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BRAZIL: RE-ENTRY INTO THE EUROBOND MARKET

AN OVERVIEW

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INTRODUCTION

The aim of this paper is to discuss some aspects related to the return of Brazil to the international capital market. The approach will focus on euromarkets and, more specifically, on eurobond market.

In order to provide a better understanding of the issue as a whole, mainly by readers not directly linked to this subject, the first two chapters present an overview of the market, its instruments and its participants.

Perhaps the first questions raised by the readers are "why Brazil lost access to the market" and "which events provided the conditions to return to the market." Chapter three makes a brief summary of the developing countries external debt crisis in the early 1980’s, and how it was dealt with, under the several debt agreements, culminating in the Brady Plan which brought the indebted countries back to the securities market.

Chapter four focuses on international market conditions in the early 1990’s. This section provides some industrial country economic indicators, examine the role of the developing country external debt agreements, and discuss some aspects involving investor confidence.

In sequence, the last chapter makes an overview of the domestic environment in 1991/1992, and analyzes some selected Brazilian eurobond issues.

1 - THE INTERNATIONAL CAPITAL MARKETS

The domestic capital markets around the world are quite developed nowadays. They embrace a lot of specific markets involving transactions in all kind of securities such as bonds, commercial paper, certificates of deposit, equities, derivatives, commodities, mutual funds and investment funds.

The international capital markets basically consist of the same transactions made internationally.

Hereafter, for the purpose of this paper, the text will concentrate upon the international market for fixed-income securities in order to differentiate them from the stock market.

A fixed-income security can be defined as a debt instrument whereby the issuer promises to pay the amount specified (principal or face value of the securities) at a stated future date (the maturity date). The repayment of the principal can occur in one lump sum at maturity (amortization bullet) or through periodic installments.

Moreover, when applicable, the issuer promises to pay a periodic (usually on an annual or semiannual basis) fixed or floating rate of interest (coupon) until the maturity date to the holders of the securities. Normally, the floating rate coupon, when used, is based on LIBOR (London Interbank Offer Rate) plus a spread.

The return on investment (yield) offered to the securities holders may be settled through the coupon or on a price discount basis, or in a combination of both.

The main features shared by fixed income securities issued abroad are:

- normally unsecured (non asset-backed) debt instrument;
- generally issued by large companies, financial institutions, sovereign states, public sector entities and supra-national institutions;
- issued in order to raise funds on a large scale for short, medium or long periods of time; and
- the issue is arranged and brought to the market by a large financial institution (the lead-manager) and sold by a group of investment banks and securities firms (the syndicate).

Graaf mentions that the classification used in the financial press in connection with internationally distributed debt securities is often confusing or inconsistent. Although, a large number of market experts classifies the several kinds of fixed income securities by their maturity.

The short term debt instruments are supposed to mature in less than one year and are closely linked to the money market. The most widely used short term debt instruments are:

- CERTIFICATES OF DEPOSITS (CD) - issued by financial institutions normally in zero-coupon basis (in this case, the yield is settled on a discount basis);
- COMMERCIAL PAPERS (CP) - similar to the CD but issued by non-financial corporations;

The medium term to long term fixed income securities are called "notes" or "bonds". The most common ones are:

- FIXED RATE NOTES - bonds in which the coupon is expressed as a fixed rate.
- FLOATING RATE NOTES - bonds whose coupon rate is adjusted periodically in line with the fluctuation of the interest rate used as a reference.
- CONVERTIBLE BONDS - bonds that combine fixed and variable income by attaching an option whereby the bondholders have the opportunity (at stated dates) to exchange the notes for stocks (issued or not by the same bond issuer) on predetermined terms.

The bonds issued internationally are divided into foreign bonds and eurobonds.

In a foreign bond issue, an issuer from one country issues debt securities in the domestic market of another country. The issue is denominated in the currency of the host country and with assistance of a syndicate from that country. The potential buyers are domestic investors.

Market practitioners have given foreign bond odd nicknames. The most famous one is the so-called "yankee bond" (denominated in US dollars and issued in the US market). Similarly, other foreign bonds are: "samurai" (Japanese market), "bulldog" (British market), "matador" (Spanish market), and "navigator" (Portuguese market) which are denominated in Japanese yen, pound sterling pound, Spanish pesetas and Portuguese escudos, respectively.

Eurobonds are bonds (or notes) issued in the international market (also called "euromarket"). The main differences usually cited is that eurobonds are intended for international investors and syndicated internationally while foreign bonds are for domestic investors and syndicated domestically.

The participants in any securities market (domestic or international) are issuers, dealers and investors.

The issuers are the entities that issue the securities in order to raise money to finance their investments, or, in the case of financial institutions, to re-lend the funds to other borrowers.

The dealers are financial institutions, usually large and traditional investment banks, responsible for arranging the operations and selling the securities to investors.

The investors are the buyers of the securities. The most important investors are pension funds, insurance companies, investment funds and mutual funds (institutional investors). The private investors around the world also represents a significant portion of the potential buyers in the market.

It is important to mention that there are large amounts of money deposited abroad (mainly in off-shore centers) owned by private investors. These funds are the so-called flight capital (money that ran away from a country searching for better yields or due to economic and/or political instability).

2 - THE EUROMARKET

2.1 CONCEPTS AND HISTORICAL EVOLUTION

First of all, at least two basic definitions need to be introduced:

Eurocurrecy - it is a monetary deposit denominated in a currency other than the currency of the country where the deposit is maintained. Therefore, eurodollar is a US dollar deposit held by a bank outside the United States. Currently, the main eurocurrencies are eurodollars (estimated around 80% of the total market), euromarks (German mark) and euroyen (Japanese yen).

The prefix "euro" is due to historical reasons in that the eurocurrency market was first developed in Europe. In fact, the market has grown beyond its European origins and has now become worldwide. Nonetheless, London was (and still is) the central marketplace for eurocurrency transactions.

