

# Brazil

February 2016

## *Country Report*

Published by  
The PRS Group, Inc.  
5800 Heritage Landing Dr., Suite E  
East Syracuse, NY 13057-9378, USA  
Tel: +1 (315) 431-0511 • Fax: +1 (315) 431-0200  
e-mail: [custserv@prsgroup.com](mailto:custserv@prsgroup.com)  
[www.PRSGroup.com](http://www.PRSGroup.com)

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**BRAZIL**

**ISSN: 1054-528X**

**Printed in U.S.A.**

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# Brazil

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# Brazil

## Country Forecast Highlights

MOST LIKELY REGIMES AND THEIR PROBABILITIES	
<b>18-Month:</b>	*Divided Government 45%
<b>Five-Year:</b>	*Centrist Coalition 45%

FORECASTS OF RISK TO INTERNATIONAL BUSINESS				
	Turmoil	Financial Transfer	Direct Investment	Export Market
<b>18-Month:</b>	High (Moderate)	C+ (B-)	B	B
<b>Five-Year:</b>	Moderate	C+ (B-)	B (B-)	B-

( ) Indicates change in rating.

\* Indicates forecast of a new regime.

KEY ECONOMIC FORECASTS			
Years	Real GDP Growth %	Inflation %	Current Account (\$bn)
2011-2015(AVG)	1.1	6.7	-70.43
2016(F)	-1.8	8.0	-63.15
2017-2021(F)	2.1	5.5	-77.20

## Political Uncertainty Will Persist

### Key Points To Watch...

- ✓ A convergence of political and economic crises has left President Dilma Rousseff fighting for her political life barely a year after she was sworn in for a second four-year term in early 2015. With her approval rating near single digits, Rousseff lacks the political authority to pressure lawmakers to approve measures required to create the foundation for an economic recovery, and a looming breakup of the political marriage between Rousseff's PT and Vice President Michel Temer's PMDB will leave her with no defense against impeachment proceedings initiated in late 2015...
- ✓ At this point, a change of government will likely have a positive effect on investor sentiment, but there are no guarantees that Rousseff's departure will bring an end to political uncertainty and legislative gridlock. The prospects for restoring stability at the center will be brighter beyond the 18-month forecast period, as the holding of regularly scheduled presidential and legislative elections in the fall of 2018 will create an opportunity for the main opposition PSDB to win a strong mandate with the congressional heft to match. But even in that case, forming a viable majority coalition may be difficult...
- ✓ Any government holding power in the near term will of necessity grant high priority to reducing a budget deficit that ballooned to more than 10% of GDP in 2015. The risk of

inaction was highlighted by Standard and Poor’s recent decision to downgrade Brazil’s bond rating for the second time in five months, which was accompanied by a warning that the sovereign rating would be downgraded deeper into junk status if the government fails to bring the deficit under control. The implied increase in the cost of state borrowing will make it harder to convince investors that the government can get its fiscal house in order, and doubts in that regard will complicate the task of stabilizing the real, which depreciated by more than 30% against the US dollar in 2015, hampering the central bank’s efforts to contain inflation...

**Timid Approach to Reform Will Blunt Recovery**

- ✓ Privatization can be expected to figure more prominently in the deficit-reduction program of a government headed by either the PMDB or the PSDB than has been the case under the PT, which promoted an expanded economic role for the public sector in key industries. Linking the sale of state-owned assets to a broader battle to root out corruption may help to dampen public opposition to divestment. However, given the continued division of legislative power among numerous parties spread across the ideological spectrum, the scope for the aggressive implementation of liberal reforms will remain limited in the near term...
- ✓ The policies of a centrist regime formed after the 2018 elections will for the most part differ from those of a PT-led administration in degree, rather than in kind. A majority centrist coalition will be less sensitive to pressure for populist spending initiatives that might impede efforts to rein in the budget deficit, but tax increases will likely be a component of a PSDB-led government’s strategy for easing fiscal strains and addressing debt-related concerns...
- ✓ With prices for commodity exports showing no sign of recovery and political uncertainty denting business and consumer confidence, another annual contraction is all but assured in 2016. The central bank has held the Selic rate steady since late July, but pressure on the currency points to a high probability of a near-term hike. Additional monetary tightening may help to hold inflation to single digits, but rate hikes will hamper the government’s efforts to reverse the economic decline...
- ✓ Economic prospects over the medium term will depend on both a sustained recovery in commodity prices and the government’s ability to make headway on structural reforms. Assuming the maintenance of a generally pro-market stance—the prospects for which are boosted by the expected election of a centrist government in 2018—inflows of FDI will be sufficient to produce positive real GDP growth of 2%–3% in the second half of the five-year forecast period, but the pace of expansion will average just 2.1% through 2021. Faster growth is possible if the government manages to overcome the political obstacles to establishing a solid legal foundation for investment in mining fairly early in the forecast period, but progress is not likely on that front until after the 2018 elections.

**Economic Forecasts for the Three Alternative Regimes**

	Centrist Coalition			Divided Government			Center-Left Coalition		
	Growth (%)	Inflation (%)	CACC (\$bn)	Growth (%)	Inflation (%)	CACC (\$bn)	Growth (%)	Inflation (%)	CACC (\$bn)
<b>2016</b>	-1.8	8.0	-63.15	-1.2	7.8	-67.30	-2.2	8.8	-55.30
<b>2017-2021</b>	2.1	5.5	-77.20	0.8	6.4	-68.40	1.4	6.2	-85.60

## Political Fact Sheet

**CAPITAL:**

Brasilia

**CONSTITUTION:**

October 5, 1988

**ADMINISTRATIVE SUBDIVISIONS:**

23 states, 3 territories, 1 federal district

**POPULATION:**

2015: 203.65 million

**AREA:**

8,511,965 sq. km.

**OFFICIAL LANGUAGE:**

Portuguese

**STATUS OF PRESS:**

free

**SECTORS OF GOVERNMENT**
**PARTICIPATION:**

petroleum refining, utilities, transportation, finance, mining, petrochemicals

**CURRENCY EXCHANGE SYSTEM:**

free-floating

**EXCHANGE RATE:**

1/27/2016 \$1=4.086 reais

**ELECTIONS:**

Presidential elections are held every four years; last, October 5 and 26, 2014; next, scheduled October 2018. Senate members serve eight-year terms; elections held on a staggered basis; last, October 5, 2014; next, scheduled October 2018. Elections for the Chamber of Deputies are held every four years; last, October 5, 2014; next, scheduled October 2018.

**HEAD OF STATE:**

President Dilma Rousseff (2011)

**HEAD OF GOVERNMENT:**

President Rousseff (2011)

**OFFICIALS:**

Michel Temer, Vice President

Katia Abreu, Agriculture

Andre Figueiredo, Communications

Aldo Rebelo, Defense

Armando Monteiro, Development, Trade & Industry

Nelson Barbosa, Finance

Mauro Luiz Vieira, Foreign Affairs

José Eduardo Cardozo, Justice

Eduardo Braga, Mines & Energy

Gilberto Magalhaes Occhi, National Integration

Valdir Simão, Planning & Budget

Celso Pansera, Science & Technology

Tereza Campelo, Social Development

Miguel Rossetto, Social Security & Labor

Henrique Lyra Alves, Tourism

Antonio Rodrigues, Transportation

Alexandre Tombini, President, Central Bank

**LEGISLATURE:**

Bicameral National Congress: 81-member Senate and 513-member Chamber of Deputies. Seat distribution in the Senate: Brazilian Democratic Movement Party (PMDB), 18; Workers' Party (PT), 14; Brazilian Social Democracy Party (PSDB), 11; Democratic Labor Party (PDT), 6; Brazilian Socialist Party (PSB), 6; Progressive Party (PP), 5; Democrats, 5; Republic Party (PR), 4; Social Democratic Party (PSD), 4; other, 8. Seat distribution in the Chamber: PMDB, 67; PT, 64; PSDB, 53; PP, 40; PR, 34; PSD, 34; PSB, 32; PTB, 25; Democrats, 22; Brazilian Republican Party (PRB), 20; PDT, 19; Solidarity (SD), 16; Social Christian Party (PSC), 13; Communist Party of Brazil (PC do B), 13; Republican Party of the Social Order (PROS), 12; Socialist People's Party (PPS), 11; other, 38.

# Brazil Databank

	2006-2010 Average	2011-2015 Average	2006	2007	2008	2009	2010
<b>Domestic Economic Indicators</b>							
GDP (Nominal, \$bn)	1615.41	2342.51	1107.79	1397.16	1695.64	1667.35	2209.12
Per Capita GDP (\$)	8403	11709	5888	7353	8842	8617	11317
Real GDP Growth Rate (%)	4.5	1.1	4.0	6.1	5.1	-0.1	7.5
Inflation Rate (%)	4.7	6.7	4.2	3.6	5.6	4.9	5.0
Capital Investment (\$bn)	288.66	417.25	179.00	238.39	315.99	292.80	417.12
Capital Investment/GDP (%)	17.7	17.9	16.2	17.1	18.6	17.6	18.9
Budget Revenues (\$bn)	369.15	544.44	249.02	317.02	389.59	368.73	521.37
Budget Revenues/GDP (%)	22.8	23.5	22.5	22.7	23.0	22.1	23.6
Budget Expenditures (\$bn)	402.85	638.90	280.45	342.59	409.57	424.63	557.02
Budget Expenditures/GDP (%)	24.9	27.9	25.3	24.5	24.2	25.5	25.2
Budget Balance (\$bn)	-33.71	-94.46	-31.43	-25.57	-19.98	-55.90	-35.65
Budget Balance/GDP (%)	-2.2	-4.4	-2.8	-1.8	-1.2	-3.4	-1.6
Money Supply (M1, \$bn)	121.04	147.03	80.16	118.86	121.83	124.11	160.25
Change in Real Wages (%)	2.3	-1.6	7.7	-0.4	0.6	2.8	0.8
Unemployment Rate (%)	8.4	5.7	10.0	9.3	7.9	8.1	6.7
<b>International Economic Indicators</b>							
Foreign Direct Investment (\$bn)	34.58	71.51	18.78	34.59	45.06	25.95	48.51
Forex Reserves (\$bn)	193.98	351.75	85.15	179.43	192.84	231.89	280.57
Gross Reserves (ex gold, \$bn)	196.37	358.37	85.16	179.43	192.84	237.36	287.06
Gold Reserves (\$bn)	1.04	2.53	0.68	0.90	0.94	1.18	1.52
Gross reserves (inc gold, \$bn)	197.41	360.90	85.84	180.33	193.78	238.54	288.58
Total Foreign Debt (\$bn)	310.92	617.72	217.54	261.55	289.39	333.46	452.67
Total Foreign Debt/GDP (%)	19.2	27.1	19.6	18.7	17.1	20.0	20.5
Debt Service (\$bn)	16.95	28.58	25.45	18.50	12.06	14.96	13.76
Debt Service/XGS (%)	8.5	10.4	15.1	9.2	4.9	7.7	5.6
Current Account (\$bn)	-16.92	-70.43	13.62	1.55	-28.19	-24.30	-47.27
Current Account/GDP (%)	-0.8	-3.0	1.2	0.1	-1.7	-1.5	-2.1
Current Account/XGS (%)	-6.8	-25.0	8.1	0.8	-11.4	-12.5	-19.2
Exports (\$bn)	170.26	230.46	137.81	160.65	197.94	153.00	201.92
Imports (\$bn)	138.91	220.89	91.35	120.62	173.11	127.71	181.77
Trade Balance (\$bn)	31.35	9.57	46.46	40.03	24.83	25.29	20.15
Exports of Services (\$bn)	26.64	38.24	19.46	23.95	30.45	27.73	31.60
Income, credit (\$bn)	9.34	11.18	6.44	11.49	12.51	8.83	7.41
Transfers, credit (\$bn)	4.93	4.77	4.85	4.97	5.32	4.74	4.78
Exports G&S (\$bn)	211.17	284.65	168.56	201.06	246.22	194.30	245.71
Liabilities (\$bn)	8.95	7.76	3.83	15.09	8.97	7.38	9.47
Net Reserves (\$bn)	188.47	353.14	82.01	165.24	184.81	231.16	279.11
Liquidity (months import cover)	16.0	19.4	10.8	16.4	12.8	21.7	18.4
Currency Exchange Rate	1.943	2.294	2.175	1.947	1.834	1.999	1.759
Currency Change (%)	6.0	-14.6	10.6	10.5	5.8	-9.0	12.0
<b>Social Indicators</b>							
Population (million)	191.72	200.33	188.13	190.00	191.77	193.49	195.21
Population Growth (%)	1.0	0.9	1.1	1.0	0.9	0.9	0.9
Infant Deaths/1000	26	19	30	28	28	23	22
Persons under Age 15 (%)	26	24	26	25	25	27	27
Urban Population (%)	84	86	83	84	84	85	86
Urban Growth (%)	1.7	0.9	1.1	2.2	0.9	2.1	2.1
Literacy % pop.	89	91	86	89	89	91	90
Agricultural Work Force (%)	20	18	20	20	20	20	20
Industry-Commerce Work Force (%)	14	13	14	14	14	14	14
Services Work Force (%)	66	69	66	66	66	66	66
Unionized Work Force (%)	18	18	19	18	19	18	18
Energy - total consumption (10 <sup>15</sup> Btu)	10.43	12.24	9.69	10.13	10.47	10.39	11.46
Energy - consumption/head (10 <sup>9</sup> Btu)	0.05	0.06	0.05	0.05	0.05	0.05	0.06



