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**THE RENEGOTIATION OF BRAZIL'S EXTERNAL DEBT
- The Internal Transfer Problem -**

“ Theory and Operation of a Modern National Economy”

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CONTENTS

1.0 - INTRODUCTION	1
2.0 - THE EXTERNAL DEBT CRISIS	4
2.1 - OVERVIEW	4
2.2 - BRAZIL'S EXTERNAL DEBT	9
3.0 - THE RENEGOTIATION PROCESS	11
3.1 - THE FOREIGN EXCHANGE APPROACH	12
3.2 - THE FISCAL APPROACH	16
4.0 - THE ASSUMPTION OF EXTERNAL OBLIGATIONS	21
4.1 - THE PUBLIC SECTOR EXTERNAL DEBT	22
4.2 - SECONDARY MARKET IMPLICATIONS	26
5.0 - THE INTERNAL TRANSFER PROBLEM	31
5.1 - FURTHER ASPECTS OF REESTRUCTURING AGREEMENTS	33
5.2 - THE "REAL PLAN" AND FISCAL POLICY	35
6.0 - CONCLUSION	40
REFERENCES	43

THE RENEGOTIATION OF BRAZIL'S EXTERNAL DEBT

The Internal Transfer Problem

1.0 -- INTRODUCTION:

Brazil's External Debt has always been subject for the bitterest debates. It has been frequently considered to be a major source of problems for the Brazilian economy. Many analysts have argued that the external debt crisis was responsible for the incredible capital outflow from developing countries to developed countries throughout the 1980's, with undesirable consequences to macroeconomic stability.

After the restructuring of the Latin America external debt, especially that with the private banks, some analysts have tended to consider the matter to have been overcome. They argue that the crisis, once a threat to the world financial system, jolted governments throughout the region into adopting economic reforms. Although it had turned the 1980's into a lost decade for most Latin American countries, by the early 1990's inflation was lower and growth was at reasonable levels. The debt had been reduced and capital was entering the region in unprecedented magnitudes.¹

¹ Cline, William - *"International Debt Reexamined"*.

Like many other developing countries, the Federative Republic of Brazil has restored normal relations with most external creditors. The extent of the debt relief is still questionable, but the most relevant fact is that it has recovered creditworthiness and has returned to the international capital markets, even though in a limited basis.

The maintenance of creditworthiness, however, is essential for achieving longer maturity structures and narrowing yield spreads. That presupposes not only the capacity to accomplish the agreed reschedulings but also the improvement of economic reforms, among which the reduction of the fiscal deficit.

However, the various mechanisms implemented by the restructuring agreements, since the 1980's, provoked the transfer of external obligations from original borrowers (states, Municipalities, state-owned enterprises and private sector) to the Federal Government. The federal government must be able to collect all such obligations efficiently and in the proper time in order to prevent increasing fiscal deficits. But there are some constraints for accomplishing such an administrative task.

The 1988 Constitution has shifted tax revenues from the Union to member states and municipalities. At the same time, it did not assign the corresponding responsibilities. The states and municipalities, on the other hand, have not yet adopted sound fiscal reforms and, frequently, they enter into default on their obligations with the federal government.

Many state-owned enterprises (SOEs), in turn, still receive government subsidies or transfers, though presenting recurrent deficits. They also frequently fail to meet their obligations with the federal government. The private sector was also included in the same package for debt restructuring and some of its obligations were also assumed by the government.

The primary objective of this study is to identify the issue, its scope and importance, and to describe some possible solutions. Are the amounts transferred mainly from the private sector or from the public sector? Will this transfer have a significant impact on the policies of adjusting fiscal balance? The paper does not intend to be complete but, to a certain degree, its purpose is to draw attention to some important administrative measures that should be taken in order to lessen the fiscal burden on the federal government.

Section 2.0 - *The External Debt Crisis* -- gives a brief overview of the external debt burden, its circumstances, development and main consequences. An explanation of the profile of Brazil's external debt is provided for an easier understanding of the subject.

Section 3.0 - *The Renegotiation Process* -- focused on the description of the different approaches in the bargaining process for debt renegotiation: the *foreign exchange approach*

and the *fiscal approach*. Their differences are extremely important for understanding the transfer discussed in this paper.

The section 3.0 - *The Assumption of External Obligations* -- concerns the mechanisms through which the external obligations were transferred to the National Treasury. The data presented reflect the amounts actually transferred after conclusion of said restructuring agreements, which changed significantly the public sector's external debt profile. The implications for the secondary market are also discussed.

Finally, section 5.0 - *The Internal Transfer Problem* -- presents an appraisal of the budgetary problems and the eventual consequences in relation to the capital markets reentry.

Some comments and suggestions on the issue are presented in the last section 6.0 - *Conclusion*. Those comments and suggestions are basically on the administrative point of view.

2.0 -- THE EXTERNAL DEBT CRISIS

2.01 - Overview

The External Debt Crisis was not only a Latin American problem. It afflicted numerous countries, especially the 17 largest debtors, the so-called "*17 heavily indebted countries*"

(17 HICs)². The largest external debtors in the early 1980's were: Brazil (\$92,961 million), Mexico (\$86,081 million), Argentina (\$43,634 million) and Venezuela (\$32,158 million)³.

The debt crisis was a consequence of many factors, ranging from inadequate policies to external circumstances. The inadequate policies relate either to the creditor's lending policies or the debtor's domestic policies.

The inadequate domestic policies were basically in development financing and macroeconomic management. In the context of the 'import substitution strategy', the various Governments decided to invest in projects with low rates of return, some of which were considered oversized. While the Industrialized Countries (ICs) tried to adjust their economies to the external economic adversities, some of the developing countries never considered halting or slowing down their development.

According to some authors, the major purpose of large-scale projects in Brazil was to procure foreign currency in order to reduce the economy's vulnerability⁴. Any way, the fact is that the external debt grew rapidly through the 1970's deepening the country's vulnerability.

²According to the World Bank, they were Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia.

³Source: World Bank, "World Debt Tables".

⁴Conceição Tavares, Maria da and Assis, J. Carlos, 1985. "O Grande Salto para o Caos". Rio de Janeiro.

As regards lending policies, the banks did not pay adequate attention either to the risk exposure or to countries' internal transfer capacity. When the developing countries decided to borrow from the commercial banks to finance their development, resources were plentiful and real interest rates were at very low levels, if not negative.

The reason was the rapid increase of capital in the growing markets of petrodollars and eurodollars. The former originated from revenues of OPEC (Organization of Petroleum Exporting Countries) members and the latter originated from considerable US capital outflows⁵. The commercial banks therefore were willing to lend huge amounts of money without proper risk provisioning.

In lending to sovereign borrowers, experience has proven that banks have more fear of the risk of debt repudiation than of insolvency. Unlike a firm, a sovereign state cannot easily offer credible collateral, but it will certainly not go into bankruptcy. It do have a variety of alternatives to continue servicing the debt. The banks had not, however, considered that a change of direction is the most probable to happen when the outflow of capital begins to jeopardize development and to create social turmoil.

⁵The OPEC members' economies couldn't absorb the huge export surpluses. Thus, they deposited the funds in mostly european banks. The US capital outflow was prompted by the regulation of financial transactions, which encouraged investments abroad.

