Key Summary:

- Brazil has regained political stability following the impeachment of Dilma Rousseff; new president Michel Temer will struggle to revive the economy and restore confidence.
- Confidence improves, but the government still must prove it can get reforms approved.
- The Brazilian economy is beginning to stabilise.
- A new government brings a new economic team and a positive confidence shock.
- The central bank will not cut rates in the near term.

Risk Maps

Overall risk scores are calculated as equally weighted averages of the six aggregate categories – Political, Economic, Legal, Taxation, Operational and Security – as depicted below.

Risk is scored on a 0.1-10 scale. The scale is logarithmic, with intervals of 0.1 magnitude. This range is split into seven bands, ranging from Low to Extreme risk.
Business environment - strengths and weaknesses

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
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<tbody>
<tr>
<td>Huge natural resources in agriculture, hydrocarbons, and minerals give Brazil significant economic potential and make it an attractive destination for investment.</td>
<td>Excessive bureaucracy, an inflexible labour market, and infrastructure bottlenecks mean that the cost of doing business is high in Brazil compared with other BRIC countries.</td>
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<td>Largest economy in Latin America and a population of 200.4 million make Brazil an attractive destination; a growing middle class offer investors a large domestic market.</td>
<td>Corporate taxes are very high by regional standards; stringent local content rules (65% in the oil sector) compound this.</td>
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<td>Growing opportunities for investment in the development of public infrastructure; new pro-business government is endorsing privatisation as a way to raise revenues to narrow a widening fiscal deficit.</td>
<td>Security remains a concern, particularly theft and ground cargo robbery.</td>
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Country risk - overall statement

Foreign investment risks in Brazil are mainly related to the security, tax, and operational environments; an ongoing economic crisis has compounded that. A complex tax system and relatively high corporate tax burden is compounded by excessive bureaucracy and political corruption. Increased state intervention was a salient feature of the left-wing governments that served between 2003 and 2016. President Michel Temer has promised to revert that and reduce a fiscal deficit of 10% of GDP by implementing an austerity programme and privatising airports and electricity distribution. Temer’s main hurdles include the approval of tax, pension, and political reforms, as well as the containment of threats to public security posed by organised crime in urban areas.

Detailed Analysis

Brazil has regained political stability following the impeachment of Dilma Rousseff; new president Michel Temer will struggle to revive the economy and restore confidence.

Former vice-president Michel Temer, of the Brazilian Democratic Movement Party (Partido do Movimento Democrático Brasileiro: PMDB), was sworn in as president on 31 August, following the removal of former president Dilma Rousseff on grounds that she breached budgetary laws. Temer, who has vowed to implement a pro-business agenda, will serve until 2018; however, he has taken over in the middle of the most serious recession in 80 years and with the difficult task of implementing austerity measures to narrow a fiscal deficit of 10% of GDP. He has promised to cut public expenditure and potentially increase taxes, but Congress and the private sector are unlikely to support higher taxation. Meanwhile, Temer has endorsed privatisation of airports and power distributors, with divestment of state assets being regarded as the most expedient way to raise extra revenue. In efforts to boost state coffers next
year the government has launched tenders for the award of private concessions of several airports. There are also plans to privatise electricity distribution as well as to ease local content requirements. Congress has also passed a bill that will open the oil sector to foreign investors. Temer faces threats from the Lava Jato corruption investigation, as he has been named in the probe. Additionally, Brazil’s Supreme Electoral Court is still to rule on whether to declare the 2014 election, in which Temer ran as vice-president, void; an adverse ruling could topple him.

Confidence improves, but the government still must prove it can get reforms approved.

Business sentiment and consumer confidence have improved in recent months, to a large extent driven by the change in government and expectations the new authorities will manage to fix economic policy. The last three months of 2016 will be crucial as Congress will discuss the 2017 budget and a bill to amend the constitution that will put a ceiling on government spending. Public finances are in dire straits, and the so-called PEC-241 bill establishes a ceiling to spending on all three branches of the government. In short, real government spending will not increase or nominal spending will only grow as much as inflation of the previous year. The rule would be in effect for the next 20 years. The celerity at which the fiscal deficit is fixed will depend, then, on how fast the economy grows. We expect congress to amend the original bill, and this will create speculation and volatility in markets and some further delays in investment.

The Brazilian economy is beginning to stabilise.

According to the monthly index of economic activity published by the central bank, Brazil’s economy slid 0.1% month on month (m/m) in July compared with June. The year-on-year (y/y) comparison shows Brazil’s economy dropped 3.4%; although it is a sizeable decline, it is still the best result on record since June 2015. In July, industrial output expanded 0.1% m/m and has been growing since March. Meanwhile, retail sales contracted 0.3% m/m and do not show a clear trend as it has been up and down through the year. The monthly index of economic activity is an indicator that mirrors GDP; July results are in line with the IHS forecast, as it confirms the stabilization of the Brazilian economy and at the same time also confirms our view that there will not be a rebound in the near term. Since the change in government in May 2016, confidence indicators such as business sentiment and consumer confidence have improved in Brazil and this has been accompanied by a sizeable appreciation of the local currency. The government still needs to get congressional approval of austerity measures that would lead to fix a sizeable fiscal deficit. In our forecast, the driver of (slow) growth will be investment as many firms can no longer postpone the replacement of worn out capital and inventories are very lean. In the near term, the Brazilian consumer cannot support a recovery as employment and real salaries are still deteriorating, and households are highly leveraged and will continue to postpone important purchases, especially of durable goods. The government, for many years, will be unable to increase spending as it needs to fix the aforementioned deficit. The outlook calls for slow recovery, IHS estimates GDP will grow 0.6–0.8% in 2017.

A new government brings a new economic team and a positive confidence shock.

As expected, Dilma Rousseff was removed from her post, and Vice President Michel Temer was sworn in along with a new cabinet; Henrique Meirelles, former central bank governor (2003–11), is now the minister of finance and Ilan Goldfajn, chief economist at Itau—the largest private bank in Brazil—replaced Alexandre Tombini at the central bank. Markets are pleased with the change in government and trust economic management will change for good. So far, the new administration managed to pass in congress the amendment of the budget law for 2016, which will avoid a government shutdown. The target primary balance was revised from a BRL30-billion surplus to a BRL170-billion deficit. IHS does not see this as a big success because the real challenge is to cut spending in order to fix public finances.

The central bank will not cut rates in the near term.

On 31 August 2016, the Central Bank of Brazil (BCB) decided to keep the SELIC reference rate unchanged at 14.25%. This was the ninth consecutive time the bank kept the rate at this level and in line with the IHS prediction. This was
the second monetary policy meeting headed by Ilan Goldfajn, who assumed as governor after being appointed by interim president Michel Temer in June 2016. The tone and wording of the communiqué released by the central bank was similar to the one posted in July—the bank again explained that there are some signs of stabilization in economic activity but pointed out the high slack in the economy, in the context of a pause to the external threats. In the balance of risks, the BCB assesses that there is no room for rate cuts. Inflation at 9.0% is still high and above target, and there is no certainty it will decelerate quickly in the upcoming months. IHS does not expect the BCB to slash the policy rate before 2017.