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**A TURNING POINT IN THE DEBT CRISIS AND THE BANK:  
A BRAZILIAN MEMOIR**

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The year 1987 was a turning point in the history of the debt crisis that fell as a thunder over Latin America in the 1980s. Brazil had an important participation in the policy transformations that took place in this year. In this paper I will present Brazil's experience and strategy in this moment - a strategy that set the basis for the Brady Plan in 1989 - and I will relate it with the role the World Bank performed in the crisis.

The World Bank is an institution that grew and affirmed itself out of confronting crisis or challenges. Since the 1980s it faced three of them. First, the growth strategy it originally adopted is blurred since late 1970s, when development economics fell into a deep crisis and the role of the state in the economy - a state that the Bank was supposed to finance - was challenged. Second, the very idea of a development bank is at bay, as the Bank tends to lose the role of a net provider of funds to developing countries. Third, the Bank performed poorly when the foreign debt crisis broke out in the early 1980s. In this paper I will deal only with this crisis, that I will analyse through the glasses of my own experience as Finance Minister of Brazil in 1987.

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The role the Bank played in the debt crisis is naturally related to its other problems. In the 1980s the Bank was clearly an institution in transition, as a conservative wave swept the United States and required new views on how to promote economic development. On the other hand, the Bank had become an enormous institution, and its main shareholders manifested reserves to further substantial increase of its loans. Thus, in that moment the Bank did not have a clear definition of its role in financing development, not only for lack of a clear growth strategy, but also because it had ceased to be a net provider of resources to the developing countries. In this difficult moment the debt crisis fell over the developing countries, particularly the Latin American ones, leading their development process to a halt. In this crisis there was a clear interest conflict between creditors, that wanted to be paid fully, and the debtors that needed discounts and larger terms. The Bank, as a natural intermediary between the two sides, had a challenging role to perform.

I, as Finance Minister of Brazil, was able to observe how the Bank responded to the new challenges. The introduction of the structural adjustment loans coupled with structural reforms and conditionality were the major institutional responses to the challenges the Bank faced. A main strategic response was the cautious position it adopted in relation to the debt crisis. Both were responses to the new realities, to the political pressures coming from its major stockholders and to the conservative neo-liberal wave that dominated Washington in the 1980s.

Today there are signs that the conservative wave is lessening down and that a renewed development economics, now more oriented to assist the market rather than replace it, is ressurging. On the other hand, the economic performance of Japan and the Asian NICs shows that moderate state intervention may not hinder foreign and internal competition, when government action is directed to stimulate competitiveness rather than protect inefficiency. The Bank is changing correspondingly. Yet, in this paper, I will not deal with these broad questions. They are in several ways answered this volume of essays and in Lewis and Webb main volume of the World Bank History Project. I am here only mentioning them because they are in the background of my personal account of the debt crisis in 1987.

In this paper I will tell the story of a crucial moment in the debt crisis: I will describe my personal experience with the Bank, particularly in 1987, when, as Finance Minister of Brazil, I made several proposals for the solution of the foreign debt, that elicited wide debate and were eventually adopted in the Brady Plan (1989), that was instrumental in solving the debt crisis. I will refrain from a more broad interpretation, that will only be delineated in section 6. In several moments in my negotiations the Bank was very helpful, although its role was rather the one of a representative of the creditors than of a uncommitted intermediary.

### 1. The Search for a New Strategy

If the debt crisis represented throughout the 1980s a central challenge for the World Bank, 1987 was a crucial moment in this crisis. In this year the creditor countries understood that the muddling through approach to the debt problem had failed or was exhausted and that new initiatives were required. In this moment I, as Finance Minister of Brazil, had the opportunity to perform a special role, calling attention to new ideas. In this process I interacted in several ways with the Bank, whose philosophy, based on the assumption of mutual interests between developed and developing countries, had suddenly fallen between two fires: the conflicting interests, particularly of Latin America with the creditor countries, clearly dominated the mutual ones in this event. The creditor countries and particularly their commercial banks suspended the roll-over of the debt and expected to collect what they have disbursed plus interests, whereas the highly indebted countries demanded long term consolidation and effective reduction of a debt that had turned too high to be regularly paid. Constrained to choose between one or the other side, the Bank had no other alternative but to essentially opt for creditors. This was not obviously consensual within the Bank. The resistance of the staff, including its high rank, was strong, but the will of the main stockholders prevailed.

The debtor countries obviously needed urgent macroeconomic adjustment. This had to be done any way, independently of the size and the speed of the debt reduction and

consolidation. The Bank pressed for the required adjustment and structural reforms, that responded both to the interests of the debtor and the creditor countries. Yet, it was much less effective in promoting the reduction and consolidation of the debt, that conveyed more specifically the demands of the developing countries, and would be part of its mission as a development bank.

In 1987 the second phase of the debt crisis, represented by the Baker Plan, proved definitively ineffective. The Brazilian moratorium, in February 1987, was a major factor pointing in this direction. The first phase, led by Paul Volker e de la Rosière - the liquidity approach - was dominant between 1982 and 1985. In this last year, with the Baker Plan, the second phase started: the adjustment and structural reforms with growth and additional financing approach. It was precisely in 1987 that it became clear that this strategy was ineffective because insufficient. The commercial banks were not willing to provide the additional finance that was essential to the plan. On the other hand, it was becoming increasingly clear that a debt relief program would be an essential part of any real solution to the crisis. The creditor governments on the leadership of Washington and the banks were becoming ready for a third phase - the "securitization or debt reduction phase" - which started that year and culminated in the Brady Plan in early 1989.

As finance minister of Brazil, between April and December 1987, I and my team had a say in the definition of this third phase. We developed a strategy in relation to the foreign debt based on two innovative ideas for that moment: the reduction of the debt through securitization and the relative delinkage between the multilateral institutions and the commercial banks in the debt negotiations. This strategy was not able to solve the Brazilian debt in 1987, but helped to change Washington strategy in relation to the debt, that at that moment faced a stalemate.

When I assumed the Finance Ministry of Brazil, in April 29 1987, Brazil was under moratorium and the country faced a deep economic and political crisis - the outcome of the failure of the Cruzado Plan. The Cruzado Plan had counted with an stupendous political support. Nevertheless, it failed because it was not accompanied by the required fiscal

adjustment. It was a well designed stabilization plan, based on the theory of inertial inflation that the Latin American economists had recently developed, but it was very poorly implemented. As a matter of fact, it was administered in a populist way. Brazil, one year before, had just completed the transition to democracy. The political and economic euphoria was enormous. All economic problems were attributed to the "orthodoxy" of the military regime policies, that had failed to control inflation. In fact, after a lot of conservative populism, the military regime had opted for an orthodox stabilization program in 1982 and again in 1983, the last one IMF sponsored. The programs were able to stabilize the balance of payments, but the rate of inflation, that was around 100 percent in 1981, changed to 200 percent a year in 1983 and remained in this level in the 1984 and 1985, in spite of all orthodox efforts to reduce it.

With the transition to democracy, the elected vice-president, Mr. José Sarney, took office in March 1985, after tragic the death of the elected president, Tancredo Neves, that fell seriously ill in the day he was supposed to assume the presidency. Populism and national-developmentalism, that had been successful between the 1930s and the 1950s in promoting Brazilian industrialization, were now being reborn. The military coup, that in 1964 had installed a military regime in Brazil, was able, in the 1960s, to stabilize the economy and adjust the fiscal budget. The macroeconomic balance so achieved permitted the 1967-1974 "Brazilian miracle". Yet, in the 1970s the military made their come-back to national-developmentalism and economic populism. They adopted a state-led, import substitution strategy. Now, instead of substituting light industry, heavy and capital-goods industry should be protected and substituted. To financed this second phase of the import substitution strategy, foreign finance was abundant in the 1970s. Yet, in this way, the distortions in the process of state intervention were being deepened. A fiscal crisis of the state was in its way.

