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PANORAMA

November 2015

BRAZIL – NO QUICK FIX FOR THE CRISIS

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By Patricia Krause, Coface Economist



Brazil has grown over the last decade, as a result of the boom in commodity prices and strong household consumption. The country endured the 2008-2009 crisis, thanks to liquidity injections from public banks. The ratio of total credit to GDP rose significantly during the 6 years from 2008 to 2014, from 39.7 % to 54.7 %. Moreover, benchmark Selic interest rates fell to their historic lowest level, to 7.25 % a.y. in October 2012. This improvement in credit conditions is in perfect synergy with the country's emerging middle class. However this movement was not followed on the supply side. Industry became increasingly vulnerable to imports, due to the combination of Brazil's weak infrastructure and high production costs. These weaknesses were particularly associated with the country's labour force, as salaries increased well above productivity during the period.

The government attempted to contain industry hemorrhaging by temporarily reducing taxes on sensitive sectors. However this succeeded only as a palliative measure and was not enough to boost activity, let alone to encourage investments. Activity has lost rhythm in recent years, as Brazil's consumption-based growth model reached exhaustion and commodity prices declined. By 2014, it was clear that major changes to the economic model needed to be implemented - notwithstanding the fact that there would be presidential election in October of the same year. GDP growth stood at a meager 0.1 % in 2014, due to repressed inflation (artificially low energy and oil prices) and increasing public expenses (+ 1.3 %).

The year of 2015 began with Dilma Rousseff's second Presidential term. She won the election, but was faced with a much tougher battle: to control inflation and the marked deterioration in public accounts. As yet, the government has failed to improve macroeconomic fundamentals.

In early September, Standard & Poor's downgraded Brazil to junk status. Coface also reviewed down the country risk assessment, from A4 to B (see table 1). The reasons leading to this decision will be more intensively explored within the first section of this panorama. The second section of this updated sector barometer reveals the effects of the recession, on a sector by sector basis. This information is based on Coface's examination of the financial performances of companies in different industries, highlighting where risks have increased and where they have remained stable. Unsurprisingly, no segments reported improvements. Three industries - the automotive, construction and steel industries - were downgraded from high risk, to very high risk.

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NO QUICK FIX FOR THE CRISIS



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INTRODUCTION

Brazil has grown over the last decade, as a result of the boom in commodity prices and strong household consumption. The country endured the 2008-2009 crisis, thanks to liquidity injections from public banks. The ratio of total credit to GDP rose significantly during the 6 years from 2008 to 2014, from 39.7 % to 54.7 %. Moreover, benchmark Selic interest rates fell to their historic lowest level, to 7.25 % a.y. in October 2012. This improvement in credit conditions is in perfect synergy with the country’s emerging middle class. However this movement was not followed on the supply side. Industry became increasingly vulnerable to imports, due to the combination of Brazil’s weak infrastructure and high production costs. These weaknesses were particularly associated with the country’s labour force, as salaries increased well above productivity during the period.

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Table 1

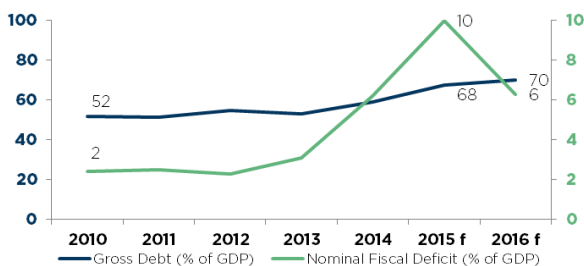


1 ECONOMY PLUNGING, WITH NO REBOUND IN SIGHT

It was already known that 2015 would be an adjustment year, mainly with regards to inflation and public accounts. Inflation ended 2014 at 6.4 %, close to the target ceiling of 6.5 %. The reality, however, was still worse, with pressure over prices even higher and hindered by artificially-low fixed prices. Energy tariffs and oil prices were repressed over a long period. At the same time, energy costs hiked, due to the use of thermal plants dependent on imported natural gas (higher costs) to complement the low number of hydroelectric reservoirs. Additionally, oil prices in the country were lower than Petrobras's costs of importing refined fuel, which directly impacted the company's profitability. Consequently, just after the elections in November 2014, the government allowed Petrobras to raise oil prices. The first increases in energy tariffs were seen in January 2015. Inflation reached 9.49 % in the 12 months accumulated to September 2015, mainly driven by a high of 16.3 % in fixed prices and the strong depreciation in exchange rates.

