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Whither Brazil: MERCOSUL and the Devaluation Crisis

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I. Brazilian Manifest Destiny.

Brazilians have long held the view that their country is unique. This is not simply because it is the only Portuguese-speaking country in the hemisphere, but also because of the large size of its territory (the world's fifth-largest country), its population (163 million—larger than Russia's), and its economy (the world's ninth largest).

Similar to the way Argentina has long viewed itself a part of Europe that found itself misplaced at the end of South America through some geographical accident, Brazil has long viewed itself as a First World nation temporarily misplaced in the Third World due to political and economic crises. The old adage is that Brazil progresses at night, when the politicians sleep. Historically, however, Brazil has been the victim of too many politicians with insomnia.

Brazil has many different faces. Certain regions of the country are highly developed and rich, while other regions are entirely opposite. Even in rich areas, one finds grinding poverty. The country has one of the most unequal income distributions in the world; the richest twenty percent receive sixty percent of the income, yet the poorest half get by with only ten percent. The top fifth receives thirty-two times the income of the bottom fifth, an extraordinarily high ratio.[1]

Brazil has historically regarded itself as destined to become a world-class power. However, until it is ready to assume its position among the countries of the First World, Brazil seeks to lead the Third World. Currently, Brazil holds an elected seat on the UN Security Council and is seeking a permanent seat to lend legitimacy to its role as a leader of the developing nations. For the first time in a long time, Brazil has a president who can be

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1 *See* William C. Smith & Nizar Messari, Democracy and Reform in Cardoso's Brazil: Caught Between Clientelism and Global Markets? (Univ. of Miami North-South Ctr. Agenda Paper No. 33, Sept. 1998), p. 6.

fairly described as both honest and competent, with the language skills, education, and sophistication to be a world leader.[2]

Until the 1990s, Brazil maintained one of the most closed economies in the world. It had vigorously pursued policies of import substitution industrialization behind high tariff barriers, government-owned and subsidized basic industries, and chronic, severe inflation. In the past eight years, however, Brazil has progressively opened its economy by sharply reducing tariffs, privatizing state-owned corporations, and eliminating important government monopolies.[3] Most importantly, since July 1994 when Fernando Enrique Cardoso, then Finance Minister under the Franco regime, implemented the *Plano Real*, the inflation rate has fallen from 2,311 percent a year in 1994 to 3.5 percent in 1998.[4] These measures should have produced robust economic growth and generated strong investor confidence; however, just the opposite has occurred. Brazil is in serious economic crisis, a crisis that began to erupt in the middle of 1998.

II. Brazil's Current Economic Crisis.

A. The Causes of the Crisis.

Even though President Cardoso has assembled a well-qualified economic team, it has not been able to correct the economic mess he inherited. Cardoso's *Plano Real* gave Brazil the first monetary stability it has known since the start of World War II, but it also has produced an overvalued currency and high unemployment. Brazilian economists generally estimate the rate of overvaluation at about fifteen percent.[5] The rate of unemployment in major cities like São Paulo has been running at nearly twenty percent.

Despite privatization, which has alleviated some of the drain on the Treasury, the federal government has been running a huge deficit. In part, this deficit is a result of the reallocation of tax revenues in the 1988 Constitution, which transferred substantial amounts of tax from the federal government to the states and municipalities without transferring concomitant increases in responsibilities.[6] Persuading the Congress to cut spending has been difficult, and persuading it to amend the Constitution, especially to permit the president to run for a second term, has been expensive in terms of pork barrel expenditures. The federal government's budget deficit rose from 3.85 percent in 1997 to 7.27 percent of GDP (gross domestic product) for the first semester of 1998, while at the same time, the

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2 Brazil's President, Fernando Henrique Cardoso, is a former sociology professor who has taught in Chile and at Stanford University. He is a well-published author and is fluent in a number of languages.

3 *See* Werner Baer, The Brazilian Economy: Its Growth and Development (4th ed. 1995); Peter Kingstone, *Political Continuity Versus Social Change: The Sustainablity of Neoliberal Reform in Brazil*, 4 NAFTA L. & Bus. Rev. Am. 38 (Spring 1998).

