INTERVIEW | LUIZ CARLOS BRESSER PEREIRA

What's Good for U.S. Banks Is Disaster for Brazil

Q. In September 1987, you made a proposal for solving the Third World debt crisis at the U.S. Congressional Summit in Vienna. Your proposal was not happily received by many of the creditor banks, and in particular by U.S. Treasury Secretary James Baker. And you subsequently resigned your position as Finance Minister in Brazil in late 1987. How do you see the debt problem and its solution today?

A. The proposal I made in Vienna, now over a year ago, outlined a global solution for the Third World debt crisis based on securitization of the debt at that time. It was clear to me that the chances for the creditor banks to collect the debt were no better in those days than they had been in 1982, when the debt crisis first broke out—with Mexico's suspension of payments on its external debt. At the time of the Vienna meeting in 1987, seven Latin American countries had stopped paying interest to private banks, and the signs indicated that the situation would deteriorate further.

Q. What signs are you referring to?

A. The signs coming from the financial markets. For example, in the secondary markets, the value of the outstanding debt instruments of Latin American countries was falling steadily lower. In other words, the market's discount on the debt was rising steadily. At the same time, the creditor banks were increasing their reserves against loan losses. The stock markets in turn devalued the shares of commercial banks, underscoring the fact that part of the existing debt on their books could not be collected. I noted that the rise in loan-loss reserves, as well as the decline in the value of bank stocks, corresponded roughly to the expected discounted value of Third World debt. The market's signals reflected the broad consensus that the "muddling through" approach to Third World debt had failed. Many analysts and policymakers were searching for new mechanisms for solving the debt problem.

Q. Where did the ideas come from?

A. The United States Congress played an innovative role. Senator Bill Bradley warned us that the developing countries can't continue to pile up debt upon debt

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forever in efforts to enable the debtor countries to pay their interest to the creditor banks. Senator Sarbanes and Congressmen LaFalce, Levin, and Morrison proposed creating a debt management facility. Congressman Schumer advocated more flexible regulations for debt restructuring. Meanwhile, experts in the academic world explored and developed new ways to cope with the financial needs of the debtor countries.

Q. What do you propose?
A. My idea was to look at the secondary markets to see how market participants valued the outstanding debt of Latin American countries. The market values have been declining steadily, year after year. At that time, September 1987, the market values of outstanding debt represented roughly 50 percent of the face value, or contract value. Using these market values, I proposed a solution of securitization, and I thought of the scheme as being a global strategy. At the time, I envisioned essentially two models to consider: One is to securitize the existing debt below the face value, using market discounts as a guide, and then schedule payments along a reasonable number of years at market interest rates. The second model is to securitize the debt at face value, but to restructure it at fixed interest rates below market rates. In either approach, the debt is restructured according to each debtor country's ability to pay.

Q. What will make creditor banks confident that debtors will be able to service the restructured debt?
A. My proposal had at the center a newly created debt management agency. Creditor countries could associate themselves with that agency and provide a guarantee to the banks for the restructured debt. This could provide a long lasting solution, rather than short-term relief. The World Bank and the International Monetary Fund could join together with the creditor countries and the newly created institution to guarantee the debt.

Q. How would the debt management agency function?
A. The creditor countries, the IMF, and the World Bank could fund the new institution with capital—the maximum amount needed might be something like $20 billion, obtained from the markets for 20-25 years. The newly created institution would use those funds to buy the debt with some pre-determined discount from the private commercial banks. The commercial banks would end up holding newly created securities of the debt managing agency, and these in turn would be guaranteed by the World Bank and the IMF. The discount would vary according to country, case by case. For Brazil, the discount would lie somewhere between 40 and 50 percent; for Argentina, it might range between 60 and 80 percent; and for Colombia, roughly 30 percent. Now those discounts would be granted to the individual countries based on certain conditions for reforming domestic policies.

