# Learning from Latin America: Debt crises, debt rescues and when and why they work

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# Brazilian experience – The crash of 1982

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Summary and conclusions

1) The first signs that an external credit bubble could be developing in Brazil date from 1974 and 1975. Price of oil had been suddenly multiplied by four at the end of 1973. Brazilian external debt rose by 35% from 1973 to 1974 and a further 25% in 1975. Current account deficit that was US$ 1,7 billion in 1973, jumped to US$ 7,1 billion in 1974 and US$ 6,7 billion in 1975. Those developments called the attention of independent economic analysts and inside the Central Bank too.

2) Several scenarios throughout the seventies had been offered by the Economic Department to the Central Bank Board and to the Ministry of Finance as well, warning of the route of collision being taken by Brazilian economic policy. They just ignored them.

3) After the crash a comprehensive solution proved impossible, due to the insolvency of Brazil. Focus was to avoid loss of control over the situation in the short run and to temporize while gaining time in order to have a real solution sometime in the future, when general conditions were eventually more favorable.

4) IMF stand-by arrangements were inadequate to provide support for a comprehensive solution, once Brazil was facing a problem of insolvency and not of liquidity. IMF assistance was designed to handle liquidity and transitory problems. Fundamental imbalances require time, patience and medium and long term macroeconomic policies. IMF deals with short term macroeconomic policies. Interesting to note that this difference of approaches was the insight behind the Baker Plan of 1985 (to bring the World Bank to the center of the stage together with IMF).

5) Temporization strategy (“muddling through") coupled with inflationary finance did the job to gain time. However it led to domestic monetary disorder, political reaction and rupture measures afterwards (aggressive moratorium on February 20th, 1987).

6) The Brady Plan came in 1989 with the explicit recognition of debt discounts. Nevertheless, the Government of Brazil (GOB) insisted that the 1/3 haircut in debt provided by the Brady Plan was not enough given the limitations of the country’s capacity of payment. Negotiations started at the end of 1990 and closed by March or

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April 1991 with scanty results: just an agreement on repayment of interest due and unpaid during the period from mid-1989 through the beginning of 1991[2].

7) The Brady Plan finally worked when international financial markets started to channel money again into Brazilian economy and interest rates came down significantly.

8) Conclusions:

a) In cases of insolvency the stalemate comes from the difficult problem of ascertaining what could be reasonably affordable to the debtor country, to the financial community and to the Governments of creditor countries. In other words, how to distribute the burden of the crisis.

b) Given the obviously complicated stalemate, temporization may be the best or the only reasonable way to deal with crises of insolvency. Comprehensive solutions from the beginning do not seem to exist.

c) Money from IMF was never important at all. IMF has been important for the strategy of temporization. As long as GOB was talking to the IMF and signing stand-by arrangements or getting other kind of IMF facilities, even if it was necessary to ask waivers, to rewrite the letters of intention and so forth, all that provided the time required by the banks to enhance their capital basis, without the need to make early provisions. During that time, partial and interim agreements with both the financial community and the export credit agencies were possible with the support of IMF presence.

[2] The GOB interrupted interest payments in mid-1989 under great domestic financial disorder. But this was a friendly moratorium, if we may say so.

## I. Antecedents

9) <u>Diagnosis of the crash: overinvestment under adverse international circumstances.</u> Terms of trade losses resulting from the first oil shock of November 1973. By that time Brazil was a heavy importer of oil. About 80% of domestic consumption was supplied from abroad. And, as a side effect of the oil shock, the slowdown of economic activity in G7 countries, that were the main destination of Brazilian exports.

10) We got the classical combination of elements that usually trigger a bubble of credit. A big pool of liquidity associated with investment opportunities that could make sense, but only in the beginning of the wave.

11) The Brazilian economy had performed wonderfully between 1968 and 1973 when GDP growth reached the yearly average of 11,1%. That performance was a result of the institutional reforms and the stabilization plan put in place by President Castelo Branco Administration (1964 through 1967). Moreover during the 14 years from 1948 through 1961 economic growth had been impressive too, showing a GDP yearly growth of 7,6%.

