A BRAZILIAN APPROACH TO EXTERNAL DEBT NEGOTIATION

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In Cheryl Lehman & Russell Moore (eds.) *Multinational Culture: Social Impacts of a Global Economy*, Westport (CT): Greenwood Press, 1991.
Paper presented to the XIV Latin American Studies Association International Congress, New Orleans, March 1988, published in LASA Forum 19(4) Winter 1989.

The 1987 attempt to negotiate the Brazilian external debt, which began with the moratorium on interest payments announced at the beginning of the year, was guided by a basic question: Is the payment of interest compatible with the national interest?

For the creditors, as well as for the nationals in each debtor country, who tend to identify their interests with the creditors, this question was impertinent or menacing. They therefore refused to seriously consider it, and assumed that the debt could be paid if the debtor country adopted an adequate combination of finance and adjustment.

For the debtor, however, this question was crucial. If the answer was negative - if the payment of interest and the economic health of the country were not compatible - the debtor had no alternative but to change its strategy. Either the debtor obtained some kind of discount on its debt, or it became victim of economic stagnation, further deteriorating its capacity to pay.

This paper discusses the question both theoretically and empirically, examining the case of Brazil. The first section describes in general terms the dominant strategy for the debt problem - the finance and adjustment approach, more recently dubbed muddling- through approach - and the evidence of its failure. The second section summarizes the problem in Brazil up to the point at which the country effectively lost its capacity to pay interest on the debt and still remain economically viable. The third section discusses the economics of the incompatibility between reasonable growth and debt. Finally, the last section briefly analyzes Brazilian strategy for the negotiation of its debt in 1987, during the period from April 29 to December 20 when I was Finance Minister of Brazil.

In 1988 this strategy, that I believe was quite innovative, was abandoned by the new Finance Minister. Trying to get the support of the conservative forces in Brazil and the good will of the banks, he suspended the moratorium - the only source of bargaining power for Brazil in the negotiations - and signed a conventional agreement with the banks and with IMF. The "regularization of Brazil's international finance", however, obviously did not solve the economic crisis the country is facing. In spite or rather due to a huge trade surplus, that is, to enormous transference of real resources, the Brazilian economy in 1988 is stagnant (zero GDP growth), while inflation nears hyperinflation (27,25 per cent in October). I will not discuss the 1988 negotiations in this paper.

The Finance and Adjustment Approach

The finance and adjustment or muddling-through approach is the strategy adopted by the banks and governments of the creditor countries. It claims that the interest on the debt can be paid provided that there is "an adequate combination of adjustment with financing." Bank financing is naturally very limited. In principle it should never go above 50 percent of the interest due each year. The debtor must produce large trade surpluses in order to pay the interest. This strategy earned the name "muddling-through approach" when it became evident that finance and adjustment alone would not solve the debt problem; despite the evidence, however, banks and governments did not change their approach. It became clear that the creditors were just postponing the solution to the problem.

The partial financing of interests is basic in this strategy. Bankers call it "new money" (they are specialists in semantics), even though no real new money is involved. The debtor country receives no new resources; there is no provision for new investment, just financing of no more than 50 percent of the interest.

It is logical to limit the financing of interests to 50 percent. Since the real interest rate is roughly 50 percent of the nominal interest rate, the real total debt will remain constant. On the other hand, bankers try to limit the financing of interest. Given the discount in secondary financial markets of about 50 percent, every time a new loan is made it immediately loses half of its real value. In 1985, with the evidence of stagnation and increased rates of inflation in debtor countries but no improvement in their capacity to pay, U.S. Secretary of the Treasury James Baker presented the Baker Plan. This added the expression "with growth" to the word "adjustment" and "with structural reforms" to "financing." Thus the formula read: "The interest on the debt can be paid provided there is an adequate combination of adjustment with growth and financing with structural reforms." This was the major creditor country's official recognition of the failure of the finance and adjustment approach.

