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Solving the debt crisis: Debt relief and adjustment

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Em 5 de janeiro de 1989, o professor Luiz Carlos Bresser Pereira, professor titular da Fundação Getúlio Vargas e editor desta Revista, apresentou o seguinte depoimento perante o Committee on Banking, Finance and Urban Affairs of the U.S. House of Representatives.

The debt crisis of highly indebted countries of the Third World has an economic, a political and a moral dimension. For the creditor countries it represented also, for a certain time, a threat of financial crisis, but today it remains a problem as long as there are mutual economic interests between them and the middle income countries of Latin America, and because there is some degree of solidarity with the low income sub-saharan countries.

In this testimony I will discuss the debt crisis of the middle income countries, most of them Latin American countries, and particularly the case of Brazil. This question was already thoroughly analyzed. The solutions for it are already known. But, as Albert Hirschman once said, for policy decisions to become effective it is not enough that the problem have been understood, it is necessary motivation to solve it. And that is exactly what is lacking, be it in the creditor or in the debtor countries.

I will present in this testimony some of my personal experience, I will make an analysis of the debt crisis differentiating it from a mere debt problem, and I will discuss the only possible solution for it: a combination of debt relief with internal fiscal adjustment.

1

The debt crisis is an economic crisis because the highly indebted countries are stagnated in per capita income terms since 1980 and because inflation rates are reaching historical records. If we take two samples of less developed countries — one of highly indebted countries and other of not highly indebted countries — and compare their economic performance in the '70s and in the 80s, we will see that the first presented similar performance to the last in GDP growth in the '70s and much worse outcomes in the '80s; between 1980 and 1988 highly indebted countries grew at a rate of 0.5 per cent a year, the developing countries without debt servicing problems grew 4.3 per cent a year. This fact suggest there is a clear causal relation between economic stagnation and the debt. Certainly we can find other causes — mainly economic populism of politicians and short-sightness of the business elites — but these are not new historical facts and do not distinguish highly indebted from non-highly indebted countries. These internal limitations always existed, they represented an obstacle but did not block growth. The only new historical fact that can explain an economic crisis without example in the past in Latin America is the debt crisis.

It is a political crisis because it is endangering democracy and the reformist governments in Latin America. In the beginning of '80s the economic crisis helped to end with several authoritarian regimes in Latin America and the Philippines; now, as this same crisis was not overcome, the fears that populist and authoritarian politicians return to power are widespread. We, in Latin America, have been fighting to set up in our countries stable democratic regimes. Democracy for us, as for the nations of the First World, is a final goal as important as economic growth and social justice. After serious setbacks in the '60s and '70s, when populist governments have been overthrown by military coups, we made the critique of populism and of technobureaucratic authoritarism and defeated the last one. It will be a terrible setback to return to populist governments that end in authoritarian regimes.

It is a moral crisis because is extremely unjust to the poor in highly indebted countries. Income per capita is stagnated in these countries, standards of living are deteriorating, real wages are going down, social benefits and public services granted by the state are being reduced, income is being concentrated in the hands of speculators that benefit from inflation and from debt-equity conversions. The costs of the debt definitely are not distributed evenly between the people in the highly indebted countries. UNESCO recently calculated that 500 thousand children died due to the increase in the infant mortality rates since the beginning of the debt crisis. When the debt was formed, in the '70s, the ones that most benefited from the loans, besides the banks that charged high spreads, were not the poor in Latin America. Now are the poor that are paying most of the adjustment required to pay the debt. I know very well that moral arguments are less compelling than economic ones. That is why, in favor of debt relief, I always chose an economic argument — the existence of a discount in the secondary market — as the better indication that the credit of the banks are not worth their face value, but is important not to forget the moral issue involved.

