STANDARD & POOR'S RATINGS SERVICES

McGRAW HILL FINANCIAL

# Brazil Foreign Currency Ratings Lowered To 'BB+/B'; Outlook Is Negative

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OVERVIEW

The political challenges Brazil faces have continued to mount, weighing on the government's ability and willingness to submit a 2016 budget to Congress consistent with the significant policy correction signaled during the first part of President Dilma Rousseff's second term.

The government's 2016 budget proposal envisions yet another change to the primary fiscal target less than six weeks after the previous downward revision, which would mean three consecutive years of a primary deficit and net general debt continuing to rise if subsequent revenue or expenditure measures are not taken.

We are lowering the long-term foreign and local currency sovereign ratings on Brazil to 'BB+' and 'BBB-', respectively.

The negative outlook reflects what we believe is a greater than one-in-three likelihood of a further downgrade due to a further deterioration of Brazil's fiscal position, potential key policy reversals given the fluid political dynamics, including a further lack of cohesion within the president's cabinet, or due to greater economic turmoil than we currently expect.

RATING ACTION

On Sept. 9, 2015, Standard & Poor's Ratings Services lowered its long-term foreign currency sovereign credit rating on the Federative Republic of Brazil to 'BB+' from 'BBB-', and the long-term local currency sovereign credit rating to 'BBB-' from 'BBB+'. The outlook is negative. We also lowered the short-term foreign currency rating to 'B' from 'A-3' and the short-term local currency rating to 'A-3' from 'A-2'. We also lowered the transfer and convertibility assessment to 'BBB' from 'BBB+'. We affirmed the 'brAAA' national-scale rating and revised the outlook on this rating to negative.

RATIONALE

We believe Brazil's credit profile has weakened further since July 28, when we revised the outlook on Brazil to negative. At that time, we signaled increased execution risks to the corrective policy changes already underway, mainly stemming from fluid political dynamics in Congress associated with spillover effects from investigations of corruption at state-owned energy company Petrobras. We now perceive less conviction within the president's cabinet on fiscal policy.

Brazil's 2016 budget proposal tabled on Aug. 31 incorporated yet another revision to the government's fiscal targets in a short period of time. The proposed budget is based on a primary deficit of 0.3% of GDP, rather than the previously revised 0.7% of GDP surplus target that was announced in July. This change reflects internal disagreement about the composition and magnitude of measures needed to redress the slippage in public finances.

Without an unexpected overperformance, the proposed fiscal target in the budget would yield three consecutive years of primary (non-interest) fiscal deficits and a continual rise of net general government debt. While the Ministry of Finance is working on putting forward various measures to regain the 0.7% of GDP initial surplus target, they will need to be negotiated piecemeal with Congress. More importantly, the series of events leading to the budget proposal suggests to us diminished cohesion within President Rousseff's cabinet and contributes to our assessment of a weaker credit profile. Given the magnitude of the challenges on the political, economic, and fiscal fronts facing Brazil, we had assumed unwavering cabinet support in order to maximize the executive's negotiating power with Congress.

We now expect the general government deficit to rise to an average of 8% of GDP in 2015 and 2016 before declining to 5.9% in 2017, versus 6.1% in 2014. We do not expect a primary fiscal surplus in 2015 or 2016. A high (and slow-to-decline) interest burden (given higher interest rates and the impact of the weaker Brazilian real on outstanding foreign exchange swaps) contributes to the large deficit. The slightly larger change in general government debt to GDP vis-à-vis the headline deficit incorporates some fluctuations in central bank repo operations and an end to off-budget (below-the-line) spending.

We expect general government debt, net of liquid assets (not including international reserves), to rise to 53% of GDP this year and to 59% next year from 47% in 2014. We also expect interest to revenues to remain above 20% this year and next, from 15% last year, and to moderate slowly given the depreciation of the Brazilian real and higher interest rates. We assess contingent liabilities from the financial sector and all Brazilian NFPEs (nonfinancial public enterprises, including Petrobras) as "limited," as our criteria define the term.

