

# Emergent Brazil and the Curse of the ‘Hen’s Flight’

Alfredo G.A. Valladão

No. 379 / February 2013

## Abstract

The ‘Emergent Brazil’ growth model is reaching its limits. Its main engines have been slowing significantly since the beginning of the global financial and economic crisis. Even its much-praised predictable macroeconomic policy has been eroded by political interference. Inflationary pressures are growing and GDP performance is anaemic. As ominous, Brazil cannot compensate for its domestic deficiencies with an export drive. Commodity exports are suffering with the world economic slow-down and the manufacturing industries’ competitiveness is in sharp decline. Brazil has put all its trade negotiation eggs into the South American and WTO baskets, and now its export market share is threatened by the Doha Round paralysis, the Latin American Alianza del Pacífico, and the US-led initiatives for a Trans-Pacific Partnership and a trade and investment agreement with the EU.

Paradoxically, this alarming situation opens a window of opportunity. There is a mounting national consensus on the need to tackle head-on the country’s and its industries’ lack of competitiveness. That means finding a solution to the much-decried ‘Brazil Cost’ and stimulating private-sector investment. It also entails an aggressive trade-negotiating stance in order to secure better access to foreign markets and to foster more competition in the domestic one. The most promising near-term goal would be the conclusion of the EU-Mercosur trade talks. A scenario to overcome the paralysis of these negotiations could trail two parallel paths: bilateral EU-Brazil agreements on ‘anything but trade’ combined with a sequencing of the EU-Mercosur talks where each member of the South American bloc could adopt faster or slower liberalisation commitments and schedules.



This study was prepared in the context of the CEPS-FRIDE project on the EU-Brazil Strategic Partnership, funded by the Gulbenkian Foundation. CEPS Working Documents are intended to give an indication of work being conducted within CEPS’ research programmes and to stimulate reactions from other experts in the field. The views expressed in this paper are those of the authors and do not necessarily represent any institution with which they are affiliated.



FUNDAÇÃO  
CALOUSTE  
GULBENKIAN



ISBN 978-94-6138-289-4

Available for free downloading from the CEPS website (<http://www.ceps.eu>)

© CEPS 2013

## Contents

---

Prolegomena .....	1
1. A virtuous – and lucky – growth model .....	2
2. All carnivals have their Ash Wednesdays .....	3
3. ‘Brazil Cost’ x ‘currency war’ .....	7
4. Brazil as a (little) currency warmonger .....	8
5. Brazilian real not guilty of dwindling trade surpluses .....	9
6. A window of opportunity for trade agreements.....	10
7. New scenarios for the EU–Mercosur talks.....	11
8. An emerging power forever? .....	12
Appendix I. The hopeless dream of taming the forex beast.....	14
Appendix II. Numbers on the US\$/R\$ exchange rate and Brazil’s exports .....	17

### List of Figures

Figure 1. Iron ore monthly price, January 1998–January 2013 (US\$ per dry metric ton).....	2
Figure 2. Commodity Agricultural Raw Materials Index, Monthly Price, January 1998–January 2013 (index number) .....	2
Figure 3. Brazil, reserves of foreign exchange and gold, 2004–11 (US\$) .....	3
Figure 4. Brazil, net inflows of FDI (current US\$) .....	3
Figure 5. Brazil, balance of trade (US\$ million) .....	4
Figure 6. Brazil, government spending.....	4
Figure 7. Brazil, exports, 1964–2010 (%).....	5
Figure 8. Brazil, consumer price index.....	6
Figure 9. Brazil, current account (US\$ million).....	6
Figure 10. Brazil, GDP annual growth rate (% change in GDP) .....	6
Figure 11. BRL/US\$ exchange rate, 1994–2013.....	8
Figure 12. US\$/BRL exchange rate, 2006–12.....	9

# Emergent Brazil and the Curse of the ‘Hen’s Flight’

Alfredo G.A. Valladão\*

CEPS Working Document No. 379 / February 2013

---

## Prolegomena

The ‘Emergent Brazil’ growth model is reaching its limits.<sup>1</sup> Its main engines have been slowing significantly since the beginning of the global financial and economic crisis in 2008, particularly in the last two years. Even its main fundament – a 15-year-old predictable macroeconomic policy – has been eroded recently by heavy-handed political interference. Inflationary pressures are growing steadily, as well as public debts. Trade surpluses are shrinking and balance-of-payments deficits are expanding. Granted, the domestic consumer market fuelled by a splurge of government-backed credit is still booming and unemployment is at a historically low level. But households’ indebtedness is becoming unsustainable and productive investments have fallen to a ridiculously low level owing to a mounting lack of trust fed by the unpredictability of Brasilia’s economic and regulatory policies. The result is a sharp decline of the manufacturing industries’ competitiveness. True, there is yet some spare cash that can be thrown away to sustain the economic activity, and the forthcoming FIFA World Cup in 2014 and the Olympic Games of 2016, which will be held in Brazil, will certainly give an incidental but medium-term boost to the country’s anaemic growth rate. Nevertheless, economic dynamism is slowly grinding to halt, and it is becoming more and more difficult to hide it.

As ominous, Brazil cannot compensate for its domestic market growing deficiencies with an export drive and better access to foreign clients. In the last decade, the country’s trade negotiating strategy has focused on the Doha Round and on securing preferential access to its South American neighbours’ economies. Now, the WTO talks are bogged down and most Latin American Pacific states are pursuing open trade agendas with a flurry of free-trade agreements (FTAs) signed with the US, the EU and some Asian partners, while also jumping onto the bandwagon of the US-led Trans-Pacific Partnership (TPP). With the recent launch of US–EU talks on a Transatlantic Trade and Investment Partnership (TTIP), Brazil is threatened by future huge losses of share in the markets of two of its most important commercial partners. And even in its home turf of South America, it is being cornered within an enlarged Mercosur made up of its most protectionist and even anti-trade neighbours (Venezuela, Argentina and, probably, Bolivia and Ecuador). Hence, Brazilian exporters – particularly the more value-added manufacturing sector – have to face a growing challenge from more competitive players (China and Asian producers in general, but also those in the US and Germany), not only on the markets of Latin American Pacific Rim countries, but also

---

\* Alfredo G.A. Valladão is Professor at The Paris School of International Affairs (PSIA – Sciences Po) and President of the EUBrasil Advisory Board.

