

## The Brazilian monetary reform, a two-edged sword

by Lorenzo Carrasco Bazúa

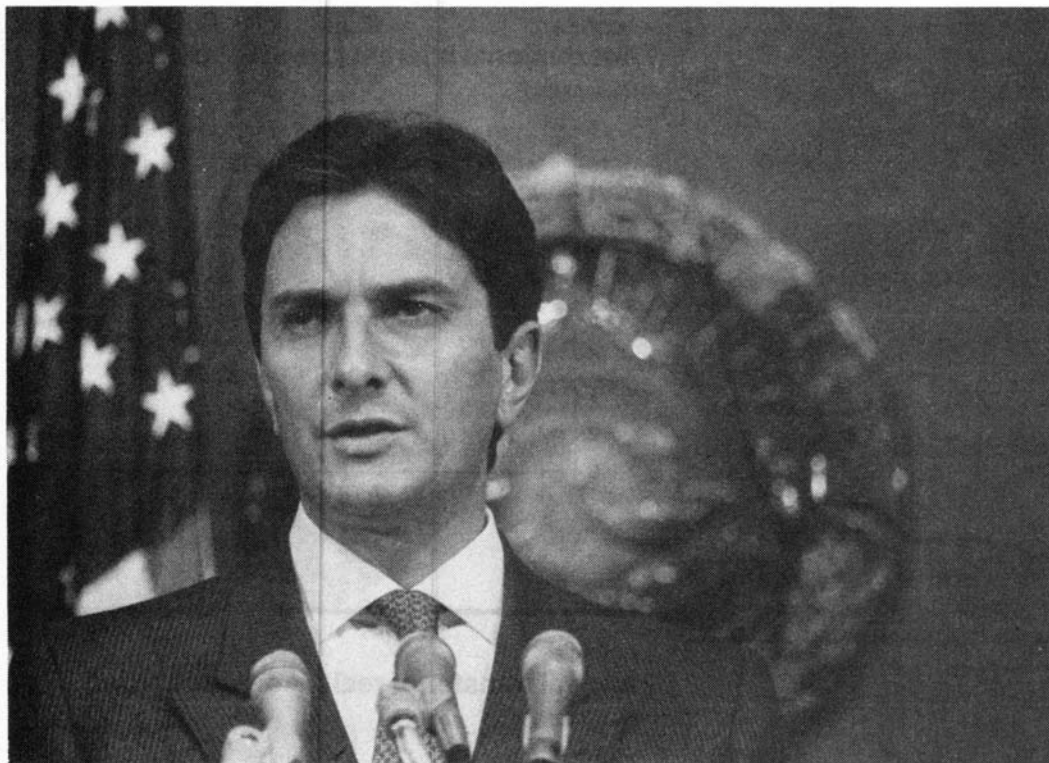
The heterogeneity of the New Brazil plan announced by the Fernando Collor de Mello government, has caused great confusion, not only among the knowledgeable public, but also, especially, among economic analysts around the world. The confusion stems from the fact that the reform simultaneously defends two economic viewpoints which, under current conditions of world depression, are mutually exclusive.

On the one hand, President Collor announced his reform within a dirigist framework, arguing for the reestablishment of the state's capacity to generate credit and money, declaring open warfare on financial speculation, and attempting the urgent utilization of monetary and credit resources for productive sectors and infrastructural projects, all with the intention of relaunching the industrial development of the country.

But, at the same time, President Collor proposed the so-called "re-entrance of Brazil into the world economy," which presupposes trade and financial concessions to foreign creditors—such as the surrender of state sector companies—which contradict the declared intentions of the monetary reform itself, namely, the strengthening of the state's capacity to invest in the economic infrastructure of the nation. The President's insistence on privatization of the state sector is a clear reflection of that contradiction.

One month after the announcement of the monetary measures, the economic health and survival potential of the country depends on a massive injection of long-term, low-interest financial resources, to set into motion major infrastructural works in the energy, transport, communications, capital goods, and agricultural sectors. Such a credit infusion is the only means for both defeating structural inflation and rescuing the nation from profound economic depression. This resource flow for infrastructural development will only be effective in the short term through the leading state companies, which must be immediately capitalized.

For a better understanding of the reform and its problems, it is necessary to



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*Brazil's new President Fernando Collor de Mello. The question of Brazil's survival is not whether to privatize the state sector or not, but how to capitalize it.*

turn our sights to the origin of the Brazilian economic crisis, and especially to the situation immediately prior to the release of the New Brazil program. Before the reform, the country was on the verge of entering into a Weimar-style hyperinflationary process. In February 1990, monthly inflation surpassed 80%, and in March broke the 100% barrier (**Figure 1**). Under this situation, every productive company with a will to survive was forced to participate in highly speculative markets which handled internal public debt paper and offered stratospheric profits to the private banking system. When the monetary reform was announced, the banking system's participation in the Gross National Product was an insane 20%. Following the reform, banking participation will be reduced to 5% of the GNP.

