THE NEW BRAZIL PLAN AND THE EXTERNAL DEBT

Governo do Brasil

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and the
External Debt

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Federative Republic of Brazil

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1. Introduction

The Government has presented an innovative proposal for renegotiation of the Brazilian external debt to the international creditor banks. For the first time, the matter is dealt with in such a way as to permanently reconcile the economic and political aspects inherent to the interests of the parties involved — Brazilian society and the international creditors.

The State is liable for 90% of the external debt. Consequently, any feasible proposal for payment of this debt must take the State's effective capacity to generate net resources into account or, in other words, the limits on the generation of primary surpluses in the public sector.

Such limits are conditioned by the meeting of social demands for economic growth and the corresponding supply of public goods and services. Aside from this, given that the external debt is concentrated in the hands of the State, the question must be viewed within the general framework of the public sector debt as a whole. Thus, the internal and external debts are two sides of the same coin. Any attempt to effect payment of the external debt at the cost of growth in the internal debt or monetary issues produces increasing inflationary pressures that result in hyperinflation. This was characteristic of the experience of the 1980s.

For this reason, distribution of the resources generated by the primary surplus to the servicing of the internal and external debts must be measured in such a way as to make the honoring of the nation's external commitments compatible with stabilization of internal prices and renewed development.

Observance of the limits of the nation's payment capacity also serves the interests of the creditors. In this way, the banks will be in a position to receive full payment of their credits, thus avoiding new and wearing future rounds of renegotiation. Sooner or later, palliative solutions would once more lead the country to interrupt its flow of external payments. In final analysis, the proposal represents an invitation to the banks to become partners in the process of Brazilian development — a partnership from which all parties involved, both external creditors and Brazilian society, have much to gain.

This is possible because the public sector is economically solvent, requiring only a period of refinancing of its external debt service. This will produce the maneuvering room necessary to achieve internal stabilization and renewed growth.

2. The External Debt and its Consequences Prior to the Collor Administration

The strategy of development with external indebtedness that marked the 1970s was based on three premises:

1. Moderate rates of inflation in the central countries, particularly the United States.

2. Maintenance of real external interest rates within the historic trajectory.

3. Possibility of refinancing part of the external debt principal and interest.

The first two premises guarantied the equilibrium of contracts based on floating rates of interest. Given the long term profile of the investments then being financed, the third premises reflexted the need to maintain the inflow of the external resources.

However, starting in 1979, the combination of a restrictive monetary policy with an expansionary fiscal policy in the United States raised interest rates from the level of 7 to 9% into the range of 20% per year. As is well known, the system of credit at floating rates is highly sensitive to these movements which implicitly reflect an acceleration of principal payments.

New financings were required for the country to bear the burden of its debt service. Indebtedness coefficients deteriorated systematically and this was accompanied by the perception, on the part of the creditors, of the risk involved in lendings to Brazil. Consequently, in mid-1982, markets in general closed their doors to Brazilian borrowers.

It was at that moment that the crisis was born that made it impossible to honor existing contracts. The new circumstances demanded a complete restructuring of those contracts. However, the renegotiations restricted themselves to providing a minimum flow of external financing over a short period of time in the hope that conditions of access to international financial markets would be rapidly reestablished.

These expectations were frustrated, since they were based on an erroneous diagnosis. Though solvent over the long term, the country required financing of a much longer period of time than that defined in those agreements. Consequently, by pushing the flow of external transfers well beyond the internal capacity of the public sector to generate resources, the governments of that period provoked profound internal imbalances.

Emphasis on the balance of payments as the determining factor of external payment capacity led to an overestimation of that capacity, since the country could generate exchange surpluses higher than the public sector's capacity to produce net surpluses in national currency.

The attempt to honor macroeconomically inconsistent agreements contributed to plunging the country into a vicious circle of inflation and stagnation. Limitations on reductions in current expenditures and tax load increases led the government to reduce public investments and expand internal indebtedness, thus producing a combination of accelerated inflation coupled with economic stagnation.

At the same time, as a consequence of the dimensions of internal imbalances, trade surpluses could not be obtained solely through exchange devaluations. As a result, such artificial mechanisms were utilized as fiscal waivers, subsidized prices for the goods and services offered by the State and its companies and direct import controls. The adverse effects that resulted from such measures were poor allocation of internal resources and imperilment of the future performance of the public sector.

