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BRAZIL'S FOREIGN DEBT
AN OVERVIEW

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PREFACE

When I first decided to write about this subject, my intention was to make a retrospective of how Brazil entered, from the very beginning, into one of the largest external debts of the world and to develop a chronology tracing the facts that happened during these recent decades when the international economy faced terrible problems. I also intended to talk about the world crisis debt and its effects not only on developing countries but also on developed countries, and finally Brazil's debt negotiations and rescheduling.

But as time passed and things happened, I decided to go further and try to make some assumptions about what may happen within the next few years. Looking ahead, despite debt reduction achieved with the Brady Plan rescheduling, with the high levels of arrears and large capital inflows to several countries and the prospect of increasing flows in the future, we could predict that a serious risk of inadequate level of financing will undermine the adjustment efforts of some indebted countries and their ability to repay debt in the near future.

INTRODUCTION

At the end of August 1982, the financial community experienced a crisis starting with Mexico's Finance Minister's announcement, in a meeting of foreign creditors, that his country could not pay its foreign debt on time. More than two dozen countries followed Mexico's example in the next 18 months.

At the beginning, one could say that it was a temporary liquidity crisis, but as time went by, it became evident that the problem was much more serious.

It is obvious that the desire to maintain the rate of economic growth made countries continue to be in a disorganized process of attraction for foreign capital. The fact that all international banks were competing to lend money to Latin American countries must indicate that something was fundamentally wrong with the decision-making procedures of the lending banks.

The debt accumulation did not happen overnight and did not go unnoticed. It was obvious that the accumulation of external debt could not continue much longer.

Despite the Brady agreements reached between creditors and developing countries and the official debt reschedulings made during these years, emerging countries are still facing difficulties. One main point that can be raised is that upon signing such agreements an indebted country already knows that the terms reached do not match the real need and the real capacity for future payments of such country. Another point is that after a "debt relief" process a country restarts growing, with high investment opportunities and high interest rates which attract foreign capital. This impetus of capital inflows requires careful concerns such as macroeconomics volatility, exchange rate fluctuations, capital controls and others.

We all know that development requires an increased and efficient utilization of resources to expand and improve the productive capacity of the economy. But for development and economic growth, it is not sufficient to increase only the supply of capital. It is also necessary to develop human resources, to achieve improvements in the quality of labor, infrastructure and institutional factors, including the organization and management of the economy.

The aim of this paper is to make a brief summary of the Brazilian foreign debt history and how the Brazilian external debt crisis was treated. Then, I will discuss why and up to what levels a country should expand international borrowings vis-à-vis the employment of funds productively by investing in infrastructure, in income distribution and in other factors that strengthen the economy and raise the standard of living. No macroeconomics models will be applied, only some observations and personal points of view.

BRAZILIAN FOREIGN DEBT - BRIEF HISTORY

The Brazilian foreign debt history began with the Independence instigation (1822). At that time D. Pedro I (the Emperor) entered into an agreement with other nations to recognize Brazil's independence. As the time it was being promulgated, Portugal was getting a loan with London specifically to avoid the independence of Brazil. Later on the loan became Brazil's loan.

After it was promulgated the independence, internal resources were not enough to ensure the defense, safety and stability of the new government established. The Emperor decided to get a loan from Europe for £ 3.686.200 at an interest rate of 5% per year. This was the beginning of the indebtedness process.

As we will see, Brazilian governments since then, systematically looked for external resources to finance their internal necessities. With permanent and huge budget deficits Brazil would frequently return to external resources to repay previous debts, beginning a strategy of rolling over the external debt.

In 1831, due to the volume of Brazilian debt and to successive deficits on trade balance, the Parliament voted a proposition of suspension of payments on foreign loans for five years. Rejected by the majority, the Government decided to obtain a new loan to pay arrears.

For almost 20 years, up to 1850, due to financial weakness, Brazil did not pay its debt service. In 1852, Brazil got a loan to pay arrears. For the first time Brazil would pay interest at a rate below 5%.

In 1865, Brazil asked for another external loan to support extraordinary expenses due to the Paraguay War. At that time British banks had advised the Brazilian Government that the total amount of credits were beyond Brazil's capacity to repay.

After the Paraguay War, Brazil began a development period, not only concerning economic growth, but also on a political level. The Government asked once more for an external loan. But for the first time, resources were applied to infra-structure.

In 1889, promulgated the Republic, the Brazilian external debt was worth £ 31,0 million. The dream that after becoming the Republic things would be better was not realized. With high levels of inflation and domestic interest rates new external loans successively took place. In 1897 when huge amounts of payments were due, once more Brazil went to creditors and asked for new loans. At this time Brazil was asked to present a kind of pledge. A "funding loan" was obtained whereby interest on all previous external loans due between 1898 and 1901 should be paid not cash but in "funding bonds". A collateral guarantee was asked by creditors. Internal revenues from customs would be linked to external payments. In addition, Brazil could not ask for new external loans.

Between 1898 and 1914 Brazil experienced a successful government plan, with a drastic reduction in the monetary base and an adequate revaluation of exchange rates, reestablishing faith within external creditors. At that time arose the idea of buyback (repurchasing notes and bonds previously issued). But even with internal finance in good shape, the Government decided to return back to external resources to pursue economic growth.

In 1913, when the First War began, Brazil experienced a deep crisis with foreign trade which culminated in internal financing through government emissions.

Difficulties which arose because of the War remained up to 1920.

Until 1900 almost all capital inflows were of British origin. British capital represented more than 80 percent of the stock of public debt until 1913. In 1921, New York became the main external Brazilian creditor.

In 1934, the Government of Brazil decided to link payments of external debt services to surpluses on trade balance. Foreign trade increased and supplier's credits were used not only by exporters but also by governmental agencies.