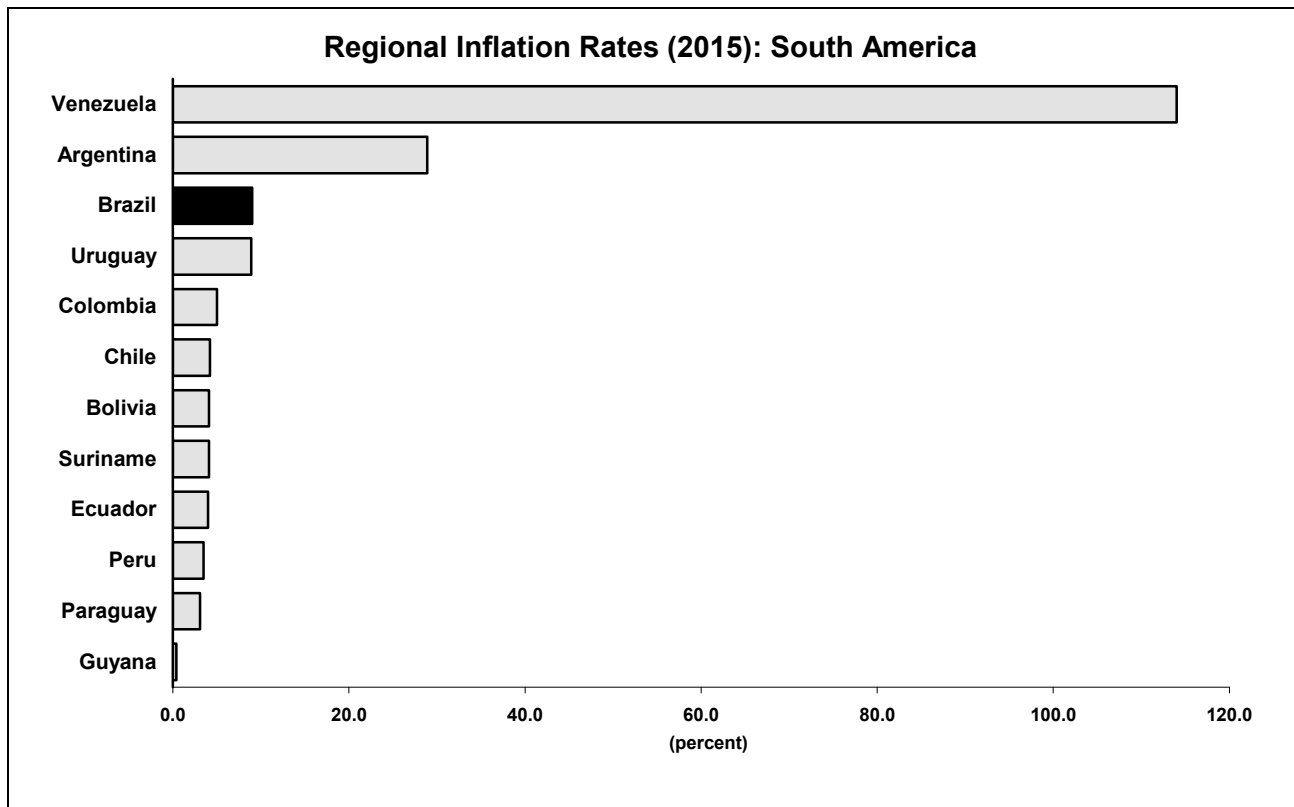
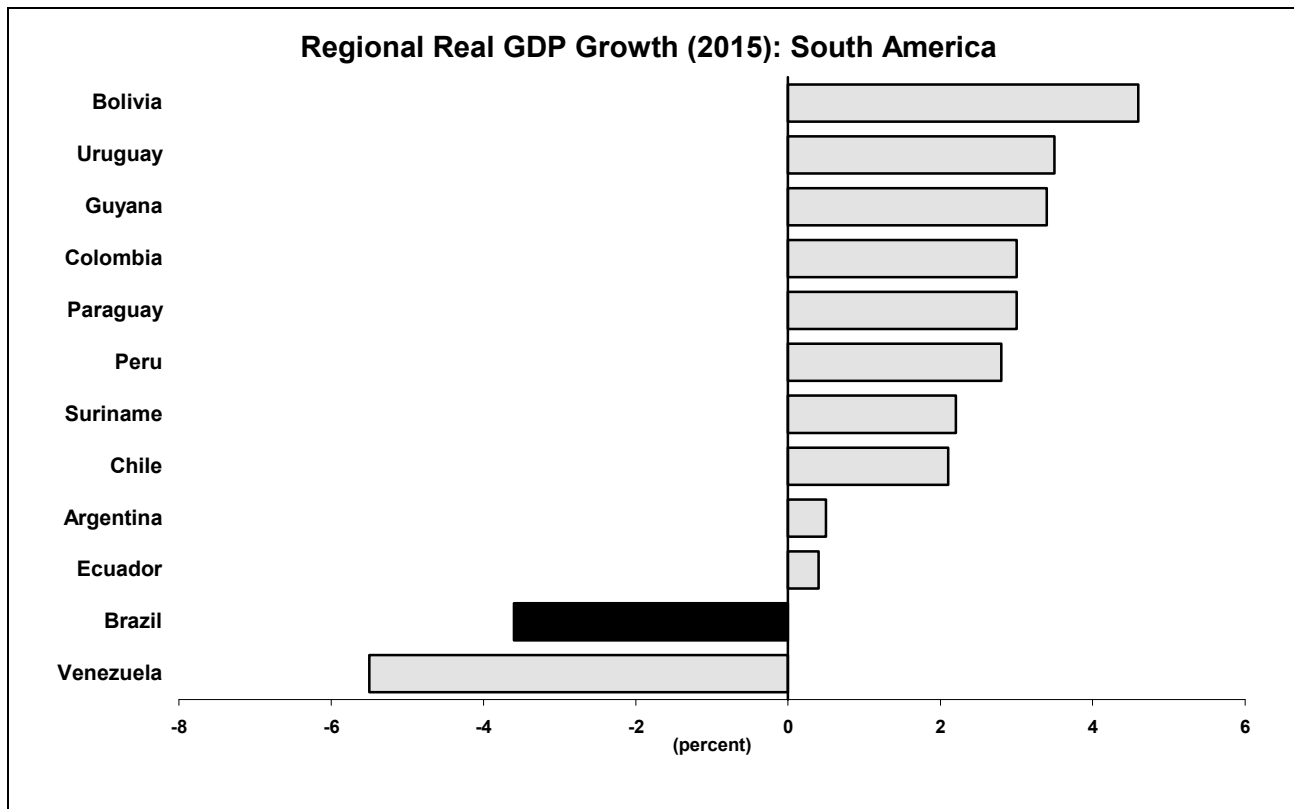
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Per Capita GDP (\$)	8403	11709	13274	12368	12273	12005	8627
Real GDP Growth Rate (%)	4.5	1.1	3.9	1.9	3.0	0.1	-3.6
Inflation Rate (%)	4.7	6.7	6.6	5.4	6.2	6.4	9.0
Capital Investment (\$bn)	288.66	417.25	477.42	408.33	410.26	464.87	325.35
Capital Investment/GDP (%)	17.7	17.9	18.3	16.6	16.7	19.2	18.5
Budget Revenues (\$bn)	369.15	544.44	589.99	547.75	565.88	520.59	498.00
Budget Revenues/GDP (%)	22.8	23.5	22.6	22.3	23.0	21.5	28.3
Budget Expenditures (\$bn)	402.85	638.90	653.94	591.86	630.34	644.67	673.70
Budget Expenditures/GDP (%)	24.9	27.9	25.0	24.1	25.6	26.6	38.4
Budget Balance (\$bn)	-33.71	-94.46	-63.95	-44.11	-64.46	-124.08	-175.70
Budget Balance/GDP (%)	-2.2	-4.4	-2.5	-1.8	-2.6	-5.1	-10.0
Money Supply (M1, \$bn)	121.04	147.03	170.58	166.18	159.35	149.74	89.29
Change in Real Wages (%)	2.3	-1.6	-0.3	0.9	3.3	-4.1	-7.9
Unemployment Rate (%)	8.4	5.7	6.0	5.5	5.4	4.8	6.9
<b>International Economic Indicators</b>							
Foreign Direct Investment (\$bn)	34.58	71.51	66.66	65.27	64.00	96.85	64.78
Forex Reserves (\$bn)	193.98	351.75	343.38	362.10	349.03	354.81	349.44
Gross Reserves (ex gold, \$bn)	196.37	358.37	350.36	369.57	356.21	360.97	354.72
Gold Reserves (\$bn)	1.04	2.53	1.65	3.58	2.59	2.56	2.29
Gross reserves (inc gold, \$bn)	197.41	360.90	352.01	373.15	358.80	363.53	357.01
Total Foreign Debt (\$bn)	310.92	617.72	515.97	570.75	621.31	712.52	668.07
Total Foreign Debt/GDP (%)	19.2	27.1	19.7	23.2	25.3	29.4	38.0
Debt Service (\$bn)	16.95	28.58	13.33	25.62	33.23	26.22	44.50
Debt Service/XGS (%)	8.5	10.4	4.3	8.6	11.2	9.3	18.8
Current Account (\$bn)	-16.92	-70.43	-52.47	-54.25	-81.23	-104.84	-59.34
Current Account/GDP (%)	-0.8	-3.0	-2.0	-2.2	-3.3	-4.3	-3.4
Current Account/XGS (%)	-6.8	-25.0	-16.9	-18.2	-27.4	-37.2	-25.1
Exports (\$bn)	170.26	230.46	256.04	242.58	242.03	224.65	187.01
Imports (\$bn)	138.91	220.89	226.25	233.18	239.75	230.89	174.39
Trade Balance (\$bn)	31.35	9.57	29.79	9.40	2.28	-6.24	12.62
Exports of Services (\$bn)	26.64	38.24	38.21	39.86	39.13	40.17	33.82
Income, credit (\$bn)	9.34	11.18	10.75	10.89	10.07	12.85	11.34
Transfers, credit (\$bn)	4.93	4.77	4.92	4.63	5.48	4.27	4.55
Exports G&S (\$bn)	211.17	284.65	309.92	297.96	296.71	281.94	236.72
Liabilities (\$bn)	8.95	7.76	9.27	5.35	8.69	5.54	9.94
Net Reserves (\$bn)	188.47	353.14	342.74	367.80	350.11	357.99	347.07
Liquidity (months import cover)	16.0	19.4	18.2	18.9	17.5	18.6	23.9
Currency Exchange Rate	1.943	2.294	1.673	1.956	2.162	2.345	3.332
Currency Change (%)	6.0	-14.6	4.9	-16.9	-10.5	-8.5	-42.1
<b>Social Indicators</b>							
Population (million)	191.72	200.33	196.94	198.66	200.36	202.03	203.65
Population Growth (%)	1.0	0.9	0.9	0.9	0.9	0.8	0.8
Infant Deaths/1000	26	19	21	18	20	19	19
Persons under Age 15 (%)	26	24	26	25	24	24	23
Urban Population (%)	84	86	87	85	85	85	86
Urban Growth (%)	1.7	0.9	2.1	-1.4	0.9	0.8	2.0
Literacy % pop.	89	91	90	90	90	93	93
Agricultural Work Force (%)	20	18	20	20	16	16	16
Industry-Commerce Work Force (%)	14	13	14	14	13	13	13
Services Work Force (%)	66	69	66	66	71	71	71
Unionized Work Force (%)	18	18	18	18	18	18	18
Energy - total consumption (10 <sup>15</sup> Btu)	10.43	12.24	11.89	12.10	12.31	12.33	12.56
Energy - consumption/head (10 <sup>9</sup> Btu)	0.05	0.06	0.06	0.06	0.06	0.06	0.06

# Brazil Country Forecast

29-Feb-2016

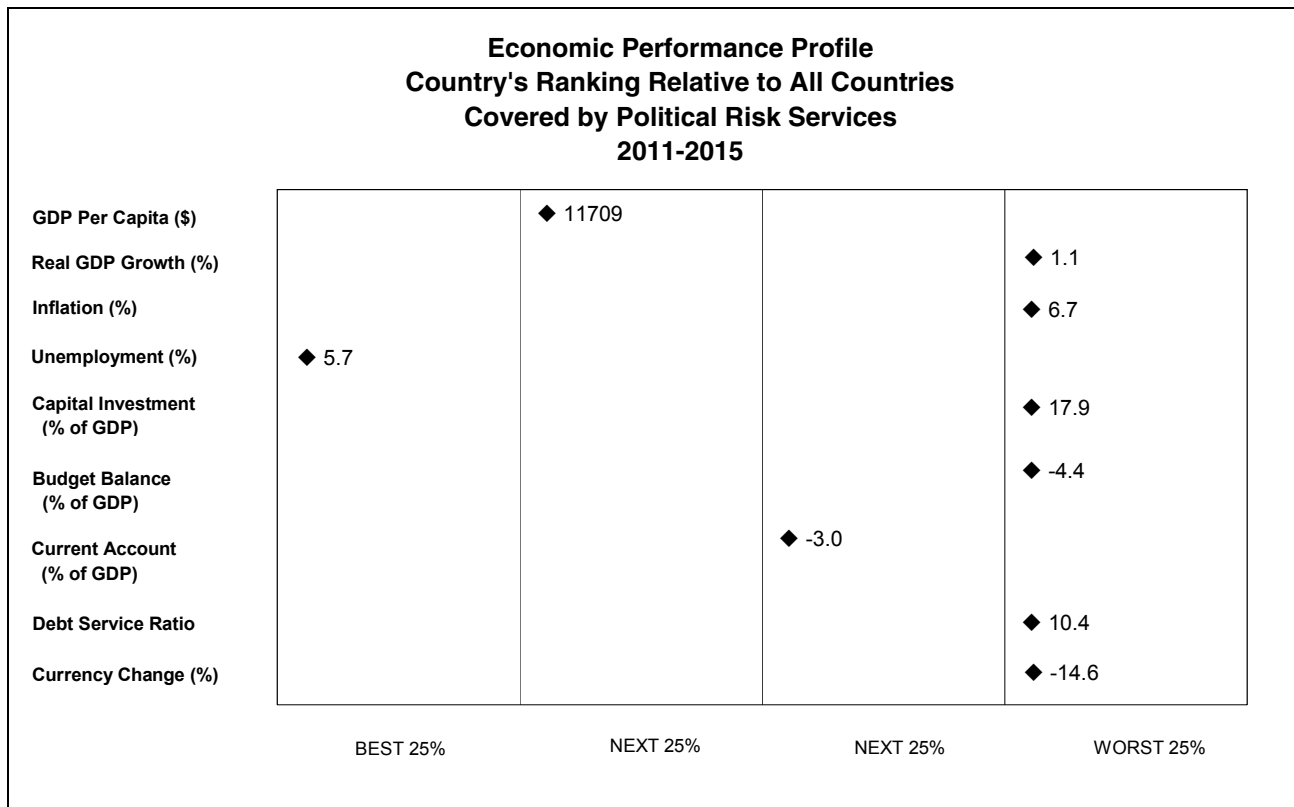
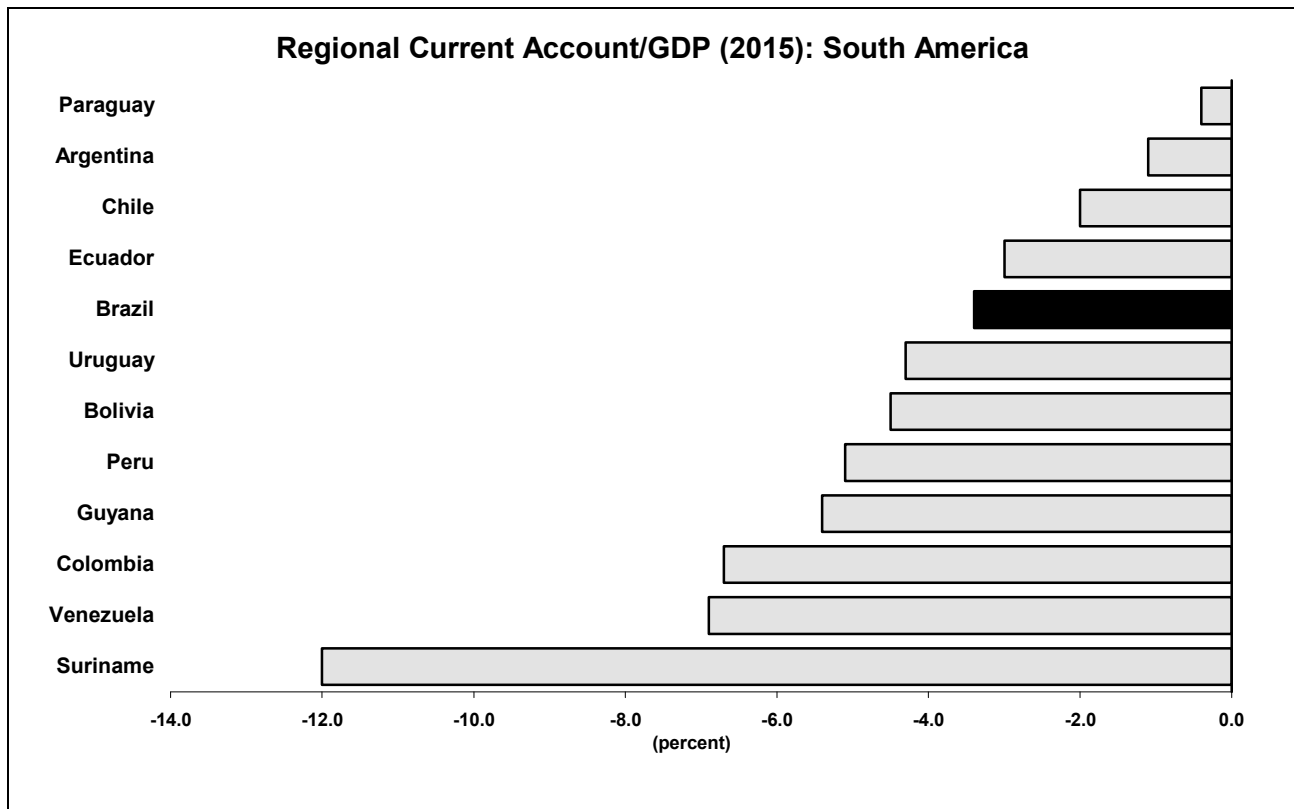
Comparison: Brazil



# Brazil Country Forecast

29-Feb-2016

Comparison: Brazil



**Social Indicators**

**as of 2015**

**Primary Energy**

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Energy Consumption (10 <sup>15</sup> Btu):	12.56
Per Capita Consumption (10 <sup>9</sup> Btu):	0.06

**Population**

---

Annual Growth	0.8%
Infant Deaths per 1,000	19
Persons Under Age 15	23%
Urban Population	86%
Urban Growth	2.0%
Literacy	93%

**Work Force Distribution**

---

Agriculture	16%
Industry-Commerce	13%
Services	71%
Unions	18%

**Ethnic Groups**

---

Portuguese and other white (48%), mixed (43%), black (8%), other (1%)

**Languages**

---

Portuguese, Spanish, German, Italian, Japanese, English

**Religions**

---

Roman Catholic (65%), Protestant (22%), other (5%), none (8%)

# Brazil

## Country Forecast Comment & Analysis

### Rousseff Losing Her Grip

A convergence of political and economic crises has left President Dilma Rousseff fighting for her political life barely a year after she was sworn in for a second four-year term in early 2015. Investigation of a massive corruption scandal involving the theft of upwards of \$800 million from the state-owned oil company, Petrobras, has implicated dozens of sitting officeholders from parties across the political spectrum, but those cases involving Rousseff's left-leaning Workers' Party (PT) and the centrist Brazilian Democratic Movement Party (PMDB), which have governed in partnership since 2003, pose the greatest immediate threat to political stability.

Although investigations have turned up no proof that Rousseff was herself involved in the corruption scheme or directly benefited from the diversion of funds from Petrobras to the PT's coffers, she chaired the Petrobras board when the theft was occurring, and her claim to have had no idea what was happening has tested the credulity of the electorate. Opinion data indicates that more than two-thirds of voters favor her impeachment, and strong public pressure for her removal (which probably reflects discontent over the abysmal state of the economy as much as anything) has provided her political enemies with a justification for moving against her.

Perhaps the most dangerous of those enemies is Eduardo Cunha, a PMDB lawmaker whose position as speaker of the lower house of Congress means that he can single-handedly block an impeachment motion. However, Cunha is accused of participating in a money-laundering operation, an allegation he denies, and has effectively declared war on the president for failing to protect him from legal jeopardy.

After months of hinting at the possibility of impeachment, Cunha finally took action in October 2015, following a finding of the Federal Audit Court (TCU) that the government delayed the transfer of some \$11 billion in funds to public banks for the payment of social security, unemployment, and welfare benefits in 2014, presumably to artificially boost the fiscal position. As a result, the government left banks in the position of having to make the payments from their own holdings, in violation of the Fiscal Responsibility Law.

The impeachment push was slowed in December, when the Supreme Court ruled that Cunha violated congressional rules in order to pack the legislative committee that will determine whether to proceed with impeachment with lawmakers who favor Rousseff's removal. With the Congress currently in recess, no further action will be taken before March 2016.

As for how long the president might be able to hold on beyond that point, some political and structural factors weigh in her favor. The impeachment process cannot proceed to a trial in the upper house without the support of a two-thirds majority in the Chamber of Deputies. As long as Rousseff is able to count on the backing of her own party and the anti-impeachment faction of the PMDB, which won an internal battle to choose the party's congressional whip in February, she can hold on to power.

