MOODY'S RATINGS

Rating Action: Moody's Ratings upgrades Brazil's ratings to Ba1 and maintains the positive outlook

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New York, October 01, 2024 -- Moody's Ratings (Moody's) has today upgraded the Government of Brazil's long-term issuer and senior unsecured bond ratings to Ba1 from Ba2, the senior unsecured shelf rating to (P)Ba1 from (P)Ba2; and maintained the positive outlook.

The upgrade reflects material credit improvements which we expect to continue, including a more robust growth performance than previously assessed and a growing track record of economic and fiscal reforms that lend resilience to the credit profile, although the credibility of Brazil's fiscal framework is still moderate, as reflected in a relatively high cost of debt. In turn, more robust growth and fiscal policy consistently adhering to the fiscal framework will allow the debt burden to stabilize in the medium term, albeit at relatively high levels.

The positive outlook reflects the possibility that steady growth and compliance with the fiscal framework will help enhance institutional credibility and reduce borrowing costs more markedly than we currently assume. In turn, a lower cost of debt would have a positive impact on Brazil's government debt path, especially if combined with more robust growth than we currently expect, allowing a decrease in the debt burden over the medium term.

Brazil's country ceilings were changed. The local-currency country ceiling is positioned four notches above the sovereign rating at A3 from Baa1, reflecting external stability, moderate political risk, against the government's relatively large footprint in the economy. The foreign-currency country ceiling is upgraded to Baa1 from Baa2, one-notch below the local-currency country ceiling reflects large foreign exchange reserves, which reduces the risk of restrictions on transfer and convertibility in times of stress, and open capital account, balanced against exchange-rate volatility and some restrictions on short-term capital flows.

RATINGS RATIONALE

RATIONALE FOR THE RATINGS UPGRADE

MORE ROBUST GROWTH OUTLOOK AND STRUCTURAL REFORMS SUPPORT CREDIT RESILIENCE

We revised our real GDP growth to 2.5% in 2024 and over the medium term, a much more solid growth performance compared to pre-pandemic years, partly the result of structural reforms implemented over successive administrations related to a range of policy areas.

Brazil's economic performance surprised to the upside in 2022-24 reflecting in part cyclical factors and the impact of structural reforms. This year, stronger growth expanded to both industry and services sectors and was supported by higher investment, reinforcing our expectations that more robust growth will persist. In the next few years, we anticipate growth will remain broad-based with domestic demand propelled by a relatively strong labor market – compared to Brazil's past - and higher real wages.

Despite a polarized political environment, successive governments have advanced difficult reforms in key areas related to monetary policy implementation and strengthened central bank independence, improved governance of state-owned enterprises (SOEs), and measures to improve the business environment, such as financial digitalization and labor reform, supporting our assessment of institutional strength and policy predictability. The upcoming overhaul of the tax regime, while taking effect over a long period, also marks a notable structural reform that will improve the business environment and allocation of resources, adding to long-term growth potential.

Since the beginning of the year, real GDP growth proved stronger and more resilient to high interest rates and the severe flooding that hit Brazil earlier this year. In addition, fiscal performance and the government budget presented for next year have remained consistent with fiscal targets.

That said, a limiting factor on Brazil's policy effectiveness is the persistent risks to achieving fiscal targets due to structural spending rigidities and rise in mandatory spending, such as social security, social assistance programs, and health and education spending. These limitations weigh on fiscal policy credibility and complicate ongoing efforts to comply with fiscal targets, which undermines policy effectiveness and contributes to relatively high-risk premia.

GRADUAL FISCAL CONSOLIDATION IN LINE WITH TARGETS WILL CONTAIN INCREASE IN DEBT AND BUILD FISCAL POLICY CREDIBILITY

In an environment of steady growth and given the government's efforts to raise revenues and incipient measures to cut spending, we expect primary fiscal results will improve gradually in line with the government targets over the next 2-3 years. The persistent increase in mandatory spending limits the government's ability to achieve faster fiscal consolidation. Moreover, the overall fiscal deficit will remain elevated on account of high interest payments.

In the absence of large shocks, compliance with the fiscal framework will lead Brazil's government debt to stabilize in the medium term, around 82% of GDP. Interest payment will remain elevated around 15% of revenues. So, while Brazil's debt burden and debt affordability will remain weaker than Ba1- and Baa3-rated sovereigns on average, the likelihood that its debt metrics stabilize has improved. Despite relatively high debt burden, Brazil's fiscal strength benefits from a large domestic market that allows the government to issue mainly in domestic currency, and sizeable liquid assets worth around 15% of GDP.

