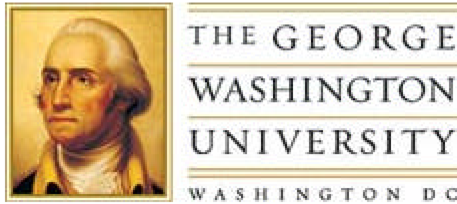

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Sovereign Risk: A Study on the Brazilian and Mexican Economies

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1. Introduction

The growing economic and financial integration, the expansion of globalized markets, and the intensification of international trade and capital flow between countries, which are characteristic of globalization, have demanded increasing adjustments on the part of organizations and investors to the new market contexts.

These changes have generated the demand for all kinds of information, at an international level, to subsidize the making of decisions, both for less complex decisions and for the definition of investment strategies, activity diversification, mergers, acquisitions, and market performance. In this context we identify the information produced by risk classification agencies.

Although much of this information can be generated by the investors themselves, its development would burden the already scarce resources available in organizations, and would not guarantee the quality, initiative and opportunity the company established with this purpose should offer.

The number of countries that resort to the international credit market, the difficulty in comparing macroeconomic data, and the complexity and diversity of these countries' economies make the task of sovereign risk evaluation excessively expensive, individually, for most investors.

In this context, risk classification agencies emerge – internationally famous entities that dedicate themselves to qualifying the risk of organizations and countries.

These agencies and their classification are an important component of the dynamics of international financial markets. Until some years ago, large international banks were the main capital suppliers of governmental entities. Nowadays, with the use of bonuses and bonds, fund raising instruments instead of union loans, the group of creditors is bigger, more evenly distributed geographically, and heterogeneous.

For the purpose of the present study, we will consider only the classification named “sovereign risk” that corresponds to the evaluation of the capacity and will of a government to pay off its debt within the stated periods of time and stipulations agreed upon with creditors, at the time the loan contract was signed.

First of all, we will present the main risk classification agencies, their purposes, origin and performance. Secondly, we will comment on the methods of sovereign risk analysis and the main aspects considered in the attribution of risk, which in most cases are coinciding among the classification agencies.

This study includes an analysis of the evolution of macroeconomic variables in Mexico and Brazil, from 1980 up until today. The impacts on the Mexican and Brazilian financial systems will be substantiated. As conclusions of this study we will show: a) whether attaining the level of investment is a cause or a consequence of economic adjustments; b) what adjustments are necessary to maintain the progress achieved in Brazil; c) possible impacts of country risk classification on the financial system, mainly on retail banks.

It is not the objective of the present study to perform statistics or probability projections. This paper will be developed under the perspective of economic facts, their effects, and possible projections when facing the evidence of previous events, from an empirical point of view.

2. Risk Classification Agencies

Financial transactions are marked by information asymmetries between resource investors and borrowers. The borrowers have more control over their will and capacity to pay the loans requested. From the creditors' point of view, this information is missing and these asymmetries will burden the premium for the inherent risks to any credit operation or acquisition of financial bonds.

The concretization of financial transactions are only possible when the negative weight of the asymmetries can be minimized, such as: gathering and processing previous information, signing contracts and following their implementation up, formalizing guarantees in case of possible default due to a debtor's insolvency or bankruptcy etc. These mechanisms generate costs and business parties involved do not always work efficiently to overcome these phases.

The lack of legal-judiciary or institutional instruments to oblige compliance with contracts and the execution of guarantees, the information asymmetry and the high costs charged due to credit risks, to an extreme extent, make the carrying out of financial operations unfeasible.

The credit risk classification (*rating*) agencies or organizations – private and public – gather and process information before operations. As units that generate information for an exclusive purpose, they develop specific competences and generate scale and scope economies in analysis and credit risk classification activities, making them commercially and economically viable.

The presence of rating agencies constitutes a necessity so that the supply of financial resources is not restricted to banks, organizations with specific competence in collecting and processing data related to the quality of their clients. The capital market – shares and negotiable credit bonds in secondary markets – in turn, due to the distance and impersonal nature of the relationship between investors and fund raisers, needs the services of a rating classification agency.

2.1 Main Agencies

The most important credit risk classification agencies in the world are: Moody's Investor Service, Standard & Poor's and Fitch Ratings, of which the first two hold around 80% (eighty percent) participation in the market.

Moody's (Dun and Bradstreet Group), Standard and Poor's (McGraw Hill Group) and Fitch Ratings (IBCA, Fitch, Duff and Phelps, Thomson BW and Fimalac France Group) agencies operate on global scale, and are more present in most countries where there is an established capital market. These rating agencies are recognized as Nationally Recognized Statistical Rating Organizations (NRSRO) by the Securities and Exchange Commission. Other four agencies in the world have the same classification.

In Brazil, the rating attribution is also performed by a few independent national companies, such as SR Rating, Atlantic Rating and Austin.

2.2 Moody's

Moody's was founded in 1900. In that same year John Moody & Company published Moody's Manual of Industrial and Miscellaneous Securities, which provides information and statistics on stocks and bonds of financial organizations, government agencies, manufacturing, mining, utilities, and food companies.

Moody's expressed his conclusions using rating letter symbols, adopted from the mercantile and credit rating system that had been used by credit-reporting firms since the late 1800s. By 1924, Moody's ratings covered nearly 100% (one hundred percent) of the American bond market.

During the great depression, Moody's continued to publish and monitor ratings, when bond default rates skyrocketed except a few bonds highly-rated by Moody's

missed payments. In the 1970s, Moody's ratings were further extended to the paper trade market and to bank deposits.

In addition to its ratings services, Moody's published an investor oriented credit research, including in-depth research on major debt issuers, industry studies, special comments and credit opinion handbooks. Moody's maintains offices in most of the world's major financial centers. The firm also has expanded into developing markets through joint ventures or affiliation agreements with local rating agencies.

Currently, the ratings and analysis track debt cover more than 100 sovereign nations, 12,000 corporate issuers, 29,000 public finance issuers and 96,000 structured finance obligations.

2.3 Standard & Poor's

Founded in 1860, when Henry Varnum Poor began to offer financial information, at a time when Europe sought more information on its position in the recently developed American infrastructure. The primary doctrine that ruled Poor's reference publications on investments was "the investor has the right to know".

In 1941, a merger between Standard Statistics and Poor's publishing happened, originating Standard & Poor's. The company was purchased by McGraw-Hill Companies Inc., in 1966.

Standard & Poor's currently provides financial information on American companies, debt ratings in bonds of sovereign ratings companies. Besides, S&P attributes ratings to securitized financings, transactions with bonds guaranteed by insurances, letters of credit, financial solidity of non-American insurance companies, bank holdings, financial guarantee companies, index monitoring systems and databases with standardized information about open capital companies.

Standard & Poor's composes the world's financial infra-structure, operating for over 140 years providing independent benchmarks so that investors all over the world can make financial and investment decisions more confidently.

2.4 Fitch Ratings

Fitch Ratings was founded by Fitch Publishing Company on December 24, 1913 by John Knowles Fitch. Fitch Publishing Company began by publishing financial statistics; its consumers included the New York Stock Exchange. Soon, the Fitch Publishing Company became a recognized leader in providing critical financial statistics to the investment community through such publications as the "Fitch Bond Book" and the "Fitch Stock and Bond Manual".

In 1924, the Fitch Publishing Company came up with the now familiar "AAA" to "D" rating scale, to meet the growing demand for independent analysis of financial securities. In 1989, Fitch Ratings was recapitalized under a new management team. Throughout the 1990s, Fitch Ratings grew in all areas, including a new group of structured finance, by providing investors with original research, clear explanations of complex credits, and more rigorous surveillance than the other ratings agencies.

In 1997, Fitch Ratings merged with IBCA Limited, located in London, what significantly increased Fitch Ratings' presence worldwide and coverage in banking, financial organizations, and sovereigns. Through the merger with IBCA, Fitch Ratings became Fimalac's property, the holding company which acquired IBCA in 1992. This merger represented the first step in Fitch Ratings' plan to meet investors' need for an alternative, global, full service rating agency.

The next step in building Fitch Ratings into the global competitor was the acquisition of Duff & Phelps Credit Rating Co., located in Chicago, in April 2000. This was followed by the acquisition, later that year, of the rating business of Thomson Financial BankWatch. These acquisitions strengthened Fitch Ratings' coverage of the

corporate, financial institution, insurance and structured finance sectors, and added a significant number of international offices and affiliates.

In October 2006, Fitch Ratings launched Derivative Fitch, the first specialized rating agency designed to provide the credit derivatives market with ratings, research, analysis, and evaluation services to address the unique needs of the market. The company's goal is to enhance understanding and improve market transparency in the growing credit derivatives sector. Derivative Fitch comprises over 100 professionals in New York, London and Hong Kong.

3. Ratings made by Specialized Agencies

The purpose of risk classification is to express a technical opinion, which is both specialized and independent, by the application of a specific methodology that has qualitative and quantitative aspects, on a credit profile to be evaluated. They do not, however, represent investment recommendations or a probability of raise in the price of the issuer's papers, or the risk of financial loss via nominal exchange devaluations. In terms of sovereign risk, the agencies only judge the possibility of the country's government failing to comply with contracts with international creditors.

The ratings are identified through symbols, with the attribution of identification numbers and letters. The rating classifications are divided in two major groups according to the level — investment grade and speculation grade. The former contemplates investments considered to be low risk credit and the latter refers to investments where there is higher default risk.

In general, the classifications are variations of the scale A, B, C, D. In the S&P and Fitch scales, the best classification is "AAA" and the worst, "D". In Moody's scale, the best classification is "Aaa" and the worst is "C". The worse the classification, the greater the probability of moratorium and vice-versa. Governments classified above "BBB-" or "Baa3" are called "investment grade", while the ones classified below that are called "speculation grade" (Canuto and Santos, 2003).

In order to differentiate governments in a same category, S&P and Fitch adopt arithmetic signals (+ and –), and Moody's uses numbers (1, 2 and 3). The higher (AAA and Aaa) and lower (CC, Ca, or lower) categories do not receive such differentiation symbols. A frequent procedure to make ratings comparable is the transposition of the risk classification scales to a numeric scale. Table I shows the transposition proposed by Bathia (2002).

TABLE 1 – Scale of Risk Classification

	S & P	Fitch	Moody's	Numeric Scale
NVESTMENT GRADE	AAA	AAA	Aaa	1
	AA+	AA+	Aa1	2
	AA	AA	Aa2	3
	AA-	AA-	Aa3	4
	A+	A+	A1	5
	A	A	A2	6
	A-	A-	A3	7
	BBB+	BBB+	Baa1	8
	BBB	BBB	Baa2	9
	BBB-	BBB-	Baa3	10
SPECULATIVE GRADE	BB+	BB+	Ba1	11
	BB	BB	Ba2	12
	BB-	BB-	Ba3	13
	B+	B+	B1	14
	B	B	B2	15
	B-	B-	B3	16
	CCC+	CCC+	Caa1	17
	CCC	CCC	Caa2	18
	CCC-	CCC-	Caa3	19
	CC	CC	-----	20
	C	C	-----	21
	SD	DDD	Ca	22
	D	DD	C	23
	-----	D	-----	24

3.1 Outlooks

The agencies' expectations towards the future of rating are pointed out through the so-called Outlook, which can be positive, negative or neutral. It represents the

probable directions of rating changes in a near future, although there is no commitment to fulfill these expectations, and no established deadline for them to occur.

Concerning sovereign risk, when a possibility of change is verified, the agencies can insert it *em separata*. Moody's qualifies this position as a watch list and offers the possible direction of the classification in the next 90 days, which can be reviewed and upgraded, reviewed and downgraded, or remain indefinite. Fitch's list is called *RatingAlert*, and S&P's list is called *CreditWatch*, with a positive, negative or indefinite character.

3.2 Methods

Agencies can classify a debtor, as well as a specific paper it issues, establishing no necessary relation between them. A paper with guarantees and legal instruments that give it liquidity may be better classified than its issuer.

In relation to the currency the debt is in, the classifications can be relative to the obligations in national or foreign currency. As for the loan term, the classifications can be divided into long-term and short-term obligations, with these defining the bonds that are due in less than one year.

A research carried out by the IMF identified that the classifications do not derive from a statistic model able to determine the probability of moratorium (IMF, 1999). The contextualization of the will to pay debts introduces a subjectivity that makes these models little efficient in evaluating sovereign risk. The classification is the result of an interdisciplinary work that conjugates the analysis through quantitative methods with the sensibility of the qualitative parameter analysts (Moody's, 2003b), while great emphasis is given to the latter.

Normally, the classification process comprises three phases: i) evaluation of the current state of affairs, ii) quantification of evaluated factors, even qualitative, through a "grading model" and iii) decision on the classification by means of the votes of a

committee, based on the analysis of the data collected in (i) and (ii) (Canuto and Santos, 2003).

The evaluation of the situation starts with a technical visit to the country whose risk will be analyzed. Besides meetings with government representatives, specialists talk to market analysts, journalists, scholars and of opposition parties. In the meetings with the government, they extend their understanding of government policies, especially the fiscal and monetary ones. The next phase is the creation of reports based on the information collected, macroeconomic data and projections, accompanied by recommendations on the classification to be given. The report is previously distributed to the members of the committee.

The committee is the main instance in the process of rate attribution. The grading model guides these meetings. Its indicators are openly discussed among the members, and are then punctuated through votes. The comparison between countries with similar classifications – independently of their location – with the purpose of avoiding discrepancies is another point of relevance in the committee meetings.

Precisely for this reason, the composition of the committee is very heterogeneous; it has analysts from many countries and regions, and from relevant private sectors, as well as analysts who are specialized in the country being evaluated.

The main agencies' grading model can be consolidated in five general categories: i) political, civil and institutional risk; ii) real sector; iii) monetary and financial sector; iv) foreign sector; and v) fiscal sector. The values of each category offer the total points of the quantitative evaluation. The quantitative factors are evaluated based on the committee members' personal experience and knowledge. The assessments are interdependent, including the evaluation of the categories in general, for one of them may interfere in the others and vice-versa. The categories and factors were specified by Canuto and Santos (2003), who built the table in Annex 2.

The projections of many macroeconomic indicators are important in the grading model. In the case of S&P, the main projections considered are: nominal GDP *per capita* (in dollars), real growth of the GDP *per capita*, nominal result of the government in general/GDP, general net or consolidated debt of the government/GDP, gross expenditures with gross interest/income, inflation measured by the index of prices to the consumer, gross necessity of external financing external/international reserves, net foreign debt of the public sector/income of bank accounts of the balance of payments, and net foreign debt of the non-financial private sector/income of bank accounts of the balance of payments (Bhatia, 2002).

The projections of the real and monetary sector are built using the IMF's and the *Consensus Forecast*, by Consensus Economics, medium-term scenarios. The agencies shape the projections for the total internal and external public debts, which are the final results of debt sustainability exercises. The basic scenario for the sustainability simulations is set by considering the specialized analysts' subjective evaluation, supported by the committee members, and not by a wide-ranging econometric model of macroeconomic projections. The premises consider more conservative variations of the official projections or the IMF to build alternative sceneries (Bhatia, 2002). Sometimes the agencies openly or reservedly condition a classification upgrade to the approval of reforms to improve the long-term perspective of public debts. This was the case of S&P, when elevating the classification of Mexico in 2001 from BB+ to BBB – after the approval of the tax reform, which at the time led the country to the category of "investment grade".

Although their criteria are similar in the attribution of ratings, it is not rare to find differences between the agency classifications, especially in the "non-investment grade" category. According to Cantor & Paker (1995), of all ratings issued by S&P and Moody's in September 1995, only 67% of the sovereign ratings in the AA/Aa category or above received the same classification by both agencies, while this number dropped to 56% in other investment grade classifications, and to 29% only in the speculation grade.

4. Mexican and Brazilian Economies – Similarities

An analysis of the Brazilian and Mexican economies since the 1940's allows us to conclude that we have made the same options in macroeconomic policies, at non-coincidental, but at almost the same periods of time.

Mexico and Brazil chose the substitution of imports for national products, and to make this policy possible protectionist models were adopted which aimed at strengthening national factories. In this same context, investments in vital economy sectors were made possible by the governments by means of foreign debts, especially in the infra-structure sector (transportation, energy, sanitation, telecommunications), whose amounts were significant and whose profit was not attractive for private investors.

To be able to obtain financing, governments resorted to foreign capital, and the numbers of the public foreign debts exposed the countries to the rumors of the international market. Successive external crises, with the consequent devaluation of national currencies, indicated that the option for foreign capital brought the advantages of fast economic growth, experienced by both countries, but also represented a heavy burden for citizens.

