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Brazilian Misfortune in the 1980s: The Painful Experience of an Economy Governed from Abroad

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Introduction

In the aftermath of the Mexico's default on external debt in 1982, Brazilian economy ended 30 years of almost uninterrupted economic fortune and came to undertake a long lasting economic downturn.[1] Neoliberal economists have blamed the prolonged poor economic performance and high financial instability of the 1980s on the government interventionist failures.

This paper documents, instead, that the major troubles the Brazilian economy experienced in the 1980s derived from the adjustment of the economy to the austerity measures established by the IMF and the foreign creditors. It takes a political economy instance to analyse the financial balance of the institutional sectors to show that the Brazilian government had to use its financial instruments to comply with the net transfer to pay the debt servicing to foreign creditors at the cost of financial instability and poor economic performance.

The second section shows that despite using the rhetoric that market forces are better than planning the governments of developed countries in fact decided to intervene in the settlement of the external debt. Through the IMF adjustment policies they avoided a general collapse of their banks. Even neoliberal economists favoured political intervention to rescue the international financial system from bankruptcy. The guiding principle for the settlement, however, was to impose a regime of net transfer from debtors to creditors. Therefore debtor countries should be forced to adopt "unpalatable changes in [their] economic policies" (Lal 1997[1983], p. 67). The second section states

[1] For a detailed historical analyses see Dalto (2007).

the international political background for the analysis of the economic policies adopted in Brazil provided in the remainder of the text.

The third section discusses the actual conditions of the Brazilian external debt negotiations. It shows that the negotiations entailed a heavy burden of net transfers abroad from Brazil.

The fourth section discusses the domestic financial instability arising from the adoption of adjustment policies. Financial instability impaired sustained economic recovery as it disrupted previous conventions and introduced great uncertainty into the economy. The government policies turned to support the private sector financial restructuring in order to avoid a general crisis of it. Therefore, it is argued that the ever-increasing public deficits and debts were instrumental in maintaining the net transfers abroad and in guaranteeing a minimum profitability for the private sector.

It concludes proposing that the adjustment policies meant the prioritisation of the interests of international and domestic rentiers with regard to public policies, at the expense of economic and social development. Such Brazilian construction of misfortune in the 1980s may serve as a lesson for troubled European countries of today.

The Political Economy of the External Debt Negotiations

In the wake of the external debt crisis of 1982, the international financial community had to come up with an urgent solution in order to rescue the international banking system from a devastating financial crash. According to Robert Guttmann (1994, pp.229-230) the nine largest United States banks had lent about 120% of their entire capital base to Mexico, Brazil and Argentina. In Brazil alone, the exposure of the nine largest United States banks was calculated at 45.7 % of their primary capital (ECLAC 1988, p.8). Japanese, British and Canadian banks also had lent heavily to Latin American countries (Palma 1995). Clearly, if Brazil and Argentina followed Mexico in defaulting on their external debt it would inexorably erode the capital of a number of international banks with likely disruptive results for the world financial system.

Such critical situation worsened as market incentives ran against individual creditor banks lending to troubled debtors. Surely, if there was no one lending debtor countries would not be able to pay their debt services and would hence be forced to default. The whole banking system would surely loose out. Although the stage was set for a catastrophe in the international financial system it did not happen.[2] Coordinated and cooperative actions from developed governments and multilateral institutions were called for. Instead of the neoliberal arm's length, to rescue the troubled credit of their banks multilateral institutions and governments of developed countries strongly intervened to allow a coordinated bank's retirement.[3]

In the management of the 1982 debt crisis there emerged what Christian Suter and Hanspeter Stamm (1992, p.647) called "the actor structure on the creditor's side" which constituted of "strong cooperative networks among creditors [capable] to exert far-reaching influence on debtor countries and to enforce hard terms of debt settlements against the interests of debtor countries…". This actor structure operated at three levels. First, multilateral intervention cooled off the crisis by adopting three immediate steps: a) the advancement of an immediate bridge loans programme whose resources were put forward by the central banks of developed countries, the Bank for International Settlements (BIS) and the United States Treasury to guarantee a minimum flow of capital to avoid further defaults and also to avoid a disordered outpouring of resources from troubled indebted countries, since banks' wealth would badly be hurt by such events (Baer 1993, pp.60-70;Guttmann 1994, pp.230-235);[4] b) the availability of credit lines under the IMF supervision, conditioned to a macroeconomic programme of adjustment and austerity to repay the bridge loan and reschedule future payments; c) case-by-case negotiation with debtor countries in order to avoid the constitution of debtors' cartel.

Second, creditor banks organized themselves into cartels called "Creditor Bank Committees", headed by the largest commercial banks, to negotiate on behalf of all creditors. These bank committees had as function to present proposals in bloc impeding therefore that debtor countries explored possible interest divergences between large and small banks.

[2] In fact, throughout the debt crisis and thereafter the United States banks' earnings were at higher levels than before the crisis (ECLAC 1988, p.10).
[3] In June 1982, all United States banks' exposure in Latin America mounted to 124.4% of banks' capital. In Brazil it was 31.1%. In March of 1987 the exposure had been reduced to 65.3% in Latin America and 19.7% in Brazil (ECLAC 1988, p.8).
[4] As Guttmann (1994, p.231) points out, such strategy was fundamental in order for the baking system to "manipulate accounting rules governing losses to their advantage". Accordingly, with the provision of a minimum of resources, which allowed debtors countries to realise parcel of the interest payments, the banks could avoid to rate assets related to LDC's debt at lower levels, like "loss" or "doubtful."

