

# The Situation in Brazil and its Implications

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before the Subcommittee on International Economic Policy and Trade House  
Committee on International Relations

February 25, 1999

The attack against the Brazilian currency, the *real*, is the most recent in a series of calamities that have beset developing countries during the past five years. The first case was the financial and economic fallout in Mexico following its awkward and unsuccessful attempt to devalue its currency in December 1994. This was followed in 1997 and 1998 by currency and economic turmoil in East Asian countries, from Korea in the north, to Thailand, Malaysia, and Indonesia in the south. Russian economic policy was deemed bankrupt by the international financial community last year.

The circumstances differ in each case, but there is a common thread: When national and foreign investors conclude that the financial and economic policies of a country are unsound, there is a cold-blooded flight from its currency. Jawboning by senior officials will not by itself change the minds of people and institutions who want to protect their assets. The flight of capital is facilitated by the advances of technology and the ability to move vast sums at the click of a computer key. The unusual -- namely, the rapid and devastating collapse of financial structures -- has become crushingly familiar. This is stimulating an intense discussion among experts about how to repair the international monetary structure to deal with this new phenomenon.

My comments today will deal with the Brazilian situation. I will divide my presentation into five themes:

1. [The nature of the problem in Brazil.](#)
2. [The contagion -- that which affected Brazil and that emanating from Brazil.](#)
3. [The role of the International Monetary Fund.](#)
4. [The implications for Mercosur.](#)
5. [The significance of Argentina's proposal to dollarize its economy.](#)

## Nature of the problem afflicting Brazil

In assessing the economic policy followed by Brazil in recent years, it is important to keep the historical context in mind. Brazil's inflation in 1994 reached about 5000 percent. Just about all monetary transactions were indexed -- mortgages, loans, other financial transactions -- as a way to neutralize the effects of this runaway inflation. In essence, therefore, money as such ceased to matter; the recalculation of obligations, based on the indexing, took center stage. With prices rising so rapidly, consumers did not delay in spending the money they received, such as to buy food and other consumer needs, lest the money lose purchasing power within hours. Not only did the timing of activities change, but the expected inflation was built into all aspects of people's lives.

The success of the current president of Brazil, Fernando Henrique Cardoso, was based on the real plan introduced in 1994 when he was finance minister. Annual inflation dropped quickly to single digits and Cardoso was later elected president mainly because of this achievement. He was reelected last year, still based on this accomplishment. It is hardly remarkable, therefore, that the central policy objective when the real came under attack in mid-1998 was to maintain the low inflation. The deputy managing director of the IMF, Stanley Fischer, when he was in Brazil earlier this month, was quoted as follows: "The critical issue now is to control inflation and to prevent inflation from returning."

The real, under Cardoso's plan, was pegged to the dollar and was permitted to fluctuate within a band. While Brazilian inflation came down, it remained higher than in the United States. As part of the anti-inflation effort, the nominal depreciations of the real were less for a number of years than this difference in inflation and resulted in increasing overvaluation of the real. This overvaluation was recognized and the Brazilian authorities were in the process of making the necessary correction, but they wished to do this gradually.

There was a conviction in Brazil, as there had been in Mexico in 1994, that there could be no discrete, small devaluations in Latin America. The Brazilian authorities were trying to buy time, but the markets did not give them this leeway. In seeking to buy this time, the Brazilians intervened in the currency markets, using as much as \$40 billion of some \$75 billion in foreign reserves they had accumulated. They raised short-term interest rates to close to 50 percent in order to attract capital and keep in place capital already in the country. When this did not work, the Central Bank widened the band within which the real traded to permit an 8 percent devaluation. This did not work either -- just as the same technique did not work when tried in Mexico in 1994 -- and the Brazilians quickly moved to a currency float. This is the situation today.

What did in the Brazilian policy? The overvalued exchange rate was one element. An uncorrected fiscal deficit, growing to what would have been 9 percent of gross domestic product this year if left untouched, added to the lack of confidence in Brazilian policy. The action by the governor of the state of Minas Gerais, the former president Itamar Franco, declaring a moratorium on the state's debt to the central government, added to the sense that the fiscal situation was out of control. This came on top of the government's failure to get all the elements of corrective legislation through the congress.

Brazil, to a large extent, did itself in. The combination of economic and political failures listed in the previous paragraph sent a message of instability to Brazilian and foreign investors alike and these investors then behaved rationally. Those who could then acted to protect their assets.

But the problem was not located uniquely in Brazil. The modern ease with which capital can move into and out of countries made possible the massive attack on the Brazilian currency. The Brazilian problem was thus created both by the international monetary system as it exists today and the internal shortcomings of Brazilian policy. The government's inability to control the political process added to the mix convincing those investors who could to save themselves.

## **Contagion**

The transference of financial problems from one country to another became part of the lore in the "tequila effect" following the Mexico peso collapse at the end of 1994. That effect turned out be short-lived. The financial collapses in Asia have had a longer-lasting effect mainly because of the economic declines that ensued, which led to a sharp drop in commodity prices and distortions in global trading relationships. One effect of this may turn out to be growing U.S. protectionism from declining U.S. exports to Asian countries and increased imports and a ballooning current account deficit in the U.S. balance of payments.

Another event that appears to have had a major impact on Brazil was the Russian collapse in 1998. Russia and Brazil are different -- very different. Brazil has a reasonably sound banking structure; Russia does not. Brazil has a sophisticated industrial base; Russia does not. Brazil has a large economy, about the eighth largest in the world; Russia has a modestly sized economy. At first glance, there is no reason why a Russian debacle should affect Brazil.

