BRAZIL

TARIFFS HEADWINDS, STRATEGIC TAILWINDS?

The tightening of US trade policy presents Brazil with numerous challenges and pressure points through its effect on economic growth, commodity prices, the need to defend its export market shares and heightened competitive pressure within its borders stemming from the rerouting of inexpensive goods. However, this new environment also presents Brazil with opportunities to reposition itself in the global trade landscape enabling it to take advantage of the reconfiguration of trade flows and global value chains. This shifting geography could also act as a catalyst to accelerate its trade integration (Mercosur, EU, Canada, Mexico). In the short term, however, the most pressing challenges will be domestic. Despite a highly restrictive monetary policy, signs of moderation in the economy have been slow to materialize. In addition, authorities are still grappling with closing the credibility gap of the new fiscal framework.

RESILIENT GROWTH, PERSISTENT INFLATION

The Brazilian macroeconomic picture presents a complex challenge for monetary authorities. Despite operating under significant constraints, economic activity has held up well; meanwhile inflation has been slow to converge to the target (+3%). Although inflation experienced a slight decline in May for the first time in four months – driven in part by easing food prices – its dynamics remain fuelled by robust demand. The labour market remains tight, credit growth has been slow to decelerate – notably due to the expansion of earmarked credit lines – and the economy continues to feel the effects of strong real wage growth (+4.8% y-o-y in 2024). These factors have helped support consumer spending – the main driver of activity in Q1 on the demand side – contributing to half the growth in real GDP over the quarter (1.4% q/q).

In the short term, although some factors should help dampen inflation (moderation of industrial activity constrained by the high-rate environment, global economic slowdown, easing of imported inflation amidst the strengthening of the *reais*), inflationary pressures could persist under the combined effect of demand and supply-side drivers. Some measures announced by the government are likely to support household disposable income: payment of *precatorios* (settlement of court-ordered payments owed by the government to individuals and companies), relaxation of withdrawal rules from the FGTS (a mandatory severance indemnity fund), expansion of the *Minha Casa Minha Vida* social housing programme, the new gas voucher programme (*Gas para Todos*) phased in January aiming to elevate coverage to 20 mn families (up from ~5.6 mn) and continued roll out of the new workers' credit programme (*Credito do Trabalhador*) launched in March. On the supply side, below-average rainfall levels and escalating tensions in the Middle East could drive up electricity and oil prices.

MONETARY AND FISCAL AUTHORITIES ON A TIGHTROPE

The strength of economic activity – and even more so the resilience of investment (+3.1% q/q in Q1) – are surprising in view of the broad base deterioration in confidence (see Chart 1) and the highly restrictive monetary policy pursued by the Central Bank of Brazil (BCB). The SELIC policy rate – now at 15% – has been raised by 450 basis points since August 2024, reaching levels both in nominal and real terms not seen in nearly 20 years. The BCB remains concerned about the persistent de-anchoring of inflation expectations, largely attributed to the credibility gap of the new fiscal framework (2023). This gap has proven difficult to mend (i) due to the absence of reforms targeting mandatory spending[1] and (ii) given the series of constraints currently facing the government (high real interest rates, prospects of slowing economic activity, political obstacles to increasing revenues[2]). The fiscal adjustment effort carried out by the central government (bringing the primary deficit – excluding interests – from 2.4% of GDP in January 2024 to 0.1% at the beginning of May 2025) has indeed been partly neutralised by a one percentage point of GDP increase in interest payments over the same period (to 6.9% of GDP over 12-months in May). To meet its target of achieving a zero primary deficit in 2025 (in alignment with the fiscal rule) the government may be forced – in the absence of new revenue-generating

FORECASTS

	2022	2023	2024e	2025e	2026e
Real GDP growth, %	3.1	3.2	3.6	2.4	1.3
Inflation, CPI, year average, %	9.3	4.6	4.4	5.5	4.8
Public sector fiscal balance / GDP, %	-4.6	-8.8	-8.5	-8.3	-7.5
Gross public debt / GDP, %	72	74	77	80	84
Current account balance / GDP, %	-2.9	-1.3	-2.5	-2.6	-2.4
External debt / GDP, %	36	34	36	37	34
Forex reserves, USD bn	324	355	329	334	352
Forex reserves, in months of imports	11	12	11	12	12

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

BRAZIL: CONFIDENCE INDICES

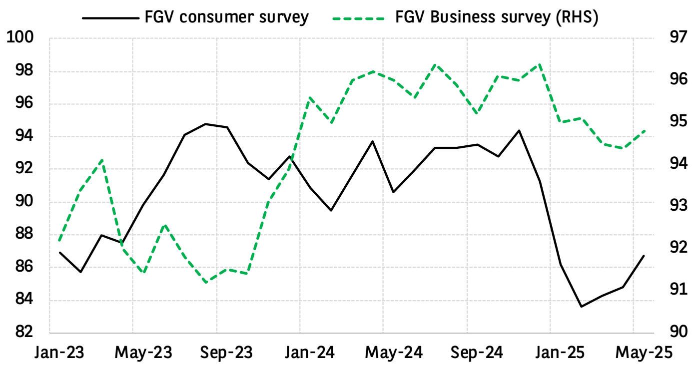

CHART 1 SOURCE: FGV

1 Including civil service salaries, pensions, social programs and constitutionally mandated minimums for health and education.
2 Illustrated by the Congressional opposition in June to the IOF decree destined to increase the tax on financial operations.

measures – to proceed to yet another budgetary freeze (after July and November 2024 and May 2025). To stabilize the public debt ratio, the authorities would need to generate a primary surplus of at least 2.4% of GDP, assuming real GDP growth of 2% and an implicit real interest rate close to 6.5%. In 2025, public debt is projected to exceed the 80% of GDP threshold.

