WELLS FARGO

International Commentary — August 23, 2024

Brazil's Bifurcated Policy & FX Outlook

Summary

Despite the Fed approaching interest rate cuts, we believe the Brazilian Central Bank (BCB) will pivot back to tighter monetary policy in the near future. Rising inflation expectations - fueled by loose fiscal policy and currency weakness - will be the driving forces for policymkaers to shift back to rate hikes, and can offer a pillar of support for the Brazilian real. We also believe Lula will demonstrate more explicit fiscal responsibility in 2025, which can also act to underpin Brazilian real strength over the medium-term. Longer term, we are less optimistic on Brazil's currency as monetary and fiscal policy dynamics should change course as local economic trends worsen and the 2026 presidential election comes into focus.

Economist(s)

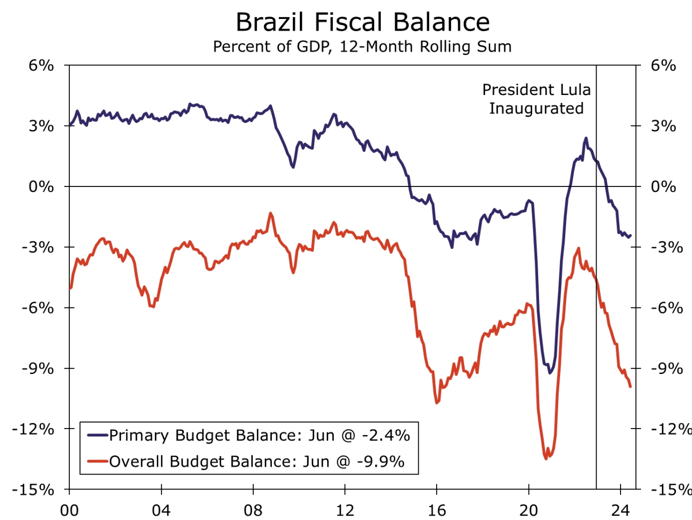
Brendan McKenna
International Economist | Wells Fargo Economics
Brendan.McKenna@wellsfargo.com | 212-214-5637

All estimates/forecasts are as of 8/23/2024 unless otherwise stated. 8/23/2024 8:47:24 EDT. **This report is available on Bloomberg WFRE**

Brazilian Central Bank to Move Back to Tightening

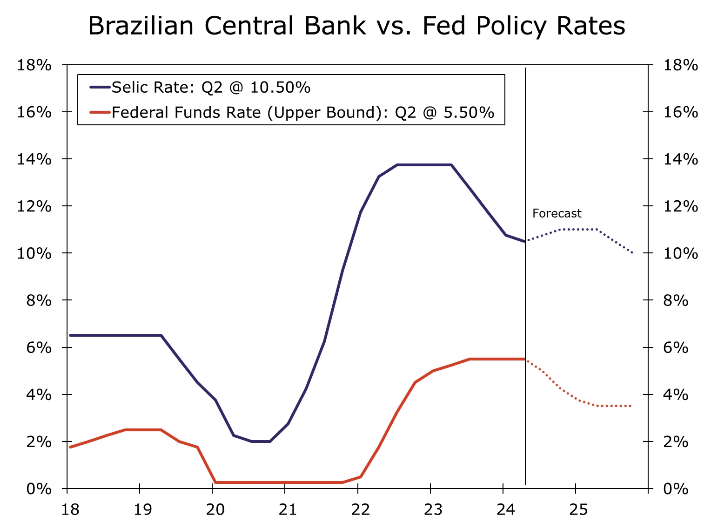
As we highlighted in our August International Economic Outlook, the Federal Reserve shifting to rate cuts in September will likely create policy space for select emerging market central banks to also lower interest rates. However, certain institutions may be more motivated to respond to domestic economic conditions rather than Federal Reserve monetary policy decisions. In our view, the Brazilian Central Bank (BCB) fits the mold of a developing economy central bank that is more focused on the evolution of local economic trends rather than the direction of policy rates in the United States. In fact, not only do we believe the Brazilian Central Bank will not pivot to easing in conjunction with the Fed, we believe BCB policymakers are likely to pursue rate hikes as early as next month. Our view for the Brazilian Central Bank to shift back to tighter monetary policy stems from renewed inflationary pressures, resilient economic activity as well as reduced political pressure to pursue accommodative monetary policy. As far as inflation, headline CPI has trended higher since April and now sits at the upper bound of the BCB's inflation target range. Food and beverage inflation has contributed meaningfully to the rise in headline inflation; in addition, services disinflation has stalled and is currently at uncomfortable levels for BCB policymakers. One of the key contributors to elevated services inflation is fiscal loosening under the Lula administration. Since Lula started his third term in office, Brazil's fiscal balance—both overall and primary—has worsened to deficits last experienced during the end of the commodity super-cycle and Brazil's political shock in 2015-2016 (Figure 1). Fiscal slippage is a concern often expressed by COPOM members in official statements and public pronouncements, and with Brazil's fiscal situation still a challenge to containing inflation expectations, we believe BCB policymakers will be most inclined to defend against a fiscal dominance scenario materializing. On activity, Brazil's June economic activity index—often viewed as a proxy for GDP—beat expectations by a wide margin coming in at 1.37% month-on-month relative to a consensus forecast of 0.50%. Stronger-than-forecast activity has been a trend for most of 2024, and with the latest data outperforming, upside risks to inflation exist and can provide additional rationale for policymakers to tighten monetary policy.

