



Press Release: Rating Action

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JCR Upgrades Ratings on Brazil to BBB/BBB+ (FC/LC)

Issuer: The Federative Republic of Brazil

FC (Foreign Currency Long-Term Senior Debts): **BBB (Stable) from BBB- (Stable)**
LC (Local Currency Long-Term Senior Debts): **BBB+ (Stable) from BBB (Stable)**

JCR has upgraded its rating on the foreign currency long-term senior debts of the Federative Republic of Brazil (Brazil) to BBB from BBB- and that on its local currency long-term senior debts to BBB+ from BBB.

The upgrading reflects improvement in Brazil's credit standing brought by mutually reinforcing effects of (i) an improved macroeconomic stability and solid domestic demand as a base of sustainable growth, (ii) enhanced resilience to external shocks on the recent accumulation of foreign exchange reserves and (iii) improving international confidence and sustained foreign investment, which have been underpinned by its political stability and prudent economic and fiscal management.

The rating outlook is stable. JCR is of the view that Brazil will, by and large, sustain moderate economic growth at around 4-5 % in the years to come under the prudent economic and fiscal management. A further improvement of its credit standing, however, will require the country to: (i) sustain and accelerate economic growth by boosting productivity and enhancing industrial competitiveness and economic diversification through improvement of the investment and business environment such as infrastructure development and streamlining of the convoluted tax system, (ii) promote financial deepening to deal better with the growing foreign capital inflow and step up capital formation and (iii) make continued efforts for further alleviation of its relatively heavy public and external debt burdens, while upholding its prudent economic and fiscal management. JCR will closely watch how the new administration of President Dilma Rousseff, inaugurated in January 2011, will address these challenges.

(1) Under the stable macroeconomic situation, growth will sustain on solid domestic demand

The Brazilian economy, which once had suffered from hyper inflation and external debt crises since the 1980s, has been stabilizing thanks to the prudent economic and fiscal management such as inflation targeting and austerity fiscal policies introduced in late 1990s. The inflation rate that had exceeded 10% in 2002 fell to the 3% levels in 2006. As the macro economy stabilized, economic growth has gradually accelerated, with real GDP growth exceeding 5% in 2007-2008,



up from 2.6% in 2001-2005. While the economy contracted in 2009 due mainly to the plunge of primary product prices amid the global economic downturn and reduced capital investment, it achieved a V-shaped recovery in 2010 posting an estimated growth rate in excess of 7% on strong domestic demand. The Rousseff administration, taking office in January 2011, is seen to take over the prudent economic and fiscal management pursued by its predecessor, such as adherence to strict fiscal discipline and appropriate monetary policy framework aimed at stabilizing the inflation rate. Brazil, embracing a population of nearly 200 millions and per capita GDP of more than USD8,000, is projected to sustain its moderate economic growth in the coming years on the robust domestic demand centering on private consumption in the improved income and employment environment brought by continued increases of the minimum wage, expansion of the middle-income group under the Lula administration's Bolsa familia policy and falling unemployment rate.

The country's financial sector has stayed generally sound, remaining profitable and maintaining a high capital adequacy ratio even after the financial crisis. The nonperforming loan ratio has been on the decline. However, the ratio of total outstanding loans to GDP remains low at 46.6% as of the end of 2010. A further deepening and diversification of the financial sector is needed in order to raise the country's relatively low savings ratio, promote capital formation through larger capital expenditure, digest foreign capital inflows and improve the public debt profiles. Personal loans have been expanding rapidly to meet the solid domestic demand. Banco Central do Brasil introduced new credit-tightening measures including stricter capital adequacy in December 2010 to avert an economic overheating. In order to enhance the growth potential in a sustainable manner, it will be critical for the country to address the structural challenges in relation with the investment and business environment particularly on its lagged infrastructure and convoluted tax system. If addressed properly, this could spur both domestic and foreign investment, boost productivity and hone the domestic industries' competitiveness. The new administration has announced initiatives for infrastructure development and simplification of the complicated tax system under its PAC2 (*Programa de Aceleracao do Crescimento 2*). It is hoped that such attempts to ease structural bottlenecks will make progress.

