

## BRAZIL MENSAL

June 2001

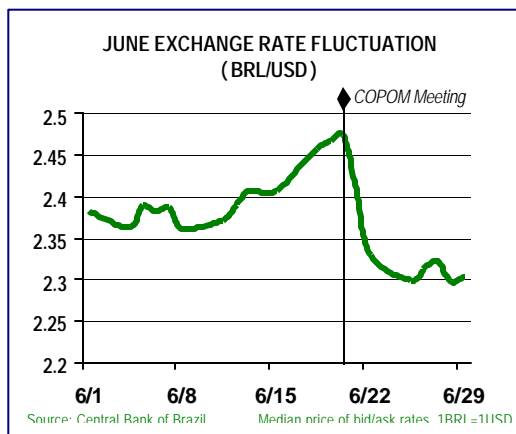
### Summary of events

Brazil has reacted. After three months of accommodation, the Central Bank has decided to intervene powerfully in the exchange market. That direction was signaled by the COPOM decision on June 18 to raise the SELIC rate by 150 basis points, followed by Arminio Fraga's statement that the Central Bank would accumulate additional resources of \$10 billion to permit it to intervene more frequently and more powerfully. Additionally, there will be greater assistance to exports. The end result was an immediate fall in the exchange rate to a little more than R\$2.30 equal to a dollar at the end of that week, after the value had reached almost R\$2.50 at the beginning of the month.

This decision will clearly test whether the real devaluation of close to 25% during the last six months has been a bubble or reflects fundamental weakness in the Brazilian economy. The combination of the Argentine crisis, the slowdown in the industrialized economies, the high price of oil, domestic political upset, and the emergence of an energy crisis in Brazil, not surprisingly, has had powerful effect in pushing the *real* lower. But there has also been a cumulative effect associated with increased demand for dollar hedge against future devaluation that has strongly contributed to currency weakness. Every time the real weakened that demand increased, thereby contributing to the depreciation.

The rise in the SELIC rate also contained a bias toward reduction. With the US Federal Reserve Board meeting at the end of this

month, and likely to reduce rates by another 50 basis points, that bias might go into effect almost certainly before the next COPOM meeting.



The Central Bank actions overshadowed the output results, which seems to have increased a little more than originally estimated in the first quarter. The fiscal reports continued to show positive results, with the required IMF surplus more than attained. The reports on the balance of payments indicate continued reluctance of foreign investors to make substantial new commitments of the magnitude necessary fully to cover the current account deficit. Energy conservation showed progress this month, and plans for expanded supply, both as a result of increased imports of gas from Bolivia and Argentina as well as potential termination of the nuclear plant Angra III, continued to take form. And, not least, politics showed the continuing likely weakness of the PSDB candidate for President next year while concern over senator Jader Barbalho's engagement in prior illegalities increased.

While there has been a constancy in much of the news coming forward, there has also been a decisive move forward in seeking to resolve the situation. By reacting in a muscular way, the Central Bank has given reason to suppose that current predictions of growth are underestimated and the new projections of the exchange rate at \$R 2.50 and above are overestimated.

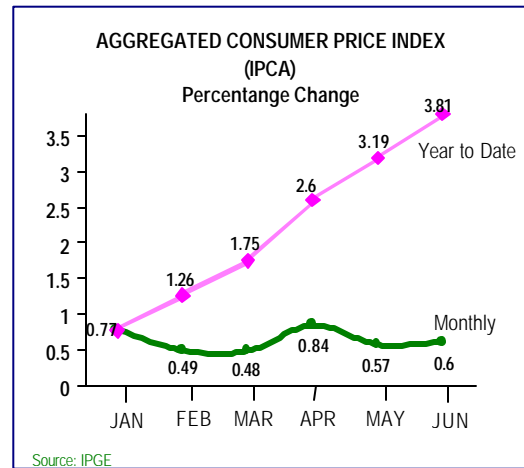
### Macroeconomics

Brazil was dangerously close to a sliding disequilibrium as a result of rising real interest rates and rising exchange rates, for inflation targeting policy implies still higher rates. The effect on exchange rates was driven by demands for hedge against the dollar that became a regular source of increased valuation.

The Central Bank reacted extremely well in avoiding what had been the standard prediction of a 50 basis points increase in the SELIC rate. That would have meant continuity of the present market reaction. Some losses occurred in the speculative activity in the foreign exchange market. The exchange rate decline seen on June 21 and 22 was close to 9%. Moreover, the Central Bank has indicated that it was accumulating something of the order of \$10 billion in foreign exchange over the rest of the year to give it the capacity to intervene in the future, as well as eliminating its demand for dollars in the market. That includes the decision not to repay the IMF immediately, as well as to secure additional resources from it. Still, the Finance Minister has indicated that the existing IMF program, set to expire this fall, will do so and not be replaced by another one.