Both countries experienced macroeconomic crises in the beginning of the 1980's, as a consequence of the international petroleum crisis, the scarcity of foreign capital to finance investments, and a possible inability to make agreed payments due to the elevation of international rates, especially after Mexico passed a moratorium of its foreign debt. The facing of the macroeconomic crises during the 1980's followed the same model, which predicted:

a) The devaluation of the national currency, aiming at increasing exports and balance payments, accumulating reserves to pay off the debt.
b) The incentive of local production, since importing goods and services hindered the development of the country's factories;

c) The control of inflation by setting fixed prices and the government's intervention in typically private economic sectors;

The result of the policies adopted also brought the same kinds of effects to both countries, and can be summarized as the following:

a) The adoption of a fixed exchange rate exposed the countries to crises in the financial system and forced the implementation of specific programs to recover the banking system;
b) Inflation rates, after making the rules imposed by the government more flexible, became out of control, reaching unimaginable levels. In Brazil, inflation rates reached 84.32% per month. In Mexico, it reached 15.46% per month.
c) The raise in foreign exchange rates had immediate consequences on the countries' foreign debt balance, forcing governments to adopt a restrictive investment policy to keep up with their payment commitments.
d) The raise in the economy's real interest rate and the emission of indexed bonds, to fulfill the need to attract domestic and foreign capital to finance the central government's budget deficit.

Since the 1990's, both Mexico and Brazil adopted similar macroeconomic policies which sought, first of all, to stabilize prices, recuperate the financial systems, control inflation and restrain government budget deficits.

One of the main economic events, both in Mexico and Brazil, was the economic opening. Both countries' integration to the international market, made possible by the signing of free trade agreements, and the elimination of import barriers, caused a true revolution in the internal industry sector. The need for international competitiveness, in terms of price and quality, forced companies to reevaluate their processes.

The control of public expenditures was one of the measures taken by both countries to reduce inflation and the exposure of the domestic economy to international crises. The generation of successive surplus, in Brazil, and the balance of public

accounts, in Mexico, show the commitment of the central government in promoting the necessary adjustments to guarantee economic stability.

Both countries adopt similar strategies to manage public debt, substituting the issuing of papers indexed to the American currency for the emission of bonds in local currency. In this same way, they act effectively on the reduction of the foreign debt. The debt profiles of both countries currently indicate the success of this initiative.

The macroeconomic adjustment programs considered the privatization of public companies as one of the ways to reduce the government's presence in activities that are not within its competence. The unburdening of the government with the costs of these structures and the amounts collected with the privatization process were factors indicated as essential to reduce government expenditures.

Both countries had to clear up their local financial systems, as a consequence of the crisis in exchange and also the lack of control rules and monitoring of the activity. The programs adopted by the countries shared the same premises, which consisted of the acquisition of credits of difficult recovery, and the cleaning up of banks. Similarly, the programs opened the financial activity to foreign capital entities, allowing the entrance of transnational organizations in the market, through mergers and acquisitions.

5. Mexican and Brazilian Economies – Differences

Some characteristics of each country's economy do not allow the adoption of the same measures to maintain economic development. Among the main differences identified between Brazil and Mexico, we highlight their tax policies as deserving a closer look.

Mexico's adhesion to NAFTA brought undeniable benefits to the Mexican economy, for the country became one of the USA's major trade partners. Physical proximity, low production costs and service to the world's greatest consumer market turns the flow of North-American investments mainly towards the Mexican territory. The foreign investment flow into Mexico is one of the most consistent among emerging economies, and is anchored on the business expansion made possible with the signing of international agreements.

On the other hand, comparing the export flow between both countries, we conclude that the close relationship between the North-American and Mexican economies turns the latter vulnerable to possible consumption crises in the neighboring country. The configuration of the Brazilian foreign trade, diversified among the European Union, China, the Middle East, Latin America and the USA, allows greater protection against an eventual economic crisis in one of these export destinations.

From the fiscal point of view, Mexico has a difficult task ahead, which is to reduce its dependence on the petroleum sector, as a preventive measure for a possible production crisis or volatility of the price of this commodity. Mexico's tax-collection rate is one of the lowest in the world and this deficiency has been compensated by the state petroleum company that, due to the transfers to the government, has had its investment capacity reduced year after year.

The maintenance of Mexico as a petroleum exporter passes necessarily through the national petroleum company's investment capacity, since the increase in production is linked to drilling petroleum from extremely deep waters, which demands significant

investments. The alternative would be to open the market to international companies. This measure would face strong resistance from the political and social sectors, since having a national petroleum sector is seen as a matter of sovereignty and is part of Mexico's ideology.

On the other hand, the concentration of productive activities in large economic groups limits the expansion of Mexico's fiscal basis. In Brazil, the limitation is of a different nature, since the country has one of the highest tax-collection rates among the countries with similar economies. The exploitation of more consistent productive nets allows the fiscal basis to be more widespread and gives government accounts greater consistency.

The adjustments to be made in Brazil show the need to cut down on expenditures to maintain the current budget levels or to raise revenues that, facing limitations to increase revenues, would be connected to the country's economic growth. New reforms would have to be implemented to change this situation and, among them, tax and social security reforms are the most important.

Government analysts and technicians indicate the adoption of new forms of tax collection as a way of fighting fiscal elision and evasion. In this sense, it would be necessary to review labor relations, through a proposal of reform in the labor legislation, since the number of Brazilians working in the informal economy has increased year after year.

Thus, it is relevant to point out that Mexico, after a period of apparent inertia before the necessary reforms, approved in April of 2007 the social security reform, and last September, the text for the fiscal reform that, among other measures, establishes a gradual cut on expenditures in the next five years and will result in the reduction of 20% of total public expenditures by the end of this period.

Regarding the low level of public debts, a relevant difference must be mentioned between the Mexican and Brazilian economies. In 2000, when Mexico was upgraded to

the category of investment grade, its net public debt was of approximately 20% (Graph 5), while in Brazil this relation is still around 45%. Besides, the Mexican debt level is below the emerging countries' average (35%).

6. Mexico's Economy in the Last 25 Years

Since the 1980's, Mexico has been seen as a reference in economic restructuring processes and structural adjustments. As a consequence of the 1982 economic crisis and the exhaustion of the industrial model of import substitution, the country adopted a new economic model, promoted the opening of its market, reduced the control over direct international investments and the financial market, and implemented an aggressive privatization program.

The economic liberalization allowed important and necessary changes in that Country, such as the adhesion to the General Agreement on Tariffs and Trade (GATT), in 1986, the signing of NAFTA (North American Free Trade Agreement) with Canada and the United States in 1994, and the adhesion to the OECD, Organization for Economic Co-operation Development, in 1996. These agreements made business expansion and the attraction of foreign capital possible. Mexico became a major trade partner to the USA, second to Canada only. In 2004, Mexico lost the second place, in function of China adhered to the World Trade Organization in November, 2001.

Consequently, foreign companies oriented to exporting, national conglomerates and companies, allied to the transnational conglomerates, became the main source of economic growth.

Long-term reforms and the orthodox macro-economy did not guarantee growth rates or economic stability throughout the decades of 1940 to 1970. On the contrary, they elevated the economic vulnerability to external events and the volatility of short-term investments was one of the causes of the financial crisis experienced in the years 1994-95, caused by the speculative attack to the Mexican currency.

The high rates paid to attract investments, to cover the costs of the fragile banking system and to reduce inflation withdrew resources from the economy to generate jobs and the adoption of high technology to guarantee the competitiveness of Mexican products. The legacy of the crisis was the growth of internal and foreign debts,

weakness of the banking system, greater discrepancy in the distribution of income and reduction in the capacity of the state to invest in infra-structure.

6.1 Market Opening

The opening measures sought to convert the private sector into the axis of economic development, acting with competitiveness in global markets. The expansion of the domestic and international markets to Mexican products, and the increase of Mexico's opening, mainly because of NAFTA, increased direct international investments in Mexico in approximately 70%.

Nowadays, Mexico has individual free trade agreements with over 60 countries around the globe, including the European Union and Japan. This makes Mexico one of the most economically open countries in Latin America.

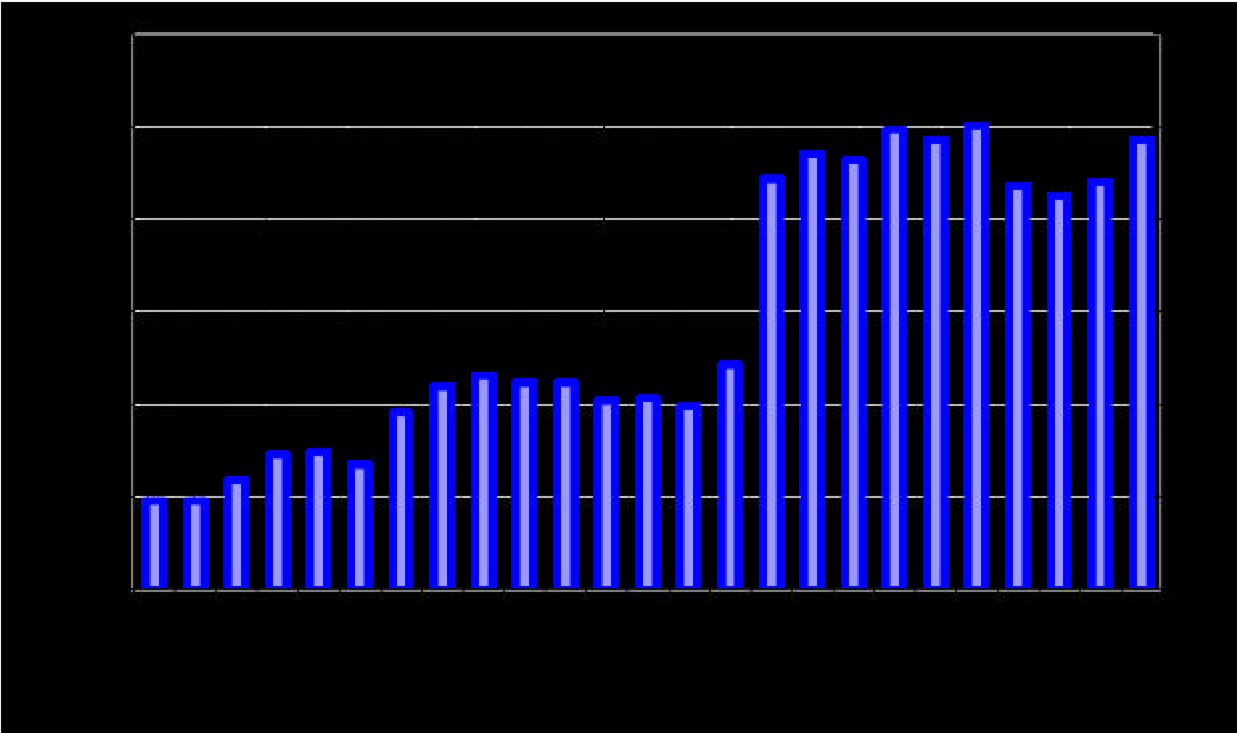
The impact of free trade in the industry began in 1965, with the establishment of free trade zones in the north of Mexico for tax free importing of components which were assembled in Mexico and exported by means of special programs. These programs became known as *maquiladoras* and became the main source of industry jobs, and the second main source of foreign exchange.

The program was very advantageous for the United States, for it allowed the reduction in production costs. Since 2002, the *maquiladoras* ceased to be low technology and manufacturing factories to become advanced technological centers, using qualified technicians, engineers and managers in their workforce.

The alterations adopted to liberalize the market to external competitors, and more recently the adhesion to the North American Free Trade Agreement, reflected upon the composition of the GDP, but was particularly noteworthy in terms of diversifying exporting. The trade flow, which represents the exporting and importing of goods and services, showed a relevant growth since 1994, when NAFTA became valid

(Graph 1). Since that date, the external sector became the main guide of the Mexican economy growth standard.

Graph 1 – Chain of Commerce (exporting + importing) the percentage of the GDP



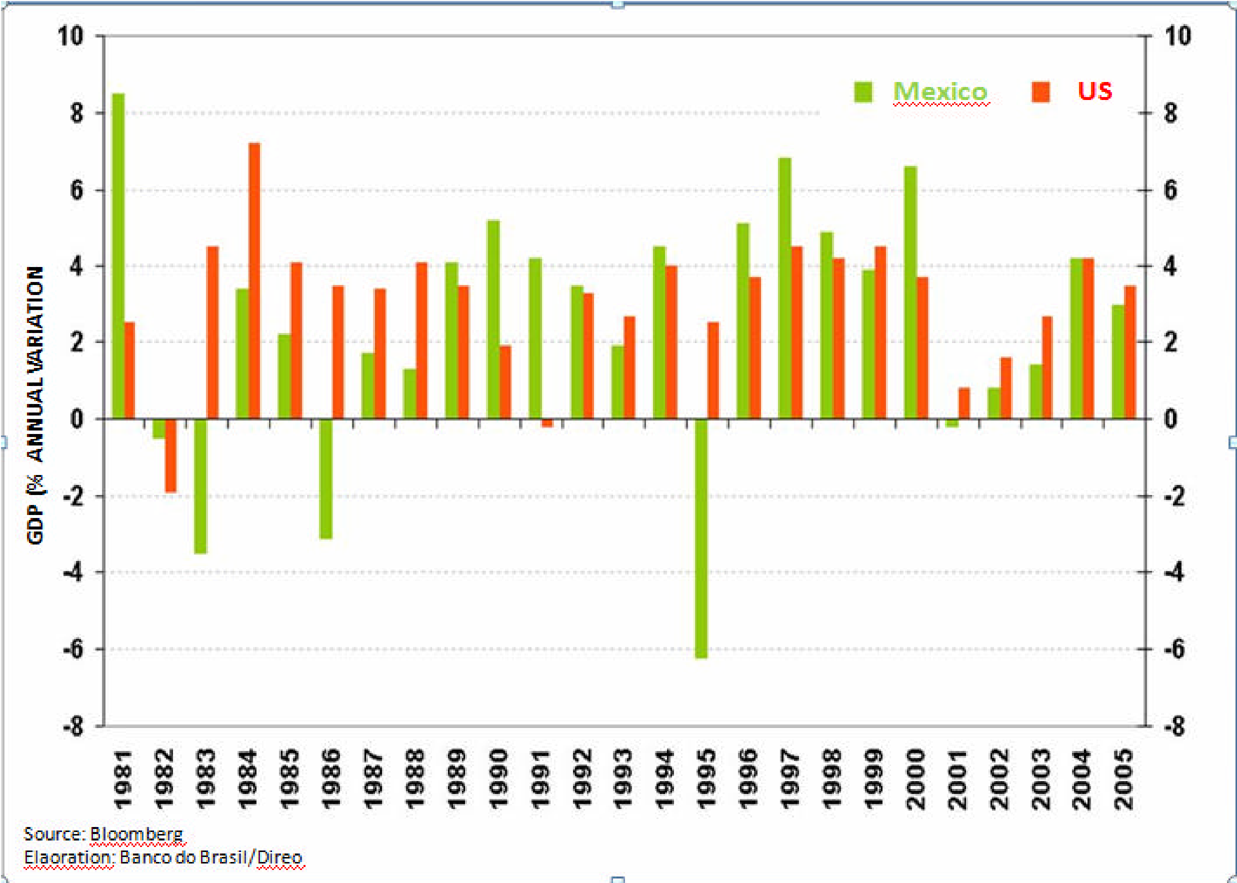
6.2 Economic growth

Although successful from the point of view of economic opening and increased quality and competitiveness of Mexican products, the adhesion to NAFTA and the increment of exports to the USA, mainly, created a greater dependence of the American cycle than before the signing of the Agreement (Graph 2). Between 1996 and 2000, the Mexican GDP growth rates were, in average, greater than the USA's.

However, with the North-American economic deceleration in 2001, there was a significant retraction in the level of economic activity. Another negative aspect is that increasing the participation of foreign trade in the GDP could not motivate a greater and more dynamic growth, able to include the other sectors of the economy through spillover effects.

In 1995, the Mexican GDP was significantly affected by the country's external crisis, as shown in Graph 2.

