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BRAZIL - THE REABILITATION IN THE INTERNATIONAL CAPITAL MARKET - NEW PERSPECTIVE FOR FINANCING

Name : Adriano Pereira de Paula

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I) Introduction: Historical Evolution of the Brazilian Debt Rescheduling Process

The success of international banking in the 1970's was based on the creation and maintenance of expansive operations characterized by low interest rates sustained by short-term capital.

Given the context of high liquidity in the 70's, it should not be surprised by the doubling of the Eurocurrency market every four years, from low of US$ 65 billion in 1970 to about US$1,400 billion in 1984.[1] But the situation changed suddenly after Mexico's moratorium in 1982, the major international banks finally realized the strong implications of holding on enormous and imbalanced foreign debt.

In fact, in the beginning of the 1980's, still affected by the second international crisis of petroleum - when prices rose

[1] Lehman, P. (Indebted Development :Strategic Bargaining and

by 50% between 1979/80 - and under the vigorous effort to reduce inflation in the industrialized countries, banks' lending capacity substantially shrunk. The monetary contraction was severe and the interest rates rose sharply: for example, six-month LIBOR rose from about 10% in 1979 to more than 16% in 1981[2].

Because of its global magnitude, it caused a retraction in the international credit, reducing capital flows to the developing countries. The combination of these effects had disastrous consequence for countries' balance of payments, specially the Latin-American countries that had a high level of indebtedness.

Bank lending to developing countries felt from around US$ 51 billion in 1981 to US$ 25 billion in 1982. The problems with Mexico and Brazil made banks more cautious in extending loans to countries in South America in 1982. As an example, new Eurocurrency bank credits fell from US$ 2.5 billion in 1981 to US$ 1.5 in 1982 to Argentina, and US$ 2.2 billion to US$ 1.1

Economic Adjustment in the Third World)

[2] IMF, World Economic Outlook, 1983

billion to Chile[3].

The developing countries were particularly vulnerable to changes in the world economic conditions in the early 80's. Higher interest rates led them to an unexpected change in cash flow and an increasing debt burden, which caused strong effects for a long period. In fact, the decade became marked by the successive restructuring of debt agreements between commercial banks and developing countries; which, considering the fragility of their economies, those agreements had failed.

[3] McKenzie, George and Thomas, Stephen (Financial Instability and the International Debt Problem)

The Brazilian indebtness process in the international capital market modified substantially in the decade of 1970 when, from 1973 to 1978, the external debt rose from US$ 6.1 billion to US$ 31.0 billion - net basis[4]. This process, resulted from the high liquidity of the Eurocurrency market in the early 70's, and occurred predominantly through the syndicated loans.

Concerning the restructuring process, Brazil started in 1983 with emergency loans from commercial banks and multilateral organizations, with an agreement of restructuring debt with the banks, tried to keep the reserves at a minimum level to fulfill international commitments.

The first agreement was composed of an IMF withdrawal of SDR 4.2 billion, for a three year period, a restructuring of US$ 4.5 billion with the banks and a "new money" loan of US$ 4.4 billion. The agreement was also extended to foreign governmental creditors (Paris Club) for US$ 3.0 billion, resulting in the restructuring of 95% of the debt maturing in 1983/84.

In 1984, the commercial banks agreed to reschedule US$ 5.2 billion of principal and provided an additional credit of US$ 6.5

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[4] Gomez, Carlos Thadeu de Freitas (Captacao de Recursos no Mercado Internacional de Capitais)

in "new money." However, the government's inability to meet all of the lending conditions established by the IMF led to successive suspensions in the IMF's disbursements to Brazil.

In the rescheduling agreement of 1986, Brazil was not able to receive "new money" from the commercial banks. The agreement covered around US$ 16 billion of medium and long-term debts and US$ 15 billion of short-term trade and interbank lines.

Despite the adjustment, a sharp drop in reserves in 1986, resulting from a large capital account deficit and a substantial current account shortfall, caused the government to declare, in February 1987, a moratorium on principal and interest payments to commercial banks.

In September of 1988, Brazil and the bank creditors concluded a complex and extended rescheduling agreement (The 1988 Brazil Financing Plan) involving approximately US$ 61.0 billion pursuant to a Multi-Year Deposit Facility Agreement (MYDFA), an additional credit of US$ 5.2 billion in "new money" according to a Parallel Financing Agreement (a syndicated loan term), a Commercial Cofinancing Agreement (parallel cofinancing with certain World Bank projects and sector loans), a New Money Trade

Deposit Facility Agreement (a medium-term trade financing), and US$ 1.0 billion of Brazil Investment Bonds ("Exit Bond").

The Agreement was accompanied by an IMF standby arrangement of US$ 1.44 billion. However, the IMF suspended the disbursement in 1989 because of the Brazilian Government's failure to reach public sector deficit targets. With the reserves under pressure, the Government imposed new restrictions on interest payments to creditors in July 1989.

It is possible to observe the variety of instruments in the composition of 1988 Brazilian agreement, which represented a new idea for treating debt rescheduling.

In August 1990 Brazil began a new round of meetings with the commercial banks. By January 1991, the Government permitted the full payment of external debts owed by the private sector and financial institutions, and 30% of the interest payments due and payable by public sector obligors. In April 1991, Brazil reached an agreement with the Bank Advisory Committee ("BAC"), comprising the twenty largest Brazilian creditors, treating US$ 9.1 billion in interest arrears from July 1989 to December 1990. Under the agreement, Brazil paid cash US$ 2.0 billion and the remainder was

exchanged for principal amounts of IDU Bonds, issued in two tranches in November 1992 and March 1993, respectively.

Concluding the rescheduling debt process on July 9, 1992, Brazil and the "BAC" reached an agreement in principle on restructuring Brazil's medium and long-term public debt to commercial banks also specific interest arrangement arrears since 1991. The agreement was based on the policy procedures of a "Brady Plan" and involved approximately US$ 43.1 billion.