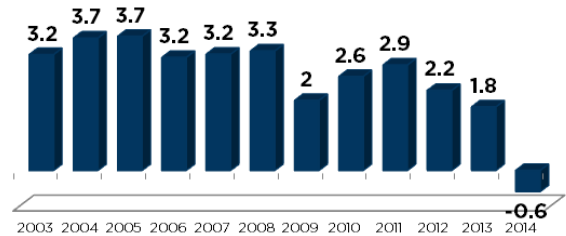
Public accounts figures deteriorated rapidly. When the incumbent president took office for her first mandate in January 2011, **gross public debt** stood at 52 % of GDP. As at August 2015, the same indicator reached 65.3 % of GDP (see chart 1). Coface forecasts that this ratio will climb to 70 % in 2016, aggravated by the high interest burden and lack of fiscal discipline. Over the years, the government has loosened its commitment to primary surplus (see chart 2), by establishing lower targets or through creative accounting. In 2014 it delivered a primary deficit of 0.6 % of GDP, breaking the Fiscal Responsibility Law established in 2000. At the beginning of October 2015, the Federal Court of Accounts (TCU) unanimously recommended the rejection of the government's figures for 2014. This was the first time since 1937 that the TCU has sent Congress an opinion favouring the rejection of government accounts. Opposition leaders have cheered this decision, even though Brazilian legislation is only expected to vote on the accounts in 2016. Even if the accounts are rejected, it is not yet clear if this would trigger an impeachment process (as the figures are associated with the former mandate).

Chart 1 - Fiscal Deficit vs Public Debt



Source: Central Bank

Chart 2 - Primary Surplus (% of GDP)



Source: Central Bank

In July, the primary surplus target for 2015, initially established at 1.1 % of GDP, was reviewed to 0.15 % and this new figure may not be achieved. Fiscal adjustment is being threatened by lower activity, weak support from Congress and delays by companies in paying taxes. In the 12 months accumulated to August 2015, fiscal deficit stood at 0.8 % of GDP. Considering the nominal concept (which is widely used to compare countries' fiscal performance and includes interest payments and monetary restatements), deficit reached 8.9 % of GDP from January to August 2015, compared to the negative result of 4.3 % of GDP for the same period in 2014. This result is comparable to countries such as Egypt and Lebanon, which have high military spending. At the beginning of September 2015, the government sent Congress a controversial budget forecast for 2016, projecting a primary deficit of 0.5 %. This was perceived by a number of analysts as a sign that the government was giving up - and was the final straw in leading to their decisions on downgrading.

Following the downgrade, the government announced a new set of proposals, intended to achieve the target of 0.7 % of GDP established for 2016. The combination of spending cuts and tax hikes total 66.2 billion Reais (roughly 17.2 billion USD or 1.1 % of GDP), although 48 % of this depends on the reestablishment of the Provisional Contribution on Financial Transfers (CPMF)¹. This requires a change in constitution which, as well as being time-consuming, faces strong opposition from the population and from Congress. Failure to meet the target would cause further political tensions and could trigger a new downgrade of Brazil's sovereign rating by agencies.

Against this backdrop, the country's already-weak activity deteriorated further in 2015. **GDP** shrunk by 2.6 %, YoY, in the second quarter of 2015. On the demand side, activity has been mainly impacted by the free fall in investments (-7.9 % for 1H2015, YoY) and by declining consumption, due to increasing inflation and unemployment (8.6 % for the quarter ended July of 2015, against 6.9 % in July 2014). On the supply side, industry remained the most affected segment (-5.2 % for 2Q2015, YoY). Furthermore, Coface expects GDP to drop by 2.5 % in 2015 and by 0.5 % in 2016.

¹ Provisional Contribution on Financial Transfers (CPMF): a tax charged on all bank operations. It was first established in 1997 and lasted for a decade. The newly proposed CPMF should expire in four years and has a rate of 0.2%.

The Brazilian Real has strongly depreciated due to this bleak conjecture, the corruption scandal involving state-owned oil company Petrobras, deteriorating terms of trade, increasing worries over Chinese activity and the recent strengthening of the USD dollar. Between January and the end of September, Brazil's currency depreciated by 49 %.

