Center for
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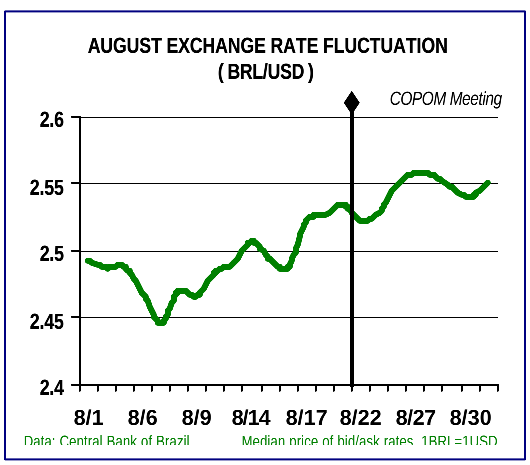
BRAZIL *MENSAL*

August 2001

Summary of events

The northern summer has not been a good one for Brazil - or for that matter- the rest of Latin America.

Everything seems to have worsened. In Brazil, interest rates went up to 19% in July. The estimated rate of growth for the second quarter went down, unexpectedly, to .8 percent, as compared with initial estimates in excess of 3 percent. This was the period before the full effects of energy shortages and rationing were really felt. Inflation, on the other side, moved steadily higher. Estimates for the full year for the IPCA index - initially set for 4% with the IMF - now come to an excess of 6 percent. As a consequence of the worsening situation in Argentina, a new IMF agreement for $15 billion has already been arranged. Exchange rate devaluation intensified, with the current rate now at R$ 2.55 equal to the dollar. Trade expectations have been reduced, both on the import and export side.



Four circumstances have interacted to produce this result.

First, the quasi-recession in the United States seems to be continuing longer than had earlier been projected. Despite passage of an immediate tax cut in June, and continuing strength in consumption and private housing, business investment in the United States seems stalled and with it, recovery is longer in coming. Worse still, Europe is now slowing perceptibly, and adding to the problem, Japan continues to lag. With the world growing more slowly than anticipated, foreign investment availability also slows as does the growth in trade.

Second, the shortages of energy in Brazil threaten to have greater impact on growth in the second half than was initially feared. Prices have been adjusted more than had been anticipated, and despite plans for rapid expansion of thermo-electric supply, many enterprises seem to have cut back their initial investments in order to see how the story plays out. As well, the possibility of early rationing in the Northeast seems now to have emerged. While overall, the public response to the potential crisis has been positive, the effects on economic growth are clearly negative.

Third, an Argentine crisis looms. While the IMF has recently granted Argentina an additional $8 billion, the two week delay in accommodating that request as well as the limited funds made available point to a potential inability of that country to satisfy the no deficit target that has been established.

In particular, all reports suggest that the last quarter -which sees a legislative election in October- will be fiscally an impossible one. Already the province of Buenos Aires is printing paper money, *patacones.*

Fourth, Brazil is readying for a Presidential election in little more than a year. Politics have become more central than they had in anticipation of that event, and that slows the willingness of Congress to pass needed legislation. In particular, the Senate remains embroiled in the possible impeachment of its president, Jader Barbalho. So it becomes unlikely that any reform of receipts will occur, nor any change in the social security system, nor anything else except those that limit the power of the Executive. Congress' return to session in August after the July recess has seen little sign of more positive movement. President Cardoso remains unpopular, and the PMDB-PSDB-PFL alliance has become ever more fragile. Lula has increased his hold on one position in the final presidential balloting, and there is increasing doubt about who will oppose him.

With these circumstances occurring, new privatizations have slowed and become ever more controversial. This is demonstrated in the case of the privatization of the Parana electric system, which received authorization by a single vote in the state legislature. Although the recent data until the end of July indicated an inflow of direct foreign investment in 2001 of $12 billion, the fear is that this will slow, putting even greater pressure on the current account deficit.

These 60 days have been difficult ones for Brazil. But there are hopeful signs that the worst may be past. The Central Bank has just maintained constant the SELIC rate at 19% last week. Unemployment did not increase in the last IBGE monthly result. Itamar Franco has given up his hopes for election as PMDB president, and seems to be now moving to join the opposition PDT. Export balances have remained more positive than had been expected in August. The PT has issued a document on economic policy that, while far from support for the government's actions, seems to pledge greater continuity than could have been imagined for a next PT administration.

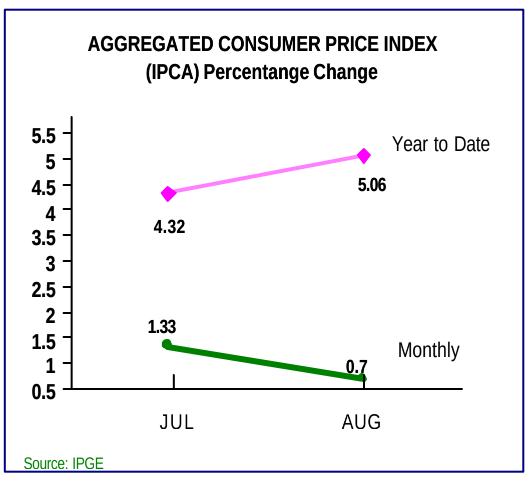
The drama in 2001 thus continues.

