



| *S p o t l i g h t* Special |

Events in Brazil under the influence of the presidential
election and the Argentinean crisis

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Dresdner Bank Lateinamerika AG
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Market situation determined by the presidential election and the Argentinean crisis

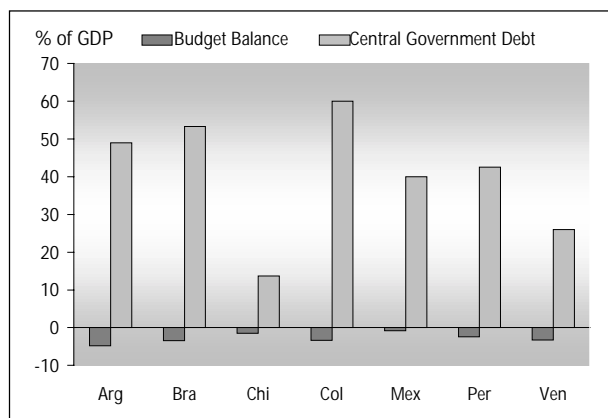
The key issues in Brazil this year will be the presidential election and developments in Argentina. Essentially, the fundamental question being raised is: **What influence are these events having on Brazil's macro-economic stability?** Will the new government continue its reform-oriented economic policy that has proved successful in the past, or will we see a post-election populist policy, causing public spending to explode? Will the Argentinean crisis result in a sustained macro-economic imbalance in Brazil, or can the country continue the process of decoupling from the influence of its neighbor south of the border?

With public-sector debt amounting to over 50% of GDP and foreign debt equivalent to roughly 300% of exports, both the country's fiscal and external-sector equilibrium is subject to numerous risks. We have analyzed the possible effects of the election and the danger of contagion from Argentina and have come to the conclusion that the risks remain manageable.

Fiscal situation has improved

Brazil's net public-sector debt in the year 2001 was in the region of US\$ 280 billion, or 53% of GDP, with roughly three-quarters of debt being denominated in *reais*. At the same time, the public-sector's budget deficit amounted to roughly 3.5% of GDP. It was possible for the average term to maturity of domestic debt to be extended within the past three years from originally six months to a current 26 months. More than 50% of debt instruments issued on the domestic market are directly or indirectly linked to the key interest rate *Selic*, and 29% is indexed to the US\$, i.e. both interest rate hikes and lower exchange rates mean additional burdens to the public-sector budget. This is one of the reasons why numerous investors last year (when the *real* depreciated, prompting the central bank to raise interest rates significantly) feared that the public finance situation could get out of control. If the national currency appreciates, the effect is reversed, i.e. meaning relief for the public budget, a situation we observed in the final months of the year 2001. Finally, it must be noted that the level of interest rates in real terms is in the region of 10% at present. Interest payments last year were equivalent to 7.3% of GDP.

KEY FIGURES FOR THE PUBLIC SECTOR



The more consistently the reforms are pushed forward, the sooner will it be possible to achieve a stabilization of public finances. Major successes have been accomplished in the past in restructuring debt of the federal states owed to the central government and in terms of privatizations. Both of these processes should be concluded soon. In addition, the Fiscal Responsibility Law was employed with a view to creating a mechanism to keep spending by public offices under control. A great deal still needs to be done as far as the pension and taxation systems are concerned.

With regard to reforming the pension system, while initial measures have been launched, up until now these have been far from adequate to stabilize the system. The deficits incurred by the pension fund amount to a charge to the public-sector budget of around 5% of GDP. About 80% of this deficit is attributable to pensions to public servants, who only constitute 5% of all pensioners.

