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FOR AGENDA

EBS/03/157
Supplement 1

CONFIDENTIAL

November 24, 2003

To: Members of the Executive Board

From: The Secretary

Subject: **Brazil—Assessment of the Risks to the Fund and the Fund's Liquidity Position**

Attached for consideration by the Executive Directors is a paper on assessment of the risks to the Fund and the Fund's liquidity position for Brazil, which provides supplementary information to the paper on the fifth review under the Stand-By Arrangement for Brazil and its requests for extension and augmentation of the arrangement and extension of repurchase expectations (EBS/03/157, 11/24/03). This subject will be brought to the agenda for discussion on **a date to be announced**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of Brazil indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Ms. Metzgen, FIN (ext. 37863) and Mr. Rosenberg, PDR (ext. 34035).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Thursday, December 4, 2003; and to the European Investment Bank and the Inter-American Development Bank, following its consideration by the Executive Board.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

9Att: (1)

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INTERNATIONAL MONETARY FUND

Brazil—Assessment of the Risks to the Fund and the Fund's Liquidity Position

Prepared by the Finance and Policy Development and Review Departments

In consultation with other Departments

Approved by Eduard Brau and Martin Fetherston

November 21, 2003

1. **In accordance with the policy on exceptional access,[1] this note assesses the risks to the Fund and the effect on the Fund's liquidity position arising from the proposed extension and augmentation of the current stand-by arrangement (SBA) for Brazil, taking into account the requested extension of repurchase expectations to an obligations basis**. The Brazilian authorities intend to treat the arrangement as precautionary, and would draw only in the event of significant balance of payments pressures. The request is viewed as part of Brazil's exit strategy from Fund support. The current SBA of SDR 22.8 billion was approved on September 6, 2002. The amount of the proposed augmentation of access in the credit tranches is equivalent to SDR 4.6 billion (or 150 percent of quota), in addition to the undrawn balance under the current arrangement (SDR 5.6 billion, or 185 percent of quota). These amounts constitute exceptional access by themselves. Moreover, given Brazil's level of credit outstanding to the Fund (769 percent of quota), any extension or augmentation of the arrangement involves exceptional access. The note discusses the proposed extension and augmentation against the backdrop of Brazil's frequent and large use of Fund credit as well as the Fund's large exposure to Brazil.

Background

2. **Brazil is currently the largest user of Fund resources**. On November 1, 2003, Brazil's outstanding use of Fund credit equaled SDR 23.4 billion or one-third of total Fund credit outstanding. Essentially, all of this borrowing has taken place over the last two years marking an unprecedented increase in the Fund's exposure in absolute terms to a single debtor and in a short time period (Figure 1).

[1] See "The Acting Chair's Summing Up of the Review of Access Policy under the Credit Tranches and the Extended Fund Facility, and Access Policy in Capital Account Crises—Modifications to the Supplemental Reserve Facility and Follow-Up Issues Related to Exceptional Access Policy" (BUFF/03/28, 3/5/03).

3. **Fund credit constitutes a large share of Brazil's debt** accounting for nearly one-quarter of Brazil's public external debt and 6 percent of total public debt. In terms of payment flows, Brazil's debt service to the Fund in 2003 accounts for about 41 percent of Brazil's public external debt service and nearly one-quarter of total external debt service.

Fund Share in Debt, 2003

	Public External Debt	Total Public Debt	Public External Debt Service
Argentina	13	8	26
Brazil	22	6	41
Turkey	26	13	23
Uruguay	25	20	11

Source: Staff estimates.

4. **Brazil has been a repeat user of Fund resources in support of its macroeconomic adjustment and reform efforts.** In the last twenty years, Brazil has had six Fund arrangements.[2] With the proposed extension, by end-2004, Brazil will have had an arrangement with the Fund for six years running, one shy of the benchmark to be considered a prolonged user.[3] However, Brazil has demonstrated good program implementation and a strong payments record reducing credit outstanding to the Fund significantly in the mid-1990s and in 2000 (Figure 1). Moreover, Brazil has made advance repurchases of SRF resources of SDR 3.3 billion in April 2000 and April 2002. Brazil's performance under the current SBA has been assessed as exemplary.[4]

5. **Access under the current arrangement, which started in September 2002, at SDR 22.8 billion, was exceptional and the single largest arrangement for the Fund** (Figure 2). The mix of resources between the SRF (about one-third or SDR 7.6 billion) and credit tranches reflected the assessment that external financing might only gradually return to normal and would smooth the profile of repayments to the Fund.[5] The program was back loaded, with 80 percent of resources available in 2003 and purchases phased in peaks

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[2] The three most recent arrangements include the current SBA, an SBA of SDR 12.1 billion approved on September 14, 2001, and an SBA of SDR 13.0 billion approved on December 2, 1998.

