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Project Seminar

Subject **The Crisis of Argentina and Brazil**

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Commentator **Joao Carlos Ferraz** Director, Institute of Economics, Federal University of Rio de Janeiro

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Nakagawa opened the symposium by introducing its theme. Today's symposium was the third in the past year to discuss the contemporary financial and economic conditions of Argentina and Brazil. Earlier symposia, however, had treated Argentina and Brazil simply as instances of recent financial crisis, or as holding lessons concerning the relations between crisis and globalization of finance markets. Today, it is probably incorrect to say that Brazil is in crisis. The larger topic we address in considering Brazil and Argentina today, then, is not so much the causes or effects of crisis, but the prospects of finding a steady growth path of countries with a recent history of serious financial crisis (which, of course, covers most countries in the world).

Nakagawa next introduced the day's speakers: Barbara Stallings, Professor of political economy at Brown University's Watson Institute of International Studies and former director of economic development for the United Nations Economic Commission for Latin America and the Caribbean (ECLAC); Joao Ferraz, director of the Instituto de Economia of the Universidade Federal do Sao Paulo; and Professor Kawai of the Institute for Social Science, former World Bank Chief Economist for East Asia and currently Deputy Vice Minister for International Affairs of Japan's Ministry of Finance. Professor Kawai participated as discussant on Professor Stallings's presentation.

Next, Nakagawa provided some background facts concerning recent events in

Latin America. On August 6 of last year, the United States extended a direct loan to Uruguay to avoid serious crisis in that country. On August 9, the IMF decided to support Brazil. On November 13, one day before a loan payment deadline, the IMF and Argentina were negotiating terms of IMF support. On November 22, the IMF agreed to a one-year extension on that loan payment. Thus, Argentina is still in crisis, Brazil has avoided crisis, and Uruguay was saved from crisis by US intervention.

With this, Nakagawa invited Professor Stallings to give her presentation.

Stallings had decided, she said, to keep her presentation at the level of "general overview," giving a background on Latin American crises, and a brief assessment of current conditions in Argentina and Brazil, and leaving Professor Ferraz time to discuss the Brazilian case in greater depth.

In this vein, Stallings began by stressing that in many respects, the 1990s are generally seen as having been "good years" for Latin American economies. After the debt crises of the 1980s, the region seemed to have "turned things around." The Mexican crisis of 1994 and 1995 proved but a minor interruption and its influence was not felt widely throughout the region. Only Argentina seemed to have suffered from it, and Argentina recovered quickly. Throughout the 1990s, GDP growth in the region as a whole averaged four or five percent annually, unemployment was falling, and inflation was heading toward "single digits." While not particularly impressive by Asian standards, these results were striking for Latin America, especially considering the poor performance of the 1980s. In 1997, economic growth hit a peak of around 5.5 per cent, and economic reforms had made many people optimistic about Latin America's continued success. With the Asian crisis breaking out that year, however, GDP growth began to fall and "never really recovered." In 2001, growth was only slightly above zero, and 2002 is expected to show a contraction of about one per cent. Unemployment is expected to hit historic highs of around 9 percent, and investment, consumption, exports, and imports are all down. Things look quite bleak.

This sudden shift from great expectations to bleak pessimism poses the question, "what went wrong?" To answer this question, Stallings argued, we need to look at the interaction of two sets of factors: the international context, and domestic problems, especially a negative interaction effect between economic reversals and political incapacity. The characteristics of political incapacity vary by country --

escalating civil war in Colombia, polarization around Hugo Chavez in Venezuela, inability to form consensus in Mexico in the wake of 70 years of rule by the PRI, and so forth -- but in most countries instability arising in the late 1990s has interacted in a vicious cycle with declining economic growth. Declining economic growth causes social strains to intensify; this makes political stability more difficult to obtain; and the lack of political stability makes social strains and their economic causes more difficult to address.

