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BRAZIL'S ECONOMIC REFORM AND THE GLOBAL FINANCIAL CRISIS

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Abstract. This report tracks Brazil's economic and financial situation, as well as the related International Monetary Fund (IMF) effort, in support of congressional interest in the changing global economy.

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Brazil's Economic Reform and the Global Financial Crisis

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Summary

Despite backing from the International Monetary Fund (IMF), capital flight from Brazil in 1998 prompted the government to jettison its pegged currency stabilization program and float the *real* on January 15, 1999, becoming another casualty of the volatile international capital markets. Brazil adjusted to its financial crisis faster than expected, which is now considered over. This report provides a final summary of Brazil's financial crisis and related IMF assistance in support of congressional interest in various aspects of the 1990s global financial turmoil. It will not be updated.

Facing increasing investor uncertainty and prolonged capital flight, Brazil devalued its currency (the *real*) on January 15, 1999, following Mexico, Asia, and Russia as the next casualty of the 1990s global financial turmoil. Although Brazil had ample foreign exchange reserves and International Monetary Fund (IMF) support, nervous investors withdrew a net $40 billion from Brazil over the four months following the August 1998 default in Russia. Yielding to market pressures, Brazil attempted an 8% "controlled" devaluation on January 13, 1999, only to increase investor anxiety and capital outflows. Rather than risk depleting its international reserves in the hope of outlasting the global run on its currency, Brazil chose to float the *real*, causing a major devaluation that eventually halted capital flight, but left the economy disrupted in other ways.

A combination of policy decisions and political events left Brazil exposed to the vagaries of international capital markets. First, Brazil had an overvalued exchange rate and huge fiscal deficits, which together could not be sustained indefinitely. Second, Brazil became increasingly dependent on the very capital markets that tend to abandon countries when they need them most. Finally, two political events in January triggered the final run on the *real*: 1) failure to pass legislation that would have addressed the large budget deficit that epitomized the country's fiscal excess; and 2) announcement of a moratorium on federal debt payments by a large state government. To grasp how these events made Brazil vulnerable to capital flight, however, it is important to understand the role of economic policies implemented earlier in the decade.

Background: Economic Stabilization and Reform

In the 1980s and early 1990s, the Brazilian economy struggled with slow growth and high inflation, aggravated by inefficient, wasteful, and at times questionable public oversight. Policies to stabilize the economy repeatedly failed, but in July 1994, then-Finance Minister (and now President) Fernando Henrique Cardoso launched the *Real* Plan to beat Brazil's high inflation. As an exchange rate stabilization strategy, it centered on eliminating price indexation and creating a new currency (the *real*) that was pegged to the dollar as a link to U.S. monetary stability. To maintain a credible peg, Brazil had to adopt responsible (tight) fiscal and monetary policies to restrain those pressures that could cause the currency to appreciate in real (inflation-adjusted) terms.

Table 1. Brazil: Selected Economic and Financial Indicators

	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000***
GDP Growth (%)	4.1	6.0	4.2	2.7	3.4	0.0	0.8	3.3
Inflation - CPI (%)	2,730	1,224	17.8	9.5	5.2	1.7	8.9	5.6
Unemploy Rate (%)	5.3	5.1	4.7	5.4	5.7	7.6	7.6	7.3
Nominal Fiscal Bal. (% of GDP)	-2.3	0.5	-7.2	-5.9	-6.1	-8.1	-10.0	-4.3
Primary Fiscal Bal.** (% of GDP)	2.9	5.1	0.4	-0.1	-1.0	0.0	3.1	3.3
Current Account Bal. (% of GDP)	-0.2	-0.2	-2.6	-3.0	-4.2	-4.3	-4.4	-3.5
Foreign Reserves ($b)	30.6	37.1	51.8	60.1	52.2	44.6	36.3	41.0

* = projected. Sources: IMF and Latin American Monitor: Brazil. May 2000.
** excludes interest payments.

