Number 238

THE BRAZILIAN ECONOMIC CRISIS: POLITICAL AND ECONOMIC IMPLICATIONS

Alexandre Barros
Alkimar R. Moura

Latin American Program
Woodrow Wilson International Center

This publication is one of a series of Working Papers of the Latin American Program of the Woodrow Wilson International Center for Scholars. The series includes papers in the humanities and social sciences from Program fellows, guest scholars, workshops, colloquia, and conferences. The series aims to extend the Program's discussions to a wider community throughout the Americas, to help authors obtain timely criticism of work in progress, and to provide, directly or indirectly, scholarly and intellectual context for contemporary policy concerns.

Single copies of Working Papers may be obtained without charge by writing to:

Latin American Program Working Papers
The Woodrow Wilson International Center
One Woodrow Wilson Plaza
1300 Pennsylvania Avenue, NW
Washington, D.C. 20004-3027

The Woodrow Wilson International Center for Scholars was created by Congress in 1968 as a "living institution expressing the ideals and concerns of Woodrow Wilson, symbolizing and strengthening the fruitful relations between the world of learning and the world of public affairs." The Center's Latin American Program was established in 1977.

Preface

These papers were prepared for a public conference held at the Woodrow Wilson Center on March 4, 1999, entitled Crisis in Brazil: Economic and Political Implications. The meeting was part of a series of activities organized by the Latin American Program that center on aspects of modern Brazil, its regional role, and its relationship with the United States. The objective of the *Brazil at the Wilson Center* project is to increase awareness and understanding of modern Brazil, its role in inter-American affairs and the broader international system, and to elevate its profile in the Washington policy community. Between 1996-1999, *Brazil at the Wilson Center* has included public meetings on the Cardoso administration, social policy and governance, prospects for political reform, the role of the media in Brazil's democracy, and U.S.-Brazilian relations. In 1998 the project cooperated with the Inter-American Development Bank to hold an exhibition of photography by Sebastião Salgado. Reports and papers from these meetings, as well as other papers from scholars of Brazil who have visited the Wilson Center as Public Policy Scholars or Fellows, are available upon request from the Latin American Program.

If you would like any further information on Brazil at the Wilson Center, please contact Ralph Espach at (202) 691 4088, or *espachra@wwic.si.edu*.

BRAZIL BEYOND 2000: THE DEVIL'S ALTERNATIVE?

Alexandre Barros

Would President Cardoso be better off if he only had one Term?

President Cardoso was reelected in the first round of a two-round election by a majority of 53 percent.

Surveys indicate that 18 -20 percent of voters would vote--or have voted--for Cardoso no matter what.

The remaining 33 percent voted for him not because of the panic with the PT which presided over the 1994 election, but, simply because they did not have an alternative.

None of the several brands of opposition were able to offer a credible option for voters.

Thus, what we basically have is a situation in which, in addition to the 47 percent of voters who did not vote for president Cardoso, an additional 33 have a low degree of allegiance. Once the magic is over, this 33 percent of voters is ready to be alienated from the government and withdraw support.

They voted for magic. That's what they want, but that's not what they are getting.

All Politics is Global Politics

The first lesson that Brazilian politicians and opinion makers are learning is that all politics is not local politics anymore. It is global politics.

Different areas of the Brazilian polity are learning this lesson at different speeds.

Actors who try to act in accordance with the idea that all politics is local are soon defeated by the uncoordinated actions of 40,000, or so, traders around the world. Accusations of conspiracy are useless. They do not solve problems, although they may relieve personal tensions.

Politicians blame globalization and they sometimes invoke the testimony of George Soros. Or satanize him. This is the good characteristic of Mr. Soros: he can be both idolized or demonized.

The world is perceived as being upside down.

What do we do now? We have been administering a tested cocktail of remedies--higher interest rates, votes of reforms--and the illness does not go away.

Are we facing a new virus which is immune to traditional treatment?

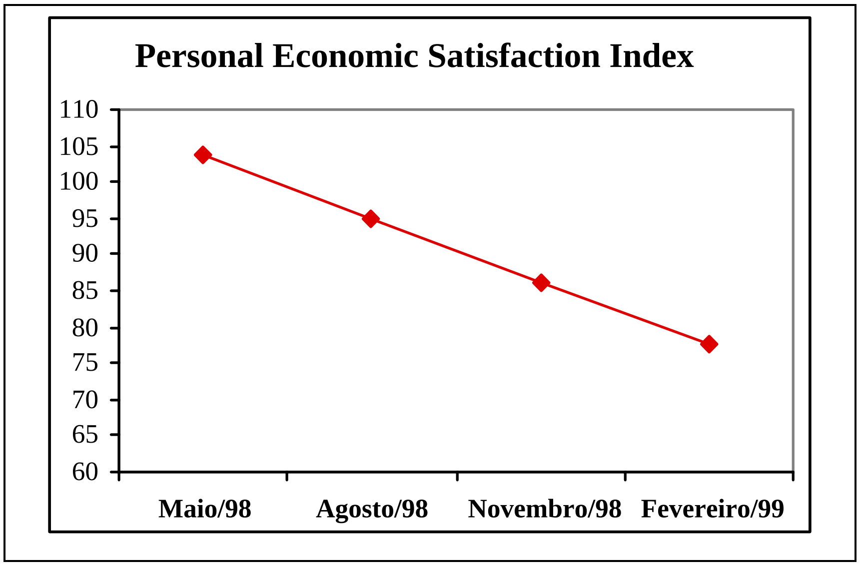
This seems to be the case. On one hand the Brazilian government follows the prescription of the Fund. Illnesses which were treated by interns in the past, are now being tended by the directors of the hospital who see their prestige and their jobs at stake. The result is the same. The patient does not get better.

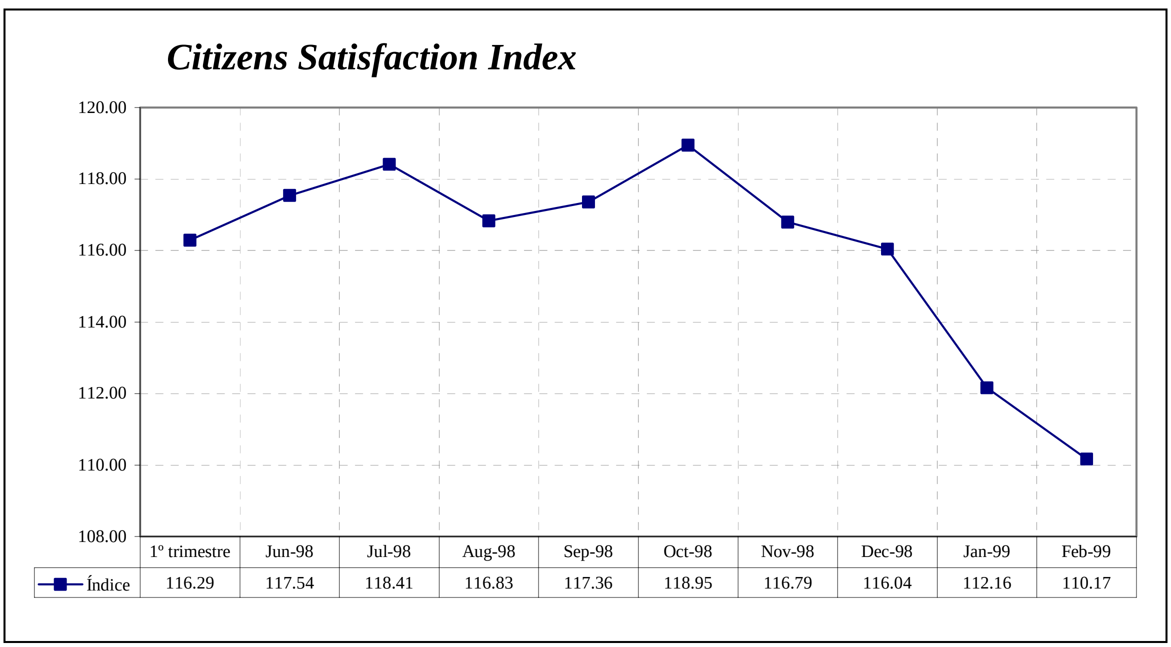
Why isn't the Magic Wand Functioning any more?