Q. And the banks didn't like the idea, did they?
A. The plan got a lot of attention, but the American banks, especially, attacked it. Treasury Secretary Baker at the time called my proposal to securitize Brazil's debt a "non-starter." He thought the idea of global securitization was unthinkable. But now, global securitization has become the basic solution for the debt crisis. There is a broad consensus supporting such an approach, a consensus that even includes more of the banks. Only a few major American banks still oppose the idea.

As I see it, the world does not face a great danger of a financial crisis because of Third World debt. The banks have mostly defended their own positions, stopped lending new sums to the developing countries, increased their own capital bases, and reduced their financial exposure to the Third World. But for the debtor countries, the economic crisis grows worse every day. So, we now have a crisis of economic growth and development in the Third World, not the danger of financial crisis.

Q. Where do we go from here?
A. There is consensus that the solution of the current problem must cut back the net financial transfers that debtor countries are now making to the advanced countries. Since it's unrealistic to expect creditor countries to make new loans to the debtors, the only alternative now is for debt reduction, or debt relief. The means for that clearly would include voluntary schemes and securitization through the market and debt equity swaps. But these piecemeal approaches will not solve the problem. Eventually, we will have to go to a global solution. Such a plan in detailed form came from James Robinson, Chairman of American Express, and from Arjun Sengupta, IMF director for India, last year in February. Japanese Finance Minister, Miryazawa made a similar proposal along the lines of global secur-

itization in the Toronto meetings in 1988. He presented his scheme again in Berlin at the IMF meetings last year.

Q. If consensus is growing in support of global securitization, why hasn't some scheme materialized?
A. First of all, there is lack of leadership in the creditor countries, especially in the United States. Actually, that means the U.S. Government has opposed it, because some of their banks still do not have adequate reserves to cover their losses. European banks, by contrast, have enough reserves, and Japanese banks have nearly enough. There is another reason: the debtor countries, themselves, are not putting pressure on the creditor countries. If President-elect Bush wants to change the U.S. position on this, he'll have difficulty if there's no pressure from the debtor countries. And debtor countries will not put pressure on the creditors.

Q. Why not?
A. Because Latin American business elites, on the whole, want to pay the debt. They are not personally suffering very much from the effects of debt repayment. And some have experienced speculative gains from inflation and debt-equity conversion. Besides, they want to be part of the First World, and they want their economies to be integrated into that world. So they don't want to confront the banks or challenge them. Business leaders want to accommodate the banks. When I was Finance Minister, I used to tell businessmen that they had to be firm with the banks, because in order to be part of the First World, Latin American economies must have growth and price stability. Being nice to banks has nothing to do with it.

The business elite also see a third problem: If you approve *external* debt reduction, you can also have *internal* debt reduction.

Q. So they're afraid that external debt reduction will be coupled with internal debt reduction, and then creditors within the debtor countries will be the losers?
A. Yes, and there is also the matter of the exports to them and the direct investments that are not being made in highly indebted countries. The debt problem poses a big obstacle to business between Latin Americans and the advanced economies. They are losing a lot of good business opportunities and that means fewer jobs, lower wages, and lower profits.

Q. What volume of loans would the new institution have to handle?
A. Some people throw around the figure of over $1 trillion as the estimate of external debt of the developing countries. That's not true. The relevant figure is for medium- to long-term debts held by private banks. That amounts to around $260 billion out of the $1 trillion total. Brazil's share, for instance, is around $65 billion of this $260 billion. With a discount of roughly 50 percent, this means that the newly created institution will have to guarantee around $130 billion for a period of 20 to 25 years, more or less. That amounts to less than half a percent of the GDP of the debtor countries. In the end, this approach would solve the basic debt problem that has made the Latin American economies stagnant for the last eight years.

