

Presentation at the Panel “Latin America: Business and financial links” at the Royal Institute of Economic Affairs Conference “Latin America: the European dimension”, Coral Gables, USA, October, 2nd 2002.

In order to address the terms of reference of the panel, i. e. to single out relevant European dimensions in transformations entertained by the Brazilian economy in the last few years, the note that follows discusses five topics: (i) the broader changes going on in Brazil as regards its place in the global economy; (ii) the specific trade policy issues that are seen as the most relevant to domestic political agenda; (iii) the prospects of the FTAA in light of Brazilian and US politics, and of the European example as seen from Brazil; (iv) the consequences of the Euro, especially as regards Iberian countries and how it came to be very important to Brazil; and (v) political changes in Brazil with a bearing on foreign stakeholders.

1 – Given the extent of changes undergone by Brazil as regards its relations with the rest of the world, one can hardly see an Europe bias

The exposure of Brazil to globalization was sudden, spectacular shocking and generated lots of opportunities, change and tension.

In many ways connectivity with globalization had been building up spontaneously as foreign firms have always been an important presence in the economy (15% of GDP) and a prime channel through which economic integration was proceeding (trade, finance, technological, brands, management, etc). Through the years, therefore, openness was driven by the private sector (multinationals mostly), and not by government policies that remained inward oriented.

It was only with the Real Plan - ending a long period of increasingly unmanageable high inflation, eventually degenerating into a true hyperinflation - that Brazil qualified to engage into normal economic relations with the rest of the world. The ensuing improvement in the business atmosphere was tantamount to changes occurring in FDI and on productivity changes.

For Brazilians, therefore, many major transformations (reforms) took place simultaneously: stabilization, trade liberalization, privatization, banking reform, social security reform, deregulation of the explosion of FDI, major gains in real income and a major acceleration in productivity growth. The exposure to globalization was part and parcel of such changes. The prevailing feeling is still perplexity as it was perhaps too much tension to be handled at such a short time span by the political system and also by the economy at large.

Being part of the global economy was novel and disturbing. Never in our history international affairs seemed so important. Domestic financial markets started to react to events in Thailand, or to wholesale purchases orders in Chicago, or by the Russian default. This “cultural” change was no less than revolutionary and

it was especially so in view of the fact that the years following 1997 offered no little action in the international financial arena.

It is indeed hard to distinguish Europe from other countries in the midst of all that, as changes taking place in Brazil were unilateral in character and conducted on our own initiative with a view at ending hyperinflation and simultaneously engaging Brazil into a rapid process of modernization.

2. Trade policy issues that acquired utmost importance in the local political agenda.

Trade liberalization in Brazil was rapid, unilateral, and aggressive; it was “across the board” and with little regional bias, mostly because it was delayed so much. Mercosul was not the main driver, although relevant to the process. It should be seen as “door opener”, a test to conceptually more important propositions, also a way to exile protectionist bureaucrats. It was indeed an experiment on things to do with all other countries on a multilateral framework, not a project to replace such focus. Notwithstanding, trade with Mercosul grew much more than our trade with the rest of the world, possibly because the initial level was unduly low. However, no party has ever shown a serious intention on advancing on macro economic coordination, let alone a single currency.

An economic comment on Mercosul is needed: having Argentina as our largest neighbor, is not the same as Mexico having the US, or Spain or Portugal having Europe. There is plenty of trade diversion in favor of the “small” country to the detriment of the “large” country in customs unions between countries of different size, and in the presence of less than free trade with the rest of the world. There has to be other reasons, generally political or national security concerns, for integration to go forwards.

As a result of trade liberalization measures and of real exchange rate appreciation, openness, as measured by import penetration ratio in industry, grew to 20% in 1998/99 from 6% in 1994. The most visible consequence of this movement was a very positive impact on TFP (Total Factor Productivity) and especially on labor productivity. One hour of labor in industry at the end of the 1990s produces around 70% more goods than at the beginning. No doubt a remarkable record and there is no question as to the positive association between openness and productivity.

