The IMF made monumental blunders in Brazil. Why isn't anybody watching the watchdog?

Brazil Fever

First, Do No Harm.

By Jeffrey Sachs

PAULO FRIDMAN/SYGMA

It's sad but true: the economics profession has failed Brazil – and much of the developing world – in the 1990's.

Dozens of "emerging markets" are in chronic or acute financial crisis while economists argue endlessly – and without resolution – about what to do next. Should interest rates be raised or lowered? Exchange rates fixed or floated? Banks kept open or closed? Budget deficits reduced or raised? Even worse, the official world has anointed a single doctor, the International Monetary Fund, whose brand of medicine is decades out of date and whose principle strategy is to blame the patient for dying.

If economics is to be useful to the billions of people in the developing world, it will have to reconstitute its professional norms and work habits. It will have to become more like clinical medicine and less like theology.

Medicine works by linking theoretical insights to practical applications. It created institutions of peer review, case histories, post-mortems, ongoing medical education and the like – institutions to translate science into practice and practical lessons back into better science. We need a new "clinical economics" with similar methods and commitments, so that economies are no longer toyed with as objects of theoretical speculation or blessed by I.M.F. incantations.

First, economists need to learn to take a case history. Every country presents unique circumstances that must be understood before therapy can be adopted. Second, economists must learn the art of differential diagnosis. It's not good enough to have a theory. The real trick in clinical practice – whether medicine or economics – is to choose among a variety of competing theories about the source of particular symptoms. The I.M.F. clearly fails this step, because it believes in a single cause of macroeconomic disease: excessive budget deficits. Third, economists must learn from mistakes of failed policies.

This regimen might have saved Brazil and much of Latin America from the current crisis. Early this year the Brazilian economy went into a tailspin. The I.M.F.'s official projections as of March 1999 put the fall in Brazil's gross domestic product at 4 percent or nearly 6.5 percent in per capita terms.

The United States has not experienced such a large one-year fall in per capita income in two decades. Moreover, Brazil is not alone: the economies of Argentina, Colombia, Ecuador and Venezuela are also likely to suffer sharp contractions this year. And it's not too late (or too academic) to ask what went wrong.

To be sure, there are hints that the economy will prove more resilient than expected. but even if Brazil claws its way out of recession, the folly of the last few years offers some shocking lessons. The crisis was predictable at least back to 1997, and really before that. Yet the malady was seriously misdiagnosed – and therefore mishandled – by the I.M.F. If there were an international court for economic malpractice, the Brazilian people case against the Washington establishment as well as their own Government.

TAKING A CASE HISTORY
Brazil has been in poor health for decades. Between 1900 and 1960, it was one of the fastest growing economies in the world. But in the 1950's and 1960's, the country's good luck ran out.

At the root of the problem was politics. With horrifying income and social inequalities – themselves rooted in centuries of slavery and in vast cultural differences between the nation's tropical and temperate zones – Brazil was unable to master the challenges of democracy, rapid population growth and explosive urbanization. The populist government was overthrown by a military coup in 1964. This was followed by a generation of political unrest and economic instability.

Brazil's generals chose a policy of economic growth at all costs, since this was seen as the ticket to political legitimacy. As a result, the military proved to be as populist-minded as the politicians it had displaced. At each crucial moment of their rule, the generals choose more public spending as a means to sustain the boom.

With a Government unable to say no, public debt mounted and inflation became more entrenched. Indeed, inflation rose from around 20 percent a year at the start of the 1970's to more than 50 percent by the end of the decade.

