# Brazil in Crisis

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After months of speculation about the sustainability of Brazil's currency, the Brazilian Central Bank president, Gustavo Franco, resigned on Wednesday, January 13. Shortly thereafter, his replacement, Francisco Lopes, allowed a devaluation of the real by widening the exchange rate band in which the real was allowed to move against the dollar by 8%. In response, the currency quickly hit the new ceiling of R$1.32. Despite this response, the government insisted that the move was still within the "crawling peg" policy.

On the same day, the Sao Paulo stock exchange's Bovespa index fell by more than 10%, triggering a circuit breaker. While the market subsequently recovered somewhat, on that day, it finished down more than 5%. On Thursday, January 14, the market displayed general concern with the expanded exchange rate band, and the Bovespa fell an additional 10%, triggering another circuit breaker (see Exhibit 1).

Ultimately, on Friday, January 15, the Brazilian government announced that it would let the currency float temporarily. Interestingly, the markets welcomed the move, and the Sao Paulo Stock Exchange market rebounded by 33%. In closing down a mere 0.5% for the week, the market made up for most of the week's earlier losses. Additionally, the real closed at R$1.43, resulting in a 16% devaluation on the week (see Exhibit 2).

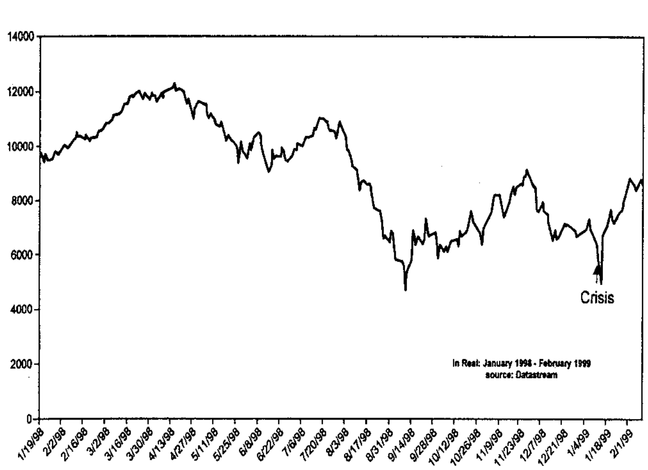
On the following Monday, January 18, the Central Bank announced that the government would permanently end its support of the real, officially ending more than four years of exchange rate controls and a strict multilevel exchange rate system. The Political Risk Services' International Country Risk Guide composite rating plunged from 69.0 at the beginning of January to 63.3 at the beginning of February (on a scale of 100). In terms of world risk ratings, Brazil fell from sixty-ninth to eighty-ninth place in only one month. Correspondingly, Standard & Poor's downgraded Brazil's long-term foreign currency debt from B+ to BB–.

In an odd case of internal political strife, actions taken by the governor of Minas Gerais, Itamar Franco (a past president of Brazil), earlier in the month triggered the process toward the eventual devaluation. On January 7, Minas Gerais announced its decision to place a moratorium on the interest payments of the state's debt to the federal government. Minas Gerais is Brazil's third-largest state, and its total debt amounts to 18.3 billion reals (or U.S. $15.3 billion prior to the devaluation and roughly U.S. $14 billion today). Minas Gerais' three-month moratorium raises questions about Brazil's ability to implement the austerity package agreed upon with the IMF last October.

