# Brazil fiscal: no easy fix

- **The negative market reaction to the re-election of Luis Inacio Lula da Silva (Lula) has been primarily a reflection of the market's assessment of how the incumbent president would handle Brazil's unravelling debt dynamics during his next term.**
- **We believe Lula's plan for a gradual fiscal adjustment is realistically achievable, albeit still relatively optimistic.**
- **Using this scenario, we forecast USD/BRL at 5.45 by the end of 2027. Should the fiscal proposals required to achieve these targets gain traction in Q227, that would create an opening for modest rate cuts to the Selic rate from then on with the terminal rate at 12.50% by the end of 2027.**
- **The risks to our forecasts are to the downside, if the fiscal efforts are deemed insufficient by the market or delayed.**



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In an unprecedented development, the incumbent president Luis Inacio Lula da Silva was re-elected as the president of Brazil. Lula made history as no previous presidential candidate achieved victory after coming in second in the first round. The polls were predicting a narrow victory for Flavio Bolsonaro, albeit with a lead that was within the margin of the expected polling error.

For our part, while surely not seeing through a crystal ball, we had warned that Bolsonaro's victory was not a forgone conclusion, after winning the first round, given that the number of valid votes that separated Bolsonaro and Lula was a lot smaller than the legions of eligible voters who did not show up to the first round (see EM Focus "Watch out the slip between the cup and the lip".)

Lula ultimately won with 51.76% against Bolsonaro with 48.24%, a 4.4m advantage, Lula spared no expense after losing to Bolsonaro by 2.2m votes in the first round. He was able to push through a milestone reform shortening the work week (see EM Pulse October 21 Brazil: the consequences of a shorter work week), accelerated increased Bolsa Familia payments for those to be received just a few days before the run-off and promised support for small businesses.

Investors were overwhelmingly positioned for Bolsonaro's win heading into the election (we had maintained a neutral position in the EM FX portfolio), which explains the heavy losses across Brazilian markets following the election.

## It is all about the fiscal

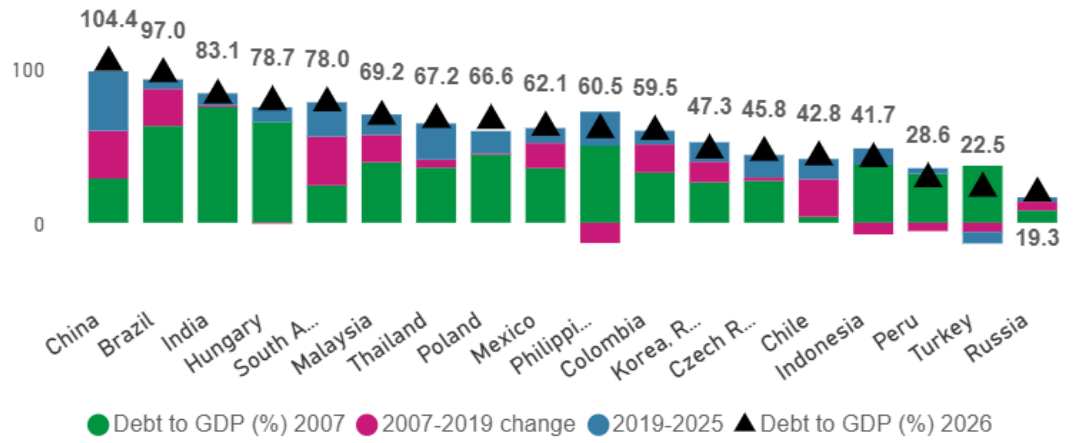
The negative reaction to Lula's victory has been primarily a reflection of the market's assessment of how Lula is likely to handle Brazil's unravelling debt dynamics. To understand the severity of Brazil's fiscal problem, it is first helpful to view Brazil's debt level and debt dynamics in an international context, using the uniform methodology of the debt ratio the IMF applies across all countries.[1]

Brazil stands out within EM with its high public debt-to-GDP burden, persistent fiscal deficits and a very high cost of borrowing. As result, the debt dynamics, ie, how the debt-to-GDP ratio evolves through mutually reinforcing variables, are very challenging.[2]

[1] *There are notable differences between the IMF and the Brazilian government's measure of debt to GDP. The IMF includes all issued government debt, while the government debt measure focuses on debt held by the market and the debt posted to the market as collateral by the central bank (which results in lower debt to GDP ratio). For cross country debt comparison, we use the IMF's standardised metric.*