Figure 1



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 2



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Reduced political pressure from President Lula may also pave the way for higher BCB policy rates. Recently, President Lula acknowledged that policymakers should respond to economic developments when setting interest rates. Lula mentioned that while he still has a preference for easier monetary policy, if the economy needs higher rates BCB members should not hesitate to deliver. In our view, Lula's recent commentary represents a notable change from prior communications when he encouraged the monetary policy committee to lower rates. While the Brazilian Central Bank is unquestionably an independent central bank, receiving a form of "permission" from Lula may make tightening monetary policy more politically acceptable and give the BCB increased flexibility in making monetary policy decisions. Considering the totality of data and the evolution of political pressure, we now believe BCB policymakers will raise the Selic rate 25 bps in September and another 25 bps in November. A cumulative 50 bps of rate hikes will take the Selic rate to 11.00% by the end of 2024

(Figure 2). A policy rate of 11.00% combined with inflation ~4%-4.5% will leave Brazil with one of the highest real interest rates of the major emerging economies. We believe Brazil's economy will soften more noticeably from more restrictive monetary policy settings in the second half of 2025, which should allow policymakers to begin the process of monetary easing. By the end of next year, we believe the Selic rate can be lowered gradually to 10.00%.

Playing Politics Can Lead to Fiscal Discipline & BRL Strength

We have also adopted a tentative assumption for fiscal responsibility from the Lula administration in 2025. Baked into our fiscal assumption is also an assumption that Lula will run for re-election in 2026. Lula has offered conflicting guidance on whether he will run again or not, but for now, we are assuming he will seek a fourth term in 2026. In our view, in the lead up to the election Lula will need to be able to point to tangible successes that Brazil has experienced under his latest administration. Those successes are, up to this point, sovereign credit rating upgrades that Brazil received from both S&P and Fitch in 2023 as well as a “positive outlook” from Moody's earlier this year. If fiscal discipline is not pursued or fiscal frameworks are eliminated in 2025, rating agencies would likely backtrack on the more positive stances they have adopted on Brazil's sovereign creditworthiness. Rather than rating upgrades being a source of validation for Lula policies ahead of the election, credit ratings and the external perception of his policies could become a political liability. We have our doubts that Lula would want to risk credit rating downgrades ahead of the election. To us, this suggests Lula will abide by spending restraints and seek to achieve, at a minimum, a balanced primary budget in 2025. Reverting to the more expansive fiscal playbook in the more immediate lead-up to the election (i.e. early-to-mid 2026) is still likely; however, with Lula's approval ratings still higher than his disapproval ratings he can afford to be patient, display fiscal responsibility and allow fiscal space to build in 2025. We would expect fiscal space generated in 2025 to ultimately be deployed in 2026 to gather electoral support, but exercising fiscal restraint and respecting fiscal frameworks can still be a cornerstone of Lula's fiscal policy next year.