President Cardoso is perceived as honest, charming and cosmopolitan. Above all he was the president who brought stability. He is seen as the statesman who put an end to a vicious circle of inflation-confiscation through under indexation-worsening of income distribution-round and round.

Questions that are in the minds of the average Brazilian voter/consumer who, only now, is starting to feel the pinch of the crisis are: Why has the situation changed? Are we going back to the same instability of the past? Is inflation coming back?

Satisfaction indices with the government are going down, as the ones below, produced by the regular surveys taken by the National Transportation Confederation.





In a survey of business people, by Early Warning, 61 percent of the 120 respondents who answered the April 1999 round of the Brazil Business Thermometer think that their companies lost with the currency fluctuation policy. Regardless of this, 84 percent consider this a correct policy.

As for the future, 78 percent of them expect better business one year from now.

However, one of the themes that concerns them is the effect that recession and unemployment may have upon political stability. 73 percent of them think that this may be the case. Only 23 percent don't see recession and unemployment threatening political stability.

The contradictory information is that although 58 percent of the respondents are unhappy with the Cardoso Administration since January 1, 1999, 80 percent think that the government is competent to overcome the crisis.

After these surveys were taken, the headlines were taken by the congressional investigations on the role of the Central Bank during the January devaluation process. The government is under suspicion, but doesn't say anything. Instead it makes attempts to deflect attention to the Congressional Investigation of the Judiciary.

The investigations of the Central Bank focus on alleged corruption in the process of rescuing two banks--with government money--during the crisis of the real in January. Those on the Judiciary focus on alleged corruption on the part of judges all over Brazil.

Congressional investigations have considerable consequences if the charges which come to the public eye are easy to understand, as is the case of the committee investigating the role of the Central Bank. The one on the judiciary is so wide, diffuse and complicated that the average citizen loses interest very quickly.

The investigation of the Central Bank is politically hot. The charges are easy to understand, they are heavily focused and they stir the indignation of the common citizen. This is so regardless of the charges being true or not.

They are as easy to understand as the Monica Lewinski investigations of President Clinton, except that, as far as public perceptions go, the loser in the Brazilian case is the tax payer. There's more involved than oral sex.

The Crisis gets to People

When stock markets falls down they make the headlines but they do not affect people immediately.

When people lose their jobs and their capacity to pay the installments for the blender (yes, people do buy blenders on credit in Brazil!), the microwave, the kid's bike, the color TV, the Fiat Palio, or even the BMW, perceptions start to change.

Optimists are predicting an unemployment rate of 8 percent for 1999. Pessimists go for 15 percent.

When he was informed that unemployment was 5 percent in the US, President Clinton allegedly said: It is good to know that 95 percent of the people are employed.

The Brazilian figures are getting to be just too big for this kind of rhetorical turnaround to function.

As of May 1999, unemployment was above 8 percent. All the polls which have been taken recently show a loss of confidence in the government.

The recent survey published by weekly magazine Época (Number 53 - 24 May 1999), owned by the powerful media group O Globo, published the results of a poll showing that President Cardoso is the Brazilian person the respondents are more ashamed of (26 percent), followed by "Don't know" (20 percent) and by the former President Collor (16 percent). *NOTE: Ralph: credit card indebtness is not a good indicator in Brazil because the number of users of credit cards is still very small.*

Negative Perceptions of President Cardoso are Bound to Return.

The basic one is that he does not understand the problems of Zé da Silva, the Brazilian version of John Doe, poorer though.

President Cardoso will gradually have to take back some statements he made in the past, such as “it is easy to govern Brazil.” He will have to face the fact that he not only presides over a nation of hillbillies (caipiras) in his own words, but those are poorer "caipiras".

These "caipiras" are not ready to be convinced that "the life of the rich is boring" (as President Cardoso recently stated). They had a taste of it. Now they’re being expelled from paradise by the angel with the fire sword.

The policy of inflation control implemented by the Cardoso Administration during its first term did benefit poor Brazilians in the sense that it eliminated (or at least reduced dramatically) the "inflation tax" which burdens the poor who live and operate on cash and have no access to indexed bank accounts such as money markets. An inflation rate of over 20 percent a month (with pay raises not taking place every month) represents a huge burden on low income people, as they can lose cumulatively over 60 percent or 70 percent of their buying power in a quarter.

Brazilians have a strange desire to own their houses--a major cause of traffic jams in the big cities because as Brazilians change jobs they have to commute, according to president Cardoso.

Maids cannot travel to Europe any more, as his personal maid did a few months ago.

Perhaps, voters will remember that during the 1994 campaign Mr. Cardoso stated that it was hard to be a candidate because one had to kiss old ladies and one voter even stole his watch.

The situation now is reversed. It is the voter who feels that his watch is being stolen by the government when the repossessors come to collect the refrigerators, blenders, microwaves, sound systems, bikes and roller skates because the poor could not pay the installments.

Banks which finance cars are having to rent parking lots to keep repossessed cars.

***What did Cardoso do wrong?* or The futile exercise of finding the guilty.**

It is a futile exercise to try to determine who is guilty. Unfortunately nations do not work this way.

The fact is that, as paradise was promised by the government, the failure to deliver it belongs to the government.

Prior to the Cardoso Administration Brazil lived an endemic crisis. Everybody knew inflation was under the bed and the problem was to know how big it would be. The poor suffered a lot. The middle class muddled through with money market accounts, and the rich made money.

With the dramatic drop in inflation from 1994 to 1998 Brazilians forgot what it meant to live in a crisis. They lowered their defenses, and the expectation was that the crisis would never come back. But it did.

The Executive insists that Congress did not vote, and did not do its homework.

The common citizen does not care whether it was Congress who did not do its homework, the fact is that it is the citizen who will be penalized.

The Brazilian Congress is basically a reactive house. More than 90 percent of the bills voted by Congress originate from the Executive (The Executive can introduce bills) and more than 90 percent of them are approved.

Furthermore, if we look at the Congressional record, all the reforms proposed and introduced by the government were voted on and approved by Congress.

If bills were not voted upon, it was because they were not introduced, or they were introduced and withdrawn by the Executive. Such was the case of the tax and revenue sharing reform. Three proposals have already been discussed by the Executive (one was actually introduced and withdrawn from Congress) and none went ahead.

All the economic reforms introduced by the Executive were duly voted. Most of the bills necessary for privatization were voted on time.

The social security and the administrative reforms, as well as the fiscal and the revenue sharing reforms were the only ones which were not voted in due time.

However, this was not because Congress did not want to vote on them, but, instead, because President Cardoso chose to introduce the amendment allowing for his own reelection prior to these.

