A Temporary Respite for Brazil

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The International Monetary Fund has now come forth with a mega-package for Brazil. The $30 billion agreement is roughly 750 per cent of Brazil's quota with the Fund. Added to existing IMF disbursements, this is the largest commitment to a Latin American country ever. As a percent of quota it is surpassed only by Turkey in 2001 and South Korea in 1997. So much for the idea that the IMF under Horst Koehler and the United States Treasury Department under Paul O'Neill would shun big bailouts!

This turn-about raises two questions. First, why the change of heart at the IMF and the U.S. Treasury? And, second, will it work? Will the IMF's $30 billion make the crisis go away?

At an obvious level, the U.S. government and the IMF opted to help Brazil in order to prevent it and the rest of Latin America from going the way of Argentina. In Argentina, economic reform and liberalization have been discredited. The feeling is that there has been no payoff to a decade of hard work at bringing down inflation, privatizing public enterprise, and opening the economy. To the contrary, the result has been only instability and rising inequality. Now populism is back, in the form of no less than presidential candidate Carlos Menem. What policies the future will bring is uncertain. All that is certain is that those policies will not be market friendly. And they will not reverse the precipitous fall in Argentine incomes anytime soon.

Doubts about the desirability of economic liberalization and reform have manifested themselves in violent street demonstrations in Venezuela, Ecuador, Paraguay and Uruguay. They have been voiced in the Brazilian presidential campaign by all three opposition candidates, most notably by the leader in the polls, Luis Inacio Lula de Silva. The fear is that more financial turmoil would further strengthen the hand of populist politicians who see economic liberalization and reform as ill advised. At their worst, populist governments would raise taxes, re-regulate labor markets, and re-nationalize private enterprise. They would close off their economies to international financial transactions and reverse the process of economic opening generally.

Halting this backtracking is the IMF's priority since, according to its model, market liberalization and reform hold the key to stability and growth. This is also the view of the Bush Administration, which takes a back seat to no one when it comes to faith in market fundamentalism.

But, at the moment, the U.S. government's priority is geopolitics, not economics. The United States is fighting a war on terrorism. The Middle East is in turmoil, and it will become even more unsettled when the U.S. launches its war on Iraq around the end of the year. The last thing the United States needs now is turmoil in Latin America, its own back yard. Some will say that the U.S. Treasury supported the IMF rescue because it helps J.P. Morgan-Chase and Citibank to get their money out of Brazil. Perhaps, but it was the State Department, not the Treasury, that drove the U.S. decision. And it was geopolitics, not Wall Street's interests, that determined the outcome.

And after having committed a series of blunders, the Bush Administration needed to signal that it cares about Latin America. Restricting imports of steel and agricultural products hit the region where it hurt. Secretary O'Neill's irresponsible comments about Latin leaders' Swiss bank accounts upset the markets at the worst possible time. Pulling the plug on Argentina in

December, after having provided the country with an additional $8 billion only four months earlier, sent confusing and inconsistent signals about U.S. intentions.

Agreeing to $1.5 billion of IMF money for Uruguay a couple of weeks ago was a modest way for the United States to indicate that it had not forgotten Latin America. But $1.5 billion is a drop in the bucket. And Uruguay is a country of only 3 million people, a fraction of those who live in Rio de Janeiro alone. The Bush Administration had to help Brazil to show that it cared about what was happening in its hemisphere.

And Brazil is not Argentina. Not only is it the world's tenth largest economy, but it is home to many U.S. multinational corporations, such as General Motors. Its debt is twice as large as Argentina's. If any Latin country matters to the U.S. economically, Brazil does.

