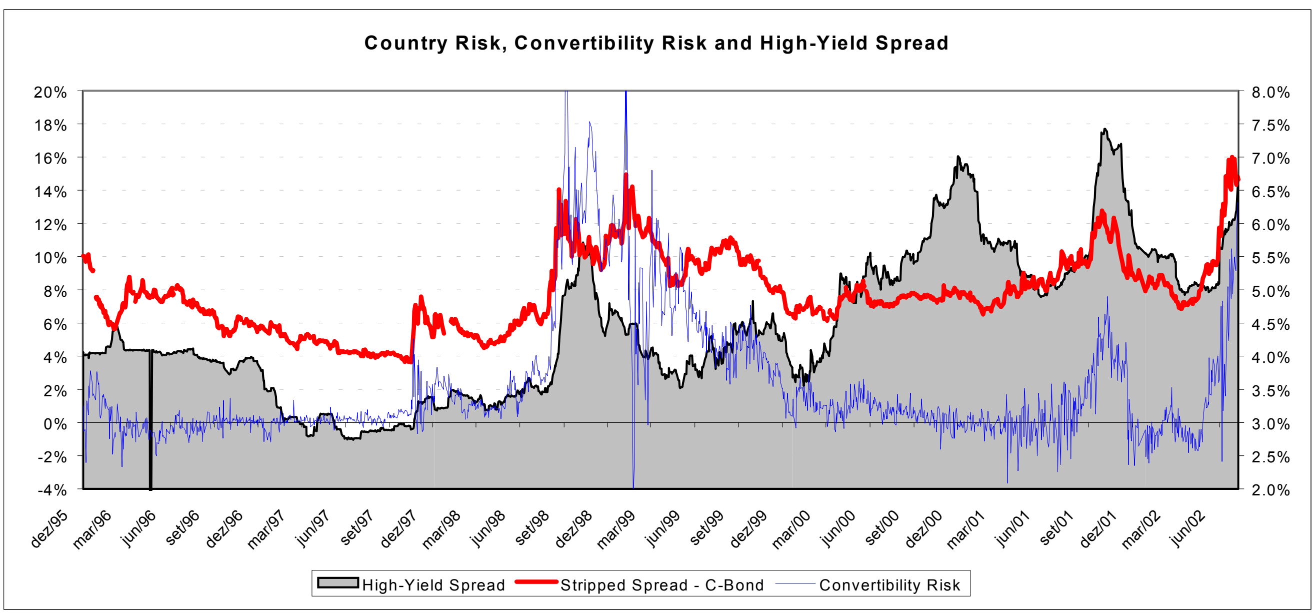
Country Risk in Brazil

Country risk measures have become very fashionable statistics. As I write this document (7/24), the web site of a major Brazilian newspaper flashes news that the Brazilian country risk reached the enormous level of 1,771 basis points. This means that the best loans to Brazil carry an extra 18 percentage points when compared to the current yield of a treasury bond of equivalent maturity. After Argentina, who is in default, Brazil competes fiercely with Nigeria for the second place, for the general dismay.

Country risk measures are basically averages of differentials from the covered interest parity condition of bonds and loans traded in international markets. The covered interest parity condition states that, when denominated in the same currency, the interest rates (bond yields) in different countries should be equalized. The covered interest parity condition holds for industrialized countries, but not for emerging markets. The differential (or deviation) of the covered interest rates parity ... *captures all barriers to integration of financial markets across national boundaries: transactions costs, information costs, capital controls, tax laws that discriminate by country of residence, default risk, and risk of future capital controls*.[1]

There are several measures of country risk for Brazil. One of the most widely used is the spread of the C-Bond, the most liquid bond of Brazilian external debt. This is the upper line in the Chart (LHS scale). The levels reached recently have never been reached in the past, even during the several crises (Asian, Russian, and Brazilian).

The previously unseen high levels of Brazilian country risk are being reached at a moment when the fiscal, monetary and exchange rate policies are much better than in previous periods. Granted, there is a large political risk concerning the continuation of such policies. Nevertheless, most pundits agree that these levels are hard to explain. It seems that a very perverse combination of political risk, external vulnerability and increase in risk aversion is at work. The area in the Chart background (RHS scale) is the high-yield spread. It measures the spread US firms with comparable rating (risk class) to Brazil have to pay for loans. It is a good measure of the market risk aversion that has nothing to do with Brazil. It increased substantially during the last quarter of 1998 (LTCM and Russian crisis), it increased again during 2000, peaked after September 11, but is now climbing back to the highest levels it had attained in the past. Therefore, Brazil (and everyone else)



[1] FRANKEL, JEFFREY A. (1991). "Quantifying International Capital Mobility in the 1980's ". In Bernheim, B. D. and Shoven, J. B., eds., *National Saving and Economic Performance*, National Bureau of Economic Research, The University of Chicago Press, Chicago.

is facing the hardest market ever.
Such a bear market is bound to hurt the most the borrowers in greatest need of funds, among those, the Brazilian economy. Not only Brazil has a sizeable current account deficit, but it also has a large external debt, although most of it is from the private sector. This, however, is of little help. When private borrowers are unable to roll over their debts abroad, they try to access the domestic markets, putting pressure on the (bear) credit markets and the exchange rate market. Both the interest rate and the exchange rate shoot up. The yield curve is currently extremely steep. For example, on 7/23, the Selic overnight rate was 17.84%, while the one-year rate was 27.49%. The exchange rate has breached the 2.9 BRL/USD level and does not seem to recede.
The extremely jagged line in the Chart (RHS scale) is the convertibility risk. It is computed by comparing the futures price of the USD at the BM&F with the inverse of the price of the BRL in the NDF (non-deliverable forward) market in New York. When it is positive, it means that the markets are charging more in BRL for one USD delivered in the US than for one USD delivered in Brazil. Note that it is not a measure of exchange rate risk, but just of the ability of transferring the equivalent in BRL of one USD from Brazil to abroad. The convertibility risk is also climbing to very high levels. It is currently at a higher level than the one that prevailed immediately after September 11. This is indeed a very concerning indicator.

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