A NEW TARIFF REGIME…

Brazil has not been in the crosshairs of the Trump administration's protectionist agenda despite (a) the structural imbalance in the effective tariff rates applied by the two countries on their respective goods (5.8% on US products versus 1.3% on Brazilian products[3]) and (b) the proportion of imports subject to non-tariff barriers in Brazil (86%) vs. the United States (77%). It is the United States' trade surplus (around USD 7 bn in 2024 according to Comtrade[4]) since 2009 that justified Brazil's inclusion on the list of countries subject to a minimum "reciprocal" tariff rate of 10% as of April 2nd. In addition to this baseline rate, specific duties on steel and aluminium – now taxed at 50% since early June – have been imposed. As a result, the average (weighted) effective tariff rate applied by the United States on Brazilian goods is now close to 9%, up from around 1.3% previously.

At this stage, no retaliatory measures have been announced by Brasilia in response to the US trade policy. The United States remains Brazil's 2nd largest foreign supplier (~15% of imports) and 3rd largest export market (capturing 12% of Brazilian exports in 2024) after China and the European Union. However, in early April, Brazil's Congress passed a reciprocity law, allowing the country to respond to trade barriers imposed by other countries, if needed.

… SOURCE OF RISKS…

This new tariff environment presents several risks for Brazil. First, its trade with the United States is likely to weaken. In addition to the short-term impact of a US economic slowdown, the tariff hike is projected to penalise the steel industry the most due to the high concentration of steel and aluminium exports to the US market (60% and 15% respectively of total Brazilian steel and aluminium exports in 2024). Brazil is the 2nd largest steel supplier to the United States after Canada.

However, three factors should help mitigate the slowdown in trade: (i) the exemption of crude oil from the new tariffs (oil was the largest US import from Brazil accounting for 14.3% of total exports to the United States in 2024), (ii) the lower price elasticity of high value-added products exported by Brazil (notably machinery and equipment as well as aerospace products) and (iii) a lower tariff rates applied to Brazil relative to China and possibly other Asian exporters (which could translate into relative competitiveness gains if the "reciprocal" tariffs announced on April 2nd, were introduced in July).

Brazil is also vulnerable to facing a growing influx of low-cost imports originating from China and other major Asian exporters. While this may have a salutary disinflationary effect it also risks intensifying competitive pressures in some sensitive industrial sectors, especially textiles and apparel, home appliances and steel.[5]

BRAZIL: ONE OF THE WINNERS OF THE FIRST SINO-AMERICAN TRADE WAR (2018-2020)

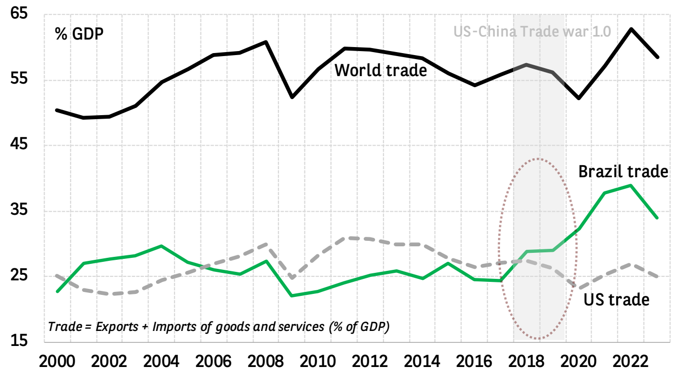

CHART 2

SOURCE: WORLD BANK

Due to various offsetting effects, the significant undervaluation of the Brazilian *reais* in real terms and the relatively limited weight of Brazilian exports to the United States (~2% of GDP compared to more than 25% of GDP in the case of Mexico), the direct impact of the US tariff shock on Brazilian economic activity is likely to be moderate. That said, indirect effects *via* the global slowdown, falling commodity prices and increased market uncertainty could exacerbate pressure on the *reais* and heighten volatility of capital flows. Finally, Brazil's strategic alignment with China could spur future tensions and become a source of geopolitical friction with Washington.

… AND OPPORTUNITIES

This new global trade order also presents opportunities for Brazil. Since April, shifting trade flows have benefited the country. China has already redirected part of its purchases of soybeans, meat, oil and, to a lesser extent, corn from the United States to Brazil. The latter now supplies over 70% of China's soybean imports, meeting strong demand from pig and poultry farmers; China also purchases more than 45% of Brazil's oil exports.

The US tariff shock is also expected to encourage Brazil and its regional partners to deepen integration into Mercosur and to accelerate the conclusion of the free trade agreement with the European Union. President Lula is also trying to advance negotiations with Mexico and Canada.

In the medium term, Brazil could benefit from the reconfiguration of global value chains, attracting firms seeking to relocate operations to access the US market at lower cost. Brazil boasts some key comparative advantages including direct access to strategic raw materials and a low-carbon energy mix. If this materializes, it could pave the way for technology transfers and support a gradual move up the value chain for Brazil's industrial base.

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3 According to the WITS database, end of 2022.
4 The trade surplus is much lower in the order of USD 250 mn according to Brazilian national data (MDIC).
5 As a reminder, in 2023, China, in the wake of its real estate crisis, directed record volumes of low-priced steel towards the rest of the world. In Brazil, this resulted in a drop in local production, job losses and factory closures – forcing the Brazilian government to introduce protectionist measures in April 2024, with similar actions taken by its neighbours Chile, Colombia and Argentina.