Our rating on Brazil reflects our view of its established political institutions and broad commitment to policies that maintain economic stability--albeit somewhat weaker than before. We find that the ongoing investigations of corruption allegations against high-profile individuals and companies--in both the private and public sectors and across political parties--have led to increased near-term political uncertainty. These independent investigations and subsequent prosecutions of corrupt practices are a testament to the institutional framework in Brazil, which contrasts with that of other emerging economies. At the same time, they have weakened near-term political cohesion and coalition dynamics. Stressed coalition dynamics between the Workers' Party and the Brazilian Democratic Movement Party augur poorly for approval of needed fiscal adjustment measures, even with a relaxed fiscal target, in our view. This is against a backdrop of low approval ratings for President Rousseff and her government, which have declined to less than 10%, and the possibility that the president may be impeached (although this outcome is not our base case).

Indeed, we continue to believe that economic weakness exacerbates execution risk. We now expect the contraction in real GDP to be deeper and longer, with another revision to our growth outlook. Our projections estimate a contraction of about 2.5% this year followed by another 0.5% contraction in 2016, before returning to modest growth in 2017.

With per capita GDP of about US$8,900, Brazil's growth prospects are, in our opinion, below that of other countries at a similar stage of development. Notwithstanding the more recent hesitation on the magnitude of the needed fiscal adjustment, the government has adopted other policies to lay the foundation for growth over the medium term. The government is reducing off-budget spending and removing various economic distortions, including artificially suppressed administered prices. To contain inflation and inflation expectations, the central bank embarked on another tightening cycle. It had also moderated intervention in the foreign exchange market (through some curtailment of the offer of U.S. dollars via its real-denominated foreign exchange swap program), facilitating depreciation of the real, though it has increased intervention recently. The government has also placed renewed emphasis on private-sector participation in infrastructure projects. We do not see, however, that these positive steps have turned around business sentiment. In our observations, policy decisions have damaged business sentiment in recent years, and the uncertainties and spillover effects associated with the corruption investigations continue to hold sentiment back. It now appears that Brazil is further away from a shift to positive growth until some of the political uncertainties settle.

We expect Brazil's external vulnerability will rise somewhat over the next several years. We don't expect foreign direct investment (FDI) to fully cover Brazil's current account deficit at about 4% of GDP in 2015-2017. We expect narrow net external debt to average of 36% of current account receipts from 2015-2017. Our estimates of external debt are calculated on a residency basis. They include nonresident holdings of locally issued real-denominated government debt estimated at about US$153 billion (55% of current account receipts) in 2014. These holdings have risen in reais terms so far this year (though were down on a monthly basis in July); however, given currency depreciation, we expect them to be lower in 2015 and 2016 in U.S. dollar terms. Our external debt data, however, do not include debt of approximately 30% of current account receipts raised offshore by Petrobras and transferred in the form of FDI to the head office. That said, despite the wider current account deficit, Brazil has low external financing needs compared with its current account receipts and its high level of international reserves compared with some of its peers.

The local currency rating on Brazil is higher than the foreign currency rating, reflecting our view of the credibility of its monetary policy, its floating exchange-rate regime, and the depth of its capital markets. In accordance with our criteria, we lowered the local currency rating two notches to narrow the gap between the two ratings because of Brazil's fiscal performance.

OUTLOOK

The negative outlook reflects our view that there is a greater than one-in-three likelihood that we could lower our ratings on Brazil again. We anticiapte that within the next year a downgrade could stem in particular from a further deterioration of Brazil's fiscal position, or from potential key policy reversals given the fluid political dynamics, including a further lack of cohesion within the cabinet. A downgrade could also result from greater economic turmoil than we currently expect either due to governability issues or the weakened external environment.

We could revise the outlook to stable if Brazil's political uncertainties and conditions for consistent policy execution were to improve across branches of government to staunch fiscal deterioration and stregthen GDP growth prospects. We expect that these improvements would support a quicker turnaround and could help Brazil exit from the current recession, facilitating improved fiscal performance and providing more room to maneuver in the face of economic shocks.

