Brazil

Economics

Economic

Credit Ratings:

Moody's: Ba1

S&P: BB+

Fitch: BB+

Nominal GDP (2006):

USD1,067.4 billion

Population (2006):

186.8 million

Total Trade / GDP:

21.5%

Currency:

Brazilian real

Exchange regime:

Independently floating

Merchandise imports from Canada (2006):

CAD 1,276mn

Main sources of Foreign Exchange (excl. FDI):

Transport equipment

Largest Merchandise Trading Partner:

United States

Argentina

Main imports:

M&E (26%)

Chemicals (16%)

Risks to the Outlook:

↑ Further progress on microeconomic reforms and rating upgrade

↓ A sharp reversal of the capital flow influx of the last two years.

October 2007

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Market Spotlight: After taking a hit in mid-August, financial markets have climbed steadily back. At the time of writing, JP Morgan's Brazilian EMBI was back down 31bps on its close of August 16th, and the Bovespa was back up 49,592pts. The *real* also regained almost all its losses. On August 23rd Moody's upgraded Brazil's LC and FC government bond rating to Ba1 (BB+ equivalent), and its country ceiling to Baa3 (BBB- equivalent).

Real Sector: The burning question is whether we'll see the effects of the global turbulence seep into Brazil's real economy. So far, however, there is no evidence of such contagion. Industrial production is running at a 2-year high, retail sales growth is at a 3-year peak, exports and imports are soaring, and wage growth has accelerated markedly. Strong regional integration, and healthy diversification of both trade partners and products, will further shelter the country from external volatility. While commodity prices should suffer from a US slowdown, the ones important to Brazilian exporters will likely not. Soft commodities, about a quarter of primary exports, are expected to benefit over the medium-term, as are iron ore prices. Meanwhile, foreign companies continue to invest in Brazil, with FDI estimated at US$25bn so far this year.

Brazil's economy grew by 5.6% in the four quarters to Q2, more than double its long-run trend. EDC Economics expects above-trend growth to persist through the forecast horizon (2007-2008), as solid income growth, a generally supportive monetary environment, and a solid *real* continue to encourage domestic demand. Historically high energy and food prices are putting upward pressure on the consumer price index, but policy credibility will help keep inflation expectations in check.

Monetary: While inflation increased to 4.2% in August, it remains below the Central Bank's generous 4.5% target. Following the COPOM's 25bps cut in September, we feel that the authorities may still have room for at least one more interest rate reduction this year, putting the Selic rate at around 11% by year-end (depending on how the current bout of global financial turbulence plays out).

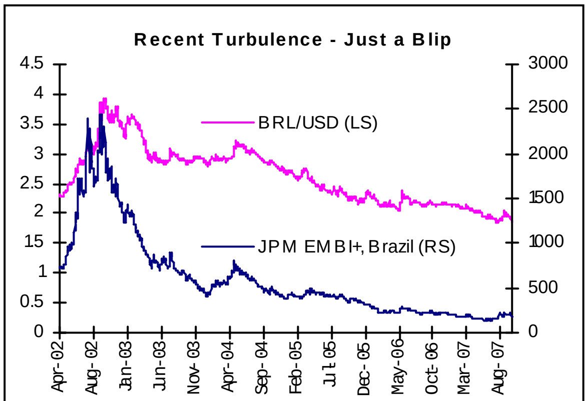
External Sector: Investor concern over the potential effects of a widespread credit crunch on Brazilian assets surged in August – with bond spreads up 90bps, the Bovespa down 53,323pts, and the *real* losing 8%. Brazil has typically been hit quite hard during episodes of widespread 'flight to quality'. However, we believe that Brazil is now better-prepared to withstand the downside of this, and future global business cycles. The Lula administration has used the last few years of solid global demand, surging commodity prices and elevated liquidity to lower external indebtedness, smooth maturity profiles, and improve currency and interest rate dynamics. Foreign exchange reserves, at US$154bn, are five times what they were in 2000. The government continues to run a primary budget surplus, and the current account remains in positive territory despite the pick-up in import demand.

Fiscal: The government has maintained the nominal value for this year's primary surplus target (BRL91bn) in response to the new GDP series. This effectively lowers the primary surplus-to-GDP ratio from 3.75% to about 3.35%. Nevertheless, based on the new series, most private estimates still place the debt-to-GDP trajectory on a downward path through 2010, to below the 40% threshold.

