

Economic

Credit Ratings
 Moody's: Baa3
 S&P: BBB-
 Fitch: BBB

Nominal GDP PPP(2011e)
 USD 2,283 billion

Population (2011e)
 193 million

Total Trade / GDP
 19%

Currency
 Brazilian real

Exchange regime
 Free floating

Merchandise imports from Canada (2011 e)
 CAD 2.6 bn

Main sources of Foreign Exchange (excl. FDI)
 Transport equipment

Largest Merchandise Trading Partner
 China; United States

Main imports
 M&E (26%)
 Chemicals (16%)

Risks to the Outlook

↑ Further progress on microeconomic reforms

↓ A sharp reversal in capital inflows or asset bubbles formation

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MARKET SPOTLIGHT: ■ The economy has experienced a sharp deceleration last year. ■ Monetary authorities continue to cut interest rates aggressively ■ As host of FIFA World Cup (2014) and the Olympic Games (2016), Brazil is expected to invest massively in new infrastructure. ■ The government has temporarily reduced import taxes on 99 capital goods and 6 IT and telecommunications products.

Real Sector: The Brazilian economy decelerated sharply last year and GDP ended up expanding by only 2.7% y/y. As the government increases fiscal and monetary stimulus this year, EDC expects domestic economic activity and consumption to pick up some speed over the forecast horizon. In addition, Brazil currently benefits from historically low levels of unemployment, continued robust credit growth and poverty reduction initiatives. EDC economics forecast GDP growth of 3.1% in 2012 and 4.1% in 2013.

Monetary: Brazil's inflation (5.24%) kept falling rapidly in March. EDC economics believes inflation will likely stay above the mid-point of the target range (4.5% +/-2%) through 2012. In response to decelerating economy and decreasing inflation, the Central Bank has lowered the benchmark SELIC target rate from 12.5% in July to 9% in April. Such cuts are expected to help sustain growth while easing upward pressure on the exchange rate. The exchange rate policy of the Central Bank will continue to be characterized by heavy intervention on Forex markets. No monetary tightening is anticipated this year.

External Sector: The government has temporarily reduced import taxes on 99 capital goods and 6 IT and telecommunications products to 2%, with the goal increasing imports of goods that not produced locally but that are required for the manufacture of domestic goods. Massive capital inflows and FX intervention have allowed foreign exchange reserves to grow to around US\$ 372bn in April which support a strong liquidity ratio with reserves covering the equivalent of more than 12 months worth of imports. EDC Economics does not anticipate any financing problems over the forecast horizon as Brazil's external financing requirement is comfortably covered by net foreign direct investment (FDI) and portfolio inflows. Overall, Brazil's net external creditor position and strong external liquidity mitigate risk to external shocks.

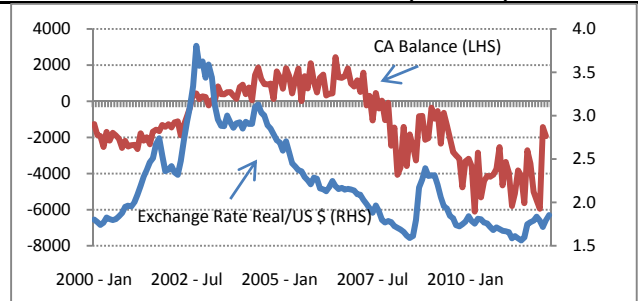
Fiscal: With the goal of stimulating the struggling industrial sector and increasing its competitive advantage against foreign products the government decided to extend its tax incentives to strategic sectors. Therefore 15 labour-intensive sectors will be exempt from paying payroll taxes and BNDES will receive a new USD25bn injection to finance the local industry. In addition, Brazilian exporters will be eligible for further tax breaks and there will be tougher import regulations. The government has projected spending in infrastructure and social developments to be in the range of US\$ 959 bn between 2011 and 2016. On the solvency side, external debt metrics are healthy and financing needs, although high, will continue to be absorbed by the domestic market.

Outlook: The outlook for the Brazilian economy is positive. Over the short-term, downside risks include the uncertainty about the magnitude of the global slowdown, as well as the tradeoff between stimulating the economy while maintaining fiscal accounts and inflation in check. The government also needs to prevent the formation of asset bubbles in the economy while banking regulators deal with rising household indebtedness and debt servicing costs relative to income. In the medium-term, both private and public consumption will continue to grow faster than GDP, posing pressures on domestic production capacity and prices. More investment will be needed to keep up with increasing domestic demand. Some structural reforms need to be undertaken to ensure sustainable growth and improve fiscal accounts. The FIFA World Cup and the Olympics will offer excellent opportunities for exporters and investors in Brazil over the next 5-7 years.