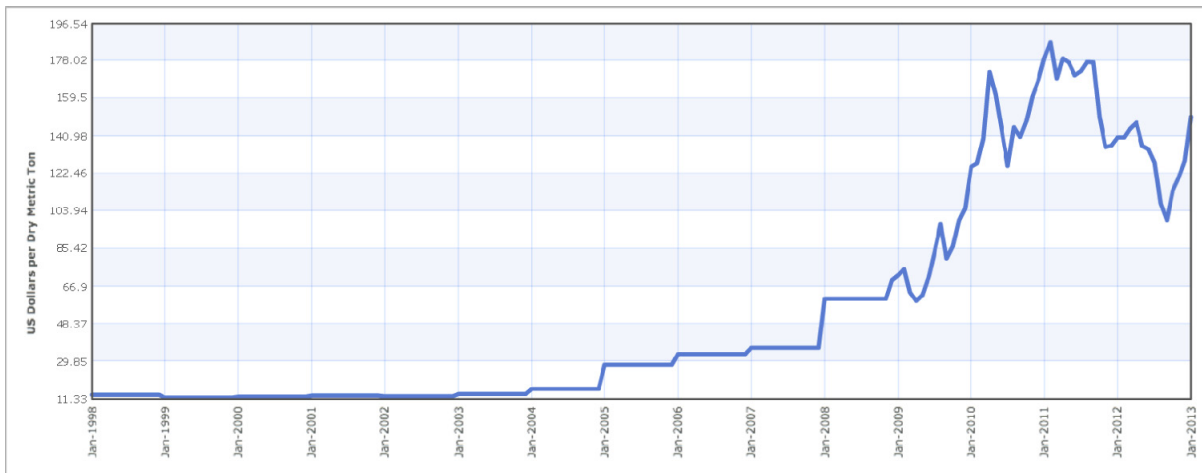
<sup>1</sup> All the statistical data in this paper, unless specified, comes from the Brazilian Ministério do Desenvolvimento, Indústria e Comércio Exterior [Ministry of Development, Industry and Foreign Trade, MDIC], Instituto Brasileiro de Geografia e Estatística [Institute of Geography and Statistics, IBGE] or the Central Bank of Brazil.

on their own domestic market. And it is not some lonely FTAs with Israel, Palestine and Egypt or two modest preferential agreements with India and the South African Customs Union that will make a difference.

## 1. A virtuous - and lucky - growth model

The Brazilian growth model of the first decade of the 2000s was supported mainly by huge trade surpluses, in large part attributable to a few commodity exports (particularly iron ore and soya beans). Indeed, during the last years of 'happy globalisation' and extraordinary global growth, raw materials reached extremely high prices and export volumes (Figures 1-2).

Figure 1. Iron ore monthly price, January 1998–January 2013 (US\$ per dry metric ton)



Source: IndexMundi.

Figure 2. Commodity Agricultural Raw Materials Index, Monthly Price, January 1998–January 2013 (index number)

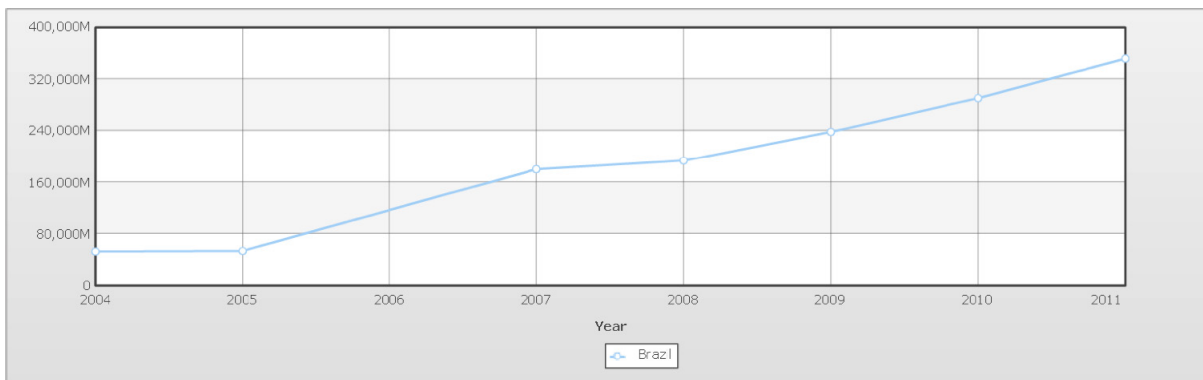


Source: IndexMundi.

Thanks to these big surpluses, the Brazilian government could drastically reduce its external debt and build significant currency reserves (Figure 3). In 2008, Brasilia could announce that the country had reached the position of being a net external-debt creditor. After decades of expensive indebtedness, this new situation provided a lot of elbow room to pursue a

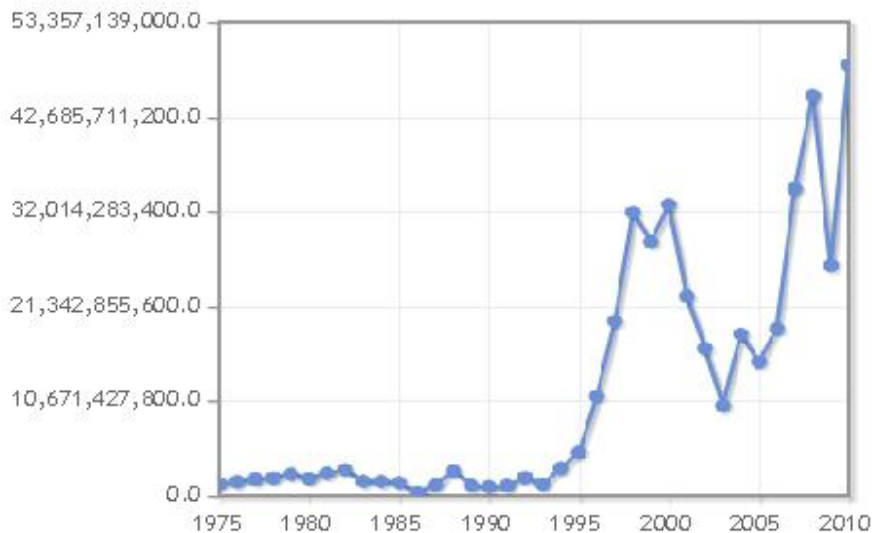
voluntarist policy of huge social transfers that became the trademark of the government of President Luiz Inácio Lula da Silva. The main effects of these transfers, combined with a responsible and predictable macroeconomic management, inherited from the previous federal government and pursued during the first six years of the PT (Workers' Party) administration, were a clean-cut reduction of the stubbornly high poverty rate, a swelling middle class and the creation of a big and thriving consumer market in Brazil. The ensuing consumer boom was good for domestic business and importers alike, and attracted an important and steady flow of foreign direct investment (FDI), particularly from Europe (Figure 4).

Figure 3. Brazil, reserves of foreign exchange and gold, 2004–11 (US\$)



Source: IndexMundi.

Figure 4. Brazil, net inflows of FDI (current US\$)



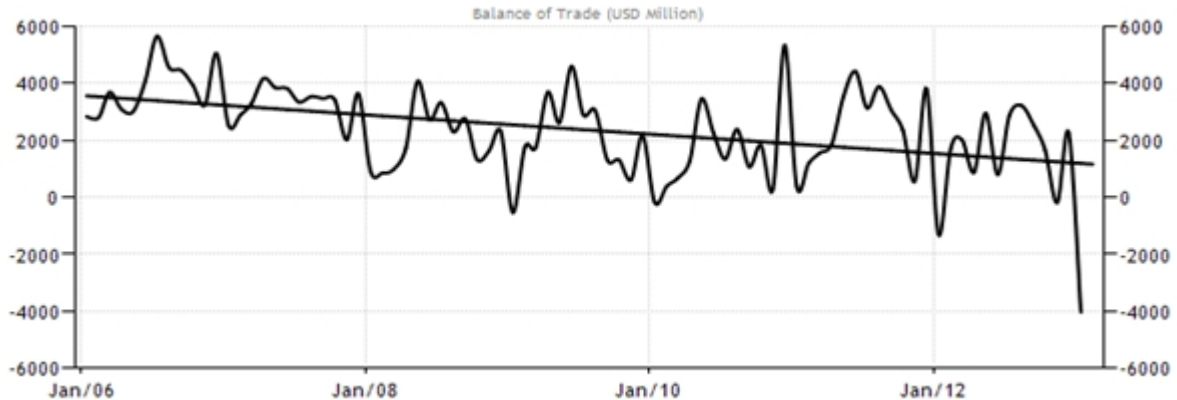
Source: IndexMundi.

