ECONOMICS: LATIN AMERICA PERSPECTIVES

BRAZIL: PETROBRAS COMES CLEAN

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Petrobras avoided a possible technical default this week by releasing its audited financial results for 2014. The announcement reduces uncertainty about the company and the Brazilian economy at large, and should be good news for Brazilian assets.

At Last, Results

By releasing its audited financial results for fiscal year 2014, state-controlled oil company Petrobras avoided a possible technical default that could have accelerated its debt payments. What's more, the results were fully endorsed by the company's auditors, much to the relief of financial markets. We think this is good news for the company, for Brazilian assets and for Brazil's economy.

Petrobras recognized a BRL6.2 billion loss associated with graft (the so-called Car Wash investigation), and a BRL44.3 billion charge because of asset impairment. Those figures were higher than expected and suggest the company was committed to being transparent. That should be welcome news for investors.

For Petrobras, the audit removes a veil of uncertainty that has been shadowing the company. It's true that market expectations for the data release have been growing over the last month as a result of encouraging comments from company officials (*Display 1*). But the actual release clearly lowers the risk of downgrade. In fact, we think there's a good chance that Moody's will upgrade Petrobas' rating by one notch; the ratings agency has said the release of the results would likely lead it to partially reverse an earlier two-notch downgrade.

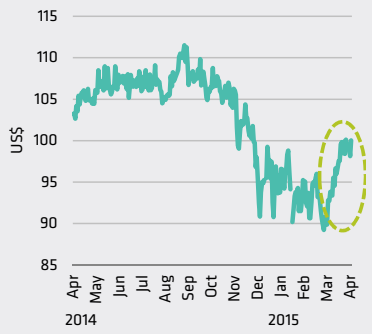
Petrobras still faces substantial challenges, including the need to reduce its high leverage through an ambitious divestment program. It will also have to streamline operations to become more competitive. But the signal conveyed by the new management, and by the government at large says the company is ready to come clean and establish new and more solid foundations. To preserve cash, Petrobras CEO Aldemir Bendine indicated that the company will not pay any dividends this year. We expect a new business plan to be unveiled within the next 30 days.

Good for Corporates, Sovereign Debt

Petrobras' decision should be supportive for the valuation of other Brazilian corporate bonds, particularly those with direct exposure to the oil company. The move could also open the door for Brazilian issuers later this year.

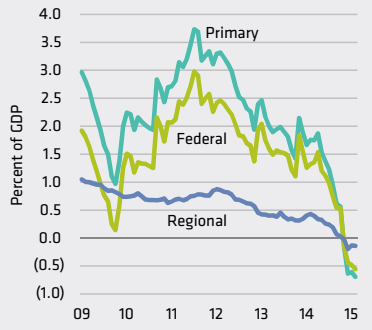
These benefits most likely will extend to the national government as well, as reduced risk of debt payment acceleration means the Treasury probably won't need to

Display 1
Fulfilled Expectations



Through April 23, 2015
Bloomberg and AB

Display 2
Still a Lot of Work on the Fiscal Front



Through February 1, 2015
Source: Banco Central do Brasil and AB

extend financial assistance to the oil giant. And given the sheer size of Petrobras in the Brazilian economy (with close to half of the country's fixed investment), better prospects at the company add up to an improved outlook for Brazil's economy.

Next Up: Fiscal Tightening

As for stabilizing overall market sentiment toward Brazil, we think Petrobras' move was the first of two necessary steps. The second thing markets want to see is evidence that the fiscal adjustment program is gaining traction, despite weak economic activity. While Finance Minister Joaquim Levy remains a market favorite and has already made progress with his policy adjustment plan, uncertainty remains about his ability to deliver on a promise to generate a primary fiscal surplus of 1.2% of gross domestic product (GDP) this year. The doubts on this score will dissipate only with three or four consecutive months of solid fiscal numbers—something the country has so far been unable to string together (*Display 2, previous page*).

We don't think the market needs to see the government hit the precise 1.2% target. But we do think it wants clear evidence that the country has turned a corner and is headed in the right fiscal direction. Even a slightly lower primary surplus will probably do the trick—for both market participants and the ratings agencies. After all, most observers appreciate how difficult it can be to tighten fiscal policy while the economy is shrinking.

Tough Year Ahead

Brazil still faces a tough road back to economic health. We still think aggregate investment will be sluggish. And we think fiscal tightening and efforts to correct relative price misalignments will keep consumption subdued. We project GDP to contract by at least 1% in 2015, while the open unemployment rate is likely to climb toward 7%. Additional headwinds may appear if water and energy shortages due to low rainfall materialize. Petrobras' divestment plan, although a necessary step, will also push activity down in the near term because of the sheer weight of the company in the country's aggregate investment.

Inflation, on the other hand, is reflecting both the change in domestic relative prices and the much weaker exchange rate. We expect headline inflation to remain above 8% during the year. In 2016, however, inflation is expected to drop significantly, most likely toward the inside of the target range, as the economy begins a very gradual recovery. In the meantime, it's critical for the authorities to press ahead with a structural reform agenda aimed at increasing productivity and growth. ■