The Baker Plan did not address the basic problem of incompatibility between payment of the debt and growth and price stability. It just said that debtor countries need structural reforms in addition to austerity programs that reduce the public deficit and make the exchange rate realistic (adjustment), and that the financing of the interest should be large enough to guarantee growth. "Structural reforms" were understood as reforms limiting state intervention, eliminating all kinds of subsidies and making the economy more competitive internationally. No suggestions were given about how to convince banks to increase their supply of credit.

During the annual IMF meeting in 1987, it became clear to everyone, including the U.S. authorities (see the speech of Mr. Baker and the communique of the Interim Committee), that while the muddling-through approach had succeeded in avoiding an international banking crisis - the creditor banks are today much stronger than in 1982 - , not only had it failed to solve the crisis in the debtor countries, but was more damaging for the debtor countries than was thought initially, and that new ideas were necessary. The failure of the approach can be illustrated in several ways:

1. The per capita income of debtor countries had not grown since 1980, when the debt problem really surfaced and banks began to demand adjustments. During the next four years, per capita income fell sharply as a consequence of the adjustment programs. Since 1984 some growth has indeed occurred due to the good export performance on the part of creditor countries and the partial abandoning of adjustment programs, but growth rates were clearly unsatisfactory. Stagnation and inflation have prevailed in all debtor countries since 1980, though to varying degrees. Latin American per capita income fell 7.6 percent between 1981 and 1986; Brazil's increased only 4 percent (after an artificial growth in 1985-86 the country returned to inflation and stagnation in 1987 and 1988).

2. The debtor countries' ability to pay did not improve; on the contrary, it deteriorated. The basic objective of adjustment programs was to increase ability to pay through increased exports and reduced imports. Imports were reduced, but the reduction reflected declining investment as well as lower consumption: thus export capacity did not improve.

3. The deteriorating ability to pay became evident in the debt ratios, particularly in the debt/export ratio. During the 1970s economists and bankers agreed that the debt/export ratio should not exceed the 2:1. In 1982 the ratio was 2.6:1 for the ten major debtors and in 1987, 3.8:1 (see World Financial Markets, June-July 1987), a 46 percent deterioration; for Brazil the ratio was 3.4:1 in 1982 and 4.7:1 in 1987, a 38 percent deterioration.

4. An increasing number of countries began resorting to total or partial moratoriums on interest payments; in 1987 nine Latin American countries were among this group. No country took the second unilateral step of defining a discount and/or saying how it would pay interest; but this was the probable next move.

5. In 1986 a discount appeared in international financial markets; it increased during 1987, reaching an average of roughly 50 percent. It was started correctly that this market was small, and incorrectly that it was not significant. If it is not significant why the big creditors do not buy the credits that are been sold?

6. As Sachs and Huizinga (1987) demonstrated, the losses in value of stocks of creditor banks are closely related to their credits against the debtor countries, and, as the authors note, this is not a small market.

7. Following the move of Citibank, American and British banks began in 1987 to do what European banks had been doing since 1983: creating reserves against probable losses.

While the discount in the secondary market and bank's stock losses were informal recognitions that the muddling-through approach had failed and that the debt could not be fully paid, the creation of reserves was a formal acknowledgment. Thus it was clear in mid-1987 that new ideas and strategies were needed to cope with the debt problem. New ideas and new strategies based on appropriation by the debtor countries of the discount existing in the secondary financial market.

In this moment it became clear to me - and to the team that helped me to define the Brazilian strategy in relation to the debt[1] that the creditor countries could and should create a debt facility controlled by IMF and World Bank, that would assure debt relief to debtors, acting as an intermediary between banks - that would receive new bonds at a discount issued by this facility in exchange for their present credits - and debtor countries, that would benefit from the discount on a case-by-case basis. Brazil made this proposal in Wien, in September 1987 (see Bresser-Pereira, 1987). In the beginning of 1988, after the detailed proposals of James Robinson III (1988), chairman of American Express, of Arjun Sengupta (1988), representative of India in the Board of IMF, and after the support of governments of Japan, France, Italy, Spain, and of the U.S. Congress, this global securitization solution seems the obvious alternative.

