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A TURNING POINT IN THE BRAZILIAN DEBT CRISIS: A MEMOIR

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Minister of Federal Administration and

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The Search for a New Strategy

The coup that had installed a military regime in Brazil in 1964 led to a stabilization of the economy and adjustments to the fiscal budget. The macroeconomic balance so achieved permitted the 1967-1974 "Brazilian miracle." Then, in the 1970s, the military moved back to national developmentalism and economic populism, adopting a state-led, import substitution strategy, except that instead of substituting light industry, heavy and capital-goods industries would be protected and substituted. Although there was abundant foreign finance for this second phase of the import substitution strategy, the distortions in the process of state intervention were being deepened. A fiscal crisis of the state was on its way.

After much conservative populism, the military regime opted for an orthodox stabilization program in 1982 and again in 1983, the latter one IMF-sponsored. The programs were able to stabilize the balance of payments, but the inflation rate, which was around 100 in 1981, increased to 200 percent in 1983 and remained at that level in 1984 and 1985, despite all orthodox efforts to reduce it. With the transition to democracy, elected Vice President José Sarney took office in March 1985, after the tragic death of the elected president, Trancredo Neves, who had fallen seriously ill on the day he was to assume office.

The next phase, the Cruzado Plan of 1986, had enormous political support; it was a well-designed stabilization plan, based on the theory of inertial inflation, which had recently been developed by Latin American economists. The Cruzado plan assumed that inflation had only inertial causes; that some budget deficit was acceptable, given a slack aggregate demand; and that income distribution, which had been concentrated during the military regime, could now be deconcentrated, while stabilization was achieved.

Nevertheless, it failed because it was not accompanied by the required fiscal adjustment and it was poorly implemented. Brazil had only completed the transition to democracy a year before. Political and economic euphoria reigned. All economic problems were attributed to the "orthodox" policies of the military regime, which had failed to control inflation. Brazilian society and its best economists totally ignored the serious fiscal crisis of the state that had developed. The Cruzado Plan reflected this naive optimism and, when it failed at the end of 1986, it did so in a big way. Macroeconomic imbalances suddenly emerged in full force. While the economy fell into recession, after the artificial expansion of the Cruzado, inflation exploded, real wages went down almost 30 percent between November 1986 and June 1987, the rate of bankruptcies broke all previous records, international reserves were dramatically reduced, and a moratorium on the foreign debt was declared. When I took office as finance minister on 29 April 1987, the economic crisis was serious and acute.

I had been invited to accept the position as a result of my experience in the government of the State of São Paulo and my active participation in the Partido do Movimento Democrático Brasileiro (PMDB), the political party that had led the transition to democracy two years earlier. Although I was critical of the populist and nationalist views that dominated Brazilian politics at that moment, it did not mean that I had adhered to economic orthodoxy. In the early 1980s I had actively participated in the formulation of the neostructuralist theory of inertial or chronic inflation, which diverges from mainstream economics because (1) it views this type of inflation as autonomous from demand, i.e., consistent with recession; (2) it views the money supply as passive or endogenous; and (3) it relates current inflation with the phased process of price and wage increases and with the distributive conflict between economic agents.[1] But it was clear to me that the Brazilian economy needed fiscal discipline and market-oriented reforms. These reforms were particularly necessary because the state faced both a fiscal crisis and a crisis in its mode of intervention (the import substitution strategy).

When I became Minister of Finance, it was clear to me that the transfer of real resources to the creditor countries involved in the debt crisis was a major cause of the high rates of inflation, the reduction in public and total savings, and the dramatic reduction in the rate of growth of the Brazilian economy in the 1980s.[2] It was also clear that Brazil could not remain under the moratorium imposed in February of that year by my predecessor, Dilson Funaro, given the depletion of Brazil's international reserves. An agreement with the commercial banks and with the International Monetary Fund was imperative. But I wanted an agreement that, although implying domestic sacrifices, was minimally consistent with price stability and the resumption of the growth rate. The Baker Plan, with its "menu approach" and the pledge of additional financing that did not materialize, seemed to me insufficient, but, at that moment, I saw no alternative. Debt reduction or debt relief schemes were not on the Brazilian agenda at that point, since they were unfamiliar or viewed as impossible in that part of the world.

I needed to present a stabilization plan that would combine orthodox and heterodox policies. The plan had to have a short-term component to stop inflation, which was exploding after the failure of the Cruzado Plan,[3] and a medium-term component to assess the Brazilian crisis and the basic policies that would orient my actions. The short-term part of the stabilization program, which came to be called the

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1 - The main findings are in Bresser Pereira and Nakano (1987).

2 - Negative transfers could also have opposite deflationary consequences, as they required tight fiscal policies from the highly indebted countries. But the fact is that inflationary components tied to the exchange rate devaluations clearly dominated not only in Brazil but in all other countries.

3 - Inflation rose from around 2 percent in November 1986 to 26 percent in June 1987.

Bresser Plan, was an emergency freeze coupled with some fiscal adjustment measures.[4] As an emergency policy, the freeze was short; we did not deindex the economy, or undertake a monetary reform, or use the exchange rate as a nominal anchor. Our objective was not to stabilize the economy in a sustained way, but to stop the inflationary explosion. My private forecast was that six months later inflation would be around 10 percent a month, due to insufficient fiscal adjustment and imbalances in relative prices at the moment of the freeze, which would require a second and definitive stabilization plan some months later.[5] The Bresser Plan became effective in June and was able to normalize the economy. It allowed for a minimum macroeconomic balance, stopped the vertical decline of real wages coupled with the explosion of inflation rates, coped with the record bankruptcies of small and medium-sized enterprises that had borrowed and invested in the Cruzado Plan euphoria, and recovered for government a minimum level of control over the economy. But, as expected, the plan was not able to solve the fiscal crisis nor fully neutralize the inertial component of inflation. The rate of inflation, after dropping from 26 to around 6 percent a month, increased in the next months at a slightly higher rate than expected. In December it reached 14 percent instead of the predicted 10 percent.[6]

The medium-term Macroeconomic Control Plan was, in some way, the orthodox part of the program. My guidelines to the excellent staff of economists who wrote it, between May and early July, had been set out in a paper I had presented to a seminar at Cambridge University on 5 April, twenty four days before taking office (Bresser Pereira,

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4 - For a comparison of the Bresser and Cruzado plans, see Bresser Pereira (1990).

5 - Obviously I did not tell the press or anybody else this prediction. It was shared only with the two economists who more directly collaborated with me in the definition of the plan: Yoshiaki Nakano and Francisco Lopes.

6 - The 6 percent "inflationary residuum" after the freeze showed that relative prices were highly unbalanced at the moment of the stabilization plan. I knew that, besides an effective fiscal adjustment, the other condition for a successful heterodox program was to have relative prices reasonably balanced at the moment of the freeze. That is why I expected a 10 percent rate of inflation in December.

1987a). Our analysis had to emphasize the fiscal crisis of the state--the fact that the budget deficit was high; that public savings, which had been highly positive in the 1970s, were turning negative, requiring budget deficits to finance public investments; that the public foreign debt was great, which demanded extensive financing; and that the internal public debt was increasing dangerously.