Table 2

	2013	2014	2015 (f)	2016 (f)
GDP	2.7%	0.1%	- 2.5%	- 0.5%
Inflation	5.9%	6.4%	9.5%	6.5%
Budget Balance (% of GDP)	- 3.1%	- 6.2%	-10%	- 6.3%
Public Debt (%of GDP)	53.3%	58.9%	67.6%	70%
Current Account (% of GDP)	-3.7%	-4.4%	-3.8%	- 3.4%

Sources: Coface, Central Bank, IMF and Santander

2 SECTOR BAROMETER

Coface's sector barometer analyses the financial performance of companies in different industries, combined with its payment experiences. Brazilian risks have generally increased in recent months, influenced by weaker domestic and external fundamentals. Most sectors are classified as high risk. Three segments – retail, agro-food and electronics & IT – have been reviewed from medium to high risk. The recession has had a more significant impact on the automotive, steel and construction industries, which are now at very high risk.

Table 3

Coface sector assessments	
Sectors	Brazil
Agro-food	●
Retail	●
Textile-clothing	●
Electronics, IT	●
Pulp	●
Automotive	●
Construction	●
Chemicals	●
Pharmaceuticals	●
Steel	●

Source: Coface

● Moderate risk ● Medium risk ● High Risk ● Very high risk

Textile – Clothing: High Risk

While the country's total imports contracted by 16.4 % from January to August 2015 compared with the same period of 2014, imports of apparel and clothing accessories grew by 1.8 %. Moreover, this increase is not due to a higher domestic market, as sales of textiles, apparel and footwear dropped by 5.5 % in the first seven months of 2015 YoY. In addition, manufacturing of apparel shrank by 10.3 % from January to July 2015, YoY. All of this shows the increasing proportion of imports in the clothing sector, despite the context of Brazil's strong currency depreciation. China is the main supplier (at roughly 64 % of imports), but other Asian countries (such as Bangladesh, Vietnam and Cambodia) have also gained market share in recent years.

Electronics, IT: High Risk

Deteriorating economic fundamentals have also impacted the Electronics & IT segment. In face of hiking inflation, increasing unemployment and rising interest rates, consumers are curtailing purchases of durable goods. Products such as smartphones and tablets, previously outstanding performers, are no longer immune. Sales of PCs dropped by 38 % in the second quarter of 2015 YoY, while sales of smartphones shrank by 13 % during the same period. Sales of tablets fell by 20 %, YoY, in the first quarter of 2015. The forecast remains bleak, as negative economic fundamentals will continue to impact household consumption intentions. Furthermore, the strong depreciation in exchange rates is increasing production costs, as many components are imported.

Pulp: Medium Risk

Brazil is the world's fourth largest producer of pulp. Its short wood production and harvesting cycle makes the country very competitive. As it holds a high export bias, this segment has benefited from the strong depreciation of the Brazilian real. The movement in exchange rates more than offsets the increase in energy costs and lower international pulp prices. From January to August 2015, production reached 11.3 million tonnes (+ 5.1 % YoY). Exports increased by 8.6 % in the same period, totaling 7.5 million tonnes. Revenues grew by 3.5 billion USD, a high of 1.3 %. This lower expansion is linked to the decline of 6.8 % in average pulp prices. Forecasts for the short and medium term are positive, due to: 1) expected continuation of currency depreciation; 2) increasing demand from China and 3) the closure of plants with higher production costs (especially in Asia). Focussing on the segment's opportunities, so far in 2015 companies have already announced 15.7 billion (roughly 3.81 billion USD) of investments in new production lines.

Construction: Very High Risk

In 2014 the construction industry contracted by 2.6 %, reflecting the sluggish economic activity and the fall in invest-

ments. The sector's performance further deteriorated this year, as a consequence of the recession and the large corruption scandal involving state-owned oil company Petrobras and the country's major construction conglomerates. The case, known as the Lava- Jato operation, is still ongoing. According to INRE (the National Recovery Corporate Institute), 253 constructions firms filed for Chapter XI² between January and August 2015 (+ 25 % YoY). This represents 20 % of the total requests in the period.

The industry fell by 5.5 % in the first half of 2015, YoY. Capacity utilisation stood at only 58 % in August 2015, the lowest level observed since the time series initiated in 2012. The rate for infrastructure is even worse, at 56 %. A survey by the non-governmental organisation, Contas Abertas, estimated that government transfers to companies being investigated by the Lava-Jato dropped by 59 % from January to August 2015 YoY, down from 2.4 billion Reais to 1 billion Reais.

