Euler Hermes Economic Research

Country Report

Brazil

Economic activity constrained by significant bottlenecks

General Information

GDP	USD2252.664bn (World ranking 7, World Bank 2012)
Population	198.66 million (World ranking 5, World Bank 2012)
Form of state	Federal Republic
Head of government	Dilma ROUSSEFF (PT)
Next elections	2014, presidential and legislative

Strengths

- Overall size of the economy
- Large domestic market and expanding middle class
- Diversified economic base (minerals, agriculture, manufacturing sector)
- Robust foreign direct investment, high level of foreign exchange reserves, moderate external debt
- Durable political system with established effective democratic transfers of power

Weaknesses

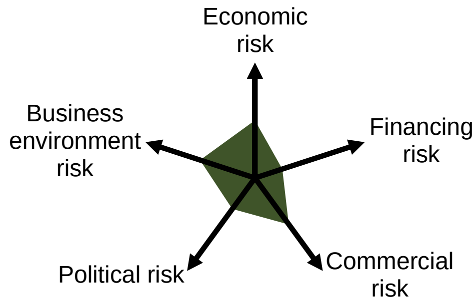
- Insufficient investment and infrastructure bottlenecks
- Sensitive to global commodity demand and prices
- Lack of qualified workforce and high production costs
- Persistent inflation and public spending stresses
- High levels of taxation and bureaucracy that undermine competitiveness
- Political and social tensions, persistent insecurity, allegations of corruption and inequalities of income distribution

Country Rating

BB1

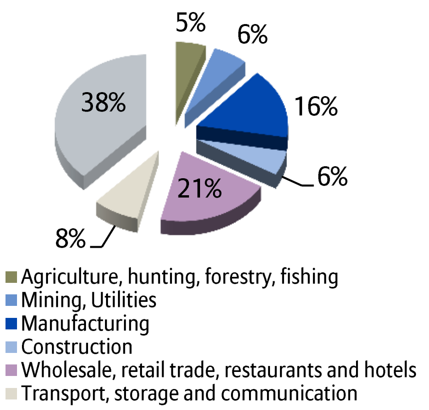
Country Grade **Country Risk Level**

Risk Dimensions



Economic Structure

GDP breakdown (% of total, 2011)



Sources: Chelem, UnctadStat, IHS Global Insight, Euler Hermes

Trade structure (% of total, 2011)

By destination / origin

Exports		Rank		Imports
China	17%	1	16%	China
United States	11%	2	16%	United States
Argentina	9%	3	8%	Argentina
Germany	5%	4	7%	Germany
Japan	4%	5	5%	South Korea

By product

Exports		Rank		Imports
Iron Ores	16%	1	8%	Refined Petroleum Products
Other Edible Agricultural Prod	11%	2	6%	Cars And Cycles
Crude Oil	10%	3	6%	Crude Oil
Sugar	7%	4	4%	Fertilizers
Meat	5%	5	4%	Basic Organic Chemicals

Economic Forecast

	2009	2010	2011	2012	2013e	2014f
GDP growth (% change)	-0.3	7.5	2.7	0.9	2.3	2.0
Inflation (%, end-year)	4.3	5.9	6.5	5.8	5.9	5.7
Fiscal balance (% of GDP)	-3.1	-2.7	-2.5	-2.7	-3.0	-3.2
Public debt (% of GDP)	66.8	65.0	64.7	68.0	68.3	69.0
Current account (% of GDP)	-1.5	-2.2	-2.1	-2.4	-3.6	-3.5
External debt (% of GDP)	12.2	12.0	12.0	13.9	14.7	15.2

Source: IHS Global Insight, national sources, Euler Hermes

Economic Growth

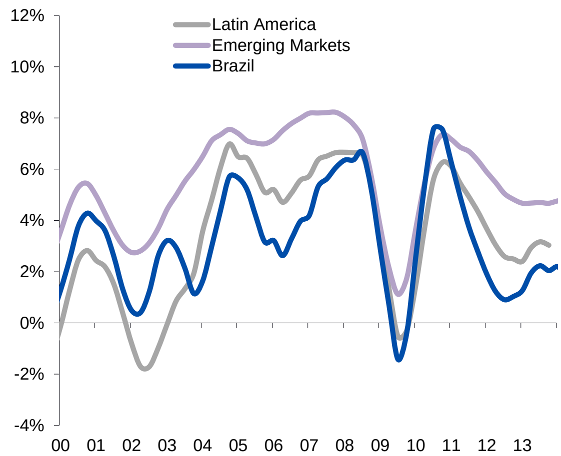
Real GDP growth constrained by both short and long term weaknesses

Economic activity is recovering at a slower-than-anticipated pace from the growth slowdown that started in mid-2011. Structural weaknesses coupled with short term factors explain this trend and are weighing on both consumer and business confidence.

