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Brazil:
Outlook for Debt (s)

Special National Intelligence Estimate

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OUTLOOK FOR DEBT ~~(S)~~

Information available as of 9 April 1957 was used in the preparation of this Estimate, which was approved by the National Foreign Intelligence Board on that date.

CONTENTS

SCOPE NOTE

On 20 February 1987, Brazil declared a moratorium on interest payments on medium- and long-term commercial debt. This Estimate addresses the status of Brazil's debt problem, reviewing the economic and political factors that will affect possible resolution of the problem over the next 12 to 18 months.

KEY JUDGMENTS

We believe the most likely outcome of the current impasse—after a lengthy hiatus in interest payments—is an accommodation between Brazil and its creditors, including some precedent-setting terms on the part of the creditors. The timing of such a settlement is unclear, however.

Domestic politics in Brazil are working against a quick resolution of the debt crisis:

- For now, President Sarney appears to believe that he can solve the debt crisis by extracting major concessions from creditor banks, thereby furthering his personal political agenda.
- Brazil's new Constituent Assembly is focusing on questions such as Sarney's term in office, the power of congress, and the role of the military.
- Leaders of the Brazilian Democratic Movement Party (PMDB), senior partner in the governing coalition, are averse to taking politically unpopular austerity measures to get the economy back on track and seem determined to take a hard line on debt.
- The military wants to avoid a high profile on the issue, and is unlikely to weigh in at this point to pressure Sarney on the debt problem.

We believe Brazil declared the interest moratorium on medium- and long-term bank debt without having a game plan. It seems likely that Brazil's initial position will be to seek a limit on debt payments relative to GNP with enough leeway to allow for substantial domestic growth. Brazil will probably also insist on up to $4 billion in "new" commercial bank funds without monitoring by the International Monetary Fund. Commercial creditors will seek to increase pressure on Brazil by appearing ready to write off Brazilian debt and positioning themselves to cut off short-term trade credits.

Brazil's willingness to negotiate a compromise over the coming year will be based largely on deteriorating economic conditions. Brazil's subpar trade performance will put further strains on foreign exchange reserves and Brazil's ability to import essential materials. We are not certain, however, how soon these pressures will grow acute, particularly if bankers reduce short-term credit lines only gradually. Although Brazil could limp along for some time, other factors could intervene:

- — Labor strikes and violence may proliferate, causing serious social disruption.
- — Speculative capital outflows and rapidly rising inflation could create substantial pressure for a settlement.

As social and economic conditions worsen, we expect civilian and military leaders initially to urge Sarney to replace Finance Minister Funaro and his economic team, which they generally consider inept, and push Sarney to implement tougher stabilization measures to restore order and to reconcile with bank creditors.

Should Sarney persist with the present policy course and fail to provide vital leadership—with or without Funaro—an unraveling economy and growing social unrest would impel civilian and military elites to take a more active role in governing Brazil and determining economic policy by (a) accelerating the date of the next presidential election, (b) curtailing Sarney's powers, or (c) forcing Sarney to resign in favor of an interim president.

Meanwhile, pressure also will be rising on the banks, especially the US money center banks. Bankers might be willing to put together a package with $2-3 billion of new money to supplement additional amounts from bilateral and multilateral lenders and to reschedule debt due over the next five years on easier terms in return for an agreement on some key economic terms. At a minimum, the banks would require a large devaluation of the cruzado, some austerity measures, and some sort of monitoring mechanism aimed at bringing the current account back toward surplus.

Should several money center banks withdraw vital short-term credits, private-sector and military pressures on the government to reconcile with foreign creditors could increase:

- — There is a strong chance, however, that such creditor pressure tactics would initially harden the government's determination to maintain its interest moratorium or even provoke a more radical backlash.

Since Brazilians expect the United States to play an active role in solving the debt crisis, as it did in the Mexican case, elements within the Brazilian Government will argue that Brazil is being treated less fairly than Mexico.

While we think reconciliation is likely, we cannot rule out an extended impasse that would bring on default and creditor efforts to seize Brazil's assets abroad. Brazil and the banks are very far apart, and the potential for miscalculation on both sides is greater than in any of the other debt crises in the 1980s. Cooperation among the banks is wearing thin, particularly after marathon sessions aimed at clearing up issues with other debtors.

A long-term impasse in the Brazilian negotiations with the country's creditor banks would not necessarily result in disastrous effects on the US banking system. Although US banks would experience substantial earnings losses from the unpaid interest, we believe the situation would be manageable, provided Brazil's actions remain isolated. In the event other major debtors also sharply limited interest payments, the impact on US banks would be much more serious.

Even though other major debtors have indicated they will not now follow Brazil's lead, the outcome of the Brazilian debt impasse will have an impact on international debt strategy:

— Should Brazil receive precedent-setting concessions in coming to terms with its creditors, others will obviously demand similar concessions.

