SOVEREIGN DEBT: WHEN SHORT-TERM SHOCKS AND SHIFTS IN DEBT STRUCTURE LEAVE A LASTING FISCAL BURDEN — THE CASE OF BRAZIL

Salim Hammad

Brazil's recent post-election yield shock risks leaving a lasting imprint on public finances — compounded by already high interest rates and a changing debt structure. Large refinancing needs and a rising share of floating-rate debt will transmit rapidly and significantly higher interest rates to the debt service through distinct but reinforcing channels.

Brazil's presidential elections triggered a sharp repricing of Brazil's rate outlook

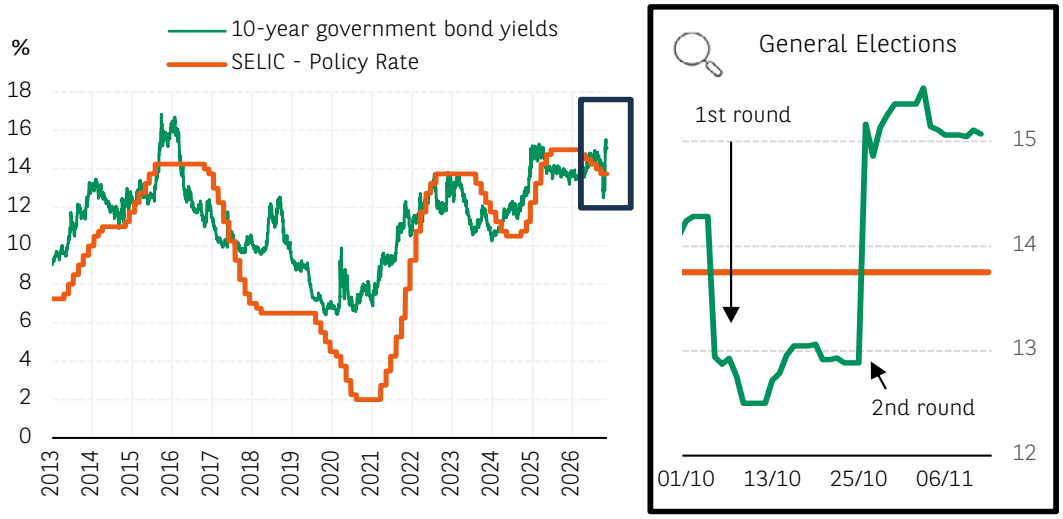


CHART 1

SOURCES : MACROBOND, BCB

An abrupt post-election market awakening

In the wake of the 2nd round of the general elections in late October, Brazilian markets — which had expected a Flavio Bolsonaro victory — sold off sharply after Luiz Inacio Lula da Silva won a fourth presidential term. Both the equity and FX markets experienced large intraday drops (14% of the Ibovespa stock index and -11% BRL *vs.* USD). Meanwhile, the yield on Brazil's 10-year government bond rose 250 basis points to 15.5%, reaching its highest level in over a decade (*Chart 1*) as investors worried about the fiscal impact of costly campaign promises amidst large and persistent fiscal imbalances.

Fiscal risks have reshaped Brazil's public debt structure, magnifying the cost of persistently high interest rates

Absent a confidence-infusing fiscal adjustment, Brazil's interest bill is unlikely to decline in the short term, maintaining upward pressure on public debt (83% of GDP in October 2026) and limiting budgetary leeway.

Three transmission channels, amplified by changing features of the debt structure, explain this persistence.

The first channel: The rise in long-term yields will increase rollover costs.

The sovereign must refinance roughly 20% of its debt stock each year. An average maturity of 4.1 years spreads refinancing over time but does not shield the interest bill from a sustained rise in borrowing costs. As maturing securities are replaced, higher issuance rates progressively lift the average borrowing cost — even for fixed-rate debt, whose interest costs remain unchanged until refinancing. A sustained yield shock therefore feeds into debt servicing as the stock rolls over.

