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# The Samba Effect in MERCOSUR

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# The "Samba" Effect in MERCOSUR

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## I. Introduction.

At the end of 1998, the government of President Fernando Enrique Cardoso adopted a number of deficit reduction measures to which markets reacted with little enthusiasm, having expected stronger action. Shortly after that, during the first days of January 1999, and due to the federal government's decision to reduce its allocations to states as a way of forcing them into balancing their accounts, the Governor of the State of Minas Gerais, Itamar Franco, announced his intention to request a ninety-day moratorium on all of that state's payments.

Governor Itamar Franco's decision caused major waves in the financial world, unleashing capital flights. On January 13, the government expanded the real exchange

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Dr. Holz was awarded a grant by the Fulbright Foundation to conduct research on the subject of "integration of the banking system" in the Universities of Arizona, Golden Gate, and Harvard Law School. Her work resulted in publication of a book on the above topic entitled *La integracion de los sistemas bancarios*. She has given courses and seminars on the securities market and banking system, as well as having written several articles and texts on the subject.
The information, data, and declarations included in this article are based on articles published in La Gazeta Mercantil (Brazil) and Ambito Financiero (Argentina) and in the weekly publication Búsqueda (Uruguay) during the period from January 8 to March 4, 1999.

rate band and two days later (January 15), Brazil's Central Bank withdrew from the foreign exchange market. By March 5, the real had devalued by 85 percent, the prices of several products had increased, shortages began to appear, there was talk of freezing oil prices, and salary adjustment negotiations began. President Cardoso's governments adopted a number of specific measures, some of which had previously been submitted to Congress for approval; among them the following were aimed at reducing the deficit: the provisional increase of the "checks tax" (Financial Movements Provisional Contribution Tax), the increase in federal employees' social security payments, and the establishment of contributions for public sector retirees.

At the same time, Brazil negotiated a new agreement with the International Monetary Fund (IMF) that envisioned, among other measures, a 15 percent annual inflation rate, and the reduction of the fiscal deficit through the elimination of several export subsidies. President Cardoso announced, as well, that the central government would work with the State of Minas Gerais to deal with its foreign debt problem and agreed to meet with other governors dissatisfied with the central government's decision to decrease state allocations.

## II. Brazil's Modification of Its Foreign Exchange System: What Does It Mean?

The devaluation of its currency, which is a natural result of Brazil's modification of its foreign exchange system, did not solve the country's critical economic and financial situation. It was merely an acknowledgment by the government of the failure of its deficit reduction plan, which was aimed, ultimately, at correcting macroeconomic unbalances. Faced with a radical fall in its foreign exchange reserves, which had been falling steadily ever since the Russian crisis, Brazil's Central Bank decreed the free floating of the real. The loss of reserves—which already mirrored the market's lack of confidence—became critical with the State of Minas Gerais' debt moratorium announcement. Such declaration brought to light the political problems President Cardoso's government faced—and still faces—to adopt the deficit reduction adjustment measures agreed upon with the IMF. Thus, the perception arose within the market that Brazil's possibilities to correct its major macroeconomic difficulties were extremely uncertain.

Brazil's economic difficulties are the result of severe fiscal unbalances and of a lax monetary policy; neither can be modified by just altering the foreign exchange system. In the old foreign exchange system, the foreign exchange market adjusted through the fluctuation (loss) of Brazil's Central Bank reserves. In the new system, the market adjusts through fluctuations in the foreign exchange rates, rather than through variations in the level of international reserves. Thus, the magnitude of the devaluation will depend on the extent of the fiscal adjustment undertaken and on the government's credibility among investors, since a lack of confidence also contributes to higher foreign exchange rates.

It is yet too early to predict the short-term outcome of Brazil's economic and fiscal stabilization policies. Once again, such outcome will depend not just on the implementation of a stable set of economic policies but also on the political system's acceptance of the stabilization policies that will be needed.

## III. Repercussions within the Region.

Brazil's current difficulties are transferred to its neighbors through two channels. The first is trade, as evidenced by the changes that have already taken place in Brazil's exports and imports in goods and services to and from neighboring countries. The second is capital movements, to and from Brazil, within the balance of payments.