The debt crisis is a central economic problem for the highly indebted countries, and a marginal — although eventually important — problem for the creditor countries and particularly for the United States. In 1982, when the debt crisis broke up, the danger of world financial crisis was real. But this threat is over. The European and the Japanese banks began to create reserves against their sovereign credit already in 1983; the American and English banks only in 1987 started to do the same. All banks, during these six years, improved their capital ratios. Only two or three big American banks are not yet entirely safe in relation to the debt. The debt, however, represents a real problem for the creditor economies as long as billions and billions of dollars of exports to the debtor countries are being lost every year. Instead of buying machines, equipment, technology and consumer goods from the creditors, the debtor countries pay them huge sums of interests. As Mr. Fritz Leutwiler, former president of the Bank of International Settlements said in the consultations on the debt crisis called by Mr. Pérez de Cuellar, United Nations General Secretary, last September, the debt crisis is causing the loss of an enormous quantity of good business opportunities for the creditor countries in Latin America.

The negative economic consequences for the world economy of the economic stagnation and the reduction of imports of the highly indebted countries has not been fully felt in unemployment and reduced rates of growth in the last years due to the huge trade deficits of the United States. Instead of exporting more to Brazil, to Mexico or to the Philippines, the European countries and Japan export to the United States. It is quite obvious however that this situation cannot be sustained for long. It is not a situation that respond to the long term economic and security interests of the United States.

2

It is not by chance that everybody today refers to a debt crisis of the highly indebted countries and not to a debt problem. These are two entirely different things. A debt problem is a liquidity problem, is a problem that can be solved with a combination of adjustment and additional financing. The adjustment is essential to reestablish the equilibrium of the balance of payments. And once this is done, once imports are reduced and exports increased to balance the current account, the question is solved, and the country will be able to resume growth. The additional financing is essential — to provide it is the classical job of IMF — because the country lost access to international credit and became temporarily unable to service its debt.

A debt crisis is an essentially different situation, although apparently a very similar one. Actually it is possible to define a debt crisis in relatively precise terms. It is a situation where the debt and its respective interest are so high in relation to exports of the country that the adjustment efforts are self-defeating and to provide additional loans makes no sense. So, it is a debt that turned out too high to be paid.

There are several reasons why the adjustment effort turns self-defeating when the interest that have to be paid on the debt are too big. To balance its current account the country has to reduce imports and increase exports beyond its capacity. In many cases the country is able to produce in the short run the required trade surplus, but this is always achieved due to a limited reduction of internal consumption and a big reduction of investment. To reduce consumption of the poor — the large majority of the population — is possible but brings limited results since there is not much to be reduced; to reduce the consumption of the middle and upper class is politically very difficult; to reduce public investments is relatively easy, but this just lowers the medium term rate of growth of the productive capacity of the country — a capacity that should increase to permit export growth.

A second reason why internal adjustment is self-defeating when a debt is too big lies in the consequences of the debt on public finance. The debt in practically all Latin American countries turned into a fiscal crisis, because the private sector was always able to transfer the burden of the debt and of the required adjustment to the public sector. In the '70s the foreign debt was about 50 per cent public and 50 per cent private; in the end of the '80s, around 80 per cent of the debt is public. Thus, at the same time that the internal fiscal adjustment measures attempted to reduce the public deficit, the increase in total interest paid by the state on its increasing foreign debt (because it was being transferred from the private to the public sector) offset the public deficit reduction efforts. On the other hand, as foreign loans were severely limited since 1982, the public deficit had to be financed internally, leading the public sector to pile up an increasing internal debt and to incur in enormous payments of interest to local investors. In Brazil, according to recent official calculations, total interest on the external debt and on the internal debt correspond respectively to 2.8 and 2.9 per cent of GDP — a total of 5.7 per cent against a public deficit of around 4 per cent of GDP in 1988.

This enormous amount of interest paid on the internal and external debt is a basic reason for the increase in the public deficit and so for the reduction of the saving capacity of the state. In Brazil, during the '70s, public sector savings used to be around 5 per cent of GDP, today they are 2 per cent negative. Public deficit did not increase correspondingly because public investments were curtailed.

Third, adjustment usually entails exchange rate devaluation. These devaluation, that are necessary, have two negative effects, both conductive to higher rates of inflation: a cost effect that directly accelerates the rate of inflation, and a public deficit effect: given the fact that the foreign debt is today mostly public the public deficit increases in proportion to the exchange rate devaluation.

This self-defeating character of the adjustment process in the highly indebted countries makes the full service of the interests on the debt inconsistent with growth and price stability, even if it is assumed the partial financing of interests with "new money".