In 1987, when this idea was first launched, it received a very cold reception from banks, specially U.S. banks. Today it is an idea broadly discussed, but, as long as debtor countries do not exert pressure on creditors, this global solution will not materialize. And, as we will see, the only effective pressure debtor countries can resort to is the decision for unilateral measures. Brazil, in 1987, had a moratorium, and was preparing for early 1988 a second step: the forced securitization of its debt, given the

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[1]- The team that helped me to formulate the Brazilian strategy in relation to the debt was formed basically by Fernão Bracher, who headed the negotiations and was my basic support, Fernando Milliet, Rubens Barbosa, Yoshiaki Nakano, Carlos Eduardo de Freitas, Antonio Pádua Seixas, Adroaldo Moura da Silva, and externally to the government, André Lara Resende, Pérsio Arida, Roberto Fonseca, Rudiger Dornbusch and specially Jeffrey Sachs.

evident unwillingness of banks to sign a reasonable agreement, in spite of concessions we had already made.

Actually, the conflict of interest is so deep that it is nonsense just to emphasize common interest. They exist, in creditor countries among intellectual, business and political elites there is a growing consensus towards debt relief. It was the realization of this fact that stimulated Brazil's strategy in 1987. But conflicting interest is yet dominant. Before examining these strategies, however, let us look more closely at Brazil.

The Case of Brazil

In the beginning of the 1980s Brazil was considered one of the wonders of the world. Growth had been very rapid from the 1930s through the 1970s, and a solid industrial basis had been established. More than 50 percent of Brazilian exports was industrial, demonstrating that sector's technological development and ability to compete internationally. There was a large working class, a strong middle or technobureaucratic class, and a competent entrepreneurial class.

Growth during the 1970s, however, was artificial. While the central countries engaged in an adjustment process after the 1973 oil crisis, Brazil decided to complete its import substitution. According to the Second PND (Project for National Development), the state responded for the basic industries (steel, oil, electric power), the private sector for capital goods and for cellulose production, and a combination of private and public sector for nonferrous metals and petrochemicals.

The cost of this strategy was clear: public deficit through external indebtedness. The justification was compelling: (a) the new liquidity of the international financial market made it possible for commercial banks to lend large sums of money to developing countries; (b) the cost of theses loans was low (real interest rates below 2 percent), and certainly considerably lower than the average rate of return on investment in Brazil, which could be particularly high given the high concentration of income; (c) Brazil had a project of national development, the Second PND, that legitimate if it did not urge large investments; (d) Brazil's exports increased rapidly during the 1970s, suggesting that the indebtedness and public deficit strategy was correct - that the country would be able to pay back its loans.

In 1979 the picture changed dramatically due to three new factors that developed in the creditor countries, particularly in the United States: (a) the second oil shock; (b) a sharp increase in nominal and real interest rates; (c) recession. The causes were, among others, the exhaustion of the deficit-oriented Keynesian economic policy and the adoption of monetary policies in accordance with the conservative wave that took hold of the central countries.

At that point there was no other alternative for Brazil but adjustment. The new finance minister, however, decided to continue growth in an effort to repeat in 1979 the successful economic policy of 1968. This was a terrible mistake. The economic conditions were entirely different from 1968. Brazil's growth rates in 1979 and 1980 were the result of irresponsible indebtedness. Brazil started adjustment only at the end of 1980, when all indications were that it was too late. Despite the strong adjustment in 1981 and 1983 and the stagnation of per capita income between 1981 and 1987, Brazil's ability to pay deteriorated, making the country unable to pay its debt.

The reason is very simple. In the second half of 1980, the Brazilian external debt was already too high to repay. Given an external debt of about $60 billion and exports of $20 billion, the compatibility between payment of interest on the debt and growth and price stability no longer existed. The debt/export ratio was well above the normally accepted ratio of 2:1.