A lot of his political-congressional capital was spent on the approval of this reform and very little remained to be invested in the remaining reforms, even before the financial crunch.

Congressional Troubles

When one looks at the Congressional figures, it is really surprising that the government did not get its recent proposals approved.

After all, both in the 1995-1999 Congress as well as in the early days of the 1999 Congress the government has ample majority to get any measures approved. The opposition has neither the muscle nor the numbers to defeat any government measure.

The government had 68 votes more than the needed ones for any constitutional reforms in the House and 38 votes in excess to the ones needed in the Senate.

During the new Congress' first week of operation(February 1999) 51 members of Congress (out of a total of 594--513 in the Chamber and 81 in the Senate) changed parties.

When one looks at recent history, the perspectives are not encouraging. During the 1991-1994 Congress, 267 Members crossed party lines. Between 1995 and 1998, 250 did the same.

Most of these did not cross lines between the opposition and the government, but, instead, switched within the same side among the 19 parties existing in Congress. The commitment of politicians to parties is minimal given the electoral system and this generates a large amount of uncertainty for the government.

This is aggravated by the hesitancy of the Executive (the Cardoso Administration) to introduce measures and make clear to Congress how much it wants several measures approved. This does not preclude the approval of measures. It simply increases their price in terms of pork barrel.

The fact is that the Brazilian proportional system puts an excessive burden on representation. As a matter of fact, the hesitancy of the government to clearly relay to Congress how much it wants measures, does delay decisions. However, all the decisions demanded by the Executive were approved by Congress.

The Brazilian system is proportional, with open lists. Practically, this means that in any state a voter can choose among as many candidates as that state has seats in Congress multiplied by the number of parties. Thus, the menu of candidates available, in large states such as São Paulo, allows each voter to choose one out of almost one thousand candidates.

This causes a very wide dispersion of votes. "Star" candidates get many more votes than the quota they need to be elected and generate left-over votes which go to the party's common basket. In addition, there is an enormous number of "small fry" candidates who get a few votes (not enough for any of them to be elected) which go to the common basket to benefit those who had some more votes. It's the sardines feeding the sharks.

Thus, the name of the game for the parties is to get as many candidates as possible to and as many "stars" as possible, so that they get many leftovers, plus fill all the candidate positions so that the "small fry" contribute with their votes for the common basket, although there is no benefit whatsoever for the "small fry" candidates.

As a result of this system, in the 1995-1998 Congress, only 13 out of 513 Members of Congress were elected with votes cast to them! And in the current Congress only 28 out of 513 Members of Congress had sufficient votes cast for them to win their seats. All the remaining Members of the Chamber of Deputies needed votes cast to other candidates or to the party--and deposited in the common basket--to get into Congress!

Furthermore, when one considers all voters and subtracts registered voters (voting is mandatory in Brazil) who did show up to vote, voters who cast blank votes, voters who voided their ballots, all those who cast votes for candidates to the Chamber of Deputies who were not elected, all those who voted for parties which did not get enough votes to elect even a single member of Congress in several states, this brings us to a Congress where only 27 percent of voters are represented. And this is a system with mandatory votes.

If we add the natural erosion of political capital of the Cardoso Administration in its second term to the blame public opinion is putting on his administration for the devaluation of the Real and its consequences--inflation, recession, unemployment--it is to be expected that the reforms during the second term will certainly be more difficult and more expensive.

This has to do with the types of reforms that will be voted now.

The reforms already undertaken and still to be undertaken by the government can be divided into three categories, depending on the clienteles they are likely to affect.

The economic reforms, which were first undertaken (oil, telecom, distinction between national and foreign companies, etc.) affected positively a very concentrated clientele (banks and investors) and negatively a very diffuse one. Thus, most of the opposition to them was ideological. Otherwise, the "losers" had very little capacity to mobilize themselves.

The second batch, mostly touching social security and the administrative reform affected negatively two relatively cohesive groups: civil servants and politicians. The later by extension, as a large proportion of Brazilian politicians originate from the government service and benefit--as well as families and supporters--from the privileged retirement conditions, the inflation in salaries and hirings for government jobs.

The third batch, still to come, will be the most difficult. It will touch on the essence of power of the Brazilian political elite; the judiciary, the tax and revenue sharing systems and the political organization.

Old Sins Have Long Shadows

To maintain its support in Congress, the Geisel Administration (1974-1979), still during the authoritarian years promoted a change--without Congressional approval--which increased dramatically the number of representatives of the most economically backward states in Brazil (concentrated on the Northern and Northeastern regions).

The number of votes needed to elect a Member of Congress in a proportional system such as the Brazilian one became much smaller in those states, which are also underpopulated. These are states where traditional patronage electoral practices prevail. It is these that the political elite mostly benefits from: a system where its representation is dramatically inflated.

The portion of the political elite which benefits from this system tends to concentrate in the parties which support the Cardoso Administration. The cost for the government is pressure to preserve the current system.

Proposals to introduce a district system more similar to the United States--which would make the system more representative--face stiff opposition because with representation, comes responsiveness, responsibility and constituency. Two of these concepts-- responsiveness and constituency--don't even have equivalent terms in the Brazilian political lexicon, simply because the institutions to which they refer do not exist in the political system.

On the fiscal and revenue sharing sides, the current situation highly benefits the most traditional elites. It favors income concentration via an unequal tax burden which penalizes large groups while preserving privileges of the elite.

The government, so far, has not had the disposition to face the challenge. As a matter of fact it introduced a bill for fiscal reform in 1995 and then withdrew it.

Another bill was discussed by the Executive in 1998, but the government seemed to not like that one either. In this case, it is not only portions of Congress that do not want to vote the bill, but the Executive has not been capable of getting its act together.

Thirdly, on the judicial side, not only are there benefits derived from nepotistic employment conditions, but there is also the fact that it is in these areas that the political and economic elites (which tend to overlap much more in economically backward states) derive benefits from an inefficient judiciary.

Many judicial questions involve inter-class (as opposed to intra-class) court cases, and the traditional elites benefit from the inefficiency of the judiciary. Inefficiency here means endless court cases that last for dozens of years and/or fall within the statues of limitations, thus preserving existing privileges.

The first batch of reforms was relatively easy because the traditional elite did not have much interest in more modern areas of the economy, such as oil and telecom (regardless of the couple of thousand of patronage jobs the Telebrás system generated for cronies of politicians), thus there was no reason to resist such reforms. Those went relatively quickly and relatively cheaply.

The second batch, was a little more difficult. Civil servants and members of the political elite could sew up an alliance to slow down the process or to dilute the reform.

The third, the political reform is even more difficult because it will touch on the essence of power of the traditional elite: political representation and court cases.

There's no Such Thing as a Second Honeymoon

Retrospectively, what we can see is that the Executive, in addition to wasting the honeymoon, in many instances, either did not make it clear what they wanted or did not make it clear how much it wanted a given measure.

Members of Congress who support the government constantly stated that either they did not know what the president wanted or they did not know how strongly the government want a given bill approved.

In this case they acted like their counterparts everywhere. They charged more for their votes in pork barrel, plum appointment for political supporters, day care centers, medical clinics and public works. Were Mayor Richard J. Daley alive he would understand the situation perfectly well.

To summarize, hesitancy and slow decision making, together with a waste of the honey moon period, took care of spoiling the process.

So, when the government comes and says that now "we" have do this or “we” have to sacrifice that, voters respond with a: If he knew he had to do it, why didn’t he do it in the first place?