(2) Fiscal position is improving moderately

Brazil's fiscal position has improved thanks to the tight fiscal policies under the fiscal responsibility law enforced in 2000. The public sector's primary fiscal balance surplus has remained stable at 3-4% of GDP, with the gross public debt outstanding reduced to 57.4% of GDP at the end of 2008 from 76.7% at the end of 2002. In 2009, the primary balance surplus dipped to 2.1%, falling below 3% for the first time in a decade on reduced tax revenues and implementation of stimulus measures, and the debt/GDP ratio rose to 62%. The government has announced a plan to bring back the surplus to 3.3% in 2010 and 3.1% in 2011 and thereafter. JCR projects the gross public debt outstanding to decrease gradually in the coming years should the target be achieved.

The public debt profile has been gradually improving and adding to stability as the government has sought to prolong the average debt maturity period, raise more funds at fixed interest rate and buy back high-interest rate bonds. Despite the alleviation in its interest payment burden, however, its ratio to GDP still exceeds 5%, quite high by international standards. Brazil primarily relies on domestic bond issuance for its budget financing. Although the ratio of bonds held by domestic investors has been declining in recent years, it is still high at around 90%. The new administration has announced plans to lower the public debt/GDP ratio through measures to cut the budget deficit such as a tighter control on pay hikes for public servants. JCR will see how the initiatives will progress.

(3) Amid the heightened international confidence, challenges arise in how to cope with the increasing inward portfolio investment

Brazil's current account balance, once in surplus from 2003 to 2007 due mainly to improved terms of trade, has turned into deficit since 2008 on a reduced trade surplus and an increased income balance deficit resulting from a bigger dividend payout by companies operating in the country. This trend is likely to continue in the years to come on import growth led by robust domestic demand. Nevertheless, such current account deficit could be financed by foreign direct investment inflows and the inward portfolio investment on the sustainable growth prospect of Brazil. The foreign direct investment in 2010 marked a record high at USD48.5 billion, which exceeded the entire current account deficit in 2010 totaling USD 47.5 billion.

Amid the global liquidity glut created by lower interest rate across the world and the persistent gap in interest rates in recent years in Brazil and other countries, the inward portfolio investments into the country have been growing in volume, adding to volatility of capital inflows and outflows. Nonresident portfolio investments in BOP statistics registered USD16.0 billion in net outflow in the fourth quarter of 2008 right after the Lehman shock, USD50.3 billion in net inflow in 2009 and USD67.8 billion in net inflow in 2010. That said, in May 2010 when Europe underwent credit woes, it recorded net inflow at USD3.6 billion, indicating certain confidence of international investors in Brazil. The authorities have stepped up foreign exchange market interventions, raised the IOF financial transaction tax and approved government-affiliated funds to buy foreign currencies in a bid to counter the vast capital inflows and the real's resultant appreciation over concerns for the decline in the domestic industry's competitiveness. Along with the expanded capital inflows, the authorities have also accumulated the foreign exchange reserves from USD193.8 billion at the end of 2008 to USD288.6 billion at the end of 2010. With the reserves well exceeding the gross external debts (USD255.7 billion), Brazil has been strengthening its resilience to external shocks. Nevertheless, given the outstanding balance of inward portfolio investments more than twice as much as the foreign reserves, JCR holds that the importance is growing for the country to steadily enforce the needed structural reforms to maintain and improve the international confidence.

*Satoshi Nakagawa, Senior Analyst
Makoto Ikushima, Analyst*

The primary rating methods applied to the ratings are posted on JCR's website (<http://www.jcr.co.jp>) "Sovereign, Public Sector Entities and Multilateral Development Bank Rating Methodology." The rating methods are subject to change or addition. However, the changes and additions including those that have been made in the past are posted in chronological order. Please refer to the rating methods above after checking by comparing the date of press release about the ratings with the release date of the rating methods (effective date of each of such rating methods).