The main external circumstances were: a) the rise of international interest rates, b) the fluctuation in oil and raw materials' prices and c) a world wide recession. The first sharply increased the debt servicing burden and the second caused a deterioration in the terms of exchange. The last factor has made even more difficult an export-driven recovery. The combination of these factors caused imbalances in many countries' external accounts. The most immediate consequence was the lack of sufficient international reserves to service the debt.

Many authors strongly emphasize the highly indebted countries' inadequate policies, which they consider the chief reason for the inability to service the debt. In short, these countries had borrowed more than they could afford. Their economies did not generate the supposed benefits from investments. They argue that the external factors would not have been so significant if the indebted countries' economies had been able to adjust quickly to the new circumstances.

Divergent authors, especially in the developing countries, stress that the interest rates rise was the prominent reason for their failure in coping with the external obligations. This fact caused an incredible growth in the payment of the external debt for most Latin American countries, which turned to be, in the following years, net exporters of capital to the developed nations. They mention that the US Government, in the attempt to halt

domestic inflation, had caused the rise of international interest rates and had led the world economy into depression.⁶

Some studies suggested that Brazil paid an additional US\$500 million per year in interest payments for every 1 percent change in the US prime rate. Brazilian debt analysts maintained that a considerable percentage (1/4) of Brazil's debt was subject to extremely volatile interest rates. In the early 1980s, floating rates that began at 8% rose to as high as 23%. The cost of such fluctuations added around US\$24 billion to Brazil's total debt⁷.

The debt crisis started in 1982 when Mexico declined to continue servicing its external debt and technically went into default. Soon, thereafter, Brazil, Argentina, and more than 25 other countries admitted similar problems. Since then, Brazil has entered into agreements with the IMF (International Monetary Fund) in order to gain additional resources and so balance external accounts through "stand-by facilities". There were, throughout the 1980's, numerous rescheduling agreements with external creditors and, sometimes, suspensions of payments.

⁶The highest inflation in the US economy occurred in 1974 and 1980. But inflation decreased quickly in the early 1980's when Federal Reserve chairman, Paul Volcker, pursued a policy of severe monetary restraint, pushing interest rates upward to historically high levels.

⁷Avery, William. *"The Origins of Debt Accumulation among LDCs in the World Political Economy"*.

The transfer of service obligations creates many problems, among which the most immediate are: a) the budgetary problem, and b) the foreign exchange problem⁸. The budgetary problem is created by the debtor country's difficulty in obtaining internal resources for supporting the payment of the debt service. The foreign exchange problem arises because surpluses have to be converted into foreign currency to service the debt. If the paying country either will not or cannot liquidate existing international reserves or other assets, there exports surpluses (real transfers) have to be earned. The foreign exchange needed for debt service has either to be saved by limiting imports or else earned through increased exports to the world market.

2.2 - Brazil's External Debt

Not including any type of securities, but just loans, Brazil's external debt can be subdivided into three categories according to the forum for their renegotiation: a) the Paris Club debt⁹, b) the Commercial Banks debt¹⁰ and c) the Multilateral Agencies Debt. Those categories are essential to understand the strategies for debt renegotiation.

⁸Reisen, Helmut and Van Trotsenburg. *Developing Country Debt: The Budgetary and Transfer Problem*.

⁹The term refers not to an organization, but to the set of procedures used for renegotiation with creditor-country government agencies to public borrowers.

¹⁰Some authors refer to the "London Club" or the "New York Club" as discussing the procedures of debt renegotiation under the private banks strategy, which is increasingly cooperative.

The first one comprises the external obligations with foreign governments and its official agencies, including guarantees for loans (bilateral agreements). The second one includes loans from the private sector, essentially commercial banks. The last one concerns the loans provided by multilateral organizations, such as the *IBRD (International Bank for Reconstruction and Development)* and the *IDB (Interamerican Development Bank)*.

As regards the respective treatment for payment, it can be generically subdivided *into "affected" and "non-affected" debt*. The affected debt is generally the old debt whose payment schedule after the crisis outbreak was eligible for restructuring. The non-affected debt is, on the other hand, from the new borrowings ("*new money*"), that's to say, loans provided after the first rescheduling agreements plus the debts with the multilateral organizations, for which Brazil has never considered halting payments. The chart bellow clearly presents these categories.

Chart I -- Brazil's external debt (categories)

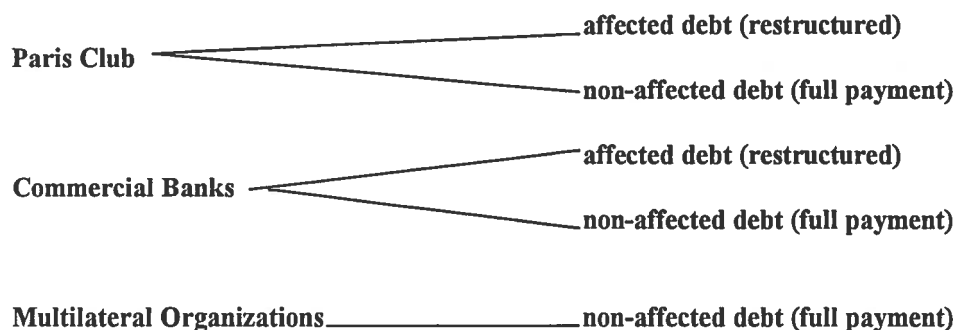
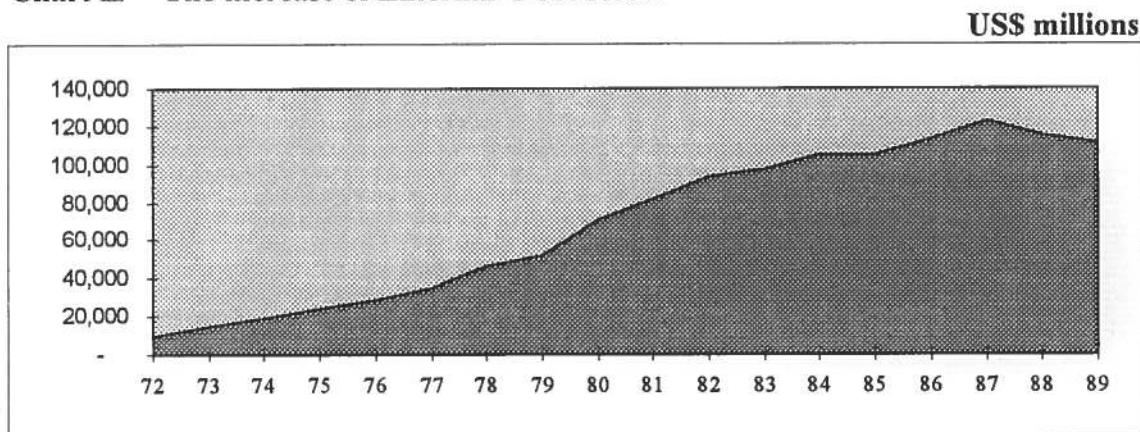


Chart II shows the development of Brazil's external debt stock (long-term and short-term debts), which increased steadily in the 1970s and even faster in the 1980s. In the first period, the expansion was due to the domestic policies which encouraged external indebtedness. The subsequent rise in the 1980s was mainly a result of accrued interest.

Chart II -- The increase of External Debt stock



The graph is based on data of both long-term and short-term debts.
 Source: World Bank - "World Debt Tables".