## 2. All carnivals have their Ash Wednesdays

Since 2009, this virtuous model has been clearly heading straight for a wall. Some of the most important parts of the engine – commodity prices and buyers' markets – have been hit by the general economic slowdown due to the global recession: the balance of trade surplus in 2011 was just about a third of the highest level in 2006 (Figure 5). To preserve domestic growth and to protect employment and social transfers, the authorities prioritised the boosting of the

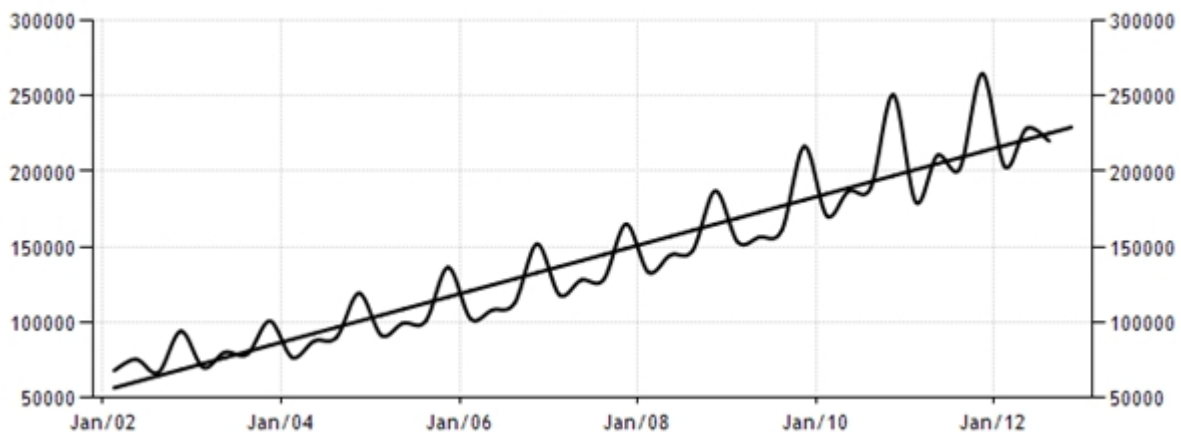
domestic consumer market through a huge injection of credit – most of it coming from public financial institutions. This government-spending binge (Figure 6), which reached an all-time high in November 2011, is fuelling rising public deficits and is crowding out much-needed productive investments.

Figure 5. Brazil, balance of trade (US\$ million)



Sources: Trading Economics (<http://www.tradingeconomics.com/>) and Ministério do Desenvolvimento, Indústria e Comércio Exterior (MDIC).

Figure 6. Brazil, government spending

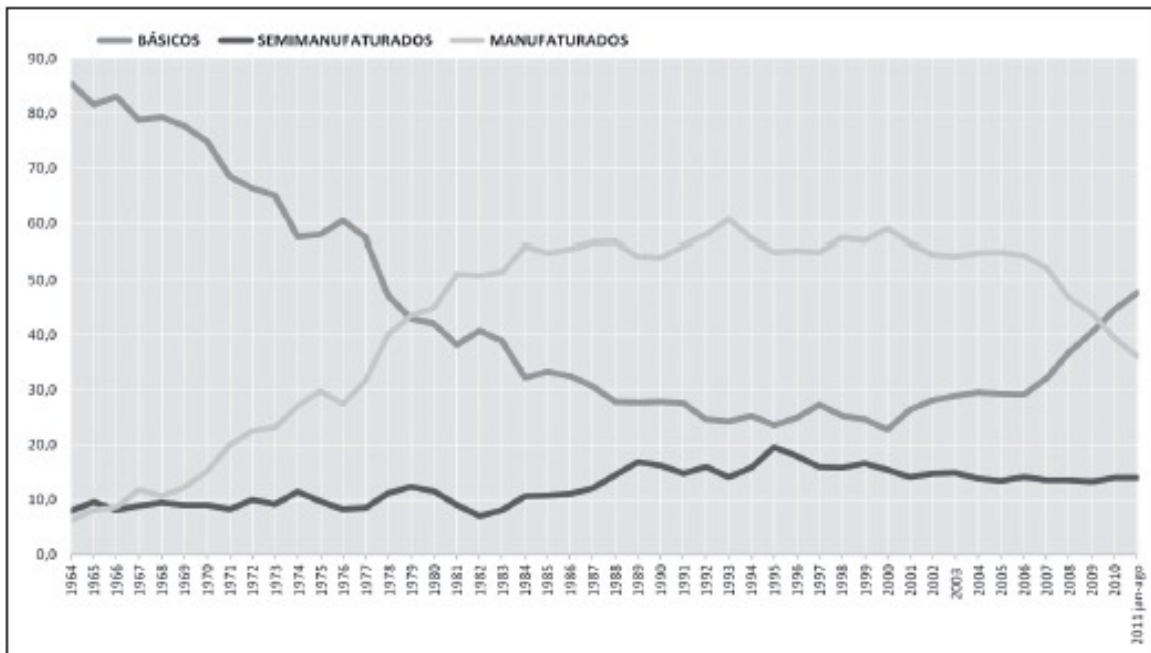


Sources: Trading Economics (<http://www.tradingeconomics.com/>), Instituto Brasileiro de Geografia e Estatística (IBGE).

In these new circumstances, the traditionally accommodating and timorous national industrial sector has focused on the immediate gains reaped from the internal market. Exports of industrial, more value-added, products have been losing ground to the venerable trade flows of raw materials. At the beginning of the 21<sup>st</sup> century, Brazilian foreign trade was made up of 60% of manufactured goods and 40% of commodities. Today, the percentages are exactly the other way around (Figure 7). There is no doubt that Brazilian industries are also suffering huge declines in competitiveness for lack of government investment to solve the country's economic bottlenecks (infrastructure modernisation, the upgrading of the education system, fiscal reform, de-bureaucratisation, regulatory predictability...) and for lack of private investment in R&D or even plant modernisation. Worse, to protect their advantages in the domestic market, many sub-sectors are clamouring for protection (particularly those of parts and components, and capital goods), which the government is happy to oblige in a piecemeal, supposedly WTO-compatible manner, shielding even more

the most archaic producers from foreign competition and hampering the efforts of those who need better-priced machines or components in order to enhance their own competitiveness. As a matter of fact, confidence in the direction of the central government's management of the economy is at such new lows that the country's investment rate is at little less than 18% of GDP (one of the smallest percentages in the developing world), while consumption (private and public) is at about 81% and savings at 16% of GDP. That is not sustainable for an 'emerging' economy.

Figure 7. Brazil, exports, 1964–2010 (%)



Source: MDIC/Brasil.

