COUNTRY DEBT PROBLEMS: THE BRAZILIAN CASE

Carlos Geraldo Langoni

The Continuing Debt Crisis

It is frustrating that only a year and a half after the Mexican default we are once again back to where we started. The financial markets continue to be paralyzed for the majority of less developed countries (LDCs). Negotiated loans with extremely high transaction costs have been substituted for normal market forces. The banks are stuck with large stocks of de facto frozen assets and nonperforming loans. They do not know exactly how to handle the problem or how to explain it to their shareholders. It is difficult for them to face reality and to revise long-held beliefs such as "sovereign lendings are risk free" and "debts with short maturities are less risky than those with longer maturities." Banks are also getting mixed and confusing signals from governments and monetary authorities. Those public officials do not know whether to stick to the past rules or to impose new and still more rigid regulations on international lending, or simply to accommodate informally a situation that affects the stability of the world financial system.

Without clear guidelines, the banks are following a policy of "buying time," trying to use a variety of accounting gimmicks to postpone recognition of the fundamental differential that was created between the book and market values of their credits. The counterpart of the inefficient governmental "tied-aid" of the 1960s is the "tied-loan" of the 1980s. The practice of specifying that new credit is to be used to repay interest is gradually changing the meaning of a "new money

Cato Journal, Vol. 4, No. 1 (Spring/Summer 1984). Copyright © Cato Institute. All rights reserved.

The author is Professor of Economics at the Getulio Vargas Foundation in Rio de Janeiro. He is a past President of the Central Bank of Brazil, a post he resigned in the fall of 1983 over policy differences. The present paper is based upon his luncheon remarks at the Cato Institute's conference on "World Debt and the Monetary Order," 21 January 1984.

facility," transforming it into something like an "interest set-off." These accounting maneuvers have suddenly transformed the LDCs from net importers of capital into net exporters. They have had a tremendous short-term recessionary impact without providing any clear indication of when the LDCs will be able to achieve steady growth.

The financial markets of course are reflecting the uncertainties surrounding the present debt negotiations. Shareholders of major international banks are already anticipating a decline in profitability and capital losses because their banks' outstanding loans to critical LDCs are unfavorably large relative to the banks' capital. Furthermore, a secondary market is beginning to develop for the LDCs' debts. The discounts at which these debts are being traded are a first approximation to the differential between market and book values.

Domestically this crisis has generated a new dimension of risk with which normal entrepreneurial behavior cannot cope. As a result, capital outflows are undermining the LDCs' efforts to acquire a minimum level of foreign resources and are curtailing private investment beyond what would be necessary even within an adjustment program.

The Inefficiency of Piecemeal Adjustment

The uncertainty surrounding the roles of the major central banks and governments of the industrialized countries has been largely responsible for the disorderly way in which the debt crisis has evolved. The basic contradiction has been that these official bodies have tried to adopt a noninterventionist posture, when in fact market forces were leading to a complete halt in loans to developing countries. The first reaction to the acute illiquidity problems of some countries with large external debts was clearly procyclical and did much to magnify those difficulties. The best example was the frustrating 1982 IMF meeting in Toronto. In the middle of the thunderstorm, the developed countries concluded that there was no need for any special action, either to reinforce the capital basis of the multilateral institutions or to establish a liquidity window that could help Third World countries not yet directly involved in the exchange crisis. In an irrational attempt to correct in a few months the overlending of many years, commercial banks applied to whole regions the concept of risk which usually were applied to individual countries. The central banks of course knew that the attempt of each individual bank to reduce quickly its own exposure would ultimately be frustrated by the destabilizing effects of these attempts on the market as a whole. This process can only be terminated by the unilateral action of the debt-

ors—which means market disruption—or by the central banks' use of compulsion, which could be seen as a method of internalizing these "financial externalities."

