Report from Rio by Lorenzo Carrasco

Banking crisis explodes in Brazil

The bailout of Banco Economico presents Brazil's anglophile President with an impossible political dilemma.

The Central Bank's intervention into Banco Economico, the seventh largest Brazilian bank with assets of over $8 billion and the oldest bank in Ibero-America, founded in 1834, which has been trying to avoid bankruptcy since the beginning of 1995, sparked a crisis of confidence in the entire Brazilian banking system and threatens to break up the base of congressional support for the government of President Fernando Henrique Cardoso.

Banco Economico, which has its home office in the northeastern state of Bahia, and its main shareholder Angelo Calmon de Sa, have been the key promoters of the political career of Sen. Antonio Carlos Magalhaes, who is President Cardoso's top political ally.

In reality, the Central Bank intervention should have occurred months ago, when rumors about Banco Economico's health provoked a gradual run on the bank which worsened its situation. According to reports confidentially given to *EIR* in Brazil, in May there was a secret visit by U.S. Federal Reserve officials, interested in the Banco Economico situation because of its ramifications in New York, London, and some of the Caribbean tax havens.

Less than a month ago, in mid-July, Banco Economico attempted, via SBC Warburg, a division of the Swiss Bank Corp., to place $750 million in debt securities on the international markets. Apparently the operation failed. According to preliminary estimates, the resources required to save Economico may add up to $3 billion, without even knowing the financial hole which has resulted from international operations on the so-called derivatives markets.

According to source reports, two of the biggest banking institutions in the country are in similar straits to Banco Economico. It is feared that a chain reaction could occur because of the interconnection of the financial system through the Certificates of Banking Deposit, by which various banks will have to pay their debts to Banco Economico, and will be forced to wait for the liquidation process to get back their deposits in that institution. The volume of rediscount in the Central Bank is in the ballpark of over $2 billion.

The Brazilian financial system will have to get ready to see other banking institutions go down with Banco Economico. The reason, besides the very dynamic of financial speculation, is the dizzying increase in the number of cases of insolvency, both personal and juridical, owing to the interest rates imposed by the Real Plan. Individual bankruptcies in the trade have already led two of the biggest retail houses, Pernambucana and Mesbla, into "Chapter 11" type reorganizations last month.

According to University of São Paulo analyst Alberto Borges Matias, loans for questionable liquidation grew from 1.5% at the end of 1994 to more than 4% in July, and this rate is expected to reach 7% by the end of the year, which will mean losses in the financial system of over $10 billion. There are some financial institutions, especially the Banco do Brasil and state-level ones, in which this index is twice as high. According to Borges Matias, 40 banks could disappear by the first half of 1996.

The prevailing cynicism was voiced by the president of the Brazilian Federation of Banks, Mauricio Schulman, who suggested that the problem of some banks, such as Economico, is that they failed to speculate sufficiently on high-risk financial instruments. That means that the only way to survive the present policy is to speculate with government securities.

Adding to his headaches, President Fernando Henrique Cardoso will be forced to face the violent attacks of Sen. Antonio Carlos Magalhaes, the leader of the Liberal Front Party (PFL), his government's main base of support. Magalhaes, who has always been the protégé of the Sa family which owns Economico, is threatening to open an investigative committee in the Congress to air in public the whole sewer of the banking system and its incestuous relations with the Central Bank. The target of the attacks is the Central Bank president, Gustavo Loyola, of whom it is insinuated that he gave inside information to his old financial market clients, causing the run on Economico.

Whether these charges are true or not, for Senator Malgalhaes, saving Banco Economico is a matter of life or death for his family's political interests. His son Luis Eduardo Magalhaes is chairman of the Chamber of Deputies, and second in line in the presidential succession. For President Cardoso, if this showdown goes on, it could bury his constitutional reforms, the guarantee his government is offering in order to lure foreign capital to Brazil. But to rescue Banco Economico, he would have to kill whatever remains of credibility for the Real Plan and his personal integrity.

The latest news indicates that Cardoso has chosen the latter option, and accepted the bailout of Banco Economico by the state of Bahia.