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Brazil: President Fernando Henrique Cardoso Imposes Stringent Economic Measures To Stem Financial Crisis

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Worldwide tremors set off in Asian financial markets have had serious repercussions in Brazil. By imposing huge interest-rate hikes and belt-tightening measures, President Fernando Henrique Cardoso has gambled that Brazil's currency, the real, can be defended against the pressures from international investors that sank several Asian currencies. However, the success of the measures is very much in doubt, and the spending cuts and staggering interests rates could trigger a recession. In the past month, Brazil's stock market has suffered its worst accumulated loss in seven years. The Sao Paulo Stock Exchange's Bovespa Index, Latin America's largest, has plunged 27.2% since Oct. 22. Brazil's vulnerability comes from its public sector budget deficit, running at 5% of GDP; its current accounts balance of payments gap of some 4.3% of GDP; and the government's refusal to devalue local currency, the real, which is estimated to be overvalued by about 20%. Critics also point out that Cardoso has been unable to push his planned reforms, such as changes in the tax laws and social security bureaucracy, through Congress (see NotiSur, 07/11/97 and 07/25/97). Until the recent financial shocks, however, Brazil had argued that its foreign exchange reserves of more than US$60 billion, plus a privatization program expected to take in US$80 billion over the next three years, protected the economy from financial risks. "The real is a well-defended wall," said Cardoso on Oct. 29. Nevertheless, the following day market events forced the Central Bank to double its prime interest rate to an annualized 43.3%. The bank jacked up its basic interest rate, known as the TBC, to 3.05% a month from 1.58%. Also, the rate at which the Central Bank lends money to banks in emergencies, the TBAN, was raised to 3.23% from 1.76%. On Nov. 4, Cardoso again vowed to defend the value of the real and keep inflation at bay. "You can be sure of one thing, we will not let the real lose value and let inflation come back," Cardoso said. "We may even have to pay a temporary price for this, but it's better to have higher interest rates for a while than to have salaries lose their value again. The real, and therefore the purchasing power of your salaries, will be protected." Cardoso introduces major cuts in spending It soon became apparent that further measures were necessary, and on Nov. 11 Cardoso announced a 51-point, US $18 billion package of cost cuts and tax increases to stop the bleeding from the public sector budget accounts and defend Brazil against speculative attacks from abroad. The cutbacks are concentrated in current expenditures, which are to shrink 15% in 1998, while investments are only to be cut 6%, said Planning Minister Antonio Kandir. Government contracts for services will also be cut by 10%, and US$500 million in tax incentives will be eliminated. But the largest reduction will come from increased revenues, through utility rate hikes, higher taxes, and the privatization of state enterprises, which is expected to bring in a combined total of US$6.2 billion. Income taxes paid by the wealthiest portion of the population will increase from 25% to 27.5%, with deductions capped at 20% of tax due. Import taxes and an excise tax on cars and liquor also will go up. Those measures, combined with utility rate hikes, will mainly hit the middle and upper socioeconomic brackets. The price of most petroleum derivatives will go up nearly 5%. The rise in gasoline and diesel prices will affect the entire economy, while the increase in the price of household gas will mainly hit the poorest sectors. The government also will lay off 33,000 workers, eliminate 70,000 now vacant