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Economic growth slowed under the *Real* Plan, but a recession was avoided and inflation fell rapidly, declining from over 2000% in 1993 to less than 20% by 1995 (see **Table 1**). The Plan also included a policy of real (inflation-adjusted) wage increases (notably the minimum wage), which, combined with falling inflation, effectively redistributed income to the poorest sectors of the economy and broadened the stabilization program's appeal.[1] Beyond stabilization, Brazil's longer term goals were promoting fast growth and deeper economic reform. Deeper reform involved structural changes such as continuing to open the economy to foreign trade and investment, overhauling financial market regulation, privatizing government-controlled firms, allowing markets to function more freely, and, most importantly in Brazil's case, reducing large fiscal deficits.

Economic Challenges and Delayed Reform

The failure to complete reform and the volatility of global capital markets were two factors that together eventually forced Brazil to abandon the *Real* Plan. Although Brazil

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[1] For details, see Dornbusch, Rudiger. Brazil's Incomplete Stabilization and Reform. *Brookings Papers on Economic Activity*. No. 1. 1997. pp. 374-78. Brazil, it should be noted, still suffers from one of the most unequal income distributions in the world.

had succeeded in bringing inflation down to historical lows, the reform program did not proceeded as swiftly as anticipated and was further impeded by inadequate economic growth. Three interrelated economic problems developed.

Exchange Rate Valuation. A pegged currency stabilization plan was the foundation of Brazil's economic reform program, which meant that inflation had to be reduced rapidly. High inflation with a pegged currency causes exports to become less competitive and imports more so, leading to growing deficits in trade (goods) and on current account (goods, services, and investment income). In effect, it causes the currency to appreciate in real (inflation-adjusted) terms. If an appreciating currency is perceived to be seriously "overvalued," it raises the prospect of a future devaluation and such speculation is frequently a critical factor causing investors to discontinue financing a country's debt, leading to capital flight and a financial crisis. Inflation and large capital inflows did cause a real appreciation of the Brazilian currency. The *real* appreciated immediately when fixed to the U.S. dollar in 1994 and continued to appreciate because of Brazil's relatively high inflation rate. In 1995, Brazil countered by tightening monetary policy to reduce inflation and by instituting a crawling peg exchange rate that would reduce the nominal value of the *real*. With a crawling peg, the *real* was traded within a narrow "band" that was depreciated over time in small increments (a crawl of about 0.6% per month) to help offset currency appreciation. The central bank bought and sold the *real* to maintain the exchange rate within the band.

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From 1995 to 1998, with inflation falling, renewed investor confidence and high real interest rates led to large capital inflows, which then became the major threat to currency stability. These inflows fueled the current account deficit, placing further upward pressure on the value of the *real*. Over time, a consensus emerged that the *real* was in fact "overvalued" by 15%-30%, increasing the risk of sudden investor withdrawal and a currency crisis, and thereby placing additional pressure on Brazil to support the *real* with appropriate macroeconomic policies, particularly fiscal austerity.[2]

Fiscal Deficit. Although monetary policy was tight, in part to defend the *Real* Plan, lax fiscal management was a second critical economic challenge. The persistently large budget deficit hit 8% of GDP in 1998 (roughly half federal, half state and local), raising three problems. First, the need to attract capital meant domestic interest rates had to exceed foreign rates, which increased the cost of financing government debt, hampering correction of the fiscal deficit even if budget cutting had been taken seriously. Second, Brazil's dependence on foreign capital (debt service) grew more burdensome as the debt: 1) increased dramatically in size; 2) shortened in maturity; and 3) became increasingly indexed to the dollar and short-term interest rates. Third, fiscal excess, by pulling in foreign capital, put upward pressure on the currency value thereby impairing credibility of the exchange rate peg. Fiscal discipline proved elusive because it required Brazil's congress to make sweeping changes to social security, pension, and tax laws, three large structural components of the deficit with well-defined and politically active constituent groups. On December 2, 1998, the Brazilian legislature failed to pass the major reform bill, suggesting that the government would be unlikely to meet its fiscal targets. Although other savings had been found, legislative gridlock raised a serious question about Brazil's commitment to fiscal austerity and broader economic reform.

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[2] DRI, Inc. *World Markets Report: Brazil*. October 1998.

