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#Brazil / #Fiscal Policy / #Monetary Policy

Brazil’s fiscal and monetary policies remain at odds

Price pressures and market scepticism regarding fiscal policy will keep the Banco Central do Brasil on a tightening path over H1. The budgetary outlook will be a key determinant of the timing and extent of rate cuts thereafter. But an eventual decline in inflation and rate expectations should provide relief for assets.

Key Takeaways

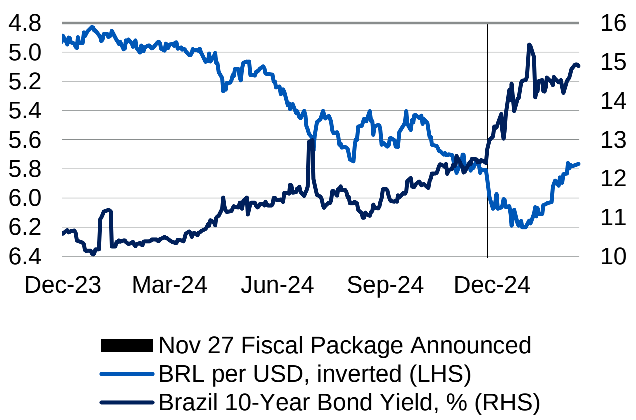
- After the Banco Central do Brasil (BCB) delivers its signalled 100bps hike to 14.25% in March, the Selic rate will likely peak at 15% by May or June unless inflation and growth show signs of cooling sustainably.
- We expect a cautious cycle of rate cuts towards 12% over 2026, with the timing and extent of monetary easing being determined by markets’ sentiment regarding the fiscal path.
- Political considerations ahead of general elections in October 2026 – when President Luiz Inácio Lula da Silva is currently slated to seek re-election – and a large bill of mandatory expenditures raise the prospect of future fiscal slippages.
- Concerns that fiscal policy is offsetting monetary tightening could therefore push the Selic rate higher and risk it being kept there for longer.
- A large and rising share of public debt being linked to the Selic rate and inflation will maintain upward pressure on the debt burden over the medium term.
- Still, the lagged effects of the BCB’s tightening should eventually lower inflation and rate expectations. Outside of election uncertainty, this can facilitate a decline in yields and relief for Brazilian assets.

Brazilian assets started 2025 on a better, albeit fragile, footing

Strong gains have been made in the year to date, but Brazilian assets remain in a fragile position after worsening sentiment regarding the country’s fiscal outlook shocked FX and bond markets in 2024.

Despite a return to monetary tightening by the Banco Central do Brasil (BCB) since September, budgetary announcements in November amplified investors’ concerns and led to further selloffs through to the end of the year.

Figure 1: 2024 was a rough year for Brazilian assets amid fiscal concerns



Source: Haver, abrdn, February 2025

In January, Congress’ break and a further 100bps hike by the BCB offered some reprieve for the *real*, which subsequently appreciated by over 7% back to its exchange rate preceding the November fiscal package announcement (see Figure 1). Equities are also up by over 3% year to date.

However, yields have proven stickier, averaging 14.6% amid continued fiscal concerns.

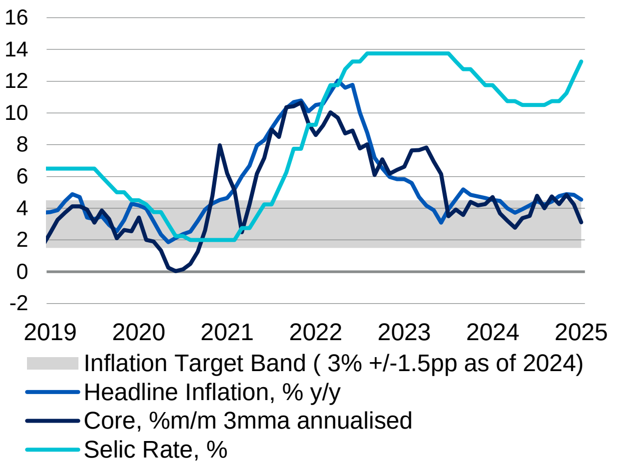
Scope for further improvements in investor sentiment is conditional on the finalised 2025 budget, which is due by March, being sufficiently convincing in its target for a balanced primary budget, alongside evidence of inflation cooling. Trade tensions with the US remain a wild card, but we judge are of secondary importance to domestic dynamics.

BCB will keep monetary policy tight over 2025, but perhaps not as tight as markets expect

A second consecutive 100bps hike by the BCB in January brought the Selic rate to 13.25%, up from 10.50% before the return to hikes in September (see Figure 2). The central bank reiterated its intention to raise rates by a further 100bps in March and added that decisions beyond then would be determined by how inflation progresses.

