Euler Hermes Economic Research

Country Report

Brazil

Still in deep recession in 2016

General Information

GDP	USD2245.7bn (World ranking 7, World Bank 2013)
Population	200 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

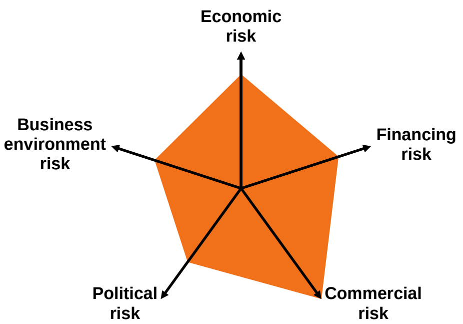
- Overall size of the economy
- Large domestic market and expanding middle class
- Diversified economic base (minerals, agriculture, manufacturing sector)
- Robust foreign direct investment, high level of foreign exchange reserves, moderate external debt
- Established political system with effective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

C3



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 (2013)

Economic Overview

Deep recession, high inflation and more corporate insolvencies

Brazil recorded in 2015 the worst economic recession in 25 years. Real GDP contracted by -3.8%, after stagnating in 2014 (+0.1%).

Most worrying was the collapse in investment: a staggering - 14% decrease brought it back to 2009 levels. Financing conditions have tightened, notably for companies. National credit outstanding for non-financial corporations has slowed strongly: +6.3% y/y in December 2015, vs. +10% on average in 2014 and +15% in 2013. At the same time, banking interest rates have risen strongly and stand now above 20% on average for companies (above 30% for non-earmarked resources and close to 10% for earmarked resources).

Companies face difficulties paying their loans. As of December 2015, arrears in banking loans accounted for 3.2% of total non-earmarked credit, while non-performing loans reached 4.5%. Both indicators are at their highest level since 2013.

Private consumption fell by -4.0% due to high inflation and the deteriorating labor market. In 2015, employment contracted by -1.4%, pushing up the unemployment rate above 7% vs. 4.8% a year earlier. Nominal payroll slowed strongly over 2015 and began to contract in September (-1.0% y/y in December 2015). On average, it grew by only +0.5% in 2015, after +5% in 2014 and +7.5% in 2013. Inflation reached +9% on average in 2015, the highest rate in 12 years and double the Central bank's target (4.5% +/-1pp).

Against this background, the Central Bank increased the key interest rate by +300bps between October 2014 and July 2015, to 14.25%, and has maintained that level since then. Monetary policy is likely to remain tight, as inflation, despite easing gradually, is expected to remain above target at least until the end of 2016.

Net exports contributed positively to growth on the back of a moderate growth in exports (+6%), but, especially, a strong collapse of imports: -14

Brazil will remain in deep recession in 2016. Real GDP is estimated to contract by -3.5%. Companies will continue to face strong difficulties amid (i) falling domestic and external demand; (ii) inflationary pressures; (iii) tight financing conditions; (iv) increased financial volatility; (v) social and political tensions. Corporate insolvencies are expected to surge by +22% after +25% in 2015.

Public finances in rapid deterioration (amid political and social tensions) is worrying

The country's fiscal accounts have deteriorated sharply. The public deficit widened to -10.3% of GDP in 2015, up from -6.0% in 2014 and -3% in 2013. This decline can be traced back to a sharp increase in payment of interests on public debt, which reached 8.5% of GDP in 2015 (vs. 5.5% in 2014).

The primary fiscal balance has also deteriorated. 2014 saw the first ever deficit in the country's history. It grew to -2% of GDP in 2015.

Although fiscal consolidation seems essential to limit the public debt surge (expected to exceed 75% of GDP in 2016), the adoption of austerity measures could prove difficult amid strong political and social tensions, as the popularity rate of President Roussef is plunging to record lows.

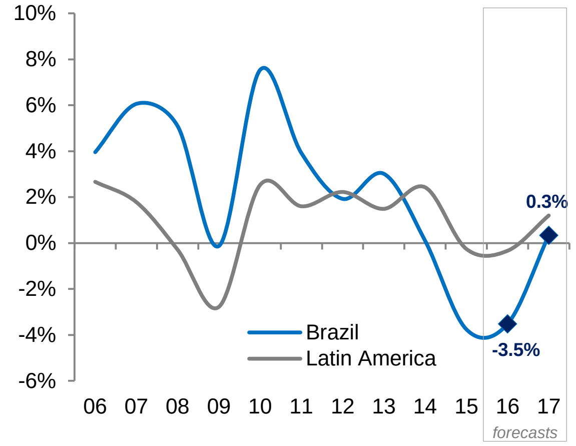
Key economic forecasts

	2014	2015	2016	2017
GDP growth (% change)	0.1	-3.8	-3.5	0.3
Inflation (%, yearly average)	6.3	9.0	8.5	5.4
Fiscal balance* (% of GDP)	-6.2	-7.7	-8.2	-7.0
Public debt* (% of GDP)	65.2	69.9	78.1	85.1
Current account (% of GDP)	-4.3	-3.6	-2.5	-3.1
External debt (% of GDP)	14.6	20.6	26.1	28.1

