Brazil: the illusion of being different

by Lorenzo Carrasco

The immense majority of economic analysts, government officials, and trained journalists have done their best to ignore the serious consequences that Mexico's financial disaster holds for Brazil, to the point of stating that Brazil is as different from Mexico as it is from all the other so-called "emerging markets."

At least in his public statements, the new Brazilian President, Fernando Henrique Cardoso, has refused to admit to the reality that the neo-liberal model of free trade and globalism shattered to pieces when the Mexican crisis exploded last December. For Brazilian officials, and for President Cardoso himself, who idealized and imposed the monetary stabilization plan for the national currency, the *real,* based on the argument that Brazil would be the "emerging market of 1995," it is proving difficult to awaken from their pleasant dreams to recognize that from here on, international capital will only flow into the country if Brazil shows a readiness to hand over its patrimony, in particular the state oil company Petrobras.

It is, of course, possible that some officials in private are recognizing what they refuse to admit in public, as there is evidence that some glimmers of reality have penetrated certain circles. For example, the Brazilian press has reported that the economic advisers closest to the President think that if Argentina should sink like Mexico, Brazil will necessarily follow the same path.

But in public, there are no such hints of realism. After the mini-crash of the Brazilian stock exchanges on Jan. 10, Finance Minister Pedro Malan finally officially recognized that the Mexican crisis was affecting the Brazilian economy, although he insisted that any comparisons between the two countries were "simplistic, ingenuous, and precipitous." Even more arrogant were the comments made to *Gazeta Mercantil* on Jan. 6 by the executive secretary of the Finance Ministry, Pedro Pullen Paente, who stated that "we know there is a storm on the horizon, but our ship is the most secure." Pullen said this after meeting in Brasilia with the South Atlantic Division chief of the International Monetary Fund (IMF), José Fajgenbaum. What the new Brazilian government is hoping is that the IMF will become its channel of communication with the "financial world," to convince it of the differences between Mexico and Brazil.

It is equally pathetic to see the collection of economic analysts who, until recently, parroted the argument that Brazil should yield its economic sovereignty to the inevitable "globalization of the markets," to the general economic opening, and other such nonsense, and who now hide from the reality of the globalized financial crisis and take refuge in isolationist hysteria. This hysteria has even reached the chauvinist extreme of claiming that the difference with Mexico is that Brazil doesn't speak Spanish, as Luís Fortes, executive of a major Brazilian petrochemical company, stated to the *Wall Street Journal* on Jan. 6. "How can investors think that Mexico affects us? We don't even speak Spanish," said Fortes.

For the government and the analysts, Brazil's differences are varied, but centered primarily in the country's foreign accounts. While Mexico's 1994 current account deficit was approximately $40 billion—or 10% of its Gross National Product—with investments in the stock market of $75 billion and foreign reserves of $6 billion, they point out, Brazil's projected deficit for 1995 is around $13 billion, or a mere 2% of GNP. They add that foreign investments in the Brazilian stock markets equal $15 billion, and that international reserves are currently $40 billion. They also argue that, unlike Mexico, Brazil has a trade surplus.

While these statistics are real enough in themselves, they mean little, given that the economic course the new Brazilian government appears committed to must rapidly lead to a Mexico-style disaster, but on a far greater dimension given the size of the Brazilian economy. The neo-liberal economic policies that Brazil is following are nearly identical to the Mexican ones, and must lead to the same results in the end. Some analysts indicate, for example, that the Brazilian *real* became overvalued to the tune of 30% in just six months, a point that Mexico's peso only reached after six years of the free-market economic program. Brazil has also adopted a policy of trade opening, and the combination of these two has contributed to trade deficits for the months of November and December 1994, the first deficits in several years.

Regarding the allegedly substantial reserves, even the orthodox monetarist Antônio Delfim Netto, a former Brazilian finance minister, explained to *Gazeta Mercantil* on Jan. 9 that, in reality, "the reserves are laughable": Of the nearly $40 billion, approximately $25 billion stems from short-term investments that entered the country to take advantage of extremely high domestic interest rates and became Brazilian public debt. Another $15 billion are largely short-term speculative investments on the stock market. That is, if a "crisis of confidence" should combine with fear of an inevitable Argentine crash, Brazil's reserves could disappear just as rapidly as Mexico's.

But there does exist one important difference between Mexico and Argentina on the one side, and Brazil on the other: Brazil has not privatized as much of its industry as have Mexico and Argentina, and therefore it still has "booty"

Child labor in São Paulo, Brazil. The IMF's "free-market" austerity programs are looting whatever remains in the economy, from its industry to its labor power.

to be handed over to the international financial pirates when they start to up the pressure.

The fall of the Brazilian stock exchanges

The fact is that, since the beginning of the Mexican meltdown, Brazil has been suffering high levels of capital flight, which are causing dramatic declines on the stock exchanges. Since Dec. 20, when the Mexican crisis broke out, through Jan. 10, the São Paulo stock exchange, Bovespa, lost 38.5% of its value as the result of withdrawals of $1.2 billion, that is, of 10% of total foreign investment in the country's stock exchanges.