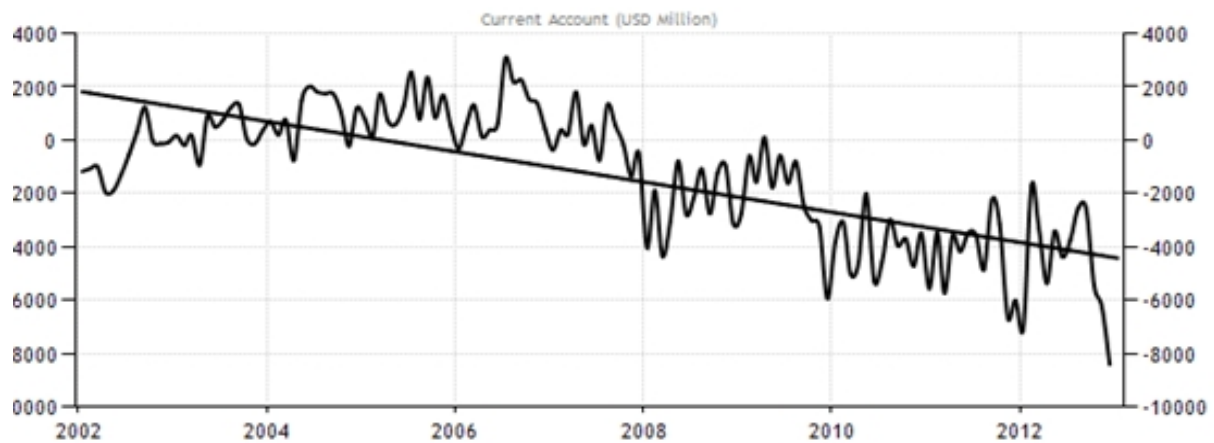
The consequences of trying at all costs to sustain an economic model that is no longer in tune with the global economic realities and constraints are worryingly. The stock of the federal public deficit swelled to R\$2 trillion (US\$1 trillion); meanwhile, inflation at around 6% (much more for the basic popular staples) is dangerously creeping up (Figure 8), threatening to go over the government's benchmark of 4.5%, plus or minus two percentage points; in 2012, investment went down more than 4% and current account deficits are getting bigger and bigger, with a historical low reached in December 2012 (Figure 9). The more disappointing headline news was the GDP growth rate of 1% for 2012 after the modest 2.5% of 2011. No wonder, Brazilians call it a '*Pibinho*' (Figure 10). More ominous still is that confronted with this batch of grim numbers, the finance ministry has appealed to many – legal – forms of budgetary 'creative accounting' to hide the bad news and has not hesitated to trample openly on the dwindling autonomy of central bank decisions in order to control the interest rate and to manipulate the exchange rate. This attitude is undermining the central pillar of Brazil's decade-old economic success: the predictability of macroeconomic policies based on fiscal responsibility, an inflation target, a floating exchange rate and central bank autonomy.

Figure 8. Brazil, consumer price index



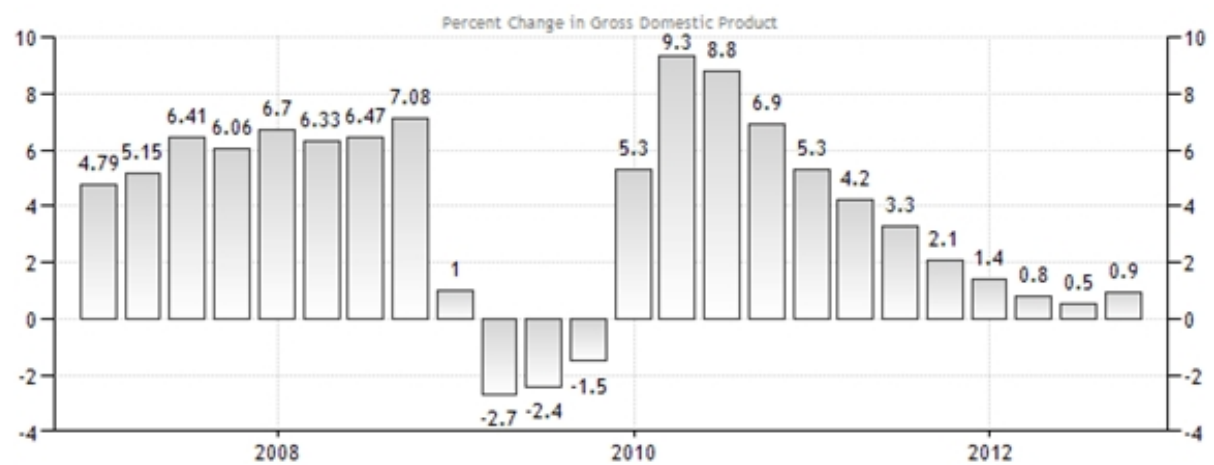
Sources: Trading Economics (<http://www.tradingeconomics.com/>) and IBGE.

Figure 9. Brazil, current account (US\$ million)



Sources: Trading Economics (<http://www.tradingeconomics.com/>) and Banco Central do Brasil.

Figure 10. Brazil, GDP annual growth rate (% change in GDP)



Sources: Trading Economics (<http://www.tradingeconomics.com/>) and IBGE.



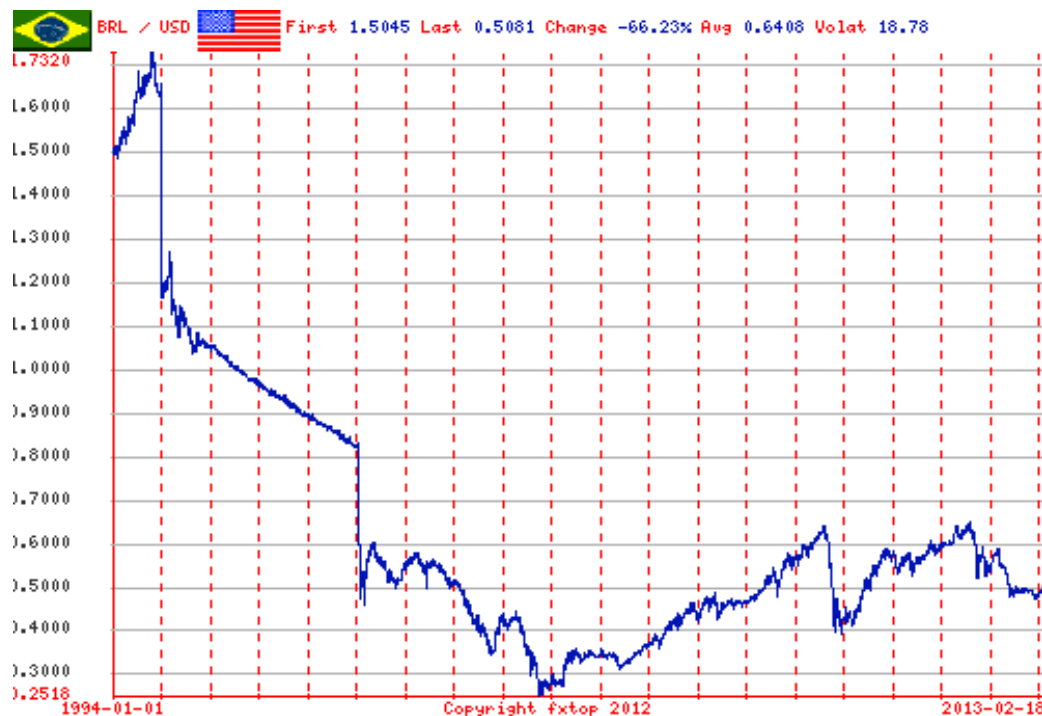
### 3. 'Brazil Cost' x 'currency war'