However, the revelation that former President Luiz Inácio "Lula" da Silva is under investigation for possible involvement in the Petrobras scandal is a potentially devastating blow for Rousseff. The alleged direct involvement of the man for whom Rousseff served as chief of staff will only make it that much harder for Brazilians to swallow the claim that she was oblivious to what was happening. Moreover, any moves by Rousseff to shield Lula from prosecution can be expected to increase the intensity of public demands for her removal from office. In any case, the president's non-PT allies are at a point where continued support for Rousseff could hurt their own political fortunes, and they are weighing their options.

### **Regime Change?**

As Rousseff's vice president, PMDB leader Michel Temer would become president if Rousseff were impeached and removed, or were to step down to avoid dragging out the crisis. Although Temer has expressed reluctance to take down Rousseff, his position has softened as the political crisis has deepened.

Cunha is attempting to force the issue, by pressing for a vote to decide whether to end the PMDB's participation in the government at a party congress scheduled for mid-March. Were the PMDB to vote to pull out of the coalition, Rousseff's chances of keeping her job would evaporate, as it is doubtful that she would have enough support to keep the impeachment process from proceeding to a trial in the Senate, and the leader of the upper house, Renan Calheiros, a member of the PMDB, has already warned that Rousseff cannot count on enough votes in the 81-member Senate to prevent her conviction and removal.

Temer's apparent wariness of pushing Rousseff out is understandable, given the current state of the economy and his unfavorable prospects for creating a stable government. Assuming the PMDB's failure to protect the president from impeachment would rule out

any chance that a Temer-led administration might count on the support of the PT, achieving a legislative majority on any kind of a consistent basis would require some form of cooperation agreement between the PMDB and the main opposition Brazilian Social Democratic Party (PSDB). However, the political damage to both Rousseff and Lula creates a golden opportunity for the PSDB to reclaim the presidency for the first time in 16 years in 2018, and its chances of doing so will not be improved by climbing into bed with the corruption-tainted PMDB and helping Temer to clean up the mess left by Rousseff.

Indeed, the PSDB will have a strong incentive to keep its distance as long as there is a possibility that the 2014 elections could be nullified. Evidence that Rousseff's campaign was financed with stolen Petrobras funds would create a justification for throwing out the results of the 2014 contest and scheduling a special presidential election, at which the PSDB candidate would be the presumptive favorite to win.

However, such a move might only heighten political instability. The PSDB controls just 53 seats in the 513-member Chamber of Deputies, which means that a PSDB-led administration would need to pick up an additional 204 votes just to claim a bare majority in the lower house. That would be a daunting challenge under any circumstances, and might be close to impossible with both of the two largest parties being ruled out as a potential coalition partners. The alternative of forming an ideologically diverse alliance of numerous smaller parties, even if achievable, would not be conducive to effective governance, particularly with regard to addressing the country's serious economic problems.

The president gives no sign that she intends to surrender power without a fight, but it seems almost as if fate is conspiring against her. The already besieged government is also dealing with an outbreak of the Zika virus, which has been blamed for more than 3,700 cases of microcephaly in newborn babies. The mosquito-borne disease has put Brazil at the epicenter of what the World Health Organization (WHO) has declared to be a global health emergency.

In some ways the health scare is a blessing for Rousseff, in that it has focused public attention on an issue that cannot be blamed on her government. Moreover, it has given the president an opportunity to show that she is both compassionate and competent, and public opinion suggests that she is succeeding on that front.

However, the Zika outbreak has also reinforced doubts about Brazil's fitness to play host to the 2016 Olympic Games, which are scheduled to open in Rio de Janeiro in August. When Rio won the bidding for the games, Brazil was a rising star among the world's

emerging markets, and its role as host was expected to provide an opportunity to underscore its arrival as an influential international player. Today many Brazilians, including President Rousseff, are simply hoping to avoid a national embarrassment.

Delays in the construction of venues and other infrastructure for the event have been compounded by cuts to government spending, and Brazil has struggled to assuage the concerns of foreign travelers about the threat of violent crime and the risk of political unrest. Even worse, worries about the health of foreign athletes, an issue first raised with regard to the fetid waterways that will be used for some events (such as crew), have been magnified by the Zika scare. Some athletes (and some governments) have suggested they might skip the games. The WHO has assured that the threat posed by the virus will be significantly reduced by August, but health officials have advised pregnant women against traveling to Brazil for the games.

Many Brazilians have come to the conclusion that hosting both the 2014 World Cup and the 2016 Olympics will ultimately prove to have been a huge waste of money that would have been better spent on social programs, public services, and productive investment. If President Rousseff is still in office when the Games open in August, there is every reason to expect that her grassroots opponents will seize the opportunity to embarrass her before a global audience.

Fears that the World Cup would be disrupted by protests resulted in the deployment of large numbers of police decked out in riot gear in larger cities. A repeat in August will do little to improve Brazil's international image, but failure to take adequate measures to ensure order during the Olympic Games could be even worse.

In a possible harbinger of things to come, demonstrations organized to protest an increase in bus fares in January resulted in clashes between protesters and police in Rio and Sao Paulo. The incidents were noteworthy because small protests over a hike in bus fares in mid-2013 quickly mushroomed into a broader anti-government movement. Although the latest protests quickly fizzled out, it is possible that the so-called Free Fare Movement will review what went wrong in January and make a fresh attempt to rouse the masses in August.

### **Aggressive Action Required to Right Economy**

Quite apart from the popular will or the political calculations of the various parties, there is a strong case to be made that Brazil simply cannot afford to let Rousseff remain in office. With her approval rating near single digits and her future uncertain, the president lacks the political authority to apply pressure on lawmakers to approve measures required to establish a basis for an economic recovery. Unfortunately, there is little



chance that the president's popular support might improve in the absence of an economic rebound and the containment of inflation, neither of which is likely as long as political uncertainty continues to weigh on confidence.

The risk of inaction was highlighted by Standard and Poor's recent decision to downgrade Brazil's bond rating for the second time in five months, a move that was accompanied by a warning that the sovereign rating would be downgraded deeper into junk status if the government fails to rein in a budget deficit that ballooned to 10.3% of GDP in 2015. The increase in the cost of state borrowing implied by the downgrade will make it harder to convince investors that the government will manage to get its fiscal house in order, and doubts in that regard will complicate the task of stabilizing the real, which depreciated by more than 30% against the US dollar in 2015, hampering the central bank's efforts to contain inflation.

Faith in the government's commitment to austerity was tested in late January, when Finance Minister Nelson Barbosa announced plans to make available lines of credit totaling \$20 billion to help businesses weather the recession, and held out the possibility of debt restructuring for financially troubled state governments. Barbosa noted that debt relief would require states to impose tight spending restrictions, and he unveiled a number of austerity measures, including proposals to cap spending growth and implement automatic cuts in pension benefits.

However, the proposed spending cuts amount to about \$5.8 billion in all, less than one-third of the savings that officials projected would be required to achieve the government's target of achieving a primary surplus (before debt payments) equivalent to 0.5% of GDP. The government had initially targeted a primary surplus equivalent to 2% of GDP, but the goal was lowered in December, with the proviso that another adjustment might be necessary. That prediction was borne out in mid-February, when the government announced that it would shoot for a primary deficit equivalent to 1% of GDP.

Opposition to spending cuts is strong within the PT, and some revenue-generating proposals – such as the revival of the CPMF, a financial transactions tax that generated \$20 billion in revenues in 2007, the last year it was in force – have met resistance from members of the PMDB, including Calheiros. Perhaps the biggest obstacle is Cunha, who has made it his personal mission to undermine Rousseff at every turn, and has managed to block passage of several pieces of legislation since declaring war on the president last year.

Of course, neither a loss of popularity nor a government's inability to address economic problems, no matter how grave, are by themselves a justification for removing a democratically elected president between elections. And it is probably safe to assume that if Rousseff were popular and the economy were healthier, the transgression for which she is threatened with impeachment would have been dismissed as nothing more than an unfortunate oversight.

Consequently, there is a danger that the president's removal could be viewed by her mostly working-class hard-core supporters as motivated by crude political opportunism, rather than respect for good governance and the rule of law. In that event, Rousseff's removal might only serve to deepen the political crisis, rather than creating a basis for restoring stability.

### **Fiscal Relaxation a Risky Strategy**

While the political machinations play out, economic policy is drifting without clear direction. Former Finance Minister Joaquim Levy, a highly respected technocrat who had managed to retain the confidence of international institutions, resigned on December 18, just days after his plan to restore fiscal stability was rejected by President Rousseff, and Fitch became the second credit-rating agency to downgrade Brazil's debt rating to junk status. Barbosa, a former planning minister and a PT stalwart, was expected to be less aggressive than his predecessor in attacking the task of deficit reduction, and that has proven to be the case.

The government's reluctance to implement a program of harsh austerity is understandable. According to central bank estimates, the economy contracted by slightly more than 4% in real terms last year, with the pace of decline accelerating in the final quarter of 2015. The unemployment rate is headed for 10%, and, despite seven interest-rate hikes last year that pushed the Selic up to 14.25%, the highest level in nine years, the lifting of price controls and the steep fall in the value of the real have contributed to a steady rise in the inflation rate, which nudged up to 10.7% (year-on-year) in January, after averaging 9% in 2015.

The government is hoping that the relaxation of fiscal constraints and the extension of \$20 billion in credit backed by public banks will create enough of a cushion to put a floor under the downturn and slow the rise in unemployment, but with prices for commodity exports showing no sign of an imminent recovery and political uncertainty denting business and consumer confidence, another annual contraction is all but assured in 2016.

The central bank has held the Selic rate steady since late July, despite the persistent upward trajectory of consumer price inflation. The inaction of monetary authorities has

fueled speculation that the central bank, which is not independent, is being influenced by political pressure, a perception that in combination with fiscal easing is likely to keep investors on edge, resulting in a further inflationary slide in the real-dollar exchange rate.

Assuming market pressure forces the central bank to take action, additional monetary tightening should help to hold inflation to single digits, but will hamper the government's efforts to reverse the economic decline. If the central bank fails to act, inflation would likely remain in double digits through 2016, with little positive effect on growth.

On a more positive note, the current account deficit narrowed to less than \$60 billion in 2015, equivalent to about 3.3% of GDP, compared to the \$104.8 billion shortfall recorded in 2014. The improvement was largely the result of a steep fall in imports, which pushed the trade balance back into surplus after falling into deficit for the first time in more than a decade in 2014. The drop in imports reflected the combined effect of lower prices for commodity imports, weak domestic demand, and the negative effect of currency depreciation on the competitiveness of foreign-produced goods. Those same factors are expected to hold the current account deficit to less than 4% of GDP once again in 2016, but rising debt-related costs will pose an obstacle to any further significant reduction of the shortfall.

The public-sector debt burden topped 66% of GDP at the end of 2015, up from 51.7% of GDP in 2013. Although an ample supply of foreign-exchange reserves, which are sufficient to provide more than 18 months of import cover, means that the risk of serious debt-related difficulties will be limited in the near term. However, with the debt-to-GDP ratio continuing on an upward track and ratings downgrades increasing the cost of servicing the debt, risks will increase over the medium term in the absence of concrete steps to rein in the fiscal deficit.



# Brazil

## Country Forecast Forecast Scenarios

### SUMMARY OF 18-MONTH FORECAST

<b>REGIMES &amp; PROBABILITIES</b>	Divided Government 45%	Centrist Coalition 30%	Center-Left Coalition 25%
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### SUMMARY OF FIVE-YEAR FORECAST

<b>REGIMES &amp; PROBABILITIES</b>	Centrist Coalition 45%	Divided Government 35%	Center-Left Coalition 20%
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### Most Likely Regime Scenario

#### 18-Month Forecast Period

Divided Government (45% Probability)

#### Five-Year Forecast Period:

Centrist Coalition (45% Probability)

Centrist Coalition	Growth (%)	Inflation (%)	CACC (\$bn)
<b>2016</b>	-1.8	8.0	-63.15
<b>2017-2021</b>	2.1	5.5	-77.20

A convergence of political and economic crises has left President Dilma Rousseff fighting for her political life barely a year after she was sworn in for a second four-year term in early 2015. Although she has not been directly implicated in a massive corruption scandal that involves the theft of upwards of \$800 million from the state-owned oil company, Petrobras, she chaired the Petrobras board when the theft was occurring, and her claim to have had no idea what was happening has tested the credulity of the electorate. Opinion data indicates that more than two-thirds of voters favor her impeachment, and strong public pressure for her removal (which is undoubtedly reinforced by the abysmal state of the economy) has provided her political enemies with a justification for moving against her.

Among the most influential of those enemies is Eduardo Cunha, the leader of the lower house of Congress. Although a member of the government-allied Brazilian Democratic Movement Party (PMDB), Cunha, who faces prosecution on money-laundering charges, declared war on the president last year, presumably over her failure to rescue him from legal jeopardy. After months of hinting at the possibility of impeachment, Cunha finally took action in October 2015, following a finding of the Federal Audit Court (TCU) that the

government delayed the transfer of some \$11 billion in funds to public banks for the payment of social security, unemployment, and welfare benefits in 2014, in violation of the Fiscal Responsibility Law.

The impeachment process will resume when the Congress reconvenes in March, but cannot proceed to a trial in the upper house without the support of a two-thirds majority in the Chamber of Deputies. As long as Rousseff is able to count on the backing of her own party and the anti-impeachment faction of the PMDB, which won an internal battle to choose the party's congressional whip in February, she can hold on to power.

The revelation that former President Luiz Inácio "Lula" da Silva is under investigation for possible involvement in the Petrobras scandal is a potentially devastating blow for Rousseff, and any moves by Rousseff to shield her mentor from prosecution can be expected to increase the intensity of public demands for her removal from office. In any case, the president's non-PT allies are at a point where continued support for Rousseff could hurt their own political fortunes, and they are weighing their options.

Cunha is pressing for a vote on the PMDB's continued participation in the government at a party congress scheduled for mid-March. As Rousseff's vice president, PMDB leader Michel Temer would become president if Rousseff were impeached and removed, or were to step down to avoid dragging out the crisis. Although Temer has expressed reluctance to take down Rousseff, his position has softened as the political crisis has deepened.

With her escape routes closing, it is more likely than not that Rousseff will leave office before the end of the 18-month forecast period. Unfortunately, her departure may not greatly improve the prospects for creating a stable government.

The assumed rupturing of the current governing alliance that precedes Rousseff's removal from office will make it difficult for a Temer-led administration to achieve a legislative majority on any reliable basis unless it concludes some form of cooperation agreement with the main opposition Brazilian Social Democratic Party (PSDB). However, the political damage to Lula (whose possible bid for the presidency in 2018 has been a subject of speculation) and to the PT more generally creates a golden opportunity for the PSDB to reclaim the presidency for the first time in 16 years at the next election, and its chances of doing so will not be improved by climbing into bed with the corruption-tainted PMDB and helping Temer to clean up the mess left by Rousseff.

Indeed, the PSDB will have a strong incentive to keep its distance as long as there is a possibility that the political crisis might result in an early presidential election. The

discovery of credible evidence that Rousseff's campaign was financed with stolen Petrobras funds would create a justification for throwing out the results of the 2014 contest and scheduling a special presidential election, at which the PSDB candidate would be the presumptive favorite to win.

However, such a development might only heighten political instability. The PSDB controls just 53 seats in the 513-member Chamber of Deputies, which means that a PSDB-led administration would need to pick up an additional 204 votes just to claim a bare majority in the lower house. That would be a daunting challenge under any circumstances, and might be close to impossible with both of the two largest parties being ruled out as a potential coalition partners. The alternative of forming an ideologically diverse alliance of numerous smaller parties, even if achievable, would not be conducive to effective governance, particularly with regard to addressing the country's serious economic problems.

The prospects for restoring stability at the center will be brighter beyond the 18-month forecast period, as the holding of regularly scheduled presidential and legislative elections in the fall of 2018 will create an opportunity for the PSDB to win a strong mandate with the congressional heft to match. But even in that case, forming a viable majority coalition may be difficult.

The PSDB will likely benefit from the electorate's loss of faith in the PT, but the PMDB's support is more a function of the ability of lawmakers to deliver benefits to their local constituencies than close identification with the national party. Consequently, it is quite probable that the PMDB will remain one of the largest parties in the Congress, despite its association with the Petrobras scandal, in which case its support may be essential to a PSDB-led administration's hopes of building a majority coalition.

The PMDB has historically displayed little discrimination in its choice of political allies, and has previously teamed with the PSDB in government. However, it has also frequently shown itself to be an unreliable partner. For that reason, the probability that the 2018 election will produce a centrist administration that enjoys reliable majority support in the Congress is less than 50%.

### **Lack of Consensus an Impediment to Aggressive Reform**

In its general outline, the policy program pursued by Rousseff has differed little from the one she inherited from Lula, which amounts to the pursuit of socialist ends through liberal means, i.e., relying on business-friendly policies to generate the strong growth and healthy revenues required to simultaneously strengthen the social safety net and pay down the debt, keep inflation in check, and maintain a competitive exchange rate.

Over the last two years, weak prices for Brazil's main commodity exports, including soybeans, crude oil, and iron ore, have contributed to a rapid deceleration of growth, slumping investment, the steep depreciation of the currency, and a significant shortfall in budget revenues. But even before the economic downturn, a worsening budget performance signaled that the PT's effort to maintain both a strong social safety net and fiscal stability could not be sustained in the absence of deeper structural reforms, including an overhaul of the pension system, labor-market reforms aimed at boosting productivity and reducing state-mandated benefits (which are estimated to double the cost of labor), and efforts to simplify and improve the transparency of the regulatory framework. Now that the tenuous fiscal equilibrium has been broken, those same reforms will be priority items in a policy program designed to nurse the economy back to health.