## ECONOMIC ENVIRONMENT

For some time, a crisis was looming on

# Exhibit 1
**Bovespa Index: Sao Paulo Stock Exchange**



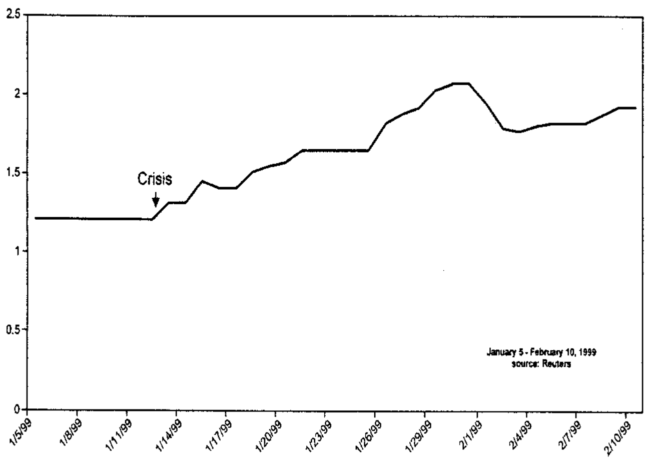

the horizon for Brazil. The world recession, the Asian crisis, and the Russian debt crisis in particular placed considerable pressure on the country's finances. Negotiations with the IMF to secure additional credit facilities have been long and difficult. Brazil seeks a rescue package to help with quickly approaching interest payments on its debt, which includes U.S. $100 million of Eurobonds that Minas Gerais owes, for which the federal government vouched. Brazil's total external debt stands at $222.1 billion, about 28% of GDP, and its short-term debt in 1998 reached $51.2 billion. In November, the Brazilian government secured U.S. $41.5 billion in international support to confront its international obligations and defend its currency. Given the short-term nature of much of Brazil's debt, estimated maturities average roughly R$30 billion each month for the next quarter.

Externally, the Asian crisis put a damper on export growth. The GDP, which grew by 3.2% in 1997, came to a halt in 1998, with zero growth. Standard & Poor's estimates that Brazil's economy will contract between 3% and 5% in 1999. The merchandise trade surplus, which was positive by U.S. $6.1 billion on average between 1992 and 1996, turned into a deficit, reaching U.S. $8.4 billion in 1997 and a projected U.S. $6.4 billion in 1998. The current account deficit has also ballooned to an estimated 34.4 billion, or about 4.4% of GDP. This has placed enormous pressure on the Brazilian government deficit, which will probably be about 8% of GDP in 1998, up from 6.1% in 1997.

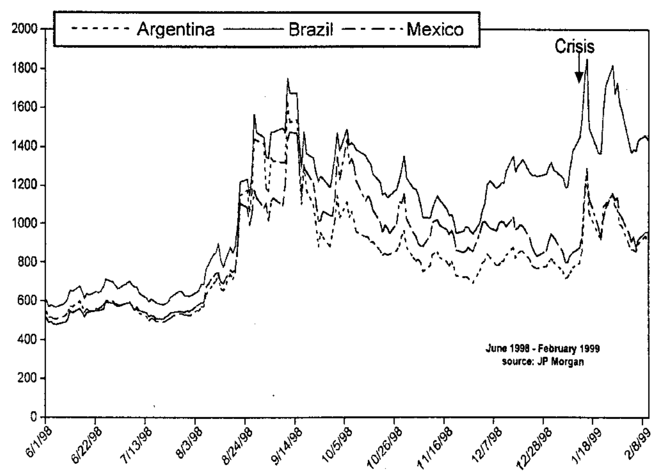
The Russian moratorium on its debt and the aftermath of the Asian crisis increased the spread on Brazilian Brady bonds from 685 basis points (bp) in the middle of last year to almost 1,800 in September. For the next few months, the spreads slowly decreased. However, anticipating Brazil's situation, the spreads reversed course and swiftly increased, reaching a maximum of 2,100 bp just before the devaluation (see Exhibit 3).

While the spread briefly fell immediately following the devaluation, it again increased, returning to levels seen just prior to the government's announcement. Spreads on Argentina and Mexico also rose in anticipation of the looming crisis, but the effect was not as strong as that following the Russian debt crisis, during which all three countries' spreads skyrocketed. This is an interesting observation,

# Exhibit 2
**Brazilian Real to U.S. Dollar**




# Exhibit 3
**Latin Sovereign Spreads**



given the relative geographical and economic proximity of Brazil and Russia to the rest of Latin America.

Last year, Brazil was forced to significantly increase its interest rate to offset international pressures on its currency. The Brazilian overnight interest rate increased from 19% in August to a maximum of 43% following the Russian crisis, to help defend its currency. Just prior to the devaluation, the overnight interest rate stood at 29.3% (see Exhibit 4).