This very high risk scenario should remain, as signals of a rebound are yet to be reported. Tighter monetary policy and more restrictive credit concessions will continue to decelerate the growth of mortgage loans. In September 2015, the construction confidence index reported a new low, at 65.9 points - far below the 5 year average of 114.5 points.

Pharmaceuticals: Moderate Risk

The pharmaceutical industry has shown resilience, strengthened by the country's aging population and the low elasticity of this segment. People will not stop using vital medicines because inflation has eroded their wages or they fear losing their jobs. Sales of pharmaceutical and medical items rose by 4.2 % from January to August 2015, YoY. It is worth noting, however, that the sector is not totally immune to the current environment. High-leveraged distributors may face difficulties, due to the deterioration in the credit market (higher rates and more restrictive supply).

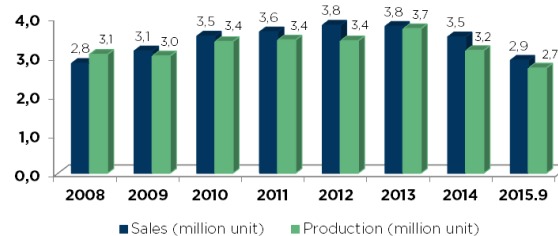
Automotive: Delicate scenario due to continued decline in confidence indexes

The auto industry plays a major role in the Brazilian economy, representing 23 % of industry activity and 5 % of total GDP. Anfavea, Brazil's **National Association** of Motor Vehicle Manufacturers, estimates that the segment is responsible for 1.5 million jobs, directly and indirectly. This sector is far from immune to the negative economic environment in Brazil.

Difficulties started to be felt in 2014, when production reported a sharp decline of 15.3 %, sales contracted by 7.1 % and exports tumbled by 30.4 % (see chart 3). As a result, Mexico overtook Brazil in the world's ranking of car manufacturers, to become Latin America's leading player. Brazil is now ranked at 8th position, down from 7th in 2013. It is

worth noting, however, that it remains the fourth biggest automotive market globally. The dismal scenario gained force this year, as the country entered into recession. Confidence indexes collapsed, also influenced by the corruption scandal involving state owned oil-giant Petrobras and the difficulties the government faces in implementing fiscal adjustments. The IPI tax on industrialised products for the auto industry was reset in January 2015. Consumers, affected by rising unemployment, the effects of hiking inflation on their real income and the deterioration of credit conditions, are uninclined to purchase durable goods such as cars.

Chart 3 – Production vs Sales



Source: Anfavea

Between January and September 2015, production fell by 20.1 %, sales by 22.7 % and exports by 10.8 %, compared to the same period in 2014. Idle capacity reached a ten year record, with capacity utilisation at 62 % in 2014, down from 77 % in 2013. For 2015, the economic consultancy Tendências forecasts a capacity utilisation rate of 53 %. Production has shrunk to 2008 levels. The crisis also triggered massive layoffs and collective vacations, with many job positions closed. As at August 2015, the industry's workforce was down by 14.4 % compared to January 2014. In an attempt to prevent further job losses, the government proposed the Project of Employment Protection (PPE) programme. The PPE programme allows car assemblies to reduce the number of working hours by 30%, for up to 12 months (with salaries reduced in proportion).

According to Luiz Man, the president of Anfavea, profitability has been squeezed in recent years due to increasing costs and fierce competition. Central Bank figures from January to July 2015 reveal that remittances to headquarters amounted to 134 million USD, down by 80%, from 663 million USD for the same period in 2014. For the full year of 2014 the amount was 884 million USD, well below the value observed in 2013 (3.3 billion USD) and the record of 5.7 billion USD reached in 2011. The loss is considerable, even when taking into account the strong depreciation of Brazil's currency against the USD.

In counterpart, loans provided by headquarters to Brazilian subsidiaries reached 3.3 billion USD during the first seven months of 2015. This figure already surpasses the 3 billion recorded during the whole year of 2014. This strong in-

² Chapter XI was established in Brazil in 2005, through the New Law of Bankruptcies (number 11.101), emphasising the rise in viable businesses experiencing difficulties but trying to avoid bankruptcy.

crease is helping to improve local cash flow and to meet investments already scheduled.