The 1986 Cruzado Plan, however, ignored the fiscal crisis of the state. It assumed that inflation had only inertial causes. That some budget deficit was acceptable, given a slack aggregate demand. That income distribution, that had been concentrated during the military

regime, could now be deconcentrated, while stabilization was achieved. The Brazilian society, including its best economists, were totally unaware that a very serious fiscal crisis of the state had developed. On the contrary, their optimism permitted one of the best Brazilian economists (Castro and Souza, 1985) to write a successful book called *Brazil in Forced March to Development*. The Cruzado Plan reflected this naive optimism. When it failed, in the end of 1986, it did in a noisy way. The macroeconomic unbalances suddenly emerged with all their force. While economy fell in 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, a moratorium of the foreign debt was adopted. The economic crises was serious and acute when I took office as finance minister in late April.

I was invited to the ministry for my experience in the government of the State of São Paulo and my active participation in PMDB (Partido do Movimento Democrático Brasileiro), the political party that had led the transition of Brazil to democracy two years earlier.

Although I was critical of the populist and nationalist views that dominated Brazilian politics at that moment, this did not mean that I had adhered to economic orthodoxy. In the early 1980s I had an active participation in the formulation of the neo-structuralist theory of inertial or chronic inflation, that diverges from mainstream economics, as (1) it views this type of inflation autonomous from demand, ie., consistent with recession, as (2) it view the money supply as passive or endogenous, and as (3) it relates present inflation with the phased process of price and wage increases and with the distributive conflict between economic agents.<sup>1</sup> But it was clear to me that the Brazilian economy urgently needed fiscal discipline and market oriented reforms. These reforms were particularly necessary because the state faced a double crisis: a crisis of its mode of intervention (the import substitution strategy) and a fiscal crisis.

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<sup>1</sup> - Our main findings are in Bresser Pereira and Nakano (1984).

In the morning of April 29, when I was preparing my acceptance speech to the ministry at Carlton Hotel, in Brasilia, I received the visit of the leaving Country Division Chief for Brazil at the Bank, Roberto Gonzalez Cofiño. Significatively it was my first meeting as finance minister. I was not known in Washington. Thus, I remember Cofiño's agreeable surprise when I told him that Brazil needed an urgent fiscal adjustment and the elimination of all subsidies permitting the recovery of the saving capacity of the state, a positive internal interest rate, a new stabilization program combining orthodox and heterodox policies, the regularization of foreign debt with a feasible agreement with the Banks, and an export led development strategy. These ideas, plus trade liberalization and privatization, routed my action in the Finance Ministry. They were the source of continuous conflict with my party, the political staff of the President, and also the Brazilian businessmen, when I made clear that fiscal adjustment involved increasing taxes, besides reducing state expenditures. My decision to leave the government seven months later derived from the lack of political support for a tax reform and for a program of public expenditures reduction that involved the elimination of several departments or sections of the state apparatus.<sup>2</sup>

When I assumed the Ministry, it was clear to me that the transference of real resources to the creditor countries involved in the debt crisis was a major cause of the high rates of inflation, of the reduction of public and total savings, and of the dramatic reduction of the rate of growth of the Brazilian economy in the 1980s.<sup>3</sup> It was clear, also, that Brazil could not remain under the moratorium that my predecessor, Dilson Funaro, had decided in February of that year, given the depletion of Brazil's international reserves. An agreement with the commercial banks and with the Fund was urgent. But I wanted an agreement that, although

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<sup>2</sup> - A report of my time as finance minister can be found in the testimony I gave to the Instituto Universitário de Pesquisas do Rio de Janeiro, IUPERJ, "Contra a corrente: a experiência no Ministério da Fazenda" (1988a).

<sup>3</sup> - Negative transfers could also have opposite deflationary consequences, as they required from the highly indebted countries tight fiscal policies. But the fact is that inflationary component tied to the exchange rate devaluations clearly dominated not only in Brazil but in all other countries.

implying domestic sacrifices, was minimally consistent with price stability and the resumption of the rate of growth. The Baker Plan, with the "menu approach" and the pledge of additional financing that did not materialize, seemed to me insufficient, but, at that moment, I did not see an alternative. Schemes of debt reduction or debt relief were not in the Brazilian agenda at that moment, since they were not known or viewed as possible in this part of the world.

I needed a stabilization plan immediately: a short run stabilization plan, that stopped inflation that was exploding after the failure of the Cruzado Plan,<sup>4</sup> and a medium run stabilization plan, that presented an assessment of the Brazilian crisis and the basic policies that would orient my action.

The short run stabilization program was an emergency freeze coupled with some fiscal adjustment measures, that came to be called the Bresser Plan.<sup>5</sup> As an emergency policy, the freeze was very short, we did not deindexate the economy, nor undertake a monetary reform, nor used the exchange rate as a nominal anchor. We did not have as objective to stabilize the economy in a sustained way, but to stop the explosion of the inflationary process. My forecast was that inflation six months later would be around 10 percent a month, due to the insufficient fiscal adjustment and the unbalances in relative prices at the moment of the freeze, requiring a second and definitive stabilization plan some months later.<sup>6</sup> The Bresser Plan became effective in June and was able to normalize the economy, ie., to allow for a minimum macroeconomic balance, for a stop in the vertical decline of real wages coupled with the explosion of inflation rates, to cope with record bankruptcies of the small and medium sized enterprises that had borrowed and invested in the Plan Cruzado euphoria, to recover for government a minimum level of control over the economy. But, as expected, the plan was not able to solve the fiscal

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<sup>4</sup> - Inflation rose from around 2 percent in November 1986 to 26 percent in June 1987.

<sup>5</sup> - For a comparison of the Bresser Plan with the Cruzado Plan see Bresser Pereira (1988b).

<sup>6</sup> - Obviously I did not tell the press or anybody else this prediction. It was just shared by myself and the two economists that more directly collaborated with me in the definition of the plan: Yoshiaki Nakano e Francisco Lopes.



crisis nor to fully neutralize the inertial component of inflation. The rate of inflation, after going down from 26 to around 6 percent a month, increased in the next months at slightly higher rate than expected. In December it reached 14 percent instead of the expected 10 percent.<sup>7</sup>

The Bresser Plan was the heterodox part of the stabilization program. The medium run stabilization plan - the *Macroeconomic Control Plan* - was in some way the orthodox part of the overall program. It was prepared by my staff between May and early July. It included a macroeconomic model of the Brazilian economy, and was supposed to reproduce in our own terms and replace a letter of intention to the IMF. It should also define the parameters of the negotiations of the foreign debt, establishing our capacity to pay. My guide-lines to the excellent staff of economists that wrote it were quite clear. These guide-lines had been advanced in a paper that I had presented to a seminar at Cambridge University, on April 5, twenty four days before taking office (Bresser Pereira, 1987a). The diagnosis should emphasize the fiscal crisis of the state: the fact that the budget deficit was high; that public savings, that used to be highly positive in the 1970s, were turning negative, requiring budget deficits to finance public investments; that the public foreign debt was very high demanding extensive finance; and that the internal public debt was dangerously increasing.