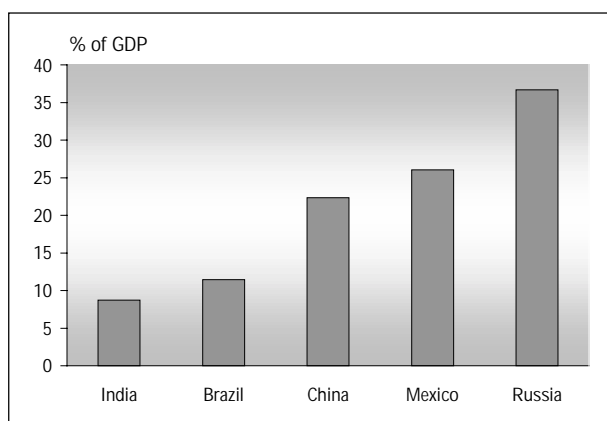
Some promising reforms have also been launched in the field of taxation. However, the system largely remains fraught with a confusing number of indirect taxes that account for half of tax revenues and virtually encourage tax evasion. Since numerous taxes are collected directly by the states and/or partly are remitted to the latter, the central government has created new taxes which it does not have to share with the federal states but which, in terms of their inherent nature, have a particularly distortive effect. The financial transaction tax is a case in point.

Flexible *real*/lowering the country's susceptibility to exogenous shocks

At end-2001, Brazil's external debt amounted to US\$ 219 billion, equivalent to 297% of annual revenues from visible and invisible exports. This ratio still remains very high, even though it has continually declined in recent years. In 1999 it was

still as high as approx. 400%. We also anticipate a further decline for the current year which, seeing as the level of debt will remain virtually unchanged, will be attributable to higher exports.

EXPORT QUOTAS OF EMERGING MARKET COUNTRIES



What the financial markets perceive as Brazil's achilles heel is the country's current account deficit, which has amounted to more than 4% for years. We consider this deficit to be unproblematic as long as Brazil can continue to expect a high level of direct investment from abroad. While net direct investment did in fact decline by roughly US\$ 6 billion last year, at US\$ 25 billion this level remained high, more than offsetting the country's current account deficit (US\$ 23.2 billion) in the process. This inflow is likely to remain at a fairly high level in future too.

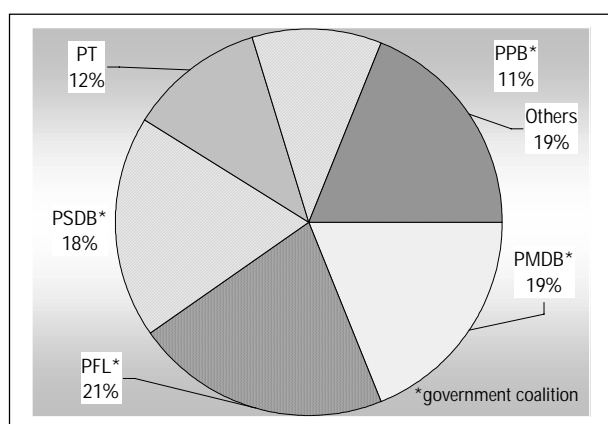
What we consider worthy of note is that Brazil's external sector still remains underdeveloped. To stabilize the external sector situation on a sustained basis, the export quota (which currently is in the region of 10% of GDP) will need to be raised significantly, reducing the country's vulnerability to fluctuating capital flows. This in turn would result in lower exchange-rate volatility.

Elections to determine the country's future economic policy

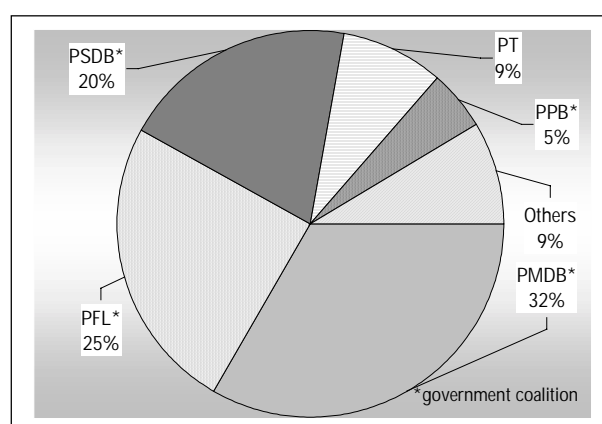
Presidential and parliamentary elections are scheduled to be held in October. The full House of Deputies, two-thirds of the Senate and all 27 state governors will be newly elected. However, the event that is making investors most nervous clearly is the outcome of the presidential election. President Cardoso is precluded from standing again in terms of the constitution. The crucial issue is whether the credible economic policy of the Cardoso government will be continued after the elections or whether a new economic model will be sought. While an election victory by the opposition would not lead to a radical change of direction, the past market economic policy course would presumably be modified; if a candidate of the ruling government wins, the stability-oriented course is basically expected to remain in place. In either event, we consider the likelihood of a dramatic break from the country's past economic policy as rather remote.