Brazil is entering a vicious cycle: less investment, less growth, more public-backed credit, more consumer indebtedness (more than 50% of families have debts), more public deficits, more inflation, more government intervention, less trust in the future of the economy and... less investment. In spite of the present full-employment consumer market, private investment was 4.5% weaker in 2012 compared with the previous year (with a worrying 12% fall in output of capital goods), and industrial production has been negative for the last five quarters. President Dilma Rousseff herself has been acknowledging that Brazil's biggest challenge is to re-establish its economic competitiveness by finally tackling head-on the infamous '*Custo Brasil*' [Brazil Cost], the tremendous infrastructure deficit, the horrendous bureaucracy and tax system (which favours a high level of corruption), the lack of any significant private-sector R&D, the lack of qualified workers (the education system is in shambles), the near monopoly that a few big construction and industrial firms have on cheap credit from the Brazilian Development Bank, leaving SMEs trying to manage with loan-shark's rates...

This core problem of the Brazilian economy – and its permanent drag on the country's growth potential – has been discussed thoroughly in the last decade. But what is obvious is not always feasible. First, the federal government cannot keep on digging deeper in its public deficits. Moreover, its ideological bias to prioritise the role of the state in the production process has become a concerning source of inflationary pressures. Second, in order to attract the private sector to the huge investments that are needed, Brasilia has to promote trust and predictability. That means important regulatory changes, a dose of fiscal reform, the reestablishment of the central bank and regulatory agencies' autonomy and credibility, and a much lighter government footprint in the economy. For a PT administration, this is tantamount to an ideological revolution and – maybe more painful – it will threaten, inevitably, many powerful vested interests that prosper by controlling the machinery of the state's apparatus, its juicy public or semi-public enterprises and its private-sector clients and allies.

No wonder that in the last two years, Brasilia has tried to put the entire blame for the economic slowdown on external causes: the global crisis in general and the Brazilian real's (BRL) overvalued exchange rate. Denouncing a global 'currency war' is easier – and sexier – than starting painful domestic adjustments. The exchange rate has become the main battle horse for Brazilian authorities in the G-20 meetings and at the WTO. No doubt that exchange rate manipulations can dangerously threaten the whole fabric of the international trade system and the global economy, and that it is absolutely legitimate to try to find ways to avoid this kind of perilous tinkering in a more permanent fashion. But the fact is that in relation to Brazil's specific competitiveness problems, this issue is at most a sideshow. This is all the more true given that Brazilian governments, including the present one, have a very long history of playing with competitive devaluations (Figure 11). In the last two years, HSBC's "Currency War Ranking" has put Brazil in top positions among the currency warmonger countries: it held second place in 2011 and fourth place in 2012.

Figure 11. BRL/US\$ exchange rate, 1994–2013



Source: fxtop.com, 2012.

#### 4. Brazil as a (little) currency warmer

The fact is that there is no strong correlation between the BRL's exchange rate and Brazil's foreign trade performance. The two Lula governments (2002–10) were characterised by a huge initial depreciation of the BRL (around 76% between April 2002 and October 2002 – from 2.25 to 3.97 BRL/US\$). Then, there was a long period where the currency strengthened steadily (around 54% between its bottom in October 2002 and February 2010 – from 3.97 to 1.86 BRL/US\$). During most of that time, business was booming and nobody was crying loudly against the exchange rate. Brazil had huge trade surpluses and growing currency reserves, and it repaid most of its public external debt. Its domestic consumer market was also booming and naturally attracted big flows of foreign capital, and the central bank, afraid of inflation, kept sky-high interest rates. Hence, currency appreciation was quite an orthodox affair. It was contributing to the country's competitiveness by making the imports of capital and intermediate goods cheaper (these types of imports represented around 70% of total imports during the period) and providing cheap foreign funds for investments.

Surprisingly, until the beginning of the global crisis in July 2008 and in spite of a strong currency appreciation, the percentage of consumption goods in total imports varied modestly around a 13–11% 'band'. This percentage shot up only in 2009–10 (around 17% of total imports), just after the huge depreciation(!) of the BRL (55% between July and December 2008, only partially mitigated by the side effects of the first US quantitative easing decision – QE1). A fall in the imports of capital goods, owing to the consequences of the global crisis, can explain part of this surge.

Dilma Rousseff inherited the 'medium-term' Lula appreciation trend. From her inauguration until July 2011, the BRL gained more 16% against the dollar. But the situation now is not the same. The global crisis has seriously reached the 'emerging economies'. Trade competition has become ferocious to keep one's market share in the huge but dwindling mature

consumer markets and to conquer the relatively small but more dynamic emerging ones. Chinese products are rapidly eating Brazilian quotas in its most important markets for value-added exports – Latin America, the US and even Brazil's domestic market itself (consumption goods imports, of which China has a big chunk, is now at around 17.5% of total imports).

With a still faltering political will to tackle seriously the *Custo Brasil* and no drive to modernise the Brazilian industrial sector (in 2012, imports of capital goods dropped to a 21<sup>st</sup> century low – 43% of total imports), the most convenient scapegoat for the problems of Brazilian industry has been the exchange rate. Finance Minister Guido Mantega had the dubious honour of being the first to bluster against the 'currency war'. But instead of facing up to China (which is Brazil's biggest client, even if it is mainly a commodities buyer – iron ore and soya), Brazilian authorities shifted the blame to the US, accused of manipulating its currency using QE policies. Ideologically, it was easier for a leftist government to take on the US instead of its Chinese South-South 'ally' and BRIC<sup>2</sup> partner. And for some members of the old São Paulo protected and protectionist business community, it was a perfect argument to ask for a hike in import tariffs – most of Rousseff's new tariff increases are focused on a very few sectors with traditionally strong lobbies. Furthermore, the Central Bank of Brazil, under 'friendly' government advice, vigorously slashed its interest rate to try to keep the domestic market booming, and decided to openly manipulate the value of the BRL as a firewall against the supposed 'currency war'. From July 2011 to the end of 2012, the BRL lost 33% of its value *vis-à-vis* the US\$ (Figure 12).

Figure 12. US\$/BRL exchange rate, 2006–12



## 5. Brazilian real not guilty of dwindling trade surpluses

Alas, this huge devaluation did not really help Brazil's manufactured exports, nor its businesses' competitiveness (see appendix II). The exchange rate certainly plays its part but the correlation is not really convincing. During the eight Lula years, with ups and downs, the BRL had an appreciation of 25% (51%! from 2002 to June 2008) in spite of the humongous 55% devaluation during the six months following the Lehman Brothers' collapse. Yet Brazilian trade grew an incredible 227%, and manufactured exports were up 180%, from 2002 to 2008 (the sharp drop in 2009 is directly linked to the global crisis). During Dilma

<sup>2</sup> BRIC refers to Brazil, Russia, India and China.

