

## BRAZIL MENSAL

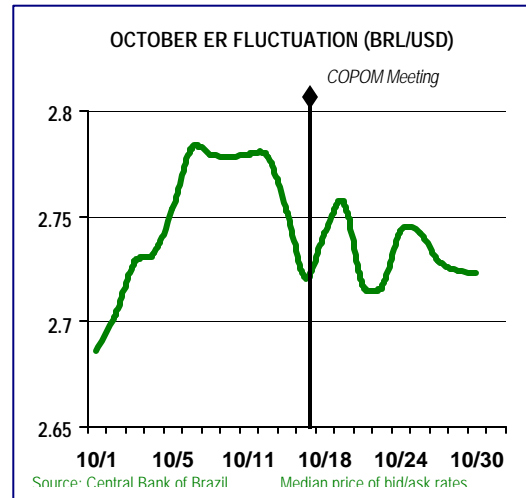
October 2001

### Summary of events

In the midst of an industrialized world that seems to be entering more serious recession - Japan and Germany have recently reported sharper slowdowns than had been anticipated; the United States does not report its third quarter results for a couple of days - and with Argentina apparently now prepared to renegotiate its debt, Brazil is looking stronger. This is the basic message of the month: Brazil may have already turned the corner, well before general presumption.

Two additional important pieces of information will be coming in successive days. These relate to presidential popularity and to political polls about Cardoso's successor; and to the magnitude of the bids in the sale of Parana's electricity distributor, COPEL. Both will additionally indicate the degree to which recovery may already be under way.

Such optimism has additional bases. One important source is the ongoing recovery of the balance of payments. A surplus on merchandise account of the order of between \$1.5 and \$2 billion for 2001 now seems a certainty. Projections for the 2002 surplus range from \$5 billion to \$10 billion. This radically alters the projected deficit on the balance of payments, with a major reduction in foreign direct investment anticipated, and means that the exchange rate will not be under such severe pressure. An indication of that is the fact that the Brazilian *real* strengthened to close at \$2.72, in the midst of a major decline in the Buenos Aires stock market and deterioration in the Argentine peso.



A second piece of information relates to energy. The crisis of 2001-2002 already seems to be disappearing as a result of strong rainfall in the Southeast. Required economies have been reduced from 20% to 5% in the most developed part of the country. Only in the Northeast do potential shortages still seem likely. On the one hand, there will be continuing investment next year as a result of construction of new generating and distribution facilities; on the other, energy prices are now unlikely to get out of line and to provoke increasing inflation.

A final encouraging piece of evidence is the continued stability of the SELIC interest rate at 19%. First, the lack of necessity to raise the rate to the extraordinary high levels characteristic of past crises - more than 40% as a result of Asia, Russia and devaluation - is a positive sign. To be sure, the decline in the Federal Reserve Rate of some 4 percent this year has helped to increase comparative Brazilian rates, but the more modest effort in

2001 is important. With a further reduction of 25 to 50 basis points anticipated in the United States this week, this may provide an opportunity for a modest reversal by the Brazilian authorities next month of the SELIC rate.

All of this adds up to a more encouraging view of current developments in Brazil, and especially in light of the more negative estimates for growth in Latin America next year. The international cycle may be real, but Brazil's continued good policy may provide some room for positive expectations over the next several months.

### **Macroeconomics**

Little new has evolved this past month. Collections of revenue have continued to be strong, despite economic slowdown. In nominal terms, Federal receipts were up 13% relative to September of 2000. Some of the factors responsible were higher income from taxes on "swaps", higher collections on income sent abroad and higher collections of the CPMF, whose rate on outstanding balances went from .30% to .38% this year.

The overall public sector deficit for September has just come out and confirms that the surplus has continued unabated. Results are again better than had been anticipated. There was a R\$ 4.4 billion surplus reported, \$3.4 billion from the Federal government, R\$ 1 billion from the state sector and states and municipalities. This means the 9 month total, R\$ 41.7, already exceeds the IMF agreement of R\$ 40.2 for the entire year. As a consequence, the government will be able to spend somewhat more generously in the final trimester than had been anticipated, providing somewhat greater impulse to a lagging economy.