The election campaign will begin to take shape in concrete terms once all candidates and election alliances have been defined (around May/June), with election polls certainly having a substantial influence. As of August each of the various political parties will be given free-of-charge advertising time on television in proportion to the number of seats held in

HOUSE OF DEPUTIES



SENATE



parliament.

This in itself should also improve the ruling coalition's chances if it were to field a common candidate. Only once the television election spots begin is the election campaign likely to enter its decisive phase. At present the outcome of the election is completely open.

Lula, from the opposition (who according to the polls, commands about 26% of voter support at present) is practically certain as the candidate of choice for his party (Workers' Party PT); he is quite likely to make it to the second ballot. However, it is improbable that he will win that round again and thus become the next state president: while he can count on 1/3 of all votes, the other 2/3 traditionally are not Lula supporters, favoring a candidate from the center instead. This did not change either when Lula and some of his party members assumed a moderate stance on economic policy issues in recent months.

According to the latest polls, Roseana Sarney, governess of the state of Maranhão in north eastern Brazil, would gain the upper hand in a run-off election. In the past, Lula has always had the majority in polls concerning a second ballot; Roseana Sarney, who has had a substantial media presence in recent weeks, has made it clear that a candidate of the government remains in a position to win the election.

This has improved the general sentiment in the camp of the ruling parties, especially among the PSDB, the State President's party which, after some vacillating, officially appointed Health Minister Serra as its preliminary candidate in mid-January. Now that Tasso Jereissati, the successful governor of the federal state of Ceará, has withdrawn from the election campaign and has pledged his support for Serra, the party will be united in fielding him as a candidate. With a past 7% of votes according to polls taken, Serra will need to take a major step forward to get anywhere near his rival, Roseana Sarney (PFL), who still has around 23%. Both want to be appointed sole presidential candidates of the ruling coalition. Serra's challenge in the next few weeks will be to oppose Roseana without this causing a rift with the PFL so that it will remain possible for the coalition to continue in the future. Whether the two parties will join forces and whom they will field as a candidate will depend on the polls; from today's perspective, Roseana Sarney's PFL stands better chances. It cannot

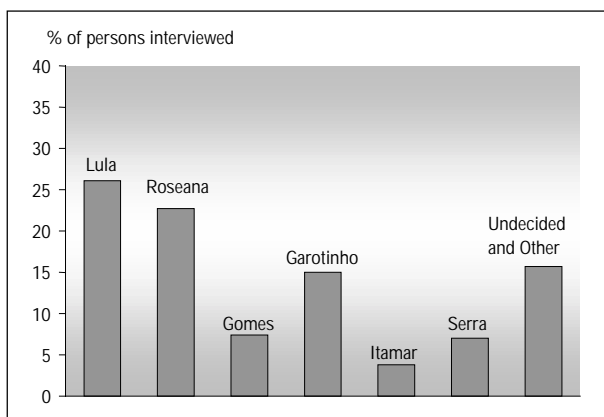
be ruled out that this issue may only be decided after the first ballot. What must be borne in mind is that the polls should be viewed with some suspicion at present as the Brazilian population's interest in the election campaign is extremely low and most politicians likewise are practically unknown in the public eye.