An additional complication arises from the fact that after 1997 the fiscal conditions of many countries in the region have markedly deteriorated. As a result, states have little room in which to carry out fiscal stimulation to combat economic contraction.

With this, Stallings proceeded to focus on Argentina and Brazil, noting first that while the original title of this symposium had been "The Crisis in Argentina and Brazil," this had wisely been changed, as the problem Brazil currently faces should not be called a crisis. Brazil and Argentina are worth focusing on, she noted, because they are the biggest economies in the region, but also because they reveal the mixed blessings of regional integration. In good times, integration tends to stimulate growth throughout the integrated region; but growth-reducing shocks are also transmitted. Stallings suggested that the problem of capitalizing on integration while avoiding its downward spiraling scenario might be worth making a focus of a future joint research project of the Institute.

Narrowing the focus to Brazil, Stallings said that the speculative attack on the Brazilian real of late 1998 makes a convenient starting point to contemporary Brazilian economic history. In the wake of the Asian crisis, the Russian crisis, and economic turbulence in the US, Brazil's soft peg to the dollar came under speculative attack. After attempting to maintain the exchange rate for a time, the Brazilian authorities gave up and, in January 1999, devalued the real. Fresh memories of the consequences of Mexican devaluation of 1994 -- negative growth of 5 percent in 1995, inflation of 40 percent, and so forth -- led many to expect greater damage from Brazilian devaluation than seems to have occurred. However, Stallings argued, while Brazil did not suffer negative growth, the costs of devaluation have been high and should not be ignored. High interest rates, set to prevent inflation in the wake of devaluation, and an expansion of public sector debt due to attempts to maintain the currency and, later, to the post-devaluation increase in Brazilian-currency terms of dollar-denominated obligations, are a drag on the economy. Nevertheless, devaluation brought some benefits, including increased policy flexibility and increased exports, which allowed for improvement in the balance of payments.

After the low but not negative growth of 1999, growth improved in 2000, she noted. In 2001, however, growth fell, partly because of natural causes leading to increased electricity rates but also partly because of increased nervousness of foreign investors in advance of the presidential elections. This nervousness of foreign investors made even trade credits difficult to obtain, she noted.

Nevertheless, the overall balance sheet of Brazil's current prospects and challenges, she claimed, is fairly positive. Two months after the presidential elections, Brazil has three great advantages. First, a surprising degree of political stability is indicated not only by Lula's having won 56 percent of the vote, but also by the striking willingness of many Serra supporters, evident even before the second round of elections, to support and work with the incoming administration. Secondly, Brazil has a strong domestic sector, in both finance and the real economy. Thanks to the finance reforms and efficiency gains in other sectors realized during the 1990s, Brazilian business is poised to grow now that the election is over. Thirdly, as Professor Nakagawa noted, Brazil clearly has the support of international financial institutions. The IMF put together a large package earlier in the Fall, the G7 countries indicated their support for Brazil, and even the private investors who were speculating against the currency in the pre-election period seem to be calming down.

On the other side of the balance sheet, however, Brazil has four well-known problems. The most important of these is its large internal and external debt. Brazil must somehow continue to make payments and even pay the debt down. A second problem, more important for most Brazilians, is that the country must somehow raise economic growth levels without raising inflation beyond acceptable levels. (How low inflation should be, she noted, is a matter of debate, but all agree that keeping it low enough is an important task of macroeconomic policy, and one of the most valuable legacies of the 1990s.) Finally, as both Lula and Serra made clear, Brazil must somehow reduce the inequality in its wealth distribution. This is not simply a matter of justice, but a necessity for sustainable growth and for social and political stability. Now, lowering interest rates is clearly an important part of combating this inequality, but if the government does lower interest rates another means of controlling inflation will have to be found.

Stallings expressed the hope that Ferraz would comment on how current policy proposals promise to address these challenges. She also noted, however, that all of them will be easier to address if world economic conditions should improve.