A complete suspension of debt remittances was declared in November 1937. In 1943, the ministry of finance decided to get in to a round table with creditors to adjust payments up to a certain level (i.e. the real capacity of payment). Brazil implemented a unilateral exchange offer to consolidate the entire Brazilian debt, stretching maturities from 40 to 60 years and adjusting down both principal and interest. Creditors were offered a choice between two plans:

Plan A: There would be no reduction of principal, but interest rates would be reduced from more than 6.5 percent to 3.375 (and less) with a provision for a sinking fund;

Plan B: For every \$ 1,000 of original bonds, bondholders would receive a cash payment of between \$ 75 and \$ 175, a new bond with face value of \$ 800 (or \$ 500 in some cases), and a coupon rate reduced to 3.75 percent. These bonds had no fixed maturity but were entitled to a sinking fund.

By early 1946, 78 percent of the bondholders had assented to the exchange offer. Plan A had been chosen by 22 percent of the bondholders, and about 56 percent had opted for Plan B.

In 1952/53 Brazil once again experienced huge problems with the balance of

payments, solved with aid from EXIMBANK, IMF and North-American creditors. By 1953 the external debt had reached US\$ 1 billion.

Total capital inflows, both direct investment and loans, increased sharply after 1955, especially with supplier's credits. From 1956 to 1960, Brazil had a firm commitment to promoting the economic growth, by managing resources to some structural sectors of the economy, such as electric power, transportation, and industry, seeking productivity for these investments. To finance these projects the Government sought for foreign capital once again. Due to the massive concentration of foreign obligations, Brazil had to negotiate a "waiver" with its creditors, avoiding that by the non-compliance with its obligations investors reduced their investments in a crucial period of development.

In this period, Brazil disagreed to some demands from the International Monetary Fund - IMF.

Following this period, due to some internal and external economic difficulties, and also political problems, Brazil faced a stagnation period, accumulating arrears without any external payment. As the economic situation deteriorated, capital inflows virtually ceased. The World Bank, previously an important source of official resources for Brazil, did not authorize a single loan between 1960 and 1964.

On July 1st, 1964 a debt rescheduling of 70 percent of the Brazilian external debt was approved and new credits became available after the military regime in 1964. The IMF returned to finance the country by giving a "stand-by" credit for US\$ 125 million.

During the sixties and seventies Brazil experienced the capitalism "boom", with huge private capital markets underwriting rapid expansion. Many multinational enterprises seeking foreign investments arrived in the country during these decades. Brazil

was dreaming for the so called “milagre economico” (economic miracle). Despite some constraints due to political regime, the country faced a enviable economic growth through the process of industrialization and modernization, seeking high productivity and higher internal savings. Although efforts were made, national savings were not sufficient to finance the accelerated rhythm of development. Foreign capital was once more needed to continue transformation and modernization of the Brazilian economy.

Up to 1973, Brazil kept a strong policy to attract capital flows. The trade balance had a huge deficit and also the service account of the Balance of Payments was strongly deficient.

The economic growth pull up corresponded to a great increase in the Brazilian external debt. From 1967 to 1973 the Brazilian external debt increased more than 300 percent. But the peak of external savings absorption was the period from 1974 to 1982, between the first and second petroleum shocks and the Latin American debt crisis. From 1975 to 1979, operating under the second Plano Nacional de Desenvolvimento, Brazil achieved a 7 percent annual GDP growth rate. Long-term investments in import substitution of intermediate and capital goods were strongly encouraged, as was a buildup of reserves in order to diminish the country’s vulnerability to balance of payments problems. We will discuss a little more about this period in the next Chapter.

ORIGINS OF THE 1982 INTERNATIONAL CRISIS

A debt crisis often arises for one or more of four reasons: first, domestic fiscal and/or political disorder translates into trade deficits or a reduction in the current account surplus; second, world economic shocks that deteriorate export earnings or increase import costs, or shocks to a country's markets that reduce export revenue; third, capital inflows that are used to finance interest payments and trade deficits suddenly dry up; and fourth, rolling of debt (principal and interest) is disrupted by a loss of confidence on the part of the world capital market.

In the Brazilian case, with the tripling of world petroleum prices in the 1973-74 period, authorities faced a major challenge. The shock occurred at the peak of the nation's so-called economic miracle. The problem was that Brazil, prior to the oil shock, had emerged as one of the largest petroleum-importing nations because of the combined effects of its energy-intensive rapid growth, its declining domestic oil production, and its heavy dependence upon its vast car and truck industry. Brazil opted not to implement market-driven responses to the oil shock, such as currency devaluation and other related measures.

To avoid interrupting the ongoing growth process, the authorities initiated a new phase of government-stimulated import substitution investment. To help finance the proposed investments, Brazil also made a deliberate decision to step up its use of external savings to supplement resources mobilized domestically. A largely predictable result was the substantial growth of the total external debt which jumped from US\$ 19.4 billion in 1974 to US\$ 53.6 billion by the end of 1978. The growth in the debt stock was accompanied by sharply increased servicing obligations.

Most of the debt has been contracted at variable interest rates (about 95

percent of the net increment in the medium and long term debt in the 1979/81 period was at variable interest rates). Given the level of Brazil's debt and the rising share of servicing requirements tied to floating rates, it was clear that the nation's external accounts were in a potentially vulnerable position. Although the Brazilian authorities adopted restrictive monetary policies in late 1980 and 1981, they did not improve the current account. The anti-inflationary policies adopted by Paul Volker in the United States, by rising sharply the interest rates caused Brazil's interest payment to soar, while precipitating a severe contraction in world trade.

This vulnerability manifested itself in the 1979-81 period, when Brazil's external debt continued to expand at an accelerated pace, but in the context of a deteriorating economic environment. Confronted with a gradual slowdown in the growth of exports, rising oil prices, and, especially, the explosion in international interest rates levels, Brazil began to experience increasing difficulties in meeting its debt-servicing requirements.

Despite the Brazil's willingness to accept average spreads of around 2.25 points over Libor, its access to international capital became further restricted during the third quarter of 1982, in the wake of the debt-servicing crisis in Mexico.

BRAZILIAN EXTERNAL DEBT RENEGOTIATION PROCESS

Brazilian debt problems have troubled world capital markets for more than 150 years. A major lesson from that history is the extraordinary repetition of events. Sometimes the precipitating events were domestic, as in the nineteenth century. At other times, as in the 1930s or the 1980s, a sudden deterioration of the world economy made a previously accumulated debt overly large and burdensome.