3.0 - THE RENEGOTIATION PROCESS

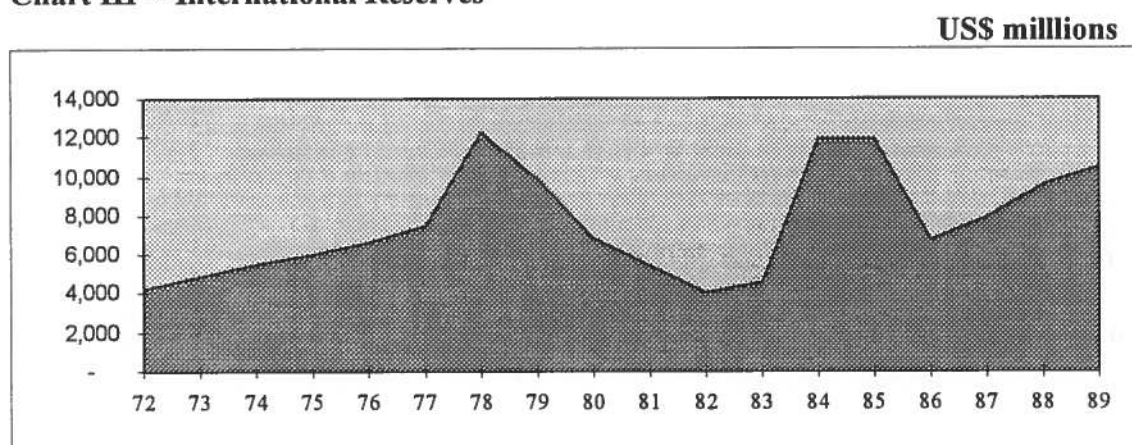
External debt renegotiation involves a bargaining process between creditors and debtors. This process has evolved over time as the financial and the political environment changed. The impact of renegotiation upon domestic economies varies among the indebted countries, given structural differences and the time when important decisions were taken.

In the case of Brazil, one can distinguish two phases: one corresponding to the “foreign exchange approach” and the other corresponding to the “fiscal approach”. The process of renegotiation was always conducted in a multilateral forum, i.e., within the global strategy for solving the world debt problem.

3.1 -- The Foreign Exchange Approach

As already indicated, in the early 1980's the Brazilian economy faced enormous external constraints. The capital outflow for debt servicing and the diminishing revenues from exports caused considerable imbalances in the external accounts. Due to frequent deficits in the current, the international reserves fluctuated jeopardizing the full accomplishment of external obligations.

Chart III -- International Reserves



Source: Central Bank

In short, the foreign exchange approach relied on the fact that the Brazilian debtors, private or governmental entities, had internal transfer capacity. They could obtain resources domestically to fulfill their obligations. The concern was rather on the foreign exchange problem, in other words, *illiquidity*¹¹. In this sense, during renegotiations, schemes that could engender better levels of international reserves and prompt a reasonable inflow of capital were extensively discussed and employed.

The system included in most Brazilian agreements consisted of the appropriation by the Central Bank of all external obligations, provided that it would maintain domestic special accounts in the same value from deposits of original borrowers. The agreements were fully guaranteed by the Republic. As agreements were intended to bring new economic conditions, future payments were also eligible. Those agreements were called Multi-year Rescheduling Agreements (MYRAs).

Paris Club Restructuring

The process of debt rescheduling in the framework of the Paris Club is conducted on a case-by-case basis. The applicant country first has to give evidence that it faces a problem of either insolvency or illiquidity. Then the base for rescheduling is set by means of a formal

¹¹A country is considered illiquid when it has an external debt whose payments cannot temporarily be met on existing terms but which are sustainable on a longer-term basis. If a country is insolvent, it's considered to have an external debt whose payments not only can not be met in the short run but cannot be maintained in the long run.

instrument, the “*agreed minute*”, upon which bilateral implementation agreements are tailored. IMF supervision and follow-up are required simultaneously with economic reforms.

In the framework of the Paris Club, many reschedulings used the same mechanism of deposit facilities. Predefined maturity periods were eligible for consolidation in the so-called phases I, II and III. The “*cut-off*” date for those reschedulings was March. 31.1983¹². Table I presents the respective eligible periods, amounts of consolidated debt, the maturities and grace periods obtained.

Table I - Paris Club Restructuring

	Date of Agreement	Consolidated periods for current maturities		Maturity (years)	Grace (years)	amounts US\$ millions
		Beginning date	period			
Phase I	Nov. 1983	01.Aug.83	17 months	9	5	2,338
Phase II	Jan. 1987	01.Jan.85	30 months	5	3	2,831
Phase III	Jul. 1988	01 Aug.88	20 months	9	5	3,693

Source: World Bank, *World Debt Tables*.

Commercial Banks Restructuring

Some authors divide the private banks' international debt strategy into two periods. The first one was from 1986 to 1988 (the “*Baker Plan*”) and the second one stretches from 1989 up to now (the “*Brady Plan*”). Both periods were based on strategies designed by the US Secretaries of Treasury in the attempt to solve the external debt problem. Others consider the two periods in a different and illustrative view: the “*New Money Approach*” (Pre-Brady Phase) and the “*Memu-Approach*” (Brady Plan).

¹² “*cut-off date*” means the deadline date after which loans falling due would not be eligible for restructuring.

Just to place the problem in context, in the first period, the exposure of Banks, particularly US banks, was extremely large. The default of sovereign debtors was considered a fact that could threaten the international financial system. The Baker initiative stressed the need to maintain net flows of funds from official and private lenders. That would permit the indebted countries to balance their external accounts and to continuing servicing their debt. The perception was of *illiquidity* rather than *insolvency*.

Table II presents the agreements implemented under this approach, which provided for new money and short-term credit. The most important agreement was the Multi-year Deposit Facility Agreement (MYDFA), executed in November 1988. Before this agreement, many others quite similar had been unsuccessfully implemented. The MYDFA involved \$61 billion in rescheduling, \$5.2 billion in new money, and the rollover of \$15 billion in short-term credits. The rescheduling provided 20-year maturities, with interest rates cut to a spread of 13/16ths above LIBOR.

Table II - Commercial Banks Restructuring

Date of Agreement	Consolidated periods for current maturities		Maturity (years)	Grace (years)	Interest (margin)	amounts US\$ millions
	Beginning date	period				
Fev.1983	01.Jan.83	12 months	8	2 1/2	2 1/4	4,800
Jan.1984	01.Jan.84	12 months	9	5	2	5,900
Jul.1986	01.Jan.85	12 months	6	4	1 1/4	6,552
Nov.1988	01.Jan.87	84 months	20	8	13/16	61,482

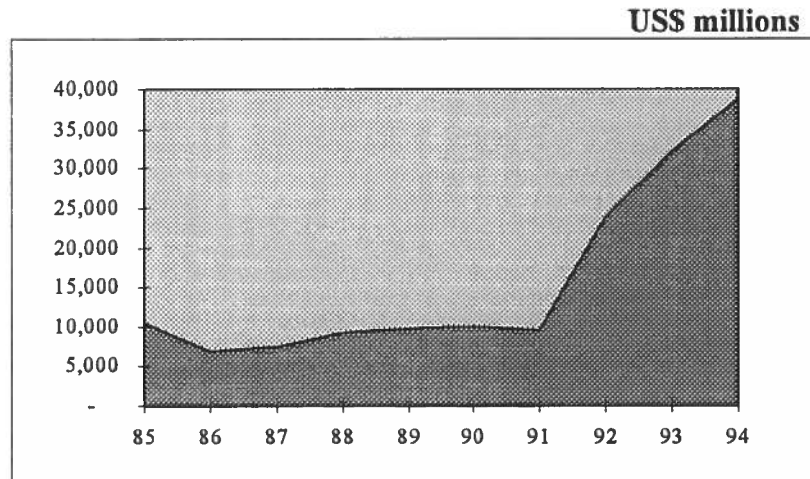
Source: World Bank, *World Debt Tables*.

