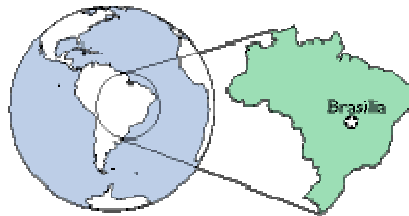


COUNTRY REVIEW

Brazil



1 September 2010

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EULER HERMES COUNTRY RISK GRADE: BB

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- Established democratic transfers of power
- Diversified economic base, large domestic market, attractive for FDI
- Flexible exchange rate regime with inflation targets as basis of monetary policy
- High level of FX reserves
- Access to international financing

Weaknesses

- Political system fragmented, which inhibits quick passage of reform legislation (also prone to scandal)
- Exposed to changes commodity prices
- Further substantive progress on structural reforms may be limited
- High (albeit improved) public debt-GDP ratio

Country Risk Assessment

Ratings	Brazil		Median Grade BB	Chile	Peers	
	Latest	Previous			Mexico	S. Korea
Systemic Political Risk:	P2+	P2+	P2+	P2+	P2-	P2+
Systemic Economic Risk:	E3	E3	E3	E2	E3	E3
ME rating:	ME3	ME3	ME3	ME2	ME3	ME3
<i>Structure</i>	1.6	2.8	4.0	4.0	2.8	3.3
<i>Policy</i>	4.0	4.8	4.3	2.2	4.2	4.2
<i>Solvency</i>	3.3	3.3	1.3	2.8	2.0	1.3
<i>External Liquidity</i>	2.8	3.3	1.0	2.8	1.7	2.2
SBE rating:	SBE3	SBE3	SBE2	SBE2	SBE3	SBE2
COUNTRY GRADE:	BB	BB	BB	A	BB	BB

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Brasilia
Population:	193.73 mn (2009)
GDP:	USD 1571508 mn (2009)
Currency:	Real (BRL)
Form of state:	Federal republic
Head of government:	President Luis Inacio Lula da Silva
Next elections:	2010 October (presidential & legislative)

Major Industries (% of GDP 2008)	Global Assumptions	2010	2011
Agriculture 6.7%	Real GDP grth (% yr/yr) *	3.3	2.9
Industry 28.0%	Inflation (% av) *	1.2	1.4
Mining 16.0%	Dated Brent (USD/b)	75	70
Services 65.3%	* World		

Main Exports (% of total, 2009)	Main Imports (% of total, 2009)
Primary products 40.5%	Consumer goods 16.9%
Semi manufactures 13.4%	Raw materials 46.8%
Manufactures 46.1%	Fuels & lubricants 13.1%
	Capital goods 23.3%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	1,364,792	1,633,088	1,571,508	1,960,892	2,094,869
Population (mn)	190.12	191.97	193.73	195.58	197.43
GDP per capita (USD)	7,179	8,507	8,112	10,026	10,611
Real GDP growth (% yr/yr)	6.1	5.1	-0.2	7.5	4.0
Inflation (% eop)	4.5	5.9	4.3	5.3	4.8
Fiscal balance (% of GDP)	-2.8	-1.9	-3.3	-3.0	-3.0
Current account balance (% of GDP)	0.1	-1.7	-1.5	-2.4	-2.8
External debt/GDP (%)	18	16	18	15	16
External debt/Exports of goods & services (%)	129	112	150	139	136
Interest payments/Exports of goods & services (%)	8	7	8	7	7
Foreign exchange reserves (USD mn)	179,433	192,884	237,364	260,000	260,000
Import cover (months)	6.5	9.8	13.3	12.7	12.0
Exchange rate assumption: USD/BRL	1.95	1.84	2.00	1.80	1.85
f: CRU central forecast					

Sources: National, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Multi-party democracy has become firmly entrenched since 1985 when the military handed power back to civil rule. The latest elections in October 2006, which saw President Lula da Silva comfortably re-elected in a second-round run-off, only served to reinforce the high degree of underlying systemic political stability. President Lula da Silva's first term election, along with that of his Workers Party (PT) as the main party in congress, in 2002, however, marked a real watershed, as it was the first hand-over from one elected president to another since the restoration of civilian rule and the first to an overtly left-of-centre government, though President Lula da Silva has been part of the regions "pragmatic left".

Nonetheless, Brazil still has a multi-layered political system, strong regional interests and relatively weak party structures, which tends to make passage of legislation slow and cumbersome. Political scandals, often involving corruption allegations of various kinds, are also relatively frequent, holding up the legislative process and weakening the government's credibility. President Lula da Silva, like his predecessor, however, has been able to remain untainted personally and he enjoys remarkably high popularity ratings.

Presidential and legislative elections are scheduled for October 2010. President Lula da Silva is not permitted to stand for a third consecutive term, but his chosen PT candidate, former chief of staff, Dilma Rousseff, has a large lead on the main opposition candidate, Jose Serra of the PSDB, in the latest opinion polls. Rousseff has benefited from Lula's popularity, the resilience to the global downturn and subsequent strong recovery as well as close association with growth acceleration programme (PAC) and the "bolsa familia" social programme.

Rousseff is likely to represent broad policy continuity with broad macroeconomic orthodoxy should she win, as seems likely, but with a strong role for public sector investment and there is some risk of a more populist emphasis. However, like her predecessors she will most probably have to form ill-disciplined coalitions in congress to progress the legislative agenda.

