BRAZIL

TWO SIDES TO EVERY COIN

The economy ended 2024 in a state of overheating (reacceleration of inflation, tensions in the labour market) – a situation fueled, in large part, by the prolonged extension of public support measures. Throughout the year, the fiscal trajectory has steadily undermined market confidence – eventually culminating in significant capital outflows in December. The resulting pressures on equities, interest rates and the exchange rate, prompted the Central Bank to take defensive measures to stabilize the BRL. In 2025, a gradual slowdown in economic activity appears inevitable, as domestic demand will be constrained by fiscal adjustment measures, tighter credit conditions, persistent inflation and a deteriorating business climate. Trade and geopolitical tensions add further risks to the outlook despite Brazil's relative resilience to increased American protectionism.

2024: A CROSS-SECTIONAL VIEW

Brazil ended 2024 with macroeconomic and financial indicators moving in a direction diametrically opposed to what most observers anticipated at the start of the year: economic activity and employment strengthened, inflation picked up again while monetary policy tightened. Moreover, the BRL hit a historic low after falling by 22% over the year, while the stock market fell by 30% in dollar terms (compared to -11% in local currency and gains of 7.5% for the MSCI Emerging Markets Index). 10-year government bond yields rose from 10.3% at the start of 2024 to 15.1% at the end of the year while the cost of insurance against a 5-year sovereign default (CDS) rose by nearly 75 basis points over the year. Despite an overall positive record in terms of growth and employment, President Luiz Inacio da Silva "Lula" has seen his popularity decline just over halfway through his term.

The erosion in market confidence throughout the year was largely driven by i/ the expansionary stance of fiscal policy, and ii/ resistance in Congress to supporting reforms raising tax revenues. The fiscal impulse[1] (although less pronounced than in 2023) contributed to the reacceleration of inflation[2] in the second half of 2024 – both directly, by keeping actual output above its potential level (resulting in a positive output gap), and indirectly, through currency depreciation. The downward revision of fiscal targets in April 2024, insufficient cost-cutting plans[3] and a headline budget deficit nearing 9% of GDP (including 7.2% of GDP in interest expenses for the central government) caused significant tensions across local financial markets. In December, these pressures culminated into a full-fledged confidence crisis in the BRL and other asset classes, which were further exacerbated by rising political risks (President Lula's surgeries to address intracranial hemorrhage; debate over his succession within the Workers' Party ahead of the next general election). Net capital outflows reached nearly USD 29 bn in December, marking a peak since 1982. For the entire year, net outflows totalled USD 18 bn – the third largest episode since September 2008. To stabilize the BRL, monetary authorities injected a little more than USD 30 bn by intervening in the FX market – however with ultimately very limited impact overall.

Will Brazil beat expectations again in 2025? Will the tug-of-war with the markets continue? What will be the implications of Trump's return to the US presidency for Brazil?

INFLATION AND MONETARY POLICY: GOING AGAINST THE GRAIN

In contrast to several emerging and advanced economies, financial conditions in Brazil are expected to tighten further in 2025.

FORECASTS

	2022	2023	2024e	2025e	2026e
Real GDP growth, %	3.1	3.2	3.6	2.1	1.0
Inflation, CPI, year average, %	9.3	4.6	4.4	5.3	4.8
Fiscal balance / GDP, %	-4.6	-8.9	-8.4	-8.7	-8.9
Gross public debt / GDP, %	72	74	79	82	84
Current account balance / GDP, %	-2.9	-1.3	-2.5	-2.0	-1.6
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: BCB FX INTERVENTIONS

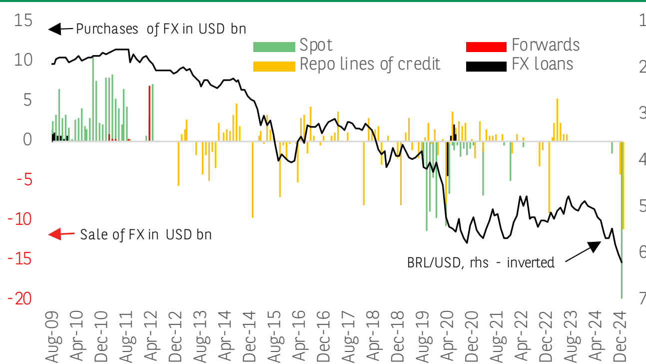

CHART 1 SOURCE: BCB, BNP PARIBAS

Inflationary pressures are likely to persist at levels above the target set by the Central Bank (BCB) under the combined effect of : i/ downward price rigidity in services ii/ a still tight labour market and iii/ continued weakness of the BRL[4] (assuming a slow convergence of inflation expectations towards the target and a strengthening dollar, as U.S. trade and fiscal policies will likely support longer-term yields, attract capital and cause the dollar to rise).

1 Year-on-year change in the primary structural balance (excluding cyclical effects and interest expenses).
2 Inflation ended 2024 at 4.8% year-on-year – above the ceiling of the 3% target +/- 1.5 percentage points. This is the 8th time since the introduction of inflation targeting in 1999 that the monetary authorities have failed to achieve the target. According to the BCB, the inflation surplus in 2024 is due to i/ imported inflation (+0.7pp), ii/ the effect of past inflation on current prices (inertia in contracts, +0.5pp), iii/ the persistence of a positive output gap (+0.5 pp) and inflation expectations (+0.3 pp).
3 The latest one, presented in November, revealed a reduction in spending amounting to about USD 12 bn over the next two years, by limiting, among other things, the increase in the minimum wage and certain social benefits, as well as the repeal of certain privileges for the military. The joint presentation of an income tax reform (aimed at reducing taxes for the middle class) was much less well received, in particular because of its pro-cyclical nature.
4 A study published by the BCB in the Q2 2024 inflation report estimates that, all other things being equal, a permanent 10% rise in the exchange rate adds almost one percentage point to headline inflation.