4 Calculated from the Wholesale Price Index numbers published in 52 International Financial Statistics 160-61 (Mar. 1999). For a description of the *Plano Real*, see Carlos Antonio Rocca, *Brazil's Plano Real: A Real Chance of Success?*, *in* Growth And Development In Brazil: Cardoso's *Real* Challenge 67-105 (Maria D'Alva Kinzo & Victor Bulmer-Thomas eds., 1995).

5 *See* Brazil Watch, Dec. 21, 1998-Jan. 11, 1999, at 10, 11.

6 *See* Keith S. Rosenn, *Brazil's New Constitution: An Exercise in Transient Constitutionalism for a Transitional Society*, 38 Am. J. Comp. L. 773, 786-87 (1990).

level of domestic debt reached 38.1 percent of GDP.[7] According to the Central Bank, Brazil's foreign debt increased by $25.8 billion in the first six months of 1998 to a total of $226.4 billion.[8] Just servicing the principal on the foreign debt required $26 billion in 1998, and interest payments are expected to total $12.5 billion. Part of the gap was being covered by direct foreign investment, which amounted to a record $19.3 billion from July 1997 to July 1998.[9]

Brazil's economy grew by 3.68 percent in 1997 to US $808 billion; however, the deficit in its current account ballooned to about $35 billion in 1997, about 4.5 percent of GDP, the highest during the 1990s. In 1997, Brazil's commercial balance was in the red by $8.364 billion. The overvalued exchange rate encouraged imports and discouraged exports, thereby exacerbating the trade deficit. The combination of a large budgetary deficit, a large foreign and domestic debt, a large current account deficit, and an overvalued exchange rate made investors nervous about the possibility that Brazil would go the way of Russia and be forced into a large devaluation, or even economic collapse. In October 1997, Brazil was able to stave off by itself the threat of an attack against its currency in the wake of the Asian crisis, even though some $10 billion fled the country in a single day. In 1998, Brazil was not so fortunate.

In the second half of 1998, dollars flowed out of Brazil at an alarming rate. Some $12 billion left the country in August 1998.[10] In that same month, the Brazilian stock market also lost about forty percent of its value. The speed of dollar withdrawal accelerated sharply after September 3, 1998, when Moody's downgraded Brazilian foreign debt from B1 to B2, five degrees below secure investment level. This downgrade placed Brazilian debt at the same level as Nicaragua, Venezuela, and Paraguay. In the first two weeks of September 1998, Brazilian foreign reserves fell by $12 billion; they decreased from $75 billion in March of 1998 to $52 billion. On September 4, 1998, the Central Bank raised the prime rate from 19 percent to 29.7 percent. Because that measure did little to stem the hemorrhaging of dollars, on September 10 the Central Bank raised the prime rate to 47.75 percent per annum. With virtually no inflation, this real rate of interest was so high that it seriously contracted economic growth. Moreover, this rise in interest rates meant a huge increase in the cost of debt service to the Brazilian government. In the month of October 1998 alone, public sector debt rose by $7 billion, reaching 40.9 percent of GDP and exacerbating the large budgetary deficit.[11]

C. THE CARDOSO REELECTION.

In October 1998, Fernando Henrique Cardoso was reelected to the presidency with slightly over fifty-three percent of the vote, eliminating the need for a run-off election. A victory by Lula da Silva (Lula), the leftist candidate of the Workers Party who came in second, would have meant a reversal of Brazil's present neoliberalist policies and a disaster for MERCOSUL. Indeed, Argentine President Menem was so concerned about the possibility

7 *See* LAT. AM. L. & BUS. REP., Sept. 30, 1998, at 5.
8 *See Latin American Newsletters*, BRAZIL REPORT, Sept. 15, 1998, at 1.
9 *Id.*
10 *See* BRAZIL WATCH, Sept. 21-Oct. 12, 1998, at 3.
11 *See* Larry Rohter, *Crisis Is Deepening in Brazilian Financial Markets*, N.Y. TIMES, Jan. 15, 1999.

of a Lula victory in the summer of 1998 that he publicly urged reelection of Cardoso. Cardoso's reelection signifies that Brazil's present liberalization, privatization, and globalization policies are likely to continue for at least the next four years.