Graph 2 – Mexico and the US: growth rate of the GDP



6.3 Fiscal Policy

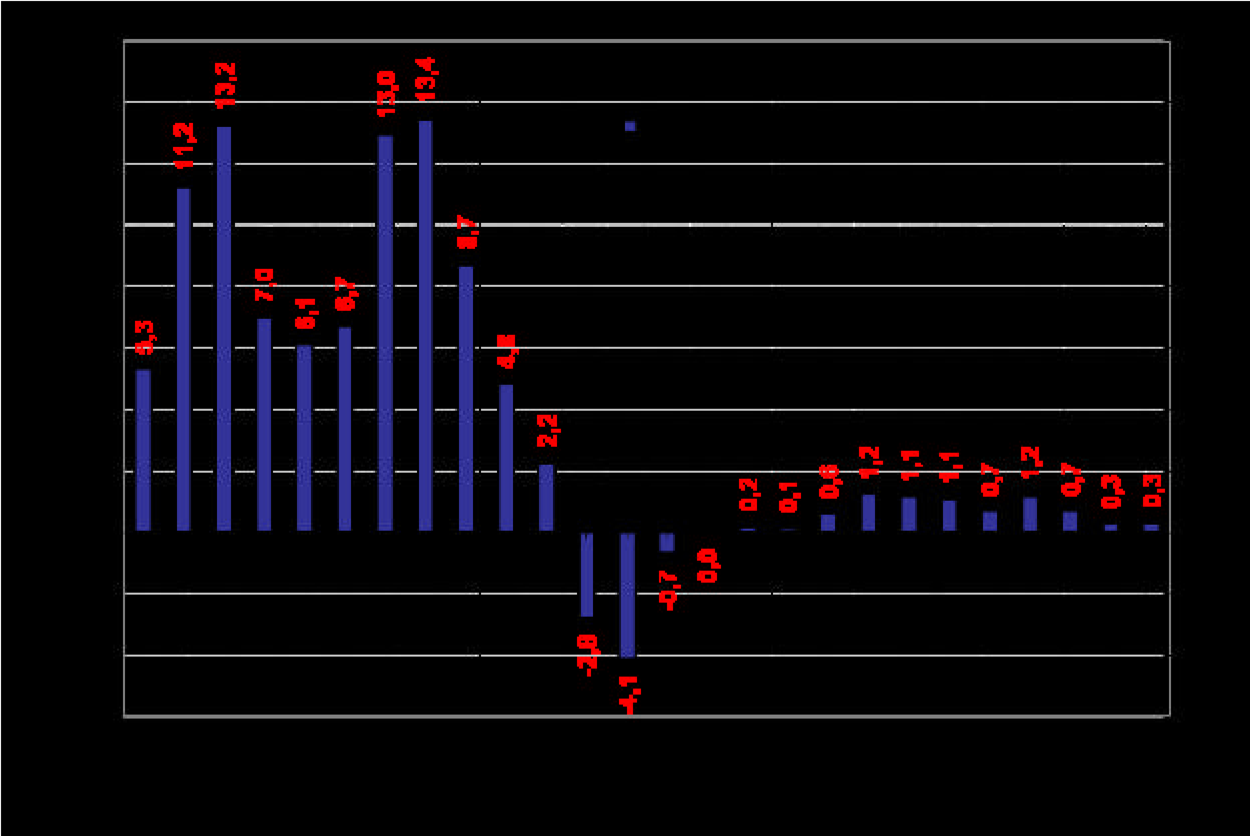
Currently, Federal government financing is greatly supported by income from petroleum activity funds, *i.e.* by the taxes collected by the State petroleum company Pemex – Mexican Petrol, which, in 2004, represented 36% of the country's income. In the same way, the transference of reserves by Mexicans living abroad has highly contributed to balance the Federal government's accounts.

Since 1982, the Mexican government has been trying to solve the problem of fiscal deficit through successive reforms of the national tax-collection system. However,

the efforts have not been enough to generate significant increase in the collection of federal taxes. The adoption of restrictive measures to public investments has been more efficient, but it has faced increasing criticism from the point of view of restriction to economic growth, due to the lack of public investment in essential activities (mainly infrastructure).

From a macro-economic point of view, the fiscal adjustment was successful. The generation of primary surplus by the government and the consequent decreasing need of financing of the public sector have contributed fundamentally to reduce the macro-economic vulnerability. The strict control of expenditures has kept the Federal public administration accounts near balance or with reduced deficit (under 1.5% of the gross revenue) in the last ten years (Graph 3).

Graph 3 – Primary Result of the Federal Public Sector



6.4 Fiscal Basis

Mexico has one of the lowest tax-collection rates among the countries that form the Organization for Economic Co-operation and Development (OECD). Tax collection is affected by the lack of tax payments which means two per cent in relation to the GDP and by the exemption policies that reach five per cent (Randall, 2006). Low tax-collection rates also derive from the government's choice to cut expenditures instead of increasing revenue.

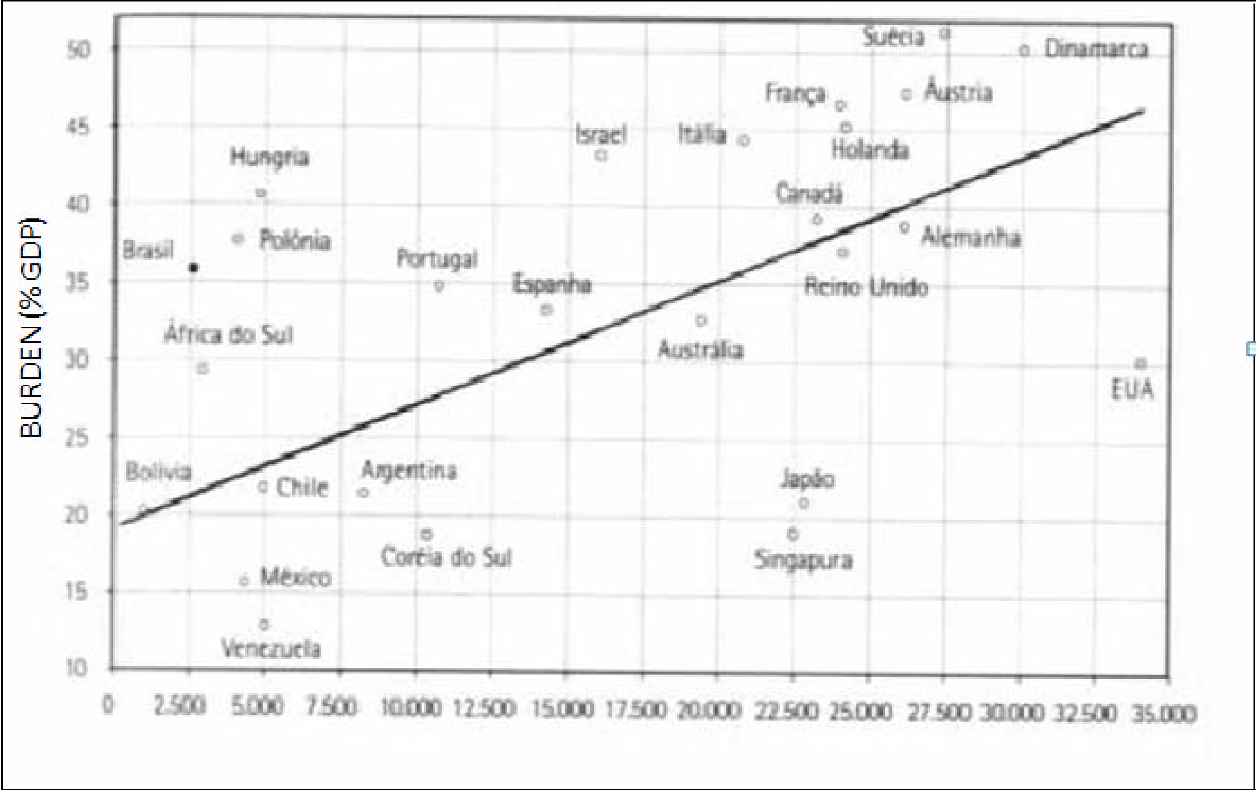
During the last 20 years, no significant change has been made by the Mexican government in its revenue collection system. The number of exceptions was reduced at the beginning of the 1990's, but a more relevant exception regarding gasoline and diesel oil has been kept. The total amount of public revenue has been strongly influenced by the price of petroleum and the value of the Mexican *peso*, which hasn't negatively influenced the government's budget planning. The impact of fiscal policies in the petroleum sector has affected its capacity to invest in maintaining the level of reserves.

The fiscal policy adopted by the government has hindered the capacity to invest in sectors that are essential to economic development, as well as consumed the necessary resources for policies in social issues. Poverty, social inequalities, access to education and health are but a few of the problems that have evolved recently in Mexican statistics. As shown before, the greatest weakness of Mexico's public finances is the country's weak tax-collection basis and its high dependence on revenue generated by tax collection on petroleum production and exporting. The country is a liquid exporter of the commodity in the global market.

Graph 4, from a study by Rodrigues and Varsano (2004), shows that countries with higher income per capita tend, in average, to present higher tax-collection rates. Mexico holds the 2nd lowest place in fiscal duty in GDP percentage among all the analyzed countries, being overcome only by Venezuela. Countries with higher income *per capita* similar to the Mexican economy, such as Poland and Hungary, present significantly higher tax-collection rates (Graph 4).

If on one hand this limitation is positive as it attracts investments, on the other it has restricted the Mexican state's capacity to improve the country's infra-structure and offer better living conditions to the poorer segment of the population. In the years between 2000 and 2004, the costs of investments represented approximately 0.35% of the Federal government's total expenditures, an inferior level to that verified in Brazil, which showed an average of 0.7% in the same period.

Graph 4 – Comparative Tax Burden of Sample of Countries for per Capita Income



The recent approval of the fiscal reform proposed by the Mexican government tends to improve the flow of tax collection by the federal government, at the same time reducing the currently existing exemptions and creating taxes on fuels.

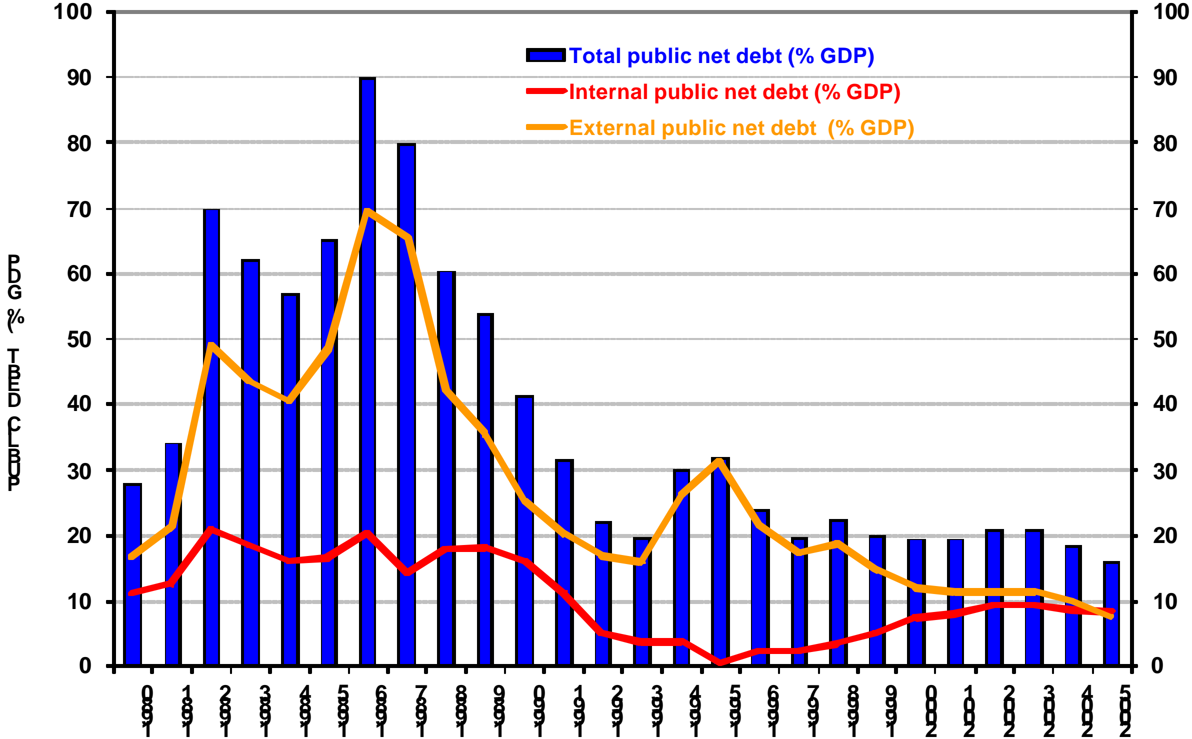
6.5 Public Debt

The government's expenditures control has been a predominant factor for the total net debt of the public sector to maintain itself at a relatively stable level – around

20% - since the middle of the last decade (Graph 5). Debt management allowed the reduction of the net foreign debt (NFD) in 32% of the GDP in 1995 to 7.7% in 2005. In relation to the total debt, the foreign debt dropped from approximately 80% to about 38% in the same period of time.

Active debt management enabled Mexico to change its debt profile. Currently the country shows better external solvency conditions and a decrease in its vulnerability to global capital flow cycles. Furthermore, Mexico's current debt level lies below the emerging countries' average, at around thirty-five percent (35%).

Graph 5 – Net Public Debt as a Percentage of the GNP



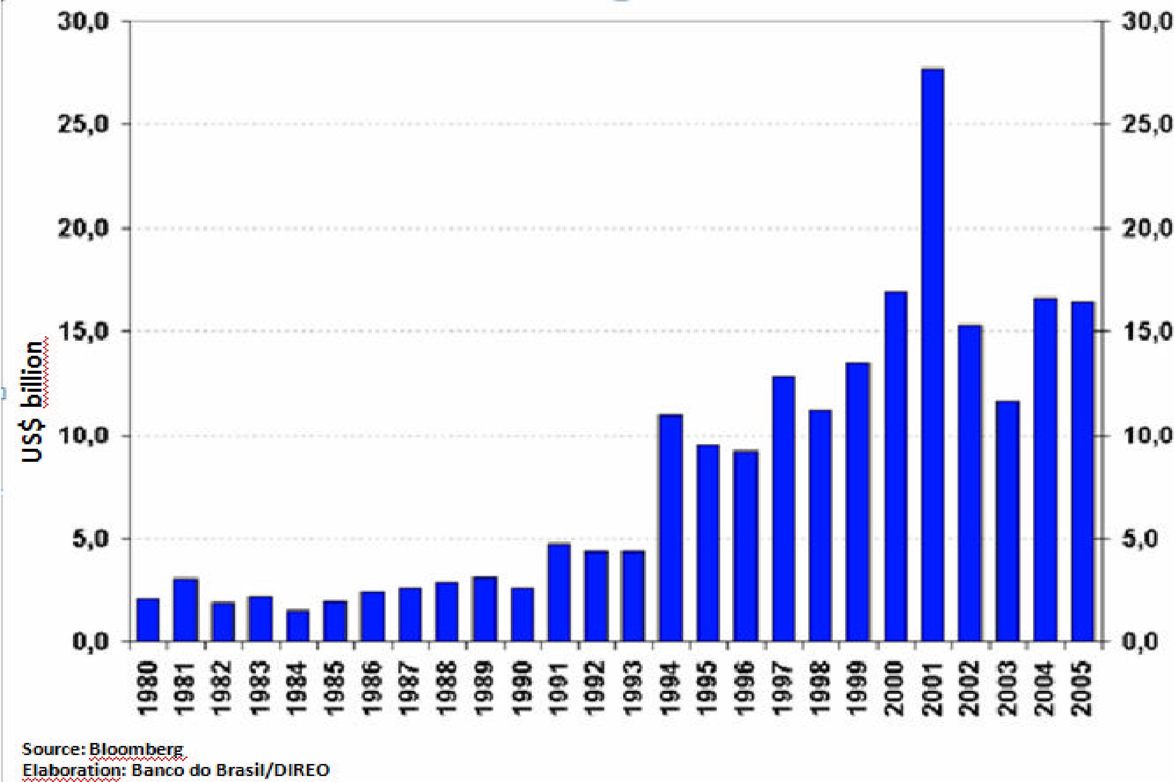
Source: Banco Central do México
Elaboration: Banco do Brasil/DIREO

6.6 Direct Investment

Following NAFTA's implementation, and also due to a more stable macroeconomic environment, the flow of foreign direct investment (FDI) into Mexico rose significantly from an average of US$ 2.9 billion yearly, between 1980-1993, to US$

14.3 billion yearly between 1994 and 2005. During the latter period, the average rose from US$ 11.2 billion yearly, between 1994 and 1999, to US$ 17.2 billion between 2000 and 2004 (Graph 6).

Graph 6 – Foreign Direct Investment in Mexico



Once again the evidence points to a close partnership with the US economy, for approximately 62% of this foreign capital had the US as its source. The capital flow originating from Spain (15% of the total) was influenced by mergers and acquisitions in the Mexican banking sector. Among the values absorbed by the Mexican economy, the manufacturing sector received the largest one, 43.6%, the highest percentage of FDI between 2000 and 2005, while the banking sector accounted for an average of 25.3%.