Observing the brief description of Brazilian agreements, we can note the distinct phases of the strategy on debt treatment. The first one (1982/86)was marked by rescheduling arrears on payments, combined with new money from banks and an IMF agreement.

The second phase (1986/89 - the Baker approach), showed the initiative of a variety of instruments within a combination of short-term balance of payments adjustments toward long-term structural change (the menu approach), and finally, the period when the decline of the debt value on the secondary market helped gain acceptability for the idea of debt reduction through market-oriented reforms(The Brady Plan).

II) The Evolution of the Creditors' Approach:

II.1) The Baker Plan

Facing evidence that the austerity approach to debt management was both stagnating the "DC's" and affecting business and trade balance, a few bankers and US government officials began to raise questions about the matter. Led by Senator Bill Bradley, they argued that some form of a debt write-off was essential to growth in the "DC's."

The result materialized during the annual meeting of the World Bank and International Monetary Fund (IMF) of 1985, when Treasury Secretary James Baker announced a plan to promote growth and adjustment, and to encourage new capital flows to heavily indebted countries from both officials and private sources.

The Baker Plan had three main features:

I) it proposed macro and structural policies within indebted countries to promote growth, balance of payments improvements and the reduction of inflation; supply side reforms were given particular importance, such as reducing subsidies and controls

over markets, and unifying multiples exchange rates;

ii) the IMF and the other official lending agencies were to continue to play a central role in monitoring progress in various countries and in supplying US$ 9.0 billion in additional new loans. If sufficient private funds were made available then capital of the official agencies could be increased;

iii) international banks were asked to make a further US$ 20 billion available to aid adjustment (along with official finance) in 15 of the most heavily indebted middle-income countries over the period 1986/88.

The components to carry out the plan had to be chosen from a menu of options to be tailored to each beneficiary country according to a case-by-case approach.

While the previous restructuring plans were exclusively directed to support the interests of the commercial banks, the Baker Plan had different concerns: (a) economic growth of the debtor countries, which should be considered the main support to recover the external debt payment capacity, and (b) the

allocation of "new money" (necessary for the payment of debts refinanced and non-refinanced), even if linked to the execution of structural reforms under IMF conditionalities.

In fact, the plan reinforced the strategy of coordinated lending while shifting the focus of the debt strategy from short-term balance of payment adjustments to long-term structural change.

However, in covering only the group of fifteen heavily indebted countries, the plan bypassed other countries across the world, whose overall debt was small if compared to Brazil, or any other major debtor, but whose debt service burden was enormous in the context of their ability to pay. Further, the amount foreseen by the plan (total of US$ 20 billion in new lending for three years) would not be sufficient to accomplish the basic premises of "sustained growth" of the countries.

Because of the economic instability in the main country beneficiaries, which were an obstacle to arrangements with the IMF, it was possible, only in 1987, to establish the first structure of a financial Brady package to Argentina called "Market-based Menu Approach." The package included some

features introduced by different agreements during 1985/87, such as (a) currency redenomination, (b) interest rate repactuation, (c) extended period payment, (d) relending funds previously rescheduled, (e) trade facilities and (f) debt-for-equity option.

Two innovations appeared: a "de minimis rule," which excludes banks below a certain level of debt from certain commitments, and API (alternative participatory instruments), which allowed banks to reduce their base exposure for recalculating new money contributions.

The aim of the API, as well as the other innovations, was to substitute more tradable financial instruments for bank claims. The process of seeking more tradable instruments represented the "securitization" of bank claims, which intended to allow banks to diversify their sources of funds. Therefore, securitization was seen as one means of obtaining higher priority claims against a debtor.

According to Cline[5], the BIS' (Bank of International

[5] Cline, William (1990, From Baker to Brady: Managing International Debt)

Settlements) data showed a reduction of bank claims by US$ 9.7 billion from the end of 1985 to the end of 1988, on beneficiary countries. In the same period the banks converted US$ 15.0 billion from debt to equity, US$ 1.0 billion into exit bonds, eliminated US$ 1.0 billion through buybacks, and cut debt by US$ 8.0 billion in discounted restructuring.

However, the strategy of the plan was threatened by the sharp drop in the "DC's" credibility, represented by the pricing of their debts in the secondary market (from a weighted average of 67 cents per dollar in 1985 to 50 cents in 1987)[6], and the position adopted by the banks against the plan, due to differences in tax and reserve treatments, European and Japanese banks were reluctant to extend new lending.

It was against this background that, in May 1987, Citicorp decided to give up entering new money packages and set aside US$3.0 billion to its loan loss reserves, a move that was matched by other international banks.

These facts contributed to the changes in the basic

[5] IMF , 1990 (International Capital Markets: Developments and Perspectives)

principles of the Baker Plan and led to changes in the structure of future arrangements. The tax regulatory and accounting environments of the banks were important factors in designing the new agreements, while the debtors sought better terms in the forms of lower spreads, debt reduction, longer maturities in order to fit with their weak cash flow positions.

II.1.1) The 1988 Brazil Financing Plan

With much of 1986 dominated by eventually successful attempts by creditors to negotiate an acceptable package of policies with Mexico, with the support of the IMF, in February 1987 Brazil declared a moratorium on principal and interest payments to commercial banks that would be formalized by The 1988 Brazil Financing Plan, signed in September 1988.

According to the World Bank's study[7], the Brazilian package was specifically structured along the lines of the market-based menu approach to sovereign debt workouts. The approach consisted of tailoring forms of participation in the package to the different needs and preferences between the banks and

[7]Laudany, Reuben (The Market Based Menu Aproach in Action), World Bank, 1989

Brazil, and was composed of four basic instruments:

(a) Multi-year Deposit Facility in Brazil's Central Bank (US$ 61 billion);

(b) 5 New Money Facilities (US$ 5.2 billion);

(c) the renewal of trade and interbank credit lines (US$ 15 billion);

(d) the issuance of an "exit" bond option (US$ 1.0 billion).

