

26 JUL 2023

Fitch Upgrades Brazil to 'BB'; Outlook Stable

Fitch Ratings - New York - 26 Jul 2023: Fitch Ratings has upgraded Brazil's Long-Term Foreign-Currency Issuer Default Rating (IDR) to 'BB', from 'BB-', with a Stable Outlook. A full list of rating actions follows at the end of this rating action commentary.

Key Rating Drivers

Ratings Upgrade: Brazil's upgrade reflects better-than-expected macroeconomic and fiscal performance amid successive shocks in recent years, proactive policies and reforms that have supported this, and Fitch's expectation that the new government will work toward further improvements.

Despite lingering political tensions since its 2018 downgrade, Brazil has achieved progress on important reforms to address economic and fiscal challenges. The new leftist Lula government advocates a shift away from the liberal economic agenda of past governments; however, Fitch expects pragmatism and broader institutional checks-and-balances should preclude radical macro- or micro-policy deviations, while the government is also pursuing initiatives to support the private sector (e.g. tax reform). The fiscal position is deteriorating in 2023 after a prior improvement, but Fitch expects new fiscal rules and tax measures to anchor a gradual consolidation. Fitch still projects debt/GDP to rise, but at a slower pace and from a much better starting point than previously forecast.

Brazil's ratings are supported by its large and diverse economy, high per-capita income, and deep domestic markets and a large cash cushion that support the sovereign's financing flexibility and its high local-currency debt share. The ratings are also supported by shock-absorption capacity, underpinned by a flexible exchange rate, robust international reserves and a sovereign net external creditor position. The ratings are constrained by high government debt, fiscal rigidities, weak economic growth potential, and relatively low governance scores.

Reform Progress: Since a period of gridlock during its 2015-2016 crisis, Brazil has achieved important policy breakthroughs, including pension reform and central bank independence. Since taking office in January, President Luiz Inacio "Lula" da Silva has been able to secure governability and advance his policy agenda, despite a conservative congress and lingering polarization that manifested in violent protests at the start of his term.

Key fiscal reforms are still pending final approval but have seen important progress, including a new fiscal framework, a major consumption tax reform (which has eluded governments for decades), among other smaller bills. Other initiatives have faced greater resistance in congress, including those related to environmental regulation. Political tensions persist, but have not resulted in adverse economic or policy outcomes, and are reflective of checks-and-balances working effectively in some

cases.

Resilient Growth: Economic momentum continues in 2023 after a healthy post-pandemic rebound, supported by a bumper agricultural harvest. Consumption has cooled on tight monetary policy, but it remains supported by a strong labor market, fiscal spending, and continued credit growth. Fitch projects real GDP growth of 2.3% in 2023, up from 0.7% previously, a moderation to 1.3% in 2024 as agricultural output normalizes, and convergence to a trend pace of 2.0% thereafter. The authorities project higher medium-term growth of 2.6%; while it is not yet clear if they can advance an economic agenda potent enough to achieve this, this could offer some upside.

Upside from Economic Agenda: President Lula advocates a shift from the liberal economic agenda of prior governments, but appears likely to adopt a pragmatic rather than interventionist approach, and his agenda still includes initiatives to boost private investment. Lula appears unlikely to pursue major reversals of liberal reforms enacted in recent years (e.g. labor reform, Eletrobras privatization), or unable to do so given checks-and-balances (e.g. the sanitation bill, attempted changes to which have been blocked by Congress).

State-run Petroleo Brasileiro (Petrobras) and Banco Nacional de Desenvolvimento Economico e Social (BNDES) are adopting moderate changes to their corporate strategies that are unlikely to rekindle the distortions that impaired economic performance in the past. The consumption tax reform offers the most upside, as it addresses one of Brazil's greatest competitiveness bottlenecks. It aims to simplify the highly complex system and eliminate distortions that fuel capital misallocation.

Prudent Monetary Policy: Inflation fell to 3.2% yoy in June 2023 from 11.9% a year earlier, as a result of lower food and energy costs and tight monetary policy. The central bank (BCB) has maintained prudent and proactive monetary policy during the recent inflation shock, and has kept its Selic rate at a restrictive 13.75% since August 2022 amid fiscal uncertainties, stickiness in core inflation and some upward drift in inflation expectations. These factors are receding, and Fitch expects rate cuts to begin by August. Lula's explicit criticism of the BCB has not resulted in attempts to introduce major changes to the inflation-targeting framework, and inflation expectations are improving after some prior jitters.