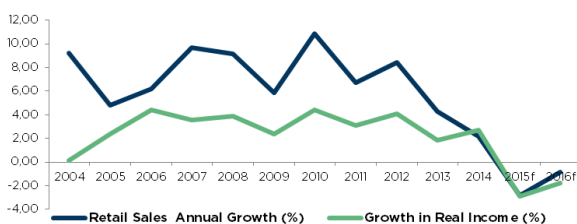
Coface reviewed the risk from high to very high. Car dealers and the auto parts industry are, in general, the most impacted, as global car producers count on the full support of their headquarters. Despite the strong slowdown in sales, not all brands are reporting negative results. However, even the positive outstanding performers could be vulnerable, as the country's car dealers typically work with more than one brand. Thus it may be part of a weak economic group.

The industry's weak performance is not expected to revert in the short term, as confidence indexes remain low. The breakdown also shows that intentions to purchase durable goods purchase over the next six months stood at 68.6 points in August 2015. This is the third lowest level recorded since the beginning of the time series in 2005 and well below the 100 points which separates optimism from pessimism. The perspectives for the export market are not encouraging either. Argentina, the main market for Brazil's vehicles, is also facing a turbulent economic scenario.

Retail: Consumers unwilling to purchase durable goods

With over 204 million inhabitants (the world's 5th largest population), Brazil possesses a significant retail market. In 2015, consulting firm AT Kearney ranked Brazil as the eighth most attractive developing country for retail investment. During the last decade it has increased on average by 6.8 %, well above the GDP's average growth of 3.6 % over the same period. These results were due to the emerging middle class, the favourable job market and improving credit conditions (lower interest rates and higher supply). This began to decelerate, however, in 2013. 2014 reported the lowest growth rate in 11 years, at 2.2 % (see chart 4).

Chart 4 - Retail Sales vs Real Income



Source: IBGE

Household consumption amounts to roughly 913 billion USD (63 % of GDP). Consumer confidence has collapsed, against a backdrop of rising unemployment rates, the erosion of real wages by high inflation and climbing interest rates. The unemployment index stood at 8.6 % in the quarter ended in July 2015, against 6.9% in the same period of 2014. Inflation rose from 6.8 % in September 2014, to 9.5 % in 12 months accumulated to September 2015. In the mean-

time, the Selic benchmark interest rate has almost doubled since April 2013 - from its historical minimum of 7.25 % a.y., to 14.25 % a.y.. Average interest rates for non-earmarked operations reached 61.2 % in August 2015, up from the 41 % a.y. prevailing at the time when the Central Bank began to increase rates, in April 2013.

In the face of this adverse scenario, retail sales dropped by 3 % from January to August 2015 YoY, and by 1.5 % over the 12 months accumulated. The reality for extended retail, which includes sales of building materials and vehicles, is even worse. It shrank by 6.9 % during the first eight months of 2015 YoY, and by 5.2% in 12 months accumulated until August 2015. The breakdown through segments shows that only a few subcategories have been resilient. These include pharmaceutical and medical items, as well as other personal items. Pharmaceutical and medical items have been positively impacted by the fact that the population is aging and by the low elasticity of their market. In counterpart, furniture and home appliances were the second worst performers, just after the auto industry). This can be partly associated with the IPI (tax on industrialised products) for this segment, that was reset in early January 2015.

Despite the challenging outlook for retail, e-commerce is continuing to grow, thanks to increasing access to the internet. Sales from internet channels reached 14.8 billion USD in 2014 (roughly + 18 % in real terms in Brazilian currency), with an average ticket of 147 USD. Moreover, since 2012, m-commerce (purchases via mobile devices) has been climbing at a fast pace.

The general outlook for retail is not positive, as employment is expected to continue rising, with real income reporting negative growth in 2016. Retailers' profitability will therefore remain under pressure. This segment usually works with tight margins, as competitiveness is very high and the strong depreciation of Brazilian currency has also increased the cost of imported products. In face of this scenario, companies that do not have a healthy capital structure and good cash flow management are highly at risk, as credit conditions have deteriorated (higher rates and a more restrictive supply). Coface has therefore reviewed the segment from moderate risk to high risk.

Steel: Headwinds from domestic and foreign markets

Brazil is positioned as the world's 9th largest steel producer, as well as being the biggest player in Latin America. With its 29 steel mills, Brazil's production capacity is estimated at 48 million tonnes per year - but it has been operating well below full capacity. In 2014, production reached 33.9 million tonnes (- 0.7 % compared with 2013), while apparent consumption dropped by 6.8 % for the same period. In 2015, the industry's vulnerability to weak external fundamentals has been exacerbated by the sharp deterioration in domestic activity.