The Brazilian case dramatically shows the devastating consequences of these forces. In the first six months of 1982, Brazil was able to borrow normally in the market at an average of $1.5 billion a month. Just after the Mexican default Brazil's access to the market was cut by half, and automatic borrowing virtually disappeared in the last quarter of the year. There is no logical reason why lenders' risk perception of Brazil should have changed so radically from one month to another. The Brazilian experience also illustrates that the implementation of further adjustment policies by the developing countries followed by an agreement with the IMF was not enough to stop this leakage.

In October, Brazil announced measures designed to cut its current account deficit by half, and by the end of 1983 an agreement had been reached with the IMF. The negative market forces, however, proved to be more powerful and Brazil lost about $4 billion of interbank deposits and about $2 billion of trade-related lines of credit. These losses added to its liquidity squeeze. It is clear from these facts that once there are no viable credit markets, we cannot continue to adhere to the noninterventionist dogma. Whether we like it or not, there must be some compulsory action to stop the drain of resources, because the speed and intensity of this drain cannot be affected by any conceivable internal adjustment by the debtor countries.

Some developed countries, central banks, and private banks apparently believe that with the surveillance of the IMF and some favorable external factors, the adjustment policies under way among the LDCs will be enough to resolve the debt crisis. They therefore argue that there is no real need for any orchestrated action or major institutional reform. Rather, what is needed are tighter *external* constraints to speed up the adjustment process. A case-by-case or piecemeal approach is thus justified, not only as a strategy to deal with the short-run situation but also as a long-term approach to the debt problem. This reasoning, which is behind the IMF diet now being forced upon many LDCs, helps us to understand not only the ingredients selected but also the speed at which the IMF plans to reduce the inflationary fat and control the excess current account weight.

Avoiding for now the question of how the adjustment costs are to be distributed among LDCs, developed countries, and the banks, we can focus on whether the approach to resolving the LDCs' debt problems is efficient. Will the present efforts of the LDCs' to drastically reduce their current account deficits lead, in a few years, to a

sustainable balance of payments? There are good reasons to doubt it. The fundamental one is related to the distinction between stocks and flows. Successful adjustment policies will substantially reduce *marginal* needs, but they can do nothing to reduce the *fixed* needs that reflect a long heritage of accumulation of debts. At the same time, in the absence of market forces, there is no reason to expect that the adjustment policies will reduce the demand for external resources as rapidly as private banks reduce their supply of funds. This last trend is the inevitable result of a lower rate of capitalization, reflecting the expected fall in profitability.

The real solution will depend on the development of new sources of funds with a long-term profile that is consistent with the nature of the investment projects to be financed. These new sources will gradually take up a greater share of the overall financial needs of the LDCs, so we should expect a more balanced participation between private and official sources. These new institutional sources need to be developed immediately, preferably through the expansion of existing multilateral organizations. There may be some tendency to substitute risk capital for financial capital, but we should not expect too much in this area until there are signs of real progress in the economies of these countries. Risk capital and financial capital are usually positively correlated, moving up and down together. In the Brazilian case, the sharp decline in the flow of foreign investment came at exactly the time when private bank loans were drying up. Foreign investment in Brazil fell from the historical level of $1.5 billion a year to $400 million. Unfortunately, in recent years capital has been largely redirected from Brazil toward the U.S. markets.

There are additional issues that must be raised. First, it is important to know whether trade surpluses are generated by a growth of exports or by an artificial compression of imports. These alternative ways of dealing with external disequilibria will determine, to a large extent, whether the improvement in the balance of payments is transitory or permanent; that is, whether the adjustment process will require a long or short recession . Only an improvement in the balance of payments resulting from a growth of exports and from import substitution, based on an effective realignment of relative prices (such as the one going on in the area of energy), can lead to long-run adjustment and a growing economy. But even if—as in the case of Brazil—the economic structure of the country allows (theoretically) for an export-oriented adjustment, another condition must be satisfied if it is to service its debt: The rate of growth of exports must be greater than the external rate of interest. High and unstable interest rates of course make the whole process still more difficult.