The crisis did not originate domestically. The Brazilian crisis, like that of the rest of Ibero-America, stems essentially from excessive interest payments on the foreign debt. The so-called Volcker revolution of 1978, which decreed a unilateral U.S. increase in interest rates (**Figure 2**), created effects similar to those of the reparations payments which slammed Weimar Germany following the Versailles Treaty. As of 1981, Ibero-America was subjected to war reparations conditions, and its physical infrastructure suffered the equivalent of a strategic bombing.

The means for implementing this destructive process were the demand for enormous trade surpluses, with which to service the foreign debt. In the 1980s, Brazil transferred abroad nearly \$85 billion, equivalent to four times the re-

sources invested in Europe by the postwar Marshall Plan (**Figures 3, 4, and 5**).

These enormous trade surpluses did not come from an increase in Brazilian economic productivity, however, but from a cheapening of its products through constant wage gouging, and by means of ever-increasing subsidies. The economic deformations thus generated ended up destroying the internal financial structure of the state, while driving healthy public companies into bankruptcy.

### **Autopsy of usury**

The destructive dynamic is very simple. The state, which possessed foreign exchange to pay its foreign creditors, bought the trade surplus generated by its exporters (often thanks to government subsidies), by means of ever-increasing issues of government paper which, of course, were backed neither by an increase in productivity nor by an increase in real physical wealth. This created the breeding ground for inflation.

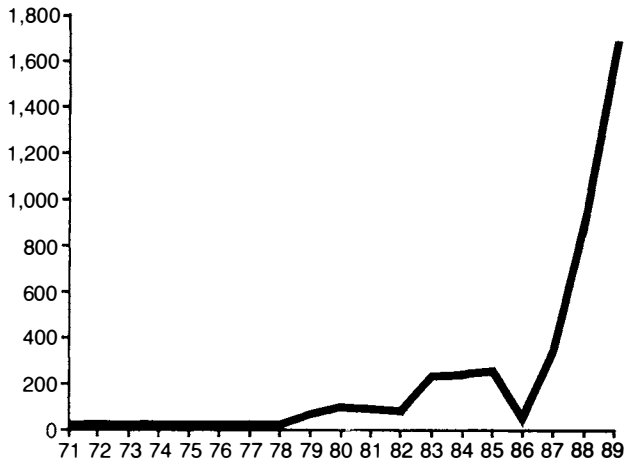
The loss in value of the Brazilian currency primarily affected those sectors whose prices are pre-fixed, such as wages, taxes, and public service rates. This triggered a major financial crisis for the state itself. The process reached its most lunatic heights when the government stopped collecting taxes on financial investments, for the explicit purpose of motivating the purchase of its own public bonds on the overheated overnight markets.

In the Jan. 20, 1989 issue of *EIR*, we warned ("Brazil's

FIGURE 1

**Official inflation rate**

(% per year)



Source: National Accounts

autopsy of usury”) that if this destruction of the country’s public finances continues, “there will be no force on Earth capable of halting the hyperinflationary holocaust that will be unleashed.” We showed how the self-aggravating inflationary process did not stem from an excess of currency printing, but rather in the exponential growth of internal public debt bonds. As noted in **Figure 6**, which deals with financial assets, we can see that such monetary instruments as checking accounts and paper currency in the hands of the public have been in constant decline, reaching a mere 6.1% of total assets. Federal, state, and municipal public debt holdings, however, represent 52.8%, to the detriment of all savings or time deposits.

Although this represents next to nothing in terms of the real economy, it does reflect certain truths that directly contradict the dogmatic defenders of the monetarist “quantity theory of money.” For example, the Summer Plan, launched in March 1989 by then Finance Minister Mailson da Nóbrega, was based on the dogma that inflation could be controlled by a drastic increase in interest rates which would in turn reduce liquidity in the economy. This, however, is insanity, in the context of a totally indexed economy in which currency had practically disappeared altogether. As a result of this process, the public debt in 1989 surpassed the foreign debt (**Figure 7**). The internal debt grew to such a point that, even though interest payments on the foreign debt were suspended, the internal cancer had already metastasized and was growing under its own dynamic. In 1989 alone, recycling of the internal debt stripped the public coffers of \$16 billion.