Third, a coordinated solution to the external debt depended on the cooperation of Latin American countries that chose adjustment over default. Many authors have argued that in previous debt crises, notoriously in the 1930s, debtor nations defaulted on their debts and bore much lower costs than in the 1980s (Sachs 1986; Dornbusch 1987; ECLAC 1988; Eichengreen and Portes 1989; Sachs and Huizinga 1987; Suter and Stamm 1992). Why did debtor countries decide to cooperate in the 1980s instead of defaulting like in the 1930s? First, as already noted, debtor countries were unable to establish a "Debtors Committee" as did creditors in part because of the IMF's strategy of negotiating case-by-case agreements in part due to divergence amongst themselves. Therefore, they were in an unlikely position to obtain good deals against a coordinated and backed creditors' cartel. Second, debtor countries were threatened with exclusion from the international financial credit system by the IMF and creditors if they declared default (Boughton 2001, p.542). Third, creditor governments backed their banks and strengthened the threat of debtors' exclusion from the international financial markets. The creditor governments intervention has been referred to by many authors as the most important factor to persuade debtor countries to comply with the net transfers of financial resources to creditor banks (Dornbusch 1987; Eichengreen and Portes 1989; Sachs 1986; Sachs and Huizinga 1987; Suter and Stamm 1992).

Eric Helleiner (1994, p.181) points out that the strong position of the governments of developed countries and the cooperation of debtor countries were also related to the "ascendancy of neoliberal frameworks of thought in both creditor and debtor countries in the early 1980s", a condition that guaranteed debtor and creditor enthusiasm in adopting an orthodox adjustment. Therefore, the issue was not that in the 1980s debt crisis creditor governments were more or less interventionist but that "U.S. officials in the eighties have made clear the priority they attach to maintaining debt service" (Eichengreen and Portes 1989, p.29).

In summary, throughout the eighties the relations between creditors and debtors favoured the former as the governments of developed countries and the IMF forced debtor countries to follow economic policies compatible with the full servicing of debts. As a consequence debtor countries had to bear the bulk of the adjustment by generating massive transferable financial resources abroad. In short, the debt settlement in the 1980s was characterised by close cooperation between creditor banks and multilateral financial institutions as supporters of creditors up against debtors as the executors of the adjustment.

The Problem of the Net Financial Transfers in Brazil

The principles that underlay the debt negotiations materialised in the agreements signed by Brazil and its creditors throughout the 1980s. Those principles were: a) a rapid settlement of the external debt in order to avoid the disruption to the international financial markets that a Brazilian default was likely to provoke; b) a coordinated reduction in exposure of foreign banks and little, if any, debt forgiveness to force Brazil to generate enough resources to pay debt servicing in full; c) to make the Brazilian government comply with the IMF adjustment programme and surveillance.

The speed the negotiations were conducted was based on a desire to avoid default declarations. As Brazil faced difficulties in servicing its external debt in the wake of the financial turmoil, international multilateral organisms and creditor governments offered a bridge loan of US$ 4.2 billion until Brazil negotiated a definite deal with creditors under IMF supervision. On the other hand, the amount of resources advanced by multilateral institutions was sufficient only to maintain debt servicing – it was not enough to meet Brazil's balance of payments needs. As a consequence, a further US$ 4.5 billion was drained from Brazil's international reserves leaving the country practically without it. These conditions put Brazilian negotiators under pressure to begin official rescheduling agreements with the IMF and creditor banks in November 1982, a situation which favoured the imposition of conditionality by the IMF.

Second, unwilling to declare default Brazilian policymakers accepted the so-called "reverse" adjustment, which meant first to estimate the amount of resources the creditors would be willing to grant and then the amount of trade surplus needed to close the gap of the current account. In addition, the terms of the rescheduling resulted in stringent conditions for Brazil's payments with high interest rates and short periods of consolidation, maturity and grace (Cerqueira 1996). In parallel to the negotiations with the private creditors, which accounted for 7/8 of Brazil's external debt, negotiations were also conducted with official creditors, a group of 16 developed countries organised within the so-called the Paris Club. Throughout negotiations, the Paris Club played the role of pressuring Brazil to formalise accords with the IMF and to accept its conditionality. As a rule, the Paris Club only accepted open negotiations with Brazil when the country had already formalised a financing accord with the IMF. Therefore, Brazil's conditions to pay the external debt services were stringent throughout the decade, resulting on small renewal of credit and high payment of debt services.

Table 1:1 Financial Flows by Creditors – US$ Million

	1982-1984	*1985-1987*	*1988-1989*
Official Sources			
Financing	11,528	5,763	2,779
Amortisation	2,976	7,439	6,802
Interest	2,894	5,552	4,346
Net	5,658	- 5,513	- 6,745
Private Sources			
Financing	25,429	1,377	5,028
Amortisation	8,019	1,312	3,055
Interest	27,172	19,177	15,912
Net	- 9,762	- 19,112	- 16,359
Other Sources			
Financing	5,516	2,167	2,028
Amortisation	4,118	1,443	1,535
Interest	4,197	1,394	868
Net	- 2,799	670	- 375
Total			
Financing	42,473	9,307	10,258
Amortisation	15,113	10,194	11,392
Interest	34,263	26,123	21,126
Net	- 6,903	- 27,010	- 22,260

Source: Carneiro (2002, p.132).