Following the devaluation, Brazil has further increased the rate, in an effort to limit capital flight. All this occurred during a period when inflation was near 2.6%. Additionally, the federal government has spent more than U.S. $30 billion in reserves defending its currency, and the stock market has also been hit hard. During 1997, stocks fell 28.1% on the year in reals, and 33.6% in dollar terms.

Internal political difficulties have manifested themselves both in the election campaign and in the formation of a coalition government lacking control of Congress. Hence, the Brazilian officials face considerable difficulty passing a tough austerity bill aimed at dealing with the budget deficit and structural reforms. Elections gave Cardoso the victory, but not all the power in Congress he needed. While he has been able to pass a law modifying the constitution, allowing for the reelection of the president, the elections did not bring a honeymoon period.

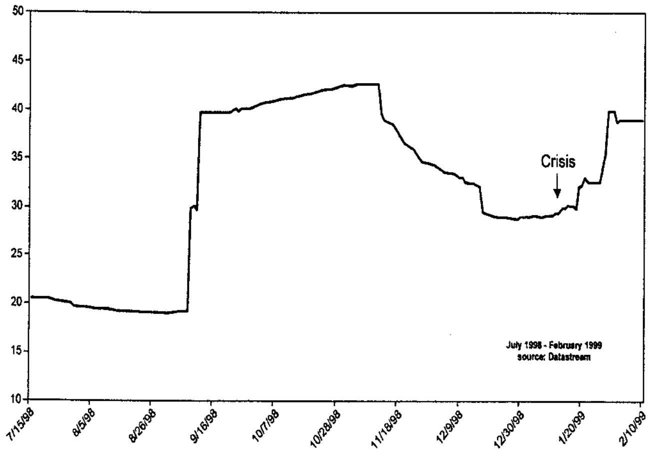
For example, the government had considerable difficulty passing an emergency package in the budget that includes cuts of R$28 billion. Also, in November of last year, four of Cardoso's main advisors resigned over allegations of corruption in the privatization and sale of the different pieces of the then-state-owned telecommunications company. The main official involved was Luiz Carlos Mendonca de Barros, the communications minister. The head of the National Development Bank and the official in charge of day-to-day privatization also resigned.

The government has lost more than U.S. $40 billion in hard currency since last August, and reserves stood at $36 billion in late January. Because the government would not lose any more hard currency in a futile attempt to defend its currency, foreign and domestic investors welcomed the final move to float the currency. However, the loss of reserves raises questions regarding the government's commitment to the IMF with regard to budget deficit and inflation.

## SIMILARITIES TO OTHER CRISES

The Latin American debt crisis of the early 1980s began with Mexico announcing a moratorium on its debt. Most other countries in Latin America followed in a period that became known as the "Lost Decade" for Latin America. The 1974 oil shock had enabled Latin America to depend heavily on debt to fund import substitution strategies. However, a fall in commodity prices and a sharp increase in worldwide interest rates seriously hurt exports, making it difficult for most countries to make good on the interest payments due. The continent has changed considerably since then, and governments now, for the most part, are trying to reintegrate into world financial markets. Healthy economic growth was the norm prior to the out-

### EXHIBIT 4
**Brazil: Overnight Interest Rate**




### EXHIBIT 5
**Foreign Exchange Flows ($ billion)**

| | Oct. | Nov. | Dec. | Jan. to 14th |
|---|---|---|---|---|
| Total | –1.91 | –1.85 | –5.19 | –5.19 |
| Commercial Dollar | 0.97 | –0.20 | –2.99 | –3.83 |
| Commercial | –0.89 | 0.08 | –0.12 | –0.15 |
| Exports | 3.19 | 3.50 | 3.32 | 1.26 |
| Imports | 4.07 | 3.42 | 3.44 | 1.41 |
| Financial | 1.85 | –0.28 | –2.87 | –3.68 |
| Inflows | 11.90 | 6.59 | 7.97 | 2.04 |
| Outflows | 10.05 | 6.87 | 10.84 | 5.72 |
| Floating Dollars (net) | –2.88 | –1.65 | –2.20 | –1.36 |

Source: J.P. Morgan.

set of the Asian crisis, as the Mexican crisis of 1994 was actually relatively short-lived. Generally, governments are still struggling to become smaller, and export promotion and the market economy have replaced import substitution and heavy government intervention.