[2] *Given a very small portion of external debt in Brazil's debt composition and reliance primarily on floating rate debt linked to Selic and on inflation linked debt, the dynamics of Brazil's debt-to-GDP ratio can be simplified as follows: d(t)=(r-g)*d(t-1)- pb, where d(t) and d(t-1) is debt to GDP*

**Debt evolution across EM**




*Source: IMF, RMA by Credit Agricole CIB*

## An optimistic, and unrealistic, scenario

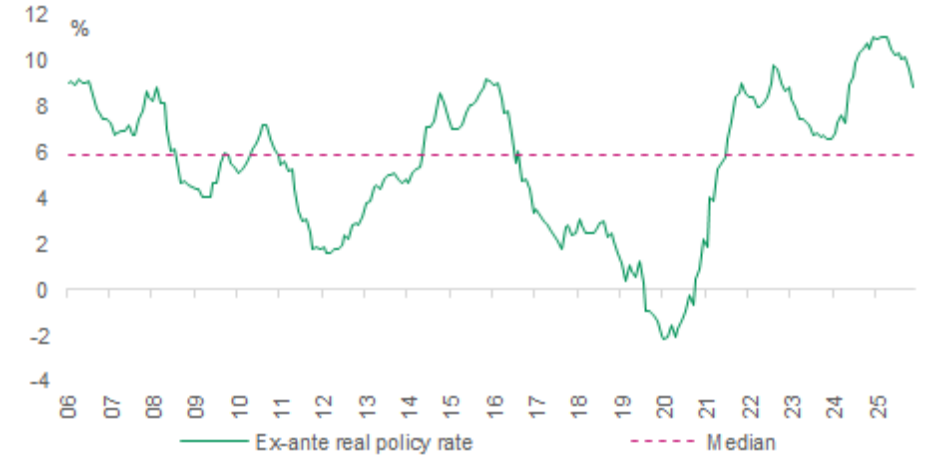
In the IMF's latest Article IV report on Brazil concluded in July[3], it projects that the government's debt ratio will increase from 93.3% last year to 97.8% this year. Looking further out, the IMF projects that debt to GDP will increase by 8% in eight years and stabilise there (at c.106%). This relatively benign outlook rests on the assumption of real GDP growth of 2.2% in 2027, 2.4% in 2028 and 2.5% thereafter, in line's with the IMF's latest estimate of Brazil's potential growth rate. The IMF real rate estimates also appear quite optimistic: just 4.7% in 2027, increasing slightly to 4.9% over the longer horizon. Finally, the IMF projects a primary surplus of 1% in 2030, improving thereafter to c.1.5% surplus.

The market appears to strongly disagree with the IMF's assessment of Brazil's real rate, growth prospects and the government's ability to consolidate its finances and run consistent surpluses.

### Inflation inertia, monetary and fiscal policy feedback loop and credit market segmentation keep interest rates high

The average level of real interest rates in Brazil, using the target Selic rate and expected 12-month inflation, hovered closer to c.6%. Why so high? This is due to a number of factors, including inflation inertia, the interconnectedness of fiscal and monetary policy and segmentation of credit markets.

**Historical ex–ante real policy rate**




*Source: Bloomberg, Credit Agricole CIB*

*ratio in periods t and t-1 respectively, r = the real interest rate, g = real growth rate and pb = primary (non-interest) budget balance.*

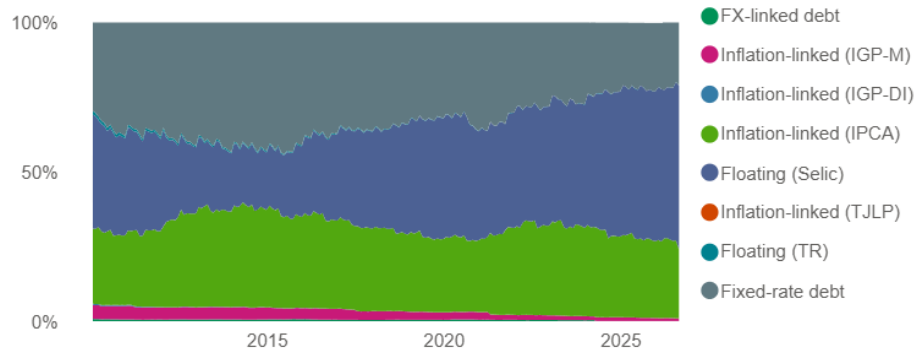
[3] *Brazil 2026 Article IV Consultation, July 2026*

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Brazil's previous history of high inflation led to a widespread backward-looking adjustment in prices, including wages, pensions and business contracts. This inflation persistence blunts the transmission of monetary policy, requiring high rates for longer.