In fact, the country had lost any concept of money. What

FIGURE 2

**International interest rates (LIBOR)**

(% per year)

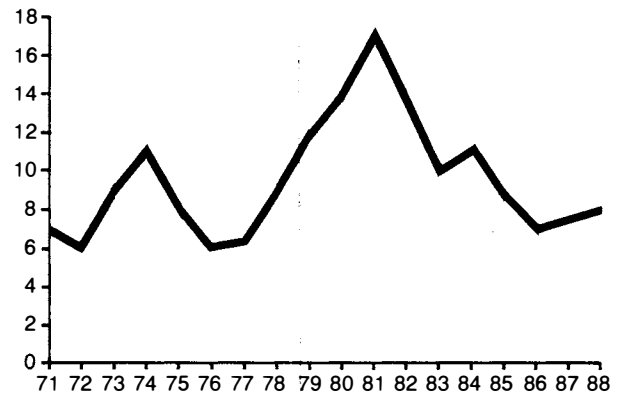
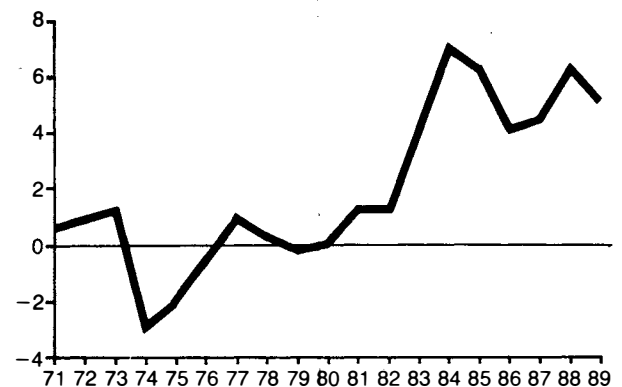


FIGURE 3

**Annual transfer of real resources abroad**

(% of GDP)



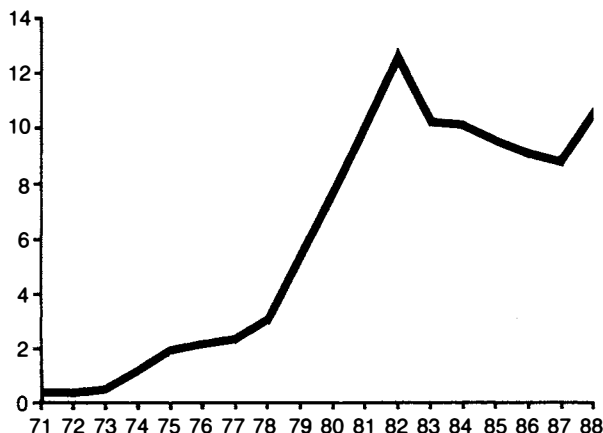
Source: Brazil Central Bank

existed in reality was a currency daily renewed on the *overnight* markets by public bonds representing immediate liquidity. That is, the public debt in its entirety was liquid at any moment. The threat of a bank run would pulverize the financial structure, dragging the real economy into an economic depression.

**The solution: a ‘sovereignty shock’**

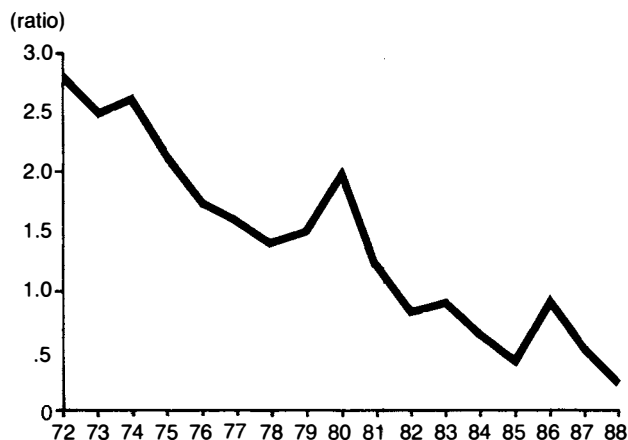
In the Oct. 6, 1989 issue of *EIR*, we published several recommendations, inspired by *EIR* Founding Editor Lyndon LaRouche, under the title “Brazil faces financial panic: time to exercise sovereignty!” The Brazilian government, we wrote, “should drastically reform the national financial and banking system, with the primary purpose of isolating government paper, which must then be protected from the specu-

