

Brazil in the Storm

Six months ago, in this same space, I wrote an article called "The Brazilian Economy in Rough World Seas" (*BBM Weekly Report*, 3/19/2001). What I then termed as world rough seas were causing a large (sic) depreciation of 10% that threatened the inflation target. At that time, I forecasted that the central bank would be forced to raise interest rates and that such measure would be *...very deleterious to the fiscal accounts, since the majority of the domestic debt is instantly indexed to the basic interest rate. It may attract capital flows, which will help to counteract the depreciation, but this is not certain given the extremely high degree of risk aversion that currently prevails in international markets.*

What a higher real interest rate will certainly do is to contain aggregate demand, and this will help the inflation target in two ways. The first is through the short run trade-off between inflation and activity. The second, and currently more important channel, is through the trade balance. Imports have been rising very fast, reacting to the recent GDP expansion. A slowdown of the economy will probably forestall the import expansion (and also help exports in the short run), thereby decreasing the pressure in the exchange rate market. The ensuing appreciation of the BRL will certainly help the central bank to achieve the inflation target.

Unfortunately, all the negative components of the forecast (the interest rate raise and the recession) became reality while the positive components (the reversal of the exchange rate depreciation) failed to materialize. The accumulated depreciation since the beginning of this year has more than quadrupled since March, reaching over 45%. The rough sea of March would look like a placid lake in September. In mid-March, the consensus forecast for the year end (2001) exchange rate, computed by the Central Bank, was 2.05 BRL/USD, while it is currently 2.70 BRL/USD!

Damage Assessment

Therefore, it is a good time to reassess the impacts of the exchange rate depreciation on the Brazilian economy. **First**, what is the main cause of such huge fall of the BRL? Certainly, the exchange rate depreciation was mainly caused by the perverse combination of two factors:

- the high foreign indebtedness and high current account deficits of the Brazilian economy;
- a marked increase in risk aversion on international financial markets, exacerbated after the terrorist attack to the WTC and the Pentagon, which made much more difficult to roll over the existing debt and to finance large current account deficits.

In order to understand how the BRL could fall so much, it is worthwhile to review a few features pertaining to the interaction between the two features highlighted above. To begin with, economic agents must perceive that debt strategies must be sustainable. That means that all debt will eventually be paid off, or, in other terms, that the present value of a country's external debt very far in the future must be zero. Therefore, if an emerging market like Brazil has both a large external debt and a sizeable current account deficit, it must at some point in the future turn the deficit into a surplus in order to repay the debt.

Suppose that at the end of last year, when growth prospects of the world economy were still good, the scenarios for the future path of the Brazilian current account results indicated that the debt was sustainable. A decrease in world growth prospects, as it has happened since then, implies that world trade will grow more slowly, and that Brazilian exports will not grow as fast as previously envisaged. This undermined the sustainability of the large Brazilian external debt. The increase in the yields of Brazilian external debt, despite the fall in world interest rates, further deteriorated the prospects of debt

sustainability. Both effects undermined investors' willingness to hold Brazilian debt, making much harder to roll over the existing debt, as well as to finance the current account deficit. Probably the effects were exaggerated, but markets are well known for exhibiting manic-depressive behavior.

The result shows up at the exchange rate market, with very few sellers and numerous buyers. As more players realize that the exchange rate has no "reasonable" upper bounds, they look for hedging alternatives, which further prop up the demand for foreign currency and the exchange rate.

Second, what are the consequences of such high depreciation on the main macroeconomic variables? To avoid a very high pass through of the depreciation to inflation, the Central Bank had to raise interest rates and may be prompted to take further restrictive monetary policy measures in the future, as it did recently by raising reserve requirements. This has already weakened the economy, as well as decreased imports, thereby improving the trade and the current accounts. These movements, however, have not yet deterred the upward movement of the exchange rate.

No doubt that eventually the exchange rate will depreciate to a level such that the current account will be in equilibrium, and that the existing supply of external finance will match Brazil's debt roll over needs. Imports will fall more, and the trade and current accounts will further improve. Brazilian assets will become so cheap that despite the increase in risk aversion, capital flows will resume.

The downside, of course, is that the fall in domestic output may be very large and take a long time. Given that 2002 is an electoral year, politics are bound to play a decisive role in what will happen in the near future.

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