Taking monetary and fiscal policy trends together, we believe the Brazilian real can strengthen against the U.S. dollar over the medium term. While the path to a stronger currency will be bumpy and non-linear we believe the combination of more attractive rate differentials and fiscal responsibility under Lula can push the USD/BRL exchange rate toward BRL5.30 by mid-2025. Idiosyncratic risks can support Brazil's currency, while we also believe the U.S. dollar can broadly weaken in the early parts of 2025. Aided by the tailwinds of a weaker dollar, the Brazilian real can be a currency that outperforms relative to peer Latin American currencies as well as currencies across the emerging markets. However, the longer-term outlook for Brazil's currency is not as optimistic. In fact, by the second half of 2025 we believe the dynamics that can support the Brazilian real through the middle of next year are likely to reverse course and become sources of depreciation. As mentioned, we believe the BCB will be easing monetary policy in the second half of 2025, which is likely to be around the same timeframe when the Fed reaches its terminal rate and is keeping monetary policy settings unchanged. Rate differentials in the back half of 2025 will be moving against the real, which we believe can place renewed depreciation pressure on the currency. Also, and arguably more influential for the real, we believe Lula will be deploying fiscal loosening ahead of the 2026 election. By most measures, Brazil's debt burden is elevated and is likely to rise in 2025 despite spending restraints as automatic debt dynamics will contribute to new debt creation. In a scenario where Lula is indeed loosening fiscal policy in 2026 ahead of the election, Brazil's debt as a percent of its economy should rise much more significantly. Fiscal loosening can not only generate sovereign stresses, but also contribute to deteriorating investor sentiment toward Brazil and BRL. In our view, this scenario of reduced fiscal discipline and weak investor sentiment will play out leading into the 2026 vote, and BRL will likely suffer the consequences. By early 2026 we believe the USD/BRL exchange rate can hit BRL5.70.

Subscription Information

To subscribe please visit: www.wellsfargo.com/economicsemail

Via The Bloomberg Professional Services at WFRE

Economics Group

Name	Title	Phone	Email
Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Senior Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Senior Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Grein	Economist	704-410-0369	Shannon.Grein@wellsfargo.com
Nicole Cervi	Economist	704-410-3059	Nicole.Cervi@wellsfargo.com
Jeremiah Kohl	Economic Analyst	212-214-1164	Jeremiah.J.Kohl@wellsfargo.com
Aubrey George	Economic Analyst	704-410-2911	Aubrey.B.George@wellsfargo.com
Delaney Conner	Economic Analyst	704-374-2150	Delaney.Conner@wellsfargo.com
Anna Stein	Economic Analyst	212-214-1063	Anna.H.Stein@wellsfargo.com
Ali Hajibeigi	Economic Analyst	212-214-8253	Ali.Hajibeigi@wellsfargo.com
Coren Miller	Administrative Assistant	704-410-6010	Coren.Miller@wellsfargo.com

Required Disclosures

This report is produced by the Economics Group of Wells Fargo Bank, N.A. (“WFBNA”). This report is not a product of Wells Fargo Global Research and the information contained in this report is not financial research. This report should not be copied, distributed, published or reproduced, in whole or in part. WFBNA distributes this report directly and through affiliates including, but not limited to, Wells Fargo Securities, LLC, Wells Fargo & Company, Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Europe S.A., and Wells Fargo Securities Canada, Ltd. Wells Fargo Securities, LLC is registered with the Commodity Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. WFBNA is registered with the Commodity Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC and WFBNA are generally engaged in the trading of futures and derivative products, any of which may be discussed within this report.

This publication has been prepared for informational purposes only and is not intended as a recommendation, offer or solicitation with respect to the purchase or sale of any security or other financial product, nor does it constitute professional advice. The information in this report has been obtained or derived from sources believed by WFBNA to be reliable, but has not been independently verified by WFBNA, may not be current, and WFBNA has no obligation to provide any updates or changes. All price references and market forecasts are as of the date of the report or such earlier date as may be indicated for a particular price or forecast. The views and opinions expressed in this report are those of its named author(s) or, where no author is indicated, the Economics Group; such views and opinions are not necessarily those of WFBNA and may differ from the views and opinions of other departments or divisions of WFBNA and its affiliates. WFBNA is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this report, neither WFBNA nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this report, and any liability therefore (including in respect of direct, indirect or consequential loss or damage) is expressly disclaimed. WFBNA is a separate legal entity and distinct from affiliated banks, and is a wholly-owned subsidiary of Wells Fargo & Company. © 2024 Wells Fargo Bank, N.A.

Important Information for Non-U.S. Recipients
For recipients in the United Kingdom, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority (“FCA”). For the purposes of Section 21 of the UK Financial Services and Markets Act 2000 (the “Act”), the content of this report has been approved by WFSIL, an authorized person under the Act. WFSIL does not deal with retail clients as defined in the Directive 2014/65/EU (“MiFID2”). The FCA rules made under the Act for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. For recipients in the EFTA, this report is distributed by WFSIL. For recipients in the EU, it is distributed by Wells Fargo Securities Europe S.A. (“WFSE”). WFSE is a French incorporated investment firm authorized and regulated by the Autorité de contrôle prudentiel et de résolution and the Autorité des marchés financiers. WFSE does not deal with retail clients as defined in MiFID2. This report is not intended for, and should not be relied upon by, retail clients.

SECURITIES: NOT FDIC-INSURED - MAY LOSE VALUE - NO BANK GUARANTEE