



StratInfo, Miami, FL: Economic and Financial Analysis

Special Alert Brazil

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Nervous Investors Apply the Domino Effect to Brazil

Because of its size and degree of openness, the Brazilian economy is vulnerable to sudden market jolts triggered by nervous investors. Since May of this year, the *real* has been under pressure as the exchange rate jumped from R2.5 per US\$ to a high of R3.4 per US\$ in July, as market fears bordered on paranoia over the outcome of the upcoming October presidential elections and continued deterioration of the Argentinean economy. Because of Brazil's high external debt, about 3.9 times exports in 2001, financial markets were busy making analogies to Argentina, which defaulted on its huge external debt of about 5.3 times exports. Of course, most analysts have missed the fundamental and critical differences between the two economies, which do not validate a comparison. At the same time, Brazil's devaluation in January 1999 was a textbook masterstroke, which resulted in a mere 5.0 percent inflation in that year. The Cardoso administration's excellent track record in the area of economic management bodes well for Brazil's outlook beyond the current economic storm.

Despite its fundamental strengths, Brazil still faces two imposing obstacles: first, the October Presidential elections; and second, the fallout from Argentina, with the possibility of a financial panic. Management of the current challenges facing the economy has been complicated by the upcoming elections. Because of election year politics, the Cardoso administration is more constrained this time than it was in early 1999, when interest rates were raised significantly, in order to deter the slide of the currency. The disappointing news for this administration is that the official candidate, Mr. Jose Serra, has been falling in the polls and now trails the other major candidates by a wide margin. At this point, it will be very difficult for Mr. Serra to garner enough support to make it to the runoff elections, which are slated for the end of November. The leading candidate, Luiz I. Da Silva (Lula), has maintained his lead for a longer period of time than in previous elections, although he is now seriously challenged by socialist Ciro Gomes. If Mr. Gomes pulls ahead in the runoff elections, we would not expect to see a major shift in economic policy, but rather a greater focus on social issues in order to ease social tensions. In fact, whoever wins the elections will have to pay more attention to the country's social problems.



Under attack by ruthless financial markets, Brazil recently negotiated a \$30 billion loan package from the IMF. The bulk or \$24 billion of these funds would be disbursed in 2003, in order to keep the pressure on the next government to maintain prudent fiscal policies. The problems faced by Brazil on the external front are a shrinking of capital inflows and increasing capital outflows by nervous investors. Direct foreign investment is a principal source of funds for financing the current account deficit. For example, in 2001, net direct foreign investment inflow was \$22.4 billion, compared with a current account deficit of \$23.2 billion. Another important source of financing is suppliers' credits and commercial bank lines, which last year amounted to about \$10.8 billion. We think that capital inflows will shrink this year, with direct foreign investment cut by half and other financing, mainly short-term credits, actually reduced by \$3.8 billion. Based on these assumptions, the projected deficit in the balance of payments would result in a decline in international reserves of about \$12 billion to a still healthy foreign exchange (FX) reserve level of \$24 billion (See Table Below).

This forecast shows that even with a sharp cutback in capital inflows, ample international reserves at the Central Bank, combined with a shrinking current account deficit, helped by the depreciation of the *real*, should facilitate the closing of the financing gap this year as well as in 2003. The risk for Brazil is that now international liquidity will be at about 5.5 months of imports or less, versus about 9 months several years earlier, which increases the currency's vulnerability to capital flows in the future. One positive factor is that the debt to export ratio is expected to move down modestly.

On the domestic front, the significant devaluation of the *real* will put upward pressures on inflation and significantly increase the debt service burden of the government's domestic debt, both through the impact of higher inflation on interest rates and through the component of the debt that is indexed to the exchange rate. We think this poses a significant fiscal challenge, but one that is also manageable. Nevertheless, the size of the domestic government debt will continue to pose a risk to macroeconomic stability.



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BRAZIL: BALANCE OF PAYMENTS

(in millions of US\$)