Brazil has continued its record of consecutive fiscal surpluses that have matched required performance. Fiscal surpluses have

continued to occur, in part because of extension of tax collection, as well as owing to efforts to reduce expenditure. Most of the latter has occurred through the series of privatizations that has delivered revenue to the government and simultaneously taken on-going losses off the books. Results continue to reflect the good economic outcome in the first quarter of 2001. There is no doubt that this commitment will continue, even though the requirements for public investments in energy have gone up over the last months. And equally, there will be no revenues from privatizing *Furnas*, *Chesf*, and *Eletronorte*. There has been only the aggregate record of results since the end of 1998, but also the demonstrated ability of the Federal government not to manipulate accounts prior to elections.

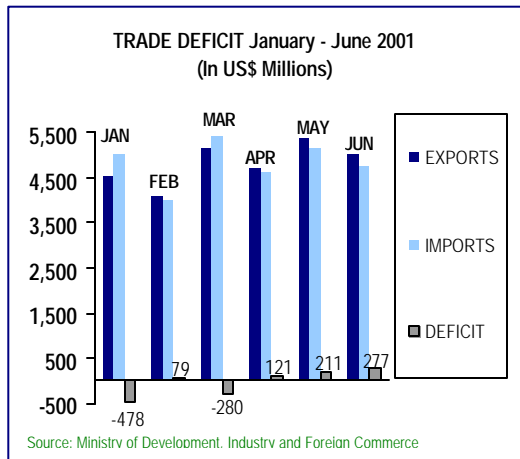


What will happen this year is a higher price index than the 4% originally targeted. But that rise will likely not exceed the 2% window initially allowed. Since there had been relatively little pass through of prices owing to exchange depreciation, the recent Central Bank intervention will assure that little effect will occur subsequently. Rises in the price of energy should not provoke a generalized increase because the weight on the wholesale price index is smaller than in the

consumer price index. And somewhat slower growth--although we expect a result higher than 3% this year, with improvement in the fourth quarter over the third--will assure that inflation will not creep back.

### International Trade

The trade accounts have begun to weaken in May and June. Imports have continued relatively strong--up buy almost 14% over May 2000--although recent June numbers begin to show a decline. As of June 17, the trade balance for the year was a negative \$400 million. Most predictions place the expected trade deficit for the year at between \$1.5 and \$2.0 billion. There will not be the small surplus the government had initially foreseen.



The current account deficit will be close to \$27 billion. Increased interest rates will reflect in larger payments on the external debt, thereby increasing this amount slightly. The major question is the magnitude of foreign investment. Last year's total of \$30 billion was not scheduled to be repeated; the Central bank was expecting \$24 billion earlier in the year, and that number has shown sliding, both as a consequence of external conditions as well as the internal challenges. Some estimates have come in

as little as \$17 billion, which would mean some pressure on reserves. The decision of the government not to pay back the IMF as well as to increase its loan suggests that the final number may be close to \$20 billion. That means some potential need for modest external debt.

What still counts is that the dollar value of exports will be up--not a trivial matter in the midst of world quasi-recession--and that efforts to move into new areas is continuing. The positive results achieved by *Embraer* at the recent air show in France are an indication that Brazil's new capabilities in this area will be sustained and expanded. Likewise, despite Argentina's problems, signs of some recovery there will provide a positive stimulus for manufacturers.

The key point to note is that the balance of payments deficit has not become unhinged as a result of the problems Brazil has faced and is facing. This order of magnitude increase can be accommodated without creating an impression of irresponsibility. But it does clearly show the importance of the external accounts to continuing Brazilian progress. Absent a more rapid recovery than is anticipated for 2002, Brazil will have to seek to expand its trade more aggressively in order to avoid the need to slow down activity to keep the external debt from rising too rapidly. Domestic interest rates are inevitably tied to the external market now. Fortunately, rates are likely to come down some more in the US and Europe and that will help.

### Privatization

Brazil's expected privatization totals for 2001 and 2001 are inevitably lower now than they were at the beginning of the year. Shortages of electricity as well as political reality of a forthcoming presidential campaign make that clear. The PT, or Labor Party, has already

published its initial draft of an economic program for Brazil, post 2002 in a PT government. It makes clear that while no return to nationalization is to occur, neither is there to be any additional privatization. In particular, the eon-going issue of the large Federal banks (the Bank of Brazil, the BNDES, and the *Caixa Economic*), existing electricity generation facilities, and *Petrobras* is clearly decided.