Another fundamental issue must be raised. Is it viable for a whole set of LDCs simultaneously to try to generate a long series of trade surpluses, without inducing a significant change in the pattern of protectionism among developed countries? Brazil is an interesting example of the conflicting consequences of these policies. In the past roughly half of our manufacturing exports have been sold to Latin America and African countries, but these countries are now being forced to cut their imports sharply. It is very hard to imagine how Brazil will develop new markets for these products over the medium run.

Finally, we should consider the detrimental long-term impact of this trade retrogression on economic efficiency and thus on the prospects for growth in the LDCs. The full impact of this effect will be correctly assessed only in the near future.

Under the present circumstances, the current strategy of relying only on LDCs' internal policies seems inadequate to prevent a dark future of adjustment with permanent recession. But in moving from the internal logic of the current strategy to the expected behavior of external factors, we will be replacing reason with hope and prayers. Thus it is not uncommon to hear that governors and bankers alike are counting on God's good will, so that oil prices remain stable, interest rates fall, commodity prices increase, industrialized countries grow, and the LDCs find a way to ensure political stability in the midst of increasing poverty and social unrest. Futhermore, this set of favorable factors must come together not only next year but for many years to come. I think that we all agree that this would require a very special action by God which, by recent evidence, should not be anticipated, especially when it should reflect the prayer of a banker. It is, therefore, unwise to link one country's future to such extreme dependence on factors that it does not control, factors whose behavior has been extremely regressive from the debtor's viewpoint, as in the case of U.S. interest rates.

Who Should Bear the Adjustment Costs?

We can now consider the question of equity: Are the adjustment costs being distributed fairly among the LDCs, the developed countries, and the banks? I think we must agree that the LDCs are bearing a disproportionate cost in the adjustment process. All of them, without exception, are experiencing recessions whose severity is unprecedented. In 1983, Brazil and Mexico both had a negative real rate of growth of around −5 percent, which sharply contrasts with

the positive real rate of growth in the United States. For Brazil, this will be the third year in a row of sharp declines in real per-capita income, which is now back roughly to its 1975 level. In 1984, we will probably see a repetition of this asymmetrical and regressive situation where growth in the industrialized economies takes place side by side with a generalized recession among the LDCs. The well-known multiplier effects, through which trade opportunities in the LDCs are enlarged by growth in the developed countries, will largely be offset by the LDCs' heavy debt-service requirements. Increasing unemployment, especially in urban areas, is changing social expectations and dangerously feeding social tensions. For many decades, social mobility associated with strong economic growth has been an important element in minimizing the potentially destabilizing consequences of large income inequalities in Brazil. This has now ended, and it is difficult to know what can happen with a prolonged combination of income inequality and social immobility.

Until recently, the majority of the LDCs have demonstrated enormous and in many cases surprising flexibility in absorbing the extremely high social costs involved in the adjustment process. In the Brazilian case, a successful political transition has, up to now, minimized social unrest. We should not dismiss, however, the dangers of the present situation, especially when society begins to realize that the adjustment process will take longer and will still require more sacrifices. These frustrations tend to increase as we discover that, despite all this social and economic cost, there are no real signs of improvement in the country's liquidity. On the contrary, most countries remain extremely vulnerable to any small deviation in some critical element such as external interest rates.

Toward a Coordinated Adjustment Strategy

Unless we sharply change the current strategy of dealing with the debt problem, we may very soon see a political overreaction by the LDCs, an inevitable refusal to accept a pattern of adjustment which is clearly regressive and offers no clear solution to the present crisis. What we need is a symmetrical adjustment process, whereby the financial system and possibly the industrialized countries as a group bear some of the costs of adjustment along with developing nations. An orchestrated action is essential if we are to find a lasting solution to the debt crisis, one which would minimize the uncertainties of the present step-by-step approach and establish the basis for the resumption of growth in the LDCs.

The Role of the Banks

First, the banks need to recognize their role and coresponsibility in the indebtedness process. Overborrowing and overlending are different sides of the same coin. Some losses will have to be internalized. Depending upon the write-off criteria, this may be done gradually to avoid any serious destabilizing impact upon the financial system as a whole. As a matter of fact, some banks are already anticipating this by voluntarily increasing provisions for future losses.