A larger share of floating rate debt transmit higher selic rates to the debt stock

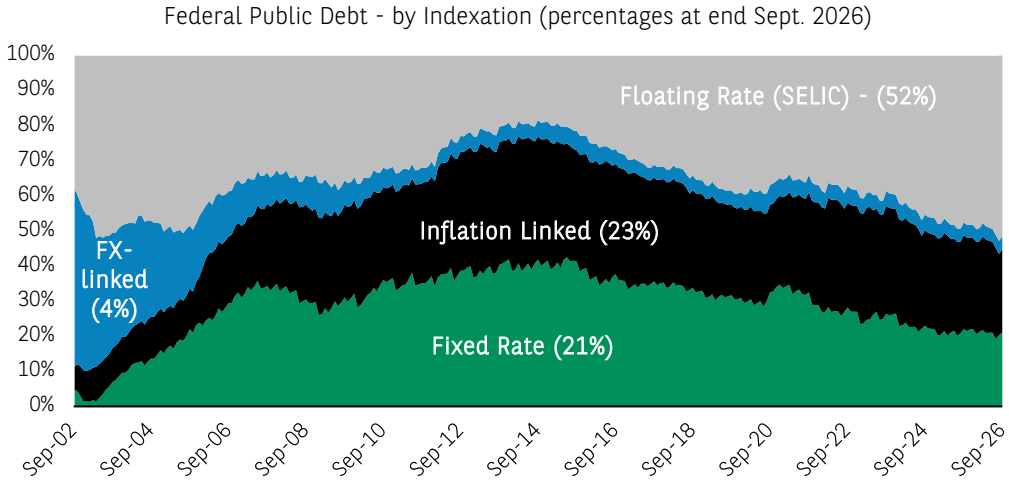


CHART 2

SOURCES : NATIONAL TREASURY, BNP PARIBAS

The second channel: Demand for floating-rate instruments will strengthen until confidence in fiscal policy improves.

In turn, a larger share of SELIC-linked debt heightens the debt stock's sensitivity to the prevailing high policy rate. Already SELIC-linked securities reached a record 52.6% of the debt stock in August 2026, around 12 percentage points above their share at the start of President Lula's last term, versus a low of 18.4% in September 2014 (*Chart 2*). Weaker demand for fixed-rate securities with maturities exceeding five years, amid increased fiscal uncertainty, has encouraged this shift[1].

The third channel: The BCB may delay rate cuts until fiscal policy over the next mandate is better defined.

A slower easing cycle would prolong high interest costs on SELIC-linked debt, whose servicing costs adjust with the policy rate without waiting for refinancing. With these securities accounting for a growing share of the debt stock, delayed monetary easing would postpone relief for the Treasury's interest bill — even if long-term market yields subsequently ease.

These channels operate at different speeds: a rise in long-term yields increases rollover costs, whereas floating-rate debt reprices with the SELIC rate, not automatically with 10-year yields. Meanwhile, a slower monetary easing cycle and stronger demand for floating-rate securities compound pressure on the interest bill.

The fiscal–monetary policy nexus is therefore likely to remain a source of strain on Brazil's public finances: fiscal uncertainty could delay monetary easing, while greater floating-rate exposure would prolong the burden of high policy rates on the interest bill.

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1 Fiscal slippage and uncertainty make investors less willing to lock in nominal returns over long horizons: if inflation or market yields rise, the purchasing power of fixed payments declines or the bonds' market value falls. Investors therefore demand higher yields to bear this risk, making long-term fixed-rate funding more expensive for the Treasury. By issuing floating-rate bonds instead, the Treasury offers returns that adjust with the SELIC rate, sustaining demand, securing financing and reducing the risk of failed auctions. However longer floating-rate maturities may reduce rollover risk, but do not remove the repricing exposure. Floating-rate issuance helps secure financing but transfers interest-rate risk to the Treasury.

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Published by BNP PARIBAS Economic Research
Head office: 16 boulevard des Italiens – 75009 Paris France
www.group.bnpparibas – www.economic-research.bnpparibas.com
Head of publication: Jean Lemierre / Chief editor: Isabelle Mateos y Lago
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