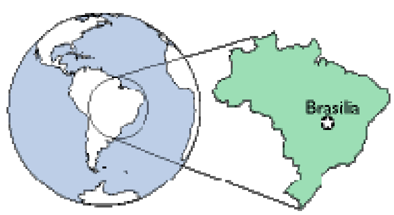
COUNTRY REVIEW

Brazil

(Update)



10 December 2009

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<u>EULER HERMES COUNTRY RISK GRADE: BB</u>

Country Risk Grades are on a scale of AA, A, BB, B, C, D

where AA is the lowest and D the highest risk.

Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	1,089,145	1,332,108	1,570,499	1,511,567	1,821,631
Population (mn)	186.77	189.30	192.13	195.00	198.00
GDP per capita (USD)	5,831	7,037	8,174	7,752	9,200
Real GDP growth (% yr/yr)	4.0	5.7	5.1	-0.2	4.5
Inflation (%, eop)	3.1	4.5	5.9	4.3	4.4
Fiscal balance (% of GDP)	-3.0	-2.8	-1.8	-3.5	-3.3
Current account balance (% of GDP)	1.2	0.1	-1.8	-1.6	-1.9
External debt/GDP (%)	18.3	18.1	16.7	17.9	15.7
External debt/Exports of goods & services (%)	123.2	126.9	112.5	148.4	137.4
Interest payments/Exports of goods & services (%)	9.2	8.1	6.7	8.1	7.3
Foreign exchange reserves (USD mn)	85,839	180,334	206,806	238,000	238,000
Import cover (months)	8.6	13.7	11.3	15.8	13.4
Exchange rate assumption, BRL:USD (av)	2.18	1.95	1.84	2.00	1.75
f: CRU central forecast					

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

UPDATE

The economy has shown remarkable resilience to the global crisis. Real GDP contracted qtr/qtr in Q4 2008 and Q1 2009, but has grown since, by 1.1% qtr/qtr in Q2 and by 1.3% in Q3. Momentum should have been maintained in Q4 and, at worst, in 2009 as a whole GDP will contract only marginally. Private consumption has held up well, investment has declined sharply, though it reached bottom in Q1, while the net export contribution in 2009 should be positive as imports have fallen more sharply than exports, though both returned to growth from Q2.

Monetary and fiscal policies are expansionary. The primary fiscal surplus target for 2009 was lowered to 2.5% of GDP and the outturn may be closer to 2% with the overall deficit likely to widen to 3.5% before narrowing slightly in 2010. Quasi-fiscal spending has also increased via lending through development bank, BNDES. The larger deficit should not prove problematic, though net public debt will increase to around 45% of GDP in 2009-10 with general government gross debt around 60%. Inflation has dropped below the mid-point of the 4.5% +/-2% target range, though at 4.2% yr/yr in November the annual rate edged up for the first time since October 2008. The decline in inflation has been accompanied by monetary easing, including a 500bps cumulative reduction in the policy interest rate (SELIC) since end-2008 to a record low of 8.75%, though at the last policy rates were left on hold.

Although banks experienced illiquidity at the height of the global financial crisis, problems were dealt with effectively by central bank intervention and facilities to help private sector companies meet external debt obligations and provide trade finance support. Also, the US Fed gave the authorities a vote of confidence by granting a temporary USD30bn swap line to the central bank and there is little doubt that Brazil would be eligible for the IMF flexible credit line (FCL)—available to countries with sound policies, low debt and a strong external position overall—though it is unlikely to be required.

Capital withdrawals were severe at the height of the crisis, mirrored in very sharp exchange rate adjustment as the USD rose by 42% against the BRL in Sept 2008-March 2009. However, the subsequent reversal has also been sharp and the exchange rate has retraced the previous fall. The current account deficit will narrow slightly in 2009 to 1.6% of GDP, as both exports and imports have fallen. FDI inflows may have halved over the year but FX reserves have continued to increase.

The stage is set for a relatively strong performance in 2010. Policies will remain generally supportive, though there will be some monetary tightening. Real GDP should grow by around 4.5% in 2010, driven largely by domestic demand as private consumption accelerates and investment shows some bounce after the sharp contraction of 2009. However there are downside risks, notably commodity prices, the impact of possible further BRL appreciation on trade and the potential for over-expansionary policies ahead of presidential elections due at the end of 2010. Also, although Brazil has weathered the global storm well it still would not be immune to further external shocks. Inflation may edge up slightly in 2010, but should remain around the mid-point of the target range. The current account deficit will widen to 1.9% of GDP in 2010, but FDI inflows will also pick up (cover 65% of the deficit). Moreover, FX reserves cover 200% of the sum of our projected current account deficit for 2010 plus principal repayments on medium-term plus short term debt outstanding at end-2009.

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