I came to realize that quite empirically when, in the beginning of the seven months and half I was Finance Minister of Brazil (April 29 to December 20, 1987), I asked my staff to prepare a macroeconomic consistency plan and gave them two parameters: 6 per cent rate of GDP growth and 50 per cent financing of interest due on the foreign debt. Thus, in that time, since I did not thought — or knew — about debt relief, I was thinking on a conventional solution to the debt. My only innovation as to turn the problem of financing interest up side down and subordinate the required "new money" to growth: the basic objective was growth; the 50 per cent financing of interest, just an indication. My staff proceeded with all the required macroeconomic simulations to prepare to plan, and, in July, they came to me with it practically finished and two observations: first, instead of 50, it would be necessary to finance 60 per cent of the interest due to the banks (more would not be minimally realistic own our part), and, second, it would be necessary to impose on the population a severe reduction on its average propensity to consume to end with the public deficit, recover the saving capacity of the public sector and increase the overall investment capacity of the economy.

This second observation was a clear demonstration of the lack of realism of the macroeconomic adjustment plan that was being prepared and of the inconsistency of the full payment of the debt with growth and price stability. Certainly, if we thought of economic policy as a kind of economic engineering, the required reduction in consumption would be feasible. But we know very well that economics and economic policy deal with real people, are politically conditioned, and cannot be reduced to a technical and abstract question.

The empirical demonstration of the self-defeating character of the adjustment attempts of the highly indebted countries is the fact that, in spite of the severe adjustment measures adopted, these countries are stagnated, inflation is rising and can be only temporarily stopped with price freezes, and the debt/export ratio, that measures the paying capacity of these countries, is today higher than six years ago.

3

When we have a debt crisis and not a debt problem, when a debt is too big and make the internal adjustment efforts self-defeating, the only solution is debt reduction or debt relief. Only debt reduction will make adjustment again feasible. Instead of a combination of adjustment with additional financing, what is needed is a combination of adjustment with debt reduction.

Debt reduction is not an unusual, much less a reproachable practice in the debtor-creditor relations. The private credit relations are well set up on this subject. The legal institution of Chapter 11 (*concordata* in Brazil) is present in practically all law systems in the world. It is a legal device created to the benefit of both debtors and creditors. It is an alternative to bankruptcy, it is a form of avoiding or reducing the losses for both creditors and debtors involved in the breakdown of a business enterprise.

Debt reduction through debt relief is the equivalent to Chapter 11 when we are dealing with sovereign debt. It should be adopted on behalf of both creditors and debtors. There are, however, two differences that should be underlined: first, it is lacking the figure of a judge or an authority that is always present and necessary in Chapter 11 situation; second, it is fairly clear who is the debtor — it is the debtor country and increasingly the public sector inside the country — but it is not so clear who is the creditor, since we should not mix the interests of the creditor country with the interests of the creditor banks.

In the case of the present debt crisis of the less developed countries, the government of the United States (through the Treasury and the Federal Reserve Bank) has been playing the role of the superior authority, in agreement with the other members of the Group of Seven, but its role is confused because it is difficult to distinguish the interests of the country from the interests of the banks.

Notice that when I am speaking that debt reduction is the only possible solution for a debt crisis, I am not including in this concept the voluntary, market controlled devices, that permit a gradual reduction of the debt: debt-equity conversion, debt-bond conversion (Mexican-Morgan style) and exit-bonds. I am speaking about across the board debt reduction, as a result of negotiation involving creditor and debtor governments and creditor banks. Such debt reduction combined with internal adjustment can solve the debt crisis. The voluntary schemes are suited for a debt problem, not a debt crisis. They will take too long to reduce the debt, and in the meantime the internal deterioration of the economies of the debtor countries will neutralize the whole process.

This caveat is important because in 1987, when the idea of debt reduction through securitization, capturing the discount existing in the secondary market, was first presented, it was immediately rejected by the creditor banks and by the government of the United States. But as the securitization proposal was compelling, it was soon coopted by the banks and included in the finance and adjustment or muddling through approach, as part of the "menu of options" that would eventually solve the dept problem. I hope to have made it clear, however, that this belief can only be rooted in the confusion between a debt crisis and a debt or liquidity problem.