Moreover, the Brazilian economy is flexible and well managed. It exports a wide variety of products, not just coffee but commuter jets. By the standard of other Latin countries, it has flexible labor markets. It has a flexible exchange rate, which means a flexible monetary policy. It has a government budget surplus. Importantly, back in 1996 it reformed the fiscal relations between the federal governments and the states. Because of those institutional reforms, it does not have Argentina's problem of chronic overspending by state and provincial governors. For all these reasons, Brazil in 2002 is a better gamble for the IMF than was Argentina in 2001. It provides the Fund an opportunity to demonstrate that it helps well-managed economies like Brazil while offering only "tough love" to delinquents like Argentina.

Will the rescue work? The markets certainly appear to think so. Spreads on Brazilian bonds fell by 200 basis points within a day of the package's announcement. The currency rallied strongly. Clearly, market participants have revised downward the probability they attach to a debt default in coming months.

Doubters have focused on the upcoming presidential election. If Lula wins, goes the conventional wisdom, big budget deficits will follow. Servicing the debt will again become problematic. The crisis will return.

In fact, this fear is misplaced. Whomever wins the election, he will follow sound and stable fiscal policies. The structure of the IMF program creates an incentive to do so. Most of the money on offer is backloaded; four fifths of it will only become available in 2003. The IMF will monitor Brazil's progress quarterly and only disburse additional funds if its targets for the budget surplus are met.

More importantly, with or without the IMF, no presidential candidate, including Lula, wants to be seen as responsible for Brazil going the way of Argentina. Reckless tax and spending policies that cause investor confidence to be lost would cause a financial meltdown and a deep depression. Populist rhetoric aside, no Brazilian politician is prepared to risk making this his legacy. Hence, the next government will meet the IMF's fiscal targets irregardless of who wins the election. It is revealing that both Lula and Ciro Gomez, the other leading left-wing candidate, have endorsed the IMF program even while seeking to distance themselves from the policies of the current government.

The real danger is not Brazil's elections but the global economic climate in 2003. To service its debt, not only does the Brazilian government have to run a primary budget surplus of 3.75 per cent of GDP, but the country has to grow by at least 3 per cent. Under other circumstances, this would not be a problem. But the prospects for growth over the next year are clouded by two risks, neither of Brazil's own making. One is the growing likelihood of a doubledip recession in the United States, where corporate scandals and a declining stock market will put a damper on consumption and investment. But, even more ominously, there is the coming U.S. invasion of Iraq. The only question about that war is its timing: December, January or February? The result will not be as quick and clean as in the case of the 1991 Gulf War. Events could quickly spiral out of control. The Saudi oil fields could be put out of commission. Messy military action will not be good for stock markets, investor confidence, or the world economy. A weaker world economy will mean slower Brazilian growth.

Brazil relies on foreign direct investment to finance its current account deficit, and a messy war will not put foreigners in an investing mood. If they flee to quality, Brazilian interest rates will shoot back up. The *real* will start weakening again, making it more expensive for the government to service its dollar-indexed and dollar-linked debt. Nearly 80 per cent of the country's debt is linked to the dollar or to domestic interest rates. The IMF's additional resources will then not be enough for Brazil to keep current on its debt servicing payments. Expanding the budget surplus will not be feasible, either economically or politically, because doing so would only aggravate the recession. The crisis will reemerge, and unless the IMF and the U.S. government are prepared to provide yet another mega-package, which is unlikely, Brazil will be forced to default and restructure its debt.

The result will be an even more painful crisis. Owing an additional $30 billion to the IMF, Brazil will have to dig itself out of an even deeper financial hole. It is at this point that the danger that the government will backtrack on its previous reform policies becomes real and present. And, its latest rescue having failed, the credibility of the IMF will suffer an additional blow.

Should the IMF have recognized that the odds of success are long and refused to help Brazil now? One can argue the point, but my own view is that this is the wrong conclusion. Brazil is too big, too important economically, and too consequential politically for the international community to do nothing. The geopolitical circumstances are too delicate for a policy of benign neglect. To be sure, if the gamble is lost, the fallout will be severe. But sometimes it makes more sense to gamble, despite the risk of losing, than not to gamble at all.

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