Table 1 above synthesises the cash flows to and from creditors according to their official or private features. Clearly there is an increasing gap between the resources Brazil received throughout the 1980s and those it paid. Consistent with the principle of avoiding a default in the first two years after the crisis the capital inflow financed all the amortization and part of the interest paid in those years. It is also evident that in this period the resources from official institutions bailed out part of the private sector withdrawal. However, as the decade gone on fewer resources were being provided by the creditors, whether private banks or officials, in order that financing plummeted and became insufficient even to cover amortization, let alone interest payments. Therefore, all the resources to cover amortization and interest had to be provided by Brazil's own means. Throughout the period private sources had been always below amortization and interests. Things went worse as from 1985 onwards even the contribution of official institutions was reduced to amounts below amortization in order to ensure that it would be Brazil's resources guaranteeing the net transfers to reduce creditors' exposure.[5]

The third aspect of the external debt settlement was how to guarantee that Brazil would comply with the terms and conditions of the negotiation. To enforce the observance of the mechanisms of financial transference for creditors the IMF was called to step in. [6] The compliance with the negotiation terms and the IMF adjustment policies was facilitated by the framework of thought of Brazilian policymakers who shared the IMF's approach. In the letter of intentions sent to the IMF in December of 1982 to grant financial support, then, the government announced an economic programme which promised to "reduce considerably the external and internal disequilibria" while in the medium-term it "will *promote structural changes* in the economy which will bring back *high and sustainable rates of economic growth*" (Brazil 1983, p.140). Brazilian policymakers also announced that such objectives would be achieved by augmenting "significantly the domestic savings, *especially in the public sector*, and to make the economy more efficient, objectives which will be attained by correcting the relative prices of many sectors of the economy, getting rid of subsidies, and reducing the government's direct and indirect intervention in the economy" (*op.cit*). Indeed, as the adjustment policies held sway, Brazil's trade surpluses more than compensated the net financial transfers (Table 2).

Table 2: Net Resources Transferred Abroad (US$ Million) and as a Percentage of GDP

	Real Transfers	Net Financial Transfers	Reserve Changes	Net Financial Transfers/GDP
1981	-654	2,474	594	1.0
1982	-1,522	-1,394	-3,513	0.5
1983	5,166	-3,589	569	1.9
1984	12,177	-4,942	7,432	2.6
1985	11,802	-11,062	-387	5.2
1986	6,969	-9,694	-4,848	3.8
1987	10,205	-7,060	698	2.5
1988	17,555	-14,183	1,682	4.6
1989	15,142	-11,918	539	2.9

Source: Banco Central do Brasil.

Whereas the IMF approach adopted at the inception of the external debt crisis was effective in reducing creditor banks' exposure, it was less effective in reducing the

[5] See Jeffrey Sachs and Harry Huizinga (1987).
[6] For details of the IMF's model of balance of payment adjustment see: Stanley Fischer (1997); Michael Mussa and Miguel Savastano (1999).

Brazil's debt burden. Table 3 below shows indicators of Brazil's external debt and Brazil's creditworthiness during the 1980s. The trend of debt ratios indicates that the management of the debt crisis did not improve the external creditworthiness of the country, contradicting the usual IMF's and creditors' argument that the sacrifices would be awarded with a quick return to the international financial market.

Table 3: Indicators of External Debt

	1981	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*
Long-term Debt (US$ Billion)	61.4	70.2	81.3	91.1	95.9	101.8	107.5	102.6	99.3
Short-term Debt (US$ Billion)	12.6	15.3	12.4	11.0	9.3	9.4	13.7	11.0	16.2
Total Debt (US$ Billion)	74.0	85.5	93.8	102.1	105.2	111.2	121.2	113.5	115.5
Net Debt (US$ Billion)	66.5	81.5	89.2	90.1	93.6	104.4	113.7	104.4	105.8
Net Debt/GDP (%)	25.7	30.0	47.1	47.5	44.3	40.5	40.3	34.1	25.4
Net Debt/Exports	2.9	4.0	4.1	3.3	3.6	4.7	4.3	3.1	3.1
Debt Service/Exports (%)	31.9	42.1	28.7	26.6	34.8	33.2	26.7	42.0	31.3

Source: Banco Central do Brasil.

Whereas the size and the dynamic of growth of the external debt are important to understand the burden the Brazilian economy had to carry through the 1980s, the composition of the domestic debtors is crucial to understanding the dynamic of the adjustment. In other words, while it is clear that the external debt settlement should benefit the foreign creditors at the expense of the domestic economy the costs of the adjustment were unevenly distributed within it.

Table 4 shows data on external debt by debtors in Brazil, from which a clear outline emerges. Public external debt as a share of the total net external debt grew at a rate of 2.8 percentage points of the total external debt per annum from the early to the mid-1980s, and then its growth fell towards the end of the decade. The sharper growth of the public share in the net external debt happened as a direct result of the negotiations with the creditors and the IMF, which made the Central Bank and Central Government primarily responsible for the management of the external debt. All the resources for financing public or private debt were deposited in the Central Bank which became the guarantor for the debt. Debtors in turn were allowed to pay their foreign debt making deposits in domestic currency in the Central Bank, while the latter remained responsible for making them good along with the final creditor. In short, the Central Bank became the only debtor in foreign currency of the resources renegotiated with the creditors, being responsible for the interest and other costs incident on the deposits accorded with the creditors.

