

BRAZIL

24

THE HIGH COST OF RESILIENCE

The Brazilian economy continues to withstand an ultra-restrictive monetary policy stance. In an election year, fiscal policy has become increasingly active to help cushion the impact of high interest rates and mitigate the effects of the oil shock on households' purchasing power. The resilience of economic activity comes at the cost of slower disinflation and a shift in the fiscal burden towards public banks. The policy mix — protective fiscal policy versus restrictive monetary policy — complicates the adjustments of prices, public finances, and inflation expectations amid more frequent supply shocks. The oil price shock has helped strengthen both external accounts and the reais. Over the medium term, it could strengthen Brazil's attractiveness as an energy supplier while accelerating the country's drive towards greater productive sovereignty.

ECONOMIC GROWTH: FISCAL SUPPORT MASKS POLITICAL DRAG

During the first half of 2026, Brazil's economy proved more resilient than expected, benefiting from the oil price shock and a rebound in private consumption. The latter was underpinned by a strong labour market, high real wages and targeted fiscal measures designed to shield households' purchasing power. In Q1 2026, GDP expanded by 1.1% compared to Q4 2025 and by 1.8% y/y. Activity remained resilient in Q2, albeit with signs of moderation. After reaching its highest level in more than a year in April, the Composite PMI slipped below the 50-point threshold in May before returning to expansion territory in June (50.7), confirming the resilience of the private sector while pointing to a gradual loss of momentum, with services remaining robust but manufacturing still subdued.

Looking ahead, exports and the oil sector should continue to underpin growth while a pre-election push to expand credit to industry, households and agriculture may provide an additional lift. Overall growth will remain constrained by inflationary pressures linked to the oil shock and the persistence of high real interest rates.

The ambivalence of the policy mix should continue to weigh on investment, compounded by a deteriorating business environment resulting from tensions between the executive and legislative branches and a series of political scandals (fallout from *Banco Master*; *Pleno*). In the race for the presidential nomination, President Lula retains a lead over Flavio Bolsonaro — although his advantage remains fragile. According to *Genial/Quaest* polls, public concerns over security, corruption and relations with the United States — notably Brazil's growing exposure to the Sino-American technological rivalry — are the main issues that could reshape the electoral campaign.

MONETARY POLICY: A CONSTRAINED EASING CYCLE

Since March, the Central Bank of Brazil (BCB) has embarked on a highly cautious easing cycle, lowering the Selic policy rate from 15% to 14.25% by mid-June. The BCB must contend with renewed inflationary pressures stemming from the oil price shock. After easing to 3.81% y/y in February, consumer price inflation (IPCA) reaccelerated to 4.72% in May, moving back above the upper bound of the central bank's inflation target (3% ± 1.5 pp). Food, fuel, housing and electricity prices have been the main drivers of the renewed inflationary pressures.

The partial easing in fuel price pressures following the reopening of the Strait of Hormuz in June is unlikely to prevent broader inflationary pressures from becoming more entrenched, as price increases are no longer confined to the energy sector. The underlying inflation indicators closely monitored by the BCB continue to rise at an annualised pace of around 5.5% for core measures and 5.6% for services inflation. Against this backdrop, the key risk is no longer a temporary overshooting of the inflation target, but rather inflation remaining above target for an extended pe-

Economic forecasts						
	2022	2023	2024	2025	2026e	2027e
Real GDP growth, %	3.1	3.2	3.6	2.3	2.3	1.4
Inflation, CPI, year average, %	9.3	4.6	4.4	5.0	4.7	5.1
Public sector fiscal balance / GDP, %	-4.6	-8.8	-8.5	-8.3	-8.8	-8.6
Gross public debt / GDP, %	72	74	77	79	82	86
Current account balance / GDP, %	-2.9	-1.2	-3.0	-2.9	-2.3	-2.5
External debt / GDP, %	35	33	33	35	36	33
Forex reserves, USD bn	324	355	329	358	365	362
Forex reserves, in months of imports	11	13	10	11	11	12

