Fitch: Palocci Successor Should Keep Brazil's 4.25% GDP Surplus

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Fitch Ratings-New York-28 March 2006: Maintaining the Brazilian government's 4.25% of GDP primary budget surplus target, in spite of Finance Minister Antonio Palocci's stepping down, will be important to ensuring that fiscal restraint continues in Brazil, one of the cornerstones of improvements in sovereign creditworthiness in recent years, according to Fitch Ratings. Fitch currently rates Brazil as follows: --Foreign currency Issuer Default Rating (IDR) 'BB-'; --Local currency Issuer Default Rating (IDR) 'BB-'; --Rating Outlook Positive. 'The continuity of sound macroeconomic policies through personnel changes is critical to improving sovereign creditworthiness in an emerging market economy such as Brazil,' said Roger Scher, Managing Director, Latin American Sovereigns, Fitch Ratings. Finance Minister Palocci has been a linchpin of fiscal policy in the Lula government, the architect of policies that helped yield primary surplus performance in excess of the 4.25% of GDP target for the non-financial public sector over the three years of President Lula's administration, including 4.84% achieved last year. Given Brazil's very high debt burden and poor GDP growth record, any relaxation of the fiscal targets would send the wrong policy signal, put the debt to GDP ratio (75.2% last year) on an upward trajectory, and could create difficulties for the government in the domestic debt auctions, where over a third of the domestic debt is rolled over every twelve months. 'Recent spending pressures, including from the proposed minimum wage hike, have been a cause for concern as well,' said Scher. Likewise the Finance Minister is a member of the National Monetary Council that sets the inflation targets for the central bank. Any slippage in these targets could jeopardize monetary policy credibility. 'Any weakening in the credibility of monetary policy will make it harder to sustain further reductions in real interest rates necessary to fundamentally improve Brazil's public debt dynamics, which remain a constraint on Brazil's sovereign ratings,' said Scher. Positive trends in Brazil's sovereign creditworthiness have been seen in recent months. A declining exposure of the public sector to foreign exchange risk and to international creditors is one such development. This has been evidenced by a decline in the ratio of Net Public External Debt to Current External Receipts to 23.9% at end 2005, down from 53.3% in 2004 but still above the BB median of 17.3%. In addition, the decline in dollar-linked domestic debt to near zero has reduced the sovereign's exposure to exchange rate risk. The government's external debt buyback program announced in February and the paydown of IMF obligations late last year will reduce its external debt service burden in the coming years. Moderating inflation expectations and declining real interest rates have buoyed Brazil's credit story as well in recent months. With expectations for lower inflation (2006 IPCA inflation is expected to hit close to the 4.5% central bank target), Brazil's central bank cut interest rates 300 bps since last October when Fitch revised the Outlook on Brazil's ratings to Positive. As a result, the real interest rate has fallen from 14.8% to a still-high 12.2% currently. Yet the Bazilian Real strengthened 3.5% against the US dollar since that time, even as US interest rates moved higher. With solid balance of payments performance, external debt ratios moving lower, and inflation under control, real interest rates could continue to fall. This of course assumes there is no additional risk premium required due to increased risks to the macro policy framework. Fitch will monitor developments in macroeconomic policy in the wake of Palocci's stepping down and other potential changes in the economic team. Likewise the October 2006 elections, no matter who the victors are, will determine the scope for reform in the government that takes office in January 2007. The incoming government, no matter whether it is led by President Lula in a second term or someone from the opposition, will be challenged to assemble a coalition in Brazil's historically fragmented Congress to pass reforms that will support non-inflationary growth as well as a downward trend in the public debt to GDP ratio. Contact: Roger M. Scher +1-212-908-0240 or Morgan Harting +1-212-908-0820, New York. Media Relations: Christopher Kimble, New York, Tel: +1 212-908-0226. Fitch's rating definitions and the terms of use of

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