Q. What about the state of Brazil's economy?
A. Brazil is mired in the worst economic crisis of the last 150 years. I look back 150 years, because that was when coffee plantations became important and growth began in Brazil. Cotton also emerged and after the turn of the century, and especially in the '30s, industry began to develop. But my point is, there was always development. Even in the Great Depression of the '30s, Brazil's economy suffered only a small crisis for two years, or three years maximum, and then started to grow once again. In contrast, since 1980, Brazil's income per capita has been stagnant. The rate of investment in Brazil went down from 23 percent of GDP in the '70s to between 16 and 17 percent of GDP in the '80s. And inflation that in the '70s was 40 percent a *year*, on average, now is 24 percent a *month*—near hyperinflation. In Brazil we call it inertial inflation.

Q. What is causing Brazil's crisis?
A. The basic cause is that the state, the public sector of Brazil's economy, is bankrupt. Our problem is not simply a flow problem—that is, large government deficits resulting from spending that exceeds tax revenues. We are also facing a huge stock problem—huge internal and external debt. Between 80 and 85 percent of Brazil's external debt are the obligations of the public sector. The government is supposed to pay interest on this debt, but it has no revenues to do that. When the debt problem first began, Brazil's total debt was split 50 percent in the public sector and 50 percent in the private sector. During the adjustment process that be-

gan in 1980, however, the private sector was able to thrust all the burden of adjustment to the public sector. For example, Brazilian firms were permitted to pay their dollar debts in cruzados deposited in the central bank. Therefore, the burden of the devaluation of the cruzado subsequently fell to the state.

Q. You mean the private business sector really tried to insulate itself from the adjustment process?
A. Yes, that was one problem. But you have to look at that in the long context of Brazil's history. For about fifty years, between 1930 and 1980, the state always played a major role in promoting Brazilian development. The role of the state changed over time, but it was always major. But in the 1980s, the state became a major obstacle to the country's development. While the private sector has flourished and has developed a very good saving capacity for investment, the state's saving capacity has declined from positive to negative. In Brazil's history, if the state is not doing well, the economy cannot do well.

Q. How large is the public sector as a share of GDP?
A. Government comprises about one-third of GDP, but it's very complicated to measure. The relevant factor behind the fiscal crisis of the state is the problem of the huge external debt, more than 80 percent of which is public. After 1982-83, Brazil began to increase the internal debt to finance its public-sector deficit that comes basically from the interest payments on the external public debt.

Q. But after 1982, didn't Brazil's external debt also rise?
A. Yes, but not by very much. New loans now are slow to rise and they have been kept really small.

Q. Hasn't Brazil borrowed more money to make interest payments to U.S. and other banks?
A. Yes, we borrowed some to make interest payments, but Brazil also has very large trade surpluses which enabled us to transfer real resources amounting to 4 percent of GDP on average in 1983-85. The negative real transfer is the basic problem behind the debt. People are quick to say that the debt is an external problem. But that's absurd; the debt is an *internal* problem for Brazil. It has two direct internal consequences: One, since we transfer real resources abroad, we do not invest them at home. So there is a direct relation between transfer of resources abroad and the decrease of the rate of investment for raising Brazil's GDP.

Q. So, the more resources you transfer abroad, the less investment and growth you have at home.
A. Exactly. That's the first internal consequence. The second internal consequence is the public-sector deficit. If the debt is public, the interest payments are part of the public-sector deficit, and interest payments abroad alone amount to about 2.8 percent of GDP, just to Brazil's creditors abroad! If you include internal public-sector debt, interest payments add up to 5 to 7 percent of GDP. These payments present a huge financial problem.

As I said before, the deficits are a very large flow problem, as they also reduce the saving capacity of the state; and the huge stock of debt generates the deficit-to-be, through interest payments. That causes a loss of confidence, because a deficit of, let's say, 4 to 5 percent of GDP cannot be financed normally. It is financed directly, 50 percent with money—an increase in money supply—and 50 percent with Brazil's treasury bonds. The Treasury borrows money from the public overnight and repays it during the morning every day, all over Brazil. It is a very sophisticated financial system that can refinance Brazil's huge debt overnight, every night.

