Is Brazil Next?

John Williamson


The author acknowledges helpful comments from William Cline and Edwin Truman, useful discussions with Francesco Giavazzi, assistance in finding facts from Paulo Sotero, and help in securing data from the Banco Central do Brasil.

Executive Summary

This policy brief examines whether the pessimism that recently gripped the financial markets about Brazil’s economic prospects is justified, and whether the big IMF program in support of Brazil announced on August 8, 2002, is likely to succeed in turning the tide. It concludes that present policies would be adequate to secure a gradual reduction in the debt/GDP ratio given return of the exchange rate to a less undervalued level and a level of interest rates that is normal by past Brazilian standards though still high by world standards, though not under the recent conditions of a severely undervalued real and astronomical interest rates. It also concludes that the strongly improving trend recently evident in Brazilian trade promises a progressive reduction in external vulnerability, though this again could be jeopardized by the maintenance of sky-high interest rates. It then argues that, despite the mixed records of the two principal opposition candidates for the presidency, neither would be likely to choose a policy of deliberately reneging on Brazil’s debts. That being so, the recent market turbulence has to be interpreted as a panic in which even those convinced that Brazil’s fundamentals are sound did not dare to speculate in favor of restoration of normality. Such situations are exactly those where the IMF can play a useful role in breaking a panic, and hence the new loan much improves the chances of Brazil avoiding the implosion that would be likely to follow a debt restructuring.

Introduction

Until the IMF package on August 7, the financial markets showed great concern that Brazil might follow Russia, Ecuador, the Heavily Indebted Poor Countries, and Argentina in defaulting on its public debt. The yield spread of Brazilian debt over US Treasury securities (“Brazil risk”) rose above 2,000 basis points in July 2002, on some
days higher than that of Nigerian debt, and second only to Argentina. One of my colleagues, Morris Goldstein, publicly estimated the probability of a Brazilian debt restructuring before the end of 2003 to be as high as 70 percent. After that (though not necessarily as a consequence!) the Brazilian real depreciated a lot more and Brazil risk rose much more. The questions addressed in this brief are whether this pessimism about the prospects of Brazil was justified, and whether the new IMF program announced on August 7, 2002, promises to bring these fears to an end once and for all.

The first section of the brief lays out the analytical framework that will be used to examine this question. This is the theory of the self-fulfilling crisis. This theory argues that there are circumstances in which, if the markets believe the debt will be serviced, then it will be possible to service it (the country will be in a “good equilibrium”); if they do not, then maintaining debt service will be impossible (the country will be in a “bad equilibrium”). Such a situation can arise where a country’s fundamentals are in an intermediate situation—i.e., they are strong enough to service the debt in the “good equilibrium” but are unable to service it in the “bad equilibrium.” The brief therefore asks whether Brazil’s fundamentals are in fact in this intermediate situation, in regard to both the domestic and the external debt, and concludes that this is indeed a legitimate characterization of the country’s present position. Since the market’s choice between focusing on the good versus bad equilibrium is influenced by the political situation in Brazil, this is the topic of the next section. The concluding section discusses the prospects of avoiding the catastrophe of yet another debt-induced economic implosion, and asks what both Brazil and the international community, including the financial markets, could do to reduce the chances of this occurring.

1. The Theory of Multiple Equilibria

Traditionally economists have thought in terms of models that were assumed without much analysis to have a single equilibrium. When Paul Krugman (1979) first formalized the analysis of foreign exchange crises, he constructed a model in which a country’s policy of fixing the exchange rate was unsustainable because the government was running a budget deficit that could not be financed without monetary expansion, and eventually the market was bound to recognize that the monetary expansion was inconsistent with a fixed exchange rate. At some point, which under his ideal assumptions would be when a run on the currency would exactly exhaust the country’s foreign exchange reserves, the market would therefore force a change in policy. This “first-generation” crisis model thus predicted exactly when a crisis would occur, with no room for the psychology of market players beyond the customary trivial assumption that they are out for number one.

The “second-generation” crisis models introduced by Maurice Obstfeld (1985) were very different. They posited instead that there were situations in which the outcome would be determined by the market, with either of two (or maybe more) equilibria being indefinitely sustainable. For example, if the market had never challenged sterling’s parity of DM 2.95 = £1 in the ERM, perhaps the UK current account deficit that resulted from that exchange rate could have been financed without an unsustainable buildup of foreign debt. But once sufficient market operators came to doubt that parity was sustainable, they all shifted out, and that portfolio shift was sufficient to exhaust the reserves and thus forced the authorities to allow the pound to depreciate. (A variant of the model acknowledges that there may have been policy measures that could have averted devaluation, but argues that these would have been even more unpalatable to the authorities than devaluation.) The current account consistent with the pound’s new depreciated level could again be financed in a way that appeared indefinitely sustainable. There were thus two possible equilibrium positions (often referred to as “good” and “bad”), and which got chosen was a matter of market psychology rather than the laws of economics. (George Soros’s theory of reflexivity is also an attempt to come to terms with the fact that outcomes can depend on opinions and their trajectory through time rather than simply objective circumstances, see Soros 2000.)

It is widely held that the possibility of multiple equilibria exists only within a certain range of the
If the fundamentals are very strong, then the authorities will have no difficulty in defending the good equilibrium (e.g., a fixed exchange rate) even if it were to be subjected to a speculative attack. If, conversely, the fundamentals are very weak, then it will be impossible for them to defend the rate even without a speculative attack. It is only with the fundamentals in some intermediate range that the possibility of multiple equilibria arises, and it is within this range that speculative attacks may occur and that their outcome is open to doubt.

The question in the Brazilian context is whether the fundamentals lie in that intermediate range where it would be perfectly feasible for Brazil to continue servicing its debt if the market offers reasonable terms, and impossible for it to do so if the market demands other terms that lie within the plausible range of what it might ask. To answer that question, it is necessary to examine both the viability of the government servicing its public debt and the country earning enough dollars to maintain the service of its foreign debt. If both would be possible under normal market conditions, then we can say that the existing fundamentals are consistent with existence of a “good equilibrium.” If either of them would be impossible under a plausible alternative set of conditions, then it follows that a “bad equilibrium” is also possible. To make the analysis explicit, we will examine whether Brazil would be able to service both the public debt and its external debt in a nonexplosive way under the conditions that the market is currently imposing, where “currently” should be interpreted as August 8, 2002.

The next two sections of this brief therefore address the question of whether the range of market conditions from normal to current is consistent with the existence of both good and bad equilibria. A good equilibrium is one in which the country can continue to service its debt without a further increase in the burden of debt and on the basis of the current and prospective fundamentals. Conversely, a bad equilibrium is one in which this is not possible, for either or both the public and/or the external debt.

There are three crucial market-determined conditions that are relevant here: (a) the real/dollar exchange rate (R$2.92 per dollar on August 8, 2002); (b) “Brazil risk”, the risk premium over US Treasuries on Brazilian sovereign bonds (1,759 basis points on August 8, 2002); and (c) the willingness of foreign banks to continue rolling over their credit lines to the Brazilian corporate sector.