Monetary policy in Brazil is also closely tied to the fiscal policy. The fiscal outlook impacts the neutral real policy rate, while the monetary policy rate directly impacts the government interest costs as more than 50% of sovereign debt is linked to the target Selic rate.

**Breakdown of sovereign debt by type**

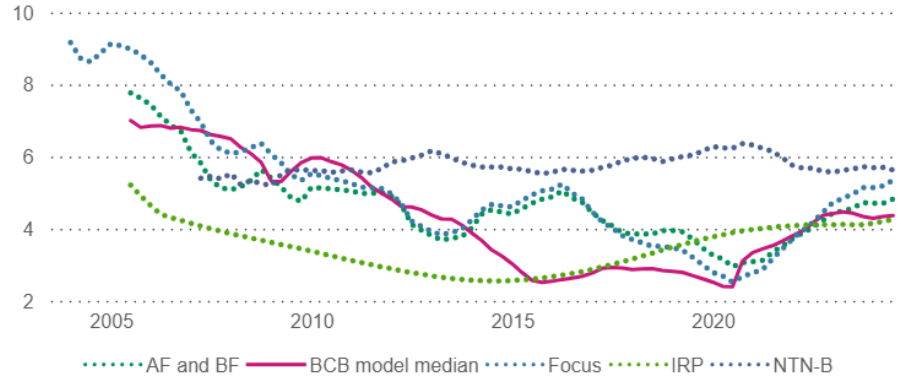



*Source: Banco Central do Brasil, RMA by Credit Agricole CIB*

The last factor contributing to the high level of markets rates is the subsidy provided by the government through various incentive schemes. The credit market is segmented into government-directed credit (more than 40% of the total) and market-based lending, which complicates the transmission of monetary policy and requires the market-based rates to be higher than they otherwise would need to be.

At the time of writing, the swaps markets (DI) were pricing a Selic rate of c.15% by the end of 2027, while the latest survey pointed to inflation expectations of c.4.3% which would imply a close to 11% real rate. This of course reflects the expectations of the central bank aggressively tightening monetary policy in response to sharply rising fiscal premium post the election. In general, real rates derived from interest rate and inflation expectations tend to run much higher than other estimates, such as those by Brazil's central bank (BCB), those derived from inflation linked bonds or models based on output gap or international interest rate parity. At the time of writing, Brazil's 8Y inflation linked bonds yielded c.6.7% in real terms. Meanwhile, the central bank's estimate of the neutral real rate prior to the election was 5%.

**Real neutral rate estimates**




*Source: Banco Central do Brasil; Note: BCB model median = median of four models used by BCB, AF and BF = high and low frequency estimates based on the output gap, IRP = estimates based on international interest-rate parity; NTN-B = inflation-linked bond rates adjusted for term premium; Focus = derived from interest rate and inflation expectations from Focus survey. Series data through 2024 Q2. Q3 26 BCB = 5.0%*

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We view the 6% real rate as a reasonable estimate of Brazil's neutral real rate on the assumption of modest reforms necessary for stabilising debt to GDP (see later discussion). This would also correspond to the average level of real rates derived from inflation linked bonds adjusted for term premium that proved to be rather stable (see chart above).

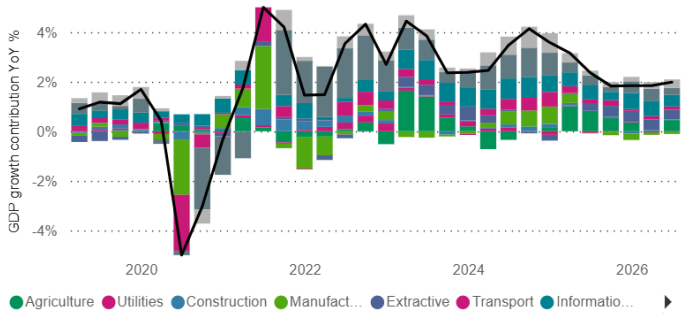
### Upside risks to growth

Brazil's growth post 2015-16 was disappointing in the range of 1-2%, however the post-pandemic pace of growth accelerated to over 3% for 2022-24, slowing only in 2025 to 2.3%. Looking at the composition of this recent high growth suggests that the 2-3% pace will not automatically extend into the future.