I wanted the Macroeconomic Control Plan to resemble, as much as possible, a letter of intent to the IMF defining the parameters for negotiating the foreign debt and establishing our capacity to pay. Such letters, usually written by the staff of the Fund and then signed by the local authorities, would define some strategic targets (the nominal, the primary, and operational budget deficit, the domestic net credit growth, the variations in the basic monetary aggregates, etc.). However, conflicts with the Fund, due to its one-sided position on the debt crisis and the failure of the 1983 IMF-sponsored stabilization program, had been inensified by populist views that prevailed in Brazil after the transition to democracy was completed in 1985.[7] There was no political possibility of my signing an agreement with the Fund at that moment. But I knew that a stabilization plan could not substantially diverge from the basic recommendations of the Fund. I also needed a plan that could be understood by the multilateral institutions, the American government, and the commercial banks in Washington and New York, where I would visit as soon as the plan was published.

In order to calculate Brazil's ability to pay, my staff used a macroeconomic simulation model. The model had its own parameters--the savings function (including public savings), the tax burden, the consumption function, the investment function, the internal and the foreign debt, the level of international reserves, and so on; to a certain extent these could also be considered as variables. Given certain additional parameters, the model could then calculate how much Brazil could pay. I proposed to my staff two

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[7] - I discuss the populist character of the period and describe the attempt I and my team made to control inflation in 1987 in Bresser Pereira (1993).

basic debt parameters: first, Brazil would limit her negative cash flow with the commercial banks, refinancing 60 percent of the interest due each term on the long-term debt and paying net to the banks 40 percent of the interest, while fully refinancing the principal;[8] second, Brazil would maintain an even cash flow with the multilateral institutions and the Paris Club--interest plus amortization would equal new disbursements. For the multilateral and official loans the even cash flow assumption seemed fair, given the interest of the creditor governments in solving the crisis. I also proposed a growth parameter of 5 percent of the GDP, less than the historical 7 percent.

After running the model we concluded that the two debt parameters and the growth objective were feasible but they implied an increase in total savings. In order to increase public savings, both a substantial increase in taxation and a reduction in state expenditures would be necessary. The objective was to reduce the operational public deficit to 3.5 percent in 1987, 2 percent in 1988, and 0 in 1989. In this way public savings would be recovered. The alternative would be to try to increase private savings, but that behavior that is very difficult to influence. The recovery of public savings was more feasible. Consumers would have to bear the burden, particularly the middle class. I needed an increase in savings of 5 percent of GDP over the next years to balance the budget and grow around 5 percent a year. The target was too tight.

The required increase in taxes and/or the reduction of public expenditures would be smaller if Brazil's creditors would accept a reasonable reduction of the debt. Burden sharing between the foreign creditors and Brazil seemed to be fair, since part of the responsibility for the foreign debt crisis rested with the creditors. Karin Lissakers, who made a deep study of relations between the commercial banks and the borrowers before and during the 1980s debt crisis, is very clear on this subject. The conventional wisdom is that commercial banks should not be involved in sovereign credit, but in their search for

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8 - Although the banks did not speak of "refinancing interest" but of "new money," they showed some disposition to finance between one-third and one-half of the interest; I was asking just a bit more.

profits they were: "the competitive drive of the larger commercial banks will lead to a resumption of significant lending [to the developing countries], probably before the end of this century....Lending to developing countries in the 1970s was far more profitable than has been generally recognized." Many countries borrowed to finance populist projects, all borrowed excessively. But "rather than responding like a 'rational' market and either curtailing credit or raising the price to such borrowers, the banking markets behaved perversely, rewarding weak borrowers with increased credit at lower prices." Lissakers concludes: "The willingness of the market to lend, not the borrower's ability to pay, became the accepted measure of credit-worthiness" (1991: 2-12).

But I also knew that in economic and political questions, the moral aspect is of minor importance. The problem was not how to assign blame for the debt crisis, but how Brazil could realistically face and survive it. I had no alternative but to ask for additional financing, for "new money," as bankers would say. It would make patent Brazil's loss of credit, but also acknowledge the seriousness of the debt crisis. Several things were clear to me: the highly indebted countries were not facing a liquidity problem, as the commercial banks, the creditor governments, and the multilateral institutions claimed; the hope of recovering credit-worthiness in the short run, which the banks insistently suggested, was meaningless; and the European banks' practice of creating reserves against their sovereign Third World credits should not be resisted but stimulated. On 20 May, when the new Chairman of Citibank, John Reed, decided to increase loan-loss reserves by $3 billion and sent envoys to each finance minister in Latin America with the mission of tranquilizing them, I surprised his representative in Brazil by my response. I did not view this as negative but as positive. The American banks were at last recognizing that the debtor countries were unable to pay all their foreign debt. Perhaps innovative solutions would now appear.

New money--the conventional response to the debt crisis--was not an innovative solution, it was just partial financing of interest. The costs of this alternative were high for Brazil. But the only other alternative I could see was some kind of "agreed default," which Anatole Kaletsky (1985) discussed in his influential book. Neither the financial markets nor Brazil were prepared for that. A third option was debt reduction, but I did not know then that debt relief mechanisms were already being considered by the creditor countries.

In order to recover foreign and domestic confidence on the part of businessmen, the essential thing for Brazil was to suspend the moratorium on the foreign debt and regularize its foreign payments. But I would only lift the moratorium if I had a feasible solution to the Brazilian debt problem. The Macroeconomic Control Plan showed that 60 percent financing of the interest due to the commercial banks plus an even cash flow with the multilateral institutions and the Paris Club were consistent in macroeconomic terms, although costly. I submitted this to the President and to the National Development Council; I published it in Portuguese and had it immediately translated and published in English. This plan, which defined the macroeconomic policies I would follow, was our unilateral letter of intention, our stabilization program, which also defined our ability to pay the foreign debt. It would be the basic document for my first visit to the United States as Finance Minister of Brazil.

Meanwhile I was discussing with Edwin Yeo--the representative of Paul Volker and Michael Camdessus, whom Latin American finance ministers called "the carrier-pigeon" or just "the pigeon"--a strategy to have a Brazilian stabilization program adopted by the Fund. The domestic resistance to this move was enormous. As for the Bank, it was, at that time, being restructured. The staff that had been working with Brazil was being changed, which virtually paralyzed the institution in that year. After consulting with the Executive Director of the Bank for Brazil, Pedro Malan, who called me as soon as he was informed of the changes, I gave my agreement to the new director for Latin America, Shaid Hussain, and the new director for Brazil, Armeane Choksi.

The Origins of an Unconventional Proposal

In mid-July 1987, two and a half months after taking office, I traveled to Washington with my Macroeconomic Control Plan. After a complimentary visit to the Interamerican Development Bank, my second appointment was with Senator Bill Bradley. On the way to his office, Marcílio Marques Moreira, the Brazilian ambassador in Washington, told me that two resolutions had already been approved in the Congress, one in the Senate, the other in the House, asking for some form of "debt relief." I had never heard that expression. Marcílio informed me that this was an issue already much discussed in the creditor countries. It was a revelation to me, which I immediately connected with the talks that I had had over the last two months with some bankers and economists about "securitization of the debt." I had become convinced that something should be done in this direction. I was not acquainted with the "two-level bargaining game," in which each player is supposed to play with two constituencies (Lehman and McCoy, 1992), but it was clear to me that my two relevant constituencies were domestic businessmen and politicians in Brazil and governments and multilateral institutions in the developing countries. My message should reach and be understood by both. My adversaries--not my enemies--were the commercial banks.