[3] See The Acting Chair's Summing Up, Conclusions of the Task Force on Prolonged Use of Fund Resources (BUFF/03/51, 4/8/03).

[4] See staff report, Staff Appraisal.

[5] See Brazil—Request for Stand-By Arrangement (EBS/02/166, 8/30/02).

corresponding to large SRF repurchases arising on an expectations basis. A large last disbursement of SDR 5.6 billion in late 2003, which remains undrawn, consisted by design entirely of credit tranche resources as drawings under the SRF are limited to a one-year time frame.[6]

6. **The exceptional level of access under the current arrangement took into account Brazil's intention to make expected repurchases including under the SRF as they arose.** So far, Brazil has repaid the Fund on this basis and maintained its good payment record. However, the unprecedented rapid increase in Fund exposure to Brazil and the early request by the Brazilian authorities that SDR 4 billion in credit tranche repurchase expectations arising in each of 2005 and 2006 be shifted to an obligations basis in 2006 and 2007 are cause for concern (see below). The augmentation of the SBA and extension of repurchase expectations imply that Brazil will continue to have access to relatively cheap Fund financing for longer duration especially with the augmentation on credit tranche rather than SRF terms.[7] This could suggest little price incentive for Brazil to repay the Fund early even with the maintenance of capital market access.

Impact on Fund finances of the proposed extension, augmentation and shift in repurchases

7. **The proposed extension and augmentation of the current SBA would result in a commitment of Fund resources through March 2005 equivalent to SDR 10.2 billion and reduce the one-year forward commitment capacity (FCC) by the same amount.**[8] A commitment of SDR 4.6 billion arises from the proposed augmentation. The undrawn balance of SDR 5.6 billion under the current SBA would remain committed to Brazil under the proposed extension of the arrangement rather than becoming available for other commitments. The commitment can be accommodated by the present level of the Fund's FCC—SDR 57 billion as of November 1, 2003.

8. **Notwithstanding Brazil's spotless record of meeting Fund obligations, the high level of the Fund's exposure to Brazil represents a risk to the Fund's income position and balance sheet.** This risk relates to the duration of a high level of Fund exposure and to Brazil's continued vulnerability to a sustained worsening of investor sentiment and

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[6] In early 2003, the Executive Board agreed to lengthen the maturity of SRF expectations by one year (and of SRF obligations by six months) and Brazil's SRF drawings since then have been on these new terms. See Decision Nos. 12943-(3/15) adopted February 21, 2003 and 11627-(97/123) adopted December 17, 1997.

[7] The authorities requested access to Fund resources in the credit tranches since staff determined that the conditions for use of SRF resources were not met.

[8] The FCC, introduced in December 2002, is the principal measure of Fund liquidity. The (one-year) FCC indicates the amount of quota-based, nonconcessional resources available for new lending over the next 12 months. See also "The Fund's Liquidity Position—Review and Outlook" (EBS/03/128, 9/3/03).

significant balance of payments pressures. Charges from Brazil on its current Fund credit outstanding are about five times the Fund's residual burden-sharing capacity.[9] In the event of nonpayment of charges by Brazil, the income shortfall would have to be compensated through an increase in the rate of charge or through reductions in the Fund's precautionary balances. Moreover, the Fund's precautionary balances are only a fraction of the arrears that could arise in the event of nonpayment by Brazil.[10]

9. **The concentration in the Fund's lending to a few members has increased markedly since 1990 and Brazil's share in Fund credit has risen dramatically.** The share of the top five borrowers in total Fund credit outstanding has risen from 50 percent in 1990 to 87 percent on November 1, 2003 (Table 1). In comparison, Brazil's debt to the Fund as a share of total credit jumped from 6 percent in 1990 to 34 percent on November 1, 2003.

10. **The Fund's record exposure to Brazil would climb to SDR 25.4 billion in 2004, if Brazil were to draw under the precautionary SBA.** If Brazil were to purchase available balances under the augmented arrangement, the Fund's exposure to Brazil would remain above SDR 20 billion for at least four years. Any actual drawing under the arrangement could result in requests for further extensions of repurchase expectations or increased access, prolonging the duration of Fund exposure to Brazil.[11] Such an outcome would also increase further the Fund's large share in Brazil's public external debt service to 44 percent, on average, in 2004-07.