Q. Now, who lends the money overnight?
A. Everyone. Individuals, banks, financial institutions. They receive their money back with a monetary correction, plus the *real* interest rate of the day.

Q. But that is not really financing the deficit. Isn't that Treasury money?
A. Exactly. It is another kind of money—money with interest. It is money protected against inflation. It is liquidity.

Q. Isn't this, after all, a classic inflation dynamic—the central bank is printing money to finance deficit spending, and that is the source of the inflation?
A. No, it's not the *source* of Brazil's inflation, but just the reverse—inertial inflation causes the deficit, which in turn generates the method of finance. Central bank financing is the consequence of inflation.

We developed in Brazil what's called the theory of inertial inflation. I wrote a book with Yoshiaki Nakano called *The Theory of Inertial Inflation* (Lynne Rienner Publishers, 1987) that explains how a country like Brazil can have a very high, chronic, and persistent rate of inflation of 5, 10, 20 percent a *month* and how you can develop such an inflation without having excess demand. We found it could occur only because past inflation was passed through to the present as a result of formal and informal indexation systems. The various income indexation mechanisms make nominal adjustments for inflation in wages, prices, the exchange rate, and financial assets. Those corrections tend to perpetuate the inflation from the past into the present. The inflation has its roots in conflicts over income distribution in the society. The source of the problem is found in the nation's income distribution. With that kind of problem, it makes no sense with inflation of, say, 15 percent a month, to try to solve it by using fiscal and monetary policy alone.

Q. But what do you do then?
A. You have to resort first to a freeze on prices and then accompany that price freeze with fiscal and monetary policies to maintain the macroeconomic balance of the economy.

From this Brazilian experience, the endogenous character of money emerges quite clearly. The theory that money is endogenous was developed by a Brazilian economist, Ignacio Rangel, in the '60s, and then Nicholas Kaldor wrote a famous article in 1970 about this endogenous character of money. In the theory of inertial inflation, money is essentially endogenous. That implies the following for policymakers: The moment that you impose a price freeze on the economy, if you cannot finance the public-sector deficit, you have to reduce it. If you cannot finance the deficit you have to start printing money to finance it, and then you will have more inflation because the equation for the quantity theory of money ultimately holds true. According to the theory of inertial inflation, the economy first experiences autonomous price increases, and then the quantity of money rises to accommodate the rise in prices. But this theory does not say that you can forget about money. The money supply continues to be a very important variable.

Q. If the price increases come first and the money supply expands later, isn't this just the reverse of Milton Friedman's quantity theory?
A. Yes, but only partially so. Policymakers will also have to control the growth of money supply if they want to prevent a worsening spiral of price increases.

In Brazil, we proposed a price freeze as a solution to the autonomous increase in prices. That was the Cruzado Plan that was introduced in the beginning of 1986. (I was not Finance Minister then; my tenure of office was from April 1987 to December 20, 1987—seven and one-half months.) Unfortunately, the Cruzado Plan led to two problems: One was the problem of excess demand, because wages and investments of small- and medium-sized firms increased quickly soon after the plan went into effect. The second was the problem of imbalances in relative prices. When the price freeze became effective, prices on some commodities were below and others were above their respective equilibrium levels.

Besides, wages were not frozen and they began to rise. So the government was unable to control excess demand, nor could it correct the distortions in the structure of relative prices, once it was frozen. The strategy attempted to get zero inflation by decree, but that's impossible when you have excess demand and selective price imbalances. When, in November 1986, the government tried to increase excise taxes on leading products, this became a sign that the economy was about to blow up the Cruzado Plan. After that, inflation began to skyrocket. Real wages then declined drastically in the five months between November 1986 and June 1987. The trade surplus that had been running about $1 billion every month plunged and turned to a deficit. After the Cruzado Plan collapsed, Brazil's reserves declined, a financial crisis erupted, and bankruptcies reached record levels.

