

FRIEDBERG'S

LDC DEBT COMMENTS

Friedberg Mercantile Group



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Brazil

Summary and recommendation

Brazil external bonds: US dollar floating-rate bonds due Oct. 15, 1999. Yield to maturity: 30.4%

Brazilian external bonds offer an intriguing investment opportunity. Trading at 51 and yielding 30% to maturity, they seem to be over-discounting the possibility of default. While clearly the Brazilian economic situation is extremely serious (as evidenced by the fact that its bank debt trades at less than 35 cents on the dollar), it is also true that a clear distinction can be drawn between external bonds held by investors on a world-wide basis and bank debt. The former represent only 1.1% of Brazil's total external debt, less than 24% of its international reserves. Its normalized debt service equals less than 1% of this year's expected trade surplus.

Bank debt, on the other hand, at \$115 billion far exceeds the country's capacity to repay. Moreover it is "negotiable" face to face with a committee of banks that is already willing to make concessions. It should be noted that since 1970, when external bonds were first issued, they were always serviced punctually and in full, even while a moratorium or suspension of payments existed on bank debt.

We conclude that aggressively oriented income portfolios should accept a modest 4% to 10% long exposure to these external bonds.

External bonds

Brazilian external bonds are medium-term and long-term income securities with specific amortization schedules and maturities issued in international capital markets by both the private sector as well as the Republic. Since 1970, Brazil has issued an estimated \$4.0 billion in "hard currency bonds," mostly in US dollars. Currently outstanding are an

estimated \$1.3 billion.

Contrary to most of Brazil's foreign debt obligations, these bonds have been serviced uninterruptedly and have not been subject to restructurings. In other words, the external bonds have attained the status of *de facto* seniors in relation to the other forms of debt. Coupled with this is the fact that the requirements of servicing the external bonds are minimal in comparison with the level of available foreign exchange.

The 'new money bonds': origin and description

"New Money Bonds" in the amount of \$670 million are Brazil's first issuance of external bonds since 1982. The funds raised through this issue are part of the overall financing scheme negotiated with private commercial banks in June 1988. In the scheme, the banks have agreed to reschedule \$60.6 billion of debt and lend Brazil an additional \$5.2 billion to cover interest that is in arrears from 1987, and to cover external financing needs for 1988 and part of 1989.

Including the \$670 million of "New Money Bonds," the total amount of Brazilian external bonds is estimated at \$1.3 billion, which works out to *approximately 1.1% of Brazil's total foreign debt*. Currently, there are approximately 12 issues outstanding, of which five will mature this year, while an additional four issues are scheduled to mature by 1991.

The total stock of external bonds outstanding will be greatly reduced over the next two years, and with nominal yields so high, it is unlikely that the government will be issuing significant amounts of new bonds. Therefore, disbursements for debt service (principal and interest) are expected to decline to less than \$175 million by 1991, or less than 1% of this year's expected trade surplus.

Description of debt offered

Issuer:	Banco Central do Brasil
Issue date:	October 15, 1988
Guarantor:	Republica Federativa do Brasil
Currency:	US dollars
Tenor:	11 years, 4-year grace period, final maturity October 15, 1999.
Amortization:	Principal paid in 14 semi-annual installments of 1/14 of original face value, beginning April 15, 1993.
Coupon:	Floating rate equal to 180 day LIBOR plus a margin of 13/16%.
Payment dates:	April 15 and October 15 of each year.
Current coupon:	11 5/16%
Current price:	51% subject to change
Current yield to maturity:	30.4%
Amount issued:	670 million U.S. dollars
Credit rating:	Moody's B2

Risks

While these bonds represent only a mere fraction of the country's total external debt and therefore make default disadvantageous and highly unlikely, one cannot deny the possibility of a suspension of debt service.

In our opinion the main risk lies in Brazil's running out of hard currency reserves. According to the May 1989 issue of the IMF's International Financial Statistics, Brazil's central bank reserves at the end of the first quarter of 1988 (yes, that's the latest available number) stood at approximately \$6.7 billion. While the central bank has not published any new statistics, it is thought that reserves stood at \$8 billion at the end of 1988.

In 1988, Brazil recorded a trade surplus of \$19

billion, and for 1989 it's estimated that Brazil will record a surplus of \$17.4 billion. These surpluses should, on the surface, be sufficient to service interest on bank debt of \$115 billion.

Unfortunately, a severe flight of capital — encouraged by disastrous economic policies — absorbs a great deal of these excess dollar earnings, with the result that debt service continues to run late and is insufficient to cover the interest bill.