With her approval rating near single digits and her future uncertain, Rousseff lacks the political authority to apply pressure on lawmakers to approve measures required to establish a basis for an economic recovery. Unfortunately, there is little chance that the president's popular support might improve in the absence of an economic rebound and the containment of inflation, neither of which is likely as long as political uncertainty continues to weigh on confidence.

The risk of inaction was highlighted by Standard and Poor's recent decision to downgrade Brazil's bond rating for the second time in five months, a move that was accompanied by a warning that the sovereign rating would be downgraded deeper into junk status if the government fails to rein in a budget deficit that ballooned to 10.3% of GDP in 2015. The increase in the cost of state borrowing implied by the downgrade will make it harder to convince investors that Rousseff's government is capable of getting its fiscal house in order, and doubts in that regard will complicate the task of stabilizing the real, which depreciated by more than 30% against the US dollar in 2015, generating strong inflation that left the central bank with little choice but to engage in aggressive monetary tightening that has sapped what little vigor remained in the economy.

Under the circumstances, there is a strong (albeit highly undemocratic) case to be made that Brazil simply cannot afford to let Rousseff remain in office. Indeed, as expectations that the president will be impeached rose in late February, yields on local bonds fell, an indication that investors are wagering that a change of government will improve the prospects for making headway on the reform front.

However, such optimism will prove to be unwarranted under a divided government scenario. Restoring fiscal discipline will of necessity be a high priority for any



administration that holds power in the near term, but it is unclear that there is any configuration of parties that might be cobbled together into a majority coalition that is willing to approve the measures required to rapidly shrink the large budget deficit.

During Lula's two-term presidency, the government adhered to a fiscal strategy that targeted achievement of a primary surplus (before debt payments) equivalent to 3.5% of GDP, with the aim of ensuring the availability of adequate funds to steadily and rapidly reduce the public-sector debt burden. Until 2008, the PT-led administration typically came close to hitting the target, but discipline was relaxed in a bid to counteract the negative impact of the global financial crisis, and it has not been fully restored under Rousseff.

For 2016, the government initially targeted a primary surplus equivalent to 2% of GDP, but the goal was lowered to 0.5% of GDP in December 2015, with the proviso that another adjustment might be necessary. In mid-February, the government announced that it would shoot for a primary deficit equivalent to 1% of GDP this year, after Finance Minister Nelson Barbosa unveiled proposed spending cuts amounting to just \$5.8 billion, or less than one-third of the total savings that officials had earlier suggested would be required to produce a primary surplus.

Opposition to spending cuts is strong within the PT, but perhaps the biggest obstacle to implementing an aggressive austerity program is Cunha, who has made it his personal mission to undermine Rousseff at every turn, and has managed to block passage of several pieces of legislation since declaring war on the president last year. Although those obstacles would presumably be eliminated in the event of Rousseff's forced departure from the presidency, some revenue-generating proposals—such as the revival of the CPMF, a financial transactions tax that generated \$20 billion in revenues in 2007, the last year it was in force—have met resistance from members of the PMDB, including Calheiros.

Privatization can be expected to figure more prominently in the deficit-reduction program of a government headed by either the PMDB or the PSDB than has been the case under the PT, which promoted an expanded economic role for the public sector in key industries, including hydrocarbons, petrochemicals, power generation, and banking. The relative success of the government's effort to protect Brazil from the impact of the 2008 global financial crisis seemed to validate the nationalizing trend, but the enormity of the scandal at Petrobras has vindicated critics who questioned the wisdom of tying the fate of key economic sectors to a corrupt state apparatus.

Privatization will also be a central feature of the anti-corruption program that the PSDB is certain to make a central plank of its campaign platform in 2018, and linking the sale of state-owned assets to a broader battle to root out corruption may help to dampen public opposition to divestment. However, given the continued division of legislative power among numerous parties spread across the ideological spectrum, the scope for the aggressive implementation of liberal reforms will remain limited in the near term.

In general, the policies of a centrist regime formed after the 2018 elections will for the most part differ from those of a PT-led administration in degree, rather than in kind. A majority centrist coalition will be less sensitive to pressure for populist spending initiatives that might impede efforts to rein in the budget deficit, but tax increases will likely be a component of a PSDB-led government's strategy for easing fiscal strains and addressing debt-related concerns.

The Petrobras scandal has highlighted the extent of official corruption in Brazil, and Rousseff's removal from office will not by itself bring any improvement in the situation. Under current law, sitting officeholders can only be prosecuted before the Supreme Court, and given the sheer numbers involved in the Petrobras scandal, the window for prosecution is likely to close on many of the cases before the backlog is cleared. Public outrage over corruption notwithstanding, there is little evidence of a commitment to reducing corruption within the political establishment, and, as yet, there are no signs of new political forces emerging to challenge the status quo in that regard.

Consequently, it is likely that corruption will remain a problem for the foreseeable future. The costs and the risk of legal jeopardy associated with official corruption are among several persistent obstacles and deterrents faced by foreign investors, which also include high levels of urban crime, a tangled and inefficient bureaucracy, and a deficient infrastructure that contributes to transportation bottlenecks.

Squabbling within the incumbent coalition has thwarted progress on a proposed overhaul of mining regulations that were first promised in 2009, and mining companies are holding off on an estimated \$20 billion of new investment awaiting approval of the new rules. The contents of the final legislation will have a bearing on royalty obligations, the duration and terms for the renewal of concessions, and local-content requirements, among other things. In early 2015, the Ministry of Mines and Energy attempted to put a positive spin on the delay, suggesting that it would provide the government with time to rework some of the more contentious provisions of the legislation. However, the prospect of further revisions only added to the uncertainty, reinforcing the negative impact of weak metals prices on investor sentiment.

The lack of consensus on the rules related to development of Brazil's natural resources was highlighted previously by a protracted battle over changes to the system for distributing the tax and royalty revenues generated by oil production. Passage was delayed when Rousseff vetoed provisions that called for the application of a new, and more equitable, formula for distributing oil revenue to the states for both future projects and those already under production. Rousseff ultimately lost the battle, as members of her coalition joined forces with the opposition to override her veto.

The legislative battle, which pitted lawmakers from oil-producing states against those from non-producing states, underscored the challenges posed by a fragmented political landscape in which delivering the goods for local constituents frequently trumps party or coalition loyalty. That obstacle will become even more daunting under a divided government scenario, and will likewise be an impediment to the approval of reforms under a centrist regime coming to power later in the forecast period, as pressure for fiscal tightening heightens the competition for spoils among the constituent parties within the governing coalition.

Another potential deterrent to investment in extractive sectors is the risk of legal troubles stemming from charges of environmental damage. A legal tussle involving US-based Chevron over a 2011 oil spill off Rio de Janeiro no doubt played a role in the evident lack of enthusiasm for concessions offered by the government in 2013, following a five-year delay caused by the wrangling over the royalties scheme. The much-anticipated auctioning of right to pre-salt deposits drew only one bidder – a consortium of Petrobras, Shell, Total, and two smaller state-owned companies from China – willing to agree to the government's terms, i.e., the sharing of more than 40% of future production with the government and the payment of a \$7 billion signing fee.

A 12th bidding round held in November 2013 focused on the auction of onshore shale deposits. Petrobras once again finished on top, being awarded (alone or in partnership) all but one of the 50 blocks for which it submitted bids. The next auction was delayed until October 2015, and with the corruption scandal at Petrobras taking the state-owned firm out of the running and the steep decline in global oil prices since mid-2014 dampening the interest of the foreign majors, the results were very disappointing. Out of 266 blocks offered, only 37 were sold, for a total of just \$89 million, compared to the \$720 million anticipated based on the minimum required bid for all of the blocks.

Larger oil companies have made clear that Brazil will need to significantly improve the terms of contracts if it hopes to attract their interest. Among the most objectionable provisions attached to the last batch of contracts were restrictions on investors' recourse to extra-judicial arbitration and onerous local-content requirements. A centrist

government coming to power later in the forecast period will likely be inclined toward compromise in that regard, but any concessions that are perceived to be costing the state potential revenue or denying Brazil a fair share of the country's oil wealth can expect to meet stiff resistance even from some of the constituent parties in the governing coalition.

In the early years of the current decade, Brazil repeatedly accused the US, Europe, and Japan of waging a "currency war" by holding their interest rates at an extremely low level, while much higher Brazilian rates attracted capital flows that contributed to the appreciation of the real, putting the country's exporters at a competitive disadvantage. The government responded with a temporary tightening of capital controls.

However, since 2012, policy makers have faced the opposite problem. A rapid outflow of capital from emerging markets in anticipation of US monetary tightening (the so-called "taper tantrum") contributed to a significant depreciation of the real against the US dollar in 2013. Aggressive monetary tightening by the central bank beginning in April 2013 helped to stabilize the exchange rate, which held fairly steady through most of 2014. More recently, however, the government's failure to hit its fiscal targets and the political uncertainty created by the Petrobras scandal triggered a renewed slide in early 2015 that pushed the exchange rate to just under BRL4.0 to the dollar by the end of the year, a decline of more than 30%.

Central bank intervention has contributed to the stabilization of the real near that level over the first two months of 2016, and signals from the US Federal Reserve Board pointing to a reduced likelihood of further tightening in the immediate near term should help to ease pressure on the currency. Moreover, just as anticipation of a change in government has contributed to a fall in bond yields, the prospect of the Rousseff administration's replacement by a more stable government that is capable of implementing a deficit-reduction program may contribute to a firming of the real.

However, any positive effect will be short-lived if the new administration struggles to pull together a majority coalition, as is assumed under 18-month scenario. The risk of volatility will remain high in the near term, but an adequate supply of foreign exchange reserves, which is sufficient to provide roughly two years of import cover, will create a cushion against external shocks. Even so, given the delicate limited scope for the use of either monetary or fiscal tools to fuel an economic recovery, the possibility that conditions may arise that tempt even a centrist coalition government to tighten capital controls cannot be discounted.

### **Somewhat Brighter Prospects for Trade Liberalization**

Trade liberalization was an essential component of the reform plans of governments in the 1990s, but Lula adopted a far more adversarial approach to trade negotiations. After he took office in early 2003, Brazil played a leading role in pushing for global economic

powers to grant concessions to emerging economies in global trade negotiations (notably, the elimination of agricultural subsidies), and his insistence that the US adopt a more flexible model for a proposed Free Trade Area of the Americas (FTAA) was a factor in the ultimate failure of the US-sponsored project.

In contrast to Lula's skepticism toward the hemisphere-wide FTAA, he enthusiastically promoted closer integration of the member states of the Southern Common Market (Mercosur), whose other members include Argentina, Uruguay, Paraguay, and, since 2013, Venezuela. Even so, tensions among the members – historically, between Brazil and Argentina, but more recently between the larger and smaller members of the bloc – create a persistent threat to the unity of the bloc.

Argentine leaders have typically demanded greater flexibility in adjusting restrictions on trade flows within Mercosur to correct imbalances, while Brazil has insisted that doing so would undermine the whole purpose of the customs union. Moreover, Paraguay and Uruguay have pressed for changes to Mercosur rules that would permit them to pursue bilateral trade agreements. Both are keen to conclude deals with the US and the EU, and could conceivably do so on a bilateral basis. However, the inclusion of Venezuela as a full member of Mercosur represents a significant impediment to achieving a bloc-wide agreement with the US as long as a leftist government remains in power in Caracas, and negotiations for an association agreement with the EU have been slowed by the resistance of the European partners to the elimination of protectionist barriers for agricultural products and Argentina's insistence that Mercosur respond with protections measures of its own.

In 2014, Brazilian officials suggested that if consensus cannot be achieved within Mercosur, a "two-speed" process – under which Brazil, Uruguay, and Paraguay would proceed without Argentina – might be a possibility. However, the election of Mauricio Macri, an advocate of free trade, as president of Argentina in late 2015 has brightened the prospects for progress toward a bloc-wide agreement with the EU, and Macri's opposition to the pursuit of bilateral agreements by member states will take the two-speed proposal off the table for the time being.

Recent electoral developments have also improved the outlook for concluding an agreement with the US, a goal that has been impeded by Washington's imposition of sanctions on the incumbent socialist administration in Venezuela. A reformist alliance committed to dismantling the institutional underpinnings of the socialist "revolution" initiated in the late 1990s by the late President Hugo Chávez won a landslide victory at legislative elections held in December 2015, and the reformist bloc is pushing to hold an early presidential election that would likely complete the downfall of Chávism.

A government headed by either the PMDB or the PSDB will be inclined to pursue enhanced trade cooperation with the US, which would win the administration points with Brazilian industry. However, a trade deal with the US is likely to meet with resistance from other interest groups, including organized labor, and a minority government coming to power in the 18-month forecast period would be reluctant to provoke protests against a backdrop of heightened political tensions that are likely to persist even if Rousseff is forced from office.

A centrist government's commitment to liberalizing trade regulations will be tested by resistance from a variety of vested interests, most especially business sectors that are vulnerable to foreign competition. That said, the commitment to Mercosur and the larger project of regional integration will remain strong, and greater cooperation within the bloc as the result of the defeat of anti-market political forces in Argentina and Venezuela will create an incentive to push forward on trade liberalization, despite domestic opposition.

### **Unmet Expectations May Result in Unrest**

Brazil has a long history of social peace, despite its many tensions and inequities, and a wave of mass protests that gripped the country in June–July 2013 caught the government by surprise. What began as a demonstration in São Paulo against an increase in transport fares quickly mushroomed into a mass phenomenon animated by discontent over the rising cost of living, rampant corruption among the political class, poor public services, and the runaway spending on preparations to host the 2014 World Cup and the 2016 Summer Olympics.

Rousseff managed to defuse the crisis by agreeing to implement a number of reforms, but the convergence of the Petrobras scandal and the economic downturn has fueled a sense of outrage among the population that has put Rousseff's political future in doubt, and could trigger a dangerous eruption of unrest if the president attempts to cling to power. In that regard, the approach of the Olympic Games is cause for concern. If Rousseff is still in office when the games open in August, her detractors will very likely attempt to exploit the global attention by organizing disruptive demonstrations timed to coincide with the two-week event.

Threats by activists to disrupt the World Cup in 2014 prompted Rousseff to deploy military troops for urban policing, and she can be expected to take similar action to ensure order during the Olympics. Such a strategy carries an inherent risk of enflaming tensions, and increasing the potential for violent clashes.

Even if Rousseff is replaced before the Olympic Games, the event is likely to be accompanied by protests, given the association of the games in the public mind with government waste, corruption, and misplaced priorities. However, a government that is not fighting for survival will have less cause to adopt the sort of zero-tolerance approach to political demonstrations that would carry a very high risk of provoking a violent response. More generally, economic difficulties that are likely to persist at least through the 18-month forecast period will contribute to simmering social tensions that could boil over into episodes of destabilizing unrest.

Despite their disappointment with the failure of successive PT-led administrations to meet the expectations that greeted Lula's election to the presidency, the unions have continued to support the party at the ballot box, as have working-class voters more generally. There is no guarantee that the unions will accept the PT's loss of political control without a fight, especially given the likelihood that Rousseff's downfall will also spell trouble for Lula, who rose to prominence as a firebrand leader of the auto workers union.

The establishment of a centrist coalition government may also spark a revival of the Landless Workers' Movement (MST), which historically has relied on land seizures – usually concentrated in an annual “red April” campaign – to publicize its grievances and apply pressure on the government to implement a program of land reform. However, increased urbanization has reduced the size of the landless population, resulting in a decrease in the size and influence of the MST, and its support among the broader population has been undermined by allegations of links to criminal gangs. The group's leaders have attempted to broaden their appeal by tying the MST's concern to those of environmentalists, most notably in the case of the government's promotion of large-scale agribusiness.

The PT campaigned on a promise to get tough on crime, but little progress has been made in containing the violence, corruption, and drug trafficking in major cities, especially Rio de Janeiro and São Paulo. The latter city, in particular, has been troubled in recent years by the eruption of violence perpetrated by the First Capital Command (PCC), a deadly street gang that began a campaign of terror in the prisons and the streets of São Paulo in May 2006.

Crime will remain a serious problem and a significant deterrent to investment under any government holding power in the five-year forecast period. Achieving order in São Paulo and elsewhere will require attacking deep-seated social ills, controlling the ownership of guns, and restoring confidence in the police. The Rio government's unrealistically

ambitious goal of confiscating 300,000 illegally held weapons served mostly as an indicator of just how advanced is the plague of violence in the cities.

Another threat to Brazilians and foreigners alike is kidnapping. Abducting family members of the wealthy has become an important source of income for many groups. Even some of the victims have expressed sympathy for the idea that kidnappings are motivated by the difficulties arising from economic privation.

The absence of overtly left-wing influences in a centrist regime coming to power later in the forecast period will be reflected in the lower priority assigned to state-directed poverty-reduction programs – although some version of the PT's generally successful program of transfers will likely be maintained – and the formal abandonment of plans for land reform. Consequently, this regime can expect to confront the periodic application of pressure from organized labor and landless groups, and unpopular policy measures required to repair the damaged economy inherited by a centrist coalition government points to at least some risk of more broad-based anti-government protests that pose a threat to stability.

### **Effective Policy Mix Key to Creating Foundation for a Rebound**

While the political machinations play out, economic policy is drifting without clear direction. Former Finance Minister Joaquim Levy, a highly respected technocrat who had managed to retain the confidence of international institutions, resigned on December 18, just days after his plan to restore fiscal stability was rejected by President Rousseff, and Fitch became the second credit-rating agency to downgrade Brazil's debt rating to junk status. Barbosa, a former planning minister and a PT stalwart, was expected to be less aggressive than his predecessor in attacking the task of deficit reduction, and that has proven to be the case.