— Should the impasse between Brazil and its creditors drag on, the larger debtors would see a Brazilian impasse as leverage to use in their own negotiations at some future point.

— Should Brazil's economic conditions seriously worsen, some debtors, such as Argentina, will be less tempted to follow a similar course.

The primary determinant of the behavior of other debtors, however, will remain the level of economic and political pressures felt by their governments. There is a growing weariness with servicing the debt and with continuing subpar economic performance. Should current poor external conditions, including slow growth in the Organization for Economic Cooperation and Development and low commodity prices, be coupled with a significant rise in interest rates, other countries for their own purposes will be tempted to take actions similar to those undertaken by Brazil.

These Key Judgments are [redacted]

DISCUSSION

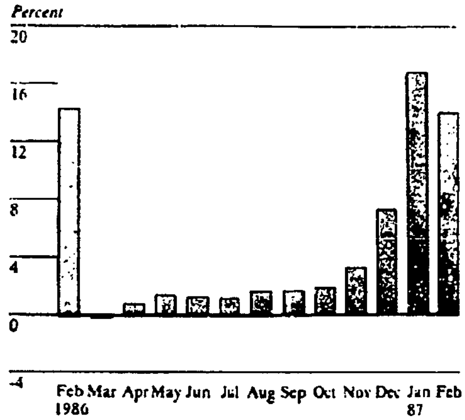
Roots of Brazil's Problem

1. The deterioration in the Brazilian economy that led to the decision to suspend interest payments on medium- and long-term foreign debt results from the populist economic policies adopted by President Sarney since he assumed office two years ago. These policies, which allowed rapid increase in consumption while discouraging investment, helped drive the official inflation rate from 3 percent in November 1986 to about 15 percent in each of the first two months in 1987—an annual rate exceeding 400 percent (see figure 1). Interest rates have followed suit, soaring from an annual rate of about 70 percent to 1,000 percent in the same period. Meanwhile, on the external front, Brazil's large trade surplus dwindled because of strong consumer demand and an overvalued cruzado, foreign investment and new borrowings virtually dried up, and capital flight accelerated. As a result, Brazil drew down more than $6 billion of its international reserves in an effort to stay current on its debt over the last year. [redacted]

2. These economic policies resulted in large measure from Sarney's perceived need to consolidate support for himself and for Brazil's newly restored democracy as well as to improve conditions for Brazil's poor. Sarney has faced an uphill struggle for public and political acceptance since suddenly succeeding to office in April 1985 after the death of President-elect Neves. Sarney was distrusted by the Brazilian Democratic Movement Party (PMDB)—the senior partner of the governing alliance that elected the civilian ticket—because of his longstanding membership in the former military government's party. The military was unhappy with Sarney for defecting from its party. To bolster his standing with the PMDB and the general populace, Sarney replaced moderate Finance Minister Francisco Dornelles, who favored undertaking an International Monetary Fund (IMF) program, with Finance Minister Dilson Funaro, who assured the President that his policies could quickly accelerate growth while simultaneously easing high inflation. [redacted]

3. With Funaro's guidance, President Sarney announced on 28 February 1986 a sweeping emergency program, dubbed the Cruzado Plan, to rein in inflation that was raging at an annual rate of more than 400 percent. Following a round of wage increases, the plan mandated a temporary but comprehensive wage and price freeze, currency reform, and the phasing out of a pervasive indexation system that had been the major impediment to conventional efforts to reduce inflation for more than 20 years. To appease labor, Brasilia promised a wage adjustment when increases in the cost of living reached 20 percent. [redacted]

Figure 1
Brazil: Official Consumer Price Index, February 1986-February 1987[a]



[a] Growth from the previous month.

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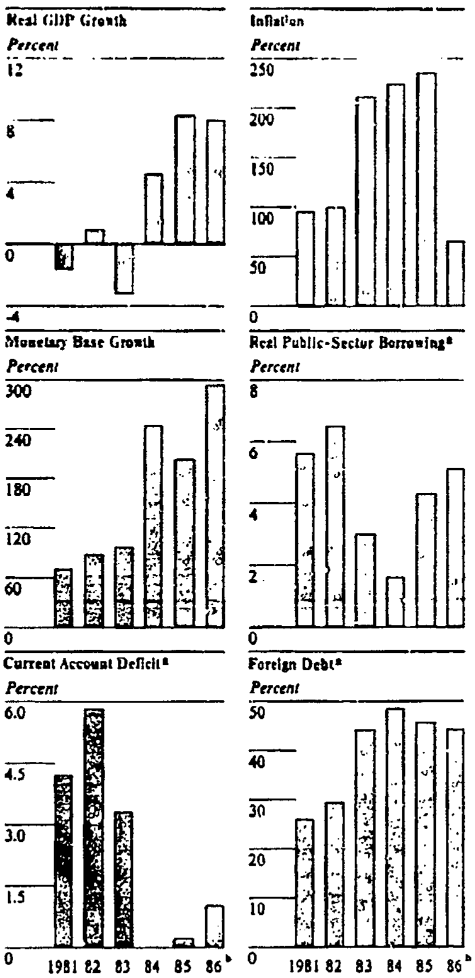
4. Initially, the plan helped boost growth to 8 percent—just above Brazil's historical trend—and temporarily suppressed inflation from the existing rate of 15 percent per month to a reported monthly average of 1.5 percent (see figure 2). For a time, Brazil was able to sustain large trade surpluses despite the high rate of domestic growth. [redacted]

