



# Brazilian Banking Conference 2019

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São Paulo

**Fitch**Ratings



# Visão Geral Sobre o Rating Soberano

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1. Global Macro Outlook
2. Brazil's Sovereign Ratings: Economic and Fiscal Profile
3. Ambitious Reform Agenda
4. What Will Fitch Monitor for Future Rating Decisions?



## Sovereign Rating Trends & Outlooks

- More 2019 upgrades than downgrades
- But more Negative Outlooks than Positive

## Global Economy

- Global slowing is clear, but we see no imminent US recession
- Plenty of fiscal and monetary support

## Trade War

- Tariffs bad, technology bans worse
- China and Mexico were gaining US market share; now both in focus

## United States

- Steady increase in GG debt levels
- Policy coherence looking worse and role of the USD may suffer

## China

- De-risking but not de-leveraging
- Plenty of policy options to sustain growth in ST, few without risks

## Europe

- ECB expected to start QE again in Q4
- Domestic demand stronger, but not strong

### Sovereign Foreign Currency Rating Changes – Positive So Far in 2019, But Outlooks Suggest a Turn Ahead

	2010-2015 Annual Average	2016	2017	2018	Jan to mid-June 2019
Upgrades	13	12	13	14	7
Downgrades	16	24	20	10	2

Source: Fitch Ratings, 14 June 2019

# Sovereign Rating Trends & Outlooks



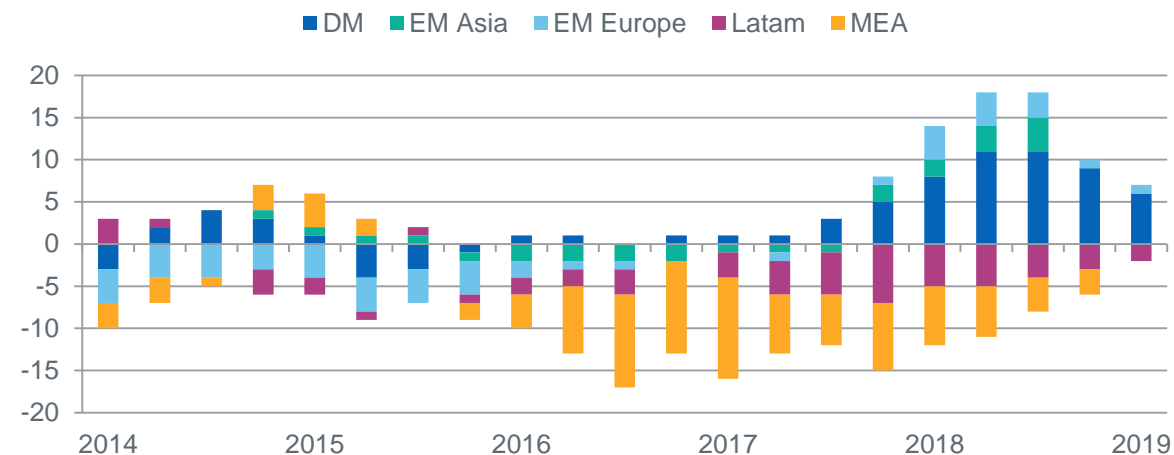
## Negative Outlook (17)

## Positive Outlook (10)

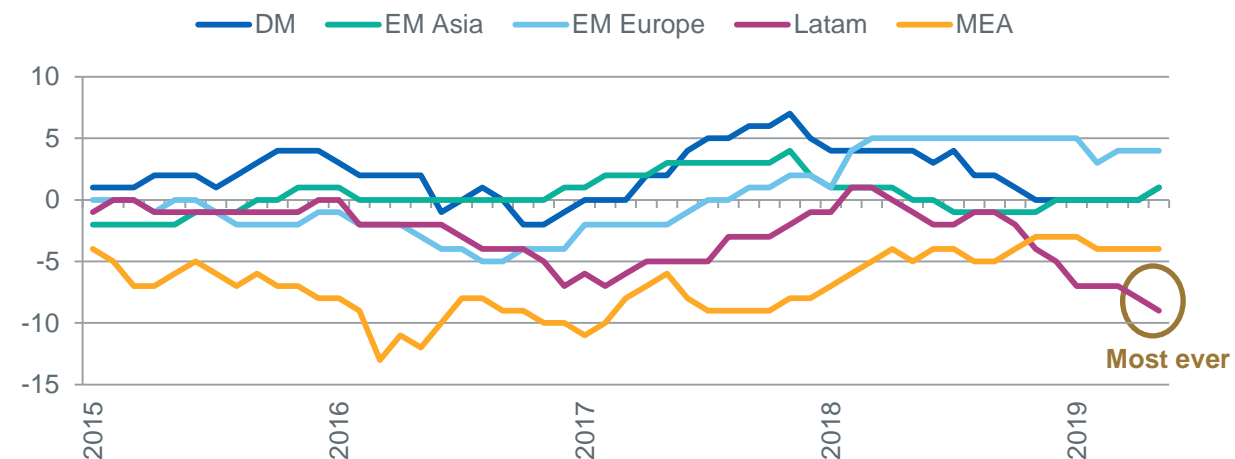
Developed Markets	Italy BBB	Austria AA+
	San Marino BBB-	Finland AA+
	UK AA	Lithuania A-
Emerging Asia		Portugal BBB
		Vietnam
Emerging Europe	Turkey BB	Armenia B+
		Bulgaria BBB
		Croatia BBB-
Latin America	Argentina B	Ecuador B-
	Aruba BBB-	Guatemala BB
	Colombia BBB	Nicaragua B-
	Costa Rica B+	Uruguay BBB-
Middle East & Africa	Lebanon B-	Namibia BB+
	Lesotho B+	Tunisia B+
	Zambia B-	Benin B

Source: Fitch Ratings, 14 June 2019

## Net Sovereign Changes by Region *Latam & MEA lower*



## Net Positive Outlooks by Region *Only EM Europe positive*





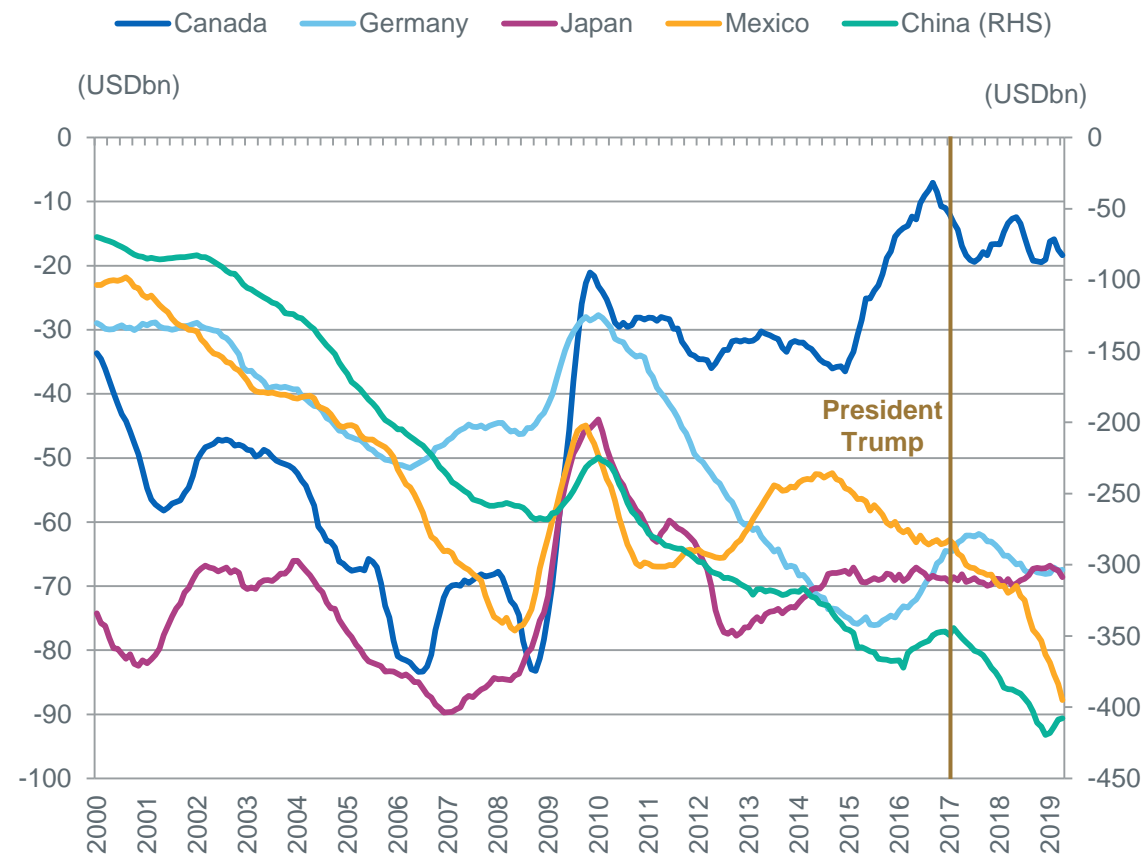
## The Cycle Peak Was 2017, Trade War Taking a Toll

### Global Economic Outlook Forecast (as of June)

	2017	2018	2019f	2020f
<b>GDP Growth (%)</b>				
World	3.3	3.2	2.8	2.7
US	2.2	2.9	2.4	1.8
Eurozone	2.4	1.9	1.2	1.3
China	6.8	6.6	6.2	6.0
Brazil	1.1	1.1	1.0	2.2
Oil (Brent, \$/bbl, average)	54.90	71.60	65.00	62.50
Fed Funds (% , year end)	1.50	2.50	2.50	2.75
USDEUR (year end)	0.83	0.87	0.88	0.88
USDCNY (year end)	6.51	6.87	7.00	7.20

## Trump Era Marked by Bigger Deficits with China and Mexico

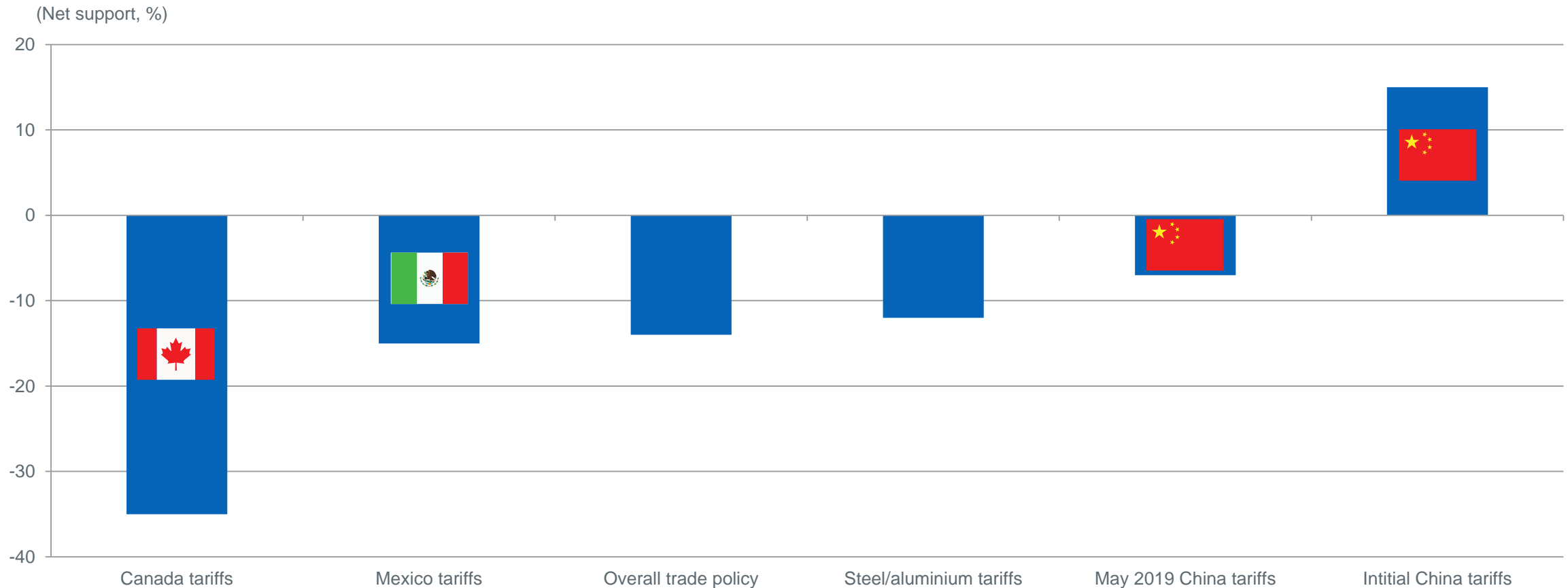
### US Trade Balance with Top 5 Trade Partners (12-month sum)