Despite its failure, the 1988 agreement marked an important evolution towards a “*menu approach*” because it contained elements of new money and debt reduction, through exit bonds and swaps, and debt-equity conversions. These latter instruments were not used as expected because of the probable negative impact on the stabilization programs under execution in Brazil. But part of the debt was exchanged for the *Brazilian Investment Bonds (BIBs)* issued for that purpose at that time (*exit bonds*) by the Federative Republic of Brazil and exchanged for equities and different sorts of investments.

3.2 -- The Fiscal Approach

In 1989, Brazil again entered into arrears. At that time there was an overall assumption that the debt servicing was creating fiscal imbalances and raising obstacles for national development. The external debt analysts eventually realised that it was a matter of insolvency rather than simply *illiquidity*. That new approach, centered in the internal transfer capacity, was supported by important political sectors.

The policies pushing exports together with very high domestic interest rates encouraged a recovery of international reserves, as indicated in the chart. By 1992, when the new phase of renegotiation had started, international reserves were around US\$ 30 billions.

Chart IV : International Reserves.

Source: Central Bank

The debt renegotiation strategy should, therefore, involve a reduction of capital outflows in order to drive investments for poverty alleviation and the generation of employment. The expected relief should be implemented through either a reduction of the debt service or of the stock. The strategy was designed to recover the internal transfer capability measured in terms of insolvency.

One aspect of the fiscal approach is that the consolidated (restructured) debt had to be of one single entity's responsibility, the Federal Republic of Brasil (federal government), given its condition of primary sovereign obligor.

Paris Club Rescheduling

In late 1988, creditor governments participating in the Paris Club adopted a new menu approach which provided concessional terms to the poorest countries. In recent years Paris Club negotiations have taken place under enhanced Toronto terms and Naples terms, special arrangements established for the poorest, most indebted countries, and under Houston terms, established for severely indebted lower-middle-income countries. However, a number of countries, including Brazil, did not benefit from the exceptional Paris Club debt relief.

Nonetheless, there has been a sharp change of concepts in the Paris Club as the problem of foreign exchange was no longer the central argument for rescheduling. The deposit facilities were discontinued and the Republic assumed the position of external debtor.

In 1992, Brazil reached an agreement with the Paris Club creditors (Phase IV) for the rescheduling of debt totalling US\$ 12.1 billions. That agreement required Brazil to make approximately US\$ 4.1 billion in debt service payments in 1992 and 1993 and provided for the rescheduling of approximately US\$ 11 billions over a fourteen-year period, with a grace period of three years. It included past rescheduling (PRDs), for the first time, in the eligible debt.

It's worth mentioning, however, that Brazil did not succeed in the fiscal approach argument with the Paris Club, in the fact that the expected *phase V* was not implemented because of the favorable level of international reserves.

Commercial Banks Rescheduling

Here one can see more clearly the *fiscal approach* being used in the context of the global external debt strategy. By the end of the 1980s, officials and bankers realized that the debt crisis was becoming prolonged and a reevaluation of the private banks' strategy had to take place. A turn for the worse had occurred in 1987 when Brazil announced a moratorium on further interest payment.

Another aspect that is emphasized by some authors prompting greater flexibility is the economic importance in Latin America as a major customer of American manufactures. The greater flexibility was due to the US need for economically sound countries with high purchasing power in Central and South America as markets for its exports.¹³

Despite the failure of the earlier *Baker Plan*, some aspects of the negotiations were positive. The agreements had begun to use the option of debt securitization. This process made

⁶ Claudia Dziobek (*Poverty of Nations*, pp.46-47) and Frenkel, Michael (*The International Debt Problem: An analysis of the Brady Plan*). This idea was included in debt reduction proposals of Senator Bradley in 1986 (the so-called "Bradley Plan").

possible transactions in the capital markets in terms of buy-backs, debt-for-debt exchanges, debt-for-equity or debt-for-investment exchanges. It gives flexibility to debt management for both creditors and borrowers.

At the time of the *Brady Plan*, the banks had already made provisions for losses from non-payment. This provisioning was in part because of the Brazilian moratorium and by the subsequent affect on the overall willingness to pay. So, the Brady Plan could support the proposition of debt reduction.

The reduction, however, should be preceded by structural economic reforms approved by the International Monetary Fund (IMF). These reforms were designed to remove government-imposed impediments to productivity and competitiveness in order to attract equity capital from abroad.

One successful feature was the so-called menu approach. Here, the banks had the possibility of choosing the new financial instruments which its loans were to be converted into. Other important characteristics were: a) the full securitization of old debt, b) the obligation for the provision of collateral, which would guarantee the payment of principal and interest thereon, and c) the participation of international organizations in financing the Plan.

Many countries soon implemented the Brady Plan, as was the case of Mexico, which was one of the most successful. Brazil has had some problems that delayed agreement. One of these problems was the accrued late interest that had to be restructured previously. It was only in 1991 that Brazil reached an agreement (*the Interest Due and Unpaid-IDU Agreement*) to begin partial payment of interest for future consolidation in an eventual global agreement.¹⁴

The Brady Plan-type agreement (*1992 Financing Plan*) was reached in the following year¹⁵. It was a package containing numerous options affecting up to \$50 billion in long term bank claims and arrears. The alternatives included many different instruments, among which discount bonds with 35% reduction in principal, par bonds with interest reduced initially to 4%, rising to 6% by the seventh year, and new money tied to conversion bonds.

4.0 -- THE ASSUMPTION OF EXTERNAL OBLIGATIONS

As discussed before, the problem of the external debt in the late 1980's and early 1990's was of insolvency rather than the country's overall liquidity. But it was, fortunately, limited to the public sector. The private sector, with some important exceptions, had been able to fulfill

¹⁴ The accrued interests were exchanged for newly issued bonds (the IDU bonds), whose issuer was the Federative Republic of Brazil.

¹⁵ Some analysts do not consider the 1992 Financing Plan a Brady Plan Agreement, because it did not fulfill all conditions precedent. The execution of the agreement, regardless the lack of IMF approval on economic reforms, was only possible as the banks eventually accepted to waive that condition.

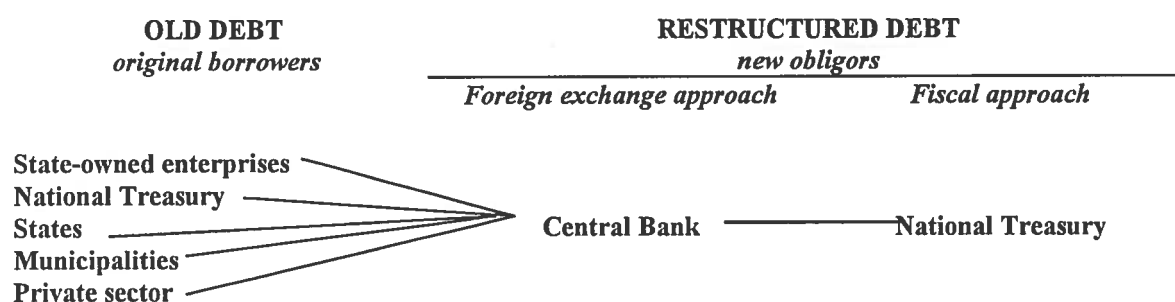
its external obligations in the framework of the deposit facility agreements. The analysis, consequently, will focus hereafter on the remaining public sector external debt and, principally, from the federal government perspective.