Cardoso claims that he is a leftist rather than a neoliberal. Certainly, in his younger days as a sociology professor, he was decidedly left of center and a leading critic of Latin American dependency on international capital. Nevertheless, he has steadily advanced Brazil along the neoliberal path first taken by Collor de Mello in 1990-91. Cardoso has tried to combine policies of capital accumulation, greater attraction of foreign investment, increased privatization, and reduction in government expenses with more equitable distribution of income, improved education, and better health care.[12] He has been frustrated by a dysfunctional Constitution,[13] political obstructionism, weak and unrepresentative political parties,[14] and a tradition of clientalist politics.[15] The Constitution has been modified twenty-six times in the past ten years,[16] but each amendment requires a vote by both houses of Congress, each by a two-thirds majority. Securing these supermajorities has required approval of large amounts of pork barrel spending measures that have contributed significantly to the fiscal crisis.

Cardoso's first government produced steady but moderate economic growth. His greatest gift to the Brazilian poor and middle classes was repeal of the inflation tax, a cruel tax that severely burdened the poor. However, Brazil remains a country with one of the most unequal distributions of income in the world.[17]

On October 28, 1998, the Brazilian Government announced a huge package of about \$23.3 billion worth of spending cuts and tax increases in a frantic attempt to restore confidence in Brazil's economic health.[18] In addition, Brazil secured a \$41.5 billion line of credit from the International Monetary Fund, the World Bank, the Inter-American Development Bank, and a number of industrialized nations through the Bank for International Settlements to try to sustain the *real*.[19] On December 14, 1998, the

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12 *See* Smith & Messari, *supra* note 1, at 1-8.

13 *See* MANOEL GONÇALVES FERREIRA FILHO, CONSTITUIÇÃO E GOVERNABILIDADE (1995); Fábio Konder Comparato, *The Economic Order in the Brazilian Constitution of 1988*, 38 AM. J. COMP. L. 753 (1990); Rosenn, *supra* note 6.

14 *See* Smith & Messari, *supra* note 1, at 13-14; Barbara Geddes & Artur Ribeiro Neto, *Institutional Sources of Corruption in Brazil*, *in* CORRUPTION AND POLITICAL REFORM IN BRAZIL: THE IMPACT OF COLLOR'S IMPEACHMENT 21, 33-41 (Keith S. Rosenn & Richard Downes eds., 1999).

15 *See* Leonardo Avritizer, *The Conflict between Civil and Political Society in Post-authoritarian Brazil: An Analysis of the Impeachment of Fernando Collor de Mello*, *in* CORRUPTION AND POLITICAL REFORM IN BRAZIL: THE IMPACT OF COLLOR'S IMPEACHMENT 119, 132-38 (Keith S. Rosenn & Richard Downes eds., 1999).

16 I have published an introduction to the first twenty-five Amendments, along with their English translations, in 3 CONSTITUTIONS OF THE COUNTRIES OF THE WORLD (Gisbert H. Flanz ed., 1998), Booklet 3 (Release 98-6 of Sept. 1998). The background and translation to Amendment 26, which reforms the Social Security system, will be published at the end of March 1999.

17 *See* Smith & Messari, *supra* note 1, at 6.

18 *See* BRAZIL WATCH, Nov. 9-23, 1998, at 1, 3-5.

19 The details of the package are explained in Michel Camdessus & Stanley Fischer, *Press Conference on Brazil* (Nov. 13, 1998) <http://www.imf.org/external/np/tr/1998/TR981113.HTM>.