3. The Brazilian Proposal and the Payment Capacity Criterion

Current policy has the objective of reversing the process of imbalance and economic stagnation that characterized the 1980s. To achieve this end, aside from the measures already implemented, an agreement on the external debt must be sought that is consistent with the solvency conditions of the national public sector.

Any alternative that implies a transfer of resources abroad that is incompatible with payment capacity would lead the economy back to the vicious circle of internal and external imbalance that marked the 1980s. Consequently, it is essential that a formula be devised for the restructuring of national external commitments that is consistent with the economy's internal capacity to generate primary surpluses.

The efforts that are being made by Government and society to reorganize and modernize leave no room for ephemeral or inflationary measures.

Inverting the posture assumed by previous administrations, the process of restructuring the country's external debt is now to be founded upon the public sector's payment capacity.

Payment capacity is defined by four factors:

1. The primary surplus of the public sector (revenues less nonfinancial expenditures).

2. *Seignorage* (to be understood as noninflationary expansion of the monetary base).

3. External financing provided to the public sector by international organizations, government agencies and private suppliers.

4. Interest revenues on international reserves.

The primary surplus, which is the principal factor in determining payment capacity, is programmed in such a way as to give due consideration to internal stability and the need for economic growth.

Consequently, the external debt restructuring proposal is subdivided into three stages:

1: 1991/1992 — Stabilization. In this stage, priority is given to consolidation of control over inflation and recovery of internal credibility in government policies. Thus, the programmed average primary surplus is higher (1.8% of GDP) and utilization of payment capacity prioritizes reduction of the internal debt as a proportion of GDP.

2: 1993/1995 — Renewed Growth. With the economy stabilized, it is possible to increase investments. The average primary surplus declines (1.1% of GDP), thus permitting public sector investments in infrastructure with the dual aim of eliminating the sectoral bottlenecks that limit growth and encouraging private investments.

3: 1996 onward — Self-Sustained Growth. With the economy in a balanced growth trajectory, it will be possible to maintain the internal debt at a constant proportion of GDP in the range of 11%, as compared to the current estimated level of 17%. In this way, the resources available for external debt payments increase, making it possible to reduce them as a ratio of GDP.

Although the instruments based on the proposal presented by the Brazilian Government to give concrete form to the debt restructuring are simple, they are also capable of taking into account the peculiarities of each creditor.

In dealing with the affected debt of the public sector, the basic idea is the adoption of a special type of bond that guaranties total amortization of the Brazilian external debt, including capitalized interest (according to a fixed market rate), over a period of 45 years (zero coupon bonds). During this period, and in consonance with its payment capacity, the Government will be accumulating the provisions required to honor these commitments. On an annual basis these provisions will be transferred to the creditors in the form of auctions of the debt bonds. The market value of these papers will be nearer the accounting value of the debt to the degree that creditor wariness in relation to these bonds decreases or, in other words, the smaller the contingent of holders of title to these bonds interested in their early liquidation. Should the provision for a specific period not be fully utilized, the Government will distribute the remaining resources in the amortization of these bonds at their respective current value, randomly selecting the bonds to be liquidated.

For those creditors unwilling to wait the required 45 years for total payment of the Brazilian external debt, there are two options available with respect to the affected debt of the public sector (interest reduction bonds and exit bonds). These creditors will be permitted to acquire papers with shorter terms (25 and 15 years), at proportionately lower rates of interest. These papers will not participate in the anticipated payment auctions. Redemption of principal will be effected at maturity and interest payments will be periodical.

All these instruments can be utilized in the Privatization Program. At the opportune time, the Government will issue norms on the form and volume of this participation.

Insofar as the private external debt is concerned, payments of both principal and interest should be effected according to the contractual terms, since this debt has no implications for the payment capacity of the public sector. For this reason, it has not been included in the restructuring process.

The short term credit lines (trade and interbank) will be offered in a totally voluntary manner. In previous agreements, these were compulsory lines and were marked by high costs. Making them voluntary will reduce the cost of these credits and, thus, make it possible to maintain the interbank and trade lines. Payment of the service of the short term debt, as well as the service of the non-affected debt of the public sector is to continue within the contracted time periods.

With regard to the arrears accumulated with the private creditors, it is expected that a corresponding bridge loan will be obtained that will be incorporated into the total affected debt.