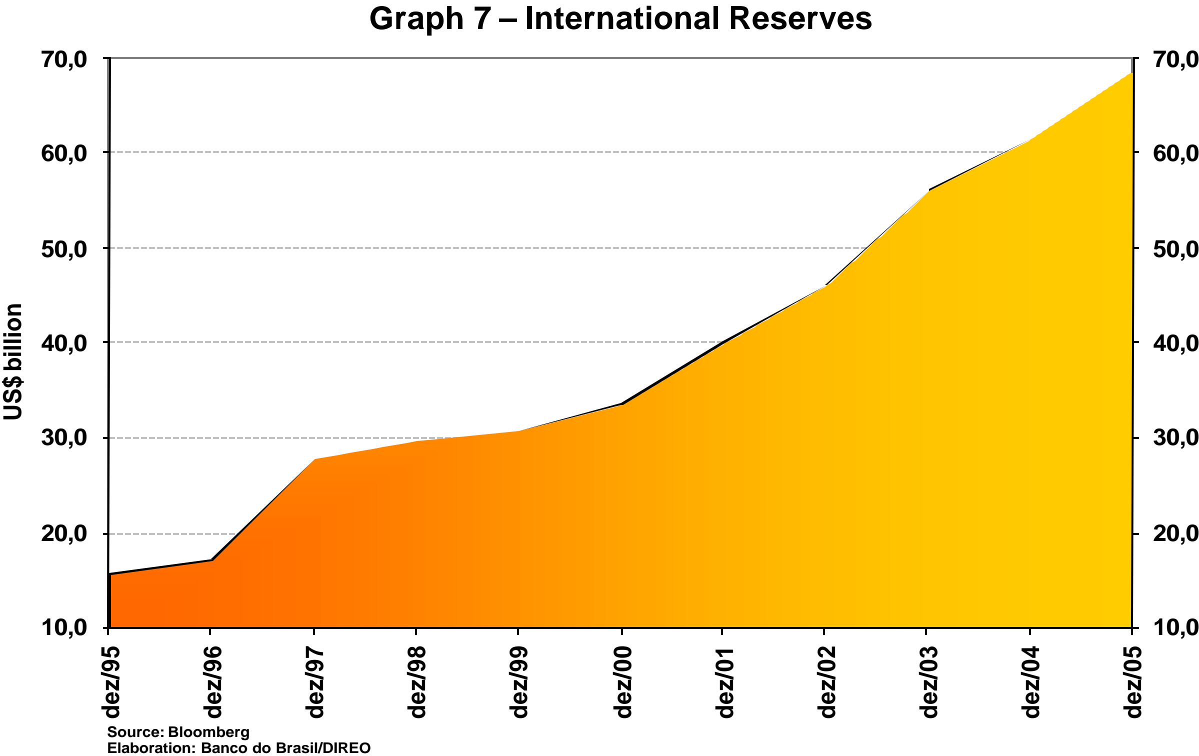
In 2004, Mexico was the biggest recipient of FDI in Latin America and the Caribbean, with approximately 35% of the total that reached that region. That corresponds to a value of US$ 16.6 billion. Moreover, the strong flow of FDI in 2001 is explained by another US-Mexico deal, the acquisition of the second largest local

financial conglomerate, Banamex-Accival, by Citigroup, which spent US$ 12.5 billion on this operation.

6.7 International Reserves

The positive capital flow of the payment balance has more than compensated for the historical bank-account deficit situation. Thus this flow has been decisive in the growth of foreign currency reserves from US$ 33.6 billion in 2000 to approximately US$ 70 billion at the end of the year 1995 (Graph 7).

Graph 7 – International Reserves

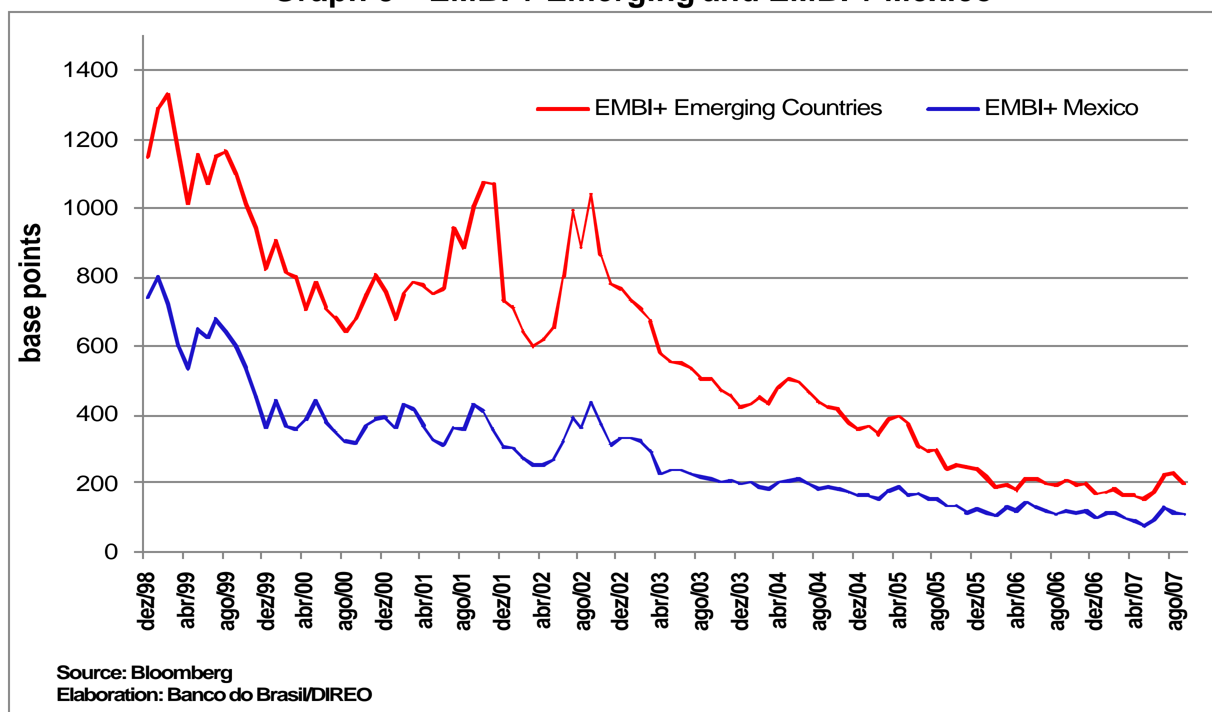


Source: Bloomberg
Elaboration: Banco do Brasil/DIREO

6.8 Country Risk

The set of changes in the macroeconomic environment listed previously – growth in commercial exchange, low levels of deficit and public debt, increase in FDI flow and international reserves – among other factors, has been crucial for the decrease in the perception of credit risk for Mexico (Graph 8).

Graph 8 – EMBI + Emerging and EMBI + Mexico



Source: Bloomberg
Elaboration: Banco do Brasil/DIREO

6.9 Financial System

Considering all sectors of the economy, a specific evaluation of Mexico's banking system is appropriate.

The Mexican financial system has gone through a series of changes since foreign debt moratorium was passed in 1982 and after the subsequent nationalization of the system by presidential decree. At that time, 43 private banks were transformed into 18 government-owned organizations and the banking sector was called upon to finance the government's public deficit.

In 1986, the "Fondo de Apoyo Preventivo para las Instituciones de la Banca Pública" was created with the objective of recuperating banking operations so as to prevent insolvency problems and to allow the operation of banks. In 1990, the Fobaproa (Fondo de Protección al Ahorro Bancario) was established to provide a complete coverage for the values deposited in Mexican banks. During President Carlos Salina's term in office (1988-1994) the "Lei de Instituciones de Crédito" (Law for Credit

Institutions) was passed with the intention of re-privatizing the banks. The first of these operations happened in 1991.

In 1994, NAFTA allowed the participation of foreign banks in the Mexican system, limited to eight per cent of the total amount of the banking system. The government sponsored a few programs that allowed the recovery of debtors and the recovery of bad loans for banks. The opening of the Mexican banking system to the international market started due to the new crisis in the system, which lasted during the following eight years.

The banking system was once again assisted by governmental aid. The programs launched after the devaluation of the *peso* had two main objectives: to help the banks pay their debts in dollar and to capitalize the system. Basically the government took over the actives and loans that would be hard to recover, in exchange for bonds or promissory notes. After this period of time, the rules of financial and banking regulation were perfected in areas such as accounting (adoption of the American accounting standards) and excellence practices in credit granting.

In 1998, the Mexican government ended all restrictions regarding the control of foreign capital in the banking system. As a result, several takeovers of local financial groups by big international banks occurred.

Nowadays, only one big *player* (Banco Banorte) is still controlled by domestic shareholders (Tables 1 and 2).

Table 1 – Ten Largest National Banks (actives 2004) – Ps$ millions

Bank	Actives	Market Share
Mercantil Del Norte (Banorte)	168,371	8.03
Banco Inbursa	87,068	4.15
Banco Del Bajio	23,755	1.13
Banco Azteca	22,809	1.09
Banco IXE	10,193	0.49
Banco Afirme	8,027	0.38
Banco Interacciones	7,684	0.37
Banregio	6,450	0.31
Invex Group	5,585	0.27
Centro	4,949	0.24
Soma Group	**344,891**	**16.46**
Financial System Total	**2,096,601**	**100.00**

Table 2 – Ten Largest Foreign Banks (actives 2004) – Ps$ millions

Bank	Actives	Market Share
BBVA Bancomer (Spain)	549,804	26.22
Banamex (Citigroup – US)	469,620	22.40
HSBC (UK)	202,832	9.67
Banco Santander Mexicana (HSBC – Spain)	174,876	8.34
Banco Serfin (HSBC – Spain)	136,192	6.50
Scotiabank Inverlat (Canada)	104,691	4.99
Bank of America (US)	31,697	1.51
ING Bank (Netherlands)	28,405	1.35
JP Morgan (US)	10,491	0.50
BE Capital (US)	6,682	0.32
Soma Group	**1,715,290**	**81.80**
Financial System Total	**2,096,601**	**100.00**

Source: Economist Intelligence Unit

Mexico's Central Bank has been trying to promote a sound development of its internal financial system. With the history of the problems mentioned above, the total of credit granted has increased nominally; nevertheless the ratio credit/GDP has presented a declining tendency. Although the banking system is more capitalized at present, Mexican banks still lack sources of long term financing.

On the other hand, multinational companies established in the Country and exporters avoid getting loans in *pesos*, and they usually go to the international market to finance their transactions. Most of the credit, in *pesos*, granted by banks has terms of less than one year.

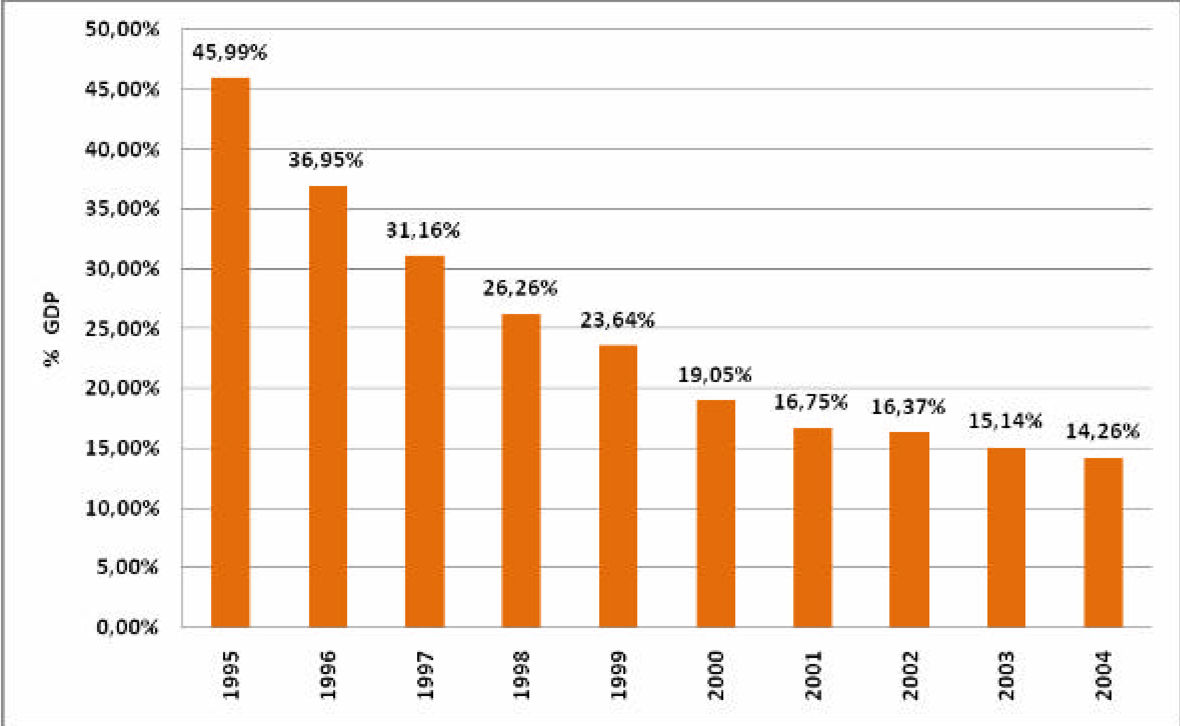
One of the factors that holds the growth of credit in Mexico back is the composition of its base of companies, characterized by oligopolies. Granting credit to small and medium-sized companies has been encouraged, but the history of payment of debts, and the inexistence of appropriate lines has hindered the increase of this kind of loan.

It is important to point out the growth of a new type of bank in the Mexican system. Banks linked to chains of retail stores, whose focus is to grant credit for consumption. In this category, we can mention the Azteca banks, connected to the conglomerate that owns the Elektra stores, one of the biggest chains of electrical appliances stores in the country. The Wal-Mart bank, connected to the biggest chain of retail stores in the world, which originated in the United States, was granted authorization to operate in Mexico in 2006. There are, also, the banks Ve por Mas (Financial Group), Famsa (Department Store), Autofin (Car Broker), Compartamos (Credit for Micro-businesses), GEA (Hospital) and Copel (Department Store), among others.

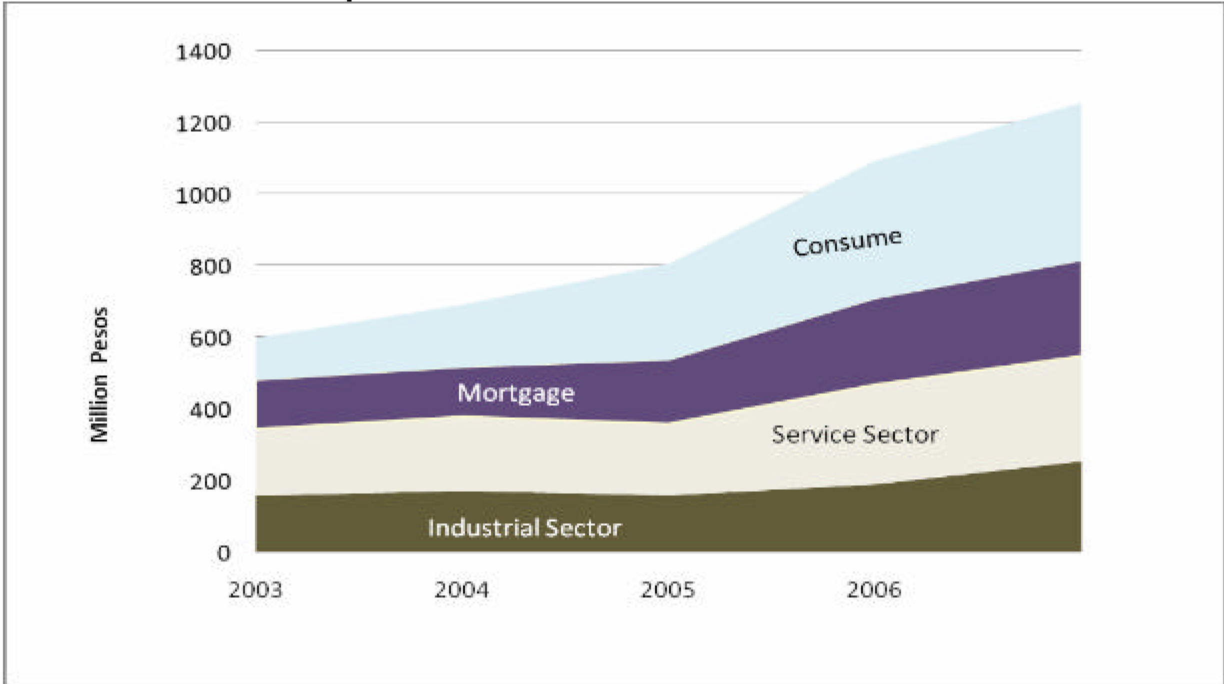
The entrance of these new banks changes the credit profile of the Mexican banks and credit to individuals grows more than other modalities. The effect of granting these new lines of credit has been minimized in the total credit of the system by the

decrease of IPAB financing, which has been substituting bank credit for market bonds. Currently, the tendency is to continue increasing the credit to consumers and to increase the offer of credit to the real estate sector, as shown in Graph 10, below.

