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IMPACTS OF THE FINANCIAL CRISIS ON BRAZIL

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As the global financial crisis entered its acute phase in mid-September, Brazil suddenly faced a negative shock in its foreign capital flows. Portfolio equity outflows and carry trade unwinding abruptly accelerated the pace at which they were taking place in previous months. Even low-risk trade credit lines vanished. As a result, not only domestic stock markets dived, but also the local currency underwent a sharp depreciation in a matter of days, while both EMBI and CDS spreads also rose substantially.

The hasty run to the exit was triggered by external reasons, such as the cover of losses and margin calls elsewhere, foreign banks preserving liquidity, or simply as a response to the systemically heightened risk aversion. Nevertheless, it was rapidly followed by a halt in the domestic interbank market and of credit in general.

Domestic credit conditions deteriorated as a peculiar form of the credit freeze happening at the core-advanced economies. Notwithstanding the small proportion of foreign sources in the total of both banking and non-banking funding, a spurt of uncertainty regarding local corporate health, both in banking and non-banking sectors, was sparked after the sudden drought of foreign finance and local-currency devaluation. News of an unexpected vulnerability to exchange-rate depreciation by corporations and smaller banks due to exposure through derivatives immediately led to a local version of doubts about hidden 'toxic assets' and financially fragile balance sheets.

The Brazilian public sector had availed itself of the current-account surpluses and foreign-capital bonanza of the last few years to reduce its foreign debt and retire dollar-denominated domestic debt, up to the point of acquiring a negative dollar-exposure in its accounts. Indeed, the recent exchange-rate depreciation has even contributed to a shrinking public-debt-to-GDP ratio. Conversely, in the private sector, confidence in a strong local currency had become so entrenched as to lead, for instance, some corporations to accept providing dollar put options to banks in exchange for lower funding costs. The fact is that the reversal of the theretofore-downward dollar trend was followed by a surprising revelation of – realised and unrealised – corporate losses and a domestic generalised credit squeeze.

The response by monetary authorities has been twofold, on both foreign exchange and domestic credit fronts. As of November 6, the Central Bank has sold US$5.2 bn (2.6 per cent of international reserves) in the spot market; combined with derivative sales of US$25.8 bn through currency swaps. Additionally, temporary dollar liquidity has been provided through repo agreements both at the spot market ($4.8 bn) and abroad ($3.3 bn). The war chest for interventions received the confidence boost given by the inclusion of the Brazilian central bank in the U.S. Federal Reserve's network of currency swap lines. Trade credit lines have returned to a level equivalent to half of the one prior to mid-September, whereas the exchange rate receded from the peak and has hovered around non-dramatic levels. The latter has mitigated fears of a deeper corporate financial stress, as well as of rising credit risks for those counterparty banks that were at the other side of corporations in structures of currency derivatives.

At the domestic credit side, besides extending its rediscount policies, the Central Bank has eased on its long-held stiff reserve requirements, in a series of moves that according to estimates may end up liberating an amount of liquidity potentially superior to 5.7 per cent of GDP and 5.6 per cent of total bank assets. The government has also announced the intention of resorting to public-sector majority-owned banks to fill in the blanks in the cases of credit to agriculture, automobiles and others, as well as to acquire partnership shares in Brazilian-based companies.

The phase of panic and financial absolute freeze seems to have ceased, nonetheless leading to several consequences. Preliminary figures for domestic credit in October point to a steady reversal of the long path of expansion previously in course. Most leading indicators of industrial production and demand, as well as business and household confidence surveys, are also suggesting a sharp economic deceleration in the last quarter of the

year. The fusion of two large domestic private banks (Itaú and Unibanco) can become a first move of a forthcoming wave of mergers and restructuring in the Brazilian financial sector.

The macroeconomic landscape for 2009 has become more challenging, and not by chance GDP growth projections have been trimmed to the range of 2–3 per cent, a substantial slowdown after a rhythm expected to end up above 5.2 per cent in 2008. Global deleveraging is still to continue affecting local asset markets and the balance-of-payment capital account. Together with weaker foreign demand for exports, softer commodity prices and less favourable terms of trade, that will imply a tighter external environment in the near future. Domestic absorption was running above potential GDP growth prior to the credit crunch and doubts remain on whether the current consumption and investment deceleration will be enough to counteract the inflationary effects of the now prevailing more depreciated levels of the exchange rate. On the other hand, the Brazilian government still retains an arsenal of monetary, foreign reserves, and fiscal and quasi-fiscal instruments to be used in case new external shocks occur and/or the domestic demand deceleration becomes too deep.

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