R&I

NEWS RELEASE

Oct 07, 2021

R&I Affirms BBB-, Changes Outlook to Negative: Federative Republic of Brazil

Rating and Investment Information, Inc. (R&I) has announced the following:

ISSUER: **Federative Republic of Brazil**

Foreign Currency Issuer Rating: BBB-, Affirmed
Rating Outlook: Negative, Changed from Stable

RATIONALE:

Brazil's economy is overcoming the impact of the COVID-19 pandemic on the back of large-scale fiscal spending. Despite the severe second wave of infections in 2021, the recovery trend remains in place. The country is free from particular external problems and will likely maintain stability in the financial system, in R&I's view. Meanwhile, stimulus measures and lower tax revenues ballooned the fiscal deficit in 2020 and therefore significantly increased outstanding public debt. Although the government re-imposed spending limits to reduce primary balance (PB) deficits, uncertainty is growing about implementation of economic and fiscal reforms, as next general elections approach. With higher interest payments also acting as a headwind, the debt ratio may start to rise again. Taking these factors into account, R&I has affirmed the Foreign Currency Issuer Rating at BBB- and changed the Rating Outlook to Negative.

The economy is expected to rebound in 2021 from the contraction in the previous year, with domestic demand boosted by progress in vaccination in the second half. Real gross domestic product (GDP) is projected to grow around 5% in 2021. Due to COVID-19 related disruptions and a drought, inflation has been accelerating since late 2020, which is a short-term risk factor. In order to bolster growth potential of the economy that has been weak since before the pandemic, it is essential to continue reforms for improving structural issues, such as high tax rates and a complicated tax system, and revitalizing the private sector. As general and presidential elections approach in October 2022, eyes are on whether the government will be able to carry out effective reforms.

Lower tax revenues and higher spending caused by huge emergency packages led to a fiscal deficit of 13.7% of GDP and a PB deficit of 9.5% of GDP in 2020. The first thing the government should tackle is to narrow the PB deficit to pre-pandemic levels while paying attention to economic recovery. The government's re-imposition of spending limits from the 2021 budget suggests its commitment to fiscal consolidation. That said, the interest rate hike for reining in inflation will increase its interest rate burden, making the pace of fiscal deficit reduction slower.

Thanks partly to a recovery in GDP, the government projects that the general government debt to GDP ratio will fall after peaking in 2020. Given the high level of uncertainty about the economic and political situation, and concerns that fiscal deficits could remain elevated, however, R&I recognizes a decent risk of the debt ratio rising further. It is vital to implement administrative and fiscal reforms steadily and ensure the level of PB surplus that can stabilize the debt ratio. The depth of financial markets, the government's cash holdings, returns from the development bank and transfers from the central bank are supporting factors for the government's funding.

Of the federal public debt, 95% is domestic debt, and around 80% thereof is held by institutional investors, such as financial institutions, investment trusts and pension funds. Non-residents hold less than 10%. While the debt level is high and the interest payment burden is heavy, the government's debt tolerance is commensurate with the rating, in R&I's view. Furthermore, the large proportion of bonds which are linked to inflation and policy rates suggests that interest payment expenses can be curtailed if the authorities succeed in reducing them. Given ample liquidity in the domestic market, R&I considers funding concerns to be limited for the time being. Foreign direct investment inflows backed by Brazil's economic potential exceed current account deficits consistently. With foreign reserves comfortably covering imports, there is no particular concern over external liquidity.

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The primary rating methodology applied to this rating is provided at "R&I's Analytical Approach to Sovereigns". The methodology is available at the web site listed below, together with other rating methodologies that are taken into consideration when assigning the rating.
https://www.r-i.co.jp/en/rating/about/rating_method.html

R&I RATINGS:

ISSUER:	**Federative Republic of Brazil**
	Foreign Currency Issuer Rating
RATING:	**BBB-, Affirmed**
RATING OUTLOOK:	**Negative, Changed from Stable**

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