

Political turmoil could hinder the economic recovery

General Information



GDP	USD1803.6526bn (World ranking 9, World Bank 2015)
Population	207.85mn (World ranking 5, World Bank 2015)
Form of state	Federal Republic
Head of government	Michel TEMER since 2016
Next elections	2018, presidential and legislative



Strengths

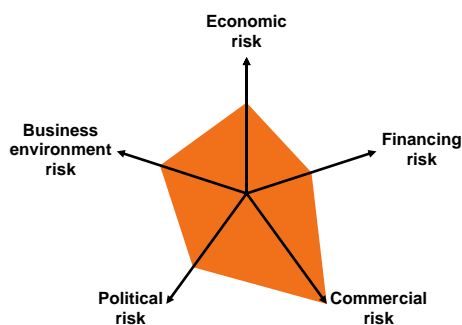
- Important role on an international and regional scale
- Diversified economy
- Growing middle class
- Robust foreign direct investment inflows, high level of foreign exchange reserves and low external debt
- Support for IFIs likely if needed

Weaknesses

- Vulnerable to global commodity prices
- High production costs
- High taxation and red tape
- Persistent inflation (although declining) and large fiscal deficits
- Political and social tensions, corruption and income inequality

Country Rating

B3



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports	Rank	Imports
China	20% 1	19% China
United States	13% 2	15% United States
Miscellaneous	8% 3	6% Germany
Argentina	6% 4	6% Argentina
Germany	4% 5	4% France

By product (% of total)

Exports	Rank	Imports
Other Edible Agricultural Prod	16% 1	5% Fertilizers
Iron Ores	9% 2	5% Refined Petroleum Products
Crude Oil	8% 3	5% Basic Organic Chemicals
Meat	6% 4	4% Telecommunications Equipment
Sugar	4% 5	4% Crude Oil

Source: Chelem (2015)



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Economic Overview

Recession is over, but the future is fraught with risks

After two consecutive years of recession, real GDP grew by +1% q/q in Q1 2017, the first positive rate since Q4-2014. Yet, on a year on year basis, GDP fell by -0.4% for the 12th consecutive quarter. From the supply side, growth was driven by the agriculture sector (+13.4% q/q) due to a bumper soy harvest. Industrial output expanded by +0.9% q/q, but services struggled to pick up (+0%). Euler Hermes expects GDP growth of +0.6% in 2017 and +1.9% in 2018, far below the pre-crisis pace of +4.5%. Risks loom as more political uncertainties could hit confidence.

Only one year after he took the office after Dilma Rousseff's Impeachment, President Michel Temer is now also being stained by a political scandal. A local newspaper claimed a secret recording allegedly proved Temer was involved in bribery. Temer's popularity has sunk below 10%.

Inflation has eased back into the target range of +4.5% +/-2pp as consumer prices moderated to +3.6% y/y in May, down from +9.3% y/y a year before and a peak of +10.7% y/y in late 2015. Hence, monetary authorities have adopted a pro-growth policy stance. The key rate has been cut by 300 bps since October 2016 to 10.25% in June. Moreover, downward pressures on the currency have faded away.

Still, the BRL remains very sensitive to political developments. It depreciated by -9% against the USD the day after the Temer scandal broke. Although the disinflation process should continue over the next months, allowing for further rate cuts, short-term risks should be closely monitored such as (i) the impact on prices of the approval of fiscal consolidation measures, (ii) the uncertain external environment and its impact on the currency and (iii) food prices shocks stemming to a large extent from tougher weather conditions.

The high fiscal deficit (-9% in 2016) risks weighing further on the public debt-to-GDP ratio already rising quickly while activity struggles to pick up. Indeed, the recession dragged down government tax revenues and pushed up borrowing costs. At the height of recession, 10-year bond yields reached 7% against the 2013-2015 average of 4.5%.

