World Agriculture & Trade

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Brazil's Financial Crisis & the Potential Aftershocks

The intensifying financial crisis in Brazil, marked by sharp devaluation of its currency in mid-January, has renewed concerns about the consequences for U.S. agriculture. Latin America and Asia together bought about 60 percent of U.S. agricultural exports last fiscal year, and Brazil's currency devaluation is already having repercussions in other countries in Latin America.

The Makings of a Devaluation

In Brazil, the Cardoso government's initiation of the *Real* Plan on March 1, 1994 led to 4 very good years. The plan brought economic stability and was effective in curbing hyperinflation, which had been a chronic problem. Under the plan, the *real* (R$, Brazil's currency) was set against a predetermined goal relative mainly to the U.S. dollar using a "mini-band" mechanism that allowed only small daily changes in the value of the currency.

As the U.S. dollar strengthened in the mid-1990s, however, the *real* began to overvalue relative to the target. The Russian financial crisis in August 1998 heightened fears among investors concerning returns in emerging markets. As capital flight picked up, observers began speculating that the Brazilian government would devalue its currency. From mid-August 1998 to the end of October 1998, the *real* had lost 2 percent of its value against the U.S. dollar through the mini-band mechanism.

The final development leading to sharp devaluation of the *real* came on January 6, 1999, when a provincial governor, a former President of Brazil, announced a 90-day moratorium on debt payments to the central government to protest strict fiscal measures under an agreement with the International Monetary Fund (IMF). The move raised investors' fears, spurring capital flight. Reportedly, about $1 billion left the country in the few days immediately following the debt moratorium.

Recognizing that the *real* was under attack, Brazil's Central Bank decided on de facto devaluation on January 13, 1999 by widening the band in which the *real* could be traded each day while preventing a free fall in the currency. The alternative would have been for the government to defend the *real* and potentially deplete its foreign currency holdings. The Central Bank president then resigned, leaving his successor to implement the devaluation. A new currency band was established with a floor of R$1.20 and ceiling of R$1.32 per U.S. dollar. This implied possible daily currency movements against the U.S. dollar of plus-or-minus 4.76 percent.

The new band lasted for only 2 days, during which another $1 billion in capital

Brazil's Currency Depreciated Sharply in January 1999

Based on daily currency movements.
Source: Pacific Exchange.
Economic Research Service, USDA

reportedly left Brazil. The next step was to allow the *real* to float freely, and by February 3 it had tumbled by 32 percent and was trading at R$1.79 per U.S. dollar. To increase market confidence and stop any panic on stock and bond markets around the world, the decision was taken to completely abandon the mini-band. As part of the package and to discourage investors from withdrawing funds from the country, the Central Bank of Brazil announced that short-term interest rates would increase from 29 to 39 percent. For now, the strategy seems to have stopped the panic, as the pace of dollar flight has declined, although reportedly a total of $7-8 billion had left the country in January. However, risk remains of a spread of the crisis to other countries.

Minimal Short-term Impact On U.S. Ag Trade

In the short run, Brazil's devaluation will have relatively little impact on U.S. agricultural trade with Brazil, though an expected reduction in U.S. agricultural exports and increase in agricultural imports will likely increase the U.S. agricultural trade deficit with Brazil ($684 million in fiscal year 1998). In the longer run, the potential for effects on U.S. agricultural trade is greater, particularly if Brazil is unable to regain financial control and the continuing crisis forces other Latin American countries to devalue currencies or change policies—such as raising import tariffs—to stay competitive.

U.S. exports to Brazil. Brazil is a small market for U.S. agricultural exports—about $0.5 billion in fiscal 1998. The U.S. exports soybeans, consumer-ready food, cotton, and a small amount of wheat and coarse grains to Brazil. A lower value *real* will make these products more expensive to Brazilian buyers, and in the short term, an overall decline in Brazilian demand for consumer-ready food products will pressure U.S. agricultural exports.