12) If we take the 26 years as a whole – 1948 through 1973 – the average growth would be 7,6% per annum too. It is worth noting that we are counting the three years of President Castelo Branco stabilization plan and the two years – 1962 and 1963 – of strong agitation and political turmoil, coupled with generalized financial disorder, that paved the ground for military intervention in March 1964 and the authoritarian regime from then on, up to March 1985.

13) Meanwhile, medium term loans had already started to flow to Brazil again, as well as to Latin American countries in general, after almost four decades of interruption, thanks to the consolidation of the Eurodollar Market.

14) The first oil shock brought the accumulation of petrodollars into the international banking system. Neither oil exporting countries nor developed G7 countries could absorb all that money. The former ones were too limited in economic scale; the latter were in a cycle of economic deceleration due to the oil shock itself. But the banks had to find a use for the idle balances in their vaults.

15) The stage was ready for the escalation of the bubble. Latin America, together with other developing regions was the obvious target. Brazil for its size became one of the important borrowers. There banks could find nice interest rates for their loans, export credit agencies could finance their countries exports to supply machinery and equipment to those developing economies thirsty for capital to gear economic development. And multinational corporations could expand their business to hopeful

economic environments. Brazil in particular offered an especially friendly climate regarding the principles that should guide market economies.

16) By the end of 1973 gross external debt was only 15% of GDP and 43% of it was matched by international hard currency official reserves. Ten years later foreign currency reserves had been exhausted[3], external debt reached 47% of GDP and 409% of exports[4].

| | External Debt/GDP | Domestic Debt/GDP | (External + Domestic Debt)/GDP |
|---|---|---|---|
| 1981 | 26,7% | 16,9% | 43,6% |
| 1982 | 29,3% | 21,3% | 50,6% |
| 1983 | 47,2% | 33,6% | 80,8% |
| 1984 | 51,5% | 40,5% | 92,0% |
| 1985 | 49,0% | 41,6% | 90,6% |
| 1986 | 42,0% | 27,7% | 69,7% |

Sources: Central Bank of Brazil, IBGE, IPEA and FUNDAP.

## II. Distress and crash

17) Financial markets had become increasingly rarefied for Brazilian borrowers since 1979 following the Federal Reserve's tight monetary policy. Interest rates skyrocketed. As of March 1980 Libor for Eurodollars reached 18,7% per annum and by December American prime rate was 20,2% per annum.

18) The Malvinas war in May 1982 coupled with the Mexican moratorium on August 13th fired the death blow in the Brazilian fourteen years old *growth cum debt* strategy. From then on financial markets closed for medium term debt to Brazil until 1992/1993. Between 1989 and 1990 there appeared the first signs of Brazilian borrowers returning to international financial markets through short term lines of credit for trade and deposits in foreign subsidiaries and branches of Brazilian banks.

19) The resistance to recognize economic realities as well as the limits of the possible were the preannouncement of the crisis: **phase of Distress**[5]. The markets start to supect that something is not marching well but are not quite sure of how things will behave, or about what to do.

[3] There were arrears instead. That's why the figure for reserves (cash concept) in December 1983 is negative (minus US$ 1.6 billion).
[4] Exports of goods (fob). Exports of non-factor services were not relevant for Brazil Balance of Payments, and continue not to be,
[5] The idea of a period of distress that comes just before the opening of the crisis comes from the classic book by Charles P. Kindleberger, Manias, Panics and Crashes.

20) As a matter of fact beginning in 1979 the hypothesis of a foreign exchange crisis should have been on the desk of all Brazilian economic policy makers. And it probably was, at least among the concerns ofProfessor Mário Henrique Simonsen who had moved from the Ministry of Finance to the Ministry of Planning with the new Administration in March 1979. Theoretically his mission would be to regain macroeconomic balance for the economy. He put in practice a gradual devaluation of the currency, interrupted new raising of loans in the international markets to avoid excessive pressure on the money supply, and started an austerity fiscal program.

