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BRAZIL'S PLACE IN THE POST-CRISIS NEW GLOBAL ECONOMIC ORDER

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The global economic crisis which came to a head in September 2008 has left the global economy in an unprecedented situation. The leading industrial nations which caused the crisis and which are at its heart have felt its effects much more strongly than many emerging nations which usually suffer the most due to fluctuations in the financial markets.

Brazil stood out from the other major developing economies during the most difficult phase of the crisis and the subsequent recovery phase. This fundamental change in its position in international terms and the health of the Brazilian national economy can be roughly attributed to two main factors: the consolidation of its macroeconomic stability and the structure and operation of its financial system.

Brazil began the 1990s with an astronomical rate of inflation. Like many less-developed countries, after a series of failed stabilisation attempts it decided to go ahead with currency reforms which would fix the exchange rate for an extended period. The new reference currency and the opening-up of the economy acted as a brake on the country's prices. Inevitably the fixed exchange rate raised export prices and led to an increased deficit in the balance of payments, resulting in the country becoming even more dependent on foreign investment. Other Asian and Latin American countries went through a similar process, and the second half of the 1990s was characterised by emerging nations becoming increasingly dependent on foreign investment. As a result they were more vulnerable to the effects of the financial crisis which hit most parts of the world. Since then, efforts to recover from the crisis have resulted in new approaches towards economic policy. They have been trying to reduce their dependency both on monetary capital and on the assistance of multilateral institutions.

After a series of crises ending in 2002, there was now the political space for manoeuvre which was necessary to consolidate the national economy's finances. The financial crisis which Brazil had been undergoing since 1997 had interrupted the flow of foreign investment, with subsequent negative effects on the economy and society. In this context it was clearly important to ensure greater stability and reduce the country's dependency on the fluctuations of the world's financial markets.

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Three decades of strong inflation had a particular impact on the behaviour of families, companies, the government and financial institutions. The high rate of inflation caused the financial institutions to change their way of operating and seriously affected their profit ratios. The finance sector was radically restructured and a new financial policy was developed.

The workings of Brazil's financial sector were deeply affected by the end of chronic inflation and the shift in economic policy, which moved over to floating exchange rates. If we want to understand Brazil's place in the global economy at the beginning of the second decade of the 21st century we need to look at the interaction of two different factors: the structure of its economic policies and the way its national financial system is regulated. The fact that Brazil is nowadays much more prominent on the international stage is due to the fact that over the last ten years it has done all sorts of things to stabilise its national economy while at the same time strengthening its financial policies.

CONSOLIDATION OF MACROECONOMIC STABILITY

The most notable and lasting phase of stabilisation in the Brazilian economy began in 1994. Like other emerging countries, Brazil had also decided to introduce a new currency which followed the U.S. dollar without being directly pegged to it. The decision to make strict changes in financial policy, managed by the Central Bank, assumed the existence of international capital reserves to prop up the currency and, if necessary, to draw on foreign investment. In this way the policies of the *Plano Real* – higher interest rates, valued exchange rates, a more open economy, disengagement from adjusted market prices – had the kind of direct effects which could be predicted by reading any economics textbook: an increase in the balance of payments deficit, limiting the impact of financial policies on domestic activities and an increased dependence on foreign investment. The effects on the manufacturing sector and financial institutions were equally huge. Customs tariff agreements on domestic products came to an end, leading to a more dynamic goods market and promoting competitiveness, which also benefited from the currency valuation. The state and the banks largely ceased to make profits from inflation.

The policies of the Plano Real had direct effects: an increase in the balance of payments deficit, limiting the impact of financial policies on domestic activities and an increased dependence on foreign investment.

The introduction of the *Plano Real* was extremely effective at halting inflation. This meant that real incomes rose, something which was particularly important for lower income groups. The manufacturing sector had to regroup and some companies were able to increase their productivity. But this formula for success would not last forever. The economic model was hiding a source of instability: the growing balance of payments deficit and the dependency on foreign investment. Higher profit margins had to be guaranteed in order to hold on to foreign investors, without losing sight of the risks. For many years the country paid the price for this in high interest rates with all the usual results: a sharp rise in public borrowing and an increase in the cost of domestic investments.

The macroeconomic system became unsustainable when the eruption of the financial crisis in other emerging countries led to foreign investment being suddenly withdrawn to be funnelled to these countries. Many of these countries had also tried to stabilise their economies by fixing their exchange rates and opening up their financial markets. After the turbulence experienced in parts of Asia and in Russia in 1997 and 1998 there was no more desire to take risks. Brazil felt the effects of the financial crisis in emerging markets very strongly without having gained long-lasting benefits from the influx of foreign capital over the preceding years. This instability was felt at every level – Brazil had to finally conduct an overhaul of its economic policy.