With this, Stallings turned to Argentina, "a country in deep trouble and in need of good policy suggestions." It is interesting, she noted, that throughout much of the 1990s Argentina actually was doing much better than Brazil. This marked a change from the general postwar trend of these two economies. Argentina's structural reforms, much deeper than Brazil's, had proved a salutary shock to its largely inefficient and uncompetitive economy. However, Stallings explained, "these reforms were accompanied by an exchange rate policy that had the effect of undermining many of them in a way that became clear only as the 1990s progressed." While the exchange rate policy was useful in combating inflation, the rigid currency board system made it very difficult to take macroeconomic policies to combat deflationary tendencies, increased the currency's dependence on foreign capital, which was becoming quite nervous, and encouraged individuals, corporations, and the government to run up unsustainable amounts of dollar-denominated debt in the belief that the peso simply would not be devalued. This last incentive effect of the currency board system made devaluation even more costly than it would have been, and largely accounts for the delay in finally accepting devaluation.

Argentina devalued three years later than Brazil. During this time, Argentina recorded average annual economic contraction of 3 percent, saw unemployment skyrocket to 18 percent by 2001, and, most significant in political terms, saw a sharp increase in poverty. Argentina does not have a history of poverty comparable to that of other Latin American countries. It is not surprising that rising poverty and unemployment have contributed to political instability, Stallings argued.

As a result of these problems, the peronists lost the election of 2000. The new radical president proving no more able to manage them, he resigned after a bit more than a year, since which time a succession of presidents --"three, four, or five, depending on how you count" -- has been completely unable to form any kind of national consensus on priorities or policy.

In this context, external shocks from the world economy only made the situation worse, Stallings said. At present, economic contraction of between 10 and 15 percent is expected, employment is already over 22 percent, and inflation forecasts of 40 percent (which would equal those of post-devaluation Mexico) are probably overly optimistic, as wholesale price inflation is already considerably higher and wholesale price increases should be transmitted to consumer prices quickly. A striking indication of how bad things are is that imports for 2002 are expected to fall to the level of the 1970s because of recession, unavailability of credit, and other factors.

One of the best-known aspects of this crisis, Stallings noted, is that attempts to deal with it have made it worse. Witness the infamous *corralito*, or impounding of bank deposits, which has been one of the major sources of political instability. This measure was adopted to deal with effects of the unbalanced way in which devaluation was carried out, with deposits and loans devalued at different rates in an attempt to protect debtors.

Stallings also invited Kawai to dispute her claim that Argentina's problems have been intensified by its treatment by the international finance community, far less favorable than that accorded Brazil and Uruguay. Stallings claimed that the IMF has micromanaged Argentine policy to an unusual extent. This may reflect a reasonable desire on the IMF's part that any agreement signed actually be carried out, as several past agreements with Brazil were not and could not have been; but the extreme level of detail of IMF demands, she said, has made negotiations impossible, and provoked crisis every time a loan payment is due.

Stallings summarized her comparison of Argentina and Brazil as follows: Argentina faces more problems with none of Brazil's assets. Argentina has "no political consensus whatsoever." Of the many candidates contesting for the presidency, none commands more than 15 percent voter support. The candidates' policy recommendations are hopelessly at odds. Meanwhile, the economy is "in shambles." The banking system will need to be "recreated", and, given that most contracts it rests on have been broken and the government has no credibility, it is unclear how this can be carried out. The most positive sign in Argentina, she stated, is that "things can't get much worse," and look indeed to be bottoming out, with rates of contraction lowering in recent months.

Argentina's best hope at the moment lies in the international community, she reasoned. If the world economy would grow faster and/or agreement could be reached with the IMF, Argentina might be able to increase exports and begin attracting renewed foreign investment. This does not mean, however, that Argentina does not also need somehow to stimulate domestic demand and provision of credit.

With this, Stallings turned the floor over to Ferraz.

Ferraz thanked Nakagawa for the chance to talk over developments in his country, and emphasized that his remarks should be taken with caution.