I wanted that the *Macroeconomic Control Plan* resembled, as much as possible, a letter of intention written to the IMF. These letters, usually written by the staff of the Fund and signed by the local authorities, 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.). I had no political possibility of signing an agreement with the Fund at that moment. The conflicts with the Fund, due to its one sided position on the debt crisis, and the

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<sup>7</sup> - 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.

failure of the 1983 IMF sponsored stabilization program, had been potentialized by populist views that dominated Brazil after the transition to democracy was completed in 1985.<sup>8</sup> But I knew that a stabilization plan could not substantially diverge from the basic recommendation of the Fund. Besides, I needed a plan that could be understood by Washington and New York - by multilateral institutions and the American government and by the commercial banks -, that I planned to visit at the moment the plan was published.

In this first trip to Washington I would start negotiating the foreign debt. Thus I also needed a plan that would define the paying capacity of Brazil. For that my staff used a macroeconomic simulation model for Brazil, that became a constitutive part of the plan. Given some parameters, the model would define how much Brazil could pay. I proposed to my staff two basic debt parameters: first, Brazil would limit her negative cash-flow with the commercial banks, refinancing 60 percent of the interests due each semester on the long term debt and paying net to the banks 40 percent of the interest, while fully refinancing the principal;<sup>9</sup> second, with the multilateral institutions and the Paris Club, Brazil would maintain an even cash flow: 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 creditors' governments to solve the crisis. I proposed also a growth parameter: 5 percent of the GDP, less than the historical 7 percent. The model had its own parameters - the savings function, including public savings, the tax burden, consumption function, the investment function, the internal and the foreign debt, the level of international reserves, etc.), that, up to a certain extent, could also be considered as variables.

Running the model my staff came to the conclusion that the two debt parameters and the growth objective were feasible, but implied an increase in total savings. Since the fall in

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<sup>8</sup> - I discussed the populist character of the period in a recent paper, "Stabilization in an adverse environment", where I describe the attempt I and my team developed to control inflation in 1987 (1993).

<sup>9</sup> - Although the banks did not to speak of "refinancing of interests" but in "new money", they showed some disposition to finance between one third and half of the interests. I was asking just a little more.

savings was due to the decrease of public savings, these one should be recovered. In order to increase public savings, it was necessary a substantial increase in taxation and a reduction of state expenditures. 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, reducing wages and consumption. Yet, there was no way to easily do that. Private savings are a behaviour parameter that is very difficult to influence. The recovery of public savings was more feasible. Consumers would have a burden, particularly the middle class. I needed a 5 percent of GDP increase in savings in the next years to balance the budget and grow around 5 percent a year. I was not happy. The target was to tight. The burden sharing between the foreign creditors and Brazil did not seem to be fair.

The required increase in taxes or the reduction of public expenditures would be smaller if creditor accept a reasonable reduction of the debt. The responsibility for the foreign debt crisis was also of the creditors. Karin Lissakers, that made a deep study of the 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 involve in sovereign credit. But in they search for profits they did this in the past, they repeated it in the 1970s and "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". And Lissakers concludes: "The willingness of the market to lend, not the borrower's ability to pay, became the accepted measure of credit-worthness" (1991: 2-12).

But I also knew that in economic and political questions the moral aspect has a minor importance. The problem was not to define the guilty for the debt crisis, but how Brazil could realistically face and survive to it. With this objective I was not viewing other alternative but to ask for additional finance. For "new money" as the bankers used to say. It was very clear to me that the highly indebted countries were not facing a liquidity problem, as the commercial banks, the creditor governments and the multilateral institutions affirmed. That the hope of recovering credit-worthiness in the short run, that the banks insistently suggest, was meaningless. That the practice of the European banks of creating reserves against their sovereign Third World credits should not be resisted but stimulated. It made patent Brazil's loss of credit, but it also acknowledged the seriousness of the debt crisis. It was for that reason that, when, in May 20, the new Chairman of Citibank, John Reed, decided to increase loan-loss reserves by \$3 billion, and send envoys to each finance minister in Latin America with the mission of tranquillizing them, I surprised his representative in Brazil with my response: "In don't receive this information as negative but positive. The American banks are at last recognizing that the debtor countries are unable to pay all their foreign debt. May be now innovative solutions will appear".

"New money" - the conventional response to the debt crisis - was not an innovative solution. It was just partial financing of interests. The costs of this alternative were high to Brazil. But the other possible alternative that I could see was some kind of "agreed default",

that Anatole Kaletsky had discussed in an influential book recently published (1985). Yet, nor financial markets nor Brazil were prepared for it. A third alternative was debt reduction. But I was not informed that debt relief mechanisms were already being thought in 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 of the foreign debt, and to regularize its foreign payments. Yet, I would only suspend the moratorium if I came to a feasible solution for the Brazilian debt problem. The *Macroeconomic Control Plan* demonstrated that 60 percent financing of the interests due to commercial banks plus and even cash-flow with the multilateral institutions and the Paris Club, were consistent in macroeconomic terms although costly. Thus I submitted the to the President and to the National Council of Development, I published it in Portuguese and made it to be rapidly translated and published in English. This plan defined the macroeconomic policies I would follow. It was our unilateral letter of intentions, our stabilization program, that also defined our ability to pay the foreign debt. It would be the basic document in my first visit to the United States as finance minister.

Meanwhile I was discussing with Edwin Yeo - a mysterious representative of Paul Volker and Michael Camdessus, who the 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 resistances to this move were, at that moment, enormous. As to the Bank, it was, at that time, being restructured. The staff that used to work with Brazil was being changed. This fact virtually paralysed 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. From Choksi I would become a personal friend. With both I would have very good relations.

## 2. The Origins of an Unconventional Proposal

In mid July 1987, two months and a half after taking office, I finally travelled to Washington, with my *Macroeconomic Control Plan*. My second appointment, after a complimentary visit to the Interamerican Development Bank, was to Senator Bill Bradley. In 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 was very surprised. I asked Marcílio to repeat, since I, as practically all Brazilians, had never heard that expression. Marcílio repeated, informed that this was an issue already well discussed in the creditor countries. It was for me a revelation, that I immediately connected with the talks about "securitization of the debt" I had had with some bankers and economists in the last two months. And I became convinced that some thing should be done in this direction. The climate in the creditor countries was favourable to new ideas. 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 act in this direction, since the climate in the creditor countries was favourable, but he doubted. He was used to receive Latin American finance ministers who said a lot of bold things when visiting him, but after followed conventional lines. I told him that with me things would be different. That evening I had a secret dinner with Michael Camdessus, that Edwin Yeo had arranged at my request. I told Camdessus that I was decided to sign an agreement with the Fund, but I was not happy with the conventional debt proposal that I was preparing. And 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 come from something like that, but he also said that "Washington is not yet mature" for this kind of solution regarding the debt. I had

to agree. But it seemed to me that the maturation process was under way. Perhaps a big debtor country like Brazil could give its contribution to its completion.

One of my visits in Washington was to Barber Conable. At his side was Moeen Qureshi, who later would become a friend. 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 due to the commercial banks. I only would close the moratorium after having secured a feasible debt negotiation, in agreement with the *Macroeconomic Control Plan*. In my interview with the President of the Bank I also proposed that he should help Brazil to securitize part of its debt with the commercial banks. On the other hand, 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 transferances to Brazil had just turned negative that year.<sup>10</sup> Conable was very warm. He is a very nice man. But when I insisted on the non-negative cash flow request, he suggested that this was not his decision; it depended on the Bank's stockholders. At that moment it became clear to me the role of the Bank in the foreign debt. As the Fund, the Bank was ready to help, but it was essentially a representative of the creditor countries, particularly of the American government, its major stockholder. Conable, as all other former World Bank's presidents were in an way or another delegates of the American government. I would get approval for commitment like that in the Treasury, never in the Bank.