Eurobanks - it is a generic term used to name the banks that make transactions in the eurocurrency market. For example, the London or Paris branch of a US bank engaged in the eurodollar market is an eurobank. In the same way, the Singapore branch of a Brazilian bank taking deposits in euroyen can be called a eurobank.

Geisst mentions that, in a world free of restrictions on capital movements, the euromarkets would not exist.

According to Graaf, the historical origin of the eurocurrency markets may be traced to shortly after World War II. At that time, the Soviet Union, the Eastern European countries and China choose to protect their dollar balances against "freezing orders" or other US governmental interference by transferring them from US banks to banks under their control in Western Europe.

During the early 1950s the US dollar supplanted sterling as the primary reserve currency used in international financial transactions and as the primary currency used in international trade. At the same time, the United States developed very substantial deficits in its balance of payments. Therefore, non-US corporations, central and other banks, and financial entities inevitably acquired large amounts of US dollars.

According to Bell the eurobanks (including the foreign branches of US banks) succeeded in offering competitive interest rates *vis-à-vis* the domestic banks in North America and Europe. It happened because the eurobanks were not required to observe US banking regulations regarding mandatory non-interest bearing reserves and the maximum interest payable on time deposits.

Consequently, dollar holdings were transferred to interest-bearing accounts with overseas branches of US banks and with European and other banks. Those accounts were maintained in dollars rather than in local or other currency because, due to avoidance of regulatory costs and extra risk, the eurodollar deposits paid higher interest rates.

In that environment of capital movement, a significant number of US residents also transferred deposits to banking institutions outside the USA, providing another source of foreign dollars.

Over time, the eurodollar market rapidly expanded to become an important, low cost and easily accessible source of funds. Other eurocurrencies have developed next to the eurodollar and share the same characteristics.

The eurodeposits generated interbank euroloans and commercial euroloans to end-users. These transactions were not necessarily short term loans; medium and long term loans (syndicated or not) were available as well. These loans were generally made at a floating rate of interest; the benchmark for pricing the overwhelming majority of eurocurrency loans was the six-month LIBOR (London Interbank Offer Rate).

The activity of the eurobanks through the intermediation of funds denominated in eurocurrencies was called euromarket.

Until the early 1960s, foreign borrowers raised money by issuing securities in the US market (foreign bonds). However, the American Monetary Authority, in order to reduce the flow of funds out of the USA and, thereby, to redress the balance of payments deficit, imposed several controls in the mid-1960s upon both domestic and foreign borrowers. As a result, many US and foreign borrowers turned to the euromarkets. This shift led to the creation of the eurosecurities market. Some examples of fixed-income eurosecurities are eurobonds, eurocommercial paper and eurocertificates of deposit.

This first eurobond issue was arranged in 1963 for an Italian issuer, denominated in US dollars and lead-managed by a British merchant bank.

Since then, the eurobond market has grown rapidly. As an indication of its present size, eurobond quarterly trading volume well exceeds US$ 1.2 trillion according to the Association of International Bond Dealers (AIBD).

2.2 - THE EUROBOND MARKET

Eurobond is a specific type of bond. An eurobond is understood as a bond issued outside of the country in whose currency it is denominated.

Geisst adds that eurobonds are usually denominated in one of the major eurocurrencies or, in some cases, a virtual currency such the European Currency Unit (ECU).

The main eurobond features are as follows:

- not issued on or into only a domestic market but marketed internationally;
- sold to a wide range of investors through a multinational syndicate of underwriting firms and banks;
- denominated in a currency that is not necessarily native to the investors or the syndicate members through whom the securities are sold. Therefore, investors in eurobonds take both credit and foreign exchange risks;
- generally bearer instruments to facilitate negotiability (high liquidity and, therefore, easy cash convertibility) and anonymity of the ultimate investors;
- either issued with the benefit of a stock exchange listing, normally in London or Luxembourg (although still placed with investors in various countries) and, therefore, called a "public offering", or placed with such investors without a listing (private placement).

Graaf emphasizes that in the eurobond market the buyers of the bonds, in the first instance, are exclusively financial institutions (the syndicate). Usually, eurobonds are not offered directly to the public, but are offered mostly to banks and other financial institutions for placing with central banks, insurance companies, investment funds, multinational corporations and private investors.

As any kind of activity (economic or not), investing in eurobonds implies in some kind of risk for all the parts involved.

Usually, the market measures that risk in terms of spread (premium) over the yield paid by the comparable notes/bonds issued by the United States Treasury (worldwide considered the lesser risk fixed-income securities available). Even the eurobonds denominated in a currency other than US dollar are compared to the US Treasury securities in a swap (exchange) basis.

In the issue process, the investors estimate their spread requests to taking the risk. The banks compile that information, set a spread range and discuss the subject with the issuers. The objective is to adjust the premium toward some equilibrium point that matches (as close as possible) issuer’s fund necessities and investors requirements, vis-à-vis the market conditions.

The spread is expressed in basis points (100 basis points means 1%, for instance).

3 - THE DEVELOPING-COUNTRY EXTERNAL DEBT CRISIS

World economic conditions were deeply affected by the second international petroleum crisis between 1979 and 1980, when oil prices rose 50%.

As inflationary pressures accumulated, the industrialized countries raised interest rates sharply. In connection, for example, six-month LIBOR rose from about 9% in 1978 to more than 16% in 1981.

The immediate impact of the anti-inflationary policies were:

- a contraction of the world trade;
- reduction in the attractiveness of investing in developing-country assets;

Because of their global magnitude, that events caused a retraction in international credit, reducing capital flows to developing countries and raising doubts about their repayment capacity. The combination of these effects had disastrous consequences for those countries’ balance of payments, specially the Latin-American countries which had a high level of indebtedness.