4

Immediately after concluding the Macroeconomic Control Plan, in July 1987, I came to the United States to present it to the American government and to the Multilateral Agencies in Washington and to consult with them about the basis for the proposal Brazil would make in relation to its debt. First, however, I visited members of the Senate and a subcommittee of the Banking and Finance Committee of the House of Representatives, and in that exact day I learned about the debt relief resolutions that have already being approved in both houses of the U.S. Congress. I, as most of the elites in Latin America, was poorly informed about the debates that were taking place in the creditor countries. I was very impressed with these ideas that were new for me. I realized that the elites in the First World were divided. That in the creditor countries there was a fair distinction between the interests of the creditor countries and the short term interests of the banks.

In the following day, talking to each one of the Washington authorities, I presented the securitization idea, with a guarantee to the new bonds granted by creditor governments through the World Bank and the IMF, as the real solution to Brazil's debt crisis. And I learned then that these ideas were good, but, as directors of the two multilateral agencies told me, "the creditor governments and the creditor banks are not mature for them".

Brazil had suspended the payment of interest in February 1987, two months before I took office. I had as a goal to end the moratorium, but I knew very well that it was the only real bargaining power that Brazil — or any debtor — had. I could only resume payment of interest in exchange for a global negotiation of the Brazilian debt that made it compatible with growth and price stability for Brazil. And it was clear to me that an effective debt reduction, capturing the discount in the secondary market, was the only possible solution. It became also clear that Brazil should not wait for the maturation of the global debt securitization idea in the creditor countries. Thus, that was the moment to present and pressure for an entirely new approach for the debt crisis.

Back to Brazil, first I had to unite my staff around the idea. This was a relatively easy job. Second, I had to convince the President. That was more difficult task because the staff of the Presidency was against innovative ideas and in favor of conventional new money agreement with the banks. In adopting this position the inner circle of the President was reflecting the general attitude of the Brazilian business elites towards the debt. But finally I got the approval of the President, and decided to present it, subsequently, in Vienna, at the U.S. Congressional Summit in the beginning of September, immediately after to the U.S. Secretary of the Treasury, and in the end of the month to the IMF-World Bank annual meeting. I knew that I was risking my job in that decision, but the only reason to stay in a public position is to be faithful to your own convictions. And in that moment I had formed a new conviction.

In my statement in Vienna I presented the global securitization scheme, based in the creation of an International Debt Facility. It was an idea that had its origin in the market, in its recognition that the credit of the banks were not worth their face value, but that could not be solved in market terms, that had to have a political solution based on a sound financial scheme. This idea, however, could not be Brazil's negotiating proposals with the banks, the condition to resume interest payments, since it depended of the creditor governments. Thus I presented to Mr. James Baker III the idea that I intended to offer to the banks: a negotiated securitization of 20 per cent of the Brazilian medium term debt with the commercial banks. Given the strong opposition of the large American banks, the idea was rejected. The word "securitization" was then considered "pornographic" by the banks.

Good ideas, that are based on market realities, that respond to deep economic needs of debtor and creditor countries, cannot be so easily put away. I had not invented the securitization and the debt facility idea. I had just been a Finance Minister of a large debtor country that had put some ideas together. These ideas were in the market, were shared by politicians, by journalists, by economists, and by some bankers. And already in the beginning of 1988 the Chairman of American Express, Mr. James Robinson III, and the then director for India at the IMF, Mr. Arjun Sengupta, presented in detailed form the global securitization idea, with the creation of a International Debt Facility that would buy the present sovereign credit of the commercial banks at a discount (based but not necessarily equal to the discount existing in the financial secondary market) and transfer it to the debtor countries.