Looking back on the elections, Brazilians decided to stick to the devil they knew, but they ended up jumping in the dark.

Four Inglorious Years: What Lies Ahead?

The future is not bright, no matter what.

What has to be done now, either in accordance with the old prescription or with any new prescription involves cutting expenditures, trimming government structure for the provision of basic services to the poor, which are already pretty bad.

These are going to be inglorious years from the point of view of any politician. Unemployment will be high. People will have access to fewer goods and services.

Deregulating the economy so as to allow the poor to make money, which was an easier proposition in the fat years will become increasingly difficult as the pie shrinks, ergo the impetus to maintain and to increase existing restrictive regulations will be much stronger than it would have been in better years.

This is something few politicians want to have in their biographies.

The so called Brazilian miracle of the early Seventies was only possible because Messrs. Octávio Gouvêa de Bulhões and Roberto Campos took care of the unpleasant clean up between 1964 and 1967, but Minister Delfim Neto is remembered as the architect of the miracle. The "miracle" of the early Seventies was seen as a policy that concentrated income, and the public view of the crisis was that although the poor were losing their share of the national income, the middle class was able to get credit to buy cars from the then newly-installed Brazilian auto industry in 36 installments, something which was not possible during the days of inflation which immediately preceded the 1964 military coup. These easier policies for the middle class became possible only thanks to the clean up by Messrs. Campos and Bulhões.

Is the Government Capable of Solving the Crisis?

Surveys mentioned earlier in this paper have been showing that gradually the degree of confidence in the government is diminishing, as the effects of the crisis migrates from the headlines to the pockets of citizens.

One trademark of the attitude of the Brazilian government, from the political point of view, is that since the Asian Crisis in 1997 it has either been paralyzed or has adopted a negative attitude.

The paralysis became clear in the fact that the markets were crumbling and the government did not know what to do in 1997. The response was a "fiscal shock" which meant higher taxes and higher interest rates with very little cut in government spending.

The same happened in the occasion of the Russian crisis in 1998.

And once again early in 1999 the Real was finally devalued as the result of an attack on the currency that the government had been swearing would not happen.

The government boasting about the US$ 70 billion in reserves which were going to allow Brazil to defend against any attack on its currency, ended in a loss of US$ 40 billion plus in reserves wasted. It was an expensive and vain effort to defend the currency.

More or less at the same time that the government was discussing the raise in taxes and the social security cuts, the higher échelons of the government: president, Chief Justice, President of the Senate and President of the Chamber of Deputies were discussing pay raises...for themselves.

The tax burden in Brazil has grown from 1996 to 1999 roughly from 29 percent of the GDP to 34.5 percent of the GDP with no increase in services. This is making voters wonder where is this money going.

Enter Itamar Franco

Early in January of 1999, former President Itamar Franco, now governor of the state of Minas Gerais, did what is making the PT extremely envious.

By saying "I won't pay [the state debt]" he achieved several things. First--and probably more important than anything from his own point of view, he staged a revenge against his former Minister of Finance--President Cardoso--whom he accuses of having denied him the "paternity" of the Real, of having side-tracked by appointing him ambassador to Portugal then to the OAS and finally--and possibly more important--of allowing the humiliation Mr. Franco suffered from the internal opposition of the PMDB in the national convention, when Mr. Franco wanted to be considered as a PMDB candidate to the presidency.

Second, Mr. Franco managed to get back in the headlines, in Brazil and abroad.

Politically, in the beginning, the reaction was that Mr. Franco was "crazy," irresponsible and the like. Pretty soon, however, as the effects started to be felt by the common citizen, the perception started to change. Mr. Franco started to be perceived as the guy who said that the emperor was naked. In other words, from being blamed for the crisis, he turned into the guy who denounced a model which was already exhausted anyway.

From the point of view of the other governors, Mr. Franco was the unrecognized spokesman for them, i.e., the governor who voiced a concern which the other governors could not because they were heavily dependent on the federal government. Mr. Franco could do it due to a combination of two things. On the one hand, he was a former president and could afford a battle of this magnitude. Second, thanks to his mercurial personality he had the guts to do it.

From the point of view of voters Mr. Franco started to position himself as a possible candidate for the 2002 presidential elections.

Some analysts are suggesting that he has been exaggerating and is blowing his chances, but Mr. Franco is betting on the widows and orphans of the Real; all those people who are frustrated by the government policy who are a growing group. He is also betting on the possibility that things will get worse before they get better.

Possible Scenarios for 2002

Congressionally, The PSDB is likely to grow during the term of Cardoso--after all people like to be in the president’s party because this is where you get the goodies, but, depending on what happens there is a good chance that they will desert the PSDB by election time.

The PFL will be trying to present its own candidate, a feat which it has attempted in the last three elections—Cardoso’s reelection excluded--without any success. So has the PMDB.

The PMDB is betting on Mr. Franco. Although denying public support for him now, the fact is that out of the two more traditional and bigger Congressional parties, the PMDB does have a potential candidate, especially if the situation worsens.

The PFL has a serious problem because it lacks a candidate. It was betting on Mr. Luiz Eduardo Magalhães, who died suddenly of a heart attack at the age of 42 in 1998 and nobody knows whether there is enough time to groom another viable candidate. His father, however, after a painful mourning, seems to have recovered and has been demonstrating an amazing degree of energy and thrust to occupy political space and position himself as a candidate, regardless of his 72 years of age. He is currently a Senator and is the President of the Senate. In any event, if Senator Antonio Carlos Magalhães decides not to run, he is certainly positioning himself as an important power-broker for the 2002 elections, not to speak of increasing PFL's chances in the 2000 municipal elections.

The dark horse in 2002 is also former president Fernando Collor who will have finished his quarantine and will be able to compete.

Immediate Risks

The recovery from the January crisis seems to have been faster than anybody expected.

The emergency room measures seem to have been relatively effective: the dollar cost rolled back and a minimum of international confidence seems to have been restored, in the hope that the reforms will come.

The real and Real danger starts now. After the emergency room and intensive care unit treatment, patients have a tendency to abandon many of the doctor's recommendations very quickly. This is a concern of some market analysts in relation to the Asian recovery and there are some who fear that Brazil might follow along the same lines.

And as the reforms will be more difficult from now on, the pressures for the government to ease up will become increasingly more intense.

This will be even more so now that the balance in the political account of the government is low. The municipal elections are just down the road (October 2000). Several presidential candidates are already trying to position themselves for the 2002 presidential elections.

When one looks at the past, all the reforms were approved--as most bills introduced by the Executive are anyway.

The trouble is not whether; it is when and how much it costs.

If the sense of urgency of the crisis is maintained, it will be possible to count on the fact that the reforms will probably come within a reasonable time. If this sense is lost, there is the risk that they may be delayed more or less indefinitely.

The question remaining is the cost. All indications are that it will be more expensive.

After all, the Executive is trying to implement reforms based on the hardly learned notion that politics now is global. It depends, however, on a political elite that not only still considers all politics to be local, but also which has a strong vested interested in maintaining it this way.

This makes representativeness into one of the key issues in the Brazilian political system.

Why will the Reforms be Increasingly Difficult from now on?

First, Mr. Cardoso started to reduce the presence of political appointees and to increase the presence of professional senior civil servants into important positions. These people are familiar with the operation of government machinery, and are more able to control costs and to tame the bureaucracy.

This change is being done without fanfare and is aimed at reducing the risks and allowing him to govern with little political capital.

This, however, increases the political costs of approving measures in Congress.