Rousseff's first year in power and until June 2011, the BRL appreciated 16%, but total exports and manufactured exports grew by 32% and 18%, respectively. In 2011, the Brazilian government orchestrated a huge, rampant devaluation of the currency (33%) but there were no significant changes (only a downward bias) in the trade pattern: more like 27% and 16% respectively for total and manufactured exports. Hence, the so-called 'currency war' does not look like the most credible culprit for the Brazil's economic woes. Brazil's export performances are clearly linked to the variations of international prices (particularly in commodities), to the economic slow-down of its main foreign partners and the incapacity of the government and many businesses to address the competitiveness conundrum.

As regards the famous QEs, the consequences for Brazil are ambiguous to say the least. QE1 (December 2008–August 2009) did coincide with a 27% appreciation of the BRL. But let us not forget that this appreciation followed a huge 55% depreciation of the BRL between the summer of 2008 (the Lehman Brothers' crisis) and December 2008 (from R\$1.56 to R\$2.43 to US\$). If we take the BRL movements from the Lehman Brothers' crisis until the end of QE1, the BRL, in fact, still lost about 11% of its value! During QE2 (November 2010–June 2011), this depreciated BRL gained about 6.5% and reached R\$1.57 per dollar: exactly the same as the pre-Lehman Brothers' level! Numbers are stubborn: the exchange rate spillovers of the first two QEs are 'neutral' regarding the BRL. The third reincarnation of QE, launched in September 2012, has so far not had any impact on the BRL exchange rate, whose present (devaluated) level is clearly and openly defended by the Brazilian Central Bank.

## 6. A window of opportunity for trade agreements

The fact that the Brazilian economy is heading for a wall does not mean it is going to crash. There is still a lot of steering power and impressive airbags. The FIFA World Cup in 2014 and the Rio Olympic Games of 2016 will undoubtedly give a big boost to many sectors (construction, transports, security, communications, tourism...). And one can also be reasonably optimistic about pre-salt oil benefits coming on-stream in the next few years. In addition, the domestic market boom still has a lot of steam owing to the incurable optimism of the Brazilian consumer and the legendary creative flexibility of local businessmen. The budgetary numbers are worsening but the country is not broken and has yet impressive foreign currency reserves. If the global economy gets a little better, the trade in commodities will rise again and Brazil will be lifted by the tide. Moreover, informed public opinion is unanimously clamouring for structural reforms and investments to reduce the 'Brazil Cost' and President Dilma Rousseff herself has publicly embraced the cause of 'competitiveness'. Brazil has a tradition of doing the right thing but only at the very last minute. This minute is arriving fast and that opens a real window of opportunity, not only for fixing the domestic problems but also for reinvigorating Brazil's trade negotiation agenda.

Tackling the *Custo Brasil* seriously is only one part of the competitiveness conundrum. In today's interdependent world economy, Brazilian industries and services will not be able to face the competition without much further integration into the global production chains and markets. The TIVA (trade in value-added) research conducted by the OECD and WTO on the world's trade flows, using value-added criteria and not the conventional total values or volumes, has clearly demonstrated that in this universe of transnational chains of production, protectionism (especially in parts and components, and capital goods) can badly hurt national exporters. And that services account for nearly 40% of the value added to industrial products. A final producer that is constrained to factor into his costs many protected and expensive nationally-produced components and services cannot survive for long the competition of those who have access to less expensive components and services imports from global producers. Let alone the fact that heavily protected industries and

services do not have any incentive to address their inefficiencies and keep losing market share internationally as well as domestically. Brazil already saw that film in the 1970s, and knows that there is no happy end.

The two huge, new initiatives for trade liberalisation, centred on the resuscitating American economy (the TPP and the TTIP), can have an enormous negative impact on Brazil's exports to its most important markets, particularly in Latin America and Europe. An EU-US agreement – say on the norms and tariffs for agricultural products – would certainly displace Brazilian agri-exports to Europe in favour of American producers. Indeed, the TTIP is all about harmonising (or rendering compatible) rules, standards, sanitary and phytosanitary (SPS) measures and the whole battery of non-tariff or technical barriers to trade. A bilateral agreement – still an unpredictable endeavour – between the world's two economic giants would create, *de facto*, a universal regulatory benchmark to which everybody else will have to abide. Brazil cannot afford to be left out of this new era of negotiations on regulations. So much so, that with the Doha Round at a dead end, and only a very small number of paltry trade agreements, Brazil does not have a choice. It has to become much more active on the trade talks front.

Leaving to rest the hoopla about 'South-South' priorities, Brasilia's authorities seem to put a new emphasis on the relationship with North America and the EU. Brazilian diplomacy is exploring the possibilities of a Mercosur-Canada trade negotiation and is clearly trying to upgrade the bilateral 2007 Economic Partnership Dialogue with the US. But reviving the nearly two decades of lagging EU-Mercosur trade negotiations looks like the most important near-term goal. During the last bi-regional meeting, in parallel with the CELAC<sup>3</sup> Summit in Santiago de Chile, in January 2013 Brazil pushed strongly to convince its more reticent 'Mercosurian' partners (especially Argentina) to make a formal commitment to break the stalemate in the talks and exchange concrete negotiating offers with the Europeans by the end of 2013.

## 7. New scenarios for the EU-Mercosur talks

Waiting one more year to start doing serious business does not look like a good start. But it is also true that EU-Mercosur negotiations are stuck in two deep potholes. One is the South American bloc's lack of consensus on this matter, with some members (Argentina and Venezuela) deeply opposed to any free trade agreement with anybody. The other is the European agricultural lobby, hostile to any concessions and powerful enough to hold hostage Brussels' and European national authorities alike.

For Brazil, the dilemma is quite straightforward: How to advance towards an agreement with Europe without jeopardising the strategic relationship with the presently *über*-protectionist Argentinean government? Mercosur is not only a trade integration scheme that is held together by the constraints of a customs union. It is also the political mechanism that seals the nearly three-decades-old cooperative relationship between Brasilia and Buenos Aires, after almost two centuries of strategic competition (including a fledging nuclear arms race in 1970–80). This Southern Cone integration process is the key to a peaceful and stable South American environment, free from the dangerous potential rivalry between the two biggest regional powers. Brazil today will not put at risk this foundation of its neighbourhood stability, neither by pushing Argentina too hard nor by prospecting for a bilateral FTA with Europe, which could lead Mercosur to implode. But it is also true that the

---

<sup>3</sup> CELAC refers to the Community of Latin American and Caribbean States.

economic and power gap between the two countries has been widening steadily, so Brasilia now has more strong arguments to 'persuade' Buenos Aires to come along.

What could be the scenario for squaring this Brazil–Mercosur circle? Presently there are two possible parallel paths that could reinforce one another. The first is to go ahead with a set of bilateral EU–Brazil agreements on 'anything but trade' (more precisely, anything but tariffs): rules, standards, SPS, investment, taxation, regulations, business facilitation, the whole arsenal of technical barriers to trade and non-tariff barriers to trade... With some political will, this can be done without endangering Mercosur, and it would strengthen the Brazilian hand in promoting the second path: the sequencing of the bi-regional talks. Mercosur would be kept as a negotiating umbrella under which each member country could adopt faster or much slower liberalisation commitments and schedules. The EU has already experienced this kind of solution in its negotiations with the Andean Community. In any case, these two complementary courses should be greatly facilitated by a fresh look at the worn-out stumbling blocks of the bi-regional talks. It is time to take into account the new prospects offered by the lessons of the OECD–WTO TIVA research, which stresses the importance of interdependent production networks and services.