## Public Support for the Trump Administration's Trade Policy Toward China Suggest No Immediate Pressure for a Deal

Net Public Support in Opinion Polls (*those who support minus those who oppose*)



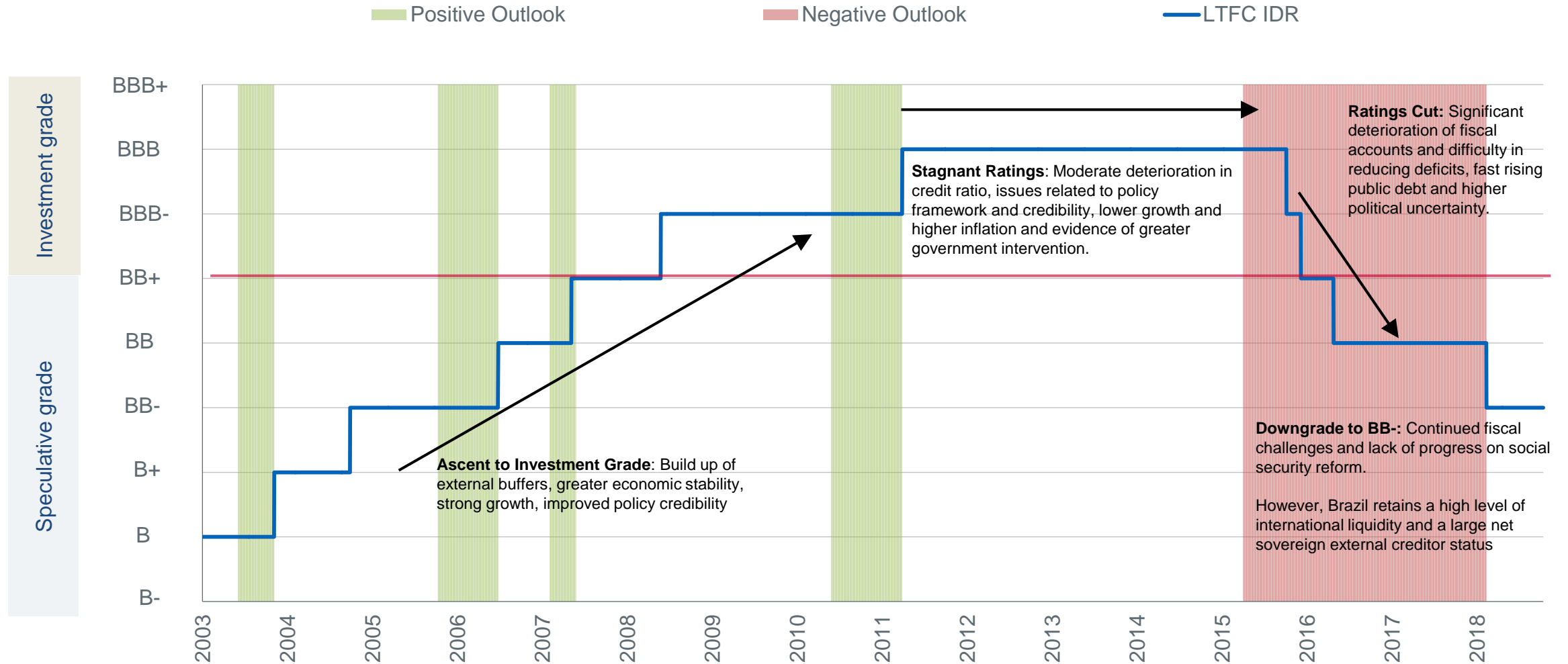
Source: PollingReport.com, Goldman Sachs, Fitch Ratings, 11 June 2019



- Brazil was downgraded to 'BB-' from 'BB' in 2018, with Stable Outlook.
- Brazil's growth is still being challenged with Fitch forecasting growth of only 1% in 2019. Market sentiment turned positive and confidence indicators improved after the elections. But this has not resulted in improvement in economic activity so far. Growth performance is weak following the nation's worst recession and fiscal challenges persist and potential growth has been revised down.
- The general government deficit – at 8.2% in 2018 – is well above peers and has led to a rapidly rising debt burden, forecast at around 80% in 2019 up from 51% in 2013.
- The new government's reform agenda, if implemented well, could be positive for growth (by addressing structural challenges) and reducing fiscal pressures.
- Progress on the implementation of the economic agenda is key, beginning with pension reform this year.
- Furthermore, Brazil maintains a strong external position relative to other EM peers



# Brazil's Rise and Fall from Investment Grade



Source: Fitch

# Brazil's Peer Group

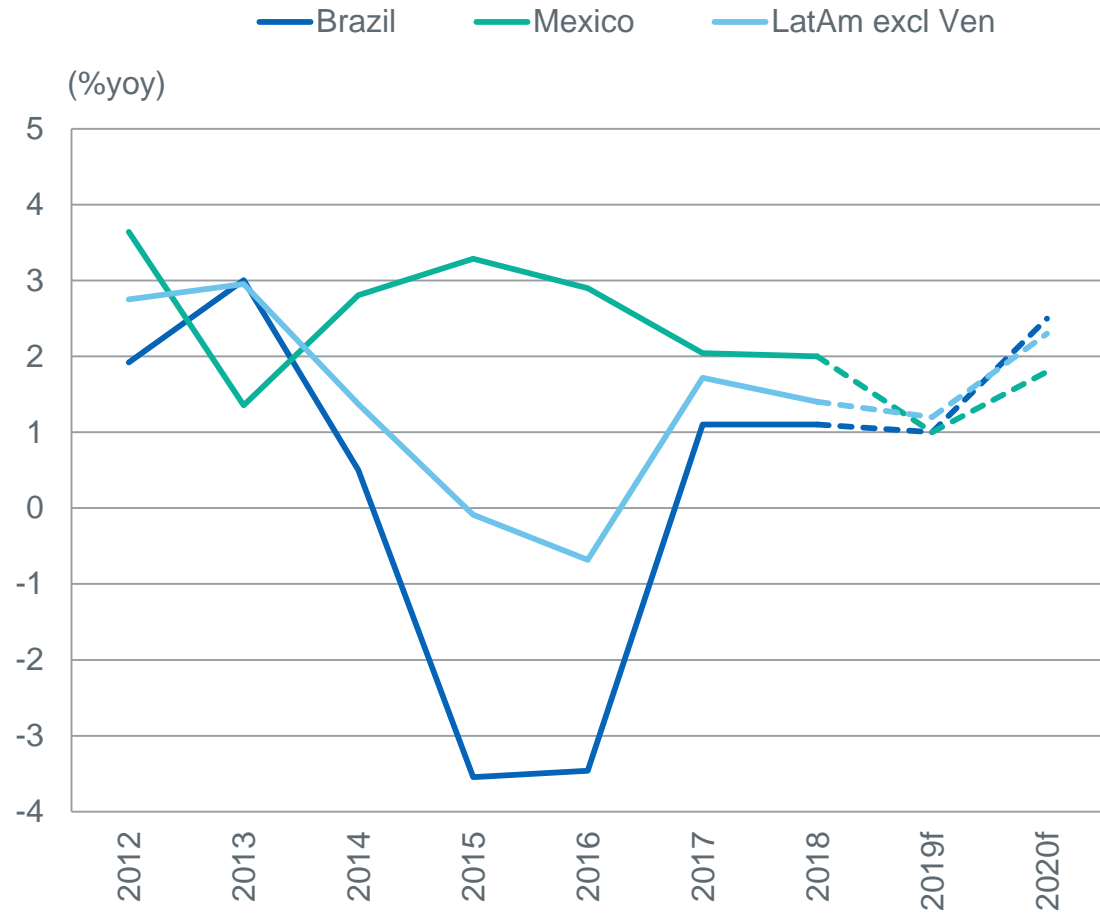


BB+	BB	BB-	B+
Azerbaijan (●)	<b>Guatemala</b> (—)	Bahrain (●)	Armenia (+)
Namibia (—)	Georgia (●)	Bangladesh (●)	Cote d'Ivoire (●)
North Macedonia (●)	Serbia (●)	<b>Bolivia</b> (—)	<b>Costa Rica</b> (—)
<b>Paraguay</b> (●)	Turkey (—)	<b>Brazil</b> (●)	Kenya (●)
South Africa (●)	Vietnam (+)	<b>Dominican Republic</b> (●)	Lesotho (—)
		Greece (●)	Maldives (●)
		Seychelles (●)	Nigeria (●)
			Rwanda (●)
			Tunisia (—)
			Uganda (●)

Latam countries in **Bold** (+) Outlook Positive (●) Outlook Stable (—) Outlook Negative