e: ESTIMATES & FORECASTS

SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TABLE 1

Lula widens lead over Flavio Bolsonaro

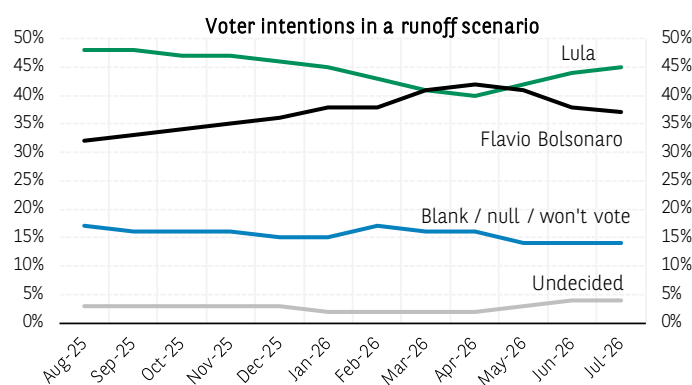


CHART 1

SOURCE: GENIAL/QUAEST SURVEY (JULY 2026), BLOOMBERG

riod, thereby limiting the scope for a more pronounced monetary easing cycle. Moreover, the El Niño weather phenomenon — by reducing harvests through droughts in the north and excessive rainfall in the south — is likely to exacerbate agricultural and food price inflation over 2026–27. At the same time, labour market conditions remain too tight to provide the BCB with reassurance. The unemployment rate fell to 5.8% in April, well below the 7–8% range generally regarded as non-inflationary. The BCB therefore faces an increasingly difficult policy trade-off: preventing inflation expectations from further de-anchoring by maintaining very high real interest rates, at the risk of exacerbating financial pressures on already fragile private-sector entities. Rising household delin-


BNP PARIBAS

The bank
for a changing
world

quencies and an increasing number of corporate restructurings illustrate the growing strain imposed by tight monetary conditions. In 2025, Brazil recorded 5,680 corporate judicial recovery filings, up 24.3% y/y.

EXTERNAL ACCOUNTS: THE OIL PRICE SHOCK BOLSTERS THE TRADE SURPLUS

During the first half of the year, the surge in oil prices, combined with record domestic hydrocarbon production and another strong agricultural harvest, provided a significant boost to exports. As a result, the trade surplus reached USD 32.7 bn by the end of May, up 34% y/y, and is projected to reach around USD 90 bn in 2026 (4% of GDP). This performance has been driven primarily by rising crude oil exports to Asia, particularly China and India, while food exports to the Gulf countries weakened owing to conflict-related logistical disruptions. Robust export performance is expected to narrow the current account deficit to 2.3% of GDP in 2026, from 2.9% in 2025. The deficit continues to be comfortably financed by strong foreign direct investment inflows (the country attracts around 5% of global flows – ranking 3rd in the world in 2025, behind the United States and China).

Stronger growth, resilient external accounts and elevated real interest rates continue to support carry trade inflows and underpin the *reais* (+6% against the USD dollar since the start of the year). However, fiscal slippage, a more accommodative stance towards inflation and rising political uncertainty ahead of the elections could undermine capital inflows and weaken the currency.

FISCAL POLICY: SUPPORT TODAY, FISCAL RISKS TOMORROW?

Overall, the energy shock has had a broadly neutral impact on the fiscal balance. Windfall revenues generated by higher oil prices (through higher dividends from Petrobras and temporary taxes on oil exports) have largely been offset by higher public spending and tax relief measures. To cushion the pass-through to domestic prices and protect household purchasing power, the authorities have temporarily subsidised diesel and LPG, while reducing or deferring selected fuel taxes. The government has also expanded targeted support for lower-income households.