The fundamentals relate to the inherited debt stocks, the growth rate of the economy, the Brazilian rate of inflation, the equilibrium exchange rate of the Brazilian real, the world interest rate, the primary fiscal surplus, and the noninterest current account balance. The assumptions made about these variables are laid out in table 1, and the figures chosen are discussed in the appendix A. Note that it will be assumed that these variables are invariant to whether the market chooses the good or bad equilibrium. This is doubtless unrealistic: for example, it is

<table>
<thead>
<tr>
<th>Table 1 Assumptions regarding Brazilian fundamentals</th>
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<tr>
<td><strong>Debt stocks</strong></td>
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<tr>
<td>Public-sector external debt (net of reserves)</td>
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<tr>
<td>Private-sector external debt</td>
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<tr>
<td>Total external debt</td>
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<tr>
<td>Public-sector domestic debt (R$2.92/dollar)</td>
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<tr>
<td>Total public-sector debt</td>
</tr>
<tr>
<td><strong>Other variables</strong></td>
</tr>
<tr>
<td>2002 GDP</td>
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<tr>
<td>Trend growth rate (percent per year)</td>
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<tr>
<td>Inflation rate (percent per year)</td>
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<tr>
<td>Equilibrium exchange rate (reais per dollar)</td>
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<tr>
<td>Primary fiscal surplus (percent of GDP)</td>
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<tr>
<td>Noninterest current account balance</td>
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<tr>
<td>(percent of GDP)</td>
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*Source: Appendix A of this policy brief.*
difficult indeed to imagine that the Brazilian economy would grow at the same rate, which is assumed to be 4 percent per year, if the bad equilibrium were to occur. But that would simply serve to make the bad equilibrium even worse; it could not conceivably transform a bad into a good equilibrium. It is only if we were to find that a bad equilibrium were not possible on the basis of current market conditions and the figures chosen for the fundamentals that we would need to worry that this source of bias might undermine our conclusions.

Without more ado, we proceed to examine Brazilian debt dynamics. The next section deals with the domestic public debt, and the one following that with the external debt situation. In both cases we are interested in examining whether it is plausible to suppose that the market could choose either a good or a bad equilibrium.

### 2. Public-Debt Dynamics

The debt of the Brazilian public sector has increased rapidly in recent years and is now substantial. Table 2 shows both the gross debt of the consolidated public sector (since the series started in 1998) and the official concept of net debt from 1994 to June 2002, and net debt so defined as a percentage of GDP. It can be seen that the latter exploded from a modest 30 percent of GDP in 1994 to 59 percent in June 2002. Moreover, there is no sign of any slowdown in its rate of growth: on the contrary, the growth in July 2002 must surely have set a record. A glance at these numbers suggests that the market had reason to be worried about the sustainability of Brazilian public finances.

Moreover, it can be argued (see, for example, Favero and Giavazzi 2002) that the official concept of net debt is too low. This is because some of the claims of the Brazilian government that are netted out are of doubtful liquidity. Favero and Giavazzi quantify these claims of doubtful liquidity as amounting to some 12 percent of GDP, or R$150 billion. Although Goldfajn (2002) defends the netting out of these claims on the ground that they are not necessarily of lower quality than those (such as the bank deposits of the public sector) that everyone agrees should be netted out, he concedes that these claims are less liquid. I propose to strike an expedient middle path by not deducting those public-sector claims that carry a long-term fixed interest rate (principally claims on BNDES), which amounted to R$71 billion at the end of June. That leaves an estimate of net debt of R$821 billion at the end of June 2002. The growth of debt in the month of July and, more important, the impact of the depreciation of the real, take this figure up to R$841 billion (66 percent of GDP) as an estimate for August 8.

It can be argued that even this figure may be too low, because there may be more “skeletons” to come out of the closet in the coming years. “Skeletons” are claims on the public sector that are not currently shown on its books. One major way in which they may still arise in the future, even if Goldfajn (2002) is right in arguing that the government has done a good job of cleaning up skeletons in the last few years, is by contingent liabilities materializing. Goldfajn quantifies about 10 percentage points of the rise in the debt/GDP ratio of the past

### Table 2  The consolidated debt of the Brazilian public sector, 1994-2002 (billions of reais)

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross (billions of reais)</th>
<th>Net (billions of reais)</th>
<th>Net of GDP</th>
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<tbody>
<tr>
<td>1994</td>
<td>n.a.</td>
<td>153</td>
<td>30.0</td>
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<tr>
<td>1995</td>
<td>n.a.</td>
<td>208</td>
<td>30.6</td>
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<tr>
<td>1996</td>
<td>n.a.</td>
<td>269</td>
<td>33.3</td>
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<tr>
<td>1997</td>
<td>n.a.</td>
<td>308</td>
<td>34.4</td>
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<tr>
<td>1998</td>
<td>507</td>
<td>386</td>
<td>41.7</td>
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<tr>
<td>1999</td>
<td>621</td>
<td>517</td>
<td>49.2</td>
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<td>2000</td>
<td>745</td>
<td>563</td>
<td>49.4</td>
</tr>
<tr>
<td>2001</td>
<td>885</td>
<td>661</td>
<td>53.3</td>
</tr>
<tr>
<td>June 2002</td>
<td>1,000</td>
<td>750</td>
<td>58.6</td>
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</table>

n.a. = not available

Source: Banco Central do Brasil.
eight years as having been due to recognition of hidden liabilities ("skeletons"), and guesses that they may add something over another percentage points in the coming six years. It is reported by Favero and Giavazzi that some market operators have guessed higher numbers (they mention a JPMorgan figure as high as another 10 percent of GDP), but these seem doubtful in view of the plaudits that the IMF gave to Brazil for fiscal transparency in its Report on the Observance of Standards and Codes (IMF 2001). I propose to follow Goldfajn’s approach of assuming that new skeletons of 0.75 percent of GDP will be recognized each year (and 1.61 percent of GDP in 2002).

This debt is far from homogeneous. In the first place, some of it is external debt and some is internal debt. The external debt amounted to $98 billion at the end of July 2002, from which one needs to net off $42 billion of international reserves, to give a net external debt of the public sector of $56 billion. At an exchange rate of R$2.92 per dollar, that amounts to R$164 billion, as shown in table 3. That table also shows R$677 billion for the domestic debt. The total estimate for the partially netted concept of debt being used amounts to R$841 billion, or 66 percent of GDP.

The memorandum items in table 3 show how the debt is broken down into components whose cost depends on different parameters. First, some 42 percent of the debt is dollar-linked. This comprises all the external debt and a significant part of the domestic debt as well. The cost of this component of the debt is the nominal interest rate on dollar-denominated debt, which averages about 9 percent, plus the rate of depreciation of the real in terms of the dollar. A second component of the domestic debt has an interest rate that is linked to the Selic (the overnight interest rate that is set by the Banco Central do Brasil). A substantial part of the debt is indeed held in overnight form and receives the Selic rate itself, while the remainder of this second component is held at longer maturities, up to two years, and receives a term premium that varies both with maturity and over time. Favero and Giavazzi (2002) find that the term premia vary closely with the risk premium on Brady bonds ("Brazil risk"), but perhaps surprisingly it is not expected that the cost of the Selic-linked debt will much exceed the Selic this year, because most of the term debt has already been issued. Part of the debt is held at interest rates that are fixed at the time the debt is issued, but the cost of this debt also seems to vary closely (though presumably with a lag) with the Selic, so it (as well as a small residual component) is aggregated with the Selic-linked debt for purposes of analysis. Another part of the domestic debt is held in inflation-linked bonds, and receives an average real interest rate of about 7.5 percent per year.