As we could see in the previous Chapters, Brazil has experienced in the past all kinds of the suggested options of Brady Plan. All of the following options have been used in the past: securitization, interest rate rebate on new bonds, front loaded principal reduction, stretch of maturities, or even colateralization of payments, with issuance different types of new bonds for creditors choice and many other options included in some adopted menu Brady rescheduling.

Brazil took exactly 10 years to reach a first sustainable called agreement to reschedule its external debt with the international financial community. On July 1992, Brazil reached an Agreement in Principle with the International Financial Community. But Brazil had a long way run before reaching this agreement. Brazil began negotiations with foreign creditors in November, 1982, after the Mexican disrupt. Argentina and Brazil and several other countries faced similar debt troubles. Brazil reached some short-term agreements before the above mentioned one which are further described in this Chapter.

Up to September, 1982, market conditions were favorable to attract foreign resources on a voluntary basis. After the beginning of the debt crisis the world faced an abrupt reduction of capital flows to developing countries. This reduction not only caused a Balance of Payment disequilibrium, but due to the reduction on interbank credits and trade credits Brazil faced a drastic reduction from a monthly average of capital inflows of about

US\$ 1.5 billion up to September, 1982 to less than US\$ 400 million.

At the end of 1982, with a deficit on the Balance of Payments of US\$ 8.8 billion and foreign reserves of US\$ 3.9 billion, Brazil sought for a compensatory credit line with IMF and received a bridge-loan with commercial banks. Brazil did not have any other alternative then to submit to an agreement with IMF. A formal agreement was reached in January, 1983 opening the doors to negotiations with the International Banking Community.

Brazil's restructuring agreements have developed somewhat differently from those of other heavily indebted countries. Virtually all external credits outstanding, as well as new money borrowings, have been converted into obligations of the Central Bank.

- The Phase I of the Brazilian Financing Plan

Addressed just to cover the estimated necessities for the year of 1983, the Phase I of the Brazilian Financing Plan was divided in four parts:

- the so called **Project 1** - a "Credit and Guarantee Agreement" to make available long term new money resources worth US\$ 4.4 billion;
- the **Project 2** - a "Deposit Facility Agreement" which was an automatic refinancing for 8 years of all maturities due on 1983 of all loans disbursed up to December 31, 1982 (the "cut off date").
- the **Project 3** - Brazil did not reach a formal agreement, but just set a gentleman agreement whereby creditors should maintain short term trade credit lines linked to Brazilian imports up to US\$ 8.8 billion (June 1982 levels);

- the **Project 4** - like Project 3, Brazil did not reach a formal agreement, but just a gentleman agreement whereby creditors should maintain interbank flows with Brazilian banks at the same level of June 1982 (US\$ 9.4 billion).

For this called "first phase" Brazil paid a flat fee of 1 1/2 percent over each deposit placed by Brazilian debtors on the DFA and over the total amount committed by banks under the CGA. Also a commitment fee of 1/2 percent had been paid to each CGA creditor.

Because of the urgency of effectiveness of such agreements, few banks had participated on the CGA (US\$ 4.4 billion were provided by about 180 banks). Within two months of negotiations these agreements were being signed (Feb 25, 1983).

A few months after signing this first phase, economic indicators showed that the Plan did not reach the objectives. Despite the compromises of creditors to maintain the level on trade and interbank facilities, a shortfall of about US\$ 3.5 billion on interbank credit lines and growing difficulties to maintain existing lines combined with the persistency of negative factors in the international markets lead Brazil to not accomplish with the IMF directives, resulting in a delay for disbursement of new CGA tranches.

On the other hand, the initial estimates of US\$ 4.4 billion for new money had been underestimated, since the trade balance surplus was overestimated and the repayment for the US\$ 4 billion bridge-loan had not been included.

- The Phase II of the Brazilian Financing Plan

Before restarting negotiations with the International Financial Community, due to the accumulation of arrears of about US\$ 1.1 billion on June, 1983, the Government had centralized through the Central Bank of Brazil all foreign payments. With such measure, all payments due to foreign creditors were to be submitted to the Central Bank which would analyze in a case-by-case criteria.

Due to the lack of reserves to provide foreign currency to the "foreign exchange contracts" due in 1983, Brazil decided to spread the widens of its debt rescheduling not only with commercial banks but also with creditor Governments and related official bilateral agencies. On August 1st, 1983, Brazil reached an agreement with the Paris Club (the first Agreed Minute). Even though it was a significative amount, in this paper I will not entered into much details of such negotiations.

After this first rescheduling, Brazil reached 3 more Paris Club Agreements. Such negotiations do not have a strict link with the negotiations with commercial banks, i.e., tenors, rescheduling conditions, warranties, etc. are different. It does not imply, as well, that any rescheduling with commercial banks has a correspondent Paris Club agreement.

It became very clear that the adopted measures concerning trade and interbank short terms credits in the Phase I were not sufficient. In the beginning of the second semester of 1983 Brazil started negotiations with the International Financial Community (through BAC - Bank Advisory Committee) seeking more favorable conditions for rescheduling its debt and arrears and also seeking a real compromise from creditors to maintain trade and interbank short term credits.

The so called Phase II, used the same methodology and structure utilized in

Phase I. To differentiate the “projects” under Phase I from the similar “projects” in Phase II, the letters A, B, C and D were used to designate Project 1, Project 2, Project 3 and Project 4, respectively. In relative terms, this Phase II reached some financial conditions more favorable than the adopted in Phase I. The tenors for Projects A and B repayments, for instance, were stretched from 8 to 9 years with a grace period of 5 years instead of 30 months. Also Brazil received a reduction on spread over LIBOR deposits from 2 1/8% to 2% and from 1 7/8% to 1 3/4% over PRIME RATE deposits.

Brazil proposed a partial capitalization of Project 1 (Phase I) interest, as an alternative way to postpone payments, but such a proposal was not accepted by the banks.