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The first phase of the *Plano Real*, between 1994 and 1998, had the effect of finally stemming the country's chronic inflation, providing a new direction for the economy and creating a new sense of optimism among private investors. But the side effects of this economic model prevented a course being set towards sustainable growth.

From January 1999 there were changes in foreign exchange policy. Considering the many uncertainties, the transformation in Brazil's economic policies actually went fairly smoothly. The fear of rising inflation even allowed the Central Bank's new management a series of interest rate increases to effect most of the changes in economic policy without damaging the achievements of the past.

In June of the same year other measures were taken to prevent inflation, along with floating exchange rates. This had been common practice around the world since the 1990s. By introducing measures to prevent inflation it was hoped to make financial policy more transparent by defining and clarifying its objectives. This gave the policy more credibility, which also helped it to achieve its aims and was in line with the expectations of business leaders.
There was a lot to do in terms of financial policy. Public borrowing was rocketing and the federal apparatus had long been in disarray. The passing of the "Lei de Responsabilidade Fiscal" (LRF – Fiscal Responsibility Law)[1] showed an unprecedented discipline within the federal states, communes and even the federal government. Another

1 | Lei Complementar No. 101, de 4 de maio de 2000 (Supplementary law No. 101, dated May 4, 2000).

positive effect of the LRF was that investors and business leaders were shown how it could be beneficial to work with the public sector to reduce the risk of a collapse in state finances and a new round of inflation.

In this way a new model was established for economic policy which guaranteed greater foresight and transparency – both critical elements for consolidating macroeconomic stability. Now all that was needed was a return to economic growth.

Changing to this policy model was not enough in itself to stimulate economic growth. A cloud of uncertainty was still hanging over the financial markets, with the attendant pressures which could lead to price increases in emerging countries such as Argentina. There were also still unresolved structural problems such as the tax system and employment laws which subjected employers to high costs and reduced the flexibility of the labour market, and the regulation of the private sector, to name just a few.

Domestic policies were limited in their ability to bring about structural reforms. Indeed, the dynamics of the country's domestic policies prevented solutions.

Ever since the first efforts had been made to stabilise the economy in the 1990s, it was clear that domestic policies were limited in their ability to bring about structural reforms. Indeed, the dynamics of the country's domestic policies prevented solutions being found to these problems.

Several factors came together to stem Brazil's economic growth. In 2001 the country had to introduce austerity measures because of an energy crisis, and as a result economic activity was restricted. Argentina established a transition period with flexible exchange rates and by 2002 it was facing a serious crisis. The gap in the balance of payments remained critical and even a sharp hike in interest rates was not enough to help Brazil attract sufficient foreign investment to help it out of its difficulties. On top of these factors, there was brewing discontent about political changes in the country. The more success Luiz Inácio Lula da Silva had in the polls, the more investment was taken out of the country as a government formed by the Worker's Party was viewed with great mistrust.

During the new government's first months in office, the benefits of the new stable economy became clear. Even without official laws being passed, the continuation of the established economic model was a fundamental step towards consolidating the economy and making Brazil more democratic. Confidence was re-established in the market and the policy was pushed forward, despite opposition from the left wing of the party. The government gave the right signals by continuing to fight inflation and guaranteeing the operational autonomy of the Central Bank. And the private sector carried on, despite their complaints about high interest rates, until recovery began to take root in 2005.

Since 2003 external finances have been looking up: the balance of payments showed a surplus in 2003 and 2007 and direct foreign investment hit record levels. The profile of external liabilities improved and foreign exchange reserves were built up. This not only contributed to an improvement in macroeconomic indicators but also to a phase of expansion in the global economy, increased raw materials prices and extensive international liquidity.

In 2007 and 2008 the Brazilian economy was in good shape until the global economic crisis struck. Brazil was awarded good ratings by international rating agencies and the real increased significantly in value. This is the point when the country took up a new position in the world economy.

It is no exaggeration to say that the global economic crisis hit at a time when Brazil was enjoying one of the best periods in its economic history. This favourable situation was a result of the country's efforts to stabilise the macroeconomy, made possible by its political stability. So a lot of its success can be attributed to institutional factors rather than just the economy. The commitment made by the last two governments to a stable macroeconomy proved to be a political innovation from which everyone benefited.

