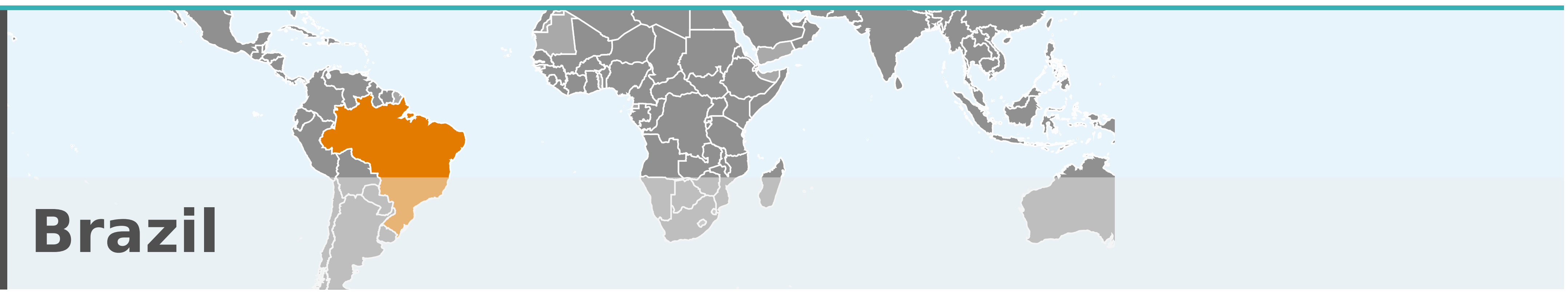
5.6



Brazil

Overview

The overall risk score for Brazil stands at 5.6, compared to the average for Latin America of 5.4. The score has remained the same compared to six months ago.

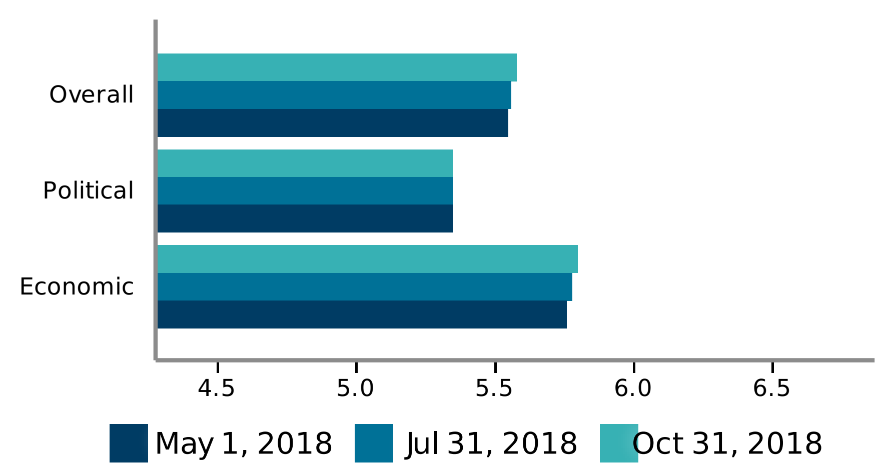
Political stability risk remains stable at 6.0. Following the October 2018 general elections, Jair Bolsonaro is inaugurated as president in January 2019, along with the new Chamber of Deputies (lower house) and Senate (upper house). Bolsonaro's initiatives will be focused on social conservative reforms and his economic pro-business agenda to appease global markets.

Bolsonaro's Social Liberal Party (PSL) will head the largest coalition in Congress, and ideological affinities will allow the new president to negotiate the occasional support of centrist politicians. Bolsonaro's controversial rhetoric will occasionally undermine his popularity among Brazilians, and he will face intransigent opposition from left-wing parties.

Brazil's overall economic risk score of 5.8 is high, leaving it ranked 92 out of 164 countries, broadly in line with the emerging market average.

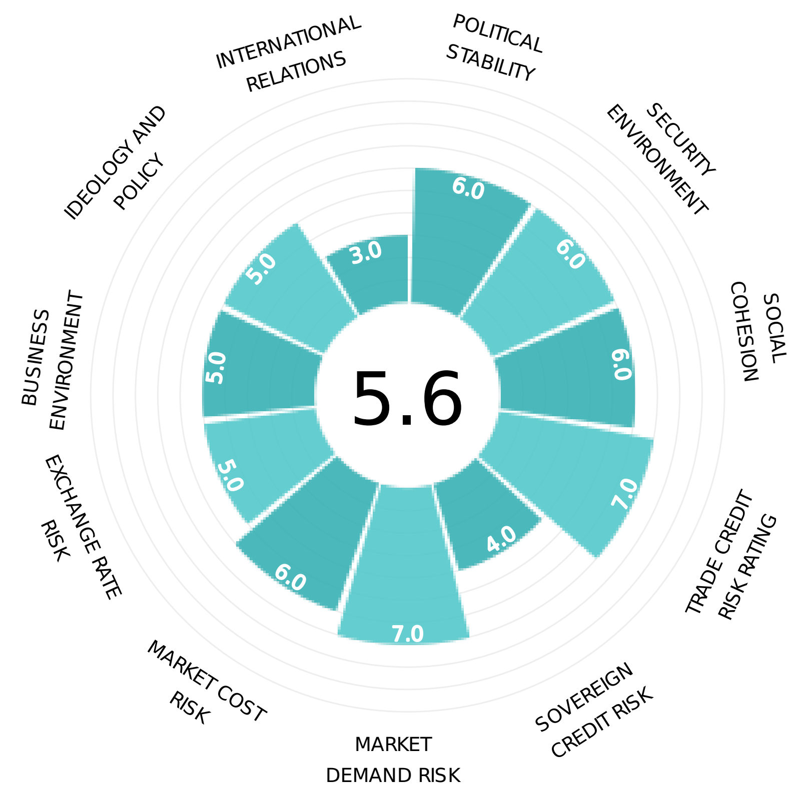
Brazil's risks are two-fold, stemming from what will follow after the deepest recession in a century and from a prolonged political crisis (that included the impeachment of former President Rousseff). On the economic front, activity has now expanded for six quarters in a row (2017 and H1 2018), which brings some relief, but we caution that growth will continue to be constrained by the large burden of public and private debt. Meanwhile, although Bolsonaro was a clear winner in the presidential election, the country's politics are now deeply polarised.