Q. Isn't that when you were appointed Finance Minister?
A. Yes, the Brazilian economy was a mess when I took office in April 1987. I announced a second freeze and proposed a macroeconomic control plan. At that point, it was very clear to me that Brazil's external debt had become such a huge problem that the idea of repaying it fully made no sense at all. I set down some targets that included a 3 percent annual rate of real economic growth for Brazil in 1987. That is less than one-half the 7 percent real growth that Brazil had experienced in its past history. To achieve that target, I had hoped to get new money from the banks to finance 60 percent of Brazil's interest payments on foreign debt.

Even to achieve a 3 percent growth rate would be very difficult because Brazil's investment was at very low rates. If Brazil's national savings were to be depleted by making interest payments to foreign banks, we would not have the necessary saving for domestic investment.

By early summer, the idea of debt relief was gaining support, especially with U.S. Senator Bradley, who was thinking seriously about a global securitization plan. It was clear to me that Brazil's internal and external problems had to be solved together. Brazil's internal burden had to be an economic adjustment with strong domestic measures. But that could not succeed if the U.S. banks did not shoulder some of the external burden by granting debt relief. The big problem I faced was the strong opposition of the U.S. Government and the American banks. In addition, at home I faced the Brazilian business elite and the president's staff who wanted to pay up the debt. This very strongly conservative group sought a conventional agreement for making interest repayments. They finally made what I regard as a very bad decision early last fall. Brazil got new money to finance less than 10 percent of the country's interest payments in 1988, instead of the 60 percent that I had initially proposed. That means Brazil had to pay over 90 percent of the interest due.

Q. Didn't that have drastic consequences for Brazil's economy?
A. That could only depress Brazil's economy. The growth rate was 3 percent in 1987, but that's because in recent years we've had excellent crops. This helped a lot. So, we didn't have a negative rate of growth in 1987 because of agricultural production. The 3 percent increase in GDP, with 2.2 percent growth of population, allowed income per capita to rise only very slightly. When the statistics are finally in for 1988, Brazil will show a zero rate of economic growth. That means per-capita income will have fallen by about 2 to 2½ percent. In addition, Brazil now suffers an absurdly high rate of inflation. In 1987, inflation was estimated at over 300 percent; in 1988, it will be around 900 percent. As I mentioned before, Brazil is making a net real transfer to the United States, and that is only possible because the country is earning a trade surplus of around $19 billion. For the American bankers, this is very good. For the Brazilian economy, this is a disaster.

Q. How can Brazilian business leaders and government officials believe that Brazil can finance these interest payments without economic growth?
A. That is hard to answer. Up until 1980, Brazil was one of the economic wonders of the world in terms of growth. After the debt crisis hit, Brazilians made a conscious judgment to carry out a serious adjustment. We took the bitter medicine prescribed by the IMF, and for two years cut back our consumption, generated a huge trade surplus which we used to pay interest to foreign banks. In 1984, the economy started to grow again, and soon the Brazilian business elite, conservative economists, and even some progressive economists were saying, "OK, the crisis is over, adjustment can be successful." Brazil's very big trade surplus was then about $13-$14 billion, on average. And with this we would be able to pay the interest on the debt and grow. What they didn't realize is that this trade surplus was obtained only with a reduction of the investment rate from 23 percent to 16-17 percent of GDP. We forget this. Great optimism spread as our growth continued in 1985-86. But we did so by using idle capacity and by increasing wages and consumption. It's now clear that was a very unsound base for growth. It is good to have wage increases, providing you also have productivity increases, and growth in output. When you have only a wage increase, be careful. That was what we did with the Cruzado Plan.

Q. So the production increase was mainly consumption goods to supply the rise of wages?
A. Yes, and using idle capacity, not new investments that we had built up. But the initial recovery made Brazilian elites very optimistic. Then when the crisis returned, they became a little confused, especially when it extended over two years of crisis—1987-88.