The increase in the nominal value of the public debt is equal to the sum of the cost of these various components, minus the nominal value of the primary budget surplus. Since I have netted out some
of the assets of the government in calculating the size of the debt, I need to add the income on those assets to the official measure of the primary surplus in order to get a correct measure of the surplus for use in this analysis. Those assets are valued at about R$71 billion and pay an average interest rate of about 8 percent, so the primary surplus needs to be augmented by R$5.6 billion, or 0.45 percent of GDP. The change in the debt/GDP ratio is equal to the percentage increase in the debt minus the increase in nominal GDP, which is increased by both inflation (as measured by the GDP deflator) and real growth.

Table 4 shows how to calculate the change in the value of public-sector debt, and thence the change in the debt/GDP ratio. The table presents estimates for both 2002 and a normal “medium-run” year, meaning years beyond the current one assuming there is no collapse. I use the nominal values of 2003 for purposes of calculating nominal values, but this should not materially affect the outcome in terms of percentage changes.

The cost of dollar-linked debt is equal to the average nominal interest rate on dollar-denominated debt, about 9 percent, plus the depreciation of the real in terms of the dollar. Given the assumption that the real will remain at R$2.92 per dollar for the rest of the year 2002, plus the fact that it started the year at R$2.31 per dollar, this cost is the nominal interest rate plus a whopping 26.4 percent, giving an interest bill of R$106 billion. Selic-linked debt has this year been costing between 18 and 19 percent, and inflation-linked debt about 15 percent. The total interest cost (including the effect of the depreciation of the real) in 2002 is estimated as R$176 billion, which vastly exceeds the expected augmented primary surplus of R$53 billion. Given another R$20 billion worth of skeletons, the debt is thus expected to increase by 20 percent, which substantially exceeds the 7.6 percent expected inflation, thus implying an 11 percent increase in the real value of the debt and a 9 percent increase in the debt/GDP ratio despite the substantial primary surplus. This looks scary, and if anything like this were to be perpetuated into the future, then the situation would not be viable.

It is even possible to envisage some considerations that might increase these costs. In particular, if external debt had to be rolled over at anything like the interest rate implied by the current spread on Brazilian Brady bonds, then the nominal interest rate on dollar-denominated debt would explode. About $5.5 billion of public-sector external debt falls due next year (other than to the international organizations), which implies that the cost of external debt service would increase by about $700 million (over R$2 billion) a year after just one year. Under these circumstances the Brazilian public-sector debt would be unsustainable without a big further increase in the primary surplus. It is thus pos-

<table>
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<th>Table 4 The dynamics of Brazilian public-sector debt</th>
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<tr>
<td>Cost of dollar-linked debt:</td>
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<tr>
<td>Percent</td>
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<tr>
<td>Billion reais</td>
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<tr>
<td>Cost of Selic-linked debt:</td>
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<tr>
<td>Percent</td>
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<tr>
<td>Billion reais</td>
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<tr>
<td>Cost of inflation-linked debt:</td>
</tr>
<tr>
<td>Percent</td>
</tr>
<tr>
<td>Billion reais</td>
</tr>
<tr>
<td>Total cost (billion reais)</td>
</tr>
<tr>
<td>Minus augmented primary surplus</td>
</tr>
<tr>
<td>Plus skeletons</td>
</tr>
<tr>
<td>Equals decrease in debt (billion reais)</td>
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<tr>
<td>Percentage increase in debt</td>
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<tr>
<td>Percentage increase in real debt</td>
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<td>Change in debt/GDP ratio</td>
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Source: Section 3 of this policy brief and Banco Central do Brasil.
sible to construct a scenario for a bad equilibrium, simply by postulating the perpetuation of present market realities.

Consider next what might be a more normal set of market realities. To begin with, in the long run one should not expect continuous real depreciation of the real. On the contrary, the real has already much overshot equilibrium by every attempt to measure equilibrium of which I am aware (see appendix A). Suppose therefore that instead of continuing to depreciate, the real were to appreciate in real terms gradually back to the most conservative estimate of its equilibrium level, which is currently some R$2.50 per dollar. Assume this were to happen gradually over five years. In this period the equilibrium level would depreciate by the inflation differential between Brazil and the United States; using Goldfajn’s figures for Brazilian inflation and assuming inflation of 2.5 percent per year in the United States, this would imply the weakest estimate of equilibrium for the real would be R$2.74 per dollar. That would im-

Expected this year to the 3.5 percent being targeted in the medium term.

This still yields a hefty R$107 billion interest bill. Together with the postulated skeletons, it outweighs the primary surplus by R$61 billion, enough to still increase the debt by 6.7 percent. That then still implies an increase in the real value of the debt, of 3.1 percent, but the debt/GDP ratio would decline marginally by 0.9 percent given growth of 4 percent.

The conclusion that the debt/GDP ratio would decline in the medium term if normality were restored can be checked by utilizing the shorthand form of the analysis presented in table 4. This is given by the well-known equation which summarizes the condition for fiscal solvency as being that in the long run the augmented primary surplus minus skeletons, $S$, must be at least as big as $(r-g)(D/Y)$, where $r$ is the average real rate of interest on the debt $(D)$, $g$ is the growth rate of the economy, and $D/Y$ is the ratio of debt to GDP $(Y)$:

$$S \geq (r-g)(D/Y). \quad (1)$$

Given that $D/Y$ is currently 0.66, a value of $g$ equal to 4 percent implies that the augmented primary surplus of 4.2 percent minus skeletons of 0.75 percent would be sufficient to avoid explosive debt dynamics provided that the average real interest rate does not exceed 9.2 percent. While the Selic-linked debt does not satisfy that condition, both the dollar-linked and inflation-linked debt do, and by a sufficient margin to reduce the weighted average to 8.3 percent.

Goldfajn (2002) reaches a similar conclusion. His baseline scenario has net debt/GDP declining from 58 percent in May 2002 to 48 percent in 2011. The assumptions are inflation and growth both at 3.5 percent for most of the period, an average real interest rate of 9 percent on government debt, nominal currency depreciation of 2 percent a year, a primary surplus of 3.75 percent of GDP, and recognition of skeletons amounting to just over 5 percent of GDP over the coming years. He notes that the shocks that could disturb his conclusions are a higher real interest rate and a lower primary surplus.

Favero and Giavazzi (2002) are less optimistic that Brazil could achieve a declining debt/GDP ratio without a further increase in the primary surplus. Their calculations appear to differ from mine in three major ways. First, they use a substantially larger debt figure than Goldfajn or I do because they net out 12 percent of GDP less from the public-sector debt than him: I have followed them part
way in this respect (I net out 6 percent less than them but 6 percent more than Goldfajn and the official figures). Second, they do not augment the primary surplus to allow for the income that the government receives on the assets that they have netted out. Third, they project a continuing real depreciation of the real for the years 2002-04. That of course highlights the problem: unless the real recovers, Brazil’s debts will indeed be unsustainable. It will end up in the “bad equilibrium.”