The cut-off date of Dec 31, 1982 should remain the same. By this strategy Brazil would demonstrate to the international market that new loans and new capital inflows should not be affected by that or any other restructuring plan.

The financial conditions of the Brazilian Financing Plan - Phase II were the following:

- **Project A** - “Credit and Guaranty Agreement - CGA” - new money worth to US\$ 6.5 billion;
- **Project B** - “Deposit Facility Agreement - DFA” - restructuring installments due on 1984 of external loans signed and disbursed prior to Dec 31, 1982;
- **Project C** - compromise from banks to maintain short term commercial credits for the whole year at the level worth US\$ 9.8 billion;
- **Project D** - compromise from banks to maintain short term interbank credits for the

whole year at the level worth US\$ 5.4 billion.

The agreements were signed on Jan 27, 1984. The flat commission over Projects A and B was reduced from 2% to 1% and commitment fee on Project A credits was maintained at 1/2%.

- Debtors mobilization

The following months were marked with a crescent mobilization of indebted countries searching for a definitive solution for the external debt problem. In September 1986, President Alan Garcia, from Peru, declared to the world that his country would not remit abroad any single cent more than the limit of 10% of its exports worth.

Between February 19 and 22, 1984, in the Cartagena Ministry Meeting, in Colombia, a joint document was developed with proposals to be adopted in order to attenuate the external debt burden and alleviate constraints to the economic development reactivation of indebted countries. In this meeting some new ideas were developed such as the notion of co-responsibility between debtors and creditors and the multi-year rescheduling necessity.

Indebted developing countries verified that outward government control measures, particularly high international interest rates and trading barriers were obstructing the reorganization of national economies. This led to a joint declaration from four developing countries (Argentina, Brazil, Colombia and Mexico) on May 19, 1984 containing an adoption proposal of stronger measures and adequate actions to reach a satisfaction and sustainable solution to the debt crisis.

- The Baker Plan

On October 1985, during the World Bank and IMF annual meetings, the Secretary of the National Treasury of the United States, James Baker, announced a revision of the American policy for the debt crisis. Baker announced a program called "Program for Sustained Growth" whereby it was declared that the solution to the debt crisis required a narrow cooperation work among commercial banks, multilateral organisms and creditor's and debtor's governments.

The central point of this plan was to reinstate the liquidity to the external transactions by asking to the banks to inject during three years, on a liquid basis concept, this is, not taking into account the principal amortization, an annual amount of about US\$ 7 billion to the 15 greater indebted countries¹ with a compromise from these countries that structural reforms should be done in each respective economy, according to the IMF traditional policies. Furthermore, multilateral agencies would increase annual liquid disbursements up to US\$ 3 billion.

Nevertheless, the Plan would maintain the same negotiations strategy as had been adopted: a case-to-case focused negotiation with external creditors and current payments updating pre-condition to start negotiations. Also it had been maintained the necessity for IMF approval to the conclusion of those agreements.

Arguing that the Baker Plan was based only on new loans from commercial banks to alleviate the cash-flow of indebted countries, the World Bank President, Barber Conable, had criticized the Plan and had asked for substantial measures for a real solution

¹ The Baker 15, as they became know were: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Morocco, Mexico, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslav.

for those countries and not only the rollover of shortfalls by granting new loans.

The Uruguay Round under the GATT negotiations had proposed a waiver of part of the external debt to each of the so-called Baker-15. The proposal was that for three years those countries should reduce interest payment and canceled up to 3 percent of each principal stock. For the first time there had been suggested a consistent way to treat the debt crisis - the write-off, a mechanism already intensively used on the financial market.

In sum, the Baker Plan would represent a shift from debt repayment to debt increase. But in reality the Baker Plan never became effective due to the complete failure of private banks to mobilize the required amount of fresh money.

- The Phase III of the Brazilian Financing Plan

After the two annual debt rescheduling negotiations of 1983 and 1984 which were not sufficient to alleviate the debt burden, the Brazilian Government decided to reach an agreement based on a multi-year rescheduling, adjusted to a payment capacity schedule.

The pre-negotiations of the Phase III were ambitious. The Government was searching for an agreement that could give the necessary peace for the external accounts in order the dedicate itself to structural reforms of the economy.

On December 18, 1984 the Brazilian Government presented a proposal with the basic concepts of a Multi-year Rescheduling Agreement - MYRA to the Bank Advisory Committee - BAC. The intention was to reschedule US\$ 45 billion due between 1985 and 1991, including Phase I maturities, with a tenor of 16 years and grace period of 7 years. It was also proposed the elimination of the flat fee and reduction of spread to 1 1/8 percent a

year.

Such proposal had been discussed with BAC member until February 1985 and was almost concluded. Unfortunately, Brazil did not reach an agreement due to non-compliance to IMF demands and the discussion fell through.

Finally on February 1986, one year late, Brazil reached an agreement with the international community for the called Brazilian Financing Plan - Phase III. Three agreements were signed on July 25, 1986: the 1986 Trade Commitment Letter, the 1986 Interbank Commitment Letter and the Amendment NR. 1 to the Deposit Facility Agreement.

The first two agreements formalized the maintenance of the short term commercial and interbank credit lines, since gentleman agreements were not followed by creditors on previous rescheduling agreements.

The Amendment NR. 1 rescheduled the 1985 principal maturities for 7 years with 5 years grace period. The maturities due on 1986 would be kept under "deposit" with the Central Bank of Brazil up to April 15, 1987 (demand deposits).

Also, the 1984-DFA was amended reducing the spread over the LIBOR from 2 percent to 1 percent a year and the Prime Rate option was deleted. Another improvement was the introduction of auctions to enable the deposited amounts with the Central Bank of Brazil to be used in internal investments.

- The Phase IV of the Brazilian Financing Plan

The Brazilian moratorium from February 1987, declared by Resolution NR.

1263 evidenced the economic difficulties of the Cruzado Plan of 1986. Interest payments due to commercial banks had been suspended. Also by a unilateral measure the Brazilian Government decided to rollover the maturities due to Projects 3 and 4 (Commercial and Interbank short term credit lines) without any foreign remittance.