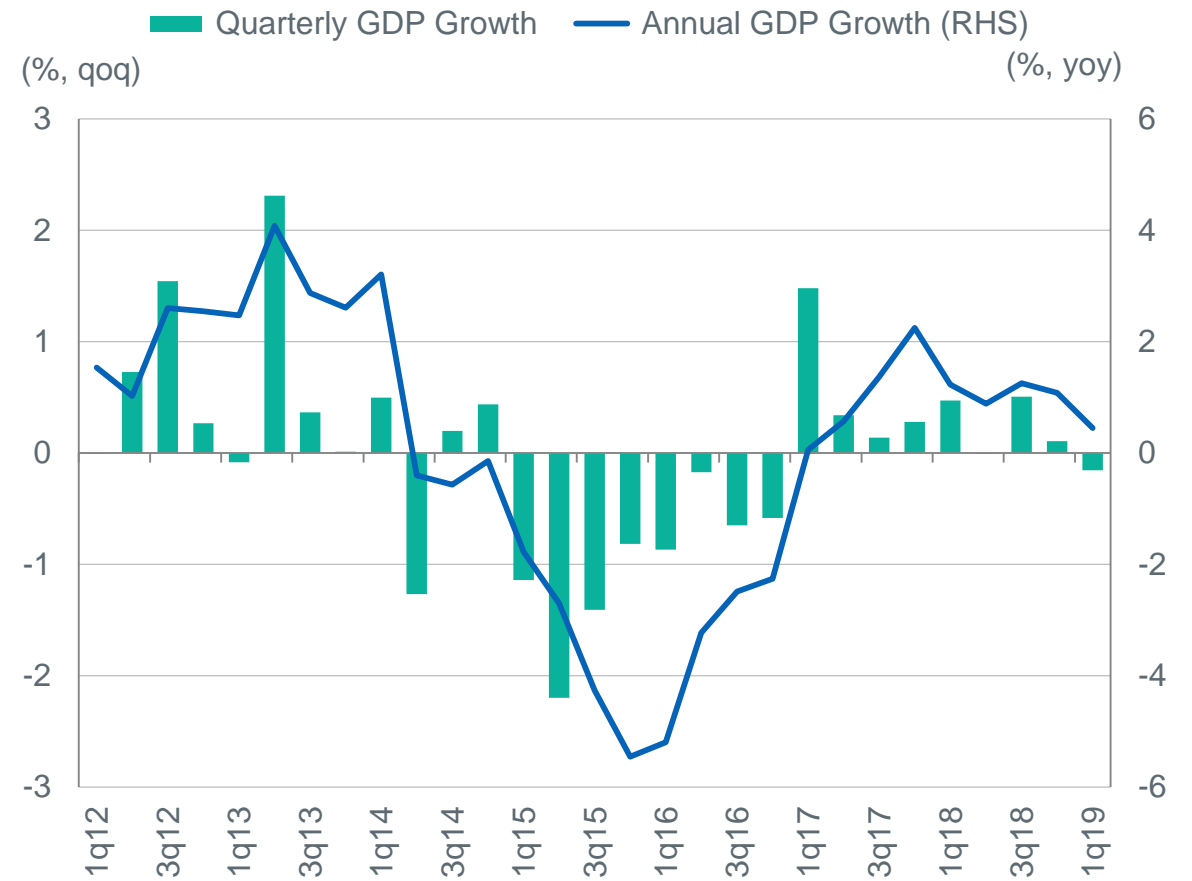


## Real GDP Growth



Source: Fitch

## Real GDP Growth

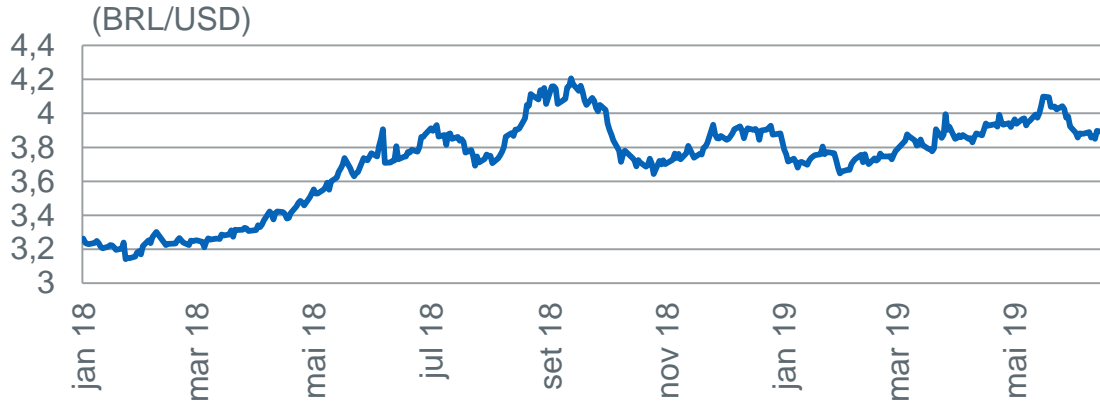


Source: Fitch Ratings, OECD, Datastream

# Past Improvement in Market Sentiment Not Sufficient Yet To Kickstart Recovery



## Exchange Rate



Source: Bloomberg

## Brazil Ibovespa Index



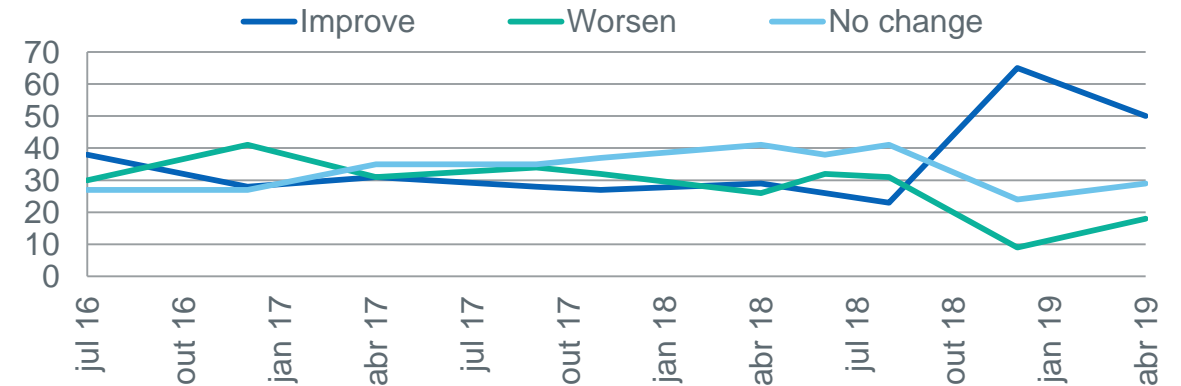
Source: Bloomberg

## Brazil: 5-year CDS USD



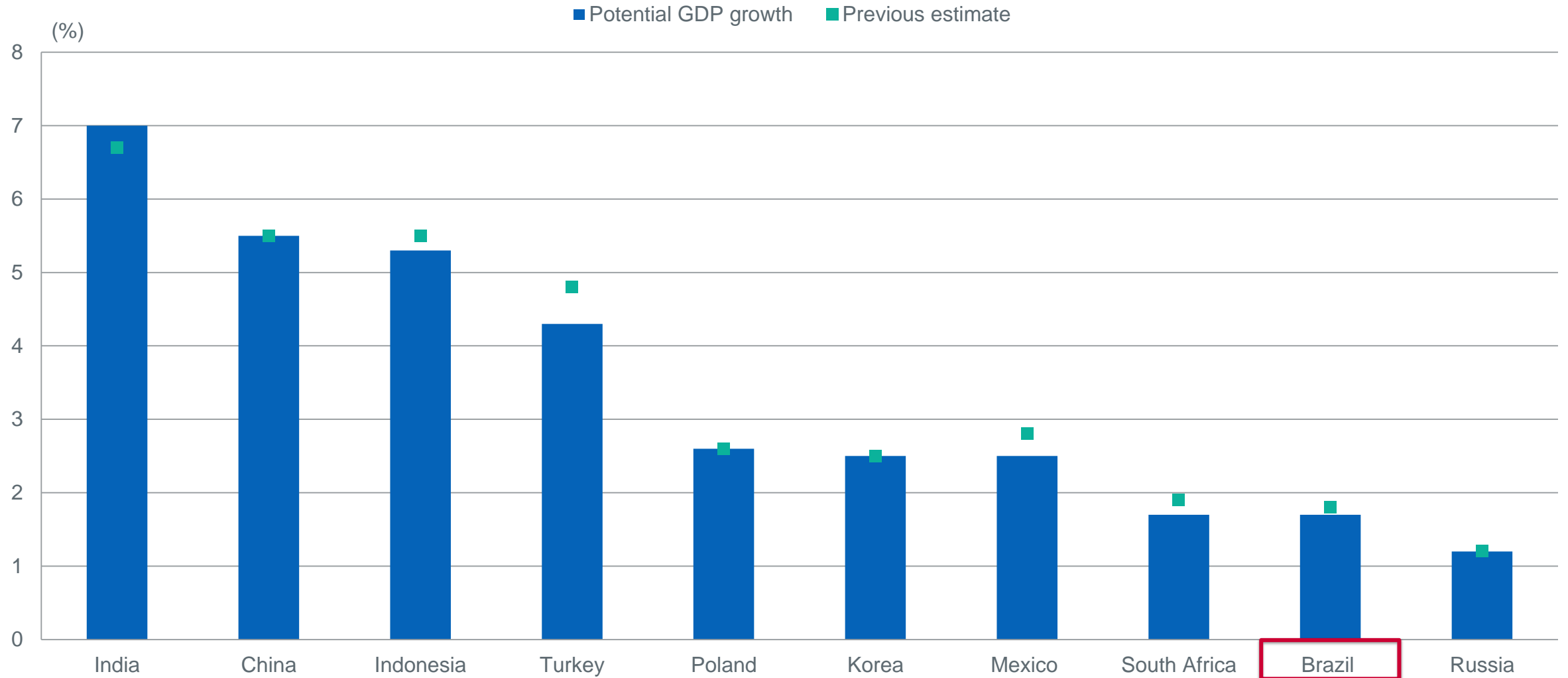