Our core expectation is that the Selic rate will peak at 15% in May or June and will be held there until the end of the year. We anticipate that headline inflation will largely fluctuate in a 4.5-5% band over H1, maintaining the backdrop that motivated the current hawkish stance.

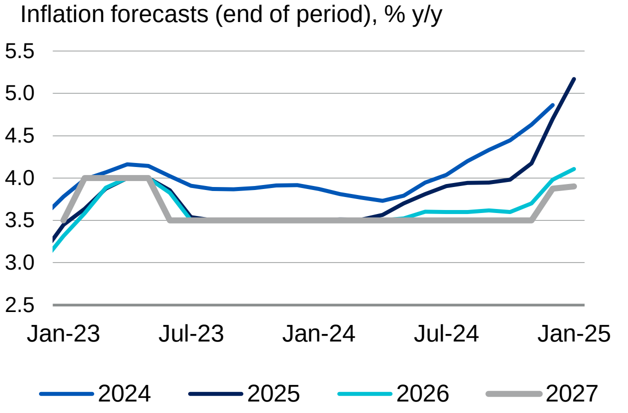
Figure 2: Selic rate to peak around 15% by mid-2025 and held through to year-end



Source: Haver, abrdn, February 2025

We continue to think it is unlikely that the Selic rate will reach 16% as markets are pricing in for Q3/Q4. But there is a risk that the BCB feels boxed in by market expectations, especially if inflationary and budgetary concerns renew bond and FX volatility. Concerns that fiscal policy is offsetting monetary tightening could push the Selic rate higher and risk it being kept there for longer.

Figure 3: Inflation expectations are a key constraint on the BCB's ability to ease



Source: BCB survey of private sector expectations, Haver, abrdn, February 2025

Key thresholds for a return to gradual easing include a meaningful improvement in market's fiscal confidence, a sustained softening of economic activity, or a sufficient loosening of historically tight labour market conditions – all of which would help lower yields, inflation expectations (see Figure 3), and the market-implied rate path.

We forecast inflation of 4.3% by the end of 2025, implying a real ex-post policy rate of 10.5%, slightly above Bloomberg consensus, reflecting our view that inflation and growth will moderate modestly over H2 (see Figure 4). Raising the real policy rate to close to its post-pandemic peak should rein in demand and give the BCB scope to begin a cautious cutting cycle early next year towards 12% by the end of 2026.

Figure 4: Major tightening of financial conditions expected to temper growth and inflation by year-end

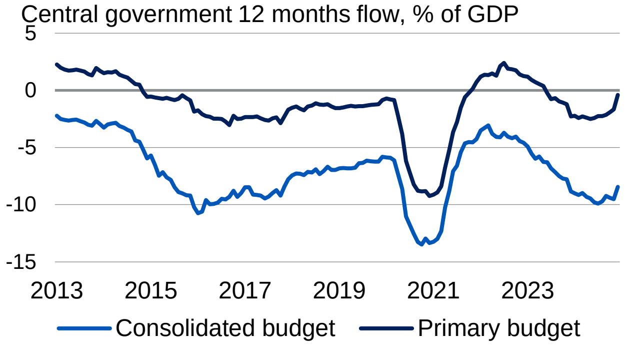
Source: Haver, abrdn, February 2025

Sentiment remains wary after the November fiscal package did little to address market concerns

The 2025 budget bill is widely expected to aim for fiscal consolidation based on optimistic revenue-raising targets rather than major spending reductions.

The November fiscal package, which was in part an attempt to address market pressure ahead of the 2025 budget's approval, included further planned savings of BRL70bn (0.6% of 2023 GDP) through to 2026. Notable proposals included caps on both growth of the minimum wage and higher public sector "super-salaries".

Figure 5: Primary deficits likely to persist until elections, while interest payments stay elevated



Source: Haver, abrdn, February 2025

These savings were intended to show the government's willingness to sustainably narrow Brazil's fiscal deficit (see Figure 5), following a move to notably more expansionary fiscal policy over the prior two years. The federal primary deficit officially shrank from -2.5% in May to -0.4% of GDP at the end of 2024, though the accounting of some 2023 revenues in 2024 flatters the improvement.

The plan was however overshadowed by Lula's plan to broaden income tax exemptions from 2026 (effectively making 75% of workers exempt, versus a current 30% according to UBS). Finance Minister Fernando Haddad stated that the move would be fiscally neutral, financed by tax increases for higher earners. But critics have labelled it as a tailwind for consumption when investors are already concerned about economic overheating.