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As a stable economy with widely-accepted regulations, the rest of the world sees the Brazilian economy as having great potential for further growth. There are still many reforms in the offing. But Brazil was not so badly hit by the crisis that it could not continue with the favourable developments it had experienced up to that point. The particular structure of the Brazilian financial system and its well-organised regulation of the financial markets helped it to limit the harmful effects of the crisis.

POSITIVE DYNAMICS AND FINANCIAL POLICY

Since the 1960's, after the structural reforms, the Brazilian financial system became a key element of the economy and yet in the almost 50 years since then the financial system has in fact made only a relatively small contribution to the country's development. This can be explained by the particular dynamics of an extremely inflationary and indexed economy in which most of the time financial yields outstripped manufacturing profits.

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Because of the potential for profits offered by inflation, the financial sector adjusted its approach in line with the times and moved away from traditional activities such as issuing loans. Government bonds and the income from taxes linked to inflation became a more lucrative proposition than lending money to businesses and families. Of course this is not to say that no loans were granted at all. Credit from public financial institutions played a very important role in financing the economy.

The fact is that as the inflation rate dropped the financial system had to rethink its approach and its profit strategy. It was vital for lending to become the banks' major activity. Only a few months after the introduction of the *Plano Real* the banks started to lend more money but ended up being plunged into a deep crisis due to high levels of default. Increasing competition amongst financial institutions saw several of them go into insolvency. The central bank was required to intervene in many of these cases and even the largest banks in the country were affected, which prompted the central bank to introduce a rescue plan for private financial institutions, the Plan for Stimulating and Restructuring the National Financial System (Programa de Estímulo à Reestruturação e ao Sistema Financeiro Nacional – PROER).

In 2001 a Programme for the Restructuring of Public Financial Institutions (PROEF) was introduced. The restructuring measures as far as the central bank was concerned included reorganisation as well an adherence to international regulations on risk avoidance. For the privatisation of the public state-owned banks it was a different matter. Here the main motivation of the PROEF was the reorganisation of state institutions for the benefit of public policies. This restructuring, together with macroeconomic stability, produced a significant change in the Brazilian economy in terms of regulations and the state-owned banks' sphere of operations. They would continue to be the main instruments of government financial policy, especially in terms of dealing with dwindling state assets, although they would also be able to work increasingly within the private sector at the same time.

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Against the background of a crisis of confidence, austerity measures introduced during 2002 and 2003, at a time when a new government was taking power, led to a change of orientation for the state-owned financial institutions. The inflation model – which was now no longer a realistic alternative – forced them to adopt a more market-oriented and efficient business approach. This became more obvious as the financial institutions and the many private banks fought to survive in a much more competitive market. Increased stability resulted in credit business playing a much more important role in the Brazilian economy and competition amongst the main players changed market behaviour.

The restructuring of the Brazilian financial sector resulted in foreign financial institutions taking a larger market share. After the problems in the Brazilian banking sector had been addressed following the stabilisation of 1995-96 and national institutions had been reorganised, the government started to open up the sector to foreign banks more and more. The presence of these new foreign banks was an important part of the restructuring of the sector. However, it should be pointed out that foreign banks, in spite of a relaxation of the rules, do not have the same role in the Brazilian financial sector as they do in other large Latin American countries such as Argentina or Mexico. It should also be noted that at no time has the Brazilian financial system dealt in foreign currencies, unlike, say, Argentina, despite the need to hold large volumes of available foreign currency during the fixed exchange rate phase.

With the new players in the market, the reorganisation of the institutions and the rationalisation of the financial sector, the financial institutions have been able to realise substantial profits since the price stabilisation. Studies, such as those by Faria and Carvalho, give a picture of the different competitive trends within the Brazilian financial markets.[2] In spite of the presence of new players in the banking and financial sector, competition was not particularly tough. The presence of three big state-owned banks had a decisive effect on the direction of the market. During the crisis from 2007 to 2009 in particular the Brazilian state-owned banks adopted an anti-cyclical approach which meant that the downturn in economic activity was much shorter than it might have been and helped to avoid a significant increase in interest rates amongst private banks. It is this peculiarity of the Brazilian financial system together with the introduction of regulation into the sector which underlies the generally positive financial dynamics of the Brazilian system.