New Fiscal Rule Takes Shape: The general government primary balance improved to a 1.2%-of-GDP surplus in 2022 - its best outturn in a decade - but is on track to deteriorate in 2023 (Fitch projects a 0.8% deficit) due to a cyclical ebb in revenue and social spending increases. Fiscal outturns in coming years will be guided by a new fiscal framework to replace a spending cap, which imposes a looser limit on spending set as a function of past revenue growth, targets gradually improved primary balances and includes contingency measures (ex ante and ex post) to prevent and correct for target noncompliance. The new rule should contain spending/GDP, but does not require much (if any) reduction, making consolidation reliant on a large revenue effort that the authorities expect to achieve by reducing numerous tax exemptions.

Fitch expects these tax efforts and the ex-ante contingency measures to bring the federal primary balance to the lower bounds of the target ranges of 0% of GDP in 2024 and 0.5% in 2025 (+/- 25 basis points). Risks are to the downside, however, given technical and political challenges to reducing tax

exemptions. Even the looser spending limit may be hard to comply with given budget rigidities, restoration of revenue earmarking for health and education, and plans to re-link the minimum wage (to which pensions are indexed) to GDP growth.

Better Debt Trajectory: General government debt fell to 73% of GDP in 2022, still above the 'BB' median of 56%, but below its pre-pandemic 2019 level. Fitch expects weaker primary balances and high real interest rates to lift debt to 75% in 2023 and gradually thereafter, but at a slower pace and much better starting point than we previously expected, particularly at the time of Brazil's 2018 downgrade. The interest/revenues ratio at around 15% in 2023 is high, but will decline as monetary policy eases, and remains below the 2015-2016 peak of around 20%. Financing risks are mitigated by a deep local market, the treasury's sizeable cash cushion (currently 11% of GDP), a high share of local-currency debt (94%), and an improved maturity profile.

Robust External Position: Brazil is on track to achieve a record trade surplus in 2023, supported by strong agricultural output and lower import costs. Fitch projects this will reduce the current account deficit to 1.8% of GDP, from 3.0% in 2022. The strong inflows and easing of concern around the policy direction under Lula have strengthened the Brazilian real in 2023. International reserves have risen by 7% so far in 2023 to USD346 billion on valuation effects and the unwinding of FX credit lines provided last year. Reserves cover 8.4 months of estimated current external payments in 2023 - among the strongest in the 'BB' category.

ESG - Governance: Brazil has an ESG Relevance Score (RS) of '5' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Brazil has a medium WBGI ranking at the 41st percentile, reflecting a record of political tension, but peaceful political transitions, a moderate level of rights for participation in the political process, moderate institutional capacity, moderate rule of law and a relatively high level of corruption.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Public Finances: Material policy shifts that undermine fiscal policy credibility and threaten medium-term public debt sustainability;

--Public Finances: A deterioration in the sovereign's domestic and/or external market borrowing conditions; for example, due to economic policy mismanagement;

--Macro: Policies that increase macroeconomic instability and/or undermine medium-term growth prospects.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Public Finances: Progress on fiscal consolidation that puts government debt/GDP on a downward

path over the medium term;

--Macro: Evidence of an improvement in investment and economic growth prospects in the context of macroeconomic stability and contained inflation.

Sovereign Rating Model (SRM) and Qualitative Overlay (QO)

Fitch's proprietary SRM assigns Brazil a score equivalent to a rating of 'BBB-' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to SRM data and output, as follows:

- Macro: -1 notch, to reflect weak potential growth, largely held back by a low albeit increased investment rate and structural impediments, such as a difficult business environment, which make it more challenging to consolidate public finances and address social pressures.
- Public Finances: -1 notch, to reflect fiscal flexibility that is hampered by the highly rigid spending profile and heavy tax burden, which complicates adjustment to economic shocks, and a high debt that Fitch projects to rise further over the medium term.

Fitch has removed a -1 notch on Structural Features that was previously applied to capture political challenges that reduce policy visibility and hamper reform prospects. Although political challenges persist, these have not precluded important progress on important reforms to improve growth and public finances, and Fitch expects broad governability and reform progress to continue.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

COUNTRY CEILING

The Country Ceiling for Brazil is 1 notch above the LT FC IDR. This reflects moderate constraints and incentives, relative to the IDR, against capital or exchange controls being imposed that would prevent or significantly impede the private sector from converting local currency into foreign currency and transferring the proceeds to non-resident creditors to service debt payments.