Even if the unemployment rate is expected to remain at a low level, consumption is set to grow at a much more moderate pace in 2014, constrained by persistent inflation, rising interest rates and a high level of household debt. Despite large-scale projects related to the World Cup, which will start next June, Brazil is set to continue to suffer from significant and chronic infrastructure shortcomings. Delays in implementing policies to boost private investment (especially in infrastructure) remain a significant downside risk on investor confidence. Exports are however expected to modestly accelerate thanks to improving global prospects.

The outlook for the Brazilian economy remains, thus, subdued. Real GDP growth is not set to gain traction this year. We forecast real GDP to grow by +2.0% in 2014, a very moderate pace compared to an annual average growth rate of +4.8% between 2003 and 2008.

GDP growth (% y/y, 4 qtrs cumulated)



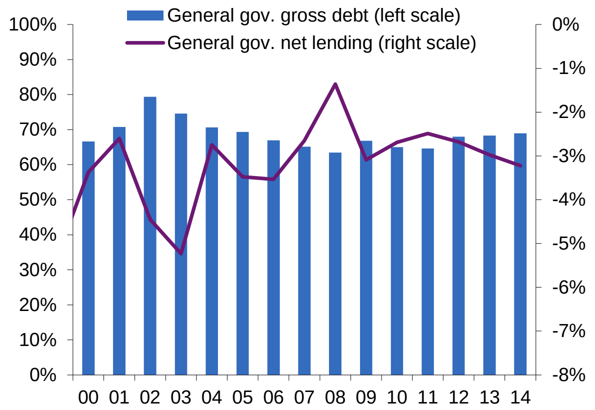
Sources: IHS Global Insight, Euler Hermes

Uncertainties over fiscal policy

Brazilian authorities have implemented several rounds of fiscal stimulus (mostly tax incentives) in order to face the deceleration in activity since 2011. The overall fiscal deficit has continuously increased over the last 3 years (-3.0% of GDP in 2013 against -2.5% in 2011). The primary surplus (excluding interest payments) has also declined. It reached 1.9% of GDP in 2013 (2.4% in 2012) while the official target was 3%. As a result, uncertainties over the government's ability to maintain a prudent fiscal policy have emerged and confidence in the fiscal framework has weakened. In order to earn credibility, the Ministry of Finance stated a cut of 44bn reals from the 2014 budget, intending an ambitious primary surplus target of 1.9% of GDP. Gross public debt is mostly domestic and has stabilized at 68% of GDP.

Given the elections and increasing social pressures, improving the fiscal situation is likely to be a key challenge in 2014. Fiscal targets might not be reached.

Fiscal balance and public debt (% of GDP)



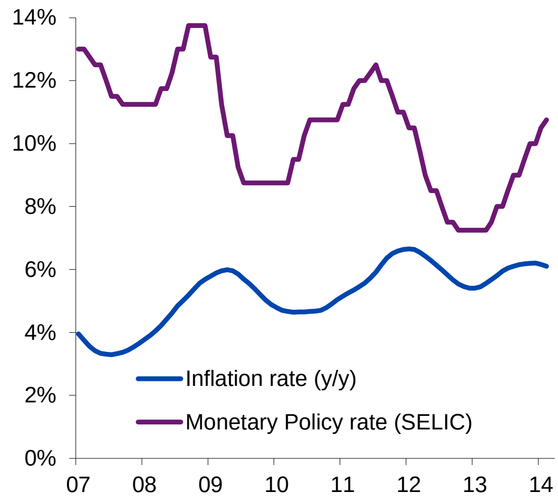
Sources: IHS Global Insight, national sources, Euler Hermes

Monetary tightening to face persistent inflation

Brazil faces persistent high inflation that has remained at the high end of the target range (4.5% ±2%), or even above, for almost three years. In response, and faced with increasing social pressures, Brazilian authorities re-asserted the prioritization of inflation control and have implemented one of the most aggressive tightening cycles. The central bank has indeed raised interest rates by 350 basis points since April 2013. The Selic rate reached 10.75% at the end of February (hike for the eighth straight time).

This restrictive monetary policy has moderated inflation, but has also hit the activity dynamism. In the long run, structural reforms are needed in order to avoid persistent inflationary pressures in the context of stronger growth. Brazil suffers from an industry weakened by its lack of competitiveness, infrastructure bottlenecks and an overdeveloped primary sector. Inflation is thus expected to remain high in 2014 (5.7%).

Inflation rate (12-month moving average, %)



Sources: IHS Global Insight, national sources, Euler Hermes

Interventions on foreign exchange markets

Following expectations of a slowdown in the Fed quantitative easing program, the real strongly depreciated against the USD during the 2013 summer. This led to the Brazilian central bank intensifying its interventions on foreign exchange markets in order to limit volatility – mainly via interventions in the currency swap market.