Further, long-awaited capital never reached the country, despite the optimistic proclamations of government officials. Therefore, it is going to be very difficult for the banks to roll over bonds and other debt paper coming due over the next few months on the international market.

For this reason, many of these instruments will have to be liquidated and paid with *reales,* which will aggravate the tendency of the reserves to decline. To get a sense of the size of this market, one must consider that, according to bank estimates, Brazil brought in some $6 billion last year in bond sales. Over the next six months, $1.6 billion worth of Eurobonds of Brazilian companies alone will mature, and are not likely to be renegotiated.

In June 1994, *EIR* insisted that approximately one-third of the government's internal debt would become de facto international debt, as a result of the Real Plan and of the links that would be established between the *real* and the dollar. Reality has proven this forecast correct, and the government itself has been forced to admit this in its actions. In the few weeks since the Mexican crisis began, the Brazilian government has begun to issue new bonds, called NTN-Ds, which are indexed to the dollar—that is, they provide guarantees to the investor against possible devaluation of the *real*. In this sense, the NTN-Ds are identical to the infamous *Tesobonos* which the Mexican government had to start issuing when foreign investors stopped buying Treasury Certificates (*Cetes*) denominated in pesos.

Former minister Delfim Netto has revealed that Brazil has already issued some $2.65 billion worth of NTN-Ds, supposedly to assure the international community that Brazil has no intention of devaluing its currency. This measure is sheer lunacy, and will, within a short period of time, place Brazil in the same situation as Mexico, with dollar-denominated international obligations that it cannot pay.

The debt cancer

So far, the new government's economic team insists on sticking with the current economic policies of the country, with the monetarist reasoning that monetary stability, and consequently an end to inflation, depend on eliminating potential excess liquidity in the national currency by raising basic interest rates upon which government debt paper is negotiated. These, of course, serve as a reference point for the entire national banking system. Thus, the increase in domestic rates of usury, which currently range from 40-50% a year, has led—within a climate of total economic "opening"—to two very serious short-term economic problems. First, the trade opening and banking and financial liberalization have allowed for the massive inflow of speculative capital of all sorts, which seeks to benefit from the financial carnival. The result has been a significant increase in indebtedness, the same which until now has hidden behind the fiction of increased international reserves.

At the same time, the financial derivatives market in Brazil tripled in the past year, reaching the fabulous sum of $1.3 trillion. According to International Finance Corp., the Brazilian stock market grew by 77% in the past year, the largest growth on the Ibero-American continent, turning the São Paulo futures market (BM&F) into the fourth largest derivatives market in the world.

This speculative income has had the immediate effect of artificially raising the value of Brazil's currency against the dollar. If we add to this artificial value of the *real,* the increase in the inflation rate since the inauguration in July 1994 of the monetary program, the exchange differential by December 1995 could reach 30%, which constitutes the upper limit beyond which the Brazilian export sector will drop dead of a heart attack. As a point of reference, it is worth noting that this 30% differential was reached in the Argentine case two years after the imposition of the Cavallo Plan, and seven years later in the Mexican case.

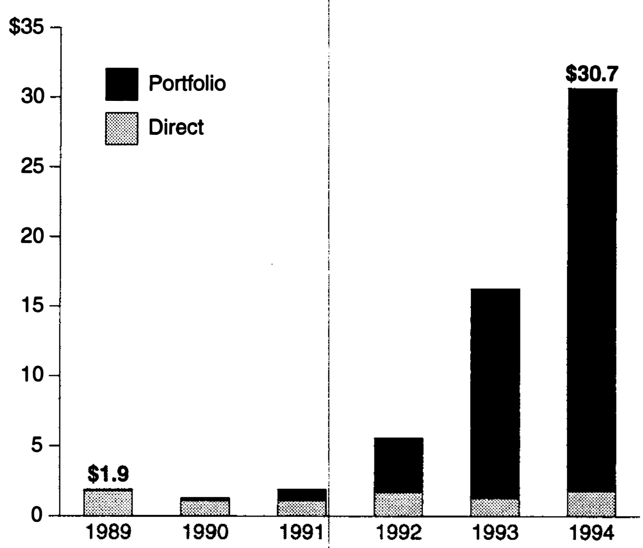
These undeniable facts have forced the country's financial authorities to intervene into the exchange market with massive dollar purchases, thereby increasing dollar reserves to, at one point, more than $40 billion, while at the same time officially encouraging capital flight and therefore a gigantic trade deficit starting in 1995. For example, the director of foreign affairs of the central bank, Gustavo Franco, declared that Brazil could have a $12 billion trade deficit in 1995.

As a result of this kind of intervention, during the last two months of 1994, Brazil's trade balance went negative after nearly two decades of surplus. In November, a deficit of $262 million was recorded, and in December, the deficit was more or less $1 billion, a substantial decline compared with the nearly $1.5 billion surpluses of August and September.

This tendency suggests a trade deficit of nearly $10 billion for 1995, which amount Brazil will have difficulty in borrowing on international markets after the Mexican collapse. If one adds the negative financial outflow to this, Brazil could have a current account deficit of $15 billion, or more than 2% of its GNP. If this should prove to be the case, the country will have to pay for this deficit with a third of its reserves.