11. **The Fund's liquidity position will be negatively affected by the authorities' early request to extend credit tranche repurchase expectations arising in 2005 and 2006 to an obligations basis in 2006 and 2007, which effectively shifts SDR 4 billion in repurchases from 2005 to 2007**. Moreover, following the requested extension of repurchase expectations, if purchases were made under the augmented arrangement, Brazil's debt repayments to the Fund would reach SDR 10.8 billion in 2007 (see Table 1 and Figure 1). This compounds the repurchase hump of SDR 8.6 billion in repurchase expectations initially arising in 2005. Thus, granting the request of extending the SDR 4 billion in repurchase expectations in the

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[9] The Fund has a "burden-sharing" mechanism to offset income losses from the nonpayment of interest by members. This mechanism works through a decrease in the rate of remuneration and a comparable increase in the rate of charge. The capacity of the Fund's burden-sharing mechanism is limited by the floor to the rate of remuneration, currently 85 percent of the SDR interest rate. Residual burden-sharing capacity represents "free capacity" and is equal to total burden-sharing capacity minus the amount currently being utilized to offset unpaid charges and build balances in the Special Contingent Account (SCA). For more information on the burden-sharing mechanism, see "Review of the Fund's Income Position, the Rate of Charge, Precautionary Balances and Burden Sharing for FY 2003 and FY 2004" (EBS/03/43, 4/7/03) and "Financing the Fund's Operations—Review of Issues" (SM/01/78, 3/5/01).

[10] The Fund's precautionary balances, which comprise reserves and balances in the SCA, are only 26 percent of the arrears that could arise in the event of nonrepayment by Brazil.

[11] See staff report, Box 5.

credit tranches arising in 2005 effectively to 2007, would increase the risks to the Fund by lengthening duration of Fund credit outstanding and worsening the repayment peaks of Brazil's total debt service.

12. **Finally, Brazil's continuing external vulnerability is reflected in a large external financing requirement.** In this regard, experience has shown that the *magnitude* of shocks that affect Brazil is such that if Brazil draws under the augmented arrangement, there is a prospect that Brazil could request additional financial support from the Fund.[12]

Assessment

13. **Brazil is the Fund's largest debtor currently accounting for 34 percent of Fund credit outstanding**. Brazil has a track record of strong implementation of Fund-supported programs and an unblemished record of prompt repayments of Fund obligations. Brazil's performance under the current SBA has been strong and the authorities have made a commitment to continue to pursue prudent policies in 2004. The proposed extension and augmentation of the SBA on a precautionary basis is intended to reduce Brazil's vulnerability to balance of payment pressures that would lead to further drawings from the Fund. Nevertheless, an extension of the current arrangement involves risks to the Fund, which are compounded by the request to extend by one year repurchase expectations arising in 2005 and 2006 to an obligations basis. The risks would be larger if Brazil, faced with significant balance of payments pressures, were to draw. In such a situation Brazil might also request further financial assistance.

14. **Fund assistance to members with capital account crises has been predicated on rapid repayment of Fund credit.** In the case of Brazil, the Fund's commitment of resources is continuing and in the credit tranches rather than on SRF terms. The proposed augmentation of the SBA, if drawn, and extension of repurchase expectations in the credit tranches, suggests that Brazil could hold on to relatively inexpensive Fund financing. Accordingly, Brazil's use of Fund resources may remain above normal access limits for a number of years, even without further shocks to the economy and purchases from the Fund. It will be important for the Fund to guard against tying up a large share of its scarce resources in Brazil in view of the risks to the financial position of the Fund and the potential impact on the Fund's ability to meet the needs of other members. Therefore, program implementation in 2004 is critical so that this SBA can serve as an exit from Fund financial support as intended. Moreover, it would be desirable for the authorities to commit themselves to advance payment of the extended repurchase expectations if conditions turn out to be more favorable than the staff's current baseline.

[12] The staff report notes that Fund resources available under the proposed augmentation and extension would be sufficient to finance about one-half of the shock experienced in 2002.