With regard to the PMDB, which also plays an important part in the coalition, the situation remains unclear: three leading politicians of this particular party – Itamar Franco, Jungmann and Simão – want to run against one another even though

this will split the party and weaken its candidates. The party is even in disunity on the decision as to whether it wants to move to the opposition or remain in power. We believe the PMDB will probably enter into an alliance with the PSDB and the Vice-President might emerge from its ranks.

The current economic policy would change most sharply if Lula were to take over to rule the country. In this event the restrictive monetary and fiscal policy would probably be eased, but his freedom of action would be restrained by the Fiscal Responsibility Law. Among other things, this Law prohibits new, long-term spending at each tier of the administration unless a corresponding new long-term

POLL JANUARY 2002



source of revenues can be created. Those responsible for such decisions can be brought to justice for violations of this Law and stand to face substantial penalties. Should there be significantly lower primary surpluses under a Lula government than in recent years, however (always more than 3% of GDP), this is soon likely to lead to a weaker *real* and higher financing costs. The market pressure created in this manner is likely to have a disciplinary influence on spending policy. The reforms in such fields as taxation and pensions as well as the privatizations would slow down under a more leftist government, however.

In our opinion a fundamental change to the institutional framework would not be possible as the country's democratic

KEY DATA FOR THE ELECTION YEAR

July 5, 2002	Last deadline for official registration of candidates
August 20, 2002	Beginning of free-of-charge radio and televised election campaign
October 3, 2002	No more election propaganda allowed from this day onward
October 6, 2002	1 st round of presidential and parliamentary elections and of the 27 governors
October 27, 2002	Run-off ballot if none of the presidential candidates manages to achieve a 50% majority at the first ballot
January 2003	Beginning of new president's term of office

institutions have largely been consolidated over time and due to the traditionally conservative majority in Congress.

We expect that the State President will again emerge from the ruling coalition after the elections. Lula's high recognition factor as a candidate is distorting the results of polls being taken at present. It is quite conceivable that Serra, who currently musters some 7% according to the polls, will speedily improve his ratings once his presence becomes more visible in the media. After all, he can look back on his successful work as Health Minister acknowledged throughout the

country (for instance, he opposed the U.S. patent directives to ensure that a remedy against AIDS can be produced and sold more cheaply in Brazil).

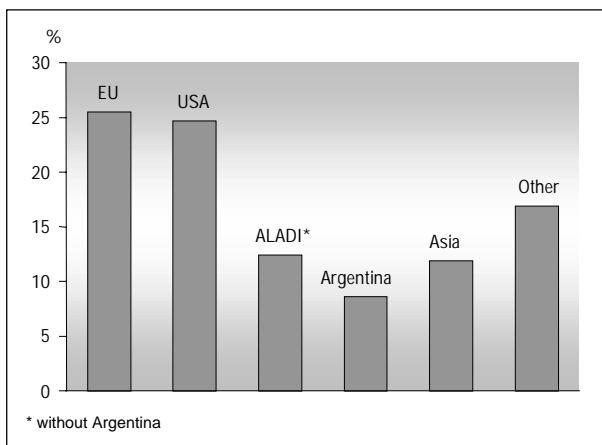
Argentinean crisis with little impact in macro-economic terms

The real economic effects of the Argentinean crisis are being felt in terms of foreign trade, tourism and direct investment. Brazil's export sector already suffered from the crisis in Argentina in 2001; exports to Argentina declined by US\$ 1 billion. As a result, the share of Brazil's total exports accounted for by Argentina shrank from 10% in the year 2000 to 8.3% in 2001. In addition, numerous Argentinean importers failed to pay their bills, either because of the poor liquidity situation or due to the restrictions in force since December, which make transfers of foreign currency abroad more difficult or almost impossible, as is the case at present. The losses sustained by Brazilian exporters are estimated at approx. US\$ 2 billion. In the current situation, there are hardly any Brazilian companies that export to Argentina unless they receive payment in

cash or guarantees have been issued. Apart from the deep recession being seen in Argentina right now, this will contribute to a further decline in exports to that country. The effects should remain slight, however; there is no major Brazilian enterprise that is geared solely to the Argentinean market. Moreover, the consequences for the Brazilian economy as a whole should be almost negligible since exports to Argentina contribute less than 1% to Brazil's GDP.

