

BRAZIL MENSAL

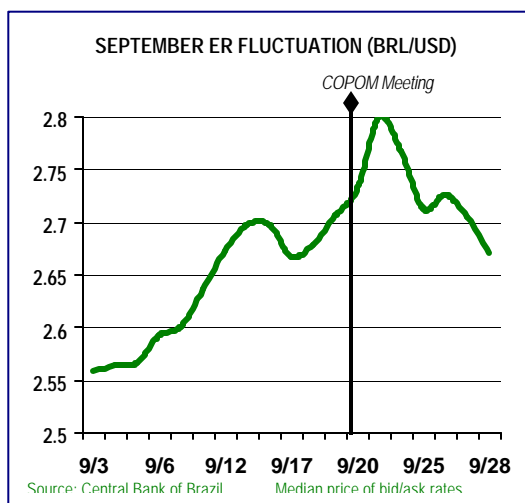
September 2001

Summary of events

This has been a hard month for Brazil and the world.

For the first time in many years it appeared that the three major blocs, the US, the EU and Japan, were now inclined toward simultaneous recession. Then came the attack on the World Trade Center and the Pentagon on September 11. That virtually assured a concerted slowdown. How serious it might be is yet unknown. Early predictions suggest very different outcomes in the 4th quarter of this year.

In Brazil the consequences of the attack were to reinforce the movements up until that time. Earlier, there had already been the deteriorating situation of Argentina, the internal energy problem, slower expansion in the United States and the forthcoming presidential election in 2002. Now all seemed to weaken, including a significant immediate rise in world oil prices.



The major development that revealed the worsened expectations was significant devaluation during the month that added to the results accumulating since August. The rate of exchange reached a peak of R\$ 2.835 to the dollar before a sharp reaction - associated with more active Central Bank intervention- at the end of the month. The rate closed at R\$ 2.67 for September.

Additionally, the authorities reduced their estimates for growth during the year -as did virtually all independent sources. The Central Bank predicted an expansion of only 2.0% in 2001; the Finance Ministry was only marginally higher. This was despite the correction in the first estimates for second quarter expansion; owing to an understatement of expansion in communications, the new result showed stability relative to the first quarter and expansion of 1.8% relative to last year, instead of the .8 previously given.

Official views, like that of the IMF, were on the high side of independent views. JP Morgan Chase, for example, reduced their estimate for the entire year to 0.5% - implying a very sharp decline in the second semester of 2001 - and only modest recovery thereafter in 2002: 1.0%. Merrill Lynch was in the same range.

One is going to see considerable uncertainty for Brazil until one gets a better sense of the speed of US recovery as well as of actual rainfall in the fourth quarter. It has already been raining above average in the Southeast, and US consumption appears to have strengthened more than early

expectations. Note that Brazilian unemployment estimates for August remained at the same level as July: 6.2%.

All analysts are agreed on higher than expected inflation this year. The Central Bank sees 6.5% for the IPCA compared to the 4% initially targeted. Next year, one also will not go down very much from this level, unless there is a major slowdown in activity.

At the end of the month, there was action taken by the Central Bank to reduce the degree of "hedging" that had led to weakness. As had been done after the devaluation in 1999, firms were given a four year period to adjust their balance sheets to diminished *real* value, but only on the non-hedged portion of their external liabilities. Additionally, there was considerable pressure put on banks to sell dollars by a variety of new regulations all reducing their liquidity. As a result sales of government bonds tied to exchange rates came down from something of the order of 10% to 6.36% a year. The Central Bank made clear that it is committed to increase the dollars available by requesting \$4.7 billion of the new \$15 billion loan of the IMF so that reserves could increase.

All of this occurred in the real economy. Internal political events were almost equally prominent, with Jader Barbalho forced to give up the presidency of the Senate and likely to resign his seat early next month. The federal government had its ability to pass "temporary" legislation significantly curtailed. *Medidas Provisorias* now were limited to 120 days, and the extension of the last 60 days could see no change in the initial provisions. Finally, new polls indicated a potentially changed position in the race for president.

The impact of many of these developments will become clearer in the next few months. Much depends upon the extent of the US reaction. But this is also a test of the leadership of Pedro Malan and Arminio Fraga as they determine the responsiveness of the Brazilian economy.

Macroeconomics

The fiscal performance continues to be much better than expected. The consolidated public sector balance -including all governmental levels- was R\$ 3.7 billion in August, well above estimates. That exceeds the nine month target agreed with the IMF.