Ferraz proposed to take Stallings's analysis as a baseline, and to go further along two lines: the current Brazilian institutional context, and Brazil's economic prospects and challenges, with special attention to the government's recent proposals.

In discussing the "assets" Stallings laid out -- political consensus, private sector strength, and support of the international community --, Ferraz argued, one must understand, first, that what Brazil has gone through in the last decade is better termed institutional change than structural reform because what have changed are the "rules governing economic and political relations." We have to go back to the 1930s, Ferraz claimed, to find the last such process of this significance. Where the 1930s planted the seeds of Brazilian state-led development, such as the Labor Code, the 1990s saw a process of liberalization, deregulation, privatization, and conservative macroeconomic management. High-intensity institutional change, deep and wide, has taken a decade to carry out, and a long period of adaptation to it is to be expected.

The general direction of this change, he explained, is a larger role for the private sector in the allocation of resources, and this will not change under the new government. The new government plausibly claims to have no plans for radical structural revision of the basic trajectory.

The second aspect of the current transformation that has to be understood, Ferraz argued, is that the administration of 2003-2006 will mark the first non-elite Brazilian government in 500 years. "Non-elite" in this context means that in place of a "leader", a bottom-up mass party system is coordinating political will and power. This is unique, Ferraz claimed, not only for Brazil but for Latin America. It is indeed difficult to find a precise parallel anywhere, he claimed; some have suggested an analogy between Lula, the immigrant from the poor rural Northeast to Sao Paulo who organized an industrial union in spite of the military regime, set up a politcal party, and ran unsuccessfully for President three times, and Lech Walesa. But the analogy is imperfect in that as soon as Walesa set his trade union into motion it took power almost immediately, and then failed to hold it.

In any case, the contrast to Argentina is strong. Where Argentina has a plethora of "lone-rider" candidates, the Brazilian election was contested between Serra's PSDB (Partido Social Democratico Brasileiro) and Lula's PT (Partido dos Trabalhadores), two structured parties capable of truly "occupying" the state. What this means, in part, is that you are seeing government within democratic rules, and this grounds a great deal of optimism in spite of the fact that a worker's party has won. Ferraz called the current political climate "impressive", and says that it is marked by an "open desire" for distinctly political negotiation.

The combination of institutional change and democratic process allows for consensus on essential points, such as respect for contracts. Established contracts will not be withdrawn, and sound macroeconomic management needed for defending them will be practiced. This commitment, of course, also reflects a consensus understanding that inflation is not a policy option as it hits the poor hardest, but it is truly extraordinary in the Brazilian context. Even more surprisingly, perhaps, expanding the scope of the private sector is not a contested goal; indeed, Serra was if anything more inclined to instituting an industrial policy than Lula was.

This general consensus on new rules and general respect for democracy have also facilitated an unprecedentedly "well-organized and transparent" transition to the new administration, Ferraz argued. The Cardoso government passed an important law allowing the present government to hire at least 50 technicians from the incoming government temporarily as, in effect, high civil servants, to be thoroughly briefed on the operations of the government, with full access to documentation. The officers of the incoming government, Ferraz stressed, "have a political structure." They are PT officials selected from local and state governments throughout Brazil, experienced in and highly capable of learning the operations of government though also full-fledged members of the party. All of this is strikingly unique, not only for Brazil but for Latin America as a whole.

With this, Ferraz proceeded to speak very briefly about the real economy. In this area, Brazil contrasts with Mexico, Chile, and other Latin American countries. Where Mexico experienced structural change in its production matrix associated with a shift toward maquiladora exports to the US, the primary trends in Brazil have been modernization and change of ownership. While what Brazil produces has not changed greatly, and Brazil still has little in the way of leading industries, "what we make is state of the art." This is a change "at the middle levels" of the economy, he emphasized. An important part of change of ownership has been deepening internationalization, with foreign companies purchasing domestic companies, purchasing other foreign companies, and taking new stakes in domestic companies.