The question is obviously whether the market will allow the real to recover further and interest rates to fall enough to allow a good equilibrium to be established. The fact is that the projections in table 4 imply that the average real interest rate r for 2002 will be around 15 percent, vastly above that which satisfies the sustainability condition (1). If the market looks backward rather than forward, and extrapolates that interest rate into the future, then it could scare itself into the bad equilibrium that is inconsistent with an improving debt situation.

These results suggest that Brazil is indeed in the intermediate situation where either a good or a bad equilibrium could be consistent with the fundamentals. Someone trying to deny the possibility of the bad equilibrium might argue that the market cannot possibly extrapolate the 2002 depreciation of the real into the future. This challenge would be more persuasive if one did not recall that it is only a matter of months since the levitation of the dollar, and the US stock market, were widely believed in the market to be permanent because they resulted from structural changes, rather than the bubbles that most people agree in retrospect they were. The fact is that most market participants operate without any concept of equilibrium in their minds, so that the markets can go off on errant paths for prolonged periods without any self-correcting forces being set in motion. Eventually reality catches up, of course, but that is scant comfort if disaster can occur before this happens. Someone denying the possibility of a good equilibrium would probably point to the fact that I am assuming that the real will recover and assert that foreign exchange rates are unforecastable, which is true in the short run but not, I would maintain, in the long run when they are as clearly misaligned as the real is now.

In short, I see little reason to doubt that Brazil is in the intermediate situation so far as its internal debt dynamics are concerned.

3. External Debt Sustainability

While most recent analytical work has focused on the sustainability of public-sector debt, most analysts (e.g., Cline 1984) during the 1980s debt crisis focused instead on whether debtor countries would earn enough foreign exchange to be able to service their foreign debt. Critics argued that it was a mistake to overlook the public finance issue posed by possible unsustainable debt dynamics. That was a legitimate criticism, but it is equally a mistake to ignore the issue of whether a country is going to earn enough foreign exchange to be able to maintain external debt service. A country’s position is unsustainable unless it is able both to service its public-sector debt without this exploding and to service its external debt under likely future conditions. (Since countries do not have captive markets for their external debt, the issue of the debt exploding does not generally arise.) In this section we therefore examine the prospects for Brazil’s external accounts.

Brazil’s foreign debt is estimated as some $176 billion. This includes $56 billion of net external debt of the public sector, i.e. $98 billion gross, minus $42 billion of international reserves. The private sector’s debt is estimated to be some $120 billion. The assets of the private sector are also believed to be very substantial, at least $70 billion and possibly as much as $170 billion, so that the private sector may conceivably be in a net creditor position vis-à-vis the rest of the world. However, these assets are not netted off, since they are not accessible to the authorities to sustain the payment of debt service. The official figure results in a ratio of external debt to GDP of 41 percent, which is fairly high (but that is partly because the real is undervalued), and a ratio of debt to exports of 326 percent, which is high by any standards. The debt service ratio (interest plus profit remittances plus amortization divided by exports) is an astronomical 91 percent.

In addition to the debts it owes to the rest of the world, there is a large volume of foreign direct investment in Brazil. In 2001 the country paid almost $5 billion in profits and dividends on this investment. Nevertheless, the value of this investment is not counted as part of Brazil’s foreign debt, and this is appropriate. This is because profit remittances have to compete with imports and other non-contractual payments for foreign exchange, whereas
Interest and amortization payments on debt are contractual payments that the country is obliged to make irrespective of competing claims for dollars. If the real depreciates, then this will automatically squeeze how many dollars direct investors will need to buy to remit their profits abroad, while it will not affect how many dollars are needed for debt service. Policymakers need to worry about whether their country has enough dollars to pay debt service, even more than the pressure on the currency caused by attempts of direct investors to remit (or hedge) their profits.

The most recent figures for Brazil’s balance of payments, with results up to June 2002, are shown in Table 5. The first column shows the outcome for 2001. The next two columns allow a comparison of the outcomes for the first half of 2001 and 2002. The fourth column shows the outcome for the 12 months to June 2002.

It can be seen that the current account is on an improving trend, as one would expect given the recent depreciation of the real. It is true that this owes more to import compression than to a boom in exports, but even this is not too surprising given not only that there is a world recession but also that the imports of one of Brazil’s main trading partners, namely Argentina, have imploded in 2002 (they have fallen by over 60 percent). In fact, Brazil’s exports to Argentina declined by $1.3 billion in the first four months of 2002 compared to the corresponding months of 2001. An overall improvement in the current account of $10 billion at an annual rate is therefore quite impressive.

The penultimate column offers a conservative projection of the balance of payments outcome in 2002. The current account deficit is almost entirely accounted for by the interest bill, and is projected at $15 billion, 3.5 percent of GDP. It is expected that it

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<thead>
<tr>
<th>Table 5 Brazilian balance of payments (billions of US dollars)</th>
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<tr>
<td><strong>Trade balance</strong></td>
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<tr>
<td></td>
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<tr>
<td>Exports</td>
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<tr>
<td>Imports</td>
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<td><strong>Services and income</strong></td>
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<tr>
<td>Net interests payments</td>
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<td>Profits and dividends</td>
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<td>International travel</td>
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<td>Other</td>
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<td><strong>Unilateral transfers</strong></td>
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<td>1.64</td>
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<tr>
<td><strong>Current account</strong></td>
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<td>Noninterest current account</td>
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<tr>
<th>Capital and financial account</th>
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<tr>
<td>27.92</td>
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<td>Foreign direct investment</td>
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<td>Other</td>
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<th>Global result of the balance of payments</th>
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</table>

**Memorandum:**

- Current account (percent of GDP) -4.61 -5.34 -3.13 -3.50
- Amortization on medium- and long-term loans 35.15 19.11 14.13 30.17
- International reserves (end of period) 35.90 37.32 42.00 42.00

*Source:* Banco Central do Brasil and UBS Warburg.

Final 2 columns: Section 3 and appendix A of this policy brief.
will be financed entirely by the inflow of FDI. (The projection of an increased deficit as a percentage of GDP reflects the depreciation of the real, which reduces the dollar value of Brazilian GDP or, if you prefer to look at it that way, increases the local currency value of the current account deficit.)

Since there will be no increase in debt, one might think that the debt indicators must be going to improve. Unfortunately this is incorrect. Both exports and GDP as measured in dollars are overwhelmingly likely to decline in 2002, so both the traditional debt indicators, debt/exports and debt/GDP, are going to worsen. Anyone in the market who is searching for reasons to be pessimistic about Brazil’s prospects will be able to focus on the worsening of those two indicators.

And debt ratios matter, because the mere fact that the current account deficit will be covered by the inflow of FDI does not mean that Brazil has no financing problem. Far from it. As table 5 shows, Brazil has to roll over about $30 billion a year of medium- and long-term debt. If that had to be rolled over on anything like the terms at which Brazilian debt currently trades in the market, with a 1,759 basis point premium over US Treasuries, the interest bill would explode, asymptotically to as much as $35 billion per year. And an even more immediate threat could be posed by bank reluctance to maintain their credit lines to Brazilian borrowers. There were reportedly a few instances of banks cutting their credit lines in early July 2002, but that threat then seemed to have faded. It reportedly revived, with a vengeance, after the panic initiated by Mr. O'Neill’s remarks on July 28. When panic-driven cuts in credit lines occurred before, after the devaluation of the real in early 1999, the central bank negotiated a collective agreement with foreign commercial banks under which these agreed to maintain their credit lines, but of course in those days there was an administration in Washington that was prepared to lean on US commercial banks in order to help bring a panic under control.

