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Research Update:

Brazil Long-Term Foreign Currency Rating Raised To Investment-Grade 'BBB-', Outlook Stable

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Rationale

On April 30, 2008, Standard & Poor's Ratings Services raised its long-term foreign currency sovereign credit rating on the Federative Republic of Brazil to investment-grade 'BBB-' from 'BB+', and its long-term local currency sovereign credit to 'BBB+' from 'BBB'. Standard & Poor's also raised its short-term foreign currency sovereign credit rating on Brazil to 'A-3' from 'B' and its short-term local currency sovereign credit rating to 'A-2' from 'A-3'. The outlook on the long-term ratings is stable. Standard & Poor's raised its transfer and convertibility assessment for Brazil to 'BBB+' from 'BBB'. The national scale credit rating on the republic was affirmed at 'brAAA'. Standard & Poor's withdrew its recovery rating of '3' on the republic; such ratings are only assigned to speculative-grade foreign currency ratings.

Brazil is the 14th sovereign to have its foreign currency debt raised to investment grade. The upgrades reflect the maturation of Brazil's institutions and policy framework, as evidenced by the easing of fiscal and external debt burdens and improved trend growth prospects. While net general government debt remains higher than that in many 'BBB' peers, a fairly predictable track-record of pragmatic fiscal and debt management policies mitigates this risk. The country's external debt net of liquid external assets has declined dramatically, with net debt amounting to a projected 3% of current account receipts (CAR) in 2008 from in excess of 100% of CAR as recently as 2004. While some deterioration is likely as the current account slips back into deficit, we expect the rise in the external debt burden to be modest.

Brazil's credit strengths include:

- A track record of policy continuity through political transitions under an inflation-targeting and floating-exchange-rate regime;
- Net external debt less than 10% of CAR; and
- A profile of government debt increasingly in line with low-investment-grade sovereigns.

The sovereign's credit weaknesses include:

- Large net general government debt and interest burdens;
- Budgetary inflexibility amid high current spending; and
- Structural impediments that keep investment and growth below that of other emerging market economies.

Generally pragmatic and predictable policy and fairly transparent institutions have underpinned macroeconomic stability in Brazil. This has facilitated a sounder foundation for economic growth and fiscal improvement over the past five years that should continue over the next several years. The maintenance of a consistent macroeconomic approach (anchored by a floating exchange-rate regime and an inflation-targeting framework) following the political transition of 2002-2003 has been a key support for Brazil's sovereign ratings.

The country's operationally independent central bank–an important institutional strength for Brazil's sovereign credit rating-has initiated a forward-looking monetary policy tightening cycle. This contrasts with the absence of appropriate corrective policy measures and unchecked inflationary pressures in other lower-rated sovereigns. Inflation has trended higher in Brazil, owing not only to global food and energy price pressures but also to robust domestic demand. A rapidly narrowing output gap helped to push inflation to 4.7% in March 2008, up from 4.5% in December 2007 and 3.1% in December 2006. Consumer-price inflation is projected around 5% in 2008-2009, given proactive central bank policy measures.

While once a key credit weakness, Brazil's external indicators are generally in line with low-investment-grade credits. External debt net of liquid assets is projected at 3%-10% of CAR in 2008-2009. Foreign direct investment, diverse in terms of size and destination, is drawn to Brazil, given its maturing growth outlook. After reaching a record US$34.6 billion in 2007, it continues at a robust pace in 2008 and is expected to cover the US$20 billion current account deficit forecast for 2008.

Fiscal policy and indicators are Brazil's foremost credit weakness. Net general government debt of 47% of GDP (including 7% of GDP in central bank repurchase operations) at year-end 2007 is higher than that in most similarly rated credit and above the 20% of GDP for the 'BBB' median. To mitigate this high debt burden, Standard & Poor's expects that fiscal policy will remain consistent with an almost 10-year track record of meeting stated fiscal targets, and that the government will continue to improve the composition of its debt. These outcomes, together with the firmer foundation for growth, all support a modest, slow decline in Brazil's comparatively high debt burden.

Fiscal policy is expected to remain expansionary in 2008-2009, but Standard & Poor's anticipates that the government will deliver a fiscal outturn consistent with its 3.8% of GDP primary (noninterest) surplus target for the nonfinancial public sector.

The profile of government debt continues to become more in line with low-investment-grade credits. Over 90% of debt is denominated in local currency, as the government has paid down external debt: fixed-rate paper now accounts for 36% of locally issued debt, while inflation-linked paper equals 27%. The average maturity of central government debt is 5.38 years: 4.76 years for locally issued debt, and 12.5 years for external debt.

Pragmatic macroeconomic policy (supported by a favorable global climate during the past five years) strengthened the foundation for sustained real GDP growth of 4%-4.5%. A broader consumer market, deepening capital market, and increasing levels of formalization support improved investment prospects. However, even higher rates of growth more in line with other emerging markets require investment greater than the current 17.9% of GDP. Additional steps to reduce "custo Brasil", simplify the tax regime, promote greater labor-market flexibility, lower import tariffs, and facilitate private investment in energy and infrastructure would strengthen Brazil's investment climate and medium-term growth outlook. Clearly, so would less crowding out of the private sector by the high level of government debt, current spending, and the requisite high level of taxation.

Outlook

The stable outlook balances Brazil's high level of government debt against maturing economic prospects and low net external indebtedness. Improved creditworthiness would follow from a more pronounced decline in government debt and fiscal imbalances. Policy steps to reduce the level of, and rigidity in, current government spending (or both) would strengthen Brazil's fiscal stance and facilitate a further decline in real interest rates, with positive implications for investment and growth and a faster decline in Brazil's debt burden. Passage of tax or social security reform—not expected by Standard & Poor's within the rating horizon—would be a positive shock to confidence and contribute to stronger creditworthiness. Conversely, if this or a future government's commitment to pragmatic fiscal and monetary policy weakens, if policy setbacks to the investment climate occur, or if the government fails to adequately respond to unforeseen shocks, the ratings could come under downward pressure.

Ratings List

Upgraded; Outlook Action

	To	From
Brazil (Federative Republic of)		
Sovereign Credit Rating		
Foreign Currency	BBB-/Stable/A-3	BB+/Positive/B
Local Currency	BBB+/Stable/A-2	BBB/Positive/A-3

Upgraded

Transfer & Convertibility Assessment	BBB+	BBB

Not Rated Action

	To	From
Brazil (Federative Republic of)		
Senior Unsecured		
Local Currency	NR	3

Ratings Affirmed

Brazil (Federative Republic of)	
Sovereign Credit Rating	
Brazilian Rating Scale	brAAA/Stable/--

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