As a matter of fact, the Fund and the Bank were part of an informal but quite cohesive power system organized to manage the debt crisis. This debt power system was headed by the Treasury and the Fed (that was stronger in Paul Volker's times). It had as two basic arms or executive institutions, the Fund and the Bank. The other finance ministers of the G-7 and the

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<sup>10</sup> - The economic analysis of Brazil's relations with the Bank are extensively analysed in Gonzalez et al. (1990) and Araújo (1991). Araújo includes an interesting analysis on the costs of the Bank's loans to Brazil.

20 chairmen of the larger international commercial banks were informal consultants to the system. Its participants met formal and informally in many occasions. Its more informal part - the 20 (or around 20) chairmen of the more prestigious international banks - did not participate in formal meetings, but were always consulting and being consulted, besides participating in cocktails, banquets, where policies could be discussed and diffused. I knew that this was a strong power system. But it was clear to me that these people were perplex, divided among themselves, as they did not have a satisfactory answer to the debt crisis. New ideas, in a moment like that, could help. Certainly they would be heard.

Back to Brazil, I started to prepare my proposal, helped by Fernão Bracher, the chief Brazilian negotiator, by Yoshiaki Nakano, my closest fellow economist, and by many others. Fernão Bracher is a banker. Had been the governor of the Central Bank of Brazil with Funaro, and left before Funaro because insisted in having real interest rates positive, while the politicians in the two governing parties (PMDB and PFL) asked for a reduction of the interest rate. He is a very special friend of mine. I wanted him again 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. Yoshiaki Nakano was a student in Getúlio Vargas Foundations and is my long time intellectual associate. Among other things we had written together a collection of papers on inertial inflation that, together with the papers published by a group of excellent economists in Rio de Janeiro's PUC (Pontifícia Universidade Católica) founded the neo-structuralist theory of inertial inflation in Brazil.<sup>11</sup> In the team helping me to define a strategy on the foreign debt I had also Fernando Milliet, the governor of Central Bank, that had been an excellent vice-chairman when I was the Chairman of the Bank of the State of São Paulo (1982-84). Two

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<sup>11</sup> - After two basic papers, published in 1981 and 1983, we published together a collection of essays, *Inflação e Recessão* (1984), later translated to English (1987). In PUC the economists that participated more directly from the formulation of the theory were André Lara Resende, Edmar Bacha, Francisco L. Lopes, Pêrsio Arida e Roberto Modiano. The real precursor of the emergence of inertial inflation paradigm - a paradigm that today is widely accepted and was partially coopted by mainstream economics - must be found in a seminal book by Felipe Pazos (1972).



technocrats, Carlos Eduardo de Freitas and Antônio Pádua Seixas, both with long experience in the debt negotiations and in the international banking practices, also belonged to the group. Less permanently but not less effectively I counted with the support of two bright MIT economists, André Lara Resende and Pêrsio Arida. André was the first person to refer the expression "securitization". And I counted with some friends with large entrepreneurial experience, particularly Sylvio Bresser Pereira, my brother, Abílio Diniz, Roberto Giannetti Fonseca and Roberto D'Utra Vaz. In a later phase I also asked technical help from two international investment banks - First Boston and S.G. Warburg - particularly for the securitization deal.<sup>12</sup>

I decided that the proposal Brazil should present to the commercial banks and Washington should be a partially unconventional proposal. The ideal would be a fully unconventional proposal, based on full securitization of the debt and the de-linkage of IMF and the banks in the negotiation process. Yet, for this it would be necessary the existence of a debt facility created in Washington and a debt reduction program through securitization that this agency would manage in behalf of the Treasury and G-7. At that time ideas like that could be the subject of a speech, but could not be the core of a concrete Brazilian proposal to the banks.

I did not invent securitization. It is an old practice in financial markets. Securitization means, simply, transformation of old debts into new ones, into securities, that would have a longer maturity and a discount or a reduced rate of interest 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 broke up, in 1982, Rohatyn (1983) and Peter Kenen (1983) made proposals in this direction. Yet, this proposals had been forgotten. Since 1985 the official "solution" for the debt crisis was the Baker Plan - an attempt to combine

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<sup>12</sup> - The two banks produced a joint memorandum regarding "Partial Securitization of Bank Debt", dated of November 16, 1987.

new finance with adjustment and structural reforms. In this way the highly indebted countries would resume growth. The "menu approach" was part of the Baker Plan. The debtor countries and the commercial banks should define a menu of alternatives to fit the individual characteristics of each country.

In 1987 it was clear that this Baker Plan had failed. The banks refused to provide additional finance. Some countries, like Mexico, were starting structural reforms. I, for instance, worked in the preparation of trade liberalization, fully restructuring the customs system. But this was a medium term process. Countries were not resuming growth. An a growing number countries were falling in arrears. Thus, I decided that it was time to innovate: in the Brazilian proposal the securitization idea would be present. Part of the Brazilian debt would have to be transformed into new securities with a discount.

The other key idea of the proposal was the relative de-linkage between IMF, World Bank and the commercial banks. I wanted to negotiate separately with these institutions. I did not want that the negotiations with the banks depended of a stand by agreement with the Fund. Nor seemed reasonable to me that a negotiation already concluded with the banks would be suspended if Brazil were not able to meet a monetary or a fiscal target agreed with the Fund. That we depended of a waiver of the Fund to continue to be financed by it, seemed reasonable. But depend of the same waiver to keep going the negotiations with the banks seemed absurd. I understood quite well that it was a power system. A strategy to increase the conditionality power of the Fund. And a kind of guarantee for the banks. But, as I said in a meeting to Baker, this system was too rigid, it implied too much power, it made negotiations almost impossible.

Thus, the Brazilian proposal would be in part conventional, asking for 60 percent finance of interest due to the commercial banks, provided that the official financial institutions committed themselves with an even cash-flow with Brazil. And in part

unconventional, asking that 20 percent of the debt be compulsorily transformed into securities according to an agreed discount, and that the negotiations with the banks would be independent from the negotiations with IMF and the World Bank.

The domestic resistances to the unconventional proposal I was preparing soon arrived. First, I faced some difficulty to convince my own staff. They agreed with the idea, but thought it dangerous. It could elicit a strong reaction from the creditors. They needed new ideas, but were not fully prepared to hear them. I remember very well Edwin Yeo telling me in his second visit to me that "after Funaro's moratorium Washington concluded that he could not remain at the Finance Minister of Brazil". It was a clear threat. I was being remembered that Washington and the commercial banks were politically powerful. My staff was also aware of this fact. Besides, domestically the Brazilian elites were not prepared to confront the creditor countries. Often these elites feel more solidarity with the international capitalism system, to which they in some way belong, than to the national interest. Yet, the internal debate with my staff ended when I said, somewhat dramatically: "I am in the Finance Ministry to solve the problems, even at the risk of losing my job. I am ready to compromise, but only on minor things, not on the essential. For Brazil the essential is to obtain a reduction of its foreign debt".