According to Paula, the developing countries were particularly vulnerable to changes in world economic conditions in the early 1980s because most of their external commercial bank debt carried floating interest rates basis. Thus, the higher interest rates caused an unexpected change in cash flow, making the previously- accumulated debt excessively large and burdensome.

In August of 1982, the international financial community experienced a crisis when Mexico’s Finance Minister announced that his country was unable to meet its foreign debt payment on time. Thereafter, more than two dozen countries followed Mexico’s example in the next 18 months, undermining the world financial market’s confidence. Thus, the capital inflows used to finance interest payments and trade deficits dried up.

The developing-country external debt crisis produced strong effects for a long period. In fact, the decade was marked by a successive restructuring of debt agreements between commercial banks and developing countries. However, considering the extreme fragility of the developing-country economies, most of those agreements failed.

Finally, creditors and debtors reached a satisfactory agreement under the so-called Brady Plan, which began started in March 1989. According to Neira, by 1994 eighteen agreements with indebted countries had been signed under the Brady Plan, involving approximately US$ 191 billion.

Mexico completed its rescheduling agreement in February 1990, Costa Rica May 1990, Venezuela June 1990, and Uruguay November 1990.

Brazil reached a preliminary understanding with its creditors in April 1991, but, the country did not conclude its agreement until April 1994.

All the bonds issued by the developing countries in exchange for debt under the Brady plan are known in the market by the nickname Brady bonds.

3.1 - THE BRAZILIAN EXTERNAL DEBT RENEGOTIATION

At the end of 1982, with a balance of payments deficit of US$ 8.8 billion and foreign reserves of US$ 3.9 billion, Brazil reached an agreement with the IMF, opening the doors to negotiations with the international banking community.

Since then, negotiations were delayed several times because did not meet previous agreements. In fact, all the agreements reached by the country prior to 1994 just postponed the external debt problem.

In 1986, due to the economic difficulties of the Cruzado Plan and to the large capital account deficit caused by substantial current account shortfalls, the level of reserves dropped sharply. This decline led the government to declare, in February 1987, a moratorium on principal and interest payments to commercial banks.

The creditors reacted immediately. The US Federal Reserve Chairman Paul Volker decided to stop negotiations with Brazil, but to go on with the other indebted countries (Chile, Philippines, Mexico and Venezuela).

In 1989, again due to internal economic problems, Brazil did not fulfill all the covenants under an agreement reached in 1988. In July 1989, the country declared a new principal and interest moratorium for medium and long-term operations.

Such actions delayed the Brazilian external debt solution for more than two years.

The relationship problems with the international community, the lack of credibility of its stabilization programs and the ineffective policies to stop inflation were reflected in the prices of Brazilian debt the secondary market. The discount rates reached more than 70%, meaning that credits were sold for less than 30% of their face value.

In fact, all the developing-country debts traded at high discount rates. It was one of the factors that led the external debt problem to a voluntary market-oriented approach implying in true debt reduction. That idea was implemented by the Brady Plan, starting in March 1989.

Mexico and Venezuela rescheduled their debt before the Brady Plan was introduced and returned to the international bond market in 1988. Mexico raised US$ 339 million and Venezuela US$ 256 million. In spite of this, those countries joined the Brady Plan and completed their agreements in February and June 1990, respectively, as already mentioned.

Argentina returned to the market in 1990, raising US$ 21 million.

Brazil began in October 1990 the last attempt to reschedule its debt. Under the Brady Plan, the country reached a preliminary agreement with its creditors in April 1991. In the same year, Brazil returned to the international bond market raising US$ 1.837 billion.

Brazil completed its bank debt restructuring package in July 1992, the Brazilian Senate approved the agreement in December 1992. The agreement became operational in April 1994 with the issue of bonds in exchange for debt.

4 - INTERNATIONAL MARKET CONDITIONS IN THE EARLY 1990's

The debt crisis virtually ended commercial banks new lending to developing countries. In the United States, for instance, the Inter Agency Sovereign Credit Risk Committee (ICERC) kept setting higher provisions for new commercial bank loans to those countries.

Besides that, the banks were reluctant to tie-up capital by making new loans to developing countries due to the uncertainty about the latter repayment capacity. Therefore, the euromarket was the only source of new money available. It was not just a question of willingness, but one of cost.

Thus, market re-entry by developing-country borrowers was typically through the international securities market (equities and fixed income instruments), and the source of funds was dominated by nonbank investors. This pattern reflected global trends toward both disintermediation and securitization.

International equity issues by companies from developing countries totaled US$ 9.3 billion in 1992 (41% of the equity issues in international equity market), compared with US$ 5.4 billion in 1991 (35%), and US$ 1.3 billion in 1990 (15.5%).

Some estimates suggested that secondary market purchases amounted to some US$ 12 billion in 1991 and US$ 14 billion in 1992, and that 28% of the total international equity flows went to emerging markets in 1992 (up from 12% in 1991). For instance, net foreign investment in the Brazilian stock exchanges increased from US$ 0.6 billion in 1991 to US$ 1.7 billion in 1992.

Nonetheless, the international bond market was the main avenue for market reentry by developing countries. Their international bond issues totaled US$ 5.5 billion in 1989, US$ 6.2 billion in 1990, US$ 12.4 billion in 1991 and US$ 23.5 billion in 1992.