That is the good news. Less positive is the fact that the nominal deficit rose from 6.2% of GDP to 6.9% of GDP. That owes itself primarily to the depreciation of the *real* in August by 5%. A similar result is likely for September. This has brought the public sector net debt up to 54% of GDP, with further increases likely through the end of the year. That compares with the 49.3% at the end of 2000. What is clear is that more rapid depreciation inevitably drives up the debt ratio. The devaluation in 1999 had a similar effect.

The Central Bank kept the SELIC interest rate at 19% at its last meeting. That was helped by the reduction of 50 basis points in the US interest rate by the Federal Reserve, and a likely further reduction at the forthcoming Fed meeting next week. A key debate within Brazil is whether a large increase in the rate should be adopted -and with it, a major recession. That would clearly diminish pressures on the price index as well as the exchange rate. On the other side, apart from the question of political ability to do so with an election coming up, another move upward in interest rates might impose

new pressures on prices and the exchange rate. Certainly the rise in real interest rates this year has been positively associated with depreciation rather than the reverse. With the slowing in industrial production, a reduction might be in order. Higher rates will not have the effect of attracting foreign capital in the current climate, as it did at other times.

Initial price indices have come in lower than had been expected. Slowdown had been anticipated, but the IPCA result of .38% in the first three weeks of September, compared to 1.3% in August during the same period, suggests that much of the pressure from increases in publicly regulated tariffs that had driven recent results is now gone. That should enable the new Central Bank target of 6.5% to be satisfactorily realized by the end of the year, especially since the economy is slowing down.

Overall, then, the picture is one of surprisingly strong tax receipts and continuing control over expenditures. Monetary policy has remained relatively restrictive. That has prevented any surge of prices as a result of continuing higher devaluation than had been foreseen. Inevitably, foreign debt has increased, and with it, the total governmental deficit. The ratio of debt to income has not gotten out of control, and continuing fiscal surpluses can resolve the situation over the course of the next year. At the same time, the rise in indebtedness will likely make the issue of a refusal to pay into a political centerpiece in the presidential campaign.

Trade and Foreign Investment

The positive results in the merchandise balance in August and the first three weeks of September are in part an accidental

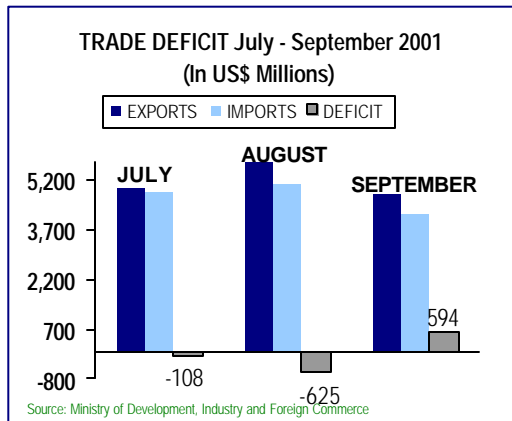
outcome. In August there was the return of airplanes; in September, oil imports have come in lower than had been anticipated and other imports have been reduced as a result of economic slowdown.

One clear thing that has emerged is the first commitment of the Cardoso administration to exports as a major element of economic policy. New Minister Sergio Amaral has spent much of his early days in office seeking to stimulate an export push. That was before September 11. Even more it becomes necessary because of the likely effects on foreign direct investment for the rest of this year and the next. A powerful new group to manage foreign trade is in the process of creation, designed to parallel the committee established to deal with the energy crisis.

The IMF new estimate for FDI for Brazil has been reduced to \$17 billion. Since the total at the end of August was recorded at \$13.6 billion, that does not leave much for the last four months. COPEL, the Parana electricity company, should bring in something of the order of \$2 billion at the end of October, and Goias may be able to sell theirs by the end of the year as well. So \$17 billion is not an unrealistic estimate.

For the next year, anticipated FDI revenues are set even lower. This clearly puts pressure on the balance of payments. A current account deficit of something of the order of \$26 billion seems still to hold. That explains both the importance of the \$15 billion in additional IMF credit that has been granted as well as the much greater attention to exports. If interest rates stay up, or even go down slightly, the only way to get the current account in line with the reduced foreign investment flows are through a large

trade surplus. That in turn means a reduction in imports as well as an increase in export earnings. And that adds up to a much more serious recession in the midst of an electoral year.