Country Risk Evolution



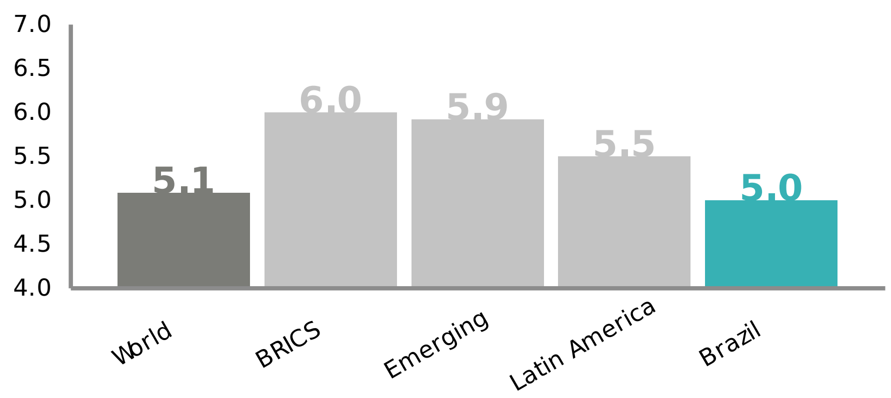
Risk indicators

Scores from 1 to 10 with 10 representing the highest risk.



Political Risk Scores 5.3

Business Environment

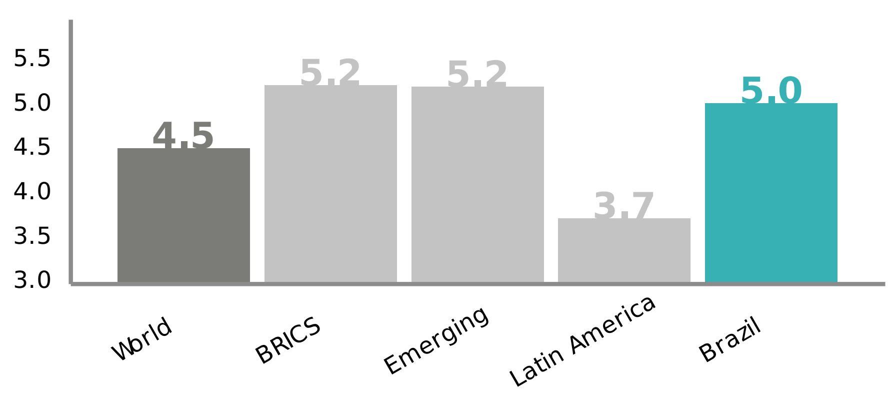


Bolsonaro is likely to push for a market-friendly agenda, similar to that implemented by outgoing president Michel Temer (2016-18), which aimed to reduce operational costs for foreign businesses, cut red tape, and increase Brazil's attractiveness to investors.

Likely finance minister Paulo Guedes, a former financial market executive who was responsible for designing the president's economic programme, is inclined towards the complete liberalisation of the economy. Guedes has pledged several initiatives to incentivise public-private partnerships (PPPs) in infrastructure projects along the lines of the existing Investment Partnerships Programme (PPI). Credit lines to enhance exports and reduce the bureaucracy associated with foreign trade operations are likely to be introduced. Rounds of auctions of oil blocks will remain a key source of revenue for the administration, and the issuance of power-generation and -transmission licences will create opportunities for foreign investors.

Guedes has also argued in favour of the deregulation of Brazil's business environment and the simplification of the country's byzantine tax regime. His main proposal is the unification of the tax system into an exclusive value-added tax (VAT – sales tax), similar to the fiscal mechanisms of several developed countries. These changes are likely to lead to gradual improvements in the business environment. However, "pork barrel" politics will continue to dominate legislative activity, reflecting structural issues such as the design of the multi-party system and lack of party loyalty. Law-enforcement agencies and the judiciary will maintain relative independence from the government, periodically exposing corruption scandals involving politicians and the private sector.