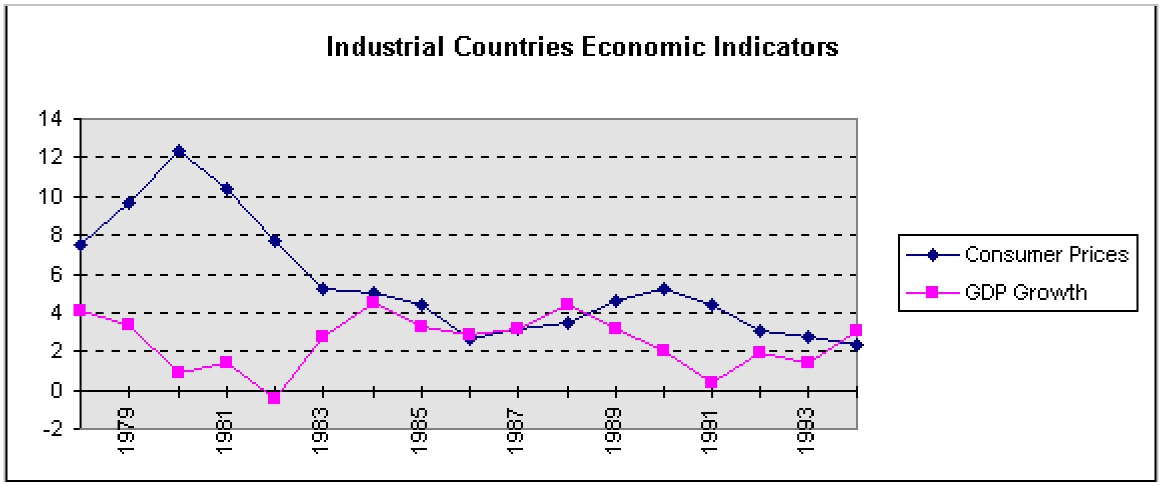
Basically, the market re-entry was through sovereign borrowers (Argentina and Chile, for instance) or high profile state-owned companies (Brazil and Mexico).

The modalities of developing-country market re-entry observed in the late 1980s and early 1990s reflected, in part, the particular international environment of that time. The main favorable factors were: the economic growth in industrial countries, the level of interest rates (mainly in the United States), the external debt agreements, and investors' receptiveness to noninvestment grade securities.

Beyond that, the market re-entry depended on particular country circumstances and on market conditions. For instance, the existence of a large pool of flight capital facilitated market re-entry by the main Latin American borrowers (mainly until 1991).

4.1 - INDUSTRIAL-COUNTRY ECONOMIC GROWTH

The inflationary phenomenon in industrial countries was controlled in the middle-1980s. Nevertheless, expecting new inflation pressures, those countries maintained real high interest rates in order to kept the economic growth under control. The chart below shows inflation and economic growth rates for the industrial countries:

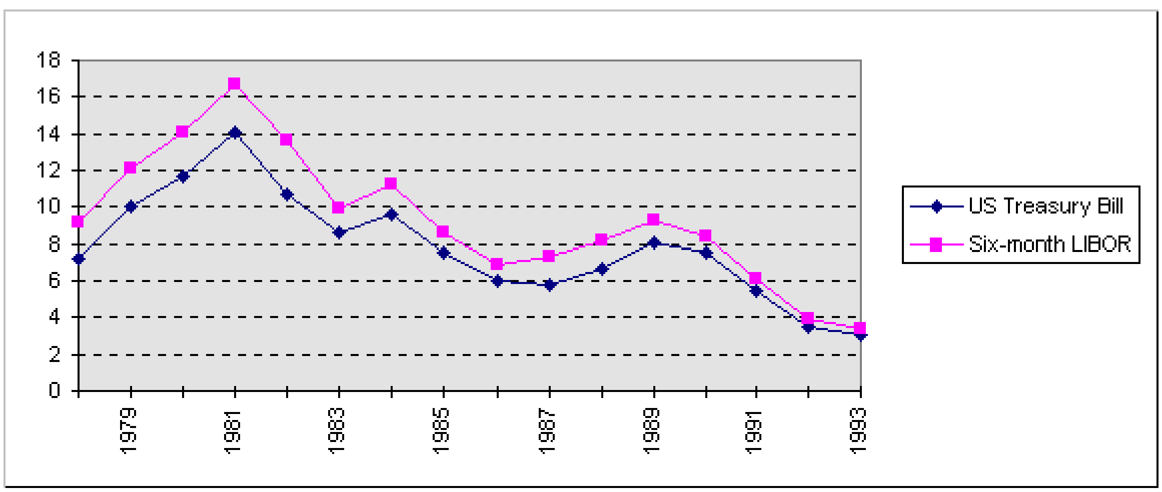


Source: IMF - International Financial Statistics Yearbook 1995

The prolonged period of slow economic growth in industrial countries dampened the demand for investment funds in many of the major markets and contributed to declining interest rates. The global environment of low interest rates and weak activity in the industrial countries encouraged financial flows to developing countries.