From the Trade Balance point of view, the Government faced an imbalance due to internal supply difficulties derived from the Cruzado Plan. Capital inflows were overestimated and exporters decided to hold back their foreign exchange contracts speculating against a probable adjustment of exchange rates.

The creditors reaction was immediate. The Federal Reserve President, Paul Volker, declared that those unilateral measures violated the rules of the game and decided to freeze developing negotiations with Brazil and go further with negotiations with other indebted countries (Chile, Philippines, Mexico and Venezuela). Commercial banks, mainly in England, due to the Bank of England policy, and in Canada, reacted immediately to the Brazilian attitude by raising their reserves on allowance for loan losses against charge off credits.

During the year of 1987 and part of 1988, interim periods were created to permit Central Bank of Brazil to keep under deposit "affected debt" maturities, and to rollover short term credit operations.

- The "boom" of the secondary market - the huge discounts

From 1987 on, the amounts deposited with the Central Bank of Brazil under the DFA's which were originally used for re-lending operations to Brazilian borrowers began to be used in another type of transaction. Amounts deposited at the Central Bank of

Brazil started being used in market operations and not only between creditors and related guarantors - the called assignments. Assignment operations were nothing more than a buy and sell operation of certain deposits or amounts under deposit in the DFA's.

Also, creditors which decided to cut the Brazilian risk from their portfolios began to sell their deposits with discounts using this assignment mechanism. At that time the average discounting rate was about 30 percent. The dealers used these assignment operations as a market transaction beyond the original objectives of the DFA's.

Interruptions with the international community, lack of credibility on stabilization programs in Brazil and ineffective policies to stop inflation reflected on prices of the Brazilian external debt. The discount rates reached 70 percent, this means that credits were sold for 20 or 30 percent their face value.

The financial market suddenly woke up. The volume of assignment operations was almost US\$ 2 billion a day, reaching four hundred operations a day. Brazilian enterprises took advantage of these great discounts to buy deposits under the DFA's and to pay their creditors with such assignment mechanism. Major creditors had enlarged their operation desks to buy and sell "deposits" and "future deposits", starting what was called the emerging market operations.

One could at this point ask: why didn't the Brazilian Government take advantage of this low value of its debt (about 30% percent of the face value) to repurchase the debt? Well, even rolling an amount of US\$ 2 billion/day, this was less than 5 percent of the stock of debt. Also, this amount was restricted to about 80 creditors dealing among themselves. So, even if the Brazilian Government could create legal mechanisms with budgeted sources to buy back its debt, as soon as an operation would be made, dealers with their effective network would know a second after Brazil's operation and prices would rise

immediately. Furthermore, there were some legal constraints in the agreements signed which prohibited the repurchase.

- The Brazilian Financing Plan of 1988

The negotiations restarted at the end of 1987. A Term Sheet was reached in June 1988 and the agreement was signed in September, 1988. As a pre-condition to the effectiveness of such agreement, Brazil was asked to pay arrears accumulated due to the Resolution 1263 decision. Therefore, on December 15, 1987, Brazil signed, in New York, the Interim Financing Agreement (IFA), a bridge-loan for the amount of US\$ 3 billion, designated specifically to pay arrears as a consequence of the Resolution 1263. The amount of arrears was at about US\$ 4,5 billion. Brazil used US\$ 1.5 billion of its foreign reserves to supplement the total arrears.

On September 22, 1988, the Brazilian Government signed a new debt rescheduling plan. The agreements became effective on October 31, 1988. This package included the issuance of two types of bonds and it was finally an evolution from the previous agreements. Brazil reached a multi-year rescheduling, giving the opportunity to creditors to choose among facilities listed in a menu, according to the Baker headlines. Although it still was a restricted menu, creditors could choose different ways for the new money options:

I - New Money options: (Total required: US\$ 5.2 billion)

- "Parallel Financing Agreement - PFA" - US\$ 3.3 billion, with disbursements scheduled in three tranches (the last one was never disbursed);

- "Commercial Bank Co-Financing Agreement - CFA" - US\$ 0.625 billion (two World

Bank co-financing were also expected under this option: one for US\$ 500 million to the electric power sector and other for US\$ 250 million to improve the financial sector);

- "New Money Trade Deposit Facility Agreement - **NMT**" - US\$ 0.6 billion;

- "New Money Bond Agreement - **NMB**" - US\$ 0.68 billion;

II - Restructuring option

- "Multi-year Deposit Facility Agreement" - **MYDFA**, rescheduling maturities from 1983 to 1993;

III - Short term credit facilities

- "1988 Interbank Commitment Letter": for US\$ 4.4 billion;

- "1988 Trade Commitment Letter": for US\$ 9.7 billion;

IV - Exit bonds

- "Brazil Investment Bond Agreement" - **BIB**: for US\$ 1 billion. This agreement had been designed to those small creditors with a small exposure with Brazil, which were no longer interested in holding Brazilian papers. These bonds included a front load interest rate discount since LIBOR were about 9% per year and the fixed interest rate of such paper was 6% per year.

This package included several innovations, besides this above menu. Brazil received a spread reduction over interest rates to 13/16% (which remained for the 1992

Financing Plan) and a change on interest payments period from quarterly to a semi-annual basis. It was also agreed a wider range of debt conversion possibilities (debt for debt swaps, debt for exports, debt for nature and debt for equity swaps).

Due to internal economic problems, Brazil could not accomplish with all covenants under the 1988 Financing Plan. On January 16, 1989, through the Resolution 1.564, the National Monetary Counsel decided to re-centralize all external payments. A new principal and interest moratorium for medium and long term operations began on July 07, 1989. Under default Brazilian government began on October 1990 the last attempt to reschedule the Brazilian debt.

- The Brady Plan

The Brady agreements began with Mexico. That country completed a multi-year rescheduling agreement in February 1990. Under this agreement participant banks allocated their claims to new money option, discount bond exchange and par bond exchange. This agreement resulted in a reduction of the present value of banks claims equivalent to 12.7 percent of the total debt owed by Mexico.

