DEBT RELIEF IS THE ONLY SOLUTION

Luiz Carlos Bresser Pereira

World Link 4, April 1989: 57-58.

Last December, monthly inflation reached 30⁰/o in Brazil, an all-time high, while GDP growth was near zero during the year. Brazil was living its worse economic crisis in history. In January the Brazilian government decided to implement a third heterodox shock –the Summer Plan – in order to control an inflation that neared hyperinflation. Contrary to the first, the Cruzado Plan, this shock combines the heterodox price freeze with orthodox monetary and fiscal policies. It is still too early to say if the new plan will be successful or not. Most analysts, including myself, believe that it will be only partially successful. It will lower inflation so hyperinflation will be avoided, but the size of the fiscal crisis and the external debt do not permit excessive optimism.

An external debt that is too high to be paid is a basic contributing factor to Brazil's current problems. What Brazil needs is not a combination of financing and adjustment, as the creditor countries propose, but a combination of debt reduction and adjustment. For some time I have been strongly proposing that Brazil reduce its debt by 50%. If we do that, the transfer of real resources will be reduced, the huge trade surpluses won't be necessary any more and the rate of investment would rise again.

But in fiscal terms, this reduction of the debt would only solve a part of the problem: the interest on the external public debt accounts for about half of the public deficit in Brazil. The rest must be solved internally, through fiscal adjustment. If you try to solve Brazil's economic problems by simply cutting the debt, you are a populist; if you try to do it without cutting the debt, you are politically unrealistic.

Forget the market

Some think the laws of the market will get us out of this mess. I see about a 20% chance of this happening and then only if the industrialized countries have five to six years of significant growth. But I don't expect this growth to happen; I expect the contrary. However, let us assume this growth and a 50% fall in interest rates. Then, maybe we would be able to get out of this crisis by the "muddling through" approach, that is, by the finance and adjustment approach. But why wait for such deliverance?

For me, the solution is debt reduction or debt relief. The First World is divided on the question, but there is an increasing majority in favour of it, a growing consensus that the "global solution", capturing the discount that there is in secondary markets, is the best solution.

Why isn't it adopted? First, because the US and British governments, supported by West Germany, are against it. Second, because there is a lack of pressure from the debtor countries. Our governments spout a lot of rhetoric about the debt while, at the same time, engaging in the worst most conventional negotiations with the banks out of fear of retaliation. The local business elite supports them because its members want to be part of the First World. Our elite want to pay the debt. So do I — Brazil's objective is to be a colleague, an associate member of the First World — but I do not feel we have to please the banks to achieve this objective, the banks should not be identified with US, Japan, Germany, France and so on. The interests of the creditor countries are not the same as the banks'. The elite in the First World knows that. Paradoxically, they are actually better informed and more enlightened about the problem than the elites in the debtor countries.

Default, but quietly

So I favour default plus a unilateral decision saying that we will reduce the debt by a given amount. Then we could reopen negotiations. This is what Brazil was preparing to do at the beginning of 1988 and it is a good interim solution as a means of applying pressure to reach our goal, a global solution. Naturally if you want to belong to the international community you cannot be in permanent confrontation. But for a time, you can; it is the only way to pressure the creditor countries economically and politically.

Brazil: Structural Indicators

	1988	1987	1986
GDP ($billion)	NA	325	282
Real GDP growth	0.04% (E)	2.9%	8.0%
Industrial production growth	-2.2%	0.2%	10.9%
Inflation	934.0%	364.7%	76.0%
Budged deficit (billion cruzados)	-3,238.4	-555.6	-438.6
Trade balance ($billion)	19.1	11.2	8.3
Foreign debt ($billion)	114.9	121.2	111.0
Principal repayments ($billion)	12.3 (P)	15.1	7.4
Export earnings ($billion)	33.8 (P)	26.3	22.4
Foreign investment ($million)	5,448.0 (P)	2,925.0	4,609.0
Brazilian investment ($million)	-100.0 (P)	77.0	537.0

P – Projected figure
E – Estimated figure
Sources: Central Bank of Brazil, CACEX, Getulio Vargas Foundation, INPES, Gazeta Mercantil, IBGE.

Unilateral decisions on the debt, if accompanied by adjustment, do not represent a radical move. Conservative governments have done it before. For instance, UNCTAD's last trade and development report has precise information about West Germany's move in 1953 to reduce its debt by 25^0/o, unilaterally. The UK did something similar in 1946. So, others have done this, but they have been quiet about it. You should do things like that quietly, without unnecessary aggression. The banks and their governments are prepared for a move in this direction.

Now, what are the prospects that this government will take steps in this direction? I am not optimistic. Brazil's recent debt negotiation was very good for the banks, very bad for Brazil. And now that Brazil has given up its bargaining power, it will be able to get anything: no one believes that we will default now. So we will have to wait, whether for the next president who will be elected at the end of this year or for a change in US policy. The prospects of Brazil resuming growth are very slim, at least for another year. We put our hopes in 1990.

Baker can change

I am also hopeful about James Baker, the new US secretary of state. He knows the problem very well and he is able to change. He has already changed a lot. He had one opinion in 1982, another in 85 and yet another in 87. As secretary of state rather than of the treasury, he will see the problem much more from a political standpoint. And more importantly, he will no longer be directly responsible for the health of the banks. So far, the US banks have been setting US policy on the debt.

Three shocks

In the meantime, while we wait for the new president, we must take some emergency measures to help lower inflation, something like the Argentinean Spring Plan of a freeze and fiscal tightening which cut inflation from 25% to 8-9% a month. After the election, we have to find a long-term solution to Brazil's economic problems focusing on two objectives: zero public debt and the recovery of our savings and investment capacity.

In that direction, I have been proposing three simultaneous shocks. First, a fiscal shock – increase taxes and cut state expenditures. Call this an internal adjustment.

Second, a debt shock – the unilateral reduction of the debt by 50% while waiting for a global solution.

Third, a new price freeze, including a freeze on the exchange rate and the total deindexation of the economy.

Freezes are somewhat discredited because we have had two in Brazil which did not work to end inflation. The first, the Cruzado Plan, in February 1986, was well designed but poorly managed, was not accompanied by fiscal adjustment and had no solution for the external debt problem. The second, the so-called Bresser Plan in June 1987, got this name from the press because I was finance minister. It was an emergency plan to solve the financial crisis in the first semester of 1987 that resulted from the failure of the Cruzado Plan. It did not intend to end inflation, because I could not freeze the exchange rate – I didn't have the reserves for that – because relative prices were very unbalanced at that moment, and because I could not end indexation if I knew inflation would come back. My projection was 10% inflation per month in December 1987; the actual rate was 14%.

Now we have the Summer Plan, the third price freeze. It is being accompanied by a fiscal shock but not by a debt shock – a unilateral reduction of the debt – so I do not believe that the government will be able to end the public deficit. The reduction of the external debt is necessary not only because it reduces the public deficit, but because it legitimates the internal sacrifices that have to be made in order to adjust the economy.

The inflation we have now is an in-between one — neither purely inertial nor hyperinflationary where prices are adjusted every day. The correct response is a freeze. It is not a miracle cure, just a signal to halt the process. Then we must have the fiscal and monetary policies to keep inflation down. We will be able to do that if we eliminate our public deficit. The debt shock has two objectives: first, to decrease the transference of real resources, and second, to contribute to a solution of the fiscal crisis. These problems will be the focus of the next election.