U.S. soybean exports will be affected less than consumer-ready food exports. Even before the devaluation, the U.S. was not expected to export soybeans to Brazil this year because of large supplies in Brazil. Most of Brazil's domestic soybeans and soybean meal go to export markets. Thus, to more fully utilize their oilseed crushing capacity, Brazilian crushers import soybeans (500,000 tons in 1998, all from Paraguay; 1.5 million tons in 1997, mostly from the U.S.). When the U.S.-Brazil price differential was favorable, soybean imports were stimulated by Brazil's drawback program, which essentially has allowed duty-free imports if the soybean products are re-exported. Brazilian crushers have been able to finance purchases via international loans with low interest rates, supporting continued soybean imports.

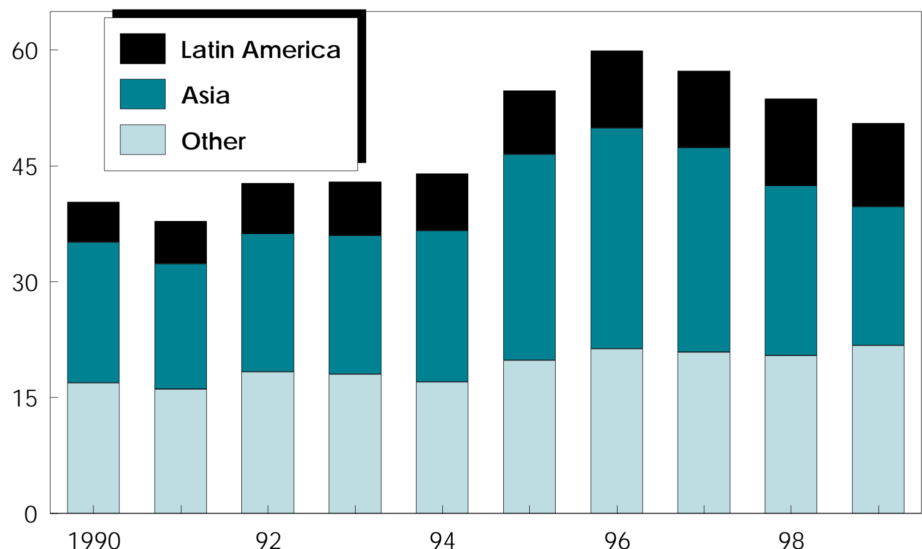
The extent of the fall in Brazilian demand for other agricultural imports will depend on internal policy adjustments taken to dampen the rise in food prices. For example, to soften the effect of higher import prices, the Brazilian millers association proposed elimination of the 13-percent import duty on wheat flour and the 25-percent tax on bulk ocean freight from countries outside MERCOSUR, the regional trading bloc that includes Argentina, Brazil, Paraguay, and Uruguay.

U.S. imports from Brazil. The U.S. bought over $1.1 billion worth of agricultural products from Brazil in fiscal 1998, mostly coffee, tobacco, sugar, prepared meat, and orange juice and other fruit products. The U.S. also imports forest products such as softwood.

The lower value of the *real* will make Brazilian goods more price-competitive in the U.S. market. U.S. consumers will benefit from the lower prices, while producers who compete with Brazilian importers will be hurt. In the short run, increases in the volume of imported food and other agricultural goods from Brazil will be limited by available supply. For example, any near-term increase in Brazil's exports of frozen concentrated orange juice (FCOJ), coffee, and tobacco would have to come at the expense of domestic sales.

While the effects on U.S. agricultural trade are expected to be small in the near-term, Brazil could become a stronger competitor in markets for poultry meat, FCOJ, tobacco, soybeans and other agricultural products if the *real* remains at its lower value over the long term and Brazilian producers respond by increasing production (although the lower *real* will raise the cost of imported inputs). Additionally, policy responses and reforms under the IMF package (e.g., tax code reform, budget deficit reduction) could improve efficiency and potentially lower production costs in the long run.

