Euler Hermes Economic Research

Country Report

Brazil

2015, worst recession since 1990

General Information

GDP	USD2346.118bn (World ranking 7, World Bank 2014)
Population	202.03mn (World ranking 5, World Bank 2014)
Form of state	Federal Republic
Head of government	Dilma ROUSSEFF (PT)
Next elections	2018, presidential and legislative

Strengths

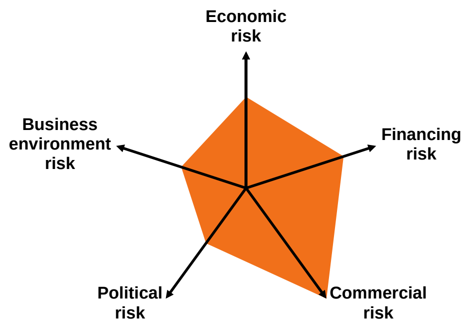
- Overall size of the economy
- Large domestic market and expanding middle class
- Diversified economic base (minerals, agriculture, manufacturing sector)
- Robust foreign direct investment, high level of foreign exchange reserves, moderate external debt
- Durable political system with established effective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

B3



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)

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Recession worse than expected

Available data for 2015 show that recession in Brazil is deeper that thought. Real GDP contracted by -1.9% q/q (-2.4% y/y) in Q2, worse than expectations, and Q1 GDP was revised downwards to -0.7% q/q (-0.2% initial estimate), bringing the carry-over for the year to -2.3%. Investment fell by -8.1% q/q, recording the worst q/q contraction since 2009, completing 8 consecutive quarters of decline and falling back to its early-2012 level. The investment rate stood at 17.8% of GDP, against 19.5% a year ago. The capacity utilization rate diminished to 77.7% in August, the lowest level since 2009 and below the LT average of 83%, suggesting that investment will continue to be depressed over the next months. Private consumption contracted by -2.1% q/q, the worst q/q drop since 2001, as unemployment hit a 5-year high in July (7.5%) and inflation continued to soar, reaching 9.6% y/y in July, the highest rate in 12 years and more than double the Central bank's 4.5% target, before cooling slightly to +9.5% in August. 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 it at that level since then. Monetary policy is likely to remain tight, with no change expected in the key rate in the near term but potential increases in 2016, as inflation, despite easing, is expected to remain above the target until the end of 2016, at least. The external sector was the only engine of growth in Q2, with exports expanding by +3.4% q/q but imports contracting sharply by -8.8% q/q, on the back of depressed domestic demand.

After broadly stagnating in 2014, with the hosting of the Soccer World Cup bringing more inflation than growth, the Brazilian economy in 2015 could record its worst recession since 1990. Euler Hermes expects real GDP will fall by -2.4% this year and stagnate (0%) in 2016. Private investment and consumption will continue to fall amid tight monetary and fiscal policies, worsening financing conditions and soaring inflation. Business and consumer confidence are both at record lows. Additionally, the external environment will remain adverse with low agricultural prices affecting the value of exports, while the slowdown in Latin America and China, and still sluggish demand from developed markets, weighs on export volumes.

Public finances are deteriorating rapidly

The primary balance of the central government has deteriorated steadily since 2013, shifting into deficit in late 2014 for the first time since 1998, at least, and reaching -0.9% of GDP over 12 months in July. Plunging tax revenues (due to weakening activity) forced the government to ease its fiscal target several times this year and it now expects a deficit of -0.5% of GDP for 2016, compared with a target of +0.7% in July and +2% at the beginning of the year. With debt service accounting for more than 6% of GDP, the global fiscal deficit could widen to -8% of GDP.

Although fiscal consolidation seems essential to limit the public debt surge (expected to reach 70% of GDP in 2016), the adoption of austerity measures could prove difficult amid strong political and social tensions, and the popularity rate of President Rousseff plunging to record lows.

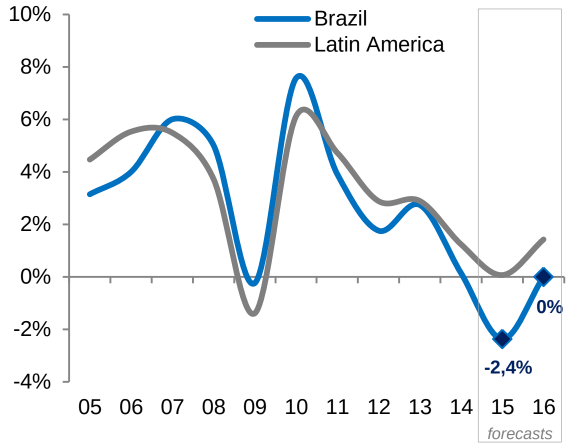
Key economic forecasts

	2013	2014	2015	2016
GDP growth (% change)	2.7	0.1	-2.4	0.0
Inflation (%, yearly average)	6.2	6.3	8.9	7.0
Fiscal balance* (% of GDP)	-3.1	-6.2	-5.3	-4.7
Public debt* (% of GDP)	62.2	65.2	68.0	70.0
Current account (% of GDP)	-3.4	-4.5	-4.3	-3.4
External debt (% of GDP)	13.0	14.9	21.7	22.5