If the IMF agreement indeed succeeds in averting crisis in the short run, then the longer-term projection appears rather favorable. Simply projecting the past rate of improvement in the trade balance shown in table 5 for a further year suggests a trade surplus of some $15 billion in 2003, which would give a noninterest current account surplus of $8 billion and a current account deficit of only $7 billion if the interest bill remains unchanged. That would imply strongly improving trends in the debt indicators, even if there were no further improvements in the current account balance after 2003, as there may not be if Brazilian growth indeed picks up to 4 percent as projected. Anyone inclined to dismiss the projection of a $15 billion trade surplus in 2003 as fantasy should note that the surplus reported in July 2002 was $1.2 billion, i.e., an annual rate of $14.4 billion. All the projection assumes is that the benefits of the recent additional real depreciation of the real are not more than offset by the pickup in Brazilian growth.

So once again it is pretty clear that Brazil faces a situation of multiple equilibria. If lenders were prepared to roll over their credits on terms broadly comparable to the existing ones, then Brazil would have no problem in financing itself over the coming year or two. If it does no more than stabilize its trade position as growth recovers, then its debt indicators would progressively improve. As the real appreciated in real terms back toward its equilibrium level, the debt indicators would also look a lot better. Thus a good equilibrium would be entirely possible.

But so is a bad equilibrium. If the markets continue to be spooked by political fears, they will be able to look to short-term worsening of the debt indicators to rationalize a decision to refuse to roll over debts on reasonable terms. In that case Brazil’s situation will become impossible even without capital flight, some of which also has to be expected under these circumstances.

Many economists have argued that a real crisis is impossible with a floating exchange rate. It is certainly true that a floating rate removes one major
source of vulnerability, namely the threat that a fixed rate will be subjected to speculation that the fixed rate cannot be sustained. But it shows a certain lack of imagination to think that this is the only way in which a financial crisis can be initiated. If a currency depreciates to a point where private-sector debtors are unable to service their existing debts, then they will default. Unless one imagines that creditors will view default with equanimity, there will be a crisis. Foreign credits will be cut off, and that can strangle trade, as was observed in both Indonesia in 1998 and Argentina in 2002, when in both cases exports fell drastically despite the countries being hyper price-competitive. It would be a tragedy if the lesson that a crisis is perfectly possible without a fixed exchange rate is demonstrated at the expense of the people of Brazil.

\[\text{It would be a tragedy if the lesson that a crisis is perfectly possible without a fixed exchange rate is demonstrated at the expense of the people of Brazil.}\]

4. Brazilian Politics

The 2002 depreciation of the real and the decline in the price of Brady bonds that signaled the explosive growth of “Brazil risk” began in early May, shortly after the public opinion polls in Brazil first indicated a strong possibility that Lula would win the presidential election. Since then the markets have reacted negatively to every new poll indicating a setback to the chances of the candidate of the governing party, José Serra. If the markets are being spooked by the fear that a victory by Lula, or perhaps by Ciro Gomes, would jeopardize the continued servicing of Brazil’s debts, it is obviously critical to examine the political scenario in Brazil.

Since its emergence from military dictatorship in the first half of the 1980s, Brazil has acquired a large array of political parties. Most of these tend to have vaguely left-wing names (which are always reduced to acronyms) and to engage in somewhat left-wing rhetoric, but in practice they usually act in a rather conservative way. President Fernando Henrique Cardoso’s PSDB (Partido Social Democrático Brasileiro, or the Brazilian Social Democratic Party) provides a good example. Before taking office Professor Cardoso wrote articles about dependency theory, and President Cardoso still likes to speak as an exponent of the Third Way, as befits the leader of a party describing itself as social democratic, but his government is generally regarded in Brazil as having been rather right-wing. He is widely denounced for having succumbed to the Washington Consensus, or neoliberalism (two concepts that are often equated in Brazil, to the distress of the present author who originally used the word consensus to emphasize that various loony bits of the neoliberal agenda had been discarded although other items like external opening and privatization had indeed won wide acceptance). But President Cardoso’s problems with the Brazilian Congress have been overwhelmingly in getting it to approve reforms that could be expected, for example, to improve income distribution. The Brazilian Congress is much like the US Congress in being stuffed full of politicians whose main mission it is to try and defend the access of their friends to pork, and who therefore resist measures that would help the less well-off, who rarely have many friends in these circles.

One party stands out from the others as having been founded to promote a distinctive ideology rather than the interests of its founders. This is the PT, the Partido dos Trabalhadores, i.e. the Workers’ Party. It was created in 1980 by trade unionists in São Paulo, led by Luís Inácio Lula da Silva, generally known as Lula, who has been the leader of the party ever since and is now contesting his fourth presidential election on behalf of the party. The party’s core is still the industrial working class, most of which is far from affluent but nonetheless earns an above-median income in Brazil. And, like most parties based on the industrial working class, its ideology has always been socialist.

Lula was born in Pernambuco, a state in the poor northeastern part of the country, but his family migrated to São Paulo when he was a child. He received only minimal formal education, but subsequently took a technical course in metallurgy and then worked two decades as a metallurgical worker. He became a trade unionist in the mid-1960s even though those were the days of the military dictatorship when unions were persecuted. He soon became a union leader, and led a series of strikes in São Paulo during the years that the power of the dictatorship was ebbing. In 1980 he helped found the PT, and was subsequently elected to Congress. In 1989 he became the PT’s candidate for the presidency, as he was again in 1994, 1998, and now in 2002. He graduated from sports shirt and jeans to neat suits, lost a lot of weight, and traveled the world. Although the PT has run a number of city and state governments, his own administrative experience is limited to that of running a trade union and a party.

At this stage there are two other serious candidates in the Brazilian presidential election that is
due to be held in two rounds in October, with the first round of voting taking place on October 6. Assuming (as is expected) that no candidate gets a majority of the vote in the first round, the two candidates with the highest votes will go forward into a second round of voting on October 27. One of those two candidates is virtually certain to be Lula. The other will be either José Serra, of the PSDB, or Ciro Gomes, of the PPS (the Partido Popular Socialista, or Popular Socialist Party), with the latter distinctly more likely as this is written according to the public opinion polls.

Ciro Gomes has a reputation in some quarters of being mercurial and unreliable, of changing his mind when it is politically expedient.

José Serra comes from São Paulo. Like many Brazilian politicians, he spent many years in exile during the military dictatorship that grabbed power in 1964. He used this time to acquire academic qualifications, first in industrial planning at CEPAL in Chile, and then in economics, first at the University of Chile and subsequently at Cornell. He also taught at the University of Chile and was a member of the Institute for Advanced Study at Princeton for two years, where he worked with the legendary Albert Hirschman. After returning to Brazil he spent a time as secretary of economics and planning of the state of São Paulo, was twice elected a deputy for that state, subsequently a senator, and has been minister of planning and the budget, and subsequently minister of health, in the Cardoso government. During his time in the latter post he has presided over one of the most rapid declines in infant mortality the world has ever seen, over an antismoking campaign far sharper and considerably more effective than any the United States has yet attempted, and over what is generally rated as one of the world’s more effective anti-AIDS campaigns (which included forcing reluctant foreign companies to license anti-AIDS drugs to local Brazilian companies so that they could be provided at a fraction of the cost of the imported products).

