2023).
5 China has been the country's main trading partner since 2009, absorbing between 25 and 30% of its exports, nearly three times more than the United States. The nature of the trading relationship, however, remains very unbalanced. Cf. *Brazil: current trade patterns with China threaten the promise of re-industrialization*.
6 China produces more than half of the world's steel. The real estate crisis in the country has reduced domestic demand for steel, creating overcapacity and lowering prices. These surpluses have become available on the international market but have been increasingly confronted with protectionist measures in the United States, Europe but also in many emerging markets (i.e. India, Vietnam, Thailand, Mexico, Brazil, Chile).
7 China sees, amongst others, a trio of industries as key to its future growth prospects: electric vehicles, lithium-ion batteries and solar panels.