Graph 9 – Mexico: Bank Credit – Percentage of the GDP

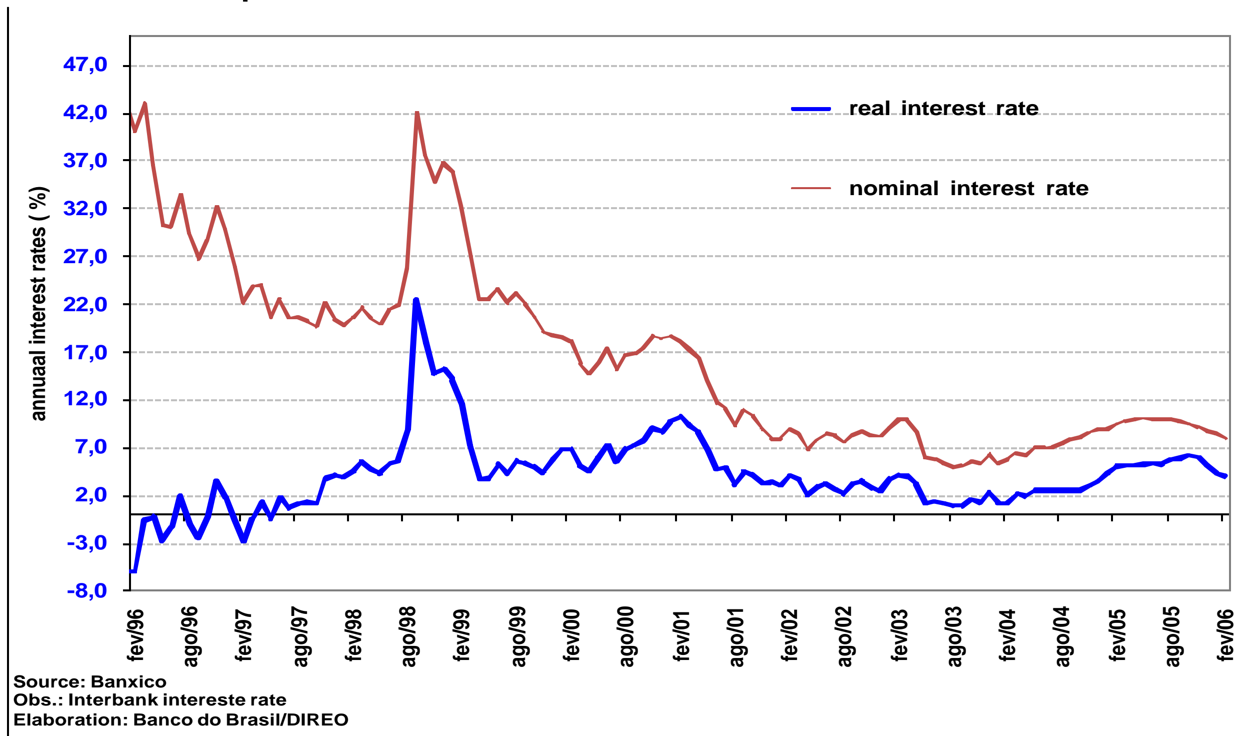


Graph 10 – Bank Credit – Recent Behavior



Another explanation for the low demand for long term credit can be found in the past history of volatile interest rates. Since 1993, when the Mexican Central Bank became independent, it has been adopting an active monetary policy of combating inflation (the goal regime for inflation was implemented in 2000). Even though the real interest rates dropped after 2000 (Graph 11), one cannot assert that this is directly related to the fact that the Country became an investment grade, especially because this period of time coincides with the North-American and Mexican deceleration. Considering the drop in the Mexican country risk factor in the international market (Graph 8), the parity condition, not covered by the interest rate, would validate this last hypothesis.

Graph 11 – Mexico: Nominal and Real Annual Interest Rate



Source: Banxico
Obs.: Interbank intereste rate
Elaboration: Banco do Brasil/DIREO

Mexico's case corroborates the expectation that the achievement of the investment grade would have implications on the measure of country risk, FDI flow and better conditions to access the international financial market. The Mexican example also suggests that the effects on the internal banking system seem to depend more on the pre-existing conditions of the sector than on the fact that the economy was classified as an investment grade.

7. Brazilian Economy in the last 25 years

Generally, a period of 25 years would not be representative enough to characterize a country's economic history. However, that is not the case with Brazil's economy, which has undergone profound transformations since the beginning of the eighties until the present day. In that period, Brazil became part of the world market, abandoned the importing substitution model and State protectionism, tamed inflation, balanced Public Finances and consequently changed the nature of the Public Debt.

We also made progress towards the stability of our currency and are close to obtaining investment grade classification by international agencies, which would allow a new flow of foreign capital, namely from pension funds, which currently are unable to invest in Brazil, due to their investment or statutory policies.

The evolution of Brazil's Economic History indicates that it has been subject to various economic plans during the course of the last century. In 1964, the Government's Economic Action Plan (called PAEG) aimed at correcting the economic distortions caused by the increase of inflation, the reduction in investments and Public/Foreign deficits. Its policies included the reform of the financial and fiscal systems, in order to increase resources to finance costs and public and private investments.

The late sixties were characterized by the recovery of the Economy and high growth rates due to favorable economic conditions internally and abroad. World trade was expanding and offered diversified lines of credit. Internally, measures were taken seeking to seize these new opportunities. Among these measures were the creation of fiscal and credit incentives towards exports, which enabled a flow of foreign capital.

The period of economic growth in Brazil came to an end in the eighties. The economic model supported by the substitution of imports in which the industrialization process occurred due to the limitations abroad. The Government's role was paramount in the protection of the internal market by setting restrictions to the importing of goods and services. The growth period was strongly supported by foreign credit and

government's investments in infrastructure needed for the expansion of Brazil's economy.

The rise of international interest rates and the disruption of the flow of foreign capital at appropriate rates and terms jointly with the second petroleum crisis caused an unbalance in Brazil's economy, called foreign debt crisis. This situation forces the government to turn to IMF for funds and for their approval in relation to the program of internal adjustments. Brazil managed to renegotiate its debts with its international creditors, as well as obtain new lines of credit, although submitting itself to the adoption of a policy of internal and external adjustments.

Goals, which included the reduction of Public Debt and the equilibrium of the payroll balance, caused severe internal impacts, and were to be achieved at the expense of the reduction of demand, loss of the population's purchasing power and the rise in inflation.

From then on, the Brazilian economy would be subject to successive stability plans. These initiatives aimed at taming inflation and balancing Public finances, which were severely damaged by the heavy weight of Domestic and Foreign debts, in order, to regain economic growth.

These plans adopted different approaches including orthodox measures, such as "freezing" prices and salaries, the adoption of new currencies, changes in the indexation rules and forfeiting contracts. Instead of assuring long term stability, these plans caused a defensive reaction from economic agents, who could not bear the instability generated by the adoption of the orthodox measures mentioned above.

Since 1990, the economic plans were established according to premises set by the IMF and World Bank – called the *Washington Consensus* – which set a three step plan to be implemented in the following order: 1) Economic stability (fight against inflation); 2) Implementation of structural reforms (privatizations, liberalization of

markets, financial and commercial liberalizations); 3) the attraction of foreign investments towards speeding the development.

Those were the main guidelines of the stability plan implemented in the early nineties. As high inflation rates showed no signs of weakness and the fiscal policy was in a critical situation (further worsened by the reduction in deadlines and the rise of the interest rates of the Public and Foreign debts), the government decided to adopt the most daring and criticized stability plan in the early nineties. This economic package was based on the premises of a provisional fiscal adjustment, prices and salaries freezes and shrinking of the monetary base by means of a financial assets blockage, which resulted in a financial chaos.

The greatest achievement of the Brazilian government was the courage to adopt a policy of promoting international competition through the elimination of the import restrictions in disagreement with previous policies. It also started the privatization process of state companies and promoted the liberalization the financial market to foreign capital, that is, laid the foundations for the integration with other markets.

Meanwhile, as previous economic plans and under a widespread political unfavorable conjuncture, the plan enjoyed a temporary success, but it was not able to attain long-term economic stability. The critical fiscal situation, the high degree of economic indexation and the pessimistic expectations of the economic agents towards the economy in general maintained a high inflation pressure.

In 1994, a new economic program was implemented – the *Plano Real* – which similarly to previous ones, aimed at controlling the fiscal adjustments that needed to be done, promoted a measure of value (*Unidade Real de Valor – URV*) that aligned relative prices and adopted a series of complex measures in the monetary policy, such as the end of indexation and contracts. The privatization process of state owned companies continued.

The acceleration of the process of commercial liberalization and the austere stand adopted at the beginning towards the monetary policy together with appreciation of Brazilian Real, were of the up most importance to the initial control of prices in the internal market through the offer of alternative imported goods.

The immediate success of the plan jointly with a drastic reduction of inflation was possible mainly due to the return of foreign capital, which supported the rigid cambial policy, as the main instrument in the fight against inflation, allowing a massive flow of short term foreign capital. However, the core of the stability program through the fixed cambial regime and the commercial and financial liberalization damaged foreign trade balance and, consequently, the balance of current transactions.

The adoption of a policy of high interest rates attracted the foreign capital and maintained prices under control, but caused a severe fiscal unbalance and raised Brazil's Foreign Debt. In this context, the conquered monetary stability and foreign capital at disposal were not sufficient to allow a sustained recovery of economic growth. The monetary and cambial stability relied on extremely fragile foundations, as well, as the Foreign Debt was subject to the humor of the foreign investors, which made Brazil highly vulnerable abroad.

7.1 Market Opening

Efforts to increase international trades, although have increased in numbers, are still very shy compared to international standards. International agreements have increased the chain of commerce in numbers superior to 100 % (one hundred percent) comparing the years of 1992 and 2005. In relative terms, the ratio chain of commerce/GDP has grown seven percent between those two years, rising the percentage to 21.74 %. The best outcome was observed in 2004, when the percentage was approximately 24 %.

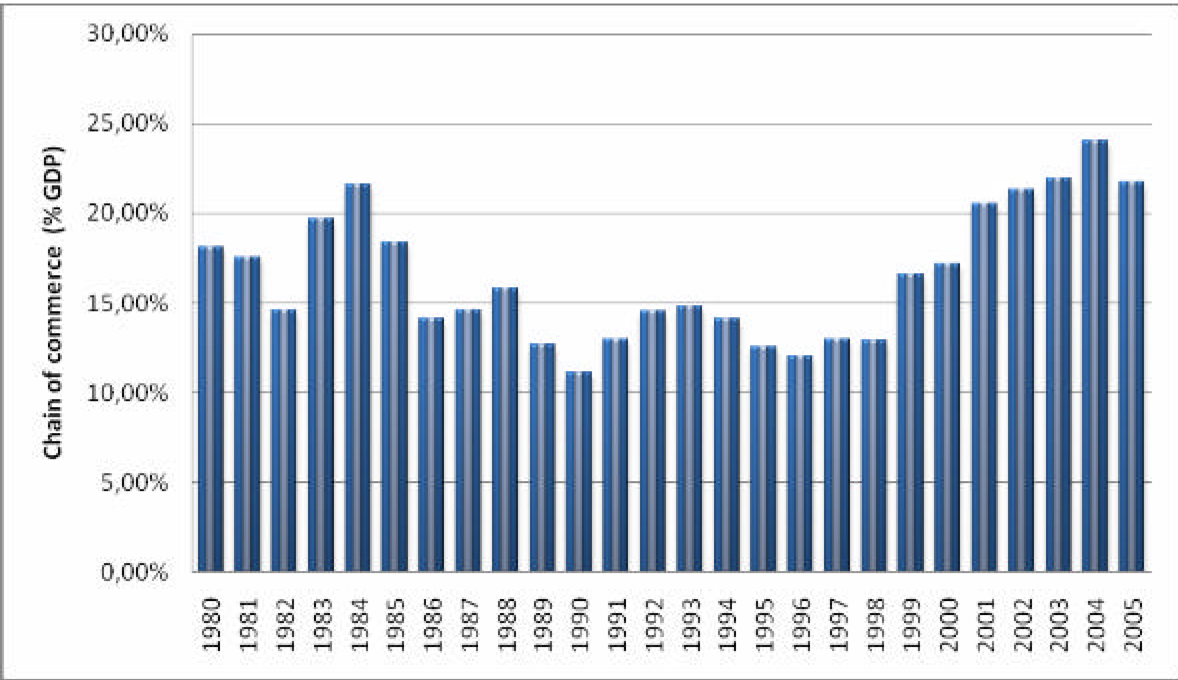
However, results obtained in Brazil are not that good when relatively compared to other emergent economies. The accumulated chain of commerce has maintained

itself close to 20% (twenty percent of GDP), as indicated in Graph 12. Although, the chain of commerce has had a significant increase since 1999, it stagnated near 15% of GDP from 1971 to 1998, which shows that Brazil is still relatively close comparing to economies such as South Korea, whose chain of commerce represents 70% of the GDP, India (34.7% of the GDP), Russia dos (41% of the GDP) and China (65.2% of the GDP).

This pattern is explained, in one hand, by the internal demand, but it indicates, on the other hand, the need to expand international trade to world consumer centers. Brazil's disadvantage in relation to other Latin American countries supports this statement, since México has a ratio chain of commerce/GDP of approximately 60%, whereas in Chile this ratio is 63%.

Although, there aren't desirable behavioral patterns of that indicator, analysts state that a ratio percentage of approximately 40% indicates that a country is less vulnerable to international currency crisis, that is, it has a more solid economy.

Graph 12 – Chain of Commerce (exporting + importing) as a percentage of the GDP



7.2 Economic Growth

After more than a decade since the economic stability process was initiated by the implementation of Plano Real, some indicators explain the disappointment towards the trajectory of economic growth. Among them, the average economic growth between 1995 and 2002 was only 2.3%, surely below expectations foreseen by the economic plan.

Brazil's GDP growth rate is well below other emergent countries, which can be partly explained by the high Public and payroll debts observed from 1995 to 1998. However, when analyzing the evolution of various variables associated to the basis of an economy, it can be seen that, if present course is maintained, we can hope for a more promising future.

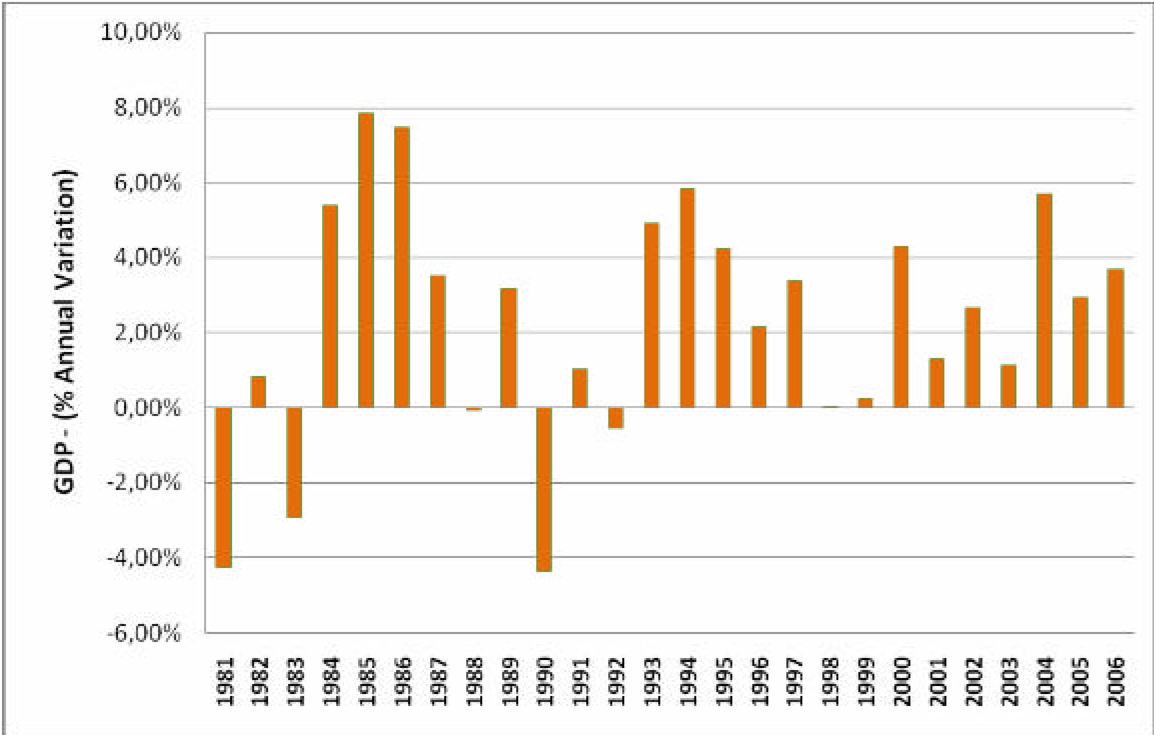
These economic bases are in accordance with a macro-economic stability based on the gradual reduction of inflation and real interest rates, as well as of external vulnerability and the maintenance of austere fiscal policies. These are the foundations which present macroeconomic policies relies on. The definition of clear investment rules and the attraction of foreign capital can lead the country to attain growth rates compatible with the world.

Jointly with internal initiatives for increasing growth, such as the approval of the Law which created the Private Public Partnerships (called PPP) and incentive programs to develop alternative technologies to fossil fuels, such as, bio diesel, the economic development still depends on investments in infrastructure, as well, as external variables.

These factors have led to shy growth rates in the last years, as shown below in Graph 13. However, indicators related to industrial activities, such as the consumption of packages and civil construction activities reinforce government's optimism towards a

higher growth rate this year more compatible with parameters observed in other emerging countries and towards maintaining an uptrend in the next years.