About the new money package it is important to mention that each creditor was expected to commit 11.4% of its outstanding Brazilian exposure as of the Base Date. This was the first New Money package in which the original base date was changed, from December 1982 to March 1987, to avoid overvaluation of the exposure in relation to the supply of funds[8].

However, the change in the base date benefited those banks that had reduced their exposure through sales or conversions and hurt the ones whose exposure was denominated in currencies that have appreciated since 1983, especially Japanese banks.

Further, banks were allowed some flexibility in deciding

[8] New money was calculated as a percentage of a bank's position on a specific base date

how to divide their commitments among the five new money facilities, although there was a predetermined cap for each facility. Furthermore, the new money would be disbursed in three tranches, each being linked in some form to World Bank and/or IMF actions.

II.1.2.) The Instruments

Under the menu, two options were implemented to restructure existing debt and five options of new money, as follow:

(a) The Multi-Year Deposit Facility (MYDF) - the outstanding claims of creditor banks were converted into a deposit account on banks' behalf in the Brazilian Central Bank. The term was 20 years, and grace period of seven years, with an amortization schedule of 26 semiannual instalments. As special feature it admitted currency switching (creditor could choose to denominate its claim in U.S. dollars or any other "home currency"); retiming of interest payments (payments shifted from a quarterly to a semiannual basis); relending (all creditors' deposits would be available for relending); debt/equity conversion (deposits would be eligible for conversion into equity in accordance with internal regulation).

(b) Exit Bonds (Brazil Investment Bond-BIB) - Brazil undertook to issue up to US$ 5.0 billion, but only US$ 1.0 billion were subscribed. The idea of the exit bonds is to create a mechanism that enables "free rider banks"(small-exposure banks) a formal exit from concerted lending while insuring an adequate burden sharing (lower interest rate 6% p.a. - longer maturity: 25 years with grace period of 10 years).

(c) Parallel New Money Facility - US$ 2.85 billion for three years. Eligible for debt/equity conversion at par rate observing a cap of US$ 1.8 in conversion.

(d) Two Cofinancing Facilities - US$ 750 million to be disbursed in connection with World Bank program and bank loans.

(e) New Money Bond - US$ 1.0 billion issued in bearer form.

(f) New Money Trade Deposit Facility - US$ 600 million available for trade financing.

(g) New and Additional Trade and Interbank Commitments - renewal of trade and interbank credit lines of approximately US$ 15.0 billion.

II.1.3) The Results

Despite the advanced formula given to Brazil, the internal

targets fixed by the agreement with the IMF were not fulfilled. Under a fiscal and monetary policy constraint, the Government imposed new restrictions on the interest payments to the creditors, causing the plan to fail ten months after its implementation.

Although the agreement had been regularly followed for 10 months, some benefits obtained by the country were impressive: debt-equity auctions reduced debt by US$ 3.0 billion, informal cruzado-based buybacks reduced another US$ 4.0 billion (prior to government restriction because of concern about the impact on the parallel discount market spread), and the use of new money in debt-equity conversions reduced debt about US$ 2.0 billion.

II.2) The Brady Plan

During the 1987/88, despite the results obtained by the menu approach, some countries tried some special features in side agreements with the banks, resulting in a reduction of the existing debt due to the banks. One example was the Mexico-Morgan Guaranty deal that extinguished, at a discount rate, the bank's claims for about US$ 3.7 billion in exchange for bonds

collateralized by U.S. Treasury zero coupon bond.

Furthermore, a shift in political pressure from the U.S. Congress claiming for a view within the U.S. administration that the public sector was taking over the risk while banks were exiting from lending. In addition, leaders criticized the debt strategy for defending the interests of the banks to the detriment of U.S. manufacturing firms and their workers (U.S. exports to Latin America had fallen from US$ 42.0 billion to US$ 26.0 billion in 1983, although they returned to US$ 44.0 billion in 1988)[9].

Moreover, the decline of secondary market debt prices, to ranges of 30 to 40 cents per dollar, created the idea that there was a market opportunity for extinguishing debt at a discounted price. In fact, there was a trend to consider that the low price on the secondary market was what the debt really worth and thus all that debtor should be willing to pay.

Considering this background up to March 1989, the U.S. Treasury Secretary, Nicholas Brady, announced a new plan that would change the strategy from coordinated lending to the

[9] IMF , 1992 (Direction of Trade Statistics Yearbook)

reduction or partial forgiveness of the outstanding debt. The Brady Plan was based upon a voluntary market-oriented approach to debt reduction.

Further, the arrangement rejected any type of mandatory reduction, which probably would have faced strong opposition from the banks and, in any event, would have risked the restoration of normal capital market conditions that the previous arrangements tried to assure.

In its sense the plan was "voluntary" and "market-oriented." By voluntary it meant that the banks had the choice between new money and forgiveness; and market-oriented because the depth of the debt reductions combined a close relationship between the secondary market price and the extent of the risk reduction by enhancement collateral.

The key provision for voluntary debt reduction was the public sector funding for use in collateralization of conversion bonds. This procedure was adopted to avoid the critique that the public sector would be bailing out the banks, and it could do so credibly because the counterpart was the

debt forgiveness. By mid-1989, around US$ 34.0 billion had been allocated for official support in collateral "enhancements," formed by US$ 12.0 billion each from the IMF and the World Bank and US$ 10.0 from the Eximbank of Japan[10].

To be able to receive such support, countries would be requested to adopt strong policies to ensure structural adjustment in an IMF program, and by this means ensure that they would be able to service their reduced debt burden. The emphasis should be given to promote internal savings and the repatriation of capital flight. In addition, countries would be encouraged to maintain their debt conversion programs to provide additional relief.