Source: Bloomberg

## Future Economic Expectations



Source: Datafolha

# Potential Growth is Below Most Other Large EMs



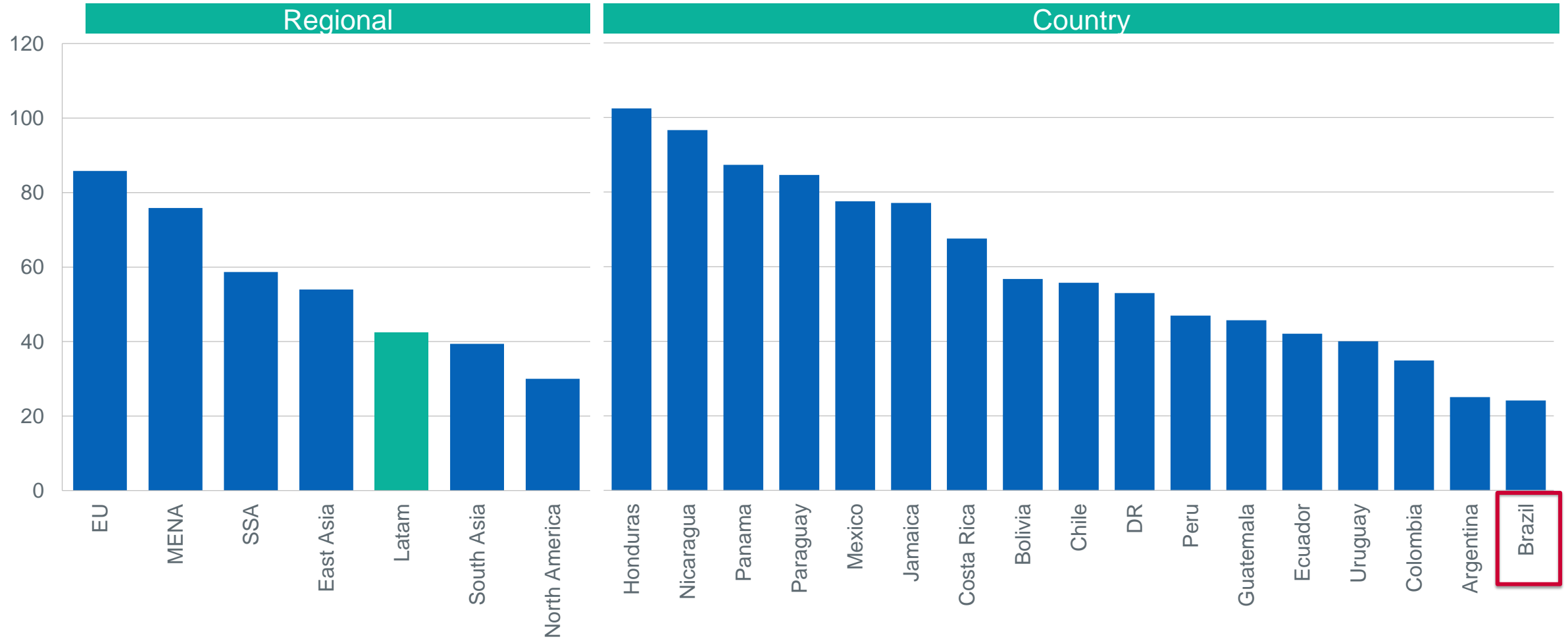
Source: Fitch Ratings

# Brazil's Closed Economy Detracts from Competitiveness and Growth



## Trade Openness

$((X+M)/GDP*100)$



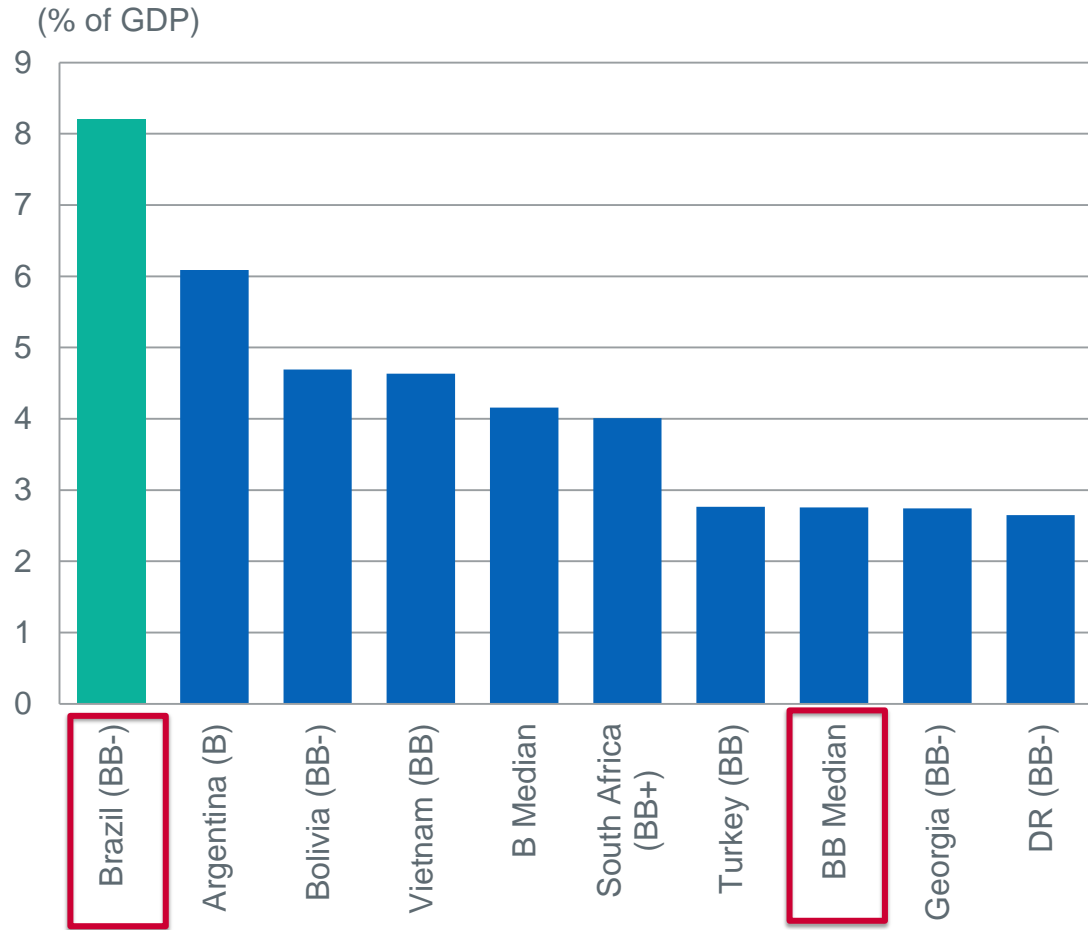
Source: World Bank 2017

# Key Fiscal Challenges Remain



## High General Government Deficit

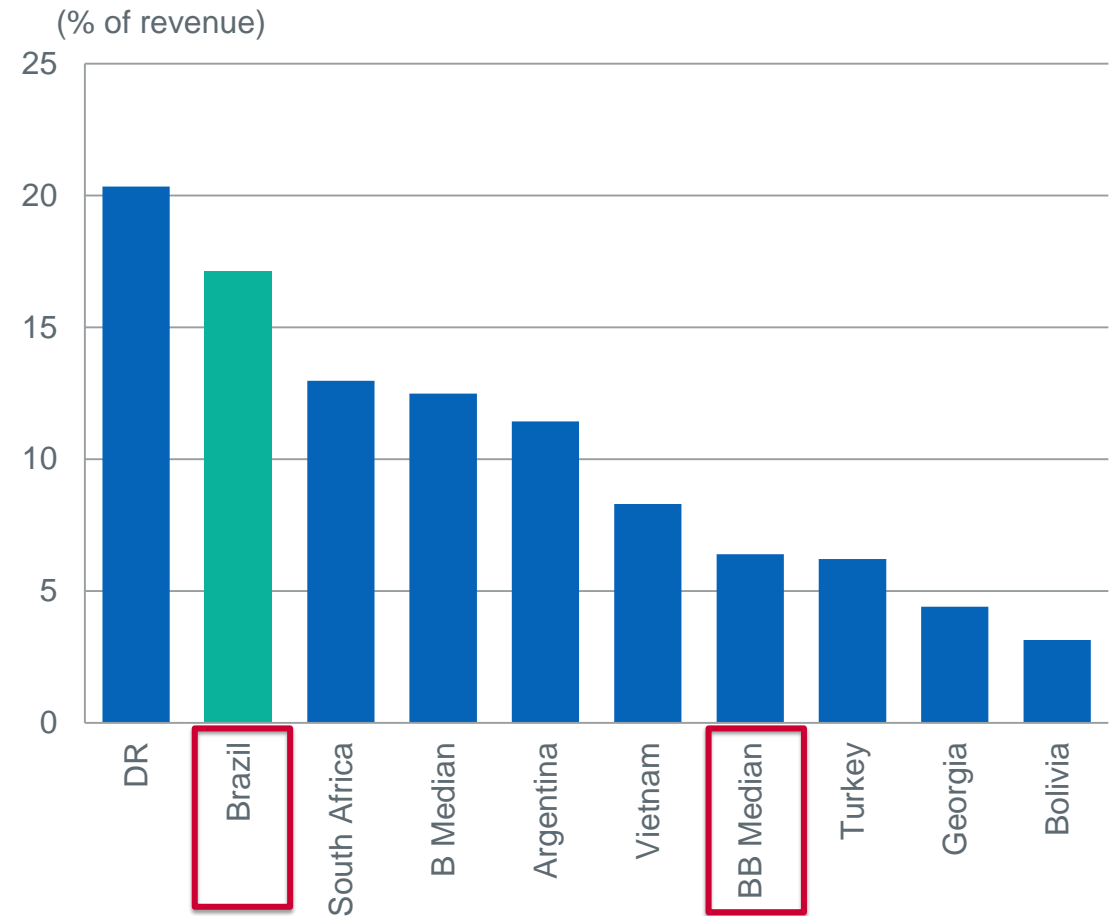