Macroeconomics

A major, and positive, macroeconomic continuity in Brazil has been the positive fiscal results that have been achieved. These continue to satisfy the IMF target of a primary fiscal surplus -excluding interest payments- of 3%. Over the last two months, the results have registered positively, and the September target has just about been satisfied. On the other side, the consequence of higher interest rates has led to a larger overall deficit than had been foreseen, and the result has shown in the higher level of public debt relative to gross product.

A major, and negative, occurrence has been the growth result for the second quarter of 2001. This has come in at only .8 percent, compared to general expectations of more than 2 percent. For the first half year, the results come to 2.5%. Expectations for the second half already had called for slowing expansion, given the problems of energy and the external economy. But these results have led Merrill Lynch to revise its estimate for the year to 1.5%. All the others have followed. JP Morgan, for example, has brought theirs down from 1.7% to .7%, arguing that the economy is probably in recession already. While there were initially suspicions within the government about the accuracy of the IBGE statistics, they seem now to have been accepted. And with this result, there is a need for a new official estimate for the year 2001. The earlier view of the Central Bank -and the IMF- had been 2.8 percent for the year, and this would imply more rapid expansion in the second half of the year than the first. So a new "official" estimate would come down to less than 2 percent for the year.

This obviously is a disappointment. More to the point, it places a real challenge upon the Central Bank. It has to bring down the interest rate in the hopes of contesting the negativism that these estimates have caused. The COPOM meeting last week held the SELIC interest rate constant at 19 percent interrupting the pattern of substantial increase imposed by the higher inflationary pressures within the economy. In future months, it is probable that the rate will start to reverse, as it will have to in order to avert a major slowdown of the Brazilian economy.



Inflation rates are continuing to stay on the higher side. The FIPE rate came in at 1.5% for the four week period ending in mid-August. Government managed prices - gas, water and sewage, electricity- are largely responsible. August as a whole may well show the maximum increase for the year as a consequence. Particularly with the reported slowing down in economic activity, and also negative movement in food prices, aggregate price behavior should turn out to be less a preoccupation in coming months.

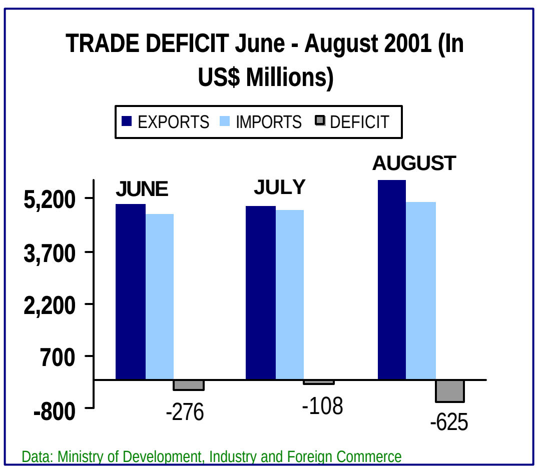
An ability to reduce the interest rate is dependent upon a capacity to stop further devaluation of the *real.* That is one of the reasons for the injection of a new $15 billion from the IMF. There already has been erosion of more than 20 percent this year after allowing for inflation. No one is arguing that the domestic currency is now overvalued. Concerns about neighboring Argentina seem to have been a principal factor in this process, rather than direct concern with the current account balance in Brazil. As is clear, higher interest rates imply a larger current account deficit and so their future reduction can restore return to a virtuous cycle rather than the current vicious one.

Trade and Foreign Investment

Estimates for the year as a whole continue to project a small deficit on trade account. Projections of both imports and exports have fallen over the last few months. Interestingly, in the swearing in of the new Minister of Industry, Sergio Amaral, President Cardoso emphasized growth in the export sector as central to Brazilian development. This was one of the first times that exports had gotten this attention in the current administration. It may be too little, too late but at least it suggests that export activity is now more important than it had been.

That may mean more attention to trade with the United States and to greater focus on FTAA. Note that one of the side lights of the IMF agreement with Argentina was a reference to negotiation between Mercosul and the United States since Argentine exports required greater expansion. Celso Lafer, the Brazilian Minister of Foreign Relations, quickly put this idea to rest, but it may reemerge in the future.

The expected current account deficit for 2001 remains about the same as it had been. A central issue is how it is going to be financed. Unlike last year, when the smaller deficit of $24.6 was more than covered by an inflow of more than $30 billions in foreign investment, this year everyone sees the difference in the other direction. The question is how much.



As of July, foreign investment had totaled $12 billion. In the five remaining months of the year, pessimists allow for little more than $15 billion, pointing to the absence of any major privatizations that might increase that flow. And an assessment of internal recession would hardly encourage greater inflows from the private sector. In particular, the depreciated exchange rate serves to attract greater interest. Microsoft's president announced that Brazil would be the first Latin American country to have access to Microsoft code. Other computer manufacturers are reacting to lesser domestic demand in the US by accelerating some of their undertakings in Brazil. If one anticipates a stronger exchange rate in the last part of the year, foreign interest could well move up in forthcoming months. We continue to believe that one will see a result close to $19 or $20 billion.