21) However the new incumbent President, General João Baptista Figueiredo, disliked the contraction of the economy that began to show up and substituted Professor Delfim Netto for Professor Simonsen, in August 1979, only five months after his inauguration. Professor Delfim Netto was a developmental economist who had been Minister of Finance for seven years, from 1967 through 1974. According to general expectations he pushed aggregate demand up. The economy grew 9,3% in 1980, but Balance of Payments was by then clearly unsustainable. Perceiving the approaching collapse, he still made a desperate move to stop the economy. GDP contracted by 4,3% in 1981. But it was too late.

22) I believe the decision to ask for IMF assistance and to move to a system of administrative refinancing of external debt was taken in the first half of 1982, by the time of the Malvinas war and before the Mexican moratorium on that unforgettable Friday, August 13$^{th}$. But there were general elections scheduled for November in Brazil. The Government thought it convenient to wait until after the elections to open everything. We, at the Central Bank International Division, received instructions to maintain normality in the foreign exchange market up to the 15$^{th}$ of November, irrespective of the almost complete freezing of the markets. It was difficult, but we succeeded.

23) For the Central Bank staff, at the Economic Department or at the International Operations Department, the collapse could have been everything buta surprise. Since 1974 several studies and scenarios for the Balance of Payments and for the economy in general had been presented by the Economic Department of the Bank. All them showed that the strategy to react to the loss in the terms of trade and to the slowdown of G7 economies through pushing domestic absorption would lead, sooner or later, to a collapse in the Balance of Payments. Nevertheless, as it is the rule in Economics, it is very hard, if not impossible, to guess the precise timing.

24) As a matter of course all the warnings had been disregarded. Loans continued to flow in. But not only economists at the Central Bank could see the danger. Other Government Offices also perceived the problems ahead. Economists at the Universities and Academic Centers of Economics raised the dangers in the horizon. Everything was

useless and we must also adress the issue of the responsibility of the lenders, and of the investors, besides that of the borrowers.

25) They had the best economic advisers any firm can have, graduated from the most prestigious academic centers of the world, with top level salaries. What were all those people doing during all those years? Preparing information memoranda to state that the economy of Brazil was sound and strong enough to afford repayment of all the loans that were coming in? They did not perceive that the loans carried floating interest rates and the US economy was suffering growing inflationary pressures? And that if sometime in the future inflation had to be curbed and those interest rates would be raised? The consequence for a borrower under the floating interest rate regime is to face anticipation in the repayment of the loan. In other words the floating interest rate regime protects the lender against inflation through the anticipation of repayment. The indexation system protects him from inflation by keeping the real value of the principal.

26) Government Authorities in the lenders countries must share the responsibilities too, because they have the duty to supervise their banks and financial institutions in general.

27) These are the moral foundations for the discounts (haircuts) in debt restructuring programs, like the Brady Plan.

## III. Acute phase

28) At the end of 1982 the crisis was apparent and came the time for the second round: the **Acute or Critical Phase of the crisis**.
Main characteristics include some waves of panic which appeared while free riders tried to escape. The IMF on behalf of lenders and investors[6] demanded unrealistic austerity policies. Successive Stand-By Arrangements had been agreed between the GOB and IMF and several Letters of Intention were signed by GOB. The so called conditionality package was systematically unfulfilled, basically concerning the Fiscal aspects.

29) One of the characteristics of the acute phase was the insistent and pervasive idea that once and for all solutions could be engineered not very long after of the bubble blowing up. Sometimes the impression is that this could be accomplished even in the immediate aftermath of the crisis' opening. However there was no definite solution from the beginning because we were facing an insolvency problem; not a liquidity one.

[6] Their point is that they are acting to preserve the integrity of international financial markets. It is true, but it is relevant to bear in mind the unavoidable responsibility of the Government and Authorities of the creditor countries who did nothing to restrict the bubble from the point of view of lenders and investors in general.

30) For instance, we may cite two episodes of liquidity crises in recent Brazilian experience. One was at the beginning of 1999 when the fixed exchange rate model collapsed. Economic fundamentals were satisfactory. The problem was the artificial appreciation of the currency. Some fiscal adjustments and reforms were of course required, but nothing striking. So an IMF agreement could be signed with easy, confidence was restored rapidly and the economy was flying again before the end of the first semester.

