Calming the financial waters

Brazil faces the risk of having its sovereign debt downgraded by international rating agencies, which would reduce capital inflows and Brazilian companies access to external financing. What can be done?

Cristina Alves

BRAZIL WAS PUT THROUGH a real stress test when the technical staff of the three major international credit agencies—Standard & Poor’s, Moody’s, and Fitch Ratings—visited the country in recent weeks. On March 23, the government economic team received with relief the news that S&P has decided to retain Brazil’s stable outlook for sovereign risk. With this endorsement, the economic team hopes to continue carrying out the reforms and the fiscal adjustment needed to revive economic growth. S&P’s rating of Brazil’s debt is BBB—, the lowest investment grade.

But anxiety about a possible downgrade in coming months has not been completely
eliminated. The agencies have specific schedules. Before they downgrade a country’s investment rating, for example, they usually change the country’s outlook to negative. Last September, in fact, Moody’s changed Brazil’s outlook to negative though retaining the Baa2 rating, its lowest investment grade, for Brazil’s debt. So a downgrade in Brazil’s rating may first come from Moody’s. Fitch kept its outlook for Brazil stable, but its BBB rating could still drop to BB (speculative).

When it revised Brazil’s outlook downward last September, Moody’s based the decision on three factors: sustained reduction in economic growth; a remarkable deterioration in investor confidence, which has negatively affected fixed investment; and deterioration in the fiscal stance, which kept government debt indicators from improving.

At the time, Moody’s stated that improving the outlook to stable would require both consolidation of the economic recovery led by investment and achievement of the fiscal balance primary surplus target of 2–3% of GDP. Given those requirements, the agency was of the view that its Brazil outlook was unlikely to return to stable in the next two years.

The main concern of the government and people in business is that if a downgrade occurs, Brazil will lose billions of dollars in investment, for one simple reason: foreign institutional investors, such as large pension funds, are not allowed to apply resources in countries whose debt is not rated investment grade. This barrier certainly jeopardizes Brazil’s economic situation.

A downgrade could also limit the access of Brazilian companies to international financing. If a country’s investment rating goes down, many companies may also have their ratings lowered, reducing their access to external financing for new projects. Already, many companies have been suffering cash flow problems because of falling commodity prices and rising interest rates.

Rating agencies look primarily at the performance of public accounts, GDP growth, the trajectory of inflation, and trade openness. They also give attention to issues such as governance and control of corruption. IBRE researcher Samuel Pessôa believes that the agencies are unlikely to downgrade Brazil’s rating this year, but he warns that the fiscal situation of the country today is the worst since 1997. The rating agencies may give some credit to the economic policy adopted by Finance Minister Joaquim Levy, he
Brazil’s inflation breaches the central bank’s ceiling target of 6.5% a year.

The economy has tanked and GDP is expected to fall by 1% in 2015.

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explains, but they know that the country’s fiscal stance has deteriorated badly.

One of the government’s biggest challenges will be to meet the fiscal balance primary surplus target of 1.2% of GDP this year, Pessôa says. The government must also bring inflation back down to the mid-point of the target range (2.5–6.5%). According to IBRE, official inflation will reach 8.2% this year, well above the central bank’s target ceiling of 6.5%. On March 27, a central bank survey of market economists found agreement on 8% inflation for 2015.

Less investment

Even though deterioration of the macroeconomic outlook does not immediately threaten Brazil’s ratings, it does have immediate consequences for the productive sector. Professor Heitor Almeida of the University of Illinois has the numbers: He points out that the companies that suffer most from the possibility of a downgrade are the largest, which typically have a credit rating equal to or greater than that of Brazil itself. They suffer more because they tend to be “downgraded” along with the country; companies with lower ratings are less affected.
Though the number of companies affected is small, Almeida explains, because they are so large, “the level of investment may fall significantly.” He estimates that fixed investment could drop 30% in the year of the downgrade from the previous year. “Assuming, for example, that these companies, which are more important, are responsible for 10% of aggregate investment, the effect would take 3% off total investment in the previous year,” Almeida explains, adding, “their downgrade may also impact other Brazilian companies that do business with them, in which case the effect would be even greater.”

Almeida also believes that the current depreciation of the exchange rate already reflects to some extent the expectation of a downgrade. He points out that “We have also seen a drop in foreign capital inflows. If the downgrade really happens, we will have another negative shock. And there are still uncertainties about the magnitude of the downgrade. The effect will be greater if the country goes from investment grade to junk grade, creating barriers for foreign investors to apply their resources here.” Almeida also says that banks tend to reduce their loan portfolios after a downgrade, choking off financing for companies.

**Domino effect**

Ricardo Carvalho, senior director of business valuation for Fitch Ratings, notes that if a country seems likely to be downgraded, the business environment begins to deteriorate.

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He sees this already happening in Brazil, where the ratio of downgrades to upgrades of companies is the worst in 10 years. So far in 2015, Fitch has downgraded 24 Brazilian corporations and has not upgraded a single one. In 2014, Fitch downgraded 32 companies and upgraded only 10. The pattern has thus reversed since 2013, when 34 companies were upgraded and 18 downgraded.