One may find, however, isolated though frequent complaints from business leaders as to the unilateral character of the trade liberalization movement, or the lack of reciprocity from developed countries. This may have started as a self-serving protectionist pitch, though it has become an important political issue in Brazil resulting into a new stance in trade negotiations.

It is true that the Brazilian economy up the 1990s was so closed and averse to foreign trade that no material was given to the country's economic diplomacy to work with. Brazil moved towards "normal" levels of protection precisely when WTO rulings started to be binding and enforceable as never before. Not only the old menu of protectionist measures could no longer be brought back, but also Brazil would have to abide by the WTO rules on the export side having no previous experience in such negotiations.

Most of the key Brazilian export products are now facing significant barriers in the US market, and very recently a new round of restrictions was enacted against Brazilian steel. In parallel, successive attempts to question European agricultural protectionism failed and the competition between Brazilian aircraft manufacturer Embraer and Canadian Bombardier not only produced many disputes within the realm of the WTO but also led to a Canadian retaliation against Brazilian meat on false grounds that it carried "mad cow disease". Such tensions have never drawn so much attention and no doubt their development do not help the cause of those in Brazil in favor of greater degrees of integration into the global economy.

3. Prospects for the FTAA are gloomy if market access is not extended

All these controversies acquired immense visibility in Brazil as the opposition to globalization has been constantly underlining the asymmetries in trade relations between Brazil and other "economic blocs". The recent Bush Administration protectionism measures, as well as the closing of international capital markets to Brazil would appear to confirm, in the eyes of many Brazilians, that the option towards globalization and the so-called Washington Consensus was a mistake. It appears intolerable not only that the free markets' champions to practice the opposite of what they preach, but also the punishment given to Brazil by financial markets after all the effort put into pro market reforms.

In this context the prospects of negotiations towards the FTAA seem gloomy at best. Left wing parties ran an independent plebiscite on the FTAA issue with a significant turnout and overwhelming results against the FTAA. The electoral campaign brought little debate on the FTAA, but jobs were the number one issue. The atmosphere is favorable to a protectionist revival that, indeed, has not taken place only because the extensive undervaluation of the currency has had the very same effect.

As a matter of fact, attitudes against the FTAA may only change if it breaks new ground as regards bilateral Brazil-USA relations or if it cracks on "old" trade issues. In fact, it may very well be that hemispheric integration may only advance significantly if the US follow the European example of offering "sweeteners" in the process of integration in order to offset economic

development asymmetries. Brazilians are aware of what was the result of process of integration in Portugal and Spain in particular, and the one aspect that attracts us is the flow of aid and investments designed to reduce asymmetries in economic development. The cloudy state of the world economy may only heighten that feeling that some true advantage is given to the small partners of the enterprise to join

Of course, it may very well be, on the other hand, that nothing of this sort takes place, in which case the FTAA will be an empty box.

4. The consequences of the Euro particularly for Iberian countries

The single European currency provides an interesting explanation for the “enrichment” of Portugal and Spain, or more precisely, of corporations based in these countries.

It is true that both countries went through “IMF type” drastic adjustment programs resulting in significant improvements in macroeconomic “fundamentals” of their economies. In themselves, these improvements would bring sovereign ratings upgrades that would enhance valuations of companies in the region. In that respect, the “preparation” seemed as good, or even better, than the event, or the single currency introduction. Yet what is commonly forgotten is that the monetary union for Iberian countries was in many ways similar to what the emerging markets macroeconomic vocabulary designates as “dollarization”.

The Escudo represented 0.69% of the ECU, and the Peseta 4,1%. As Iberian countries adopted the Euro as their national currency, they were doing nothing much different from Argentina in adopting a foreign currency, a “hard currency” (the dollar) as her national currency. The same goes for Baltic countries adopting currency boards. The interesting question is what does it do to Spain and Portugal, and particularly to companies based in these countries?

