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Financial guillotine poised over Brazil

by Lorenzo Carrasco

The worsening of world financial turbulence on Aug. 21, which has become known in Brazil as "Black Friday," triggered a moment of pure panic on the São Paulo financial markets, when the Bovespa index plummeted more than 10%, forcing resort to a "circuit breaker" which suspended stock operations for more than an hour and a half. This mechanism has not been used since last October, when the stock market suffered a 14% one-day fall. Later in the day, due to behind-the-scenes intervention of the government—which ordered the National Bank of Economic and Social Development and the pension funds to buy up falling stocks en masse—the market decline was halted, and closed down just 2.9% for the day.

Over the month of August, the Bovespa index registered a nearly 30% loss. At the same time, Brazil's renegotiated foreign debt bonds, known as C-Bonds, also collapsed. During "Black Friday," they reached the point of being negotiated at 54.5% of their face value, meaning that interest rates on these bonds rose to 11.76% above what is being paid for 30-year U.S. Treasury Bonds, the worst level since April 1995, at the height of the Mexico crisis. All of this means an increased risk for international speculators in Brazil; put another way, this could be the forerunner of what could turn into a major speculative attack against the country, a high probability given that international speculators know full well that the only goal of the current government of Fernando Henrique Cardoso is to guarantee his reelection in the six weeks before the Oct. 4 elections.

As a result of this scenario, capital flight during August approached $7 billion; at the time of this writing, no one knows how much the country's reserves have fallen. Central Bank President Gustavo Franco acknowledged that monetary authorities are ready to lose $10 billion of the nearly $70 billion in reserves, in defense of Brazil's currency, the real. But, taking into account the financial market as a whole, potential flight capital could well exceed the government's projection. In fact, the government's most recent measures reveal that it, too, is aware of this probability.

Desperate measures

On the day of the panic, the Brazilian Central Bank offered speculators 1 billion reals (some $900 million) in Special Central Bank Notes (NBC-E), which are one of the government's numerous internal debt bonds that are indexed to the dollar exchange rate—that is, they are effectively denominated in dollars. Interest rates offered on the NBC-Es were 18.5% above the exchange rate, when in previous auctions the rate was 12%. In the coming days, another half-billion reals worth of NBC-E bonds will be put up for auction, as will 500 million reals in National Treasury Notes, Series D (NTN-D), which are also indexed to the U.S. dollar. Further, the government will allow the minimum time that foreign capital must remain in Brazil to be reduced, thereby allowing in more volatile capital. Equally suicidal, the government will allow 100% of the loans Brazil's banks are taking in abroad, supposedly to finance agriculture, to be invested in government debt paper.

What is clear from all of these hyperinflationary measures is that the government has no other defense available to it but to burn up its reserves, or to issue still more domestic debt paper. An increase in interest rates, as was done last October, will not have the same effect of keeping capital inside the country, given that 60% of the domestic debt is linked to "post-fixed bonds," that is, to bonds whose interest rates are fixed at the point they come due (not at the time of issuance), as the average of the rate applicable during the term of the bond. Therefore, the government insists that it will not increase domestic financial rates, because this would cause the fiscal deficit to rise even more dramatically than it currently is.

Speculation in domestic debt

Beyond all the speculative algebra, the real problem lies in the escalation of the domestic debt, and in the payments on that debt, which have worsened the fiscal deficit—today more than 7.1% of the Gross National Product. As Nestor Perini, the coordinator of the Economic Council of the Rio Grande do Sul Industrialists Federation, declared on Aug. 21 to the newspaper *Correio do Povo* of Pôrto Alegre, the conservatively estimated 15% interest rate carried by the 315 billion reals public debt requires annual debt service payments of $45 billion, approximately 6% of Brazil's GNP. Meanwhile, the private sector, with its debt of 570 billion reals at an interest rate of 30-35%, is paying 170 billion reals annually in debt service (20% of GNP).

In sum, and despite the government's systematic denial that the country is vulnerable to a situation like that of Russia, there is no doubt that the guillotine of the financial speculators is being readied against Brazil, notwithstanding the agreements from early this year struck between President Cardoso and mega-gambler George Soros. The only real question now is whether the crisis will hit before or after the Presidential elections on Oct. 4. If before the elections, such a crisis will lead to the evaporation—within hours—not only of Brazil's monetary reserves, but also of the reelection dreams of the supposedly invincible President Cardoso.

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