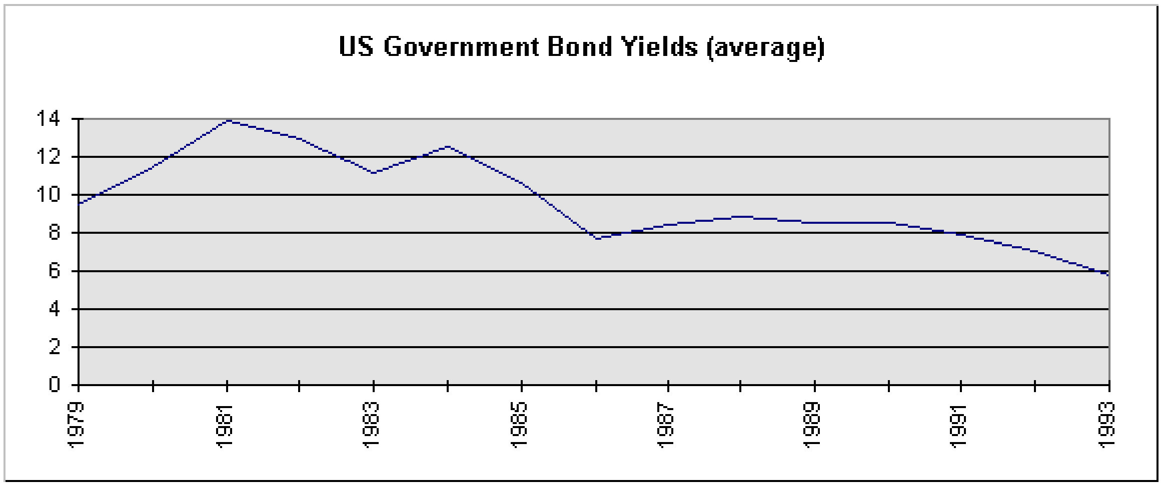
4.2 - INDUSTRIAL-COUNTRY INTEREST RATES

The nominal industrial-country interest rates declined slowly during the second half of the 1980s, following the downward trend in US interest rates. The US Treasury Bill Rate (average) dropped to 7.51% in 1990, down sharply from the record level of 14.08% observed in 1981. At the same time, the average six-month London Interbank Offer Rate (LIBOR) on US dollar deposits dropped to 8.35% in 1990 (from 16.72% in 1981). The chart below shows the evolution of these two rates:



Source: IMF - International Financial Statistics Yearbook 1995

The medium-to long-term rates also dropped. The chart below shows the evolution of the average yields provided by US Government Bonds:



Source: IMF - International Financial Statistics Yearbook 1995

In connection with interest rate reduction, international capital started seeking high-yield investment alternatives in order to increase its short-term performance goals.

4.3 - EXTERNAL DEBT AGREEMENTS

According to data from the IMF, by 1992, 16 countries (accounting for about 80 percent of the bank debt of developing countries) had restructured, or reached agreements to restructure, their bank debt under the Brady Plan. A number of other countries were actively negotiating with bank creditors on debt packages.

The amounts of medium and long-term bank debt restructured were US$ 80.2 billion in 1988, US$ 50.7 billion in 1989, US$ 28 billion in 1990, US$ 17.8 billion in 1991 and US$ 80.5 billion in 1992.

Given that the market-oriented negotiations concluded under the Brady Plan implied significant debt reduction (compared with previous failed agreements), the market was optimistic about the process providing a definitive solution for the developing countries' external debt.

Another element that facilitated re-entry in the wake of debt operations was the fact that restructurings involved securitization of old debt. This fact laid the basis for the emergence of a liquid secondary market for high-yielding instruments and attracted new investors not previously interested in developing-country securities.

Moreover, to the extent that securitization has contributed to an upward trend in the prices of existing debt on the secondary market, the yield on new debt instruments required to attract investor interest may be reduced, thus facilitating market re-entry.

4.4 - INVESTORS CONFIDENCE

The number of new issues on the international bond market reached record levels in the early 1990s, confirming the appetite for high-yielding sub-investment grade debt at that time. Improvements in the economic performance of developing countries were of key importance to this sharp turnaround in international investor sentiment

Reestablishing credibility with foreign investors hinged critically on a combination of sound macroeconomic policies centered around fiscal consolidation and market-oriented structural reforms in the developing countries.

The resulting trends toward more stable macroeconomic environment and increasingly dynamic private sectors persuaded investors that developing-country borrowers were in an improved position to service their new debt and, in the case of private sector debt, to obtain the foreign exchange needed for debt service.

Investor interest in the high returns offered by developing countries was also encouraged by the demise of other high-yielding sectors, such as the junk bond market in the United States and real estate markets more generally.

Also, the implementation of extensive privatization programs created new opportunities and helped attract large investment flows from abroad, exposing investors to emerging market securities. As a result, the institutional investors (mutual funds, pension funds and insurance companies) entered the market.

Finally, the successful experience of early re-entrants, including Mexico, contributed to improving investor confidence levels, facilitating re-entry by other developing countries.

5 - BRAZIL'S RETURN TO THE INTERNATIONAL BOND MARKET

Brazil returned to the international bond market on July 10, 1991.

5.1 - DOMESTIC ENVIRONMENT

Since the beginning of the external debt crisis in 1982, Brazil experienced erratic growth and stagnant per capita GDP. Weighed down by its foreign debt and a bankrupt public sector, and cut off from international capital, it failed to make the investments needed for sustained growth. During the 1980s, the country alternated between large GDP growth rates (9.2% in 1980 and 7.6% in 1986, for instance) and extreme recession (-4.4% in 1981, -3.4% 1983 and -4.0% in 1990).

In 10 years (1981-1991), the cumulative inflation was about 540 million per cent, the country had four different currencies and devaluation against the US dollar was about 259 million per cent.

In March 1990, Fernando Collor de Mello was sworn in as Brazil's first directly elected president since 1960. At that time the private sector was financing the government at high interest rates, on an overnight basis, and the inflation was approaching 100% per month. The new Government quickly introduced the Collor Plan, promising radical reforms like shrinking the role of the state, opening the economy to foreign competition, restoring fiscal integrity, and controlling the inflation.

The Collor Plan was the most audacious one ever implemented in Brazil. It froze all prices and wages and adopted extremely restrictive monetary (drastic reduction of the money stock by freezing 80% of the private sector's financial assets) and fiscal policies (raising taxes, increasing prices of state-produced goods and cutting subsidies).

Such measures precipitated a deep and widespread recession that shrunk real GDP by 4% in 1990.

The Collor Plan also initiated a pronounced reversal in Brazilian trade policy. The government announced its commitment to remove import restrictions and to reduce tariffs in order to minimize price pressures by stimulating competition and economic efficiency.

The stabilization measures produced some results against the inflation, but they were temporary. The monthly rates dropped at the beginning but soon they started to accelerate again. In November of the same year the monthly rate came back to 20%.

The much-promised structural reforms did not happen, mainly because the government did not have a strong political base in the Brazilian Congress, which had to approve most of the proposed reforms.