Throughout the 1980s the private sector, in turn, reduced its indebtedness by transferring it to the public sector. The private sector used these mechanisms to transfer its external debt to the public sector in order to protect itself from the devaluation of the exchange rates and from the increase in the international interest rates.

Table 4: External Debt: Public and Private

	1981	1982	1983	1984	1985	1986	1987	1988	1989
External Debt (US$ Billions)	61.4	70.2	81.3	91.1	95.8	101.7	107.5	102.5	99.3
Net External Debt (US$ Billions)	53.9	66.2	76.7	79.1	84.2	95.0	100.1	93.4	89.6
I - Private External Debt (% Net Debt)	36.3	34.4	27.4	24.4	20.4	15.4	14.4	12.3	11.0
II - Public External Debt (% Net Debt)	63.6	65.6	72.6	75.6	79.7	84.6	85.6	87.7	89.1
a) Central Bank and Central Government	19.7	21.1	31.7	30.0	30.0	39.1	46.0	50.3	55.5
b) Public Enterprises	40.0	40.2	37.4	41.2	44.2	40.0	34.9	32.5	29.5
c) State and Municipal Governments	3.9	4.2	3.5	4.4	5.5	5.5	4.7	4.9	4.2

Sources: Banco Central do Brasil; Ipea.

Thus, despite the free-market rhetoric of the foreign banks and governments of developed countries they nevertheless called on the Brazilian state to play a central role in adjusting the Brazilian economy to the debt crisis. By placing the responsibility on the government, creditors reduced the risk of default as well as shared transaction costs with the Brazilian government. These mechanisms served to reduce the creditors' risk and allowed transference of private external debt to public sector.

The nationalisation of the external debt in the aftermath of the debt crisis had important consequences for public finances. First, the stock dynamic of public external debt, dominated by the mechanisms of transference of external debt to public sector, was of paramount importance in determining interest payments on public external debt, hence public deficits, in the 1980s. Interest payments on external debt became an extraordinary cost for the public sector. Second, as external debt concentrated on the central government and the state enterprises the adjustment of the public finances to accommodate the interest payments came through reductions in public investments. The next sections discuss the ensuing financial instability that emerged from such arrangement.

Financial Instability and Fragility Resulting from the Adjustment Policies

The price "corrections" (or switching policies) aimed at inducing greater net exports and the restrictive fiscal and monetary policies aimed at reducing domestic absorption (expenditure reducing policies) produced awkward financial instability expressed in the increasing volatility of inflation, exchange rates and interest rates.

A devalued exchange rate was selected as the main mechanism to increase exports and to adjust the economy to the regime of resource transferences. The first consequence of the policy of devaluation was the introduction of considerable uncertainty concerning the exchange rates as they became highly unstable throughout the 1980s. In addition, the inflationary effects of devaluation were powered by the widespread indexation of the Brazilian economy which added to the instability and uncertainty of the exchange rates. For instance, after the maxi-devaluation of 30% in 1979 Brazil's wholesale price index quickly climbed from around 40% annually in 1978 to around 120% in 1980. As inflation reversed the exchange rate policy objectives, in February 1983, when the adjustment became tighter under IMF rules, another maxi-devaluation of 30% happened. To thwart another appreciation of the real exchange rate by inflation the government indexed the nominal exchange rate to the domestic inflation rates.

The second leg of the adjustment policy was the maintenance of high real interest rates. The objectives of the monetary policies were twofold: to prevent inflation from rising and to contract domestic demand in order to generate a trade surplus. The typically negative interest rates of the 1970s and the public subsidised credit came under great pressure from the IMF in 1983. The IMF technical note to Brazil in 1983 stressed that "it is time to abandon the huge subsidies in the interest rates enjoyed by some economic sectors and carry through the liberalisation of interest rates across the financial system…It has also to be permitted that the higher financial costs to the producer be passed on to costumers" (IMF 1983, p.154). Indeed, the real interest rates charged on public securities (Selic) began their ascending trend in 1980, became positive in 1982 and went to levels of 10% to 15% per year by 1985 (Table 5 below).

Table 5: Annual Interest Rates (%)

	Nominal Annual Interest Rates		*Actual Annual Interest Rates**	
	Selic	On Working Capital Loans	Selic	On Working Capital Loans
1980	46.3	87.5	- 26.7	- 6.1
1981	89.3	141.7	-2.2	24.9

1982	119.3	159.8	9.5	29.7
1983	199.7	265.5	7.8	31.5
1984	255.5	346.5	15.0	44.5
1985	275.6	309.8	11.1	21.0
1986	66.5	58.9	4.6	- 0.2
1987	352.9	491.3	- 8.4	19.6
1988	1057.6	1105.6	5.9	10.3
1989	2407.3	2529.4	27.7	34.0

Source: Ipea.
* Deflated by the National Consumer Price Index (INPC).