Renewed political instability weighs on the implementation of the reform agenda

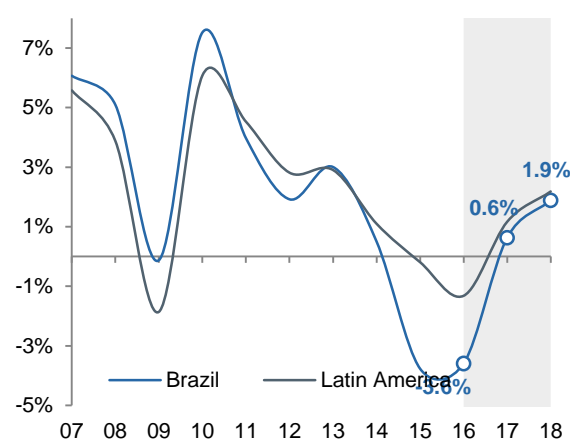
As the economy begins to emerge from the recession, the government continues to push for ambitious reforms. Last on the agenda, the **pension system reform** should set a minimum retirement age of 65 for men and 62 for women and reduce pension benefits. Currently, Brazilians retire at 54 on average with almost full benefits. Reforming one of the most generous systems in the world seems essential to alleviate the pressure on public finances. The government also aims to **reform the bankruptcy law** to help indebted firms emerge faster from creditor protection. The aim is to reduce the average length of bankruptcy protection to 2 years, against 7-8 years currently, and to help companies under creditor protection to maintain operations and borrow funds.

Key economic forecasts

	2015	2016	2017	2018
GDP growth (% change)	-3.8	-3.6	0.6	1.9
Inflation (% , yearly average)	9.0	8.7	3.8	4.0
Fiscal balance (% of GDP)	-10.3	-9.0	-9.1	-7.5
Public debt (% of GDP)	72.5	78.3	80.8	82.3
Current account (% of GDP)	-3.3	-1.3	-1.5	-2.1
External debt (% of GDP)	19.5	19.0	17.6	17.6

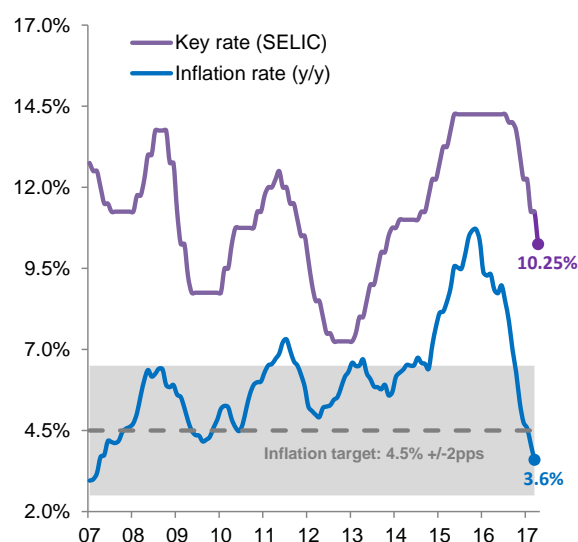
Sources: National statistics, IMF, Euler Hermes

GDP Growth in Brazil and Latin America (%)



Sources: National statistics (IBGE), Euler Hermes

Inflation and policy rates in Brazil (%)



Sources: National Statistics, Euler Hermes

Moderate external risk as conditions improve

A strong upturn in Brazilian exports is visible since the beginning of the year. In 2017, growth of exports over 12 months turned positive for the first time since August 2014 and the April figure (+4.6% y/y) was the highest since July 2012. In levels, exports are 8% higher than the last recession low but still 19% lower than the last peak.

This trend is expected to continue on the back of: (i) positive crops' forecasts and, notably, plentiful soy and corn harvests; (ii) rising commodity prices; and (iii) recovering global trade, with exports to China and the US leading the way.