Besides, for the first time, the IMF would not insist that a country have a previous agreement with the banks before the institution extended stabilization lending. The same tolerant position was adopted by U.S. Treasury officials in relation to country arrears on interest owed to the banks. The arrears were considered by them as a "message" to the banks relating to their market claims pricing.

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[10] Cline, William 1990 (From Baker to Brady: Managing International Debt), pg. 93.

During the evolution of Brady’s principles there was a major shift away in the debt paradigm from concerted new lending toward market-oriented debt reduction. Some authors, such as Cline and Williamson[11], considered the debt reduction as an important opportunity presented by the secondary market developments. Others, including officials from international financial institutions, sought a more definitive shift, implicitly with a greater element of coercion on the banks.

In the end, the Brady Plan was launched with the purpose of reinforcing the principle of debt reduction, but in practice the plan was sometimes applied with more emphasis on new lending by banks that planned to remain (Venezuela and Philippines); or in other cases (Argentina and Brazil) the emphasis stressed debt reduction.

Given the complexity of the new agreement, Mexico took four months of negotiations from the announcement of the deal to the agreement in principle on a debt reduction program, in July 1989. The central issue was the depth of the reduction. Initially, Mexico requested 55% forgiveness (practically the

same discount prevailing in the secondary market). The agreement was reached with the banks accepting a 22% discount of the amount tendered to discount bonds.

Although the debt forgiveness was smaller in Mexico agreement than had been proposed originally, it set the basic pattern for most subsequent agreements, showing an advance in the debate of the features and their evolution.

By May 1994, fully five years of the Brady Plan, there had been 18 deals completed or announced, in which the countries restructured approximately US$ 191.0 billion of the original bank claims. Among the Latin-American countries, all had received Brady treatment in their debt, except for Chile, Colombia and Jamaica. They did not request a debt reduction.

II.2.1) Negotiation Structure and Basic Instruments

Negotiating a debt reduction has been a difficult and complex process. On the side of the creditors, considering they are a large number, they are represented by a bank advisory committee ("BAC") that is composed of one group of

[11] William Cline and John Williamson

leaders (the "chair") and some subcommittees for different purposes (financial analysis, legal aspects etc.).

Starting the negotiation, the first step is to secure an "agreement in principle" in which the proposed deal and the specification of the menu of options ("head of terms") are defined. For the debtors, these packages are equivalent in impact to a partial debt buyback at market price and a restructuring of the remainder, according to a case-by-case approach.

The next step is to circulate a legally precise description of the terms and the waivers required for the original loans (the "term sheet"). By an agreed date, the creditors present their selection among the options of the menu.

For the debt reduction to take effect, the banks must commit a minimum proportion of their eligible claims ("critical mass"). The agreement is then signed by all creditors and a specific date is set (the "closing date"). On the Closing Date, the loans are repurchased or exchanged for new financial instruments (the bonds) and the collateral is deposited in a "collateral agent," previously chosen by the parts.

The options in the debt reduction agreements usually are:

a) Buybacks - the debtor country is allowed to repurchase part of its debt at an agreed discount (a debt reduction option);

b) Discount bond exchange - loans are exchanged for bonds at an agreed discount with the bonds yielding a market rate of interest (a debt reduction option);

c) Par bond exchange - loans are exchanged at their face value for bonds yielding a lower interest rate than that on the original loan (debt service reduction option);

d) Conversion bond combined with new money - loans are exchanged for bonds at a par that yield a market rate, but banks must provide new money in a fixed proportion of the amount converted (an option for banks unable or unwilling to participate in debt or debt service reduction).

The maturity of the Par and Discount bonds are normally 30 years with a bullet repayment, and principal is usually collateralized with 30 year U.S. Treasury zero-coupon bonds. The collateral for interests, if any, according to the case, is provided by depositing(escrow account) the appropriate

amount in financial instruments covering interest falling due over a fixed period, say 12 or 18 months (rolling interest guarantees), calculated at a rate of interest specified in the agreement. This means that if the country remains current on interest payments, the interest guarantee rolls forward covering the next period, but the interest earned from the escrow account returns to the debtor.

For the debtor, the collateral accounts also effectively reduce the burden of the debt because expected rebates of the interest and principal from accounts, eventually cover the cost of funding of collateral accounts (the rebates would be expected to be equal in present value to the money originally drawn or borrowed from the reserves and deposited in the accounts).

By contrast, in the case of buyback operations, there is no prospect of future rebates because a country's debt is merely reduced by the amount of debt purchased, and increased by the borrowing obtained to finance the operation.

Some variations of debt service reduction bonds had evolved through the negotiation of the Brady agreements. Some bonds

combined a permanent reduction of interest with very low rates of early maturities (step-down/step-up interest). Front-loaded interest reduction bonds (FLIRBs) offer only a temporary interest rate reduction, featuring low fixed interest rates for a few years and then reverting to market rates until maturity.

Despite the different characteristics of the various countries, Brady packages have shown tendencies toward both uniformity in the options' design and a specific need of an individual country. These features are represented by the par and discount options that generally kept the extent of principal and interest rate reduction at about 1/3 (banks were unwilling to give more favorable terms than was given to Mexico); and by the different levels of collateralization (which were correlated with the different secondary market discounts over country's debt prevailing before the agreements).

In many cases, countries were slow to carry out appropriate macroeconomic reforms that would provide a basis for needed official financial support. In addition, the complexity of the menu options made negotiations difficult, particularly when precedent did not exist or when countries tried to insert any

innovations.

It must be considered that some agreements, such as with Mexico, Philippines, Uruguay and Venezuela, dealt with principal debt only, as these countries remained current with their interest payments. But other deals, such as with Argentina, Brazil and Costa Rica, and all recent agreements, have included also interest arrears.