The positive effect of the first year of the Collor government was the reduction on the highly protectionist imports barriers. The fact marked the beginning of the Brazilian economic opening, promoting an impressive development in international trade over the next few years. This important process of economic opening bore fruits from 1992 on.

In 1991, the year started with another economic plan. On January 31, the Government announced the second phase of the stabilization program - the so-called Collor Plan II, including a temporary price freeze and the end of the overnight interest-bearing deposits for individuals and for non-financial companies .

In May, the Economy Minister Zelia Cardoso de Mello resigned. The Euromoney magazine mentioned that *Zelia Cardoso, although well-intentioned, had adopted a confrontional style, creating friction, making enemies and undermining the government's credibility.*

The economy minister Marcilio Marques Moreira, a former banker and diplomat, led the new economic team. His appointment was greeted with relief, at home and abroad and his two main priorities were to reduce the inflation and resolve the country's foreign debt problem.

Under the command of Marcilio Marques Moreira, the Brazilian stabilization measures came back to an orthodox strategy. The monetary and fiscal policies remained restrictive, with a substantial increase in interest rates and a new adjustment on the prices of state-produced goods. The Government also promised a rigorous fiscal discipline. As a result, the real GDP only 0.2% in 1991 and shrank by 0.8% in 1992 as shown in the chart below:

Source: IMF - International Financial Statistics Yearbook 1995

The inflation, after a record level of 2,937.8% in 1990, dropped to 440.9% in 1991. However, as the stag-inflation process was not contained, the price level accelerated again to 1,008.7% in 1992. It increased even more during the following years and was not controlled just until 1994/1995 by the Real Plan.

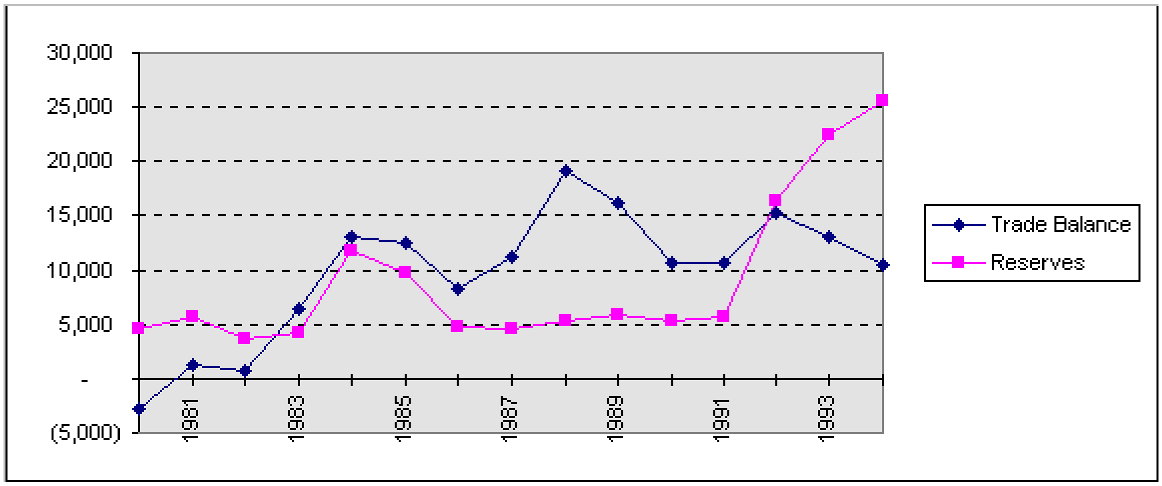
Another strategic objective of the Collor government was privatization (complementing the objective of reducing the role of the state), which could greatly improve public finances and thereby help to control inflation. The privatization program aimed at reducing the public deficit to 2,5% of GDP. However, due to strong domestic opposition, the government sold just one company in 1991 (USIMINAS - the major steel firm). The performance improved in 1992 when thirteen companies were privatized. By late 1992, the privatization program helped to reduce government debt by US$ 3 billion.

About the external performance, in July 1991, the total reserves reached US$ 9 billion (mainly due to non-payment of external debt) and the forecast for the international trade surplus that year was between US$ 13 billion and US$ 15 billion.

At the same time, the country was proceeding with its external debt negotiation with the IMF and foreign creditors.

In fact, at the end of 1991, the trade surplus was US$ 10.6 billion and total reserves were US$ 5.7 billion. These figures improved significantly in 1992 when the trade surplus reached US$ 15.2 billion and reserves totaled US$ 16.5 billion in December.

The chart below shows the evolution of Brazilian trade balance and total reserves in US$ million:



Source: IMF - International International Financial Statistics Yearbook 1995 and Brazilian Central Bank (trade balance of 1994).

An optimistic economic climate greeted 1992. At the beginning of the year, the government made a large ministerial reform suggesting enlargement of its political base in the Brazilian Congress. However, in May 1992, a serious political crisis emerged in Brazil blocking any economic recovery in that year. Charged with large corruption, President Collor was dismissed in October 1992 by an impeachment process.

The economic recovery started in 1993. Since then, Brazil has reached reasonable economic growth rates (4.1% in 1993 and 5.7% in 1994).

5.2 - THE RETURN

Brazil returned to the international voluntary bond market arena on July 10, 1991 (launching date) through an eurobond issued by Petrobras, the state-owned oil company, led by Chase Investment Bank Limited.

The main characteristics of the issue were:

- amount: US$ 250 million;
- issue date: August 2, 1991;
- maturity date: August 2, 1993;
- option: call August 2, 1992 at par;
- term: 2 years;
- coupon: 10% payable semiannually;
- issue price: 94.0388%;

- yield to maturity: 13.5% p.a.;
- spread over US Treasury: 659 basis points.

Euromoney magazine considered the PETROBRAS issue to be the main event of the year related to Brazil.