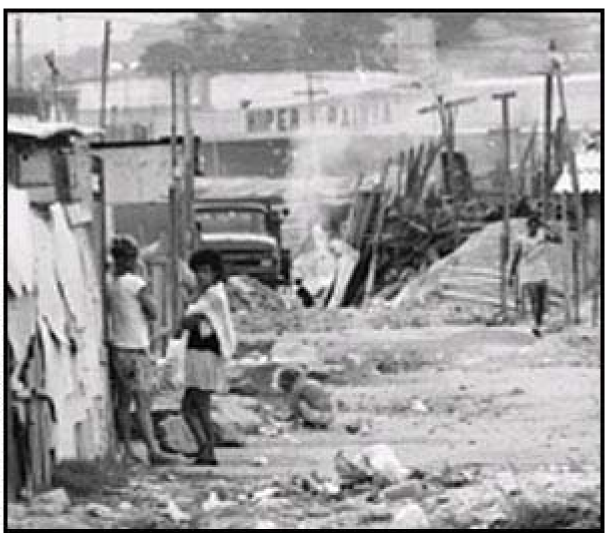
The generals got out while the getting was good, bequeathing an economic debacle to their democratic successors in 1985. The Government was bankrupt, inflation was rampant, and the economy was collapsing under the weight of debt, external and internal. Administrations came and went in the 1980's, trying fitfully to address the problems. Adding to the misery, the first democratic President-elect, Tancredo Neves, died before taking office in 1985. His replacement proved to be incompetent.

In 1990, a bright young President, Fernando Collor de Mello, offered renewed hope. But these hopes were dashed in corruption charges that forced Collor from office in 1992. The political revolving door, combined with crushing debts, led to years of chronic inflation, which finally boiled over into hyperinflation in the early 1990's.

The year 1994 was a moment of truth. The mountain of foreign debt was reduced through a series of debt cancellations, while Brazil's internal debts were pared to tolerable levels by high inflation that reduced the value of outstanding Government bonds. Even the budget deficit succumbed to austerity.

Yet inflation remained rampant. And with an election looming at the end of 1994, it seemed an inauspicious time for a bold attack on the problem. Unexpectedly, Government technocrats under the leadership of Fernando Henrique Cardoso, then the Finance Minister, spotted an opening.

Brazil's high inflation, they knew, had started in the 1970's in the conventional way – as the side effect of Government profligacy. But by 1994 it had become a self-fulfilling process.



JOHN CHIASSON/GAMMA-LIASON

Wages would chase price increases in the previous month, in turn causing the next month of inflation. The money supply grew automatically in line with inflation since bank deposits were indexed to the price level. And the exchange rate (the price of a dollar in terms of Brazilian currency) was also adjusted routinely to keep it in line with domestic prices. Thus, wages, prices, money and the exchange rate all rose in lockstep, driven by momentum alone.

Cardoso's technocrats saw a chance to break this feedback process, to stop the futile race between wages and prices. Beginning in March 1994, they linked wages to a new index, which was effectively tied to the United States dollar rather than to the previous month's price increases. Then in July they introduced a new currency, the Real, which in turn was linked to the new index – and hence to the United States dollar at an exchange rate of roughly one to one.

With both the currency and wages linked to the dollar, a stable exchange rate meant a stable number of Reals in monthly paychecks. A stable wage, in turn, meant stable prices, so inflation melted away as part of the change in the monetary standard.

Brazil didn't need the blood, sweat and tears of fiscal stringency to tame inflation.

The economics team had thus discovered the magic bullet. Since inflation was largely a self-fulfilling process by 1994, Brazil didn't need the blood, sweat and tears of fiscal stringency to tame inflation. The economy merely needed to break the momentum of inflation by shifting to a new monetary standard linked to the dollar.

It was a pain-free stabilization, one richly rewarded at the polls. In an unusual twist the Finance Minister was elected President in a landslide – a fitting tribute for his leadership in a very clever and effective monetary reform.

Ironically, the I.M.F. had missed the boat. It had declined to back the Real Plan, claiming that the end of high inflation must, of necessity, require heavy budget cuts. After all, in the I.M.F.'s worldview, inflation is always the result of large budget deficits. The I.M.F. couldn't imagine a self-sustaining inflation, so it couldn't imagine how inflation could be stabilized without budget austerity.

By casual analysis, the I.M.F.'s pessimism about the Real Plan seemed on the mark. The budget deficit, on paper, was a whopping 52 percent of G.D.P. in 1993. But this was attributable solely to high interest rates on Government debt, needed to compensate bondholders for inflation. Once the inflation component of the interest rates was stripped out, the budget was actually in surplus. Thus, when inflation was broken in 1994, the massive budget deficit vanished. The deficit had been caused by inflation – inflation had not been caused by the deficit.