Adjusting the pricing of the rescheduled debt to more realistic levels would improve the chance of reducing future capital losses, which could arise from unilateral action by the LDCs. There is no logical reason for insisting that market terms be applied to a nonmarket situation. An interesting idea is to use a long-term expected rate and a fixed real rate of interest in the renegotiations, instead of the usual current short-term rates. This would keep a market reference but would be more consistent with the LDCs' capacity to service the debt. It would also minimize the impact of interest rate fluctuations, which have been an important disturbing element behind the scenes. This long-term rate is the level to which current rates would move if all our expectations about future U.S. deficits and monetary management were realized.

In a nonmarket situation, of course, it is very hard to establish a correlation between spreads and risks. Furthermore, because of IMF collateral, margins after rescheduling necessarily should be lower than before. Slowly there has been a recognition that renegotiated spreads should reflect transaction costs rather than an arbitrary evaluation of risks. Such an evaluation cannot be taken seriously after a default or a de facto transformation of short-term into long-term money.

Besides reducing interest rates and spreads, some sort of capitalization of interest payments may still be necessary to make the present debt negotiations feasible. Brazil is again a classic example. This year Brazil will have to pay about $10.5 billion of interest under the assumption that LIBOR (London Interbank Offered Rate) remains at 10.5 percent. Medium- and long-term interest payments to foreign banks are estimated at $6.5 billion, which is roughly equal to the amount of new money recently committed by the banks. If LIBOR increases an average of just 1 percentage point, the additional resources needed to keep the same current account target will be about $700 million. Unless we address fundamental questions objectively, we will unnecessarily delay the correction of the LDCs' external disequilibrium and increase the social and economic costs of the adjustment process.

The increasing costs of trying to put together sizable amounts of money under the new label of "negotiated lending" should be recognized, especially since a significant fraction of the resources will be used to pay back the bank themselves. Capitalization of interest, similar to what has been already done with amortization, would make the whole process simpler. In most cases it would eliminate the need to seek sizable amounts through nonmarket channels. This capitalization of interest will require that legal constraints be adapted to reality, but the resistance of the banks—particularly the money-center banks—will also have to be overcome by a clear answer to the fundamental question of who will be controlling the process. Under the present circumstances the banks have the initiative. They fear that by extending the refinancing concept to include both amortization and interest payments, the whole rescheduling process may become more or less automatic and the LDCs might lose the impetus to continue to correct their external imbalances. This, of course, is not necessarily true: For many countries, the refinancing of amortization and interest on medium- and long-term loans would still require a tremendous effort to improve their trade balances. This is certainly the case of Brazil. Interesting enough, because of the difficulties of the present stepwise approach and particularly its impact on market expectations, many banks, especially the Europeans, are openly discussing the capitalization alternative.

The Necessity of Official Support

We may find out, however, that at any given moment the losses implicit in the differential between current and expected real rates are too high to be entirely absorbed by the banks. There will then be no alternative but to look for some official support, either at an individual country level or via a multilateral institution. In the end an "interest facility" may be necessary to ensure the implementation of the new debt-adjustment program. The costs of such a program would clearly be offset by the benefits of reducing the uncertainties which are severely affecting the working of the financial markets. The program would open the way to a real possibility of a new path of "adjustment with growth."

Official participation may be justified by extending the coresponsibility principle to the industrialized nations' governments. In general, governments of creditor nations have taken an openly favorable position toward the new recycling role of the banks. Private recycling has replaced the bilateral action of the past and, in many cases, governments have competed among themselves for newly created world money centers. All of them believed in the efficiency and

automatism of the world money market. None could anticipate a market failure, but now that it has occurred someone will have to pay the cost. The United States has a special responsibility because of the direct relationship between its fiscal and monetary policies and external rates of interest, whose unprecedented high levels during the last five years have added to the LDCs' indebtedness problems.