Bittencourt reported the sentiment expressed by Jorge Jasson, a vice-president of Chase Manhattan Bank in New York, about the operation just one day before the launching date. Jasson said: *Tomorrow, Chase will be launching the first Eurobond for PETROBRAS in more than a decade. It is really a bond, no hedging, no guaranty, no collateral or receivable attached. It is not a commercial paper but a real Eurobond. It is not a Brazilian CD, not an interbank corporate deposit, but really a corporate issue. And the good news is, we were thinking about US$ 100 million deal, but given the institutional investors' appetite, we are moving up to US$ 200 million".*

The above comments show the importance of the operation to all the parts involved (issuer, lead-manager, investors and Brazil). A real straight eurobond meant that the international market was accepting the Brazil risk again, providing new voluntary money without any credit enhancement.

The deal surpassed the expectations. When the Petrobras eurobond came out, it was a US$ 250 million deal.

The company paid a premium of 659 basis points over the comparable US Treasury Note. Three months earlier, the Mexican equivalent of Petrobras, Pemex, was able to issue a US$ 125 million bond for two years, paying just 316 basis points over the comparable US Treasury Note.

Thus, the market considered Petrobras bond as an alternative investment in Latin America. According to sources from Chase Manhattan Bank, the bond reached global distribution. That was not an issue targeted for retail. Rather, Chase placed the notes with institutional investors in several countries in Europe, in the Far East and in Latin American countries other than Brazil.

At this point, it is important to record that, when Mexico returned to the international bond market in 1988, it had to offer around 800 basis points spread, implying in yield to maturity more than 17% p.a.

Another evidence about the success of the deal was the price performance in the secondary market. Chase established a fixed reoffer price to assure stability at the beginning of the secondary market transactions. After a short time, the lead-manager confirmed its confidence in the deal by bidding the notes at the reoffer price.

The term of the issue (2 years) reflected the maximum term accepted by the market in order to take the risk. The investors looked at the company (size, core business, managing, etc.), but they also considered the country economic instability and the next presidential elections in 1994 (within 3 years).

Robinson added that the investors bought the Petrobras bonds because they realized that a default by the largest Brazilian company would cut the country's access to the market for more 20 years. Thus, the Brazilian government would care to protect Brazil's interest in the international bond market.

Besides Chase Manhattan (the lead-manager), 10 other traditional banks joined the syndicate. Credit Suisse First Boston (CSFB) and JP Morgan acted as co-lead managers. Bear Stearns, Salomon Brothers, Swiss Bank Corporation, S.G. Warburg, Banque Indosuez, First Interstate, Banque Bruxelles Lambert and Deutsch-Sudamerikanische Bank were co-managers.

By mid-1991, Mexico, Venezuela and Argentina were already back in the euromarket. Thus, considering Brazil's return, the 1980s - that lost decade for Latin American countries that began with

Mexico’s moratorium in August 1982 - finally started to look like a thing of the past.

5.3 - SUBSEQUENT BRAZILIAN EUROBOND ISSUES

5.3.1 - 1991: The state-owned company wave

Including the first Petrobras deal, Brazilian companies issued 23 euronotes between July and December 1991.The issues totaled US$ 1.84 billion and the state-owned big companies raised most of those funds (US$ 1.36 billion - 73.64%). The most important issues were:

Petrobras 10% due 1996 - it was a 5-year deal launched on August 10, 1991, by JP Morgan. This time, Petrobras raised US$ 200 million, paying a spread of 505 basis points over the 5-year US Treasury Bond.

The issuer included a 2-year call option and a 3-year put option. Thus, the market perceived that as a 3-year bond. Nonetheless, the term was longer while the spread and yield (to maturity: 12.25% and to put: 12.375%) were lower than the first Petrobras issue. It meant improvements in the investors’ risk perception and lower costs to the company.

The operation was a success. Roland Wogenodski, chief of Latin American operations at JP Morgan, said this second issue was all placed within a few hours of launching. Unlike the first deal, via Chase, the "Morgan bond" had a 144-A tranche, which allowed it to be sold in the United States, hence broadening the investors’ base for Brazilian issues .

According to JP Morgan, the US buyers were institutional investors, such as pension funds and insurance companies.

The syndicate was the same as the first issue (Chase acted as co-lead manager), minus First Interstate Bank.

CVRD 10% due 1994 - the state-owned mining company Companhia Vale do Rio Doce (CVRD) issued a US$ 200 million bond, launched by Citicorp on September 9. It was a 3-year deal carrying a 11.45% yield to maturity (spread of 491 basis points over the 3-year US Treasury bond).

The syndicate had 19 banks. Some traditional institutions, like Lehman Brothers, UBS and Banque Paribas, participated in their first Brazilian issue by joining this syndicate. It also included Unibanco, the first Brazilian bank participation in a syndicate to place eurobonds.

The operation was set originally to US$ 100 million. It doubled to US$ 200 million due to strong market demand.

The issue had a 1-year call option and a 2-year put option paying a 11.42% yield to put (approximately 518 basis points over the 2-year US Treasury Note). Thus, the investors were comfortable in taking the risk for, at least, 2 years. Nevertheless, the premium was 141 basis points lower than the first Petrobras issue (same term) that had been launched just 2 months earlier.

It is true that CVRD was considered (and it still is) by the market as the better Brazilian risk company. However, as CVRD and Petrobras are very similar companies, the comparison is valid.

Finally, it is important to emphasize that both companies were able to return to the euromarket paying much less than Mexico had to in its comeback three years earlier.

According to the lead-manager, besides institutional investors in Europe and in the United States (through 144-A tranche), private investors in Latin America also bought the bonds.

TELEBRAS 10% due 1996 - the telecommunication state-owned holding issued US$ 200 million for 5-years. Merrill Lynch brought the issue to market on September 18. The principal repayment was made by installments reducing the average life to 3.5 years.