KEY STATISTICS

## Table 1
**Selected Indicators**

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|---|
| ECONOMIC INDICATORS (%) | | | | | | | | | | |
| Nominal GDP (bil. LC) | 3,328 | 3,887 | 4,375 | 4,713 | 5,158 | 5,521 | 5,864 | 6,297 | 6,757 | 7,284 |
| Nominal GDP (bil. $) | 1,665 | 2,209 | 2,615 | 2,412 | 2,392 | 2,346 | 1,817 | 1,574 | 1,553 | 1,619 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| GDP per capita (000s $) | 8.6 | 11.3 | 13.2 | 12.1 | 11.9 | 11.6 | 8.9 | 7.6 | 7.5 | 7.7 |
| Real GDP growth | (0.2) | 7.6 | 3.9 | 1.8 | 2.7 | 0.1 | (2.5) | (0.5) | 1.0 | 2.5 |
| Real GDP per capita growth | (1.3) | 6.5 | 2.9 | 0.8 | 1.8 | (0.7) | (3.3) | (1.3) | 0.2 | 1.7 |
| Real investment growth | (1.9) | 17.8 | 6.6 | (0.6) | 6.1 | (4.4) | (10.0) | (0.5) | 4.0 | 8.0 |
| Investment/GDP | 19.2 | 20.6 | 20.6 | 20.2 | 20.5 | 19.7 | 17.7 | 17.8 | 18.2 | 19.6 |
| Savings/GDP | 17.7 | 18.5 | 18.6 | 18.0 | 17.1 | 15.3 | 13.2 | 13.5 | 14.5 | 16.2 |
| Exports/GDP | 10.9 | 10.7 | 11.5 | 12.0 | 12.0 | 11.5 | 11.3 | 12.1 | 12.2 | 12.2 |
| Real exports growth | (9.2) | 11.7 | 4.8 | 0.5 | 2.1 | (1.1) | 2.0 | 5.0 | 5.0 | 5.0 |
| Unemployment rate | 8.1 | 6.7 | 6.0 | 5.5 | 5.4 | 4.9 | 6.4 | 7.0 | 7.6 | 7.0 |
| EXTERNAL INDICATORS (%) | | | | | | | | | | |
| Current account balance/GDP | (1.5) | (2.1) | (2.0) | (2.2) | (3.4) | (4.4) | (4.4) | (4.3) | (3.7) | (3.3) |
| Current account balance/CARs | (12.5) | (19.2) | (16.9) | (18.2) | (27.3) | (36.7) | (33.4) | (26.0) | (20.5) | (18.2) |
| Trade balance/GDP | 1.5 | 0.9 | 1.1 | 0.8 | 0.1 | (0.3) | 0.1 | 1.1 | 1.6 | 1.7 |
| Net FDI/GDP | 2.2 | 1.7 | 2.6 | 2.8 | 2.8 | 3.0 | 2.2 | 2.9 | 3.2 | 3.7 |
| Net portfolio equity inflow/GDP | 2.4 | 2.0 | 0.6 | 0.1 | 0.4 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 |
| Gross external financing needs/CARs plus usable reserves | 72.7 | 71.5 | 75.6 | 66.0 | 70.1 | 71.6 | 74.0 | 69.6 | 65.8 | 65.0 |
| Narrow net external debt/CARs | (11.9) | 6.8 | (2.3) | (7.1) | 1.7 | 29.0 | 33.0 | 36.0 | 40.3 | 33.8 |
| Net external liabilities/CARs | 287.8 | 368.9 | 261.5 | 266.6 | 250.7 | 277.9 | 320.9 | 310.5 | 300.7 | 285.6 |
| Short-term external debt by remaining maturity/CARs | 32.6 | 21.7 | 29.1 | 25.8 | 31.0 | 26.0 | 52.6 | 41.7 | 31.0 | 26.2 |
| Reserves/CAPs (months) | 10.6 | 9.8 | 9.6 | 12.0 | 11.9 | 11.2 | 13.6 | 13.4 | 13.0 | 12.4 |
| FISCAL INDICATORS (%, General government) | | | | | | | | | | |
| Balance/GDP | (3.2) | (2.4) | (2.5) | (2.2) | (3.0) | (6.1) | (8.0) | (8.1) | (5.9) | (4.3) |
| Change in debt/GDP | 7.0 | 1.0 | 5.3 | 7.2 | 3.2 | 9.1 | 9.5 | 9.5 | 7.0 | 4.3 |
| Primary balance/GDP | 1.9 | 2.6 | 2.9 | 2.3 | 1.8 | (0.5) | (0.0) | (0.3) | 0.9 | 1.5 |
| Revenue/GDP | 36.9 | 39.3 | 37.6 | 37.5 | 38.1 | 36.9 | 35.8 | 35.6 | 37.4 | 39.0 |
| Expenditures/GDP | 40.2 | 41.8 | 40.1 | 39.7 | 41.1 | 43.0 | 43.8 | 43.7 | 43.4 | 43.3 |
| Interest /revenues | 14.0 | 12.6 | 14.2 | 12.0 | 12.5 | 15.1 | 22.4 | 21.8 | 18.2 | 14.8 |
| Debt/GDP | 59.3 | 51.8 | 51.3 | 54.8 | 53.3 | 58.9 | 65.0 | 70.0 | 72.2 | 71.3 |
| Net debt/GDP | 45.9 | 40.1 | 39.2 | 40.3 | 39.2 | 46.7 | 53.5 | 59.3 | 62.3 | 62.0 |
| Liquid assets/GDP | 13.4 | 11.6 | 12.1 | 14.5 | 14.1 | 12.2 | 11.5 | 10.7 | 10.0 | 9.3 |
| MONETARY INDICATORS (%) | | | | | | | | | | |
| CPI growth | 4.9 | 5.0 | 6.6 | 5.4 | 6.2 | 6.3 | 8.7 | 7.9 | 6.3 | 5.3 |
| GDP deflator growth | 7.4 | 8.6 | 8.3 | 5.9 | 6.5 | 6.9 | 8.9 | 7.9 | 6.2 | 5.2 |
| Banks' claims on resident private sector growth | 16.8 | 20.1 | 19.5 | 16.8 | 14.4 | 11.7 | 6.3 | 10.0 | 11.0 | 11.0 |
| Banks' claims on resident private sector/GDP | 43.6 | 44.8 | 47.5 | 51.5 | 53.9 | 56.2 | 56.2 | 57.6 | 59.6 | 61.3 |