5. Sarney and the PMDB also reaped considerable benefit from this economic policy as the President's public approval rating rose from its January 1986 low

Figure 2 *Note scale change*
Brazil: Economic Indicators 1981-86



[a] As a share of GDP.
[b] Estimated.

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of 35 percent to an unprecedented 90 percent a few months later; the PMDB won a landslide victory in the November 1986 gubernatorial and congressional elections. [redacted]

6. By the second half of 1986, however, the Cruzado Plan was veering seriously off course because the government had failed to take followup fiscal and monetary measures to contain domestic spending. Rampant consumer demand fueled by artificially low prices, high wage increases, and insufficient investment in new plant capacity stemming from squeezed profits and business uncertainty swelled inflationary pressures. Because the President was loath to raise prices before the 15 November election, the pressure created serious price distortions and product shortages. This high level of domestic demand was in large measure responsible for the reduction in the monthly trade surpluses from the rate of roughly $1 billion per month through September to about $150 million per month currently. [redacted]

7. The international economic climate in 1986 was conducive to achieving as in 1985 another $12 billion trade surplus and balanced current account (see table). Sharply falling international oil prices and interest rates saved Brazil more than $2 billion in foreign exchange payments in 1986. The decline in the value of the US dollar—to which Brazil's currency was pegged before it was frozen under the Cruzado Plan—also has bolstered the competitiveness of Brazilian exports in many major foreign markets. Although growth in the Organization for Economic Cooperation and Development (OECD) and world commodity prices remain low by past standards, these conditions were not significantly worse in 1986 than they were a year earlier. [redacted]

Recent Developments

8. The adjustments to the Cruzado Plan that were made after the November 1986 election were ill timed and poorly administered, rebounding badly on the Sarney government. Inflation picked up significantly, Sarney's popularity declined sharply, capital flight increased, and a loss of confidence in the government's economic policy occurred across the board. Businessmen began blatantly to ignore the government's price guidelines. [redacted]

9. In reaction to these rapidly deteriorating conditions, a political consensus developed within the administration in favor of tougher action against creditors:

— Newly elected governors and members of the PMDB coalition publicly advocated limits on debt repayment to support growth.

[redacted]

Brazil: Balance of Payments, 1985-87

Million US $

	1985	1986 [a]	1987 [b]
Trade balance	12,471	9,500	7,500
Exports	25,639	22,400	17,500
Imports	13,168	12,900	10,000
Net services and transfers	−12,196	−12,400	−11,500
Interest on debt	−11,092	−10,000	−9,300 [c]
Current account	275	−2,900	−4,000
Capital account	−2,500	−3,500	100
Net direct investment	700	−100	200
Net government and official agencies, credit	−1,000	−900	1,200
Net commercial bank and other lending	−2,200	−2,500	−1,300
Change in reserve	−2,200	−6,400	NA
Financing needs	0	0	3,900

[a] Estimated.
[b] Projected.
[c] Estimated obligation under current agreements. Interest payments suspended on medium- and long-term debt to international banks on 20 February. Arrearages of about $560 million per month will accumulate during the suspension.

This table is Confidential [redacted]

— Public opinion polls indicated the electorate also favored a "get tough" stance.

— Although the economic cabinet was initially divided, the near depletion of reserves apparently helped tilt the decision toward the harder line.

In the end, only business elites argued against such a policy. These pressures resulted in Brazil's decision to suspend interest payments on medium- and long-term commercial debt and seek a "political solution" to the debt problem. We believe a political solution means Brazil wants Western governments to intervene to reduce debt payments significantly via radical concessions of some kind. Brasilia's intended pressure tactics probably have been encouraged by the success of its tough bargaining stand in January 1987 in arranging a rescheduling of $4.1 billion of its obligations to official Paris Club creditors without IMF conditionality. [redacted]