Latin America Has Been a Growing Market for U.S. Agricultural Exports



1999 forecast.
Economic Research Service, USDA

Other Latin American Countries Under Pressure

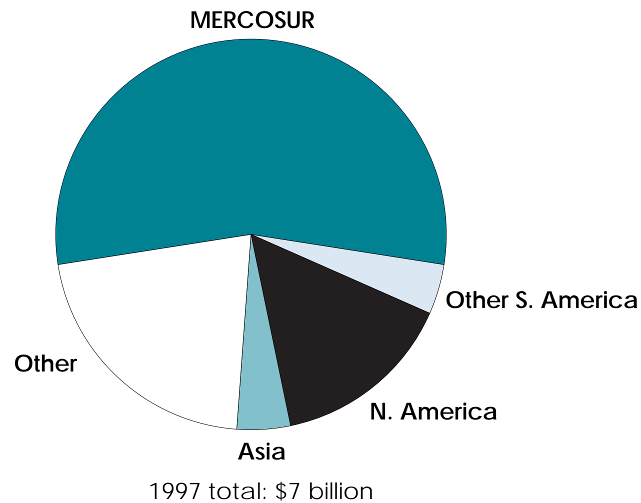
The international financial crisis beginning in Asia in 1997 generated speculative pressures in Latin America and slowed growth rates of many Latin American countries. Brazil's crisis could further affect other Latin American countries through loss of investor confidence and shocks to intra-regional trade. Because of Latin America's dependence on foreign capital to finance current account deficits, the region is vulnerable to sudden withdrawals of foreign capital.

In 1997, Latin America had a current account deficit (the difference between imported and exported goods and services, plus net income and transfers) of $60 billion, with Brazil alone accounting for more than $30 billion, or nearly 4 percent of the country's gross domestic product (GDP). In Chile, the current account deficit reached over 5 percent of GDP, followed by 4.3 percent for Argentina and over 2 percent for Mexico. The deficits have increased since 1997. World financial markets and institutions become concerned when current account deficits approach 5 percent of GDP.

A rise in the current account deficit puts pressure on the value of a country's currency. Most currencies in Latin American countries have lost value against the U.S. dollar since 1997— Chile's *peso* over 13 percent, Colombia's *peso* 22 percent, Ecuador's *sucre* nearly 43 percent, Mexico's *peso* 30 percent, Peru's *sol* 14 percent, and Venezuela's *bolivar* almost 18 percent. Argentina pegged its *peso* to the U.S. dollar, preventing any devaluation.

Lack of confidence among foreign investors led to a massive drain on foreign reserves in 1998 for Brazil—the economy that accounts for 40 percent of Latin America's GDP. At the end of 1998, foreign exchange reserves declined to $40 billion, down from nearly $70 billion at the end of August 1998. To head off outflows of capital, other countries followed Brazil in raising short-term interest rates in 1998—Argentina to 10 percent, Chile to 14 percent, Colombia to 33 percent, Mexico to 31 percent, and Venezuela to more than 44 percent.

Brazil's Ag Imports Come Mainly from South America



Brazil is a member of MERCOSUR, which also includes Argentina, Paraguay, and Uruguay.
Source: United Nations.
Economic Research Service, USDA

The principal risk from tightening monetary policy is a slowdown in economic growth that will further weaken domestic and import demand. As interest rates rise, the cost of capital also increases, reducing use of credit for working capital. High interest rates at this time, however, are important to curb the flight of capital and provide these countries time to deal with immediate problems.

Latin America has a significant level of intra-regional trade, which magnifies the potential for the Brazilian crisis to spread. Nearly 40 percent of Brazil's total imports and 60 percent of agricultural imports came from other South American countries in 1997. In addition, total exports are a significant portion of GDP for these countries, ranging from nearly 9 percent for Argentina to 28 percent for Mexico. However, the U.S. is a much more important trade partner for Mexico than for Brazil.

With relatively higher import prices and lower purchasing power, Brazilian import demand will fall. A decline in Brazil's import demand could have a ripple effect on its regional trading partners in Latin America, particularly Argentina. Because Argentina pegs its *peso* to the U.S. dollar, the lower value of the *real* will make Argentine exports to Brazil more expensive. With about 30 percent of its products exported to Brazil, Argentina could be more vulnerable to a trade-linked spread of the crisis than other countries in the region. Argentina, in particular, could look to other markets for wheat and corn exports, intensifying competition with the U.S. To soften the blow of Brazil's currency devaluation, Argentina has requested that Brazil reduce its low-cost financing measure for consumer goods exports to MERCOSUR members. Recently, Brazil agreed to eliminate the measure. AO

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