The government's reluctance to implement a program of harsh austerity is understandable. According to central bank estimates, the economy contracted by 3.8% in real terms in 2015, with the pace of decline accelerating sharply in the final quarter of the year. The unemployment rate is headed for 10%, and, despite seven interest-rate hikes last year that pushed the Selic up to 14.25%, the highest level in nine years, the lifting of price controls and the steep fall in the value of the real have contributed to a steady rise in the inflation rate, which averaged 9% in 2015, and reached 10.7% at the end of the year, the highest level since 2002.

The government is hoping that the relaxation of fiscal constraints and the extension of \$20 billion in credit backed by public banks will create enough of a cushion to put a floor under the downturn and slow the rise in unemployment. In any case, with prices for



commodity exports showing no sign of an imminent recovery and political uncertainty denting business and consumer confidence, another annual contraction is all but assured in 2016.

The central bank has held the Selic rate steady since late July, despite the persistent upward trajectory of consumer price inflation. The inaction of monetary authorities has fueled speculation that the decisions of the central bank, which is not independent, are being influenced by political pressure, a perception that in combination with the fiscal easing proposed by the government is likely to keep investors on edge, increasing the risk of a further inflationary slide in the real-dollar exchange rate. Assuming market pressure forces the central bank to take action, additional monetary tightening may help to hold inflation to single digits in 2016, but rate hikes will counter efforts to reverse the economic decline.

Economic prospects over the medium term will depend not only on a sustained recovery in commodity prices, but also on the government's ability to make headway on structural reforms. Barring unexpected progress in reforming the pension system, the government's high operating costs will impede its ability to increase state investment without jeopardizing fiscal health. Assuming the maintenance of a generally pro-market stance – the prospects for which are boosted by the expected election of a centrist government in 2018 – inflows of FDI will be sufficient to produce positive real GDP growth of 2%–3% in the second half of the five-year forecast period, but the pace of expansion will average just 2.1% through 2021.

Faster growth is possible if the government manages to overcome the political obstacles to establishing a solid legal foundation for investment in mining fairly early in the forecast period, but progress is not likely on that front until after the 2018 elections. Assuming further serious external shocks are minimized during the forecast period, the central bank's conservative monetary stance will hold inflation to an average of 5.5% per year over the five-year forecast period.

### **Debt Risk Limited**

The current account deficit narrowed to less than \$60 billion in 2015, equivalent to about 3.3% of GDP, compared to the \$104.8 billion shortfall recorded in 2014. The improvement was largely the result of a steep fall in imports, which pushed the trade balance back into surplus after falling into deficit for the first time in more than a decade in 2014. The drop in imports reflected the combined effect of lower prices for commodity imports, weak domestic demand, and the negative effect of currency depreciation on the competitiveness of foreign-produced goods. Those same factors are expected to hold the

current account deficit to less than 4% of GDP once again in 2016, but rising debt-related costs will pose an obstacle to any further significant reduction of the shortfall.

The public-sector debt burden topped 66% of GDP at the end of 2015, up from 51.7% of GDP in 2013. An ample supply of foreign-exchange reserves, which are sufficient to provide nearly two years of import cover, means that the risk of serious debt-related difficulties will be limited in the near term. However, with the debt-to-GDP ratio continuing on an upward track and ratings downgrades raising the cost of new debt, risks will increase over the medium term in the absence of aggressive steps to rein in the fiscal deficit.

The terms of trade will remain unfavorable over the middle of the forecast period, and external factors will have more of an influence on the external balances than domestic political developments. The return of moderate positive growth will be accompanied by strengthening demand for imports, but the trade balance will continue to show a small surplus. However, persistent large shortfalls in the services and income balances will contribute to sizeable current account deficits averaging \$77.2 billion per year, equivalent to roughly 3% of GDP, through 2021.

## Second Most Likely Regime Scenario

### 18-Month Forecast Period:

Centrist Coalition (30% Probability)

### Five-Year Forecast Period:

Divided Government (35% Probability)

Divided Government	Growth (%)	Inflation (%)	CACC (\$bn)
2016	-1.2	7.8	-67.30
2017-2021	0.8	6.4	-68.40

Either a PMDB-led administration taking power after Rousseff's impeachment and removal from office or a PSDB-led administration taking power as the result of a special presidential election held within the 18-month forecast period might be able to secure the backing of a majority coalition in the Congress, but the chances of that happening will be quite low in either case in the absence of cooperation between the PMDB and PSDB. The former's reputation as an unreliable coalition partner and its close association with the Petrobras scandal will give the PSDB two reasons to avoid a formal alliance with the PMDB in the 18-month forecast period, regardless of which party controls the presidency, making it less likely that a stable centrist coalition government might be formed before the end of the 18-month forecast period.

There is a comparable probability that the winner of the 2018 presidential election could prove incapable of securing the reliable backing of a legislative majority. The risk of a

divided government scenario persisting through the end of the five-year forecast period would be especially great were public disgust with the political establishment to result in the election of an “outsider” presidential candidate who lacks a base within the Congress around which to build a larger coalition.

### **Protracted Malaise**

A centrist coalition government formed in the 18-month forecast would of necessity grant very high priority to implementing a program of rapid fiscal consolidation, which would likely include temporary tax increases and unpopular cutbacks in social spending that would dampen that would negatively affect investment and dampen domestic consumption. Attracting the higher levels of private investment needed to counter the negative impact of public-sector austerity would require aggressive action on a comprehensive program to reduce labor costs and boost productivity.

Given the already elevated political temperature inside Brazil, there is a high probability that aggressive near-term moves to impose austerity and implement structural reforms, including business-friendly changes to workplace rules, would trigger a strong backlash, with militant unions and civic groups joining together to organize mass anti-austerity demonstrations. Policy differences among the members of an ideologically diverse, multiparty coalition would be more difficult to bridge under such circumstances, creating a risk that dilution of reform measures would limit their effectiveness.

The barriers to effective policy implementation would be significantly more pronounced under a scenario in which the government elected in 2018 could not count on the support of a congressional majority. Reform measures would remain hung up in the Congress, stalling efforts to boost competitiveness and contributing to a weakening of business confidence. Slower growth would generate public demands for increased social outlays even as the fiscal strains resulting from revenue shortfalls contributed to pressure for more aggressive austerity measures. The threat to fiscal stability would increase the risk that sectors dominated by foreign firms might be targeted for tax increases, and the higher potential for a protracted period of currency volatility would mean a bigger risk of moves to tighten foreign exchange controls and introduce restrictions on the repatriation of profits.

Trade policy would continue to be guided by the country’s obligations as a member of Mercosur. Some liberalization of trade restrictions could be expected, but the maintenance of sizeable external surpluses would leave a minority administration disinclined to significantly reduce barriers to imports except as required under trade agreements concluded by Mercosur.

### Higher Turmoil Risk

The reduced political obstacles to imposing fiscal austerity and pursuing structural reforms implied under the 18-month scenario would increase the risk of public demonstrations and labor-led protests, and it is highly doubtful that unpopular measures implemented in the near term would produce positive economic results that might help to reduce social tensions before the end of the 18-month period. The persistence of divided government over the medium term would similarly be associated with heightened risk of turmoil, as both financial and legislative obstacles would limit the ability of policymakers to dampen the discontent that would result as prolonged economic sluggishness contributed to a deterioration of living standards. An already worrisome crime problem would worsen under this scenario, the result of both socioeconomic factors and the political/fiscal impediments to implementing an effective anti-crime policy program.

### Dimmer Economic Prospects

A prolonged period of political gridlock would have a significant negative impact on the economy, as the failure to remove impediments to investment and address competitive weaknesses would hold inflows of FDI and export growth below potential, while budget strains would limit the scope for the use of fiscal tools to sustain domestic demand, even as the persistence of large deficits necessitated the maintenance of a very tight monetary policy. Real GDP growth would average less than 1% annually through 2021. Currency volatility would bring a risk of imported inflation, but the combination of sluggish domestic demand and a conservative monetary stance would help to hold inflation to an average of 6.4% over the five-year forecast period.

Weaker domestic demand would slow the growth of imports, resulting in a widening of the trade surplus, but a larger debt-service burden would limit the positive effect on the current account deficit, which would remain quite large, averaging \$68.4 billion per year through 2021.

### Third Most Likely Regime Scenario

#### 18-Month Forecast Period:

Center-Left Coalition (25% Probability)

#### Five-Year Forecast Period:

Center-Left Coalition (20% Probability)

Center-Left Coalition	Growth (%)	Inflation (%)	CACC (\$bn)
2016	-2.2	8.8	-55.30
2017-2021	1.4	6.2	-85.60

Although it appears to be very unlikely at present, it is possible that the alliance of the PT and the PMDB will survive the current political storm, enabling President Rousseff to hang on long enough to complete her second and final term in office. However, as her political support erodes, Rousseff cannot assume that even her own party will rise to her

defense against impeachment proceedings. With Lula's legal troubles casting doubt on the PT's chances of retaining the presidency beyond the current term, and the risk of crippling damage to the party's legislative standing likely to increase the longer the PT abets Rousseff's efforts to cling to power, it is not inconceivable that ambitious figures within the PT might decide it is best to cut the party's losses, and pursue a deal with the PMDB, under which the existing alliance would be continued under an administration headed by Temer.

In that event, Temer would serve as president for the remainder of the current term. Any hope that Temer might win a four-year term in his own right in 2018 would hinge on the quick restoration of political stability, and at least some progress toward putting the economy on a path to recovery. Unfortunately, the second condition would likely not be met if a PMDB-led administration depends on the support of the PT to fulfill the first. Consequently, the probability that the government formed after the 2018 elections would be center-left in orientation is quite low.

### **Limited Progress on Liberalization**

Any majority coalition formed in the wake of a presidential crisis would be unwieldy and characterized by a heightened degree of political opportunism, factors that would limit the administration's ability to meet the challenges of restoring trust in the government and sparking an economic recovery. Owing to the PMDB's notorious lack of internal discipline, a government headed by Temer would be more prone to giving in to pressure for overtly populist moves that might produce a temporary bump in the government's popularity at a long-term cost to the country's reputation among investors. A center-left coalition build around a core of the PMDB and the PT would no less susceptible than the current administration to pressure to tread carefully with regard to anti-corruption efforts.

In any case, the government's straitened circumstances would rule out any realistic possibility of business-friendly tax cuts, especially in the early part of the forecast period, and might very well force the administration to introduce temporary tax increases that would be justified as emergency measures. Little substantive headway would be made on reform of the pension system or labor rules in the 18-month forecast period. A center-left coalition would honor its obligations as a member of Mercosur with regard to trade rules, but corruption would persist as an informal barrier to trade.

### **Lingering Domestic Tensions**

The departure of Rousseff might temporarily contribute to an easing of political tensions, but the perpetuation of a governing alliance dependent upon the support of dozens of corruption tainted lawmakers would quickly give rise to a renewed risk of overt displays

of widespread discontent, particularly as fiscal strains necessitate unavoidable and unpopular cuts to state spending.

The formation of a center-left administration following elections in 2018 would most likely occur as the result of divisions within the opposition, the PT's ability to retain the loyalty of its traditional base, and a lack of faith among the electorate that the election of the PSDB would produce any significant improvement in the quality or integrity of the government. Unfortunately, such a development would not significantly improve the prospects for more aggressive action on the reform front over the medium term, and the persistence of economic difficulties would bring a risk that festering discontent might trigger a social explosion.

### **Cautious Approach to Reform Would Delay Economic Recovery**

Near-term economic performance would be weaker under this 18-month scenario than under either of the more likely alternatives, as what amounted to the continuation of the current government minus Rousseff would likely rule out any positive effect from the president's departure. The majority status of the government in both the 18-month and five-year time frames would provide a more solid basis for correcting deficiencies than would be the case in a divided government scenario, but the extent of progress in that regard would fall far short of what might be expected under a centrist government claiming a reliable majority in the Congress. On balance, real GDP growth average 1.4% per year through 2021.

A political arrangement that helps to reduce the current political uncertainty would reduce the risk of chronic currency volatility, and a combination of fiscal restraint and a conservative monetary policy would contain inflation, holding consumer price increases to an average of 6.2% per year over the entire five-year forecast period. Domestic demand would remain weak under conditions of tepid economic growth, but sluggish export activity would result in a moderate widening of the current account deficit to an average of \$85.6 billion per year through 2021. Assuming a generally stable domestic political climate, inflows of FDI would remain sufficient to limit the risk of serious financing difficulties.

## Forecast Summary

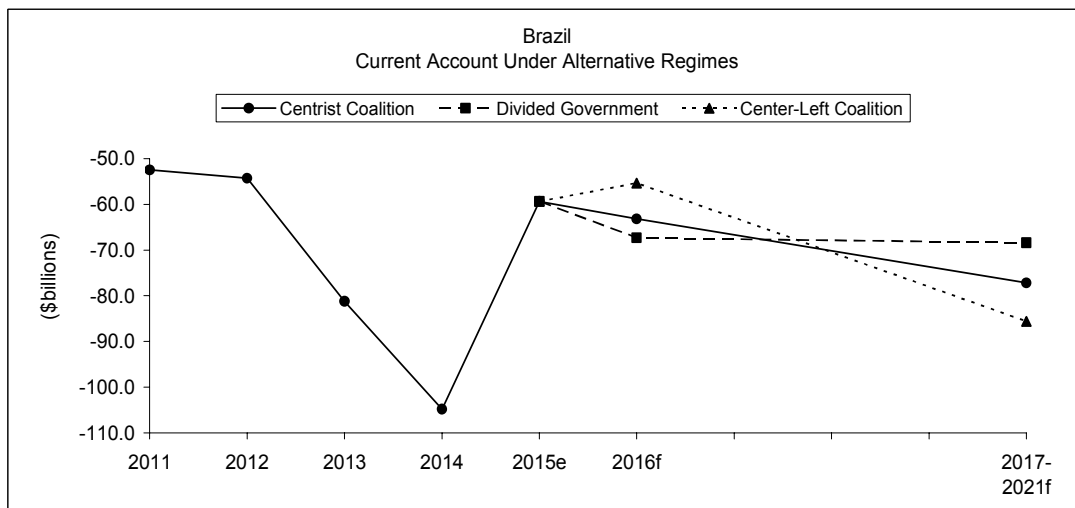
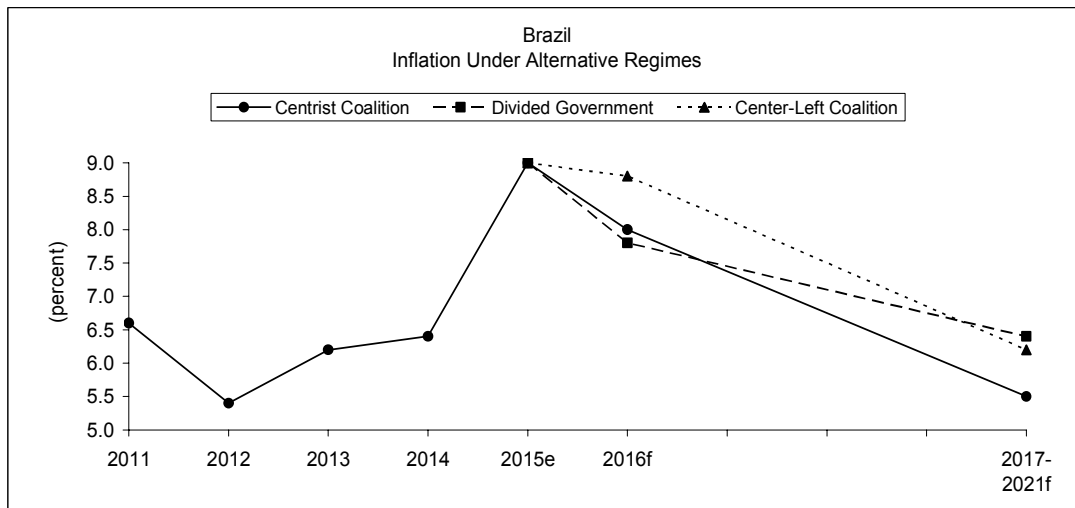
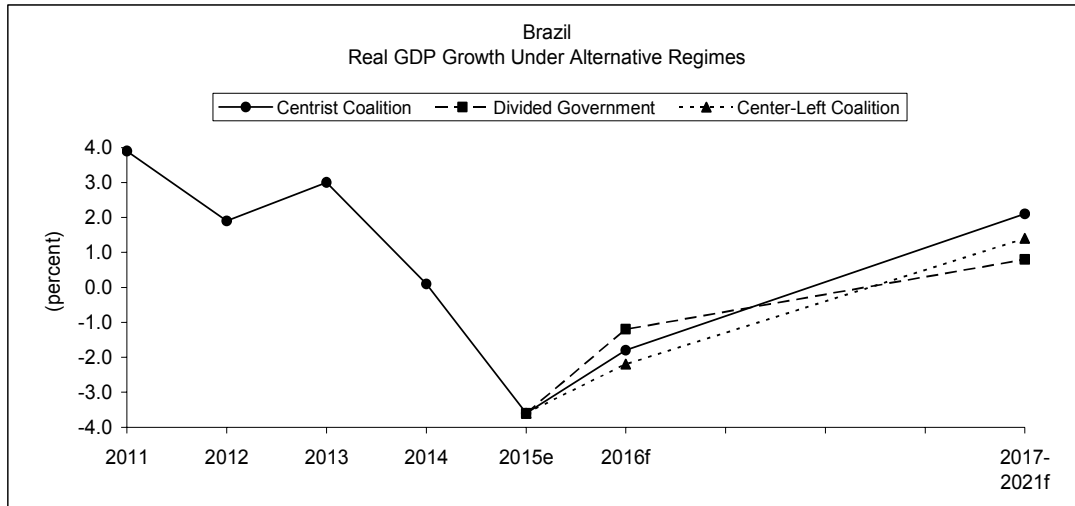
### SUMMARY OF 18-MONTH FORECAST