Yet, at the same time, some minor progress continues on this front. The state of São Paulo is advancing on legislation that would permit the sale of 49% of the remaining state-owned bank, *Nossa Caixa*. Equally, the National Petroleum Agency coordinated an auction of 53 new off-shore areas where petroleum exploration will be permitted. 34 of the 53 areas were sold for a total return of almost \$600 million. Phillips Petroleum acquired 26% of the areas. *Petrobras* acquired 15 areas, still showing itself to be a major presence. The insurance branch of the *Caixa Economica* was sold to the French CNP when the courts finally ended the injunction on the February purchase. Finally, the privatization of the Brazilian Reinsurance Institute last year is likely to be ruled upon by the Supreme Court.

Note one other advance: the package that has been directed at making up the deficit on payments of the FGTS (the Unemployment Insurance Fund) has now been approved. The government and the private sector will participate jointly in making up the R\$40 billion package. This had been a measure that had aroused significant opposition from private contributors, but has been put into effect. It is to occur over the next several years. This case deserves substantial mention. When the courts originally rules against the government, there was fear that

any settlement would disrupt the tight fiscal program in place. Here now there is a legislative outcome that allows this matter to disappear from the agenda. Another victory by the government that is unnoticed among the toils and tasks imposed by the external and external shocks.

### **Argentina**

Argentina has continued its series of economic measures designed by Domingo Cavallo to take the country out of recession and restore it to growth. The two notable events this month were the restructuring of the dollar and peso denominated debt, and the creation of a two-tier exchange rate. Brazil is inevitably affected, not merely because of its trade with Argentina, but more fundamentally, because of Mercosur.

The rescheduling exercise was designed to reduce external payments on debt service this year and next. It did so at the cost of a modest increase in total debt service--including the commissions on the rescheduling. The consequence of this large package--a similar exercise in Euros is supposed to be on the agenda--is that Cavallo has a couple of years to turn the economy around before he has to go to the external markets for substantial additional finance.

That was followed by the Argentine decision to move to a two-tier exchange rate over the holiday weekend of June 15-18. The move was done by using Euro+Dollar to revalue the exchange rate on trade, while retaining the dollar solely for the capital account. This meant that the exchange rate now was 8% more expensive for imports while yielding 8% more in export revenues. Simultaneously, levels of added tariffs just recently imposed

were cut by the amount of the exchange rate increased.

By proceeding with this complicated procedure, Cavallo seeks to avoid a massive reaction that might accompany devaluation. When the final step occurs, and there is variation with respect to all currencies, the shock is scheduled to be less. In reality, since local prices have gone up without any accommodations in the exchange rate, the 8% increase in the export price is not enough to make a large difference in competitiveness. But it is a start.

All of this was accompanied by an indication that growth in the first quarter was negative by 2.1%. Still more policy changes are likely to occur. Cavallo is committed to succeed in turning the economy around, and, thereby, to becoming the next President.

For Brazil, the actions of the last week were characterized by a different Argentine response than the earlier measures. Cavallo made a point of going to Brazil first to explain the actions he was about to undertake, hence avoiding any suggestion of independence. At the Mercosur meeting in Paraguay, he similarly made clear his commitment to the regional grouping. Clearly, this is not the last of Brazil-Argentine differences. For both countries, their bilateral trade is important.

### **Politics**

The latest poll in Brazil confirmed the reality of the PSDB difficulty in ascension to the presidency in succession of Fernando Henrique Cardoso. The poll results were not much different than earlier ones: Lula was in first place with about 30%; Ciro Gomes was second with 20%, and Itamar Franco, no doubt benefiting from all the publicity of his

opposition to government energy policy, was in third with 16%. A new name, Garotinho, the governor of Rio de Janeiro, was tied with Jose Serra of the PSDB with 8%.

What all this means is that there may very well be two candidates in the final round of the presidential election in October 2002 who are both opposed to the policies of the present government. That prospect will dim the possibility of 2002 being a normal year economically. Foreign investment will obviously be restrained, and domestic investment itself will be affected.

Meanwhile, despite the politics and the continuing corruption issue, the Congress seems to be getting some work done now. The law on rights of minority share holders seems to be moving ahead. Some new legislation will be proposed on Federal revenues on the last week of June by Finance Minister Malan. There is the possibility of a mini-constituent assembly in February 2003, after the election, to take up the question of political reforms as well as some fiscal reforms.

### **Conclusion**

The story this month clearly is the action of the Central Bank in breaking its previous policy of accommodation. It has now taken a leading role in response to the gradually depreciating exchange rate. The coming months will test whether this issue has diminished, and whether Brazil can get on with the need to deal with the energy problem and other internal issues.