It apparently did because investors had to meet margin and other calls for assets and Brazil was one place to cash in. Emerging markets have been weak in recent years, after the Mexican and Asian crises, and the Russian example strengthened the perception that this weakness would not exclude South America.

Will there be a "samba effect" in Latin American from the Brazilian crisis? The first place to look is Argentina because it sends one-third of its exports to Brazil. However, exports are only a modest proportion of Argentina's GDP, less than 10 percent, and even a large decline need not be devastating. U.S. exports to Brazil are also modest, around \$15 billion, and these represent an infinitesimally small proportion of U.S. GDP. U.S. banks are less exposed in Brazil than are European banks.

The biggest danger from a samba effect is a slowdown in capital flows to all of Latin America and this would force many countries to curtail imports due to lack of financing. This would lead to trade declines and slower growth. It is hard now to predict Latin American GDP growth this year; a reasonable estimate is that it will be between 0 and 1 percent. In Brazil itself, GDP decline may reach 5 percent, and this would bring horrible hardships.

## **The IMF Role**

The IMF, with U.S. support, tried something new in Brazil late last year. It pulled together a \$41.5 billion line of credit for Brazil while the real was under attack but before the collapse. The credit was conditioned on Brazilian actions, especially budgetary stringency.

The Brazilian legislature passed some of the necessary measures to deal with the budgetary excesses, but did not approve some critical ones dealing with the pensions of civil servants and a financial transaction tax. What followed, exacerbated by the action of Itamar Franco, spelled doom for the IMF gamble.

Was the IMF action prudent? My own view is yes. It was hard to predict that, when faced with disaster, the Brazilian legislature and individual Brazilian governors, would not act prudently. Part of the fault may have been the government's and its failure to lobby adequately with the congress.

The IMF is back once again. The legislation defeated earlier is on the way to passage. The IMF is now insisting on larger budget cuts than were demanded earlier. The primary budget surplus (i.e., before interest payments) for this year is projected to be between 3 and 3.5 percent of GDP. The IMF is apparently also insisting on high interest rates, probably in excess of 40 percent. If carried out, all of this means a sharp drop in GDP, but perhaps limiting inflation. The government's earlier aim was to hold this to less than 10 percent this year, but this is widely optimistic.

Many Brazilians and non-Brazilians, including George Soros, are critical of the high interest rates. This is sure to stifle economic activity, especially if continued very long. It also exacerbates the government's internal debt problem, which already is acute. But the alternative is high inflation. Therein lies the rub. If inflation shoots way up, the real plan is completely dead and Cardoso's claim to presidential success would be largely destroyed. By contrast, a decline in GDP for a limited time -- say, a year -- may be less destructive.

Outsiders must be careful about shooting off their mouths on this delicate tradeoff. Too much is at stake for this presidency and for the future of Brazil over the coming years. Brazilians are better positioned to make determinations about their own political priorities and this, essentially, is the debate taking place within the country.

## **The Future of Mercosur**

Mercosur, a customs union comprising Brazil, Argentina, Paraguay, and Uruguay, has been immensely successful. From 1995-1997, internal exports among member countries grew by about 20 percent a year, about triple the rate of exports outside the customs union area. This intra-Mercosur trade declined slightly in 1998, largely because of the uncertainty in Brazil.

The decline in value of the real, coupled with the near certainty of a decline in the Brazilian economy, puts the future of Mercosur in some peril, especially in the short term. The Argentina peso is fixed at 1-to-1 with the U.S. dollar and cannot be devalued without destroying the convertibility that made it possible to rid Argentina of its inflation scourge. Meanwhile the Brazilian real has declined from about 1.32 to the dollar to about 1.97 (as of Monday afternoon, February 22), or by 50 percent (as of that point). This will make it easier for Brazil to export to Argentina and harder for Argentine traders to sell to Brazil. The decline in the Brazilian economy will complicate matters further.

In the short term, Brazilian-Argentine trade will become unbalanced, as will Brazil's trade with Paraguay and Uruguay. The presidents of Brazil and Argentina (Cardoso and Carlos Menem) met earlier this month about the future of Mercosur. Each country has benefited too much from the customs union to let it collapse, but it faces difficult short-term problems.

My institution, the Center for Strategic and International Studies, devotes much attention to Mercosur and has organized a congressional study group (CSG) to keep Mercosur developments under constant examination. The co-chairs of the CSG are Senators John Breaux (D-LA), Mike DeWine (R-OH), Bob Graham (D-FL), Representatives Robert Matsui (D-CA), Robert Menendez (D-NJ), and Jim Ramstad (R-MN). We would encourage more members to join.

## **Dollarization of Argentina**

Argentina now operates under a currency board designed to limit central bank discretion in setting monetary policy. Each Argentine peso in circulation is fully backed by dollar reserves in order to assure convertibility. This structure was threatened by the tequila effect, but Argentina did not succumb to devaluation. What this structure means, however, that any fallout from the samba effect cannot be corrected by devaluation of the peso, but must be taken by a decline in the overall Argentine economy.

President Menem, no doubt to augment the conviction in the minds of Argentines and foreigners, recently suggested moving from the currency board structure to full dollarization of the Argentina economy. The U.S. dollar would be the legal currency and the peso would disappear. Panama has precisely such a system, except for coins. The Brazilian authorities have made it clear they are not prepared for such a momentous step, namely, to give up any independent monetary policy.

It is hard to say how far the dollarization idea will go, how the United States will react, and how much more widespread it could become in Latin America. For now it is an idea put into the public domain, one which has its logic and its difficulties. My sense is that we in the hemisphere are only at the start of a discussion on the concept.