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positions, freeze the salaries of government workers in 1998, and cancel some 100,000 pensions that are paid irregularly. By cutting public spending, while at the same time providing various incentives to exporters, the government's goal is to reduce the budget and trade deficits, thus bolstering international confidence in the economy. Even if successful, however, the measures are a bitter pill for consumers and taxpayers. However, the initial reaction from international lenders to Brazil's belt-tightening was positive. "We welcome this package, which attests to the government's determination to safeguard the gains made with the Plan Real in disinflation and improving the living standards for the Brazilian people," International Monetary Fund (IMF) Managing Director Michel Camdessus said. "The firm implementation of these measures, in combination with the rapid approval of constitutional reforms pending before Congress and with the use of most of the privatization receipts to reduce public debt will create conditions for a rapid improvement of the balance of payments and for an early and sustainable decline in interest rates." Crisis is not over yet Despite the government's sweeping measures, on Nov. 12 the Bovespa dropped a sharp 10.2%, which triggered the exchanges's circuit breaker to halt trade for half an hour for the third time in two weeks. The exchange, which was up 93.4% for the year at its close on July 8, has seen most of that gain evaporate. It is now up 11.1% for the year. The further drops in the market raised fears that a devaluation would follow, or that the economy will slip into a major recession because interest rates will need to remain high. Any recession in Brazil could have a profoundly negative effect on economies throughout the region, especially Argentina and Uruguay, which are major trading partners of Brazil. Concern is growing that Brazil will not be able to withstand the gale blowing from Asia indefinitely. "The longer this turmoil persists in Asia, the less likely Brazil is to pull through," said Carmen Reinhart, economics professor at the University of Maryland and co-author of a recent IMF paper on currency crises. "Whether [Brazil] can hold on or not will depend on how quickly these currency markets settle down." Some economists believe the government waited too long to cut the deficit, and its measures may be counterproductive because they could provoke increased tax evasion, leading to a fall in tax revenue from struggling businesses. These economists argue that a devaluation of the real, which has been pegged to the dollar, may be inevitable. Government measures encounter opposition Meanwhile, the government's austerity plan has brought broad opposition from labor and campesino groups. Demonstrators brought the center of the Brazilian capital to a standstill on Nov. 12 to protest the budget cuts. Public servants, landless representatives, and the labor movement led the criticism of Cardoso. "Once again Fernando Henrique has adopted dictatorial methods in decreeing these measures without any consultation of the people," said the head of the Central Unica dos Trabalhadores (CUT), Vicente Paulo da Silva. "The financial crisis that started in Asia and spread throughout the world will be paid for, in Brazil, by the consumer," read an editorial in the newspaper Correio Braziliense, which noted that interest charged on bank overdrafts, borrowings, leasing contracts, and ordinary consumer credit would soar, possibly throwing Brazil into recession and devastating Christmas sales. Cardoso said he will take "the necessary measures" to avoid a recessive Christmas. And, regarding criticism that the middle class will bear the brunt of the adjustment, the president said he belongs to the middle class, but he must also look out for the poorest people in the country. The government is betting that Brazilians will accept belt-tightening and even mild recession as long as the inflation that a devaluation would usher in does not return. "Although the election is still a year away, the only thing that Brazilians will remember when they go into the voting booth is whether inflation has gone up," said Amaury de Souza, a political scientist. "If inflation increases, then Cardoso is doomed. At this point, it's his only real opposition." Cardoso said he would sacrifice his political ambitions rather than allow the return of hyperinflation. "Brazil comes first," said Cardoso. "Our efforts to protect the real and

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present Brazil as a country with a future come first." Cardoso must now convince Congress to pass his measures. Several senior figures in Congress have spoken out against the increase in income taxes, which Congress must approve. Instead of an income tax hike, the lawmakers have suggested raising a financial transaction tax, known as the CPMF, which levies a 0.2% charge on all financial transactions. Presidential spokesperson Sergio Amaral said the government would consider the suggestion. Economic slowdown expected even without a recession Although confident it can avoid a major recession, the administration acknowledged that growth will slow down. Secretary of Economic Policy Jose Roberto Mendonza de Barros estimated that GDP would grow 2% in 1998, compared with nearly 4% this year. James Winder, Merrill Lynch chief economist and global economics manager, said the firm had revised its growth forecast for Brazil downward to 1% from 4% after the Nov. 12 drop on the stock exchange. "They've really done all they could possibly do but investors lack confidence in Brazil," Winder said. "All they can do is hope Asia stabilizes." [Sources: PRNewswire, Journal of Commerce, 11/05/97; Spanish news service EFE, 10/31/97, 11/08/97, 11/10/97; Inter Press Service, 10/31/97, 11/10/97; Agence France-Presse, 11/10/97; The Miami Herald, 11/04/97, 11/11/97; The New York Times, 11/07/97, 11/11/97; Clarin (Argentina), El Nuevo Herald, 11/11/97; Associated Press, 10/30/97, 11/05/97, 11/12/97; BBC, 11/12/97; Reuter, 10/30/97, 10/31/97, 11/04/97, 11/10/97, 11/11-13/97]

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