Graph 13 – Brazil – GDP growth rates



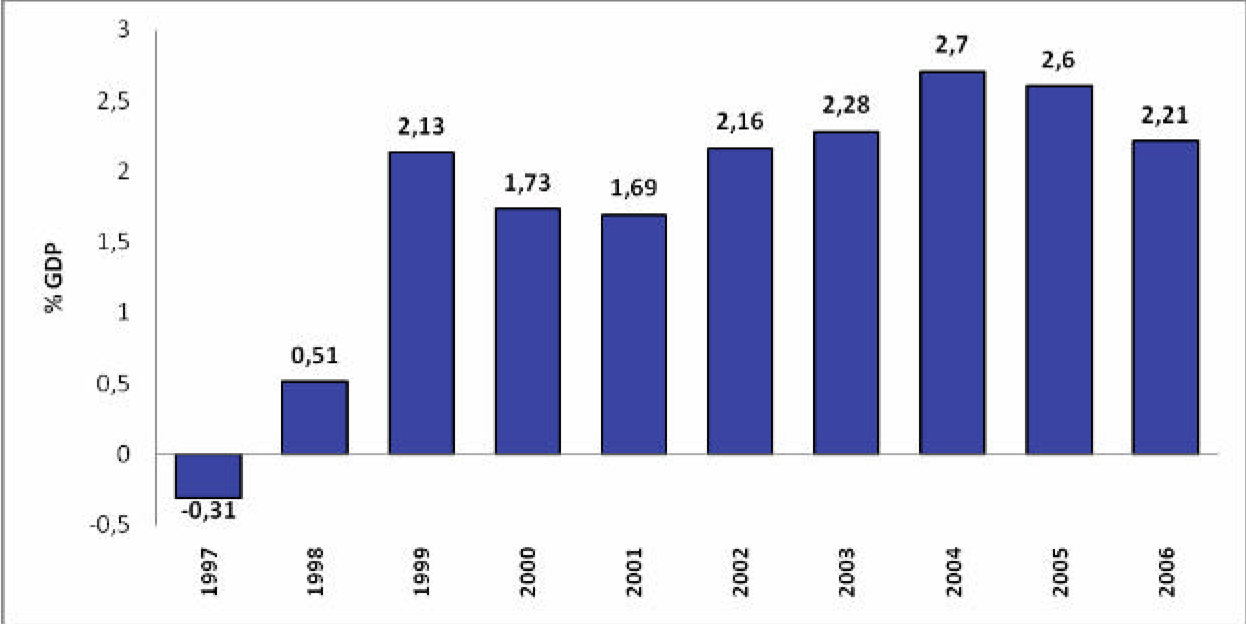
7.3 Fiscal Policy

The fiscal unbalance has been pointed out as one of Brazil's major challenges. Despite of the successive primary surplus shown below in graphs, analysts and economists, taking operational deficits during the last years into consideration, say that there is a need for urgent reforms, in order, to achieve a balance in Public Budget. The most relevant are the reform of the fiscal and social security systems.

The reform of the social security system is, in particular, the most challenging. The Brazilian social security system is in need of more effective measure to achieve balance after successive operational deficits during the last years. Built around the format of simple partition, the system depends of the flow of resources to make the monthly payments. Two major problems demand an urgent reformulation of the system. The rise of life expectancy in Brazil recommends revising the minimum age for

retirement. Also the high level of informality in employment leads to a high number of workers that do not contribute to the system, worsening the budgeting situation more and more. Special pensions and the implementation of social policies also take funds from the social security system.

Graph 14 – Primary result of Central Government



7.4 Fiscal Basis

In relation to tax collection, Brazil shows poor indicators compared to the majority of emergent countries (see graph 4 above). Brazil has one of the heaviest tax loads in the group of emergent countries. The primary surplus achieved in the last years has been a consequence of the expressive growth in tax rates. The apologists of the fiscal reform mention the need to extend taxes to all elements of the productive chain including the informal economy. Simultaneously, they also defend the reduction of the tax load for those earning salaries and micro and small companies

The truth is that significant efforts have not been made to reduce current expenditures and, therefore, fiscal results have been relying on the substantial increase of taxes and on the reduction of public investment. This policy has been unable to tend

to urgent demands in primary infrastructure and can compromise long-term economic growth.

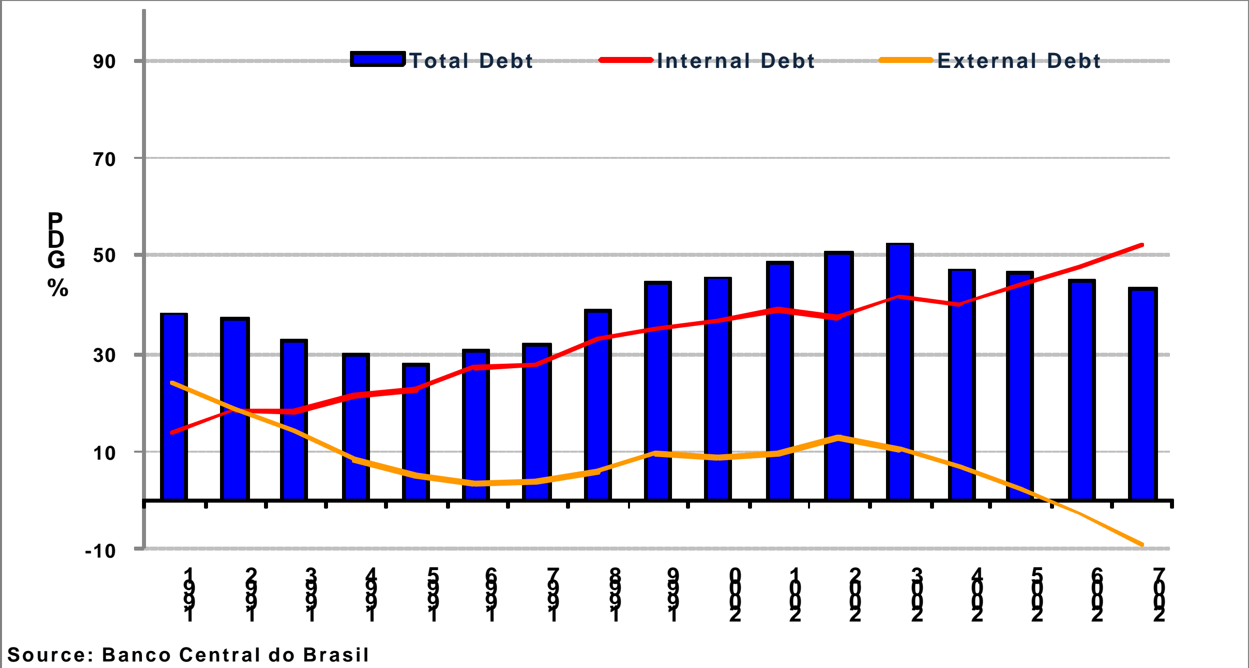
7.5 Public Debt

In an effort to promote fiscal discipline, the federal government approved in 2000 the Fiscal Responsibility Law. Among other measures, it restricted personnel and staff expenditures and set goals, in order, to control revenues and expenditures. In fact, it is a code of conduct to public administrators, including the Executive, Legislative and Federal branches on all three spheres of power: federal, state and local.

Successive primary surplus jointly with the reduction in the internal interest rate and the value of the *real* in contrast with the dollar has allowed an increased control over the ratio Debt/GDP. This indicator reached its peak in 2003, when debt overcame 50% of GDP. Presently, this percentage is 43.13% and the government has revealed the intention to reduce it to less than 40% over the course of next year, as shown below in graph 15.

Whereas the ratio of International Reserves/Foreign Debt is 0.74 in Brazil, the average ratio in emergent countries is 0.78. Excluding the Asian emergent countries, the average ratio falls to 0.57, which means that Brazil is positioned above average.

Graph 15 – Relation Debt / GDP



Source: Banco Central do Brasil

One should mention the efforts made to change the nature of the Debt. Graph 15 shows that Brazil has gone from debtor to creditor and now concentrate its debt in internal assets with independent indexes from international currencies, therefore, significantly reducing exposure to events in foreign economies. Today, the external debt is less than the international reserve.

7.6 Direct Investment

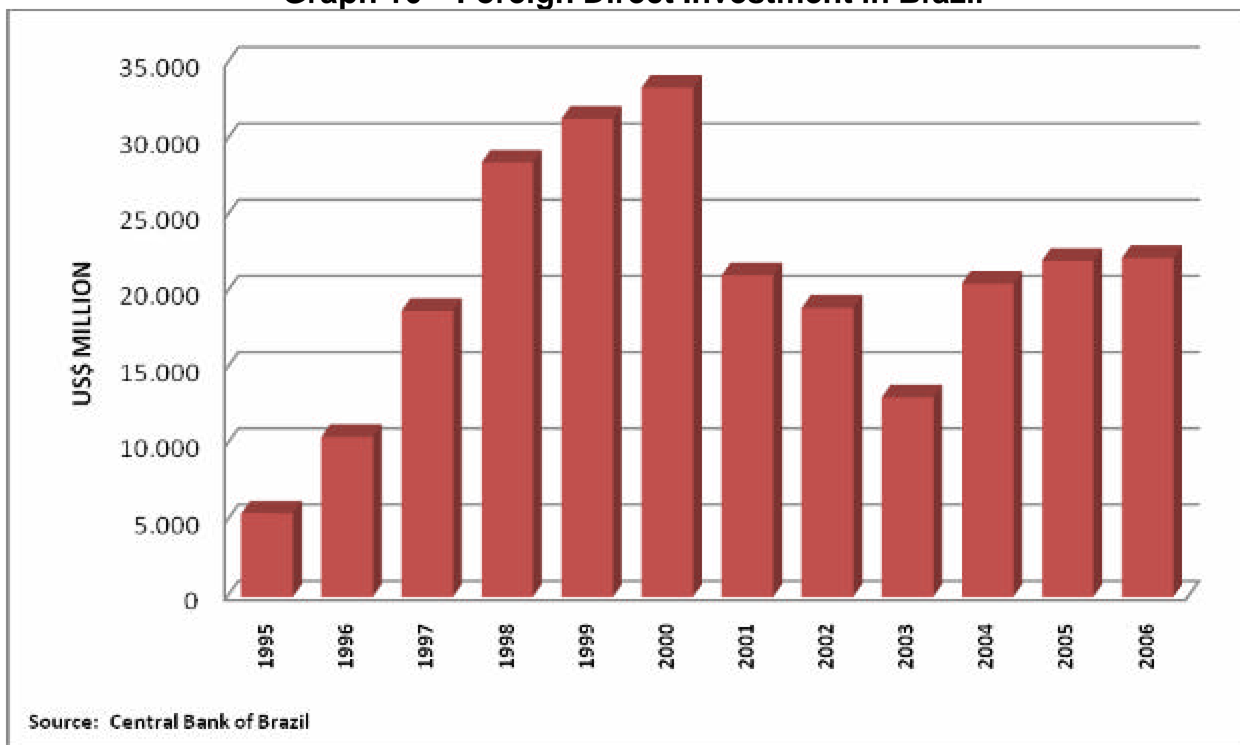
Besides the rise in Brazilian exports, direct investment has been one of the contributing factors to the growth of Brazil's Federal Reserves. Brazil has been consistently receiving the highest volume of resources of that kind in last few years (graph 16). Only in 2001, México overcame Brazil as the main Latin American destination of direct investments.

Favored by the growth of the world's economy and the market internationalization initiated in the nineties, Brazil has been the destination of resources of different origins, in particular from the United States, Holland, France, Germany and Spain. From 1995 to 2006, the economic sectors that received the highest amounts were the automotive, chemical and food factories. The sectors of services more benefited were the financial, electric and telecommunication services.

In the period between the years of 1995 and 2000, the high volume of resources were mainly due to the privatization of state owned companies, merges and acquisitions in the banking system.

This expansion of foreign investment is a direct consequence of a net international market, the liberalization of national economies and the strategy of multinational companies.

Graph 16 – Foreign Direct Investment in Brazil

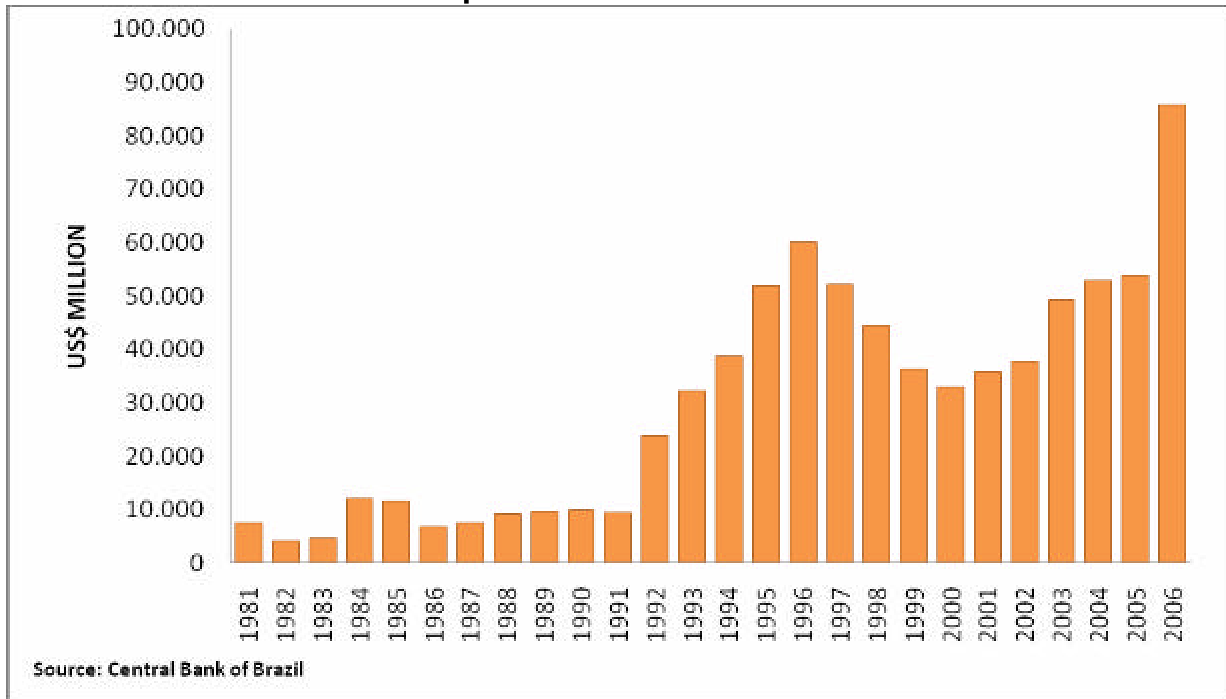


7.7 International Reserves

One of the main policies adopted by the Central Bank of Brazil since 2002 is the reinforcement of the Federal Reserve in foreign currency. Heavy purchases of foreign currency will set a record level of reserves by the end of this year. In August 2007, the amount of reserves reached US$ 161 billions in comparison with the amount of US$ 89 billions reached at the end of 2006.

The high level of accumulated Federal Reserves, seen below in graph 17, guarantees less vulnerability to variations of the external markets and reduces the volatility of the internal currency enabling to face an eventual foreign investment crisis easily and, consequently, bringing an added consistency to the monetary policy,

Graph 17 – International Reserves

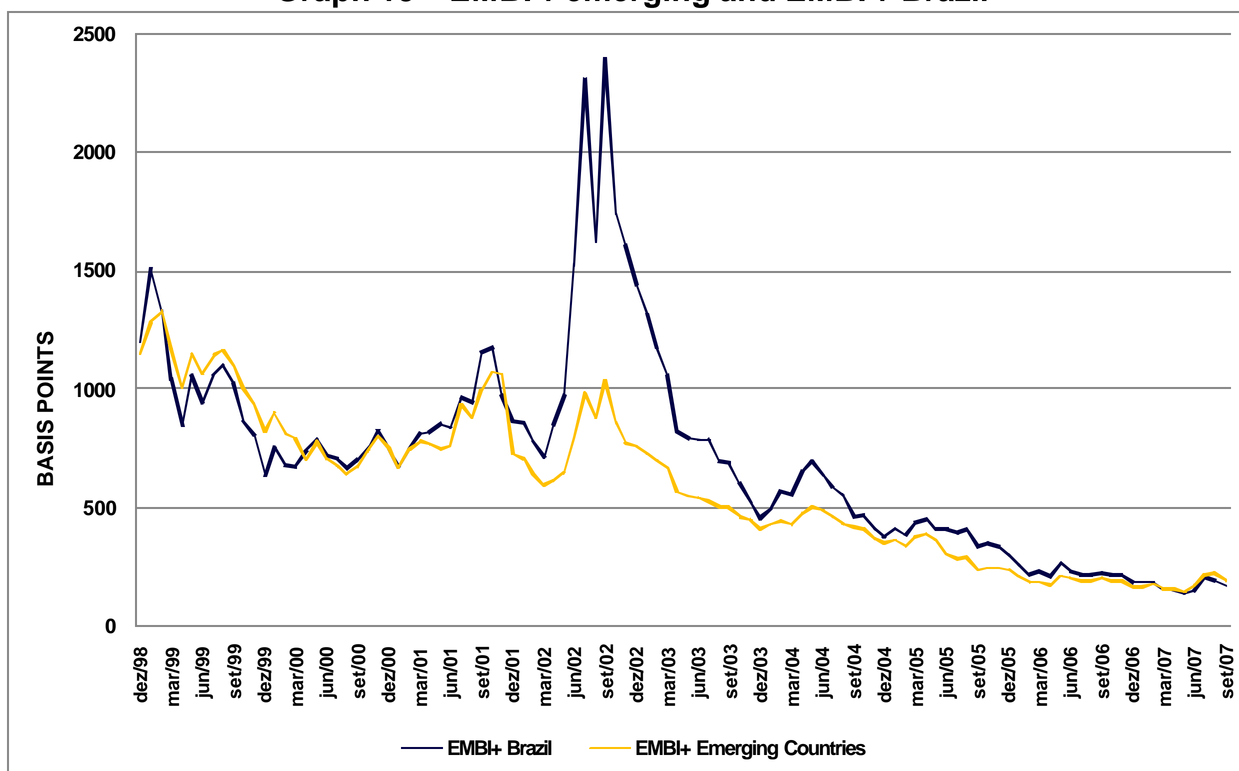


7.8 Country Risk

Brazil has shown solid macro economic indicators in the last few years, mainly in relation to successive primary surpluses, and therefore, the country risk, measured by JP Morgan through its Emerging Market Bond Index-Plus – EMBI + has shown a decreasing trend.

