Brazil: The First Financial Crisis of 1999

IN JANUARY BRAZIL—the eighth largest economy in the world—devalued its currency, initiating the first financial crisis of 1999. To understand Brazil's crisis, it is useful to examine the economic program that preceded it.

In 1994, after years of failed price stabilization plans and resulting high inflation, Brazil initiated a stabilization plan named for its new currency, the real. Despite some problems, the Real Plan was cause for optimism. Brazil took steps to correct a large federal deficit, reducing funds transferred by the federal government to the states and municipalities and increasing federal income taxes. Monetary policy became more restrained. Finally, Brazil pegged its currency to the dollar. Pegging involved using the central bank's dollar reserves to buy reais or using the real to buy dollars, whichever was necessary, to control the number of reais a dollar could buy.[1] In other words, if the free market would not supply as many dollars as real holders wanted at the official exchange rate, then the government would supply dollars out of its reserves.

By pegging its currency, Brazil was sending a signal not only about its currency but also about its monetary policy. To effectively peg its currency to the dollar, a country must follow a monetary policy parallel to that of the United States. If Brazil were to peg to the dollar and run a significantly more inflationary monetary policy than the United States, the difference between its inflation rate and U.S. inflation would ultimately cause intolerable stresses for its currency system; that is, U.S. prices expressed in reais would become cheap to Brazilians, but Brazilian prices expressed in dollars would be expensive to U.S. consumers. Everyone would buy American and no one would buy Brazilian. Brazil suspected it could not match U.S. monetary or inflation policy exactly, so it maintained a crawling peg. This meant the exchange rate would be allowed to slide, but within limits.

The pegged exchange rate plus the other aspects of the Real Plan did send an important message to the world: Brazil was making a persistent effort to control inflation and was achieving its goal. In 1994, the year the Real Plan began, Brazil's annual inflation rate exceeded 900 percent. By the end of 1998, price movements were negative.

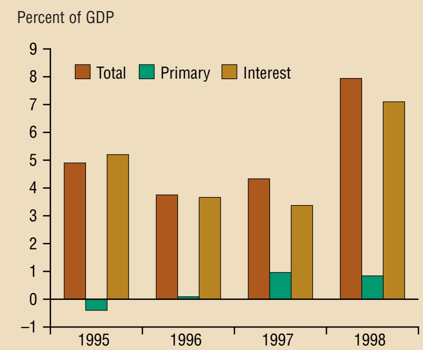
Despite the plan's success, however, the controlled devaluation built into Brazil's crawling peg was not enough to offset the cumulative differences between U.S. and Brazilian inflation rates. This overvaluation of the real made it harder to sell Brazilian products abroad because they were so expensive in dollars, and also motivated more Brazilians to shop abroad.

Financial Contagion

Another event aggravated the fiscal problems the country had hoped to address with programs linked to the Real Plan. Brazil began to suffer from financial contagion, in part because of worries about its overvaluation. Contagion occurs when a financial crisis in one country motivates investors to remove their funds from other—perhaps similar—countries as well. When financial crises swept Asia in 1997 and Russia in 1998, investors who were pulling their investments out of those countries also began to withdraw them from Brazil. To discourage the outflow of dollars, which the central bank would have to supply to maintain the pegged exchange rate, Brazil raised interest rates—a step intended to entice investors to hold their money in Brazil to earn high interest rates. Chart 1 reveals Brazilian interest rate surges, which reflect investor nervousness during the Korean and Russian financial crises.

CHART 1
BRAZILIAN INTEREST RATES

CHART 2
FISCAL DEFICIT WORSENS



The large increases in Brazilian interest rates, however, were not enough to keep foreign currency in the country. To maintain its pegged exchange rate, Brazil also had to devote much of its foreign currency reserves to defend the real. Dollar reserves, which had peaked at more than $70 billion at the beginning of 1998, dropped by half that amount by year's end.

A growing fiscal deficit frightened investors. Chart 2 breaks down the deficit between the portion attributed to interest payments—marked *interest*—and the portion—labeled *primary*—that is the difference between government expenditures on goods and services and the government's income from taxes and fees. The primary deficit is not large on

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a year-to-year basis, but the year-in/year-out accumulation of these deficits by a country that has a history of debt moratoriums can worry investors—especially in the context of financial crises in Asia and Russia. Nevertheless, even some usual measures of overall indebtedness, such as the debt–gross domestic product (GDP) ratio, did not suggest an existing crisis.

While the primary deficit was not large, the increases in interest rates made the overall deficit much greater. Last year, the two parts of the deficit—the primary and interest portions—summed to about 8 percent of GDP. That, together with signs that the primary deficit problems might continue, made investors nervous. Increasingly uncomfortable with Brazilian debt in any case, debtholders became particularly more reluctant to hold longer-term Brazilian debt. The ratio of short-term to total Brazilian debt increased markedly.

The Endgame to Devaluation

As problems became more acute in 1998, some well-known economists—but not all of them—began to call openly for a Brazilian devaluation. After the re-election of President Fernando Henrique Cardoso last fall, hopes began to rise that he could effectively address Brazil's budgetary difficulties. He announced a new budget plan to save about $23 billion. Some analysts began to forecast federal primary surpluses for 1999. A $41.5 billion International Monetary Fund (IMF) pre-emptive program was announced to assure currency speculators that attacks on the real would not be warranted.

Then hopes began to fade. In December, a deficit reduction bill was voted down, in part by members of the president's own coalition. A significant pension reform effort failed. Meanwhile, still in December, the rate of capital outflows accelerated rapidly, to as much as $350 million per day.

If a particular event could be said to have triggered Brazil's devaluation, it was the announcement by the new governor of the Brazilian state of Minas Gerais that he would suspend his state's debt payments to Brazil's national government for three months. Capital outflows accelerated even more rapidly. By mid-January, Brazil announced that pegging was over and its exchange rate would be allowed to float.

What Next?

What are the implications of Brazil's crisis for the United States, and for Texas in particular? Although about 20 percent of U.S. trade is with Latin America, Brazil accounts for only about 2 percent of total U.S. exports and 1 percent of total imports. Similarly, Texas sends only 2 percent of its total exports to Brazil. For Texas, direct trade effects of the crisis will be small. Brazil's trade links with Texas' chief trading partners, Canada and Mexico, are also extremely limited.

Does this mean Brazil will have no international impact? Weakness in Brazil will have impacts on its chief trading partners, of which Argentina is a primary example. But a broader concern is that while Brazil had been subject to contagion effects, it might now trigger them. Although such effects were evident in some Latin American markets immediately after the onset of Brazil's crisis, they appear to have subsided. For now, the principal focus with respect to Brazil's problems is Brazil itself, where the economy is already in recession. In the wake of the devaluation and float, Brazil began to approve fiscal reforms, including much-needed pension reforms. Of particular interest will be the new IMF agreement, debt negotiations between state governors and the national government, and further congressional actions to address the central government's fiscal deficit. All these factors will be significant as Brazil attempts to resolve its crisis.

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Note

[1] In Portuguese, the national language of Brazil, the plural form of words ending in the letter *l* is typically *is*. Under this rule, because one unit of Brazilian currency is a *real*, we refer to more than one as *reais*.