The external challenges are well established. As China represents roughly 50% of the world steel market, both in terms of production and consumption, it holds a decisive position in determining prices. With China's steel industry being mainly state-owned, decisions on how much to produce are not necessarily linked to economic efficiency. These factors are aggravated by the context of lower world

demand. China's growth model, which is based on strong investments, has reached exhaustion. This means that its idle capacity levels have increased, causing a negative impact on international steel prices. World average capacity utilisation stood at only 68 % in August 2015, the lowest level in six years. Moreover, the global steel industry has been exposed to cheap products emanating from China.

According to Acelpa (the Latin America Steel Association), steel from China represents 13 % of Latin America's consumption. The number of shipments from China has increased by 70 % in the last two years. China accounted for 70 % of the total steel imports by Brazil in 2014, compared to just 20% in 2009.

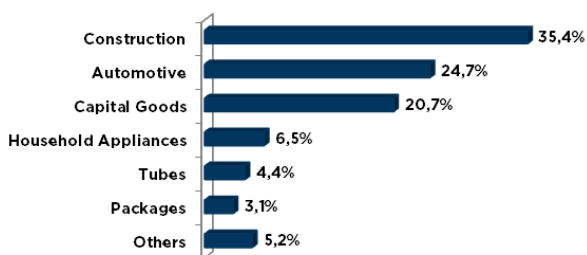
Table 4 – Top 10 steel producers

Top 10 Steel Producers		
Rank	Country	Production in 2014 (Mt)
1	China	822.7
2	Japan	110.7
3	United States	88.3
4	India	83.2
5	South Korea	71
6	Russia	70.7
7	Germany	42.9
8	Turkey	34
9	Brazil	33.9
10	Ukraine	27.2

Source: World Steel Association

Brazil's main steel consumers are the construction, automotive and capital goods industries (see chart 5). All are extremely vulnerable within the current economic scenario. Construction was impacted by lower activity, the deteriorating job market and the corruption scandal involving Petrobras, the state-owned oil company. The automotive industry contracted by 20.1% from January to September 2015 YoY (for more details, see the automobile overview in this section). Capital goods contracted by 22.4 % from January to August 2015, YoY. Entrepreneurs are not willing to invest within the current climate of strong political and economic tensions and high uncertainty over the future.

Chart 5 - Steel Consumption in Brazil



Source: Brazil Steel Institute

Against this background, clients reduced purchases, adjusted or postponed investments.

According to Inda (the National Steel Distributor Association), inventory turnover stands at 3.9 months (far from the 2.8 months considered as a good average). Distributors have thus been giving discount for some lots. Furthermore, both steel purchases by distributors and sales contracted by 22 % in first nine months of the year, YoY. Carlos Loureira, the president of Inda, recently mentioned that the Ebitda margin³ currently stands at around 1.5%, compared to the old levels of 7 %. In 2015, the segment's workforce has already been reduced by 11 %.

Distributors are also usually exposed to exchange rate movements, due to purchases of imported steel. As a result, the risks associated with this segment have considerably increased with the strong depreciation of the Brazilian real (62 % in the one year up to end of September 2015). Distributors do not normally hedge and are not naturally protected through exports. Hiking delinquency and insolvencies have been observed.

Idle capacity has reached 31% and some Brazilian steel industries have implemented layoffs and collective vacations, to try to adapt their production. According to IaBr (the Brazil Steel Institute), production observed a slight high of 1.2% from January to September 2015, mainly associated with the rise in semi-finished steel (lower added value and geared towards external markets). It is worth noting, however, that long and flat steel production contracted, by 12.7% and 4.8% respectively, during the same period. Meanwhile apparent consumption was recorded at 16.9 million tonnes, down by 12.8

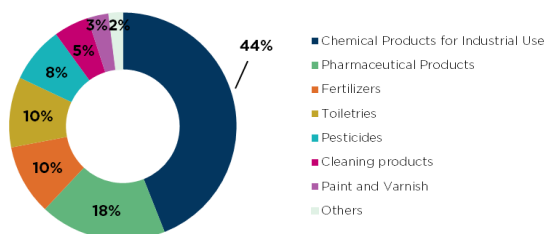
The current situation, as well as the perspectives for the upcoming periods, are bleak. The sensitive conjecture faced by the country's main steel consumers, along with world oversupply, are not expected to improve in the short term. The risk associated with the sector has thus been downgraded from high risk to very high risk.