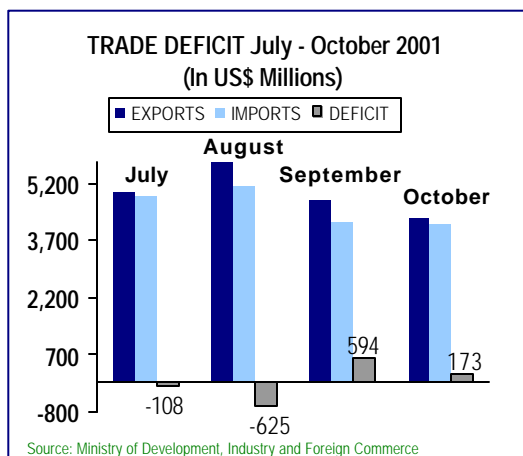
Consistently, the COPOM report came out more positively last week after leaving interest rates unchanged at 19%, where it has been since July.. It provides arguments for diminishing inflation next year -it sees little pass through from the higher 6.5% rate this year- and on the contrary sees the exchange rate stabilizing. This coincides with evidence that inflation currently seems to be settling back after advancing for the last months with increases in public sector prices. The IPCA came in at .4% in the latest month to month comparison. While certain food prices have increased sharply, putting up the index, this is but a temporary phenomenon. Reports from the Agriculture Ministry came out showing another large increase in domestic production anticipated for the next year. This continuing growth of supply is important to overall price stabilization.

On the other side, there is considerable uncertainty within the Brazilian market and sales of debt tied to the exchange rate continue to rise as a proportion of outstanding indebtedness. With the continuing devaluation that has occurred over the course of the year, such issues have turned out to be more profitable than initially anticipated. If exchange rates stabilize, on the other hand, the market will begin to shift back to the domestic interest rate.

Finally, the debt/GDP ratio has begun to stabilize with greater regularity of the exchange rate. The Central Bank has indicated that one can anticipate a ratio of 56% at the end of the year. This is much higher than the initial estimate at the beginning of the year, but seems to be reasonable. Much remains to be seen on the evolution of the Argentine situation.

## Trade and Foreign Investment

The major story this month is the immense turnaround of the trade balance. To give an initial indication, in mid-September, one was still operating with expectations of a negative small balance for 2001; currently, a surplus of between \$1 and \$2 billion is anticipated. But the real drama is 2002: the Central Bank is projecting a surplus of \$5 billion, while forecasts of such observers as JP Morgan have already gone up to \$10 billion.



This comes about as a result of various factors. First there is the real devaluation that has occurred. That clearly has consequence, both on the supply as well as the demand side. If the world economy is stronger than anticipated, exports may finally gain significantly. Last month we indicated the new commitment of the government to increase in exports; that effort, if carried out, may yield even stronger results and provide an important element differentiating Brazil from Argentina. Second, there is recognition that capital inflows are likely to be lower next year in the midst of an uncertain international environment. That clearly provides a new incentive to policy measures to limit external exposure. Next year's election reinforces that tendency. Third, there is special sensitivity of Spanish investors in

telecommunications, finance, petroleum, and electricity to what is going on in Argentina. A major rescheduling there can mean considerable losses, and therefore -in the midst of European recession- a scaling back in the substantial commitments that have occurred in Brazil.

Accepting all these factors, the Central Bank is likely to be more correct than JP Morgan. For one, imports are unlikely to reduce as substantially as the latter predicts. A decline of almost 20% would imply much more negative GDP growth than they themselves predict. Secondly, foreign direct investment is unlikely to drop as extensively as they suggest, down to \$12 billion next year, even with the negative consequences on Spanish engagement. Some privatization of state-owned facilities will continue next year even though no Federal sales of electricity generating will occur. Moreover, expansion of exports will offer opportunities for greater foreign engagement in these areas. And finally, support from external sources like the IMF, World Bank and Inter-American Development Bank provides an element of assurance to Brazil even in the absence of better overall performance.

These elements contribute to a more positive set of growth expectations for Brazil as well as a more positive external environment. But they also emphasize that the nature of international expectations is much more volatile and perilous this year than for a long time. The attack of September 11 has spilled over last month into armed attack on Afghanistan, and the wave of anthrax scares -as well as actual detection- are not finished. Clearly, a broader engagement would have more severe economic consequences. There is also the reality of international recession and its possible negative

reinforcing qualities. And internally, the political position of Brazil remains to be decided.

External circumstances, despite this uncertainty, are likely to evolve more favorably for Brazil next year than they have this year. In these conditions, a more stable exchange rate is likely, even though there may be months of high variability. It is reasonable now to bet that the odds have shifted in favor of real appreciation than continuing real devaluation.

### **Privatization**

Privatization of COPEL is imminent. Despite many court delays, close votes in the Parana legislature, etc., it is about to happen. Three groups remain engaged. Two are Brazilian; one is foreign, the Belgian Tractebel. There is rumor that the auction may be postponed at the last moment, and that a new partnership may be formed between Maromba -a group consisting of Votorantim, Bradesco and Camargo Correa on the one hand and CVRD on the other- and Tractebel.

What is clear is that Brazil needs a good result in the auction process, and also needs foreign participation. The latter reflects itself in the availability of additional foreign resources entering the country. A minimum price of \$ 2 billion has been set. Postponement, or worse, no actual bids, would have negative consequences on expectations. Just a few days ago, Antonio Emirio de Moraes, the head of Votorantim sought a delay, for example. On the contrary, satisfactory conclusion could be a very positive signal.