For cases in which significant interest arrears had accumulated, agreement on the level of payments to the banks after the packages were adopted often presented a key hurdle. Further, reconciling overdue interest claims proved to be a difficult task. Because of these factors, some countries spent much time to achieve the complete carrying out.

In Brazil’s case, the remaining interest arrears were converted into a "PDI" bond (past-due interest). These bonds generally have a shorter maturity and grace period than the Brady's. Most of them have yielded a market interest rate, typically the London interbank rate (LIBOR) plus 13/16 percent points.

II.2.2) The Role of the Multilateral Institutions

As the flow of new money from the international capital market to a debtor country reduced it had implication for the official sector. In fact, it increased the pressure on the World Bank and IMF to play a larger role both in financing balance of payment deficits, and in articulating appropriate adjustment strategies through the conditionality that both institutions can bring to debtor nations.

If banks provisioning made the debt problem worse by increasing the incentive for debtor default, it increased the need for compensating action. The unanimous feeling among different authors is that the multilateral institutions should have done more to help the debt problem, not only making financial concessions and remodeling conditionalities, but also in terms of orchestrating and taking a general approach to third-world debt.

The first phase of the debt crisis was marked by voluntary lending by banks orchestrated by IMF, which played the role of overcoming the free-rider incentive of banks acting individually. The main premise was that the debt problem was

not one of insolvency. Thus, further lending was appropriate. However, by 1985, imports had been compressed severely and internal disarray lead the developing countries to a new crisis.

Concerns have also been expressed about application of official conditionalities to developing countries. First by placing the charge of the adjustment upon the shoulders of the borrowers, this approach neglects the fact that the main cause may derive from exogenous facts. Second, the burden of such restrictive adjustment policy typically falls over those whose abilities to adjust are weak, the economies in crisis.

In this respect and observing the problems faced by the DC's during the mid 80's, analytical works were developed at the IMF and the World Bank to reflect the changing dominant paradigm of the problem from iliquidity to insolvency. By the end of 1988, US policy makers conducted an intensive review of the debt strategy, in part because the original time horizon for the Baker Plan was ending.

In March 1989, the new US Treasury Secretary Nicholas Brady announced the next phase of the debt strategy, emphasizing debt

reduction and structural reforms. The plan also proposed additional new money lending by the banks that preferred this option. On the case of official enhancements for conversion bonds, the new strategy added the stick of IMF "lending into arrears," a reversal of the past policy by which that agency had refused to lend to a country until it had reached an agreement with the banks.

Furthermore, IMF and the World Bank would be responsible for making available part of their loans to finance operations that included debt reduction.

II.3) The 1992 Brazilian Financing Plan

Brazil's agreement with the banks in July 1992 led to the 1992 Financing Plan. The deal was approved by the Brazilian Senate in December 1992, and distributed to creditors in January 1993.

According to the agreement, the restructuring involved Brazil's medium and long-term public sector principal debt, as well as interest arrears accrued in respect of such debt, since January 1991. Accomplishing with the agreement, on April 15,

1994, Brazil issued approximately US$ 43.1 billion of the principal amount of bonds in exchange for debt, restructuring about US$ 41.6 billion of eligible debt and US$ 5.5 billion in eligible interest arrears.

For the purposes of the plan, the outstanding debt eligible for treatment was divided into two categories, Old Debt and 1988 New Money. The 1988 New Money was composed of US$ 3.6 billion disbursed under the Parallel Financing Agreement, the Commercial Cofinancing Agreement and the New Money Trade Deposit Facility from the 1988 financing plan. The Old Debt included the aggregate principal amount of over US$ 24.0 billion outstanding under the Multi-Year Deposit Facility (MYDF).

The Old Debt was exchangeable for a menu of options, including bonds types that had been used in earlier Brady agreements: par bonds, discount bonds, front-loaded interest reduction bond, and the new money bond linked to a debt conversion bond.

The 1988 New Money was treated more favorably because it represented new credit provided to Brazil in 1988. Credits

under the NMTDF were exchangeable for new money bonds without commitment of fresh money and credits under CBCFA were exchangeable for the debt conversion bond also without commitment for fresh money. The case of PFA was more complicated. Because it was created in 1988, it was accepted in exchange for new money bonds, debt conversion bond and one specific bond denominated in Brazilian currency(IF Cruzeiro Bond), to be used to capitalize any Brazilian financial institution, Brazilian holding company, or a combination of the two.

The Brazilian menu was the most complicated approach with six options. The discount bond had the standard features. The par bond had a "step-down/step-up" feature for interest rates (which dropped to 4% in the first year and rose gradually to 6% by the seventh year, and remained at this rate thereafter). A front-loaded interest reduction bond (FLIRB) also cut the interest to 4% and then gradually raised the rate to LIBOR plus 7/8ths by the seventh year, and set the maturity in 15 years. The new money option called for a 18% increase in exposure at LIBOR plus 7/8ths, but was only available tied to a parallel adoption of about six times as much money base placed into conversion bonds. A 20-year FLIRB with

capitalization (C-Bond) set the interest at a fixed 8%, but capitalized the difference between that rate and a step-down/step-up calendar starting with 4% and rising to 8% in the seventh year.

A special category of bonds was part of the menu: the phase-in bonds. These bonds were not collateralized. To be amortized in 10 years with two years of grace period with a schedule of interest rates similar to a step-down/step-up related to rates of the par and discount bonds.

These bonds were part of the Phase-In period that provided for a phased delivery of total collateral (US$ 3.9 billion) over a period of up to two years (five installments, the initial collateral - US$ 2.8 billion - on the exchange date and four collateral shortfalls - US$ 275 million - in semiannual installments until April 15, 1996). Such innovation was accepted by creditors since the Brazilian government suggested that the amount of collateral to be made available at the closing date would not be sufficient to collateralize fully the par and discount bonds.