Fitch's Country Ceiling Model produced a starting point uplift of +0 notches above the IDR. Fitch's rating committee applied a +1 notch qualitative adjustment to this, under the Balance of Payments Restrictions pillar to reflect Brazil's relatively open capital account, and ongoing efforts to make the currency fully convertible, that are not reflected by the high number of capital-account restrictions recorded in the IMF's AREAER report that feed into the model score.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

Brazil has an ESG Relevance Score of '5' for Political Stability and Rights as WBGs have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Brazil has a percentile rank below 50 for the respective Governance Indicator, this has a negative impact on the credit profile.

Brazil has an ESG Relevance Score of '5' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as WBGs have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Brazil has a percentile rank below 50 for the respective Governance Indicators, this has a negative impact on the credit profile.

Brazil has an ESG Relevance Score of '4' [+] for Human Rights and Political Freedoms as the Voice and Accountability pillar of the WBGs is relevant to the rating and a rating driver. As Brazil has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Brazil has an ESG Relevance Score of '4' [+] for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Brazil, as for all sovereigns. As Brazil has track record of 20+ years without a restructuring of public debt and captured in Fitch's SRM variable, this has a positive impact on the credit profile.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/topics/esg/products#esg-relevance-scores

Fitch Ratings Analysts

Todd Martinez

Senior Director

Primary Rating Analyst

+1 212 908 0897

Fitch Ratings, Inc. Hearst Tower 300 W. 57th Street New York, NY 10019

Shelly Shetty

Managing Director

Secondary Rating Analyst

+1 212 908 0324

Richard Francis

Senior Director

Committee Chairperson

+1 212 908 0858

Media Contacts

Elizabeth Fogerty

New York

+1 212 908 0526

elizabeth.fogerty@thefitchgroup.com

Rating Actions

| ENTITY/DEBT | RATING | | RECOVERY | PRIOR |
|-------------|-----------------------|--|----------|---|
| Brazil | LT IDR | BB  | Upgrade | BB-  |
| | ST IDR | B | Affirmed | B |
| | LC LT IDR | BB  | Upgrade | BB-  |
| | LC ST IDR | B | Affirmed | B |
| | Country Ceiling | BB+ | Upgrade | BB |
| | • senior LT unsecured | BB | Upgrade | BB- |

RATINGS KEY OUTLOOK WATCH

| | | |
|----------|---|---|
| POSITIVE | ⊕ | ◊ |
| NEGATIVE | ⊖ | ◊ |
| EVOLVING | ◊ | ◆ |
| STABLE | ○ | |

Applicable Criteria

[Country Ceiling Criteria \(pub.24 Jul 2023\)](#)

[Sovereign Rating Criteria \(pub.06 Apr 2023\) \(including rating assumption sensitivity\)](#)

Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v2.0.0 [\(1\)](#)

Debt Dynamics Model, v1.3.2 [\(1\)](#)

Macro-Prudential Indicator Model, v1.5.0 [\(1\)](#)

Sovereign Rating Model, v3.13.3 [\(1\)](#)

Additional Disclosures

[Solicitation Status](#)

Endorsement Status

Brazil EU Endorsed, UK Endorsed

DISCLAIMER & DISCLOSURES

All Fitch Ratings (Fitch) credit ratings are subject to certain limitations and disclaimers. Please read

these limitations and disclaimers by following this link: <https://www.fitchratings.com/understandingcreditratings>. In addition, the following <https://www.fitchratings.com/rating-definitions-document> details Fitch's rating definitions for each rating scale and rating categories, including definitions relating to default. ESMA and the FCA are required to publish historical default rates in a central repository in accordance with Articles 11(2) of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 and The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 respectively.

Published ratings, criteria, and methodologies are available from this site at all times. Fitch's code of conduct, confidentiality, conflicts of interest, affiliate firewall, compliance, and other relevant policies and procedures are also available from the Code of Conduct section of this site. Directors and shareholders' relevant interests are available at <https://www.fitchratings.com/site/regulatory>. Fitch may have provided another permissible or ancillary service to the rated entity or its related third parties. Details of permissible or ancillary service(s) for which the lead analyst is based in an ESMA- or FCA-registered Fitch Ratings company (or branch of such a company) can be found on the entity summary page for this issuer on the Fitch Ratings website.

In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the

requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001. Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see <https://www.fitchratings.com/site/regulatory>), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

dv01, a Fitch Solutions company, and an affiliate of Fitch Ratings, may from time to time serve as loan data agent on certain structured finance transactions rated by Fitch Ratings.

Copyright © 2023 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved.

Endorsement policy

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's [Regulatory Affairs](#) page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.