

RATING PERSPECTIVE

Brazil

Off to a rugged start in 2009

- The Brazilian economy has achieved remarkable development in the last decade. The country has recovered its creditworthiness through departure from the chronically high inflation. Bank lending to the private sector has sharply grown following the central bank's decision to ease its tight monetary policy. Due to these compound factors, domestic demand has expanded dramatically from 2007 to 2008.
- Brazil also succeeded in building up its foreign exchange reserves after maintaining constant current account surplus thanks to the high commodity prices and expansion of exports to Asia and Europe. The external debt/GDP ratio has also steadily declined. Foreign direct investment (FDI) inflows, which have remained sluggish for a long time, increased markedly from 2007 to 2008.
- The country had long been plagued by a poor fiscal balance under the pressure of heavy public debt burden. However, it has gradually eased the debt burden and reduced the fiscal deficit as it maintained a primary balance surplus through a series of fiscal reforms implemented under the administration of President Fernando Henrique Cardoso (from 1999 to 2002) and the first administration of President Luiz Inacio Lula da Silva (from 2003 to 2006).
- Brazil still has structural social restraints such as a wide income disparity and a low labor productivity resulting from inefficient labor input as characterized by a higher percentage of non-regular workers. However, it has

achieved an annual real GDP growth higher than 5% in 2007 and 2008 on expansion of domestic demand brought by the shift to an easy monetary policy in 2007 and increased employment mainly by booming export industries. For this country, the global economic recession and financial crisis came just as it toiled its way into a virtuous business cycle in 2008.

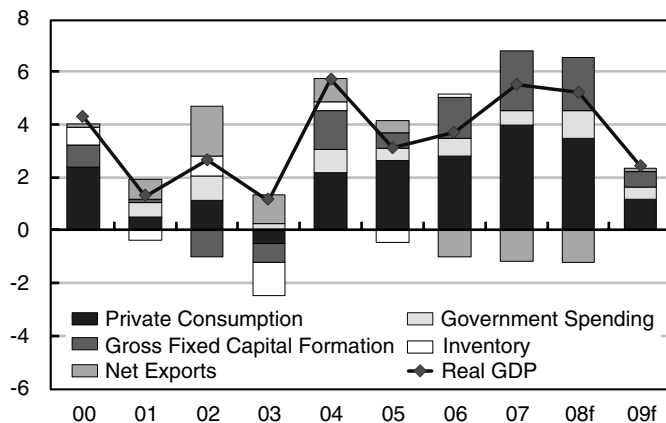
- This report analyzes the impact of the unprecedented global economic and financial crisis on the Brazilian economy in 2009 and the country's current political situation and outlook despite uncertain prospects of the presidential election in 2010.

1. Macroeconomic situation

1.1 Improvement of the economic fundamentals after 2000

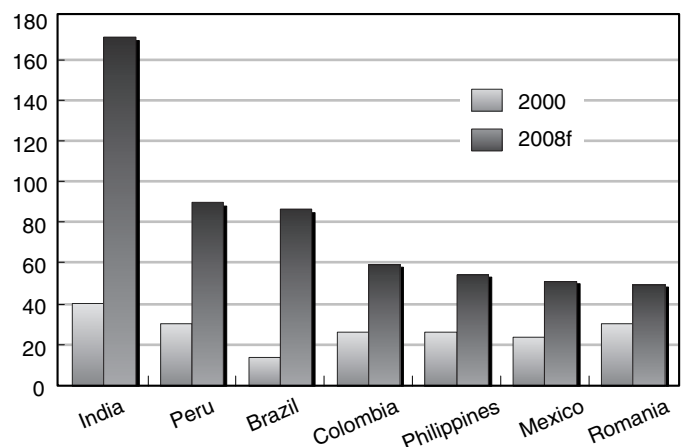
Brazil's economic fundamentals have remarkably improved in recent years as the government maintained pertinent macroeconomic policies, notably adherence to a strict fiscal discipline and a prudent monetary policy aimed for the stabilization of inflation. Brazil achieved external demand-led economic growth from 2002 to 2004. After 2004, it has switched to domestic demand-led growth through stabilized inflation, eased monetary policy, increased employment and rapidly expanded private-sector credit (Chart 1). Gross fixed capital formation, on the gradual increase in recent years, has been bolstering domestic demand, although its ratio to GDP still remained lower at around 19% as compared with 23-25% in Mexico, Peru and Colombia. Brazil's