I told Bradley that I would move in this direction, since the climate in the creditor countries was favorable; he was doubtful. He was used to receiving Latin American finance ministers who said bold things when visiting him, but afterward followed conventional lines. That evening I had a secret dinner with Michael Camdessus, which Edwin Yeo had arranged at my request. I told Camdessus that I had decided to sign an agreement with the Fund, but I was not happy with the conventional debt proposal. For the first time, I delineated my own proposal, the idea of securitizing part of the debt. Camdessus agreed that the real solution had to be something like that, but he also said that Washington was "not yet mature" enough for this kind of solution. I had to agree.

But it seemed to me that the maturation process had begun; perhaps a large debtor country like Brazil could contribute to its progress.

One of my visits in Washington was to Barber Conable, president of the World Bank, and Moeen Qureshi. Washington was strongly committed to convince Brazil to regularize its payments, to end the Brazilian moratorium. So was I. But to do that I needed a global negotiation of the Brazilian debt, including a partial reduction of the debt owed to the commercial banks. I would only end the moratorium after having secured a feasible debt negotiation, in agreement with the Macroeconomic Control Plan. I also suggested that the Bank should help Brazil to securitize part of its debt with the commercial banks. I stressed that a condition for the macroeconomic consistency of the Brazilian debt proposal would be that the cash flow of the Bank and other multilateral and official institutions with Brazil be even. The Bank's net transfers to Brazil had just turned negative that year.[9] Conable was a very warm, nice man. But when I insisted on the non-negative cash flow request, he indicated that this was not his decision to make; it depended on the Bank's stockholders. The role of the Bank in the foreign debt became clear to me at that moment. As with the Fund, the Bank was ready to help, but it essentially represented the creditor countries, particularly the American government, its major stockholder. Conable, as were all other former World Bank presidents, was in one way or another a delegate of the American government. I could get approval for a commitment like that only from the Treasury, never from the Bank.

As a matter of fact, an informal but quite cohesive power system was organized to manage the debt crisis. It was headed by the Treasury and the Fed (which was stronger in Paul Volker's time), and had as two basic arms or executive institutions the Fund and the Bank. The other G-7 finance ministers and the twenty chairmen of the larger international commercial banks were informal consultants to the system. Its participants

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9 - The economic analysis of Brazil's relations with the Bank are extensively analyzed in Gonzalez et al. (1990) and Araújo (1991). Araújo includes an interesting analysis of the costs of the Bank's loans to Brazil.

met formally and informally on many occasions. Its more informal side--the chairmen of the more prestigious international banks--did not participate in formal meetings, but were always consulting and being consulted, besides attending cocktail parties and banquets, where policies could be discussed. I knew that this was a strong power system. But it was clear to me that these people were perplexed, divided among themselves, because they did not have a satisfactory answer to the debt crisis. New ideas, in a moment like that, could help. At least they would be heard.

Once back in Brazil I started to prepare my proposal, helped by Fernão Bracher, the chief Brazilian negotiator; Yoshiaki Nakano, my close fellow economist; and many others. Bracher, a banker, had been governor of the Central Bank of Brazil with Funaro; he left because Funaro insisted on increasing real interest rates, while the politicians in the two governing parties (PMDB and PFL) asked for a reduction in the interest rate. I had wanted him as governor of the Central Bank, but Sarney only accepted his name as chief negotiator of the debt two months after I had taken office. Nakano was a student at the Getúlio Vargas Foundation and my long-time intellectual associate. Among other things we had written together a collection of papers on inertial inflation that, along with the papers published by a group of excellent economists in Rio de Janeiro's Pontifícia Universidade Católica (PUC), founded the neostructuralist theory of inertial inflation in Brazil.[10]

The team helping me to define a strategy on the foreign debt also included Fernando Milliet, the governor of the Central Bank, who had been an excellent vice-chairman when I was the Chairman of the Bank of the State of São Paulo (1982-84). Two technocrats, Carlos Eduardo de Freitas and Antônio Pádua Seixas, both with long

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10 - After two basic papers, published in 1981 and 1983, we published together a collection of essaysin 1984, *Inflação e Recessão* (1984), later translated into English (1987). At PUC the economists who participated more directly in the formulation of the theory were André Lara Resende, Edmar Bacha, Francisco L. Lopes, Pérsio Arida, and Roberto Modiano. The real precursor of the inertial inflation paradigm--a paradigm that is widely accepted today and was partially co-opted by mainstream economics--is found in a seminal book by Felipe Pazos (1972).

experience in debt negotiations and in international banking practices, also belonged to the group. Less permanently but no less effectively I counted on the support of two bright MIT economists, André Lara Resende and Pérsio Arida. André was the first person to use the expression "securitization." I also relied on friends with entrepreneurial experience, particularly my brother, Sylvio Bresser Pereira, Abílio Diniz, Roberto Giannetti Fonseca, and Roberto D'Utra Vaz. In a later phase I also sought technical help from two international investment banks--First Boston and S.G. Warburg--particularly for the securitization deal.[11]

I did not invent securitization. It is an old practice in financial markets. Securitization means, simply, the transformation of old debts into new ones, into securities with a longer maturity and a discount or a lower interest rate in relation to the market rate. It is a form of debt relief, but a financial form that permits the bank to easily trade the new securities. Securitization was the way Felix Rohatyn solved the debt crisis of the City of New York in the 1970s. When the Third World debt crisis erupted in 1982, there were proposals made in this direction (see Rohatyn, 1983), but they were ignored.

In 1985 the official "solution" for the debt crisis had been the Baker Plan--an attempt to combine new financing with adjustment and structural reforms so that the highly indebted countries could resume growth. Using the "menu approach," the debtor countries and the commercial banks defined alternatives to fit the individual characteristics of each country. By 1987 it was clear that the Baker Plan had failed. The banks refused to provide additional financing. Some countries, like Mexico, were starting structural reforms. I had begun work on preparing for trade liberalization, fully restructuring the customs system, but this was a medium-term process. Growth was not resuming, and a growing number of countries were in arrears.

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[11] - The two banks issued a joint memorandum on "Partial Securitization of Bank Debt," dated November 16, 1987.

I decided that Brazil's proposal to the commercial banks and Washington should be somewhat unconventional. The ideal--a fully unconventional proposal, based on full securitization of the debt and the delinkage of IMF and the banks in the negotiation process--would require the existence of a debt facility created in Washington and a debt reduction program through securitization that this agency would manage on behalf of the Treasury and G-7. At that time, such an idea could be the subject of a speech, but not the core of a concrete proposal to banks. But I would propose that *part* of the Brazilian debt be securitized, transformed into new securities at a discount.

The other key idea of the proposal would be the relative delinkage among the IMF, the World Bank, and the commercial banks. I wanted to negotiate separately with these institutions. I did not want negotiations with the banks to depend on a standby agreement with the Fund, nor did it seem reasonable to me that a negotiation already concluded with the banks should be suspended if Brazil were not able to meet a monetary or a fiscal target agreed on with the Fund. That we needed a waiver from the Fund to continue to be financed by it seemed reasonable, but to depend on the same waiver to keep negotiating with the banks seemed absurd. I understood that it was a power play, a strategy to increase the power of the Fund to impose conditions, and a kind of guarantee for the banks. But, this system was too rigid, it implied too much power, it made negotiations almost impossible.

Thus, the Brazilian proposal would ask (1) that 60 percent of the interest due to the commercial banks be financed, provided that the official financial institutions committed themselves to an even cash-flow with Brazil, (2) that 20 percent of the debt be compulsorily transformed into securities at an agreed discount, and (3) that negotiations with the banks would be independent of negotiations with the IMF and the World Bank.