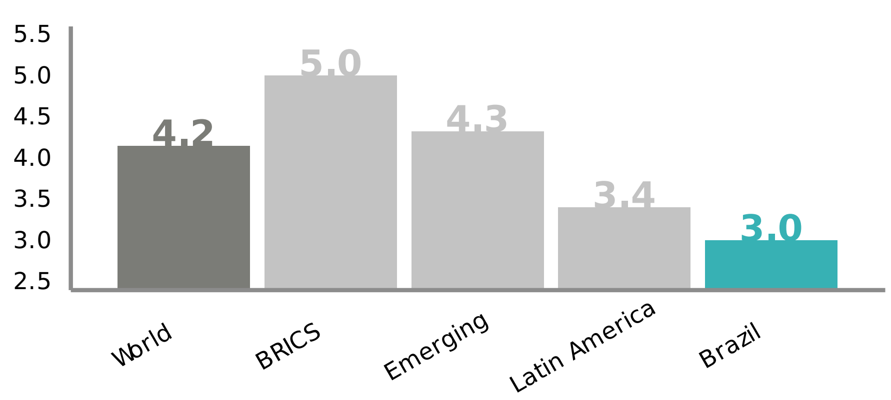
Ideology and Policy



Brazil's recent political history had indicated that its "centre of gravity" was closer to the centre-left. This dramatically changes with the election of the far-right Bolsonaro and a largely right-wing, conservative Congress. This brings efforts to reduce the size of the state, cut government spending, implement social conservative measures and increase the participation of foreign investors in Brazil's economy. Guedes will be the main standard-bearer for such ideas, which will translate into privatisation, deregulation and opening the economy to international trade. However, differences between the liberal view of the economic team and a more nationalistic and statist stance espoused by PSL members (and occasionally Bolsonaro himself) are likely to lead to frequent impasses and have a moderating effect on Guedes' pro-business drive.

Bolsonaro is likely to adopt a more protectionist stance towards specific sectors such as agribusiness and manufacturing to shield them from international competition and protect jobs. This is likely to take the form of subsidies, import taxes, tariffs and non-tariff barriers, as well as incentives programmes to maintain industrial activity.

International Relations

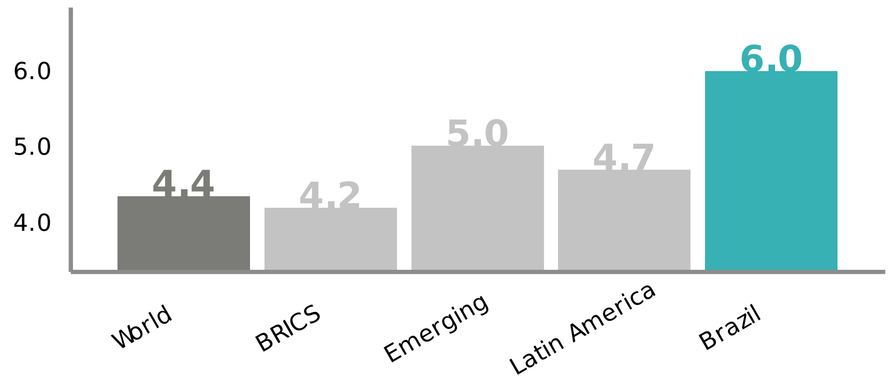


While Bolsonaro's approach to international relations remains vague, he is likely to largely mirror US foreign policy, favouring bilateral relations rather than multilateral engagement. He has pledged that he will pull Brazil out of the Paris Climate Agreement, which he claims violates the country's sovereignty, and the UN.

Bolsonaro will likely seek to align his administration with countries and world leaders that share his ideological vision, particularly the US, Italy, Japan, South Korea and Israel. Brazil will maintain broadly positive relations with its Latin American neighbours, but will adopt a highly critical stance towards leftist administrations, particularly Cuba and Venezuela. Bolsonaro has also openly criticised Chinese investment in the country, which he perceives as detrimental to Brazil's strategic interests. However, he is likely to tone down this radical rhetoric once in office and will be compelled to adopt a more pragmatic approach to diplomacy.

Overall, domestic concerns will sideline the international relations agenda throughout his term. Ongoing processes such as the negotiations between the Southern Common Market (Mercosur and the EU) for a free-trade agreement and Brazil's OECD entrance will continue to advance slowly.

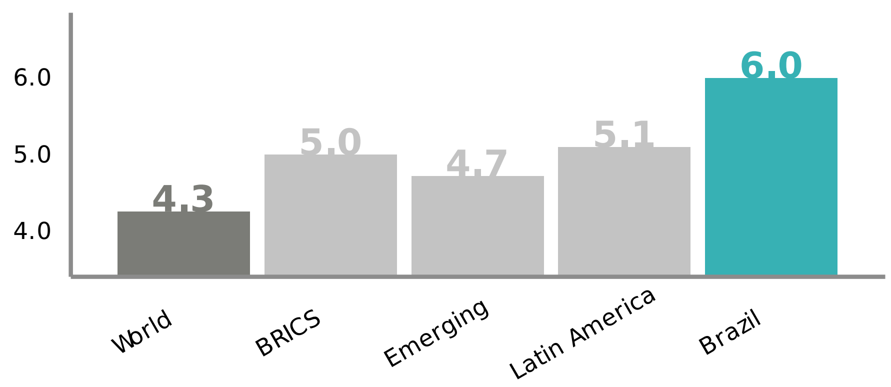
Political Stability



The PSL elected 52 lawmakers (out of a total of 513), becoming the second-largest party in the lower house. These numbers are poised to increase throughout 2019, as the electoral threshold rule forces elected deputies from underrepresented parties to migrate to larger parties. This impressive performance will prove positive for the Bolsonaro administration. The PSL will likely spearhead the largest coalition in Congress, though it will not be able to secure an absolute majority in either congressional house. Nevertheless, alliances based on ideological affinities will allow Bolsonaro to obtain ad hoc majorities and approve specific legislation. The electoral victory will offer him enough political capital to introduce the social conservative reforms he pledged during his campaign, as well as pro-business measures to simplify the tax system, deregulate the economy, and carry out a privitisation agenda.

Although Bolsonaro will enjoy a honeymoon period in the first six months of his administration, major constitutional amendments will likely be hindered by the most fragmented Congress in recent history and intransigent opposition from left-wing parties. Such opposition, coupled with Bolsonaro’s high rejection rates, will likely fuel frequent demonstrations and protests. Nonetheless, the country’s democratic tradition and historically peaceful competition at the ballot box will continue to mitigate the risk of acute political instability, including authoritarian reversal.