On the financial side, Mr. Cardoso finally seems to have understood that all politics is global, not local.

The Central Bank which was a stronghold of innovative economists--such as Mr. Gustavo Franco [no relation to former President Itamar Franco], dismissed early in January, and professional bureaucrats was turned over to a group of young financial wizards under the leadership of Mr. Armínio Fraga, former Manager of the Soros Fund, Mr. Daniel Gleizer, former IMF Economist and ex-market analyst of the First Boston-Crédit Suisse-Garantia Investment Bank and Mr. Sérgio Werlang formerly from Banco da Bahia.

Now, with congressional investigations about improper--if not illegal--acts on the part of the Central Bank on the occasion of the devaluation of the Real, the government effort is to prevent spill over of old sins into the current situation which seems to be showing faster signs of improvement than it was the case.

Whether it will succeed is a big question mark.

So far, The containment operation seems to have been fairly successful. The dollar rolled back from a high of R$2.20 in January to R$1.68 late in April.

The unexpected political trouble is the Congressional investigation of the "financial system" which the government wanted to avoid for fear that it might unearth embarrassing facts--not necessarily proved--and divert Congressional attention from more important reforms.

Very seldom do Congressional investigation committees lead anywhere. Usually it is a lot of noise with few, if any, results. The exception is when the allegations they investigate are easy to understand by the average citizen. And, in this case, the allegations are very easy to understand:

the Central Bank sold dollars to a few banks for less than it sold to others. And one of the bankers involved allegedly paid $125,000 a month to unidentified sources inside the Central Bank for privileged information on the exchange rate policy.

From the public's point of view it is relatively irrelevant if this charge is true or not. The fact is that it is easy to understand and the expectation will be that new charges are still to come.

This is creating a schizophrenic situation: from the economic point of view the situation does not seem to be as bad as it seems at first, but from a political point of view there are several retarded-effects bombs which could explode at any moment.

Mid-Term risks

Austerity measures are always controversial. Some actors win and others lose.

The current Brazilian situation is not different.

Regarding unemployment, it's business as usual. The rates are going up. The question is whether such raises will be socially and politically tolerable.

Socially, they certainly will. Brazil has a wide net through the informal economy which is estimated to be one third of the above ground economy. Thus, chances are that this net will become even wider. With a lowering of standards of living, of course. The poor are expected to suffer even more than they already are. However, major upheavals are not expected.

Politically, however the situation is different. President Cardoso has built his reputation on the stability of the currency. Once this is lost--and it may be thanks to the inflation resulting from the devaluation--the 33% of voters who chose Mr. Cardoso in the last election for lack of another choice will be ready to withdraw their support.

The consequences of this are likely to start to be felt in the municipal elections of the year 2000, but these will not be very serious because there tends to be a long distance between local and national elections, although the PSDB is likely to lose some local governments in this election. In addition, it will probably not gain as many as it could in the absence of the crisis.

The most serious consequence from the government's point of view however, is likely to appear in the 2002 presidential election, when the PSDB in the absence of a strong political candidate may fall hostage to either the more rightist PFL, which may try to run with Senator Antonio Carlos Magalhães, or to the PT, which may run with current Governor of Rio Grande do Sul Olívio Dutra.

There is also a surprise hypothesis in the event of an alienation of too many voters from the Cardoso Administration, which is the revival of former Presidents Fernando Collor and Itamar Franco, who may try to settle their disputes in 2002.

On the economic side, although the price of the dollar is rolling back, the risk seems to be a dramatic increase in the public deficit thanks to the successive dramatic hikes in interest rates which have been in effect on and off since the Asian crisis in 1997.

The most important characteristic now is that most players in the political arena are already playing with an eye on the 2002 presidential elections.

A very shrewd observer of the Brazilian and US political scenes, Paulo Sotero, veteran correspondent of O Estado de São Paulo in Washington--and a long time US resident-- stated in August of 1998 that one of the risks of the re-election in Brazil was that the Brazilian political system did not have any experience with re-election, so there was the risk that the president could become lame duck president very early in his second term.

The risk is real. Each politician who sees himself with a chance in 2002 decided to unearth a theme that might catch the limelight. Some of these do not touch the government directly, such as the investigation on the Judiciary proposed by combative Senator and Senate President Antonio Carlos Magalhães. Others may, such as the investigation of the financial system, or the campaign of Governor Itamar Franco against the government.

Competition can be good or bad. In this case, as each alleged scandal or investigation loses terrain for others, their sponsors are likely to escalate.

THE COLLAPSE OF THE BRAZILIAN FOREIGN EXCHANGE ANCHOR[1]

Alkimar R. Moura[2]

Introduction

The objective of these notes is to review the recent collapse of the Brazilian currency, the "real," after the enormous outflow of foreign capital, which reached its peak following the Russian moratorium. Between August 1998 and February 1999, Brazil lost US$ 31,837 billion in foreign reserves, or 62 percent of the stock held at the end of 1997. Even the availability of the so-called "enhanced" lending facility set up by the IMF and other multilateral organizations with the assistance of some of the industrialized nations could not prevent a decline of the domestic currency in relation to the US dollar. This event led to the demise of the existing currency band system. Given the key role of the pegged exchange rate regime in the stabilization program, such an event was expected to represent a challenging threat to domestic price stability and a non-trivial risk for the continuation of the Real Plan, with all its attendant political and social implications.

This paper contains three parts, besides this introduction. The first compares some macroeconomic data for three countries also affected by the same type of foreign exchange crisis. The second discusses some of the probable effects of the devaluation on the Brazilian

---

[1] Some of the ideas contained in this paper were presented at the seminar on the Brazilian crisis held at the Wilson Center, on March 4, 1999.

[2] Professor of Economics, Escola de Administração de Empresas de S. Paulo, Fundação Getulio Vargas., S.Paulo, former member of the Board of Directors, Banco Central do Brasil (1994-1997). E-mail: alkimar@fgvsp.br.

economy. Finally, the third section comments on the unexpected favorable results concerning the short run adjustment of the Brazilian economy to the sharp change in the exchange rate regime. It seems that the most the feared risk – a return to the inflationary environment that has plagued the Brazilian society for many years – has been exorcised for the time being. However, the Brazilian economy remains vulnerable to the very same risks that have led to the collapse of the foreign exchange anchor.

Some Comparisons with other Recent Episodes of Currency Crisis

On January 15th, after a little over 1400 days experimenting with an exchange rate mechanism that pegged the domestic currency to the US dollar, Brazil was forced to let the “real” float. Such exchange rate policy can best be characterized as a crawling band. It rested on the operational procedure of letting the currency band drift upwards so as to generate a nominal devaluation of around 7.5 percent yearly against the US dollar. This exchange rate policy, the main pillar of Brazil’s successful stabilization program, had been implemented in March 1995 as a response to the reverberations of the Mexican devaluation on the Brazilian economy, and had also survived the Asian crisis of October 1997. However, floatation and devaluation were made inevitable by the nervous reactions of foreign investors to the Russian government’s decision to devalue the ruble and default on some of the country’s internal and external debt. International creditors expected the same to happen in Brazil, particularly after the governor of the State of Minas Gerais declared a ninety-day moratorium on its debt to the federal government and to some external investors.[3] Hence the capital flight mentioned earlier, which was basically a move initiated by foreign investors and international banks, to be followed by some residents.

[3] Actually, the default on external obligations was not effective because the federal government assumed the payment in lieu of the final debtor.

