Brazil crisis exposes global faultlines

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Less than 24 hours after devaluing the *real* by 8 percent Brazilian monetary authorities gave up trying to maintain the currency's new value and initiated what amounted to a floating exchange rate policy.

The result was a massive boom on the Brazilian stockmarket as money poured in to pick up share bargains and a corresponding upsurge on Wall Street.

But the euphoria could be short lived as the currency slide will raise further problems down the track-particularly with debt repayments.

The credit rating agency Standard and Poor's has already warned that devaluation increases risks for the economy and has cast doubt on the government's ability to meet International Monetary Fund targets. While the devaluation has boosted share values, it has increased the risk of debt default, both domestically and on international loans.

As a comment in one British newspaper put it: "The devaluation of the Brazilian *real* is eerily reminiscent of the Russian financial collapse last summer, which set off a panic flight from emerging markets around the world, rocked Wall Street, and led to emergency action by the US Federal Reserve."

The spectre of debt default has already raised itself. The finance secretary of the Minas Gerais, the Brazilian state that last week declared a moratorium on its debts to the federal government, thereby sparking the currency crisis, warned that he could not guarantee the full repayment of a $100 million international bond next month.

While his remarks were immediately contradicted by the state's deputy governor, the threat of debt default and a widening global crisis remains a real one.

The British business magazine, *The Economist,* noted in an editorial: "At this point a single question haunts investors and policymakers alike. Will a Brazilian devaluation precipitate global financial meltdown? Scarcely three months ago, when markets were at their most jittery, that seemed a strong possibility. Whether it remains so depends on two other questions. Will Brazil be able to control this devaluation, to regain investor confidence and to continue with its economic reforms--or will it descend into Asian-style chaos? And will the rest of the world react calmly or in panic?"

One thing is certain. No answers to these questions will be found at the headquarters of the IMF. The Brazilian devaluation represents the collapse of its efforts to contain the deepening crisis of the global financial system. Last November's $41.5 billion package organized by the IMF and the US Treasury was meant to initiate a new era of preventative financial measures. Rather than the IMF stepping in after a currency crisis had developed, it would intervene to prevent such an occurrence.

In fact, the onset of the crisis was virtually guaranteed by the IMF measures. Under the terms of the bailout the Brazilian government was to slash spending and maintain high interest rates in order to prevent a currency devaluation and protect the investments of US and other banks. But with interest rates of around 29 percent and inflation at close to zero this program inevitably resulted in a crisis for state budgets.

Soon after he took office on January 1, the governor of Minas Gerais, Itamar Franco, announced that his state would default on its debts owed to the central government, triggering a plunge on the stockmarket and a rush of capital out of the country. But the stream turned into a torrent of $1 billion per day when the southernmost state of Rio Grande do Sul announced that it would be unable to make payments on its debts of nearly $1 billion to the central government.

The Brazilian crisis has not only cast a shadow over so-called emerging markets, it has raised the danger that the global credit crunch which began to develop last September and October will quickly return. A violent contraction of credit followed the Russian default and the subsequent collapse and rescue of the hedge fund Long Term Capital Management. This provoked three emergency interest rate cuts by the US Federal Reserve. These cuts brought a rebound on Wall Street and new record highs as credit conditions eased. But there are objective limits to the capacity of the Fed to sustain Wall Street and the financial system through the continuous injection of credit.

An analysis of the latest statistics on the flow of funds in the United States carried out by the British firm Smithers & Co points to some of them. It showed that the Wall Street boom is increasingly being sustained by the stockmarket purchases of major US companies which are investing at an annual rate of $222 billion a year, either buying their own shares or carrying out takeovers.

According to this report: "Not only is the expansion of US business being financed entirely with debt, but the equity base on which this debt pyramid is being built is actually shrinking, even though US companies are already heavily in debt. Half the capital they need is now borrowed and if they continue to buy shares, the situation will rapidly get worse. It seems, therefore, that if Wall Street is not to crash, US companies must be increasingly debt-ridden."

Drawing attention to the implications of these statistics, *The Economist* noted that the situation in the US, where investment from firms is now the mainstay of the stockmarket, is "reminiscent of Japan in the late 1980s, just before its bubble burst."

Another factor that could have an immediate impact on the ability of the Fed to avert a crisis through further cuts in interest rates is the growing weakness of the US dollar. The US balance of payments deficit for 1998 was $230 billion, with an even bigger deficit predicted for 1999. The expansion of the deficit raises the possibility that the Fed could be confronted with a major dilemma as it tries to confront the financial crisis. On the one hand the emergence of a credit crunch may necessitate further cuts in interest rates, while on the other, a fall in the value of the dollar would indicate the need for interest rates to rise.

The scope of the potential turbulence can be seen in the violent swings in the dollar-yen rate. This week the dollar fell to below 110 yen, signifying a 35 percent increase in the value of the Japanese currency since last August.

And with the launch of the euro at the beginning of the year a new destabilising factor has entered the situation. So far international investors have been prepared to place their funds in US dollars. But if a differential opens up between the US and Europe, there could well be a shift of funds out of the dollar and into the euro, leading to a further crisis in the US.