To have any chance of success, this double-track negotiating strategy has to crack two hard nuts. Brasilia has to convince Buenos Aires (and eventually Caracas) to follow its lead on that matter without embarking upon a dramatic Mercosur mid-life crisis. For any 'sequenced' negotiations, the initiative has to be taken by the 'Mercosurians' – the EU will never flaunt such idea for fear of being labelled a Mercosur demolition squad. Brazil by itself has been growing a lot of muscle in the region. But will it flex it? The second problem has to do with the EU itself. There will be no possibility of an agreement if Brussels does not put on the table a much better offer on agriculture, particularly on beef and poultry. More access to the EU's agricultural market is practically the sole main advantage that Mercosur member countries could trade for opening their domestic markets to Europe's industrial products and services. Yet that means a lot of political willpower from Brussels and the more free trade-oriented EU members, especially in the present times of deep economic crisis and with a struggling Socialist government in France, which has to deal with the most over-powerful agri-lobby of the whole continent. If these two nuts can be cracked, all the other issues – even if still difficult to negotiate – will be cherries on the cake.

## 8. An emerging power forever?

Whatever the future of this Loch Ness monster of bi-regional negotiation, the Brazilian economy cannot remain stuck in its one-time successful 'Lula model'. Stagflation – slow growth and high inflation – is looming on the horizon. The country has to accept a big jump into the global economic swimming pool, which means a much more open and competitive economy and society. A new growth model entails, necessarily, more access to foreign markets (and the EU is still Brazil's more important customer) and a serious liberalisation of its domestic market. Competitiveness comes at that price and time is growing shorter for deciding to pay it or not. New – and crucial – presidential elections will be held in the autumn of 2014. As of today, President Dilma Rousseff, with her sky-high numbers in the polls, is by far the strongest candidate, but an economy heading towards prolonged stagflation would hardly be the best trump card for her re-election campaign. Of course, this challenge could be good news (inducing the government to force the pace of liberalisation) or bad news (prompting a new demagogic splurge of government money in order to guarantee the election's outcome).

An apocryphal quote, attributed to General Charles de Gaulle, states that “Brazil is the land of the future, and will always be”. Apart from the Gallic arrogance, the present dire prospects for the Brazilian growth model are threatening the country’s status as an ‘emerging power’. Not that it will ‘submerge’ again; Brazil is now too rich and sophisticated for that. But what if it never ‘emerges’ and stays an emerging power forever? Brazilians are haunted by the curse of the *voo de galinha* [the ‘hen’s flight’]: the centuries-old succession of brief periods of strong economic growth followed by phases of stagnation and depression. Let us hope that this time, it will finally be different. Otherwise, we will witness, again, the glorious cock-a-doodle-doo one-yard flight followed by the inevitable hard landing in the middle of the unimpressed hencoop.

## Appendix I. The hopeless dream of taming the forex beast

Exchange rate ups and downs are far from being responsible for Brazil's falling foreign trade performance. True, the BRL has been under pressure. But Brazil is a bit disingenuous when it condemns the American and European growth-boosting or meltdown-avoiding programmes and, concurrently, it lectures Brussels and Washington about the urgent need to adopt pro-growth policies and spend their way out of the recession. For the good health of the Brazilian economy it should be clear that a successful US QE is much better than a US depression. Nevertheless, that does not mean that manipulation of currencies could not become a serious problem for world trade, and could even threaten the whole fabric of the WTO. Since the 1930s Great Depression, we know how currency wars can exact a horrific price on the world economy. Still, the big financial powers have not yet slipped into this kind of 'beggar-thy-neighbour' policy and most of the exchange-rate movements are more or less unintended consequences of national stimulus packages to fight the present global crisis and its deflationary trend. But the problem remains and could get worse. The question is how the international community can square the exchange rate circle.

### The dirty secret of collective currency arrangements

Researchers from the Peterson Institute of International Economics in Washington (Fred Bergsten and Joseph Gagnon), and from the Getúlio Vargas Foundation in São Paulo (Vera Thorstensen) have been floating the idea of a 'world currency' that would be established as an anchor in the WTO and would be materialised in a 'negotiated band' that could be used as a convergence goal. This goal would be attainable by using instruments for constraining trade rules. This author confesses to meeting this new concept with certain scepticism.

Since President Richard Nixon's assassination of the gold exchange standard (GES), many people are nostalgic for a fixed economic unit of account (either related to a fixed anchor or in the form of a fluctuation band). Compulsory monetary 'snakes' and even SDRs have been put forward as possible solutions to the volatility and manipulation of currency markets or even as a tool to discipline markets and governments. The problem is that, like in every multilateral construct, the stability of these various types of 'snakes' is dependent on a guarantor of last resort – somebody down the line has to pick the bill. The post-World War II GES was in fact a gold-dollar standard, with the US currency pegged to a fixed price of gold. The European 'snake' band of the 1970s and the European Monetary System (EMS) in the 1980s were based, de facto, on the Deutsche Mark. Today, the present European crisis is clearly demonstrating that the euro – which was supposed to correct all the drawbacks of the 'snake' and then of the ECU – is also German-dependent (and will remain so as long as there is not a unified European economic policy and monetary authority). Indeed, the 'euro crisis' has taught us that a euro without an economic government is, in reality, a hidden currency basket pegged to Germany's economic performance.

On the other hand, the SDR is also a basket of currencies where the main anchor, by far, is still the US dollar. Like it or not, today's global financial system is anchored on the dollar for the simple reason that it is the American financial markets (closely linked to London's) – with their huge 'depth' and 'liquidity', respect for the rule of law and property rights, the wide convertibility of the currency and the protective umbrella of the downright power of the US (including military power) – that function as guarantors of last resort. Would China and the other 'emerging powers' constitute an alternative setting? As a young London City trader would say: "an emerging market is one you can't emerge from in an emergency".

The main problem with currency basket formulas is that they represent 'virtual' money: you cannot buy things with it. Their existence is just a function of a 'real money' anchor. Today, a WTO 'world currency', even in the form of a consensual, circumscribed fluctuation 'band',



would have to be pegged to a very strong backbone, and for the time being the only one available is still the US dollar. But the idea that the US would agree to exchange special drawing rights (SDRs) or any other type of 'world currency' for a fixed dollar rate is a complete non-starter in Congress and the White House. On the other hand, if this world currency should only be a theoretical, negotiated benchmark without any link to 'real' money, how can we arrive at a consensus on its composition among the 180 or so members of the trade organisation? And how could 'convergence' through trade instruments be defined in a world of rapid and constant economic and technological change with huge disparities in competitiveness? Not to mention the transnational fragmentation of the production chains of value and the fact that more than half of international trade is made up of intra-firm or intra-sector intermediate goods and components, and another big chunk is composed of commodities and raw materials, whose prices are defined by the global markets. Because sophisticated economists do not have the power or the authority to impose such a 'currency', the whole exercise cannot but end up as another sophisticated academic construct.