On the production side, record agricultural and oil-and-gas output helped propel the economy. The prior discoveries of additional hydrocarbon reserves led to Brazil substantially increasing its oil output from less than 1 million barrels per day (mbd) in 1997 to c.4.5mbd currently. While the new elevated level of production is likely here to stay, the increase in energy prices during this period is less predictable given the link to the geopolitical shocks, such as the war in Ukraine in 2022 and most recently the war in the Middle East. On the expenditure side, Brazil's growth has been sustained by strong consumption, but that has been underpinned by fiscal expansion during Lula's current presidency.

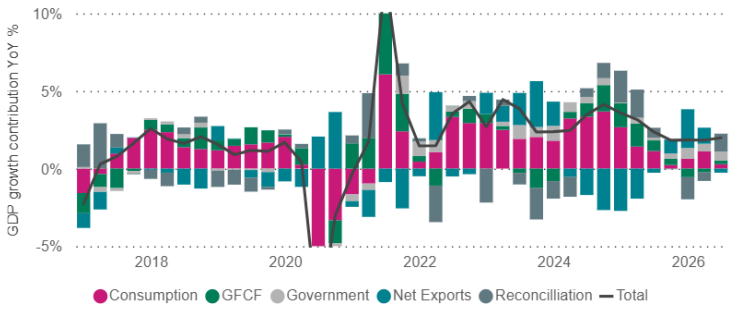
We acknowledge that there are several potential catalysts to higher growth in Brazil, including its potential role in the supply of industrial metals and critical minerals in the age of AI. However, we envision Brazil's baseline growth closer to 2% in 2026 and 2027 and for the foreseeable future, in the absence of more sustainable catalysts, such as market friendly reforms inviting substantial foreign investment for example, materialising.

**GDP growth by activity**




*Source: IBGE, RMA by Credit Agricole CIB*

**GDP growth by expenditure**



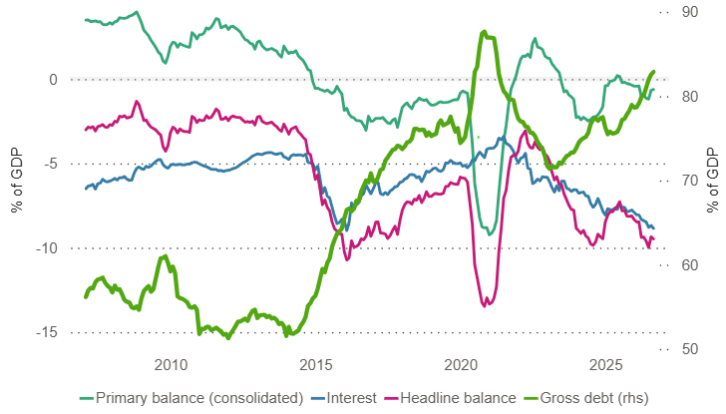

*Source: IBGE, RMA by Credit Agricole CIB; Note: Vertical scale limited for readability; Covid-period values (2020-21) fall outside the displayed range.*

## A realistic, yet still relatively optimistic scenario

Using the more realistic assumptions of c.6% real interest rates and c.2% real growth we arrive at a debt-stabilising primary surplus in the order of 3.3% depending on the horizon, with delayed action requiring a greater adjustment.
Lula's team has proposed a gradual fiscal adjustment, targeting a surplus of 1.3% of GDP by 2030. If successfully executed, the plan would keep the debt ratio rising to 94% by the end of the next presidential term and 104.4% by 2034, provided the surplus is maintained at the same level thereafter.

