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Fitch Downgrades Brazil to 'BBB-'; Outlook Negative

Fitch Ratings-New York-15 October 2015: Fitch Ratings has downgraded Brazil's sovereign ratings as follows:

--Long-term foreign and local currency IDRs to 'BBB-'from 'BBB'; Outlook remains Negative;
--Senior unsecured foreign and local currency bonds to 'BBB-' from 'BBB';
--Country Ceiling to 'BBB' from 'BBB+';
--Short-term foreign-currency IDR to 'F3' from 'F2'.

KEY RATING DRIVERS
The rating downgrade reflects Brazil's rising government debt burden, increased challenges to fiscal consolidation and a worsening economic growth backdrop. The difficult political environment is hampering progress on the government's legislative agenda and creating a negative feedback loop for the broader economy. The Negative Outlook reflects Fitch's view that economic and fiscal underperformance is likely to persist while political uncertainty could continue weighing on broader confidence, delay a turnaround in investment and growth, and increase risks for the medium term fiscal consolidation needed for debt stabilization.

The greater than anticipated impact of economic recession on government revenues, difficulty in implementing offsetting measures and a complicated political backdrop have undermined the government's fiscal consolidation strategy. Consequently, in July the government lowered the primary surplus targets materially for 2015 and beyond. In another setback to fiscal credibility, the government submitted a 2016 budget with an even weaker fiscal goal.

Although the government is working on certain tax and spending proposals to regain the fiscal path embedded in the July projections, considerable uncertainty remains on implementation especially in the context of the current political gridlock. Curbing mandatory spending is gaining importance in light of an already high tax burden and budgetary rigidities, limits to further cuts in discretionary spending and a shallow economic recovery. However, such measures will require broader political consensus and support, which may be difficult to obtain.

Fitch currently projects that the general government deficit will deteriorate to close to 9% of GDP in 2015 due to higher interest payments, partly reflecting the losses on FX swaps offered by the central bank. Average fiscal deficits during 2016-17 are forecasted to remain elevated at over 6% of GDP, based on Fitch's expectation that the government will have difficulty in reaching its stated primary surplus targets of 0.7% and 1.3% of GDP, in 2016 and 2017, respectively. Fitch forecasts a primary balance in 2016 and a surplus of 0.5% of GDP in 2017, although downside risks persist to our forecasts. As a result, Fitch forecasts Brazil's general government debt burden to reach close to 70% of GDP by 2016 (significantly above the 'BBB' median of 43%) and will continue rising in 2017.

A deeper recession and net job destruction, reduced popularity of President Rousseff, tensions between the government and congress, expanding reach of Petrobras investigations and risks of presidential impeachment are clouding the political environment and creating governability challenges and policy uncertainty. This complicated political environment could continue constraining the government's ability to garner sufficient support on fiscal and microeconomic reforms that are needed to materially strengthen fiscal and growth prospects

Brazil's economic recession is likely to be deeper and longer than Fitch's earlier expectations and its performance has diverged materially from those of its rating peers. Medium-term prospects also look weak compared to peers and most other large emerging markets. Fitch forecasts that Brazil's economy will contract by 3% and 1%, respectively in 2015 and 2016 before recording modest growth in 2017, with risks skewed largely to the downside. Reduced confidence levels, the construction sector malaise, continued political and policy uncertainties have added to domestic economic woes, while the economy continues to feel the pinch from the external headwinds of lower commodity prices, weaker growth in main trading partners and increased international financial volatility.

Notwithstanding a deeper recession, inflation has remained under pressure, partly owing to increases in administered prices and the sharp BRL depreciation. IPCA inflation rate is currently hovering close to 10% (more than three times the 'BBB' median), and convergence with the peer median is unlikely even with the expected reduction in Brazil's inflation rate in 2016-17.

The BRL depreciation and the economic slump have helped reduce the current account deficit by 29% in USD terms during January-August compared with a year ago. This adjustment is important given the likelihood of weaker capital inflows during the forecast period. The sharp BRL depreciation has led to deterioration in external debt metrics, which were already being impacted by increased private sector external borrowing in recent years. However, solid international reserves position, established central bank tools to handle FX liquidity issues and use of corporate hedging are mitigating factors.

Brazil's 'BBB-' ratings are supported by its economic diversity and entrenched civil institutions, with its per capita income and governance indicators broadly in line with low investment grade sovereigns. The country's shock absorption capacity is boosted by its robust international reserves, a strong net sovereign external creditor position, deep and developed domestic government debt capital markets, an adequately capitalized banking system and a flexible exchange rate. The share of foreign currency debt in total general government debt remains low and prudent liability management has reduced interest rate and refinancing risks.

Finally, Brazil has shown some ability to correct course under difficult economic conditions, evident from the relative price adjustments, tightening of monetary policy and reining in of quasi-fiscal stimulus although implementation of policies to strengthen the outlook for public finances has suffered.

RATING SENSITIVITIES

The main factors that could lead to a downgrade are:

--Further growth under-performance or difficulty in consolidating fiscal accounts leading to continued increases in government debt burden. Crystallization of material contingent liabilities would be negative.
--Continued political and governability risks that undermine policy making and dent confidence and growth prospects.
--Erosion of international reserves and deterioration of government debt composition.

The Outlook is Negative. Consequently, Fitch's sensitivity analysis does not currently anticipate developments with a high likelihood of leading to a positive rating change. Future developments that could individually, or collectively, result in a stabilization of the Outlook include:

--Fiscal consolidation that that leads to greater confidence in the government's capacity to stabilize the debt burden.
--Improved investment and growth environment and a reduction in macroeconomic imbalances.
--A better political environment that is conducive for boosting credibility of policies and reform prospects.

KEY ASSUMPTIONS

The ratings and Outlooks are sensitive to a number of assumptions:

--Fitch assumes that China (an important trading partner for Brazil) will manage a gradual slowdown, growing by 6.8%m 6.3% and 5.5% in 2015, 2016, and 2017, respectively, thus providing limited upside for commodity prices. Argentina's economic performance (key destination of manufacturing exports) is likely to remain subdued over the forecast period.

--Fitch assumes that Brazil maintains international and domestic market access even if there is return of higher international financial volatility and further domestic confidence shocks.

--Fitch assumes that political uncertainty will continue to hamper progress on the government's legislative agenda.