Near-Term Political Constraints

10. We believe that Sarney's priorities and style, together with current political constraints, will prevent Brazil from abandoning its search for a radical solution to the debt problem for at least several months. Sarney's key concerns are for his own political life and that of new democratic processes. Progress on reversing the economic slide and reducing debt service are crucial to both. Sarney follows a consensus-building approach to policymaking by consulting widely with cabinet advisers, congressional leaders, governors, the military, and business leaders. He is reluctant to adopt unpopular economic measures—painful in the short term but nevertheless necessary—that could lead the Constituent Assembly to shorten his six-year term to four years or even less. He also realizes, however, that continued economic deterioration will hurt him politically. [redacted]

11. Sarney's main concern for the present is clearly with *Brazil's Constituent Assembly*, which began drafting a new constitution on 15 March 1987 and also serves as Brazil's congress. Sarney believes it is politically necessary to hold consultations with the legislature and has indicated he will discuss with it any new economic plan. The numerous decisions that the Assembly will deliberate include President Sarney's term in office, Brazil's future system of government (presi-

dential versus parliamentary), the role of the military, the power of congress, and the treatment of foreign capital. Although the Constituent Assembly has an overall moderate, centralist ideological cast (see figure 3), much of its initial work has shown a penchant for economic nationalism. For example, delegates, especially those allied with labor, are already surfacing constitutional provisions for greater control of foreign capital, including limits on payment of interest on foreign debt as well as limits on the repatriation of dividends and royalties. According to the US Embassy, politicians representing business interests have so far maintained a low profile but are expected to defend their interests more vigorously in coming months. [redacted]

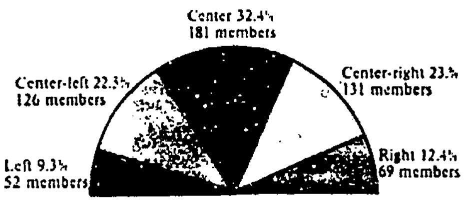
12. Sarney especially must respect the wishes of the *Brazilian Democratic Movement Party*, the senior partner of the governing alliance. (Sarney nominally is head of the PMDB but had to give up a leadership position in the Liberal Front Party to assume the presidency.) The PMDB carries more weight than ever in the Sarney administration's policymaking process as a result of the November 1986 election, which put it in control of both houses in the new Constituent Assembly and 21 of 23 governorships. [redacted] Numerous press reports indicate that PMDB leaders are determined to make their hardline views on foreign debt stick. They believe limits on foreign debt payments not only will free up federal revenue for social projects but also will refurbish their images as champions of the working class. Through Finance Minister Funaro, the PMDB has succeeded in implementing most of its economic platform, including growth-oriented policies, expanded social programs, and refusal to submit to an IMF program. [redacted]

13. We believe it is unlikely in the short term that Sarney's Finance Minister will be removed in favor of someone who will offer more moderate action. Indeed, *Finance Minister Funaro* recently has increased his power and influence in the government's economic policy making process. Despite the growing pressures on the President from many Brazilian groups to replace Funaro, Sarney continues to support his Finance Minister:

— Dissenters from Funaro's unorthodox policy prescriptions, most notably Central Bank President Fernao Bracher and Planning Minister Jose Sayad, have resigned. A Funaro protege was installed as the head of the Central Bank. Although a conservative PMDB politician was appointed planning minister, the Ministry's charter was changed to include only social rather than economic planning.

— Funaro is the government's leading economic spokesman, as demonstrated by his recent trip to approach official creditors for a political solution to the debt and in his authoritative domestic press interviews. [redacted]

Figure 3
Brazil: Ideological Composition of the Constituent Assembly



Note: The source is a January 1987 Sao Paulo newspaper.
The total number of Assembly members is 559.

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Various sources indicate that Sarney would be likely to seek his resignation only in the wake of a serious deterioration in the Brazilian economy, a process that will become more pronounced later in the year. Even in this event, it is not certain that Funaro's initial replacement would espouse significantly more orthodox policies. (s [redacted]

14. Sarney also faces problems from *organized labor*. In 1985 the two major Brazilian labor federations—the militant, Marxist-dominated Unified Workers Central (CUT) and the broader based, moderate General Workers Confederation (CGT)—exploited Sarney's tenuous political position by launching a series of strikes and obtaining higher wages and other labor reforms. Most recently, they collaborated in organizing a general strike in December 1986 with several independents to protest Sarney's adjustments to the price freeze and to call for a moratorium on foreign debt. Both major unions are using the debt

The Other Political Parties

The *Liberal Front Party* (PFL), with its center-right political orientation, maintains appreciable influence with the Sarney administration as the minority partner of the alliance. Several of Sarney's cabinet posts are occupied by PFL members, although none is involved in economic policy. Within congress, the US Embassy notes, the PFL has become a sufficiently disciplined force to offset effectively the PMDB left wing on many issues. According to a generally reliable source, the PFL recently has become badly disillusioned with the government's economic program and is withdrawing support from Funaro's policies. Its economic policy views reportedly are now aligned with those propounded by the *Social Democratic Party* (PDS), the rightwing descendant from the majority party under the military government. PDS leadership, according to the US Embassy, is impressing political observers with its persuasive criticism of economic policy and the decision to suspend interest payments. Both the PFL and the PDS will probably counsel moderation in the Sarney government's relations with creditors, including an early end to the moratorium. [redacted]