That would, of course, go along with the recent decision to reduce energy rationing in the Southeast and Center-West. Some two-

thirds of national production is located there, so the consequences are obvious. While the Northeast continues in threat, and Friday holidays are beginning to occur there, the overall situation is now much more favorable.

Privatization will clearly slow next year. The budget shows only modest efforts centered on sale of state development banks and sale of shares in BNDES. So what happens in COPEL will be even more important now.

### **Argentina**

The Argentine election was held in the middle of the month. About the only surprising result was the very large number of abstentions. These amounted to a plurality in the municipio of Buenos Aires. The Peronists won a majority in the House and continued with the lead in the Senate. Reports rapidly emerged encouraging the exit of finance minister Domingo Cavallo.

President de la Rúa continued with his negotiations with Governors of the Provincias for reduction in Federal transfers in order to be able to meet fiscal targets agreed with the IMF. Cavallo suggested that a positive solution was imminent, and went off on a dramatic trip to Washington last week seeking more resources.

Finally, the end has virtually just come. Cavallo has announced that \$38 billion--some investment banks say as much as \$55 billion--will have to be rescheduled. That report, on October 29, coincided with a rise in the Argentine premium to a record 2088 points. Additionally, resignation of the vice-Minister, Julio Dreizzen, occurred; and Jacob Frenkel, formerly head of the Central Bank of Israel and currently head of Merrill Lynch International, was supposedly in charge of organizing the renegotiations.

This is just the first part of the story. Some change in the value of the peso is now widely anticipated. One month contracts rose to 1.0325 pesos per dollar. Rescheduling absent some change in the peso is unlikely to be sufficient. Two alternatives seem possible. One is movement to dollarization; the other is introduction of a new domestic currency--Locaps--already being used by the Provinces to cover their deficits in order to engage in orderly devaluation. This is analogous to the way in which Brazil originally moved toward the *real* in July 1994. There it was called the URV, the *unidade real de valor*. Both Locaps and pesos would circulate, but the former at a depreciating value to the latter. Eventually with stabilization of the Locap, it would become the new currency. Argentina requires a new exchange rate to become more competitive, so even dollarization would only be effective were some devaluation imposed.

It is good for Brazil that the Argentine situation is now in its final phase. With resolution now under way it should be possible to see more careful analysis of what is going on in the country itself, rather than reflected uncertainty, determining the cost of foreign funds.

### **Politics**

One is now in the final phase toward the presidential election. The reshuffling of parties has occurred prior to the October 5 deadline. Perhaps the only surprise was the decision of Pedro Malan not to compete for the presidential nomination.

The government is now moving more aggressively to consolidate its coalition of the PSDB, the PMDB and the PFL. The leader of the PMDB in the Congress, Michel Temer, is actively seeking to prevent Itamar Franco

from becoming an active candidate for president as he has sought to do. There is supposed to be a PMDB primary in January.

Meanwhile, the race for presidential nominee for the PSDB/PFL seems to have come down to Tasso Jereissati and Jose Serra. Roseana Sarney, daughter of the former president and governor of Maranhao, has been running strongly in the recent election polls, and has emerged as a new force -but much more likely as a candidate for vice president.

Lurking in the background, and a potential candidate, is the leader of the House, Aécio Neves, from Minas Gerais and grand-son of the President-elect, Tancredo Neves, who died before inauguration.

Still in contention are Ciro Gomes and Garotinho, the governor of Rio de Janeiro, although both are seen as having peaked and beginning to lack allies in leading parties able to have access to (free) television exposure. Ciro Gomes, who had earlier agreed to come together with Brizola of the PDT, now has broken that engagement.

All in all, one candidate seems certain, Lula from the PT. He is well ahead in all of the polls, with a vote of 35%. The fear is that the initial vote is close to the maximum, and that he will lose in the final round as he already has in the last three elections.

So attention is focused on the alternative. Jereissati now has the following couple of months to try to move his campaign up to higher levels. He has recently appeared in São Paulo and is seeking to gain a national position in the polls; currently his support is close to 3%. But Serra, despite his strong position within the PSDB and PMDB, is not

well regarded by the PFL, which much prefers Jereissati. That is why Neves may suddenly emerge as a guarantor against Itamar Franco -both are from the same state- and as a new face satisfactory to all. Stay tuned.

## **Conclusion**

In the midst of continued concern for the world economy -and world politics-, in the midst of Argentine collapse next door, large real devaluation and decline in the Brazilian bolsa, things may have changed in Brazil for the better over the course of the last month. It is still early, but the signals are already apparent.

Next month should provide better indication of whether this prevision is correct. But for now, amidst all of the negative news from the developed countries, Brazil may very well be a signal of better times.