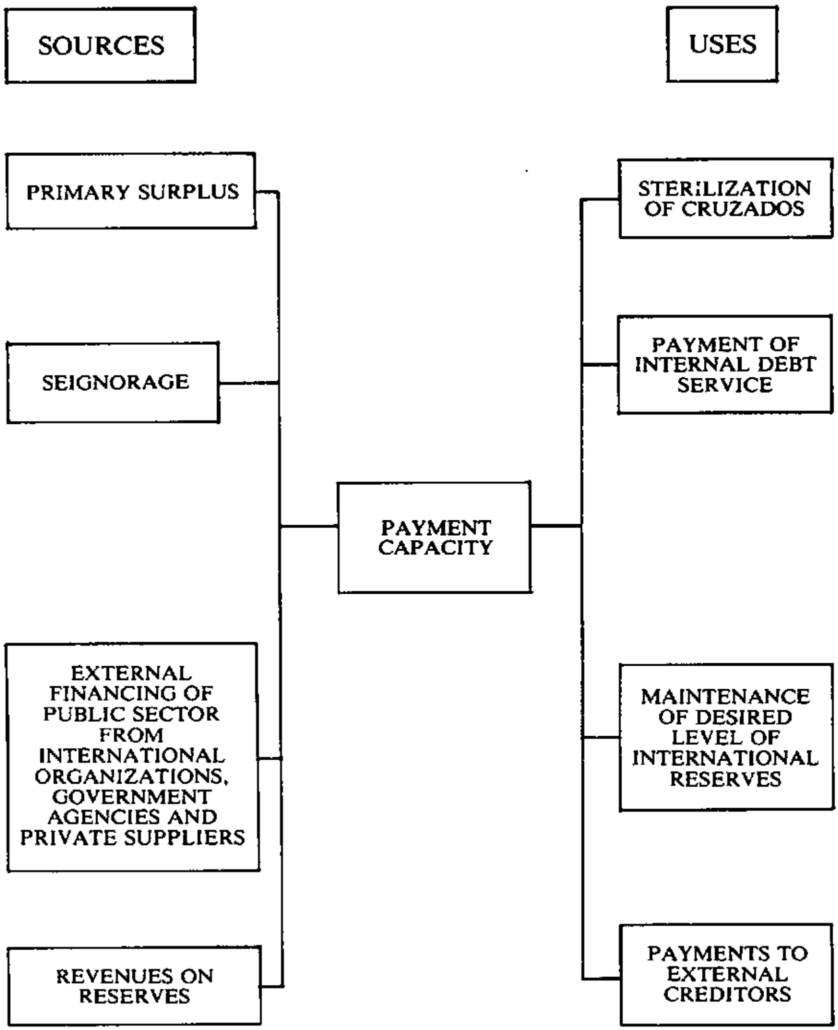
The forms of instrumentalization suggested by the Brazilian Government in no way exhaust the universe of acceptable alternatives. The central point of the proposal is observance of the principle of public sector payment capacity, a principle that is not negotiable. Financial formatting is a variable subject to adjustments as the negotiations go forward.

It should be noted that this proposal represents an overall financing plan that involves the international agencies. Consequently, the allocation of payments among the different governmental and private creditors will be subject to adjustments as a function of the possible results produced by the negotiating process.

As already seen, the proposal has the objective of achieving a permanent solution to the external strangulation which has victimized Brazilian society. At the same time, it encourages creditors to coordinate means of reconciling their interests with the national interests of Brazil.

Appendix 1

Sources and Uses of Payment Capacity



Appendix 2

Glossary

1. External Sector

Floating interest rate loans — Loans that will be paid at the market rate of interest in effect at the time of payment.

Indebtedness coefficient — The coefficient of the External Debt/GDP ratio.

International organizations — Multilateral credit institutions, among which the most important are the World Bank, Interamerican Development Bank, IMF.

Government agencies — International entities that provide loans guarantied by the government to which they are connected. These loans are negotiated in the context of the Paris Club.

Private suppliers of financing — Financial entities that provide loans earmarked to the financing of merchandise on the international market.

Public sector affected debt — That share of the medium and long term public sector external debt with commercial banks which will be included in the process of restructuring. Excludes debts contracted after March 1983, debts excluded from rescheduling, New Money Bonds and Exit Bonds of the 1988 agreement.

2. Public Sector

Fiscal waivers — Revenues which the public sector opts not to receive to achieve some economic policy objective.

Current expenditures — Current outlays of the direct and indirect administration of the Government, including personnel and social charges and current government transfers.

Public sector solvency — The public sector is considered solvent if the present value of the expected primary surpluses is equivalent to the stock of its debts (internal and external), excepting the international reserves and privatization revenues.

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