Economics

WELLS FARGO

International Commentary — November 1, 2024

Brazil's Fiscal Fiction To Foil BRL

Summary

While we retain a modest degree of short-term optimism for the Brazilian real, we have become materially more pessimistic on the long-term outlook for the currency. External factors—such as a less dovish Fed and our view for worsening sentiment toward China—should contribute to a weaker Brazilian currency; however, the intersection of local politics and fiscal policy should be the driving force of BRL underperformance in 2025 and 2026. Local elections reveal that momentum behind Lula is fading, which we believe will lead to aggressive fiscal resource deployment from the current administration in an effort to gather support ahead of 2026 presidential and congressional elections. Our prior outlook baked in election-related fiscal stimulus; however, given poor results in municipal elections we now believe Lula will deliver fiscal stimulus much earlier and more often than originally anticipated. While near-term headlines may indicate Lula attempting to exercise fiscal discipline, we ultimately believe those efforts will prove to be insufficient, temporary, and not enough to change the fiscal narrative in Brazil. In our view, these fiscal concerns will be reflected in a Brazilian real that consistently hits new lows against the U.S. dollar over the course of 2025 and into 2026.

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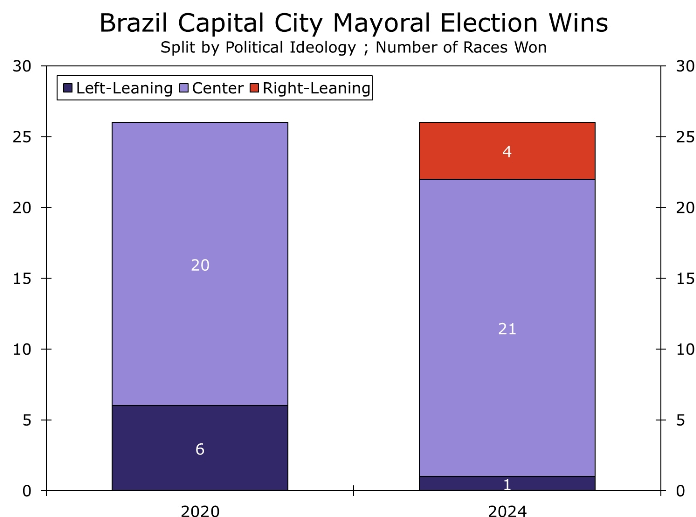
Brazilian Real on a Path to Record Weakness

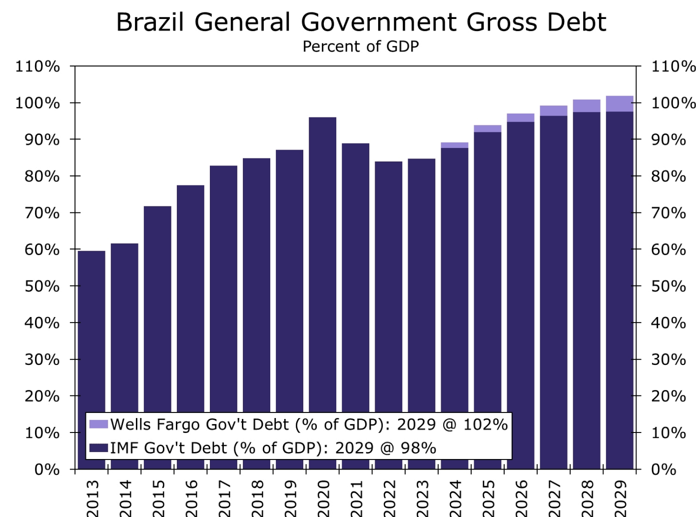
Our October International Economic Outlook primarily focused on dynamics surrounding the U.S. election; however, embedded in the document were notable adjustments to our outlook for select currencies. One of the more noteworthy outlook changes—warranting its own standalone report—is our view on the Brazilian real. This month, we turned significantly more pessimistic on the longer-term direction of the currency. Prior to this month, our forecast profile for the Brazilian real was somewhat bifurcated. In the short-term, we felt Brazil's Central Bank (BCB) flipping back to rate hikes would support the Brazilian currency. We also believed President Lula would exercise a degree of fiscal discipline in the near-term as his approval ratings remained elevated and an immediate need for fiscal stimulus to shore up political support and economic activity was probably not necessary. A combination of more attractive carry, especially at a time when the Fed is cutting rates, and fiscal responsibility, in our view, would be enough to support BRL through the end of 2024 and into H1-2025. Longer-term, we felt BCB policymakers would pivot to rate cuts and remove a pillar of support from BRL, but most importantly, we believed President Lula would start to deploy fiscal stimulus by the end of next year to start rallying support for his re-election campaign in 2026. Easier BCB monetary policy and looser fiscal policy would be a combination that would impact financial market sentiment toward Brazil and place downward pressure on the real starting in H2-2025 and persisting through the end of our forecast horizon.