Chemicals: Depreciated exchange rates are not enough to improve competitiveness

The challenging scenario faced by Brazil's chemical industry is not new. It is the result of years of underinvestment, high costs and dependence on imported raw materials (mainly natural gas). The sector has thus become highly exposed to imports over the years. In 2014, trade deficit stood at 31.2 billion USD - just 2.4 % lower than the record of 32 billion USD observed in 2013. Apparent consumption (production + imports – exports) grew by a marginal 0.8 %. Breaking down the index, production contracted by 4.5 %, exports increased by 1.4 % and imports observed a high of 9.3 %. As a consequence, imports reached 36 % of domestic consumption. Moreover, the average utilisation capacity during the year was 79 %, down three percentage points from the previous year and below 80% for the first time in seven years.

³ Ebitda: Earnings before Interest, Taxes, Depreciation, and Amortization

Chart 6 - Breakdown of the Chemical Industry



Source: Abiquim

The strong depreciation in the Real, which deepened in 2015, contributed to the rise in exports in terms of volume. Total chemical exports dropped by 8.7 % in the first eight months of 2015 YoY, as global demand is also weakening. Imports were down by - 21.5 % (in terms of volume), due to decreasing domestic activity and higher prices in Reais. Within this context, the trade deficit continued to decrease in 2015, to end August at 17.3 billion, at -15% for the first eight months of 2015 (compared with 2014) and at 28.1 billion USD in 12 months accumulated.

While depreciated exchange rates tend to positively impact activity, the main costs of industry are also under pressure. According to CNI (the Industry National Confederation), energy tariffs increased by 49.4 % in the second quarter of 2015 compared with the same period of 2014. Brazil imports roughly 50 % of all of the natural gas it consumes. International prices shrank by 29 % in the year until end August 2015, but this has not implied lower prices. This is because the Brazilian Real depreciated by 61 % during the same period. Moreover, in May 2015, Petrobras (which is almost the only gas supplier in the country), announced that it would gradually remove its discount policy up to the end of the year. In force since 2011, the aim of this policy has been to prevent fuel prices from climbing, by giving discounts for purchases by distributors (of roughly 20 %).

Government attempts to balance the fiscal budget have also impacted the chemical industry. Two of the measures announced in September 2015 were not welcomed by the segment. A reduction of 50 % in the relief of PIS/Cofins taxes for 2016 was announced, with the same to be reset in 2017. This benefit has been in place since mid-2013, when the government decided to decrease taxes on raw materials for the chemical industry from 5.6 % to 1 %. The strategy was to compensate for part of the competitiveness imbalances between local and international industries. In addition, the Reintegra tax rate (the programme that returns some of exporter's costs to them) was modified again. Back in early February 2015, the government had already reduced the Reintegra rate from 3 % to 1 %. However, just seven months later, the programme was reviewed to a meager 0.1 % for 2016, rising to 1 % in 2017, 2 % in 2018 and finally 3 % in 2019. This decision not only reduces the

attractiveness of the export market, but also shows the lack of predictability regarding economic measures.

This sector should remain at high risk. Domestic activity is not expected to rebound in the short term, costs remain under pressure and improvements in exports are limited by the strong competitiveness gap and by constant changes in the rules. Finally, the strong increase in interest rates also implies higher risks for leveraged companies.

Agriculture: not immune to the current climate of economic turmoil

Brazil has a diversified agro industry which benefits from its long stretches of fertile land and favourable climate. It is the world's main producer of coffee and sugar, as well as being the second largest producer of soya and its main exporter. Brazil's strategic role in the agro segment extends through to other sectors - but it is not easy to achieve profitability in the context of infrastructure bottlenecks, high interest rates and tax burdens. In 2014 the agro segment grew by only 0.4 %, but in the first half of 2015 expanded by 3 % against the same period of 2014. This is a good result when compared to the decline of 1.2 % in GDP during the same period.

The 2014/15 harvest reached a new record, with 209.5 million tonnes (+ 8.2 % compared to the crop of 2013/14). According to Conab (the National Food Supply Agency), this result was driven by an 11.8% increase in soya (see chart 7) and by the second corn crop (+12.6 %). Good weather conditions also allowed the season's productivity to increase by 6.4 % during the period. Despite the positive performance, prices are generally slowing down. This movement is mainly explained by weaker demand and by the good harvests experienced in other countries. Soya, Brazil's main exported product, is an illustration of this. From January to August 2015 soya exports totalled 22.5 billion USD, down by 17.4 % YoY. The exported volume rose by 9 % during the period, but was more than offset by the decline of 24.6 % in international prices.