2018



Source: Fitch

## ...and High Interest Burden

2018

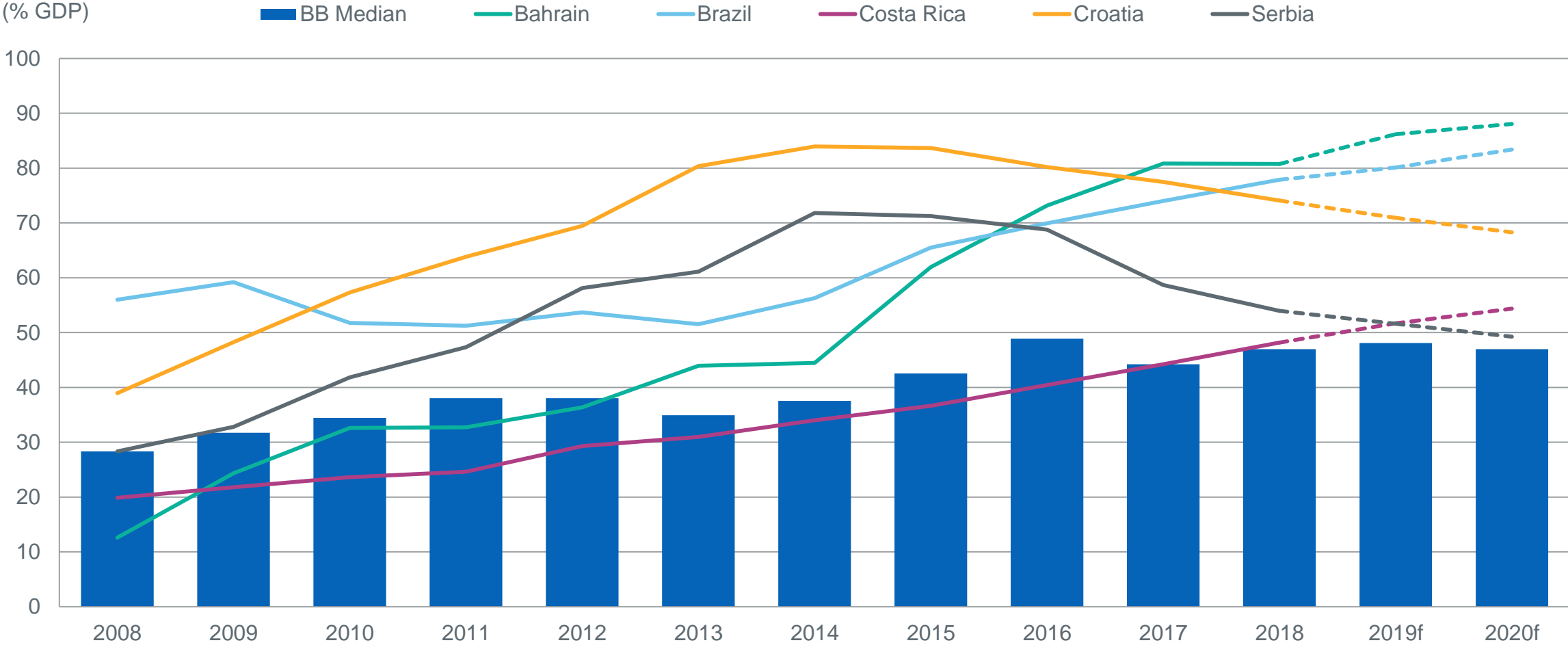


Source: Fitch

# Rising Debt Burden Undermines Flexibility



## General Government Debt

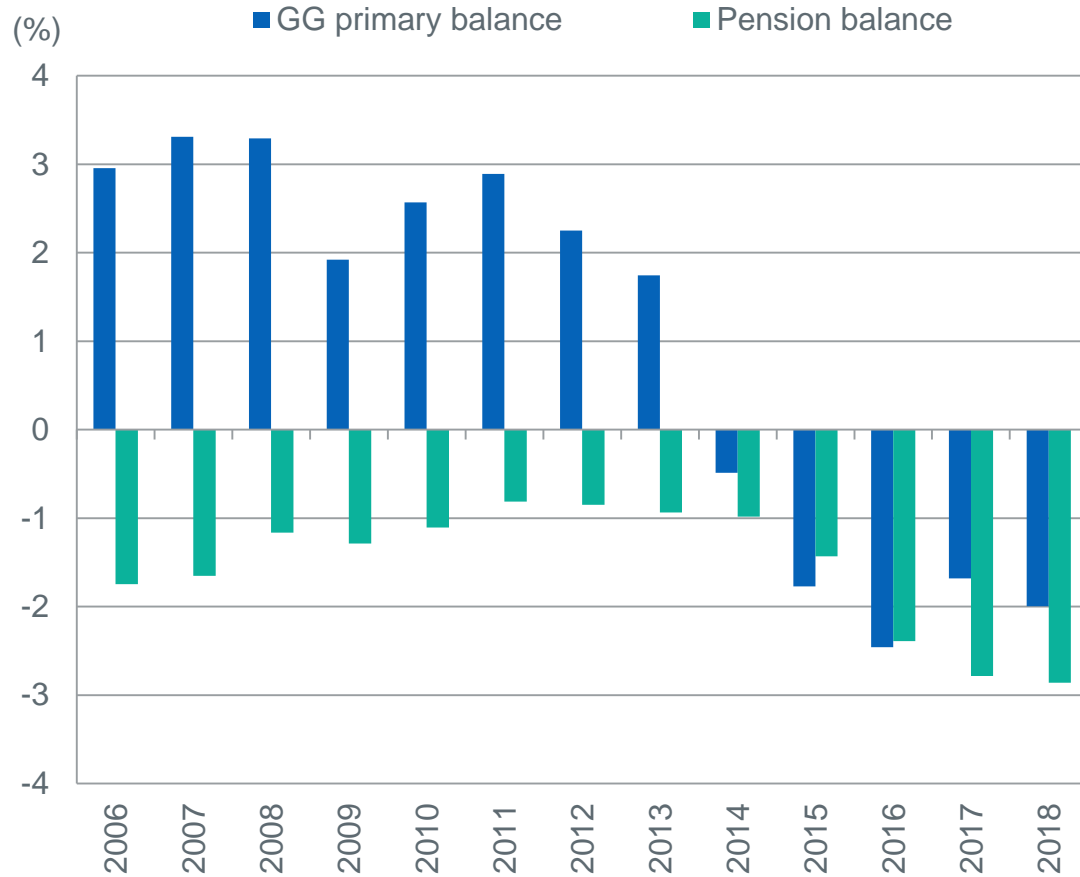


Source: National authorities, Fitch



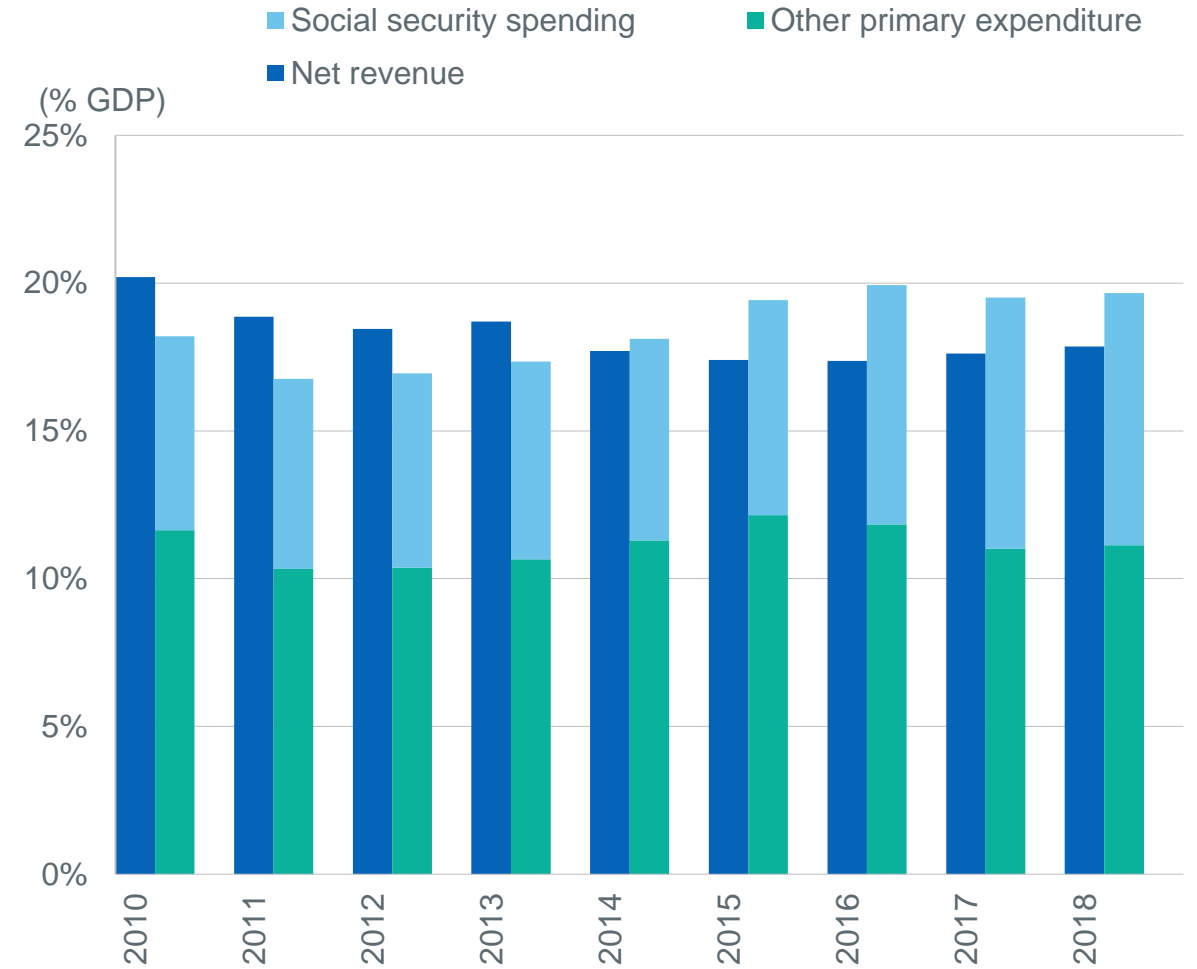


## Pension Deficit Exceeding Primary Deficit



Source: Fitch

## Rising Spending Pressures

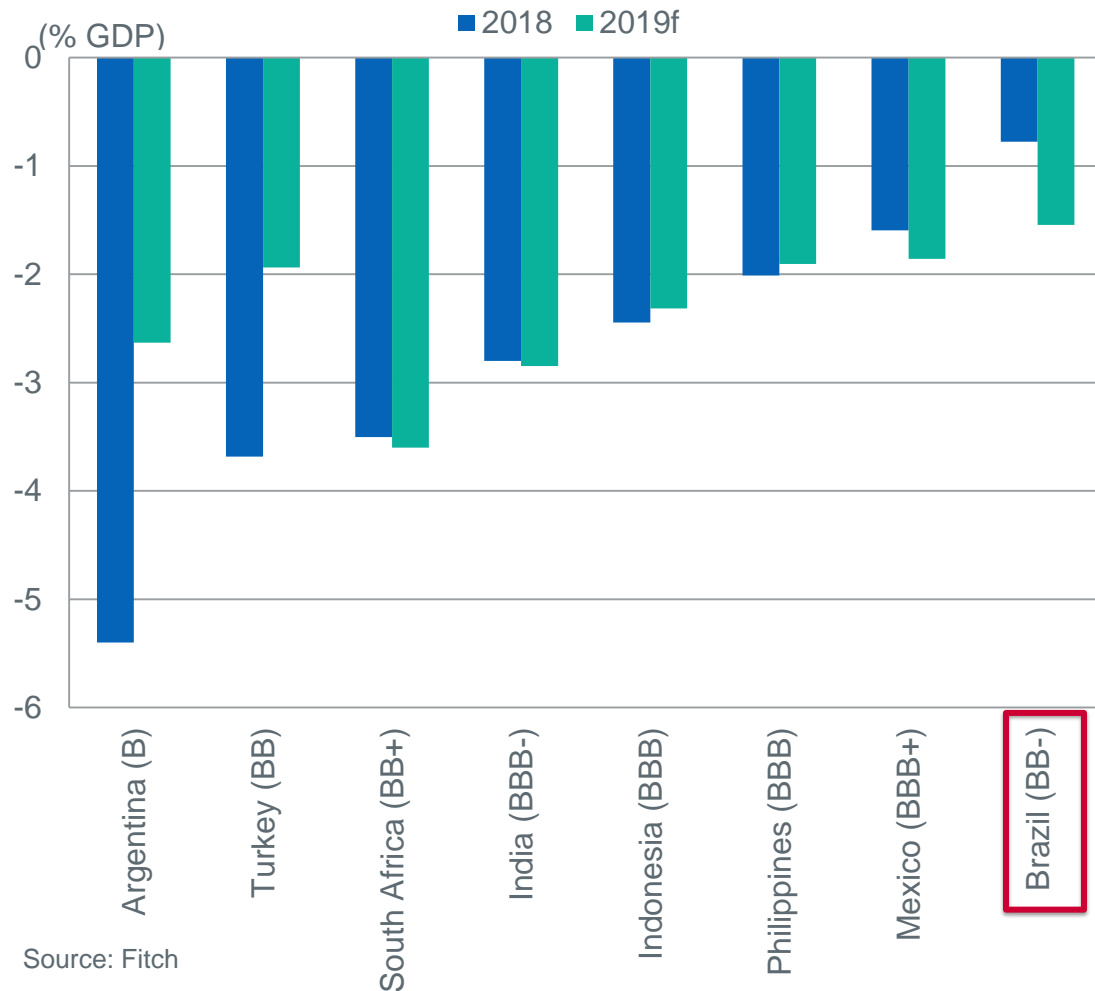