This is the basic reason that creditors refused new loans to Brazil in 1980. The continuous rise of the Brazilian debt at a higher rate than the increase in exports made new loans to Brazil too risky. At the end of 1980 the Brazilian government changed its internal economic policy and started an adjustment process, and until August 1982 creditors again made voluntary loans to Brazil, but only to partially finance interest payments. Brazil has received no real new money to finance new investments since 1979. With Mexico's moratorium in 1982, voluntary lending to Brazil ceased.

In spite of the suspension of voluntary lending to Brazil, neither creditor nor the debtor acknowledged that the debt was too high and that its interest could not be paid. Creditors proposed, and Brazilian authorities accepted, the finance and adjustment approach, hoping to reestablish the country's ability to pay. Actually they mistook a structural disequilibrium for a conjunctural one. They confused a stock problem (an external debt that was too high) with a flow problem (a balance-of-payments deficit). Consequently Brazil's ability to pay did not improve; it deteriorated, while the debt/export ratio grew above the 4:1 and per capita income stagnated.

Reasons for Failure

I am suggesting that the finance and adjustment approach failed in Brazil because the external debt was too high to be repaid, that the sheer size of the debt made the payment of the interest inconsistent with growth. Experience is demonstrating that this is true, but the proposition requires further discussion. The simple affirmation that the debt/export ratio should not go above 2:1 is not sufficient.

External debt of a country becomes "too high", that is, inconsistent with growth and price stability, when payment of respective interest, provided a "reasonable" rate of interest financing, requires a given level of trade surplus and so a given increase of exports that country is unable to achieve. The required trade surplus may be achieved through reduction of imports, but in this case investment capacity - and so, growth and export capacity of the country - will be reduced, defeating the final objectives of adjustment process: the increase of the paying capacity of the country and the resumption of its economic growth through increase of its saving and investment capacity.

Brazil's external debt became too high to be paid around 1981 - the year that the country finally starts its adjustment process. The Brazilian external debt reached $60 billion, and exports and imports were around $20 billion at the end of 1980. Given the assumption that Brazil could reduce imports in 10 percent without hurting its investment capacity - only reducing internal consumption - and that maximum rate of financing of interest the banks would provide would be 50 percent, Brazil should increase 30 percent its exports during the adjustment period in order to achieve required trade surplus of $8 billion.

Actually these targets proved not to be feasible. After three years of adjustment required trade surplus was obtained, but export and import objectives have been reversed: exports only increased 9 percent while imports decreased 33 percent. As a consequence of such net transference of real resources, saving and investment capacity of the country that was around 22 percent of GDP was reduced to 16 percent. Thus growth and export capacity of the Brazilian economy was seriously hurt.

The success of the finance and adjustment approach will be measured by the growth rate achieved by the country after adjustment process and by the decrease of the debt/export ratio. To calculate the required trade surplus to pay service of the debt is necessary to make some simplifying assumptions: (a) international reserves will remain constant; (b) the "investment balance" between direct investments and net payment of profits and dividends will be negative; (c) creditors, including multilateral agencies and official export banks, will, on the average, limit financing to 50 percent of the annual total interest owned by a country.

The direct consequences of these objectives and assumptions are that the country will need a surplus in real transactions (trade surplus minus real services) equal to 50 percent of the interest to be paid plus the negative investment balance, and that exports have to increase at a rate equal to 50 percent of the prevailing rate of interest including spreads. For example, if the debt is l00, the rate of interest 10 percent, and the negative capital balance 2, the real transactions surplus must be 7 (or trade surplus must be 10, given net real services of 3), in order to be consistent with 50 percent financing of interest; exports must increase at a 5 percent so that the debt/export ratio remains constant.

If we relate these numbers to billions of dollars, they correspond roughly to the Brazilian case. The question, then, is first whether a trade surplus of $10 billion can be obtained and maintained while the country continues to grow, and second whether exports and imports can increase at a rate of 5 percent after the required trade surplus is achieved.