Domestic resistance to this unconventional proposal soon appeared. First, I faced some difficulty convincing my own staff. They agreed with the idea, but thought it dangerous. It could elicit a strong reaction from the creditors, who needed new ideas but were not fully prepared to hear them. Edwin Yeo told me on his second visit that after Funaro imposed the moratorium, Washington concluded that he could not remain Finance Minister of Brazil. It was a clear threat. My staff and I were being reminded that the commercial banks in Washington were politically powerful. Besides, the Brazilian elites were not prepared to confront the creditor countries; they often felt more solidarity with the international capitalist system, to which they in some way belong, than with the national interest. The internal debate with my staff ended when I said, somewhat dramatically: "I am in the Finance Ministry to solve these problems, even at the risk of losing my job. I am ready to compromise, but only on minor things, not on the essential. It is essential for Brazil to obtain a reduction in its foreign debt."

Much more serious was the resistance from the President's staff. A very able diplomat, Rubens Ricúpero, was the International Adviser to the President. He obtained the support of Marcílio Marques Moreira, the Brazilian ambassador in Washington, and Jorge Murad, the conservative son-in-law of the President, and developed the following argument against such an unconventional debt proposal: the Sarney administration already faced economic and political crises domestically; it was not advisable to risk an international crisis. Thus, Brazil should make a conventional proposal to the banks. I argued that the risk was not so great, since the proposal that was being prepared was unconventional but moderate, and since there was a growing conviction in the creditor countries that the Baker Plan had failed to solve the debt crisis. Besides, I added, some risk was part of the game when the national interest was involved. After a difficult debate, part of which took place during Sarney's visit to Mexico in August, I was surprised to find that, despite the presence of Marques Moreira, Ricúpero, and Murad, all three of whom were determined to defeat my proposal, the President accepted my reasoning.

Baker's "Non-Starter"

The strongest resistance, however, came from the commercial banks and the U.S. Treasury. At the end of August, Secretary James Baker, who was informed that I was preparing a debt proposal, asked me to visit him. An invitation to a Latin American finance minister from the U.S. Secretary of the Treasury amounts to an order. I said I would visit him on September 8, after having participated in a conference on the debt crisis that a group of congressmen, including Bill Bradley, had organized in Vienna during the first week of September ("The U.S. Congressional Summit").

My plan was to present at this conference my ideas on securitization of the debt and on the creation of a debt facility to guarantee the new bonds in general terms. I did not want to speak about the Brazilian proposal that was scheduled to be presented to the commercial banks in New York on September 25.[12] It was the first time a finance minister formally proposed debt reduction, including the financial mechanism of securitization. My speech in Vienna received worldwide press coverage. In addition, the specific content of the Brazilian proposal to the banks was leaked to the press, but leaked in a mistaken and exaggerated way. Our proposal involved a discount of 50 percent on 20 percent of the debt; the press reported that Brazil would ask for a discount of 50 percent on the total debt to the commercial banks. This brought about a strong reaction from the banks, which the press, particularly *The Wall Street Journal*, conveyed in a biased way in early September. Even the *Financial Times* interpreted the Brazilian proposal incorrectly. In its September 10 edition, just after my visit to Baker, it wrote: "The U.S. Treasury's rapid heading off of Brazil's radical plan to convert half its bank debt into securities...."

Thus, when I arrived in Washington, the climate was not favorable. Baker was clearly under pressure from the banks and the press to deal with this finance minister

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12 - This speech was published only in Portuguese, in Bresser Pereira (1991).

from a developing country who was challenging the banks and the Washington establishment, taking initiatives that only the Treasury could take. This was politically very bad for me. The banks and some newspapers were clearly pushing this interpretation in order to create a conflict between me and Baker. I was well aware of this, but I hoped to have a good conversation with him anyway. And indeed, I did.

James Baker is an earnest and straightforward person. He used to divide interviews with finance ministers into two parts: the first part, a private talk; the second, a debate with both staffs on each side of a table. In the morning, he asked about my proposal. I said that it was both conventional and unconventional. The conventional part proposed 60 percent financing of the payments due to the commercial banks and 100 percent financing of the payments due to the multilateral institutions and the Paris Club. The less conventional part had two aspects: first, the securitization of 20 percent of the debt to the commercial banks, with a discount of around 50 percent, and, second, the delinkage of the Fund from the commercial banks, so that negotiations could proceed in a relatively independent way.

Baker said that he did not agree with 20 percent obligatory securitization. I believe he even used the expression "this is a non starter," but in a polite and passing way. My proposal, indeed, asked that all banks accept securitization, that it would be compulsory--a required part of the debt agreement--although limited to a small part of the debt. I could have argued, but I felt that some compromise on my part was necessary. The press had made too much fuss already. A managed and limited retreat was convenient. I asked if he would agree to voluntary securitization and delinkage.[13] Baker immediately agreed. When we went to the larger meeting with both staffs, I was happy, feeling that my gains had been greater than the concessions I had made.

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13 - The term "voluntary" securitization is a bit ambiguous. The commercial banks preferred leaving things as they were, but recognized that this was impossible. Thus, they came to adopt the expression and the idea, to avoid the alternative, "compulsory" securitization, i.e., securitization that would be compulsory for the banks as an outcome of the negotiations.

While we were getting seated, Baker joked: "I heard that yesterday you were visiting senators and the House. That is good, but don't be misled. The power is here." In the hours ahead he would demonstrate that.[14]

At this meeting, David Mulford, the Assistant Secretary of the Treasury for International Affairs, and Charles Dallara, the Executive Director for the United States at the IMF, strongly resisted the securitization and particularly the delinkage idea. They argued that since the debt crisis broke out, the linkage between the multilateral institutions and the commercial banks was essential for negotiations. I replied that this was an essential reason why negotiations were so difficult and so unsatisfactory to the debtor countries. I did not have any illusions about destroying the system that had been established in Washington to manage the debt, but I thought it was essential to create some flexibility in the system. Besides, I indicated, I had already come to an agreement with Baker. In spite of the disagreement among his staff, Baker kept his word. But, a few hours later, I would pay for the imprudence of having challenged the Washington bureaucracy.

At the end of the meeting Baker asked who would talk to the press. I said I could do that, since the journalists were waiting at the entrance of the Treasury building. Baker agreed. I met the journalists in the lobby and told them, in a very earnest and frank way, the outcome of the meeting. I spoke first in English and then in Portuguese to the Brazilian journalists. Essentially I said that I was pleased with the conversations, that I had made a small retreat in accepting that securitization was to be voluntary instead of obligatory for the banks, but that, as a trade-off, Baker had accepted the idea of securitization and the relative delinkage between the multilateral institutions and the banks.

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14 - This significant episode was recently recounted by Rubens Barbosa, who was my Secretary for International Affairs.

An hour later, when I was having lunch at the Brazilian embassy, Marcílio received news that Baker was unhappy. Immediately after the meeting, Reuters had reported, based on my words, that Baker had fully accepted the Brazilian ideas on the debt. I sensed the danger, and immediately called Baker. I said that my report to the press had been faithful to the meeting, but that I was ready to make it more clear and would call back Reuters. Baker answered that this was not necessary since he had already issued a note to the press. I understood from Baker that he, too, had made a faithful report in his note; I felt relieved.