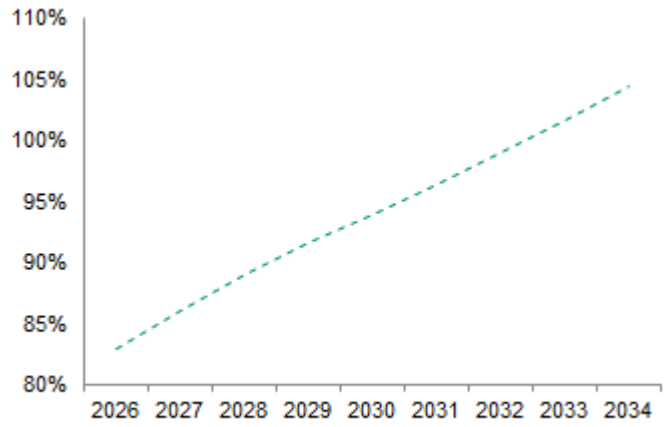
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**Gross debt rising with primary deficits and interest costs**




*Source: BCB, RMA by Credit Agricole CIB*

**The base case under Lula would still see a steep rise of the debt ratio**



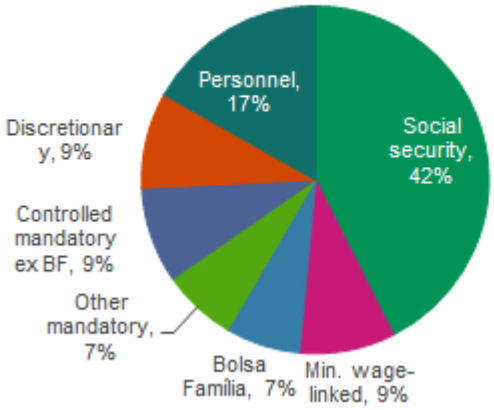

*Source: Ministry of Planning 2027-2030 primary balance assumptions as of April 2026, Credit Agricole CIB*

## Rigidity of expenditures prevents an easy fix

Are Lula's targets achievable? There are no easy fixes, such as cuts to discretionary spending for example that can be achieved through a regular budging process. Brazil's mandatory expenditures, including pensions, social benefits and payroll, consume most of the budget (c.90% of total or c.0.3% of GDP after parliamentary earmarks and basic administrative costs necessary to keep the government running).

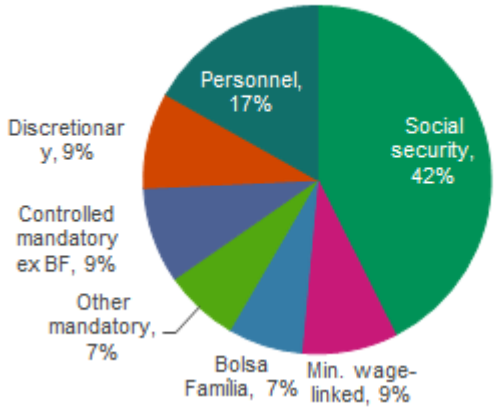
More than half of the expenditures are indexed to the minimum wage, which, in line with the constitutional requirement to preserve purchasing power, is adjusted annually based on the prior year's inflation rate plus real GDP growth from two years prior. In other words, the government cannot simply cut discretionary expenditures, of which there are very few, but instead would need to confront entitlements protected by the constitution and received by the vast majority of the population.