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This development has enabled Brazil to make significant progress in recent years in regulating its financial activities. Since the financial reforms of 1964 the Central Bank has been responsible for overseeing the financial system. It is only in more recent times, since the 1990s, that Brazil has attempted to align its own regulations with the criteria of the Bank of International Settlements (BIS) agreed in Basel. So for the whole of the last decade the national

2 | Cf. Fernando J. C. Carvalho, "Estrutura e padrões de competição no sistema bancário brasileiro: uma hipótese para investigação e alguma evidência preliminar," in: Luiz F. Paula, José L. Oreiro, *Sistema financeiro. Uma análise do setor bancário brasileiro*. Rio de Janeiro: Elsevier (2007). Cf. also id., "Regulação prudencial na encruzilhada: depois de Basileia II, o dilúvio?" in: Paula and Oreiro, *Sistema financeiro*, loc. cit. Cf. also João A. Faria, Luiz F. Paula, Alexandre Marinho, "Eficiência do setor bancário brasileiro: a experiência recente das fusões e aquisições," in: Paula and Oreiro, *Sistema financeiro*, loc. cit.

banking system has had to comply with international regulatory standards. The Central Bank has also tried to stop the financial institutions letting their lending become higher than their capital reserves, which is in fact a stricter requirement than under the Basel Index. The Brazilian Exchange and Securities Commission, Comissão de Valores Mobiliários (CVM), also oversees the capital markets in order to avoid potential increased risks for financial institutions.

Financial regulation and a slight opening-up of the system for dealing in foreign currencies have ensured that the financial system is to a large extent protected against the kind of severe international fluctuations that have been seen in recent times.

RECENT CAPITAL FLOWS AND THE DEBATE ON THE INTERNATIONAL MONETARY SYSTEM

The crisis of 2007 to 2009 threw the spotlight on the global debate about the configuration and restructuring of the international monetary system. As it was the leading industrialised nations which suffered most from the crisis, it is understandable that these countries were keen to discuss how to restructure their own financial systems and allow developing countries to become more involved. This meant that the forums which represented these countries suddenly became much more significant.

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However, Brazil's representatives argued that in view of the acute crisis the Group of Twenty (G20) – the 20 largest economies, representing around 85 per cent of the world's gross domestic product (GDP) – should be adapted to coordinate the actions which needed to be taken. Brazil played an increasingly important role after taking over the rotating presidency of the G20 in 2008. None of the previous proposals can be directly attributed to Brazil, as proposals for domestic reforms to reduce risk in the financial system have become increasingly similar since the crisis. However, there are still some important items on the agenda.

In reality, the global challenge of creating new structures for the financial and monetary systems goes far beyond analysing individual measures taken and bills drafted within national economies. Capital flows in international systems have arisen because advanced economies accumulated dollar reserves due to the introduction of regional monetary systems. In this way they hoped to protect themselves from extreme currency fluctuations and avoid recurring financial crises like those of the previous decade. The macroeconomic set-up of these advanced economies now looks quite different. And in the case of Brazil, as mentioned before, it is looking much more favourable and much more secure.

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The extent of the crisis and the fact that it was mainly the major western economic powers which were affected shows that the existing instruments are not able to withstand this kind of turbulence. The International Monetary Fund does not have the means to simultaneously bail out both the U.S. economy and the main European economies, and the idea of turning to multilateral institutions was not taken into account.

For more than ten years there has been talk of carrying out necessary reforms to the international financial system. But this international restructuring needs to be different from the Bretton Woods system which was introduced 65 years ago. This system envisaged a new international monetary system with fixed exchange rates; a rigid system which gave the industrial powers a great deal of economic power; and a system which gave supranational bodies the power to coordinate, supervise and control the international monetary system.

Different historical circumstances have meant that currency and foreign exchange regulations have undergone fundamental changes – particularly during the 1970s and as a result of the global liberalisation which followed in the subsequent decade. The new international monetary system no longer needed to be created by international treaty, as it was already defined by the global markets: the currency market, assets, commodity trading and the service sector.

The crisis has shown how excessive financial liberalisation during periods of high international liquidity and overheated economic activity can lead to serious problems. The leading industrial nations, which often only lightly regulated the activities of their financial institutions, were the hardest hit by the crisis. The latest crises to affect developing countries led to these nations adopting more cautious policies over recent years, something which in the end protected them from the effects of the global crisis.

