Fitch Revises Brazil' Outlook to Positive, Affirms 'BB' Ratings

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Fitch Ratings-New York-05 February 2007: Fitch Ratings today revised the Outlook on Brazil's long-term foreign and local currency sovereign Issuer Default Ratings to Positive from Stable, while affirming both ratings at 'BB'. The agency also affirmed Brazil's Short-term IDR at 'B' and the Country Ceiling at 'BB+'. 'The rapid improvement in Brazil's external balance sheet, notably its shift in 2006 to being a net public external creditor, raises the likelihood of an upgrade over the next two years,' said Roger Scher, Managing Director for Latin American Sovereign Ratings, 'as long as public finances do not deteriorate.' Fitch estimates that a key external solvency measure, external debt net of liquid external assets (NXD) fell to 49.3% of current external receipts (CXR) by year-end 2006, from 78.8% in 2005, on a stronger-than-anticipated current account surplus and substantial capital inflows. While this ratio still exceeds both the 'BB' and 'BBB' medians (39.4% and 28.8%, respectively), persistent current account surpluses have underpinned a more rapid improvement in this ratio in Brazil, which should continue in the near future. 'The public sector has shifted from net external debtor to net external creditor,' said Scher, 'which compares favorably with peer sovereigns.' Official foreign exchange reserves rose to US$91.6 billion by early February. The government's liability management, featuring external debt buybacks and the reduction of foreign exchange-linked obligations, has helped reduce the public sector's exposure to exchange rate risk and external creditors. Moreover, sound macroeconomic policies in recent years have underpinned disinflation in Brazil, with IPCA consumer price inflation finishing 2006 at 3%. 'On the other hand, the overall government debt burden remains high and fell only marginally in 2006, in part due to some fiscal policy slippage,' added Scher. The non-financial public sector (NFPS) primary budget surplus slipped to 4.32% of GDP in 2006 from 4.83% in 2005. Real growth of central government spending (10.5% in 2006) rose faster than revenues (8%) on a combination of public wage and employment growth and expansion of social programs. The authorities have announced their intention to deduct up to 0.5% of GDP from the NFPS primary surplus target of 4.25% of GDP in 2007 due to increased investment outlays. On the other hand, they have announced measures to control public and minimum wage growth. 'Brazil is an outlier relative to peers in terms of its government debt burden,' said Scher, 'and robust primary surpluses as well as structural reforms that would release the country's growth potential are needed to get the debt to GDP ratio on a rapid downward trajectory.' Fitch estimates that gross general government debt to GDP ended 2006 at 74.9%, versus 'BB' and 'BBB' medians of 40.4% and 34%, respectively. The government tax burden, which may have reached a high of 39% of GDP in 2006, squelches growth in the formal economy. GDP growth is low in Brazil relative to peers, averaging 2.5% per year over the last five years, versus 5% and 4.8% for the 'BB' and 'BBB' medians, respectively. Public expenditure control could provide room to reduce the tax burden. Likewise, other measures that would underpin improved public debt dynamics and growth prospects include reforms to social security, sales taxes, the labor market, trade policy, the central bank and the banking sector; yet it will prove challenging for President Lula, reelected to a second four-year term in October, to pass these measures in Brazil's fractious congress. Finally, capital inflows picked up in 2006, including some US$12 billion into Brazil's fixed income market and US$7.7 billion into equities. Brazil's official reserve position remains formidable relative to these flows, evidenced in a 2007 external liquidity ratio of 158.4% versus 175.2% and 137.1% for 'BB' and 'BBB' medians, respectively. However, non-resident investors have taken positions in Brazil's on-shore yield curve via derivatives, which could introduce volatility in the foreign exchange and government securities markets should sentiment in Brazil and emerging markets more broadly deteriorate. Sustained macroeconomic stability, underpinned by low inflation and fiscal discipline, would support an improvement in Brazil's sovereign creditworthiness over the medium-term. However, material fiscal slippage and weaker macroeconomic performance than expected would undermine the

prospects for a sovereign rating upgrade, given the still high government debt burden. Contact: Roger M. Scher +1-212-908-0240 or Shelly Shetty +1-212-908-0324, New York