### A. Foreign Trade.

Exports to Brazil, particularly from neighboring countries, decreased or slowed down during the first months of 1999. For example, almost one-third of Argentina's total annual exports of automobiles, family consumer goods, foodstuffs, and agricultural and animal products such as oil, cereals, fuel, lubricant oil, etc. are to Brazil. Because of the changing value of Brazil's currency, which makes it hard for Brazilian importers to estimate their total cost, most ongoing trade operations were suspended. At a later stage, exports decreased due to the fact that they were not able to compete in price with local products and to a fall in Brazil's internal demand caused by the difficult situation experienced by consumers.

Similarly, third countries' producers found it difficult to compete with Brazilian goods. Thus, trade with neighboring countries was also affected by an increase in imports from Brazil, which hurt those local products unable to compete with Brazil's lower prices. Both developments resulted in a decrease in the region's demand for goods and services, which caused a fall in production and prices, thus unleashing a recession.

### B. Capital Flows.

Capital flows were affected to the extent that investors perceived the region's situation as critical, since this caused a decrease of resources in the capital market. At the microeconomic level, this negative perception derived from expected decreases in the demand for goods and services and, at the macroeconomic level, from the probable decrease in fiscal revenues that would make it difficult for the region's governments to balance their budgets and honor their commitments. To this we could add the uncertainty regarding the stability of foreign exchange systems and the devaluation tendency within MERCOSUR countries, particularly Argentina.

### C. Governments' Answer.

The region's countries' immediate reaction to Brazil's devaluation was to defend their foreign exchange systems, assuring that they would not be modified. Such assurances were meant to assuage the concerns expressed by each country's economic agents and by international organizations and investors.

In the case of Argentina, the government's defense of the peso's conversion plan went so far as considering the possibility of totally transforming the economy into a dollar economy. This defensive position, clearly expressed by Argentina's authorities, timidly considered by some private sector experts in Uruguay and Paraguay and forcefully rejected by Brazil's technocrats, was adopted in order to dispel all doubts regarding the future of each country's foreign exchange policy since any uncertainty would affect the confidence of internal and external economic agents.

Together with their decision to maintain their foreign exchange systems, and in order to improve the competitiveness of their country's products, the governments of the region cut down their annual expenditures and investment plans (as in the case of Uruguay), sped up the progressive reduction of employers' contributions to retirement funds in several productive sectors (Argentina), and in general, adopted a more prudent and restrained public expenditures policy for 1999. They have also implemented some financial mechanisms, such as the one adopted for Uruguay's export sector and for the purchase of low-priced vehicles in Argentina.

These types of measures are aimed primarily at insuring economic stability, and secondarily, at improving the competitiveness of locally produced goods and services. By curbing public expenditures, the potential expansion of the fiscal deficit, which could cause a contraction of the economy and therefore a reduction in tax revenues, is avoided. These policies also strengthen indirectly the balance of payments' capital flows since macroeconomic stability is fundamental to insure investors' confidence. Moreover, they have not generated a debate nor caused upheavals within the countries that have adopted them.

D. The Productive Agents.

Nevertheless, the productive sectors of the region's countries feel that the measures adopted are not sufficient to offset their products' loss of competitiveness. Most of their demands and complaints to their governments are in this regard. Moreover, the type of microeconomic measures and the policies they are claiming to protect local production from Brazil's more competitive goods and services are casting an ominous shadow on the future of MERCOSUR.

Also, some sectors within the region's governments, worried about the future of local producers, are supporting this type of request. A survey of some of the complaints and demands voiced by industrial and productive sectors within the region illustrates the extreme concern of the population for the current situation. Moreover, these demands are being voiced in spite of the fact that some MERCOSUR countries' public and private sectors have met on several occasions with Brazilian authorities to analyze the situation of their productive sectors and to formally and informally exchange suggestions on the measures to be adopted.