4.1. - The Public Sector External Debt

One consequence of the debt restructuring process was the transfer, from the external perspective, of obligations from original borrowers to the Federal Government. This process can be better understood if we consider the essential features of the two phases and how the transfer of obligations to the National Treasury took place.

Chart VIII shows the transfer of external obligations, describing the entities involved in the process. The old debt consisted of sovereign guaranteed and non-guaranteed loans. Under the mechanisms established under the *foreign exchange approach*, the Central Bank was designated the main obligor and the Republic the guarantor. Differently, under the *fiscal approach*, the Republic appears as the sole obligor, with responsibility for internal arrangements.

Chart V -- The Transfer of external Obligations.



In the context of the foreign exchange approach, all external debt from any national person should be eligible for the mechanism of deposit facilities. The objective was to increase the level of international reserves to a reasonable level. The problem was the unexpected overall default, which included not only public agencies and state-owned enterprises, but also private entities. Table III presents the obligations that were not deposited in the Central Bank at the time of respective renegotiations.

Table III- Depository facilities default

	Commercial Banks		Paris Club		US\$ 1,000
		%		%	Total
State-Owned enterprises	10.854.805	74,73	4.086.528	99,75	14.941.333
Federal Public entities	822.151	5,66	-	-	822.151
States	2.301.924	15,85	10.300	0,25	2.312.224
Municipalities	201.331	1,39	-	-	201.331
Private sector	69.307	0,48	-	-	69.307
Others	275.242	1,89	-	-	275.242
Total	14.524.760	100,00	4.096.828	100,00	18.621.588

Source: Central Bank-Firce

Even though the majority of obligations was originally guaranteed by the Republic or some subordinated public entities, a reasonable portion of it consisted of non-guaranteed loans. After the deposit facility arrangements, those obligations were transferred to the public administration.

The same problem had occurred before when the Federative Republic of Brazil issued special series of bonds in exchange for part of the old debt: the *exit bonds (BIBs - Brazilian Investment Bonds)* in the framework of the 1988 Agreement and the *IDU (Interest Due and Unpaid)* bonds under the 1992 Financing Plan.

Table IV presents the total amount of debt effectively transferred to the federal government, according to the nature of the original borrower. Not surprisingly, the federal state-owned enterprises account for the greatest percentage followed by the states and municipalities. Even though the private sector accounts for only 0.6% of the total amount transferred, they consist of extremely high risky borrowers.

Table IV : The Transfer of External Obligations (bonds)

	US\$			
	Exit Bonds	IDU bonds	Brady bonds	Total
state-owned enterprises	168.317.106	1.122.782.046	11.004.235.988	12.295.335.140
States (*)	62.687.870	634.299.165	5.851.282.224	6.548.269.259
Municipalities	6.500.000	19.207.509	223.595.257	249.302.766
Private Sector	4.871.032	14.061.524	101.192.496	120.125.052
Total	242.376.008	1.790.350.244	17.180.305.965	19.213.032.217

(*) State and state-owned enterprises

Source: National Treasury Secretariat (STN)

One reason why the percentage of the private sector was not very high was the timely exception of those private loans in the foreign restrictive mechanisms. Some state-owned enterprises like CVRD (“Companhia Vale do Rio Doce”), PETROBRAS (“Petroleo Brasileiro S.A.”) and ITAIPU, were also exempted earlier.

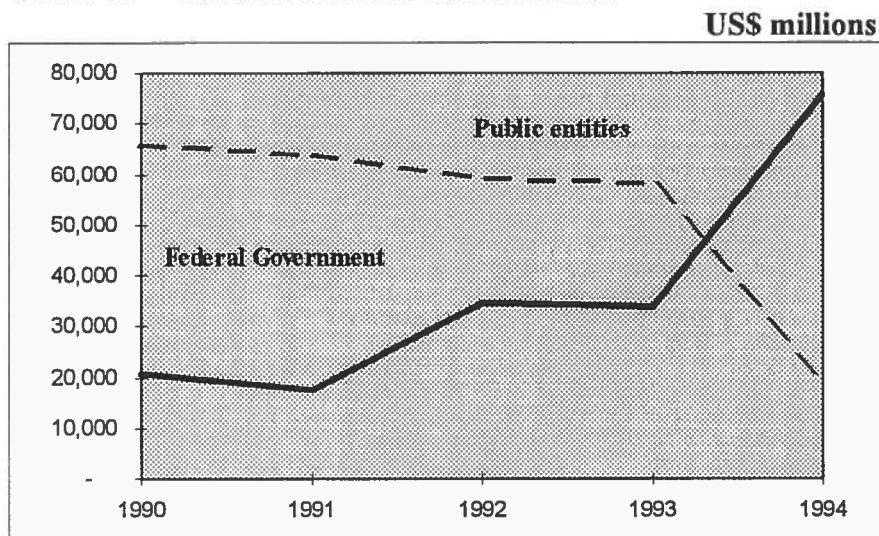
Table VII shows the recent development of the public sector external debt, differentiating among categories of borrowers. It’s interesting to note that while the federal government’s external debt increased significantly from 1993 to 1995, the other public entities’s debt decreased at the same pace. The primary reason for that abrupt shift was the transfer of external obligations. Chart VII illustrates this phenomenon.

Table VII - Public Sector External Debt

	US\$ millions				
	1990	1991	1992	1993	1994
Federal Government	20,523	17,623	34,609	33,717	75,701
Public Entities (*)	65,832	63,785	59,117	58,051	18,825
Guaranteed	57,563	55,245	52,283	50,590	11,838
Non-Guaranteed	8,269	8,540	6,834	7,561	6,987
Total	86,355	81,408	93,726	91,768	94,526

(*) Includes the Central Bank, state-owned enterprises, states and municipalities

Source: Central Bank

Chart VI -- The Public Sector External Debt

Source: Central Bank

4.2. - Secondary Market Implications

But one could argue that, if the majority of original obligations consisted of publicly guaranteed debt, there should be no difference in terms of external responsibilities. That may be legally true, but there are fundamental differences as regards the instruments issued and how they influence creditworthiness.

An important percentage of the external debt was fully exchanged for securities, whose issuer is the Federative Republic of Brazil. Those securities are freely negotiable in the secondary market, making it difficult to assemble the country's private creditors. The bargaining feature of the past debt renegotiations is therefore unlikely to happen again.

Consequently, the Republic cannot delay any payment in any situation or reschedule it easily, even if all original borrowers do not fulfill their obligations. The consequence of a new default would be catastrophic and the return to the capital market increasingly difficult. The newly issued bonds are expressly exempted from future restructurings and from new money requests.

Just to give an example on how big the problem could be, table IV presents data demonstrating the long delay for bond market reentry after the defaults of 1930. Countries classified as “heavy” defaulters, such as Brazil, did not reenter the market until the early 1970s, about 40 years later. Even “light” defaulters reentered only in the late 1950s. The earlier restructurings have prevented a longer delay for the indebted countries’ reentry to the capital market. Such an international strategy for solving the external debt crisis did not exist in the 1930s, but no one can assure that it’s likely to occur repeatedly.

