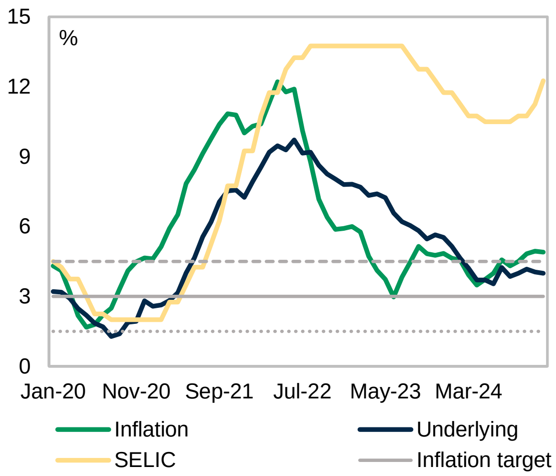
No. 25/017 – 21 January 2025

BRAZIL – The shadow of fiscal imbalance looms over a fast-growing economy

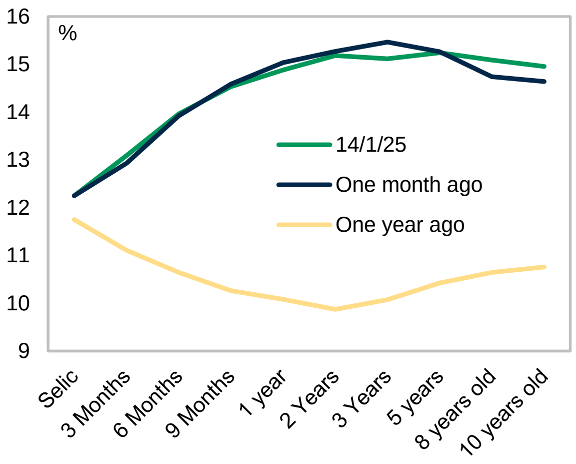
While Brazil's growth performance has been quite remarkable, its success has been overshadowed by persistent fiscal concerns. At a time when the currency is already weakened by an unfavorable international context, fiscal uncertainty is accentuating the depreciation of the Brazilian real (BRL/USD), which in turn is tending to reinforce the inflationary pressures seen since May. To maintain its credibility in the fight against inflation, the Central Bank of Brazil (BCB) had to resume its monetary tightening; the key rate (SELIC) has risen from 10.5% in August to 12.25% at present. However, market expectations (Focus Market Readout, BCB, 10 January) now point to a SELIC rate of 15% by the end of 2025. The rises in both inflation and the key interest rate are pushing up the cost of public debt, a large proportion of which is indexed to the SELIC (54%) or to inflation (21%).

Brazil – Inflation and monetary policy



Sources: BCB, Crédit Agricole S.A./ECO

Brazil – Sovereign interest rate curve



Sources: Bloomberg, Crédit Agricole S.A./ECO

The combination of high interest rates and rising expenditure is raising concerns about the trajectory of public debt, despite sustained economic growth. Recent developments have been rather disappointing: the trend towards debt reduction observed in 2021-2022 has been reversed; the new fiscal anchor appears to be ineffective, or its credibility has already been tarnished[1]. In short, the current increase in debt is worrying investors, despite the government's promises that it will achieve its primary deficit targets.

[1] Adopted by Parliament in August 2023, the new fiscal framework first set primary balance targets (ranging from -0.3% of GDP in 2023 to 1% of GDP in 2026 and then increasing by 0.5 percentage points per year, with a tolerance band of [+0.25%, -0.25%] of GDP in relation to the target for the year).

In addition, spending growth was linked to revenue growth: spending growth was limited to 70% of revenue growth if the primary deficit target was met (with a margin of 0.25% of GDP) or 50% otherwise.

In all cases, the increase in spending must remain between 0.6% and 2.5% in real terms. Congress tightened the rules (reducing the number of exceptions to the new budgetary rule, including mandatory budgetary adjustment measures if targets are not met, and limiting the amount of investment spending permitted in the event of an extraordinary surplus).

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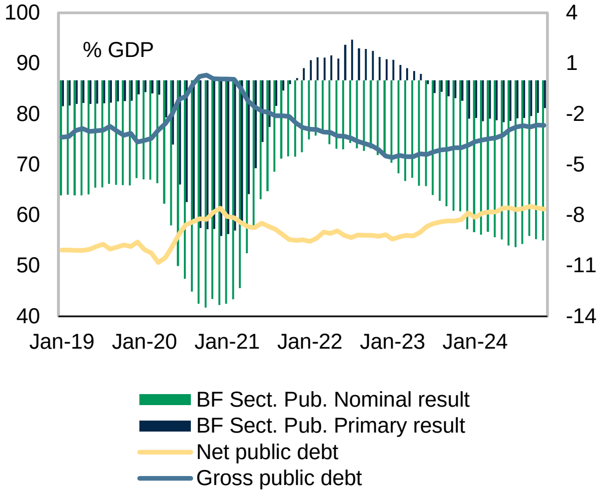
Brazil – Financing requirements and debt