After the elections, however, the I.M.F. quickly rushed to Cardoso's side. Indeed, this affection for success later helped lead to their mutual undoing.

Cardoso's booming popularity also provided the opportunity for a thoroughgoing reform and democratization of Brazil's complex state apparatus. Problems abounded: corruption, pork-barrel politics, unconscionable inefficiencies in state enterprises. The early Cardoso administration fought and even won some valiant battles, opening Brazil's infrastructure – telecommunications, power, ports – to market forces for the first time in decades.

But the war on inefficiency was compromised by the President's need to campaign for re-election, a campaign that required a constitutional amendment and therefore votes from Brazil's patronage-hungry Congress. In the years after stabilization, the combined federal, state and local budget deficits widened to around 4 percent of G.D.P. – not a disaster, but certainly a discomfort and a warning that instability was on the horizon.

The first two years of the Cardozo administration went magnificently, with low inflation and high growth led by a consumption binge on the part of lower- and middle-class households. Public spending added froth. But problems crept into view by 1996.

The biggest problem was the exchange rate. While the Real kept its value with respect to the United States dollar, domestic wages and prices in Brazil nearly doubled between March 1994 and December 1995. The consumer boom fueled sharp increases in the prices of land and domestic services, while the price of goods subject to international competition remained fairly stable. World markets set the dollar prices of such goods, and the dollar prices translated into Real prices at a nearly stable exchange rate.

As a result, the cost of internationally traded goods declined relative to non-tradable goods, a condition that economists call a "real" (not to be confused with Real) appreciation of the currency. In 1995, the I.M.F.'s own technical staff put the real appreciation at around 35 percent.

Exporters were squeezed between rising domestic costs and stable prices for their output. This didn't worry Brazilians very much in the early years. After all, why be concerned about selling abroad when there is a consumption blitz at home? But the portents were serious.

Brazil is a chronically inward-looking country, one never successful for long on world markets. As of 1998, Brazil had perhaps the lowest ratio of exports to domestic output of any major country in the world – just 6 percent, a shade above the ratios in Haiti and Rwanda.

Yet export growth plays a critical role in Brazil, generating the foreign exchange needed to buy modern capital and technology from the rest of the world. Thus, the currency appreciation posed a direct threat to long-term growth. And it would soon pose an acute short-term threat to stability.

> **T**he IMF's own policy of high interest rates was, ironically, directly responsible for much of the rise of the budget deficit.

The Brazilian technocrats were not oblivious to the problems of currency overvaluation. By 1996, they were depreciating the currency with respect to the dollar at a rate of around 7 percent a year. Since Brazil's inflation was still a bit above the United States rate, part of the 7 percent merely compensated for the continuing difference in inflation. A bit more compensated for the huge currency appreciation that had occurred at the start of the Real Plan. Still, the pace of currency adjustment was tiny compared with the overhang from this initial appreciation.

The torrid economic growth of 1994 (6 percent) slowed in 1995 (4 percent) and declined still further in 1996 and 1997 (3 percent). The consumption boom ebbed, but exports were not sufficiently competitive on world markets to pick up the slack. By mid-1997 Brazil seemed to be falling into a slow-growth trap, with an overvalued currency, an excessive budget deficit and waning domestic consumption. Nonetheless, the public seemed happy. Inflation was low for the first time in a generation, and the economy was moving forward.

The turning point came in the fall of 1997. Asia had succumbed to crisis in mid-1997, when foreign investors began a stampede out of Southeast Asia. Asian currencies, like the Brazilian Real, had become overvalued. Like Brazil, export performance had been weak. Like Brazil, foreign lenders had been making up the difference between imports and exports. Suddenly, with the devaluation of the Thai baht in mid-1997, they got spooked.

The rush from Asia caused investors to reassess their positions in all parts of the developing world – from Korea to Russia to Brazil. By the fall of 1997, all of these currencies were under attack. There was, of course, only one doctor on call for these sick economies, and that was the I.M.F.