Economic Indicators

	2006-2010 avg	2011(e)	2012(f)	2013(f)
Real GDP (%)	4.5%	3.0%	3.1%	4.1%
Inflation (CPI, %)	4.7%	6.6%	5.5%	5.5%
Budget Balance (% of GDP)	-2.7%	-2.6%	-2.4%	-2.2%
Export of goods (%)	13.1%	27%	3%	6%
Import of goods (%)	23.1%	23.7%	9%	12%
Current Account Balance (% of GDP)	-0.8%	-2.2%	-3.6%	-3.6%
Reserves (months of current account)	10.1	11.8	10.2	9.6
External Debt (% of GDP)	16.9%	16.3%	15.3%	14.4%
Debt service ratio, due (%)	26.18%	25.7%	28.3%	26.7%
Exchange rate (LCU/US\$, avg)	1.9	1.7	1.8	1.8

Brazil's Current Account Balance (US\$ mn) vs Real



Source: Brazil Central Bank. HAVER Analytics

Sources : EIU, EDC Economics

Political

Political Structure

Federal Republic; currently ruled by a 10-party coalition representing 70% of Congress

President

Dilma Rousseff (PT)

Vice President

Michel Temer (PMDB)

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 (88/14)
- Partido do Movimento Democrático Brasileiro - PMDB (79/21)
- Partido da Social Democracia Brasileiro - PSDB (53/10)
- Democrats (DEM)(43/6)
- Total (513/81 seats). More than 20 parties are represented in the Chamber of Deputies, and 14 parties in the Senate.

Last Elections

- Presidential and Legislative: October 2010

Next Elections

- Presidential and Legislative: October 2014

Press Freedom Survey

- 2011 Score: 43 (Partly Free) (0: Free; 100: Not Free)
FreedomHouse.org

Control of Corruption Index:

- 2010 Score: -0.06 (-2.5: Worst; +2.5: Best)
World Bank Governance Indicators

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General Political Environment: Brazilian politics are characterized by a partisan 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. In addition, a tradition of switching parties has made party politics and political strength in Congress fluid. In 2007 the Supreme Court barred members of Congress from party-hopping; however this has yet to forge stronger party loyalty.

Political progress requires constant horse-trading that slows the passage of fundamental reforms such as tax policies, widely considered necessary to maintain fiscal sustainability and to accelerate growth to a level that will continue to move Brazil forward. A difficult balancing between promoting business and making progress on social issues undermines the government's ability to meet expectations on all fronts.

President Dilma Rousseff took office January 1st, 2011 backed by a ten-party coalition representing 70% of Congress. Like her mentor, former-President Luiz Inácio Lula da Silva, Rousseff faces challenges maintaining a cohesive alliance particularly with the centrist *Partido do Movimento Democrático Brasileiro* (PMDB). The PMDB will jockey for political posts since it holds the most seats in the ruling congressional alliance (across both Chambers) as well as in the Senate. However, in Brazil's fragmented Congress the party's absolute number of seats is fairly small. Rousseff is considered a competent technocrat.

Rousseff's administration has been so far characterized by economic policy continuity, as her government is taking steps to keep inflation low and government spending under control.

Although Brazil's ratings for control of corruption (see sidebar) are improving, corruption is an ongoing concern. It is more visible now than in the past because of increased transparency and willingness to prosecute. During his presidency Lula remained skillfully at arm's length of the various corruption scandals that touched many of his close allies and PT party. Although Rousseff does not share Lula's level of popularity yet she has managed to emerge relatively unscathed from the resignation of many of her ministers since June 2011 over allegations of corruption.

Investment Environment: Brazil is a poster child for the moderate left in Latin America, promoting policies that strengthen the investment environment. This said, Lula advocated for both government participation in the economy and respect for investors' contractual rights; he actively promoted public-private partnerships, not privatizations, to attract private capital. Rousseff has continued this approach which functions as a moderate disincentive to investment. The government is adopting a model for oil investments that features a high level of government participation in exploiting huge new reserves.

Despite significant progress in the liberalization of the foreign exchange regime, important residual controls remain. Weak regulation and cumbersome bureaucracy are hallmarks. According to the World Bank's *2011 Doing Business* survey, starting a business in Brazil takes 120 days against a regional average of 56.7 days, an example of what is widely referred to as the "Brazil Cost" of doing business in the country. The judicial system is regarded as fair, but slow and complex.

Political Violence: The main source of violence in Brazil is criminal rather than political. Personal security is poor as there is an extremely high rate of criminal activity in major cities, where 25% of the population is believed to live in *favelas* or shantytowns. Lula's social policies made marked progress towards reducing inequalities in Brazil, but only concerted work will improve conditions.

An 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 known as the Landless Workers' Movement (MST) highlight the issue.

Political Outlook

State intervention in the economy is likely to continue with Brazil's policy of supporting "national champions" – companies that can perform well in both the domestic and international spheres. Lula set Brazil on a path of regional leadership and increasing influence on the world stage. However, increased power will likely come with increased responsibility that will limit Brazil's ability to appear as an ideal mediator that is friendly with nations of all ideologies. Major infrastructure spending and security demands loom in advance of the 2014 World Cup and 2016 Olympics. Rousseff needs to meet these challenges while delivering key social pledges in order to ensure that these issues have no serious effects on her popularity.