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Report from Rio by Lorenzo Carrasco

Currency devaluation panics the markets

The old monetarist policies won't prevent Brazil from becoming another Mexico.

The March 6 decision by Brazilian monetary authorities to begin a phased devaluation of the national currency, the *real,* was enough to unleash a speculative orgy unprecedented in the country's recent history, which in only three days forced the government to use up $6 billion of its foreign reserves. Two billion of these were taken out of the country by so-called foreign investors.

The crisis began when the central bank established floating bands—a "politically correct" way of announcing a devaluation—fixing a range of 0.86-0.90 centavos for the buying and selling of the dollar, which would change to 0.98 centavos by May. The significance of the measure wasn't the relatively low percentage of devaluation, but rather the fact that the government recognized the impossibility of maintaining the artificially high value of the *real* as a guarantee of monetary stability—that is, the impossibility of maintaining the so-called exchange anchor.

Since the implementation of the *Real* Plan last July, the currency had become overvalued by 20 to 25%, so that the mere action of changing the exchange rate provoked a run by speculators, who assumed that the devaluation would place the currency in a relationship of 1 or 1.2 to the dollar.

Aside from the panic which struck President Fernando Henrique Cardoso's government, the ensuing market chaos had the effect of demonstrating that the Brazilian monetary situation isn't very far from what happened in Mexico last Dec. 20 as part of the ongoing world economic collapse.

The truth is that the artificially high exchange rates, combined with a flood of imports, have caused a trade deficit which was $492 million last November, and grew to $884 million in December. Although it dropped to $290 million in January, February's deficit is expected to exceed $1 billion. Thus in four months, the trade balance went from a $1 billion monthly surplus to a quarterly deficit of $2 billion. If this trend continues, the monthly trade deficit will soon reach $10 billion.

The devaluation is intended as a pragmatic way to encourage exports and generate a trade surplus of $5 billion this year; the government reasons that this will partly compensate for $15-17 billion in interest payments on the foreign debt and lead to a current-account deficit of $10-12 billion. Foreign reserves would then be maintained at an acceptable level of $25 billion or more.

But such calculations are illusory, since the reserves, estimated at $40 billion at the beginning of this year, dropped to $32 billion after the devaluation panic.

The government is still operating on the assumption that it can attract foreign capital to compensate for the deficit in its accounts, but reality says otherwise. Thus far this year, $11.2 billion in foreign capital has fled the country, against $5.24 billion in new investment, making the total capital flight figure a little under $6 billion.

As a way of attracting this foreign capital, the Cardoso government is dangling the sale of one of the richest state companies, Vale do Rio Doce, the world's largest iron ore producer, and promising to make the state oil and telecommunications monopolies more "flexible." It is also offering to open up state banks to foreign capital. And, within the logic of this monetarist lunacy, President Cardoso and his economics team are proposing to cut $10 billion from the 1995 budget, especially in the area of investment in the state-run sector of the economy.

No less harmful was the fact that the government calmed the speculative thirst of "market agents" by raising the interest rates paid on public bonds from 3.25 to 4.25% monthly. This caused an immediate increase in the interbank lending rate from 4% to 6%, and will almost certainly cause regular bank interest rates to increase to 80% annually. The effect on the country's productive sectors, already bludgeoned by the flood of cheap foreign products coming into the country, will be devastating. At the same time, the central bank put on the market $12.08 billion in dollar-denominated treasury notes, (NTN-Ds), similar to the *Tesobonos* which helped bankrupt Mexico.

Calm has returned to the markets, but it won't last. During the March panic, the Brazilian government saw what it was like to have one foot over the cliff. But it also realized that to get out of the trap the *Real* Plan represents, it's not good enough to return to the old devaluation policy to generate trade deficits. If the government wants monetary stability, it must recognize the global nature of the economic crisis, and take sovereign action to control the flow of capital and the exchange rate, while freezing the cancerous national financial system.

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