The primary balance target of 0.25% of GDP (called for by the fiscal rule) remains technically achievable according to the Independent Fiscal Institute (IFI). But formal compliance relies on the exclusion of certain expenditure from the calculation of the primary balance. In addition, policy support is increasingly being channelled through off-budget instruments, subsidised lending and implicit guarantees. In order to ease the monetary squeeze on the private sector, the government is relying more heavily (i) on the development bank (BNDES) to support industry (*Nova Industria programme*, launched in 2024 experienced a recent injection of BRL 140 bn), (ii) on Banco do Brasil and Caixa to support distressed households, but also on otherwise creditworthy borrowers whose repayment capacity has been eroded by persistently high interest rates, particularly informal workers (*Nova Desenrola programme* and its recent extension *Desenrola Adimplentes*); (iii) The government has also expanded directed lending and other forms of subsidised credit to support agriculture (*Plano Safra 2026/27*). Since mid-2025, these quasi-fiscal measures have amounted to around BRL 275 bn (2.1% of GDP). While politically attractive, this approach risks shifting fiscal risks onto the balance sheets of public financial institutions.

With gross public debt standing at around 81% of GDP and projected to rise further in 2027, the required fiscal adjustment cannot rely indefinitely on windfall revenues. Persistently high real interest rates that remain above real GDP growth make debt stabilisation difficult without a structural improvement in the primary balance, even with extensive

Public debt ratio: an upward trend difficult to curb

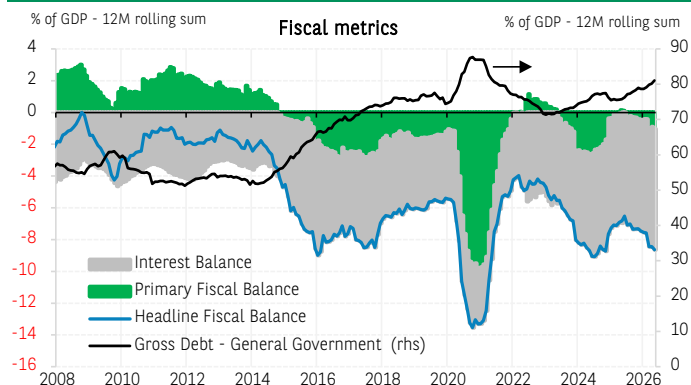


CHART 2

SOURCE: NATIONAL TREASURY, BNP PARIBAS

recourse to off-budget support measures. These developments point to a deterioration in sovereign risk which warrant close monitoring, given the already elevated interest burden (~7.6% of GDP) and the forthcoming electoral cycle — which could further delay monetary easing and push sovereign risk premia higher. In a context where global financial conditions could tighten, the government may face durably higher debt refinancing costs.

THE ENERGY SHOCK REINFORCES BRAZIL'S DRIVE TOWARDS PRODUCTIVE SOVEREIGNTY

As a net exporter of hydrocarbons with a largely decarbonised energy mix, Brazil has turned the disruption in the Strait of Hormuz into an opportunity rather than a constraint. Beyond the immediate cyclical gains for exports, public finances and the *reais*, the energy crisis has strengthened Brazil's strategic positioning as a reliable energy supplier — given its lesser exposure to geopolitical risks compared to Russia and Gulf producers. The key structural challenge now lies in transforming oil windfall revenues into productive investment. This transformation is essential to boost the country's growth potential, which remains hampered by low total factor productivity, limited trade openness and prohibitively high financing costs for local businesses.

The shock has nevertheless highlighted several structural vulnerabilities. Insufficient domestic refining capacity forces Brazil to import around 25% of its diesel requirements. Given diesel's critical role in agriculture as well as transport and logistics (about 60% of freight is carried by road) — this dependence leaves the economy vulnerable to price volatility¹ and transport disruptions (eg. truckers strike). The energy shock thereby underscored the need for additional investment in domestic refining capacity.

These energy-related vulnerabilities are compounded by Brazil's heavy reliance on imported fertilisers, which account for around 85% of domestic consumption, with the Middle East remaining a major supplier. Against this backdrop, the authorities have recently designated fertiliser production as a strategic priority under the *Nova Industria Brasil* (NIB) programme, illustrating how the energy shock has reinforced Brazil's drive towards greater productive sovereignty.

Article completed on 15 July 2026

Salim Hammad salim.hammad@bnpparibas.com

¹ By contrast, gasoline prices are regulated in Brazil and adjusted on an ad hoc basis by Petrobras, which controls around 70% of domestic oil production.


BNP PARIBAS

The bank
for a changing
world