That afternoon, after a short visit to the Fed, I flew back to Brazil. On landing at Rio de Janeiro, I read the Brazilian newspapers with surprise and indignation. Baker's note to the press, obviously suggested by his unconvinced staff, was the short and aggressive note of a hegemonic power. It said that the Brazilian proposal on the debt was "a non-starter" and nothing else. It did not mention that he had accepted the two radical changes of policy, which eighteen months later would be the basis of the Brady Plan--voluntary securitization and delinkage. The only part of the Brazilian proposal that he did not accept was the required securitization of 20 percent of the debt to the banks.

That note meant political defeat for me. In the next two weeks, while I was preparing to return to the United States to present the Brazilian proposal to the banks and to participate in the IMF-World Bank annual meeting in Washington, I faced the most serious domestic crisis since I had taken office four months before. I knew that my ideas on the debt were reasonable, that they did not confront the national interests of the United States or the creditor countries. They were not even detrimental to the banks, although I could understand why they feared innovations that implied some debt reduction. It was clear to the elites in the creditor countries that trying to muddle through the debt crisis had failed, that some kind of debt relief had to be considered. Nobody had officially proposed that, but the idea was not new, at least to the specialists. Why, then, such aggressive behavior? Was it because the United States government could not accept that an unknown finance minister from a debtor country had changed the agenda on the debt crisis? Because, even if the press had accurately reported on the meeting, this would represent a defeat for the Treasury? Because the commercial banks were pressing? Because the press, particularly *The Wall Street Journal,* had created a climate of conflict between Brazil and the creditor countries that Baker represented--a conflict that had to end with a clear victory by the stronger party? Because Reuters had indeed reported inaccurately?

I did not check this last hypothesis. I assumed that some misunderstanding had taken place on the part of Reuters. Three months later, after leaving the Finance Ministry of Brazil, I gave a long interview to the Brazilian magazine *Isto É-Senhor,* in which I told the story.[15] I immediately received a phone call from the Reuters representative in Brazil, saying that they absolutely had not reported wrongly on the meeting. He sent me a copy of the story that, indeed, was short but fully faithful to the meeting, reporting what Baker had accepted and what he had not accepted of the Brazilian proposal.

In the two weeks that followed Baker's note I had to face an internal crisis that was augmented by the subordination to or ideological dependency of the Brazilian press and the Brazilian elites on the United States. A developing country is dependent not only in economic and political terms, but also in cultural terms. Our culture and our ideology are imported. Sometimes Brazilians are nationalistic--import substitution was a nationalist industrialization strategy; at other times we seem to believe that the truth and the whole truth is found only in the North. We recognize the superiority of American or European culture, and accept it uncritically. We may admit that Brazil's national interest often does not coincide with the national interests of the developed countries, but we fear conflict and prefer accommodation, if not subordination. Thus, when Baker said that the Brazilian proposal was a non-starter, the Brazilian press did not ask who was right. It

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15 - *Isto É-Senhor*, January 5, 1988. This and the other significant interviews to the press were published in Sardenberg (1989).

only underlined the Brazilian defeat, the Brazilian humiliation. The elites remained silent.

In addition to finishing the preparation of Brazil's proposal to its creditors, I planned a counterattack. I invited the most influential Brazilian businessmen to a meeting at which I reported on the debt negotiations, saying that the Brazilian proposal would be partially unconventional and that for this reason an agreement with the banks would take some time. The trade-off for the delay in concluding the negotiations would be a better deal for Brazil. I asked for their support. They gave it. Roberto Giannetti Fonseca played an important role in this. On the eve of my next trip to the United States, a communiqué signed by the leading Brazilian entrepreneurs was published in *Folha de S. Paulo*, giving support for my policy on the debt.

From abroad the only support I received was a short interview with the then Finance Minister of Japan (now Prime Minister) Kiichi Myiasawa. In a speech in a small town in Japan, reported in *Gazeta Mercantil*, he said that my proposal seemed to him "attractive." I tried to contact him in Japan and later in Washington, but it was impossible. Yet Myiasawa did not forget the idea. To the dismay of the American representatives who did not want to lose the initiative to Japan, he presented his own version of it one year later, in the Toronto Annual Meeting of IMF/World Bank.

The IMF/World Bank Annual Meeting

In my August visit to Mexico I had made the following proposal: If the creditor countries could have a G-7, why could not Argentina, Brazil, and Mexico have a G-3? Presidents Sarney and de la Madrid accepted the idea. Gustavo Petricioli, the finance minister of Mexico, and I immediately called Juan Sourrouille, economy minister of Argentina. Sourrouille also liked the idea, consulted President Alfonsin, and the group was formed. The group would limit itself to working on the debt problem, and would be formed by the three finance ministers. Its first meeting would take place in New York, on the eve of the annual meeting of the IMF/World Bank.[16]

When I arrived in New York on September 24, the first journalist I met was Moisés Rabinovitch, the correspondent of *O Estado de S. Paulo*. I met him on the street; he only had time to say: "Everything has changed in this country in the last two weeks. Everybody is talking about securitization." I had proposed securitization because I was convinced that there was space for the idea among our creditors. This space or this interest was now confirmed. Indeed, securitization had become "the talk of the town" among bankers, government officials, and representatives of multilateral institutions. And the talk was positive. The banks were seeing the possibility for new financial transactions, and the officials, a way out of the stalemate. The "non-starter" had turned into a starter.

The first person to convey the new mood in Washington to me was Armeane Choksi, the director of Brazil's department at the World Bank. I met him when I was entering the IMF building. In a warm and enthusiastic way he said: "Bresser, you have just opened the third phase of the debt crisis." Indeed, after Volker's and de la Rosière's "liquidity approach" (1983-85), and Baker's "adjustment and structural reforms with financing and growth approach" (1985-87), we were now seeing the "securitization or debt reduction approach," which would materialize in the Brady Plan (February 1989): 1988 would see proposals for a global solution to the crisis with the creation of a debt facility and the securitization of the total debt.[17] It would see the meeting of experts promoted by the United Nations that resulted in a strong position in favor of debt reduction coming

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16 - The first meeting in New York was excellent. There was no intention of forming a cartel, but dissatisfaction with the solutions to the debt crisis was manifest. We had a second meeting in Washington a few days later. The third meeting was scheduled for Mexico, at the end of November, to take advantage of the meeting of eight Latin American presidents in Acapulco.

17 - Among these proposals I would highlight those of Arjun Sengupata (1988), the Director for India at the IMF, James D. Robinson III, (1988), chairman of the American Express Bank, and Jeffrey Sachs (1988).

from General Secretary Perez de Cuellar. It would see Myiasawa's proposal at the Toronto annual meeting. And finally, at the beginning of the Bush administration, it would see the Brady Plan, although modest and insufficient compared to the proposed global solution, become Washington's official approach to the debt crisis. This plan, supported by the U.S. Treasury and the G-7, had as its cornerstones the voluntary (but managed) securitization of the debt and the relative delinkage of the multilateral institutions and the commercial banks--exactly the two initiatives that had triggered the "non-starter" response from Baker.[18]

The 1987 IMF/World Bank annual meeting was in many ways the best moment in my short time as Finance Minister of Brazil. The organizers of the meeting had a public relations concern: they told me that they were deliberately placing my speech to the Interim Committee and to the General Assembly just after or just before Baker's speech. We were supposed to confront each other for the benefit of the audience. Actually, we did not, or, if we did, it was in a very polite way. I had a new meeting with Baker, on my condition that the meeting not take place in the Treasury but in the IMF building. It was tense at the beginning, but Baker reaffirmed his disposition to back voluntary securitization and delinkage; indeed, he gave me some support in my interviews with the finance ministers of the G-7.[19] Probably under pressure from his staff and for good political reasons--the reasons of a hegemonic nation--he had not played fair with me in the "non-starter" episode, but thereafter he kept his commitments.