Figure 1. Brazil: Fund Credit Outstanding, 1983-2009
In SDR billion

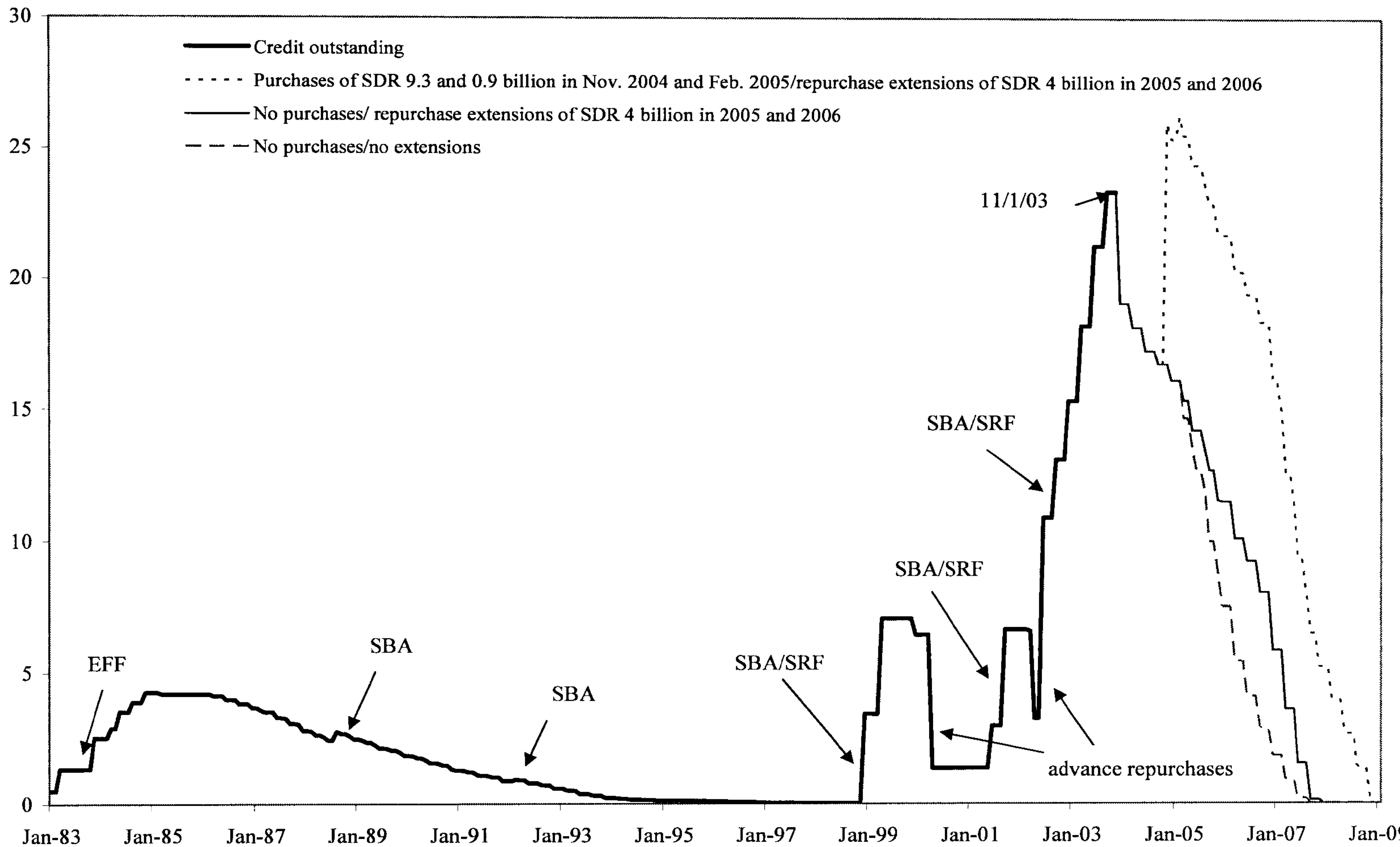
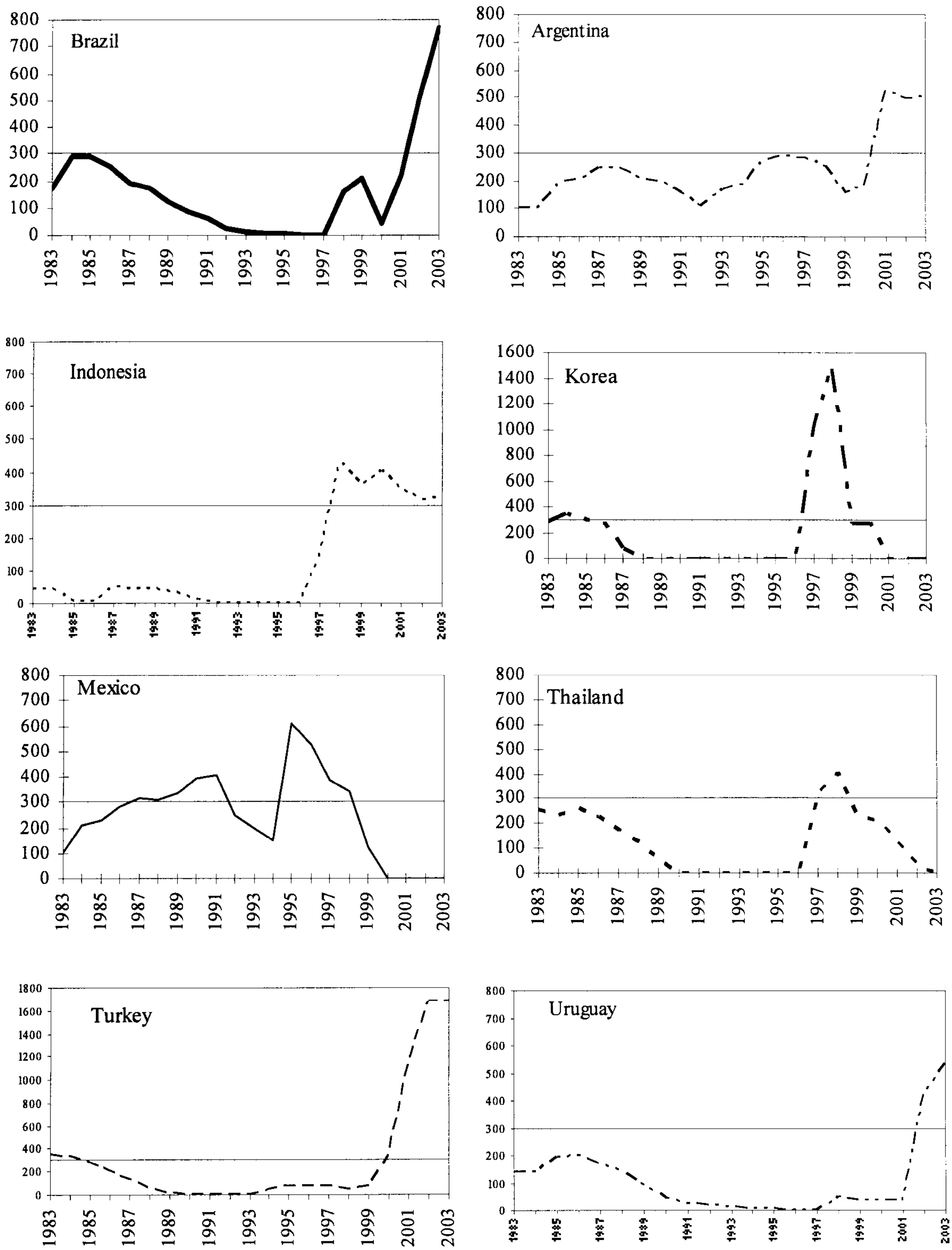