Observe that the volume of trade surplus depends crucially on the volume of the debt, while the required rate of export increase is dependent on the rate of interest. If the debt were a reasonable 50 instead of 100, and if the interest rate were 5 - that is, similar to historic interest rates before 1979 - instead of 10%, the required trade surplus and the minimum rate of export growth would be much smaller.

To answer the first question, we have to add assumptions about the initial volume of exports and of trade surplus. Continuing our simplification process, let us assume for 1980 (since adjustment began in Brazil in 1981) 20 of exports (actually, 20.1 billion dollars) and zero trade surplus (actually, 2.8 billion dollars deficit). In that year the debt was around 60, so the required trade surplus in 1981 was 2 billions smaller (3 to cover 50 percent of interest, 2 for the negative direct investment balance, and 3 for real services equal 8). Finally, let us assume that the adjustment period would be of three years, and that reduction of imports above 2 would have to be made at expenses of investments, the 2 corresponding to a viable reduction of consumption.

Given these assumptions, Brazil's exports would have had to increase 30 percent (9% per year) and imports decrease 10 percent during the three years of adjustment (1981-1983) to achieve the required initial surplus of 6 billions. Such a reduction of imports was realistic, but not the increase in exports. The only new factor that would lead to a permanent increase in exports would be a real devaluation of the national currency, and it is quite unlikely that devaluation would lead to such a large increase in exports. What actually happened in Brazil was a 9 percent increase in exports between 1980 and 1983, while imports decreased 33%.

The large reduction of imports, which is typical of all adjustment processes monitored by IMF and creditor banks, was made not only at the expense of consumption but also of investment, as can be seen by the reduced rate of investment in the country, from 22.45 in 1980 to 16% in 1983-84. During the same period, the transference of real resources to creditors (identified with the surplus of real transactions), increased from 2.5% negative in 1980 to 5.4% positive in 1984. In the most recent years, this transfer averaged 3% of GDP.

If increased transfer of real resources results from increased exports, investment is not harmed; but if it really results from reduced imports, there is a direct correlation between this transfer and reduced rate of investment. That is what happened in Brazil and in Latin America generally. In 1983 the targeted $8 billion of trade surplus was almost achieved, but at the cost of reduced rate of growth and investment. Since 1984 trade surpluses for Brazil have averaged $11 billion, but it is quite clear that this has been possible only with reduced growth rates of GDP and investment.

The increase in exports can be explained by the real devaluation of the cruzado and by the utilization of idle capacity. Given the decreased rate of investment, however, the rate of increase in total capacity declined. In addition, given a modest but effective rate of increase in internal demand, the country's export capacity also declined. In 1986, with a large increase in internal demand, idle capacity was exhausted. This became very clear in 1987; exports increased $4 billion, but only because the economy's deceleration.

When Castro and Sousa (1985) emphasized the importance of the Second PND, they were correct; but when they concluded that the investments of the 1970s had produced a structural trade surplus that would allow Brazil to repay its debt, they were clearly influenced by the growth of exports of 1984 that had been possible by a particularly good year for the economies of the central countries and by Brazil's use of idle capacity. And they disregarded the reduction in savings and investments and the increase in the fiscal deficit involved in the transfer of real resources.

Currently, to pay the interest on its debt in accordance with the finance and adjustment approach, and given the fact that its trade surplus is around $11 billion (approximately consistent with the financing of 50 percent of the interest), Brazil would need to increase its exports at a rate of just 5 percent a year[2]. This seems quite feasible. Given the rate of inflation in U.S. dollars, the required increase of exports would be around 2 percent. This analysis, however, suggests that the $11 billion trade surplus is incompatible with a 6 percent growth rate for the Brazilian economy. The surplus was achieved not through increased exports but through decreased imports and reduction in the capacity to invest and export. The problem is not the necessary rate of export growth, but rather the present level of trade surplus, which is not consistent with growth and price stability in Brazil.

