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Brazil and Mexico: Institutional differences

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Is Brazil headed for a Mexico-style crisis? Some parallels warn us of coming trouble. Much depends on the struggle for moral and political cohesion led by President Fernando Henrique Cardoso, who is trying to manage institutional problems that dwarf anything seen in Mexico in recent years. Brazil's multiplying financial difficulties now exceed those of Mexico in late 1994.
Foreign money is pouring into Latin America this year at a faster rate than in 1994, during the "emerging markets" boom that preceded the Mexican crisis. Net private capital flows to Mexico surged from a yearly average of $1.7 billion in 1980-90 to an average of $25 billion in 1991-93, only to evaporate to $9.7 billion in 1994 and to $15.4 billion in capital flight in 1995. Benefiting from the same convergence of growing cash surpluses and low interest rates in the rich countries, Brazil's annual private capital receipts rose from $3.8 billion in 1980-90 to an average of $9 billion in 1992-94 to $32 billion in 1995. The biggest share of Brazil's swelling capital flows ($8.9 billion) came from hard currency borrowing by banks and companies that increased Brazil's private foreign debt to $49 billion, against $23 billion when the Real Plan began and only $9.6 billion when Brazil adopted its high interest rate policy in early 1991. This foreign borrowing parallels what happened in Mexico, where 60% of financial liabilities of large and mid-sized companies were denominated in foreign currencies, although exports were less than 10% of all sales. Heavy private foreign borrowing makes adjusting an overvalued exchange rate more difficult. Borrowers in dollars must earn more pesos and reais to pay their debts when local currencies lose value.

Some differences between Brazil and Mexico may be more important than the similarities. Although Brazil has been bloodied over the past decade by alarming escalation of civil violence, it has suffered no political trauma like the Zapatista revolt in Chiapas in January 1994 or the assassination of Presidential candidate Luís Donaldo Colosio in March. Brazilian economists like to say that "inflation wounds but a foreign exchange crisis kills," but the maxim applies more to Mexico than to Brazil. Unlike Brazil, Mexico has clung to fixed exchange rates for most of the past half-century.

Each devaluation —in 1953, 1976, 1982 and 1994, usually near the time when the Presidency changed hands— has caused a political shock. The Mexican shock was aggravated by President Carlos Salinas de Gotari's refusal to adjust the exchange rate after the August 1994 election because devaluation might spoil his candidacy to head the new World Trade Organization. Brazil avoided such devaluation crises over the past generation by indexing its exchange rate. The Bank of Mexico was accused of loose monetary policy when, facing investors' resistance to holding government debt, it expanded credit, making it easier for speculators to buy dollars and bet against the peso in 1994. Brazil now is loosening credit to lower interest rates and avoid recession in an election year. Both governments took short-term portfolio investments from foreigners, the difference being that Mexico's tesobonos were denominated in dollars while Brazil's new public debt is in local currency. A bigger difference is that Brazil has no hope of a rescue, if needed, on the scale of the $52 billion support package for Mexico in early 1995 arranged by the U.S.

government, the International Monetary Fund and a group of central banks, one of several assistance efforts for Mexico since 1976. Brazil has no leverage on U.S. politics like the threat of disorder across the tense U.S. border with Mexico, especially so soon after creation of NAFTA (North American Free Trade Agreement), whose collapse would hurt President Bill Clinton's chances for reelection. Edward M. Truman of the U.S. Federal Reserve Board warned later that "the scale of potential financial assistance needed to stave off a full-blown crisis in Mexico has proved to be much larger than anyone could have imagined as recently as 1994, and the scale of any similar operation in the future (even allowing for the special circumstances of the Mexican case) is likely to be larger than the official sector will be able or willing to assemble."

Differences between Brazil and Mexico go deeper, especially in terms of political institutions. The histories of the Bank of Mexico and the Central Bank of Brazil show these differences. The Bank of Mexico was created in 1926 in the wake of the chaos and hyperinflation of the Mexican Revolution, pursuing conservative policies in the next half-century. While criticized at times for lack of independence in monetary policy, the Bank of Mexico's influence on government is shown by the fact that two of Mexico's three most recent Presidents, Miguel de la Madrid (1982-88) and Ernesto Zedillo (1994-2000) emerged from the ranks of its career officers. While only four Governors headed the Bank of Mexico since 1953, the Central Bank of Brazil had 21 Presidents since it began operations in 1965, 14 of them since military rule ended in 1985. Between 1953 and 1994, the price level multiplied six-fold in the United States and 1,571 times in Mexico while Brazilian inflation shot into Outer Space, multiplying prices something like 33 trillion times. In 1994, the year of the peso's collapse and the launching of the Real Plan, Brazil's inflation was 2,669% while Mexico's was 7%. Institutional differences like these enabled Mexico to carry out three successful efforts at fiscal stabilization since 1982 while Brazil moved to the brink of hyperinflation in 1990 and 1994.