**FIGURE 4**  
**Annual interest payments on foreign debt**  
 (billions \$)



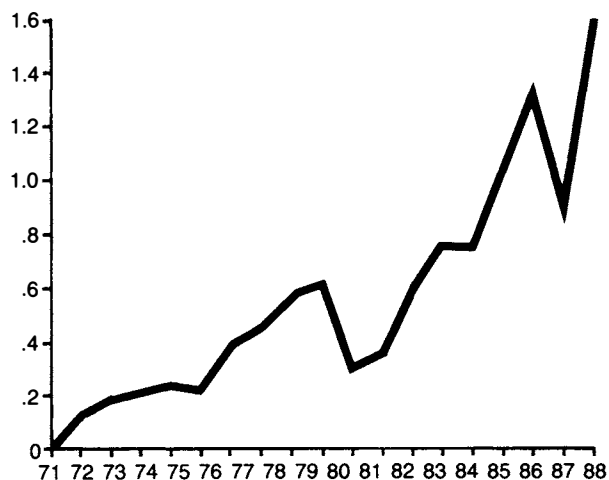
Source: Brazil Central Bank

**FIGURE 6**  
**Ratio of monetary assets to Federal bonds and bills**  
 (ratio)



Source: Brazil Central Bank

**FIGURE 5**  
**Annual profit and dividend remittances abroad**  
 (billions \$)



Source: Brazil Central Bank

lative oscillations of the markets and exchange rates of foreign currencies. . . . With the backing of the national Congress, the government has the prerogative of buying back these bonds with new debt instruments, setting fixed interest rates and longer repayment deadlines. This task would be simpler than it appears, since 80% of the market for government paper is concentrated in the hands of private banks, non-financial companies, and financial brokers, who should

understand that this is the only possible—not to mention patriotic—way out of the current crisis. These new government debt instruments could be viewed by the companies as discountable assets . . . once it is demonstrated that the money would be invested in the company's own expansion."

The reform announced by President Collor attacked precisely this speculative bubble created through the financial markets, which, at the same time, usurped the function of issuing currency and credit, thereby reducing the central bank to a rediscount agency for the financial operations of both national and foreign bankers. As a whole, the financial markets handled something on the order of \$120 billion, composed of \$70 billion on the overnight market, \$20 billion in bearer bonds and short-term funds, and \$30 billion in savings accounts, which, during the weeks just prior to the reform, had served as a refuge for the major financial speculators.

The creation of the cruzeiro as a new currency to replace the cruzado novo allows for a process of differentiation between real currency and the consolidated internal debt. Although the central bank is retaining nearly 80% of the \$120 billion, this does not mean that money in the hands of the public, or in checking accounts, is reduced. In fact, during the first 15 days of Collor's program, the amount of money in circulation actually doubled.

Although a large percentage of the central bank's frozen funds are actually public debt—which automatically went from paying interest of 3-4% above inflation per month, with 24-hour turnaround, to a 6% annual interest rate payable in 18 months—\$20 billion of the total frozen funds is actually working capital and future investments of productive companies—in other words, resources upon which these companies depend for their survival.

As Lyndon LaRouche noted in an article published in *EIR* on Sept. 8, 1989 (“Ibero-America’s response to the coming crash”) the measure the government should immediately take to confront the crisis is “to get existing resources—this means agriculture, manufacturing, and basic economic infrastructure—into motion at all costs. Every viable section of physical production and development, and maintenance of economic infrastructure, must be put back into motion as rapidly

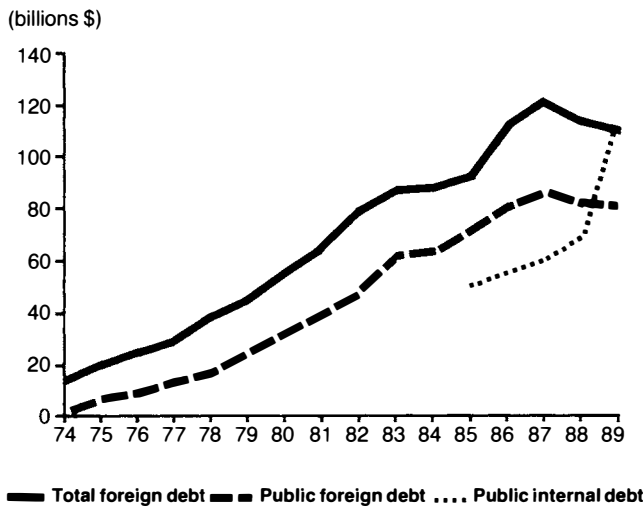
as possible. What must be done is that the new issue of national currency must be loaned through national banking at a modest discount for medium-term and long-term loans to agriculture, manufacturing, to investments in maintenance and improvement of basic economic infrastructure, and to some degree, for financing of foreign trade, in order to get the economy moving again.

