Euler Hermes Economic Research

Country Report

Brazil

Recession ahead

General Information

GDP	USD2245.7 bn (World ranking 7, World Bank 2013)
Population	200.4 mn (World ranking 5, World Bank 2013)
Form of state	Federal Republic
Head of government	Dilma ROUSSEFF (PT)
Next elections	2018, presidential and legislative

Strengths

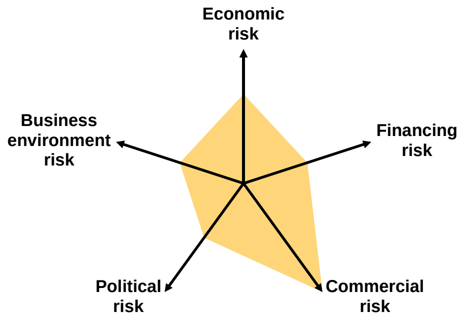
- Overall size of the economy
- Large domestic market and expanding middle class
- Diversified economic base (minerals, agriculture, manufacturing sector)
- Robust foreign direct investment, high level of foreign exchange reserves, moderate external debt
- Durable political system with established effective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

Weaknesses

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

Country Rating

B2



Source: Euler Hermes

Trade Structure

By destination / origin (% of total)

Exports		Rank		Imports
China	17%	1	16%	China
United States	12%	2	15%	United States
Argentina	7%	3	7%	Argentina
Germany	5%	4	6%	Germany
Japan	4%	5	5%	Nigeria

By product (% of total)

Exports		Rank		Imports
Iron Ores	14%	1	9%	Refined Petroleum
Other Agri. Products	12%	2	6%	Crude Oil
Crude Oil	9%	3	4%	Fertilizers
Sugar	6%	4	4%	Cars and Cycles
Meat	5%	5	4%	Engines

Source: Chelem, UNCTAD (2012)

Economic Overview

Lack of competitiveness

The Brazilian economy largely benefited from raw material revenues and large capital inflows over 2003-2008, and registered an average annual growth of +5% over that period. These resources were, however, very demand-oriented as consumption (public + private) accounted for over 70% of real growth, while investment remained relatively weak. The investment rate in Brazil stands below 20% of GDP, the lowest among the BRIC grouping (China 47%; India 34% and Russia 24%) and below the Latin American average (Argentina, Chile and Colombia 24%, Mexico 22% and Peru 28%), according to IMF data. Less favorable external conditions highlighted the weaknesses inherent to the Brazilian economic model. Local production could not keep up the momentum of domestic demand, generating internal (inflation) and external (current account deficit) imbalances, and weighing on growth.

Euler Hermes estimates that the investment deficit cumulated by the Brazilian economy over the past 10 years reached USD1100 bn. The lack of investment in infrastructure combined with the persistent problems of protectionism, excessive bureaucracy, high labor costs and a complex and punitive tax system greatly hinders the national business environment and cripples competitiveness.

Recession in 2015

2014 was a complicated year for Brazil. As Euler Hermes expected, the hosting of the Soccer World Cup brought more inflation than growth for Brazil. Additionally, the external environment remained adverse. The economy had to deal with local currency depreciation and volatility along with tighter financing conditions due to the Fed's tapering disruption. The sharp fall in agriculture prices largely affected the value of exports, while the slowdown in Latin America and China, and still sluggish demand from developed markets (albeit recovering in the U.S.) weighed on export volumes. All this highlights the inherent weaknesses of the Brazilian economic model (demand-based and chronic under-investment) that is crippling growth.

2015 will be very challenging. The external environment will remain tight, mainly driven down by commodity prices and strong FX volatility, while global demand, although recovering, should remain subdued. Internally, the Central Bank is expected to continue tightening its monetary policy (key rate raised to 12.75% in March, the highest level since 2008), as inflationary pressures will continue to be above the inflation target of 4.5% +/-2pp (the inflation rate reached 7.7% y/y in February, a 12-year high). Alongside this, the new Finance Minister, Joaquim Levy, committed to address fiscal accounts. The target is to reach a primary surplus of +1.3% of GDP in 2015 and +2% in 2016-2017. However, austerity measures are likely to be difficult to enact amid political tensions. Combined with restrictive economic policies, the already weak economic activity will be heavily impacted by the fragile outlook for the investment plans of Petrobras (which accounts for around 10% of total Brazilian investment) as well as water and electricity cuts. After stagnating in 2014, we expect Brazil will fall into recession in 2015, with real GDP contracting by -0.7%, at least.

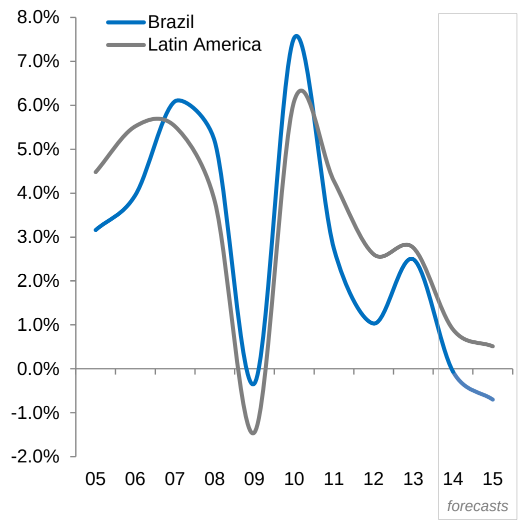
Key economic forecasts

	2012	2013	2014e	2015f
GDP growth (% change)	1.0	2.5	-0.1	-0.7
Inflation (%, yearly average)	5.4	6.2	6.3	6.0
Fiscal balance* (% of GDP)	-2.8	-3.3	-3.9	-3.2
Public debt* (% of GDP)	68.2	66.2	65.8	65.9
Current account (% of GDP)	-2.4	-3.6	-4.2	-4.0
External debt (% of GDP)	13.9	13.7	15.6	17.8