Current Account Deficit. The third major economic issue was the current account deficit, which exceeded 4% of GDP in 1998. Although below levels seen as unsustainable (e.g. 8% in the case of Mexico in 1994), it was higher than generally considered desirable (3%). The current account deficit may be viewed as a function of Brazil's low domestic saving rate. Brazil used foreign capital to supplement the shortfall of domestic savings to finance private investment and the government deficit. To bring about higher saving rates, Brazil would have had to encourage private sector saving over consumption, which is not easily done through public policy, or directly increase saving on the public side by cutting the federal budget deficit, which it had failed to do.

By January 1999, Brazil had to support a policy of high real interest rates to attract foreign capital required to finance the fiscal and current account deficits, rather than reduce interest rates to help stimulate the economy. Given this constraint on monetary policy, shrinking the fiscal deficit was key to resolving Brazil's economic problems. A smaller fiscal deficit would have reduced the need for foreign capital and related high interest costs, effectively lowering the current account deficit while increasing saving, which would have exerted downward pressure on interest rates and the exchange rate. Although this would have taken time, decisive movement toward fiscal austerity might have allowed capital markets to retain confidence in Brazil's financial future.

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Capital Flight and the IMF Package[3]

Following Russia's devaluation and default in August 1998, investors viewed Brazil's overvalued currency, weak fiscal position, and policy gridlock with great skepticism. Capital flight ensued and Brazil approached the IMF for aid even before a full-scale currency crisis had erupted. On December 2, 1998, the IMF approved a stand-by arrangement comprising financial commitments from the IMF, World Bank, Inter-American Development Bank (IDB), and 20 individual countries, including the United States (see **Table 2**). The IMF's overriding goal was to provide private capital markets with sufficient assurance of Brazil's short-term liquidity to avoid a speculative attack on the *real*. It was intended to buy time for Brazil to: 1) pass reform measures aimed at addressing deeper economic problems, particularly fiscal reform; and 2) increase the depreciation rate of its crawling peg to allay concerns over exchange rate valuation.[4]

Total financial assistance amounted to $41.5 billion. The IMF had the largest portion at $18.0 billion, with $5.5 billion (30%) offered under the normal stand-by arrangements, provided at slightly above U.S. Treasury rates and disbursed over three years subject to IMF reviews of Brazil's policy commitments. The remaining $12.6 billion (70%) was made available through the IMF's new Supplemental Reserve Facility (SRF) at a higher rate and for only a one-year period. Both the World Bank and the IDB provided three-year loans of $4.5 billion, available in 1999. Twenty countries also committed to guarantees of loans made through the Bank of International Settlements (BIS), of which the U.S. portion was a $5.0 billion commitment from the U.S. Treasury's Exchange Stabilization Fund (ESF).

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[3] For IMF details, see: CRS Report RL30575, *The International Monetary Fund: An Overview of Its Mission and Operations*, by J. F. Hornbeck and the IMF web page: [http://www.IMF.org].

[4] Ironically, this assistance was approved the same day Brazil failed to pass the fiscal reform bill.

Table 2. IMF Financial Arrangement for Brazil ($ billions)
(Approved December 2,1998)

	Amount	Comments
IMF	$18.0	70% under new SRF* at 3 percentage points over normal rates (expired 12/1/99); 30% as normal stand-by arrangement.
World Bank	$4.5	4 percentage point over normal lending rates.
IDB	$4.5	4 percentage points over normal lending rates.
Bilateral	$14.5	Loans from BIS** guaranteed by 20 countries; 4 percentage points above U.S. Treasury rates.
Total	$41.5	

*Supplemental Reserve Facility (see paragraph below).
** Bank of International Settlements - Basle, Switzerland. U.S. portion ($5.0 billion) committed from Exchange Stabilization Fund (ESF), U.S. Department of the Treasury.[5]
Source: IMF, IDB, and U.S. Treasury.

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There were some ground breaking aspects to the Brazilian package. First, it used the SRF, which was established by the IMF only one year earlier in December 1997 to meet short-term liquidity problems in countries that have experienced a sudden loss of market confidence, but that also have reform measures in place to suggest that market confidence can again be obtained relatively quickly. Second, for the first time, the IMF activated the New Arrangements to Borrow (NAB) to finance the Brazilian loan. The NAB is a new agreement with certain countries to have them lend supplementary funds to the IMF to assist with financial crises at times when the IMF's liquidity is low. Third, it was originally a preemptive loan arrangement in which Brazil requested support before it actually had a financial crisis. Fourth, the IMF "front loaded" the package, allowing most funds to be disbursed in 1999.