One of the most common demands being voiced is that governments should request that Brazil review its exports incentives policy and its reimbursement of sales taxes on products aimed at MERCOSUR. At the same time, pressure is mounting within each country of the region to limit border trade by stopping the massive flow of Brazil's goods through their borders. Argentina and, partially Uruguay, have already begun to adopt this type of measure.

Also, pressure is mounting in Argentina and Uruguay to review the implementation of escape clauses or other types of WTO-approved mechanisms that may stop the massive flow of Brazilian goods into neighboring countries. Those sectors that have been most affected by the change in the competitiveness of the region's products are clamoring for the adoption of non-tariff, individual, ad-hoc trade barriers. Unfortunately, the very real possibility of company shut downs and unemployment will rapidly build support for these types of measures.

Other demands that are being voiced refer to the adoption of several types of subsidies for those sectors most heavily affected by Brazil's measures. All such requests are in clear violation of WTO rules. Brazil's media, on the other hand, has "counter-attacked" by pointing to the systematic increase in the balance of trade deficit within MERCOSUR between 1992 and 1997. They point to the well-documented increase of Argentina's exports to Brazil (from U.S.$1.67 to U.S.$7.7 billion) admitting, though, that Brazil's exports to Argentina have a greater aggregate value than that country's exports to Brazil.

Within this context, the future of MERCOSUR is often questioned in Brazil and Argentina in light of the dramatic changes that have taken place in Brazil and their impact on the region. Finally, on a more constructive note, both the Argentinean and Uruguayan governments have pointed out that they will double their efforts and collaborate with their private sectors to increase their exports to new markets outside MERCOSUR.

## IV. MERCOSUR's Near Future.

### A. In General Terms.

There is no doubt that MERCOSUR is experiencing its worst crisis since its creation. The mechanisms that will be used to correct the impact of the new price relations between its members will be fundamental for the future of this integration agreement.

With a GDP of approximately $500 million, Brazil has considerable influence over MERCOSUR's trade. Argentina's production equals 43 percent of that of Brazil, and Uruguay's and Paraguay's joint outputs are barely 5 percent of Brazil's output. Because of this, Brazil's macroeconomic stability is of fundamental relevance to the region. It affects regional trade—which increases considerably when there is stability—as has been the case since the adoption of the Real Plan. This, together with a price level relatively higher than that of its trade partners led to a sustained increase in the region's trade, to the detriment of Brazil's balance of trade deficit, which also registered a surge.

In 1993, Brazil's trade registered a $13.3 billion surplus, while in 1998 the trade deficit reached over $6 billion. During that same period, Uruguay and Argentina's exports to Brazil increased 150% and 188% respectively (including goods that are hard to place in other markets and are covered by special export regimes within MERCOSUR).

As these numbers indicate, it is difficult to ascertain to what extent the trade increase within the region is due to the Real Plan—MERCOSUR's trade preferences or a combination of both: the first, due to the overvaluation of Brazil's currency and the ensuing increase in its products' prices; the second, due to the different treatment granted products depending on whether they are from within or outside MERCOSUR. Brazil's crisis has considerably altered the first such component.

The higher prices of Brazil's products, which curtailed their access to the other countries of the region and stimulated imports within Brazil, have suffered a reversal. Today, the prices of Brazilian goods represent a competitive advantage compared to those of other countries. This has created an unexpected and complex situation for the future of MERCOSUR. As mentioned above, much will depend on the type of mechanisms that are adopted to lessen or offset the impact caused by the abrupt change in relative prices within MERCOSUR.

As highlighted by the press, the future of MERCOSUR's integration appears somber and, at the very least, uncertain in all countries of the region. The reason for this is twofold. In the first place, it is very difficult and even inconvenient to continue with an integration process that encompasses countries with very different macroeconomic policies, especially when one of them—whose economy represents more than half the total product of MERCOSUR member countries—is experiencing great instability and a macroeconomic crisis. In the second place, there is the possibility that in order to protect some sectors, some or several of the countries' members of the Asunción Treaty may decide to adopt mechanisms or non-tariff barriers that are not compatible with MERCOSUR or WTO regulations.