Concerning the macroeconomy, Ferraz stated that "we are always expecting growth" and growth of 1 to 1.5 percent is forecast for 2002. However, a recent concern is that devaluation pressures have created something of an inflationary bubble. As it has been provoked by the exchange rate, this inflation differs from past inflation, which was usually related to macroeconomic mismanagement, especially public finance problems. The current inflation is stranger. Prices are going up in two areas: food, where the devaluation of the real effectively raises the price which products like soy and corn command abroad the domestic price follows; and "administered prices" of sectors such as energy and telecom. The price rise in these sectors is explained as follows: when these sectors were privatized, the new owners raised loans in dollars to buy the assets; the fall of the real makes the debt burden higher, and the burden is shifted to consumers.

The fall of the real has also caused import substitution and stimulated exports. As a result, a surplus of around 11 billion dollars is expected for 2002.

Inflation has also led monetary authorities to keep interest rates high. (It is interesting, Ferraz noted, that this policy, involving rate hikes just weeks before the election, indicates a degree of central bank independence anomalous in the Latin American context and not indicated by the bank's enabling statutes.)

Public finances, Ferraz argued, are sounder than recent speculative attacks lead one to imagine. The "primary surplus" is 3.95% of GDP, higher than target of 3.75 demanded by the IMF. The ratio of debt to GDP is 63%. With a third of the debt in dollars and the remainder indexed to wholesale prices, devaluation-induced inflationary pressures are also putting upward pressure on the debt. In the private sector, debt has fallen sharply; large companies are retiring their debt rapidly.

Ferraz characterized the new government's economic policy as resting on three pillars: cautious macroeconomic management, tax and social security reform essential for cementing the political alliances the government is trying to set up, and the priority Lula declared first, combating hunger. Combating hunger, Ferraz emphasized, should not be seen as a populist policy per se; if the regime can ensure that people have three meals a day, this will do much to ensure consolidation of the political consensus, thus giving the necessary credibility for conservative macroeconomic management and facilitating stable economic growth. The annual cost of this program is a mere two billion dollars; a plastic card would be distributed to every household and used to buy about twenty dollars worth of groceries per month. Negotiations in the coming week should finalize next year's budget.

In short, Ferraz said, the fundamentals seem in place and reasonably solid. The "wild card", however, is access to foreign capital. Even this may be less pressing than in previous years, however. The need for external finance is expected to be only about half as high in 2002 as in 2001. However, if foreign capital does not come in and country risk remains high, pressure on the exchange rate will not be relieved and foreign reserves will be drained. At the current rate of reserve drain as of early November, foreign reserves will have been exhausted by April or May. If this scenario should play out, we will see what we have seen before -- stalemate, continual negotiation about the debt -- but on a different, more intractable pattern; for while in the past the country had to negotiate with banks, debt is now increasingly held by investment funds, and this increases the complexity of the problem. This will of course threaten growth.

So we have plausible optimistic and pessimistic scenarios. At this point, one cannot predict events any more confidently.

Kawai spoke next, as discussant. He began by confirming Stallings's assessment of world opinion of Latin America during the 1990s. Indeed, by what we might call implementation of the "Washington consensus", Kawai recalled, Argentina and Latin America as a whole seemed to have overcome the syndrome of Latin America's "lost decade": low growth, high inflation, and high debt. Latin America was even taken as a model for other developing countries. Kawai stated, however, that even during the 1990s it was easy to see Latin America as "quite vulnerable." Particularly after the Mexican crisis, instability caused by social tensions, including inequality of wealth distribution, were worrying. Further, public finance was always fragile; low tax revenue and consequent dependence on foreign borrowing, low savings rates also causing dependence on foreign capital, and excessive labor market rigidity (especially in the formal sector) were remarkable throughout the period. Trade, too, was always weak; openness, expressed as a ratio of exports plus imports to GDP, remains low in spite of the acknowledged importance of trade as a driver of development. The contrast with Asian countries, such as Malaysia with openness of 140 percent by that measure, is striking. As a result of the lack of openness the trade-investment linkage, which powerfully fueled growth in Asia, was less effective in Latin America.

