RIO DE JANEIRO--A collective sigh of relief was heard ‘round the world when, on November 12th, the International Monetary Fund announced a $41 billion assistance package for Brazil. With a replenished war chest and an ambitious macroeconomic adjustment plan, the world’s eighth largest economy appeared to be on the way to solving its perennial fiscal imbalance. Moreover, the reelection of President Fernando Henrique Cardoso one month earlier, by a vast majority, suggested a mandate for reform and a real chance for Brazil to finally join the ranks of stable economies.

Such enthusiasm, however, now appears to have been premature. The government has recently been unable to garner support from congressional deputies in its own coalition. The lower house of congress has been reluctant to pass even modest fiscal measures, and the adjustment package unveiled in October now looks insufficient.

Devaluation rumors have resumed and investors continue demanding high interest rates on Brazilian debt. Once again Brazil seems vulnerable and the market apprehension that has characterized the last 12 months is resurfacing. In the first 11 days of December international reserves declined by $1.4 billion.

Now the stakes are higher. After Brazil’s having received the full support of the IMF, the U.S. Treasury and the G-7 nations, a collapse of its economy--and in particular, a devaluation of the local currency, the *real*--would shake the world market. Confidence would plummet, U.S. banks would be deeply affected, and the rest of Latin America would be likely to suffer an Asian-style debacle.

Brazil still has time for one last effort at implementing corrective measures. A credible package has to be based on a fiscal adjustment with substantial expenditure cuts, realistic tax revenue projections and market-based mechanisms aimed at lengthening the maturity of the internal debt. This has to be done while reassuring the world that the currency will not be devalued. Such a package would allow Brazil to lower interest rates from currently unmanageable levels and, thus, help end the recession. Time, however, is running out. There is no leeway for devising elegant strategies based on “optimal sequencing.”

Brazil’s most serious problem is that the fiscal adjustment program announced in October, which is supposed to generate 28 billion *real* ($23 billion) in 1999, is not credible. On close scrutiny it looks like a collection of rounding errors. Projections of tax revenues are too optimistic; they assume that economic activity will remain stronger than most independent analysts are forecasting.

Only one item on the agenda--the increased tax on financial transactions--is meaty. It is expected to raise 7 billion *real*. But its passage by congress is far from certain. In fact, the government’s political ineptitude to pass even modest legislation has become painfully apparent during the last few weeks. A bill aimed at limiting social security benefits to former bureaucrats was voted down on December 2 by members of the government’s own coalition, and efforts to introduce key legislation in the special session of congress has been opposed by the president of the senate, supposedly an administration supporter, on the grounds that he was not properly informed.

The size, maturity, currency structure and cost of Brazil's foreign debt are another area of concern. At over 300 billion *real*, with an ever-shorter average maturity and at interest costs as high as 35% per year, the debt situation is potentially explosive. Furthermore, according to a recent study by the Department of Economics of Rio de Janeiro's Catholic University, the quality of the public debt has deteriorated significantly. This is the result of two factors: first, the government rescue of three private sector banks since 1995, and second, the national government's generous restructuring of the states' debt in recent years.

Moreover, Brazilian policy makers are in denial about the country's internal debt problem. They claim that the highly patriotic Brazilians will hold on to government-issued securities come what may; and that, by issuing debt indexed to the short-term interest rate--zero duration debt, in technical jargon--the public is instantaneously compensated for changes in market sentiments and, thus, will not flee.

Both premises ignore lessons from recent crises. Patriotism is beside the point. Patriotic domestic residents are as prone to ditch government paper, as not-so-patriotic foreigners when a crisis appears imminent. That was the case in Mexico in December 1994, and in Russia in August of this year, just to mention two prominent crises. Moreover, the indexation of debt is no guarantee that it will be rolled over automatically. In fact, during the period August 28 and September 9 of this year the public was unwilling to buy the amount of indexed debt offered by the Brazilian government. The situation was so difficult that on September 4 the government placed less than 20% of the debt offered.

Most analysts have indeed interpreted the massive losses of international reserves as an indication that, in spite of patriotism and indexation, domestic residents have tried to protect themselves from currency uncertainty. With a public sector deficit in excess of 8% of gross domestic product, a non-credible adjustment package and obscenely high interest rates, Brazil is on the brink of crisis. A broader and more creative approach based on three pillars is needed now. First, new expenditure cuts--deep and massive--should be announced. There is still plenty of pork in the national budget, and expenditures can be slashed through legislation that only requires approval by a majority of deputies in attendance. This is a political hurdle far easier to clear than what is required for constitutional amendments, especially given the poor attendance record in congress. For 1999 expenditure cuts should be increased to 13 billion *real* from the 8 billion *real* currently contemplated.

The second component of the program should be a deepening of the privatization program--including sacred cows such as Brazil's National Development Bank and Petrobras, the government owned oil company.

And finally, a currency board that would dispel once and for all the notion of a *real* devaluation, should be adopted. With approximately $40 billion in international reserves, and a $41 billion contingent credit line, the implementation of this type of system, that has served neighboring Argentina so well, is technically feasible.

With these three measures in place, interest rates will rapidly decline, growth will resume and Brazil will be able to move towards heretofore elusive prosperity.

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