Brazil's two largest leftist parties—the *Democratic Workers Party* (PDT) and the *Workers Party* (PT)—have increasingly been accepted by the public as legitimate and responsible political opponents and, consequently, have increased their size and influence. The PDT was founded by Gov. Leonel Brizola primarily as a political vehicle to gain the presidency. Although in public statements to lure the more educated he likens the party's ideology to European social democracy, he uses highly nationalistic and socialist rhetoric to appeal to lower classes, including qualified support for the suspension of foreign interest payments and, more recently, demanding an audit to weed out "illegitimate" debt. The PT is an umbrella group of Marxist parties, headed by Labor leader Lula de Silva, that supports labor militancy to improve workers' living standards. Lula has campaigned along socialist lines, advocating an economic system that redistributes economic gain more equitably. Lula joined Castro's call for Latin debtor governments to repudiate their debts in 1985. [redacted]

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issue to gain rank-and-file support, and the CUT leadership has mounted a propaganda campaign for outright debt repudiation. [redacted]

15. Brazil's *industrialists* have become increasingly dissatisfied with the government's economic policies since mid-1986 and some businessmen are mounting a political campaign to effect changes. According to the US Embassy and Brazil's press, business groups have complained about the Sarney administration's excessive dependence on price controls, its lack of commitment to public-sector reform, and its current economic drift. They also have reacted negatively—by a series of scathing editorials in the conservative press—to the government's moratorium on debt payments. They argue that not only does the moratorium put at risk the country's previously good relations with creditors but will also severely damage foreign trade and investment. According to the US Embassy, the Sao Paulo State Federation of Industries (FIESP) believes that the Sarney government should quickly implement a credible economic stabilization plan and reach an early agreement with commercial creditors. Although businessmen have not had a major voice in the administration's policy deliberations, they have a latent power to influence Sarney by sabotaging his economic plans. [redacted]

16. The *military* historically has served as an arbiter in Brazilian politics and the ultimate guarantor of internal stability and security. US military attache reporting indicates that Brazil's armed forces remain firmly in support of democratic rule and, indeed, are among President Sarney's most important backers. Nevertheless, the military high command has privately begun to express serious concern about the stability of the Sarney administration. Since December 1986, generally reliable sources have indicated that the military cabinet ministers are increasingly distressed by the government's indecision and inability to arrest Brazil's rapid economic deterioration, which also is eroding military salaries. Most recently, according to the same sources, they stressed that the military will act within the bounds of its constitutional authority, but cannot stand by and permit serious economic deterioration that could result in a breakdown in social order. [redacted]

Brazil's Short-Term Position

17. Sarney believes he has the upper hand in his confrontation with the banks and will concentrate on domestic issues while waiting to see if foreign creditors cave in and meet Brazil's demands for radical concessions. Finance Minister Funaro maintains that Brasilia will not undertake a major new domestic program, in part because the government believes its current policies already are causing economic growth and inflation to slow. Accordingly, Brasilia probably will institute few significant domestic reforms or adjustments—such as trimming the bloated government budget.

Instead, Brasilia, for the present, probably intends to continue patchwork economic measures and to rely on government interventionist policies. The Sarney administration may opt for another price freeze after sufficient time has elapsed for prices to realign after the last freeze. In addition, it will continue to reintroduce indexation mechanisms into the economy to help ease the brunt of high inflation.

18. The Sarney government has not yet either set a date to commence negotiations with bankers or divulged the details of the new financial package it will propose to the international banking community. Indeed, we believe it has not yet formulated a comprehensive economic package. According to the press, Sarney and Finance Minister Funaro said they will present a proposal to Brazil's creditors that stresses economic growth more than paying debts. They continue to insist that an IMF monitoring role is out of the question. According to press reports, Brasilia will seek a limit to net debt transfers of 2.5 percent of GDP to enable the country to maintain 7-percent annual economic growth. US Embassy reporting indicates that Brazil's proposal to private creditors will include a request for at least $4 billion of "new" money and multiyear rescheduling of commercial debt on terms equal to or better than those Mexico received last year. Finance Minister Funaro, according to generally reliable sources, also may push for a contingency clause that would limit debt servicing payments in the event of resurging interest rates. In addition, Brasilia has already announced plans to freeze the country's $15 billion in short-term credits and interbank deposits in the event bankers attempt to cut these facilities.

