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'Real Plan' monetary reform leaves Brazil in a two-year-long coma

by Lorenzo Carrasco

On the first of July, Brazil's monetary stabilization plan known as the "Real Plan" completed its first two years. It is undeniable that the plan, named for the country's currency, the *real,* has succeeded in lowering inflation. But the cost of this "success" could prove to be the explosive collapse of the national financial system as a whole, in much the same way that Mexico suffered a near "meltdown" in December 1994.

The international financial media, as well as Brazil's authorities, are hysterically trying to deny this reality. For example, the *Wall Street Journal* published an article on July 26 by economics professor Sebastian Edwards, with the suggestive title, "Why Brazil Is Not Mexico—Yet." Edwards insists that "Brazil's economic conditions today are far different from those Mexico faced in mid-1994. . . . The probability of a Mexican-style currency crisis in the short run is extremely low—almost zero." Edwards then goes on to demand that the government of Fernando Henrique Cardoso slash government spending and lay off workers, stop subsidizing exports, use proceeds from privatization only to pay off the foreign debt, and change labor legislation to eliminate worker benefits.

It is precisely such policies à la the International Monetary Fund, of course, that sent Mexico into bankruptcy in 1994, and are producing the same results in Brazil today. Indeed, the "conceptual" grounding of the Real Plan's creators—President Fernando Henrique Cardoso, Finance Minister Pedro Malan, and Central Bank director of foreign affairs Gustavo Franco—stems from the assumption of a "virtual economy" that can grow and develop, sustained by nothing but a flow of international capital. This assumption presupposes that the dismantling of the institutions of the nation-state is the best guarantee for foreign investment.

As we have indicated in previous articles, but which is worth repeating here, this plan of "virtual stability" is based on three pillars of disastrous consequence for the national economy. First, the deregulation of exchange rates and trade liberalization has caused a growing trade deficit, which is being met by international financial flows. Second, to keep the inflation rate of the basic market basket of consumer goods low, the government has fixed the prices for agricultural products below the basic production cost. This has provoked a sudden wave of agricultural bankruptcies and, consequently, a collapse of the industrial sectors involved in production of agricultural inputs.

As if this weren't enough, the government has also freed imports of artificially cheap agricultural products, which is functioning like "self-dumping" against national agricultural production, at a moment when the marketing of the largest grain crop in history, nearly 80 million tons, is just beginning. While it is true that this has kept inflation for the poorest classes low, for the rest of the population, who pay rent, send their children to school, and have to pay for their health plans, inflation has been greater than 100% during the two years of the Real Plan.

The third element of destruction was the hike in interest rates to 10-12% a month! This, of course, helped to keep foreign capital flowing in, while at the same time depressing consumption of domestically produced consumer goods, whose cost had abruptly risen just at the time that cheap imported goods were invading the country.

So far from the First World, so close to Mexico

Instead of serving as a basis for abandonment of the "virtual economy" model premised on foreign capital flows, the Mexican bankruptcy of December 1994 led the newly inaugurated government of Brazilian President Cardoso to take some palliative secondary measures, while pursuing the same basic orientation in his economic policy. As we can see in **Figure 1,** the current account deficit for 1995 was $18 billion, and everything indicates that this will persist or even rise in 1996, due to the impact of agricultural imports. As in the Mexican case (see **Figure 2**), this deficit is being covered by foreign capital flows, which appear in the upper portion of the graph. Incoming capital flows grew at a dizzying rate between 1990 and 1994. Even in 1995, when the Mexican crisis triggered a net flight of capital from the rest of Ibero-America, capital continues to come into Brazil, if at a reduced rate.

By 1996, the financial orgy took off once again. As one can see, through the month of May, more than $14 billion entered Brazil—$10 billion in speculative portfolios, and $3.372 billion in "direct investments." This last figure doesn't really reflect productive activity either, since it includes the purchase of existing Brazilian companies by foreign groups, as well as foreign earnings from the privatization of public firms. For all of 1996, it is expected that this category of "direct investment" will reach $7 billion, while portfolio investments could reach, if the present euphoria continues, as