International Monetary Fund deposited $4.8 billion in Brazil's account, followed by an additional $4.6 billion tranche a few days later. For a brief period, it appeared as though Brazil had successfully secured the *real.*

D. Major Devaluation of the Real.

In December 1998, Brazil's Congress approved a constitutional amendment reforming the social security system but rejected the most controversial of the proposed new fiscal measures, the eleven percent tax on the pensions of retired civil servants that was projected to raise $2.5 billion. Adding to investor anxiety was governors revolt led by Itamar Franco, former president and now governor of the State of Minas Gerais. Franco demanded renegotiation of his state's $18.5 billion debt to the federal government and refused to make payments on it until his demands were met. He was supported in this incredibly ill-timed intransigence by the Governors of the states of Rio de Janeiro and Rio Grande do Sul.[20] The dollar outflow, which appeared to have stabilized at about $100 million per day, jumped to $650 million on December 11, as investors voiced concerns that the federal government was unlikely to put its fiscal house in order. During the month of December, nearly $5.2 billion left Brazil, with almost $1 billion exiting on December 28.[21] Brazil continued to deplete its reserves, which had fallen to about $28 billion (excluding the borrowing from the International Monetary Fund), in a futile effort to sustain the *real.* Finally, on January 13, 1999, the Central Bank made a last-ditch effort to stem the tide by devaluing the *real* by eight percent. It was, however, too little and too late. The following day Standard and Poor's lowered its rating on $58.1 billion worth of Brazilian foreign debt from B+ to BB, and $1.8 billion left the country. On January 18, 1999, fearful that it would soon exhaust all of its dwindling foreign reserves, the Central Bank allowed the *real* to float. The exchange rate quickly plummeted by eighty percent, from 1.20 *reals* to the dollar in the beginning of January to a low of 2.20 *reals* to the dollar in February.[22] Brazil is now maintaining a "dirty float," with the Central Bank intervening from time to time to drive down the exchange rate. The *real* has been gradually strengthening, closing at 1.835 *reals* to the dollar on March 25, 1999. By mid-March 1999, Brazil's foreign reserves stood at $34.64 billion.[23]

Brazil recently revised its commitments to the International Monetary Fund. The new agreement requires that Brazil increase its budgetary surplus, excluding debt interest payments, from 2.6 percent as previously agreed upon to 3.1 percent of GDP. Brazil must also reduce its total public debt below 46.5 percent of GDP. This revised accord will limit the Central Bank's ability to intervene to sustain the *real,* placing a ceiling on interventions of $3 billion for March, $2 billion for April, and $1.5 billion a month for May and June.[24]

Now that Brazil has allowed the *real* to float, the big question is whether the inflation rate will once again soar to triple digits. The fear is that the substantial devaluation will

20 *See* Brazil Watch, Jan. 11-25, 1999, at 8.

21 *See* Brazil Watch, Jan. 11-25, 1999, at 3.

22 Within minutes of lifting of exchange controls, the *real* fell from 1.32 to 1.60 to the dollar. Diana J. Schemo, *Brazil Devalues Further, and Stocks Soar by 33%,* N.Y. Times, Jan. 16, 1999. In the past two months, it fell as low as 2.20 to the dollar before Central Bank intervention drove the *real* up.

23 *See* Miami Herald, Mar. 18, 1998, at 2C.

24 *See* Larry Rohter, *Aid Pact Further Restricts Brazil,* Miami Herald, Mar. 9, 1999, at 1C and 2C.

rekindle the embers of Brazilian inflation and will do incalculable damage to the president's prestige. The wholesale price index increased by 5.82 percent in February 1999, more than the entire past year, and economists are forecasting that the inflation rate will be somewhere between twelve and twenty-five percent for 1999.[25]

The Cardoso regime is currently putting together a package of tax increases and spending cuts that they hope will increase the federal government's net receipts by some $20 billion in 1999. Much of this $20 billion is going to have to come from spending cuts by states and counties, which is hard to do, and even harder for the federal government to mandate, without Constitutional reform. Even before the crisis hit, Brazilian planners were projecting only modest growth for the economy in 1999. Today the optimistic view is that Brazil will have zero growth next year while the pessimistic view is that the growth rate will be substantially negative.

