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BRAZILIAN ELECTIONS

Brazil's Election Sparks Concerns for Its Neighbors

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The election of a left-leaning president in Brazil Sunday is resurrecting the fear that the financial woes of South America's economic powerhouse could send shock waves through its neighbors.

Economists, investors and officials are especially concerned that a Brazilian default on its massive $259 billion net public debt would ripple through the economies of Chile and Mexico, countries considered the region's models of free-market probity.

"I'm not saying they'd go down the drain," says Guillermo Calvo, chief economist at the Inter-American Development Bank. "But they would be hurt."

So far, other major markets haven't suffered much fallout from Brazil's problems, though some Latin American government debt has weakened slightly, and some currencies have come under pressure. Still, investors have learned things can deteriorate quickly. It wasn't that long ago that Argentina -- now in default and a general state of economic collapse -- was a favorite of the free marketeers. When Argentina went under, Brazil was seen as safe because its economic team toed the orthodox line.

But these days it is an open question as to whether Brazil, under the leadership of President-elect Luiz Inácio Lula da Silva, will be willing and able to stay current on its public debt. Mr. da Silva, a former labor leader, has tried to reassure Wall Street and his country's own business executives, but his intentions are still murky enough to keep markets and other governments on edge. So far this year, Brazil's Bovespa stock index is down 54%, though it is up 5.5% since the first round of the election on Oct. 6 in response to signs that Mr. da Silva might be more economically mainstream than was initially feared.

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- See an interactive graphic[3] of key events in Latin America's economic and political crisis.

U.S. officials are keeping a nervous eye on the situation, although they stress that they monitor all emerging markets and, in general, believe investors are able to distinguish good bets from bad ones. "How can they not be worried?" asks Massachusetts Institute of Technology economist Kristin Forbes, the former top Latin America hand at the Treasury Department. She suggests that in the event of a Brazilian default, the Bush administration would likely take pains to persuade markets that Chile and Mexico are on firm financial footing.

In fact, Chile and Mexico do differ from Brazil in key ways. Neither is a big borrower. Mexico escaped Argentina's meltdown virtually unscathed, helping it build a reputation as a country whose economic future is tied more to its free-trade partners in North America than to its volatile cousins down south. While the

Mexican peso fell against the dollar this year after a remarkable run of strength, the adjustment was as much due to weak U.S. growth as anything happening on the streets of Buenos Aires.

Chile has just $5.7 billion in public foreign debts, while it has foreign-currency reserves of $15 billion. Its foreign bonds are seen as so safe that they yield just 2.2 percentage points more than ultrasecure U.S. Treasury securities, just slightly up from 2.1 percentage points three months ago and 1.7 percentage points at the start of this year. Mexico's foreign bonds offer returns just 3.6 percentage points above the U.S. government note, compared with 3.5 percentage points three months ago and 2.9 percentage points in January. Meanwhile, Brazil's are considered so risky they have to pay about 18 percentage points more, about steady from the 19 percentage points the government paid three months ago but way above the 8.3 percentage points it paid at the beginning of this year.

A Brazilian default would likely lead investors -- already shy about Latin markets -- to demand even higher rates there. "A Brazilian restructuring following on an Argentine restructuring...would sour emerging-markets investors for a long time," says economist Barry Eichengreen of the University of California at Berkeley.

Analysts say there is very little risk of a Chilean default. However, Brazil's troubles could reach Chile through other channels. Foreign investment in Chile, which has slowed dramatically over the last few years, could weaken even further. Chile also sends about 7% of its total exports to Brazil, where consumption could severely contract following a default.

These factors would wipe half a percentage point off Chile's gross-domestic-product growth if Brazil defaults, estimates Roger Scher, head of Latin sovereign ratings at Fitch. That is no small share, since he predicts that Chile's economy will grow by just 2% to 2.5% this year.

Chile's currency is especially vulnerable to contagion from Brazil. Currency traders often use Chile's peso as a proxy for Brazil's real, since -- because of trading restrictions on the real -- it is far cheaper to bet that the peso will decline against the U.S. dollar. Chile's peso has fallen 11% over the last six months, while the real has declined 37%.

Faced with Brazil's volatility, Mexican officials offer brave talk about their own sound policies, but they too glance anxiously to the south. "We are not so arrogant as to think we're completely immune," says Mexican Finance Ministry spokesman Raul Martinez. "But markets have learned to differentiate, and they usually see Mexico as a quality choice within the region." To help buttress Mexico further, the government of President Vicente Fox will present a budget for next year that seeks to lower the shortfall in overall spending to 0.5% of economic output compared with about 0.65% right now.

Despite turmoil in Brazil and Argentina, Mexico's interest rates have barely budged this year, and the effect on prices from the recent fall in the peso has been muted. But a full-blown Brazilian debt crisis would certainly raise borrowing costs for both Mexican companies and the government, as well as hit the peso and other Mexican prices.

"Brazil is critical," says Mexican central-bank Governor Guillermo Ortiz. "We hope Mr. Lula sees and understands the consequences of restructuring the debt, even if it's done in a benevolent way."

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