HOW THE I.M.F. FAILED ITS PATIENTS

An economy comes to your clinic. It looks anemic. You take the pulse; growth is slowing sharply. It spikes a fever, as foreign investors flee the financial markets. What is your diagnosis? What do you prescribe?

In the not-so-distant 18th century, medical doctors had a sure response: bleed the patient. Reputable authority was quite sure of the treatment. Yet the scientific basis for the judgment was, of course, absent, and we shake our heads in amazement today at the utter uselessness of the remedy.

But in the late 20th century, the I.M.F. doesn't perform much better. It, too, has a cure-all: cut the budget deficit (or if the budget is already in surplus, raise the surplus). So one-dimensional is the I.M.F.'s outlook that even the United States Deputy Treasury Secretary, Lawrence Summers, a major defender of the institution, jokes that I.M.F. stands for "It's Mainly Fiscal,"

In the fall of 1997, the I.M.F. had similar advice for countries stretching from Thailand to Indonesia to Korea to Russia to Brazil: cut the budget and raise interest rates, with the latter step intended to encourage foreign investors to hold on to the domestic currency.

In the first four of these countries, the I.M.F. actually lent money to encourage these actions. In the case of Brazil, the fund was merely a cheerleader, with the serious money to come only in November 1998 – after Brazil had used up most of its own foreign exchange reserves.

In both Russia and Brazil the I.M.F. urged a defense of their exchange rates at all costs, encouraging them to raise interest rates sufficiently to avoid weakening the currency. One year later, the I.M.F. recanted its early advice to cut the budgets in Thailand, Indonesia and Korea. And well it might have: G.D.P. plunged by 5 to 15 percent in these economies in 1998, in stark contrast to the I.M.F's. forecast of 2 to 3 percent growth.

The I.M.F. has not yet commented on its early advice to Russia and Brazil in the fall of 1997. But others have not been as shy. The I.M.F. simply assumed that the Brazilian budget deficit was the main source of market anxiety. Indeed, in a world in which investment bankers mindlessly parrot the words of the I.M.F., the insistence on budget cutting became part of the financial market litany.

Just as the I.M.F. had assumed that large budget deficits were behind Brazil's high inflation in 1994 (and was then proved wrong by the Real Plan), the fund assumed that large budget deficits were behind the market panics in Asia, Russia and Latin America. But something else was at work. In all of these countries (with the possible exception of Russia), two other phenomena were much more important than budget deficits.

The first was currency overvaluation. In each of these countries, exporters were getting squeezed and the markets knew it. They anticipated that policymakers would eventually allow – or be forced to allow – the exchange rate to weaken in order to restore export competitiveness.

The second was the heavy burden created by short-term borrowing abroad. Foreign banks had lent large sums to each of these countries, usually with loan maturities of one to three months. If the banks yanked their loans in anticipation of devaluation, default was likely. The countries simply lacked the foreign currency to repay their short-term debts. That fact alone made the bankers skittish and more likely to panic in a way that made default a self-fulfilling prophecy.

When the diagnosis is one thing (budget deficits) but the underlying disease is another (currency overvaluation plus excessive short-term debt), the treatment is likely not only to fail, but to fail spectacularly. In Brazil, the costs of faulty medicine are manifest today.

In October 1997, Brazil first faced the intense speculation emanating from the Asian panic. It raised interest rates to more than 50 percent and announced plans to slash the budget deficit from around 4.5 percent of G.D.P. to 2.5 percent. Growth was forecast for 3 percent in 1998. But how that was to be achieved in the teeth of astronomical interest rates, sharp budget cuts and an unchanged exchange rate policy was never explained.

Brazilian growth evaporated in 1998; in fact, output fell by 1.5 percent in per capita terms. The budget deficit went up to 8 percent of G.D.P. – not down, as had been programmed – and for laughably predictable reasons. High interest rates designed to defend the exchange rate fed directly into the costs of servicing the Government debt. And since Government debt in Brazil is very short term (who would trust the Government for longer?), a change in interest rates becomes embedded in nearly the entire debt within months. By 1998, interest payments on the internal debt approached 10 percent of G.D.P. And unlike the case in 1994, these interest payments were not merely a reflection of inflation, but were "real."