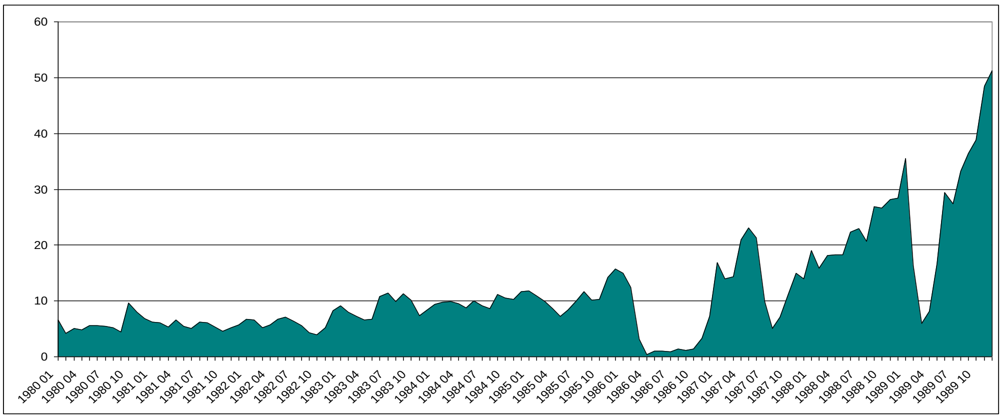
Despite the astronomical interest rates inflation kept on rising. The orthodox stabilisation programme was clearly inadequate to deal with the institutional setting of the Brazilian economy. The high instability of the exchange and interest rates perverted the conventions sustaining normal pricing practices within Brazilian economy as financial and production costs – especially of imported raw material – could change unpredictably. As Maria da Conceição Tavares and Luiz Gonzaga Belluzzo (1986, pp.52-53) pointed out "both the inventory prices and the value of assets and liabilities begin to oscillate without control during the production period, turning uncertain the horizon of capitalists' calculus…[The] supply prices, planned by producers, tend to be relentlessly overstated in an attempt to *anticipate* a likely devaluation of the net worth…Thus, the desired profit margin, instead of being a stable mark-up over the prime costs turns out to be an uncertain margin." In other words, past inflation was abandoned as a guide for forming expectations about the future supply prices and demand prices. The IMF's diagnosis that excessive demand caused inflation was unwarranted as the risk of firms running into under-pricing and of losing profits per unit of produce sold became higher than the risk associated with sales lost.[7] Accordingly, firms in Brazil used their market power to protect their wealth and profitability by increasing their mark-ups irrespective of the decrease in their sales. Inflation in turn more than doubled in relation to the level observed in 1982 and achieved 235% per year in 1983, rapidly approaching hyperinflation levels.

From a conventional point of view, Brazil's institutional structure established a bewildering relation between price formation and interest rates. The existence of the indexed money established a positive correlation between higher real interest rates and faster growth in prices. Consequently, the orthodox measures adopted to control

[7] See Roberto Frenkel (1979) for theoretical formulation.

inflation by increasing interest rates in actual fact had the opposite effect, fuelling inflation hikes. Surely, theoretical beliefs and unawareness of the problem made policymakers insist on keeping real interest rates high. However, the ultimate reason seemed to lie in the fact that economic policy was stuck in the foreign currency trap established by the net transfer abroad. With the net transfer regime, foreign currency became *the* liquid asset in the Brazilian context in order that any easing of monetary policy – a reduction in the real interest rate – would threaten the economy as the bondholders would convert their liquid financial assets into foreign currency and press the Central Bank's foreign holdings.

Figure 1: Monthly Inflation Rates (%)



Source: IBGE.
National Consumer Price Index (INPC).

This overwhelming financial instability associated with high interest rates imposed a high social cost by reducing public and private investments and the long-term growth of the economy. However, the burden of instability costs was unevenly borne. In the conditions of the exchange and monetary policies prevailing in the 1980s the government financed the restructuring of private sector at the expense of the financial fragility of the state. Indeed, the public sector ended up financing the emergence of the rentier behaviour of the private sector.

Public Financial Fragility

The government's attempts to reduce domestic demand and to switch market outwards by increasing real interest rates and devaluating exchange rates created cumulative fiscal problems. First, by 1983 most of the Brazilian external debt had been nationalised as foreign creditors and the domestic private sector sought protection with Brazilian government. Thus, the maxi-devaluation in 1983 produced an additional increase in public sector indebtedness. Second, by making the public sector the main external debtor the adjustment created a link between public external debt and public internal debt. To repay its debt the Central Bank had to purchase the foreign exchange generated by the private sector. As the adjustment entailed a restrictive monetary policy the only way to repay the debt was by increasing public internal debt (Table 6).

Table 6: Net Public Debt as a Percentage of GDP

	Central Government	*Municipal and States*	*Public Enterprises*	*Total*	*Internal*	*External*
1982	8.9	6.0	17.9	32.8	14.9	17.9
1983	19.0	6.5	26.0	51.5	18.4	33.1
1984	21.7	7.0	27.1	55.8	22.4	33.4
1985	18.9	7.1	26.6	52.6	21.7	30.9
1986	20.0	6.6	22.9	49.4	20.6	28.8
1987	20.4	7.9	22.0	50.3	19.3	31.0
1988	19.6	6.7	20.6	46.9	21.3	25.6
1989	19.9	5.9	14.4	40.2	21.7	18.5
1990	15.2	7.8	17.6	40.6	17.8	22.8

Source: Banco Central do Brasil.

Such an astonishing increase in the public debt had a destabilising impact on the public current deficits by increasing the interest rates payments. In the first years of the adjustment the government tried to compensate for this increase in public deficits with a mixture of tax increases and expenditure reductions (Table 7 below). This policy was, however, clearly insufficient to sort out the deficits due to the by-products of the restrictive policies. On one hand, the interest payments on public debt were increasing with the interest rates. On the other, high interest rates reinforced inflation and recession and both tended to reduce public revenues and to turn fiscal adjustment more difficult. In short, whereas the monetary policy tended to produce reinforcing effects on public deficits and indebtedness public finances became increasingly dominated by the interest of the bondholders.