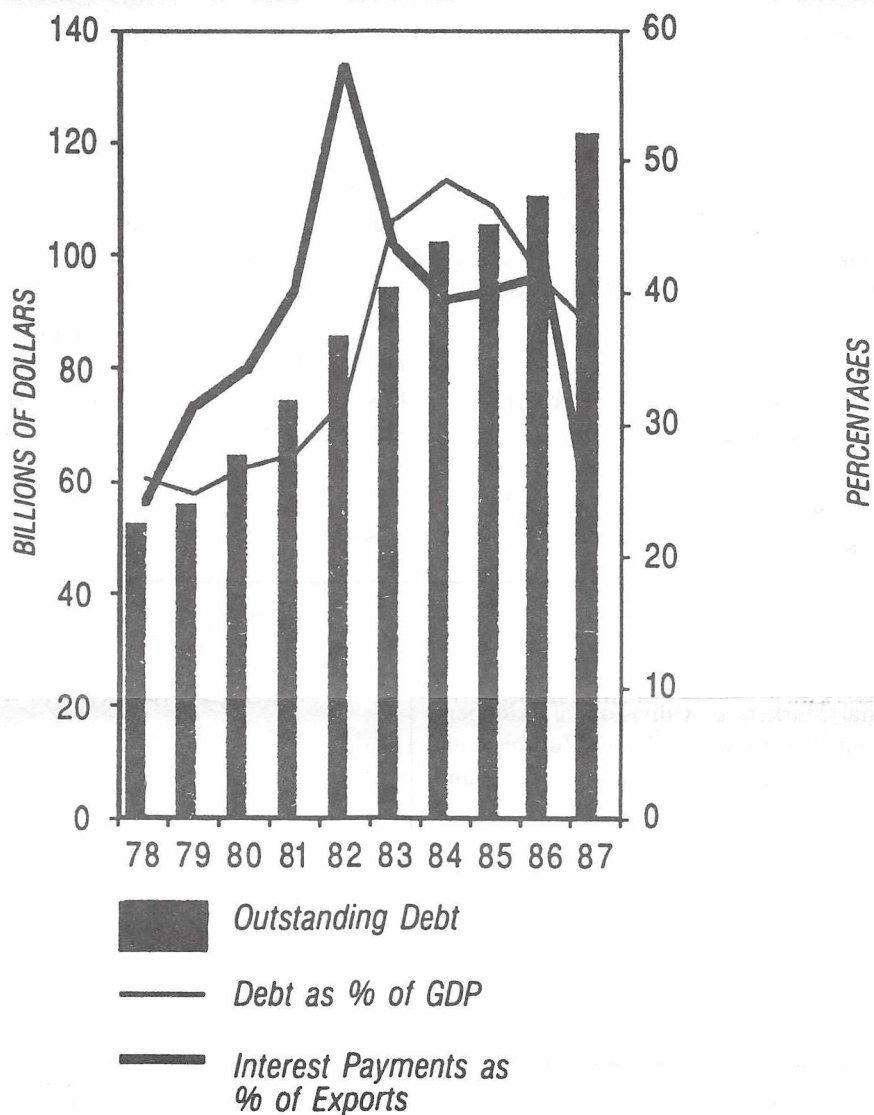
Moreover, the maintenance of a highly overvalued domestic currency (which has now gone to a ridiculous extreme, as the unofficial dollar trades at a 300% premium to the official dollar) can conceivably wipe out official reserves in a short time — as we saw in Argentina last January and in Mexico in 1987.

Consequently it would appear that for our purposes, *the most important variable is the gap between the official and the unofficial dollar*. It is imperative that the gap be narrowed — if we are to harbour realistic hopes regarding an adequate level of official dollar holdings.

The real risk is that given the currently in-

coherent and even chaotic political situation (as we move towards a year-end election), an otherwise pragmatic central bank will become paralyzed and avoid making the only realistic adjustment possible: first a massive devaluation and then a series of mini-devaluations to preserve competitiveness.

TOTAL EXTERNAL DEBT 1978-1987



	1983	1984	1985	1986	1987	1988	
Money, prices and salaries			(Growth rates)				
Domestic credit to private sector	146.1	203.4	249.0	118.8	282.6		
Money supply (M1)	97.4	201.9	304.3	306.7	133.3	289*	
Consumer prices (annual average).....	142.0	196.7	226.9	143.7	231.7	796**	
Real minimum wage	-11.4	-14.8	12.2	0.1	-27.5		
Exchange rate			(Annual Average)				
Official rate (national currency units per dollar)	576.2	1,845.4	6,204.9	13.65***	36.7***		
Real effective exchange rate (Index 1980 = 100).....	107.1	115.3	118.5	123.6	121.2		
Terms of trade (Index 1980 = 100).....			78.0	86.0	84.0	96.0	92.0
Balance of payments			(Millions of dollars)				
Current account balance.....	-6,797.8	55.4	-335.1	-4,476.0	-1,439.0	-1,275	
Merchandise balance	6,485.6	13,114.0	12,411.5	8,349.0	11,161.0		
Merchandise exports (FOB)	21,923.1	27,050.0	25,538.8	22,393.0	26,213.0	33,500	
Merchandise imports (FOB).....	15,437.5	13,936.0	13,127.3	14,044.0	15,032.0	14,500	
Net services	-13,391.4	-13,229.8	-12,901.9	-12,911.0	-12,700.0		
Transfers	108.0	171.2	154.4	86.0	100	80	
Capital account (net).....	5,542.8	4,950.8	311.7	1,774.0	3,134.0		
Change in net reserves (- = increase).....	1,872.9	-5,410.0	522.9	3,242.0	-1,695.0		
Gross foreign debt			(Millions of dollars)				
	93,600.6	102,000.0	105,000.1	111,000.0	121,300.0	114,900.0	
Interest payments on foreign debt as % of exports	43.4%	39.5%	40.3%	41.4%	21.7%		
Economic growth (percent change in GDP)	-2.5%	5.7%	8.4%	8.0%	2.9%		
*year/year - Aug 88/Aug 87							
**year/year - Oct 88/Oct 87							
***new cruzados							

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