Although the principles of the Brady Plan required previous

adjustment with the IMF to reach an agreement, Brazil broke the rule obtaining creditors' waiver and carrying out its Brady agreement without help from IMF, World Bank, or other foreign official funding for enhancements. This was possible because of the wave of capital inflow that enabled country to accumulate a high level of international reserves. The Brazilian government even skirted the US Treasury's attempt to hold out for IMF approval by quietly buying up 30-year Treasury coupon bonds for months ahead of the agreement then waiting for a special US Treasury issuance.

According to Cline[12], as a result of this autonomy, some purists might insist that the Brazilian agreement should not be considered part of the Brady agreement, assuming that the official sector did not play a direct role in providing enhancement. On the other hand, it is inappropriate to think that Brazil would have been able to agree with the banks outside of the institutional apparatus of the Brady Plan.

The 1992 Financing Plan produced a reduction of US$ 4.0 billion in the debt stock (discount bond effect). In addition,

[12] Cline, William 1994 (The International Debt Reexamined), p.p. 240.

the Government estimated that another US$ 4.0 billion will be saved on interest payments over the 30-year repayment period.

The completion of the Brazilian agreement in April 15, 1994, was considered one the most important signals that not only the debt crisis was over, but the Brady Plan was widely accepted. Indeed, the Brazilian agreement paved the path for completion of the remaining Brady agreements.

In October 1995, Brazil released the current installment of collateral due and advanced the payment of the last collateral shortfall due in April 1996, thereby ending the Phase-in period. Moreover, with this procedure, Brazil became able to enter into any program of buybacks (other than debt-for-equity in a privatization program) of its Brady bonds that it was not permitted by the agreement.

II.3.1) The Instruments:

Bond Type	Annual Int. Rate	Principal Repayment	Amount Issued in US$ Billion	% of Total

Par	fixed rate stepping up from 4% to 6% in year 6 and subsequently	Bullet - 4/15/2024	10,133	23.69
Discount	six-month LIBOR + 13/16%	Bullet - 4/15/2024	7,287	16.89
Phase-In	various	16 consecutive equal semiannual installments beginning 4/15/96(1)	409	.95
FLIRB	various fixed rate stepping up from 4% to 5% in year 6; and LIBOR + 13/16% thereafter	13 consecutive equal semiannual installments beginning 4/15/03	1.738	4.06
C-Bond	fixed 8%(2)	21 consecutive equal semiannual installments beginning 4/15/04(3)	7.407	17.16
New Money	6 month LIBOR + 7/8%	17 consecutive equal semiannual installments beginning 4/15/01	2.239	5.19
Debt Conversion	6mont.LIBOR + 7/8%	17 consecutive equal semiannual installments beginning 4/15/04	8.490	19,68
EI Bond	6mont.LIBOR + 13/16%	19 consecutive equal semiannual installments beginning 4/15/97	5.445	12.62
		TOTAL	43.148	100%

(1) If exchanged for Par or Discount Bond, principal repayment occurs April 15, 2024
(2) A portion of the interest payable under C-Bonds during first six years from 4/15/94 will be capitalized as principal
(3) principal to be repaid under the C-Bond includes capitalized interest.

II.4) The Costs and Benefits

Although a short period of time has passed since the majority of the debtor countries have reached an agreement under the Brady idea, some critique has appeared in relation to the short-term effects of the plan

A central theme in these critiques is related to size of the forgiveness, considered too small to solve any debtor country problems. In fact, the extent of the debt reduction achieved is only one element to measure the impact of carrying out the agreements. In the case of Brazil, the fiscal impact is also important, not only in terms of a reduction in the external debt service, but also through a reduction in the interest rate on domestic debt (source of funds for payment).

With respect to debt reduction, even the IMF and the World Bank argued that the deal was "underfinanced" and reported that their expectation was that, even after partial forgiveness, the financial flow of voluntary capital would not be forthcoming.

TABLE 1 - Debt Reduction Equivalent of Commercial Debt (US$ million)

Country	ARGENTINA	BRAZIL	MEXICO
Face value of commercial bank debt (1)	29,335	57,600	47,170
face value of debt reduction(2)	3,265	3,994	7,061
New money(3)	0	350	1,027
Net face value of debt reduction (4)=(2)-(3)	3,265	3,644	6,034
Face value of new debt (5)=(1)-(4)	26,070	53,956	41,136
PV of interest service reduction(*)(6)	5,159	3,196	7,090
Prepayment equivalent of collateral (7)	3,032	3,783	7,166
Net adjustments (8)=(6)+(7)	8,191	6,979	14,256
Debt reduction equivalent (9)=(4)+(8)	11,456	10,623	20,290
Additional official lending (10)	2,117	0	3,732
Total debt reduction equivalent (11)=(9)-(10)	9,339	10,623	16,558

Source: World Bank - World Debt Table 1993/94
(*) relative to market rates prevailing at the time of the agreement.

Table 1 shows part of the study made by the World Bank comparing the debt reduction achieved through Brady operations. We can note that some results are outstanding, such as obtained by Mexico with the total debt reduction, 35.1%, over the ones obtained by Brazil (18.44%) and Argentina (31.83%).

Notwithstanding those figures, it should be noted that the debt reduction equivalent measures only one dimension of the

extent of the debt reduction, and not the cost at which this reduction was achieved.

For example, in the case of Brazil the interest accrued between 1992 and 1993 was capped at a fixed rate of 4%, involving an amount of debt reduction not precisely calculated by the World Bank. Further, the advantage obtained by Brazil with the Phase-In can be observed when compared with the prepayment in collateral, which represented for Brazil 6.3% of the debt's face value, while Mexico had 12.8% and Argentina 11.1%.

Another interesting point is the fact that, although the plan had canceled significant amounts of debt, it did not provide countries with cash relief as happened in the previous approach. Some countries like, Brazil and Argentina, when restored to normal relations with creditors through Brady Plan had a significant increase in their debt service payment.