Very obviously it is much easier to reduce imports than to push exports into a declining world market. That, of course, is exactly what happened in the early 1980s after capital inflows disappeared in the midst of the debt crisis. But the way of doing that was a major cutback in growth. Not accidentally, Brazil ended its military government in 1985, a full six years prematurely, as a result of the economic pressure.

So this becomes another uncertainty, with very real and direct political consequences. If the estimates of the Institute of International Finance hold, net private capital flows to emerging market economies will come only to \$106 billion in 2001 after attaining \$167 billion a year ago. Next year they will not much change. At the same time deficits are supposed to increase. So reserves will be under pressure. That will particularly be the case given the substantial investments in energy resources that are required, even in the event of good rainfall, for 2002.

It is little wonder that the Brazilian stock market continues downward and that country risk widened by 150 points in September compared to a general increase for emerging countries of 90 basis points.

Politics

In the midst of what already was a month of much economic news, politics became progressively more central in Brazil.

First off, the case of Jader Barbalho seems closer to solution. Earlier in the month, he resigned the presidency of the Senate, succeeded by Ramez Tebet of his own party. That did not end matters. The Senate Ethics Committee inquiring into the matter voted 11 to 4 in favor of formal expulsion proceedings. Many are speculating that he will choose to resign early this week-and thereby retain his future political rights. But there is some question of his potential exposure to prosecution once he is out of the Senate.

Second, the new Presidential poll results became available. The clear message they all seem to emphasize is that Roseana Sarney, daughter of the former president, and currently governor of their home state of Maranhao, is running very strongly. She has come up strongly in public preference, and now substantially outranks Jose Serra of the ruling PSDB party. In contrast to her rise has been his concomitant decline. That clearly had been unanticipated. It places the PFL in a new position of importance in negotiating with the PSDB of President Cardoso, and may put increased pressure on a declaration of his preference for a successor to early next year. That is when the PMDB intends to nominate its candidate. At the moment, it is likely that the PMDB will do just that and end its association with the PSDB/PFL coalition.

Note that this does not mean that Ms Sarney necessarily would be the candidate. On the contrary. It virtually assures that she could be the vice-presidential candidate, bringing with her strong support. That still leaves the question open of whom Cardoso would choose as his successor. As of October 5 one element in that equation gets resolved. Pedro Malan, the minister of Finance, has officially to choose a party by that date. Were he to opt for the PSDB, the ongoing doubt of whether he has Cardoso's support would remain.

Equally important, new polls suggest some improvement in President Cardoso's own approval ratings. But these all retain a very strong negative evaluation. Other information suggests a continuing concern with the position of the Brazilian public in the midst of slowdown, and a much lesser commitment to retention of the anti-inflation strategy that has defined governmental policy over the last years. After the problem of Argentina and President de la Rúa, there may in the end be a preference for greater continuity in the instance of Brazil.

This may be reinforced by greater proximity of Brazil and the United States in the midst of the current international situation. Brazil seems to be acquiring a more favorable stance within the present environment. If circumstances should lead on to Congressional approval in the next months of Trade Promotion Authority (or fast-track, as it used to be called), the possibility of progress on the FTAA negotiations during 2002 might very well play some role in Brazilian political decisions during the same year.

Finally, Lula is planning a visit to Europe this week where he is scheduled to meet with Premier Jospin of France and Premier

Guterres of Portugal. It is still not entirely clear whether Lula's support of a more moderate economic policy is a reality or merely a mirage. That will become clearer over the next months.

Conclusion

The horrendous events of this month will have continuing economic consequences over the course of the immediate future. Brazil, no less than other emerging nations, will be affected. Indeed, because of its special reliance on external finance, it could suffer greatly. It has the largest current account deficit in the region, and faces one of the highest interest rates as well.

Additionally, it faces forthcoming national elections in little more than a year. Few months are available for any Congressional action on revenues, and with the fiscal balance now the central point favorable to the government, that looks as though it, and a variety of other areas, will simply have to wait. It remains to be seen whether any action gets taken on an independent Central Bank, something of critical importance in the event of a PT victory in the presidential race.

Performance in trade over the next months will be closely observed, as will the strategy of limiting depreciation of the *real*. So will the continuing strength of government income. Despite the weakening economy -less so than originally been thought- revenues and the fiscal surplus have stayed up.

Earlier, it was just Argentina and the energy crisis. Now it is the economic performance of the world as a whole that will have great weight. Brazil's range of maneuver is now curtailed; but that does not make the eventual outcome necessarily negative.