Outlook: *Longer-term, we still have concerns regarding the country's enduring legacy of under-investment. Recent industrial production figures exceed the sector's sustainable growth rate, as suggested by rising levels of capacity utilization. In this regard, more needs to be done to improve the overall business climate. However, the country's fractious political backdrop makes necessary microeconomic reforms difficult.*

Economic Indicators

	01-05 avg.	2006	2007	2008
GDP (% growth, real)	2.7	3.7	4.5	4.2
Inflation (% change, eop)	8.7	4.2	3.7	3.9
Fiscal Balance (% of GDP)	-3.5	-3.0	-2.2	-1.7
Exports (% growth)	16.5	16.5	13.0	7.0
Imports (% growth)	5.7	24.1	25.0	15.0
Current Account (% of GDP)	-0.3	1.3	0.5	-0.5
Reserves (month of imports)	5.6	6.6	10.6	10.3
External Debt (% of GDP)	37.0	17.9	18.0	16.3
Debt Service/Current Account	62.3	25.9	20.2	20.1
Exchange rate (eop)	2.7	2.1	2.2	1.9



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General Political Environment:

Brazilian politics are characterized by a fractiousness that mirrors the country's diverse socio-economic make-up. Relations are generally difficult between the executive and the legislature, as well as between federal and state governments. Political progress requires constant horse-trading that slows the passage of reforms, including those widely considered necessary for continued fiscal sustainability and to accelerate growth to a level that will move Brazil forward.

Populist president Luiz Inácio Lula da Silva (Lula) won a second term in October 2006 by defeating the pro-business candidate, Geraldo Alckmin, in the run-off elections. Lula's political party, the Partido dos Trabalhadores (PT), again has a minority position in the legislature, and only secured 5 out of the 27 influential governor roles across the country. Lula has fashioned an 11-party coalition, and will depend on the continued support of the PMDB, the centrist party that won the most seats in both houses in the 2006 elections.

Policy continuity is forecast over the next four years, and Lula is expected to seek a balance between pragmatic economic policies and initiatives to address the country's social ills. He will likely continue to depend on fiscal revenues and as a result maintain tax rates at their current high levels in order to fund new social initiatives, improve education, and expand on landmark social programs such as the *bolsa familia*.

This difficult balancing act coupled with inevitable legislative challenges may undermine his ability to meet expectations on all fronts. It is only in March 2007 that Lula finally managed to form a new cabinet, and he will need to act decisively to tackle some of the country's structural weaknesses early in this mandate. The reception accorded to a fiscal reform package, which is scheduled to be tabled by September, will likely give a good indication of the strength of Lula's coalition.

Rampant political corruption in Brazil came to the forefront of the pubic eye over the past year. Lula skillfully remained at arms length of the various corruption scandals that reached many of his close allies as well as his political party, the PT. Despite Lula's success in shielding himself from the allegations, corruption will likely remain an issue of concern and could continue distract the government's attention and drain resources. A direct accusation targeting the President could potentially lead to political instability.

Investment Environment:

Lula has become a poster child for the moderate left in Latin America. Unlike other leftist leaders in the region, he has not promoted nationalist policies that would seriously weaken the investment environment. This said, Lula advocates for both government participation in the economy and respect for the contractual rights of investors. Accordingly, he is actively promoting public-private partnerships, not privatizations, to attract private capital. This approach functions as a moderate disincentive to investment.

While there is ongoing and significant progress in the liberalization of the foreign exchange regime, there are a number of important residual controls. Foreign currency bank accounts (such as in USD) are not permitted in Brazil.

Regulatory agencies are weak and the bureaucracy is cumbersome.

The judicial system has problems with corruption, is over-burdened and is beset by procedural uncertainty.

Political Violence:

The main source of violence in Brazil is criminal rather than political. Personal security is poor owing to an extremely high rate of criminal activity in major cities. Underpaid and corrupt elements of Brazil's security forces have at times served to exacerbate the problem. The lack of security in Rio de Janeiro has prompted authorities to seek support from the Brazilian army.

The imbalance in land distribution leads to episodic violence in rural areas, specifically in the Amazon. Land invasions are common and mostly affect the agriculture sector, although the scope of land so targeted is broadening. Protests by groups of landless individuals have become more prevalent recently, and radical action by these groups that would affect infrastructure, albeit not on a large scale, is possible going forward.

Political

Political Structure
Federal Republic; currently ruled by coalition

President
Luiz Inácio Lula da Silva

Vice President
José Alencar

Legislative Bodies
- Federal: Chamber of Deputies (513 seats), Senate (81 seats)
- States: Unicameral legislatures in each state (26) and Federal District

Major Parties (seats in Chamber of Deputies/ Senate)
- Partido dos Trabalhadores - PT (82/11)
- Partido do Movimento Democratico Brasileiro - PMDB (89/15)
- Partido da Social Democracia Brasileiro - PSDB (65/15)
- Partido da Frente Liberal - PFL (65/18)

Last Elections
- October 2006

Next Elections
- October 2010

Press Freedom Survey:
- 2006 Score: 39 – Partly Free

(0: Free; 100: Partly Free)
freedomhouse.org

Control of Corruption Index:
- 2006 Score: -0.33

(-2.5: Worst; +2.5: Best)
worldbank.org

August 2007
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Political Outlook

A mix between moderate nationalism and neo-liberal economic policies will likely be the core of Lula's policy program in his last term as President. If he is successful in achieving this juggling act, investors will feel more confident that politics and economics can be separately assessed paving the way towards a potential investment grade in the medium-term. Policy continuity may not necessarily provide the best solution to address Brazil's weaknesses; however it has served to strike a balance between the interests of the country's various stakeholders and it will likely continue to do so. All this said, there is a downside risk that Lula engages in excessive social spending to guarantee social legally.