Commercial Creditors Take a Hard Line

19. The bank advisory committee (BAC) representing Brazil's creditors is taking a strong stand at the start against Brasilia's proposals. Members of the committee are growing extremely concerned about Brazil's worsening balance of payments, failure to institute a credible economic program, heavyhanded tactics, and failure to set a date for negotiations. Most bankers continue to be opposed to committing new loans without an IMF-supported program, according to these same sources. Even with some role for the IMF, representatives of the BAC believe that raising new money will be extremely difficult, especially in light of Brasilia's tampering with their short-term credits, which traditionally are serviced even during the most severe debt confrontations.

20. Various sources indicate that the differing interests among the US money center banks, the smaller US regional banks, and the non-US banks will impede the formation of a consensus on financial support for Brazil. Most money center banks, with their heavy loan exposures in Brazil, will probably continue to maintain their short-term credit lines and push for a new medium-term financial package, perhaps at the cost of dropping a rigorous IMF monitoring requirement, in order to get Brazil to restart interest payments. A few of the money center banks nevertheless are intensifying pressure on Brazil by taking steps to place Brazil's loans on a nonaccrual basis. In contrast, US regional banks are hardening their attitudes toward Brazil as a result of the moratorium. Some regional banks already have taken steps to withdraw short-term credit lines, and numerous others are reportedly considering either placing their loans on a nonaccrual basis or writing off their entire exposures. West European and Japanese banks also are becoming less willing participants in new money deals for Latin American borrowers, preferring interest rate capitalization or other forms of debt relief. Although non-US banks would be hurt by a prolonged interest suspension, they generally are in better shape than the major US banks to absorb the financial losses because of greater reserves against troubled loans and regulations that make it easier to write off debts.

No Support From Other Creditors

21. Finance Minister Funaro's entourage apparently received little encouragement from Western government leaders in its search for "a political solution" to the debt problem during a tour of the United States, Western Europe, and Japan in early March. Although the Brazilians obtained some expressions of sympathy for their debt action and a few small government export credits in Europe, most Western officials impressed upon Brazil the need to work with the IMF and to apply remedial measures to its inflation-ridden economy. According to the US Embassy, the Governments of France, West Germany, and the United States reported to the Paris Club that each was unresponsive to Funaro's call for a political solution of the debt. Instead, they urged the Brazilians to reconcile their differences with bank creditors as soon as possible. Moreover, a number of the Western governments indicated they probably would not reopen official credit lines as a followup to the Paris Club accord until bilateral government-to-government agreements were signed, a position that Funaro maintains violates Brazil's January Paris Club accord.

[redacted]

Getting Debt Negotiations To Start

Currently, the basis for the startup of debt negotiations does not exist, mainly because Brasilia has yet to present an economic plan to the banks. On 2 April 1987, Finance Minister Funaro revealed a program for financing economic development before a PMDB caucus. According to the program, Brazil will need an average $4 billion in additional financial resources each year through 1991 to enable Brazil to achieve 7-percent annual growth. The additional funds would be generated by significantly lowering the average cost of debt servicing, automatically refinancing part of interest payments, and converting debt to equity. According to the US Embassy, however, government officials have said they have not yet agreed upon appropriate domestic adjustment measures. [redacted]

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Prospects for a Settlement

22. We believe the most likely outcome of the current impasse—after a lengthy hiatus in interest payments—is for an accommodation between the creditors and Brazil, including some precedent-setting terms on the part of the creditors. The timing of such a settlement is unclear, however. Brazil's willingness to negotiate a compromise with its bank creditors over the coming year will depend heavily on the emergence of political pressures for a settlement stemming from serious economic deterioration and resulting social disorder. Finance Minister Funaro's current economic strategy of adjusting price controls, reindexing the economy, and undertaking modest efforts to contain government spending or monetary expansion will lead to some deterioration of domestic economic conditions over the coming months. Hence, we expect a further contraction of investment, slower economic growth, rising unemployment, and continued high inflation. In addition, without a substantial devaluation of the cruzado, Brazil's subpar trade performance will put further strains on foreign exchange reserves and Brazil's ability to import essential materials. [redacted]

23. We are not certain, however, how soon these pressures will grow acute, particularly if banks reduce short-term credit lines only gradually, thereby allowing foreign trade to continue. Brazil could limp along for some time, perhaps a year or more. Other factors could intervene, however. At some point, repressed inflation will accelerate rapidly as a result of high government spending, spot shortages, and high wage settlements. Furthermore, as social and economic conditions worsen, labor strikes and violence will be likely to proliferate, causing serious economic and social disruption. These disruptions could fuel speculative capital outflows, putting substantial downward pressure on the cruzado, and could create an environment in which pressures within Brazil would escalate rapidly. [redacted]