An Expanded Paris Club

Our analysis has shown that the strong interdependence among LDCs, developed countries, and the banks requires a formal institutional framework, one in which negotiations over the rescheduling of billions of dollars of debt can be coordinated. A simple idea is to have an expanded Paris Club that would deal not only with government debts but also with *private* debts, which represent the major fraction of the LDCs' external debt. Under this umbrella we could assemble officials from the IMF, private banks, central banks, LDCs, and the industrialized nations to search for a new regulatory framework in which the real issues behind the LDCs' debt problem could be addressed. This new framework is essential for increasing the relative bargaining power of the LDCs at the negotiation table. Their bargaining position has been fundamentally affected by the fact that, as a direct corollary of the illiquidity crisis, the LDCs have no international reserves. This new forum would also help to establish a common and more unified action among governments, regulatory agencies, and monetary authorities whose conflicting views have been one of the more disturbing aspects of the present world debt crisis.

The IMF's Dilemma

The IMF is clearly suffering from the contradiction between its present role and the new role that needs to be performed. The existing debt problems have required the IMF to adopt an interventionist posture—contrary to its market dogmas—to ensure that fulfillment of the minimal financial needs consistent with the balance-of-payments targets implicit in the adjustment programs it has cosponsored. The IMF's role has been innovative and important, and has helped to provide the leadership that has been seriously lacking from the governments of major industrialized nations. Nevertheless, it needs to go beyond the quantitative aspects of the financial packages and look into the fundamental pricing issues discussed above. No one is in a better position than the IMF to understand the vulnerability of a country's cash-flow projections to variations in interest rates. Since

"half intervention" is like "half pregnancy," there are no logical reasons why the IMF could not begin to increase its pressure on the banks about this issue.

The Fund has found it difficult to design adjustment programs that are internally consistent, yet take account of the existing social and political constraints. In Latin America, for example, all the adjustment programs except for the Mexican ones had to be revised after only a few months. Overambitious goals, reflected in too short a period of adjustment, have created a credibility gap which makes the implementation of the policies still more difficult.

The need for the LDCs to adjust to the new set of external constraints and to correct their internal imbalances is well understood. But it is equally important to recognize that the structural nature of the problem requires a *sustainable* adjustment process. When we talk about sustainability we must explicitly consider not only economic factors but also social and political restrictions. Therefore time is a key element for a succcessful readaptation of the LDCs. It took Brazil nearly 10 years to achieve a structural transformation in response to the oil crisis. How long will it take to implement fundamental changes that will allow a resumption of growth with a much lower access to external finance? This is a very difficult question. The compounding effects of the oil and interest crises indicate that adjustment will not be completed within the fixed three-year period which characterizes the Extended Fund Facility (EFF). The IMF needs to accept this reality and plan for longer and more flexible programs.

Learning from Brazil

The Brazilian experience dramatically illustrates all the different dimensions, economic and social, of the present debt crisis. Here we have a country with tremendous natural resources, large investment opportunities, and a vast managerial capacity whose dynamism has been its trademark in the past, paralyzed by a financial crisis whose causes and consequences are beyond its own sphere of influence. No country in the world will accept a condemnation to stagnation especially when it is a country as Brazil in which growth is critical to social mobility.

It is clear from the foregoing analysis that under the present rules of renegotiation, a successful adjustment process—characterized by the control of inflation and a steady reduction in the current account deficit—will not lead to a new growth path for the LDCs. What is needed is a simultaneous adjustment of the financial system itself. This process will not happen spontaneously but, on the contrary, will

require the concerted action of governments and multilateral institutions. These orchestrated changes are essential for the preservation of the infant market economies that have recently emerged in many of the developing countries. A further delay in setting up a new strategy to deal with the LDCs' debt situation and their external financial needs will certainly lead to political radicalization and a renewed trend toward economic isolation.

The debt crisis has dramatically illustrated how financial flows have integrated the world. What happens in Rio de Janeiro, Buenos Aires, or Mexico City has a profound impact on the major financial centers of the world. Let us learn this important lesson and work together to find common solutions that are geared toward the economic and social welfare of the world as a whole.