

By JEFFREY SACHS and STEVEN RADELET

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The financial crisis that swept through Asia and Russia has turned its gale-force winds on Brazil. Reports from Washington indicate that an emergency bailout of \$30 billion or more is being cobbled together to help fend off the storm. Unfortunately, the policies that will likely form the core of the package -- shoring up Brazil's overvalued currency through International Monetary Fund loans, tight credit and budget cuts -- could condemn Brazil to follow Asia and Russia into deep recession.

A different approach is needed, one that allows the currency to find a more realistic market value and that takes steps to prevent either a panicked flight by Brazil's creditors or a bailout.

Getting things right is important. Brazil is the world's ninth largest economy. It accounts for about half of the output of Latin America, a region which purchases some one-fifth of American exports. In March, American banks had a reported \$27 billion in loans to Brazil, four times their exposure in Russia. A disaster in Brazil would surely rattle the world economy and further tarnish the credibility of the United States and the I.M.F.

Many commentators have argued that Brazil's economy is fundamentally sound and just needs a fire wall against the Asian crisis. The reality is that Brazil faces serious problems.

The public sector deficit is huge, approaching 8 percent of Brazil's gross domestic product. The Government owes approximately \$250 billion in domestic

debt, much of it due in the short term. Brazilian borrowers, including the Government, owe about \$75 billion to foreign banks. About \$50 billion is due within a year, according to the latest data, and short-term debt owed to other creditors would add substantially to the total. But the central bank has only about \$45 billion in foreign reserves to pay all of the short-term debt in the event that investors flee from Brazil.

In addition, Brazil's currency, the real, is overvalued by at least 25 percent, and perhaps much more. This means that wages and prices, when translated into dollars, are too high for Brazil to compete effectively and to achieve sustained growth. The recent weakening of the dollar helps Brazil, since the real is also made cheaper relative to the European and Japanese currencies. But the currency still remains seriously overvalued.

Anticipating a devaluation, creditors are fleeing. The Government, in desperation, recently raised interest rates to about 50 percent a year, to try to stanch the outflow, but so far to no avail. As in Russia, the high interest rates are taken as a warning of serious trouble rather than as an inducement to keep money in Brazil. The hemorrhaging continues: Brazil has lost more than \$20 billion of reserves in less than eight weeks.

How best to deal with these interconnected problems? Everyone agrees the Government deficit has to be reduced. Sharp budget cuts, however, would tend to push the economy toward recession, and care must be taken that other policies do not add to the contraction.

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The key is the currency. The plan being considered would keep the currency at today's levels, supported by I.M.F. funds and tight monetary policies. Although this strategy could conceivably be successful in maintaining a stable currency, the economy would crumble under the weight of crushing interest rates and huge spending cuts. Foreign investors would take their money and run, enjoying a bailout at the public's expense.

A package of assistance to Brazil should aim to fix its interrelated problems, not to perform a high-wire act of trying to save an overvalued currency with sky-high interest rates. A far better approach would be to allow the real to weaken, according to market forces, and to bring interest rates down to sustainable levels. The big concern then would be to untie the currency from the dollar without generating a panicked retreat of creditors.

The trick to avoiding a panic would be to insure that Brazil and its creditor banks agree on an orderly rollover of short-term debt into longer-term notes: not a default but a collective resolve to meet the interests of creditors and debtors. A committee of large-bank creditors should be set up immediately and proceed to negotiate directly with the Brazilians. Without such a collective step, individual creditors will rationally cut and run, even though the rush to be repaid will leave many with nothing at all.

The banks have agreed to such rollovers in the past (though they prefer to be bailed out!). With an orderly rollover of debts in place, a far smaller package of official loans -- from the I.M.F., World Bank and other sources -- would usefully provide further insurance against a panic, without bailing out the private investors.

This kind of private-sector rollover is effectively what happened in Korea at the end of 1997. The panic ended, and the currency stopped its precipitous

collapse. Surprisingly, the I.M.F. has not encouraged this approach in other countries in crisis.

Let's be done with the failed approaches of the past year. Let's hope the leaders in Brazil, the international banks, the I.M.F. and the United States can take the steps necessary to ease Brazil's crisis in an orderly and fair way.

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