“No significant loan, except for special governmental uses, such as national defense, should be made directly to any other sector of the economy, such as the finance sector. But rather, the other sectors of the economy, apart from agriculture, manufacturing, and infrastructure, should rely on secondary credit generated through banks on the basis of deposits by agriculture, manufacturing, and infrastructural activities. That’s the basic recovery program: physical economy.”

The Brazilian monetary reform has de facto re-nationalized the central bank and reestablished its sovereign capacity to issue money and credit. Nonetheless, the reform is insufficient to resolve the serious problems the Brazilian economy suffers. Because of continued adherence to the model of paying the foreign debt at all cost, there is constant loss of economic productivity, long-term inflation, and consequent economic and financial deformation.

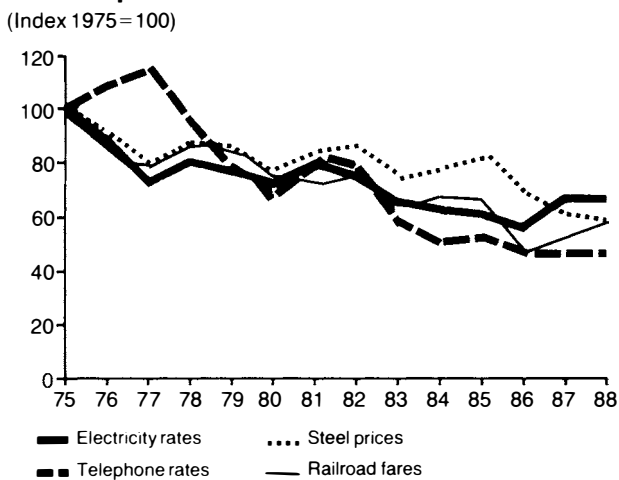
The process of economic looting in the 1980s fell most heavily upon the productive state sector, which has been drastically decapitalized. And this was not caused by the “inherent incompetence” of the public sector, as the free enterprise oracles of Thatcherite neo-liberalism try to prove in their zeal to plunder the public patrimony with the indiscriminate sale of state companies to private domestic and foreign interests. What actually happened during the past

FIGURE 7  
**Total foreign debt, and public sector debt, foreign and internal**



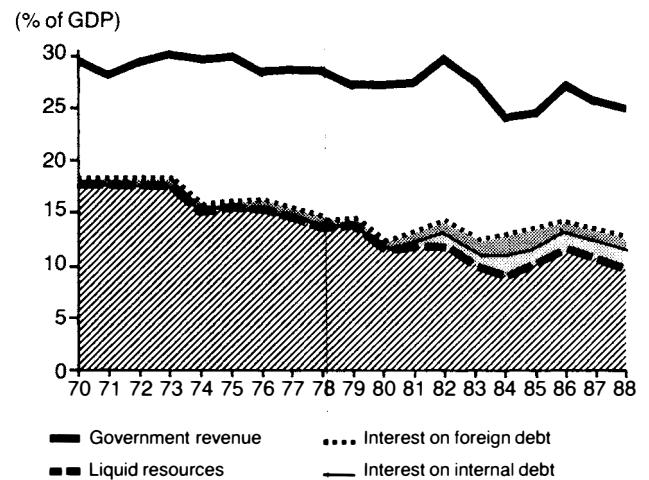
Source: Brazil Central Bank

FIGURE 8  
**Inflation-adjusted prices, rates and fares for Brazil’s public sector**



Source: C.N.I.

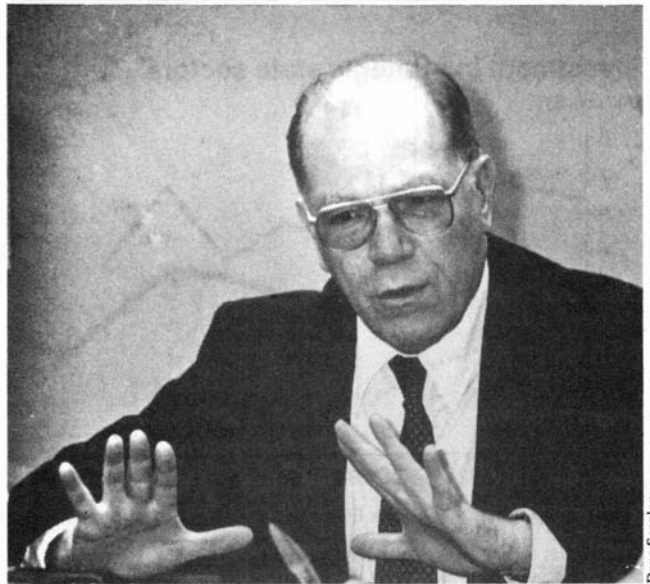
FIGURE 9  
**Government revenues compared to liquid resources and interest**