Source: STN

# Strong External Position Relative to EM Peers

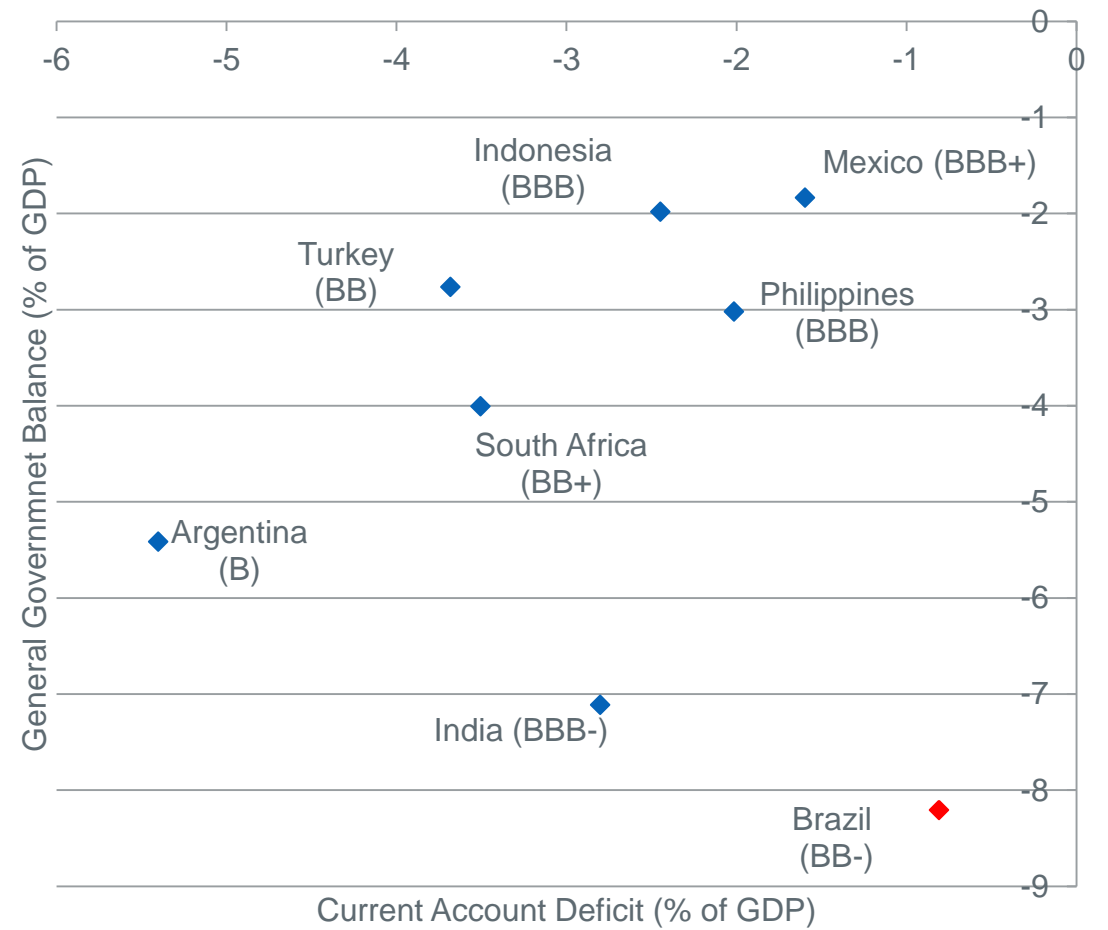


## Current Account Balance



## Dual deficits

2018



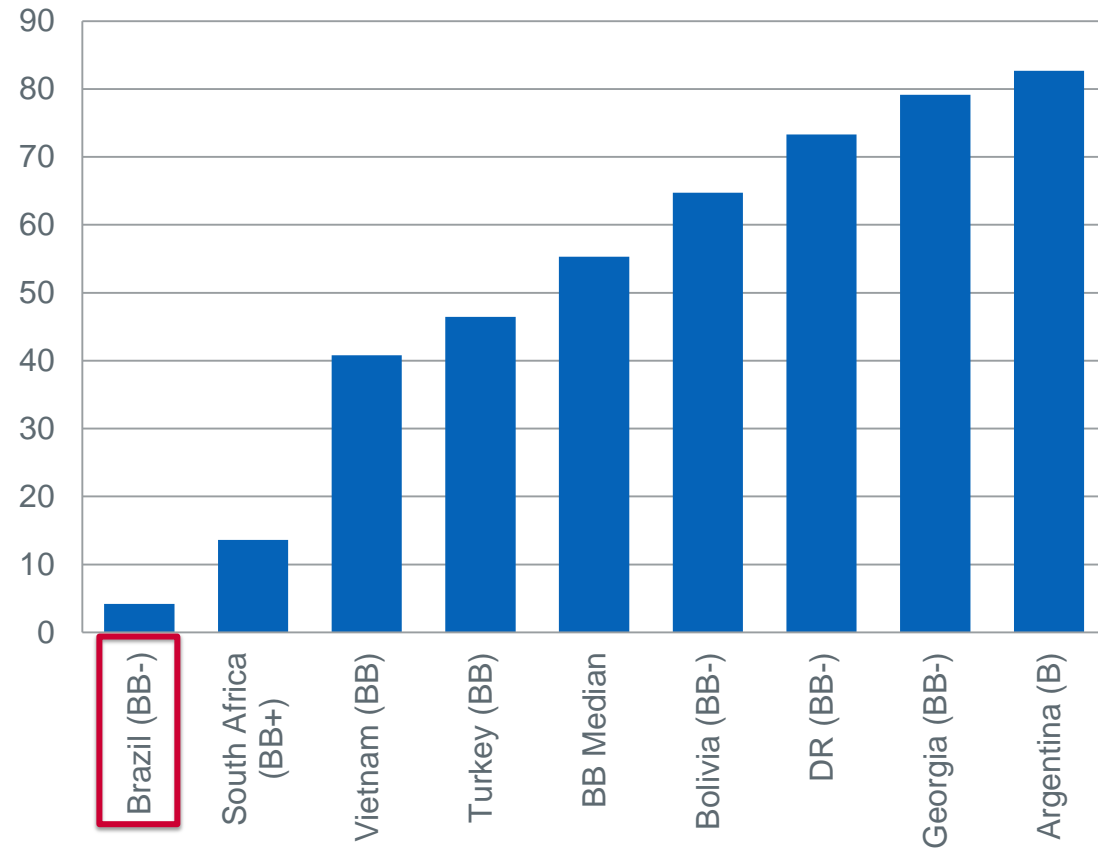
# Despite High Debt, Strong Risk Mitigating Factors



## Share of GG Debt in FX

2018

(% of total)

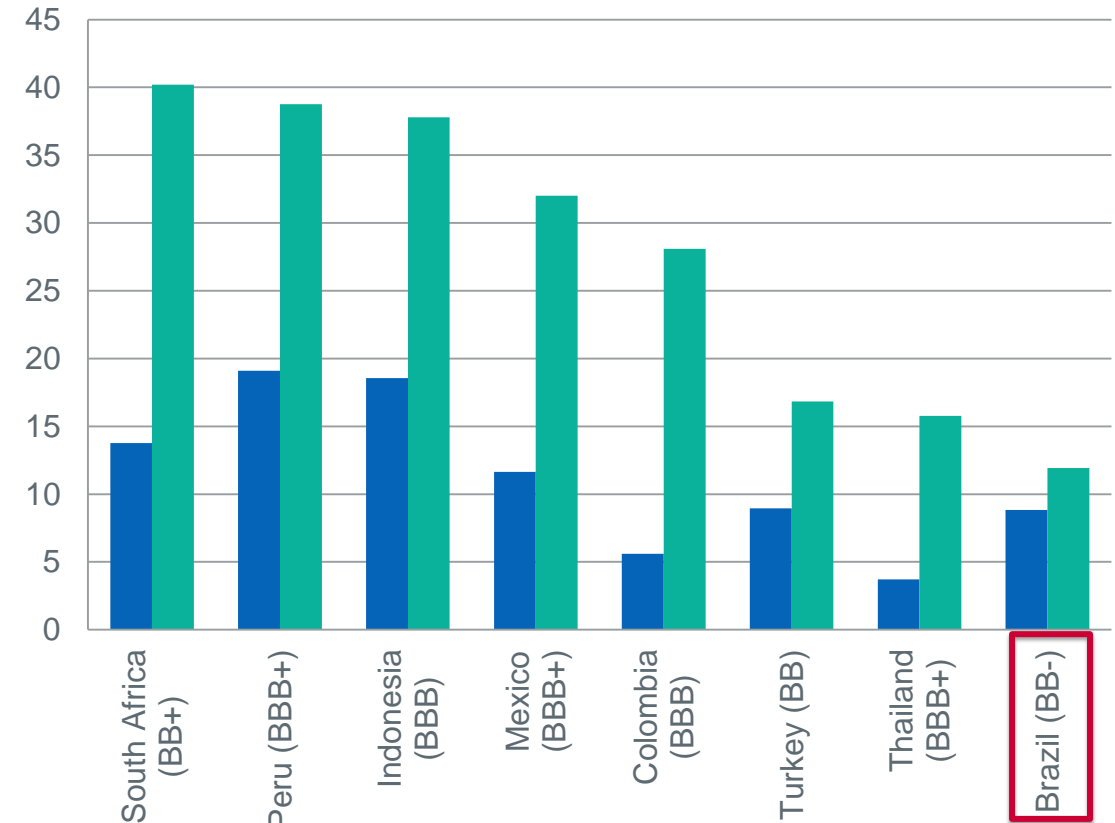


Source: Fitch

## Foreign Ownership of Local Currency Government Securities

(% of outstanding)