Prices should remain low, influenced by good crops in Brazil and the United States, high inventory levels and the strong US dollar. The soya harvest begins in mid-September and, according to the 5th Survey of the US Department of Agriculture, Brazil's 2015/2016 crop production should reach 97 million tonnes. This would represent a high of 2.6 % compared to the previous crop.

Despite this, a delay in the purchase of fertilizers for the 2015/16 crop has been reported. According to Anda (Brazil's National Fertilizer Association), input sales dropped by 7.7 % from January to July 2015 compared with the same period of 2014. This movement is associated with delays in credit concessions and the volatile exchange rate, as 80 % of Brazil's fertilizers are imported. Higher prices may also influence farmers' decisions on how much to produce and the quantity of fertilizers to be used during planting. The raw material represents, on average, 30 % of farmers' production costs.

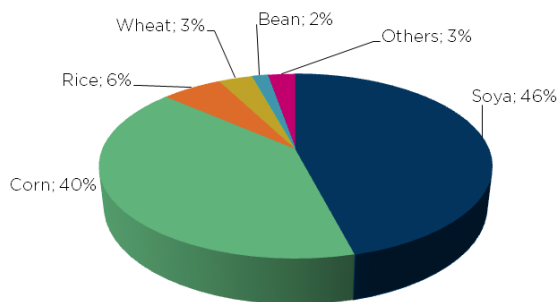
Producers that have not yet negotiated their purchases of fertilizers may pay even more. The strong depreciation in the Real is not expected to reverse in the short term and

logistical issues may put further pressure on prices. According to FC Consultancy, there are long queues of ships at the ports, which impacts costs.

As concerns credit conditions, in early June 2015 the government announced that the “Plano Agrícola e Pecuniário 2015/16” will raise 187.7 billion Reais (roughly 41 billion USD) for financing costs, trading and investments. This represents a rise of 20% compared with the previous year and the highest volume supplied to date. Nevertheless, interest rates were also raised, reflecting the hike observed in the benchmark Selic rate since the last programme. The rate for financing costs, for example, was raised from 6.5% to 7.75 %.

Risks for the agro segment are forecast to remain high. The sector is already working with longer terms of payment, which necessitate good cash flow management. In the context of depreciating exchange rates and increasing interest rates, the challenges will be tougher. The agro sector will not recover to its old levels, as China, its main consumer, is experiencing a deceleration in growth. Coface expects China to grow by 6.7 % in 2015 and by 6.2 % in 2016, down from 7.3 % in 2014.

Chart 7 - 12° Crop Survey 2014/15



Source: Conab

3 CONCLUSION

Brazil has been facing a scenario of economic juggling. The Central Bank increased interest rates to control inflation, which compromises GDP. Lower activity is reducing tax revenues and threatening fiscal adjustment. In addition, the government needs the backing from Congress in order to reach its primary surplus targets – but support from Congress is low. Political uncertainties are heavily impacting the country's economic performance

Activity will continue to be sluggish – and this is confirmed by confidence indexes, which remain close to their lowest historical levels. Businesses are not willing to invest in the current environment of high political tension. At the same time, as unemployment continues to rise, household consumption will not support a rebound in activity.

The perspectives for exports are more promising, as the strong depreciation of the Real has increased the attractiveness of Brazil's manufactured exports. Nevertheless, trade balance figures have failed to show improvements so far. Exports dropped by 17.7 % from January to September 2015 YoY. One explanation might be that there is usually a gap between strong movements in exchange rates and the effect on exports, as it takes time to recover old clients or to obtain new ones. Moreover, the current volatile scenario is unwelcome, even for industries which target foreign markets, due to the difficulties in making forecasts. Above all, the main hindrances are the country's poor infrastructure, high tax burdens and its constant changes in rules.

The following months have big challenges in store for Dilma Rousseff. One is the possible rejection of the 2014 accounts. Another question is if the primary surplus targets for 2015 and 2016 are really achievable. Finally, the president's popularity has been tumbling. A recent Survey of CNI/Ibope shows that 69 % of the population disapproves of her government. It will be not an easy task to put the economy back on track, when she first needs to protect her own position in power.

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