**Includes Local Government; Nonfinancial Public Corporation; Social Security Funds; State Government*

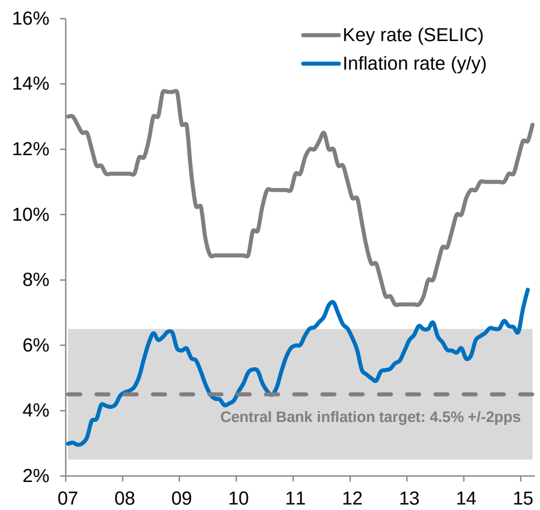
Sources: National sources, IHS, Euler Hermes

GDP growth (%)



Sources: National sources, IHS, Euler Hermes

Inflation rate and Monetary policy rate (%)



Sources: National sources, IHS, Euler Hermes

The current account deficit will remain wide, but external vulnerability is under control

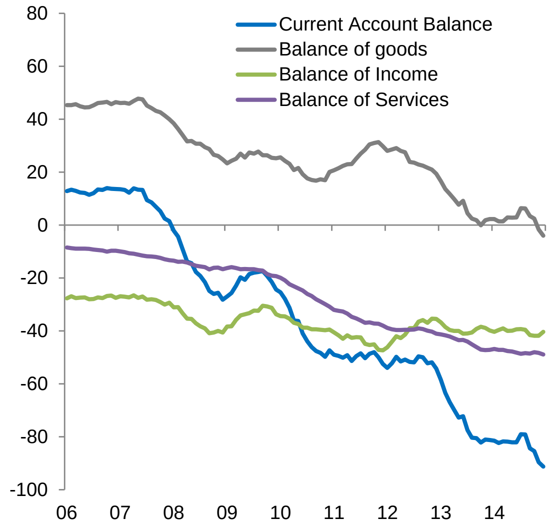
The current account deficit worsened in recent years (estimated at -4.2% of GDP in 2014 vs a surplus of +0.1% of GDP in 2007), mainly due to a decrease in commodity prices coupled with higher domestic demand and weak competitiveness of Brazilian industry. The deficit is likely to remain wide as long as structural weaknesses (notably competitiveness issues) are not tackled.

However, external vulnerability is under control. Net FDI inflows cover around 70% of the current account deficit, while the level of foreign exchange reserves is very comfortable, covering more than 12 months of goods and services imports. Thanks to this financial cushion, the Central Bank is able to avoid liquidity shortages despite the tight external environment. Encouragingly, external debt is moderate, amounting to about 14% of GDP or 113% of exports of goods and services

Some reforms might be difficult to enact

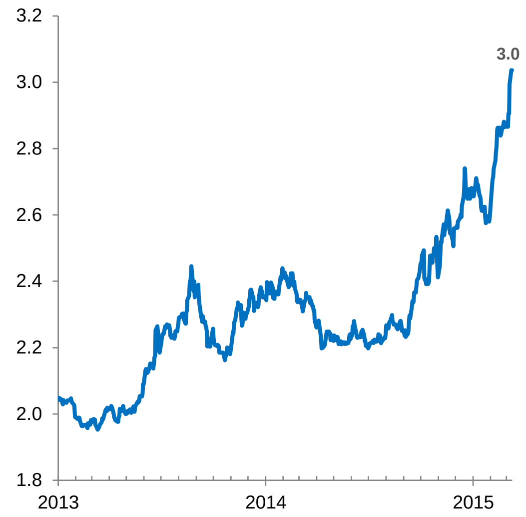
In a close-run presidential vote, Dilma Rousseff was re-elected with 51.64% of the vote, compared with 48.36% for Aécio Neves. President Dilma Rousseff pledged to combat inflation in her second term, and the new Finance Minister, Joaquim Levy, committed to address fiscal accounts. During her first term, Rousseff experienced difficulties in relation to implementation of structural reforms - aiming to sustain investment, increase the competitiveness of industry and improve the business environment - and these obstacles are likely to continue amid political tensions. In March, for example, a presidential decree aiming to increase payroll taxes was rejected by legislative leaders from Rousseff's coalition.

Current account balance breakdown (over 12 months, % of GDP)



Sources: National sources, IHS, Euler Hermes

Brazilian real (BRL) per USD



Sources: National sources, IHS, Euler Hermes

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