24. As economic and social difficulties grow acute, we expect that Brazil's civilian elite, with the support of the military, will bring influence to bear more forcefully on the Sarney administration's policies. The large and powerful industrial class—hobbled by squeezed profits, reduced supplies of foreign inputs, and increasing dominance of the public sector—would play a prominent role in this process. Initially, we expect civilian and military leaders to urge Sarney to replace Finance Minister Funaro and his economic team, which they generally consider inept, and push Sarney to implement tougher stabilization measures to restore order and to reconcile with bank creditors. While such measures may worsen economic conditions for a time, the military would work with the civilian administration to keep order. [redacted]

25. Should President Sarney persist in the present policy course and fail to provide vital leadership—with or without Funaro—an unraveling economy and growing social unrest would impel civilian and military elites to take a more active role in governing Brazil and determining economic policy by (a) accelerating the date of the next presidential election, (b) curtailing Sarney's powers, or (c) forcing Sarney to resign in favor of an interim president. [redacted]

26. Should several major money center banks withdraw vital short-term credits, private-sector and military pressures on the government to reconcile with

Impact of Brazil's Debt Actions on US Banks

If Brazil does not resume servicing its medium- and long-term debt, US banks will face two financial milestones in the coming months. When the payments are 90 days past due, banks must list the unserviced loans as nonperforming. Banks also have the option of listing the loans as nonperforming before the 90-day deadline, and a number of major banks already have done so. Interest accrued but not actually collected must be subtracted from income. Subsequent interest payments will be counted as income only when actually received. The effect of putting Brazil's loans in a nonperforming status or recording loan interest only when it is received would cut the nine money center banks' quarterly earnings about 15 to 20 percent. The banking community will seek to reach an agreement to avoid earnings losses with Brazil before any action is required. [redacted]

If Brazil were to withhold interest payments for 180 days and there were no definite prospect for a restoration of debt service, regulatory policy requires that US Government bank regulators classify Brazil's loans as value impaired. Once such a classification is made, banks generally would have one year to place an amount equal to 10 percent of the loan principal in a special reserve known as the Allocated Transfer Risk Reserve. In subsequent years, 15 percent would have to be allocated to reserves annually, unless the situation improves. At the discretion of the regulators, the amount can be changed. Money set aside in this special reserve does not count toward the banks' capital, and is not deductible for tax purposes. Alternatively, a bank can write down or reduce the book value of the loan by an amount equal to the special reserve. [redacted]

foreign creditors could increase. There is a strong chance, however, that such creditor pressure tactics would initially harden the government's determination to maintain its interest moratorium or even provoke a more radical backlash. Since Brazilians expect the United States to play an active role in solving the debt crisis, as it did in the Mexican case, elements within the Brazilian Government will argue that Brazil is being treated less fairly. [redacted]

27. While pressure is rising on Brazil, pressure also is rising on the US money center banks. They might be willing to put together a package with $2-3 billion of new money to supplement an equal amount from bilateral and multilateral lenders and to reschedule debt due over the next five years on easier terms—including a reduction in the interest spread over the London Interbank Offering Rate (LIBOR) from 2 to 1 percent or less—in return for agreement on some key economic terms. The banks would, at a minimum, require a large devaluation of the cruzado and some austerity measures, aimed at bringing the current account back toward surplus, before offering up new money. Some sort of monitoring mechanism also would have to be included. [redacted]

28. Although we think it unlikely, there is some chance that Brazil and its creditors will fail to break their prolonged negotiating impasse and that the Sarney administration will extend its moratorium on interest payments well beyond a year. Under such circumstances, the government would take few, if any, constructive adjustment measures but would temporarily shield the public from the consequences through heavy state intervention, including price controls and greater spending on social programs. Under this scenario, Brazil's military—crucial to the outcome in any event—might view the banks' actions as hostile and decide to back Sarney's hardline stand. [redacted]

29. A long-term impasse in the Brazilian negotiations with its creditor banks would not necessarily result in disastrous effects on the US banking system. Although US banks would experience substantial earnings losses from the unpaid interest, we believe the situation would be manageable, provided Brazil's actions remain isolated. In the event other major debtors also sharply limited interest payments, however, the impact on US banks would be much more serious. [redacted]

30. We believe Brazil could endure a lengthy break with creditors, but only at substantial cost to its economy. Many years of import-substitution industrialization policies have considerably reduced Brazil's dependence on a number of basic imported goods, including energy, raw materials, and consumer products. Its recently inaugurated economic integration scheme with Argentina and Uruguay further improves its position to withstand the impact of constricted trade relations with Western developed countries. Moreover, Brazil has established channels for, and experience in, countertrade with numerous Third World countries, an added advantage in evading trade sanctions. Brazil probably would expand its exports of arms as well—already a major foreign exchange earner. Nevertheless, the costs of autarky will be substantial and will wear heavily on Brazil over time by confining the country to long-term economic stagflation. Without further access to foreign capital and state-of-the-art technology—which has been a vital ingredient in Brazil's past industrialization successes—Brazil's economic modernization and development drive will be slowed and the country will lose significant ground in its quest to become a major economic power. [redacted]