Figure 2. Fund Credit Outstanding in Exceptional Access Cases, 1983 - October 2003

(percent of quota)



Source: Staff estimates.

Table 1. Brazil: Impact on Fund Finances 1/

(In billions of SDRs, and end of period, unless otherwise indicated)

	2001	2002	11/1/03	2003	2004	2005	2006	2007
Exposure								
Fund credit outstanding to Brazil								
No augmentation and no further purchases 2/	6.6	15.3	23.4	19.1	16.1	11.5	5.8	0.0
Proposed augmentation-no purchases	n.a.	n.a.	n.a.	19.1	16.1	11.5	5.8	0.0
Proposed augmentation-purchases of SDR 10.2 billion 3/	n.a.	n.a.	n.a.	19.1	25.4	21.7	16.0	5.2
Fund credit outstanding to Brazil (percent of total outstanding credit)	12.4	24.1	33.5	...	...	...	...	...
Fund credit outstanding to 5 largest debtors (percent of total outstanding credit)	78.8	84.0	86.7	...	...	...	...	...
Liquidity								
One-year Forward Commitment Capacity (FCC)	61.0	54.7	56.8	...	...	...	...	...
Brazil's impact on FCC 4/								
No augmentation and no further purchases 2/	-11.5	-24.7	-22.4	-16.1	-11.5	...	...	...
Proposed augmentation-no purchases	n.a.	n.a.	n.a.	-26.3	-21.7	...	...	...
Proposed augmentation-purchases of SDR 10.2 billion 3/	n.a.	n.a.	n.a.	-26.3	-21.7	...	...	...
Prudential Measures								
Fund credit outstanding to Brazil as a percent of current precautionary balances 5/								
No augmentation and no further purchases 2/	111	255	389	318	269	...	...	...
Proposed augmentation-no purchases	n.a.	n.a.	n.a.	318	269	...	...	...
Proposed augmentation-purchases of SDR 10.2 billion 3/	n.a.	n.a.	n.a.	318	423	...	...	...
Brazil's annual charges as a percent of Fund's residual burden-sharing capacity 6/								
No augmentation and no further purchases 2/	63	216	n.a.	509	...	...	...	...
Proposed augmentation-no purchases	n.a.	n.a.	n.a.	509	...	...	...	...
Proposed augmentation-purchases of SDR 10.2 billion 3/	n.a.	n.a.	n.a.	509	...	...	...	...
Memorandum items:								
Brazil's debt to Fund as a percent of its total public external debt								
Proposed augmentation-no purchases	9.0	18.0	...	22.4	20.1	15.0	8.1	0.0
Proposed augmentation-purchases of SDR 10.2 billion 7/	n.a.	n.a.	n.a.	22.4	28.4	24.9	19.4	7.2
Brazil's debt to Fund as a percent of its total public debt-no purchases	2.2	4.5	...	6.2	5.0	3.5	1.7	0.0
Brazil's debt to multilaterals as a percent of its total public debt-no purchases	10.3	13.4	...	16.2	13.9	11.7	9.2	6.7
Fund's precautionary balances 5/	4.8	5.2	6.0	...	...	...	...	...
Fund's residual burden-sharing capacity 6/	0.2	0.2	0.2	...	...	...	...	...
Undrawn commitments to Brazil								
No augmentation and no further purchases 2/	8.5	18.3	5.6	0.0	0.0	0.0	0.0	0.0
Proposed augmentation-no purchases	n.a.	n.a.	n.a.	10.2	10.2	0.0	0.0	0.0
Proposed augmentation-purchases of SDR 10.2 billion 3/	n.a.	n.a.	n.a.	10.2	0.9	0.0	0.0	0.0
Repurchases of Brazil 8/								
No augmentation and no further purchases 2/	0.0	3.6	n.a.	8.9	2.9	4.6	5.7	5.8
Proposed augmentation-no purchases	n.a.	n.a.	n.a.	8.9	2.9	4.6	5.7	5.8
Proposed augmentation-purchases of SDR 10.2 billion 3/	n.a.	n.a.	n.a.	8.9	2.9	4.6	5.7	10.8
Annual charges 8/								
No augmentation and no further purchases 2/	0.1	0.4	n.a.	0.8	0.6	0.5	0.2	0.1
Proposed augmentation-no purchases	n.a.	n.a.	n.a.	0.8	0.6	0.5	0.2	0.1
Proposed augmentation-purchases of SDR 10.2 billion 3/	n.a.	n.a.	n.a.	0.8	0.7	0.7	0.4	0.2

Source: Staff estimates.

1/ Assuming repurchase expectations extensions of SDR 4 billion in 2005 and 2006.

2/ Assumes no augmentation and no further purchases by Brazil.

3/ Assumes disbursements of SDR 9.3 billion in November 2004 and 0.9 billion in February 2005 (SDR 5.6 under current arrangement and SDR 4.6 billion augmentation)

4/ Forward Commitment Capacity is a measure of the resources available for new financial commitments in the coming year, equal to uncommitted usable resources plus repurchases one-year forward minus the prudential balance. A single country's negative impact on the FCC is defined as the sum of outstanding Fund credit and undrawn commitments minus repurchases one-year forward.

5/ See Review of the Fund's Income Position, the Rate of Charge, Precautionary Balances and Burden Sharing for FY2003 and FY 2004 (EBS/03/43, 4/7/03).

6/ Burden-sharing capacity is calculated based on the floor for remuneration at 85 percent of the SDR interest rate (see Decision No. 12989 (03/36), adopted 4/21/03). Residual burden-sharing capacity is equal to the total burden-sharing capacity minus the portion being currently utilized to offset deferred charges and to build SCA-1 balances.

7/ Changes in the debt figures are only based on the impact of purchases of SDR 9.3 billion in November 2004 and 0.9 billion in February 2005.

8/ Flows during the period.