Macro economic stability with low inflation, strong domestic currency and a fiscal policy consistent with a reduction in Public Debt in relation to GDP have been the contributing factors to improvements of country risk ratings, as shown below graph 18:

Graph 18 – EMBI + emerging and EMBI + Brazil



7.9 Financial System

As in the Mexican Economy, Brazil had to adjust its financial system in the early nineties due to a strong cambial depreciation and a shortness of liquidity due to the high risk level of loans and the indexation of the financial revenues to the American currency, which unable debtors to make the payments.

The impacts of Plano Real forced banks to diversify the structure of their financial results through a reduction in costs or by generating new sources of revenue. The solution found was to charge for their services. In that same period, the market liberalization introduced foreign banks in the country leading to a consolidation of the banking system. Consequently, some organizations ceased to exist, others were sold or incorporated. It was already clear that the new macro economic environment was not compatible with the dimension that the Brazilian banking system had achieved by then.

Banks themselves worsened the banking crisis. Banks believe that Plano Real would have the same fate as previous plans and took too long to take action. It was only after some organizations filed bankruptcy that banks took measures, in order, to coexist in a new macroeconomic scenario. This situation was favored by the high interest rates adopted at the beginning of Plano Real and by the rise of the total amount deposited in the financial system, which partly lead to a reduction in the loss of inflation revenues.

In November of 1995, the Government launched the PROER – Program of Incentives to Restructuring and Strengthening of the National Financial System, which adopted several measures towards strengthening of the National Financial System. This adjustment cost the equivalent of 2.5% of the GDP to the Public finances and injected R$ 30 billions into the program. From a strictly legal and economic point of view, these measures were necessary to prevent the collapse of the national economy. However, there is no doubt they were a consequence of bad and irresponsible administration by bankers during the inflationary period.

The significant market share of public regional banks forced Government to adopt a specific program to rehabilitate those organizations. Besides sharing the same difficulties as private organizations, regional banks had to live with the duality of being competitive in the market and being State owned, and also implementing public policies. Sometimes they were used to channel resources to Government by financing State owned companies.

In 1996, the Central Government launched the Program of Incentives for Reducing the State's Presence in the Banking Sector – called PROES – which predicted the whole payment of expenses by the Federal Government, in order, to implement the necessary measures towards the sanitation of the institution, in the cases of extinction, privatization, restructuring into foment agencies and transference of control to the Federal Government. It also allowed the transference to the Federal Government of the loans taken by regional banks and their renegotiation, along with all existing debts, to more suitable deadlines according to the capacity of the states.

Rules established by the National Monetary Council (CMN) and by the Central Bank and changes in legislation provided the necessary conditions that allowed the program for restructuring banks to promote the acquisition of the healthy part of insolvent banks. These operations recovered the liquidation process by preserving the clients of the banks, investors and jobs and classified controllers' assets as unavailable for a possible reimbursement to the Central Bank.

From then on and during a following five-year period, the financial system went through significant adjustments characterized by its consolidation through merges and acquisitions and the decrease of the number of organizations in the system.

Puga (1999) published the table shown below (Table 3) indicating an expressive growth of the number of banks under foreign control. This adjustment led to a process of acquisition of regional public banks, mergers with private organizations and the birth of new organizations due to more flexible conditions compared to previous existing conditions.

Table 3 – Evolution of the number of Foreign Banks in Brazil

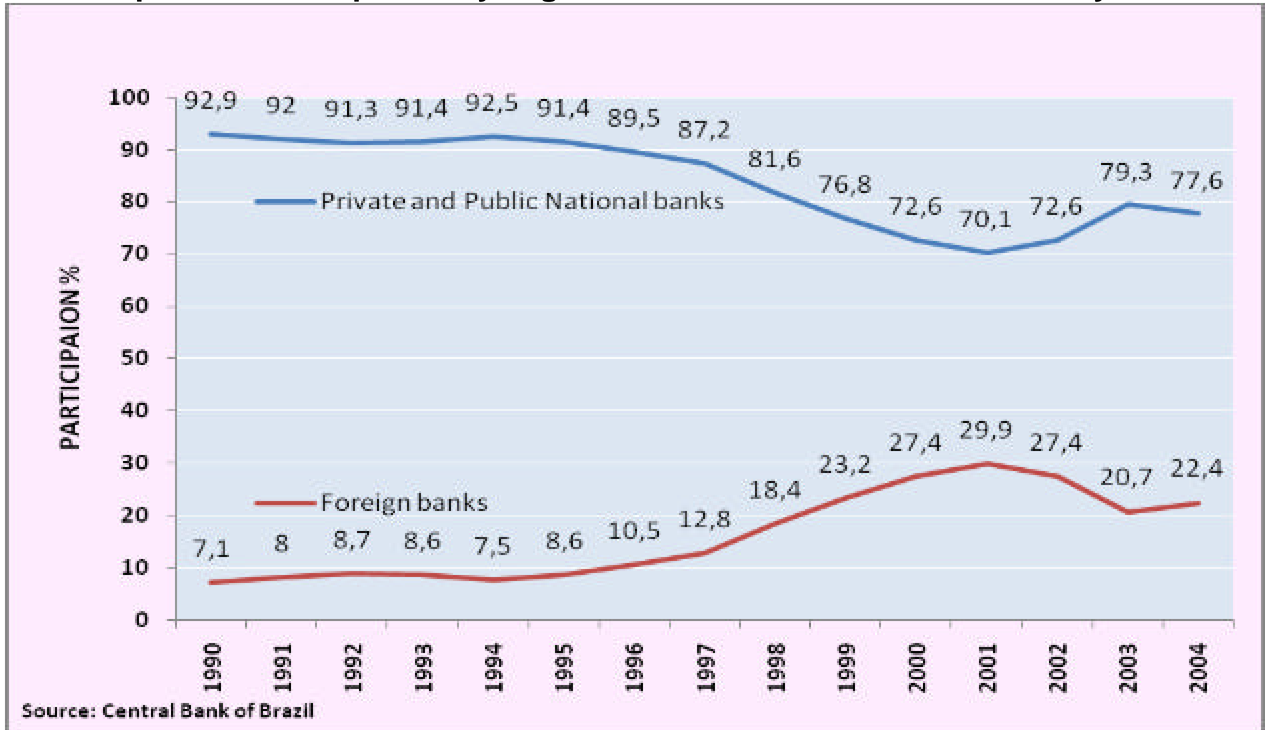
Types of Institution	**Jun/1995**	**Dez/1998**
Branches of Foreign Banks	17	16
Private Banks under Foreign Control	2-	36
Total number of Foreign Banks (A)	**37**	**52**
Total number of Multiple and Commercial Banks (B)	240	203
Participation of Foreigners (A/B) (%)	**15.4**	**25.6**

Source: Puga (1999), page 23.

As shown in graph 19, the volume of foreign capital that entered the banking system tripled between 1996 and 2001, and then retracted to levels near 20% between 2003 and 2004. Parallel to this retraction, the report called "The Evolution of the National Financial System" published by the Central Bank of Brazil emphasized that "*an analysis of the last eight years shows that the assets of foreign banks more than doubled its value during the period from 1996 to 2001. There were approximately 50 organizations*

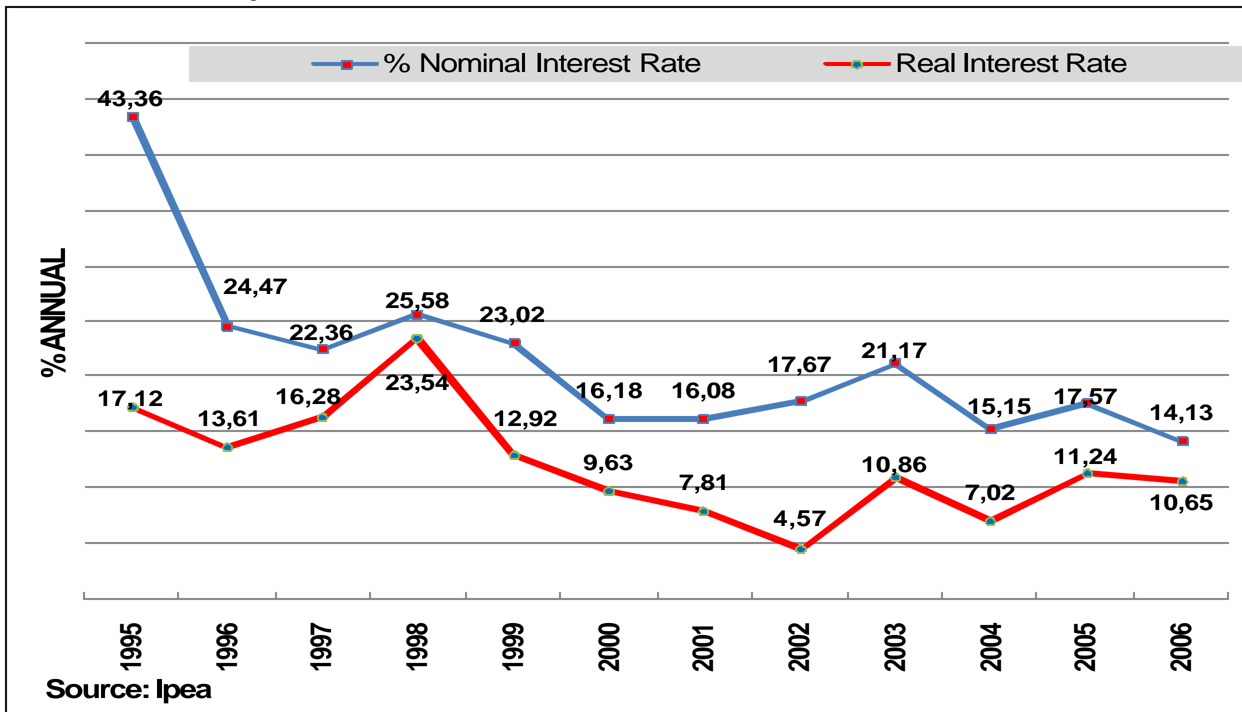
of that kind in 2004". As the arrival of foreign banks in the domestic market was directly related to the privatization of regional banks, it is considered that there is now little room left for expansion.

Graph 19 – Participation by segment in th active total of the bank system



The continuous improvement of the economic fundaments, express through positive commercial balances, the convergence of inflation to the trajectory of goals, fiscal responsibility with the perspective of reducing the ratio debt over the GDP, and the increase of international reserves have contributed to the gradual drop in the nominal internal interest rate, according to Graph 20 below, and a relative decrease of the measure of country risk in comparison to the emerging countries' average, and moves towards the conquest of greater credibility in the international financial market.

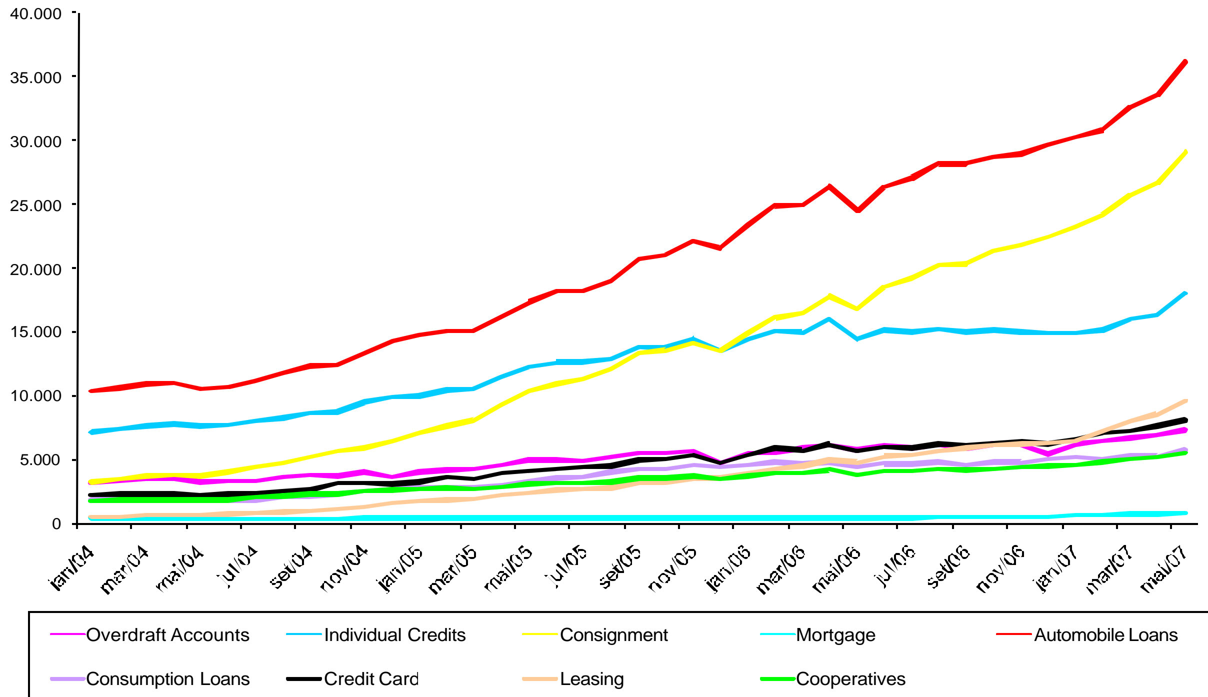
Graph 20 – Brazil: Nominal and Real Annual Interest Rate



These conditions point to a possible reorganization of the national financial system, possibly characterized by an increasing foreign interest in the national market, in a similar movement to what happened with the Mexican economy. Let us highlight that there is, at first, no similarity between the situations of the two countries, since the Brazilian system is more robust than the existing one at the time of the Mexican opening to foreign capital, whose reorganization process was still being carried out.

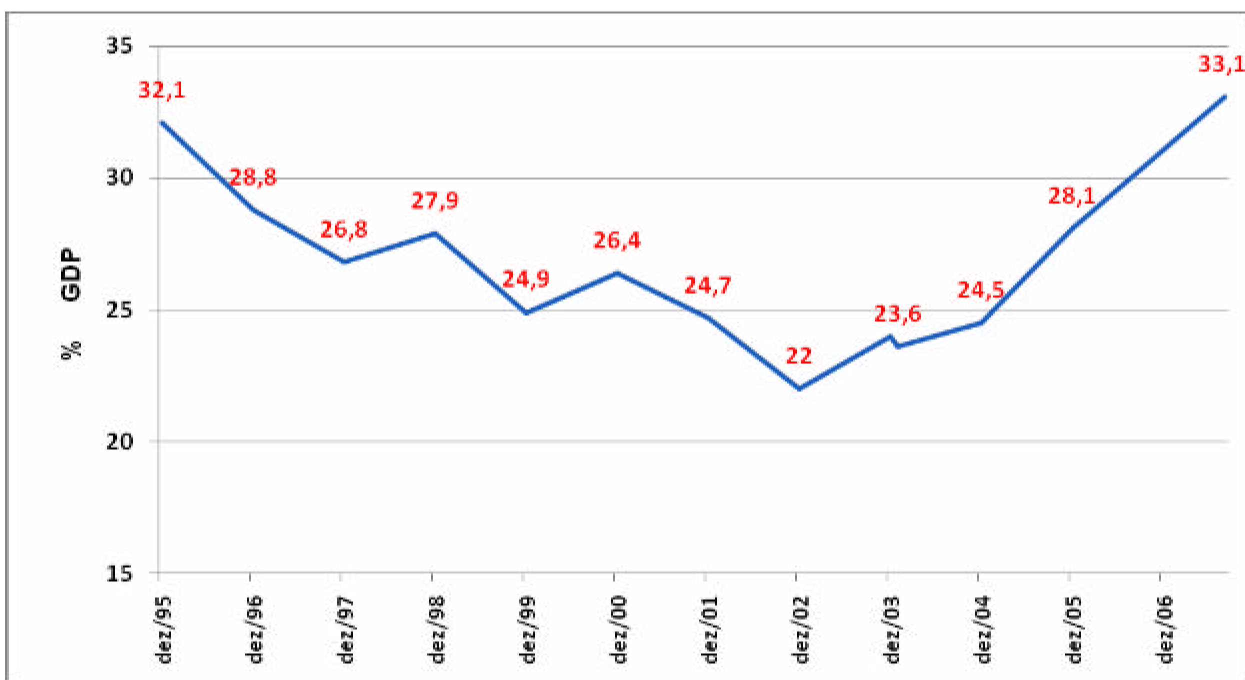
Brazil counts on very well structured private banks, with capacity to adapt to the macroeconomic changes, which basically indicate impacts on the treasury gains due to the reduction of the economy's basic interests. The large retail private banks have a diversified service structure and act on consumption financing through cooperation with large retail corporations. The expansion of credit to the consumer has been a strong characteristic of the recent Brazilian financial market, based, essentially, on the credit consignation modality, as shown in Graph 21.