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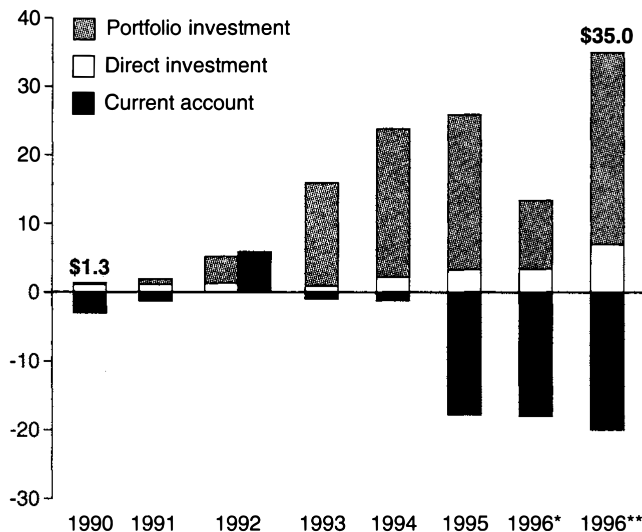
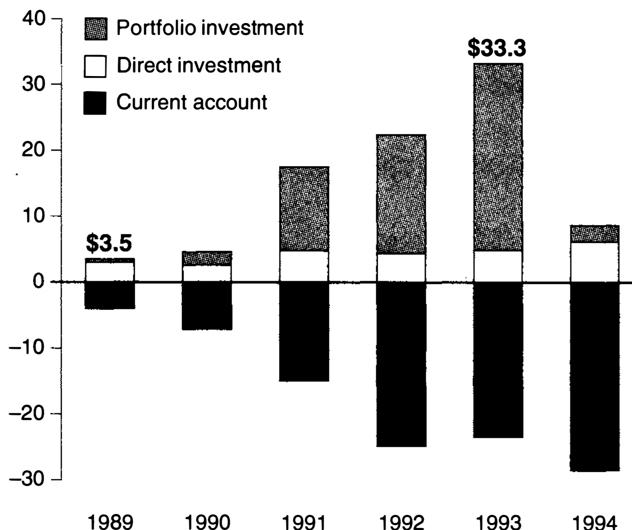
FIGURE 1
Brazil: foreign investment vs. current account deficit
(billions $)



* through May 96.
** *EIR* projection.

FIGURE 2
Mexico: foreign investment vs. current account deficit
(billions $)



Sources: Banco de México, World Bank, Inter-American Development Bank, *Summa.*

much as $28 billion, for a total of $35 billion, equivalent to Mexico's total earnings in 1993.

With these foreign investment flows, the Cardoso government has been able to accumulate, through June 1996, exchange reserves on the order of $60 billion, which one would think would provide a sufficiently thick cushion to survive flight capital, such as that which Mexico suffered in 1994. One forgets that in February 1994, ten months before the crisis, Mexico had nearly $30 billion in reserves, which, in proportion to its national economy, was greater than what Brazil holds today.

Domestic bubble swells

To overcome the so-called "Tequila effect," the Brazilian government has artificially contained the pressure from foreign accounts, transferring that pressure instead to the domestic economy: It has created a bubble of public internal debt that is now threatening to burst violently. As can be seen in **Figure 3,** the debt of government paper, adding together federal, state, and municipal debt accumulated over the past two years, grew nearly two and a half times, going from $80.8 billion in June 1994, to $195.5 billion in May 1996.

And this isn't even the total public debt! One must add to this figure bank and contractual debt, both of states and municipalities, as well as of public firms. For example, the total liquid internal debt of states and municipalities in May 1996 reached $80 billion, while, according to Central Bank figures, the debt in government paper was "only" $44.843 billion. That is, bond holdings account for only half the total debt, in this category. At the same time, public companies have accumulated a liquid internal debt of $34 billion. Thus, the total public debt actually reached $230 billion by mid-1996.

This uncontrolled growth of internal finances has several causes. First, the increase in capital flows into the country, which are changed upon entering Brazil into local currency, which in turn is collected by the Central Bank through bond issues of the National Treasury and of the Central Bank itself. Second, the bankruptcy of the national banking system, as a function of the high levels of non-performing industrial, trade, and consumer debt, has forced the government to restructure its bank protection program PROER, to channel substantial assistance to the troubled private banking system. Through May 1996, this program had already disbursed $12.1 billion.

Third, the agricultural crisis has hit the Bank of Brazil especially hard; its accumulated losses in the first half of 1996 were approximately $6.4 billion, which are being covered by the National Treasury. That is, in the course of 1996 thus far, the government has had to disburse $18.5 billion, to try to control the banking crisis. In vain, it would appear, as levels of non-performing debt have not ceased to grow.