Certainly a large increase in Brazilian exports would solve this problem, but it is nonsense to hope that a substantial increase in the rates of growth of the central countries or a sharp decrease of the interest rate will lead respectively to large increase in exports and a reduction of export requirements. Even the more optimist analysts of the world economy would not subscribe to such a perspective for the next few years.

If the basic problem is reduced investment capacity caused by decreased imports or by the transfer of real resources to creditor countries, would a compensatory increase in the country's internal saving capacity not be possible? Theoretically it is possible, and was the strategy proposed in the Macroeconomic Control Plan of July 1987. But we should not mix political economy, our science, with some kind of social engineering or mechanistic economics. To compensate for excess transfers of real

[2] Brazil will need 13 instead of $11 billion due to the negative flow of dividends in relation to direct investments. If we drop the assumption of 50 percent financing of investment the required trade surplus will near $18 billion.

resources caused by the excessive size of the debt, it would be necessary to substantially reduce internal consumption, well below the historic levels of average Brazilian propensity to consume. There is no doubt that a strong internal effort must be made in this direction. The priority of the Macroeconomic Control Plan was the reduction of the public deficit and thus recuperation of public sector's saving capacity; but the limitations of this strategy are quite obvious. The public sector exhibits disequilibrium not only in flow but also in stock.

The problem is not only the public deficit but also the public debt, especially the external public debt. Total public debt represents more than 50 percent of GDP, and its respective interest cost 3.5 percent of GDP; the external public debt alone represents more than 30 percent of GDP, and its interest 2.3 percent of GDP. Thus there is a structural or stock dimension of the public deficit that can be solved only through a reduction of the public debt, particularly the external public debt. To try to compensate for insufficient internal savings through reduction of internal consumption is not realistic.

On the other hand, it is convenient to remember that a reduction in consumption, if not correctly managed, may have perverse results. Instead of increasing savings capacity, it may reduce it. If the reduction in consumption is abrupt, as it was in 1983, the contraction of internal demand will lead to a decline in investments and consequently, in savings. To avoid such distortion, it would be necessary to compensate for reduced internal consumption with increased exports and export-oriented investment. But such a change cannot be easily achieved.

Finally, we have to take into account the damaging effects of the external debt in public finances. In Brazil almost 85 percent of the external debt is public. The payment of interests by the public sector on its external debt corresponds to almost 3 percent of GDP every year. The exporters are private, the government is the responsible for the payment of interests on external debt. Actually, fiscal crisis, behind inflation and stagnation in Brazil, is tightly related to an external debt too high to be paid.

In conclusion, the Brazilian external debt was already too high at the end of 1980, when the finance and adjustment approach was first implemented. In 1988 it is still higher, while the country's export capacity has been relatively reduced as the rate of transfer of real resources to creditors has sharply increased and the rate of investment has decreased accordingly. If at the beginning of the decade we already faced a basic incompatibility between growth and payment of interest on the external debt, this inconsistency is all the more evident at the present time.

Brazil's 1987 Strategy

I must admit that I was not completely aware of this inconsistency when, as Finance Minister of Brazil, I presented the Macroeconomic Control Plan. In May I asked my staff to prepare a plan with two basic objectives: a 6 percent growth of GDP after an adjustment process during 1987, and a trade surplus consistent with a 50 percent financing of interest by external creditors. My implicit assumption was that these two objectives were consistent: that it was possible for Brazil to grow at a rate of around 6 percent and negotiate its debt in conventional terms, according to the finance and adjustment approach.

In July 1987, however, practically at the moment that the plan was completed and published, I realized that it was unrealistic. During the elaboration of the plan, two things became clear: first, that 50 percent financing of interest was insufficient and that we must change to 60 percent, consistent with trade surpluses in the following years a little more than $10 billion; second, and more important, that a very great reduction of internal consumption would be needed to increase the public sector's saving capacity to 5 percent in four years, and that only a heroic economic policy fully supported by society would achieve such a result.