Source: National Accounts and Brazil Central Bank



Stuart Lewis



Dana Scanlon

*The problem: The policy of the creditors' cartel, whose main unofficial adviser throughout the 1980s has been Henry Kissinger, has been to loot Ibero-America, by plundering especially the productive state sector industries.*

*The solution: Lyndon LaRouche recommended last September that Brazil should immediately "get existing resources—this means agriculture, manufacturing, and basic economic infrastructure—into motion at all costs," using a new issue of national currency to generate credit for productive investment.*

decade, was that a criminal policy was adopted, of deliberately asphyxiating the productive public sector to force it into either bankruptcy or privatization. This strategy was adopted at the 1983 Vail, Colorado meeting of the "creditors' cartel," run unofficially by Henry Kissinger.

The story begins around the end of the 1970s with the policy of trying to combat inflation through reduction of prices and public service charges. As can be seen in **Figure 8**, electricity, telephone, and railroad costs had fallen an average of 25% over 1975 levels. As of 1982, the government

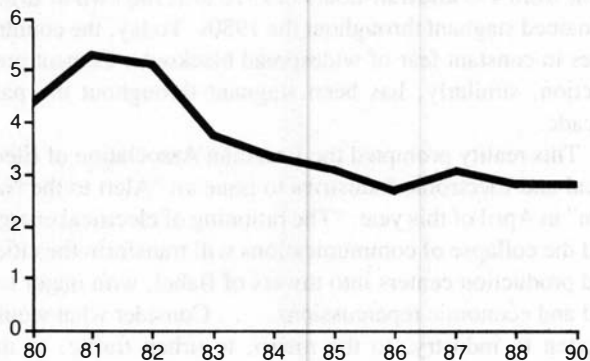
resolved to solve its balance of payments problems caused by the drastic rise in international interest rates by forcing state companies to 1) accept unnecessary foreign loans for operating capital, and 2) grant subsidies to exporters by reducing prices and tariffs by as much as 40% compared to 1975 levels. The most shocking example was that of a kilogram of flat steel, which now cost the equivalent of a dozen bananas.

The maxi-devaluations imposed on Brazil by the international financial agencies dramatically increased the debts of the state companies, especially of Siderbras and Electrobras, which are responsible for half of the total state sector indebtedness. At the same time, the federal government significantly reduced its own tax base (**Figure 9**). Between 1982 and 1984, it lost tax revenues equivalent to 2% of the GNP—some \$5 billion worth. Also in 1984, available liquid funds had fallen to less than 10% of GNP, as compared to nearly 18% in 1975. This represented the equivalent of \$20 billion that the government lost in one year.

The result of this process was that the operating costs of the state sector companies went through the ceiling. In the period of 1980-84, these costs tripled as a percentage of GNP, going from .84% to 2.58%—around \$4 billion per year. During that same period, investments in the state companies fell from 5.2% to 3.33% of GNP. Today, they are down to a mere 2.8% of GNP (**Figure 10**). This translates into a loss of nearly \$10 billion worth of annual investment into the infrastructure of the country.

A closer look is even more striking. Investments in the

**FIGURE 10**  
**Investment in state sector industries**  
(% of GDP)

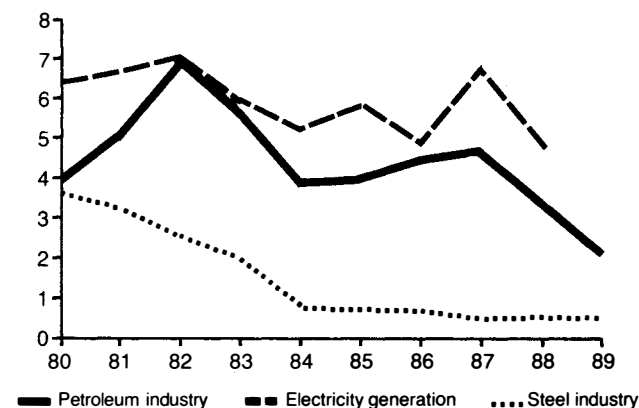


Source: Brazil Central Bank

FIGURE 11

### Investment in strategic state sectors

(billions \$)