Yet, the Brazilian banking sector is on the verge of a generalized crisis much larger than that which hit Mexico. This is the stated opinion, for example, of the U.S. rating agency Standard & Poors, which circulated a report in July acknowledging that the systemic risk of the Brazilian banking system is the worst in all of Ibero-America. In January 1994,

FIGURE 3
Brazil: public bonded debt
(billions $)

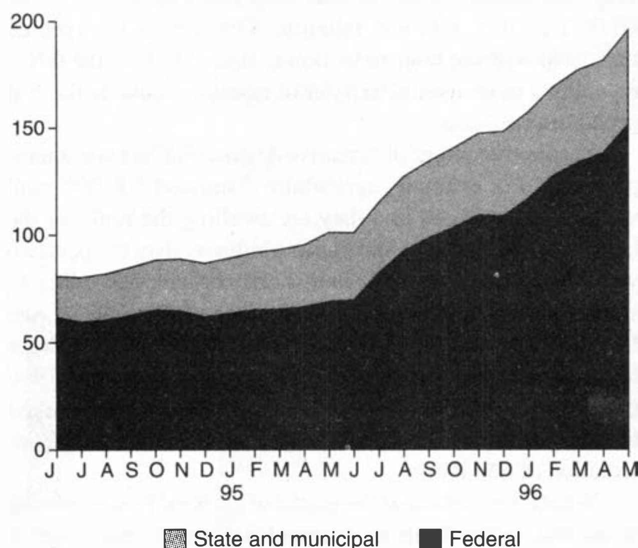
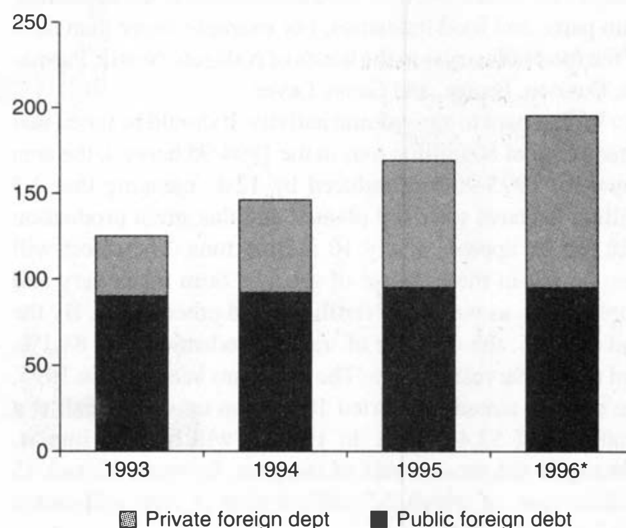


FIGURE 4
Brazil: official foreign debt
(billions $)



* *EIR* projection.

the total non-performing debt (calculated after 180 days of non-payment) was equal to 4% of the banking system's total outstanding loans. In January 1995, that figure was 4.8%, and in January 1996, it had risen to 9%. As of last June, it had reached a level of 12%. three times greater than at the start of the Real Plan, and equivalent to $20 billion of non-performing debt. The level of arrears—that is, after 90 days of non-payment—was calculated at nearly 25% of total outstanding loans, or nearly $40 billion.

The high interest rates have also forced companies and private banks to raise their own foreign indebtedness, not just through cash loans, but primarily through placing of bonds which have forced the private portion of the foreign debt dramatically upward. As we can see in **Figure 4,** according to government data compiled and released by the U.N.'s Economic Commission on Latin America (ECLA), the official foreign debt grew from $113.5 billion in 1988 (not shown here), to $125 billion in 1993, and then to $169 billion in 1995, of which $74 billion corresponds to the private portion. At this rate, it is expected that by early 1997, the official foreign debt will pass $200 billion. That is, it will have grown by nearly 60% in three years.

All of this, in turn, caused a 1995 fiscal debt equivalent to 5% of the GNP, or $32.2 billion. For 1996, according to the World Bank's own estimates, it will be nearly impossible to reduce that deficit, despite the fact that domestic interest rates have begun to fall. One of the causes of the fiscal deficit is the crisis of the banking system, from which the state has historically collected 20-25% of total tax revenues. With the wave of bankruptcies, this has fallen to 7-10%.

Darwinist 'creative destruction'

One mustn't fall into the error of concluding that this economic devastation is unplanned. At least for Central Bank officer Gustavo Franco, one of the architects of the Real Plan, this process of economic demolition is not only necessary, but desirable. During a June 18 economic seminar in São Paulo, Franco declared that current economic policy, especially exchange policy, is inspired by the concept of "creative destruction" of Austrian economist Joseph Schumpeter, according to which one can build a modern and technologically advanced industrial sector upon the ashes of industrial destruction, brought about through fierce trade competition.