The Mexican crisis is perhaps the most similar to that in Brazil. In Mexico, there was a great deal of political turmoil. The assassinations of the presidential candidate Luis Donaldo Colosio and Jose Francisco Ruiz Massieu, the secretary general of the Institutional Revolutionary Party (PRI) were strongly felt in the political and economic landscape. There are similar political problems in Brazil, some of which have only recently been resolved with the reelection of Cardoso. Even though the reelection gave him a strong mandate, he still has to deal with a coalition government. In particular, it is critical in Brazil for the federal government to unite its coalition in Congress to pass the tough legislation agreed to in the IMF negotiations.

However, important differences between Brazil and Mexico exist. Mexico tried to defend its currency for a considerably longer time, basically exhausting available reserves. Brazil still has a significant amount of reserves on hand to smooth any future flare-ups. Also, the fact that the interest rate remains high indicates that they will have an easier time smoothing potential currency fluctuations. Additionally, this high interest rate will probably temper, along with the expected recession, any inflationary pressures. However, this might indicate that the economic slowdown will be stronger and more prolonged than that of Mexico, which will not assist the budget deficit resolution.

The Asian crisis is perhaps the most different. Consumption in Malaysia and Thailand, corruption and cronyism in Malaysia, the problematic banking system in Korea, and the crash of the real state bubble in Hong Kong were the main culprits of the 1997 crisis. Moreover, the composition of the debt in Brazil and Asia is very different. In 1998, Brazil's corporate debt was 41% of GDP, while for South Korea it was 193% and 128% for Indonesia. This is due in large part to interest rates in Brazil having been so prohibitively high for many years, and to the fact that international markets only recently resumed lending to Brazilian companies, mainly because of the reduction in inflation.

## IMPACT ON THE REGION

Brazil is the largest economy in Latin America, and the eighth most important in the world. In response to the Brazilian devaluation, Argentina's stock market exchange blue-chip index, the Merval, fell by 6.85%. Also, Mexico was forced to sell $200 million of hard currency to curb the sharp fall of the freely floating peso.

Argentina, Brazil's neighbor, its most important trading partner, and the other country at the core of Mercosur (the trade accord between Brazil, Argentina, Uruguay, and Paraguay), also finds its exchange rate system under attack. Its fiscal policies are more stable at the moment, and the IMF has moved to support its exchange rate system. Argentina currently has a U.S. $29 billion credit facility, and can draw on U.S. $840 million of it. The Argentinean economic planning minister, Rogelio Frigerio, maintains that the one-to-one convertibility to the dollar is not a matter of economic policy, but of popular will. For the time being, Argentina is placing its bets on using dollars as its currency.

On January 23, the Argentinean Central Bank president, Pedro Pou, announced that the government was looking into three different plans to discourage the use of the peso, and eventually move the country into a permanent dollarized economy like that of Panama. This move is being studied in cooperation with the U.S. Treasury department. Argentinean officials argue that this move would allow for a lower interest rate, given a reduced fear of future devaluation in fully dollarized economies, which in turn would spark economic growth. However, such a move would also restrict the ability of the Argentinean government to conduct an independent monetary policy, as they would have to surrender to the prevailing economic conditions in the U.S. For instance, in times of tight monetary policy in the U.S., say, because of a boom economy, Argentina would have to endure high interest rates even if it was going through an economic slowdown.

Given the devaluation in Brazil and its move toward a floating exchange rate regime, Argentinean export competitiveness slipped in the region, especially on its bilateral trade with Brazil, the recipient of 30% of Argentinean exports. However, Argentina has been able to increase its foreign reserves, in contrast to Brazil, and announced that they had reached a record U.S. $27.7 billion of foreign reserves in early January. Still, the economic slowdown that was expected for 1999 may turn into an economic contraction, given the Brazilian recession and the effects it will have on the Argentine economy, particularly on its external accounts.