Graph 21 - Bank Individual Credit for sort of destination



The smallest relative income of the treasury operations would lead to a greater competition in the credit and capital markets. The Brazilian credit market represents, nowadays, only 33,1% of the GDP, according to Graph 21 below, with a restrict participation of the real estate credit that, only in the last few months, has shown considerable raise.

Graph 22 – Brazil Bank Credit - % GDP



On the other hand, large and medium-sized companies would have increased the fundraising opportunities in the international market, increasing their negotiation power with banks. Competition for greater access to the credit market shall have, as a consequence, the drop of the bank spread and the reduction in the sector's yield rates.

The participation of large state banks in the retail market is a factor that deserves more attention when we analyze the financial system, once the performance of theses banks guarantees an expressive participation in the system. Just like the private sector, the merger of state organizations can mean a strategic move, necessary to face the new approaching macroeconomic scene.

The strategic retail movements of the large Brazilian financial corporations, after the privatization period, have concentrated efforts in the conquest and maintenance of businesses with the public sector, a provider of accounts for individuals by means of wage payments. The business model predicts the reversion of the gains made possible by retail businesses to employers.

These movements, which began shyly in the mid-nineties, have gradually intensified to the point of reaching significant amounts for the public budgets and to compromise good part of the financial margins of the acquiring banks. Recently, Banco

do Brasil, the largest Brazilian bank and one of the largest in Latin America, acquired the businesses which belonged to the states of Minas Gerais and Bahia, previously controlled by banks Itaú and Bradesco, respectively. At the same time, the state Bank will take over the control of still existing state banks, such as the ones linked to the states: Santa Catarina, Piauí and Distrito Federal.

This move by the federal bank generated reactions from its competitors, who tried to appeal the decisions of the state governments. The main fact is that the state bank's strategic movement goes against the expansion strategies of private banks and exposes these organizations to large international banks that, when faced with a probable decrease in profit resulting from treasury operations and the expansion of the credit, mainly for consumption and to the real estate sector, envisage opportunities for its entry or increase in its participation in the Brazilian market.

This perspective is confirmed by the recent moves of Bank Santander, whose participation in the consortium that purchased the Dutch Bank ABN Amro, which aimed at taking over the operations of this bank in the Brazilian market. When the deal comes through, Santander will become one of the biggest retail banks in the Country and will reinforce its participation exactly in areas in which it needs to increase its performance, such as financing vehicles and credit to individuals.

The entry of other foreign banks, such as the Canadian Scotiabank, in the Brazilian market by means of the acquisition of state banks, was frustrated by the government's decision that Banco do Brasil will absorb those organizations, which reinforces the theory that there will be new mergers and acquisitions in the Brazilian financial system.

8. CONCLUSION

The analysis of the risk classification methods, the Brazilian and the Mexican macroeconomic evolution, the impacts that happen because of the financial system's public policies in both countries require an explanation of each of these topics, which we will present next.

8.1 Risk Classification

The agencies and their classifications are today an important component of the international financial markets dynamics. The large number of countries that frequently seek fundraising in the international market, the problems that follow the difficulty to obtain them and the comparison of macroeconomic data, as well as the complexity and diversity of these countries' economies, make the task of sovereign risk evaluation too expensive individually for the majority of investors.

Whenever there is a crisis of large proportions, such as the Asian crisis and recently the American Subprimes crisis, there is an increase in criticisms regarding classification agencies and their methods increase. On their side, agencies reason that they do not always count on data or evidence that allow a perfect evaluation of the sovereign risk, apart from the fact that the market is in constant evolution.

However, despite these criticisms and the limitations of risk evaluation the conclusion is that it is an important instrument for the financial market to quantify and qualify the credit to be offered, and its use, including as a regulation parameter for financial regulation, is solid and increasing.

8.2 Investment Grade – Cause or consequence?

The methods used by the risk classification agencies allow us to conclude that reaching the indicator is a consequence of the macroeconomic policies adopted by the

countries. The total sum of the indicators will point to the final rating indication to be given to the country analyzed.

In this aspect, we noticed that among the factors that contributed for Mexico to reach the qualification before Brazil is, as registered by Standard and Poor's in their publication Sovereign Ratings in Latin America (September 2005), directly connected to its adhesion to NAFTA. The improvement in the economic growth indicators, volume of exports, payment balances and commerce current, as well as the reduction of the fiscal deficit, were the bases that permitted a raise in the Mexican indicator.

The current Picture and the perspective for the Brazilian economy point to a change in the risk evaluation by the rating agencies. This means that the continuous improvement of the economic basis, express through positive commercial balances, the convergence of inflation to the trajectory of goals, fiscal responsibility with the perspective of reducing the relation debt over GDP, and the raise in international reserves, have contributed to the gradual drop in the nominal internal interest rate, a relative decrease in the level of country risk in comparison to the average of the emerging countries, and the movement towards the conquest of greater credibility in the international financial market.

Constant political crises in the national congress and the lack of follow up for the implementation of important reforms can, subjectively, influence the elevation of the Brazilian indicator negatively.

8.3 Necessary Adjustments

If on one hand we must acknowledge the efforts Brazil has made to reach better international evaluation, we cannot fail to point out the basis on which the country needs to promote adjustments.

In this sense, it is important to register the need to control current expenditures as a form of balancing the government revenues and expenditures. The recovery of the

state's investment capacity is a condition to support economic growth, by applying budget funds, using incentive mechanisms to the private sector, or by using the *Parcerias Público Privadas* - PPP (Public Private Partnerships) mechanism.

The same relevance must be given to the conduction of the social security system and the Labor Law reforms, as a mechanism of insertion of the informal sector among the beneficiaries of the social security and assistance programs, and mainly as a long-term social policy.

The tax reform, maybe, the most delicate equation Brazil has ahead, since the society's capacity to contribute is exhausted. The raise in tax collecting happens, necessarily, through the expansion of the tax basis, reducing exemptions or including the part of the economy which do not contribute, by tax planning or informal practice of economic activities, with the government's budget income. The equation will reach a better solution as the country recovers its economic growth capacity.

8.4 Financial System

Taking the Mexican experience into consideration, at first, Brazil's upgrade to the investment category would not have such a significant impact on the domestic banks. However, there are certain characteristics of the Brazilian case that must be highlighted. The convergence to the *investment grade* would mean a drop in the real interest rates, acceleration of the economic growth rates and a probable change in the composition of the actives of banking organizations.

One can assume that under the *investment grade*'s perspective and the drop in the profit margins that some merger process will happen, with the decrease of the organizations that operate in Brazil. In that sense, BCB's comment which emphasizes that "*the strategic decision to continue operating in Brazil requires investments that will aggregate scale, either by organic growth or by the acquisition of other organizations*..." becomes pertinent.

The attraction of foreign capital by means of portfolio or direct investment is one of the effects a stable economy tends to promote. Raising resources, nowadays inaccessible to the Brazilian financial system, by the classification of the country's risk, such as from big international private social security companies, can be one of the ways for banks to spread the decrease in profit caused by the reduction of treasury earnings.

It is clear that credit to individuals has been growing steadily in Brazil and in Mexico, influencing the ratio credit/GDP that, when compared to developed countries, shows a high expansion potential. Nevertheless, considering the Mexican example, the expansion to credit may not happen immediately, but as a consequence of the economic growth, even taking the fundamental differences between the Mexican and Brazilian economic sectors into consideration, mainly in the chains of industry and commerce.

8.5 Final Conclusion

The achievement of the qualification of investment grade will be an effect of the maintenance of the macroeconomic bases that exist at present. We would like to highlight that a bigger worldwide integration, if on one side enables the country to benefit from global growth, on the other exposes it to the effects of a deceleration of the world's economy. The maintenance of favorable growth rates worldwide tends to assist the country's growth.

The adoption of measures that contemplate revising retirement rules and the reduction of informality in the Brazilian labor market are more and more pressing, and can anticipate Brazil's qualification as an investment grade by rating agencies, just like what happened in Mexico that, as soon as the fiscal reform was approved, last September, it had its evaluation revised by the agency Fitch Ratings, increasing it three points above the investment grade.

It is essential that the government solve the fiscal question once and for all, because the limitation of the investment capacity and the restriction of imposed social policies by the successive generation of primary surplus must, in the long run, represent

high costs for the population, including compromising the expected economic growth and depriving the Country of the favorable international economic moment, as observed in recent years. It is advisable that the choice to maintain the current tax criteria be accompanied by a strong will on the government's part to cut down on its current expenditures that, at present, have been growing in the same proportion as the increase experienced by the revenues.

Nevertheless, under the macroeconomic aspect we conclude that the achievement of the investment grade will not mean relevant gain for Brazil, since the market has already been giving price to the improvement in Brazil economic performance, mainly after the last presidential election, which made the evolution of the Country's existing democracy evident.

Finally and concerning the national financial system, we understand that the moment is favorable for the expansion of business, mainly in regard to the increase of credit, development of new mechanisms for raising capital via market to cater to medium-sized and big companies and raising resources from international private funds.

However, the appeal of the Brazilian market to big international corporations, as regards profitability, dynamics and volume of business, can expose the system to a new wave of mergers and acquisitions. Regarding federal institutions, the road to be taken depends on the definition of the role the government attributes to each one of them, since from a strictly commercial, financial and economic point of view the close relationship between several banks under the federal government's wing is absolutely unnecessary.

ANNEX 1 – Main Factors and Variables Considered in the Risk Evaluation

Category	Factors Assessed	Variables Considered
Political, Civil and Institutional Risk	Stability and legitimacy of the political organizations; constitution and relationship between main organizations; independence of the judiciary; citizen participation in political processes; integrity in the process of changing leadership; characteristics of political parties and the government's support basis (stable or unstable, ample or narrow); level of cohesion of the main political parties regarding the guidelines for the economic policy; independence of the central bank; transparency in the decisions and objectives of the economic policy; history on how government officials reacted in adverse situations; credibility of the most important members of the government; objectives and strategy of foreign policy; participation in international organizations and commercial blocks; relationship with multilateral credit organizations (IMF, World Bank etc); geopolitical risk (possibility of war); risk of revolution or coup d'etat; size, growth and importance of armed forces; public safety; freedom of speech; legislation and organizations created to regulate competition; social pressure due to the low standards of life of the population; development of health and sanitation services; the existence of ethnical and religious conflicts.	Human development index (Worlds Bank); corruption perception index (Transparency International); list of "true democracies" (Freedom House); political rights index (Freedom House); civil freedom / liberty index (Freedom House).
Real Sector and Economic Structure	Rate and standard of economic growth; prosperity, diversity and level of guidance to the market economy; existence of distorted industrial and agricultural policies; bad income distribution; how competitive and profitable is the non-financial private sector; efficiency of the public sector; size of the public sector in contrast with the private sector; size and importance of financial and non-financial state companies, and perspectives of privatization; protectionism and other influences contrary to the market economy; financial and commercial integration with foreign countries; volume and composition of savings and investment accounts; diversity of the production structure and exports; flexibility and qualification of the labor force; educational level of the population; transport and communications infra-structure; availability of natural resources, including proven minerals reserves and fossil fuels.	GDP (in US$ and based on PPC2); real growth of the GDP; GDP per capita (in US$ and based on the PPC); real growth of the GDP per capita; investment/GDP, with details regarding private and public investments; domestic savings/GDP, with details regarding the public sector, private sector and families; consumption/GDP; real growth of investment; unemployment rate; the Gini coefficient; populational growth; productivity growth; composition of the GDP by sectors (agriculture, services and industry); petroleum consumption/GDP; percentage of population enrolled at high schools or at colleges; level of opening (imports + exports/GDP); average importing fee; non-duty (non-tariff) barriers; foreign trade structure by products and commercial partners.

ANNEX 1 (Continuation) – Main Factors and Variables Considered in the Risk Evaluation

Category	Factors Assessed	Variables Considered
Fiscal Sector	Conduction of the fiscal policy and its short and long term objectives; revenue and expenditures of the government in general; gross and net financing needs of the government in general; financing sources of the public sector (internal or external, monetary or non-monetary); flexibility in the administration of revenue, which is related to the government's capacity to increase tax collection whenever necessary; flexibility in the administration of expenditures, which is related to the rigidity of the primary expenditures due to the high percentage of non-related expenditures; efficiency of public expenditures; structural pressure on the growth of public expenditures, as future payment of pensions, growth of expenditures with social security and contingency liabilities; current and future revenue with privatization; accumulation of delayed payments; part of the revenue compromised with interests; composition by currency and profile of the public debt; composition of the public debt by debtor and creditor; size and soundness of the non- financial companies of the public sector; punctuality, comprehensiveness and transparency of the fiscal reports;	Revenue/GDP; expenditures/GDP; discretionary expenditures/total expenditures; nominal and primary result/GDP; gross and net debt/revenue; net and gross debt/GDP; interest paid/GDP; interest paid/total revenue; estimated contingency liabilities (skeletons)/GDP; debt in foreign currency or indexed in foreign currency/total debt; foreign debt/total debt; % composition of the debt by creditor; sensitivity of the debt fluctuations of the interest rate.
Monetary and Financial Sector	Coherence and sustainability of monetary and exchange policies; compatibility of the exchange regime with the monetary objectives; behavior of prices in the economic cycles; monetary and credit expansion; institutional factors, such as the level of independence of the central bank; comprehensiveness and efficiency of the monetary policy tools; level of development of the local capital market; effectiveness of the financial sector as an intermediary of resources; availability of credit; soundness of the financial sector; soundness of the financial sector.	Inflation (consumer price index); total domestic credit/GDP; domestic credit to the private sector/GDP; real growth of the total domestic credit; real growth of domestic credit to the private sector; M2/GDP; nominal growth of the M2; level of dollarization (total amount of deposits in foreign currency in the internal banking system/total amount of deposits in the internal banking system);

ANNEX 1 (Continuation) – Main Factors and Variables Considered in the Risk Evaluation

External / Foreign Sector	Impact of the monetary policies on the external accounts; structure of the bank account of the payment balance; level and composition of the capital flow (short or long term; foreign investments in portfolio or direct); level and profile of earnings of the total foreign debt (public and private); composition of the foreign debt for coins / currencies, by term (short or long term) and its sensitivity to international interest rate fluctuations; level and composition of the net international reserves, trying to exclude the amount destined to maintain a fixed exchange regime, such as the *currency board* , domestic banks' deposits in their branches abroad, operations in the stock exchange and other operations that reduce the level effectively usable by international reserves.	Gross and net foreign debt (total, public and private)/revenue in bank accounts; total gross and net foreign debt (total, public and private)/GDP; service of the debt (total, public and private)/revenue in bank accounts; service of the debt (total, public and private)/GDP; short term foreign debt/foreign debt (total, public and private); gross needs of foreign financing (in US$); net international reserves (in importing months); net reserves/short term foreign debt; gross international reserves/M2; result in bank accounts/GDP; nominal and real growth of goods and services exports; nominal and real growth of goods and services imports; direct foreign investment (in US$ and in % of the GDP).

Sources: Standard & Poor's, Bathia (2002), Fitch and Moody's apud Canuto and Santos (2003)

1. The factors and variables described in this table are taken into consideration by at least one of the three agencies, but not necessarily by the three of them.
2. Parity of purchase capacity.
3. The fiscal accounts refer to the government in general, which includes the federal government or central administration, including the social security system, central bank and local government. It does not include financial and non-financial state companies.
4. Exporting of goods and services, factors and non-factors, plus unilateral transfers.

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