On the other hand I was learning a great deal more about the debt problem, discussing it almost daily with bankers, economists and politicians. The discount in the financial secondary markets was a clear indication that bankers had also realized that the finance and adjustment approach was unrealistic, that it was actually a muddling-through approach, a strategy for the banks and for economic authorities in the creditor countries to postpone solving the problem. Its only positive effect was to give the banks time to strengthen their financial position, to improve their capital ratios, and thus to minimize the negative impact that sooner or later would occur when the partial default of the debtor countries became a reality that must be included in their profit-and-loss statements.

I also learned that there was another alternative for the debtor countries besides the unilateral decision to partially reduce the debt. Considerations were being given to debt relief systems based on conversion of the debt to discounted bonds with a guarantee by the creditor countries. There was some support in the United States for debt relief along these lines, although this did not change the generally conservative position of the U.S. government.

I further learned that after the Citibank's decision to create large reserves to cover defaults on its foreign loans, American and English banks were finally following the example of Europeans banks and assuming a more realistic approach to the debt problem. Both banks and debtor countries began to realize that the threat of retaliation by the banks would ultimately lose force. As a Japanese banker told me in August 1987, five years after the 1982 crisis, it was obvious that: (1) the muddling-through approach had failed; (2) a discount on the debt was unavoidable; (3) banks and taxpayers in the creditor countries would have to share the burden of the discount; and (4) the creditor countries, with the exception of the United States government, were coming to a consensus on these three points.

It then became clear to me that the moment had come for Brazil to denounce the finance and adjustment (muddling-through) approach and to propose an alternative solution - one in which the burden would be shared by debtors and creditors. In February Brazil had declared moratorium on payment of interest due to commercial banks on long and medium-term loans. The best way to suspend the moratorium was to replace it with an innovative agreement with creditors.

I was also clearly to me that this agreement should ultimately involve the creation of a debt authority controlled by IMF and World Bank that would buy the credits extended by the commercial banks to the highly indebted countries at a discount, exchanging them for its own bonds; this discount would then be transferred to the debtor countries on a case-by-case basis. I made this proposal in Wien, at the U.S. Congressional Summit: An Agenda for the 90s (1987).

I could not wait then for the maturation of this global solution that is now widely discussed in the creditor countries; it was obvious, however, that Brazil needed to take some initiative in that direction.

My first proposal to the banks then was a partial and negotiated securitization of the present debt into new bonds, either with the same face value but fixed rates of interest bellow market rates, or with a discounted value and interest at market rates. This securitization would have to be partial because the new bonds would have to be secured; the ideal situation would be for the government of the creditor countries to guarantee the new bonds, but they were not ready to accept this alternative. The debt-bond conversion would be negotiated in the sense that Brazil would propose and discuss with its advisory committee what portion of the debt - say 20 percent - would be securitized initially.

The reaction to this idea by the banks, and specially by the U.S. government, was very negative. This was the first time that a finance minister of a debtor country had spoken clearly about the need for a discount on the debt and had offered an alternative to obtain this discount based on the behavior of the market. The creditors felt threatened, the American government challenged. Initiatives on the debt problem had heretofore always been taken by creditors. Just after my global proposal at Wien, I flew to Washington to propose a negotiated debt securitization, as a condition for the suspension of Brazilian moratorium. Then I received, in a quite rude way, the "non starter" from the U.S. Secretary of the Treasury.

Since I was committed to seeking a negotiated solution for the moratorium, I decided to change my proposal, making the securitization completely voluntary. It was not the ideal solution but would a step ahead, while we would wait for the maturation of the concerted or negotiated securitization idea in the creditor countries. In Brazil's formal proposal of September 25, 1987, however, the conventional aspect, based on "new money" or the finance and adjustment approach, was clearly distinguished from the proposal for a long-term solution based on the securitization approach, that is, on reduction of the debt. Two mechanisms should be used to reduce the debt: debt-equity conversion, much favored by the banks, and debt-bond conversion. To count on the debt-equity conversion alone is unrealistic given the monetary limitations of this mechanism[3].