At the annual meeting, the Bank's part in the power system that implemented policies essentially defined by the Treasury was confirmed. Moeen Qureshi, executive vice-president of the Bank, played a particularly important role. He was supportive of

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18 - Referring to this episode in mid-1992, Baker, then heading the Department of State, said to the press that he lamented it.

19 - At the Annual Meeting I spoke with the finance ministers of France, England and Spain, and with the vice-ministers of Germany and Japan. As a result of these conversations and Baker's support, the final communique of the Interim Committee was quite satisfactory.

Brazil while faithful to his institution and their main shareholders. In a very elegant way he was able to make clear Washington's desires and moods and to suggest a way to meet them that would be consistent with Brazil's interests. He was very helpful to me. He was convinced, as most World Bank officials were, that Brazil needed a substantial debt reduction, but he was well aware of the political limitations involved. Ten months later, in a consultation organized by United Nations' General Secretary Perez de Cuellar to help the U.N. to define its position on the debt crisis, Qureshi declared quite earnestly that the best alternative was the securitization of the debt as I had proposed, but that Washington had not yet reached an agreement on the subject. He almost repeated Camdessus's words of July 1987.

Yet, neither Choksi, nor Qureshi, nor the many Bank officials who were committed to the highly indebted countries were able to do much for them. Interests of developed and developing countries are often shared ones. If not, the Bank would only have charitable reasons to exist. But in the debt crisis episode there was a clear conflict of national interest between the creditor countries (that defined their national interest as protecting their commercial banks) and the debtor countries. The Bank rested essentially with the former, with its main shareholders.[20]

The Bank and the Debt

The Bank faced many contradictions, contradictions that may be explained by its dependence on its major shareholders. It also responded to the ideological change that had taken place within the Bank in the early 1980s. The conservative, neoliberal wave that swept the economics departments of American universities since early 1970s and led development economics to a crisis (Hirschman 1981), was also the main factor behind the

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[20] - As Catherine Gwin writes "the United States has viewed the Bank as an instrument of foreign policy to be used in support of specific U.S. aims and objectives" (1992: 1).

ideological transformation within the Bank; a conservative president in the White House enhanced this change.

With Ronald Reagan's victory in 1980 , the Bank came under increasing pressure from its major stockholders.[21] As Karin Lissakers (1991: 16) observes, first an "ideological purge" was achieved within the American government; the Bretton Woods institutions came second. Given its earlier commitments to development economics, the Bank--or rather its staff--was suspected by the American government of "liberal," statist, or even leftist views. The role of the Bank as a provider of financing for strategic infrastructure projects was challenged; and the view that the Bank had lost its *raison d'être* unless it changed its strategies, unless it financed private business enterprises rather than government, became dominant within the American government.

It was in this unfavorable climate that the debt crisis broke out in 1982. Whereas the Fund was viewed as a tool of the commercial banks, or, more broadly, of the international financial community, developing countries viewed the Bank as owing basic allegiance to the highly indebted countries, since its commitment was supposed to be to development, not to balance-of-payment adjustments. Yet, the Bank did not live up to these expectations. It soon became clear that the Bank and the Fund were two basic instruments that creditor countries used to manage the debt crisis and protect their commercial banks.[22]

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21 - Writing in this moment, Cheryl Payer notes: "The crisis relation with the U.S. government is overt: the accession of Ronald Reagan to the presidency meant that for the first time in its history, the support of the U.S. executive branch to continued expansion of the World Bank is in question" (1982: 44). Robert Gilpin is still more clear: "Some conservatives in the developed countries have regarded the World Bank and the IMF (sic.) as purveyors of socialism and dispensers of wealth to profligate countries living beyond their means. This was certainly the view of the Reagan Administration until it realized that it needed the IMF to save the American banking system, then threatened by the debt crisis" (1987: 313). Soon after the Reagan Administration realized that the World Bank, although less trustworthy, could perform a similar role.

22 - *The Economist*, (1986: 4) in a long survey of the Bank, wrote: "The 1980s have so far proved an unhappy chapter in the history of the World Bank. The Bank failed to anticipate the debt crisis that erupted in 1982. Four years on, it is still trying to work out its response."

The very existence of the World Bank is based on the assumption that there are common interests between the developed and the developing countries. The debt crisis, however, was defined as a conflict of interest between the debtor and the creditor countries. Conflicting aspects of the crisis clearly overcame common interests in this case. It is not a question of imperialism. Imperialist ideas to explain underdevelopment definitely lost ground in the 1970s, when the new Latin American dependency theory became dominant among the moderate left in Latin America and the liberals or social-democrats in the First World. Only the traditional or communist left and the radical nationalists remained faithful to imperialist interpretations of underdevelopment.[23] Yet, even for those who essentially believe in the "mutual-benefit claim" (Hirschman 1981) that was adopted by development economics, the conflict in the case of the debt crisis is clear: the creditor countries wanted interest on the debt to be paid; the debtors, unable to pay it, needed to cancel part of the principal. The Bank, created on the assumption of mutual benefit, but whose main objective is to promote growth in the developing countries, was trapped in a deep contradiction. It tried its best to find solutions that were mutually beneficial, but when this proved unfeasible, it positioned itself with the creditors.

In the 1980s, the creditor governments had informally organized a power system to manage the debt crisis: at the top were the Treasury and the Fed; as consulting groups, the finance ministers of the G-7 and the chairmen (about 20) of the major commercial banks; and as executive agencies, the Fund and the Bank. The Fund was directly charged with the task of negotiating with the debtor governments, the Bank with performing a complementary and intermediary role in the negotiations.

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23 - The "new dependency theory," whose basic work is Cardoso and Faletto (1979), should be clearly distinguished from the "old dependency theory" or "imperialist theory" of development, based on Lenin. See Cardoso (1979) and Bresser Pereira (1984).

Some believe that the Bank, in assuming this role, lost an opportunity to perform its role as a genuine development bank. According to this view, the Bank "failed" in not adopting a more active role in the search for solutions to the debt crisis, in not advocating debt relief from the beginning. Richard E. Feinberg, for instance, says that "the Bank took a back seat to the IMF, not sufficiently anticipating that severe austerity would de-fund the investment projects that were the Bank's stocks in trade as well as play havoc with nations' development plans" (1986: 7). As a matter of fact, given the pressures the Bank was undergoing in the early 1980s, the debt crisis represented an opportunity for the Bank to change from an institution that primarily financed and promoted development to an institution that imposed conditions, that constrained developing countries to follow the economic directives that the First World believed suitable.