Additionally, the crisis may impact privatization efforts in Argentina. Argentina has scheduled the sale of 14.99% of the state-controlled energy company YPF SA, and the initial public offering of 25% of the state mortgage bank Banco Hipotecario Nacional, which will probably fetch less money now than the government had originally hoped. These events come in the year that Argentineans choose a successor to President Carlos Menem in October. International investors hope that Argentina will not become another Mexico, forced to devalue in a presidential election year.

Brazil's economic woes have already begun to hurt the Argentinean economy. All but one of the major car manufacturers in Argentina, which include French Peugeot, Italian Fiat, and the U.S.'s Ford, have signed agreements with labor unions to suspend operations, in some cases well into the next year. The Brazilian market is a key market for Argentina's car exports. Argentina's new vehicle production in December totaled 14,888 units, a 44.2% drop from the same period a year earlier, and a 54.6% decline from November, according to Argentina's association of car makers. Fiat has also announced that it is considering moving part of its operations to Brazil from Argentina to offset the impact of new devaluations.

Regionally, Mercosur will also be affected by the Brazilian move. The trade accord, which has Chile and Bolivia waiting to come in as associate members, will suffer from Brazil's devaluation. Brazil's slowdown has already hurt exports for the other three member countries. Chile, which also uses the dollar as a nominal anchor, has seen its exchange rate policy under attack by short-sellers as well.

Overall, the increase in the cost of capital throughout the region will make the global slowdown tougher to ride. However, economists still don't expect the crisis in Brazil to spread to other countries in the region, like the degree of contagion seen in Asia following Thailand's devaluation. Nevertheless, the increased cost of capital coupled with Brazil's devaluation and economic slowdown will cost other Latin American countries in terms of economic growth. Most agree that, other than Venezuela, the economic fundamentals of the other major economies in the region are much improved from the time of the 1980s' crisis.

## IMPACT WORLDWIDE

On January 9, the *Wall Street Journal* predicted that 1999 would be the year that bubbles burst. They emphasized the significant impact that emerging market troubles, such as those in Brazil, have on the world economy. On average, emerging market fund managers had more exposure to Brazil than anywhere else in the world prior to Brazil's devaluation. As reported by Standard & Poor's in December of last year, 200 emerging market funds had 11% of their assets in Brazil.

U.S. banks had an exposure of U.S. $37 billion in Brazil. However, many anticipated Brazil's troubles, and had moved to limit their overall exposure to levels considerably less than those of the early 1980s. Nevertheless, S&P has negatively changed its outlook on seven international banks with exposure in Latin America: Citigroup Inc., J.P. Morgan & Co., BankBoston Corp., Societe Generale, Banco Santander SA, Dresdner Bank AG, and ABN Amro Bank NV. S&P also placed the ratings of Banco Bilbao Vizcaya SA on CreditWatch, which joins Deutsche Bank AG and Bank of Nova Scotia.

## WHAT NOW?

The worldwide impact of the latest crisis has yet to be determined, as the resolution to the crisis plays out in the coming months. The key elements now that Brazil has decided to forego its "crawling peg" exchange rate system are: 1) the negotiations with the IMF; 2) the success of Cardoso's government in passing through Congress its structural reform package; and 3) the arrangements it can make with its internal states, particularly Minas Gerais.

The new negotiations with the IMF will be of primary global importance. If Brazil does not follow through with its promises, the IMF will have to decide whether to withdraw support. There is the important question of moral hazard for other countries potentially needing IMF support. Conversely, however, Brazil is generally seen as the cornerstone of the Latin American economy and its health.

Shortly after the devaluation, a mission of high-level Brazilian diplomats to Washington took place, led by finance minister Pedro Malan. He negotiated with the IMF, the World Bank, the Inter-American Development Bank, and the U.S. Treasury department. The delegation tried to bolster support for its devaluation, and to convince its debtors that the Brazilian government was serious about reform. However, it has become clear that the IMF will not be making any early disbursements from the U.S. $41.5 billion package. Brazil will have to pass the austerity package before it receives any additional funds, a precondition established when the latest IMF deal was approved two months ago.