Internationally, President da Silva's government has been more assertive of Brazil's leadership role in the region and the developing world than its predecessor, but has managed to steer a course between good relations with the US and the region's radical left. Brazil is an important player in the G-20. His successor will need to find a similar balance.

Economic Stability

Brazil is an upper middle income country with an estimated GDP per capita of just over USD8,000 in 2009. The economy is large and diverse and exports are geographically well spread. Annual average growth of real GDP per capita in the past ten years was a moderate 2%.

Annual average growth of real GDP was 4.8% in 2004-08, but contracted marginally (-0.2%) in 2009, as the impact of the global financial crisis and recession was felt. Nonetheless, the economy has been remarkably resilient to the crisis and recovered well, beginning in Q2 2009, with growth accelerating to 9% yr/yr in Q1 2010. In Q2 growth moderated to 8.9 yr/yr and 1.2 qtr/qtr and earlier fears of overheating have receded. Full year growth in 2010 will exceed 7%, partly a reflection of the low base in 2009, followed by around 4% in 2011.

In 2009 the primary fiscal surplus fell to 2.1% of GDP from 3.5% in 2008, as the government moved to a more expansionary stance to offset the downturn and the overall deficit widened to 3.3% of GDP (1.9% 2008). For 2010 surplus target was raised to 3.3% of GDP, as the authorities have begun to withdraw earlier fiscal stimulus measures. Nevertheless, in Jan-July the surplus was 2.1%, more or less the same as in the same period of 2009. The overall deficit was 3.3% of GDP in Jan-July, was also virtually the same as in Jan-July 2009. Quasi-fiscal spending has also increased since the onset of the global crisis via lending through development bank, BNDES, the operations of which are estimated by the IMF at 2.5% of GDP.

The deficit should not prove problematic in the short term, however, as net public debt was held to 43% of GDP at end-2009 and had eased to 41.7% in July 2010. General government gross public debt was 60% in July 2010, down from 63% at end-2009, but is still on the high side. The structure of the public debt has improved in recent years as exchange-rate linked debt has been eliminated and maturities considerably extended. The strong fiscal position and conservative monetary policy has been a major positive during the global crisis.

Monetary policy is based on inflation targets with a flexible exchange rate. Inflation accelerated from a low of 4.2% in October 2009 to 5.3% yr/yr in April 2010, but has since eased to 4.6%, against a 4.5%

+/-2% target range. Policymaking concerns shifted from fears of below-trend growth to overheating in early 2010 and the monetary policy stance shifted accordingly. Interest rates were raised by 200bps in April-August taking the policy rate (SELIC) to 10.75%, having been lowered by a cumulative 500bps to a record low 8.75% during 2009. Policy has been on hold since then, however, and may remain so for a while. Private sector credit expansion has begun to pick up in 2010, indicative of more sustainable growth and the banking sector is generally strong, though the sector experienced illiquidity at the height of the global crisis. Capital withdrawals were severe at that time, mirrored in very sharp exchange rate depreciation, but these outflows subsequently reversed and the exchange rate strengthened accordingly. Indeed, the real effective rate is now stronger than pre-crisis and is back in overvalued territory, which has led to the re-introduction of measures to control on short term capital inflows.

The current account external balance returned to deficit of 1.8% of GDP in 2008 (after surpluses in 2003-07) and was 1.7% in 2009, as both exports and imports fell sharply in nominal terms. Exports have recovered strongly, helped by higher commodity prices as 40% of exports are primary products, but so too have imports (higher domestic demand) and the current account is set to widen to 2.4% of GDP in 2010 and 2.8% in 2011. About one-half of the current account deficit should be covered by net FDI flows, which have also recovered from the lows of 2009 inflows. Other capital flows have been very strong, however, and FX reserves have increased to USD260bn. At these levels FX reserves provide 12 months cover of projected 2011 imports and 350% of external debt falling due (short and medium-term). Total FX reserves also amount to 118% of the sum of our projected current account deficit for 2011 plus principal repayments on medium-term plus projected short term debt outstanding at end-2010.

External debt as a proportion of GDP rose to 18% of GDP at end-2009 (still low) but should fall to 15% at end-2010 and 139% of exports of goods and services (moderate) with interest payments on the debt at a moderate 7% of exports of goods and services.

Brazil has weathered the global crisis well, though it was not immune and renewed risk aversion or commodity price falls would take their toll on growth. Sound policies, however, meant that Brazil had access to the IMF's flexible credit line and a swap line with the US fed during the crisis and should retain access to these facilities in the future (if necessary) unless there is an unexpected departure from the current policy framework. More recently concerns about overheating have receded as growth has moderated and inflation eased, as monetary policy was tightened and some direct fiscal supports removed.

Structural Business Environment

The Structural Business Environment is above average in our assessment, but falls short of the strongest ratings overall.

Based on data and definitions from the World Bank's 2010 Doing Business Survey, Starting a Business, Dealing with Construction Permits, Registering Property, Trading Across Borders, Enforcing Contracts and Closing a Business were weaker areas, ranking below average, while Employing Workers and Paying Taxes were particularly weak. The World Bank Institute's Governance Research Indicator puts Regulatory Quality, Control of Corruption and Rule of Law above average for the Latin American Region. Transparency International's Corruption Perception Index, 2009, assigns Brazil a score of 3.7—on a scale of 1 (bad) to 10 (good)—and a ranking of 75= out of 180 (the same as Colombia, Peru and Suriname). As a broad measure of the pro-business environment The Heritage Foundation's 2010 Index of Economic Freedom ranks Brazil 113 out of 179.

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Charts