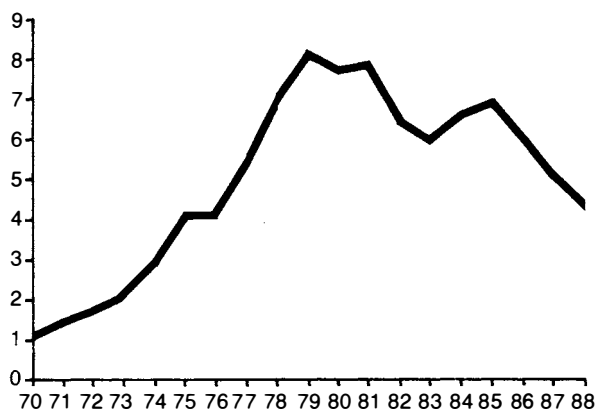


Source: C.N.I., Petrobras, Siderbras, Electrobras

FIGURE 12

### Production of capital goods

(billions \$)



Source: C.N.I., ABDIB

state oil monopoly Petrobras fell from \$7 billion in 1982 to slightly more than \$2 billion in 1989. The same with state steel company Siderbras, which received \$3.6 billion worth of investments in 1980, and scarcely \$500 million in 1989. In 1982, the state electricity company Electrobras invested \$6.9 billion in infrastructural works, and only \$4.9 billion in 1988 (Figure 11).

This process of decapitalization of the public sector is reflected in the collapse of the average annual growth rate of overall investment in Brazil. According to World Bank reports, this rate saw an average annual increase of 10.2% between 1965 and 1980, but became -5% a year between 1980 and 1985. At the same time, the rate of gross capital

formation—which was 25% of GNP in 1965—fell in 1985 by exactly the same percentage as investments in productive state enterprises.

As dramatic as these figures are, the nominal monetary value of gross capital formation does not reveal the true dimension of the damage: first, because the GNP remained virtually constant throughout the 1980s; and second, because the participation of civil construction in gross capital formation was 74.3% in 1988, as compared to scarcely 25.7% for capital goods production. These figures in 1970 were 55.6% and 42%, respectively. That is, the destruction of infrastructure is qualitative, and not merely quantitative.

### Agony of the capital goods industry

Although the impact is on the overall economy, the capital goods industry has been the hardest hit by the decapitalization of the public sector. For example, Petrobras alone is responsible for 20% of all capital goods purchases in Brazil. The relation of the state companies to the capital goods sector has the most significant multiplier effect on the productivity of Brazil's physical economy, and consequently, the most negative impact. We can see this in greater detail.

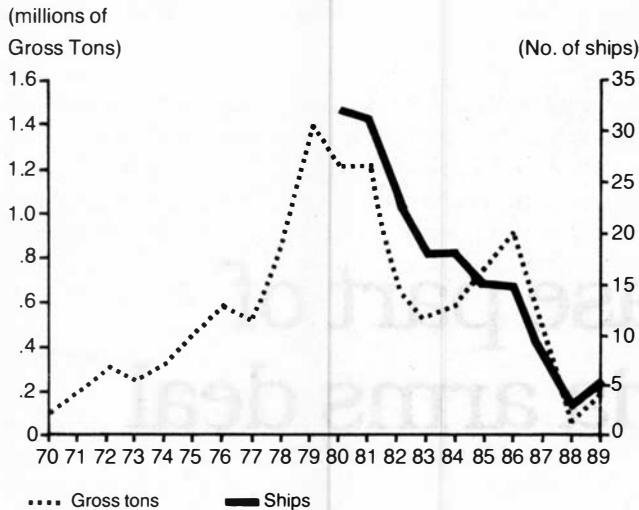
In 1980, thanks to a policy of building great infrastructural projects, the capital goods sector—production of boilers, metal, electrical, shipbuilding, and railroad products—reached the figure of \$8 billion a year. Starting with the debt crisis of 1981-82, this production collapsed to \$4 billion in 1989, with an idle capacity of nearly 40% (Figure 12).

The hardest-hit sectors were shipbuilding and railroad, with dramatic falls in their orders. The shipbuilding industry, which in 1979 produced 32 ships worth \$1.4 billion, fell virtually to zero in 1988 (Figures 13 and 14). The same could be said of the railroad industry, which in 1976 produced \$4.5 billion worth of freight cars, 106 locomotives, and 87 passenger cars; in 1989 it produced only \$2.5 billion worth—4 locomotives and 13 passenger cars.

This clearly reflects a deterioration in living standards as well. For example, per capita consumption of steel rose from 64 kilograms in 1970 to 120 kg in 1980, and fell to 85 kg in 1988. Similarly, per capita consumption of electricity, which grew from 490 kilowatt-hours in 1970 to 1,100 kwh in 1980, remained stagnant throughout the 1980s. Today, the country lives in constant fear of widespread blackouts. Cement production, similarly, has been stagnant throughout the past decade.