The debt relief proposal through some of debt securitization was supported, during 1988, by the U.S. Congress, by the Japanese, the French, the Italian, the Spanish and the Soviet Union governments. In September the United Nations General Secretary, Mr. Pérez de Cuellar, called a consultation on the debt crisis with fifteen personalities and gave his support to a global debt relief scheme. In this consultation, from which participated Mr. Michel Camdessus, managing director of IMF, Mr. Moeen Qureshi, senior vice-president of the World Bank, Mr. Helmut Schmidt, among others, a clear consensus was established about the following points: (1) the situation of the highly indebted countries worsens every year, while the situation of the creditor banks improves; (2) to reduce the transfer of real resources by increasing the loans of the banks is not realistic; (3) voluntary securitization may be a way of reducing the debt, but the ideal solution is its global securitization. Thus, this consultation implied a clear endorsement of the proposal of the Chairman of American Express Bank, Mr. James Robinson III, who was also present to the meeting. During the IMF-World Bank meeting of 1988 Mr. Camdessus tried to open the discussion of the global solution, but was not successful.

5

With so many things happening in the last two years in favor of a global solution to the debt problem, in favor of some sort of debt relief, in favor to the securitization of the debt, why nothing happened, except Brazil suspending the moratorium? A global and definitive solution to the debt problem has not been adopted yet for two main reasons: because the United States government, supported by the United Kingdom and Germany, is against it; and because the debtor countries do not exercise the necessary pressure to obtain it.

The lack of pressure on the part of the debtor countries is a result of the disposition of their elites, as well as of their governments, to try to pay the debt, even though their countries do not have the objective conditions to do this. This phenomenon was obvious in Brazil: (1) in 1987 most of the businessmen placed themselves against the moratorium; (2) in 1988, when the moratorium was suspended (after an entirely unsubstantiated assertion that it had negative effects on the Brazilian economy) and a conventional agreement was signed by Brazil and the banks. This agreement solved none of Brazil's problems, it was a negative agreement for Brazil and in the short run very positive for the banks, but the elites and press in Brazil hailed it as a positive development, as a "normalization" of Brazil's financial relations with the creditor countries. Only recently they began to realize their mistake. The market, however, were not fooled. They perceived that although the agreement benefited them, it only harmed the Brazilian economy, and they left this fact clear by increasing the discount of the Brazilian debt right after the agreement was signed from 49 to 58 per cent.

This attitude on the part of the elites of debtor countries is naturally not monolithic. There is a growing number of politicians, businessmen and economists who understand that the debt cannot be paid. The awareness that Brazil signed a bad agreement in 1988 is growing today in Brazil. The Finance Minister who signed it, Mailson da Nóbrega, recently admitted in a column published in the newspaper *Folha de S. Paulo* that this agreement does not represent a solution to the problems of the country, and that it is necessary to return to the thesis of reducing the stock of debt.

But, in spite of the growing evidence of the impossibility of paying the entire debt, a significative portion of the elites in the debtor countries remains willing to try to pay it. We can think of a number of explanations for that attitude — fear or retaliations by the banks, cultural subordination to the First World, willingness to be part of it, identification of the interest of the creditor countries with the interests of the banks, lack of information about the debates among thc elites of the creditor countries about the debt, unability to size up the internal economic crisis in their own countries, identification of firm positions for debt reduction to radical or nationalist political attitudes — but I want in this testimony to underline only one explanation: the elites in general in the debtor countries are certainly not the ones that suffer most from the debt crisis; on the contrary, part of them is taking advantage from the debt.

The debt is a change for speculation and profit. The increase of the domestic interest rate as a result of the debt obviously favors rentiers and the financial institutions within the debtor country. Formal and informal (through the parallel exchange rate market) debt-equity conversions make possible huge gains from speculation for some. These discount in the secondary market is shared by a number of people — bankers, brokers, investors, lawyers — and this people know that, if a global securitization solution is adopted, they will loose this extraordinary source of gains.

Actually it is possible to take two opposite views about the debt-equity conversions. You can think that this is a positive way of gradually reducing the debt, or you can think that this is a form of coopting the elites of the debtor countries, making their interests common to the interests of the major creditor banks. I am today firmly convinced that the second alternative is the correct one. These debt-equity swaps are based on the discount in the secondary market, that is, in the misery of many in the debtor countries whose incapacity to pay is so potrayed, but the ones who make large profits from these conversions are a small, but influential, minority in the debtor countries. Thus the debt-equity conversions are a powerful — and subtle — instrument to turn a significative part of the elites in the debtor countries contrary to or at least uninterested in a global debt reduction scheme.