The I.M.F.'s own policy recommendation of high interest rates was thus, ironically, responsible for much of the rise of the budget deficit. In 1998 Brazil was chasing its own tail – and all with enthusiastic support from Washington.

Austerity in 1997 pushed Brazil into recession. In 1998, it pushed Brazil over the cliff. When Russia defaulted on its debts on Aug. 17, 1998 (its I.M.F. program collapsing within four weeks of signing), Brazil was hit again with a new wave of speculation.

Again the I.M.F. pointed to the budget deficit as the culprit and again urged Brazil to defend its exchange rate through a policy of high interest rates. As of August 1998, Brazil's central bank still had about $70 billion of foreign exchange reserves. But after several months of speculative attack, in which foreign investors cashed in their credit lines and Brazilian investors moved their money to offshore accounts, the central bank had lost approximately $45 billion of reserves.

In mid-January the Brazilian Government threw in the towel, abandoning the defense of the currency and allowing it to float. As of mid-March 1999, the Real had lost approximately 36 percent of its value vis-à-vis the dollar.

The low level of reserves ($25 billion) has left Brazil in a fragile position. Investors might still panic this year, especially in the face of the huge gap between short-term debts (perhaps $50 billion to $60 billion foreign short-term debts and as much as $250 billion worth of internal short-term debts) and meager liquid assets. Even if investors do not cut and run, they will certainly demand interest-rate premiums for holding Brazilian securities. And that will lead to a deeper recession than would have been likely a few months ago, when reserves were still around $70 billion.

Washington argued for currency stability to the bitter end, even throwing Brazil a $41 billion lifeline in November 1998. The terms of the agreement were pure I.M.F. boilerplate: use I.M.F. money to defend the currency; raise interest rates further; commit to huge fiscal cuts. This program lasted just eight weeks before it collapsed. Like the Russian plan the previous summer, it did nothing to restore market confidence, to ease the hemorrhaging of reserves or to bolster the internal political equilibrium in favor of the chosen economic policies.

When the Real collapsed in January 1999, the Brazilian team rushed back to Washington for "further instructions" from the I.M.F. They got the same package – high interest rates and budget cuts – but without a fixed exchange rate. This time, however, even the I.M.F. acknowledged that the Brazilian economy was in collapse. Its dreary November forecast (growth of minus 1 percent in 1999) had further darkened to a projected minus 4 percent as of March. In recent weeks, the Real has stabilized and Brazil is tiptoeing back into the global financial markets. But the economy is hardly out of the woods, and the damage caused by the futile effort to hold the line on the exchange rate will endure.

DIAGNOSING THE DIAGNOSIS

What should have been done?

The principle error was to defend the exchange rate at all costs, living with high interest rates for one and a half years and running down foreign exchange reserves to dangerous levels.

John F. Kennedy once observed that "success has a hundred fathers, while failure is an orphan." But even if nobody will accept the blame, the reasons for policy debacles are usually manifold. Before more patients are needlessly lost in the I.M.F.'s emergency room, it's worth trying to disentangle how the blunders were made.

One culprit, of course, was the Brazilian Government. As in many other countries, the economics team fell in love with the pegged exchange rate. After all, the prize for stabilizing the currency had been the presidency of Brazil. How could it be easily forsaken?

History had shown that exchange-rate-based stabilization often leads to severe real appreciation of the currency. Hence, the initial pegged rate should be followed by either a devaluation or a flexible system (as was done, for example, in Israel in the 1980's and Poland in the early 1990's). For once inflation has been wrung out of the system, a modest devaluation under non-crisis conditions will not re-ignite inflation. Brazil willfully ignored this simple lesson.

Second, Brazil's love affair with the pegged rate became embroiled in politics. Even after the Real was under attack, the Government refused to budge. Part of the reason, no doubt, was technocratic analysis: the pegged exchange rate, some argued, was best for Brazil. Another large part, however, was presidential politics.