On January 21, the Brazilian congress approved a tax on Social Security checks on retirees and an increase in contributions by active civil servants. On January 26, the Brazilian congress approved a central element of the IMF agreements by passing a tough budget that had been stalled since August 31, when the financial crisis first hit Brazil. The budget includes drastic cuts that aim to save over U.S. $14 billion this year alone. A congressional committee also voted to extend and increase an unpopular tax on financial transactions to earn more revenue for the federal government. The tax on all banking transactions currently stands at 0.20%, and would be increased to 0.38% for the current year.

The flight of dollars from Brazil represents a problem, and is a fundamental symptom of the loss of investor confidence. The Central Bank has tried to alleviate the problems this may cause for Brazilian firms attempting to refinance their debt by lowering the minimum terms necessary to roll over foreign loans held by both the private and public sectors. Despite the moves from the Central Bank, the currency has continued to show high volatility. On Friday, January 29, the real broke the R$2/U.S. $1 mark and reached 2.06 by the end of the day. Since the government moved to end the parity on January 13, the real has lost 41% of its value as of early February.

Recent moves by the Brazilian government to increase borrowing rates will alleviate the dollar drain and inflation pressures. On the other hand, increasing the level of interest rates works against economic recovery, and causes the internal debt to balloon. The economy is expected to contract this year, further reducing tax revenue. The issue of internal debt has become a major headache. Not only did the Cardoso administration agree to stop its expansion under the IMF accords, but many of the states seem to be joining Minas Gerais in avoiding payments of their federal debts to the federal government. Rio Grande do Sul has announced that it is placing revenue in an escrow account to keep it out of reach of the federal government and the World Bank has moved to suspend loans to the two rebelling states.

As this is a central issue requiring resolution, Cardoso is considering a cash advance of federal money to the states in an attempt to restore solvency and goodwill. The states need to trim their budgets, but generally lack the political will; this may bolster support for the reform effort at the state level.

On February 2, Cardoso appointed a new Central Bank president, the third in as many weeks. International investors welcomed the new chief, Arminio Fraga. Having worked under George Soros in New York, he is a familiar face. However, at the local level, many questions remain as to whether Mr. Fraga will just protect his own, and whether Cardoso will be able to get the country out of the mess. There are already signs that a mood of pessimism is washing over the population at large. Expectations, both internally and within the international financial community, will shape a great deal of Brazil's future.

For this reason, the road to development for Brazil is still a long one. Nevertheless, Fraga and Brazil's finance minister are travelling the world's financial centers in an attempt to boost confidence, and, indeed, the future does hold some promise as Brazil now anticipates receiving the next IMF tranche in April. Furthermore, Fraga announced that Brazil is considering issuing sovereign bonds following the IMF's disbursement.

There also remains the question of the sustainability of exchange rate-based stabilization, like that in Argentina and Brazil. While Argentina is making a strong move toward the dollar, Brazil's devaluation frees its hands in some respect. It was the opinion of many economists at the Davos World Economic Forum that only two feasible exchange rate policies could be sustained over the long term: a currency board that fixes the exchange rate (like in Argentina), or a flexible exchange rate (like in Mexico). The general consensus: Crawling pegs and currency bands cannot be sustained in the long run, because either speculators will attack them or the government will abandon them.

One thing that Brazil has in its favor is that the congress and central government have moved quickly to adopt emergency measures to fulfill IMF agreements. This was not the case in Russia, Malaysia, or Indonesia. New economic conditions will make renegotiations necessary. The strongest option for Brazil is to decide on credible and sound fiscal and monetary policies that appease the markets. The Brazilian government has to convince the international community that there will not be a new onset of hyperinflation, and that the government will not default on the debt. This is easier said than done, as not even the international community can agree on a set of prudent policies. Foreign banks, however, have kept the lines of credit open, despite Brazil's lower credit ratings, and inflation appears to be under control. Furthermore, President Cardoso must retain popular support and backing amidst an always unpleasant, but necessary, period of fiscal austerity.