■ 2009Q4 ■ 2018Q2

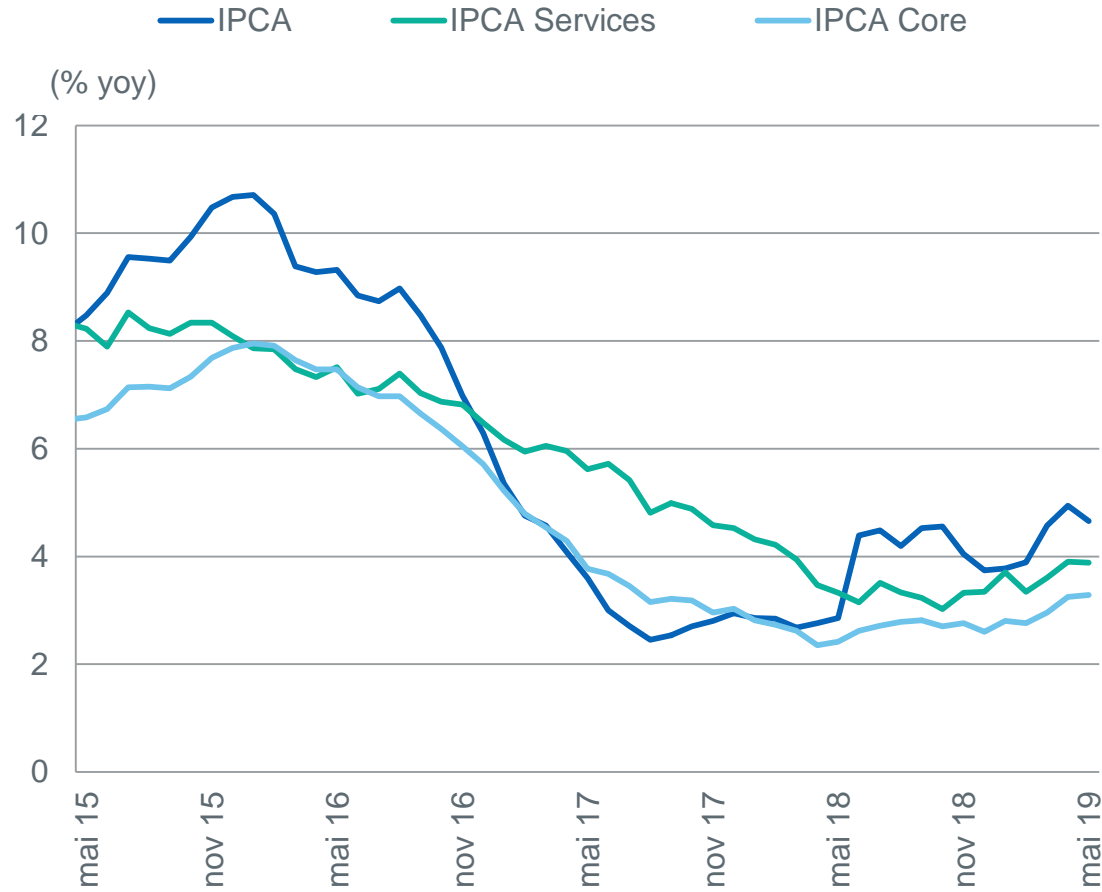


Source: Arslanalp and Tsuda, IMF Working Paper

# Inflation Under Control With Expectations Well-Anchored

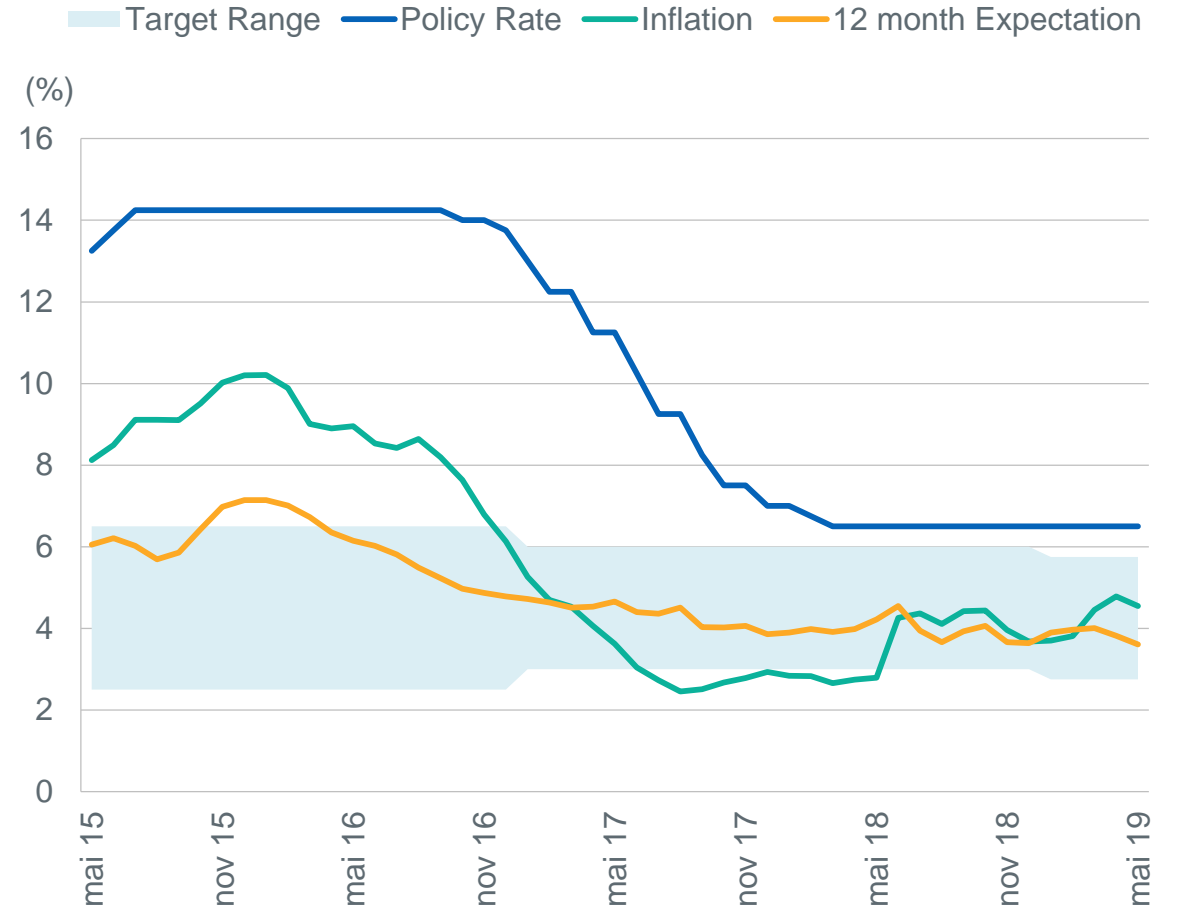


## Inflation



Source: BCB

## Inflation Exepctions and Target



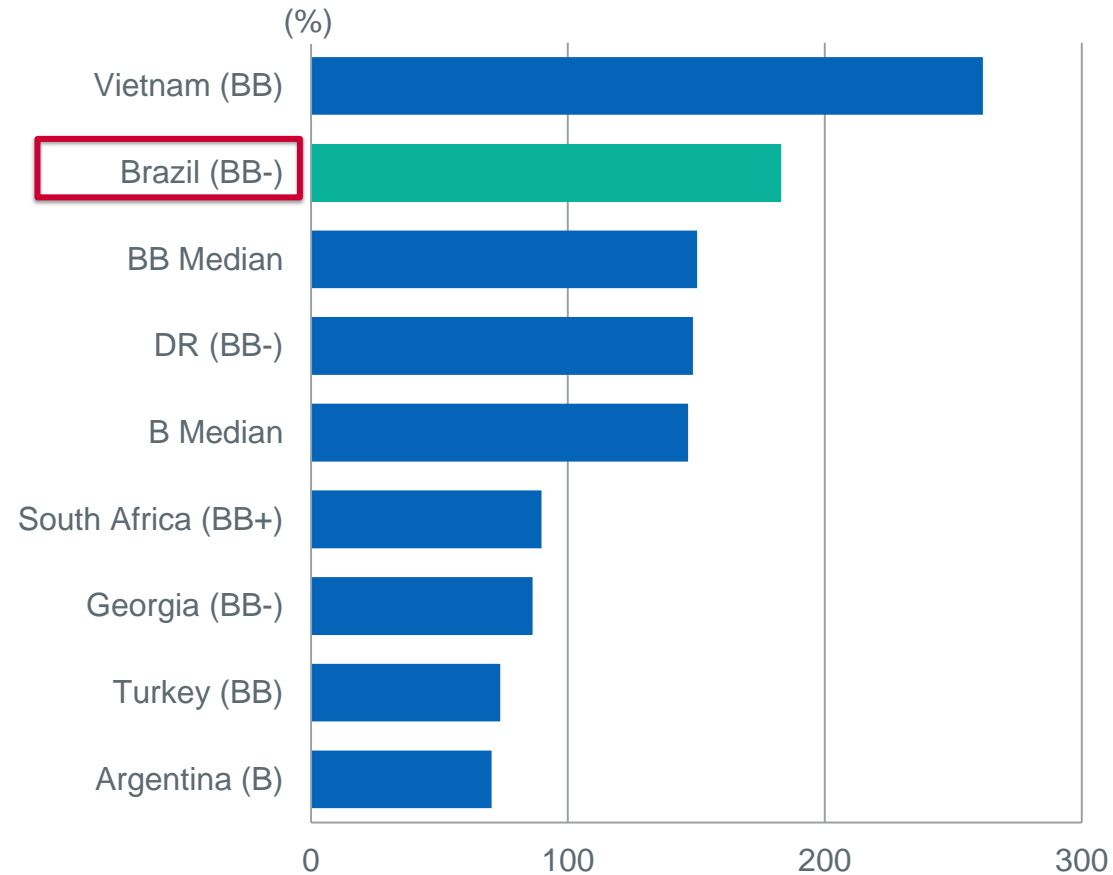
Source: BCB

# Strong International Liquidity and Reserves Position



## Liquidity Ratio

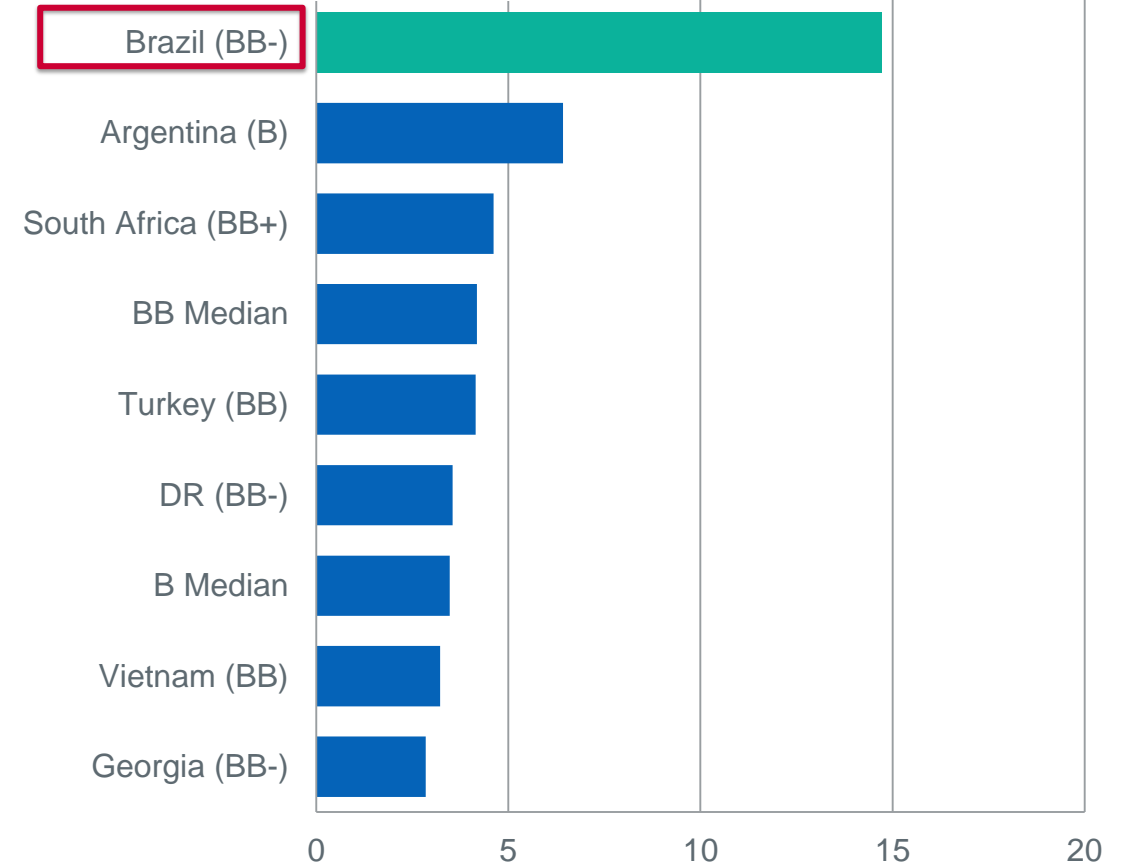
2018



Source: Fitch

## Official international reserves

(in months of CXP cover)

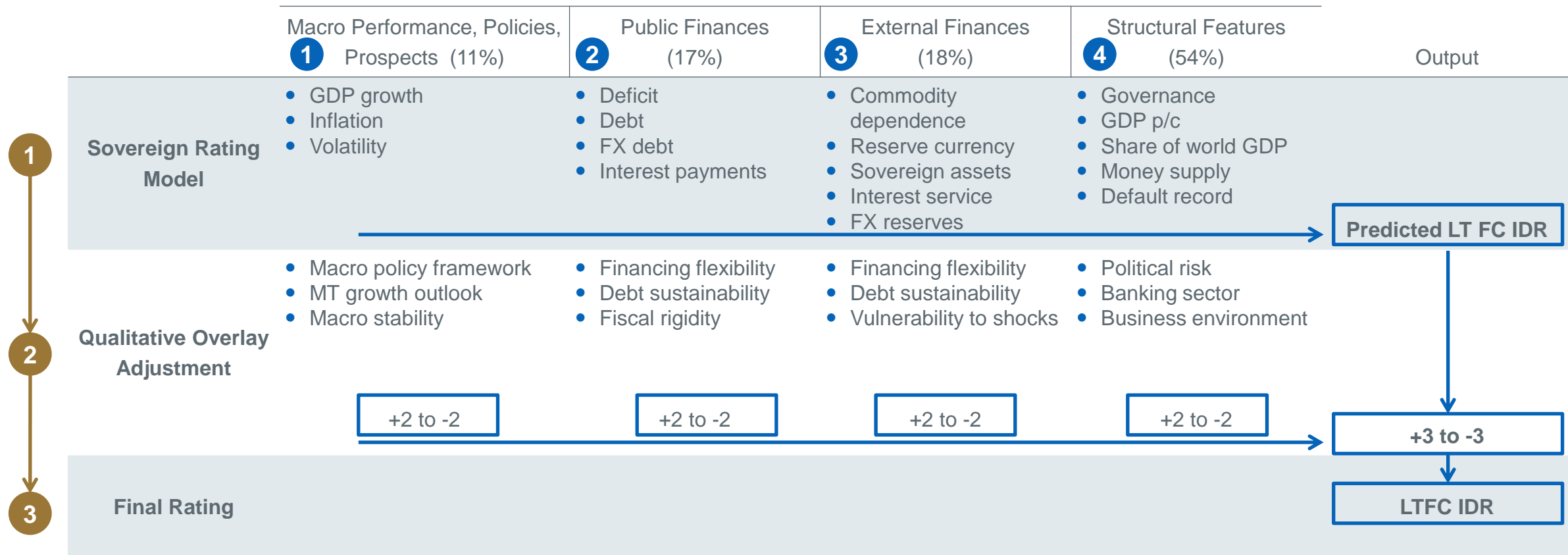


Source: Fitch

# Fitch's Sovereign Rating Criteria Overview



## Analytical Pillars of the Long-term Foreign Currency Issuer Default Rating (LTFC IDR)



The Sovereign Rating Model estimates a predicted rating based on 3-year averages (t-1, t, t+1), then the Qualitative Overlay is applied (+3 to -3 notches) by the rating committee to account for issues and factors not captured by the data

