

# BRAZIL TAKES BITTER MEDICINE

IN AN INTERVIEW WITH *LATIN AMERICAN LAW AND BUSINESS REPORT*, **PAULO VIEIRA DA CUNHA** OF LEHMAN BROTHERS CONSIDERS WHETHER BRAZIL WILL BE BROUGHT DOWN BY AN ARGENTINE DEFAULT.

**A**rgentina has not been the only country to suffer from the perceived danger of a foreign debt default. The contagion has spread to other Latin American countries, most notably neighbouring Brazil.

The turnaround for Brazil has been dramatic. Until early this year the country was thought to be entering the rarefied economic heights of a second consecutive year of GDP growth of over 5%. While Argentina is not the sole cause of Brazil's present economic downturn (the energy rationing programme which forced many businesses to cut back on production schedules has clearly not helped), the events have reminded many foreign investors of how volatile the region can be, and how quickly the seemingly right formula can give way to pessimism as local currency is exchanged for dollars.

Will Brazil be brought down by an Argentinean default? Actually, the reverse just might be true, says Paulo Vieira da Cunha, Senior Vice-President and Senior Latin American Economist for Lehman Brothers' Global Economics Group. The continuing uncertainty over a possible default by Argentina on its debt payments is probably worse than a resolution, even if the 'resolution' is an Argentinean organised default or workout arrangement, Vieira da Cunha told *Latin American Law and Business Report* (LALBR). Once the events take place, Brazil's Central Bank can take actions to defend against the contagion, and investors can see that the worst is over, Vieira da Cunha says. And while the value of the Brazilian currency has fallen precipitously in reaction to the Argentinean crisis, by year's end the real could strengthen slightly, depending on when Argentina resolves its crisis. More worrisome for the long-term interests of Brazil are the country's high debt payments, which exact significant fiscal sacrifice, even though Brazil's budget is now largely balanced.

**LALBR:** How serious would the contagion be to Brazil from an Argentinean default on its foreign debt?

**VIEIRA DA CUNHA:** The question is not how 'would' Brazil be affected. The contagion from the Argentine crisis has already had strong and negative effects on Brazil. The Brazilian Central Bank has had to make difficult interest rate hikes to check the inflationary effects of a drop in the value of the real, due in large part to the

Argentine crisis. Of course, the contagion has already significantly changed the outlook for the Brazilian economy for this year and next.

## END TO UNCERTAINTY WOULD BE POSITIVE

**LALBR:** And if Argentina defaults on its debt payments, will the contagion effect increase become even more severe?

**VIEIRA DA CUNHA:** My sense is that a resolution in Argentina, one way or the other (I think it will be an organised default and not an outright unorganised default), actually will be positive for Brazil. What is really driving the exchange rate in Brazil is the sense that worse things could come from Argentina. As a result, a number of corporates have decided to hedge not only their flows of dollar-denominated payments, as would be customary, but corporates are also hedging part of their balance sheets, that is, their asset base. If the Argentina uncertainty is ended, then the boards of these corporations are going to revise their hedge positions. Most firms, I think, will stay with the level of hedge they are in, but at least they will not continue to increase their hedged positions. This should bring stability to the Brazilian real and will also permit the Cardoso administration to implement more pro-growth types of policies in a macroeconomically-sound way.

**LALBR:** Wasn't the \$8bn package of aid that the IMF announced on August 21 designed to ward off a default?

**VIEIRA DA CUNHA:** The new IMF programme has done little to change the outlook. In fact, the value of the real fell sharply immediately after the announcement. The market perceived, correctly in my view, that the IMF package was too little to 'resolve' the problem. The uncertainty remains. However, the programme may have helped to reduce the speed that the value of the real fell. At least now the market is apparently willing to wait and see. [For more information on the recent IMF aid package, see box on page 58.]

## LIKELIHOOD OF ARGENTINE DEFAULT

**LALBR:** How likely is a default by Argentina?

**VIEIRA DA CUNHA:** My sense is that there is an 80% likelihood. Consider that there is a 90% probability of 'event risk', the chance

## 'THE CONTAGION HAS ALREADY SIGNIFICANTLY CHANGED THE OUTLOOK FOR THE BRAZILIAN ECONOMY FOR THIS YEAR AND NEXT YEAR'

that something will happen (eg, a violent strike, the need to increase the wage cuts to 18 to 20%, to stop transfers to the provinces, etc.) to push popular sentiment from fear and apathy to revolt; and consider that, given the event risk, the probability of default or some major disruption in the flow of payments is 90%. Then the joint probability is 81%. Although technically it may not be called a default, it will be a default in the sense that bondholders will lose part of the face value of the bond, perhaps 20 to 30%, for example.