As for Brazil's macroeconomic policies and the stabilization of its economic and financial situation, it appears that the policies adopted so far are headed in the right direction. There is no doubt that the adoption of adequate macroeconomic policies in coordination with the other countries' MERCOSUR members is the pillar that will insure the continuation of this integration agreement. Discipline on the part of all countries is a key element. Any adjustment such as the one that took place in Brazil offsets the transition mechanisms that have been carefully planned for the more sensitive sectors in all four of the MERCOSUR member countries.

On the other hand, regarding the possible unilateral adoption by some MERCOSUR members of policies that may contradict this agreement's rules, it is significant and highly positive that, to date, none has done so. On the contrary, pressure is mounting in Brazil to adopt MERCOSUR and WTO-approved measures and to allow other MERCOSUR countries to do the same.

Finally, we can state that the measures adopted by the other MERCOSUR countries denote maturity and meditation and are consistent with the special needs of economies that are involved in an integration process. Such measures reveal MERCOSUR member countries' commitment to the Agreement.

### B. In Specific Terms.

We will review here several measures that Brazil could adopt to lessen the impact of its policies on the other MERCOSUR countries and that are compatible with this organization's rules.

Should the other MERCOSUR countries' imports from Brazil increase significantly and should there be a consensus regarding the need to mitigate such situation, one of the first things that could be done is to adopt some measures in accordance with MERCOSUR and WTO regulations. MERCOSUR, however, has not envisioned any type of defense mechanism to counterbalance situations such as the one Brazil and the regions are experiencing today. Thus, given the lack of specific regulations within MERCOSUR, the alternative would be to turn to WTO-approved safeguard measures. It is doubtful, however, that such mechanisms may be applied to MERCOSUR members since in a case such as this that agreement's rules should prevail. On the other hand, the strict application of safeguard measures requires the implementation of a number of regulations, and since this could take some time, the damage could be worse.

Another legitimate possibility that could turn out to be more effective, practical, and swift would be to obtain Brazil's consent to the temporary application of a defense mechanism against the enormous flow of Brazil's goods into the markets of its MERCOSUR partners. For example, a tariff could be levied equal to a fraction of the real's devaluation. Even though this measure would address only part of the difficulties faced by the other MERCOSUR countries, and only on a temporal basis, it would, at least, preempt the need for other legitimate measures that could have a destructive impact on relations between MERCOSUR countries.

Be that as it may, recently Brazil began to consider some of the complaints from its MERCOSUR partners. In this regard, it decided to eliminate its subsidies to Brazilian exporters—in response to Argentina's claim—and to make its exports financing system more flexible—in response to Uruguay's request. The Brazilian government has also announced that it will study the effects of further export tax returns and that it will implement an automatic licensing system—licenses will be granted within twenty-four hours—for the importation of goods, thus eliminating non-tariff barriers on imports from other MERCOSUR countries. Finally, the Brazilian government has proposed the establishment of a technical commission to follow up on trade flows and to evaluate the effects on the different countries of the different measures that may be adopted.

## V. Final Considerations.

1. Following the successive Asian, Russian, and Brazilian crises the first reflection that comes to mind refers to the cost-benefit relation of integration and the globalization of financial markets. Are the benefits enough to justify the harsh costs and risks societies are facing? In this author's opinion, the liberalization of the flow of goods, services, and capital results in an increase in trade—and thus in product—and greater efficiency in the global allocation of resources and capital, which contributes to the well being and better quality of life of societies living within the framework of integration. In regard to integration and financial globalization, we must keep in mind that freer access to available external savings is what has enabled, at least partially, many Asian and Latin American countries to build a modern industry and a dynamic economy, while acknowledging the dangers of relying on very short-term capital.

   These positive aspects are still apparent today, in spite of a greater awareness of the risks and costs they entail, and which we must learn to understand fully in order to avoid them or at least lessen them.
2. One common trait of the Asian, Russian, and Brazilian crises—which were caused in part by different factors—is that they began and deepened because of a lack of consistency in macroeconomic policy over a period of time, enduring unsustainable structural deficits coupled with a significant and often short-term external debt, and other similar mechanisms aimed at financing the deficit without correcting its causes. When markets' confidence regarding the sustainability of economic policies falters, a crisis erupts.