# SRM and Qualitative Overlay



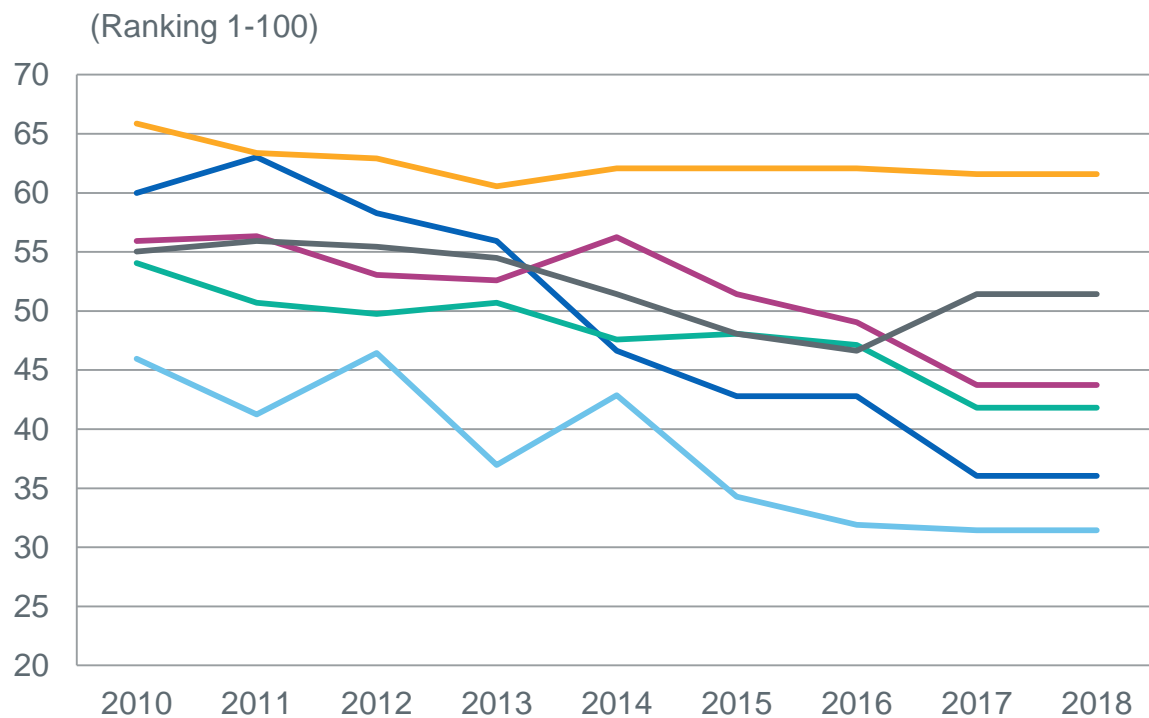
SRM output	Qualitative overlay		FC IDR
BBB-	Factor	Notch adjustment	BB-
	Macro	0	
	Public finances - Rapidly worsened general government debt burden, which is expected to continue increasing during the forecast period. - Highly rigid spending profile and a heavy tax burden make adjustment to shocks difficult.	-1	
	External finances	0	
	Structural features - Challenging political environment and corruption-related issues that have hampered timely progress on reforms to improve confidence in the medium-term trajectory of public finances. - Ease of Doing Business indicators are weaker than the 'BB' median	-2	
	<b>Total</b>	<b>-3</b>	

	Macro	Public Finance	External	Structural
Status	Weakness	Weakness	Strength	Neutral
Trend	Stable	Negative	Stable	Stable



## Governance Pillars

- Control of Corruption
- Government Effectiveness
- Political Stability and Absence of Violence
- Rule of Law
- Voice and Accountability
- Regulatory Quality



Source: World Governance Indicators

## Ease of Doing Business

Rank (1-190)

Indicator	Brazil	India	South Africa	Turkey	Indonesia	Thailand
Overall rank	109	77	82	43	73	27
Starting a business	140	137	134	78	134	39
Dealing with construction permits	175	52	96	59	112	67
Registering property	137	166	106	39	100	66
Getting credit	99	22	73	32	44	44
Paying taxes	184	121	46	80	112	59
Trading across borders	106	80	143	42	116	59

Source: World Bank, Doing Business 2019

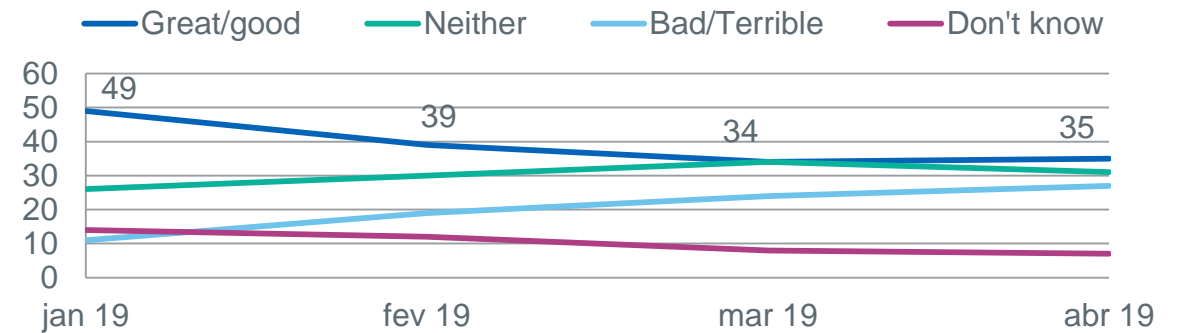




- A pro-market economic agenda, if implemented, would be positive for confidence and growth
- Achieving a primary surplus in 2 years will be quite challenging and will require more than a social security reform
- Complying with the spending cap will require a social security reform and other spending adjustments
- Any reduction in the tax burden without offsetting measures will worsen public finances
- Reduction in payroll tax exemptions will be politically difficult and require confronting vested interests
- Aggressive privatization faces political, social and congressional limitations
- Effectiveness of the new style of political negotiations and the cohesion in congressional support needs to be monitored.
- Idiosyncratic risks related to corruption investigations can delay/derail the reform agenda

## Quickly Falling Popularity

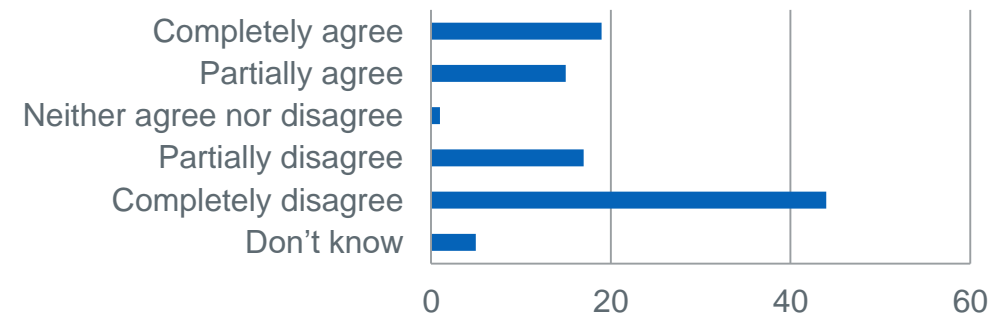
Evaluation of Bolsonaro's Government



Source: Pesquisa Ibope

## Government should privatize as many state companies as possible

(% of respondents)



Source: Datafolha, January 2019



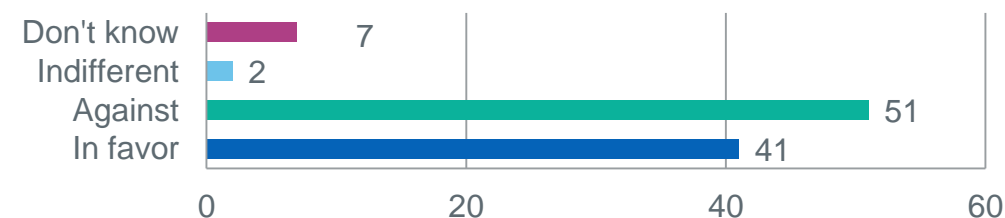
## Key elements of proposal

- Presented to Congress on February 20
- Estimated savings of more than BRL1 trillion over a decade, in its current form
- Raise minimum retirement age to 65 for men and 62 for women in addition to meeting a minimum number of years of contribution (to be phased in over a transition period)
- Increase progressivity of benefits
- Improve harmonization of benefits across regimes and reduce survivors' benefits
- Raise the eligible criteria for receiving social assistance
- Reduce the scope for annual bonus salary payments
- Military pension reform less aggressive with savings diluted by the increase in salaries

## Challenges Ahead

- Reform diluted already in the special committee report (BRL913 bn) and further dilution could occur too. Redirection of certain taxes towards pensions being proposed to further increase the savings
- Untested administration in working with a highly fragmented legislature
- Reform requires amending the Constitution which needs support of more than three-fifths of both houses of Congress in two rounds of voting
- Additional reforms required to comply with spending cap (i.e., adjustments to minimum wage formula)

## Opinion on Pension Reform



Source: Datafolha, April 2019



- Political willingness and capacity for economic reforms
- Cohesiveness of the economic team to implement the policy agenda
- Operational and formal independence of the BCB
- Political strategy of the administration to negotiate in congress to pursue and approve reforms
- Assessment of fiscal proposals and the degree to which those reduce fiscal deficits and stabilize the rising debt burden
- Broader micro economic reform agenda to boost growth and reduce unemployment

## Positive Rating Sensitivities

- Improvement in the political environment that facilitates the implementation of credible policy initiatives to address medium term public debt sustainability
- Fiscal consolidation and improved prospects for debt stabilization
- Improved growth outlook amid continued macroeconomic stability

## Negative Rating Sensitivities

- Lack of fiscal reform that is sufficient to support an improvement in the fiscal and growth prospects, leading to a rapid growth in the government debt burden that threatens medium term public debt sustainability
- Deterioration in the sovereign's domestic and/or external borrowing conditions
- Erosion of international reserves buffer and the broader external balance sheet

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