It is curious to observe that countries that were paying in full the interest service before Brady agreement (such as Mexico), coincidentally, were the ones who did not benefit from new money loans on the previous agreement, had not incurred on arrears, and consequently benefited more from the cash relief

(see Table 2).

The Brady operations differed from the previous new money approach more by greatly extending the time horizon of the contractual relief than by reducing the likelihood of further rescheduling or of new money request.

TABLE 2 - Annual Net Transfer* to Banks Before and After Brady Plan(billion of dollars)

Country	Before Brady Plan	Pos Brady Short run	Pos Brady Long run
Argentina	0.59	1.19	2.09
Brazil	2.20	2.45	4.44
Mexico	3.24	3.59	3.59

Source: World Bank, World Debt Tables/WB's estimates

(*)Net transfers before debt reduction are defined as cash debt service payments minus disbursements from banks. Transfers after the plans are defined as payment due under the new instruments issued (principal/interest and any other obligation).

Despite the critics, the Brady plan architects proved they were right in saying that there would be renewed voluntary capital flows because of the favorable psychological environment

created by the agreement. As we can note, the timing of this new flow was closely linked to the announcements of implementation of Brady Plan arrangements (see Table 3).

TABLE 3 - CAPITAL INFLOWS (billion of dollars)

Period/Country	ARGENTINA	BRAZIL	MEXICO
1990	0.8	5.3	8.5
1991	5.8	0.8	20.0
1992	13.8	8.8	26.0

Source: IDB 1991, 1993; IMF 1992 Statistic Yearbook

Another positive result of the plan was related to its impact on the secondary debt market prices. Using monthly data on secondary market prices from 1986 to 1993, the World Bank showed that "for all countries, secondary-market prices rose quickly after the conclusion of debt reduction operation" [13].

Taken fourth quarter of 1989 as a base, by the fourth quarter of 1993 some prices had risen about 128% for Mexico, 408% for Argentina and 109% for Brazil[14].

[13] World Bank - World Debt Table 1993/94

[14] World bank - Financial Flows and the Developing Countries

Restoring market access has always been a central goal of debt strategy, and the shift brought by the Brady arrangement was an important step toward this end. Trying to lock debt service relief into a longer horizon, it supported the implementation of a program of reforms that would allow debtors to repay the restructured debt as well as the new borrowing requested. In fact, on March 10, 1989, Secretary Brady told the Breton Wood Committee that "the path toward greater creditworthiness and a return to the markets needs to involve debt reduction[15]."

Advancing toward these goals, the plan tried to provide a more stable long-run financial framework that, combined with structural reforms by the debtor countries, would lead to restoration of international capital market access. But, in order to gain significant market access, countries had to show evidence of improved debt-servicing capacity as a reflection of the structural reforms implemented.

III) THE INTERNATIONAL CAPITAL MARKET

III.1) Risks and Benefits

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[15] Clark, John, 1994 (Debt Reduction and Market Reentry under the Brady Plan)

After following into default on its bonds in the 1930's, Latin America was set apart from the capital market for four decades. On early 1991, Latin America entered into a new era of capital market abundance. The discussion of the debt crisis on a market-oriented basis certainly contributed to this outcome, although there are some experts that reported that the Greenspan Plan (low interest rates)[16] complemented the Brady Plan in bringing about the capital flow.

Certainly, one of the remarkable recent developments in the international financial market has been the increase in private capital flow to developing countries, especially the ones who carried out Brady agreements. Most of the new flows had different forms in direct and portfolio investment, both through equity and securities market, and through repatriation of capital flight.

[16] With the recession in the United States, dollar-based interest rates felt encouraging capital flows in pursuing of high returns.

For Latin America, the net capital inflow doubled in 1990 (from US$ 10.9 billion to US$ 21.7 billion) and reached a peak of approximately US$ 58.0 billion by 1992, after which net inflow moderated to around US$ 42 billion in 1993[17].

In short, the weak commercial bank financial market for lending to Latin America was replaced by portfolio security financing. National repatriation of flight capital also played an important role in the new flow.

Research made by the IMF suggested that whereas capital repatriation was dominant through 1990/92, since 1993 there has been a shift toward a new class of "institutional investor[18]." As a result mutual funds, pension funds and insurance companies entered aggressively into the market.

There were two main reasons for this trend. First was the fact that some countries were consolidating their economic situation; second, considering that some investors have "short term performance goals" they were under pressure to increase their gains, as dollar returns on equity investment in emerging

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[17] IMF - The World Economic Outlook
[18] IMF - Goldstein and Folkert-Landau

markets reached 80% in 1993.

Whereas the flight capital portfolio model tends to point toward a moderation in capital inflows after the initial readjustment, the model "institutional investor" would seem to hold the promise of more sustained flow. However, mutual funds seem vulnerable to herd dynamics, with corresponding potential volatility for flows to debtor countries.

In the return of the debtor countries to the market there was a distinctive feature that was the role of the float rate bonds issued in the international market. Table 4 below reports some examples of issuances during the period of 1990/93:

TABLE 4 - INTERNATIONAL BONDS ISSUED BY DEBTOR COUNTRIES (Billion of dollars)

Country/Period	1990	1991	1992	1993
Argentina	0.02	0.80	1.57	6.20
Brazil	0.0	1.84	3.66	6.30
Mexico	2.31	3.37	5.92	8.40

Source : World Bank - World Debt Table 1993/94

According to Cline, there were three basic reasons that affected positively the return of countries with Brady agreements

to the capital market. First, after the implementation, it was implausible for these countries to return soon to unsecured, syndicated bank lending of the 1970's style. Thus, they were interested in bonds. Second, on the supply side there was a collapse of the interest rates in the US market that compelled investors in a searching for higher yields abroad. Third, during the debt crisis, bonds had generally been held harmless, in contrast to long-term bank claims. The implicit senior status of bonds provided a psychological environment that made creditors more willing to lend through this instrument.

