

LOOKING FOR LIGHT AT TUNNELS END**By****Sebastian Edwards*****LOS ANGELES TIMES*****January 21ST, 1999**

The much-awaited Brazilian crisis is finally here. As many analysts had predicted, at 8 percent of gross domestic product, Brazil's run away fiscal deficit turned out to be inconsistent with the country's rigid exchange rate policy. At the end, the hemorrhage of international reserves proved to be too large, and last Friday Brazil was forced to float its currency. Since then the *real* has lost almost one third of its value. Not even a gigantic IMF support package exceeding US\$41 billion could save the currency from fiscal largesse.

Although the Brazilian crisis has lacked the drama of the Mexican, East Asian and Russian currency collapses, it is being closely monitored by policy makers in the industrialized countries. After all, Brazil is the eighth largest economy in the world, and the largest country in Latin America. A Brazilian meltdown would be a major blow to the region's young democracies and market-oriented economies.

Now that the uncertainty on the exchange rate regime is over, Brazil's challenge is to avoid a deepening of the crisis. Although it is too early to pass firm judgement, the signals coming from Brasilia are not very encouraging. The authorities don't seem to have a consistent plan for addressing the emergency, and the mood continues to be dominated by wishful thinking and self-delusion. Neither the political leadership or the

public appear to understand that this is a deep crisis, and that as such it will be painful. Moreover, the stand-off between president Fernando Henrique Cardoso, and a group of governors led by former president Itamar Franco, on the states' debt payments to the federal government continues to generate uncertainty.

A simple analysis of Brazil's external accounts suggests that the worst is yet to come. In fact, even under optimistic assumptions, Brazil's financing requirements for 1999 will be of the order of US\$ 40 billion. In the next 12 months US\$ 8 billion in government bonds, and US\$ 7 billion in corporate bonds will become due. In addition, projections for current account deficit during this period exceed US\$26 billion. But this is not all. To make things worse, according to a recent report by the Bank of International Settlements approximately US\$70 billion of short-term loans by international banks will come due during the next twelve months. If some of these loans are not rolled over – as invariably will be the case --, Brazil's cash needs will increase accordingly.

On the internal front, things don't look much better. Almost one third of domestic debt is linked to the dollar, and has a very short maturity. Moreover, in order to persuade local investors to hold government securities, the authorities have issued increasing amounts of indexed debt, whose cost is bound to increase with inflation.

An orderly adjustment will require avoiding a spiraling devaluation process, and maintaining inflation under control. To achieve these goals decisive action will have to be taken on several fronts. First, the fiscal imbalance has to be tackled rapidly. Now that the devaluation has increased the cost of servicing debt denominated in foreign currency, the adjustment effort will have to be larger than originally envisaged. The recent vote in

the senate to increase the tax on financial transactions is encouraging, but it is not enough. In fact, it will be almost impossible for Brazil to reduce its deficit without implementing a new round of expenditure cuts. Second, interest rates will have to be raised in the short run. In that regard, the Central bank's decision to hike the benchmark rate to 41% on Monday is a move in the right direction. It is important to resist, however, the temptation of a premature reduction in interest rates. As Mexico found out in mid 1995, although politically popular, an early relaxation of interest rate policy will generate a loss in confidence, and send the currency tumbling. Third, it is imperative to move forward with the privatization process. Putting on the block "sacred cows," such as the state oil company *Petrobras* and the development bank *BNDS* would not only help raise urgently needed funds, but would cut a bureaucracy of legendary proportions.

Securing the remaining US\$ 32 billion from the IMF package is also essential to avoid unnecessary hardship. Before disbursing new monies, however, the fund should insist on a coherent plan along the lines discussed above. Otherwise, it risks throwing good money after bad, as it has done so often during the last few years.

The challenge that President Cardoso faces should not be underestimated. Undertaking the policies required to stabilize the economy will be difficult, even politically unpopular. But it has to be done. If, however, he succumbs to populist temptations, imposes capital controls, lowers interest rates prematurely, and unilaterally restructures the debt, Brazil will experience a tremendous retrogression.

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