Current Positions of Other Debtors

31. The unilateral Brazilian moratorium on interest payments comes at a time when many other Third World debtors are experiencing deterioration of their external accounts because of poor export performances and dwindling capital inflows. A number of the more important debtors have negotiated or are in the process of negotiating with their international creditors new and favorable financial packages that they will be reluctant to jeopardize. Although a number of debtors are studying Brazil's action and the impact it will have on debt negotiations to see if it will eventually work to their advantage, few Third World governments have publicly lauded Brazil's moratorium or have any inclination to follow suit until they are able to see the outcome of the Brazilian situation. [redacted]

32. *Mexico* gave public assurances that it will continue to service its debt and not follow Brazil in declaring a moratorium. President de la Madrid's top priority is to restore economic growth and deliver a smooth victory for his ruling party in next year's national election. Realizing that he needs fresh credit to achieve this goal, de la Madrid will avoid action that could jeopardize the $7.7 billion commercial loan package. The banks plan to disburse a first installment, amounting to $3.5 billion, in late April 1987. [redacted]

33. *Argentina* indicated initially that it would suspend interest payments on its debt if Western banks refuse to provide more than $2 billion in new loans, but has since demonstrated its preference for cooperating with the international financial community. President Alfonsin has announced a new stabilization program, negotiated a $1.4 billion loan with the IMF, gained a pledge from 12 developed countries for a $500 million bridge loan, and is making progress in new money and debt rescheduling talks with banks. [redacted]

34. The *Philippines* reached an agreement in March 1987 with its bank advisory committee to reschedule $10.2 billion of its medium- to long-term debt at an interest rate of seven-eighths of a percentage point over LIBOR. In addition, $3 billion in trade credits were rolled over with the interest spread over LIBOR reduced to three-quarters of a percentage point. Creditor banks were also given an option of converting some of their interest receipts into Philippine investment notes that would finance government-approved investments in the country. [redacted]

35. Both *Chile* and *Venezuela* wrapped up favorable accords with international banks within days after the Brazilian action. Santiago not only gained a cut in its interest spread over LIBOR from 2 to 1 percent but also was able to postpone payment of $440 million by persuading the banks to accept interest payments annually instead of semiannually. Caracas won a lightening of its scheduled principal repayments and an even lower interest rate spread of seven-eighths of a percentage point over LIBOR on its $21 billion rescheduling package. [redacted]

The Cuban and Soviet Perspectives

36. *Cuba* is using the Brazilian debt payment moratorium as an opportunity to rekindle earlier rhetoric advocating collective action by Third World countries against Western creditors. Cuban President Fidel Castro loudly applauded the Brazilian moratorium as a historic move, claiming that the time was ripe for the poor of the world to right injustices perpetrated at the hands of creditors. Havana also made the debt burden a major focus of the March 1987 Nonaligned Movement ministerial meeting in Guyana in order to strengthen its image as a Third World political leader and to bolster its newly developing relations with Brazil. Nevertheless, Havana probably has lost much of its already limited credibility in the eyes of many Third World debtors by negotiating with its own creditors as it urged aggressive action by others. [redacted]

37. The *Soviet Union* is privately expressing sympathy for Brazil's debt problems and is willing to increase bilateral trade. Moscow will probably quietly use the opportunity to play on regional resentment against the United States and other Western creditors. Concern for their own economic interests, however, will be likely to keep the Soviets from publicly endorsing unilateral moratoriums by Latin debtors. Moscow has urged Cuba—which, along with Peru and Nicaragua, is substantially in debt to the USSR—to tone down its calls for Latin debt repudiation as well. [redacted]

Lessons for Others

38. Even though other major debtors have indicated they will not now follow Brazil's lead, the outcome of the Brazilian debt impasse will have an impact on international debt strategy:

- Should Brazil receive precedent-setting concessions in coming to terms with its creditors, others will obviously demand similar concessions.
- Should the impasse between Brazil and its creditors drag on, others will be likely to stay on the sidelines to watch the outcome, although the larger debtors would see a Brazilian impasse as leverage to use in their own negotiations at some future point.

— Should other debtors feel that, by taking this confrontational course, Brazil worsened economic conditions more than would have been the case under a cooperative tack, some, such as Argentina, will be less tempted to follow a similar course.

39. The primary determinant of the behavior of other debtors, however, will remain the level of economic and political pressure felt by the governments. There is a growing weariness with servicing the debt and the continuing subpar economic performance. Should current poor external conditions including slow OECD growth and low commodity prices be coupled with a significant rise in interest rates, other countries for their own purposes will be tempted to take actions similar to those undertaken by Brazil.

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