6

The government of the United States has been systematically against a global solution. Even at the IMF meeting in Berlin (September 1988), the new Secretary of the Treasury, Nicholas Brady, was emphatic in his opposition. That is the basic reason why a global solution for the debt was not adopted in spite of the increasing consensus in this direction. I have no intention to say to the U.S. congressmen why this happens. They know better. But I want to finish this testimony discussing the arguments that the American government and the American bankers use to back this position.

First, the U.S. Treasury says that it will not bail out the banks. But, in fact, that is what is being done. It is quite clear that the U.S. policy in relation to the debt was since 1982 oriented to protect the banks and avoid a financial crisis. And I would say that in that moment, from the point of view of the creditor countries — and I would add, of the world economy —, that was the right position to take. But time elapsed. The banks improved their capital ratios. The financial crisis was avoided. But the U.S. government did not change substantially its views on the debt, while other creditor governments did. The only explanation for that is that some of their biggest banks are still having difficulties in absorbing losses all at once. Actually, the creditor banks are divided into two groups: on one side are the banks from continental Europe, Japan and the regional banks from the United States that favor or do not oppose a global solution for the debt because they already have accumulated reserves to protect themselves, and, on the other, some of the big North American and English banks that will have some difficulties with the immediate adoption of a global securitization scheme. But for sure they will not break down. And in the medium term they probably will be better off. It is not sound business to try to collect a debt that cannot be paid.

A similar but different argument is that taxpayers should not be made responsible for the costs involved in guaranteeing the third world debt — costs that are supposed to be high. Actually they are not. The long and medium term debt of the highly indebted countries to the commercial banks (the debt that is eligible for discount) is approximately US$ 260 billion. This debt is much less than the one trillion dollars generally mentioned in the press, that includes all kinds of debts, whether they are from highly indebted countries or not. If the average discount obtained were 50 per cent, the debt facility would have to guarantee US$ 130 billion. To guarantee this, a paid-in capital of 20 per cent would be enough: US$ 26 billion (twice the sum foreseen in the American Express proposal). Assuming that this capital would be subscribed for a ten year term (half the term of the bonds that would be issued by the debt facility), the creditor countries would then have to pay US$ 2.6 billion annually over the next ten years. Considering that the GNP of the industrial countries, according to the classification of the World Bank, was US$ 12.224 billion in 1987, and considering that the industrial countries can be identified as the creditor countries, their annual contribution for ten years would be 0.2 per cent of their GNP. This is an extremely small amount, and it would probably be made up for by the higher level of employment and by the greater growth of the central economies. Actually I believe that American taxpayers are paying much more with the loss of exports and jobs originated by the debt crisis.

Recently became common to hear that the global debt relief scheme is the best alternative, but that it is a grandiose solution for which the creditor countries are not yet politically prepared. Actually I first heard this view in July 1987. To call an American Express-type of solution "grandiose" is not a real argument, but the demonstration that some participants in the debate have ran out of arguments. It is just a form of avoiding or postponing the problem.

An entirely different type of argument is that a global scheme would contradict the case by case approach, but this argument makes no sense. The financial scheme is global, but it will be applied case by case. In James Robinson's proposal debt deduction would be granted as and while the debtor country adjusts its economy. In the same direction, it is said that debt relief would stimulate populist government in the debtor countries not to take the necessary adjustment measures. For sure, debt relief can be taken by these governments as a substitute for adjustment. But it is quite clear that if the government is populist the debt crisis of each individual country will not come to an end, with or without debt relief.

I hope to have made clear that adjustment is self-defeating when the debt is too big, and that without adjustment it is impossible to overcome the crisis. With debt relief, with the reduction of the debt, adjustment will become feasible again, and it will be possible to resume growth with price stability.

There has been an emerging consensus on this matter: the current debt strategy must be revised. There is no lack of proposals, there is no lack of understanding of the nature of the problems to be faced. What is lacking is political will to act with courage and determination in the best interest of debtors and creditors alike. The U.S. Congress has been playing an enormously important role in this area. I am confident that it will continue to do so.