As in other previous cases of sudden devaluations, the Brazilian decision led to an initial overshooting of the exchange rate (a real depreciation of the domestic currency in relation to the US dollar, which was higher than the expected equilibrium real depreciation in the long run). This movement was exacerbated by two consecutive shifts in the presidency of the Central Bank. All combined, this produced the worst crisis faced by the Cardoso administration. However, beginning in March, the “real” reversed its declining route. After having reached a maximum R$/US$ rate of 2.22 in the beginning of March 1999, implying a nominal depreciation of 83.5 percent relative to its value in December 1998, the rate of depreciation has fallen to 41.9 percent and to 37.6 percent at the end of March and April, respectively. Nominal devaluations have been higher in other emerging countries, as indicated by Buria: 115 percent in Mexico in 1994-95, 228 percent, 96 percent, and 87 percent, respectively, in Indonesia, Korea, and Thailand in 1997, and 135 percent in Russia in 1998. (Buria, 1999).

Recently, many emerging countries following a relatively fixed exchange rate policy have experienced drastic changes in their foreign exchange regimes. Some of them can be used as a comparison to the Brazilian situation in order to try to evaluate the macroeconomic conditions before the devaluation. Moreover, such an exercise can indicate possible trajectories for the national economy, after the change in the foreign exchange rate regime. Three cases, with decreasing levels of success, were selected as references for this comparison: South Korea, Mexico and Russia. A summary of their macroeconomic data in the year before or during the devaluation is provided in Table 1:

Macroeconomic data in the pre-crisis situation

		real GDP(%)	government balance (%of GDP)	current account (%of GDP)	debt %	interest rate (%)
Mexico	1994	4.5	(0.4)	(7.1)	11.4*	19.0
South Korea	1997	5.5	0.0	(1.8)	13.4	12.1
Russia	1998	(6.3)	(6.0)	2.5	3.6	80.0**
Brazil	1998	0.15	(8.0)	(4.5)	20.5*	28.6

* averages 1991-1995
** Lombard rate
Source: World Financial Markets, Bloomberg.

What are the similarities and differences between Brazil and these emerging countries which were forced to react in an almost similar way, by floating and subsequent devaluation, to the foreign exchange crisis? Except for Russia, a common feature among the three other economies was the current account disequilibrium, a possible consequence of similar exchange rate policies leading to various degrees of appreciation of their domestic currencies in relation to the US dollar. Clearly, in the case of Mexico and South Korea, the fiscal stance of the public sector was far better than either Brazil or Russia. Therefore, in the latter economies, excess absorption was due not only to the difference between private investment and private savings but also to the fiscal deficit. This has to do with the economic policy mix of the Brazilian government, which may help to explain why the country became so vulnerable to external contagion and currency attack.

Another variable not included in conventional macroeconomic statistics may also account for the similarities and differences: the situation of the banking system at the onset of the foreign exchange crisis. It is argued here that this factor may be counted on to explain the intensity and duration of the foreign exchange crisis in Brazil, in comparison with the three other cases under consideration. It is now clear that, in a world of capital mobility, a weak and poorly regulated banking system has difficulties in coping with the risks associated with abrupt changes in assets prices and capital flows. This seems to be the case in the East Asian countries where moral hazard plus severe structural weakness in the financial and corporate sectors led them to engage in risky investment, excessive external borrowing and current account deficits which finally caused the currency turmoil and the break-down of economic activity(Corsetti, Pesenti and Roubini, 1998).

The Assymetrical Economic Policy Mix

The economic policy mix of the Cardoso Administration in his first term (from January1995 to December 1998) can be summarized as a combination of very tight monetary policy with a rather lax fiscal posture. As far as monetary policy is concerned, its degree of tightness can be inferred from the level of real interest rate prevailing during the stabilization program. From 1994 to 1998, real interest rates remained extremely high: the average "ex-post" real rate for the period was 22.7 percent yearly for the basic interest rate in the Brazilian economy[4] (at such rate, the real value of the stock of gross public debt would double in less than four years[5]). On top of the basic interest rate, the prevalence of high levels of reserve requirements on the banking system and the numerous taxes on financial intermediation have

[4] On theoretical grounds, it is acknowledged that the level of the real rate of interest can not be taken by itself as a sole indicator of the posture of the Brazilian monetary policy, without reference to the exchange rate regime.

[5] This numerical extrapolation assumes that all internal public debt is denominated in domestic currency, which is not the case. As shown later in the paper, there is a dollar component in the stock of federal debt.

caused sharp differences between the lending and borrowing rates, leading to still larger upward movements in the real cost of money to borrowers in the domestic financial market.

These restrictive monetary and credit policies can be explained by two factors: first, by the need to avoid an explosion of aggregate demand in the months following the introduction of the stabilization program (July 1994). Second, from 1996 onwards the high rate policy is justified by the tyranny of the foreign-exchange coupon, or by the need to maintain a generous difference between the domestic and the foreign interest rates, so as to attract foreign capital in order to finance the high and rising current account deficit. Inflows of dollars were bought by the Central Bank so as to preserve the currency band leading to higher levels of international reserves but which, in turn, required an expansion of the monetary base. The latter impact was then sterilized through sales of domestic securities, which helped to preserve the interest rate differential, at a cost of higher levels of internal public debt.

Such behavioral response was accentuated by the Brazilian authorities` reaction to both the Asian crisis of October 1997 and the Russian debacle of August 17, 1998. The common response was again centered on raising interest rates to defend the "real" against the external contagion. Naturally, over time the high domestic interest rate policy negatively affected the private sector, generating a perverse crowding out effect, especially to small and medium size firms without access to a less expensive source of foreign funds. The final outcome was a declining GDP growth performance combined with a worsening of the public sector balance. Also, due to factors associated with adverse selection and moral hazard, increasing interest rates gradually lost their effectiveness as an incentive to attract flows of foreign portfolio capital, but rather the more opportunistic and short-term type of investment.

On the fiscal side, the deterioration of the budgetary conditions which took place in Brazil in the last few years at every level of the government, including the federal, state and municipal companies was worse than expected. Part of this deterioration is related to the effect of the restrictive monetary policy on the fiscal position of the public sector. A high interest rate directly affects the federal budget, due to the burden of interest expenditures and indirectly by issues of new public debt in order to sterilize the monetary impact of the capital inflows, so as to keep the exchange rate within the currency band.

However, even not considering the role of monetary policy in influencing the total deficit, the figures also show a gradual weakening of public finances. As a percentage of GDP, the primary balance (which does not include interest expenses) fell from a surplus of 5.1 percent in 1994 to a mere 0.01 percent in 1998, representing a 99.8 percent decrease in that ratio. To explain this reduction, a larger fraction (48.6 percent) falls on the central government(including the Federal Treasury, the Central Bank and the Social Security System) followed by the state-owned companies (federal, state and municipal firms, responsible for a 30.3 percent decline) and finally states and municipalities, with a remainder of 20.9 percent. See Table 2 for details. A further indication of the dramatic worsening of the fiscal posture is given by the following comparison: in 1994, the primary surplus was 27 percent higher than the expenditures on interest payments (but not payments due to monetary correction), while in 1998, for each R$1.00 of interest expenses, the primary surplus covered only R$0.001 or less than 0.16%. Hence, the remaining 99.84 percent of the interest payments had to be financed with new debt. Thus, irrespective of the level of the domestic real interest rate, that financial condition implies a growth path for internal debt that is difficult to sustain in the long run.