Mexico's more stable institutions were built upon bitter lessons of the political and economic disorder of the Mexican Revolution eight decades ago. Having suffered no such convulsion so far, Brazil has enjoyed the luxury of learning more slowly. Thus Mexican Presidents are more powerful than Brazilian Presidents. For nearly seven decades Mexico has been under a one-party system that is evolving painfully now into a more democratic three-party system, while Brazil's atomized multi-party system seems chronically unable to muster stable majorities in Congress. The reins of power in Mexico are held by a federal bureaucracy, while in Brazil power is spread among Congress and state governors skilled at extracting money from the Executive in exchange for different kinds of political support. Brazil is one of few countries where state governments are allowed to own banks, a fearsome source of money-creation and fiscal chaos, while Mexico's political system tolerates fewer loose cannon in public finance. Mexico has no financial institutions like the Bank of Brazil and the CEF (a federal savings bank with many parallel functions) that have become reservoirs of non-performing loans and failed projects, each running balance sheets nearly as big as the federal budget and jointly controlling one-third of the banking system's assets.

While Brazil's Treasury has avoided the exchange rate risk assumed by Mexico's government in using dollar-denominated tesobonos to fund its internal debt, other danger signals are surfacing that appeared in the months before devaluation of the Mexican peso. As in Mexico before 1995, the currency is overvalued against the dollar.
A widening gap between tradeable and non-tradeable prices, measured in Brazilian reais, is pressuring manufacturers in both domestic and export markets. In dollar terms, prices of a taxi ride, a restaurant meal or apartment rents are at German or French levels, while salaries are much lower.

In The Economist's widely quoted Big Mac index, a hamburger in São Paulo costs roughly 20% more than the average of other major cities in the world. The government adds to pressures on the real by borrowing too fast and too much. Private business adds to the debt burden by taking dollar loans like crazy to arbitrage between low international and high domestic interest rates. Both Brazil and Mexico have been flooded with hot foreign money, little of which was invested in productive facilities. Since the Real Plan was launched, federal debt has grown more than twice as fast as reserves.

Over the past year, state and federal debts have grown from $80 billion to $206 billion, while reserves increased from $40 billion to $60 billion. In Mexico, public debt grew only slightly in 1993-94 but became more dependent on foreign financing that dried up amid the political convulsions of 1994. Mexico's government was a net saver in the four years before the peso's collapse, while Brazil's public savings have been chronically negative over the past generation. However, Mexico eased its fiscal policy in 1994 as the Bank of Mexico and development banks pumped money into the economy. What sunk Mexico's international credit, aside from political violence, was a rising current account deficit in 1991-94, approaching 8% of GDP. Brazil's strategy, on the contrary, is to support an overvalued exchange rate by increasing its reserves even more while avoiding foreign imbalances like Mexico's by financing exporters at international rather than domestic interest rates. So far, this strategy has been successful. Brazil's current account deficit was contained at 3.1% of GDP in 1995, at a cost of rising unem-ployment, but this balance may weaken because of disappointing trade figures in 1996. The big question is whether these balances can be controlled if devaluations keep lagging behind inflation, making dollars even cheaper, in the face of credit expansions driven by foreign borrowing, falling domestic interest rates and bailouts of banks and state governments.
After a 7% loss of output in 1995, Mexico is recovering. Its economy grew by 7.2% in the second quarter of 1996 over the same period last year, seeming to vindicate the harsh stabilization program pursued by the Zedillo administration, while Brazil's economy is slowing. The share of past due bank loans, 48% in July, has begun to fall and consumer purchases are rising, even though the basic annual interest rate on government debt is still 27%. Zedillo said he would be "cheating the people" if he claimed that Mexico would quickly restore living standards to pre-crisis levels. At least Mexico is moving in the right direction. "In Brazil the problems don't change," observed Tancredo Neves, who fell fatally ill in 1985 on the eve of his inauguration as the country's first civilian President in two decades. "They just become more difficult."

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