

Contagion Effect Taking Hold in Latin America

By David Felix

Washington and the IMF badly underestimated the regional contagion from the Argentine disaster. It is now spreading along both financial and political channels, threatening more defaults and challenges to U.S. regional hegemony. Financial markets view Uruguay and Brazil as headed for default. Uruguay's foreign reserves have fallen this year by more than half. Despite a hurried \$3 billion IMF loan in June, risk premium on Uruguayan government bonds still hovered around 13%, with Moody downgrading the sovereign bonds and the foreign currency liabilities of the country's banks to near junk levels. After Brazil in June drew \$10 billion of its \$15 billion IMF standby to stanch capital flight, accompanied by messages of full confidence from IMF Executive Director Horst Koehler and U.S. Treasury Secretary O'Neill, Brazilian dollar bonds still carried a 15% risk premium and a Standard & Poor B+ rating—on a par with Senegal and Jamaica.

Brazil is of course South America's largest economy, more than twice the size of the Argentine economy before its collapse. But its government debt, about half of it in dollar liabilities, has risen to ratio to GDP that's nearly 20% higher than Argentina's on the eve of its default. The Brazilian government has been relying on IMF-approved medicine—raising interest rates and cutting primary spending—but has nevertheless fallen into a debt trap dynamic comparable to Argentina's.

Exchange rate depreciation and rising risk premiums keep increasing both the government's and the corporate sector's dollar-denominated debt loads, while higher interest rates for real-denominated bonds add to their domestic currency payment burdens. High interest rates and a credit crunch are depressing industrial output and real wages, with unemployment approaching double digits. The political fallout in Brazil includes a strong likelihood that the runoff in

the fall 2002 presidential election will be between two left-wing candidates, each pledged to renegotiate the foreign debt. Analysts disagree on whether even an unexpected victory for the centrist candidate will suffice to avert default.

The political fallout extends to Bolivia and Peru, where left-nationalistic populism is on the rise and neoliberalism has become a political kiss of death. But populism can also evoke responses reminiscent of the "national security state" era. Currently, the affluent Venezuelan classes, furious at the redistributive reforms of the Chávez government, are foregoing the electoral process and openly urging the military to drive out that democratically elected government.

Latin American governments are also retreating from broad trade liberalization to bilateral and sub-regional trade compacts, and are trying to lessen their dependence on the U.S. by strengthening trade ties with the European Union. Here the main motive is resentment and distrust of the Bush administration for its protectionist moves in steel and agriculture, and its retreat from the Clintonian financial bailout stance, as illustrated by the harsh treatment of Argentina. Even Mexico, upset at the Bush administration, is negotiating bilateral trade agreements with Brazil and MERCOSUR.

All this now has the Bush administration and the IMF rushing to shore up defenses against new defaults with an abrupt return to the despised Clinton bailout strategy. On August 4, the U.S. Treasury gave Uruguay a \$1.5 billion bridge loan, pending the award of additional IMF credits, which was announced 3 days later. On August 7 the IMF also announced agreement with Brazilian negotiators on a \$30 billion standby arrangement of 15 months duration, to begin in September.

Eighty percent of the funds for Brazil are earmarked for quarterly disbursement in 2003, and each disbursement is contingent on the government maintaining a primary fiscal surplus in that quarter of at least 3.75% of GDP to cover debt servicing, which works out to maintaining primary budget surpluses of about 18%. Surpluses of this size would put the newly elected government, left-wing or not, in a strait jacket, virtually denying it financial resources to carry out populist reforms. The announcement, however, also puts the two left-wing candidates in a pre-election bind. Fearful of being denounced as spoilers, they have given tepid approval to the new standby, without fully committing themselves to meeting its conditions if elected.

Wall Street banks are clearly skeptical. For the past few months they have been reducing their Brazilian exposure by refusing to roll over maturing

short-term loans, even export credits, to Brazilian entities. Although they had pushed behind the scenes for the IMF bailout, they have since announced they will wait until after the October elections before deciding whether to resume Brazilian lending.

In the interim Brazilian dollar reserves will keep shrinking as firms payoff their maturing dollar debts. All this will put the next president in a still tighter bind. If it's one of the left-wing candidates, he will be quickly confronted with a Hobson's choice. Suspend dollar debt servicing and renegotiate the payment terms in order to gain some financial space for funding the reforms he promised the electorate, or become a Brazilian De la Rúa or Duhalde, and acquiesce to the IMF austerity conditions.

It is too early to predict what the choice in Brazil will be and how it would play out politically and financially. What is clear is that despite the

IMF's reformist rhetoric about "bailing in" foreign investors and distributing adjustment costs more equitably, there is nothing novel about the new IMF standby credit. It is once again about bailing out banks and bondholders.

At the same time, Argentina has not yet benefited from the Bush administration's reprise of the Clintonian bailout strategy. Having already defaulted, Argentina is still left swinging in the wind without IMF financial support.

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