Chart 1: Domestic demand is likely to slowdown



Source: IBGE (Brazilian Statistics Office)

Chart 2: Gross External debt to International Reserves (%)



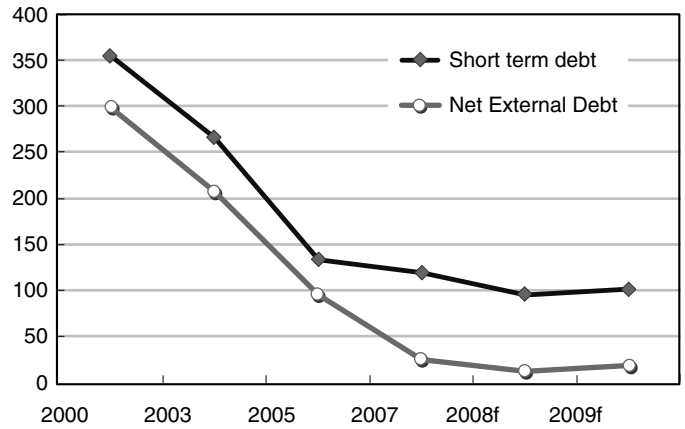
Source: EIU

external balance had worsened due to the heavy external debt burdens and chronic current account deficit amid the several economic and currency crises that hit the country between the late 90s and 2005. However, the current account has turned into surplus as terms of trade improved on the recent upsurge of commodity prices. External debt burden has been eased and the foreign exchange reserves have steadily increased (Charts 2 & 3). As for capital balance, portfolio investment has been rapidly growing since 2007 amid higher interest rates and improved economic fundamentals. FDI inflows, which had long been stagnant, also recovered to reach around 2.5% of GDP in 2008. While portfolio investment fell sharply in 2008 amid the global financial crisis, FDI inflows remained at the same level as the year before. The heavy public debt burden brought by the chronic current account deficit has gradually but steadily improved as the country has kept registering a primary balance surplus since 1998. The stabilization of economic fundamentals has led to recovery of the trust in the money market and promoted the growth of the stock and bond markets. When the global financial unrest stemming from the U.S. subprime mortgage woes came to the fore in August 2007, the Brazilian financial market was hit by temporary volatility but quickly recovered. This proved the market's restored credibility underpinned by stable economic developments. However, shockwaves from the financial crisis triggered by the collapse of Lehman Brothers in September 2008 and the accompanying global recession have been steadily rushing to the Brazilian economy.

1.2 Economic changes after October 2008

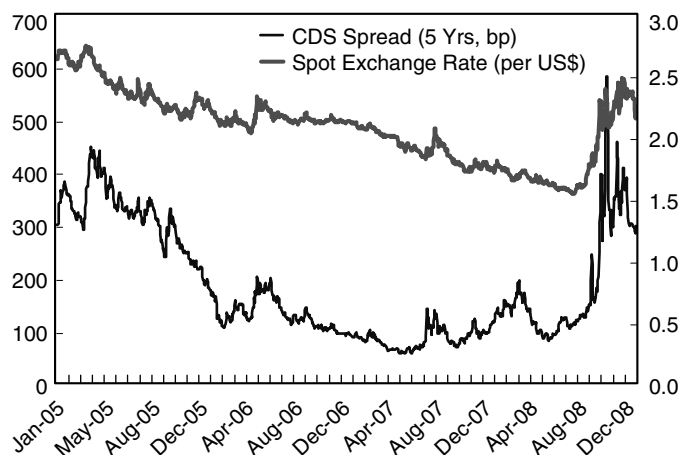
Initial signs of economic slowdown were observed in credit contraction caused by the currency depreciation and increase in spreads after October 2008. As Brazilian financial institutions had few subprime mortgage-related assets, they could maintain their sound fiscal position. However, credit growth slowed down and private corporations' financing from abroad became harder due to a steep rise in credit default swap (CDS) spreads and the plunge of the currency value and stock prices. Spreads on five-year CDS widened to 586bp in October 2008 from 101bp at the beginning of 2008. They stayed high at around 400bp in February 2009. The Brazilian currency has lost much of its value, falling from 1.77 real per dollar at the beginning of 2008 to 2.3 real in December 2008 (Chart 4). There has been no major confusion so far, however, as Banco Central do Brasil promptly provided additional liquidity and announced foreign exchange stabilization measures aimed to ease the impact of the credit contraction. However, private credit supply, which had fueled domestic demand through annual expansion in excess of 30% since October 2007, shrank 0.3% year-on-year in December 2008 (Chart 5). The contraction was apparently due to a gradual increase in the delinquency rate and the stricter lending criteria applied by financial institutions in tighter liquidity position. This trend may continue through