Table VIII - Bond Market reentry after 1930s defaults

Light defaulters	Year	Heavy defaulters	Year
Australia	1945	Germany	1965
Canada	1949	Hungary	1971
Belgium	1954	Costa Rica	1971
Norway	1955	Brazil	1972
Austria	1958	Greece	1972
Denmark	1959	Colombia	1973
France	1959	Chile	1974
Italy	1959	Poland	1976
Japan	1959	El Salvador	1978
Argentina	1961		
Spain	1967		

Source: Cline, William - *International Debt Reexamined*.

In addition to the same argument, prior to the restructuring, a very small percentage of Brazil's public external indebtedness was represented by bonds. However this percentage has increased significantly as a result of the Brady-Type restructuring. Table IX shows that sharp increase after the Exchange Date (1994).

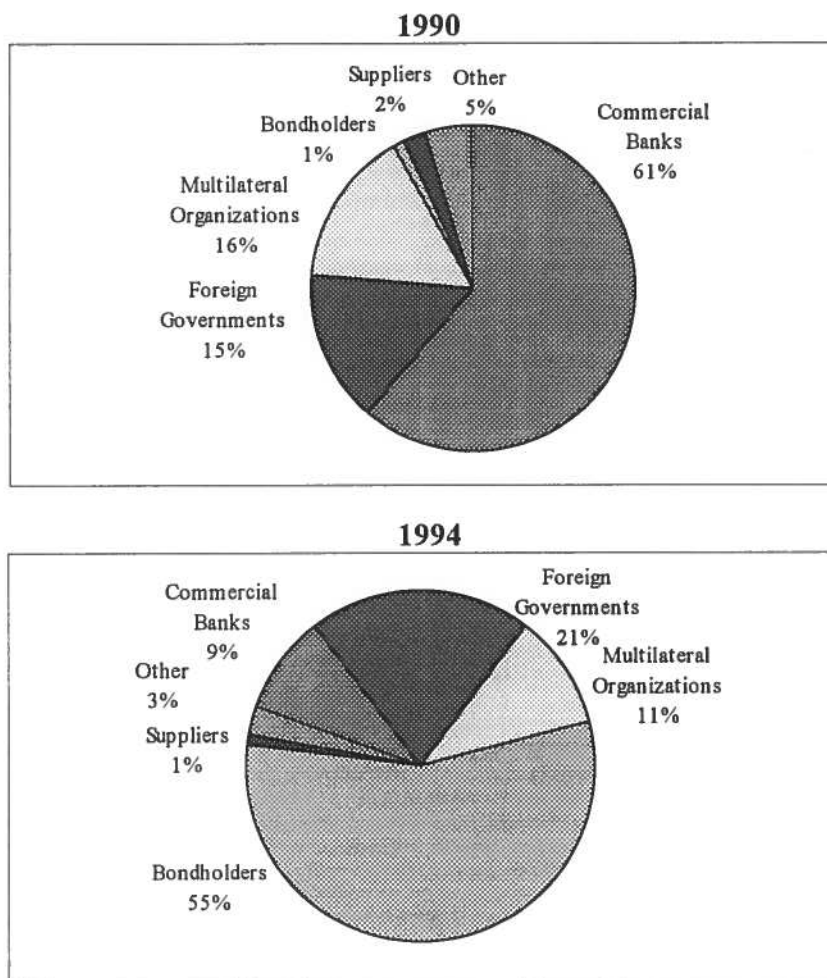
Table IX: Public Sector External Debt by Type of Creditors

	US\$ millions				
	1990	1991	1992	1993	1994
Commercial Banks	52.751	49.324	46.036	46.126	8.771
Foreign Governments	12.925	11.042	19.981	19.552	19.495
Multilateral Org.	13.738	12.130	11.321	10.365	10.098
Bondholders	1.026	2.268	9.996	9.925	52.858
Suppliers	1.953	2.304	1.248	982	630
Other	3.962	4.340	5.144	4.818	2.674
Total	86.355	81.408	93.726	91.768	94.526

Includes the Central Bank, state-owned enterprises, states and municipalities

Source: Central Bank

The graphs below illustrate the radical change in the public sector's external debt profile. The share of securities increased from 1% in 1990 to 55% in 1994. Such a percentage is pretty high for a developing country. This means that any financial circumstances of the debtor will have a huge impact on the secondary market. The consequences are the volatility of either bond prices or yields. In other words, if the federal government does not meet all obligations irrevocably, the conditions for obtaining new money will deteriorate, not only for the public sector, but for the whole economy.

Chart VII: The Securitization of Public Sector External Debt

Source: Central Bank

Certainly, the share of securities is still small compared to the developed countries. But it's important to note that these countries are much less risky. As long as the country continues its the economic reforms and becomes an active participant on the capital markets, total debt owned to bond holders is likely to increase, but gradually.

Creditworthiness has improved after conclusion of restructuring agreements. Many Brazilian state-owned enterprises and even the Republic have issued bonds in the international capital market, notably in the euromarket. However, maturities and yields are not yet satisfactory. The majority of Brazilian bond issues consist of medium term notes, three year in general. Mexican bond issues, by contrast, have reached maturities of five to ten years ¹⁶. The yields have followed the same trend. Though they tend to decrease slowly, the benchmark for most emerging markets issues is very high yet.

Especially in the case of Brazil, further efforts are needed in order to improve creditworthiness and to obtain better conditions. Table X gives a sample of some Brady participants's ratings. The prospects for the future are pretty good, but one can note that Brazil has not reached the same standards as Mexico and Argentina did.

Table X - Some Brady Participant's ratings

	Moody's	Standard&Poors	S&P Outlook
Argentina	B1	BB-	(+)
Brazil	B1	B	(+)
Mexico	Ba2	BB+	(+)
Polaand	Baa3	NR	N
Uruguay	Ba1	BB+	N
Venezuela	Ba2	B+	(-)

Source: Brady Bonds Guide

¹⁶Although it's a special case, Mexican PEMEX has issued bonds with 30 years maturities. Appendix - Sample of bond issues (1992/1995).

The improved creditworthiness can also be noticed by the increase of secondary market prices for most Brady bonds. The only fact that recently forced the prices down slightly was the 1994 Mexican crisis and the so-called "tequilla effect".

5.0 -- THE INTERNAL TRANSFER PROBLEM:

The assumption of external obligations by the Federal government may ultimately worsen the internal transfer problem, and that is the main focus of this study. Consequently, the National Treasury must, effectively and in a timely manner, rescue all obligations from original borrowers in order to prevent increasing fiscal impact.

William Cline remarked that in Argentina, the debt problem had stemmed from the effective transfer of external debt from the private to public sector without a commensurate transfer of private assets to the public sector. According to Cline, the phenomenon imposed an internal (fiscal) problem, on top of the external transfer problem, that subsequently dominated Argentina's debt difficulties.