**LALBR:** Brazil's Finance Minister (Pedro Malan) recently said Brazil's economic growth should reach 2.8% in 2001. Is this realistic?

**VIEIRA DA CUNHA:** I don't think so. The Ministry of Finance probably made that assessment before the economic results of the second quarter were known. Growth in the second quarter was very low, just 0.9%. I, too, was surprised by the drop in growth. Either there is something wrong with these numbers, which is unlikely, or we have misunderstood the dynamics of the economy. We were anticipating that the manufacturing sector would take a hit, but the GDP numbers show that other sectors have contracted tremendously, particularly the retail sector, construction, some services and some agriculture. More worrisome is that looking ahead there are very few sources of new demand; because Brazil is largely a closed economy, sources of domestic demand are important. However, domestic demand was very depressed because of the monetary policy that has had to be pursued to keep macro-balances in check with contagion from Argentina. If the Ministry of Finance people were to do their forecast now, they would probably put growth at 2% or lower.

### CENTRAL BANK BETWEEN A ROCK AND A HARD PLACE

**LALBR:** The Brazilian Central Bank has had to keep interest rates high to discourage investors from selling reals and moving into dollars, further weakening the real. On the other hand, Brazil's economic growth is down and consumer confidence is sliding. What should the Central Bank do?

**VIEIRA DA CUNHA:** The Central Bank is between a rock and a hard place. The problem is very difficult to implement but it is simple to understand. The kind of monetary policy that Brazil has been successfully carrying out is one that depends very much on the credibility of the Central Bank. The Central Bank does not actually use quantitative controls on the amount of money that it puts into the economy; it does not target the quantity of money and eschews any simple rule to link base money growth with inflation. Instead, the bank targets inflation itself. If it perceives inflation to trend above the target the bank increases the interest rate, and then waits to see a sufficiently large drop in demand to deflate the price level back to the desired trend. To maintain this credibility the Central Bank must lead the market, particularly at the short end of the interest rate curve. But, to be sure, the bank wants to influence the entire yield curve. In a situation like the one we are seeing now, the bank would like to see a flattening or even a slight inversion in the yield curve—the perception by the market that inflation will come down even if it has

risen recently. Unfortunately, the market is not validating this perception. Despite large increases in the overnight rate (controlled by the Central Bank), the yield curve has steepened. Importantly, however, the market remains sensitive to Central Bank action. The Central Bank has credibility because the market believes that it is focusing on inflation 12 to 18 months out and it is taking the measures that are necessary to reach the inflation targets. Admittedly, the Central Bank will not reach the targets this year, 2001, but that is understood because there have been so many shocks. Nonetheless, the market still believes that the Central Bank will reach those targets 12 and 18 months ahead even if it misses this closer target.

**LALBR:** Has the strategy of the Central Bank been altered by the severe energy crisis?

**VIEIRA DA CUNHA:** The Central Bank was actually helped by the energy crisis between March and July this year. The energy crisis lowered expectations that companies could produce at their normal output. So even though the Central Bank was raising interest rates due to the Argentine crisis, the negative effect on growth was not criticised because companies felt they could not produce much in any case. It now seems likely that the energy crisis will be ameliorated next year so that the economy can produce more. But this increased production means that the interest rates need to come down so that an increase in demand can absorb an increase in production. I think that the Central Bank is going to be quite cautious in considering the tradeoff between inflation and growth from now on.

### DROP IN FOREIGN INVESTMENT

**LALBR:** How much will foreign direct investment fall in Brazil this year?

**VIEIRA DA CUNHA:** It is going to drop very significantly. Last year's total FDI was \$32bn. I expect this year, it will be under \$20bn. And the pure FDI excluding intercompany loans and the like will be around \$17bn. Why the difference? Well, the last two years were exceptional. Most of the privatisations were actually delayed until 1999 and 2000. So FDI for the last two years was skewed by the inflow due to the large telecom privatisations. Additionally, corporations in the US are making very few new investments, due in large part to the downturn in the US economy. This affects not only investments in the US but investments worldwide.

### CONTINUED ACCESS TO INTERNATIONAL MARKETS CRITICAL

**LALBR:** With less money coming in, will investors begin to question whether Brazil can meet its foreign-debt obligations? Could the potential of a Brazilian default become more tangible to foreign investors?