Table 7: Public Deficits in Alternative Concepts and Actual Interest Burden (% GDP)

	Primary	*Actual Interest*	*Operational*	*Nominal*
1981	--	--	- 6.3	- 12.5
1982	- 0.8	- 5.8	- 6.9	- 15.8
1983	1.7	- 4.7	- 3.1	- 19.9

1984	4.2	- 6.9	- 2.8	- 23.3
1985	2.6	- 7.0	- 4.4	- 28.6
1986	1.6	- 5.2	- 3.6	- 11.3
1987	- 1.0	- 4.6	- 5.6	- 32.3
1988	0.9	- 5.8	- 4.9	- 53.0
1989	- 1.0	- 6.1	- 7.1	- 83.1

Source: Ipea; Conjuntura Econômica (August 2003).
* All levels of government and public enterprises.

Between 1986 and 1989 the public finances scenario worsened as the economy approached hyperinflation. The Central Bank was forced to introduce institutional innovations that not merely protected bondholders against inflationary depreciation but also constituted profitable mechanisms for them. It introduced a public bond – first called Central Bank Bills (LBC – *Letras do Banco Central*), and later, Treasury Bills (LFT – *Letras Financeiras do Tesouro*) – which was indexed to the daily interest rate (*overnight*). With this mechanism of indexation those public securities embodied inflation expectations for the next month making the value of government debt almost immune to rises in inflation. Moreover, these public bonds possessed high liquidity as they served as second-order banking reserves and were "automatically" negotiable with the Central Bank. The operation of this mechanism permitted a reduction of the average maturity of public bonds, which plummeted from around 28 months in December 1983 to less than 5 months in December 1989. In addition, those indexed bonds and the mechanism of daily repurchase agreement guaranteed the bondholders enough flexibility to evade attempts by the government to lower public debt by expelling monetary correction. In a nutshell, those mechanisms concurrently protected the real value of bondholders' wealth and warranted high liquidity which maintained the attraction of public bonds *vis-à-vis* other speculative investments, especially foreign currencies, even in condition of hyperinflation. From the point of view of public finances, however, it implied an increasing transference of resources from taxpayers to bondholders, a transference mirrored by the increase in public expenditures with interest payments at the expense of public investments.[8]

[8] As Luiz Gonzaga Belluzzo and Júlio Gomes de Almeida (2002, p.152) point out, the introduction of these institutional innovations "allowed the access to 'inflation tax' to all the agents (not only the banks) who acquired or 'purchased' in the old money, which was instantly devaluated by high inflation, while lent or 'sold' in the 'indexed money'."

While the neoliberal perspective usually suggests that in the eighties public deficits resulted from persistent government overspending in an attempt to maintain previous levels of growth, it has been shown that the actual mechanisms by which Brazilian public debt grew in fact derived from the external debt negotiation, the orthodox adjustment policies and the protection and incentives offered to the private sector to avoid the costs of the adjustment. Whereas the underlying problems of public finances were worsened by the adjustment policies, the government became increasingly more fragile to redirect the economy towards growth. Worse still were the incentives the government conceded to the private sector which lived the life of a rentier on the float of the indexed financial assets.

The "Securitisation" of the Wealth of the Private Sector

As a result of the increasing financial instability caused by the adjustment policies the private sector developed new methods for evaluating good performance that can be described as *financialisation*. Their portfolios became increasingly dominated by short-term financial assets and in both the measurement of performance became accordingly dominated by short-term financial gains stemming from indexed financial assets. The aforementioned public indebtedness played a central role in all that as those indexed financial assets were either public daily indexed bonds or backed by them. In other words, the adjustment of the private sector was symmetrical to the indebtedness of the public sector.

Table 8 shows that as far as profitability is concerned the decade began badly for non-financial firms. The profitability of Brazilian private firms dropped dramatically between 1978 and 1983. In that period there was a significant increase in financial costs for all firms but above all for public enterprises. The orthodox policy of high interest rates along with decreasing effective demand dictated the increase in firms' financial costs and the consequent fall in profitability. To protect themselves against these costs private firms reacted with reductions in their physical investments on one hand and with increases in their mark-ups to retire their debts on the other. By the mid-1980s private firms had already reduced indebtedness, increased mark-ups and profitability.

Table 8: Some Indicators of Financial Posture and Performance of the Thousand Largest Firms in Brazil (%)

	1978-1980	*1981-1983*	*1984-1986*	*1987-1989*
Foreign Firms				
Profitability	16.3	9.7	12.3	15.1
Mark-up	28.4	31.5	33.5	51.9
Indebtedness	128.2	115.4	86.1	88.6
Financial Costs	4.6	7.9	6.9	14.2
Prime Costs	65.6	66.3	66.1	54.6
National Private				
Profitability	23.1	9.0	10.6	7.1
Mark-up	45.0	47.0	53.3	80.3
Indebtedness	92.3	76.3	46.8	50.1
Financial Costs	4.9	9.2	8.3	20.7
Prime Costs	64.0	60.6	57.7	49.3
Public Enterprises				
Profitability	8.2	5.5	5.3	0.4
Mark-up	47.8	34.0	45.6	52.9
Indebtedness	116.4	128.1	129.7	107.1
Financial Costs	22.6	44.1	19.0	36.2
Prime Costs	61.1	67.4	62.1	59.2
All Firms				
Profitability	13.2	6.8	7.8	3.8
Mark-up	41.1	38.4	45.9	64.0
Indebtedness	110.4	111.7	95.7	85.7
Financial Costs	10.6	21.7	11.9	24.7
Prime Costs	63.5	64.4	61.1	53.9

Source: *Conjuntura Econômica* (various years).