In addition, it seems that such poor performance in the fiscal accounts does not have any relation to the movements in the business cycle. Even after accounting for cyclical changes in domestic economic activities, and their effect on tax revenues and government expenditures, public finances worsened over time.

Table 2

Changes in the primary surplus between 1994 and 1998

	1994		1998		changes98/94
	%GDP	%	%GDP	%	decompos.
Central government	3.05	59.8	0.57	5,700	(48,6)
States and mun.	0.85	16.9	(0.20)	(2,000)	(20,9)
State compan.	1.19	23.3	(0.36)	(3,600)	(30,3)
Total	5.09	100.0	0.07	100.0	(99,8)

Source: Central Bank: Informações econômicas.

The conclusion is clear: the combination of a tight monetary policy with a declining primary balance led to an escalating stock of net domestic public debt: as a fraction of GDP, the internal debt went from 20 percent in December 1994 to 36.05 percent in December 1998.

The Domestic Banking Sector

One factor differentiating the Brazilian case from the former three economies is the situation of the banking system before the foreign exchange crisis. As it is known, the Brazilian economy experienced an incipient banking crisis in 1995 and 1996. There are at least two causes for the banking turmoil. First, the successful stabilization program led to a sharp reduction in the floating gains retained by large retail banks. Second, the tensions imposed upon the banking system by the restrictive monetary and credit policies, though on one hand necessary to avoid a premature disruption in the stabilization program, on the other revealed certain weakness in the conditions of some large private and state banks. To avoid the systemic consequences of a banking crisis, a program of restructuring of private banks was then launched: the Program for the Restructuring and Strengthening of the National Financial System (PROER in Portuguese). The controlled opening of the Brazilian banking market to the participation of foreign financial institutions was also a very important component of such program. For the first time in modern Brazilian history, foreign banks were allowed to enter the then highly protected domestic retail banking market.

A similar program was devised for the state-controlled banks, with the objective of reducing the size of the financial intermediation held by the public sector. Simultaneously, the existing banking safety net was enlarged with the creation of a privately run deposit guarantee facility. In a parallel initiative, the Central Bank implemented changes in the regulatory and supervisory framework, including a new approach to on-site inspections, designed to monitor more closely risks assumed by the banking system.

The aforementioned changes resulted in a banking system less vulnerable to economic and financial shocks. Moreover, banks are not bound to amplify the negative macroeconomic impacts of the recent devaluation. It is highly probable that some borrowers in foreign currency will be unable to meet their contractual obligations after the devaluation. Hence, currency risks will be translated into credit risk for banks. However, this additional pressure resulting from a higher share of non-performing loans in the total credit portfolio will probably not cause any disruption to those large private retail banks that constitute the core of the banking system. As a result, Brazil is not likely to face a combination of foreign exchange and banking crises which have accompanied other recent episodes of currency collapses in emerging countries.

Apres le Deluge

Drastic changes in crucial prices including the foreign exchange rate have important macroeconomic consequences for the domestic economy. While some of the latter impacts are instantaneous, others have their effects distributed over time, as the economy adjusts to new conditions.

a) On the fiscal accounts

The currency devaluation put instantaneous additional burden on the fiscal accounts, though it will contribute in the medium-run to improvnig future tax revenues due to the probable resumption of export-led economic growth. As far as the former impact is concerned, there are three channels through which devaluation worsens the fiscal balance: first, by raising the domestic costs of the external debt held by the public sector. The latter's external liabilities reached 40.4% out of a total stock of external debt amounting to US$235 billion in December 1998. Second, by increasing expenditures associated with the fraction of the domestic debt with exchange rate clause. In the months preceding the devaluation, the federal government increased its foreign exchange rate exposure by issuing securities with debt-service payments indexed to the US dollar. As of December 1998, dollar-indexed bonds comprised 21% (R$68,0 billion) of the total federal debt, in comparison to 9.7% in September 1997. Third, in order to defend the existing currency band, it has been argued that public financial institutions have taken positions in the futures market for the "real"/dollar exchange rate. The devaluation caused those financial institutions to suffer large, yet unknown losses associated with those off-balance sheet positions in the futures market for US dollars.

b) On the external disequilibrium

If the nominal devaluation is not eroded by domestic inflation, one should expect a consistent reduction in the current account deficit in absolute and relative terms, due mainly to a highly probable surplus in the trade account. The Brazilian experience in the early 1980's, with large nominal and real devaluation showed an impressive reaction of the trade accounts to the change in tradeables/non-tradeables price ratio.[6] At that time, Brazil bought its way out of the external debt crisis by improving its capacity to pay by generating a sizeable trade surplus. The result was instrumental in allowing the country to receive new loans from private banks, thought it had not met all the targets contained in the stand-by agreement with the International Monetary Fund.

It is well known that a real depreciation will help to attain a favorable trade balance. However, the latter result will depend to a large extent on the economic growth prospects for the industrial countries. In fact, recent studies have shown that for the period 1990-1995 the most important variable to account for changes in the Brazilian trade balance was the ratio between income elasticity of exports and imports. Thus, income effects seems to be more relevant than price effects for the external trade adjustment(Holland, Canuto and Xavier, 1998). This means that the expected lower growth in world trade in 1999 will negatively affect Brazilian exports in spite of the devaluation. The same trade variable will also explain the poor performance of commodity prices in world markets, which again means lower export revenues.

---

[6] According to Pastore, Blum and Pinotti, the 30% nominal devaluation of the Brazilian currency against the US dollar in Febrauary 1983 was made effective with the help of a rather monetary policy (Pastore,Blum and Pinotti 1998).

c) On the conduct of monetary policy

In a floating exchange rate regime, it is known that the Central Bank can use monetary policy instruments to achieve domestic objectives. Under the present circumstances, price stability seems to be the most important target for monetary policy, as the rate of inflation went up following the overshooting of the nominal exchange rate.[7] During this transition period towards an equilibrium real exchange rate, and considering the long Brazilian inflationary experience, it is reasonable to assume that the demand for formal or informal indexation mechanisms would have risen. Therefore, to avoid the transmission of the relative price change to a rising rate of inflation, monetary policy would have to maintain a tight posture, at least for some time.

The implementation of the new strategy implied the utilization of the basic interest rate as the operating target for monetary policy. But now the interest rate was assigned to the crucial objective of reducing inflation, not to the financing of the external unbalance. The Central Bank first moves centered on increasing reserve requirements on time deposits in order to reduce banking liquidity and on raising the basic interest rate as a precaution against higher expected inflation rate. As it turned out, however, the inflation outcome was better than expected[8]. At the same time similar accomodative movements occurred in the foreign exchange markets, as mentioned earlier. In fact, during that nervous period of high instability in the foreign exchange market, depreciation of the exchange rate was mainly governed by the heavy concentration of

---

[7] In fact, the wholesale price index which best captures the inflationary impact of the devaluation went from a monthly rate of 1.58% to 6.99% in January and February 1999 respectively, a four times increase in the period.

[8] After having reached a monthly rate of 3.61% in February 1999, the general price index (IGPM) came down to 2.83% and 0.71% in March and April, respectively. Parallel movements were observed for the consumer price indexes.

maturing external financial liabiliaties which could not be rolled over due to credit restrictions faced by Brazilian borrowers in the international financial markets. Moreover, with the approval at the end of March of the revised version of the stand-by agreement with the IMF, the Central Bank had at its disposal a large sum of foreign funds to intervenne in the market to avoid excessive depreciation of the "real" in relation to the US dollar.