Chart 3: External debts are remarkably declining



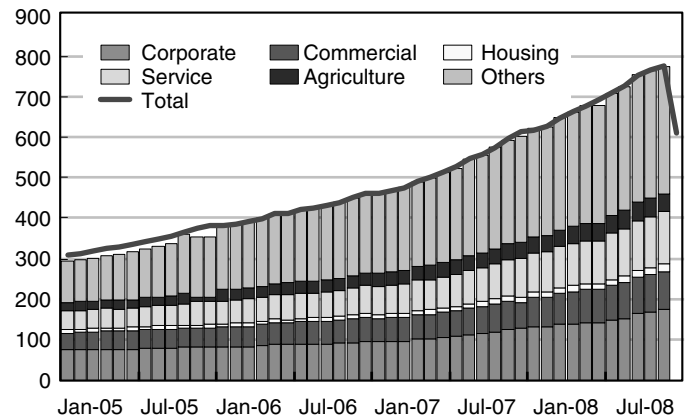
Source: IMF International Financial Statistics (IFS)

Chart 4: CDS Spread and FX



Source: Bloomberg

Chart 5: Private Credit Outstanding (mn Real)



Source: Banco Central do Brasil

2009. In particular, auto loans have turned into negative growth since July 2008, shrinking by 3% year-on-year as of the end of November that year. Considering that both domestic car sales and housing sales have been on the decrease since October 2008 (Chart 6), the growth of private credit other than auto loans is likely to slow down over the coming months. This will cause a sharp slowdown of private consumption in 2009. Banks' reluctance to lend amid the global credit squeeze is also affecting trade credit, damaging the activities of both exporters and importers. Despite the credit contraction at home, Brazilian banks have been keeping their management sound through maintenance of higher capital adequacy ratios and profitability as compared with those in other emerging countries. In the future, however, they may accelerate their moves toward integration to provide against a prolonged slump of the financial market. Already, Banco Itau and Unibanco have merged and Banco Brazil has acquired Sao Paulo State Bank. Through reorganization, Brazilian banks are expected to enhance their resilience to the economic downturn and expand their operational base and business activities.

Brazil posted its first current account deficit in five years in 2008. But the deficit was estimated at a mere 1.8% of GDP, which can be covered by FDI inflows in the year (estimated at around 2.5% of GDP). This means that Brazil has no external finance problems for the present. The foreign exchange reserves, which swelled amid higher commodity prices and so on, covered roughly 80% of the gross external debt as of the end of 2008. The improving external balance may again deteriorate after 2009 with the current account balance worsening and FDI inflows declining amid the recession in major trading partners and falling commodity prices. In 2007 and 2008, big foreign companies built new plants and expanded facilities in emerging markets like Brazil. However, many of them have put off new investment

projects planned for 2009 and announced production adjustment. This may lead to a slowdown of the gross fixed capital formation, another support of domestic demand expansion.