In its formal proposal Brazil underlined the failure of the muddling-through approach, and stated clearly that the negotiation should be an improvement over the former Mexican and Argentinean model of negotiation, which did not represent a solution to the debt problem. To demonstrate its willingness to end the moratorium through a process of negotiation, the Brazilian government yielded to the U.S. Government and signed an interim agreement in November that extended negotiations until the end of January.

Clearly the banks had little desire to negotiate an agreement that even slightly contradicted the muddling-through approach. Brazil, on the other hand, had demonstrated its willingness to negotiate in good faith. Therefore in November 1987, before leaving the Ministry of Finance, I had already decided with the President of Brazil that if an agreement was not reached by 29 January, 1988, Brazil would dismiss its advisory committee and begin negotiations on the securitization approach with each bank individually. In other words, Brazil would go a step beyond the moratorium. The moratorium meant only the suspension of interest payments; the next step would be to say how much and in what manner Brazil would pay. Brazil would only resume payments to individual banks after signing new contracts with them, converting the present debt into new bonds with the required discount. Global negotiations would continue only with governments and multilateral agencies, that would be pressed to create a international debt facility that would offer guarantees to the new bonds, in accordance to my speech in Wien in September 4 (Bresser-Pereira, 1987).

It was quite clear to me that this decision carried risks. The creditors would say that Brazil was taking a unilateral position and would eventually try to retaliate. But their retaliation measures would be of minor importance. And in this way we would be pressing creditor countries to take steps in direction of the global securitization of the debt of the highly indebted countries.

[3]- Later I realized that we should limit debt reduction to debt-bond conversion. Debt-equity conversion has strong effects on internal money expansion or implies in the government exchanging external debt for internal debt with higher interest rates. Besides, debt-equity conversion is a source of internal speculation and a form for creditor banks to coop the elites in debtor countries. The perspective of large gains with the conversion makes the elites disinterested in a global debt reduction that would end with this opportunity.

Brazil could take these steps alone, but certainly an agreement with other debtor countries would strength our position. In previous August I had done a step in this direction when I proposed, in Mexico, the formation of G-3, that is, an official and regular meeting of the three larger (and also larder) debtor countries in Latin America: Argentina, Mexico and Brazil. The presidents approved the idea; we had a formal meeting in September, in New York, just before the IMF/World Bank meeting, and two informal meeting. That was all.

More important was the agreement I established with Argentina during the Acapulco meeting of the eight presidents, in the end of November. In this meeting the position of Argentina in relation to the debt was very tough. President Alfonsin was literally indignant. He wanted to limit payment of interests to 4 percent, with five years of grace. In the last day of the meeting I had a private lunch with Juan Sorrouille, the Finance Minister of Argentina. He spoke about the intention of Argentina to declare moratorium once it had received the disbursements from the banks in the next days. I told him about our decision (President Sarney's and mine) to reduce unilaterally the debt after January 29, 1988. We agreed that the two countries would make an agreement so as to announce the unilateral measures in the same day, in a concerted manner. Brazil and Argentina would continue to negotiate their debts individually, but we would maintain a permanent flow of information and of cooperation between the two countries. I was convinced, and I am still convinced now, that a negotiated debt reduction or debt relief is the only alternative that will make payment of the debt compatible growth. Brazil will pay its debt, but according to what is realistically possible. It will pay the debt, but with a discount, since it was clear that paying interest on the Brazilian debt in full is to condemn the country to its present condition of stagnation and inflation.

I was also convinced that to seek a solution to the Brazilian economic crisis by demanding sacrifices only on the part of creditors was neither reasonable nor sufficient. One way to solve the structural disequilibrium of the public sector is to obtain reduction of the external debt, but another necessary way is to proceed with the adjustment process, to seriously fight the public deficit, by demanding effective sacrifices from the workers and from business enterprises. When I realized conclusively that such action was not possible in Brazil at this time, that the government was not ready to adopt this line of action, I resigned. It would be meaningless to adopt strong measures with respect to the external debt and do nothing, or very little, with respect to internal problems.

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