The priority of the creditor governments was to protect their banks, and, more broadly, the health of the international financial system. While the Fund remained responsible for fiscal and balance-of-payment adjustments, the Bank was made accountable for "structural reforms." And, in this way, the Bank--whose development economics-based role as a provider of financial funds for strategic state investments was under attack--assumed a new role that the governments of the creditor countries believed essential: to promote privatization, liberalization, and financial reform. Feinberg observes that, in doing that, the Bank would become "like the IMF--pushing simplistic, standardized formulas that slight the particular history, culture, and politics of individual nations" (1986: 12). Indeed this happened. Although the original objectives of structural adjustment loans were not to serve as tools to impose standard neoliberal reforms on the developing countries, but "to support--by means of a series of (possibly three or four) discrete lending operations over a period of approximately five years--measures specifically designed to strengthen countries' balances of payments over the medium range" (Stern, 1983: 92), the final outcome was this: The emphasis on macroeconomic stabilization turned into getting the prices right and reducing all forms of state intervention. In the mix within the Bank's own staff a new dominance emerged of units and analysts focused on macroeconomic management. But, as a trade-off, the Bank, as a bureaucratic organization striving for survival and growth, recovered its prestige among Washington authorities, a prestige that was essential for the accomplishment of its basic organizational objectives.[24]

Negotiations with the Commercial Banks

I left the joint World Bank/IMF annual meeting with a sense of victory. But I knew that in the months ahead, the chief Brazilian negotiator, Fernão Bracher, and I would have a hard time with the commercial banks. Bracher and Fernando Milliet de Oliveira, governor of the Central Bank, had presented the Brazilian proposal in New York on September 25. It was a written proposal, although Bracher insisted it were not. I wanted to formalize my earnest intention to end the moratorium, but I wanted also to make clear my conditions for that. Bracher argued that bankers do not reason or negotiate in these terms; I insisted. Brazil was not making an inflexible proposal, but establishing the terms of reference for an agreement with the banks.[25] According to my agreement with Baker, the proposal had a conventional part--"new money," actually, refinancing of interest--and an unconventional part--voluntary securitization and delinkage. Knowing that the time had come for a change in the negotiation pattern, the banks were uneasy. They were interested in the securitization scheme, but were insecure about it; they were decidedly against delinkage. They did not want to negotiate by

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24 - *The Economist,* in a second survey of the Bank and the Fund (1991: 4), remarked: "Their [the Bank's and the Fund's] role in the world economy remains as central today as the Bretton Woods architects intended. This is partly because they have proved extremely adaptable--and partly too, no doubt, because international bureaucracies are even harder to shut down than they are to set up."

25 - This proposal as well as my speeches to the Interim Committee and the General Assembly of the IMF/World Bank annual meeting were published in Bresser Pereria (1987b).

themselves, without the full backing of the multilateral agencies. It was clear that the negotiations would take time. The 60 percent "new money" was also a problem; they obviously wanted to disburse less.

The Treasury immediately asked for an interim agreement and the suspension of the moratorium. I made it very clear that I would suspend the moratorium only after a definitive agreement with the banks. I resisted the interim agreement for some time, but the pressure from Baker was strong. He called from Washington several times. They made a threat: on October 26 the Interagency Country Exposure Committee (ICERC), which regularly assesses country risk, would meet; since Brazil was in arrears for more than six months, there would be no alternative but to classify Brazil. The classification, according to the Treasury's interpretation, would make further negotiations with the banks impracticable. I doubted that this threat was real, but I was not sure. What was clear was the pressure from the Washington.[26] Bracher and I believed that it was essential to demonstrate our sincere interest to come to an agreement with the banks, clearly signaling our intention to end the moratorium. We agreed to sign an interim agreement in November.

The agreement meant a payment of US $500 million to the banks, and established a deadline for signing the term sheet of January 29, 1988. I wanted December 30, but the banks pressed as much as they could for a delay. If the term sheet was signed before that date, the moratorium would be lifted, and an additional US $2.5 billion would be paid to the banks. If not, the moratorium would be reaffirmed, and Brazil would have no alternative but to decide, on her own terms, how much and when to pay the banks. This last part was not written into the agreement, but it was my understanding that Brazil would unilaterally start paying about one-third of the interest.

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26 - ICERC is formed by the Treasury, the Federal Reserve, the Federal Deposit Insurance Corporation and the Controller of the Currency. It was later demonstrated that classification of Brazil by the ICERC would not have prevented negotiations. After I left the government, Brazil's debt was classified, but negotiations continued.

The interim agreement included a commitment on the part of the banks to accept securitization as an integral part of the agreement, and that the negotiations would proceed independently of the agreement Brazil intended to form with the IMF. Brazil committed itself to signing a stabilization program with the IMF, but negotiations with the banks would not depend on Brazil's meeting all the targets defined in the agreement.

The interim agreement was negatively received in Brazil. I had a tempest inside my own party, the PMDB. Some, like Pimenta da Veiga, whom I respect, did not accept my arguments. Most understood that I was suspending the moratorium, which was not true. The idea of signing a new letter of intention with the IMF was also not accepted. I counted on the strong support from some politicians, particularly Ulysses Guimarões and Fernando Henrique Cardoso. President Sarney gave me private support, but in public he suggested that responsibility for the agreement was mine alone. This was a constant in the President's behavior: He liked to be responsible for popular moves and wash his hands of unpopular ones.

I proceeded with the negotiations. I asked Pedro Malan, an excellent economist, experienced with the debt as Executive Director for Brazil at the Bank, to help Bracher on the economic aspects of the negotiation.[27] I also decided to run the macroeconomic model through the computer again, with the new parameters that were emerging from the negotiations. This time the fiscal constraint to an agreement with the banks, which had already emerged as the crucial variable in the first version of the plan, was defined as the major limitation. In 1990 this would be called by the Collor administration "the internal capacity to pay criterion." At this moment, the officials of the Bank, who were involved in a macroeconomic assessment of Brazil, were asked to testify in New York about Brazil's ability to pay. They were divided: They supported the Brazilian policies,

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[27] - In 1992-93 Malan, as head of the Brazilian negotiation team, would finally conclude an agreement with the commercial banks, along the lines of the Brady Plan, before Brazil, Mexico, Costa Rica, Venezuela, Philippines and Argentina did the same.

with only minor criticisms,[28] but for political reasons they could not side with Brazil in the negotiations. They also wanted to press Brazil into as conventional an agreement as possible. Only after the Brady Plan (February 1989) would the Bank be able to change its policy.

The World Bank economists were studying the macroeconomic situation of the country very carefully, thus, they were quite capable of informing the commercial banks. At that time Choksi told me that his team was planning to write a macroeconomic assessment of Brazil, but that it was not clear if they would do it or not; iif they did, they probably would not publish it. Obviously he was referring to the Bank's difficulties with the Fund. I urged him to write and publish it with a red cover, not with a gray one, so that everyone would have access to it. A *public* macroeconomic assessment was really needed. It was important to make clear to everybody what--according to the Bank--went right or wrong with economic policy in Brazil. It would be from this type of debate, rather than from imposing strict conditions, that the Bank would be able to help.

Choksi, somewhat surprised, agreed and went on with the idea of writing and publishing a World Bank report (1987) that, since then, has become a regular report. Choksi recalls that this was the first time that the World Bank made a formal macroeconomic assessment of a country.

Yet, my suggestion to publish it so as to be available to everybody interested was not accepted. The World Bank, as other multilateral organizations, is always extremely concerned with not interfering in the internal affairs of the countries, although to interfere through setting conditions is precisely its job. Multilateral institutions interfere secretly. It would be more democratic and more effective if the interference were open, transparent; on most occasions, this interference would be of help. Policy recommendations that would be part of a macroeconomic assessment should be public.

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28 - See The World Bank (1987).

Formal imposition of conditions may work very well when domestic authorities are willing to follow the targets; today, however, Bank officials like to view the World Bank as a service institution.