The Argentine example is quite different because the government had indeed established a foreign exchange subsidy mechanism to help private companies to cope with external obligations¹⁷. In Brazil, as explained, the government had exempted the private sector, which

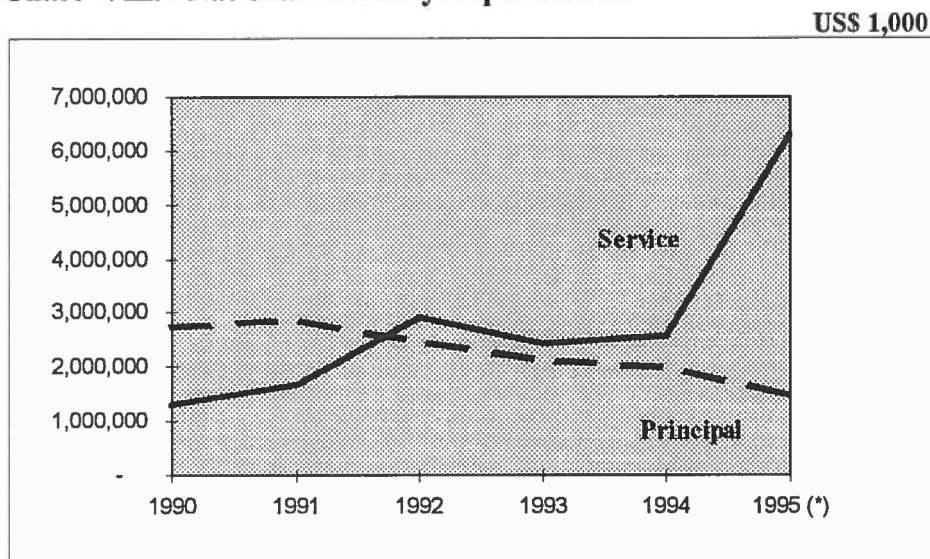
¹⁷Cline, William. "International Debt Reexamined". pp.316-317.

had been able, in turn, to meet its obligations. The case is interesting, anyway, to perceive how internal arrangements may threaten the country's capacity to mobilize fiscal transfers to service the debt.

The new reschedullings will raise the total external debt expenditures carried in the federal budget. That seems, at first glance, to be fallacious, as the recent literature has pleaded for a significant debt reduction. Undoubtedly the total public debt was reduced, but some important must to be clarified.

On one hand, just the *non-affected debt* was being fully honored. In the case of *the affected debt*, only part of the interest due was being paid. On the other hand, because of the assumption of obligations, the Republic will have to pay the debtor first and then charge the original borrowers. In the case of guaranteed obligations, the Republic is only the ultimate payer.

This situation can be noticed on the chart bellow, representing the National Treasury total annual expeditures in relation to payments of principal and service (interest and other charges). Note how the line representing the debt service has increased from 1994 to 1995. The difference will be still higher because the 1995 figures do not include the remaining months. The principal has not changed abruptly as a result of reschedullings (longer maturities).

Chart VIII - National Treasury Expenditures.

(*) until June

Source: National Treasury Secretariat

5.1 - Further aspects of restructuring agreements

According to a World Bank estimate, debt reduction on Brazil's external debt, provided by the Brady Plan, was supposed to reach US\$ 16 billion. Unfortunately that has not occurred.

The reduction is now estimated by the Central Bank at US\$ 8 billion.¹⁸

The Brady Plan reduction was intended to be implemented through: a) outright buy-backs, b) interest reduction (par and interest reduction bonds), c) discount exchange (discount bonds), and c) prepayment (collateralization).

¹⁸ Central Bank estimates, *Offering Circular*

The reduction was modest because of some relevant factors. First, in the Brazilian case, there was no buy-backs, one of the most important elements for reduction. Secondly, when the 1992 *Financing Plan* agreements were executed, floating interest rates were at a very low level, minimizing the effect of interest reduction bonds, which provided for relief in the first years. Third, as the Brazilian menu comprised six options (Mexican and Argentine menus were just two options), the percentage allocated for the discount bond was not sufficient to provide a larger reduction.

One of the most important feature of the Brady Plan was the financial contribution of the international financial organizations and other foreign official creditors to the financing of the deals. The IMF, the World Bank, the IDB and official bilateral donor, have lent funds only when an officially supported structural adjustment program was in place. The table below presents the domestic and foreign financial contribution to the Brady Plans.

Table XI: The Financing of Brady Plan Agreements

	US\$ million				
	Total	IMF/IBRD	New Money	Own	Ratio
Costa Rica	216	86	102	28	0,870
Mexico	7.000	3.707	2.050	1.243	0,822
Philippines	670	320	107	243	0,637
Uruguay	463	99	38	326	0,296
Venezuela	2.380	1.380	600	400	0,832
Argentina	3.032	2.117	0	915	0,698
Brazil	4.250	-	350	3.900	0,082

Source: World Bank, *World Debt Tables*.

It's worth noting that Argentina and Uruguay did not receive as much as the other countries. Brazil, in contrast, received external support from international organizations. That situation is due to the fact that macroeconomic economic reforms were delayed and the Real Plan was finally introduced only by 1994. This meant that the National Treasury had to "purchase" the reserves from the Central Bank in order to provide the collateral. As there were no sufficient tax funds available, they were obtained by issuing internal bonds on the domestic market.

Some papers suggest that the international financial organizations were preoccupied with their increasing exposure to risk, in substitution of private creditors as a result of the Brady Plan, particularly in the cases of Argentina and Brazil. According to a World Bank analysis, even prior to the Brady initiative, some risks were transferred from the private to official creditors. The Brady restructurings would increase the official sector's exposure further and its risks to the same extent as they were expected to finance collateral and buy-backs.¹⁹

5.2 -- The "Real Plan" and Fiscal Policy

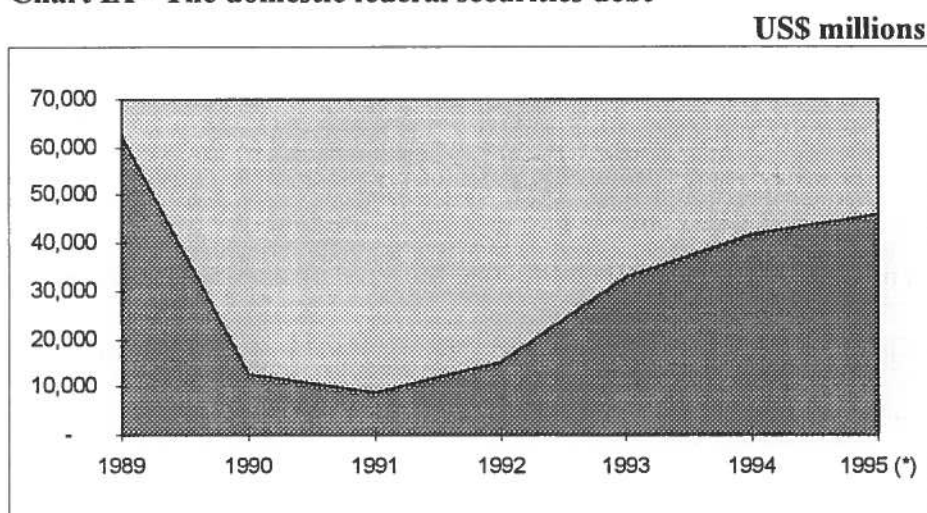
The Real Plan has strongly focused on the fiscal policy as a measure for structural reforms in order to guarantee long term stabilization. The federal government is therefore trying to impose a fiscal discipline capable of keeping the public accounts balanced.

¹⁹ *World Debt Tables 1990-91*, volume 1, pp. 07.

Because of the high domestic interest rates and the short maturities, the internal debt represents a burden for the public entities, including the federal government. As tax income is still insufficient to support all debt payments, the source for additional funds is the issuance of domestic bonds. That is not only the case of principal repayment and debt servicing, but also the provision of collateral.