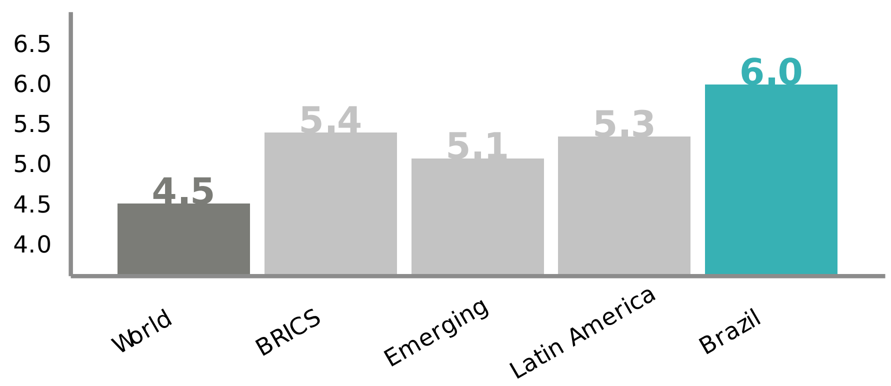
Security Environment



Public safety will be a key topic. Bolsonaro will maintain Temer’s approach of increasing the role of the federal government in driving security policymaking, while adopting a more aggressive stance against crime. Bolsonaro will increase “boots on the ground” policing and encourage security forces to engage in confrontations with organised criminal groups. However, already high levels of violent crime are likely to increase, as clashes between security forces and criminals occur frequently across major urban centres (albeit largely restricted to low-income neighbourhoods). This confrontational approach is also likely to increase incarceration levels, prompting a deterioration in conditions in prison facilities, fuelling riots and amplifying recruiting opportunities for prison-based gangs such as the First Capital Command (PCC).

Furthermore, the government is unlikely to devote efforts to address the key drivers of insecurity – such as social inequality, the widespread availability of firearms, ineffective intelligence operations and the growing influence of drug-trafficking gangs. Land disputes and the persistent threat of land activism will also continue to fuel crime in rural areas.

Social Cohesion

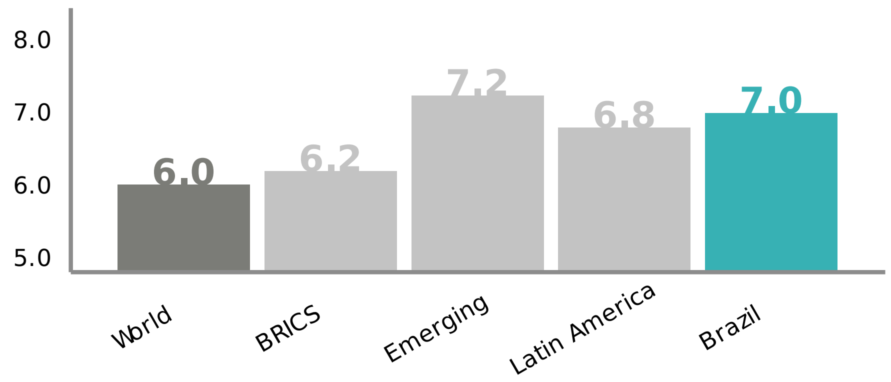


Following the 2018 general elections, society will remain highly polarised over conflicting narratives between the left and the right. Protests will likely increase during 2019. Bolsonaro’s social conservative discourse and rhetoric against women’s and minorities’ rights will provoke opposition from a large portion of Brazilians, fuelling occasional protests. Disapproval of Bolsonaro’s radical views will also translate into high rejection rates for the president throughout his term. Meanwhile, Bolsonaro’s supporters are well-organised and engaged, and are likely to stage demonstrations in favour of the retired army captain, pressuring lawmakers to fast-track the approval of his initiatives. In both cases, demonstrations are likely to remain largely peaceful.

Unions and other interest groups will continue to oppose the government-led pro-business agenda, particularly the pension reform and privatisations of state-owned companies. However, unions have been significantly weakened as a result of the labour reform, in force since November 2017, which eliminated workers’ compulsory payments to unions.