Since September, authorities have raised the key interest rate (SELIC) by 275 basis points, bringing it to 13.25% by the end of January. The SELIC could peak at 14.75% by May 2025, its highest level since 2006.[5] The real interest rate could hover around 10%, a 20-year high and nearly double the neutral rate, signalling a very restrictive monetary policy. Such a high real interest-rate environment is expected to encourage carry trade strategies but will weigh on household consumption and investment.

FISCAL POLICY: IN A BIND

Since Lula took office, fiscal policy has helped boost growth and reduce poverty. But it has come at the expense of increased public debt vulnerabilities (78% of GDP for the general government at the end of 2024). The authorities now have limited leeway : i/ the rise in interest rates will amplify fiscal imbalances (increase in the debt burden, slowdown in activity and therefore in tax revenues); ii/ the very rigid spending structure (several outlays are protected by the Constitution) and a fragmented Congress make adjustments difficult; in addition, iii/ the fiscal control mechanism voted in 2023 has lost credibility; and iv / the authorities' ability to react to demand or supply shocks (e.g climate events) without raising market concerns has been curtailed.

To restore market confidence and meet primary deficit targets (i.e. excluding interests), a new spending reduction plan is a necessary step. However, to improve the medium-term fiscal outlook, a deep reform of the rules governing mandatory spending is required (new pension reform, unlinking social and pensions from the minimum wage, eliminating spending floors for health and education). Most of these measures conflict with President Lula's economic agenda. Despite the potential political costs, the most likely outcome, nonetheless, seems to be a credible recalibration of spending. Breaking free from the markets could potentially prove more expensive by doubling the macroeconomic effects (acceleration of inflation) with increased instability in the prices of financial assets (stress on the BRL, surge in the cost of debt).

ACTIVITY: MODERATION IN SIGHT

Given the highly restrictive interest rate environment, fiscal policy constraints, and uncertainties surrounding external demand, our central scenario projects real GDP growth of 2.1% in 2025. The statistical carryover from 2024, combined with favourable prospects in the agricultural sector should help keep growth slightly above 2%. Growth is expected to return to its potential, which should help gradually ease pressures on wages and employment.[6]

This scenario assumes a more marked slowdown in activity in the second half of 2025, although some indicators already show early signs of deceleration (slower job creation, credit deceleration, and declining confidence). This forecast includes several upside risks, particularly if authorities resort to extra-budgetary measures to stimulate activity, as seen in the past (e.g., interference in state-owned enterprises' investment policies or boosting public banks' lending activity).

BRAZIL : ECONOMIC ACTIVITY HAS HELD UP MUCH BETTER THAN EXPECTED

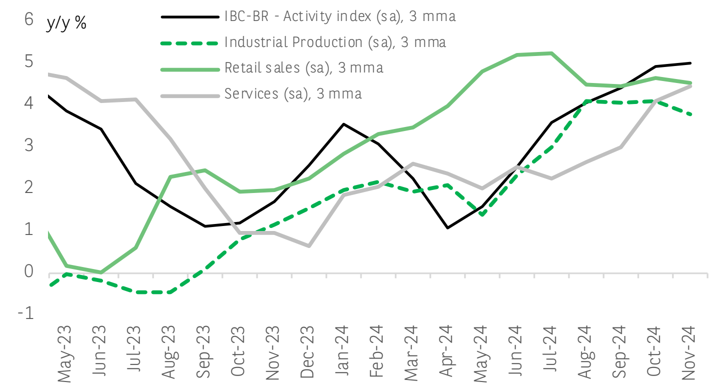

CHART 2 SOURCE: IBGE, BCB, BNP PARIBAS

Additionally, the weak BRL and softer commodity prices could provide stronger-than-expected support to export volumes. Conversely, climate-related shocks affecting agricultural production and energy costs pose downside risks to the central projection.

BRAZIL AND US PROTECTIONISM

Brazil seems less vulnerable to the protectionist threats posed by the new U.S. president than other emerging economies (e.g., Mexico). Firstly, Brazil is not heavily integrated into global value chains and is one of the most closed economies in the world.[7] Secondly, the U.S. does not have a trade deficit with Brazil. Finally, Brazil exports three times more to China than to the U.S. However, the U.S. remains a major economic partner: it accounts for 10% of Brazil's exports (USD 75 bn in 2023) and is the primary destination for Brazilian manufactured goods. The U.S. is also Brazil's third-largest supplier of goods and the leading source of foreign direct investment (FDI).

Simulations using the WTO's GTM model suggest that certain Brazilian sectors would be particularly vulnerable to the imposition of 20% tariffs by the U.S. (oil, metals, and transportation equipment). Beyond the trade channel, the impact of U.S. policy on the dollar and global interest rates could affect Brazil's growth and monetary policy. Finally, the closer ties between President Lula's government and China (with both countries signing 37 new strategic cooperation agreements following the G20 summit in late November), historical tensions between the Brazilian judiciary and Elon Musk, and Lula's desire to move away from the dollar could increasingly put Brazil in Washington's crosshairs.

Salim Hammad
salim.hammad@bnpparibas.com

5 At its December meeting, the BCB reintroduced its forward guidance policy announcing 100 bps hikes at its January and March meetings.
6 As a reminder, the level of unemployment is estimated to be between 2 and 3 points below the level considered non-inflationary (NAIRU: ~8.5% and 9.5%). In Q4 2024, wages were growing by close to 5% in real terms.
7 Imports + exports accounted for only 34% of GDP in 2023 compared to 95% on average worldwide. The sensitivity of GDP to exports is therefore lower.