The domestic federal securities debt (Treasury bonds and bills) has been increasing since 1991 as demonstrated in the chart IX. The growth in the amount of Treasury bonds and bills outstanding in 1992 in part represented a substitution of one type of debt for another, but with higher interest. In addition, the issuance of Treasury bonds and bills offset the increase in international reserves during this period. Nevertheless, the debt service, as indicated, is a burden for the federal government.

Chart IX - The domestic federal securities debt



(*) until February

Source: Central Bank.

The problem acquires a more important role in the process of adjusting fiscal balances if we consider the burden of the federal government because of the current relationship with states, municipalities, state-owned enterprises and the private sector.

Brazil's tax revenue and expenditure assignment structure after the 1988 Constitution has significantly deteriorated the federal government's historical position vis-à-vis state and local governments. States command one of the most dynamic revenue bases (the ICMS) and municipalities are guaranteed a larger share of federal and state revenue collections. The share of revenues does not fit the share of expenditures. The 1988 Constitution decentralized responsibilities, but it did not assign tax revenues to the same extent. The constitutional transfers, despite their important redistribute role, have contributed to deepen even more the federal government's fiscal imbalance.

Some states are in a situation of complete disarray. In connection with the approval of tax reforms, the government agreed to the rescheduling of state debts over a 20-year period and provided for the restructuring of certain bankrupt state development banks. All state and most municipalities completed their debt restructuring agreements with the federal institutions in March 1994. The agreements, covering approximately US\$23 billions, call for a resumption of debt service, limited to 9% of specified revenue in 1994 and 11% of such revenue in the second through the twentieth years. In the event that accrued debt service

exceeds these limits, the difference is to be capitalized and become payable in the 10 years following the original 20-year term.

The problem of tax revenue assignment had become evident when the Federal government assumed that it could not afford any more additional counterpart funds for many large projects supported by multilateral organizations (particularly the IBRD and the IDB) in states and municipalities. A World Bank study suggests an immediate turnback of direct federal involvement in functions of a purely local nature, such as primary and secondary education, urban grading, bridges, zoning etc. Health administration and education should be, from that viewpoint, a state responsibility²⁰.

In the case of federal-controlled enterprises, the impact on the National Treasury's deficit is even worse. They account for the majority of total outstanding credits from the transfer of external obligations. The sectors that face the major problems are energy, steel and transport.

The energy sector is characterised by an overall default. As regards the electric power companies, the Treasury has been obliged to honor, as guarantor, a large share of *its non-affected debt* and the outstanding credits are mounting. In the case of nuclear plants, the

²⁰Shah, Anwar. "The New Fiscal Federalism in Brazil". World Bank Discussion Papers, vol.24.

majority of obligations has been transferred to the federal government, as provided by Law, and there are still bills at the Brazilian Congress designed to provide more subsidies.

The steel companies were privatized in the framework of the National Privatization Program (PND). Though the privatization has been considered a success in the context of economic reforms, the sector's internal and external debts were also transferred to the National Treasury in order to obtain better bid prices. Usiminas was sold in October 1991, CST in July 1992, Acesita in October 1992, CSN in April 1993, Cosipa in August 1993, and Acominas in September 1993.

The transport sector is represented by the highly inefficient Federal Railway Company (RFFSA). The company receives annual subsidies for normal operation and a large amount of its debt was transferred to the National Treasury as provided by Law.

Moreover, experience has shown that the federal government has great difficulty in recovering assigned credits promptly. The same problem has occurred in the early case of the Exit bonds and the IDU bonds. In both examples, in spite of the immediate payment of obligations to the respective holders, there still are significant outstanding credits domestically. The reasons for such difficulty are of a political, administrative and economic nature.

6.0 -- CONCLUSION

The affect of the the *Brady Plan* and the Paris Club agreements on the debt burden is relatively modest and cannot itself solve the debt problem. But, on the other hand, the improved country creditworthiness and more attractive investment opportunities increased the availability of additional external resouces, mainly through reentry to the capital market. But the interest rates are still pretty high. It's important to improve the economic reforms in order to obtain better conditions.

The transfer of external obligations from original borrowers to the federal government is a burden that will increase the difficulties of achieving equilibrium in the public sector accounts. Nonetheless, the impact of the problem is not as great as initially suggested, because of the timely liberalization of the private sector. The majority of the debt was originally borrowed by federal-controlled enterprises. Despite the real transfer through mechanisms imposed by renegotiations, will be anyway assumed by the federal government as a consequence of the domestic legislation.

It's extremely important that the government draw the attention to the internal transfer problem and execute mechanisms in order to recover efficiently and timely the payments it has made in behalf of the original borrowers.

One of the measures is the limitation of the public sector indebtedness. Since 1990, the federal government has taken action to limit the expansion of credit to the public sector. In 1993, consolidated gross public debt was approximately US\$203.7 billion. In 1994, consolidated gross public debt was US\$268.7 billion. The trend in the aggregate growth of public debt is attributable in large part to the substantial increase in the gross debt of state and local governments.²¹

Another possible measure is the decision of not granting any additional guarantee to any public entity in default with the federal government. To achieve this purpose, the federal government has created an integrated system that reports any payment in arrears entitled to any federal agency (CADIN - "*Cadastro Informativo de Creditos Nao Quitados*").

But the most important measure is probably the tax reform, that is currently in discussion in the federal government, states, municipalities and the Brazilian Congress. The Constitution shall be amended in order to fix the problems created by the tax revenue assignment, among other related issues.

Undoubtedly the Brazilian *import substitution* development model, based on strong state intervention, cannot be afforded any more, as it has proven to be inefficient nowadays. The bad performance of most state-owned enterprises is proof that production has now to be performed by the private sector. The overall subsidies and the real transfer from the National Treasury to state-owned companies are constraining the fiscal policy.

²¹Source: Central Bank.

The best way to deal with that persistent issue is privatization. The government should improve the privatization program, not only by broadening its scope, but also by preventing any additional cost for the federal government. Liabilities should be transferred only to make the bid process possible. At the same time, no further investments should be permitted, as the potential return is questionable. Let the new private sector's owners make the best choice for their investments. The debt should be repaid from the proceeds expected from increased private sector productivity. To ensure that all obligations are fulfilled, the new stock holder should provide adequate collateral for the federal government.

The IBRD and the IDB have recently supported efforts to finance projects for reform of the State, which aim at reducing the public sector cost and promoting fiscal balance. Such projects seem to be quite interesting for Brazil, not only in the state level, but also at the federal level. A modern state could prevent the inefficient allocation of public resources. The projects might well start with the tax reforms under discussion, including tax collection, budgeting and public expenditures. On this last issue it's important to remember the need for restructuring the audit system in Brazil in order to prevent corruption and the bad use of public resources.

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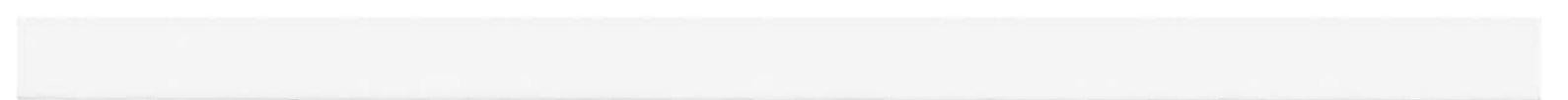
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