As we discovered in 1997, Asia, too had serious weaknesses. But the problems mentioned above were not so marked in the Asian case. Inequality, for example, was not so bad in the middle-income countries of Asia. Public finance, while it deteriorated rapidly during and shortly after the crisis, was brought under control except in Indonesia. Savings rates and trade ratios remain higher in Asia than in Latin America. (It would be worth bringing the accession countries of Eastern Europe into the comparison, Kawai suggested.)

The recent Argentine and Brazilian crises, Kawai said, have simply deepened the impression of Latin American fragility he felt throughout the 1990s.

Kawai then turned to answer Stallings's claim of prejudicial international treatment of Argentina. The contrast with Uruguay is misleading, he suggested, because Uruguay was helped to deal with an extraordinary situation caused largely by the impact of the Argentine crisis and, to a smaller extent, the Brazilian turmoil. Uruguay's domestic problems, he claimed, were never so severe as Argentina's. In Brazil, too, he said, the "economic fundamentals" were sounder than in Argentina. Some lingering weakness from the devaluation, and concern generated by the election campaign, had created worries that needed to be addressed, but structural weaknesses were less pronounced than in Argentina's case. Kawai noted in passing here that the IMF tried and failed to get letters from the Brazilian presidential candidates promising to honor the debt after election. It had gotten such letters from South Korean presidential candidates during that nation's crisis.

Argentina has presented a case of much weaker fundamentals, and had displayed great unwillingness to change its exchange rate regime until the very end. Moreover, the Argentine government remains opposed to several basic IMF conditions. The IMF is now asking the Argentine government to agree on three things at least: monetary anchoring (a money supply target), fiscal policy, and banking sector restructuring, with utility pricing included within fiscal policy. But Argentina is so far unwilling, and it is possible that Argentina will have to default on IMF loans. Should it do so, Kawai warned, Argentina will be "charting a dangerous course."

As nobody from the IMF was present to answer charges, Kawai hesitated to point out that both the IMF and Argentina had made a serious mistake in fiscal monitoring under the currency board arrangement. Both monetary and fiscal tightness were needed under the currency board, and the provincial governments were unwilling or unable to practice fiscal discipline. The IMF missed this completely, and the central government was insufficiently alarmed by it.

The IMF may also be faulted, Kawai argued, for missing the regional implications of its single-country policies in Latin America. Insufficient thought was given in advance to effects on neighboring countries of Brazilian devaluation of its currency.

Kawai decided to limit himself to these brief comments in the interest of open discussion. Nakagawa then invited Ferraz and Stallings to comment on Kawai's remarks.

Ferraz commented on three points. First, while he agreed that the IMF should take a regional approach, Ferraz suggested that the failure to do so was not its only unreasonable action with respect to Brazil. Transcripts of IMF-Brazil negotiations indicate, he said, that within a space of two hours the IMF pressed first for a currency board arrangement similar to Argentina's, then for a very free float of the real. This sort of extreme oscillation in policy position is not responsible, he suggested. Secondly, he pointed out that Brazil, like Argentina, had had a problem of provincial government finance, but that years of hard negotiation under the Cardoso administration may have produced a better way of handling the problem of center-province budget relations. Ferraz may have been suggesting here that the IMF is insufficiently aware of the need for time and political process to address this institutional problem. Finally, he argued that Latin America's trade openness is not in fact particularly low. The year 2000 shows the following country figures for trade as a percentage of GDP: US, 11%; UK, 26%; Japan, a mere 1%; Latin America, 25%; Argentina, 22%; Brazil, 21%; Mexico, 16%; China, 50%; Asia in general, 30% (this figure inflated by Hong Kong's highly exceptional 250% trade ratio); Korea, 8%; and Malaysia 65%. The fact remains, Ferraz said, that Brazil could do more, especially on the export side, but an absence of trade is not statistically striking.