<b>REGIMES &amp; PROBABILITIES</b>		*Divided Government 45%	Centrist Coalition 30%	Center-Left Coalition 25%
<b>RISK FACTORS</b>	<b>CURRENT</b>			
<b>Turmoil</b>	Moderate	SLIGHTLY MORE	SLIGHTLY MORE	SLIGHTLY MORE
<b>Investment</b>				
<b>Equity</b>	Moderate	Same	SLIGHTLY LESS	Same
<b>Operations</b>	High	Same	Same	SLIGHTLY LESS
<b>Taxation</b>	Moderate	Same	SLIGHTLY MORE	Same
<b>Repatriation</b>	Low	SLIGHTLY MORE	Same	Same
<b>Exchange</b>	Moderate	SLIGHTLY MORE	Same	Same
<b>Trade</b>				
<b>Tariffs</b>	Moderate	SLIGHTLY LESS	SLIGHTLY LESS	SLIGHTLY LESS
<b>Other Barriers</b>	Moderate	Same	SLIGHTLY LESS	Same
<b>Payment Delays</b>	Moderate	Same	Same	Same
<b>Economic Policy</b>				
<b>Expansion</b>	High	Same	Same	SLIGHTLY MORE
<b>Labor Costs</b>	Moderate	SLIGHTLY MORE	Same	SLIGHTLY MORE
<b>Foreign Debt</b>	High	Same	SLIGHTLY LESS	Same

### SUMMARY OF FIVE-YEAR FORECAST

<b>REGIMES &amp; PROBABILITIES</b>		*Centrist Coalition 45%	Divided Government 35%	Center-Left Coalition 20%
<b>RISK FACTORS</b>	<b>BASE</b>			
<b>Turmoil</b>	Moderate	Same	SLIGHTLY MORE	SLIGHTLY MORE
<b>Restrictions</b>				
<b>Investment</b>	Moderate	SLIGHTLY LESS	Same	SLIGHTLY LESS
<b>Trade</b>	Moderate	Same	Same	Same
<b>Economic Problems</b>				
<b>Domestic</b>	High	SLIGHTLY LESS	Same	Same
<b>International</b>	Very High	LESS	SLIGHTLY LESS	SLIGHTLY LESS

\* When present, indicates forecast of a new regime





# Brazil

## Country Forecast

### Political Framework

#### *Players To Watch*

**Dilma Rousseff:** A convergence of political and economic crises has left the president fighting for her political life barely a year after she was sworn in for a second four-year term in early 2015. Although Rousseff has not been directly tied to a massive corruption scandal at the state-owned oil company, she chaired the Petrobras board when the theft of upwards of \$800 million was occurring, and her claim to have had no idea what was happening has tested the credulity of the electorate. Opinion data indicates that more than two-thirds of voters favor her impeachment, and strong public pressure for her removal (which probably reflects discontent over the abysmal state of the economy as much as anything) has provided her political enemies with a justification for moving against her. Although she retains the support of her own party, some members of the PMDB, an essential ally in the PT-led governing coalition, are pushing for a political divorce that would almost certainly result in Rousseff's removal from office. At this point, Rousseff's influence with regard to political risk stems mostly from the negative contribution that would result if she attempts to cling to power.

**Michel Temer:** The leader of the PMDB stood as Rousseff's running-mate at the 2010 and 2014 elections, with the aim of cementing the relationship between the PT and its most important coalition partner. Ironically, by positioning Temer as Rousseff's constitutional successor, the arrangement probably increases the likelihood that her presidency will come to an early end. Temer has a reputation as a business-friendly pragmatist who is skilled at cutting political deals, and his elevation to the presidency would undoubtedly be welcomed by investors looking for an end to the current political uncertainty. However, his ability to implement the unpopular austerities measures and structural reforms that will be required to lay a foundation for an economic revival cannot be taken for granted, given the evident factional strife within his own party, and the obstacles he will likely face as he attempts to pull together a majority coalition. Moreover, his claim to the presidency could be threatened if electoral authorities determine that the PT-PMDB campaign benefited from funds stolen from Petrobras.

**Workers' Party:** The center-left PT's discipline in Congress has historically stood in stark contrast to the fractious center right. However, the party's left wing resisted Lula's effort

to pull the PT toward the political center, and corruption scandals widened rifts among the moderate and leftist factions. The PT maintained its position as the largest party in the lower house of Congress at the October 2014 elections, but significant losses (which have been compounded by post-election defections) have deepened the party's dependence on its partnership with the PMDB, not merely for a legislative majority, but also to keep Rousseff from being forced out of the presidency. As Rousseff's ouster becomes increasingly likely, the PT faces the prospect of being pushed into the opposition for the first time in more than a decade, and with Lula's alleged involvement in the Petrobras scandal possibly ruling out any chance that he might stand as the PT's presidential candidate in 2018, there is a high probability that more left-leaning elements will gain control of the party, in the process reducing the PT's suitability as a coalition partner for a government headed by either the PMDB or the PSDB.

**Brazilian Democratic Movement Party:** The PMDB's partnership with the PT was solidified by the inclusion of party leader Temer as Rousseff's running-mate at the 2010 and 2014 elections. However, the PMDB has long been troubled by a lack of internal discipline that has made it an often unreliable partner. Indeed, Eduardo Cunha, a member of the PMDB and the speaker of the Chamber of Deputies, has played a key role in orchestrating what appears to be President Rousseff's inevitable political downfall. The party's perennially large presence in the Congress reflects a strategy that relies on the ability of lawmakers to deliver benefits to their local constituencies, rather than voters' close identification with the national party. Consequently, although many members of the PMDB, including Cunha, have themselves been tainted by scandal, it is quite probable that the party will remain one of the largest in the Congress after the 2018 elections. The PMDB has historically displayed little discrimination in its choice of political allies, but it may find it difficult to attract coalition partners if it finds itself in the unusual position of controlling the presidency.

**Brazilian Social Democracy Party:** The centrist PSDB has been the PT's main rival for power, and, as the leader of the opposition for the last 13 years, it is the only major party not tainted by the Petrobras scandal. That fact may work to its benefit in the event that electoral authorities find cause to schedule a special presidential election, but the PSDB could suffer collateral damage if the corruption scandal and the ongoing political upheaval contribute to a generalized anti-establishment sentiment among the electorate. When in power, the PSDB has implemented a fairly orthodox policy program, and can be expected to do so if it is returned to power in the near term. However, the party's ability to build a congressional majority is a matter of some doubt, owing to a history of acrimonious relations with other opposition parties, ideological differences with the PT, and ethical issues that rule out the renewal of the party's alliance with the PMDB, which created the basis for a congressional majority the last time the PSDB held the presidency.

# Brazil

## Country Conditions

### Climate for Investment & Trade

#### Overview

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##### *Openness to Foreign Investment*

Foreign Direct Investment (FDI) is prevalent across Brazil's economy. Brazil is open to and encourages FDI.

**Other Investment Policy Reviews.** The latest Organization for Economic Cooperation and Development (OECD) Economic Survey for Brazil was released in 2013. The OECD Survey applauds Brazil's efforts to promote inclusive growth and to sustainably manage natural resources, but recommends continued fiscal consolidation, more aggressive monetary policy to bring inflation closer towards the center of the target band, and improvements to productivity and competitiveness. The OECD report can be found at: [http://www.oecd.org/eco/surveys/Brazil\\_2013\\_Overview\\_ENG.pdf](http://www.oecd.org/eco/surveys/Brazil_2013_Overview_ENG.pdf).

**Laws/Regulations of Foreign Direct Investment.** The GOB currently restricts foreign investment in domestic airline companies to a maximum of 20 percent (Law 7565/1986, Article 181). A bill in the Chamber of Deputies (PL6716/2009) that would increase the ceiling to 49 percent has been pending since 2009. On March 19, 2011, representatives from the U.S. and Brazilian governments signed an Air Transport Agreement that will lead to an Open Skies relationship between the United States and Brazil, eliminating numerical limits on passenger and cargo flights between the two countries. If it is approved by Brazil's Congress, the agreement will take effect in October 2015. The agreement currently sits with the Brazilian executive branch waiting to be reviewed and sent to Congress for ratification. On March 18, 2011, both parties also signed a Memorandum of Consultation (MOC) that incrementally increases flight limits in the interim.

To enter Brazil's insurance and reinsurance market, U.S. companies must establish a subsidiary, enter into a joint venture, or acquire or partner with a local company. Market entry for banks may occur on a case-by-case basis. Of the top 50 banks in Brazil, 20 are owned or controlled by foreign interests. The Brazilian reinsurance market opened to competition in 2007. In December 2010 and March 2011, however, the Brazilian National Council on Private Insurance (CNSP) rolled back market liberalization through the issuance of Resolutions 225 and 232, which disproportionately affect foreign insurers operating in the Brazilian market. Resolution 225 requires that 40 percent of all reinsurance risk be placed with Brazilian companies. Resolution 232 allows insurance companies to place only 20 percent of risk with affiliated reinsurance companies. In December 2011, the CNSP issued Resolution 241, which walked back some of the restrictions of Resolution 225 by allowing the 40 percent requirement to be waived if local reinsurance capacity does not exist.

In September 2011, President Rousseff signed into force a law covering the subscription television market that removed the previous 49 percent limit on foreign ownership of cable TV companies. Under Law 12485/2011, telecom companies will be allowed to offer television packages with their service. Content quotas require every channel to air at least three and a half hours per week of Brazilian programming during primetime. Additionally, one-third of all channels included in any TV package have to be Brazilian.

Foreign ownership of land within 150 km of national borders remains prohibited unless approved by Brazil's National Security Council, per Law 6634/1979. On August 23, 2013, the National Land Reform and Settlement Institute (INCRA) published a set of rules covering the purchase of Brazilian land by foreigners. Under the new rules, the area bought or leased by foreigners cannot account for more than 25 percent of the overall area in any municipal district. Additionally, no more than 10 percent of the land in any given municipal district may be owned or leased by foreign nationals from the same country. The rules also make it necessary to obtain congressional approval before large plots of land can be purchased by foreigners, foreign companies, or Brazilian companies with the majority of shareholders from foreign countries.

On February 25, 2014, the Attorney General of Brazil and the Minister of Agrarian Development co-signed a bill that stipulates the rural lands purchased by foreigners between June 7, 1994 and August 22, 2010 in which companies that have foreigners as partners will be considered Brazilian and be regulated to prevent judicial insecurity. In the state of São Paulo, due to a judicial impasse, foreigners have been able to buy unrestricted amounts of land since the end of 2013. Companies controlled by foreign entities have been taking advantage of the opportunity and have been seeking investment properties.

**Industrial Promotion.** In August 2011, Brazil announced a new industrial policy, Plano Brasil Maior (the "Bigger Brazil" plan), to support domestic producers, encourage investment, and spur innovation. The plan, covering the period of 2011-2014, set targets for investment spending to reach 22.4 percent of GDP by 2014, up from a 2010 baseline of 18.4 percent. Private investment in R&D was to reach 0.90 percent of GDP by 2014, up from the 2010 figure of 0.59 percent. Brasil Maior also set targets for making the economy more energy-efficient, reducing the amount of petroleum used per unit of GDP by 9 percent, and nearly tripling broadband internet penetration from 13.8 million households in 2010 to 40 million households in 2014. The GOB is still assessing the results of the 2011-2014 period.

**Limits on Foreign Control.** FDI is prevalent across Brazil's economy, although certain sectors are subject to foreign ownership limitations as specified in the sections above. A 1995 constitutional amendment (EC 6/1995) terminated the distinction between foreign and local capital in general, but there are laws that restrict foreign ownership within some sectors, notably aviation, insurance, and media.

**Privatization Program.** Brazil has begun an ambitious USD 133 billion Logistics Investment Program (PIL) to draw in private capital and managerial expertise to upgrade the nation's infrastructure, including projects in roads, ports, airports, energy, and urban mobility. All of the infrastructure concessions are open to foreign companies. In fact, in the airport concessions, foreign companies have not only been encouraged to bid, but the auction criteria have been defined in a way that has the effect of requiring the participation of foreign airport operators. The bidding process is non-discriminatory, transparent, and performed without political interference.

In addition to the PIL mentioned above, between January 2011 and December 2014, the government's Program to Accelerate Growth (PAC) disbursed USD 530 billion to fund transportation, energy, housing, and sanitation projects, representing 96.5 percent of total spending projected by the end of 2014. The next phase of PAC will launch in 2015.

**Screening of FDI.** Foreigners investing in Brazil must register their investment with the BCB within 30 days of the inflow of resources to Brazil. Registration is done electronically. Investments involving royalties and technology transfer must be registered with Brazil's patent office, the National Institute of Industrial Property (INPI). Investors must also have a local representative in Brazil. Portfolio investors must have a Brazilian financial administrator and register with the Brazilian Securities Exchange Commission (CVM).

**Competition Law.** Regulatory review of mergers and acquisitions are carried out by the Administrative Council for Economic Defense (CADE). In October 2012, Brazil performed its first-ever pre-merger review of a pending merger, bringing Brazil in line with U.S. and European practices. This shift in merger review was a result of 2011 legislation (Law 12529), which was adopted to modernize Brazil's antitrust review and to combine the antitrust functions of the Ministry of Justice and the Ministry of Finance into those of the so-called "Super CADE." This government body is responsible for enforcement of competition laws, consumer defense, and combating abuse of economic power.

**Investment Trends.** Brazil was the fifth largest destination for global FDI flows in 2014. New FDI into Brazil reached approximately USD 64 billion in 2013, and Brazil typically receives close to half of South America's total incoming FDI. The GOB has made attracting private investment in infrastructure a top priority for 2015.

### ***Transparency of the Regulatory System***

In the 2015 World Bank "Doing Business" report, Brazil ranked 120th out of 189 countries in terms of overall ease of doing business, an improvement of three positions compared to the 2014 report. According to the study, it takes an average of 12 procedures and 102.5 days to start a new business in São Paulo, significantly longer than the OECD high-income economies' average of 9.2 days. In Rio de Janeiro, it takes an average of 11 procedures and 54 days to start a new business. The study noted that the annual administrative burden to a medium-size business of tax payments in Brazil is an average of 2,600 hours versus 176 hours in the OECD high-income economies. According to this same study, the total tax rate for a medium-sized business in Brazil is 69 percent of profits, compared to 41.3 percent in the OECD high-income economies. Business managers often complain of not understanding tax regulations, despite their investments in large tax and accounting departments.

Tax regulations, while burdensome and numerous, do not differentiate between foreign and domestic firms. However, there have been instances of complaints that the value-added tax collected by individual states (ICMS) favors local companies. Although the tax is designed to be refunded when goods are exported abroad, exporters in many states have had difficulty receiving their ICMS rebates. Taxes on commercial and financial transactions are particularly burdensome, and businesses complain that these taxes hinder the international competitiveness of Brazilian-made products. In addition, the U.S. government is evaluating Provisional Measure 668, which increases the PIS/Cofins tax rate on imported goods only and is scheduled to take effect May 1, 2015.

Of Brazil's ten federal regulatory agencies, the most prominent include ANVISA (the Brazilian equivalent of the U.S. Food and Drug Administration), which has regulatory authority over the production and marketing of food, drugs and medical devices; ANATEL, the country's telecommunication agency, which handles licensing and assigning of bandwidth; ANP, the National Petroleum Agency, which regulates oil and gas contracts and oversees the bidding process for oil blocks, including for pre-salt oil; ANAC, the agency that oversees the civil aviation industry; and ANEEL, the country's electric energy agency. In addition to these federal regulatory agencies, Brazil has at least 27 state-level agencies and 17 municipal-level agencies.

The Office of the Presidency's Program for the Strengthening of Institutional Capacity for Management in Regulation (PRO-REG), created in 2007 by Decree 6062, has tried to introduce a broad program for improving the regulatory framework in Brazil including via a 2014 Work Plan with the White House Office of Information and Regulatory Affairs to exchange best practices in developing regulations. Five exchanges under the work plan occurred in 2014.

Pursuant to the GOB's priority to improve transparency, the general public has online access to both approved and proposed federal legislation via websites for the Chamber of Deputies, Federal Senate, and the Office of the Presidency. Brazil is seeking to improve its public comment and stakeholder input process. Since 2004, the Brazilian government has instituted a Transparency Portal, a website in which data is available on funds transferred to and from the federal, state and city governments, as well as to and from foreign countries. It also includes information on civil servants' salaries. The Brazilian Transparency Portal has been a model for other developing countries, and the United States partnered with Brazil to replicate the portal in El Salvador.

Foreign investors have encountered obstacles engaging with regulatory agencies. Notable examples include companies in the electric power sector that have complained about the high level of regulatory risk, including the tariff review process. Additionally, some industries have reported challenges in obtaining licenses from IBAMA, the environmental regulator, citing unclear licensing requirements, though the process was reportedly streamlined in 2008. There have also been examples of federal agencies levying significant fines on U.S. companies.

### *Foreign/Free Trade Zones/Ports*

The federal government has granted tax benefits for certain free trade zones. Most of these free trade zones aim to attract investment to the country's relatively underdeveloped North and Northeast regions. The most prominent of these is the Manaus Free Trade Zone, in Amazonas State, which has attracted significant foreign investment, including from U.S. companies. In October 2011, President Rousseff signed a constitutional amendment that extends Manaus's status as an industrial zone for another 50 years. Constitutional amendment 83/2014 came into force in August 2014 and extended the status of Manaus Free Trade Zone until the year 2073.