RATIONALE FOR THE POSITIVE OUTLOOK

The positive outlook reflects the possibility that sustained solid growth, and the implementation of spending measures will support compliance with the fiscal framework and will help reduce uncertainty around Brazil's debt trajectory. This would enhance the credibility of fiscal policy and support overall institutional strength. Improved credibility would contribute to lower borrowing costs and could improve debt dynamics more than we currently expect. Lower cost of debt, combined with solid growth performance would have a positive impact on Brazil's debt trajectory, allowing a decrease in the debt burden over the medium term.

On the fiscal side, maintaining commitment to fiscal targets and introducing spending measures to contain the increase in mandatory spending would ensure compliance with the fiscal framework and help build the credibility of fiscal policy and anchor market expectations. In turn, this would reduce uncertainty around Brazil's fiscal trajectory and support a reduction in risk premia, leading to lower borrowing costs for the government, accelerating debt stabilization.

Meanwhile, as regards growth prospects, the government's energy transition agenda, which aims to attract private investment into clean energy projects with incentives and a favorable regulatory framework, adds upside to medium- to-longer-term growth potential if it enhances the attractiveness of Brazil as a production location and improves its competitiveness. In addition, advancing Brazil's energy transition efforts would reduce future vulnerability to climate shocks.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Brazil's Credit Impact Score (CIS-3) reflects exposure to environmental and social risks, and moderately strong institutions. Social and environmental risks are driven by high income inequality and exposure to carbon transition risk.

Brazil's exposure to environmental risks (E-3 issuer profile score) reflects carbon-transition risk, impacting its oil sector, and risks related to waste and pollution, water management and the depletion of natural capital. However, those risks are mitigated by Brazil's significant endowment of natural capital and its continental landmass, where any given climate shock impacts only part of the country. Environmental risks are also mitigated by the government's emphasis on supporting investment in green energy through a host of policy initiatives and efforts to meet the national climate resilience targets.

Exposure to social risks (S-3 issuer profile score) reflects high income inequality and some deficiency in the provision of basic services, notwithstanding a large social safety net. Future social pressure may arise if employment and wage growth were to persistently weaken, leading to deterioration in living standards.

The influence of governance on Brazil's credit profile (G-2 issuer profile score) reflects the effectiveness of economic, political, and judicial institutions in enacting difficult reforms across multiple administrations and strong monetary policy framework set against our assessment of the impact of relatively weak governance indicators related to corruption and rule of law.

GDP per capita (PPP basis, US$): 20,001 (2023) (also known as Per Capita Income)

Real GDP growth (% change): 2.9% (2023) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 4.6% (2023)

Gen. Gov. Financial Balance/GDP: -7.9% (2023) (also known as Fiscal Balance)

Current Account Balance/GDP: -1% (2023) (also known as External Balance)

External debt/GDP: 33.7% (2023)

Economic resiliency: baa1

Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 26 September 2024, a rating committee was called to discuss the rating of the Brazil, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have materially increased. The issuer's institutions and governance strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer's susceptibility to event risks has not materially changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Brazil's sovereign rating would be upgraded if the government was able to address underlying spending rigidities and introduce structural fiscal measures to contain the increase in mandatory spending on a sustainable basis. This would facilitate the decline in debt burden when the economic environment is favorable and limit its increase when the economic cycle turns. It would also indicate higher policy effectiveness, supporting our assessment of institutional strength and resiliency to shocks. In turn, higher policy effectiveness and generally more credible institutions would likely be reflected in lower risk premia and a lower cost of debt, contributing to more favorable debt dynamics.

The positive outlook indicates that a downgrade is unlikely in the near term. The outlook could return to stable if commitment or capacity to implement fiscal consolidation weakens, leading to a likely deterioration or absence of improvement in the primary and overall fiscal balances. This would also suggest weaker fiscal policy effectiveness which would weigh further on investor confidence, investment, and growth. Continued increase in government funding costs would also weaken the sovereign's creditworthiness. A return of persistently low GDP growth would represent a credit-negative development that would adversely affect Brazil's credit profile.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at https://ratings.moodys.com/rmc-documents/395819 . Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions .

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