### WTO 'world currency': A political and social straightjacket

Calculations about the 'real value' of each currency exchange rate are just elaborate mathematical toss-ups if they do not take into account all these new variables, including the political and social ones – but then, their complexity would become intractable. As demonstrated overtly by the OECD-WTO's recent TIVA research – paradoxically an impressive academic breakthrough – nowadays, in a world of global chains of value, imports are intertwined with exports and imports again...an acknowledgment that begs for the elaboration of new and very distinct trade statistics. Competitiveness in one country is closely linked to the play of domestic vested interests, power games, the resistance of powerful rentist sectors, etc. In such a profoundly interdependent economic reality, what does convergence 'through trade' among 'national' societies mean? Is there a social-political universal model towards which we should converge? Is the ultimate goal the elimination (or the containment within a pre-established 'band') of any and every imbalance in so-called 'comparative advantages' (if we still can define the ambit of those advantages in a growing interdependent world)? These matters are not economic but political. A 'negotiated band', if it came to life, would only reflect a particular power balance between unequal participants in a particular economic context.

But even if, by magic, it was possible to put together a binding WTO 'currency' and a negotiated band among all the sovereign states, we would only kick the can farther away: if adjustments to competitiveness imbalances cannot be done by using exchange rates, the solution is dumped inevitably into the lap of domestic fiscal, budgetary and social policies. One just has to look at what is happening to Greece, Italy, Portugal, Spain or Ireland to understand not only the suffering this solution entails, but also the intractable political knot squeezing the neck of any government brave enough to rise to the challenge.

It was exactly this policy straitjacket that led the US to abandon the gold-dollar standard in 1971 and, since then, it has prevented the creation of a new fixed economic unit of account (SDRs were never seriously contemplated to do the job). The only other significant experiment on this matter is the euro, which could unravel in time unless it becomes the 'real' currency of a single, integrated, European economic government and stops being an ersatz part of a currency basket. In 1992, the European Exchange Rate Mechanism was irretrievably damaged by the British and Italian opt-outs from the 'European' Deutsche Mark discipline in order to recover more elbow room for the management of their national competitiveness problems. Today, the euro is endangered by a crisis equivalent to the EMS

in 1992, but because it is a single currency the blows now come from the bond markets and not the forex.

### **The anchor sets the rules**

Summing up, a WTO 'world currency', even in the form of a negotiated 'band', cannot exist without a big political and monetary power serving as a guarantor of last resort. That means two things: 1) this guarantor will only accept playing that role if it can use its position to soften the blows of global imbalances to its own economic constituencies or to export its domestic problems to the other members of the 'currency'; and 2) these other members will have to accept that situation and live with it. By the way, this is already the case today: the effective world currency is the US dollar and this is a US privilege that the others have to swallow. Why would the Americans suddenly accept being put into a new collective monetary straightjacket? The fact is that no other economic power can presently play that anchor role, so a WTO 'snake', 'currency' or 'negotiated band' without the US would just be a theoretical formula from which every government, powerful or not, would escape in case of necessity. Where there is a collective monetary instrument, the 'anchor' sets the rules – and the exceptions to the rules. If this guarantor of last resort will not or can no longer exercise this power or the rule-takers can no longer bear to abide by the rules – or become strong enough to skirt them – the instrument just disintegrates. The paradox is thus: an anti-manipulation, collective 'currency' created to foster stability would probably increase instability and manipulation.

## Appendix II. Numbers on the US\$/R\$ exchange rate and Brazil's exports (weekly averages)

### Lula governments

October 2001	R\$ 2.89 <i>Lula's election</i>	Appreciation of the BRL: +22%
April 2002	R\$ 2.25 <i>Three months of the Lula government</i>	Depreciation of the BRL: -76%
September/October 2002	R\$ 3.97	Appreciation of the BRL: +29%
July 2003	R\$ 2.80	Depreciation of the BRL: -12%
June 2004	R\$ 3.15	Appreciation of the BRL: +50%

### Start of global crisis

July 2008	R\$ 1.56 <i>Lehman Brothers' meltdown</i>	Depreciation of the BRL: -55%
December 2008	R\$ 2.43 <i>Start of US QE1</i>	Appreciation of the BRL: +27%
September 2009	R\$ 1.77 <i>End of US QE1</i>	Depreciation of the BRL: -07%
December 2009	R\$ 1.74 <i>End of Lula's two terms</i>	
<b>Appreciation of the BRL during the Lula period (1.1.2002-31.12.2009): +25.24%</b>		

### Dilma government

January 2010	R\$ 1.73 <i>Dilma takes charge</i>	Depreciation of the BRL: -07%
February 2010	R\$ 1.86 <i>First month of Dilma's government</i>	Appreciation of the BRL: +09%
November 2010	R\$ 1.68 <i>Start of US QE2</i>	Appreciation of the BRL: +06%
June 2011	R\$ 1.57 <i>End of US QE2</i>	Depreciation of the BRL: -16%
October 2011	R\$ 1.83	Appreciation of the BRL: +06%
February 2012	R\$ 1.71	Devaluation of the BRL: -18%
September 2012	R\$ 2.02 <i>Start of US QE3</i>	
<b>Devaluation of the BRL during the Dilma period (1.1.2010-17.10.2012): -17.34%</b>		

## R\$ and exports – Fundamental movements

- First Lula government until the Lehman Brothers' crisis: **+51%** BRL appreciation  
Total exports (2002-08): **+227%**  
Total manufactured exports (2002-08): **+180%**
- From Lehman Brothers until December 2008: **-55%** BRL depreciation  
Total exports (2009): **-22.7%**  
Total manufactured exports (2009): **-27.3%**
- First two months of the Dilma government (Lula legacy): **+16%** BRL appreciation  
Total exports (2010): **+31.9%**  
Total manufactured exports (2010): **+18.1%**
- The great 'Dilma devaluation' (July 2011-June 2012): **-33%** BRL devaluation  
Total exports (2011): **+26.8%**  
Total manufactured exports (2011): **+15.9%**



## ABOUT CEPS

Founded in Brussels in 1983, the Centre for European Policy Studies (CEPS) is widely recognised as the most experienced and authoritative think tank operating in the European Union today. CEPS acts as a leading forum for debate on EU affairs, distinguished by its strong in-house research capacity, complemented by an extensive network of partner institutes throughout the world.

### Goals

- Carry out state-of-the-art policy research leading to innovative solutions to the challenges facing Europe today,
- Maintain the highest standards of academic excellence and unqualified independence
- Act as a forum for discussion among all stakeholders in the European policy process, and
- Provide a regular flow of authoritative publications offering policy analysis and recommendations,

### Assets

- Multidisciplinary, multinational & multicultural research team of knowledgeable analysts,
- Participation in several research networks, comprising other highly reputable research institutes from throughout Europe, to complement and consolidate CEPS' research expertise and to extend its outreach,
- An extensive membership base of some 132 Corporate Members and 118 Institutional Members, which provide expertise and practical experience and act as a sounding board for the feasibility of CEPS policy proposals.

## Programme Structure

### **In-house Research Programmes**

Economic and Social Welfare Policies  
Financial Institutions and Markets  
Energy and Climate Change  
EU Foreign, Security and Neighbourhood Policy  
Justice and Home Affairs  
Politics and Institutions  
Regulatory Affairs  
Agricultural and Rural Policy

### **Independent Research Institutes managed by CEPS**

European Capital Markets Institute (ECMI)  
European Credit Research Institute (ECRI)

### **Research Networks organised by CEPS**

European Climate Platform (ECP)  
European Network for Better Regulation (ENBR)  
European Network of Economic Policy  
Research Institutes (ENEPRI)  
European Policy Institutes Network (EPIN)