Q. But that still brings me back to my earlier question. If business leaders see that they cannot make new investments in capital formation, how can they be satisfied with the outlook for the Brazilian economy?
A. There is an explanation. One of the arguments of businessmen, other elites, and conservative economists is that the only problem is inflation. And if they are able to finally finish off inflation, they say, all will be solved. They cannot see that inflation is always tied to the external debt. From my perspective, particularly from my experience as Finance Minister, we have to analyze Brazil's problems in the broad perspective of North-South problems. We have to cope with three

shocks: Inflation can be solved only in connection with solving the debt crisis. A new price freeze could work, and I advise that, but that policy must be coupled with some kind of debt freeze. The issue is not simply suspension of payments to the banks—another moratorium. We should tell the banks that we would pay off the debt, using a global securitization strategy, including a discount between 40 and 50 percent.

Q. A price freeze with a debt freeze are the first two shocks?
A. Yes, and the third is a fiscal shock. In December 1987, I had proposed to the president of Brazil a fiscal program that would have increased taxes—especially taxes on income from property and capital. It proposed decreasing public expenditures—eliminating several departments and small- to medium-size public enterprises. When the president rejected my proposal, I resigned the office of Finance Minister. He was not willing to make the internal adjustments—the fiscal shock—that we needed. And to reduce unilaterally the debt without internal adjustment is just populist politics.

Q. Many are concerned about newly emerging democratic governments in Latin America under the severe impact of economic crisis. What is your outlook for Brazil?
A. I have just come from a conference in Montreal where we discussed the process of consolidating democracy in the world—not only in Latin America. And my basic concern is that the same economic crisis in the beginning of the '80s, that helped defeat the authoritarian regimes in Brazil, Argentina, and Peru, is still going on. Now the crisis is destabilizing the new democratic governments—the same crisis has been continuing for almost ten years! The situation in Brazil is terrible. In Argentina it's worse—if it's possible to be worse. In Mexico, for the first time in 50 years, the government practically lost last July's elections.

Q. What do you mean that the political situation in Brazil is terrible?
A. The government today has no support from anybody. It has no credibility. It has no support from the people, the middle-class, or the business class. Everybody is waiting for a new president, and hoping that the new president will do a better job. But the elections won't come before November 1989 and we are pessimistic about the current political situation.

Q. Is there a danger of a political-military coup?
A. I don't believe so, because it happens that the military doesn't have a program for Brazil. Nor does the revolutionary left, which doesn't even exist in Brazil. Neither the revolutionary left nor the military nor authoritarian right have a program. That's very good. Our democracy may be disappointing because of not being able to promote development and social progress, but, in any case, it is much better to have democracy than some kind of authoritarian regime. If the bourgeoisie felt threatened by the revolutionary left, it would ask for the support of the military. Since the bourgeoisie doesn't feel threatened, the military remains quiet. Still, we must be cautious—it's not safe to play with fire.

Q. Given Brazil's enormous problems, are you pessimistic about the future.
A. I am optimistic about Brazil's economic future, though we need international cooperation to solve the debt and development problems. I am convinced that Brazil has the best, the most balanced and sophisticated industrial system in the Third World. I believe that investments are being made to maintain a modern system that is competitive. Brazil's technology is reasonably good. We are exporting a wide range of manufactured goods including cars and auto parts. Our country may have lost the decade of the '80s in terms of economic growth. But this has not been a decade of regression. Brazilian industry is not being junked.

Q. . . . as is happening in Argentina, for example?
A. I think so. Argentina's capital stock has actually declined in the '70s and continues to decline in the '80s.

Q. But that's not happening in Brazil yet?
A. No, and I hope we are able to solve the debt problem before that happens. But that requires a change of thinking in the First World—particularly in the United States—as well as in Brazil and the Third World. With the right pressure in your society, as well as in our own, there will be solutions and the '90s will bring new aggregate growth. I am not a pessimist. The '80s may be lost, but not the '90s. I hope!