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

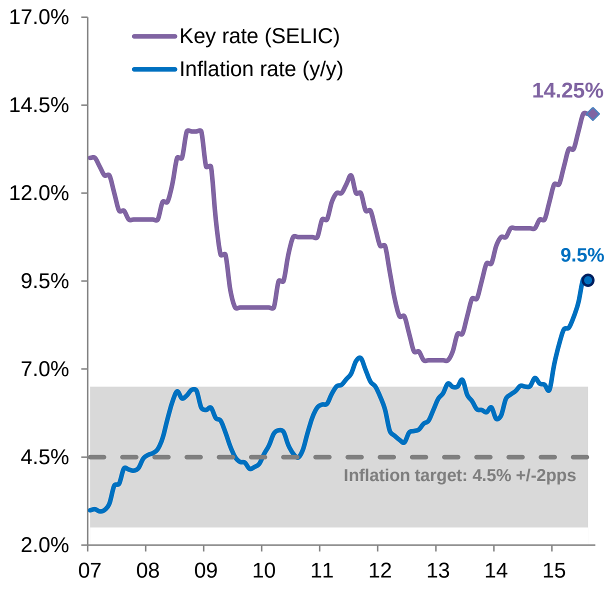
Sources: National sources, IHS, Euler Hermes

GDP growth (%)



Sources: National sources, IHS, Euler Hermes

Inflation rate and Monetary policy rate (%)



Sources: National sources, IHS, Euler Hermes

Sharp depreciaiton, but external vulnerability is under control

The current account deficit is expected to remain wider than -4% of GDP in 2015 and 2016, dragged down mainly by still wide deficits in services and Income. The deficit is likely to remain wide as long as structural weaknesses (notably competitiveness issues) are not tackled. The local currency will continue to be plagued by downward pressures and high volatility due to capital flight (reflecting declining investor confidence) and, especially, the Fed's tapering disruption. The BRL has already lost -40% against the USD over the past 12 months.

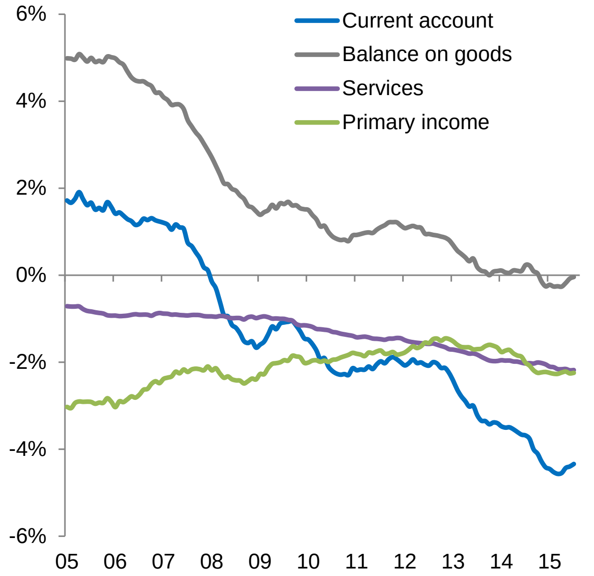
However, external vulnerability is under control. Net FDI inflows cover around 70% of the current account deficit, while the level of FX reserves is very comfortable, covering more than 12 months of imports. Encouragingly, external debt is moderate, amounting to about 14% of GDP or 113% of exports of goods and services

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 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 in the Brazilian economic model. Local production could not keep up with the momentum of domestic demand, generating internal (inflation) and external (current account deficit) imbalances and weighing on growth.

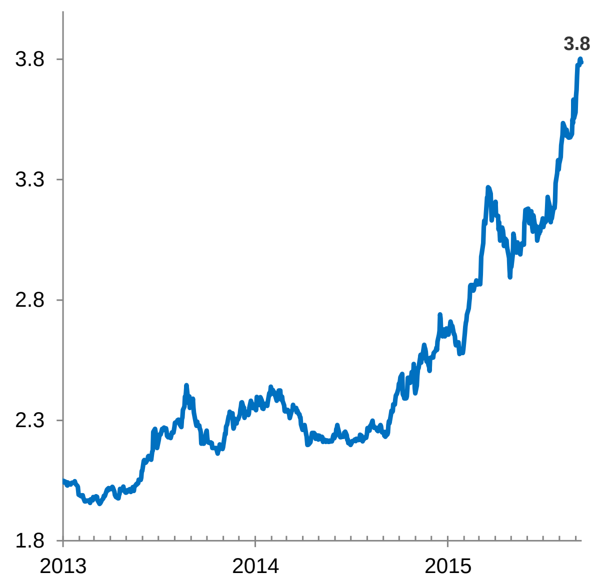
The lack of investment (notably in infrastructure) combined with the persistent problems of protectionism, excessive bureaucracy, high labor costs and a complex and punitive tax system greatly hinders the national business environment and cripples competitiveness.

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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