Brazil is one of the key travel destinations for Argentineans. In the year 2001 some 1.8 million Argentinean tourists were expected. The associated inflow of foreign currency has been estimated at US\$ 1.5 billion. This year very few Argentineans will probably be able to

EXPORTS BY REGION



afford a vacation abroad. Brazilian hotels in the south report cancellation quotas of 30% for this season.

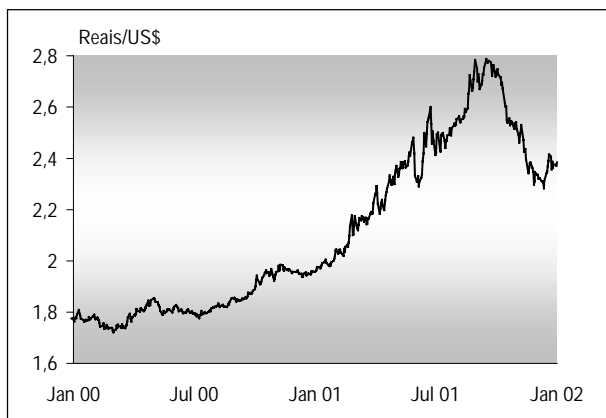
Brazilian enterprises invested around US\$ 8 billion in Argentina from 1994 to 2000, which accounts for more than half the total of Brazilian direct investments made abroad in that period. The size of the losses Brazilian enterprises will suffer is difficult to estimate. To some extent, however, these are export-oriented businesses which are thus likely to benefit from a devaluation. In the short term, however, some businesses will be hard hit, especially smaller-scale operations. Businesses with exposures in Argentina are predominantly industrial companies from the oil, steel, textile, and food & beverage sectors.

As the economic impact in real terms is only low, we do not expect any sustained pressure on the *real* or on bond prices to emerge from that quarter.

Possible destabilization via the financial markets?

Both the elections and the Argentinean crisis may have an adverse impact on Brazil's fiscal and external sector equilibrium via the financial markets. Should the *real* come under pressure again, this would re-intensify inflationary expectations and limit the central bank's scope for interest rate cuts. With interest rates remaining at their present level or even rising, the revitalization of the economy that we expect would probably fail to materialize. At the same time, the bond spreads would increase and financing on the international capital markets would become increasingly difficult.

EXCHANGE RATE

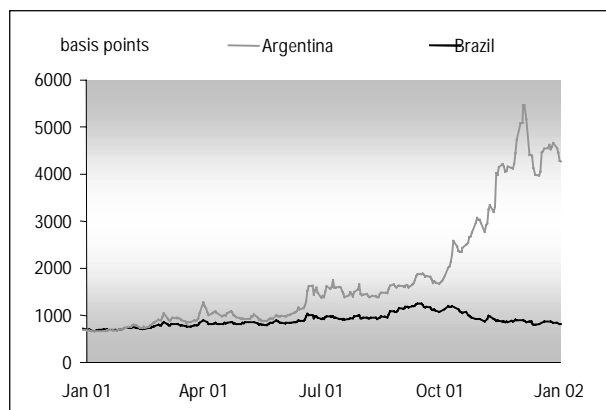


1 billion many market participants had expected. Seeing as Brazil launched more than US\$ 3 billion in corporate bonds, since November 2001 the international capital market has been considered "open" again to Brazilian corporations; this is leading to additional capital inflows. Furthermore, numerous banks and companies are reported to hold surplus dollar and hedge positions. Finally, the Brazilian currency is probably slightly undervalued at its current level. All in all, we consider a sustained depreciation of the *real* unlikely, which means that the vicious circle of devaluation, interest-rate hikes,

However, there are several factors that raise doubts concerning the sustainability of these effects. For one thing, what was evident last year is that the current account reacts positively to the devaluation of the *real*. The trade deficit of the past several years has swung into surplus (US\$ 2.6 billion), which is likely to rise to US\$ 4.3 billion in the current year. This swing served to strengthen the *real*, in turn automatically reducing pressure on the public-sector budget. Another contributory factor to the *real's* appreciation has been that fears of a general collapse in direct investment turned out to be unwarranted. In the last quarter, net direct investment averaged US\$ 2.46 billion per month, or a great deal more than the US\$

deterioration in public budget figures etc. witnessed last year will not materialize this year.

