FitchRatings

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Fitch Downgrades Brazil to 'BB+'; Outlook Negative

Fitch Ratings-New York-16 December 2015: Fitch Ratings has downgraded Brazil's ratings as follows:

--Long-term foreign and local currency Issuer Default Ratings (IDRs) to 'BB+' from 'BBB-', Outlook remains Negative;
--Senior unsecured foreign and local currency bonds to 'BB+' from 'BBB-';
--Country Ceiling to 'BBB-' from 'BBB';
--Short-term foreign currency IDR to 'B' from 'F3'.

KEY RATING DRIVERS

Brazil's downgrade reflects the economy's deeper recession than previously anticipated, continued adverse fiscal developments and the increased political uncertainty that could further undermine the government's capacity to effectively implement fiscal measures to stabilize the growing debt burden. The Negative Outlook highlights continued uncertainty and downside risks related to economic, fiscal and political developments. The deteriorating domestic backdrop is increasing challenges for the authorities to take timely corrective policy actions to support confidence and improve prospects for growth, fiscal consolidation and debt stabilization.

Brazil's economic slump is not abating as highlighted by the third quarter of 2015 (3Q15) GDP figures with both consumption and investment retreating. The economy contracted by 1.7% (quarter-over-quarter [QOQ]) and 4.5% (year-over-year [YOY]) in 3Q15. Fitch now forecasts growth of -3.7% and -2.5% in 2015 and 2016, respectively with risks skewed mainly to the downside. Increased unemployment rates, constrained credit, depressed confidence and high inflation are weighing on consumption while political and policy uncertainties, the construction sector malaise and negative spill overs from the Petrobras corruption investigations and capex cuts have hurt investment. The external environment remains difficult for Brazil with the slide in commodity prices, China's slowdown and tightening international financial conditions.

Fiscal deterioration continues against the backdrop of weaker economic conditions. In December, the government secured congressional approval for a 2% of GDP primary deficit ceiling for 2015, reflecting the adverse revenue performance, constrained ability to cut spending and potential one-time payments (of around 1% of GDP). The repeated changes in fiscal targets have undermined the credibility of fiscal policy. The weaker starting point of fiscal accounts, deeper-than- previously projected economic contraction in 2016 and increased political uncertainty in recent weeks cast further doubt on the ability of the government to secure timely legislative approval to meet its primary surplus target for 2016. Moreover, the passage of measures to structurally improve the outlook for public finances and enhance the credibility of medium term fiscal consolidation appears difficult in the current political environment.

Consequently, Fitch's baseline fiscal projections have deteriorated, with the agency forecasting the general government fiscal deficit to reach over 10% of GDP in 2015 and remain elevated, averaging over 7% of GDP during 2016-2017. The high deficit in 2015 is also due to higher interest payments, partly reflecting the losses on FX swaps offered by the central bank. Higher fiscal deficits coupled with deeper economic contraction is leading to a faster growth in the government debt burden than previously expected, with Fitch forecasting general government debt to reach over 70% of GDP in 2016 and increasing further in 2017. These ratios are significantly higher than both the 'BBB' (43% of GDP) and 'BB' (44.4% of GDP) medians.

The recent start of impeachment proceedings against President Rousseff is adding uncertainty to an already difficult political environment and leading to continued political stalemate. The outcome of the proceedings is uncertain. Fitch believes that they would detract from timely and effective implementation of corrective fiscal adjustments. The political landscape has already been contaminated by the growing reach of the Petrobras investigations, often strained relationship of the government with its congressional allies and reduced popularity of the president. Higher unemployment rates and a deepening economic slump could lead to additional political and governance challenges in the coming year.

The reduction in some macro imbalances is continuing. The economic slump and BRL depreciation have facilitated a 36% reduction in the current account deficit in nominal USD terms during January-October compared to the same period of last year. Further reduction in the current account deficit is expected during the forecast period, which could mitigate risks related to potential tighter external financing conditions. On the other hand, inflation remains high at 10.5%, and inflation expectations, after inching downwards have reversed course and have begun to increase for 2016 and 2017, remaining above the 4.5% inflation target.

Brazil's 'BB+' ratings are supported by its economic diversity and entrenched civil institutions, with its per capita income and governance indicators better than the 'BB' median. The country's shock absorption capacity is boosted by its flexible exchange rate, robust international reserves, a strong net sovereign external creditor position, deep and developed domestic government debt capital markets, and an adequately capitalized banking system. The share of foreign currency debt in total general government debt remains low and prudent liability management has reduced interest rate and refinancing risks. In addition, the government has shown some capacity to respond in difficult conditions by implementing relative price adjustments, tightening monetary policy amidst a deepening recession and reining in quasi-fiscal stimulus.

RATING SENSITIVITIES
The main factors that could lead to a downgrade are:

--Failure to arrest the pace of increase in the government debt burden. Crystallization of material contingent liabilities would also be negative.
--A deeper and more prolonged recession which further undermines government debt dynamics and stokes political and social instability.
--Erosion of international reserves and deterioration in government debt composition.

The Rating 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:

--An improvement in the political environment that is conducive to improved policy implementation and supports confidence, growth and reform prospects.
--Fiscal consolidation that leads to greater confidence in the capacity of the government to achieve debt stabilization.
--Improved investment and growth environment and a reduction in macroeconomic imbalances.

KEY ASSUMPTIONS
--Fitch assumes that China (an important trading partner for Brazil) will avoid a hard-landing and be able to manage a gradual slowdown, 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 broader banking sector stability remains sound and the spill-overs from the recent difficulties in BTG Pactual are contained.

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

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Applicable Criteria
Sovereign Rating Criteria (pub. 12 Aug 2014)

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