The government announced fiscal expansion measures in January 2009 in a bid to deter a slowdown of domestic demand caused by sluggish private investment and gross capital formation. As the government seems to have enough capacity to implement urgent fiscal measures after maintaining a tight fiscal policy for long in the past, its demand stimulus measures may bolster the domestic demand for a while. Turning to the monetary policy, Banco Central do Brasil already cut its interest rate in January 2009. Until the end of 2008, the central bank had found it hard to lower the interest rate in view of the higher inflation rate. However, the inflation will stabilize amid a slower growth of domestic demand in the future, allowing the bank to implement further rate cuts to simulate the economy.

2. Favorable fiscal position and future fiscal policy

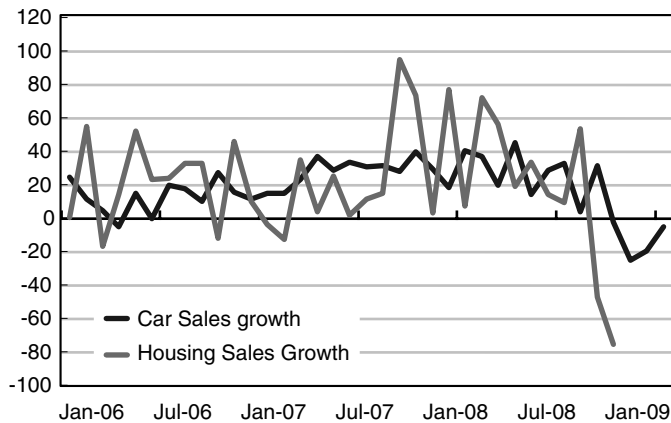
2.1 Fiscal position kept sound in 2008

Until early in the 90s, Brazil had reeled under heavy public debt burden brought by the lax fiscal policies and economic crises accompanied by hyperinflation and high interest rates. However, it has achieved a high annual primary balance surplus equivalent to 3-4% of GDP in the last decade thanks to the fiscal reforms initiated by the Cardoso administration under its "Fiscal Stability Plan." The Lula administration has been carrying out pension and tax reforms since 2002, allowing both the central and state governments to register stable primary balance surpluses. The public debt burden has been gradually declining. As of the end of October 2008, the central government's primary balance surplus stood at 4.0% of GDP, substantially up from 3.0% the year before. The total fiscal deficit also declined remarkably to 0.1% of GDP from 1.36%. Much of the improvement came from increased tax revenues brought by the 5%-plus economic growth in 2008. Tax revenues may decline amid an economic slowdown in 2009. But any major fall is unlikely as the country's tax base is diversified and the percentage of the total revenues to GDP is relatively high. In a departure from its long tight policy, the government has announced an economic stimulus package calling for a significant expansion of fiscal expenditures in 2009. The country's net public debt remains relatively high, though it has been steadily declining after peaking in 2003. At the end of 2008, it stood at 39.6% of GDP.

2.2 Planned fiscal reforms to be put off to give priority to economic stimulus measures

Since its inauguration in 2002, the Lula administration has implemented a spate of fiscal structural reforms. However, its reform initiatives planned in 2009 are likely to be postponed, given the necessity to take prompt fiscal measures to minimize the impact of the global recession amid weakening domestic demand. Moreover, with the presidential election scheduled for 2010, the administration may find increased

Chart 6: Rapid Falls in Car and Housing Sales (YOY, %)



Source: Bloomberg

fiscal expenditures all important as they will be most appealing to the voters. At this time, election results are hard to predict. There is an opinion that the governor of Sao Paulo State, a possible candidate from the opposition Brazilian Social Democratic Party (PSDB), may have the game in his hands in this economically difficult period. On the other hand, the ruling Workers' Party (PT) has yet to reach a consensus as to who should run in the election. A possible candidate at this moment is Ms. Dilma Roussef, the chief of staff at the presidential office, who is supported by President Lula himself. However, the ruling camp is not fully united behind Ms. Roussef. Much seems to depend on how the Lula administration and the presidential candidate of the ruling party will manage the ongoing difficult economic situation.

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