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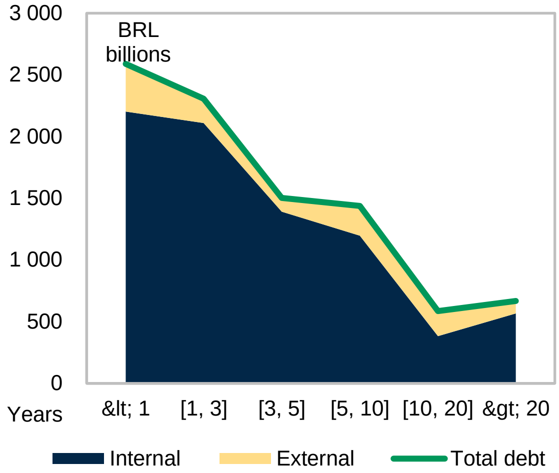
Brazil – Amortization of public debt



Sources: BCB, Crédit Agricole S.A./ECO

Public sector borrowing requirements reached 9.5% of GDP, their highest level since the Covid-19 crisis, even in a context of good tax revenues (99.3% of budgeted revenues), still sustained GDP growth and low unemployment (historically low). If the expenditure (nearly 36 billion reais) linked to the floods in the *Rio Grande do Sul* region is excluded, the primary deficit will be less than 0.3%, just within the margin of error of the target set. However, this exclusion has been seen as a short-term solution that cannot disguise the persistent structural problems of a primary deficit and high interest rates.

Indeed, in the second half of 2024, flood-related spending, and rising deficits, as well as rising inflation and interest rates in a difficult international environment, have intensified investor pressure. Investors are calling for compliance with the fiscal rule and reforms to increase the flexibility of spending[2] , fearing that Brazil could slide into "fiscal dominance". The primary surplus has now been postponed until 2027, and investors do not expect any major changes before a new government takes office.

In response to these concerns, at the end of November the government proposed cost-cutting measures, estimated at 72 billion reais over two years (an estimate considered somewhat optimistic). These measures include limiting the indexation of the minimum wage (real increase capped at 2.5%) and tightening the conditions of access to social assistance. At the same time, however, it has proposed a change to income tax, raising the exemption threshold for low earners. Despite the government's assurance that this fall in revenue would be offset by higher taxation on high earners, investors took a dim view of these announcements, signaling the lack of will which is required to tackle rigid spending.

At the end of December, after a lengthy parliamentary session, two important bills were passed. They concern the capping of minimum wage indexation and mechanisms for dealing with budget deficits. From now on, the minimum wage will be adjusted according to the rules of the budgetary framework for other expenditure. In the event of a primary deficit, tax exemptions will be prohibited and growth in personnel costs will be limited to 0.6%. Tougher access to subsidies has also been adopted. On the other hand, several proposals were rejected, including limits on "super salaries" for civil servants and changes to military pensions. The government estimates that the impact of these rejections on the planned savings is minimal (2.1 billion reais) compared with the savings expected over two years (nearly 70 billion reais). Income tax reform will be discussed later in 2025.

Finally, the Brazilian Congress recently adopted the regulations for the VAT tax reform, a long-awaited measure that will be implemented gradually. This reform aims to simplify Brazil's notoriously complex indirect taxation system by reducing the number of taxes from five to two: a state tax and a federal tax. Although the exact rate has yet to be determined, the broad outlines have been established for different

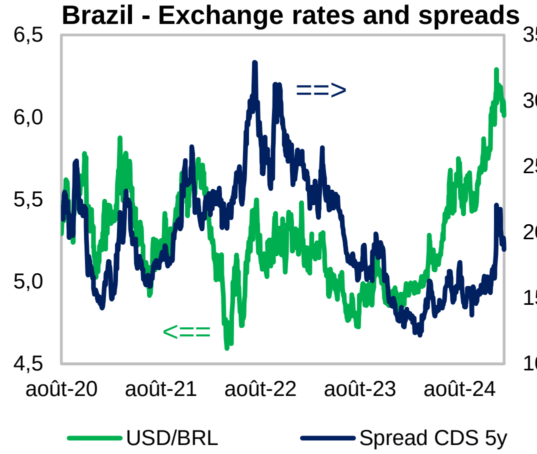
[2] The budget is extremely rigid, which obviously limits public investment (less than 1% of GDP in 2024); 92% of expenditure is compulsory and often indexed to the minimum wage, which itself replicates inflation.

product categories. Currently, the average rate is estimated at 34%, but the new system could reduce it to around 28%.

This simplification should considerably improve the competitiveness of Brazilian companies, long hampered by the complexity of the tax system. It should also help to reduce "tax dumping" and competition between states.

☑ **Our view –** *The Economy Minister Economy, F. Haddad, assures that the government is prepared to make more cuts if necessary and that some of the rejected reforms will be discussed again. The government is not insensitive to market expectations. Market concerns seem to have eased very recently, thanks to recent announcements and the approval of bills. In addition, the commitment to reducing inflation by G. Galipolo, a close friend of Lula and now head of the BCB, is likely to reassure investors and could help reduce the criticism of the central bank for being too orthodox.*

The fact that a large proportion of public debt is indexed to inflation or the SELIC is obviously a disadvantage. However, despite high financing requirements and heavy public debt for an emerging country, the structure of Brazilian debt (95% in local currency) is favorable. Finally, domestic interest rates, the spread on external debt and, above all, the real, which is considered to be largely undervalued, seem to indicate that the worst has already been priced in by the markets



Sources: BCB, Bloomberg, Crédit Agricole S.A./ECO

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