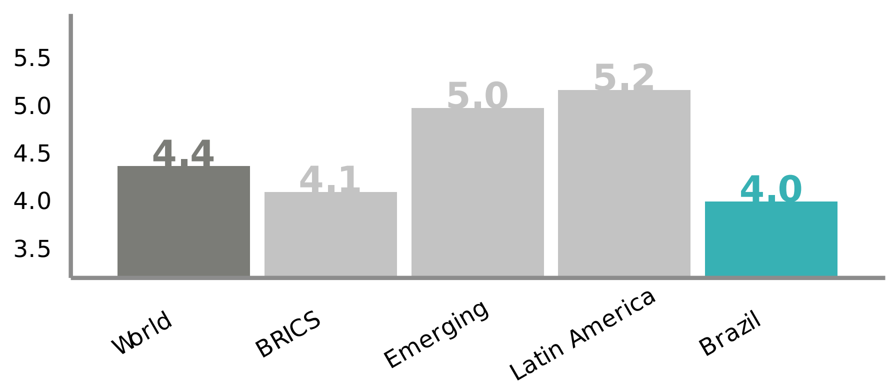
Economic Risk Scores 5.8

Trade Credit Risk Rating



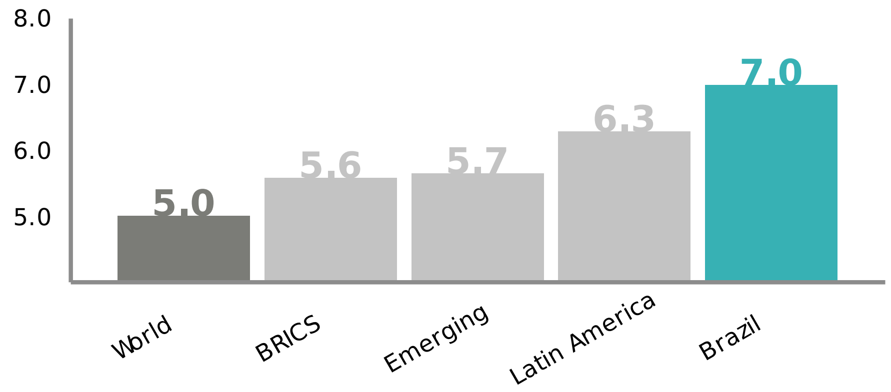
Trade credit risk – a measure of private sector repayment risk – is broadly in line with the regional and the EM averages, but it remains relatively high for a large economy such as Brazil. This mostly reflects tight credit conditions for firms and households who are struggling to service their debts, notwithstanding the fact that the policy rate is at an all-time low of 6.5%. Still, the fact that interest rates for final consumers in Brazil are among the highest in the world – for credit cards for example they average 300% per year – can make debt servicing costs prohibitively expensive at times.

Sovereign Credit Risk



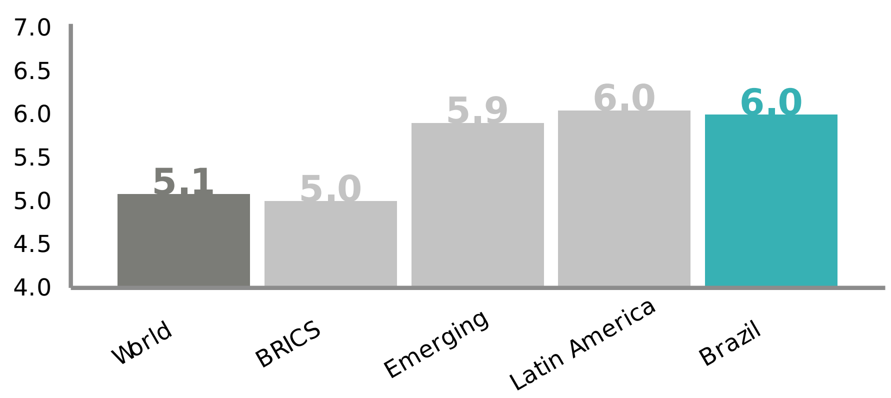
In our model of sovereign credit risk, Brazil is mainly held back by its poor fiscal position (by contrast, its inflation performance has improved greatly over the last 18 months). The deterioration in Brazil's fiscal metrics since 2012 can be mostly explained by mismanagement, populism and a sharp fall in revenues caused by a negative terms of trade shock. The resulting near 30% of GDP increase in public debt will take at least 20 years to be reversed and public sector deleveraging will weigh on growth, either through tax hikes or spending cuts.Brazil has lost its investment grade status from all three main rating agencies since 2015 (indeed, it was downgraded to BB- by S&P and Fitch in Q1 2018).

Market Demand Risk



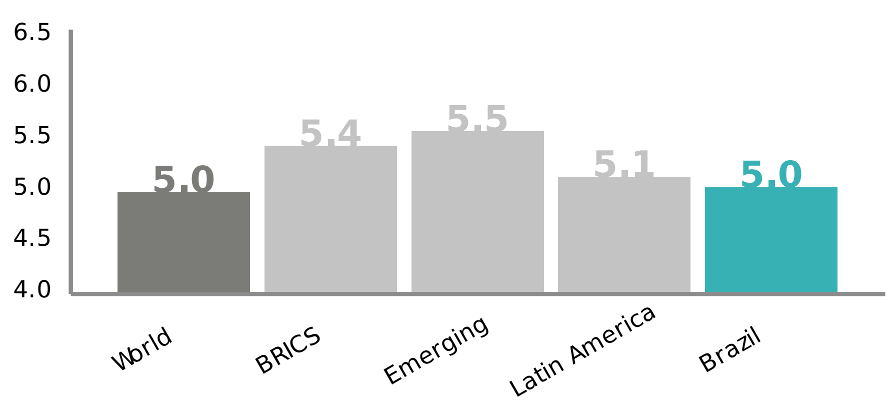
The demand risk score is reasonably high at 7.0, above the average for the Americas. This reflects the 10% loss in Brazil's GDP per capita since 2013 and the relatively slow recovery we expect for the coming years.Market demand risk is driving the overall economic and political risk average up in Brazil and in the rest of Latin America. Brazil's recession, which started in 2014 and only ended in Q1 2017, was the worst since records began in 1901. Public and private deleveraging will hamper the recovery, meaning Brazil will only recover its 2013 level of per capita GDP by 2022.

Market Cost Risk



The market cost risk score is also high, at 6.0. This reflects the fact that Brazil went through a wage-inflation spiral in recent years, increasing unit labour costs because productivity was dismal. This process is reversing now, but only after a massive recession, which has caused a moderate fall in real wages. Hampering a faster adjustment is the rule that the minimum wage and pensions change to reflect past inflation and real GDP growth. As a result, Brazil is expensive compared to its regional peers.