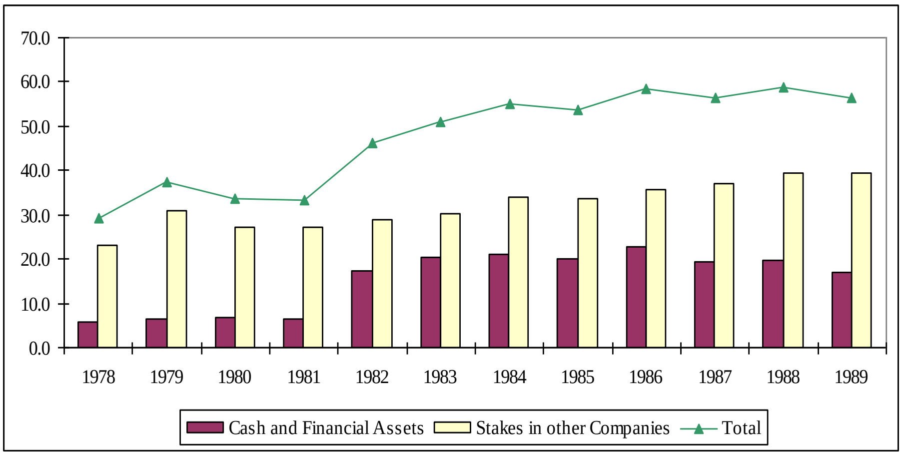
When financial instability was at its worst, after the failure of several stabilisation plans, firms intensified their financial restructuring by increasing mark-ups and investing in indexed financial assets. As noted earlier, firms began to adopt the daily indexed overnight interest rates to determine prices to ensure that their profit margins would cover their prime and financial costs as the economy was permanently threatened by hyperinflation. Luiz Gonzaga Belluzzo and Júlio Gomes de Almeida (2002, p.182) describe this mechanism as the "financialisation of pricing", a concept which reflects the detachment of pricing formation from the costs of production and from capital reposition to the emergence of speculative behaviour in price formation. Indeed, from 1987 to 1989 the mark-ups resumed an ascendant trajectory at a higher speed achieving maximums of 92% (local private capital) and 62% (foreign capital) in 1989.[9]

Financial instability produced a second fundamental change in the behaviour of firms in the 1980s, which is related to their preferences between productive and financial investments (Figure 2). The combination of a weak effective demand, the exchange

[9] In a typical process of the self-fulfilment of prophesy, this behaviour of non-financial firms led the economy to hyperinflation when by 1988-1989 inflation rates reached three digits.

depreciation and high interest rates brought enormous threats to the firms' values. As a consequence such combination discouraged less liquid productive investments as well. The high interest rates in turn opened opportunities to the most liquid firms to invest in financial assets to such an extent to gross high returns upon them.

Figure 2: Total Financial Investments of Firms – (% of Net Worth)



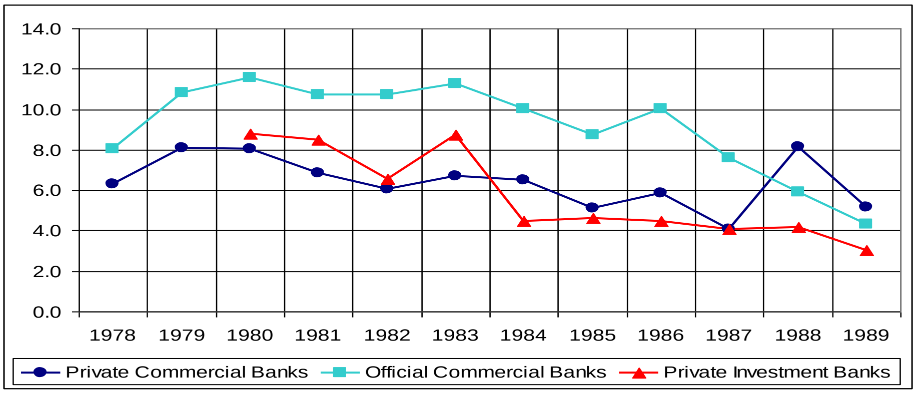
Source: As Table 8.

As a result of the financialisation of pricing and investments, the profitability of the private companies in 1989 were as high as before the recession of 1981-1983 (Table 8). These processes had an unequivocal conclusion: it became quite profitable to hold money and other financial assets and certainly much less risky than the productive investments.

The growth in the output of financial institutions as a percentage of GDP – from around 8% in 1980 to nearly 21% in 1989 – epitomises the greatest beneficiary of the adjustment policies in the 1980s. The mechanisms by which such a performance was achieved were not very distinct from what took place in the non-financial corporations described above. Indeed, the banks became the main agents operating the financialisation of non-financial corporation investments and became in the process the main beneficiary of the increase of the real interest rates.