BOND SPREAD EMBI+



launched a US\$ bond issue amounting to 1.25 billion. We take it for granted that it will issue a total volume of US\$ 5 billion in bonds this year according to schedule.

Should there actually be a major increase in bond spreads, this will not cast any doubt on whether the country's public-sector foreign debt falling due for the current year (US\$ 8.6 billion, excluding state-owned banks) will in fact be serviced. For instance, US\$ 10 billion is still available under the IMF agreement of September 2001 (lifetime: 1 year). At the end of January the IMF confirmed that Brazil met the targets agreed for the year 2001 and cleared a further tranche. This agreement gives the state the certainty of not being dependent on the international capital market. In January, the government

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BRAZIL		1999	2000	2001e	2002f	2003f
DOMESTIC ECONOMY						
GDP change (real)	%	0,8	4,5	1,8	2,5	3,5
GDP	US\$ bn	529,4	588,0	508,7	511,0	546,7
Inflation (year-end)	%	8,9	6,0	7,7	4,8	4,2
Inflation (average)	%	4,9	7,0	6,8	6,0	4,6
PUBLIC SECTOR						
Budget balance, central government	% GDP	-2,7	-1,5	-1,5	-1,6	-1,5
Budget balance, public sector	% GDP	-5,9	-3,7	-3,6	-3,7	-3,7
Public debt	% GDP	49,4	49,5	53,3	51,0	50,0
EXTERNAL SECTOR						
Merchandise exports	US\$ bn	48,0	55,1	58,2	61,9	66,6
Merchandise imports	US\$ bn	49,3	55,8	55,6	57,6	61,9
Trade balance	US\$ bn	-1,3	-0,7	2,6	4,3	4,7
Current account balance	US\$ bn	-25,4	-24,6	-23,2	-21,5	-20,0
Current account balance	% GDP	-4,8	-4,2	-4,6	-4,2	-3,7
Net foreign direct investment	US\$ bn	26,9	30,5	24,9	16,0	16,0
Foreign exchange reserves, year-end	US\$ bn	34,8	32,5	36,0	36,0	36,0
Import cover **	months	4,8	4,1	4,4	4,3	4,1
US\$ exchange rate, year-end	Reais	1,79	1,96	2,32	2,5	2,61
US\$ exchange rate, average	Reais	1,82	1,83	2,33	2,52	2,55
FOREIGN DEBT						
Gross foreign debt*	US\$ bn	232,3	216,9	220,9	223,4	224,4
Foreign debt	% exports**	393	319	305	291	275
Short-term foreign debt	US\$ bn	26,6	27,4	28,5	29,5	29,0
Foreign debt amortization	US\$ bn	44,3	28,1	32,0	32,0	32,0
Foreign debt service	US\$ bn	61,4	45,2	49,5	50,0	50,0
Foreign debt service	% exports**	104	66	68	65	61
FINANCIAL MARKETS (year-end)						
Interbank interest rate, overnight	%	18,8	15,8	19,0	16,0	15,0
Bovespa stock index (real based. 2002: 01/31)		17091	15258	13019	12721	
IFCI stock index (US\$ based, 2002: 01/31)		459	411	288	295	
Bond market yield (2002: 01/31)***	%	12,5	13,1	14,6	14,3	
Yield spread (2002: 01/31)***	bp	562	731	886	846	
* according to revised CB data **goods and services *** 10 1/8 % US\$-Bond (2027)					e=estimate f=forecast	

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