Exchange Rate Risk



Exchange rate risk is moderate, slightly below the emerging market (EM) average. On the face of it, given the real (BRL) has been one of the three most volatile currencies in 2014-16 it should deserve a higher risk. However, Brazil also (now) boasts a credible central bank with over US$370bn in FX reserves that cover the country's entire stock of public and private external debt. Brazil operates a 'dirty floating' FX regime, like most EM with an open capital account. Therefore, the FX rate adjusts to external shocks, with the central bank intervening to dampen excess volatility (caused by commodity price swings, changes to global monetary policy or domestic politics).

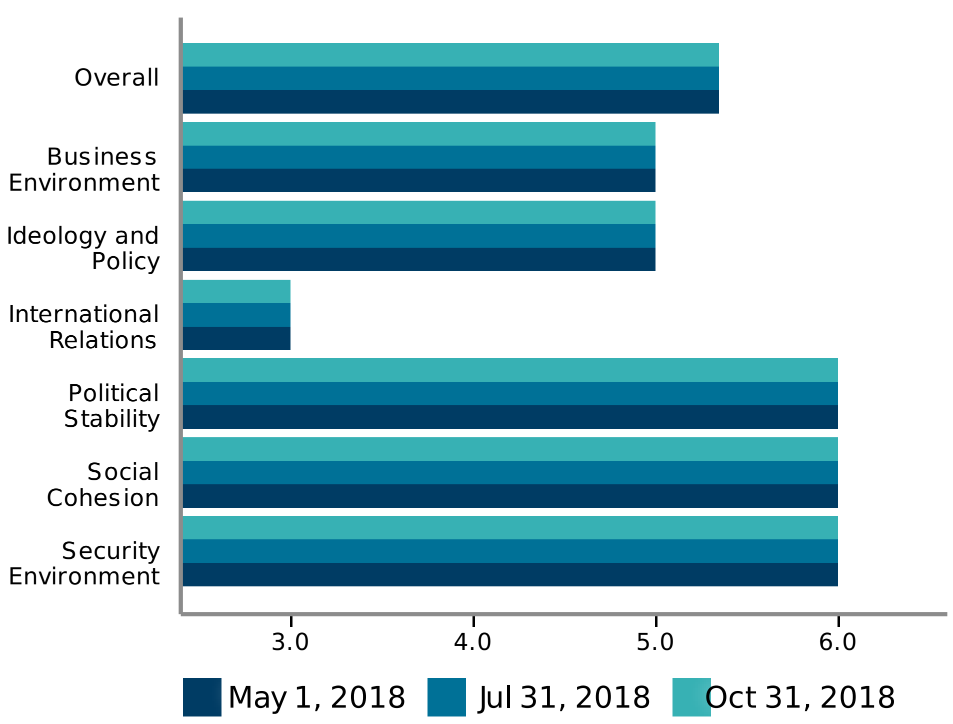
Detailed Risk Scores

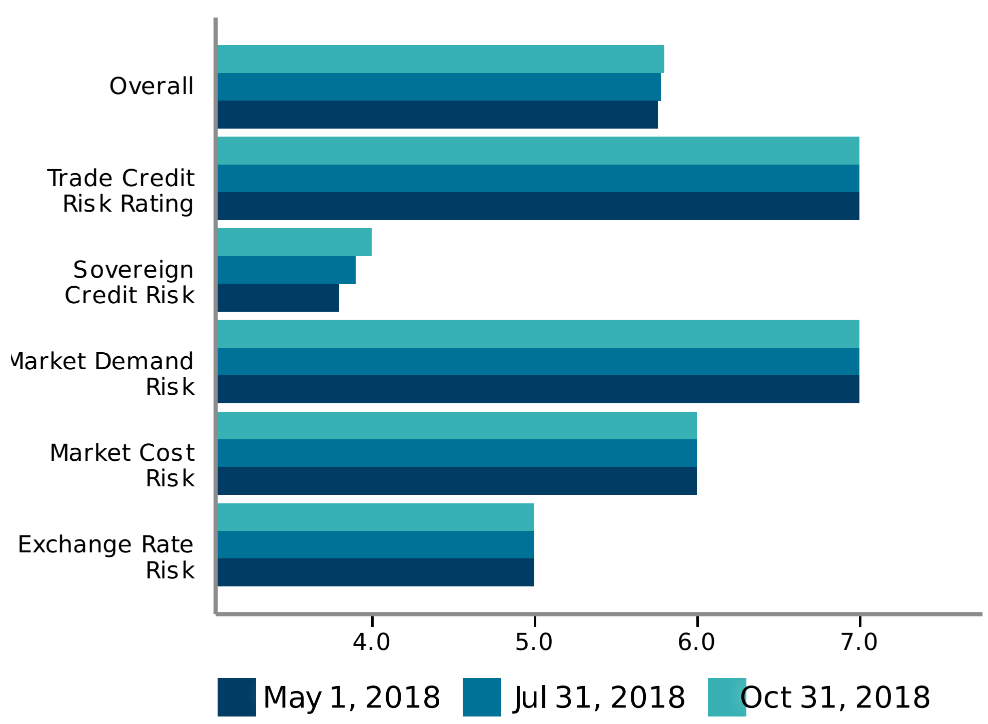
Political Risk Evolution

	Weight (%)	Score
Political Stability	25.0%	6.0
Security Environment	10.0%	6.0
Social Cohesion	20.0%	6.0
Business Environment	20.0%	5.0
Ideology and Policy	15.0%	5.0
International Relations	10.0%	3.0
Overall political risk	100%	5.4

Economic Risk Evolution

	Weight (%)	Score
Trade Credit Risk Rating	20.0%	7.0
Sovereign Credit Risk	20.0%	4.0
Market Demand Risk	20.0%	7.0
Market Cost Risk	20.0%	6.0
Exchange Rate Risk	20.0%	5.0
Overall economic risk	100%	5.8





Political Forecast

Corruption scandals will continue to undermine political stability. Rather than pointing to an increase in corruption risks, the recent wave of investigations highlights the strengthening of Brazil's anti-corruption framework and its enforcement institutions.