Scope for fiscal consolidation limited by re-election concerns and mandatory spending

Legislators in Congress will look to finalise the 2025 budget bill by mid-March. Haddad and other members of government have alluded to the potential for further spending and tax changes to narrow the deficit. But the political will for major spending cuts is likely to be low.

This follows the rightward shift seen in October's municipal elections. Left-wing parties, including Lula's Worker's Party (PT), underperformed in Brazil's 26 state capitals. Meanwhile, centre-right and right-wing parties saw notable gains or consolidated regional dominance.

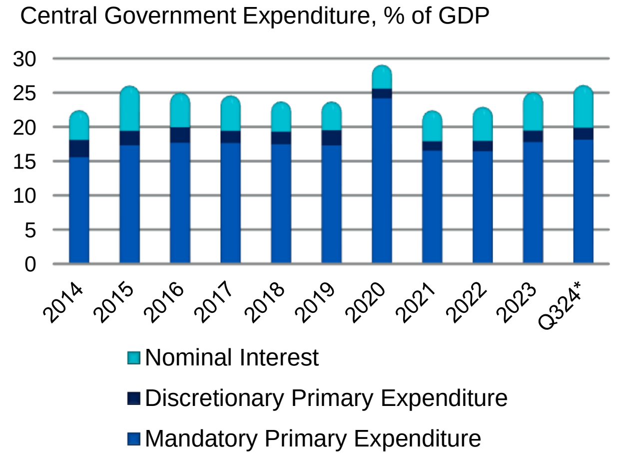
Mounting economic headwinds for the electorate – particularly rising food prices (+7.2% year over year in January), and higher interest rates – risk further weighing on already declining support for Lula and his government.

This backdrop will thereby deter Lula from sharply reining in popular expenditures. Meanwhile, an already large tax burden (33.3% of GDP in 2022) leaves few options for raising additional revenues without pushback.

Moreover, a large bill of constitutionally mandated spending further limits room for manoeuvre (see Figure 6). Of total central government primary spending, the share of mandatory expenses (related to areas including pensions and a range of social programs) has exceeded 90% of total spending since 2020, reaching an equivalent of 18.1% of GDP in the year to Q3 2024.

Discretionary primary expenditure, at an already low 1.7%, has little room for meaningful adjustment, while interest payments are at their highest since 2015 (6.3%), amid elevated interest rates.

Figure 6: Large share of mandatory expenditure leaves government with little room for 'easy' reductions



* Q324 figure is for year-to-date. Source: Haver, abrdn, February 2025.

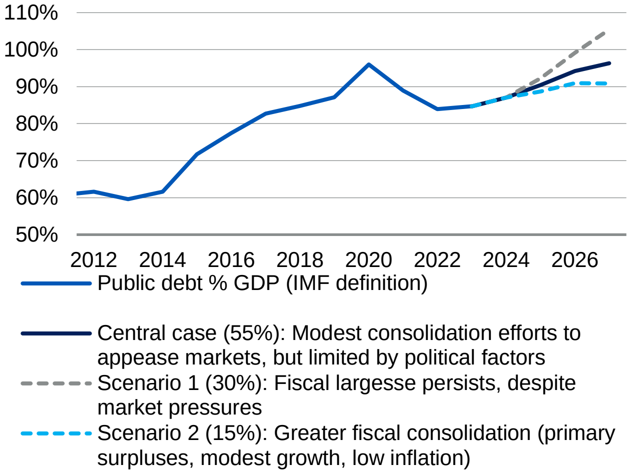
Brazilian debt is especially sensitive to tight monetary policy

The interplay between monetary and fiscal policy is key given the large stock of Brazilian debt tied to both the policy rate and the inflation rate.

Our central case (55% probability) assumes only modest budgetary tightening in the near term. Political considerations will see cuts centred on discretionary and perhaps a small number of less contentious mandatory expenses over 2025. A more neutral impulse from fiscal policy, combined with the tightening of monetary policy, suggests there could be a window whereby a cooling economy takes pressure off government interest rate expenses.

As we approach the late-2026 general elections the ability to cut spending will however become increasingly constrained by political-economy dynamics, and fiscal policy risks moving from a broadly neutral position to a slightly expansionary one. This scenario could still see a recovery in yields, even if the debt-to-GDP ratio remains on an upward trend. Indeed, we expect debt to hit 97% by 2027 (see Figure 7), owing to overall limited political will for a more substantive reining in of the consolidated deficit.