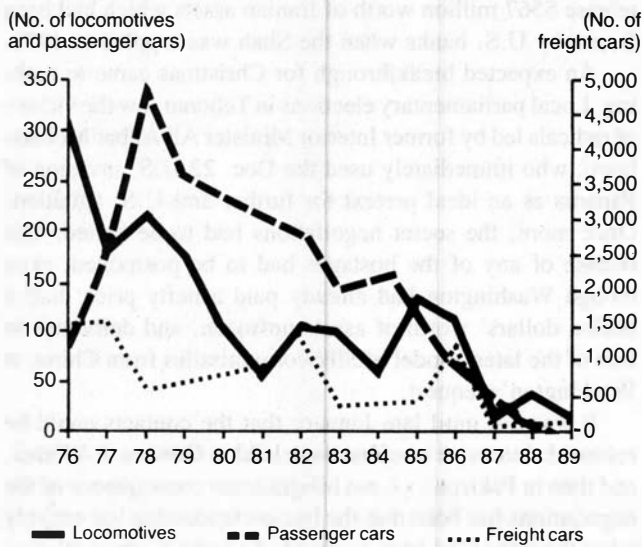
This reality prompted the Brazilian Association of Electrical and Electronic Industries to issue an "Alert to the Nation" in April of this year: "The rationing of electrical energy and the collapse of communications will transform the cities and production centers into towers of Babel, with major social and economic repercussions. . . . Consider what would happen to industry, to the metro, to urban traffic, to the water supply, to schools and hospitals, to the loss of life, the paralysis of refrigerators, elevators, public and residential

FIGURE 13  
**Shipbuilding industry**

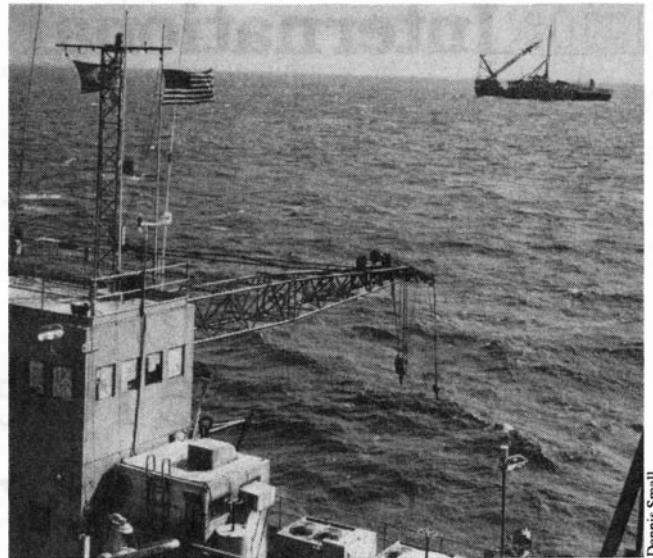


Source: ABDIB

FIGURE 14  
**Production of railroad rolling stock**



lighting, traffic lights, computer and telecommunications systems . . . and you will get some idea of what the blackouts will bring. . . . In view of these facts, it can be said that Brazil will need an Itaipú [Dam] every four years. . . . We should have installed nearly 3 million or more kilowatts a year between 1986 and 1990, raising installed capacity from 43,000 megawatts in 1986 to 58,000 necessary megawatts in 1990. Backwardness in planning is irreversible, aggravating the probability of insufficient supply and the risk of an



The Enchova platform drilling for oil off the coast of Brazil in 1982, using U.S.-built equipment. The state oil company Petrobras is capable of generating massive capital investment, but only if it stops being looted.

energy deficit. We urge the installation of a million telephone terminals each year. . . . This is imposed on us by the reality of the modern world. It is the crossroads between underdevelopment and development, between a great power and a third-rate one."

As we have seen, the economic and financial crisis of the country is not the result of inherent inefficiency of the public sector. Any strategy that is not premised on the rapid capitalization of the state sector is a guaranteed failure. The state sector companies like Petrobras and Electrobras are the only ones capable of injecting investments into the high-productivity sectors of the economy. Petrobras and Electrobras alone would be capable of delivering \$20 billion worth of infrastructural investment this year. Such an infusion, together with the transport sector, would produce the rapid recovery of the strategic capital goods sector, today on its last legs. Investments in agricultural infrastructure projects, such as irrigation and mechanization, would set this South American giant in motion again.

To achieve these ends, the Collor de Mello government does not need to surrender the public patrimony to its bank creditors, through a precipitous privatization program based on the illusion that this will somehow bring in foreign capital. The deep crisis affecting the international financial system requires the country to launch a high-growth strategy with its own resources, based on reclaiming the capacity to issue sovereign credit—the stated purpose of Collor's monetary reform.

The question is not whether to privatize the state sector or not, but how to capitalize it. On this depends the nation's capacity to survive.