III. Brazil's Approach to Economic Integration.

A. Growing MERCOSUL.

Since its inception in 1991, MERCOSUL has been extraordinarily successful in establishing a free trade area among Argentina, Brazil, Paraguay, and Uruguay. It has also made a promising start to establishing a customs union with a common external tariff among the four countries. MERCOSUL has become an important part of Brazil's foreign trade. Initially accounting for only four percent of Brazil's foreign trade, MERCOSUL presently accounts for seventeen percent. Brazil now buys thirty percent of Argentina's exports, and Argentina sells more to Brazil than to the United States.

MERCOSUL represents more than half the total economy of Latin America: more than fifty percent of its industrial product, forty-six percent of its interregional trade (fifty-eight percent if you include Bolivia and Chile), forty-five percent of the population, and fifty-nine percent of the land surface. Foreign direct investment last year in MERCOSUL totaled $21.235 billion, slightly less than half of all foreign direct investment in Latin America and the Caribbean for the year. Thus far, MERCOSUL has been very successful in facilitating the free flow of goods among its participants. It now needs to consolidate its organization and achieve free flow of services, people, and capital. It also has to eliminate the significant exceptions from its common tariff.

B. Creating SAFTA.

Brazil has been actively seeking to expand the membership of MERCOSUL. To this end, MERCOSUL has brought in Chile and Bolivia as associate members, and it is seeking free trade pacts with the Andean Community, Mexico, and the European Community. In 1995, MERCOSUL signed an economic and commercial cooperation agreement with the European Union, which is a basis for progressive trade liberalization between the two blocs. Chile joined the MERCOSUL free trade zone, but not the common external tariff, in June 1996. The terms of membership were very favorable to Chile, perhaps to seduce it away from

25 *See* 16 Brazil Watch 3, 12 (No. 5, Mar. 8-29, 1999).

the FTAA. Bolivia also agreed to participate in the free trade zone, and by 1999, Brazil hopes to have a free trade agreement in force with the Andean Community. In April 1998, an official timetable for negotiation and implementation of a free trade zone between the two trading blocs was established. In March 1999, representatives of both groups met in Lima to negotiate tariff preferences,[26] and Colombia and Venezuela established 4+1 agreements with MERCOSUL; similar to those negotiated with Bolivia and Chile.

Brazil's goal is to create a South American Free Trade Area (SAFTA) by the year 2005. It would include all of South America except for French Guiana, Guyana, and Suriname, in a single free trade area. Initially limited to trade in goods, SAFTA would automatically reduce customs duties and other trade barriers. It would operate as a network of free trade agreements among the South American member states of the Latin American Integration Association (LAIA), in accordance with the rules of the World Trade Organization and the Montevideo Treaty of 1980.

C. Bloc Negotiation with the United States on the FTAA.

Brazil is also actively seeking to contest U.S. hegemony over trade issues in the Americas. However, despite its size, it is still not powerful enough to do this on its own. But MERCOSUL, with an annual GDP of more than $US one trillion, considerably amplifies Brazil's voice.

MERCOSUL countries are speaking with a single voice on issues of economic integration in the Americas, and Brazil has become their spokesman. They are seeking to advance a clear agenda and negotiate with the rest of the Americas as a unified trade bloc. They are also seeking to slow the pace of economic integration with NAFTA, regarding 2005 as unrealistically soon. Brazilian industries are fearful that they will not be in a position to compete with U.S. and Canadian firms by that time. Brazil has been helped by the refusal of U.S. Congress to give President Clinton fast-track authority, without which he is unlikely to be able to negotiate any extensions of NAFTA.

D. Brazilian Trading Goals.

According to Brazilian Foreign Minister, Luiz Felipe Lampeira, "MERCOSUL is not a stage towards a Free Trade Area of the Americas. It is an end in itself. We don't want MERCOSUL to dissolve with the advent of the FTAA."