**Composition of expenditures**




*Source: Resultado do Tesouro Nacional*

**Composition of revenues**

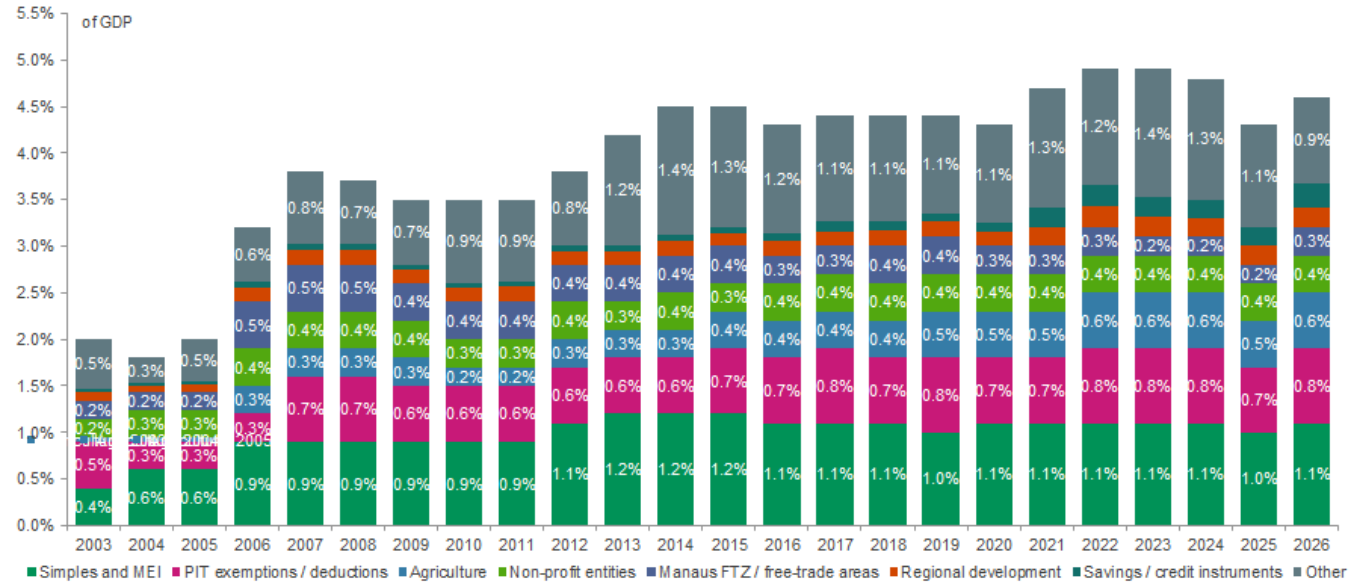



*Source: Resultado do Tesouro Nacional*

Most likely, a combination of tax-exemption reductions, additional revenue (ie, higher taxes), public pay restraint and at least some changes to mandatory spending would be required. The tax expenditures amount to c.4.5% of GDP and represent tax exemptions and preferential treatment of small businesses, certain industries, non-profit entities, designated free-trade zones, etc (see chart below). Tackling these would require confronting powerful special interests and opposition from the right-leaning congress.

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**Tax expenditures could generate substantial savings, but require confronting powerful special interests**




*Source: Receita Federal, Demonstrativo does Gastos Tributarios, PLOA 2026*

The most impactful reforms to mandatory spending would include: (1) changing indexation of expenditures currently linked to the minimum wage (more than 52% of expenditures) to inflation only; (2) delinking certain expenditures from revenues, such as health & education, and indexing to inflation only; and (3) parametric pension reform increasing the minimum retirement age for various groups and addressing survivors' benefits.

Lula has explicitly ruled out adjustment to the minimum wage rule and has vowed to maintain real minimum wage increases and the pension and benefits linked to it (1). We believe delinking the health and education expenditures from revenues and keeping these items frozen in real terms is likely(2). Finally, we believe a pension reform tightening specific pension schemes and contribution rules is more feasible than a broad-based reform increasing Brazil's current statutory retirement age of 62 for women and 65 for men. (3). In summary, we believe that the scenario outlined by Lula's team, while still lacking in all the details, is a realistic scenario that we would consider our base case. Importantly, this scenario would require the changes we outlined above and a working relationship with congress.

## Less likely, but possible is market-induced forced adjustment

Meanwhile, even a balanced budget would most likely lead to the debt ratio rising exponentially with continued adverse repricing of the fiscal premium. Worse, a potential stand-off between the new congress dominated by the centre and centre-right parties could mean that market conditions could get substantially worse before they get better. It is also conceivable that the new congress could seek to impeach the president with two-thirds majority in each chamber, potentially on the grounds of violating the fiscal responsibility law, the same route used to impeach the previous president Dilma Rousseff in 2016. These scenarios would be associated with real rates rising to over 8% and the BRL trading at over USD/BRL 6.00, which would force the government to adopt at least some consolidation measures.

Using the realistic, yet still admittedly relatively optimistic scenario of Lula and the right-leaning congress finding a common ground on a modest consolidation, we forecast USD/BRL at 5.45 by the end of 2027. Should the fiscal proposals gain traction in Q22027, that would create an opening for modest rate cuts to the Selic rate from then on with the terminal rate at 12.50% by the end of 2027. The risks to our forecasts are to the downside, if the fiscal efforts are deemed insufficient by the market or be delayed. For more, follow our new Brazil dashboard at Red Mount Analytics.

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*Source: RMA by Crédit Agricole CIB*

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