Is Brazil Another Argentina?
An Update on Latin America

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As global bond managers, we at Payden & Rygel appreciate the interdependence of world financial markets. Our research team monitors political and economic events around the world, paying close attention to how developments overseas may affect U.S. markets. Brazil's upcoming presidential election in October is of particular importance, and not just for Brazilians. As one of the world's ten largest countries, both by population (170 million) and by GDP (US$ 500 billion), Brazil commands attention.

Brazilian financial assets have been hit hard in recent weeks, as investors have grown concerned by Brazil's election. In addition to deciding the presidency, the election may also determine whether Brazil's current financial market turmoil will subside or snowball into economic crisis. This would have serious ramifications in global financial markets, following so closely on the heels of the Argentine crisis and coming in the midst of high volatility and risk aversion in the U.S.

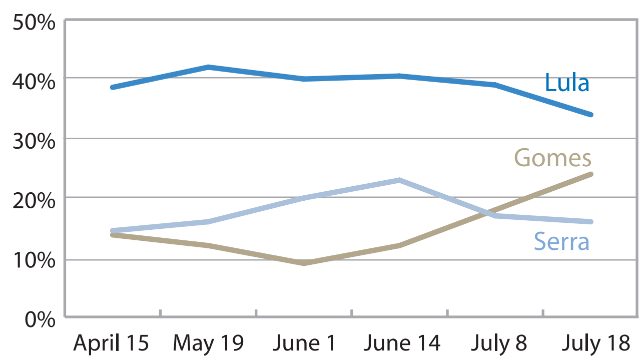
Many investors wonder if Brazil is another Argentina—an economy that held great promise five years ago and is now in deep turmoil. The differences between Brazil and Argentina are significant, however. Brazil's superior economic reform record and stronger relationship with the IMF better position it to avoid economic crisis and default. And while Brazil's political uncertainty carries risk, it may also carry opportunities. Given current depressed asset levels, a positive resolution of the political uncertainties would lead Brazilian assets to outperform after the elections. But it is still too early to predict an outcome.

Brazil's Upcoming Election

At the heart of investor concerns about Brazil's election are leftist presidential candidates Inacio Lula and Ciro Gomes. Lula, who has previously run for the presidency three times and lost, is still a strong contender based upon his current lead in the polls at 35-40% (see graph). Investors distrust Lula because of his past statements advocating a restructuring of Brazil's debt, and because his economic team is likely to be less fiscally responsible than the current administration of Fernando Henrique Cardoso.

Lula has disavowed his previous position and now states that, if elected, his administration would honor all debt. Nonetheless investors fear that a deterioration in investor confidence and capital flight following a Lula victory could trigger an economic crisis and possibly a debt default. The government's less charismatic, but more market-friendly, candidate Jose Serra has remained at an average 15-20% in the polls. He is now in third place trailing an unpredictable left-of-center candidate Ciro Gomes. Recent gains by Gomes have been boosted by increased television advertisements, but his advance in the polls has also unnerved investors.

Brazil's Presidential Candidates: Voter Preferences (Poll Dates, April - July 2002)



With approximately half of the voters still undecided and the presidential campaign just officially opening in early July, it is too early to make a call on the outcome of Brazil's elections. Television exposure is expected to have a great influence on voter sentiment and Serra's standing should improve as his appearances on television increase in late August. As the government candidate, Serra will enjoy the support of the two largest political party machines in the country.

Why are investors concerned about the link between Brazil's election and its debt load? Brazil's level of gross public debt to GDP has grown from 53% in 1998 to 72% today. Given that 51% of its public debt stock is indexed to policy rates and 28% to the U.S. dollar, Brazil's debt level is highly sensitive to changes in either interest rates or the exchange rate. Both of these are in turn very dependent on investor confidence. At the beginning of this year, many investors felt confident that Serra would win the presidential election and overweighted Brazil in their portfolios. However, as Lula (and later, Gomes) began to rise in the polls, concerns about Brazil's debt dynamics surfaced because of the strong link between confidence and debt sustainability.

A Crisis in Brazil Would Cause Contagion...

While a crisis is avoidable, any potential economic turmoil in Brazil would have a more serious impact on global markets than was the case with Argentina. First, Brazil dwarfs Argentina both in terms of population and size of economy. Second, many international investors entirely withdrew from Argentina before its default, but are unlikely to do so in Brazil, as the outcome of the Brazilian case is far less certain; if Serra wins, there is significant upside in asset prices. Brazil also comprises over 20% of emerging market debt benchmarks, so investors who track benchmarks have high exposure to Brazil. Finally, the timing of a Brazil crisis would be very damaging in terms of financial contagion, especially within the region. Capital inflows to Latin America have already been curbed by the Argentine default, and by political instability in Venezuela and Colombia. A default in Brazil would also call into question other emerging market countries with difficult debt dynamics, such as Turkey, Uruguay and Ecuador.

The effects of economic crisis in Brazil would also reach beyond the emerging markets. A default in Brazil could exacerbate the current risk aversion plaguing U.S. markets. In addition to portfolio investment, foreign multinational corporations have committed billions of direct investment to Brazil. International organizations such as the IMF and the U.S. administration have recently affirmed their support for Brazil, recognizing its significance. The IMF's number two official, Anne Krueger, will visit the country this month amid speculation that Brazil will seek additional IMF funding. After initially dismissing more aid to Brazil and stirring more turbulence in Brazilian assets, U.S. Treasury Secretary Paul O'Neill also plans to visit the region this month. Continued support from multilateral organizations and the U.S. will be an important determinant of investor sentiment in the run-up to the October elections.

...but Brazil is Stronger than Argentina.

Many wonder whether Brazil will follow Argentina down the path of default, political instability and economic crisis. There is no question that Brazil's debt dynamics are fragile. In addition, Brazil's growth rate has slowed since 2000; exports are limited; and a current account deficit of nearly 4% of GDP means that the country is dependent on capital inflows. Declining global risk appetite has not helped Brazil's delicate situation.

At the same time, however, Brazil enjoys numerous advantages that Argentina did not enjoy at the time of its default, including a floating exchange rate, demonstrated fiscal adjustment over the past years and strong economic policy management. Much of Brazil's debt is domestic as opposed to external, which was not the case in Argentina. In addition, Brazil's relationship with the IMF has been much stronger than Argentina's, given Brazil's superior track record in achieving economic reforms. Argentina was unable to deliver on promised fiscal measures, while Brazil implemented one of the most impressive fiscal adjustments among emerging market countries in recent years.

Finally, market-friendly candidate Serra still has a good chance to win the elections. In that case, positive momentum in currency and interest rates will have beneficial effects on Brazil's debt trends. Even in this more positive scenario, however, Brazil must build upon its record of implementing reforms to make its debt more sustainable in the medium-term. Deeper fiscal reforms, lengthening of domestic debt maturities, and improvements in export performance are needed to achieve higher economic growth rates and to reduce Brazil's dependence on capital inflows.