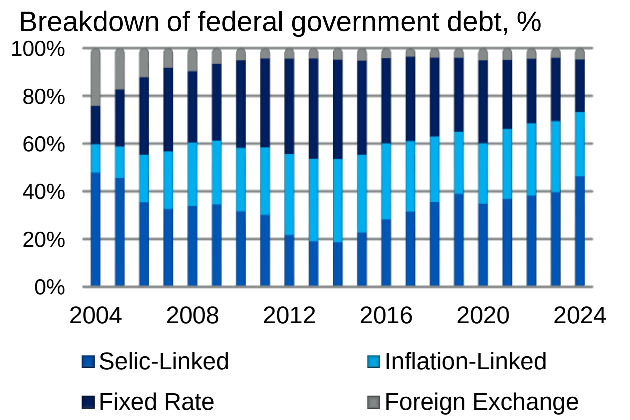
Figure 7: Brazilian debt set to remain elevated over the near term



Source: Haver, IMF, abrdn, February 2025

Brazil's debt composition makes reducing it especially difficult. As of December, the share of government debt with a floating interest rate tied to the Selic rate was 46.3%, the highest since 2005 (see Figure 8). The National Treasury's 2025 borrowing plan projects this share rising to 48-52%, which, alongside a high Selic rate and sticky inflation, will keep upward pressure on total debt through to 2027.

Figure 8: Brazil's share of debt tied to the policy rate is at a near two decade high, with a rising overall stock



Source: Haver, abrdn, February 2025

Still, we expect the lagged effects of the BCB's tightening cycle to drive an eventual easing of inflation, especially during 2026, that should reduce expectations for both inflation and the Selic rate's trajectory next year versus current pricing. In turn, a more significant decline for Brazilian yields, despite rising debt and lingering concerns for post-election fiscal policy, should allow for the BCB to lower rates, providing relief for assets. Possible perceptions of the BCB having 'overtightened', given the historically high real policy rate, could also see a faster turnaround in yields and inflation expectations.

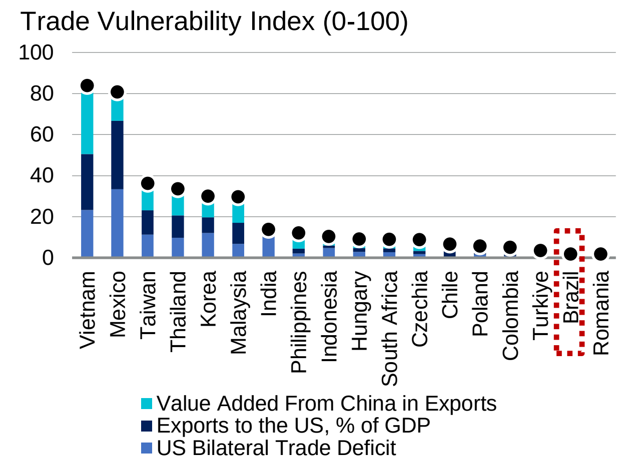
However, we outline two alternative scenarios. The first one (30%) reflects the potential for market pressures to prove insufficient in motivating Lula's government to rein in spending, which could risk a more antagonistic response to FX and bond volatility.

Here, the primary deficit widens once again, as non-interest expenditure rises (averaging 40.6% of GDP over 2025-2027). Demand-side price pressures, elevated yields and currency depreciation force the BCB to be even more hawkish than in our base case. A modest negative feedback loop develops where pressures on households from higher rates leads to even more accommodative fiscal policy.

The composition of the debt stock would still provide some cap on potential borrowing via market pressure, though less than in our base case. The consolidated deficit could remain around the 10% range, pushing total debt towards 108% by 2027.

The second scenario (15%) sees debt beginning to stabilise in 2026 around the 90% mark. Though unlikely given the need for politically challenging reforms, a major shift regarding mandatory spending, perhaps combined with an unexpected fall in inflation, could trigger a marked improvement for Brazilian yields and the *real*. This would allow the BCB to lower the Selic more significantly than in our base case, easing debt servicing costs and also reducing the cost of fiscal consolidation.

Figure 9: Trade tensions are currently of less concern for Brazil than fiscal dynamics



Source: Haver, IMF, OECD, abrdn, February 2025

Finally, there are factors working in Brazil's favour. A lower dependence on exporting to the US than other major EMs makes its economy more insulated from the impacts of potential trade restrictions (see Figure 9). Should reform momentum and market sentiment materially improve, the prior underperformance of the *real* and equities compared to that of other EMs could reverse.

Author

Tettey Addy

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