On May 1990, Costa Rica signed an agreement including debt and debt service reduction. This package include a buy-back option.

On June 1990, Venezuela agreed to a debt and debt service reduction package which included a menu of five options. Four involved debt or debt service reductions by exchanging eligible debt for new bonds. The fifth one was a new money option.

Uruguay signed an agreement with its creditors under the Brady scope in

November 1990 which included three main options: a buy-back, a par bond exchange and a new money option.

Following this trend many other developing countries reached agreements under the Brady Plan headlines. Up to 1994, eighteen agreements with indebted countries, under the scope of the Brady Plan have been signed. About US\$ 191 billion of old debt had been changed into Brady bonds with a debt reduction of almost US\$ 61 billion.

The Brady initiative has worked to reach a mechanism for dealing with crescent delays in payments. Returning to the policies started with the Baker Plan, the Brady Plan introduced a menu where creditors would choose those appropriate alternatives to participate on a rescheduling agreement. Basically, private creditors could choose among three options, namely, reductions in outstanding debt or in interest rates, or granting new loans.

The Brady Plan also introduced the need for official guarantees from IMF, World Bank, IDB and collateral from developed country governments.

By introducing the voluntary debt reduction proposal, the Plan has simply formalized an alternative that already was in due course in the market.

But the process worked too slowly. Although banks complained that they have been forced into debt reduction deals, prices and external debt discount rates agreed in the agreement did not reflected what was occurring in the market. The discount average of Brady agreements was about 35 percent and discounts practiced in the market were around 60 percent or more. Definitely banks have benefited. The Plan has in fact protected banks, nonetheless some countries have clearly received positive net benefits from Brady agreements.

The discussion on debt relief for Third World countries have been under discussion for a long period. The impact of the Latin American Crisis on the United States lead the US government to find alternatives to the old fashioned way of restructuring external debts. When a indebted country could not make a debt payment, creditors would provide fresh money to cover the shortfall, leaving a higher debt with no new productive assets to recover development. With the Mexican crisis in 1982, creditors and governments started cogitate about a debt reduction possibility. In an article at Business Week magazine dated February 28, 1983, came a proposal of stretching maturities to 25 or 30 years and maintenance of fixed interest rates at a level of 6 percent a year (below market rates at that time). It was also mentioned that creditors should use IMF or World Bank as partners to develop a new mechanism of debt relief. But no detailed suggestion was given at that time.

In 1987, Ministry Bresser Pereira, Brazil's Ministry of Finance had proposed a non-conventional way of negotiations with creditors that could respect the necessity of development without violating the market rules imposed by the international financial community. Bresser proposed alternatives to the common place of negotiations such as the securitization of debt with the appropriation by the debtor of part of the discount practiced by the secondary market. This proposal was first announced in Vienna. It consisted, basically, of the exchange of old debt into bonds with face value, with diminishing interest rates, but collateralized, this means with a guarantee of priority payment. Prices and discounts were to be negotiated individually with each creditor.

Between 1982 and 1987, several suggestions of debt relief came from the academic people, from members of the parliament, from investment creditors, but no single one developed. The concern of developed country governments with the possibility that the burden of a debt reduction with commercial banks could reflect into their national treasuries, dispersed any initiative.

The great merit of the Brady Plan is that it organized market proposals and obtained support of the developed country governments and private creditors to alternatives that already were in due course on the market.

But probably the present debt-settlement strategy will only postpone the debt-service incapacity of certain indebted countries. Under the Brady plan, creditors could choose among options which were basically based in three points: 1) issuance of new obligations reducing outstanding debt; 2) issuance of new obligations with reduced interest rates; and 3) granting new loans. Even with some principal and interest payments already guaranteed by collaterals, we can not assure that no future debt payment crisis will arise. These settlements may represent a shift from structural debt crisis to debt repayment difficulties in the near future.

- The 1992 Financing Plan

Once Resolution 1564 had postponed payments of principal and arrears as a condition to start negotiations (as usual), creditors asked to pay such arrears. It had been negotiated that arrears up to December 31, 1990 (approximately US\$ 9 billion) would be paid as follows: 25 percent but up to US\$ 2 billion should be paid immediately and for the remaining amount Brazil would issue bonds (the 1989/90 IDU Bonds) with tenor of 10 years with 3 years grace period. In April 1991, Brazil reached a preliminary agreement with its creditors for the settlement of its arrears outstanding as of end 1990.

Its important to emphasize that the internal mechanism created by the Central Bank to accomplish with the DFA's (the called serial pick-up) had changed the internal debt

profile. Through this mechanism, an original private debtor would, instead of paying to its creditor abroad, place a deposit at the Central Bank of Brazil. Thus, the original borrower would not be responsible anymore to the old debt but the Central Bank of Brazil was. Therefore, the Central Bank of Brazil became by far the major debtor.

On the other hand, old rescheduling agreements never transferred the more favorable conditions obtained with the negotiations to original debtors. The original payment schedules should have been followed as to pay original maturities on the original due dates with original interest rates. With the gradual increasing of foreign exchange reserves, the Government faced that the bottle neck was not insufficient foreign exchange reserves but the incapacity to obtain legitimate fiscal resources to buy the foreign currency.

Some steps were taken before the negotiations. In December 26, 1990, through Resolution 1.781 permitted the free remittance of private debt were permitted. Later on, the Resolution 1.812, of April 5 1991, extended this possibility to some Governmental companies: Petrobras and Cia. Vale do Rio Doce.

Besides reestablishing the current remittance of the private sector, which had been controlled for almost 10 years, the Resolution 1.781 also stated that from January 1st, 1991, 30 percent of interest due by public sector borrowers should be paid abroad on their respective maturities. The remaining 70 percent would be included in the negotiations.

On July 9, 1992, Brazil reached an agreement with creditors, called "Term Sheet". From that date on payments on interest maturities due by the public sector would increase from 30 percent to 50 percent.