Ciro Gomes can also boast a dazzling career. While he too was born in Brazil’s industrial heartland of São Paulo, he comes from an old political family from the poor northeastern state of Ceará, to which his family moved back when he was an infant. He studied law and became a professor of tax law and public finance for a brief period, before his political career pushed these commitments aside. He was elected a state Deputy in Ceará at the age of 24, the mayor of its capital city, Fortaleza, six years later, and the governor of the state only two years after that. While governor he was awarded (jointly with his predecessor) a UNICEF prize for Ceará’s progress in improving child health. He resigned from being governor in 1994 in order to act as interim national finance minister for 4 months, shortly after the initiation of the Plano Real, during which time he faced down a threat to reintroduce wage indexation in the auto industry by slashing the tariffs on imported cars. Since then he has studied at Harvard, acted as author, speaker, and consultant, and was a minor candidate for the presidency in 1998. He emerged rather suddenly from again being a minor candidate to his current position as one of the leading contenders for the presidency in July 2002.

To judge by their resumés, Brazil is rather fortunate to enjoy a choice between three such distinguished candidates for the presidency. Why should the markets have panicked at the prospect of one of them becoming president?

Unfortunately, one cannot say that this is completely irrational. Consider first the PT and its candidate Lula. In the 1980s they spoke approvingly of repudiating Brazil’s debts. They were slow to endorse the Plano Real. As recently as December 2001 the PT issued a program that spoke of “breaking with the current economic model, which is based on opening the market and radical deregulation, and the consequent subordination of the dynamic of the national economy to the interests and whims of global financial capital” (PT 2001, para 1). It promised to revise external tariffs so as to promote import substitution, to regulate the entry of speculative capital, and to reorient foreign direct investment so as to compensate for the increase in the value of profits, dividends and royalties (ibid, para 49). It spoke of denouncing the existing agreement with the IMF and auditing and renegotiating the external debt (ibid, para 51). It proposed various initiatives that would have expanded state activity, and said these would be financed by “a complete revision of the policy of giving priority to the payment of debt service” (ibid, para 60). While one may sympathize with some of these attitudes, such as the promise to regulate inflows of speculative capital, it is hardly surprising that foreign investors (or, for that matter, domestic capitalists) should have taken fright at the prospect of a party with such a policy agenda coming to power.
Or consider Ciro Gomes. (One does not need to
counter the PPS, because unlike the PT this is not
a disciplined political party with a coherent team
making policy. Ciro is pretty much a one-man band,
supported by the Brazilian/Harvard lawyer and phi-
losopher Roberto Mangabeira Unger and a ragbag
of supporters from many parties and with wide dif-
ferences in ideological positions.) He too has a record
of having favored debt default in the past (see
Giambiagi 2002 for an account of an interview he
gave in 1999 in which he affirmed his willingness
to declare a unilateral moratorium to permit a re-
negotiation of the debt). More recently he has spo-
ken of debt restructuring, albeit voluntary restruc-
turing to lengthen the maturity of the debt (the sort
of restructuring that Domingo Cavallo was attempt-
ing to secure in Argentina when his world collapsed).
At one stage he refused to contemplate entering
into an agreement that might help secure IMF back-
ing to reduce the dangers of the transition. He too
has been denouncing the neoliberalism of the gov-
ernment. His program for growth appears to be
based on the comforting conviction that during his
government a double Say's Law will operate, so that
demand will create its own supply and supply will
create its own demand. He has talked of changing
the system of inflation targeting to one where the
central bank would be instructed to try to mini-
mize Okun’s “misery index”, i.e., an average of in-
flation and unemployment. His political program
calls for introducing plebiscites to allow him to over-
ride Congress any time they disagree and reorga-
nizing the federal structure of the country. He has
a reputation in some quarters of being mercurial
and unreliable, of changing his mind when it is
politically expedient. So when the polls said that
Ciro Gomes is the most likely alternative to Lula, it
is perhaps not altogether surprising that the mar-
kets should have tanked again.

José Serra is, in contrast, the candidate of the
government, the one who can be relied on to per-
petuate the policies of the past eight years that most
foreigners, if not most Brazilians, seem to think have
served the country rather well. Until April 2002, most
people in the financial markets assumed that he
would win. The polls might show Lula ahead, as they
had shown him ahead of Cardoso in 1994, but when
it came to the second round he would be able to rely
on the innate conservatism of the majority of Brazil-
ian voters to win. (And conservatism on the part of
the poor is not necessarily irrational in the Brazilian
context: the PT represents the interests of the in-
dustrial working class, not the poor, whose prime
interest is to avoid any revival of the inflation that
so penalized them for 30 years before 1994.) But
this reasoning overlooked the weaknesses of Serra
as a candidate. To begin with, he does not succeed
in creating the impression that he enjoys kissing
babies. And to crown it, in May he tried using Brazil’s
economic vulnerability as a tactic into scaring vot-
ers away from Lula, by suggesting that Brazil might
suffer Argentina’s fate if they were to elect Lula in-
stead of him. Most Brazilians feel, correctly in my
view, that there are such significant differences be-
tween the situation in Brazil today and that in Ar-
gentina a year ago that this is what an Englishman
like me would describe as not being cricket.

José Serra is the candidate
of the government, the one
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the past eight years...

A PT government would face
a problem of inexperience
in governing at the national
level, but that it would compound
its problems by deliberately
staking a financial crisis
seems most unlikely.
• A healthy banking system (yes, due in part to past bailouts, but bailouts that have already happened and whose cost is therefore included in the debt statistics).
• A stronger fiscal situation, with the high debt/GDP ratio of the moment reflecting an overshooting of the exchange rate that has already happened.
• Substantial privatizable assets (including half of Petrobras and all the power generating sector) still in the hands of the public sector in Brazil, whereas almost everything conceivably privatizable had already been sold off in Argentina.
• Center-state fiscal relations that have been successfully reformed during the Cardoso government. Central grants are based on objective and progressive formulae rather than the traditional horse-trading. The states are now subject to hard budget constraints and are in fact running fiscal surpluses, rather than the provincial deficits effectively unconstrained by rules that prevailed in Argentina.
• A much less brittle macroeconomic policy regime, with a floating exchange rate coupled with a successful policy of inflation targeting instead of a currency board with a peg to a totally inappropriate currency.

This is a set of powerful differences. But unfortunately there is also one important similarity, namely the fact that both are sufficiently highly indebted externally to be vulnerable to a loss of confidence by the international capital market. And the fact that Argentina ultimately defaulted despite having had its policy regime lauded for a decade by the international powers-that-be makes life far more difficult for its neighbor, and partner, Brazil. If Argentina could ultimately be forced into doing what it tried so hard to avoid, and where everyone who mattered claimed it was doing all the right things, can they be certain that a Brazil run by a president with a past record of sympathizing with default will not take the easy way out?

There are of course no certainties in this business. Nevertheless, the assumption that either Lula or Ciro Gomes would be likely to seek a debt reconstruction seems implausible.

This is clearest with respect to Lula. The program of the coalition supporting Lula (which is wider than, though dominated by, the PT), issued in July 2002, is unambiguous in declaring that a Lula government “would not break contracts or revoke established rules” (Coligação Lula Presidente 2002, p.17). It promises to preserve the primary surplus and if necessary even raise it sufficiently further to avoid increases in the debt/GDP ratio. It commits a Lula government to preserving the policy of inflation targeting.