Brazil views MERCOSUL rather than the FTAA as the principal mechanism for economic integration in the Americas. Although Brazil's top priority is MERCOSUL rather than the FTAA, this does not mean that it opposes the FTAA or globalization. In fact, Brazil does not view regionalization and globalization as mutually inconsistent goals.

Brazil is very much interested in free trade; wanting unrestricted access to world markets for its exports. It is a global trader, sending about twenty-seven percent of its $53 billion in exports to the European Union, twenty percent to NAFTA, twenty-four percent to South America (including seventeen percent to its MERCOSUL partners), fifteen percent to Asia and the remaining fourteen percent to other regions.[27] It is concerned about eliminating various forms of protectionism abroad, such as the dumping and countervailing duties suits against its exports to the United States, and environmental restrictions to trade, such as

26 *See Andinos e MERCOSUL negociam preferências tarifárias em Lima* (Mar. 18, 1999) <http://www.trix.net/MERCOSUL_noticias>.

27 *See* Minister José Botafogo Gonçalves, Latin America: Tigers or Sick Cubs, May 6, 1998, at 3.

restrictions on timber exports and eco-labelling. On the other hand, it is also concerned about exposing its own industries too soon to unprotected competition with goods manufactured in Asia, North America, and Europe, especially while its currency is overvalued.

E. THE EFFECT OF BRAZIL'S DEVALUATION ON MERCOSUL.

Brazil's major devaluation has seriously undermined MERCOSUL, by revealing how vulnerable the economies of all the other members are to Brazil's turmoil. Since one of the reasons for the large amount of trade between Argentina and Brazil was that both countries had overvalued exchange rates, Brazil's devaluation has changed the nature of their relationship. The devaluation will make it very difficult for Argentina to export to Brazil and will make Argentina vulnerable to cheaper Brazilian imports.[28] To attempt to minimize that threat to Argentine producers, Brazil has recently curtailed subsidies on exports to Argentina.

Argentina is in a serious dilemma, for its peso has been fixed at one to one with the dollar since 1992. Because of its Convertibility Law,[29] Argentina cannot devalue without changing the law. That means public debate, which will inevitably lead to massive capital flight. Since MERCOSUL lacks any binding dispute resolution mechanism, this threat to the region's economic integration will have to be worked out by negotiation at the highest level.

IV. Conclusion.

Brazil sees MERCOSUL and NAFTA as two building blocks for forming the FTAA. It views MERCOSUL as more than a customs union; it also has cultural, political, security, and educational dimensions. Brazil would very much like to see MERCOSUL maintain its identity even if the FTAA becomes a reality in 2005. MERCOSUL is a critical part of Brazil's long-run view of its world role. It is an important means of consolidating the opening of Brazil's economy, of modernization, and of monetary stabilization.

If Brazil is able to weather the present crisis, chances are good that it will successfully continue to privatize and modernize its economic structure. Thus far, its currency has been battered, as well as the national dream of soon assuming the ranks of the First World. But, Brazil has not suffered the kind of meltdown that occurred in Russia and some of the Asian countries. It allowed its currency to float before it exhausted its reserves, Congress has been enacting many of the necessary fiscal measures, and the exchange rate has been slowly but steadily dropping. Barring a major setback, Brazil is likely to recover.

However, Brazil still has to confront the difficult political problems of income redistribution, restructuring of the party system, fair reallocation of congressional seats, and reallocation of tax burdens and benefits among the various federative entities. This is a tall order. Perhaps, however, if the politicians learn to sleep longer, Brazil will complete the modernization process and become a full-fledged member of the First World. There is some reason for optimism, but also real concern about the difficulty of surmounting the obstacles ahead.

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28 As a result of the devaluation, Argentina's favorable trade balance with Brazil fell from $121 million in January 1999 to $11 million in February and is expected to become negative for the rest of the year. *Brasil terá superavit com a Argentina em 1999* (Mar. 17, 1999) <http://www.trix.net/MERCOSUL_noticias>.

29 Law No. 23.928 of 1992.