Facing the increasing uncertainties introduced by the adjustment policies, banks reacted by reducing their leverage, measured by assets as a proportion of the bank's own capital (Figure 3). The private banks showed greater flexibility than official banks in reducing leverage. Public banks, especially state ones, could not process such rapid reduction of leverage because they bailed out local business and governments. In this connection it is worth noting that the bank's adjustment proceeded mostly through reductions in credit operations to private sector and reallocation of resources for financing public sector, by that time a less risky client. In view of the increasing credit risk stemming from the recession, and the restrictions imposed by economic policy, the private bank's credit operations decreased 4.6% annually on average between 1978 and 1983. Even after the economic recovery experienced between 1984 and 1985, the amount of credit private banks conceded was still only 96% of the 1982 amount.

Figure 3: Adjusted Leverage of the Banking System – Assets/Capital



Source: Banco Central do Brasil.
* Official Commercial Banks do not include Banco do Brasil.

The private banks' strategy constituted also of concentrating investments on assets issued or granted by the public sector. First, banks promptly redirected credit operations conceded to private sector towards public entities (Table 9 below). Second, the foreign currency remunerated deposits (DMER) in the Central Bank became very popular amongst private banks. Third, the Central Bank promptly attended to the banks' desire to replace risk-free public securities with risky assets the banking system was carrying. The Central Bank issues of public securities were the main reason why commercial banks' investments in shares and securities increased from 3.2% of total assets in 1979 to around 9% in 1983. Whereas public securities accounted for only 17% of investments in shares and securities in 1979, in 1983 they accounted for 80%.

Table 9: Selected Assets and Liabilities of Private Commercial Banks (% of Total)

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989

Assets												
Banking Reserves	16.7	13.6	11.9	10.0	8.1	4.3	6.7	6.2	12.6	6.1	1.4	1.2
Foreign Currency Deposits in the Central Bank (DMER)	1.6	2.8	1.6	2.9	2.8	9.2	7.4	6.4	2.3	1.4	0.5	0.2
Credit Operations	57.0	55.5	53.1	49.6	47.5	40.1	42.5	51.0	58.5	41.8	39.7	43.1
Exchange Operations	11.5	14.7	14.5	16.1	14.9	22.9	20.9	12.1	7.6	8.8	9.0	11.3
Shares and Securities	3.5	3.2	7.8	9.2	13.9	8.8	6.8	9.8	9.7	27.9	39.6	33.2
Public Securities	0.6	2.0	5.9	6.9	9.5	6.2	5.4	7.5	1.7	23.7	6.1	25.6
Private Securities and Shares	2.9	1.2	2.9	2.3	4.4	2.6	1.4	2.3	8.0	4.2	33.5	7.6
Liabilities												
Deposits	46.4	45.4	40.8	32.7	29.8	23.5	27.8	37.8	59.7	28.5	50.4	39.1
Exchange Operations	26.3	32.2	36.1	42.4	43.4	56.2	53.0	41.0	22.4	24.1	17.6	18.5

Source: Banco Central do Brasil.

The banking system also showed great flexibility in adjusting to and profiting from inflation and the hikes in real interest rates. Between 1980 and 1984 the banking system number of branches increased by 31% to leverage deposit collection (Paula 1998). Free of charge services and high investments in automation were also marked features of banking competition. The race for idle cash, especially sight deposits, was totally justified by the massive gains with *float* provided by growing inflation. That is, banks profited considerably by collecting non-indexed money from the public in sight deposits to invest them in indexed public securities or other indexed financial assets.

Between 1988 and 1989, as several stabilization plans failed, banks reduced their credit operations and returned to invest in financial assets, especially public securities, moving in the direction desired by the policymakers. Once again the banking system's strategy of investing heavily in public securities and liquid financial assets amidst a high inflation of four digits proved remarkably rewarding. In 1989, for instance, the rate of profitability achieved 17.3% for the largest local banks and 20% for the largest foreign banks (Belluzzo and Almeida 2002, p.268).

The financial system performed the central role in connecting non-financial corporations' and wealthy citizens' idle balances with the circuit of financial accumulation developed around the indexed public securities and other indexed financial assets negotiated in the overnight system. In addition, those speculative gains were nurtured by the inflation process so that the banking system and its wealthier clients became associates of the inflation hikes.

Final Remarks

In conclusion, the external debt crisis management which did happen from 1982 locked the Brazilian economy in an unfortunate trap. The negotiations with the IMF and the creditor banks resulted in a pro-creditor solution to the debt crisis. As a result domestic economy fortune became a by-product of the external needs.

Largely, the adjustment policies favoured the financier interests. First, the nationalisation of debt was imposed on the state, either to guarantee foreign creditors' claims or to permit the private domestic sector to reduce its indebtedness. The government in turn lost control over its monetary policies as it had to acquire foreign exchange from the private export sector to repay the external debt services. Whereas the exchange rate should be devalued to stimulate exports, the domestic interest rates should be high to induce private sector to hold public debts. In Brazil, high real interest rates were maintained through a complex and sophisticated mechanism of daily indexed public securities. Unsurprisingly, most conventional analysts have identified the financial instability of the eighties, especially its inflationary dimension, with the public deficits in a way that causality went from deficits to money issuing to inflation (Edwards 1995; G. Tullio and M. Ronci. 1996). However, the indexed money mechanism was more complex than that, and in fact causality ran the other way around. In macroeconomic balance, the public debt and deficit must be the private credit and surplus. In actual fact, public resources were being used to protect bondholders at the expenses of one sole debtor, the state.

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