The testimony of the Bank economists on the negotiations with the commercial banks did not help or hinder. They could not strongly support the Brazilian proposal, although they obviously viewed it with sympathy. Negotiations with the banks continued, slowly. Soon Bracher and I realized that the January 29 deadline would not be met. The commercial banks were confused, not knowing how to behave. The highly indebted countries were clearly unable to fully pay interest, and the banks were not ready to increase their commitments to them. A general policy coming from the Treasury and the multilateral institutions was clearly lacking.

Yet, Brazil could not and would not rest indefinitely on the dependency of the banks. As expected, inflation rates were accelerating. In November they were already above 10 percent--the figure that we had projected for December. I had to prepare a new stabilization plan, including a new heterodox shock. But this shock could not be an emergency stabilization program, as the Bresser Plan had been.

At the end of November, while I and my team prepared a fiscal adjustment plan that, together with the agreement on the foreign debt, would be the basic conditions for the new stabilization program, I went to Mexico to participate with Sarney in a meeting of eight Latin American presidents in Acapulco. The foreign debt was the major topic of the meeting. I had little opportunity to talk with Mexico's Finance Minister, Gustavo Petricioli, since he was deeply involved in negotiations with the unions that, a few days later, would lead to the heterodox stabilization plan, involving price and wage freezes that, coupled with fiscal adjustment and structural reforms, would stabilize Mexican inflation. But I had an important conversation with the other member of the G-3, Juan Sourrouille, from Argentina. We agreed that we would wait until the beginning of February. If the two countries did not reach a reasonable agreement with the banks by then, we would decide in a coordinated way on an Argentinean moratorium and Brazil's unilateral decision to start paying about one-third of the interest due to the commercial banks. I would not have the opportunity to test these ideas and strategies about the foreign debt; for lack of political support for my stabilization program, particularly for a comprehensive fiscal adjustment program, I handed in my resignation less than three weeks after the Acapulco meeting.

Stabilization and the Decision to Resign

Stabilization, not the foreign debt, was my first and main concern in the seven and a half months that I was finance minister of Brazil. Stabilization started with the Bresser Plan, on June 12, but this was strictly an emergency plan. I and my team did not expect that inflation would be effectively controlled with a short price freeze and some fiscal adjustment measures. What was required was a radical fiscal adjustment coupled with some clear-cut solution to the foreign debt problem.

I started to define the new and hopefully definitive stabilization plan in early October, after my return from the IMF/World Bank annual meeting. The new stabilization plan was scheduled for the first months of 1988. It would to have to be well prepared and based on a minimum social agreement on prices and wages. First, relative prices should be well balanced, so that on the day the plan was instituted there would be no maxi-devaluation or large increases in public prices (*tarifaços*). According to the neostructuralist theory of inertial or chronic inflation, any shock coupled with a *tarifaço* and a sharp devaluation of the local currency is doomed. When inflation is high and inertial or indexated, the inflationary process is a process of moving equilibria and disequilibria in relative prices, as prices are corrected according to past inflation in a phased and systematic way. While in hyperinflation prices are corrected every day if not every hour, in informally indexated inflation prices are corrected every month, after the publication of price indexes. Thus, in order to coordinate expectations and stop this phased process, a social agreement and a price freeze is required. A nominal anchor will not work. But the price freeze must avoid as much as possible any interference in the market relative price equilibrium.

Second, a fiscal adjustment should precede the plan. Heterodox policies, i.e., income policies that directly affect prices and wages, are required in high inflations that do not reach full hyperinflation,[29] but these policies necessarily have a limited scope. They do not replace but complement orthodox fiscal and monetary policies.

Third, I had to make very clear Brazil's international commitments in terms of its foreign debt. In broad terms we were able to pay about one-third of the interest due and none of the amortization. If an agreement with the banks was not reached in this direction, Brazil would unilaterally have to start paying according to this rule. To maintain the total moratorium indefinitely was unfeasible and damaging.

President Sarney was informed and agreed to the need for a new stabilization plan at the beginning of the year. Actually I had been preparing this second plan from the moment I implemented the first one. Relative prices were basically balanced. Practically all price controls had been eliminated three months after the freeze. As to the prices of public utilities, that are by definition government controlled, I had consistently increased the prices above inflation in order to avoid the need of a new *tarifaço* on the day of the new plan. The exchange rate, after a two real devaluations in my first days in office, had been kept at the right level. Wages were being indexated on a monthly basis, making a new freeze easier.[30] As to the foreign debt, Sarney agreed that if we did not come to an

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29 - In open hyperinflation the asynchrony or the phased character of price increases, which characterizes high inertial inflation, ends. The economy becomes dollarized. Thus, to stabilize it is enough to promote a credible fiscal adjustment and to have sufficient international reserves to transform the exchange rate in a nominal anchor.

30 - When, in high and inertial inflation, wages are indexated monthly, it is enough to set the freeze in the middle of the month to have nominal wages equal to average real wages.

agreement with the banks by January 29, Brazil would have to decide unilaterally how much to pay, and make its plans and budgets accordingly. He also agreed that a fiscal adjustment plan was necessary and urgent, but it was in this area that he eventually withdrew his support in December, leading me to the decision to resign. [31]

The new stabilization plan and the planned coordination of action between Brazil and Argentina were aborted with my resignation from the Finance Ministry. After my return from Washington at the end of September, I had defined as my absolute priority a fiscal adjustment plan, involving a sizable reduction of expenditures and subsidies, and a tax reform increasing the tax burden and making it more progressive. I worked incessantly on this project for two months, always keeping President Sarney informed about the progress my team and I were making in the definition of the plan. Yet, when I presented the plan to the President in the third week of December, I did not get his support.

Why not? For several reasons. First, because the dominant views on economic policy in 1987 were populist. The Cruzado Plan was no accident. It was not only President Sarney who was not prepared for an effective fiscal adjustment in Brazil; Brazilian society and the Brazilian congress were not either. National developmentalism --a close relative of economic populism--had been successful in promoting economic growth between the 1930s and the 1950s. The military were not orthodox. On many occasions, particularly in the 1970s, they adopted populist and nationalist policies. But since 1981 they had been engaged in orthodox economic policies, whose short-term costs were high in terms of recession. They were able to stabilize the balance of payments but not prices. Thus, it was a natural move for the democratic opposition, in its endeavor to overthrow the military, to attribute all evils to orthodox policies. The general idea was a return to the good old days of development and democracy.

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[31] - A report of my time as finance minister can be found in Bresser Pereira (1992).

Second, businessmen were not yet convinced of the seriousness of the economic crisis. When I insisted that the basic reason for the high inflation was a fiscal crisis of the state, they did not understand. Thus, the idea of paying higher and more progressive taxes was strongly resisted. The business associations of São Paulo signed a communiqué protesting my tax reform, when I presented it in December.

Third, President Sarney was deeply involved in getting support from the Congress to stay in the presidency for five years instead of four. To obtain it, he needed to please the "Centrão"--the populist and conservative group in Congress that was formed in the last quarter of 1987 to give him political support.

Fourth, a conservative group in the President's staff, led by Jorge Murad and Antonio Carlos Magalhóes, a powerful politician from Bahia, was unhappy with my policies, which did not respond to their personal and political interests; they pressed the President not to accept my fiscal adjustment plan.

The president hesitated, but finally bowed to this group. He asked me to stay, saying that "next year" he would approve the expenditure reductions and the tax reform I was proposing, but that made little sense to me. I had no alternative but to resign.

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