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

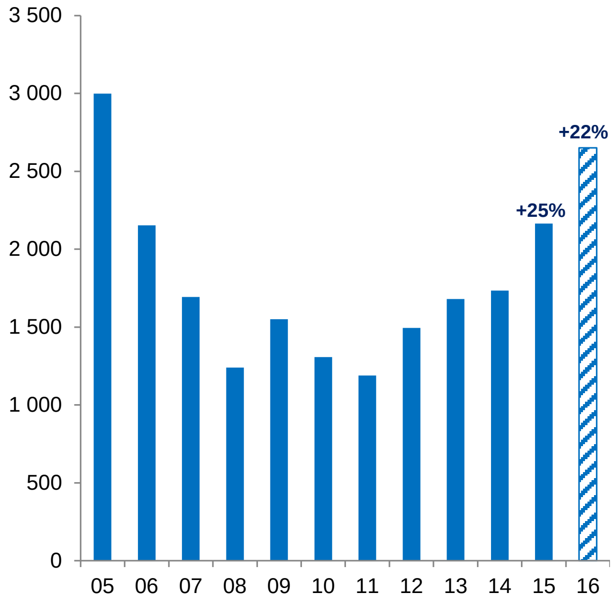
Sources: National sources, IHS, Euler Hermes

GDP growth (%)



Sources: National sources, IHS, Euler Hermes

Inflation rate and Monetary policy rate (%)



Sources: National sources, IHS, Euler Hermes

External imbalances began to be absorbed

External conditions are adverse. The tightening of US monetary policy combined with the Petrobras scandal and the deterioration of economic indicators in Brazil led to strong downward pressures on the currency and increased financial volatility. The BRL has lost more than -55% against the USD since its last peak in June 2014. It will continue to be plagued by downward pressures and high volatility over 2016.

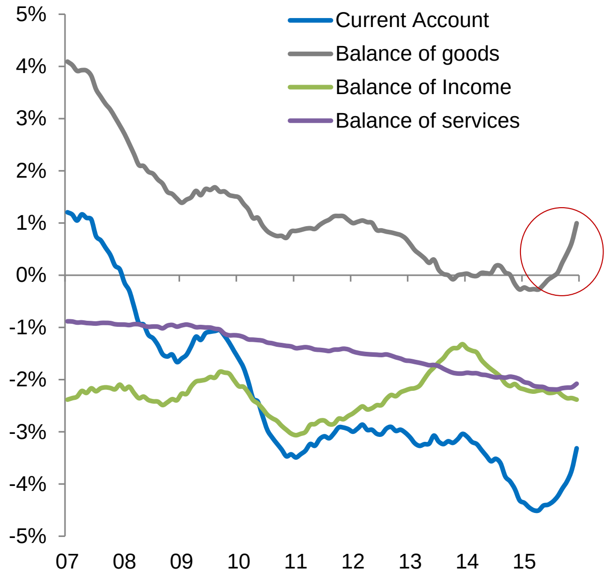
Portfolio inflows tumbled over 2015 to USD7bn over 12 months in October vs. USD45bn at the beginning of 2015, but have recovered somewhat since then to USD18bn in December.

However, foreign direct investment remained strong. Overall, net FDI inflows (inflows-outflows) stood at USD62bn, enough to cover the entire current account deficit. This has entered a trend of correction and is expected to narrow to -2.5% of GDP in 2016.

Moreover, FX reserves are at a comfortable level, covering more than 15 months of imports. External debt is moderate, amounting to about 15% of GDP or 113% of exports of goods and services in 2015.

External vulnerability seems under control.

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



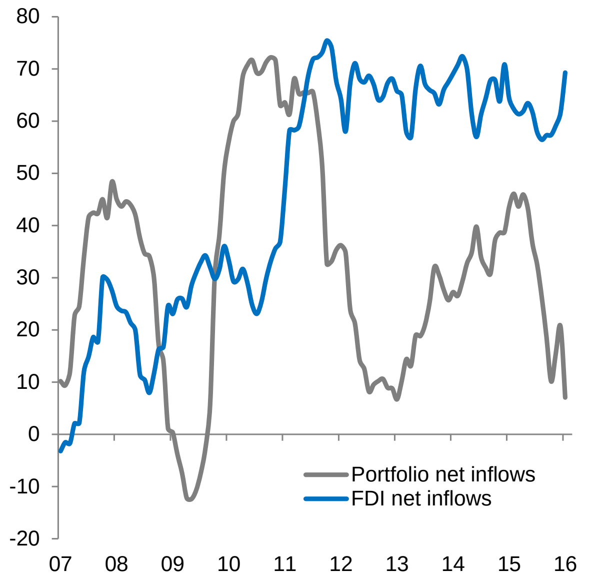
Sources: National sources, IHS, Euler Hermes

Lack of competitiveness is the main drag on growth potential

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

The lack of investment (notably in infrastructure) combined with increasing protectionism, excessive bureaucracy, high labor costs and a complex and punitive tax system greatly hinders the national business environment and cripples competitiveness.

Foreign investment inflows (USD bn, over 12 months)



Sources: National sources, IHS, Euler Hermes

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