Temer has become a premature 'lame duck', failing to implement much-needed austerity measures such as the pension reform – his administration's flagship initiative. Major regulatory changes are unlikely to be implemented by year-end, as cabinet ministers and lawmakers will be focused in running re-election campaigns ahead of the October polls, and will refrain from partnering with the highly unpopular president. Temer, however, will continue to implement small, positive changes to attract foreign investors in sectors as diverse as renewables, mining, healthcare, and education, among others. These will likely be implemented through presidential decrees or executive orders at the cabinet level in order to bypass lawmakers. The government will also hold successful auctions for oil and gas blocks and will privatise a number of major infrastructure projects.

Despite greater investment, infrastructure has been inadequate to support recent levels of growth. Poor national infrastructure adds to the cost of doing business, particularly given the limited rail network and the bottlenecks in port infrastructure.

Foreign investment has been consistently welcomed, but bureaucracy, red tape and a confusing tax system remain a problem. Corruption is pervasive and can occur at all levels, but there has been an increase in investigations and media scrutiny in the last three years. Expropriations or nationalisations are highly unlikely. The judicial system is generally fair, though cumbersome and overstretched by a large number of processes.

Economic Forecast

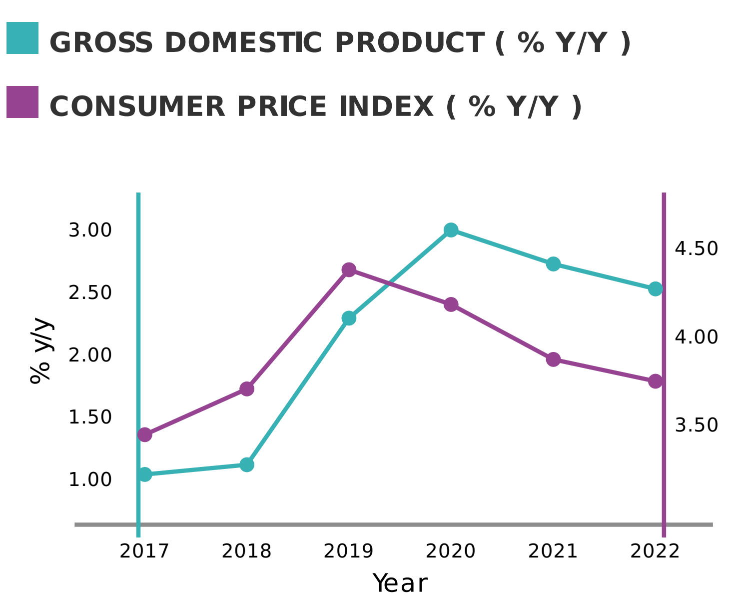
After a polarised campaign, Brazilians elected the far-right Jair Bolsonaro (PSL) as their next president. Having defeated left-wing Fernando Haddad (PT) by over 10 million votes, Bolsonaro addressed the nation with a somewhat moderate speech, pledging to respect the constitution and democratic rule. The president-elect reinforced his commitment to restore growth by reducing the debt burden and opening the economy to foreign trade. We think investors will give him the benefit of the doubt and focus on the upside risks for now, so the rally of Brazilian assets seen in the past month should continue. However, we also see downside risks from a potential “trial and error” presidency.

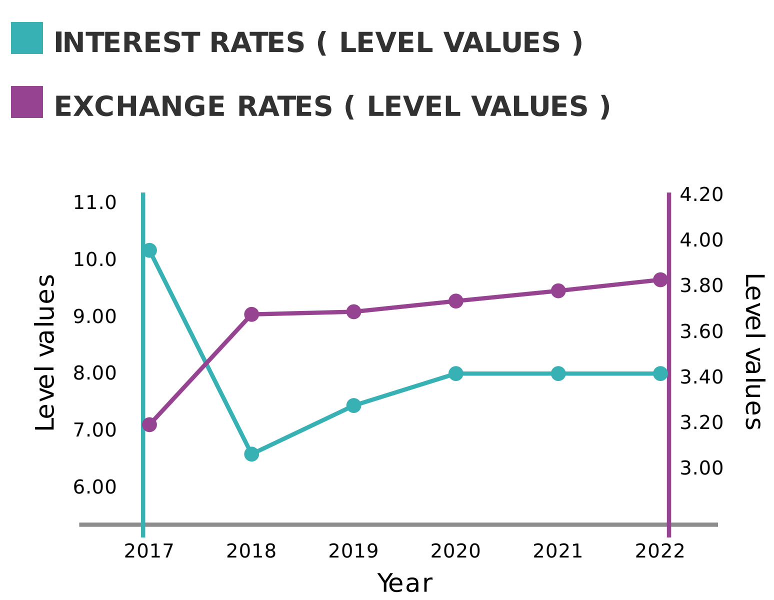
The Brazilian real (BRL) has gained over 10% versus the US$ since mid-September to 3.70/$, and is likely to stay around this sort of level (or even appreciate slightly) over the next year or so, in spite of the strengthening of the US$ versus other currencies. With the risks of a BRL depreciation relatively contained now, the central bank (BCB) won’t need to raise the Selic rate from 6.5% until Q1 next year or later.