This Term Sheet was the most complex one already negotiated. It took into account that the total external debt stock would be changed into bonds, and included all

previous rescheduling agreements. It also restructured all public sector debt (due but not paid and future maturities).

Creditors could make their options within the menu offered. Financial conditions of those bonds offered a equivalent present value. Some of these new bonds had the guarantee of principal and/or interest payments based on US Treasury bills and deposits on "escrow accounts".

The main structure of the plan was:

- **Par Bonds:** nominal bonds with a bullet payment after 30 years with principal payment guarantee and interest payment roll-over guarantee. Interest rates were fixed i.e. not market rates but starting at a level of 4 percent and going up to 6 percent after the 7th year;
- **Discount Bonds:** nominal bonds with a bullet payment after 30 years, with principal payment guarantee and interest payment roll-over guarantee similar to Par Bonds. These bonds were issued with a 35 percent rebate on the face value over old debt changed. Interest rates were Libor plus 13/16 percent per year;
- **FLIRBS (Front Loaded Interest Reduction Bonds):** bearer bonds with a payment tenor of 15 years with 9 years grace period, and a roll-over interest payment guarantee for each 12 months for the first 6 years. Interest rates were fixed increasing from the first to the sixth year. Afterwards Libor plus 13/16 percent per year would be applied;
- **Capitalization Bonds (Front Loaded Interest Reduction with Capitalization Bonds):** bearer bonds with a payment tenor of 20 years and 10 years grace period. It was called capitalization since the difference between 8 percent (the interest rate to be applied) and

the annual increasing fixed rates to be applied for the first 6 years was to be capitalized;

- **Debt Conversion Bonds:** bearer bonds with a payment tenor of 18 years and 10 years grace period. The interest rate was established as Libor plus 7/8 percent per year. For each US\$ 5.50 of old debt exchanged for this bonds, creditors should offer US\$ 1.00 for new money loan in New Money Bonds;

- **Restructuring option:** This option was the only one that did not use any change for a new paper. Deposits were to be kept with the Central Bank of Brazil with a repayment schedule of 20 years with a 10 year grace period. Interest rates were fixed and increased each year up to the sixth year. From the seventh year on, interest rates were to be Libor plus 13/16 percent per year. Even though creditors were not attracted to this option, it became a very important part of the deal, because of a dispute between a hidden creditor of almost US\$ 1,4 billion that kept its credits under this facility (the Dart family) and the Brazilian government. Recently, on March 1996, the dispute was finally settled and an agreement was reached on arrears and principal amounts deposited under old MYDFA.

This final rescheduling under the scope of the Brady Plan is still in force and has been one of the basis for the success of the Real Plan of President Fernando H. Cardoso. By reducing debt stock and applicable interest rates, stretching tenors and also taking into consideration a high stock of foreign exchange reserves, Brazil was able to put in practice one of the most successful economic stabilization plans ever designed.

ADVANTAGES AND DANGERS OF FOREIGN CAPITAL

Worrying about capital inflows may seem strange. On one side there are the indebted and poor countries, looking to raise their standards of life and searching for new investments to enable economic growth; on the other side there are the investors looking for good opportunities to invest their money. So, how can this trade be weak for one or both parties ?

Of course, there are many positive aspects and economic benefits of external resources attraction such as I) on investments - the rate of capital formation increases, national income increases, etc.; II) on trade balance - higher imports and exports, III) on positive foreign exchange reserves - with higher level of foreign exchange reserves a country can easier deal with domestic unbalances. Foreign resources allow a country to invest and consume beyond the limits of current domestic production.

But, first of all we have to admit that capital flows are unstable. From 1990 to 1995 capital flows to developing countries increased from about US\$ 46 billion, to US\$ 65 billion in 1991, to US\$ 104 billion in 1992, to US\$ 160 billion in 1993, to US\$ 168 billion in 1994 maintaining this level of inflows in 1995. Certainly, at the same rate of growth or even more quickly, capital inflows can slow down and turn into capital flight, generating serious foreign exchange reserve problems.

Foreign direct investment (FDI) has been as important component of capital inflow in recent years and is now almost one-third of private capital inflows. Attracted by privatization programs in developing countries, sustained economic recovery, trade liberalization and the good prospects for the future, the FDI is a potential developmental contribution to economic growth. Beyond its role as a source of risk capital for investment, FDI can play an important role by transferring new technology and business practice,

stimulation innovation and investment in the recipient country through linkage to domestic firms.

Foreign direct investments in Brazil during 1995 achieved the highest level of the last 13 years (see table below). These resources are applicable direct to productive investments and do not include capital invested in stock market and other speculative alternatives of the financial market. This record figure denotes that Brazil is becoming to be again a priority for multinational enterprises. In 1994, the foreign direct investment reached US\$ 2.5 billion. Taking into account recent years, only on 1987/1989 the country received such a huge amount as 1995. But there is a great difference. Most of the total invested (about 75 percent) between 1987 and 1989 became out of debt for investment operations of debt rescheduling agreements. In that case there was no effective entry of external resources, but just exchange of foreign debt for investment.

Foreign direct investment in Brazil

US\$ billion

1982	3.0
1986	1.0
1988	3.2
1993	1.3
1994	2.5
1995	3.2
1996	5.0(*)

- (*) - estimated
- Source: Central Bank of Brazil

On the other hand, Brazil has reached a record last year on issuance of commercial papers, notes and bonds. This voluntary market basis has been increasing a lot since 1990. Mexican corporations were the largest issuers of bonds in Latin America in 1991 and 1992. In 1993 Brazil led Latin American countries in the share of bonds issued, but Brazilian corporations that have access to these markets borrowed at significantly higher rates of interest and shorter maturities than did those in other countries. Despite the considerable worth in short term credits, Latin American issuances are getting greater tenors recently. The average tenor of Latin American issuances has increased from 2.417 years to 3.37 years up to the end of 1995. The Brazilian average tenor is about 2.688 years.