Much more serious was the resistance the staff of the President posed. A very able diplomat, Rubens Ricúpero was the International Adviser of 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 an unconventional debt proposal: the Sarney administration already faced domestically an economic and a political crisis; 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 an increasing 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, where I was surprised with the presence of Marcílio Marques Moreira, besides Ricúpero e Murad, the three determined to defeat my proposal, the President accepted my reasons.

### 3. Baker's "Non Starter".

The strongest resistance, however, would come from the commercial banks and the U.S. Treasury. At the end of August I received a call from Secretary James Baker. He was informed that I was preparing a debt proposal and asked me to visit him. An invitation from the U.S. Secretary of the Treasury to a Latin American finance minister is 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, among which Bill Bradley, had organized in Vienna in the first days of September ("The U.S. Congressional Summit").

My plan for this conference was to present my ideas on securitization of the debt and on the creation of a debt facility that would 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. In fact, my Vienna speech limited itself to this agenda.<sup>13</sup> It was already a lot. That was the first time a finance minister formally proposed debt reduction, giving additionally the financial mechanism: securitization. My speech in Vienna had a world wide press coverage. But, additionally, the specific content of the Brazilian proposal to the banks leaked to the press. And leaked in a mistaken and exaggerated way. Our proposal involved a discount of 50 percent on 20 percent of the debt, but the press informed that it was 50 percent of the total debt to the commercial banks that Brazil would ask. This brought about a strong reaction from the banks, that the press, particularly *The Wall Street Journal*, conveyed in a biased way in early September. Even *Financial Times* interpreted the

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<sup>13</sup> - This speech was only published in Portuguese, in my book *A Crise do Estado* (1991).

Brazilian proposal wrong. In its September 10 edition, just after my visit to Baker, it published: "The U.S. Treasury's rapid heading off of Brazil radical plan to convert half its bank debt into securities..."

Thus, when I arrived in Washington for my meeting with Baker, the climate was not favourable. The Secretary of the Treasury was clearly under pressure from the banks and the press. The idea was that a financing minister from a developing country was challenging the banks and the Washington establishment, by taking initiatives that only the Treasury could take. This was politically very bad to 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 problem. The leakage of the Brazilian proposal through the press in a distorted way had been unlucky. But I hoped to have a good conversation with Baker anyway. And indeed, I had.

James Baker is a earnest and straightforward person. He used to divide the interviews with finance ministers in two parts: the first part, a private talk; the second, a debate with both staffs in each side of a table. The meeting was in the morning. In the first part, he asked about my proposal. I said that it had two parts: a conventional and a non-conventional. The conventional part implied 60 percent financing of the payments due to the commercial banks and 100 percent financing of the payments 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 de-linkage of the Fund from the commercial banks, so that the 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 accepted securitization, that would be compulsory - a required part of the debt agreement - although limited to a small part of the debt: 20 percent. I could argue, but I felt that some compromise on my part was necessary. The press had made too much fuss around the Brazilian proposal. A managed and limited retreat was convenient. I asked if he

would agree with a voluntary securitization scheme and with the delinkage idea.<sup>14</sup> Baker immediately agreed. When Baker and I went to the larger meeting with both staffs, I was happy, feeling that my gains had been bigger than the concessions I had made.

While we were sitting, Baker made a joke. "I heard that yesterday you have been 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.<sup>15</sup>

In 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 to the securitization and particularly to the de-linkage idea. They argued that since the debt crisis broke out the linkage between the multilateral institutions and the commercial banks was an essential feature of the negotiations. I replied that this was one essential reason why the negotiations were so difficult and so unsatisfactory to the debtor countries. I did not have the foolish intention of destroying the system that had been established in Washington to manage the debt, but I thought that some flexibility in this system was essential. Besides, I insisted that I had already come to an agreement with Baker. In spite of the unconformity of his staff, Baker maintained his word. Yet, 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 felt that this was a good solution. 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

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<sup>14</sup> - The term "voluntary" securitization is a bit ambiguous. The commercial banks preferred leaving things as they were. But the banks recognized that this was impossible. Thus, they came to adopt the expression and the idea, to avoid the alternative, "compulsory" securitization, ie., securitization that would be compulsory to the banks as an outcome of the negotiations.

<sup>15</sup> - This significative episode was recently revoked by Rubens Barbosa, that was my Secretary for International Affairs.

made a small retreat, accepting that the securitization were voluntary instead of obligatory for the banks, but that, as a trade-off, Baker had accepted the voluntary securitization idea and the relative de-linkage between the multilateral institutions and the banks.

One hour later, when I was having lunch at the Brazilian embassy, Marcílio received information that Baker was very unhappy because Reuters, immediately after the meeting, had reported, based on my words, that he had fully accepted the Brazilian ideas on the debt. I felt the danger. The interpretation of the press could never be that. I had been very clear about the concessions I had made. So, I immediately called Baker, said that my report to the press had been faithful to the meeting, but that I was ready to make it more clear, calling back Reuters. Baker answered that this was not necessary since he had already issued a note to the press. I understood that Baker too had made a faithful report in his note and felt relieved.

That afternoon, after a short visit to the Fed, I flew back to Brazil. Landing at the Rio de Janeiro airport, I read the Brazilian newspapers with surprise and indignation. Baker's note to the press, that had been obviously suggested by his unconformed staff, was short and aggressive. It was a note of an 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 two radical changes of policy, that eighteen months later would be the basis of the Brady Plan: voluntary securitization of the debt and de-linkage of the multilateral institution and the commercial banks. 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.

A note like that, coming from the U.S. Secretary of the Treasury, was a political defeat for me. In the next two weeks, while I was preparing myself 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 an domestic crisis. The most serious crisis I had faced since I had taken office four months before. I knew that my ideas on the debt were quite reasonable. That they did not confront the national interest of the United States or the creditor countries. They were not even detrimental to the banks, although I could understand that they feared

innovations that implied some debt reduction. It was clear to the elites in the creditor countries that the muddling through approach 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 for the specialists. Why, then, such aggressive behaviour? Was it because the United States government could not accept that an unknown finance minister from a debtor country changed the agenda on the debt crisis? Because, even if the press had given an accurate report of 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 creditors countries that Baker represented - a conflict that had to end with a clear victory of the stronger part? Because Reuters had indeed reported wrongly?

I did not check this last hypothesis. I assumed that some misunderstanding had taken place on the part of Reuters. Yet, three months later, after leaving the Finance Ministry of Brazil, I gave a long interview to the Brazilian magazine *Isto É-Senhor*, where I told the story.<sup>16</sup> I immediately received a phone call from the Reuters representative in Brazil, saying that his company had absolutely not made a wrong report on the meeting. He sent me 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 or ideological dependency of the Brazilian press and the Brazilian elites to the United States. A developing country is a dependent country not only in economic and political terms, but also in cultural terms. Our culture and our ideology is an imported one. In some moments, Brazilian are very nationalist. The import substitution strategy was a nationalist industrialization strategy. But in others we seem to believe that the truth and the whole truth is in the North. We recognize the superiority of the American or the European

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<sup>16</sup> - *Isto É-Senhor*, January 5, 1988. This and the other significative interviews to the presses were put together in a book edit by Sardenberg (1989).



culture, and accept it uncritically. We may admit that the national interest of Brazil often does not coincide with the national interest of the developed countries, but we fear conflict, we 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 only underlined the Brazilian defeat, the Brazilian humiliation. The elites remained silent.