And the new IMF loan clearly provides a way of closing the gap. Additionally, the floor for international reserves has been lowered, allowing the government greater freedom to intervene in the market. At the end of the day, the current account deficit is likely to exceed 5% of product in 2001, up from the 4.2% last year. The key question is what happens to the exchange rate. In order to move toward balance, the current rate of R$ 2.55 will have to come down over the next months, just when the difficulties in Argentina are likely to heat up again.

Privatization

This has been a quiet period. COPENE has been privatized -finally- going to the Odebrecht-Mariani group for R$ 785 million. COPEL, the state owned electric utility in Parana, won a vote in the state legislature for privatization by a single ballot. That came after an initial session had to be postponed because of the invasion of the legislative building by militants. It is scheduled for sale in late October. The repeated offering of the "C" band for cellular telecommunications by ANATEL wound up without a single bidder yet again. It had been hoped that companies already operating on the "A" and "B" bands would have been willing to bid to get the opportunity to offer multimedia services to their customers. But the operating companies are suffering from lack of payments on their existing positions. There are already 39 companies in the market in Brazil

The PT's position on privatization is to oppose any further sale. Indeed, there were criticisms that the IMF agreement was prelude to sale of the Bank of Brazil and the Caixa, and even the BNDES. Clearly, this issue is going to recur in the presidential campaign. As noted earlier, the generation of power remains substantially, i.e, 90%, in the public sector. The new version of the IMF agreement distinctly excludes the sale of Furnas or the rest of the Eletrobras system.

But the issues of regulatory administration and reorganization of the government's role will emerge. There is already discussion about whether it is sensible to create a new National Energy Agency. With Minister Pedro Parente seeking to control overlapping jurisdictions of electricity, natural gas, petroleum and nuclear energy, the question is a natural one.

Finally, there is indication that the government is intent upon enforcing its newly won position on drug production. Health Minister Serra had secured agreement from the US to back off from its WTO claims on patent rights. More recently, Brazil has indicated it intends to end the patent held by the Swiss firm Roche on Nelfinavir. This is one of the principal inputs used in the Brazilian treatment for AIDs and costs some $90 million a year.

Politics

Brazil is clearly entering its election year early. There is little prospect that the new legislative session that has just begun will produce productive changes in a number of the areas that need additional effort: social security, federal revenues, creation of an independent central bank, claims of minority share holders, end to unlimited *medidas provisorios,* etc.

The government has been forced by court decision to grant an increase in salary to federal officials. It has offered an increase of only 3.5%, causing a negative reaction. There have been many wildcat walkouts, as well as longer strikes by some, including federal universities. This decision, overdue, has led to greater protest.

The case against Jader Barbalho continues. Federal prosecutors, the Central Bank and the Federal Police have produced evidence of fraud in the cases of SUDAM, and even earlier, Banpara. He is likely to have a hearing in September. In the meantime, it creates a strange situation, impeding the holding of any joint sessions of the House and Senate, necessary for voting a variety of special items on the legislative agenda. The Senate argues that Barbalho's temporary substitute should chair the meetings of Congress; the House contends the Vice President of the House should chair.

Itamar Franco has emerged again, retiring from the election to chair the PMDB. He had selected this strategy as one that would favor his attempt to assure that the party would break with the government and nominate him for the presidency. Now he is likely to leave the party and join Brizola's PDT where he is certain to become the candidate. More recently he has had a meeting with Ciro Gomes and Leonel Brizola in which the possibility of a joint ticket was discussed. Choice of a party must be made by October

5, so there is not too long to wait to see what happens here.

Meanwhile Lula's popular support continues to climb, approaching 35%, and virtually assuring him a position in the final two-man runoff, for the fourth time since 1989. The problem of the government coalition, PMDB-PSDB-PFL, is that its potential candidates - Serra, Jeraisati, Malan, Paulo Renato (all of the PSDB) do not run very well, and hence would not be guaranteed a position in the second round. That is the logic of a Ciro-Itamar ticket that would prevent any government candidate as well as Garotinho, governor of Rio, from getting to the finals. A parallel result emerged earlier in the Mayoral election in Sao Paulo, where the PSDB candidate barely failed to make the finals, and the PT easily won in the final round.

President Cardoso is eager to have a substitute who will carry on the policies he has started, and who might be able to move on the many areas in which he was unable to progress. Hence he is seeking to use the various pressures (and benefits) of incumbency to delay the decision as long as possible as well as assuring the maintenance of a Congressional majority.

Conclusion

Over the next months, the central question will be the ability of the government to focus on the complicated internal and external economic issues that will arise. If Brazil is able to deal with these questions and emerge without a continuous slow-down, it will confirm its commitment of the last seven years to the new style of capitalism found in Chile and Mexico. If inflation emerges again, and the external deficit rises without check, almost inevitably there will be a new leader who will be anti-Cardoso in name, if not, in fact.

So not only the near term future of the country, but also the longer term will be much influenced by the behavior of the economy over the semester that lies ahead.