Figure 1



Source: Wells Fargo Economics

Figure 2



Source: IMF and Wells Fargo Economics

Our latest forecast profile for the Brazilian real still includes a degree of short-term optimism as we believe BCB policymakers will pick up the pace of monetary tightening at the upcoming November meeting; however, we now believe BRL's underperformance will start earlier and the currency will depreciate more rapidly over the longer-term than previously expected. Part of our less favorable long-term outlook stems from a Federal Reserve that is likely to take a more gradual approach to interest rate cuts. At the same time, in the second half of next year, BCB policymakers should start to unwind rate hikes and will likely be cutting more quickly against a Fed moving gradually. Another component is that we view Chinese authorities recent policy actions as underwhelming. Over time, we believe financial market sentiment toward China will fade and eventually act as a source of depreciation for "high beta" emerging market currencies, BRL included. While dynamics surrounding the Fed-BCB and China should contribute to a weaker Brazilian currency for much of next year and beyond, we believe the interplay between local politics and fiscal policy will be the driving force of the Brazilian real hitting new all-time lows against the U.S. dollar. In that respect, we can point to local municipal elections as the genesis behind our outlook for future sharp BRL depreciation. Municipal elections—aimed at electing mayors and councilors across Brazil—did not go well for Lula's Workers' Party (PT) nor political parties ideologically aligned with Lula. Left-leaning political parties underperformed across the country and across elections, but notably lost out in Mayoral voting in Brazil's capital cities (Figure 1). In 2020, political parties on the left-end of the spectrum won elections

in six capital cities; however, won only two elections this year with more centrist and right-leaning parties performing well.

Time will ultimately tell if left-leaning political parties performing poorly in local elections is a leading indicator for elections in 2026; however, we believe Lula will take action in the near future to support his Workers' Party and broader left-leaning platform. To that point, we now believe Lula and his cabinet will pull forward fiscal stimulus as a way of gathering electoral support well in advance of 2026 elections. Rather than fiscal resources being deployed toward the end of next year, we now believe fiscal support will be deployed in H1-2025. Additional stimulus is also likely to be offered in H2-2025, and in our view, consistently over the course of 2026, especially as election day gets closer. While we are not calling for Brazil's fiscal framework to be eliminated, aggressive fiscal spending can at least lead to market participants questioning the credibility of the framework and concerns around its long-term viability. Brazil is already on track to run a primary fiscal deficit of ~0.70% of GDP for both of the next two years according to the IMF, although we believe risks are tilted toward a wider deficit as election-related spending materializes. A wider primary account deficit can also lead to a sharper rise in Brazil's debt burden relative to IMF forecasts. In our view, election spending, along with other factors, could push the sovereign debt-to-GDP ratio to over 100% in the next five years (Figure 2). The Brazilian real is highly sensitive to fiscal policy developments given Brazil's already high debt burden and historical challenges achieving a balanced budget. In the very near-term, Lula's cabinet may trim expenditures, but we believe these spending concessions will prove to be limited, temporary and ultimately not enough to prevent a material worsening in Brazil's public finance position. Concerns around the sustainability and strength of the fiscal framework, combined with monetary policy trends and renewed fears over China's growth trajectory should, in our view, drive the USD/BRL exchange rate to cross BRL6.00 by H2-2025, the weakest the Brazilian real has been against on the dollar on record. Further out, persistent fiscal concerns can ultimately result in BRL consistently setting new record lows against the dollar. By the end of our forecast horizon (Q1-2026), we believe the USD/BRL exchange rate can reach BRL6.50 as the culmination of multiple risks—both domestic and external—become reflected in Brazil's currency.

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