However, the bond investors are discriminating. They usually charge high junk-bond premiums for borrowers with the least secure outlook. For instance, during 1991/1993, Brazil paid an average spread of 500 basis points above US treasury bonds, whereas Chile paid only an average of 150 basis points. Nonetheless, Brazilian private firms were willing to pay the premium because domestic rates were even higher.

In addition, creditworthiness is evaluated on a continuing basis and is influenced by the market's perception of the "quality" of the country's macroeconomic and financial policy. These evaluations are expressed most explicitly by the credit-

rating agencies, which characterize the investment quality of a country's debt.

In this regard, perceptions that a country is executing a weak or inconsistent policy can have an immediate impact not only on its cost of funds and access to credit (downgrading on country's rating), but also on its ability to sustain a particular exchange rate or monetary policy (capital flight outflows).

The Mexican crisis in late December 1994, can be a good example of inability to sustain a monetary and exchange rate policy under great pressure from a huge capital flight. The consequence for the market was an alert against the euphoria of free capital seeking high returns and the absence of control over short-term liquidity.

III.2) The Perspectives for Brazil

The international bond market has been the main path for market reentry by developing countries. Basically, the reentry was made through the sovereign borrower (Argentina, Chile) or a

high profile stated-owned enterprise (Mexico and Brazil).

The cases of Argentina and Brazil in regaining access to the international capital market before their Brady agreements were completed, call to attention the relative importance of the debt operation and, in particular for Brazil, where high levels of inflation and uncertainties related to the agreements were common- place.

Brazil returned to the market through a bond issued by PETROBRAS in order to obtain funds for new project financing. Although the company had not obtained good financial condition (maturity in 2 ½ years with 13.5% p.a./ 480 bps), the success of PETROBRAS' issuance was to mark the country market reentry.

For both Brazil and Argentina, access to new capital flows followed changes in the market's perception of their capacity to service their debt. As a result, the new flow was priced on the basis of expected post-deal creditworthiness, causing high yield spreads.

TABLE 5- YIELD SPREAD* AT LAUNCH FOR UNENHANCED BOND ISSUES

BY THE PUBLIC SECTOR

Country/Period	1991	1992	1993	1994
ARGENTINA	n.a.	n.a	440	338
BRAZIL	480	428	481	450

Source : IMF: International Capital Market
(*) weighted average

In fact, high yields paid on initial issues are accepted as an “entry cost” needed to bring investors into unfamiliar territory and proved to be a good "icebreaker.” As investors became more comfortable in the new territory, subsequent issues have usually been on more advantageous terms.

During the initial phase of the reentry process, in early 1990, the initial issues of the countries that had faced debt restructuring programs were marked by short-term, high-yielding notes issued in small amounts. For example, Mexico first issues, an US$ 100 million Euronote by BANCOMEXT, in 1989, were 2 ½ years, and priced to yield 820 basis points over the yield on US

Treasury bonds[19].

Brazil's strategy has followed the rule of the other countries in Latin America. The reentry through PETROBRAS paved the way for other state-owned enterprises as well as for the private sector. During 1991, 1992 and 1993, according to data from the Central Bank of Brazil, approximately US$ 400, US$ 970, and US$ 1,292 million, respectively, were issued.

With the implementation of a new economic stabilization plan in December 1993, and complying with the guidelines of its Brady agreement, the Brazilian government made its reentry by issuing two short-term fixed-rate eurobonds, in June and July 1994. The bonds were denominated in Yen and Deutsche marc, equivalent to US$ 800 million and US$ 670 million, respectively.

The issues created great expectation in the market because they were the first ones from emerging markets after the Mexican crisis in December 1994. However, both securities were well accepted in the market.

[19] IMF: Private Market Financing for Developing Countries

According to IMF research, despite limited progress in macroeconomic policy, Brazil's reentry has also been facilitated by an increase of investor confidence in the dynamic private sector, which promises considerable growth.

The Brazilian strategy followed the trend issuing first within the Euromarket, which provides for wide distribution and relatively limited disclosure requirements, although the bonds usually have short maturity.

Trying to improve the benchmark established by the first issues, the next step could be new issuances within the Euromarket, or try to go into a new market looking for spreading over the alternatives for funding and investor base.

In this regard, the US private placement market is the final target of developing countries because it is more easily tailored to fit specific requirements for both borrowers and investors, is less expensive, and the securities are sold more rapidly than in a public offering. Another relevant factor to support the strategy is the predominance of institutional

investors in the market, making bond maturities usually longer than in the Euromarket.

IV) Conclusion

Since the beginning of the debt crisis in 1982, policy makers have tried different methods and inventives to avoid threats to financial system and to gain some time over the countries' capital shortage.

Trying to solve the debt crisis providing new money to debtor countries without a deep structural reform in their economies had a "boomerang" effect. The money lent was used for short-term cashflow relief to repay the own lenders. In fact, insisting on that strategy proved to be waste of time during the crisis.

Revising the model was the first virtue of the Brady approach. Requiring the implementation of structural reforms

before providing more stable and long run rescheduling debt service, helped to restore developing countries' payment capacity and lead them toward the international capital market.

With the increasing international mobility of capital and the integration of the capital markets, a number of recent episodes have shown the importance of the international financial market as both a transmitter of economic disturbance and an evaluator of policies.

However, for some developing countries, such as Brazil, due to the short period of time that has passed since the implementation of the Brady plan, significant risks remain. The economy is still fragile in relation to exogenous variables. What happened in Mexico was a good example.

While the reassessment of the international market is helpful, the key to sustained growth and creditworthiness is in the control over the macroeconomic reforms. Keeping the pace of the reforms toward the free market and providing the appropriate regulation proved to be a sound incentive to gradually attract

foreign capital.

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