Even if the national currency recovered somewhat thereafter, a new depreciation trend is observable since October 2013. Despite a slight reinforcement since the beginning of February (+5%), the real remains weakened (2.33 BRS/USD by the beginning of March). The authorities announced an extension of the swap program for 2014 in order to avoid high exchange rate volatility. While the depreciation could support competitiveness, the latter is still undermined by weaknesses in the manufacturing industry, rising unit labor costs, heavy bureaucracy, high levels of taxations and a complex tax system.

Exchange rate (BRS/USD)

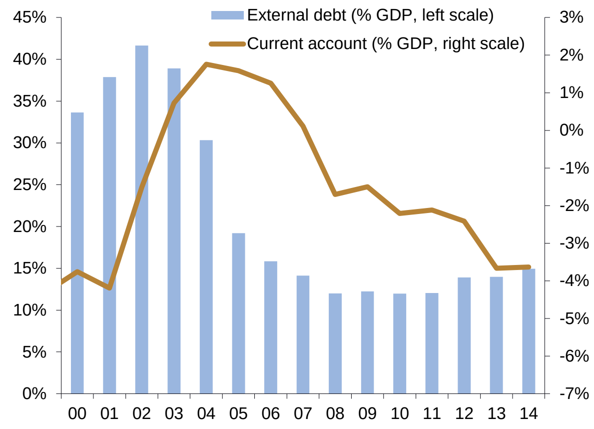
Sources: IHS Global Insight, Euler Hermes

Increasing current account deficit

The current account deficit (-3.6% of GDP in 2013) has risen in recent years, mainly due to a decrease in commodity prices coupled with higher domestic demand and weak competitiveness of the Brazilian industry.

Improving global prospects and a weaker exchange rate should be (modestly) beneficial for the export sector in 2014. Exports are geographically well spread and heavily dependent on commodity prices. China has become the largest export market reflecting its expanded demand for raw material inputs. Consequently developments in commodity prices and in the Chinese economy will have a significant impact on Brazil's export performance. On the other hand, imports are set to continue to be driven by significant domestic demand. The trade surplus is thus set to be modest in 2014. Services and income balances are expected to remain in deficit, leading to a narrow decrease in current account (expected at -3.5% of GDP this year).

Current account and external debt (% of GDP)



Sources: IHS Global Insight, national sources, Euler Hermes

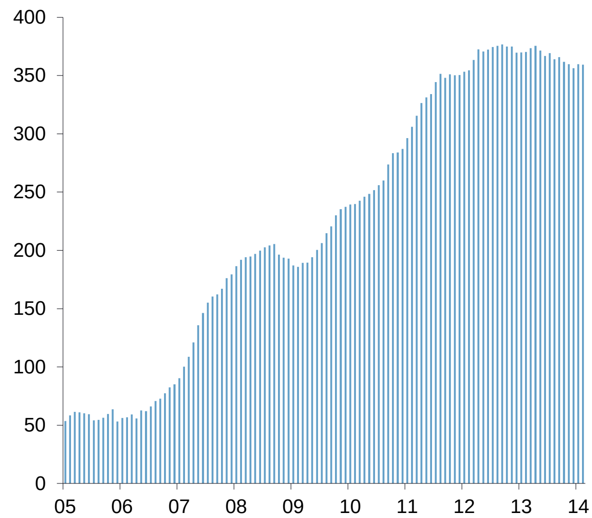
External vulnerability remains under control

Foreign direct investment inflows have recovered strongly after a short, sharp fall in 2009 during the global financial crisis. Net capital inflows (USD 75bn in 2013, of which USD 65bn of FDI) almost covered the current account deficit (USD 80bn), limiting the need for debt financing inflows. FDI is set to help to finance infrastructure in the medium term.

The level of foreign exchange reserves remains high despite the intervention in foreign exchange markets by the central bank (USD 368 billion in February 2014, representing about 13 months of import cover).

External debt is moderate, amounting to about 15% of GDP or 109% of exports of goods and services, and interest payments are 5% of exports of goods and services.

Foreign exchange reserves (USD billion)



Sources: Brazilian Central Bank, Euler Hermes

But downside external risks remain significant

Brazil's external position is still sound thanks to the stability of FDI and high foreign exchange reserves, which could act as buffers against external shocks. However, downsides risks have to be watched, mainly regarding global financial conditions as illustrated by the concerns sparked during the summer of 2013 with the acceleration in capital outflows as a result of expectations of a slowdown in the US Fed quantitative easing program. Managing a (progressive) exit from easy money will be a key issue to monitor.

Contact Euler Hermes Economic Research Team
research@eulerhermes.com

Last review: 2014-03-10
Country Risk Analysts:
Daniela Ordonez, Rémy Carasse
daniela.ordonez@eulerhermes.com