	1998	1999	2000	2001	2002 ^F	2003 ^F
CURRENT ACCOUNT:						
Exports						
Primary Products	12,977	11,828	12,562	15,342	16,109	18,525
Semi-Manufactured	8,120	7,982	8,499	8,243	8,078	9,290
Manufactured	29,387	27,330	32,528	32,901	35,862	39,448
Special	656	872	1,497	1,736	1,823	1,914
Total Exports	51,140	48,012	55,086	58,222	61,872	69,178
	-3.5	-6.1	14.7	5.7	6.3	11.8
Imports	57,714	49,210	55,783	55,581	53,358	60,294
	-3.4	-14.7	13.4	-0.4	-4.0	13.0
Trade Balance	(6,574)	(1,198)	(697)	2,641	8,514	8,883
Services Exports Non-Income	7,897	7,194	9,498	9,322	9,788	10,767
	14.8	-8.9	32.0	-1.9	5.0	10.0
Services Imports Non-Income	18,008	14,171	16,660	17,071	16,388	17,699
	2.8	-21.3	17.6	2.5	-4.0	8.0
Net Services Non-Income	(10,111)	(6,977)	(7,162)	(7,749)	(6,600)	(6,932)
Services Income Export	4,599	3,935	3,621	3,280	3,116	3,334
	-10.9	-14.4	-8.0	-9.4	-5.0	7.0
Services Income Import						
Interest (est)	15,321	17,100	17,096	17,621	17,633	18,061
Other	7,466	5,683	4,411	5,402	5,132	5,902
Total Services Income I	22,787	22,783	21,507	23,023	22,765	23,963
Net Services Income	(18,188)	(18,848)	(17,886)	(19,743)	(19,649)	(20,629)
Net Services Total	(28,299)	(25,825)	(25,048)	(27,492)	(26,249)	(27,561)
Net Transfers	1,458	1,689	1,521	1,638	1,700	1,800
CURRENT ACCOUNT BALANCE	(33,415)	(25,334)	(24,224)	(23,213)	(16,035)	(16,878)

BRAZIL: BALANCE OF PAYMENTS (Continued)

(in millions of US\$)

	1998	1999	2000	2001	2002F	2003F
CAPITAL ACCOUNT:						
Direct Foreign Investment:						
Inflow	28,856	28,578	32,779	22,457	10,100	18,250
Equity	25,479	29,983	30,016	18,765	9,000	16,000
Inter-Company Loans	3,377	(1,405)	2,763	3,692	1,100	2,250
Outflow	2,854	1,690	2,282	(2,258)	(1,200)	200
Net Direct Fgn Invest	26,002	26,888	30,497	24,715	11,300	18,050
Portfolio Investment:						
Portfolio Inflow:						
Equity Securities Net	995	2,572	3,076	2,481	1,000	2,500
Debt Securities Net	17,588	971	5,575	(1,609)	2,250	5,000
Disbursements	31,955	23,342	20,470	19,003	21,466	23,061
Amortizations	14,367	22,371	14,895	20,612	19,216	18,061
Net Portfolio Invest	18,583	3,543	8,651	872	3,250	7,500
Portfolio Outflow:						
Equity Securities Net	(20)	864	1,953	1,121	500	1,600
Debt Securities Net	477	(1,123)	(258)	(326)	(150)	200
Net Portfolio Invest	457	(259)	1,695	795	350	1,800
Net Portfolio Inves	18,126	3,802	6,956	77	2,900	5,700
Derivatives (Net)	(460)	(88)	(197)	(471)	(450)	(500)
Other Investments:						
Inflows	(2,895)	(9,223)	(15,212)	10,223	(3,800)	3,500
Suppliers Credits (net)	2,740	(7,284)	(6,409)	5,103	(500)	2,500
Other Loans (net)	4,031	1,342	(8,774)	5,716	(2,500)	4,000
Currency and Deposits	(9,666)	(3,281)	(29)	(596)	(800)	(3,000)
Outflows	11,392	4,397	2,989	6,586	6,000	5,000
Net Other Investments	(14,287)	(13,620)	(18,201)	3,637	(9,800)	(1,500)
Other capital account	320	338	273	(36)	300	400
CAPITAL ACCOUNT BALANCE	29,701	17,320	19,328	27,922	4,250	22,150
Errors & Omissions	(4,256)	194	2,637	(1,405)	(100)	100
OVERALL BALANCE	(7,970)	(7,820)	(2,259)	3,304	(11,885)	5,372
Memo Items:						
FX Reserves	42,578	34,786	32,488	36,000	24,115	29,487
Import Coverage (months)	8.9	8.5	7.0	7.8	5.4	5.9
Current Account to GDP (%)	-4.0	-3.6	-3.7	-4.1	-3.0	-3.5
External Debt	241,644	241,469	236,157	226,067	225,767	236,317
Debt to Exports ratio	4.7	5.0	4.3	3.9	3.6	3.4
Interest as % of debt	NA	7.1	7.1	7.5	7.8	8.0
Amortization as % of debt	NA	NA	6.2	8.7	8.5	8.0

Source: Central Bank of Brazil and StratInfo forecast.

Note: GDP and other indicators used in this forecast are derived from StratInfo's economic forecasts of the Brazilian economy which are updated regularly.