Why should anyone believe these promises rather than the earlier less reassuring ones? Perhaps because to win power the PT is already having to try and appeal to the median voter, and to turn around after the election and try and force the Congress (in which it will not command anything like a majority) to endorse a debt repudiation would set it up for a battle from which it could not hope to emerge with an ounce of credibility. Or else because one may be aware of how many other socialist parties around the world, from Willy Brandt’s social democrats in Germany to Tony Blair’s Labour Party in Britain to Felipe Gonzalez’s socialists in Spain to Ricardo Lagos’s socialists in Chile to the former communist party in Poland that presided over the Polish economic boom of the mid-1990s, have already trodden this path. Or else one may be impressed by the professional, relatively clean and modern way in which the PT has governed a raft of Brazilian cities and states in recent years, without a hint of Neanderthal fire-breathing socialism. Obviously a PT government would face a problem of inexperience in governing at the national level, but that it would compound its problems by deliberately stoking a financial crisis seems most unlikely.

It is less easy to be confident of how a government led by Ciro Gomes would behave. He has a reputation for unpredictability and for changing his mind. Defenders may claim that this is part of the art of being a good politician, but the concern is whether it would make him as good at running a government as at getting elected. Nevertheless,
there are two reasons for believing that he too would be unlikely to initiate a debt restructuring that was not forced on him. One is that his record when actually in power in Ceará belies the reputation he has built for himself when in opposition: he acted pragmatically, responsibly, and intelligently, indeed some say he showed brilliance. The other reason for doubting whether he would act irresponsibly is that as he has moved from being a marginal candidate to being the man to beat, he has attracted a retinue of more orthodox supporters than those on whom he had to rely when his electoral prospects appeared bleak. It is far from clear that this process is now exhausted: if he did indeed beat José Serra, it seems quite likely that some of those now in power would be prepared to work for him, and would be welcomed by him, and they would act as a restraining influence.

Specifically, they could be relied on to set out before him a more realistic cost-benefit analysis of the results of a debt reconstruction than any he had available when making the off-the-cuff remarks that have so spooked the markets. The Brazilian public sector owes something like $76 billion abroad other than to the multilateral institutions. If the face value of this were reduced in line with recent market prices, it would be reconstructed with an equivalent face value of $40 billion, which would save interest of about $3 billion a year on the external accounts, plus maybe another $5.5 billion in amortization payments, which would be significantly less than the projected improvement in next year’s trade balance. It would also reduce the burden of debt service on the budget by around R$25 billion a year. That is significant, but a reduction in the burden of the domestic debt is far more important in this context. But if anything like an equivalent reduction in the value of Brazil’s domestic debt were to be engineered, then the banks (which hold about 30 percent of their assets in the form of claims on the public sector) would need bailing out again, unless the government decided that bank depositors should be required to bear the burden of reducing the value of the debt. A new bank bailout would much reduce the benefit to the public finances of the debt reconstruction. If the government attempted to avoid all the confusion that a new bank bailout would engender by exempting the banks from the requirement to write down the value of their assets, one can imagine that a long queue of other applicants would request similar treatment. The arbitrary upsetting of debtor/creditor relationships that would be inevitable in any discriminating debt reduction exercise would undermine the basic ethic of a market economy that Brazil has been developing, as well as redirecting attention away from the real economy modernization that the country needs toward a series of financial battles. Debt reconstructions sometimes become inevitable, but to imagine that they are an easy short cut to rapid growth is wishful thinking. On the contrary, experience to date suggests that one would be likely to usher in a strong recession.

A far more promising way of cutting the burden of domestic debt, and one that would be delayed rather than enhanced by a debt restructuring, is to reduce the level of domestic interest rates. Table 4 showed that the projected burden of the Selic-linked debt will still be enormous in the medium term unless something changes. In fact, there seems a good chance that the level of domestic interest rates in Brazil could drop to its lowest level in many years if Brazil emerges from the current crisis without a debt restructuring. Ironically, they might drop furthest under a Lula government that showed itself to be responsible, because the market’s ever-present fear of a PT government renouncing Brazil’s debts would be once and for all laid to rest.

Hence it seems unlikely that any of the three candidates would choose to walk away from Brazil’s debts. That is not to say that they would be prepared to make unlimited sacrifices to maintain debt
service: it is to say that, if they are offered the good equilibrium, it is unlikely that any of them would decide to upset the apple cart.

5. So Is Brazil Next?

Sections 2 and 3 concluded that Brazil would be capable of servicing its debts in a sustainable way if the markets give it a chance by again starting to supply loans on reasonable terms and avoiding a new collapse of the exchange rate. Section 4 concluded that none of the candidates for the presidency would be rational in seeking a debt reconstruction. So how can one explain the fact that the real depreciated even further and Brazil risk rose even more while this brief was being written, until the IMF program was announced?

By far the most convincing explanation is that the markets were gripped by panic and no one was prepared to act on the sort of analysis laid out above. Even those who agreed with the line of reasoning were afraid that to speculate in favor of the good equilibrium might expose them to further losses as the market continued its rush to the cliff edge.

If that is correct, then Brazil could in principle be saved by either of two routes, the first originating in the private sector and the second in the official sector. The private route would involve enough market actors deciding that they were prepared to take a risk and bet in favor of a recovery. Foreign financial institutions would recognize that they stand to make a lot of money by defeating the forces of panic that had driven the real to such an undervalued level and Brazilian assets to such low prices. Investors could see the current low prices of Brazilian assets as offering an opportunity to buy at bargain basement prices. (With Brady bonds selling for under 60 cents on the dollar, there was scope for a price appreciation of over 50 percent if Brazil recovers without a debt reconstruction.) The international credit rating agencies could look at the analysis in this brief and decide that it justifies upgrading Brazil’s credit rating, if they were prepared to make a radical break with their traditional practice of providing a lagging indicator by mechanically downgrading every country that encounters market turbulence. Brazilian firms could refuse to cover their dollar liabilities by buying dollars at the exorbitant price currently prevailing in the foreign exchange market, and Brazilian residents could desist from trying to move wealth offshore. Foreign banks could renew their credit lines so that Brazilian firms would no longer be under the same pressure to buy dollars to cover their positions. If enough actors acted in these ways, then they would all have made a lot of money by defeating the forces of panic that had driven the real to such an undervalued level and Brazilian assets to such low prices.

The trouble was that they faced a collective action problem in that they have no mechanism for bringing them together to achieve the good equilibrium. It is one purpose of government to resolve such collective action problems. The traditional way for official actions to stem a panic involves a central bank acting as lender of last resort by standing ready to lend at a penalty rate against good collateral. The closest analogy we have to this mechanism at the international level is the IMF, which traditionally has lent to countries in trouble once it has assured that their policies are consistent with eventual recovery. At one time an IMF program was regarded as a “good housekeeping seal of approval” and was expected to initiate a prompt resumption of international capital flows to the country involved. Unfortunately that can no longer be relied on, although the recovery of the real on August 1 after Mr. O’Neill said that he was prepared to support a new IMF package, and the reaction to the package on August 8, suggests that it still retains considerable potency.