The yield to maturity was 11.5%, or a spread of 497 basis points over the interpolated 3.5-year US Treasury Bond. It represented a slight premium reduction (compared to the previous state-owned company issues) for six-month longer term.

This issue broke the reluctance of investors about principal repayments set for dates after the presidential election foreseen to 1994.

The secondary market liquidity for this deal was lower. Perhaps, the main reason was that there was no syndicate placing the securities. Merrill Lynch alone was able to underwrite all the bonds.

5.3.1 - 1992: The banks wave

The state-owned companies paved the way for the consolidation of Brazil's presence in the international bond market in 1991.

All the issues totaled US$ 3.66 billion in 1992. The Brazilian commercial banks dominated the country's issuance that year, launching 53 out of 76 issues raising US$ 2.45 billion (67%).

Brazil has faced (for a long time) a chronic lack of medium to long term resources in order to finance a sustainable economic growth. The domestic funds, when available, are very expensive or, rather, prohibitive. Thus, as external funds usually are cheaper and longer-term, foreign capital is always welcome in the country.

In 1992 it was not different. The year was marked by deep economic and political instability. The most recent economic stabilization plans had failed, inflation resurged strongly and the government kept the domestic interest rates at high levels. Therefore, companies demanded external funds to make their investments viable or just to lower their indebtedness.

In this environment, and considering Brazil's re-entry into the international market, the Brazilian commercial banks decided to take advantage of the difference between external and domestic interest rates by borrowing funds abroad and re-lending them domestically. By this mechanism, the banks were able to provide funds at lower costs to the Brazilian companies.

Most of the eurobond issues in 1992 happened during the first semester because the second half of the year was very confused due to political instability. Some issues among the largest ones in 1992 were:

Banco Frances e Brasileiro (BFB) - the subsidiary of the French bank Credit Lyonnais raised US$ 110 million for 2 years. Credit Lyonnais, the mother company, brought the issue to market on March 13. The issuer paid a 11% yield to maturity (spread of 516 basis points).

According to the lead-manager, institutional investors in Europe, particularly investment funds, bought most of that securities.

CVRD 9% due 1995 - in its second issue, CVRD was able to raise US$ 150 million for 3 years. The bonds carried a 9.06% yield to maturity and were launched on April 5 by Chase Manhattan Bank .

The premium was the lowest one up to that point and the lowest one of the whole year: 318 basis points. Compared to the first Brazilian issue, the cost was 341 bps less. Undoubtedly, it reflected a significant improvement in investor perception of the Brazilian risk.

Banco do Brasil 9% due 1995 - the state-owned bank raised US$ 200 million for 3 years. CSFB brought the issue to market on April 14 brought. Banco do Brasil paid a 9.57% yield to maturity, meaning a spread of 395 basis points over the 3-year US Treasury Bond.

This one was the first 3-year straight eurobond issued by a 100% Brazilian commercial bank. Once more, a state-owned company contributed to expanding the maturity for Brazilian issues.

Unibanco 10.5% due 1995 - launched on April 22 by Citicorp, it was a US$ 100 million deal for 3 years. Unibanco paid a 10.65% yield to maturity (spread 475 basis points).

Unibanco was the first Brazilian private bank to issue a bond maturing in 3 years.

Others important private banks that came to the market in 1992 were: Bradesco, Banco Bamerindus, Banco Economico, Banco Nacional e Banco Real.

5.4 - THE BRAZILIAN EUROBOND BUYERS

This is the most difficult issue to track, for several reasons. The banks in the syndicate were sometimes the buyers, either because they manage their own portfolio with some Latin American high-yields risks, or because they buy securities on behalf of private clients and/or companies.

Thus, the banks normally do not discuss details about their client base, out of fear that this would help their competitors.

Another reason bankers have to be careful about naming buyers is that the bonds are mostly issued in bearer form in order to protect investor identities. With bearer bonds it is much more difficult for an issuer to identify the buyers, and so to try reschedule payments. In the eurobond market, any default means default to all the market instead of specific lenders (like in the bank loans). Therefore, the consequences for issuers are much more serious because the access to the market may be blocked.

Given such set of constraints, maybe the banks do not tell the truth.

When asked about the types of investor or distribution of the bonds by region, the banks frequently provide similar answers. One example of standard information is: "most of the bonds were placed with institutional investors in Europe and United States (when the issue has a 144-A tranche). Some portion was placed through retail sales in Europe, Latin America and Far East".

Bittencourt researched Brazilian eurobonds destination, by interviewing syndicate members. Focusing on bonds issued in 1991, he interviewed 40 syndicate members. The results were: 37.5% mentioned institutional investors (pension funds, insurance companies, and country funds), and 7.5% cited financial institutions. The largest part (55%) was divided among: private bank, money managers, retail and flight capital.

Concerning the bonds issued in 1992, Bittencourt expanded his research by interviewing 202 syndicate members. The results were: 27.3% mentioned institutional investors (including mutual funds, high-yield funds, and others funds), 10.9% cited financial institutions and companies. Again, the largest portion (61.8%) included private bank, retail, flight capital, money managers, fund managers and private investors.

In fact, all the buyers last mentioned (private bank, retail, flight capital, money managers, fund managers) can be classified as private investors. And private investors can be related to flight capital.

Bittencourt also mentions a study by an European bank saying that 70% of Latin American issues ended up bought by the flight capital. In the case of Brazilian eurobonds, some market sources estimates that flight capital accounted for as many as 80% of all buyers.

The estimates for Brazilian flight capital overseas in the early 1990's varied widely, from a minimum in the US$ 20 billion range to a maximum of around US$ 80 billion. Bittencourt concludes that, if flight capital buyers indeed took as much as 80% of Brazilian euroissues, the second figure seems more plausible. But nobody really knows the precise figure.

In spite of uncertainty about Brazilian bond buyers, there is no doubt that capital flight represented an important role in the process of Brazil re-entry into the international bond market.

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