Brazil Gets Upgrade from Fitch. It's BB All Over.

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Fitch has upgraded the ratings for Brazil as follows: Long-term foreign currency Issuer Default Rating (IDR) to 'BB' from 'BB-'; long-term local currency Issuer Default Rating (IDR) to 'BB' from 'BB-'; country ceiling to 'BB' from 'BB-'. Fitch also affirms Brazil's short-term rating at 'B'. The Rating Outlook is stable.

The rating actions reflect the ongoing improvement in Brazil's public and private external finances and a macroeconomic policy framework that has proved robust in the face of political and financial market pressures, says Fitch.

The ratings firm forecasts that public external debt will fall below 10% of GDP by the end of 2006, the lowest for more than a decade, while foreign currency denominated and indexed debt has fallen from 38% of GDP in 2002 to around 10% currently, as the authorities have engaged in buybacks of foreign debt and deepened domestic capital markets, significantly reducing the public sector vulnerability to exchange rate shocks.

The current account surpluses since 2002 have also allowed the private sector to reduce its net external debt position. Moreover, due to progress on the inflation front, the central bank has been able to bring nominal and real interest rates down, even during the recent market turmoil, underpinning an economic recovery and easing fiscal pressures.

"It is a reflection of Brazil's much improved external balance sheet," said Roger Scher, head of Latin American Sovereign Ratings at Fitch, "that the country has weathered rather well the latest storm for emerging markets in the global capital markets. The central bank was able to continue its easing cycle, even though other emerging market central banks have had to tighten monetary policy due to sharply weaker currencies and rising inflationary pressures."

Nevertheless, further improvement in sovereign creditworthiness would have to be driven by progress in public debt dynamics, notably, a higher trend rate of GDP growth and a further sustainable reduction in real interest rates that together with high primary budget surpluses would place the public debt to GDP ratio more firmly on a downward path.

While some moderate easing of the fiscal stance is likely, in part due to general elections later this year, Fitch expects the current and future administration to maintain a primary surplus equivalent to at least 4.25% of GDP, consistent with a stable public debt burden.

Fitch expects Brazil to end 2006 with official foreign exchange reserves at over US$ 60 billion, up from US$ 53.8 billion in 2005, driven by a persistent current account surplus and robust capital inflows, resulting in an external liquidity ratio of 139.6% for 2007, versus the forecast 'BB' median of 145.4%.

Net external debt to current external receipts (CXR), a key external solvency ratio, is expected to fall to 63% this year, down from nearly 128% just two years ago, but still above the forecast 'BB' median of 42.6%.

This ratio is expected to continue to improve, underpinned by moderate export growth and continued rising foreign exchange reserves. More impressive is the fact that the external exposure of the public sector is forecast to fall dramatically, with net public external debt to CXR ending 2006 at 9.1%, nearly half the 'BB' median of 18.1%.

"While Brazil is not immune to further shocks to market confidence," said Scher, "the Brazilian authorities have largely financed this year's external debt amortizations and have engaged in an aggressive program of external debt paydown and buybacks, significantly reducing their exposure to sentiment in the international capital markets.".

Nonetheless, the vulnerability of the public sector to shifts in market sentiment remains, given that 25%-30% of domestic debt matures each year. This fact was underscored in May when the Brazilian treasury suspended a domestic debt auction.

The authorities got right back in the market, placing nearly R$ 30 billion by June 20, though the mix of debt offered represented, at the margin, a deterioration in the debt composition, as floating-rate securities were offered in place of fixed-rate and inflation-indexed notes.

The stable outlook reflects the balance of improvements in Brazil's external finances and more secure macroeconomic stability against still major structural impediments to sustaining lower real interest rates and boosting the economy's growth potential necessary to cement the long-term sustainability of public finances.

It is Fitch's current judgment that the next administration is unlikely to pursue deep structural reforms, such as central bank autonomy and social security reform, despite maintaining prudent fiscal and monetary policies.

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