Of the $30 billion IMF loan, $24 billion would be disbursed only in 2003, after the new government takes office, and will therefore be subject to the new government continuing to satisfy the conditionality agreed by the current government.

Brazil would be capable of servicing its debts in a sustainable way if the markets give it a chance by again starting to supply loans on reasonable terms and avoiding a new collapse of the exchange rate.
absolute program in Fund history. Of this $30 billion, $24 billion would be disbursed only in 2003, after the new government takes office, and will therefore be subject to the new government continuing to satisfy the conditionality agreed by the current government. The main element of this is the maintenance of a primary surplus of at least 3.75 percent of GDP. In addition, the program provides for a $10 billion reduction in the reserve floor immediately the program is agreed by the Fund Board (expected to be in early September), adding that much extra to the funds potentially available to defend the real before the election.

Will this program succeed in bringing a permanent change in market sentiment toward Brazil, and thus allow the country to achieve the good equilibrium? The program does not provide for any formal endorsement by the opposition candidates in the presidential election, on the model of the Korean program of 1997 and as called for by Truman (2002). Nevertheless, its success or failure will surely depend on whether both Lula and Ciro Gomes convince the financial markets that they would stick to its terms if elected. If they indeed allow themselves to be bound by the current fiscal targets, then fears that they might end up unable to service the debt despite an intention to do so would be laid to rest. The absence of a demand for explicit endorsement, like the absence of a demand for a yet bigger primary surplus, may have been calculated to ease their way to an implicit acceptance that will not be seen as an unacceptable provocation to their more radical supporters. (The absence of a requirement that the primary surplus be further increased in the depths of the current recession is also good economics; what would have been really nice would have been an agreement to maintain the primary surplus constant in cyclically adjusted terms when recovery comes, which would secure an even larger primary surplus and hence a rapid reduction in the country’s vulnerability during the next boom.) But if either of the serious opposition candidates undermine the notion that they are giving even an implicit endorsement, the outlook for Brazil is not good. The international community through the IMF can help countries that are helping themselves; it is important to help those that lack the cohesion to endorse a program that promises to restore viability in the medium term.

So is Brazil next? The chances of it pulling through without the need for a debt restructuring and the chaos that would bring are now much better than they appeared to be when I began writing this brief, but they still depend on two conditions being satisfied:

- Implicit acceptance of the conditionality of the IMF program by both the main opposition candidates.
- That the appraisal that Brazilian fundamentals are in relatively good shape carries conviction with the financial markets, so that the current situation is seen as a favorable time to buy into Brazil rather than any recovery being viewed as an opportunity to cut and run.

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Appendix A: Brazilian Fundamentals

Table 1 lays out the assumptions that are being made about those variables that are being treated as fundamentals in the analysis of this brief. This appendix describes why the particular values in the table were selected.

**Debt Stocks**

At the end of June 2002 Brazil’s public sector had $98 billion of external debt but this was partially offset by assets of $42 billion of reserves, leaving a net external debt of $56 billion on the part of the public sector. I assume that this figure did not change subsequently, which is surely untrue in detail but nonetheless the changes are likely to have been relatively small and partly offsetting. The central bank estimates the private sector to have net external debts of the order of $120 billion, which is partly or largely offset by private holdings of external assets, but this offset is not included in table 1 because these assets are not in practice available to the authorities. (Deutsche Bank estimates a much higher figure, $173 billion.)

Public-sector domestic debt is estimated as R$677 billion on August 8, 2002. This takes the debt stocks reported by the Banco Central on June 30, makes what looks like a reasonable allowance for growth in the debt stock since then, revalues the dollar-linked portion of the debt in proportion to the devaluation of the real between June 30 and August 8, and does not net out R$71 billion (on June 30) of
assets of the public sector in the form of claims on BNDES and other arguably illiquid assets. The total does, however, net out something over R$100 billion of other claims, such as central bank holdings of government debt and government holdings of bank deposits.

Total public-sector debt is the sum of $56 billion of net external debt, worth R$164 billion at R$2.92 = $1, and the R$677 billion of internal debt.

Growth Rate

A figure of 4 percent per year was selected as the basic assumption for the trend growth rate of the economy. This is above the average growth rate since the Plano Real was launched in 1994, which has been 2.9 percent per year. However, a series of crises (in Asia, that which led up to the devaluation of the real, the crisis in Argentina, and now the renewed crisis in Brazil) have pulled the growth rate down, and Brazil has grown significantly faster in crisis-free periods. The Banco Central do Brasil estimates the supply side to be capable of a trend growth rate of 4.5 percent per year. The PT has proclaimed a growth target of 5 percent per year. The 4 percent figure therefore looks reasonably conservative.

Inflation

The inflation target proclaimed by the Banco Central do Brasil is 3.5 percent in 2003 and thereafter.

Equilibrium Exchange Rate

Estimates put this in the range of 1.9 reais per dollar to 2.5 reais per dollar. (Since the relevant concept of the exchange rate for defining equilibrium is the real effective exchange rate rather than the nominal bilateral rate against the dollar, these equilibrium figures will vary with third-party exchange rates and relative inflation rates. However, these differences are likely to be small enough in the short run relevant for crisis management to justify the simplification of focusing on the dollar rate.)

Goldman Sachs 1.9 reais per dollar
Ilan Goldfajn (2002) 2.2 reais per dollar (average real rate over last 15 years).
Deutsche Bank 2.5 reais per dollar.

Primary Fiscal Surplus

A surplus of 3.75 percent of GDP has been assumed, in line with government commitments for the future. This commitment has been explicitly endorsed by the PT. The actual primary surplus was 3.5 percent of GDP in 2000 and 3.7 percent in 2001.

The augmented primary surplus used in the text adds the interest on the assets that were not netted off in developing our measure of the debt, giving a figure of 4.2 percent.

Noninterest Current Account Balance

A near equivalent to the concept of the primary fiscal surplus in the balance of payments context is the current account balance excluding interest payments. An estimate of what this will be in 2002-03 is based on the data in table 5, and is shown in the final two columns of that table.

This shows that trade was in surplus by $2.6 billion in the first six months of 2002, which is the same as in the second half of 2001. That was achieved despite a decline in exports to Argentina of about $1.3 billion between the first four months of 2001 and the first 4 months of 2002, i.e. a decline of $4 billion per year. Extrapolating this rate of improvement in the trade balance forward to reflect the continuing results of the present hypercompetitive exchange rate, one may estimate the trade balance as likely to be around $4.6 billion in the second half of 2002, $6.6 billion in the first half of 2003, and $8.6 billion in the second half of 2003. That would give a trade surplus of $7 billion in 2002 and $15 billion in 2003 (as shown in the final columns of table 5). Since the trade surplus reported in July 2002 was $1.2 billion, this projection appears conservative.

All other items except “Other Services and Income” are projected to remain unchanged, after rounding, from those in the most recent 12-month period. But these other services are showing a strongly improving trend, so a further improvement to a deficit of $4 billion in 2002 and $3 billion in 2003 is projected.

These assumptions yield a noninterest current account that is almost in balance, with a deficit of a mere $1 billion, in 2002. If the projection of a strongly improving trade account continues to hold good, the outlook in 2003 is for a trade surplus of some $15 billion, and hence a noninterest current account surplus of $8 billion.
References


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