Brazil drew $9.4 billion in December 1998 divided between IMF and the bilateral commitments. The draw was conditioned on following a number of policies including reducing its fiscal deficit, following a strict monetary policy, enacting various structural reforms, and maintaining its pegged exchange rate. The *real's* stability at this point depended on the credibility of Brazilian policies, which was lost when Brazil's congress failed to pass reform legislation. The resulting capital flight forced Brazil to float the *real* within a month, its value dropping by 40% at its low point. Moving from a pegged to a floating exchange rate meant that technically Brazil was no longer in compliance with initial IMF conditions, requiring a renegotiation of terms. On March 30, 1999, with reforms underway, the IMF in its second review agreed to new terms with Brazil; one week later Brazil drew a second installment of $4.9 billion from the IMF, another $4.9 billion from the bilateral commitments, the full $4.5 billion from the IDB, and $1.0 billion from the World Bank.

Subsequently, as a condition for making available the remaining IMF resources, the Fund conducted three more reviews of the Brazilian economy on July 28, 1999, November

[5] For details on the ESF, see: CRS Report RL30125, *The Exchange Stabilization Fund of the U.S. Treasury Department: Purpose, History, and Legislative Activity*, by Arlene Wilson.

29, 1999, and May 31, 2000. The economy adjusted faster than many analysts had predicted and Brazil did not need to access the full amount of the IMF package. From the IMF alone, it drew a total of $11 billion, but repaid all the higher interest loans from the SRF and bilateral agreements in April 2000, six months ahead of schedule. As of June 1, 2000, Brazil had an outstanding IMF credit balance of $1.9 billion from the three-year stand-by arrangement.

Outlook and Implications

Economic indicators suggest Brazil has clearly beat all expectations regarding its recovery from the January 1999 devaluation and effectively Brazil's financial crisis is over. Although at one time Brazil was expected to enter a deep recession, GDP actually grew by nearly 1% in 1999, employment increased by 2.5%, and the annual inflation rate was restrained to 9%, within the target range expected by the IMF. The current account deficit was higher than anticipated due to weak export prices and the rising cost of oil, as well as a slower than expected response of export prices to the devaluation. Foreign capital has begun to return to Brazil, however, so the current account deficit has been fully financed with foreign capital and Brazil's reserve position has stabilized, even as it has repaid the IMF. Improving trends in 2000 so far support Brazil's optimistic assessment that its worst economic problems are now past.

Economic policy and IMF assistance appear to have been two important variables reducing the severity of Brazil's financial crisis. Although implementing economic reform earlier might have averted the crisis to begin with, clearly the economic fallout could have been much worse. Structural reforms played an important role, particularly the fiscal effects related to congressional action in 1999-2000 on redefining the public and private pension systems, the fiscal responsibility law and broader tax reform, which affects federal, state, and municipal budgets, and heightening regulatory oversight (and consolidation) of the financial sector. Fiscal and monetary policy have held firm, keeping a check on inflation while supporting solid economic growth in 2000. Fiscal excess, viewed by many as a core problem, has improved as seen in the expected rise of the primary fiscal balance (excludes interest expense) from 0% of GDP in 1998 to over 3% in 2000, although reducing Brazil's public debt remains a long-term challenge.

Many view the Brazilian IMF program as a success, providing liquidity and credit enhancement as capital fled and conditionality working as a major catalyst for policy reform, which Brazil clearly resisted right up to the January 1999 devaluation. The devaluation rather than IMF assistance, however, was the major event halting capital flight, a decision Brazil would have faced in the absence of IMF assistance. Brazil also would have probably had to make policy adjustments in any case, but the fact that the IMF worked closely with Brazil even prior to the actual crisis suggests that there may be some merit in evaluating pre-emptive IMF assistance in cases of perceived potential crisis, versus responding after the fact. Finally, the fact that Brazil's recovery hinged on its ability to pass long-delayed reform measures speaks to the importance of pushing for such change before the onset of a financial crisis, a debate that is currently flourishing over the broader issue of defining appropriate IMF assistance. Enacting such deep structural reform, while also addressing severe social problems, remains one of the major political challenges facing Brazil and the rest of the developing world.

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