Both favorable results on the inflationary front and in the behavior of the foreign exchange rate allowed the Central Bank to reverse its policy stance and initiate a downward movement in the interest rate earlier than expected. The trend towards declining interest rates also brought beneficial impacts to the management and costs of the internal debt, as the Treasury could resort to successful sales of fixed price securities, a practice which had been suspended since the Russian crisis.

d) On expectations, reputation and credibility

The floating and subsequent devaluation left the stabilization program without any nominal anchor to influence expectations among economic agents. Also, the circumstances which led to the modification of the exchange rate regime, after the resignation of the Central Bank's governor and an unsuccessful two-day experience with a widened trading band, were rather abnormal, to say the least. Naturally, such events did not help to improve the authorities' credibility both at home and abroad. In February 1999, President Cardoso's approval rate registered the lowest level ever since he took office in January 1995. This result can affect governability given the volatile political coalition supporting the executive and the lax rules concerning party allegiance in the country. On the external front, the Brazilian emerging market bond index reached the highest risk premium on the day before the floatation.

Conclusion: 1999: A Successful Devaluation?

Clearly, the currency devaluation posed the most challenging and pressing threat to the Real Plan. Such risks bear on economic as well as political factors. Until the devaluation of January 15th, financing was the usual method of dealing with the external unbalance of the Brazilian economy, with the resulting increase in the stock of external debt. A real devaluation marks the beginning of the adjustment process which, if successful, will address the question of the external disequilibrium, leaving the domestic interest rate to deal with internal balance and inflation. Given the rigidities in the budgetary conditions in Brazil, the burden of the adjustment will certainly fall on private absorption, which means lower levels of economic activity and employment. Therefore, at least in the short run, the expected positive trade balance will be mostly determined by lower imports due to the recession rather than by higher exports. The rate of unemployment is expected to rise further than the already high percentage, which has been considered the highest number registered since the beginning of the statistical series. Needless to say, social unrest and urban violence will tend to grow as the economic conditions deteriorate.

As a matter of fact, and contrary to the pessimistic scenario envisaged by many analysts of the Brazilian economy, the short-run adjustment to the real depreciation of the exchange rate seems to have been faster and smoother than expected. Also, fortunately the decline in the level of economic activity has been less drastic than previous private as well as official forecasts had anticipated. In fact, GDP fell 0.99 percent in the first quarter of 1999, in comparison with the same period one year ago. On a quarter by quarter basis, the seasonally adjusted positive growth rate of 1.02 percent for the first quarter of the current year, following two consecutive quarterly drops in economic activity, seems to indicate that the worst of the recession is over. Two factors may account for this favorable result. First, the weakening of the “real” increased the profitability of some import-substitution activities, contributing therefore to reduce the depth and duration of the recession in the manufacturing sector. Second, the agriculture sector showed an exceptional growth rate of 9.22 percent in the first quarter of 1999, thus partly alleviating the negative performance of the manufacturing sector.

One can advance the following hypotheses to explain why the collapse of the exchange rate regime in Brazil has not caused enormous economic and social dislocations observed in similar events in other emerging markets:

a) As mentioned earlier, the domestic banking system was less vulnerable to large economic and financial shocks, thereby failing to amplify the negative effects of the currency collapse. This is not to say that there were no banking losses associated with the depreciation of the “real”. So far, large foreign exchange losses were restricted to the Central Bank and in smaller scale to some investment banks. However, there will be losses incurred by the banking system as some unhedged borrowers may fail to meet their contractual obligations in foreign currencies. Such credit risks are not likely to give origin to asset problems of magnitude sufficiently large so as to affect the stability of the domestic financial system;

b) In spite of the negative impact of the currency devaluation on the government’s fiscal position, the economic policy mix has shown considerable improvement in the first quarter of 1999. On one hand, the public sector posted a surprisingly high primary surplus of R$9.2 billion during that same period, equivalent to approximately 0.9 percent of the GDP and 53.3 percent higher than the fiscal target contained in the IMF stand-by adjustment program. On the other hand, monetary policy became less restrictive, as the Central Bank initiated a series of consecutive downward movements in the basic interest rate(the latter went from 45 percent to 27 percent in less than two months) and at the same time it reduced the reserve requirement on time deposits(from 30 percent to 25 percent). Hence, a better balance in the economic policy mix helped to somewhat alleviate the degree of assymetry mentioned earlier between fiscal and monetary policies. Lower interest rates also reduce the nominal deficit while providing incentives for crowding in private expenditures, which in turn lead to higher tax proceeds;

c) Other factors can also account for the favorable performance of the Brazilian economy in the short run, including the low degree of leverage of Brazilian firms in comparison with their counterparts in Southeast Asia. Additionally, when the contagion triggered by the Russian "debacle" reached Brazil, the domestic economy was already operating at low levels of productive activity, as a result of the lagged effects of the Asian crisis. Finally, when the authorities decided on the flotation, international reserves had not been exhausted yet but remained at satisfactory levels, in comparison with similar periods in other emerging countries.

Now that the turbulence associated with the collapse of the foreign exchange anchor is over, the relevant question concerns the future of the present stabilization program. So far, the Real Plan has been successful in delivering price stability at the cost of a frustrating growth performance. While maintaining its compromise with price stability, is it possible to assure better prospects for economic growth, as well as other characteristics including being market-friendly, open to the international economy, privately oriented but with a vision towards reducing poverty and income inequality?

The worst scenario for Brazil, that is to say, a leap backward towards a high inflation cum indexation mechanism, seems to have been avoided. However, some risks remain concerning the country’s vulnerability to economic policy inaction at home or to another wave of external turbulence. Notwithstanding the primary surplus mentioned earlier, it cannot be taken as a signal of fiscal prudence for the months to come due to the following two reasons. First, part of that surplus was explained by privatization proceeds and one once-and-for-all tax revenue gain that is not going to occur again. Second, the fiscal effort is strongly biased towards tax increases that are distortionary and cumulative, thus raising the burden on the private sector. Furthermore, the much-needed tax and social security reforms are still waiting to be discussed by a reluctant Congress, which only seems to operate under the pressure of international threats.

On the external accounts, the results so far have been disappointing particularly in relation to the performance of exports. Declining commodity prices and low international trade growth account for most of the slow reaction of export revenue. Thus, once again growth prospects for Brazil will be constrained by export behavior, which depend to a large extent on the global economy. Slow exports require high domestic interest rates to finance the external disequilibrium, hence short-term capital inflows, currency appreciation, and low levels of economic activity and higher unemployment rate. Therefore, in spite of an apparently successful devaluation, Brazil has not completely eliminated the risks of another currency crisis, the same problem that the depreciation was supposed to solve. But only time and growth of the international economy will tell.

References

Buira, A. “An Alternative Approach to Financial Crises,” in Essays in International Finance, no. 212,Department of Economics, International Finance Section, Princeton University, February 1999.

Corsetti, G. Pesenti, P. and Roubini, N. “Paper tigers? A model of the Asian crisis” Federal Reserve Bank of New York Research Paper 9822, Revised Version October 1998.

Holland, M., Canuto, O. and Xavier, C. “Taxas de cambio, elasticidades-renda e saldo comercial na economia brasileira,” in Revista Brasileira de Economia, vol.52, no.2, April/June 1998.

Pastore, A.C., Blum, B.S. and Pinotti, M.C. “Paridade de poder de compra, cambio real e saldos comerciais,” in Revista Brasileira de Economia, vol. 52, no. 3, July-Sept. 1998.