I had to counter attack, besides finishing the preparation of Brazil's proposal to the creditors. For the first time, I invited the most influential Brazilian businessmen to a meeting, where I made a report of the debt negotiations, said that the Brazilian proposal would be partially not conventional and that for this reason an agreement with the banks would take some time. Thus, I was asking for their support. The trade off of the delay in concluding the negotiations would be a better deal for Brazil. This support was given. Roberto Giannetti Fonseca had an important role in this outcome. In the eve of my new trip to the United States, a communique signed by the leading Brazilian entrepreneurs was published in *Folha de S. Paulo*, giving support to my policy on the debt.

From abroad the only support I received was a short interview of the then Finance Minister of Japan (now Prime Minister) Kiichi Myiasawa, that, in a speech in a small town in Japan, reported in *Gazeta Mercantil*, said that my proposal seemed to him "attractive". I tried to enter in contact with him in Japan and later in Washington, but it was impossible. Yet Myiasawa did not forget the idea. To the dismay of the American representation, that 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.

#### 4. The IMF/World Bank Annual Meeting

I arrived in New York on September 24, to participate in the first G-3 meeting - the group formed by the finance ministers of Argentina, Brazil and Mexico to regularly consult on the debt crisis. I had made the proposal of organizing this group in the August visit to Mexico.

If the creditor countries could have a G-7, why could we not have a G-3? I offered this idea to President Sarney and President de la Madrid and to the respective finance and foreign ministers. The group would limit itself to the debt problem, and would be formed by the three finance ministers. The two presidents accepted the idea. I and Gustavo Petricioli, the finance minister of Mexico - immediately called Juan Sourrouille, economy minister of Argentina. Sourrouille also liked the idea, consulted President Alfonsín, and the group was formed. The first meeting would take place in New York, on the eve of the IMF/World Bank annual meeting.<sup>17</sup>

When I arrived in New York, the first journalist I met was the correspondent of *O Estado de S. Paulo*, Moisés Rabinovitch. I met him in the street, but he had time to say: "By gosh, Minister, everything changed in this country in the last two weeks. Everybody is discussing securitization".

I was surprised, but not much. I had only proposed the securitization because I was convinced that there was space for the idea among the creditors. This space or this interest was now confirmed. Indeed, securitization had become "the talk of the town" among bankers, government officials and multilateral institutions representatives. And the attitude was quite positive. The banks were seeing a possibility of new financial transactions. The officials, a way out of the stalemate. The "non starter" had turned into a starter.

In Washington the first person who conveyed the new mood was Armeane Choksi, the director of Brazil's department at the World Bank. I met him when I was entering the IMF building. In an enthusiastic and warm way he said: "Bresser, your ideas are coming true. You just opened the third phase of the debt crisis". Indeed, after Volker's and de la Rosière's

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<sup>17</sup> - The first meeting in New York was excellent. There was no intention of forming a cartel, but the dissatisfaction of the three countries with the current 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, in the end of November, profiting the meeting of eight Latin American presidents in Acapulco. This meeting never happened. The Mexicans demonstrated clearly their disinterest. Besides, Petricioli was deeply involved in coming to an agreement with workers and businessmen that would end, in December, an 180 percent inflation, with a price freeze.

"liquidity approach" (1983-1985), and Baker's "adjustment and structural reforms with financing and growth approach" (1985-1987), at that moment was beginning the "securitization or debt reduction approach", that would become victorious in the Brady Plan (February 1989). 1988 would see the proposals of a global solution of the debt with the creation of a debt facility and the securitization of the total debt.<sup>18</sup> It would see the meeting of experts promoted by the United Nations, that resulted in a strong position in favour of debt reduction coming from the General Secretary Perez de Cuellar. It would see Myiasawa's proposal at the Toronto Annual Meeting. And finally, in the beginning of the Bush administration, the Brady Plan, although modest and insufficient if compared with the proposed global solution, became Washington official approach to the debt crisis. This plan, supported by the U.S. Treasury and the G-7, had as its corner-stones the voluntary (but managed) securitization of the debt and the relative de-linkage between the multilateral institutions and the commercial banks - exactly the two initiatives that had triggered the "non starter" from Baker.<sup>19</sup>

The 1987 IMF/World Bank Annual Meeting was in many ways the best moment of my short time in the Finance Ministry of Brazil. The organizers of the meeting have a public relations concern. Thus, they told me that they were deliberately placing my speech in the Interim Committee and in the General Assembly just after or just before Baker's speech. We were supposed to confront each other in 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. My condition was that the meeting would not take place in the Treasury but in the IMF building. In the beginning it was a tense meeting, but Baker reaffirmed his disposition to back the voluntary securitization and the de-linkage idea. And he indeed gave me some support in my interviews with the finance ministers of the G-7, from whom I asked for support to my proposal and particularly to the

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<sup>18</sup> - Among these proposals I would underline Arjun Sengupta's, the Director for India (1988) at the IMF, and James Robinson III's, chairman of the American Express Bank (1988), besides Jeffrey Sachs' proposal (1988).

<sup>19</sup> - In mid 1992, referring to this episode, Baker, then heading the Department of State, said to the press that he lamented it.

securitization and delinkage ideas.<sup>20</sup> Probably under pressure from his staff and for good political reasons - the reasons of the hegemonic nation - he had not played fair with me in the "non starter" episode, but after this he kept his commitments.

In the Annual Meeting the Bank's role as a part of 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 Brazil while faithful to his institution and their main shareholders. In a very elegant way he was able to make clear Washington 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 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' July 1987 words.

Yet, nor Choksi, nor Qureshi, nor the many Bank officials that 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 national interest conflict between the creditor countries (that defined as their national interest to protect their commercial banks) and the debtor countries. The Bank rested essentially with the former, with its main shareholders.<sup>21</sup>

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<sup>20</sup> - In the Annual Meeting I spoke with the finance ministers of France, England and Spain, and with the vice-ministers of Germany and Japan. Due this conversations and Baker's support the final communique of the Interim Committee was quite satisfactory for my thesis.

<sup>21</sup> - As Catherine Gwin writes in another essay in this volume, "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). \*

## 5. The Bank and the Debt

The role the Bank was playing in the debt crisis became clear to me in the Annual Meeting. My meetings with Qureshi were particularly illustrative of the contradictions the Bank faced. The contradictory performance may be explained by its dependence on its major shareholders. Secondly it responded to the ideological change that took place within the Bank in the early 1980s. The conservative, neo-liberal wave that swept departments of economics of the American Universities since early 1970s and led development economics to a crisis (Hirschman, 1979), was also the main factor behind the ideological transformation within the Bank. The presence of a conservative president in the White House enhanced this change.