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. LC--Local Currency. CARs--Current account receipts. FDI--Foreign Direct Investment. CAPs--Current account payments. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

RATINGS SCORE SNAPSHOT

**Table 2**

**Ratings Score Snapshot**

| **Key rating factors** | |
|---|---|
| Institutional assessment | Neutral |
| Economic assessment | Weakness |
| External assessment | Neutral |
| Fiscal assessment: flexibility and performance | Weakness |
| Fiscal assessment: debt burden | Weakness |
| Monetary assessment | Neutral |

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard &

Poor's "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength," "neutral," or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

RELATED CRITERIA AND RESEARCH

Related Criteria
Sovereign Rating Methodology, Dec. 23, 2014
Standard & Poor's National And Regional Scale Mapping Tables, Sept. 30, 2014
National And Regional Scale Credit Ratings, Sept. 22, 2014
Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research
Brazil Outlook Revised To Negative; Ratings Affirmed, July 28, 2015
Latin American And Caribbean Sovereign Rating Trends Mid-Year 2015, July 13, 2015 (accessible for free at www.spratings.com/sovereignoutlook)
Sovereign Risk Indicators, June 30, 2015 (a free interactive version can be found at www.spratings.com/sri)
Supplementary Analysis: Federative Republic of Brazil, June 19, 2015
2014 Annual Sovereign Default Study And Rating Transitions, May 18, 2015

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that "fiscal assessment: flexibility and performance" had deteriorated. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

RATINGS LIST
Downgraded

| | To | From |
|---|---|---|

| | | |
|---|---|---|
| Brazil (Federative Republic of) | | |
| Sovereign Credit Rating | | |
| Foreign Currency | BB+/Negative/B | BBB-/Negative/A-3 |
| Local Currency | BBB-/Negative/A-3 | BBB+/Negative/A-2 |
| Transfer & Convertibility Assessment | BBB | BBB+ |
| Senior Unsecured | | |
| Local Currency | BBB- | BBB+ |
| Foreign Currency | BB+ | BBB- |
| Short-Term Debt | | |
| Local Currency | A-3 | A-2 |

Ratings Affirmed; Outlook To Negative

| | To | From |
|---|---|---|
| Brazil (Federative Republic of) | | |
| Sovereign Credit Rating | | |
| Brazil National Scale | brAAA/Negative/-- | brAAA/Stable/-- |

Ratings Affirmed

| | |
|---|---|
| Brazil (Federative Republic of) | |
| Senior Unsecured | brAAA |

TELECONFERENCE INFORMATION

Standard & Poor's will hold a telephone conference call to discuss its ratings on Brazil. The teleconference call will take place on Thursday, Sept. 10, 2015, at 11:30 a.m. U.S. EDT.

Information on joining the teleconference will be communicated separately.

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.

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