Brazil's only hope of avoiding collapse
By Sebastian Edwards
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Brazil is on the brink of collapse. Since the start of the year the currency has lost almost one half of its value, bond prices have plummeted and growth has come to a halt. Unless investors' confidence returns, there will be no alternative but to default on the public debt. This would be tragic, not only for Brazil but also for the rest of South America, which is experiencing severe contagion.

What should the international community do? An increasingly popular view is to do nothing. Do not throw good money after bad, the argument goes. Some have recalled Rudi Dornbusch's celebrated 1998 quip: "When Brazil calls 1-800-BAILOUT, let the phone ring. Don't answer it." This is a great line but a dated one.

In late 1998 Brazil was facing the consequences of an electoral-driven public expenditure binge and had a grossly overvalued currency and a public sector deficit above 8 per cent of gross domestic product. Things are very different today. Since 1999 Brazil has been a model pupil: it has met International Monetary Fund targets, it has a primary public sector surplus above 3.5 per cent of GDP, it has a flexible exchange rate and the central bank runs an inflation targeting policy.

Yet, in spite of this, international portfolio investors have decided to pull out of Brazil. Worse still, international bank credit lines - including trade credit - are not being renewed.

This "sudden stop" is the consequence of several factors, including a generalised deleveraging in international markets, a lower appetite for risk, and political uncertainty regarding the outcome of Brazil's October presidential elections. Investors are worried that if either of the front-runners - Luiz Inacio Lula da Silva or Ciro Gomes - is elected, he will restructure the public debt. Statements by both candidates indicating that they will respect debt contracts have been to no avail. Part of the problem is that the current IMF programme expires on December 13 and no one knows what will happen next day.

What Brazil needs immediately is a new IMF programme that goes well beyond the October elections, possibly into 2004. Last Thursday the IMF intimated its willingness to consider a multi-year programme, as long as all presidential candidates endorsed it. The opposition has not given this plan the support it deserves. In a confusing statement, Mr Lula da Silva said on Friday that the government should not accept policies "imposed" by the IMF. And according to the newspaper O Globo, Ciro Gomes has said he would not fall into the trap of making commitments he cannot honour.

Brazil is trapped in a classical "co-ordination failure" problem. None of the opposition candidates wants to be the first to endorse strongly a new multi-year IMF programme, as he may lose votes to other candidates that denounce it.

An "honest broker" is urgently needed to help solve this impasse. He or she will have to...
convince all presidential hopefuls that strongly supporting the programme - and, equally important, achieving it - is Brazil's only hope of avoiding collapse. No one is better qualified for this job than Chilean president Ricardo Lagos. He has an untarnished left-of-centre reputation and has shown that it is possible to be a modern Latin American socialist, while supporting market-friendly policies.

Mr Lagos should be able to convince Brazil's presidential contenders - all of whom are also left of centre - of the need to achieve a public sector primary balance compatible with debt sustainability. He should consider the merits of an independent central bank - sorely needed in Brazil - and opening the economy further. Mr Lagos may be reluctant to get involved in another country's domestic politics but he has to realise that, with contagion almost certain, the future of all of South America is at risk.

The new multi-year IMF programme should be lean and provide strong macro-economic safeguards, while not overburdening the government with excessive and ancillary conditionality. It should include sufficient new funds to give comfort to the market and should consider resumption of growth as a prime objective.

It is not easy to know how much money is "enough money". But if a realistic multi-year programme with universal support is crafted, the IMF should consider increasing its Brazil exposure by roughly $16bn- $18bn (£10bn-£11bn). This would put Brazil's package at about 800 per cent above quota, slightly higher than aid to South Korea in the late 1990s and about half of what Turkey has received recently.

Brazil is an important country and its collapse would surely take Latin America with it. This is not the time to play politics or to try new approaches to crisis prevention. There is still time to avoid the worst.

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