With the victory of Ronald Reagan in the 1980 presidential elections, the Banks came under increasing pressure from its major stockholder.<sup>22</sup> First, as observes Karin Lissakers (1991: 16), 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 viewed by the American government as suspect of "liberal", statist or even leftist views. The role of the Bank as a provider of financing for strategic infrastructure projects was challenged. 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 is in this unfavourable climate that the debt crisis broke out in 1982. The role the developing countries expected from the Bank was a very positive one. Whereas the Fund was

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<sup>22</sup> - Writing in this moment, Cheryl Payer notes: "The crisis relations 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 conservative 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.

viewed as a tool of the commercial banks, or, more broadly, of the international financial community, the Bank was supposed to hold a basic allegiance to the highly indebted countries, since its commitment was supposed to be with development, not with balance of payment adjustment. Yet, the Bank did not correspond to the expectations of the developing countries. Soon, it became clear that the Bank and the Fund were the two basic instruments that creditor countries used to manage the debt crisis and protect their commercial banks.<sup>23</sup>

The very existence of the World Bank is based on the realist assumption that there are common interests between the developed and the developing countries. The debt crisis, however, was defined by a conflict of interests between the debtor and the creditor countries. The conflicting aspects of the crisis clearly surmounted the common interests in this case. It is not a question of imperialism or not. The imperialist ideas to explain underdevelopment lost definitely ground in the 1970s, when the Latin American new 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 radical nationalists remained faithful to imperialist interpretation of underdevelopment.<sup>24</sup> Yet, even for the ones that essentially believe in the "mutual-benefit claim" (Hirschman, 1979), that was adopted by development economics, it is clear the conflict in the case of the debt crisis: the creditor countries wanted the interests on the debt to be paid, the debtors, unable to pay them, needed to cancel part of the principal. The Bank, that was created on the assumption of the mutual-benefits, but that has as its main objective to promote growth in the developing countries, was trapped in a deep contradiction. It tried at its best to find solutions that were mutually beneficial - that, till a certain extent indeed exist -, but when, in the limit, this alternative was not feasible, it positioned with the creditors.

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<sup>23</sup> - *The Economist*, in a long survey of the Bank (September 27, 1986: 4) 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".

<sup>24</sup> - The "new dependency theory", whose basic works is Cardoso and Faletto's book (1969), should be clearly distinguished from the "old dependency theory" or "imperialist theory" of development, based in Lenin. See Cardoso (1977) and Bresser Pereira (1982).

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

Some believe that the Bank, in adopting this role, lost an opportunity to perform its genuine role as a development bank. According to this view, the Bank "failed" in not adopting a more active role in the search for solutions for the debt crisis, in not advocating debt relief since the beginning. 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 finances and promotes development to an institution that imposes conditionality, that constrains developing countries to follow the economic directives the First World believes suitable.

The priority for the creditor governments was to protect their banks, and, more broadly, the health of international financial system. While the Fund remained responsible for fiscal and balance of payments adjustment, 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 is in danger of becoming like the IMF - pushing simplistic, standardized formulas that slight the particular history, culture, and politics of individual nations" (Feinberg, 1986: 12). Indeed this happened. Although the original objectives of structural adjustment loans were not to serve as a tool to impose standard neo-liberal reforms on the developing countries, but "to support - by means of

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 focussed on macroeconomic management. But, as a trade-off, the Bank, as a bureaucratic organization that strives for survival and growth, recovered its prestige among Washington authorities, a prestige that was essential for the accomplishment of its basic organizational objectives.<sup>25</sup>

## 6. The Negotiations with the Commercial Banks

I left joint World Bank/IMF Annual Meeting with a sense of victory. But I knew that in the months ahead, Fernóo Bracher, the chief Brazilian negotiator, and I have a hard time with the commercial banks. Fernóo Bracher and Fernando Milliet de Oliveira, the 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 make clear my conditions for that. Bracher argued that bankers do not reason or negotiate in these terms, but I insisted. Brazil was not making an inflexible proposal, but establishing the terms of reference for the agreement with the banks.<sup>26</sup> According to what I had agreed with Baker, the proposal had a conventional and a

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<sup>25</sup> - *The Economist*, in a second survey of the Bank and the Fund (October 12, 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".

<sup>26</sup> - This proposal as well as my speeches in the Interim Committee and in the General Assembly of the IMF/World Bank annual meeting were published in the Finance Ministry of Brazil brochure, *A Proposal for Negotiating the Foreign Debt* (1987).



non-conventional part. The conventional part was "new money", actually, refinancing of interest; the non-conventional, voluntary securitization and the de-linkage. The banks, whereas knowing that time for a change in the negotiation pattern had come, were uneasy about how to behave. They were interested in the securitization scheme, but were insecure about it. As to the de-linkage, they were decidedly against it. They did not want to negotiate by 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. Baker called personally to ask this. I made it very clear that I just would suspend the moratorium with a definitive agreement with the banks. As to the interim agreement, I resisted for some time, but the pressure from Baker was strong. He called from Washington several times. They had a threat: in October 26 the ICERC - a commission formed by U.S. government agencies to regularly assess country risk - would meet and, since Brazil was in arrears for more than six months, there would be no other alternative but to classify Brazil.<sup>27</sup> The classification, according to the Treasury's interpretation, would make further the negotiations with the banks impracticable. I doubted that this last threat was realistic, but I was not sure. What was clear was the pressure from the Washington. Later it was demonstrated that the classification of Brazil by the ICERC would not prevent negotiations. After I left the government, Brazil's debt was classified, but the negotiations continued. Anyway, Bracher and I believed that, at that moment, it was essential to demonstrate our sincere interest to come to an agreement with the banks, clearly signaling our intention to end of the moratorium. Thus, we agreed to sign an interim agreement with the banks.

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<sup>27</sup> - ICERC - Interagency Country Exposure Committee, formed by the Treasury, the Federal Reserve, the Federal Deposit Insurance Corporation and the Controller of the Currency.

The agreement, signed in November, meant a payment of US \$ 500 million to the banks, and established a deadline for the signature of the term sheet: January 29, 1988. I wanted December 30, but the banks pressed as much as they could for a delay. If before that date the term sheet was signed, the moratorium would be suspended, 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 other alternative but to decide according to his own terms how much and when to pay the banks. This last part was not written in the agreement, but was how I understood it. Brazil would start unilaterally paying around one third of the interests.

In the interim agreement there was a commitment on the part of the banks that they would accept securitization as an integral part of the agreement, and also that the negotiations would proceed independently of the agreement Brazil had intention to firm with IMF. This was the de-linkage aspect. Brazil committed itself to sign a stabilization program with IMF, but the 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, that I fully respect, did not accept my arguments. Most understood that I was suspending the moratorium, what was not true. The idea of signing a new letter of intention to the IMF still was also not accepted. Yet, I counted with the strong support of some politicians, particularly from Ulysses Guimarães and Fernando Henrique Cardoso. President Sarney gave me private support, but in public he passed the idea that the responsibility for the agreement was only mine. This was a constant in the President's behaviour. He liked to respond for the popular moves and wash his hands in relation to the unpopular ones.

Anyway, I proceeded with the negotiations. I asked Pedro Malan, who is an excellent economist and had a good experience with the debt as Executive Director for Brazil at the

Bank, to help Bracher in the economic aspects of the negotiation.<sup>28</sup> On the other hand, I decided to run the macroeconomic model in the computer again, with the new parameters that were emerging from the negotiations. Now the fiscal constraint to an agreement with the banks, that had already emerged as the crucial variable in the first version of the plan, was defined as the major limitation. In 1990 this criterion 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 capacity to pay. They were divided, because they supported the Brazilian policies, having only minor critiques,<sup>29</sup> but for political reasons they could not side with Brazil in the negotiations. They had also to press Brazil to an agreement as conventional as possible. Only after the Brady Plan (February 1989) the Bank would be able to change its policy.

The World Bank economists were studying very carefully the macroeconomic situation of the country. 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. And, if they did, they probably would not publish it. Obviously he was referring to the Bank's difficulties with the Fund. I strongly stimulate him to write and publish. I said:

"You should publish the report with the red cover, not with the grey one, so that everybody has access to it. Multilateral institutions use and abuse of secrecy. They are concerned in not imposing on the developing countries, so they use restricted documents. What we really need is a public macroeconomic assessment. I may disagree, although I believe that we will mostly agree. The important, however, is to make clear to everybody what, according

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<sup>28</sup> - In 1992-93 Malan, as head of the Brazilian negotiation team, would finally conclude an agreement with the commercial banks, in the lines of the Brady Plan. Before Brazil, Mexico, Costa Rica, Venezuela, Philippines and Argentina did the same.