## **Tariff and Non-tariff Barriers**

Brazil ranked 116 out of 189 countries in the World Bank's 2014 Doing Business Report. U.S. exporters to Brazil face challenges. U.S. companies cite high tariffs, an uncertain customs system, high and unpredictable tax burdens, and an overburdened legal system as major hurdles they must overcome to do business in Brazil. U.S. exporters in regulated industries (e.g., medical devices, health, and safety products) have a particularly challenging time navigating Brazilian rules and regulations.

As the Government of Brazil has implemented the Brasil Maior (Greater Brazil) plan, a rise in trade protections has been observed, such as tax breaks to benefit local manufacturers, increased tariffs, and local content requirements. U.S. companies will increase their chances of success by working with strategic Brazilian partners and highlighting their commitment to the Brazilian market. U.S. companies may face market access challenges in Brazil over the next several years, such as increasing pressures on the GOB to raise tariffs and impose non-tariff barriers. Brazil's "Buy Brazil" policy is one such measure.

## **Policies**

### *Conversion and Transfer*

**Foreign Exchange.** There are few restrictions on converting or transferring funds associated with a foreign investment in Brazil. Foreign investors may freely convert Brazilian currency in the unified foreign exchange market where buy-sell rates are determined by market forces. All foreign exchange transactions, including identifying data, must be reported to the BCB. Foreign exchange transactions on the current account have been fully liberalized.

All incoming foreign loans must be approved by the BCB. In most instances, the loans are automatically approved. Automatic approval is not issued when the costs of the loan are “not compatible with normal market conditions and practices.” In such instances, the BCB may request additional information regarding the transaction. Foreign loans obtained abroad do not require advance approval by the BCB, provided the recipient is not a government entity. Loans to government entities, however, require prior approval from the Brazilian Senate as well as from the Finance Ministry’s Treasury Secretariat, and must be registered with the BCB.

Interest and amortization payments specified in a loan contract can be made without additional approval from the BCB. Early payments can also be made without additional approvals, if the contract includes a provision for them. Otherwise, early payment requires notification to the BCB to ensure accurate records of Brazil’s stock of debt.

On March 6, 2014, the Federal Revenue Service of Brazil consolidated the regulations on withholding tax (IRRF) applicable to earnings and capital gains realized by individuals and legal entities resident or domiciled outside Brazil. The regulation states that the cost of acquisition must be calculated “in reais.” The drafting is not clear enough to determine, however, whether the acquisition cost in reais is obtained by converting the value of the direct foreign investment registered with the BCB using the quoted exchange rate on the date of acquisition (the historic rate), or the quoted rate for the date of the sale, or the rate for day two days prior to the sale. Additional requirements were also created for the application of a zero-rate IRRF, such as good tax standing (formalities not specified). Also, the “technical services” definition was broadened to include administrative support and consulting services rendered by individuals (employees or not) or resulting from automated structures having clear technological content. This change is significant for the purposes of determining the applicable IRRF rate, whether the Contribution of Intervention in the Economic Domain (CIDE) tax applies, and for the application of Treaties to Avoid Double Taxation.

**Remittance Policies.** Foreign investors, upon registering their investment with the BCB, are able to remit dividends, capital (including capital gains), and, if applicable, royalties. Remittances must also be registered with the BCB. Dividends cannot exceed corporate profits. The remittance transaction may be carried out at any bank by documenting the source of the transaction (evidence of profit or sale of assets) and showing that applicable taxes have been paid.

Capital gain remittances are subject to a 15 percent income withholding tax, with the exception of the capital gains and interest payments on tax-exempt domestically issued Brazilian bonds. Repatriation of the initial investment is also exempt from income tax. Lease payments are assessed a 15 percent withholding tax. Remittances related to technology transfers are not subject to the tax on credit, foreign exchange, and insurance, although they are subject to a 15 percent withholding tax and an extra 10 percent CIDE.

### **Performance Requirements**

**WTO/TRIMS.** Brazil is not a signatory to the World Trade Organization (WTO) Agreement on Government Procurement (GPA). U.S. companies seeking to participate in Brazil’s public sector procurement effectively need to partner with a local firm or have operations in Brazil. Foreign companies are often successful in obtaining subcontracting opportunities with large Brazilian firms that win government contracts.

**Investment Incentives.** The Brazilian government uses a variety of tax incentives and attractive financing through the National Bank for Economic and Social Development (BNDES) to actively encourage both domestic and foreign investment. BNDES is one of the largest development banks in the world, outpacing the lending of even the World Bank. BNDES lending in 2014 was concentrated in infrastructure and Micro,

Small and Medium Enterprises, accounting respectively for 36.7 and 32 percent of total disbursements. Industry accounted for 26.7 percent of total disbursements, a setback of 14 percent compared to 2013. The telecommunications sector saw the largest proportional growth in lending, with total disbursement of R\$5.3 billion, a 97 percent increase over the previous year.

As part of its package of fiscal tightening, in December 2014, the GOB announced its intention to scale back the expansionary activities of BNDES. The GOB will end direct Treasury support to the bank, which provided 20 percent of BNDES cash flow in 2014, and raised the Long Term Interest Rate that serves as the basis for BNDES loans from 5.0 to 5.5 percent.

The GOB extends tax benefits for investment in less developed parts of the country, such as the Northeast and the Amazon regions, with equal application to foreign and domestic investors. These incentives have been successful in attracting major foreign plants to areas like the Manaus Free Trade Zone, but most foreign investment remains concentrated in the more industrialized southern part of Brazil.

Individual states have sought to attract investment by offering ad hoc tax benefits and infrastructure support to specific companies, negotiated on a case by case basis. These benefits have spurred a so-called "fiscal war" between the states, with some states challenging the tax benefits as harmful fiscal competition. In June 2011, the Brazilian Supreme Court ruled that the benefits granted by 14 states on interstate commerce are unconstitutional, since they were implemented without unanimous consent from the National Council of Fiscal Policy (Confaz). In November 2012, the Ministry of Finance proposed to Congress an end to the "fiscal war" by setting the interstate tax rate on goods at 4 percent for all states, thus limiting states' ability to offer special tax incentives to attract investment away from other states. However, state finance secretaries have been unable reach consensus on the tax rate exemptions proposal.

In January 2015, the Minister of Finance proposed reversing an October 2012 decree (7819) in support of domestic auto manufacturers. The decree raised the Industrial Products Tax (IPI) by 30 percentage points of the price of the vehicle on all vehicle sales in the Brazilian market on or after January 1, 2013. This change affected all vehicles in Brazil. Auto manufacturers are able to apply for a tax credit based on their ability to meet certain criteria, including the number of manufacturing processes performed in Brazil, enhancing fuel efficiency, committing to invest in research and development in Brazil or to use Brazilian engineering services, and agreeing to participate in a fuel-efficiency labeling scheme.

In September 2014, the GOB issued Decree 8304 to reinstate the Special Regime for the Reinstatement of Taxes for Exporters, dubbed the Reintegra Program. Under the program, exporters of products covering 8,630 tariff codes receive a subsidy of 3 percent of the value of their exports. To qualify, the imported content of the exported goods cannot exceed 40 percent, except in the case of high-tech goods, such as pharmaceuticals, electronics, and aircraft and parts, which are permitted to have up to 65 percent of inputs imported. In addition, Reintegra exempts exporters from so-called indirect taxes on capital expenditures, including the PIS/Cofins social contribution taxes and the IOF tax on financial transactions. On February 27, 2015, Decree 8415 revoked Decree 8304 and determined new regulations for the program; however, the three percent subsidy on the value of the exports is still in effect.

In May 2010, the GOB launched a National Broadband Plan, which featured fiscal incentives, private sector participation, and regulatory reform to build out internet infrastructure under the leadership of state-owned firm Telebras. While the plan provided commercial opportunities for foreign investors, it also sought to boost Brazilian technology by granting domestic IT equipment tax exemptions, favorable BNDES financing, and preference in the procurement process.



**Research and Development.** Tax credits are available based on a producer's ability to meet certain criteria, including investing in research and development in Brazil.

**Performance Requirements.** In firms employing three or more persons, Brazilian nationals must constitute at least two-thirds of all employees and receive at least two-thirds of total payroll, according to Brazilian Labor Law Articles 352 to 354. Foreign specialists in fields where Brazilians are unavailable are not counted in calculating the one-third permitted for non-Brazilians.

Law 8666 (from 1993) covers most government procurement other than information technology/telecommunications and requires non-discriminatory treatment for all bidders regardless of nationality or origin of the product or service. GOB procurement rules apply to purchases by government entities and state-owned companies. Brazil has an open competition process for major government procurements. The GOB may not make a distinction between domestic and foreign-owned companies during the tendering process; however, when two equally qualified vendors are considered, the law's implementing regulations provide for a preference for Brazilian goods and services. Price is to be the overriding factor in selecting suppliers. However, the law's implementing regulations also allow for consideration of non-price factors, giving preferences to certain goods produced in Brazil and stipulating local content requirements in order to qualify for tax benefits. Additionally, nearly all bids require establishment of a local representative for any foreign company bidding.

Government procurement is just one of thirty-five industrial policy components under Brasil Maior intended to support Brazilian industry and protect domestic producers, particularly the labor-intensive sectors threatened by imports. The textile, clothing and footwear industries – among the few industries to have lost jobs during the current growth period – were the first to benefit from Brasil Maior when, in November 2011, the Ministry of Development, Industry and Commerce implemented an 8 percent preference margin for domestic producers in these industries when bidding on government contracts. In April 2012, Decrees 7709 and 7713 expanded the use of preference margins to pharmaceuticals and medicine (8 or 20 percent) and excavators and bulldozers (15 and 25 percent). The preference margins for these goods are valid until December 31, 2015.

Decree 7174 (2010), which regulates the procurement of information technology goods and services, requires federal agencies and parastatal entities to give preferential treatment to domestically produced computer products and goods or services with technology developed in Brazil based on a complicated price/technology matrix.

**Data Storage.** In general, the government does not explicitly practice "forced localization" in which foreign investors must use domestic content in goods and technology, but local content products have the advantage of tax breaks, BNDES financing, and price preferences of up to 25 percent in government purchases. To date, there is no general requirement for foreign IT providers to turn over source codes or otherwise provide access to surveillance, but Decree 8135 of 2013 calls for auditing of hardware and software used in government data communications.

In 2014, Brazil passed the comprehensive Marco Civil Internet Law without an explicit data localization requirement. The law states, however, that data collected, stored, retained, or treated in Brazil shall respect Brazilian law, implying that certain data stored overseas by foreign companies might be subject to the law. Penalties for non-compliance could include fines of up to 10 percent of gross Brazil revenues and/or suspension or prohibition of related operations in country.

## Legal Framework

### *Expropriation and Compensation*

There have been no known expropriation actions in Brazil against foreign interests in the recent past, nor have there been any signs that the current government is contemplating such actions. Some claims regarding land expropriations by state agencies have been judged by Brazilian courts in U.S. citizens' favor; however, compensation has not always been paid, as states have filed appeals to these decisions, and the Brazilian judicial system moves slowly. In June 2014, an amendment to Article 243 of the Constitution was approved, determining that assets can be expropriated if human slavery or planting of illegal psychotropic plants is confirmed on the grounds. Expropriation will be done through all lawful means, with the right to appeal, but once determined, the owner will not receive the money generated through the sale of the asset.

### *Dispute Settlement*

**Legal System, Specialized Courts, Judicial Independence, Judgments of Foreign Courts.** The Brazilian court system is overburdened, and contract disputes can be lengthy and complex. Brazil has both a federal and a state court system, and jurisprudence is based on civil law. Federal judges hear most disputes in which one of the parties is the State and rule on lawsuits between a foreign State or international organization and a municipality or a person residing in Brazil. Five regional federal courts hear appeals of federal judges' decisions.

**Bankruptcy.** Brazil has a commercial code that governs most aspects of commercial association, except for corporations formed for the provision of professional services, which are governed by the civil code. In 2005, bankruptcy legislation (Law 11101) went into effect creating a system modeled on Chapter 11 of the U.S. bankruptcy code, which allows a company in financial trouble to negotiate a restructuring with its creditors outside of the courts. In the event a company does fail despite restructuring efforts, the reforms improve creditors' ability to recover their debts.

**Investment Disputes.** Article 34 of the 1996 Brazilian Arbitration Act (Law 9307) defines a foreign arbitration judgment as any judgment rendered outside the national territory. The law established that the Brazilian Federal Supreme Court must ratify foreign arbitration awards. Law 9307 also stipulates that the foreign arbitration award is to be recognized or executed in Brazil in conformity with the international agreements ratified by the country and, in their absence, with domestic law. [Note: A 2001 Brazilian Federal Supreme Court ruling established that the 1996 Brazilian Arbitration Act, permitting international arbitration subject to Federal Supreme Court ratification of arbitration decisions, does not violate the Federal Constitution's provision that "the law shall not exclude any injury or threat to a right from the consideration of the Judicial Power."]

**International Arbitration.** Brazil has ratified the 1975 Inter-American Convention on International Commercial Arbitration (Panama Convention) and the 1979 Inter-American Convention on Extraterritorial Validity of Foreign Judgments and Arbitration Awards (Montevideo Convention).

**ICSID Convention and New York Convention.** Brazil has ratified the 1958 Convention on the Recognition and Enforcement of Foreign Arbitration Awards (New York Convention). Brazil, however, is not a member of the International Center for the Settlement of Investment Disputes (ICSID), also known as the Washington Convention.

**Duration of Dispute Resolution.** The 2015 World Bank, Doing Business report found that on average it takes 44 procedures and 731 days to litigate a contract breach at an average cost of 16.5 percent of the claim.

### *Right to Ownership and Establishment*

Foreign and domestic private entities may establish, own, and dispose of business enterprises.

### *Protection of Property Rights*

**Real Property.** Brazil has a system in place for mortgage registration, but implementation is uneven and there is no standardized contract. Foreign individuals or foreign-owned companies can purchase real property in Brazil. These buyers frequently arrange alternative financing in their own countries, where rates may be more attractive. Law 9514 (from 1997) helped spur the mortgage industry by establishing a legal framework for a secondary market in mortgages and streamlining the foreclosure process, but the mortgage market in Brazil is still underdeveloped, and foreigners may have difficulty obtaining mortgage financing. Large U.S. real estate firms, nonetheless, are expanding their portfolios in Brazil.

**Intellectual Property Rights.** The quality of Intellectual Property Right (IPR) protection and level of enforcement within Brazil is improving. The country has an array of domestic laws and regulations that address IP, and government entities and private industry pay attention to the issue. National and local authorities are active in carrying out enforcement actions, but a long land border and active ports complicate this effort. While Brazil itself is not a major producer of counterfeit and pirated products, societal attitudes toward their purchase remain permissive, and industry stakeholders are increasingly concerned about online IP violations.

Brazil is a member of the WTO, and has legislatively implemented its obligations under the Trade Related Aspects of Intellectual Property (TRIPS) agreement through its 1996 Industrial Property Law and 1998 Copyrights Law. Brazil is a signatory of the Berne Convention for the Protection of Literary and Artistic Works, the Patent Cooperation Treaty, the Convention on Plant Variety Protection, and the Paris Convention on Protection of Intellectual Property, and plays an active role at the World Intellectual Property Organization (WIPO). Brazil is not a party to the WIPO Copyright Treaty or the WIPO Performances and Phonograms Treaty, collectively known as the WIPO Internet Treaties, nor the Anti-Counterfeiting Trade Agreement (ACTA). Brazil has been taking steps to join the Madrid Agreement Concerning the International Registration of Marks ("Madrid Protocol"), which would make the process of obtaining a trademark in Brazil faster.

In multilateral negotiations and the WTO TRIPS Council, Brazil, together with other countries, presses demands for unlimited technology transfer that could lead to coercion of private rights holders, weakening their property rights. These outcomes could undermine innovation, trade, and investment in IP-intensive products and services that are critical parts of the response to climate change, sustainable economic development, and other challenges. By advancing such positions, the Brazilian government is creating uncertainty with respect to its commitment to create a domestic environment that will encourage innovation and investment in innovative industries.

Brazil is developing a revised copyright law that will more directly address digital issues, as well as other bills to address such items as the ownership of genetic biodiversity resources. These laws might clarify the IP landscape, but foreign industry stakeholders are watching carefully to see how they might affect their IP interests.

Brazil does not publish a comprehensive database on counterfeit seizures, but a recent non-government estimate placed losses to illicit commerce (including contraband) at over USD 20 billion in 2014 <http://arte.folha.uol.com.br/mercado/2015/03/12/crime-sem-castigo/> . Brazil has remained on the "Watch List" of the U.S. Trade Representative's Special 301 report since 2007, when it was upgraded from

the “Priority Watch List” in recognition of improvements in its IPR regime. Continuing challenges include regulatory issues such as the longstanding role of the health regulator in reviewing pharmaceutical patent applications before the patent office considers them, long wait time in the patent application process, and high levels of digital and hard-goods piracy and counterfeiting. USTR’s 2015 “Notorious Markets” report flagged Sao Paulo’s Galeria Page market for its high levels of illicit goods and low levels of enforcement. The report also flagged [baixeturbo.org](http://baixeturbo.org), an overseas website with infringing content that targets Brazilian users.

Customs officers have ex-officio authority to seize suspected counterfeit goods. The authorities, however, are required to retain such goods throughout the investigative and legal process, rather than merely keeping a representational sample. This taxes physical storage and budget capabilities of the authorities, hampering overall enforcement. Rights holders are not responsible for paying for the storage and destruction of counterfeit goods. Counterfeit goods readily available in Brazil include apparel, fashion accessories, toys, and audiovisual entertainment products; these items are produced within Brazil, in neighboring countries such as Paraguay, and in Asia. Smuggled genuine goods, such as cigarettes and beverages, are also a serious concern.