Imports have recovered as well, but not as fast as exports. Hence, driven by a rapidly improving balance of goods, the current account deficit narrowed significantly from -3.3% of GDP in 2015 to -1.3% in 2016. It should remain stable at -1.5% in 2017. FDI flows comfortably cover 103% of the external deficit and have proven resilient.

Yet portfolio investments have proven much more sensitive to cyclical downturns. These plummeted in 2015 and turned negative in 2016 (reaching -USD20bn outflows in last November). Although they have stabilized since the beginning of the year, further volatility cannot be ruled out on the back of a new wave of political turmoil.

Brazil's vulnerability to capital swings is mitigated by ample foreign exchange reserves covering more than 20 months of imports. Moreover, external debt-to-GDP ratio is low (19% in 2016) and projected to remain at this level.

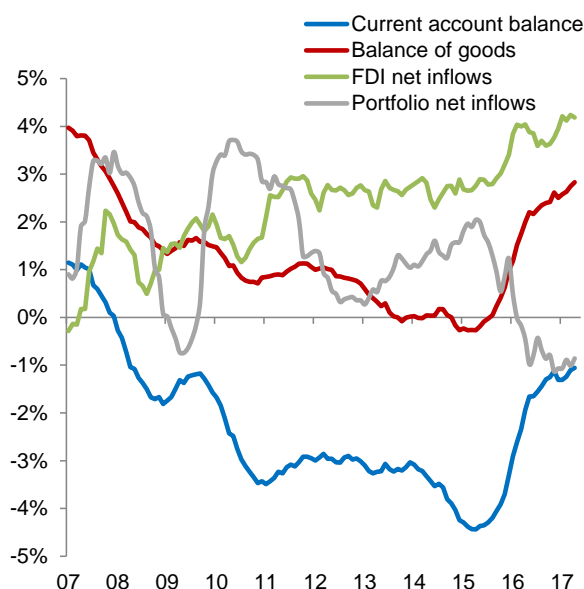
Poor business environment

Brazil ranks 123rd out of 190 countries in the World Bank 2017 Doing Business Survey, below the Latin American average. Except for protecting investors (32nd), enforcing contracts (37th) and getting electricity (47th), the business environment is poor.

The control of corruption, ease of starting a business or the simplicity and efficiency of the tax system are among the main shortcomings. If enacted, the future bankruptcy law could enhance the business climate.

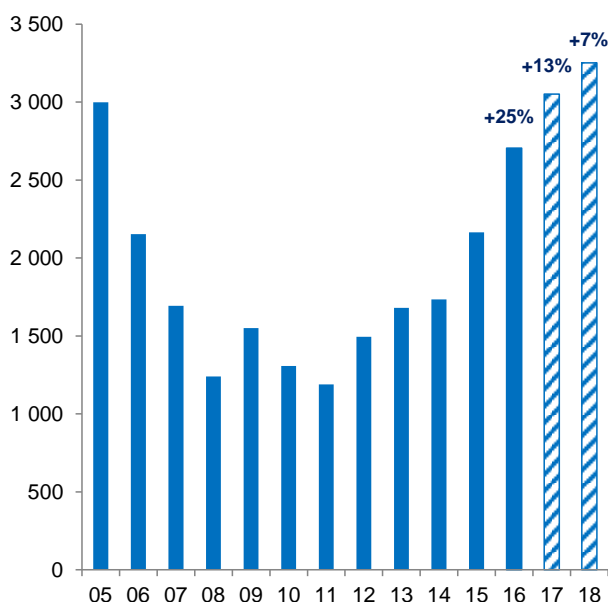
After two consecutive years of marked increases (+25% in 2016 and 2015), the surge in corporate insolvencies should moderate to +13% in 2017 and +7% in 2018 as Brazil gradually exits from recession.

Balance of payments components (% GDP)



Sources: Banco Central do Brasil, Euler Hermes

Number of company insolvencies in Brazil



Sources: National statistics, Euler Hermes

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