The answer is that in addition to the upgrade caused by macroeconomic convergence (“preparation”), there is an interest rate convergence equalizing the cost of capital with which corporate valuations are made in the entire Euro area, which resulted in increasing the value of cash flows in the Iberian Peninsula. Besides, it was like corporations that had revenues in pesetas instantly converting their revenues in Deutsche Marks. Furthermore, Spanish and Portuguese firms could now raise capital in Germany or France as if they were “national” companies. Therefore, ratings, valuations, the cost of capital and access to cheap capital were all significantly increased or improved for Iberian countries. The market capitalization of Iberian companies was therefore sharply increased, with very concrete impacts in Brazil.

In 1995, there were 6.322 foreign companies in Brazil, and the stock of FDI was of US\$ 42 billion, of which Iberian countries were responsible for meagre 0,84% of this total. In 2002 the number of foreign companies operating in Brazil was raised to 11.404, and between 1995 and 2002 US\$ 100 billion in FDI entered Brazil in addition to the stock existing in 1995. In 1999 alone, 29.4% of FDI flows – US\$ 8.1 billion – out of a total of US\$ 27.5 billion, came from Iberian countries. In 2000 this proportion was raised to astounding 40.5% - US\$ 12,1 billion - out of an equally impressive total of US\$ 30 billion.

No doubt, through this tidal wave of FDI apparently provoked by the advent of the single European country as a “push” factor, and the Brazilian stabilization and reforms and privation as the “pull” factor, the Iberian Peninsula has built a major bridge from Europe to Brazil. The presence of such major corporations in some of the key infra-structure sector in Brazil created brand new forms of economic intercourse, and by all means integration, raising the economic relationship between the two areas to an entirely new level^[1]. Anything affecting the state of the Brazilian economy, immediately affects prospective profits of major Portuguese and Spanish corporations in their native stock exchanges; connections of this type have been hardly noticed in other countries for whom investments in Brazil are not especially large with respect to overall outward FDI and local companies market capitalization. No doubt, contagion is now a factor, and this creates a keen interest on business in Brazil.

5. Final observations on the issue of Democracy and political change.

As the outcome of the 2002 presidential elections Brazilians are most likely choosing Mr. Lula da Silva, who is running for the fourth time. In his previous campaigns he had built a reputation of being a radical, but now he presents himself in much more moderated fashion, not only championing social democratic ideas, as opposed to the outright left wing platform of the past, but also with a number of alliances, regional and national, that would very likely dilute what is now considered a “minority” of true radical within his party.

The challenge to the young Brazilian Democracy is a significant one: electing a former union leader, just recently converted to social democratic ideas might bring tension to the political system. But in the recent past, Brazilian political institutions had shown considerable strength under pressure. Brazilians seem to display no fear of their choice; in fact, the ascendancy of former metal-worker to the Presidency is, in itself, demonstrates that mass democracy in Brazil is for real.

In addition, Mr. Lula da Silva’s party – PT (Workers’ Party) – was extremely successful in parliamentary elections becoming the largest single party at the Lower House; in the Senate, PT was the party with the largest growth. This

performance, however, is far from securing majority: in the Chamber of Deputies PT has nearly 25% of the vote, and 15% at the Senate. There are no natural coalitions at the “center left” to secure majority, perhaps not even to elect the President of Chamber of Deputies; the majority of Parliament is center to right. Since “pork barrel politics” has been an important practice to by pass the absence of stable majorities, one may legitimately expected PT to participate in the Parliamentary life in a much less sectarian way, as compared to its previous stance when at the opposition and much smaller.

In essence, Brazilians are expecting an active parliamentary life in which the Executive will be heavily involved. This is more an opportunity than a challenge to PT, and to the Brazilian Society at large, as the issue at stake is whether Brazilian Democracy is effective in producing decisions to address difficult economic circumstances. If there is no consensus, there should be consent and leadership. Depending upon the quality of these decisions Brazil will overcome present difficulties as a much stronger economy a society.

There are no shortages of European examples of opposition governments of left wing or social-democrat orientation that alternate in power with conservative parties, without disruption of policies pertaining to the national interest. Brazilians may very well be served by these examples and turn to Europe in a moment the US administration has single mindedly adopted one single issue as the sole end of their foreign policy: the fight against terrorism. It remains, for Brazilians, to show political maturity thus dissipating fears, foreign and domestic, of radical measures in the future.