Carvalho points out that today Brazilian companies are investing only the minimum necessary: “In Peru, investment is two and a half times the rate of depreciation. Until two years ago, in Brazil, capital expenditure was twice depreciation. Today the ratio is 1.3. This means that these companies are not investing enough to really improve cash flow. The expected growth did not happen, the country has not grown. Industry has lost competitiveness, and there is inefficiency in the cost structure.”
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Carvalho predicts that in 2016, some companies may have to struggle to meet their financial commitments. A large concentration of corporate debt is maturing then. “We have a great concern about limited liquidity as a result of possible restricted access to international credit lines. To access these funds, companies would have to pay higher risk premiums.”

Second division risk

“The worrying fiscal stance is still the greatest risk related to Brazil’s loss of investment grade rating, but undoubtedly the deterioration of external solvency indicators is also a serious concern,” says Carlos Kawall, Safra Bank chief economist and former Secretary of the Treasury. He warns that the quality of external financing has declined and there is increasing reliance on portfolio investments.

As the fiscal stance deteriorates, the country risk measured by the spreads on credit default swaps (CDS) for Brazil increases.

Source: Central Bank of Brazil.
and short-term debt. “Our terms of trade are returning to levels of a decade ago. Part of the current macroeconomic adjustment involves reducing absorption of foreign savings and increasing domestic savings by means of fiscal tightening,” he says.

In recent years, Kawall points out the country experienced a “bubble” caused by rising commodity prices and abundant global liquidity. Now, he says, it is necessary that the Brazilian currency depreciate to help reduce fiscal and external deficits.

“We must avoid a return to the ‘second division,’ the loss of investment grade, which would lead to more expensive and scarcer foreign credit,” Kawall says. He commends the progress the new economic team has made in its first 100 days in office. He particularly considers the fiscal effort significant, notably the unprecedented effort to reduce transfers, especially in such social programs as unemployment insurance and salary bonuses he considers “anachronistic” and “too generously sized.” He also praises the changes in the rules for pensions for survivors, which were outliers in terms of international practice.

“The adjustment involves a very brave measure of tariff realism, notably the increase in electricity rates is equivalent to 1% of GDP. Finally, the government has addressed the expansion of off-budget spending, such as the Investment Support Program and the Fund for Financing Higher Education,” Kawall says. “The policy measures adopted should ensure that the rating agencies give us the benefit of the doubt if Congress approves them and the government meets the fiscal target.”

In the short term, Kawall thinks, there is a risk that because of its systemic importance, the situation of the state oil company Petrobras will threaten the country’s investment rating. He explains that since the necessary exchange rate depreciation worsens the financial and economic situation of the company, the federal government as the controlling shareholder may need to provide credit guarantees or recapitalize the company. Kamall advocates a complete overhaul of the company governance that gives it autonomy to price its products; a review of national content policies; and a strategic reorientation of priorities. But he cautions: “The new economic team is very competent, determined, and knows the right way. But it is too early to celebrate; there are many challenges, many beyond the macroeconomic level, such as the electric power crisis, how the investigations of corruption at Petrobras...”
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Carlos Kawall

unfold, and political instability. Not to mention the agenda for micro reforms—almost a lost dream in the current context.”

Otaviano Canuto, senior adviser to the World Bank, sees no point in discussing whether the ratings agencies have goodwill toward the new economic team. “Willingness to pay debt is not an exact science,” he says, pointing out that the rating is nothing more than an indication of the probability that the government will default on public debt.

According to Canuto, the two areas that need work to put the Brazilian economy on a better track are adjustment of controlled prices and devaluation of the exchange rate. It is also necessary to reverse the recent fiscal deterioration. But he is optimistic: “The homework is being done. And the exchange rate is depreciating.”

In commenting on whether the government can meet its 2015 fiscal primary balance surplus target of 1.2% of GDP, Canuto is again optimistic: “I think there is great determination to meet the fiscal target. If we do not get there, it will be very close to the target. … I am optimistic about the government’s ability to fulfill its commitments.” He warns, however, that it will be necessary to contain the spillover effects of the exchange rate devaluation. He believes that by the end of 2016 or early 2017 Brazil’s inflation will converge to the mid-point of the inflation target range (4.5%).

“Rating agencies are going to evaluate what is being done. I believe that both the fiscal program and the adjustment of controlled prices will be successful.” But, like other economists, Canuto agrees that the possibility of a downgrade has a troubling impact on company investment capacity, and that companies that are not able to hedge against exchange rate fluctuations may have serious problems. “The company that has to worry is the company that has revenues in Brazilian currency and expenses in U.S. dollars,” he says.

Like Kamall and others, Canuto fears that the corruption scandal will have a negative effect on Petrobras finances, because Petrobras will have to correct its inflated assets in the face of falling oil prices; that means it will have to sell assets and renegotiate its debt with suppliers. The effects on the Brazilian economy as a whole, he says, could be very negative because of the weight of Petrobras in GDP.

Canuto disagrees with other economists on one point: He is not so worried about the current account deficit (trade and services) of 4.2% of GDP. He notes that Brazil’s international reserves are substantial and the exchange rate is evolving to a more realistic level.