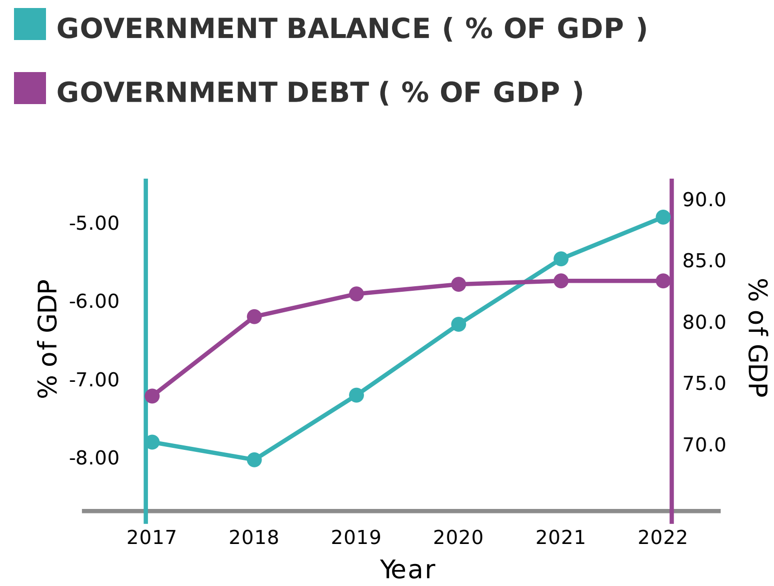
Taken at face value, Bolsonaro’s plans for the economy represent clear upside risks to our baseline forecasts for GDP growth of 1.1% for 2018 and 2.3% for 2019. However, the external environment is not getting any better for emerging markets and the new president’s plan to slash the primary fiscal deficit in one year and privatise over 100 state-owned companies is likely to face many obstacles in Congress.

We have little reason to change our inflation forecasts for 2018 and 2019. Data for September showed consumer prices rising by 0.5% on the month, implying an annual rise of 4.5%. We thus reaffirm our forecast that inflation will end 2018 at 4.3% and 2019 at 4.4% – broadly in line with the BCB’s targets of 4.5% and 4.25%.

	2017	2018	2019	2020	2021	2022
Real GDP growth (% year)	1	1.1	2.3	3	2.7	2.5
CPI inflation (%)	3.45	3.71	4.38	4.19	3.87	3.75
Exports of Goods ($ millions)	217242.5	231934.4	240711.2	250492.7	264037.8	278636.3
Exports of Services ($ millions)	34478.4	33610.78	37705.54	40609.81	43643	46924.2
Imports of Goods ($ millions)	153214.5	175036.3	187076.2	204991.1	219363.9	233827.9
Imports of Services ($ millions)	68328.8	65389.7	71861.7	76842.4	82112.2	87648.6
Exports of Goods (% y/y)	18	6.8	3.8	4.1	5.4	5.5
Imports of Goods (% y/y)	9.9	14	6.9	9.6	7	6.6
Current Account ($ millions)	-9761.5	-14695.8	-20826.3	-31684.4	-34002.8	-37753
Official exchange rate per USD (year avg)	3.1919	3.676	3.6875	3.7344	3.7793	3.8278
External Debt Total ($ millions)	317305	324608	346687	368766	390397	409353
Government balance (% of GDP)	-7.79	-8.02	-7.19	-6.29	-5.45	-4.92
Population (millions)	209.5	211.1	212.6	214	215.4	216.8
Nominal GDP ($ millions)	2054959	1874145	1988945	2105888	2220580	2332078
GDP per Capita ($ current prices)	9809.551	8880.58	9355.47	9838.18	10306.28	10756.4







What to Watch

Watch out for the privatisation of state-owned companies, as well as efforts to attract foreign investors, such as tax reforms and incentives for industrial companies. These are likely to create opportunities for businesses and gradually improve the business environment.

Watch out for potential conflicts between Bolsonaro’s statist and protectionist views and the liberal perspective of his economic team, particularly concerning the pension reform.

The highly fragmented nature of Congress is likely to undermine Bolsonaro’s ability to govern. His PSL did not secure a majority and will be forced to negotiate the approval of legislation with several different caucuses. Opposition from left-wing parties will also hinder the implementation of Bolsonaro’s pro-business and austerity agendas.

Bolsonaro will hold his administration to high integrity standards amid intense scrutiny from media and the public. Corruption scandals implicating the president or members of his inner circle would be extremely politically costly.

Social discontent leading to popular demonstrations: during the campaign, Bolsonaro made direct attacks on the left, often promoting the use of violence against “the rise of communism”. Together with jailed former president Lula’s rhetoric of “us against them”, this contributed to a society split down the middle and created the most polarised election in Brazil’s history. Now that the elections are over, unless Bolsonaro moves his rhetoric more to the centre, many of his possible policy changes are likely to be met by popular demonstrations (and even if he does adopt a more moderate tone, the changes are still likely to trigger protest).

A potential return to military rule: if Bolsonaro’s government turns out to be unpopular or a threat to the constitution, Congress may impeach him – as it did with Dilma Rousseff in 2016. However, Bolsonaro’s vice president is a retired army general, meaning Brazil could return to effective military rule in the next four years.

Policy execution risks: the plan to freeze real public spending for 20 years poses major challenges for policy-makers. Without reforms, pension disbursements are set to grow by 0.3% of GDP pa, implying that spending on health, education and payrolls will have to be cut. Brazilian society may not be ready for such a drastic change, suggesting high risks to the implementation of the real spending freeze. Moreover, Bolsonaro lacks any experience in executive positions, has limited knowledge of economics and his party does not have a majority in Congress. This means we expect some degree of “trial and error” during his presidency and no smooth path towards the implementation of a badly-needed structural reform agenda.