31) The other was in 2002 after the political uncertainties regarding the high probability of President Lula's election that year. Electoral stress came from the old radical platform of the Workers' Party, which embodied, among other old fashioned items, moratorium and auditing of Government Debt and so forth. There was capital flight, severe exchange volatility with strong devaluation of the real. Once President Lula took office and those ideas were abandoned, the concerns went out and the economy returned to the tracks along 2003.

32) One point deserves notice. At the same time Brazil was facing its electoral economic problems, between 2001 and 2002 Argentina confronted dramatic days with an unprecedented crisis in its severity and deepness following the collapse of their fixed exchange rate regime. Notwithstanding all the economic, social and cultural similarities between both countries, this time, differently from 1982, there was no contagion. Why? Because economic fundamentals in Brazil were solid. In other words, it doesn't seem that contagion is just a herd phenomenon. No. What seems more reasonable is that, when a given economy is performing badly, all the others that share economic characteristics with the one that is failing need to be scrutinized in detail. If the fundamentals are good and economic policy reliable and consistent, contagion does not arise.

33) But the real challenge of this critical phase was to avoid disruption and do not allow free riders to pull out short term lines of credit and interbank deposits to foreign branches and subsidiaries of Brazilian banks. An insufficiency of short term credit could severely destabilize the economy with unpredictable consequences.

34) Brazil missed part of the conditionality package of the first Stand-By Arrangement signed in the beginning of 1983. Brazil started to accumulate arrears already in February of that year and by July a bridge loan from BIS could not be repaid because IMF had not disbursed the first tranche of the Stand-By.

35) Short term credit continued to leak. In a major meeting with the Liaison Committee of the banks in April the Balance of Payments situation was presented clearly and frankly. Although the news was not at all good, this meeting calmed the financial community because it brought transparency to economic data and showed perspectives that seemed reliable and conceptually reasonable.

36) Once it became crystal clear that a comprehensive solution was impossible at that time, the financial community and the GOB took the wise decision to move to a temporization strategy. A steering committee was organized and negotiations started with the Paris Club envisaging rescheduling of the debt with export credit agencies.

37) The steering committee started immediately to fight tooth and nail to keep the banks together in a big effort to maintain the short term lines to the Brazilian banking system, before this could be done through a firm commitment agreement.

38) Why was a comprehensive solution impossible? Because Brazil was facing a double constraint: Balance of Payments and Fiscal challenges. If the exchange rate were devalued, dollars could be generated in the amounts required to satisfy payments under the terms and conditions acceptable to the creditors. But external debt servicing would become too expensive in domestic currency due to exchange rate devaluation; the Government could not generate primary surpluses large enough to purchase the needed dollars. The Balance of Payments conditions of the IMF were met, but not the fiscal targets.

39) The other way around, if the exchange rate appreciated, Brazil would be short of dollars, but now the Government would be able to buy the hard currency in the amounts acceptable to the creditors. Unfortunately there would not be the required surpluses of dollars.

40) So there was a stalemate. The banks argued that they could not grant softer conditions because of a lack of capital basis. The GOB sustained that there was no additional room to put further pressure on domestic investment and consumption.

## IV. Crisis becomes chronic

41) To escape the stalemate and continue to gain time the GOB signed a new agreement with the banks for 1984 maturities and for new money. Brazilian currency was devaluated by 30% in February 1983; exports jumped and imports contracted. 1984 trade account surplus came well above the projections, so the contractual new money became abundant. Central Bank was able to rebuild international reserves. Arrears were paid. Balance of Payments and foreign exchange market normalized. All that thanks to the administration of the external financing of the country. The intervention of governments (Brazilian and those of the creditor countries under the leadership of the United States and the UK) and of the financial community under the leadership of the steering committee did work. As a matter of fact they did a good job.

42) From the point of view of the Balance of Payments one could believe the crisis was over. But the stalemate mentioned herein above (paragraphs 38, 39 and 40) was there. To lift the Balance of Payments constraint the GOB used inflationary finance.

Inflation that was already high (around 100% per annum) jumped to 200%. Forced savings and inflationary tax did the job of generating the required fiscal surplus to support the transfer of real resources abroad.