BONDS, NOTES AND COMMERCIAL PAPERS ISSUED ABROAD
In US\$ (1975/1995)

1975	35,000,000
1976	268,700,000
1977	856,000,000
1978	936,000,000
1979	736,000,000
1980	316,000,000
1981	61,000,000
1982	101,000,000
1983	—
1984	—
1985	—
1986	300,000,000
1987	90,000,000
1988	77,000,000
1989	371,000,000
1991	1,476,000,000
1992	3,215,000,000
1993	8,966,900,000
1994	5,959,000,000
1995	9,576,600,000

Source: OECD, Merrill Lynch, IMF, IRDB, Deutsche Bank

As we can see from the above table, during the recent years the issuance volume has increased dramatically. Not only Brazil, but an increasing number of mostly middle-income countries have been able to access private capital markets. A major portion of the increase has come from voluntary financing in the international bond and equity markets. Commercial banks, which provided the bulk of the region's external capital in the 1970s and early 1980s, have refocused their activities on trade financing.

If foreign capital does not flow to productive investments nor there is the capacity to absorb such capital, in the long run exports will not increase at the necessary level to face debt service. Foreign borrowing must lead to increased productivity and to an export growth, so that the debt service on new borrowing can be paid. At an extreme point, when resources are not used for productive investments, capital from abroad will probably finance old debt due to deficiency of foreign reserves which should be generated by exports.

In a world where all decisions are made by market forces alone, governments would not be involved in deciding how much their countries should borrow from abroad. But actually governments are involved because in most of the countries the public sector itself is the largest borrower. Therefore the debt management needs to be treated as a major policy concern. By managing foreign debt a country can obtain the benefits of foreign borrowing while avoiding future problems of macroeconomics and balance of payments stability.

A number of rules have been suggested to manage the overall level of indebtedness, but no simple rule is adequate in all circumstances. A country's ability to sustain any particular debt ratio depends on a number of factors including the outlook for the country's exports, expectations about future terms of trade and interest rates, and the flexibility of the country to adjust rapidly if necessary. Two standard ratio indexes are mainly used to analyze the burden of external debt. One of these ratios is the relation

between level of exports and level of debt service. This ratio shows the current ability of a certain country to serve the debt. The other ratio measures the stock of external debt vis-à-vis the Gross National Product (GNP). With this relation one can see the solvency of a country. The first one is related to current flows and the second one is related to stock. Although there is widespread acceptance of these ratios as measures of creditworthiness, there are no firm critical levels which, if exceeded, constitute a danger for the indebted country.

FINAL REMARKS

Since its independence, Brazil has fought for years against political, economic and social hazards and with the inexperienced mistakes of a disorganized administration of the ex-colony.

Then, because of continuous and huge domestic deficits, complementary external resources were successively required. For decades foreign capital has been used as a way to cover internal deficits and not used for productive investment.

During the 70's, due to the high supply on the international capital markets and due to attractive interest rate levels, as well as to the Brazilian growth policy, Brazil experienced an excessive and rapid increase of its foreign debt.

Some mistakes committed by indebted countries need to be taken into account when we talk about the strangle of the economic growth of Latin American economies due to the massive transference of resources to industrialized countries during the 70's and 80's, such as service debt, capital flight due to over appreciation of domestic currencies or international interest rate levels. First of all, governors were optimists in excessive with growth perspectives, mainly during the early 70's. Second, countries have financed their development needs mainly through banking loans at floating interest rates, instead of searching for more moderate and balanced programs of investments with official credits and direct investments, this last one due to the fear of opening estate-owned economies. Third, these countries did not follow continuous domestic policies such as applying foreign investments in productive sectors or infra-structure needs. Fourth, governments let huge and uncontrollable budget deficits run for years. And fifth, these countries had been victims of not only frauds and corruption on the use of external resources, but also a massive capital flight due to internal politic and economic instability.

“Most of the money lent to developing countries has already returned to the developed countries, but a considerable part has been stolen and wasted. Other parts have been used to buy weapons and unnecessary or postponable uses or expenses. And just a few parts have been used in some infra-structure needs and productive investments.”²

“Large capital inflows to several countries and the prospect of increasing inflows in the future have led to a real appreciation of their currencies. This appreciation, if maintained over the medium term, can disrupt efforts to expand and diversify these countries’ exports, and as a consequence, their ability to service debt in the future. Countries experiencing large capital inflows must find a way to manage their exchange rate so as to minimize the destabilizing impact of capital flows on the exchange rate and on export growth.

Looking ahead, there is a serious risk that inadequate financing will undermine the adjustment efforts of severely indebted countries. A substantial portion of official net flows have been used for collateralization of debt reduction operations and not for financing imports or investment.

On the positive side, for countries that have undertaken successful structural adjustment and reform programs accompanied by officially supported debt reduction programs, there has been a considerable positive “incentive” effect through improved market perception, renewed confidence in their economies, repatriation of flight capital, and restored access to international capital markets which has resulted in increased private investment and resumed growth.”³

² Castro, Fidel, *The External Debt*, 1986

³ Jaspersen, Fred. *Latin American Debt and Capital Flows: Progress and Prospects* - IDB

Latin American countries that, during the past decade, were plagued by a large external debt burden, are becoming private capital recipients and growing economies. It is important to keep in mind that these inflows are believed to be long-term investment capital and not purely “hot money” seeking the best short-term returns. Furthermore, developing country governments need to ensure that foreign resources will be invested in the productive sector and will generate enough domestic currency to repay the loan. Of course, the availability of enough foreign exchange is the responsibility of the monetary authorities.

Foreign aid and external resources replace internal efforts but scarce savings. What a developing country government should be cautious of and keep always in mind is at up to what level a country can attract foreign capital without any future compromise for the debt repayment, or what would be the optimal level of investment given the utility function on social cost of capital. Managing the appropriate level and composition of capital inflows and debt, organizing the external liabilities and assets of the nation are great challenges for developing countries within the next few years. Effective management of foreign capital is not a substitute for sound macroeconomics management but an essential part of it.

Nobody, even creditors, wants to remember those stormy days of 1982 or afford another “lost decade”. Because of the countries integration within trade blocks and the globalization of the world, we could guess that it will not happen again, but why not prevent being overwhelmed in a few years ?

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