FitchRatings

05 MAY 2016 5:05 PM EST

Fitch Downgrades Brazil to 'BB'; Outlook Negative

Fitch Ratings-New York-05 May 2016: Fitch Ratings has downgraded Brazil's Long-Term Foreign- and Local-Currency IDRs to 'BB' from 'BB+'. The issue ratings on Brazil's senior unsecured Foreign- and Local-Currency bonds are also downgraded to 'BB' from 'BB+'. The Rating Outlook on the Long-Term IDRs remains Negative. The Country Ceiling is downgraded to 'BB+' from 'BBB-' and the Short-Term Foreign-Currency IDR is affirmed at 'B'.

KEY RATING DRIVERS

The downgrade of Brazil's ratings reflects the deeper-than-anticipated economic contraction, failure of the government to stabilize the outlook for public finances and the sustained legislative gridlock and elevated political uncertainty that are sapping domestic confidence and undermining governability as well as policy effectiveness. The maintenance of the Negative Outlook reflects continued uncertainty surrounding the progress that can be made to improve the outlook for growth, public finances and the government debt trajectory.

Near-term growth prospects continued to weaken since Fitch's downgrade of Brazil to 'BB+' in December 2015. The agency now forecasts that growth will reach -3.8% in 2016 and 0.5% in 2017, down from the December forecast of -2.5% and 1.2%, respectively. The continuing deep economic contraction reflects the high level of political uncertainty, depressed confidence, deteriorating labor markets and strong external headwinds from lower commodity prices, China's slowdown and tighter external financing conditions. Medium-term prospects also appear subdued, as the country's investment rate has fallen in recent years and microeconomic reforms to improve competitiveness and the business environment have not made material progress.

Brazil's public finances remain under pressure and the repeated changes to fiscal targets have undermined fiscal credibility. The public sector primary deficit reached nearly 2% of GDP in 2015 and the ongoing pressures on revenues, difficulty in reining in spending, and the growing social security deficit will make consolidation difficult in 2016. The government has asked congress to amend its primary surplus target; by introducing several escape clauses, the change would effectively give the government the ability to incur a public sector primary deficit of around 1.5% of GDP in 2016. Downside risks to meeting fiscal targets remain. If approved by congress, the debt rescheduling by states with the federal government could lead to a further deterioration of regional governments' primary balances. Despite a cyclical recovery in the future, it is difficult to foresee significant consolidation without structural measures that reduce the pace of growth in mandatory spending.

Fitch forecasts the general government deficit to average over 8% of GDP in 2016-17, down from over 10% in 2015. On current policy settings, Fitch forecasts that Brazil will continue to incur primary deficits during 2016-17. The general government debt burden is expected to reach nearly 80% of GDP by 2017 (making Brazil one of the most indebted sovereigns in the 'BB' category) and remain on a rising trend unless growth recovers more materially and fiscal consolidation gains pace.

Brazil continues to confront a very challenging political environment. The low popularity of the President, the expanding reach of the 'Lava Jato' corruption investigations, street protests, and the run-up to the impeachment of President Rousseff have all contaminated the political environment. After a vote in favor of impeachment was passed in the Lower House, the Senate is expected to vote on this issue in the coming week. If the Senate votes in favor of the impeachment, President Rousseff would need to temporarily step down and Vice President Michel Temer of the PMDB party would take over.

While any political transition during the impeachment process could represent a new opportunity for proceeding in economic adjustment and reforms, implementation risks will remain. A deep and prolonged recession accompanied by a rising unemployment rate and the uncertainty as to the strength and stability of the governing coalition (especially for approving reforms) highlight the challenges that a potential Temer-led government would confront.

Moreover, the continuing Lava Jato investigations could also lead to unpredictable political upsets. Given the magnitude of the economic and fiscal challenges that Brazil is confronting, a strong political willingness and capacity to execute measures in a relatively short period of time will be required in order to materially improve confidence in the economic adjustment process.

On the positive side, some macroeconomic imbalances have begun to improve. Brazil's external accounts adjustment continues to proceed on the back of a prolonged economic slump and a weaker BRL. Fitch forecasts that the current account deficit will average just over 1% of GDP in 2016-17 compared to the nearly 4% average in 2014-15, and will be fully financed by foreign direct investment flows. The reduction in the current account deficit is facilitating Brazil's adjustment to tighter external financing conditions. Similarly, after peaking at 10.7% in January 2016, IPCA inflation has begun to decline, a process that should continue during the year, although inflation will likely remain above the central bank's target of 4.5%+/-2% by year-end. Finally, the central bank has also been reducing the net position of FX swaps in recent weeks, thereby reducing its exposure to future FX depreciation.

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 capacity to absorb shocks is bolstered by its flexible exchange rate, robust international reserves position, a strong net sovereign external creditor position, deep and developed domestic government debt securities markets, and an adequately capitalized banking system. The average maturity of debt has continued to increase in recent years and the small share of foreign currency debt in total general government debt limits vulnerability of debt dynamics to FX movements.

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

--Failure to take policy action to arrest the pace of increase in the government debt burden. Crystallization of contingent liabilities would be negative.

--Policy drift and an inability to implement measures that improve the outlook for growth and public finances.

--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 improves 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, offering a limited upside for commodity prices. Argentina's economic performance (key destination of manufacturing exports) is likely to improve moderately over the forecast period.

--Fitch assumes that Brazil maintains international and domestic market access even during periods of higher international financial volatility and further domestic shocks.

--Fitch assumes that any political transition to a new government during the impeachment process will be smooth and peaceful.

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Applicable Criteria
Country Ceilings (pub. 20 Aug 2015)
Sovereign Rating Criteria (pub. 12 Aug 2014)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
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