43) Political reactions did not take long to show up. The new democratic Administration was plenty of old opponents of the authoritarian regime with noticeable nationalist and leftist biases. The mega trade account surpluses were closely associated with hyperinflation and economic stagnation. Besides that the new Administration seemed convinced that to accept the terms of the banks would be useless, since they believed that financial markets would not return to bring fresh funds to Brazil in the foreseeable future. The facts showed they were completely wrong. Six years after the moratorium on external debt payments imposed on February 20th, 1987, the international financial community was once again voluntarily pumping resources into the Brazilian economy.

44) As a matter of fact moratorium was an interruption of interest payments to banks. Principal repayments to them were being refinanced through successive interim agreements. Payments of principal and interest to the export agencies had stopped since 1985, although the GOB had resumed talks with the Paris Club envisaging some interim agreements or something of the like. Interest to short term debt was not affected.

45) Three months later, in May 1987 Mr. Funaro substituted for Mr. Bresser-Pereira in the Ministry of Finance. The new Minister brought GOB back to the temporization strategy. Nevertheless moratorium was suspended only one year later, by July 1988 with a new agreement with the creditors.

## V. The way out

46) Just after the moratorium Citibank announced that they would build provisions of capital to allow for a discount to Brazilian debt. Citi was followed by other banks, so that between 1987 and 1988 the international banking system was finally getting ready for the unavoidable haircut and to offer more acceptable terms and conditions for the rescheduling exercises.

47) This came with the Brady Plan in 1989. Nevertheless, the GOB insisted that the 1/3 haircut in debt stipulated in the Brady Plan was not enough, given the country's capacity of payment. Negotiations started at the end of 1990 and closed by March or April 1991 with scanty results: only an agreement on refinancing of interest due and unpaid during the period from mid-1989 through the beginning of 1991[7].

[7] The GOB had interrupted interest payments in mid-1989 under great financial disorder. But this was a friendly moratorium, if we may say so.

48) The Brady Plan finally worked when international financial markets started to pump money again into the Brazilian economy and interest rates dropped significantly.

49) Nevertheless the final closing of the agreements under the rules of the Brady Plan, in 1994, did not receive IMF blessing, because fiscal fundamentals were not strong enough yet. But the financial community decided to go on irrespective of the IMF. Both sides were right. The IMF was right since Fiscal plicy actually needed additional reforms and adjustments. Part of this has eventually been done, but basically in President Fernando Henrique Cardoso's second term, after the liquidity crisis of January 1999. But part of this is still waiting to be realized.

50) But the financial community was right as well. From a practical point of view a well-conceived monetary reform was in place, international financial markets were once again operative and there was a renewed confidence in the country. So, although in the first moment the domestic distributive conflicts would have to be financed from abroad[8], in an atmosphere of economic growth and monetary stability it would probably be possible to enhance the Fiscal instance gradually.

51) The facts showed that the Financial Community was clever to go ahead with the closing of the final agreement for Brazilian debt even without an IMF facility in place to guarantee the soundness of economic policy.

52) Conclusion (1): in cases of insolvency, the stalemate comes from the difficult problem of ascertaining what could be reasonably affordable to the three actors in the drama: debtor country, financial community and the Governments of creditor countries. In other words, how to divide the burden of the crisis.

47) Conclusion (2): Given the obviously complicated stalemate, temporization may be the best or the only reasonable way to deal with a crisis of insolvency. Comprehensive solutions from the beginning do not seem to exist.

48) Conclusion (3): Money from the IMF was never important at all. The IMF has been important for the strategy of temporization. As long as GOB was talking to the IMF and signing stand-by arrangements or other kinds of IMF facilities, even if it were necessary to ask waivers, to rewrite letters of intention and so forth, all of that provided the time required by the banks to enhance their capital basis, without the need to make early provisions. During that time, partial and interim agreements with both the financial community and the export credit agencies were possible with the support of IMF presence.

[8] The Fiscal performance of President Cardoso's first term has been really poor: a very small primary surplus in 1995 (0,26% of GDP), followed by two successive deficits in 1996 (0,1% of GDP) and in 1997 (0,96% of GDP), closing with a surplus of only 0,02% of GDP, in 1998.