This creative destruction is evident especially in the levels of bankruptcy and industrial unemployment in the city of São Paulo, Brazil's industrial heartland. During the first year of the Real Plan, from July 1994 to June 1995, the total number of bankruptcies rose to 5,076. The next year, ending in June 1996, saw a tripling of that figure, to 15,000. The industrial sector most at risk for bankruptcy is the auto parts industry, which in the first year of the Real Plan went from a level of indebtedness of 85% of its total capital, to 324%, which means that for every *real* in assets, it owes 3.24 *reals.* It is followed by the toy industry, which went from 77% to 99%; food, from 61% to 65%; and telecommunications, which went from 32% to 62%. All of these figures come from the consulting firm Lopez Filhos Associates.

But the financial reality of other sectors is not very different. For example, textiles, shoe-making, wine-making, etc., are all being destroyed by a combination of cheap imports

and contraband. This is forcing all these sectors to sell off their companies to the multinationals, which, today, after two years of the Real Plan, now hold monopolies in the appliance, auto parts, and food industries. For example, more than 60% of the food industry is in the hands of Nabisco, Nestlé, Parmalat, Dannon, Bunge, and Gessy Lever.

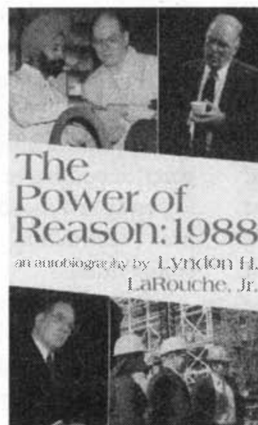
With regard to agricultural activity, it should be noted that after a crop of 80 million tons in the 1994-95 harvest, the area sown for 1995-96 was reduced by 12%, meaning that 2.3 million hectares were not planted and that grain production will fall by approximately 10 million tons. The effect will also be felt in the collapse of sales of farm machinery and implements, as well as of fertilizers and other inputs. By the end of 1995, the collapse of tractor production was 84.1%, and that of harvesters 67%. The result has been that, in 1995, the country already imported 10 million tons of cereal, at a total cost of $2.4 billion. In 1996, it will have to import, starting in the second half of the year, between 12 and 15 million tons, of which 2-3 million tons of corn will cost a minimum of $4 billion.

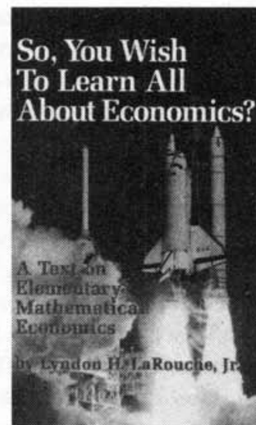
This destructive effect can also be noted in the abrupt decline of agricultural land values. According to the Institute of Agricultural Economics, of the São Paulo Ministry of Agriculture, the price of land has fallen 30% in the state. This situation does not differ significantly from the rest of the country. The result is that the specific weight of industry and agriculture in the economy as a whole, is rapidly declining. In 1994, when the participation of these two sectors in the economy was already on the decline, they added up to 51% of the GNP. By 1995, this had fallen to 47%, and it is expected that 1996 will see their reduction to under 45% of the GNP, meaning a monumental transfer of resources outside the real productive process.

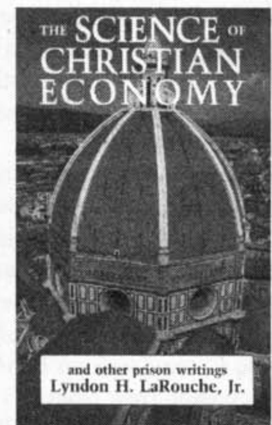
Yet another image of "creative destruction" is mass unemployment. For example, agriculture dismissed 500,000 rural workers in one year, and they are swelling the ranks of the homeless and landless. São Paulo's industry over the past two years lost nearly 350,000 industrial workers, according to statistics of the Federation of Industries of the State of São Paulo. In the area of civil construction, 180,000 jobs were lost, reaching an historic low for the sector as of January 1996 of 567,000 workers, as opposed to the 1,130,000 who worked for the industry in 1990, according to the Union of Civil Construction of São Paulo.

What is certain is that the model of the Real Plan is coming to an end, either from an eventual flight of foreign capital that will put an end to the speculative orgy, or because of an explosion of the Brazilian banking system itself, which would only be a reflection of the imminent explosion of the world financial crisis. And so, if it serves as any consolation, the creators of the Real Plan, will end up as victims of their own "creative destruction."

Books by Lyndon H. LaRouche, Jr.







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—Former U.S. Attorney General Ramsey Clark

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