**VIEIRA DA CUNHA:** That fear is always there. For Brazil the important thing is to have fluid and deep international capital markets, that is, markets that – at a price – are willing to take additional exposure in the country. It is one thing to have to face (temporarily) an increase in country risk and the resulting higher interest rates. It is quite another matter to be shut off from the market because it is not willing to lend at any price. Brazil's gross borrowing requirements this year are on the order of \$52bn – very large. Much of this borrowing is in the form of loans that, in the normal course of events, get rolled over, such as short-term lines of trade credit. If there is a major disruption in the US economy or Japan or a crisis as occurred when Russia defaulted on its debt in the autumn of 1998, then we will see greater anxiety over the possibility of default in Brazil. Most analysts are not so worried about a default

**□ IMF STEPS IN WITH \$8BN AID PACKAGE TO ARGENTINA**

PACKAGE AVOIDS DEFAULT; INVESTORS LOOK FOR LONGER TERM SOLUTIONS

With the threat of a default on its foreign debt looking ever more likely, the IMF offered beleaguered Argentina \$8bn in fresh funds on August 21 – \$5bn of the package consisted of immediate credits; the remaining \$3bn is to be disbursed in regular allotments. The package was designed to support the banking system as Argentines continued to trade in pesos for dollars. The package was also expected to give Argentina some breathing room to fashion a longer-term solution to its financial crisis. Some investors said the package came just in time to permit Argentina to avoid defaulting on its debt obligations.

**OPPOSITION TO SPENDING CUTS GROWING.** The bigger problem for Argentina will be to balance its fiscal accounts in order to obtain enough cash to meet its foreign debt obligations. While the government has announced important measures to boost tax revenues and cut spending, investors are uncertain if the measures are proving effective. Several of the measures have yet to be implemented. Moreover, the measures already approved, such as a 13% cut in salaries to government employees and many pensioners, has sparked growing street demonstrations and protests. Organised opposition is coming from the largest unions, and an increasing number of politicians are opposing the austerity plans. Midterm elections are due to take place in October.

"The new IMF program may be seen as both giving Argentina just enough rope to hang itself, and as a lifeline to buy time for a reasonable solution to emerge," said Lehman Brothers' Paulo Vieira da Cunha. Many investors will be sceptical because the government is perceived as unlikely to be able to meet the draconian zero-deficit target, Vieira da Cunha noted.

**PLAN PROPOSES WRITE-OFFS BY BONDHOLDERS.** One element of the package that was particularly interesting to investors was the \$3bn portion of the package that is to be used towards a "market friendly" rescheduling of the debt. "Clearly the \$3bn is not enough," Vieira da Cunha said, "but the fact that this element was included in the package has already produced a number of proposals to reduce the principal of the debt through voluntary measures." Such measures could include an agreement between Argentina and bondholders to reduce the face value of bonds by 30 percent, or other measures to reduce the stock of debt or guarantee payment of the debt. "These programs would cost something on the order of \$20 to \$25bn, much more than anything that is being talked about now. But at least the topic is now being discussed," Vieira da Cunha said.

Scott Studebaker  
Managing Editor of LALBR.

on the external debt; Brazil's external public debt is relatively small. Rather the focus has been on Brazil's public domestic debt. This public domestic debt is large, and part of it is indexed to the foreign exchange and so in some sense, it is an external liability. Most of the domestic public debt is short-term debt. A lot of it is floating, so when the interest rates increase, the effect is immediately passed on to the debt stock. Whenever there is a fall in the value of the real, this also gets passed on. Since mid-March until today the Central Bank has had to increase interest rates and at the same time accept a

weaker currency. This has cost the Brazilian Treasury a great deal of money and the debt to GDP ratio, which had been falling and was as low as 49%, is now forecast to close the year at 53% of GDP. In the past when there had been instability periods in Brazil, the question was always whether the Central Bank or the Treasury would be capable of rolling over this stock of domestic debt and under what conditions. Brazil survived some very difficult macroeconomic periods without defaulting on the domestic debt, even though it has defaulted on the foreign debt. Brazil has protected the banking system. The Central Bank has spent a lot of money, about 10 to 12% of GDP, trying to improve the quality of the banking system so that it can live without these kinds of indexed bonds. Hopefully the banks are now in better condition to withstand the volatility.