The situation could prove more serious still. The technical departments of the private banks project a current account deficit for the month of January 1995 of $2.8 billion, a tendency which—if maintained—would virtually wipe out Brazil's reserves.

FIGURE 1
Foreign investment in Brazil
(billions $)



Source: Brazilian Central Bank.

The government's insane adherence to free-trade policies has already begun to inundate the national markets with every kind of imported consumer goods, at artificially depressed dollar prices. As if this weren't enough, the rise in interest rates is having a devastating effect on the productive sector, raising the basic costs of production and ground rent in general, which is the real cause of the rise in inflation, despite the commitment to keep prices frozen. With the inflation of real costs, the national industry will not be able to survive much longer, as important businessmen like Claudio Bardella, president of the Bardella Group, and Affonso Hennel, of Semp Toshiba, have already warned.

Under these circumstances, the only thing that can buy time is privatization of the public sector. But auctioning off the national patrimony can only prolong for a little while the agony of a dying monetary system.

What we see in **Figure 1** is a partial view of the monetarist policy seen through the flow of speculative money which began to pour into Brazil as of 1992. In 1993, this amount tripled over the previous year. By September 1994, which is the date of the last figures available, this flow doubled with respect to the entire previous year, reaching the sum of $30.7 billion.

Of this over $30 billion figure, nearly all of it—some $28.9 billion—was portfolio investment, both in the stock market and in the money market and other activities, as permitted by Resolution 63 of the central bank. Only $1.758 billion is actual direct investment, a sum nearly identical to direct investment in 1993.

On this point, it is interesting to note that the flow of speculative capital into Brazil began to slow several weeks before the Mexico crisis, and without any apparent cause given that Brazil had been fully compliant with creditor demands and had just elected President Cardoso, architect of the monetary stability program now in force.

One of the reasons for this decline, aggravated in the aftermath of the Mexican peso devaluation, is that the Brazilian central bank eased legal restrictions on repatriation of capital, unlike the case of Mexico and Argentina, which used these flows to cover their balance of payments deficits. The result is that international speculators who had been stung in Mexico made up their losses by selling out on the Brazilian exchanges, walking away with dollar profits of 57% for one-year investments, while hoping that the effects would be less severe globally than the desperate withdrawals from the Mexican and Argentine markets. As we indicated earlier, however, this behavior has already provoked waves of panic on the Brazilian exchanges, driving them to the brink of a crash.

Internal debt and banking crisis

But these huge profit margins, which sustain the speculative bubble, are themselves sustained through a dramatic increase in internal debt. For example, the debt in government paper and bonds went from 46.2 billion *reales* in January 1994 to 65.2 billion *reales* in October of that same year. At the same time, the internal debt of Brazil's states and municipalities rose, from July to October (that is, after the *real* was introduced), by 20%, going from 19 billion to 23.14 billion *reales*.

The result of this process is that the entire state banking system is in crisis. Recently, the central bank intervened in Banco de São Paulo (Banespa) and Banco de Rio de Janeiro (Banerj), to prevent further liquidity problems and, in the final instance, their bankruptcy. There are persistent rumors that the government's intention is to privatize these banks as soon as they have been "cleaned up."

In 1994, the federal Treasury had to disburse 7 billion *reales* in interest payments on the internal debt. For 1995, the budget office foresees $12 billion *reales* in interest costs. Here we see the insanity of the privatization policy, which is supposedly intended to reduce the accumulated foreign debt burden. Between 1991 and 1993, Brazil sold off public companies to the tune of $8.3 billion, equal to 7 billion *reales* paid in interest on the internal debt in just one year! In this way, the house is being sold to pay for gambling debts.

As far as is publicly known, the Cardoso government in 1995 expects to garner some $5 billion from privatizations, and that before a constitutional reform allows for the selloff of the national electrical system, telecommunications, minerals processing, the gigantic Vale de Rio Doce company, and parts of the state oil monopoly.

Former Brazilian Finance Minister Antonio Delfim Netto, an orthodox monetarist. Even he admits that Brazil's reserves could disappear overnight, just as Mexico's did.

In the face of this disastrous picture, it is difficult to argue that Brazil can continue the current economic course without facing a Mexico-style crash in the near future. What is true is that, so far, Brazil has not handed over its public patrimony to the outrageous extent that Mexico has done, and even more so, Argentina. Brazil has maintained the relative integrity of its industrial and agricultural plant. From the standpoint of the financial vultures, the intention is to maintain the Real Plan for at least two more years, based on an escalating privatization of public companies and high interest rates—that is, if a general blowout of the international financial system doesn't happen first.

The truth is that if Brazil wants to hold onto its monetary program and reestablish the flow of speculative capital, it will have to go further than Mexico in its offers to the international speculators. Nor will this free it from the ongoing monetary devaluation and the immediate consequence of resurgent inflation.

But if President Cardoso, in the face of impending economic disaster, recognizes that the Real Plan is axiomatically flawed, and if he determines to safeguard the rest of the Brazilian economy, he will have to take a very different approach.