<sup>29</sup> - See The World Bank's report no.7057-BR, *Brazil: an Assessment of the Current Macroeconomic Situation*, December 1987.

to the Bank, went right or wrong with economic policy in Brazil. This will help me, even if you make some restrictions to my policies. Anyway, it is from this type of debate, rather than from strict conditionality, that the Bank will be able to help us".

Choksi, somewhat surprised, liked what he heard from me, and went on with the idea of writing and publishing a World Bank report, *The Macroeconomic Assessment of Brazil - 1987*, that, since then, became a regular report. After that, Choksi several times remembered this fact, saying that this was a historical fact, because it was the first time the World Bank made a formal macroeconomic assessment of a country.

Yet, my suggestion of publishing it in the red colour, so as to be available to everybody interested, was not accepted. In a contradictory way, the World Bank, as other multilateral organizations, is always extremely concerned in not interfering in the internal affairs of the countries, although to interfere through conditionality is precisely its job. Actually, the multilateral institutions interfere in a secret way. It would be more democratic and more effective if the interference were open, transparent. In most occasion this interference would be a help. Formal conditionality may work very well, when the domestic authorities are willing to follow the targets, but, besides conditionality the Bank exercise counselling. Bank official today like to view the World Bank as a service institution. The policy recommendations that would be part of the macroeconomic assessment should be public, transparent.

The testimony of the Bank economists in the negotiations with the commercial banks did not help nor hinder the negotiations. They could not strongly support the Brazilian proposal, although they obviously see it with sympathy. The negotiations with the banks continued. Very slowly. Soon Bracher and I realized that the January 29 deadline would not be met. The commercial banks were very 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 with them. A general policy coming from the Treasury and the multilateral institutions was clearly lacking.

Yet, Brazil could not and would not rest on the dependency of the banks indefinitely. As expected, inflation rates were accelerating. In November they were already above 10 percent - the figure that in June 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 made a new visit to Mexico, now to participate with Sarney in a meeting of eight Latin American presidents in Acapulco. The foreign debt was the major issue in the meeting. I had little opportunity to talk with Mexico's Finance Minister, Gustavo Petricioli, since he was deeply involved in the negotiations with the unions that, a few days later, would lead to the heterodox stabilization plan, involving prices and wages freeze that, coupled with the fiscal adjustment and the structural reforms, stabilized Mexican inflation since then. Yet, I had an important conversation with the other member of the G-3, Juan Sourrouille, from Argentina. In this meeting we agreed that we would wait till the beginning of next February. If the two countries did not reach a reasonable agreement with the banks until then, we would decide in a coordinated way an Argentinean moratorium and Brazil's unilateral decision to start paying around one third of interests due to the commercial banks. We were not creating a debtor's cartel, that is not feasible, but defining a minimum coordination level for our policies. Yet, I would not have 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 resigned less three weeks after the Acapulco meeting.

## 7. Stabilization and the Decision to Resign

Stabilization, not the foreign debt, was my first and main concern in the seven months and half I remained as finance minister of Brazil. Stabilization started with the Bresser Plan, in 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. The fiscal adjustment coupled with some clear-cut solution for the foreign debt problem and a new and short price freeze would stabilize the Brazilian economy.

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 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 in the day of the plan we would have no maxi-devaluation nor large increases in public prices ("tarifaços"). According to the neo-structuralist theory of inertial or chronic inflation, a shock coupled with a "tarifaço" and a sharp devaluation of the local currency is condemned in advance. When inflation is high and inertial or indexed, the inflationary process is a process of moving equilibria and desequilibria 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 indexed inflation prices are corrected every month, after the publication of the price indexes. Thus, in order to co-ordinate 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 to interfere in the market relative price equilibrium.

Second, a fiscal adjustment should precede the plan. Heterodox policies, ie., incomes policies that directly affect prices and wages, are required in high inflations that did not reach

full hyperinflation,<sup>30</sup> but these policies have necessarily a limited scope. They don't replace but complement orthodox fiscal and monetary policies.

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

President Sarney was informed and agreed on the need of a new stabilization plan for 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 their prices above inflation in order to avoid the need of a new "tarifaço" in the day of the new plan. The exchange rate, after a two real devaluations in the first days in office, had been kept in the right level. Wages were being indexed on a monthly basis, making easier a new freeze.<sup>31</sup> As to the foreign debt, Sarney agreed that, if we did not come to an agreement with the banks up to January 29, Brazil would have to decide unilaterally how much to pay, and make its plans and budgets according to this decision. 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.

But, the new stabilization plan and the coordination of actions between Brazil and Argentina aborted with my resignation from the Finance Ministry, for lack of support for the

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<sup>30</sup> - In open hyperinflation the asynchrony or the phased character of price increases, that characterizes high inertial inflations, 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.

<sup>31</sup> - When, in high and inertial inflation, wages are indexed monthly, it is enough to decide the freeze in the middle of the month to have the nominal wages equal to the average real wages.

fiscal adjustment plan I and my team proposed. Since my return from Washington at the end of September, I had defined as my absolute priority a fiscal adjustment plan, involving a sizeable reduction of expenditures and subsidies, and a tax reform increasing the tax burden and making it more progressive. I worked incessantly in this project for two months. Always maintaining President Sarney informed about the progresses my team and I were making in the definition of the plan. Yet, when the plan was ready, at the third week of December, and I presented it to the President, I did not get his support.

Why President Sarney was not able to provide the support I was asking for? For several reasons. First, because the dominant views on economic policy were in 1987 populist. The Cruzado Plan was no accident. It was not only President Sarney that was not prepared for a effective fiscal adjustment in Brazil. Brazilian society and the Brazilian congress were not either. National developmentalism - a close relative to economic populism - had been successful in promoting economic growth between the 1930s and the 1950s. The military were not orthodox. In 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 endeavour to overthrow the military, to attribute all evils of the orthodox policies. The general idea was return to the good old days of development and democracy.

Second, because business men were not yet convinced of the seriousness of the economic crisis. When I said - as I insistently deed - that 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. When, in December, I presented my tax reform, the business associations of São Paulo signed a communique protesting.

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



give him political support. Forth, because a conservative group in the staff of the President, led by Jorge Murad and Antonio Carlos Magalhães, a powerful politician from Bahia, was unhappy with my policies, that did not respond to their personal and political interests, pressed the President not to accept my fiscal adjustment plan.

The president hesitated, but finally bowed to this group, leaving me no other alternative but to resign. I was not in office just to exercise political power. The president insistently 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. Why next year, if he could approve the plan that year?

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A tense and fascinating period as Finance Minister of Brazil was over. In this period I was involved with the Bank in many ways. Mostly in a positive way, although the Bank sided with the creditor countries and particularly with the United States in relation to a crucial problem: the foreign debt. In the 1980s the Bank adopted neo-liberal views and was unable to give effective support to the debtor countries. But while this was being done, its staff did not lose perspective of its long term growth objectives. More than that, they did not break up their basic solidarity with the developing countries. This was certainly done in a contradictory way - what was inevitable. In a decade the saw no growth for the highly indebted developing countries, in a time where adjustment had necessary priority over growth, the role of the Bank was inherently contradictory. These contradictions will be the second and more general part of this essay.

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