Industry stakeholders continue to voice concern over INPI’s backlog of pending patent applications. INPI has increased its hiring and training of new examiners, but it still takes about 10 years for a patent to be granted. The average time from application to grant of trademark is 46 months. Brazil has modern trade secret laws, including criminal penalties, and Brazilian courts are accessible and equitable to foreigners. In most respects, the Industrial Property Law meets the international standards specified in TRIPS regarding patent and trademark protection. The law does provide for compulsory licensing if a patent owner has failed to adequately commercialize the technology, but there are several exceptions to this that can be referenced by the patent holder so that compulsory licensing can be averted.

IP protections in general are improving in Brazil, exemplified by continued whole-of-government dialogue and efforts under the National Council on Combating Piracy. Authorities conduct and publicize raids in cities like Brasilia and Rio. The 2014 FIFA soccer World Cup helped draw attention to IP issues, and it is expected that the 2016 Olympics will further boost enforcement and IP protection efforts.

## Infrastructure

Brazilian transportation infrastructure faces many challenges. Roads and ports need to be upgraded. Trucks hauling cargo on roads are the most used method of transportation. Despite the existence of several rivers, waterways are rarely used, except in the Amazon region, where rivers are usually the only way to access many isolated points. Railroads are few and uncompetitive. The use of trains for long distance transportation of passengers is restricted to a few urban tourist routes, while cargo transportation is mostly restricted to raw minerals.

According to the Government of Brazilian (GOB), investments needed to reduce bottlenecks in the transportation sector in the medium and long term will total US\$220 billion between 2008 and 2023. Investments include extension of highways, the interconnection of the North-South regions with the Southeast region, ferries to cover North-South regions, and port construction.

Major international sporting events including the 2014 World Cup and 2016 Olympics have spurred Brazil to act quickly to improve its transportation infrastructure. The government is developing new concessions and public-private partnerships, leveraging the private sector in a way that is mutually beneficial to investors and the government.

Between 2012 and 2013, President Rousseff launched the Logistics Investment Program, an initiative designed on the basis of strategic partnerships with the private sector and focused on renewal and integration of Brazil's transportation network. The goal is to meet growth demands of a country with continental dimensions. The Logistics Investment Program consists of a wide concession set in transportation logistics, which implies large private investment in infrastructure. Since 2013, the GOB has been staging concession auctions for large projects such as highways (7,500 km), railways (10,000 km) and ports.

**Logistics.** Brazil has one of the highest logistics costs in the world. Market analysts estimate that the distribution cost structure represents approximately 31.8% of logistics cost. This includes management, warehousing, inventory, legal requirements and transportation costs. Logistical costs represent an average of 20% of Brazil's gross domestic product (GDP), twice that of the United States. The objective of the GOB's Logistics Investment Program is to provide Brazil with a transportation system that reflects its continental scale. The project faced some challenges initially, but will use an investment model that favors partnerships between public and private sectors. Concessions will be used for highway projects, while public-private partnerships will be developed for railway projects.

**Roads.** Highways represent more than half of all public transportation infrastructure in Brazil, followed by railways with 25%, waterways with 17% and others, such as air transportation. As the chart above indicates, the GOB plans to spend US\$32.8 billion in the next five years, with another US\$11.8 billion in the following 20 years. This amount will be used to create and improve roads in the five Brazilian regions (North, Northeast, Midwest, Southeast, and South). This process includes not only the construction of bridges and paths, but also their paving, duplication, maintenance and preservation. Brazil will also open concessions for some major highways in the northern and northeastern states of Minas Gerais, Bahia, Espírito Santo, Goiás and Tocantins.

**Railways.** Brazil has less than half as many kilometers of railroads as do either China or India. Transportation by roads represents 61% of total freight, while that of railroad comprises 21%. Rail transportation has proven to be up to 30% cheaper and more efficient than paved roads. To make the country more competitive, the federal government plans to invest US\$46 billion to build, repair and modernize Brazil's railroads. US\$28 billion will be invested within the next five years and US\$17 billion in the 25 years following (see above chart). Such investments would result in 10,000 kilometers of expanded capacity. The objective is to improve the connection between the North and South regions by connecting preexisting railways and by building new ones.

**Ports.** In the past year, the Brazilian Government announced a concession program to attract some US\$25 billion in investments for Brazil's aging port infrastructure within the next four years. The main objective is to increase Brazil's competitiveness, reduce barriers to market entry, modernize port management, increase trade, and reduce the high cost of doing business in Brazil. The government plans to re-auction 55 public terminals whose operators entered into contracts with the GOB before the 1993 Ports Law was approved. The concessions will not be awarded on the basis of the highest bidder, but rather on the most cargo moved at the lowest price. Port operators will be allowed to end the practice of differentiating between their own cargo and that of a third party. In effect, this change will allow privately-owned port operators to compete for container traffic for the first time. A national dredging plan of US\$1.8 billion was also announced in the same ceremony; this may offer opportunities to U.S.-based dredge manufacturers and service providers. All of these investments will enable the reduction of tariffs and freight cost, contributing in turn to reduced cargo transportation by road.

**Waterways.** Brazil's use of transportation by waterways is small when compared to other countries. For example, 25% of cargo is transported by river in the United States and 35% in Canada. In Brazil, only 14% of cargo is transported by this method. Brazil has enormous potential for river traffic with approximately 63,000 km of rivers and lakes, of which 45,000 km are navigable. The potential is still largely untapped, however, with navigation occurring in only 15,000 km, with a greatest concentration in the Amazon region. Currently, the largest share of investments comes from the public sector, representing 97% of the funds (or about US\$3 billion per year). This situation is expected to change by the end of 2022, when mixed investments (private and public) may reach an average annual investment of US\$ 4.6 billion.

**Public Transportation.** The current metropolitan rail system transports about six million people daily throughout all major Brazilian cities. Research indicates that that figure should equal the number of people transported by the metro system in the metropolitan area of São Paulo alone. According to a study done by ANTP (National Association of Public Transportation), the social cost incurred by the city of São Paulo due to its current insufficient public transportation system is about R\$40 billion a year (US\$22.22 billion). Furthermore, the study showed that 63% of cities with more than 300,000 residents use illegal, unsafe and unreliable means of transportation; millions of people spend three to six hours a day traveling to and from work or school. These many problems in the current system signal opportunities for growth and investment, including for U.S. companies.

## Corruption and other Bureaucratic Obstacles

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In 2013, Brazil ranked 72nd (out of 175 countries) in Transparency International's Corruption Perceptions Index. In South America, Brazil ranked behind Chile and Uruguay, and ranked ahead of Colombia, Peru, Argentina, Suriname, Bolivia, Ecuador, Guyana, Paraguay and Venezuela. With regard to major emerging economies in the BRICS grouping, Brazil ranked ahead of China (80th), India (94th), and Russia (127th), and tied with South Africa (72nd).

Corruption scandals are a regular feature of Brazilian political life. Since 2014, focus has centered on what could be the biggest corruption scandal in Brazil's history, involving Petrobras, the para-statal petroleum company. Known as Operation Car Wash (Lava Jato), more than 103 people have been criminally charged in the scandal, including former Petrobras directors and executives of the biggest private construction companies in Brazil. Nearly fifty politicians are reportedly under investigation as well, including leaders of both houses of Brazil's Congress. In 2015, prosecutors announced "Operacao Zelotes" (i.e. "Operation Zealots"), in which firms are alleged to have bribed tax officials to reduce their assessments. Experts predict that these scandals could take years to unravel, and judicial proceedings usually move quite slowly in Brazil. Still, these investigations are seen as largely independent and a positive step in breaking widespread corruption in Brazil.

**UN Anticorruption Convention, OECD Convention on Combatting Bribery.** Brazil is a signatory to the OECD Anti-Bribery Convention and a participating member of the OECD Working Group on bribery. It was one of the founders, along with the United States, of the intergovernmental Open Government Partnership, which seeks to help governments increase transparency. Brazil has laws, regulations and penalties to combat corruption, but their effectiveness is inconsistent. Bribery is illegal, and a bribe by a local company to a foreign official is a criminal act. A company cannot deduct a bribe to a foreign official from its taxes. While federal government authorities generally investigate allegations of corruption, there are inconsistencies in the level of enforcement among individual states. Corruption has been reported to be problematic in business dealings with some authorities, particularly at the municipal level. U.S. companies operating in Brazil are subject to the U.S. Foreign Corrupt Practices Act.

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## International Agreements

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**Trade Agreements.** Brazil is a member of the Mercosul trading bloc, which has its own regional standards organization that issues and harmonizes standards. Technical committees write and recommend standards in selected areas. Each country must ratify the standard before they are adopted in that country. A number of standards have already been adopted as Mercosul standards. Adopted and proposed Mercosul standards are listed on Mercosul's website: <http://www.amn.org.br>. The Executive Secretariat of the Mercosul Standards Organization is located in São Paulo.

**Bilateral Investment Agreements.** Brazil does not have a Bilateral Investment Treaty (BIT) with the United States. On March 26, 2015, Brazil signed a Bilateral Investment Treaty with Mozambique. In the 1990's Brazil signed BITs with Belgium and Luxembourg, Chile, Cuba, Denmark, Finland, France, Germany, Italy, the Republic of Korea, the Netherlands, Portugal, Switzerland, the United Kingdom and Venezuela, but none of these have been approved by the Brazilian Congress. In 2002, an inter-ministerial working group decided to withdraw the agreements from Congress for approval, so they have not and will not be voted on any time soon. Brazil also has not ratified the Mercosul investment protocol.

**Bilateral Taxation Treaties.** Brazil does not have a double taxation treaty with the United States, but it does have such treaties with 33 other countries, including, among others, Japan, France, Italy, the Netherlands, Canada, Spain, Portugal, and Argentina. Brazil signed a Tax Information Exchange Agreement (TIEA) with the United States in March 2007, and that agreement entered into force on May 15, 2013, signed by President Dilma Rousseff in Decree 8003/2013.

**OPIC and Other Investment Insurance Programs.** Programs of the Overseas Private Investment Corporation (OPIC) are fully available, and activity has increased in recent years. The size of OPIC's exposure in Brazil may occasionally limit its capacity for new coverage. Brazil has been a member of the Multilateral Investment Guarantee Agency (MIGA) since 1992.

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## Labor Conditions

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The Brazilian Ministry of Labor estimates that in 2014, only 396,993 formal jobs were created, a drop of 64.4 percent compared to 1.1 million in 2013. Job creation results for 2014 were Brazil's worst on record since 1999, when the country created only 196,000 formal jobs. Still, the Brazilian Institute of Geography and Statistics (IBGE) estimated unemployment in the six major metropolitan areas to be 4.3 percent at the end of 2014, the lowest level since the survey began in 2002. Unemployment levels vary significantly across regions.

According to a 2011 IBGE report, the Brazilian labor force has 92.5 million workers. In 2014, roughly 58 percent were located in the services sector, 15 percent in agriculture, and 21 percent in the construction and manufacturing sectors. Brazil has ratified a number of International Labor Organization (ILO) conventions. Brazil is party to the UN Convention on the Rights of the Child and major ILO conventions concerning the prohibition of child labor, forced labor and discrimination.

Brazil's labor code is highly detailed. Formal sector workers are guaranteed 30 days of annual leave and severance pay in the case of dismissal without cause. Brazilian employers are required to pay a "thirteenth month" of salary to employees at the end of the year. Brazil also has a system of labor courts that are charged with resolving routine cases involving unfair dismissal, working conditions, salary disputes, and other grievances. Labor courts have the power to impose an agreement on employers and unions if negotiations break down and either side appeals to the court system. As a result, labor courts routinely are called upon to determine wages and working conditions in industries across the country. The system is

tantamount to compulsory arbitration and does not encourage collective bargaining. In recent years, however, both labor and management have become more flexible and collective bargaining has assumed greater relevance.

The Ministry of Labor estimates that there are nearly 11,000 labor unions in Brazil, but officials note that these figures are inexact. Labor unions, especially in sectors such as metalworking and banking, tend to be well-organized and aggressive in advocating for wages and working conditions and account for approximately 19 percent of the official workforce according to a recent IBGE release. Strikes occur periodically, particularly among public sector unions. Unions in various sectors engage in industry-wide collective bargaining negotiations mandated by federal regulation. While some labor organizations and their leadership operate independently of the government and of political parties, others are considered to be closely associated with political parties.

Employer federations, supported by mandatory fees based on payroll, play a significant role in both public policy and labor relations. Each state has its own federation, which reports to the National Confederation of Industries (CNI), headquartered in Brasilia.

**Sources:** 2015 INVESTMENT CLIMATE STATEMENT-BRAZIL, BUREAU OF ECONOMIC AND BUSINESS AFFAIRS, US DEPARTMENT OF STATE; BRAZIL COUNTRY COMMERCIAL GUIDE FY 2014, US & FOREIGN COMMERCIAL SERVICE AND US DEPARTMENT OF STATE; PRS Data Files.



# Brazil

## Country Conditions

### Background

#### Geography

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Brazil, the fifth-largest country in the world and the largest country in Latin America, shares borders with every South American country except Ecuador and Chile. Occupying nearly one-half of the continent, its vast terrain is marked by sharp geographic variations. The Atlantic coastline is more than 7,200 kilometers long. About 90% of the population lives on 10% of the land. West of Brasilia, the capital, enormous natural resources, new mineral discoveries, and agricultural developments are being exploited, assuring Brazil's future as one of the world's leading exporters of raw materials and commodities. The country imports petroleum, but at declining rates as a result of production and substitution programs; however, Brazil remains heavily dependent on imports of hydropower.

During January, Rio de Janeiro, located in the southeast, averages low and high temperatures of 24°C and 32°C, and receives an average of four days of precipitation; during July, its average temperatures range from 17°C to 27°C, and it receives an average of two days of rainfall.

#### Social Conditions

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**Ethnic and Racial Divisions.** Almost half of the population is black or has a mixed racial heritage, and there are deep divisions between whites and blacks. Blacks lack adequate political representation, education, housing and health care, and their living standards are far below those of whites. Illiteracy is twice as high among blacks as among whites, and on average, a black worker makes about half the income of a white worker. The constitution guarantees Brazil's approximately 300,000 Indians exclusive use of the soil, waters, and minerals on their traditional lands, about 11% of Brazil's total land area, but widespread illegal mining, logging, and ranching by non-Indians often leads to violent disputes. A constitutional provision called for the completion of the demarcation of indigenous lands during the 1990s. Although indigenous groups criticized the decree, it helped to speed the process by transferring the resolution of conflicting claims from the extremely slow and inefficient civil courts to administration by the Justice Ministry.

**Regional and Class Divisions.** Brazil's income distribution is among the world's most disparate. Ten percent of the population holds more than 40% of Brazil's national wealth. Poverty rates have more than halved over the last decade but 9% of Brazil's people still live in poverty. The poorer classes suffered badly from the erratic economic growth of the 1990s. The growth of poverty, along with the skewed distribution of wealth and land, contributed to widespread kidnappings, land invasions, and other violent crimes. Regional imbalances in income and political power aggravate social tensions. The huge disparity in living standards between the impoverished northeast and the developed south has produced massive migration to the cities, swelling the population in the slums. The south and southeast account for about 75% of GDP. More than 60% of MERCOSUR's wealth and population is within the regions of São Paulo and Buenos Aires, making the south more likely to attract investment, while the northeast remains impoverished.

**Education.** The education system is universal in principle, but highly selective in practice. The literacy rate is 93%. By law, schooling is free and compulsory between ages seven and 14, but millions of children receive no education because their families are poor, because of malnutrition, or because they must work to

survive. Furthermore, the quality of schools is poor, especially in the less wealthy states. In addition, teachers' salaries are well below the averages of other professionals.

**Health.** Although Brazil is a major agricultural exporter, about two-thirds of its population suffers from malnutrition. Life expectancy averages 73 years of age, and the infant mortality rate, 19 per 1,000, is among the highest in Latin America. Chronic health crises also arise from widespread drug abuse and outbreaks of bubonic plague, cholera, and AIDS. Government efforts to cope with the massive health problems are thwarted by shrinking revenues, political stalemate, bureaucratic inertia, and the diversion of government funds. Although the 1988 constitution provides for shifting state and federal health services to city councils, much medical care is still delivered through private services, such as those available through employment.

## Government

Brazil is a federal republic with 26 states and a federal district. The 1988 constitution grants broad powers to the federal government, made up of executive, legislative, and judicial branches. The president holds office for four years, with the right to re-election for an additional four-year term, and appoints the cabinet. There are 81 senators, three for each state and the Federal District, and 513 deputies. Senate terms are eight years, staggered so that two-thirds of the upper house is up for election at one time and one-third four years later. Chamber terms are four years, with elections based on a complex system of proportional representation by states. Each state is eligible for a minimum of eight seats; the largest state delegation (Sao Paulo's) is capped at 70 seats. This system is weighted in favor of geographically large but sparsely populated states.

Several political parties are represented in Congress. Since representatives to the lower house may switch parties, the proportion of congressional seats held by particular parties can change. Brazil's major political parties include:

- Workers' Party (PT-center-left)
- Democrats (DEM-center-right)
- Brazilian Democratic Movement Party (PMDB-center)
- Brazilian Social Democratic Party (PSDB-center)
- Green Party (PV-center-left)
- Brazilian Labor Party (PTB-center-right)
- Brazilian Socialist Party (PSB-center-left)
- Democratic Labor Party (PDT-center-left)
- Communist Party of Brazil (PC do B-left)
- Progressive Party (PP-center-right)
- Party of the Republic (PR-center-right)
- Brazilian Republican Party (PRB-center)
- Christian Social Party (PSC-center)
- Social Democratic Party (PSD-center-right)