With Cardoso's re-election looming in November 1998 and with the stability of the currency his most noted achievement, even a modest devaluation looked too chancy. As in Mexico in 1994, the painful choice of currency adjustment was put off until after elections. And as in Mexico, the collapse came in the immediate wake of the returns.

Third, Washington fell in love with Cardoso's administration and was intent on keeping him in power. Without doubt, America gave Brazil remarkable latitude to follow a course of self-destruction. United States officials plead now that it was Brazil's choice, not theirs. But it was Washington's decision to create a package of $41 billion in emergency aid, and this allowed Brazil to dig its own financial grave. The I.M.F. developed a similar crush on the Cardoso administration, with the close relationship between the deputy managing director, Stanley Fischer, and President Cardoso seemingly contributing to a loss of judgment at the fund.

One intriguing hint that personalities overruled substance can be found in the technical papers of the I.M.F. In April 1998, the organization issued a document titled "Brazil: Recent Economic Developments" (www.imf.org). It reaches the conclusion that the real appreciation of the Real cannot be ascribed to improvements in underlying productivity. In other words, the technicians argued that the currency was unambiguously overvalued, even as the I.M.F. senior management continued to back the exchange rate peg.

A fourth factor was Wall Street. With tens of billions already invested in Brazilian assets, Wall Street was ardently in favor of a bailout – and ardently against devaluation. Self-interest is, of course, a sound motivation. What's remarkable here is the extent to which Wall Street has called the shots for the Clinton Administration regarding the emerging markets. This is an Administration that has asked virtually nothing of the commercial banks while it has contributed around $160 billion to international bailouts.

Last are the failings of economics itself. The profession's lack of clarity with regard to emerging markets policy gives scope for brazen Brazilian politics, I.M.F. incompetence and U.S. Government myopia. Academic economists pontificate about which exchange rate system to adopt, but precious few get their hands dirty in the field.

Meanwhile, no one is there to fill the intellectual gap. Business economists are driven by the interests of their companies, not the search for truth. Investment bankers privately whispered that Brazil was foolhardy to defend the currency, while proclaiming the importance of doing just that.

WHERE TO NOW?

Brazil is in a mess this year. The human costs are enormous, though they will hardly be felt or even commented upon in the United States as long as the Dow Jones industrial average continues its miraculous ascent. The one reliable prediction is that the I.M.F. will remain in charge of the outside world's policy toward Brazil. No matter how many blunders that institution makes, it remains the lone doctor on call, thanks to the unswerving support of the U. S. Treasury. The I.M.F. will urge Brazil to keep interest rates high and to cut spending sharply. In short, it will contribute to the economic contraction.

There is no easy way out. At best, Brazil will remain on the edge of a precipice with very modest foreign reserves to keep it from going over. If international and domestic investors panic, the downturn could be closer to 10 percent of G.D.P. If investors regain confidence, the downturn might be a "mere" 2 to 3 percent of G.D.P.

To encourage the better of these bad possible outcomes, Brazil should lower interest rates, an idea the Government has taken to heart in recent weeks. It should negotiate directly with banks to keep their credit lines in place (something that seems to be happening). And it should take administrative steps to make lemonade out of some very sour lemons, using the failed currency to trigger an export boom.

No matter how many blunders the institution makes, the IMF remains the lone doctor on call.

Seen in this context, recent United States anti-dumping actions against Brazilian steel and other products are shameless and cynical manipulations of the U. S. market – steps that close off one hope for moderating Brazil's looming recession. But then again, there are few limits to the Clinton Administration's craven behavior in the face of protectionist impulses within the Democratic Party – and almost no understanding in America of how its callous actions abroad diminish the country's moral authority in the world.

We don't need a new international institution, much less a stronger I.M.F., as some have advocated. Flexible exchange rates and limits on international flows of short-term debt would have moderated or eliminated the crises that have cascaded through Latin America, Asia and Russia since 1994. But to Washington, such simple prescriptions might not be exciting enough.

JEFFREY SACHS is the director of Harvard's Institute for International Development.