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Dailami and Masoon assessed the need for a multi-polar economic system in which the emerging nations would for the first time have the chance to play a decisive role.[3] The BRIC countries (Brazil, Russia, India and China) have been enjoying a phase of intensive economic growth and a certain amount of financial stability. They have accumulated foreign exchange and are now in a position of power which serves to weaken the strength of the U.S. dollar in global terms. Dailami and Masoon recognised an alternative in the euro, which had gained in importance during the course of the crisis. This possible multi-polarity, with a trend towards consolidation in the areas of trade and politics, is an innovation when it comes to capital flows. Eichengreen has also identified new trends in the international monetary system but sees no alternative to the dollar.[4]

The alternatives to the dollar call for new rules to be drawn up regarding the operation, regulation and supervision of the international monetary system. If it were up to the developing nations, a better-administrated monetary system would be established.

In November 2008, when the crisis was at its worst, the G20 presented a plan to improve market supervision, introduce rules of conduct, strengthen international cooperation and give the IMF more influence. At the G20 summit in Pittsburgh at the end of September 2009, the

3 | Mansoor Dailami and Paul Masson, "The New Multi-polar International Monetary System," *Policy Research Working Paper* No. 5147 (2009), World Bank.
4 | Barry Eichengreen, "The Dollar Dilemma. The Worlds Top Currency Faces Competition", *Foreign Affairs*, September/October 2009.

G20 countries not only defended the public policies which were supposed to support global economic recovery but also reemphasized the importance of developing countries being present at the debate on international financial architecture. In this way the G20 became the main forum for international economic cooperation, and at the same time a change in IMF quota distribution was proposed. But according to a U.S. journalist, the G20 ignored one important issue: the accumulated currency reserves (in dollars) are held by countries such as China.

These reforms were supposed to take this important issue into account. The major developing nations have accumulated large reserves over the last few years thanks to worldwide economic growth and as protection against financial crises. This was particularly the case because the IMF in its existing form was not in a position to provide these countries with adequate protection in the event of a currency crisis. This fact and the devaluation of the dollar meant that countries who had reserves of this currency were put in a difficult situation, as other currencies were much stronger – particularly the euro. And all this happened at a time when exports were just starting to recover.

It is quite possible that the dollar will lose some of its weight in the global system. Perhaps this would be a good thing. It may well be that another lead currency would not take the same position; for example other agreements could be made, such as an expansion of regional monetary cooperation. This would be a foundation for multilateral currency unions.

An introduction of supervisory measures and safety nets should signify a new start for our sixty-year-old multilateral institutions.

Alongside the economic problems linked to the equilibrium between currencies and currency speculation, the present situation heightens the urgent need to define new rules for the international monetary and financial systems. These should however not lead to markets being sealed off nor to setbacks in market growth. Rather, the introduction of supervisory measures and safety nets should signify a new start for our sixty-year-old multilateral institutions.

Brazil has popped up during G20 discussions in this respect. Although the Group's actual procedures are not yet fully institutionalised, the summits act as a signal for potential political system reforms. Although countries took joint action at the height of the crisis, this had little effect. Now that the worst of the crisis is over, the major international financial bodies are pressing for regulation – but not pressing too hard, as was shown at the Davos economic summit in January 2010.

Regulatory measures must be found which are able to reduce risks to the system caused by high levels of cleverly-invested bank reserves and which redefine the existing mechanisms of the Basel II Accord. Included in the proposals is the idea of capping the salaries of top bankers. From an institutional point of view, the Financial Stability Board has already accepted new countries, including the BRIC states.

On 9 December 2009 the Brazilian Central Bank incorporated the committees for global financial systems and markets into its budget information system. Both institutions have the task of minimising the instability of the international financial system by monitoring the financial markets and their trends.

Brazil is taking an increasingly important role in the discussions about a new global financial and monetary system. What is Brazil's agenda? It is difficult to list all the items, but a weakening in the position of the U.S. dollar would certainly be an advantage to Brazil as this would reduce currency risk and diversify the profit potential of international transactions. However a major devaluation of the dollar would not be desirable, as international reserves are generally in this currency and it would require a general and supervised asset restructuring. As far as financial regulation is concerned, Brazil has developed a management policy which has protected it from financial crises. In this respect it is immaterial whether the deregulation of global markets is maintained or further dismantled.

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It is generally recognised that a new order will not come about through a major international convention but rather through developments in the global economy over the coming months and years. At the beginning of 2010 Brazil's position was much more stable and secure than it ever was during the 20th century. Its influence among developing countries is also likely to keep growing.

This scenario is the reward for the work it has put into its domestic economic system and the way it has consolidated its democratic systems. It was also helped by the favourable global economic situation before the crisis. After the 2010 transfer of power, things still look promising.

This article has been translated from the Portuguese.