**BALANCING THE BUDGET REQUIRES AD-HOC MEASURES**

**LALBR:** When might this imbalance become severe enough to cause the markets to react?

**VIEIRA DA CUNHA:** The unfortunate thing is that it can happen very, very fast. Brazil recently increased the target of the primary surplus from 3.1% to 3.35% for this year, and from 3.0% to 3.5% for next year. If the planners had lowered their targets to 2.5% this year and 2% next year, for example, we probably would have seen a very quick reaction, and interest rates on the debt would begin to rise sharply. If the Central Bank at such a point forestalled an increase in interest rates, by refusing to accept higher rates in the overnight market which it controls, we would see a sharp increase of the yield curve. Eventually, the short rates would increase – for the treasury can not stay long without placing new paper (typically indexed on the overnight rate) and accepting the demand of the market. The room for maneuver is quite limited and the market understands the dangers that result from economic mismanagement. The more interesting question is, when will Brazil simply be able to balance its fiscal accounts as standard operating procedure? What is unnerving today is that Brazil still depends very much on the actions of the Ministry of the Budget, the Ministry of Finance, and ultimately of the president, to balance the budget. The system, in and of itself, does not generate an approximately balanced or sustainable fiscal situation. The size and the structure of the debt requires very close, day-to-day management. If the institutions of the budget are permitted to run by themselves, they will not produce a balanced budget, even with the fiscal responsibility law.

**TAX SYSTEM IS EFFICIENT, BUT HARMFUL TO PRODUCTIVITY GAINS**

**LALBR:** But isn't Brazil actually quite efficient at collecting taxes?

**VIEIRA DA CUNHA:** Brazil has a buoyant tax system and the buoyancy has actually increased. The tax revenue stream is largely insensitive to shocks. The federal budget is better planned and executed. At the federal level, there is a multi-year exercise in budget planning and meeting objectives. This is a dramatic change over the old method where the money was just divided among the ministries and political powers. Additionally the portion of the budget allotted to state and municipal governments and to state-owned companies has been rationalised. A number of state-owned companies, such as banks, have been restructured or closed. But it is important to point out that the tax revenue mechanism, while very efficient in generating revenue, is harmful because it punishes producers. The tax structure depends on many esoteric-types of measures that will have to be redesigned, particularly if Brazil wants to have a higher productivity growth, and better incentives for growth.

**LALBR:** What is your forecast for the value of the currency and

inflation by the end of this year?

**VIEIRA DA CUNHA:** For this year, we forecast GDP growth of 2% and inflation, as measured by the rise in consumer prices, to reach 6.4%. The real, by the end of the year, will be around 2.4 to the dollar, although I expect that the exchange rate will first go up after the Argentine crisis is resolved, and then come down.

**LALBR:** So it is going to get weaker and then get stronger by the end of the year?

**VIEIRA DA CUNHA:** I am assuming that some kind of resolution on Argentina will occur in September. In that case, yes.

#### **PRESIDENTIAL ELECTIONS—IF LULA WINS PRESIDENCY**

**LALBR:** Campaigning has already started for Brazil's presidential elections next year. The candidate of the Workers' Party (*Partido dos Trabalhadores – PT*), Luis Inacio Lula da Silva (Lula), has been doing much better than in his previous three attempts, and is leading in the polls. Should foreign investors be concerned?

**VIEIRA DA CUNHA:** It is too early to say that Lula is going to be the next president. Many things can happen before elections, and in Brazil, often do. Nonetheless, Lula would not be the worst candidate. Some of the most responsible state and municipal administrations have come from the PT. There is a difference between the PT rhetoric and the mechanisms that PT candidates have put into practice once elected. A Lula administration, for example, would not change the laws or take actions against private property or other radical actions because it understands what these actions would mean to much of the society. Actually, the PT supports, if anything, more transparency at the institutional level. I see the difficulties with a Lula victory

resulting from a lack of experience. The PT has never held a federal public office. But then not many parties in Brazil have held federal office – this is a consequence of the years of dictatorship in Brazil. There have only been three presidential elections since the military coup in the sixties, and two of those were won by Mr. Cardoso. What most concerns me about a PT presidency is the party's support for a very activist fiscal policy. Many PT economists apparently believe that they can avoid a downturn by simply stimulating the economy. This kind of fiscal management would lead down a slippery slope. The reaction would be felt quickly on the cost of the debt. Whatever the economic managers could do to try to stimulate the economy would be eaten away by higher interest payments, and then there is always the danger that such an administration might want to avoid these high interest payments. That is where the problem might lie.

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