   This demonstrates that in order for integration processes to be viable, the macroeconomic policies of all the countries' MERCOSUR members of such an arrangement must be aimed at insuring a sustainable deficit, debt, and growth level in each of them. Moreover, within a framework of free circulation of capital and financial globalization, the consistency and coherence of each country's macroeconomic policies is one of the fundamental pillars needed to insure the confidence of international markets and free access to international investment and credit.
3. The situation we are currently experiencing within MERCOSUR points once again to the need to closely coordinate the definition and implementation of

the macroeconomic variables that affect all countries' MERCOSUR members of an integration agreement. Monetary, foreign exchange, and inflation policies; the situation and evolution of the balance of payments; the close monitoring of these and other major economic variables, are some of the issues that concern each and every country. Thus, all stages of macroeconomic policies, from their initial definition to the follow up of their evolution, must be closely monitored in a joint and coordinated manner by all the governments, in the understanding that an imbalance in any of the economy's major variables within any of their countries will affect the others with ever increasing strength, and all the more if progress has been made in the free circulation of goods and services within the region. The sudden adjustment of one country's foreign exchange policy causes an unforeseen and misarranged fluctuation in the relative prices of the other MERCOSUR members' goods and services. A variation in any other major economic variable would cause a similar effect. For example, in a free circulation of services type of arrangement, one country's unemployment will be balanced by the migration of labor to another country within the integration agreement that enjoys a better relative employment situation, thus the latter country's unemployment level will increase as the first country's unemployment level decreases.

4. In order to prevent distortions in the macroeconomic policies of the region, countries must intensify their coordination and commit themselves to the implementation and follow-up of such policies. Each country is responsible not only for the good management of its country's economic variables but also for insuring that such policies do not hamper the development of the economies of the other members of the integration agreement. Continued access to and the flow of international credit and investments throughout the region also depend on this.
5. Moreover, in the coordination that may develop between the countries of MERCOSUR to prevent distortions and difficulties in the implementation of economic policies by any of its members, the following variables must be taken into account internally:
   - The information, both regarding the public and the private sector, exchanged between countries must increase, as it influences the implementation and coordination of policies and contributes to a better functioning of financial markets. Transparency must also increase. Information must be exchanged, particularly regarding each country's international reserves, foreign debt—particularly, short-term debt—and capital flows. Better quality and more fluid information regarding economic policies and the evolution of economic and financial indicators allow countries to evaluate risks with greater accuracy; thus it is extremely important that countries coordinate their actions. At the same time, better quality information affects the adoption of more precise and adequate economic policies since it facilitates their analysis and discussion by the other members of the integration agreement.
   - International accounting, auditing, and insolvency regime standards must be applied with greater discipline. These standards will contribute to the development of healthier trade practices and will allow for a better differentiation of debtors by financial markets. We must remember that the

strengthening of each MERCOSUR country's internal systems is aimed, in part, at attracting international credit markets, which, as investors and lenders, will closely monitor all improvements and modifications that may take place within this group of emerging countries. On the other hand, the intensification of these standards will allow for better understanding of the policies each country adopts and, thus, more credibility.

- The strengthening of internal financial systems—including monitoring mechanisms—is indispensable to offset the weaknesses of the respective systems. On the one hand, it is necessary to contribute to the development of an adequate banking system, with good liquidity and management of exchange rate risk, by developing effective internal monitoring systems that may balance risks and profitability. This also requires a free and transparent flow of information, adequate regulations and prudent supervision, direct inspections or auditing, and swift action should any institution's position be weakened or inadequate measures be adopted. The strengthening of the system of payments and of legal systems regulating the execution of contracts and situations of insolvency is also required. Likewise, it is important to be informed of the activities of institutional investors, particularly their operations involving very high leverage financing, and on their exposure. Internal financial systems are important because of their close effect on macroeconomic variables, and because any difficulty they may experience may affect the other countries of the region and even the rest of the world through systems of payment and inter-bank credits and deposits.