

Fitch: Brazil's Elections Fail to Produce Reform Mandate

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Fitch Ratings-New York-October 4, 2006: This is a correction for a previous message. It corrects the headline in the release. Brazil's first-round national elections on Sunday, October 1st yielded a deeply divided Congress lacking clear coalitions, making the prospect for economic reform challenging. Fitch Ratings last upgraded Brazil's sovereign ratings (long-term foreign and local currency Issuer Default Ratings (IDR)) to 'BB' from 'BB-' in June, reflecting the improvement in the country's external finances, especially the sharp reduction in the public sector's external exposure. The Outlook on the Ratings is Stable. Nevertheless, uncertain prospects in the next government for the passage of a pro-growth reform agenda, as well as likely pressures to loosen macroeconomic policies, could slow improvement in Brazil's sovereign creditworthiness. President Lula failed to win a second term Sunday in the first round of voting, and none of the major political parties won unambiguously in Congressional elections. By only obtaining 48.6% of the votes, Lula, of the ruling leftist PT party, will have to face his principal opponent, Geraldo Alckmin of the opposition PSDB party, who obtained 41.6% of the votes, in a run-off on October 29th. 'Whether Alckmin or Lula wins in the second round,' said Roger Scher, head of Latin American sovereign ratings at Fitch, 'the next president will have great difficulty forging a reform coalition.' The centrist PMDB party gained seats in the lower house of Congress and has become the largest single party in that chamber. Not currently affiliated with either the government or the opposition, the PMDB could be the key to governing Brazil in the next four years. Yet even this party lost seats in the Senate (upper house), yielding its leadership position to the PFL, one of the principal opposition parties. The current coalition of opposition parties headed by the PSDB gained seats in the lower house, but fell some 30 seats short of the ruling PT coalition, which with 223 seats is itself short of a simple majority. Furthermore, a new electoral rule (the 'minimum barrier clause') will penalize parties that failed to meet a minimum threshold of votes, making existing coalitions untenable. Hence, either Alckmin or Lula as president will not only have to lure the PMDB party into a coalition, but will have to appeal to opposition parties to obtain the votes of 60% of both chambers necessary to reform the constitution. Brazil's constitution regulates minute aspects of public policy, necessitating constitutional amendments for ordinary economic reforms. 'In order to maintain the current level of taxation and ensure spending flexibility,' said Scher, 'Constitutional amendments extending the term of the CPMF financial transactions tax and the DRU de-earmarking provision, both of which expire in 2007, will be needed.' Fitch's upgrade of Brazil's sovereign ratings last June reflected not only improved external finances, but also the assumption that the country's sound macroeconomic policy settings would continue into the next administration. The commitment to a sizable primary budget surplus target, currently at 4.25% of GDP, to a prudent inflation-targeting monetary policy, and to a flexible exchange rate has underpinned lower inflation and a decline in real interest rates in recent years. Yet public spending growth has been very strong in this election year, with real federal spending rising 9.6% in 1H06. The incoming government will likely have to apply the brakes on spending in order to ensure meeting the primary surplus target next year. Any further unwinding of the commitment to sound macro policies in the coming years would result in a deterioration in sovereign creditworthiness. Fitch will closely monitor the next government's choices to fill key economic policy posts, as well as their statements about the continuity of macro policies. 'Over the longer term, however,' said Scher, 'good macro policies are not enough. Pro-growth reforms are the only way to get Brazil's heavy government debt burden, which stands at 70%-75% of GDP, on a clear downward path. And that is the only way for Brazil to experience marked improvement in sovereign creditworthiness.' The list of reforms that would improve growth prospects and public debt dynamics is well-known: central bank independence; social security reform; a more pro-business tax regime and ultimately a lower tax burden; permanent de-earmarking of revenues and broad spending control; labor

reform easing restrictions on hiring and firing; microeconomic reforms and policies promoting infrastructure investment; and reforms encouraging financial sector competition. Given Brazil's heavy electoral calendar, early passage of reforms is critical to a new government's success. In addition to economic reform, sovereign creditworthiness in Brazil would be served by a political reform that strengthens political parties and reduces the current fragmentation of power, which would enhance the prospects for substantive public policy action. Contact: Roger M. Scher +1-212-908-0240 or Morgan C. Harting, +1-212-908-0820, New York. Fitch's rating definitions and the terms of use of such ratings are available on the agency's public site, 'www.fitchratings.com'. Published ratings, criteria and methodologies are available from this site, at all times. Fitch's code of conduct, confidentiality, conflicts of interest, affiliate firewall, compliance and other relevant policies and procedures are also available from the 'Code of Conduct' section of this site. Media Relations: Chris Kimble +1-212-908-0226, New York