Stallings jumped in at this point, noting that as trade ratios tend to fall as a country's economy grows beyond a certain point, Argentina's trade ratio is rather low given its size. She also remarked that, as Kawai had mentioned, the scale of trade itself may be less important than the degree to which a trade-investment linkage is forged, and that on this score Asia has been far more successful than Latin America.

Stallings then challenged Kawai to explain his position that the IMF should have paid greater attention to regional implications in its handling of the Brazilian devaluation. "What," she asked, "would you have had the IMF do? Tell Brazil not to devalue? Warn Argentina that devaluation was coming?" Kawai responded that the IMF should have allowed Argentina to exit from the currency board arrangement. (Ferraz interjected here that the IMF should have *forced* Argentina to do so.) Stallings questioned this answer on the grounds that reports suggest that the IMF had pressed Argentina *not* to devalue. Kawai responded that this is a debatable point, as Argentina was insistent on keeping the currency board. Stallings suggested that this claim is implausible, insofar as Cavalho, the Argentine official stubbornly committed to the currency board, was not finance minister at the time of Brazil's devaluation.

Also, recalling that in the July symposium Kawai had criticised the IMF for imposing excessively detailed conditionalities on Korea, Stallings asked him whether the IMF is not doing the same thing with respect to Argentina. Kawai answered that IMF conditionalities are not comparably excessive in the Argentine case. Even, in Stallings's words, "telling the Argentines how to run their banking system," is understandable given, as Stallings says, that it is currently a shambles.

At this point, a member of the audience asked Ferraz whether his analysis did not overstate the importance of the foreign-capital constraint and understate the importance of political party alignments to the search for sustainable growth-producing economic policy. The Mexican case, he argued, where foreign capital after the crisis was not lacking but political consensus was, seems to make this point. Ferraz granted that the problem of domestic politics merits more analysis than he had devoted to it in his presentation, and offered a brief summary of current political conditions. First of all, the government is already under pressure to renegotiate debt with the states. Secondly, opponents of the new government's minimum wage proposals are already saying that they will not allow their passage. Thirdly, the PT will have to negotiate with public servants, the base of the party, in January. In short, the government will have serious conflict on its hands as early as January and February, and the PT is sharply divided internally.

Now, the new government is hoping to push through its tax and social security proposals in alliance with the Left parties, including the communists. But the more important alliance will be with the PMDB, which was also part of Cardoso's coalition. Serra's PSDB will certainly be in the opposition, but if the government can bring the PMDB into coalition, it will have a majority in both houses of the legislature, and this would make realization of its larger programme more feasible.

Stallings asked Ferraz at this point whether Brazilian politicians had learned from Mexico what *not* to do. Ferraz responded that the more salient lessons probably come from the failures of the Cardoso government, which was hamstrung by divisions within its party coalition. Brazil, in other words, has had its own Mexican experience to learn from.

Finally, a member of the audience asked for Ferraz's thinking on exchange rate policy and the mixed blessings of foreign investment. Given that neither a hard peg nor a free float will work, that setting targets needed to administer a managed float well is not something monetary authorities know how to do, and that the US is pushing for dollarization of Latin American economies, what exchange rate policy would be most sensible? Ferraz responded by asking whether what Brazil needs more than a particular exchange rate policy is an inflation target, which, at present, it has? On the problem of how to handle foreign inflows in such a way as not to encourage poor fiscal policy, as has happened in many countries, Ferraz returned to his initial stress on institutions. The necessary institutions are in process of creation, he said, though this is not to say that they will be created in time. There is a general sense, he claimed, that increased market freedom requires increased regulation, but not the kind of regulation familiar from Brazil's past, such as price controls. In any case, Ferraz stated that he expects little increase in foreign investment for two to three years; the "creative work" is being done, but it is "painful and slow."

（Jonathan Bloch）