

EXTERNAL DEBT ACCUMULATION, DEBT CRISIS,

AND ADJUSTMENT EXPERIENCE IN BRAZIL 1968-1986.

by

MARIO C. BERRIOS

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Supervisor: Professor Michel Chossudovsky

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## INTRODUCTION.

The purpose of this paper is to analyse the causes of external debt accumulation in Brazil between 1968 and 1986, and the structural adjustment policies used to address various external shocks and the debt crisis after 1982. Within this time frame from 1968-86, there are four distinct periods of accumulation of external debt and concomitant adjustment policies. These periods are:

- 1968-73      The establishment of high rates of growth which is known as the "Economic Miracle". Brazil then launched into its first large involvement in the international financial markets.
- 1974-78      Increased oil prices were the first significant external shock. As a result, Brazil expanded its industrialization strategy and investment in oil production, both of which caused the country to contract further debt. The domestic adjustment policy implemented in this period was the strategy of import-substitution.
- 1979-82      A second wave of external shocks –increases in oil prices, increases in interest rates, recession, deterioration of the terms of trade, and protectionism–increased the deficit of the current account. Again, debt expansion was the means of financing this deficit.
- 1982-86      Period of external debt crisis: Brazil can no longer service the debt and finance the trade deficit. The main reason for debt expansion is to service the debt itself.

The characteristics of each of these periods will be explained. Had Brazil not suffered these external shocks, the domestic economy may have been able to sustain a large part of the process of investment, and thereby maintain the process of economic growth. These goals would have been achieved by the tendency of the post-1964 governments to keep real wages low as the main means of increasing both profits and the rate of capital formation.

Brazil has been chosen as the subject of analysis for two reasons: 1) it represents a special case of the problem of external debt in terms of its size, and the size and productive capacity of the Brazilian economy (currently, it is the eighth largest western industrial economy); and 2) it illustrates very clearly the conflict between two opposite views of economic growth, namely, the view of accelerated economic growth with strong government intervention (implicit in the Brazilian economic policy in the postwar period), and the orthodox view of free market economy implicit in the International Monetary Fund (IMF) approach to economic growth and stabilization. The IMF approach to stabilization and adjustment will be examined in the context of the most important external and domestic constraints on Brazil's economy. The paper will also examine some theoretical and policy problems of the IMF paradigm to understand those Brazilian conditions. For that paradigm relates to the IMF's function as an institution dealing with the correction and adjustment of BOP problems; as a lender of last resort; and as one of the main organizations in the negotiations of new loans, and an intermediary between developing countries and international commercial banks and official institutions. That is, the paper will discuss how the attainment of a broad-based structural transformation is influenced through the use of the IMF approach to stabilization and adjustment. A comparison of the IMF paradigm and some central aspects of the Brazilian economic policy should throw light on the central problems faced in the study both of the causes of Brazil's external disequilibrium, and of the solutions or adjustment policies which the external debt necessitated.

One important topic of this paper is to discuss the limitations and to question how realistic the monetarist aspects of the orthodox programmes dealing with the problems of external disequilibrium, external debt, and adjustment policies were. The paper recognises the eclectic nature of IMF theory and policy, but focuses on the IMF's "preferred interest" (David, 1985, p. 10) of the monetarist view of BOP disequilibrium. In particular, the solution of the case-by-case approach implemented after 1982 will be discussed, in terms of its consequences as a model of net transfer of real resources (by decreasing imports and increasing exports)

from Brazil to the creditor nations.

In order to do this analysis, the paper is divided into two parts, the first of which deals with some central theoretical aspects of external disequilibrium, structural adjustment, and the IMF's approach to them. Here, the objective is to establish the theoretical links between the adjustment programs of the IMF, and the monetary approach of the Balance of Payments (BOP) and the theory of austerity. The second part analyses the specific conditions of the process of debt accumulation and the adjustment to external shocks and debt crisis conditions. The works of five authors, David (1985), Villarreal (1984), Batista (1987), Martone (1987), and Carneiro (1987 and 1988), were particularly important sources of analysis and data.

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PART I.  
SOME THEORETICAL AND POLICY ASPECTS OF ADJUSTMENT  
PROGRAMMES.

THE IMF PARADIGM.

The IMF approach is an eclectic one, drawn from neoclassical, keynesian, and monetarist sources (David 1985, p. 7). According to David (1985, p. 4), there has been a heated academic debate about the nature and consequences of programs supported by the IMF, because the relationship between theory and policy in their programs is a complex one. At best, there usually is what David calls a symbiotic relationship between the theoretical sources and policy, and a perfect correspondence is not always found in practice (David 1985, p. 5). In this sense, the theoretical and policy foundations of the IMF programs are not uniform, but there is a high degree of correspondence between some preferred theoretical frameworks and the policy advice given to developing countries.

This relationship between theory and policy is of central importance since the supporting body of theoretical and empirical generalizations usually form the basis of the IMF policy diagnosis, objectives, and targets (David 1985, p. 5). The policy-theoretical framework underlying IMF lending programs are related to the orthodox paradigm\* of economics and economic development (David 1985, p. 6). In general, this proposition is supported by the fact that IMF policy prescription relies heavily on market preferences for orthodox theories and economic philosophies (David 1985, pp. 6-7).

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\* According to David (1985, p. 5), a paradigm is understood in the sense of:

"A set of shared intellectual commitments that help to shape our perception about social and economic reality. It provides the intellectual framework for the study of such reality, defines the sets of problems that are considered worthy of investigation, and delineates the requisite sets of criteria for judging the appropriateness of answers to such problems. Such an intellectual framework is typically governed by a world view or ideology together with supporting sets of theories, policies, methodological approaches and research programs."

Particularly important within the orthodox view of the IMF is the principle that there should be some mechanism to translate the private decisions as expressed in the market place into the society's objectives (David 1985, p. 9). Thus, orthodoxy gives preference to the market mechanism, provided that private decisions, as expressed in the market place, and society's welfare, are consistent.

Another important orthodox principle is a preferred interest in an international environment governed by free trade and exchange as the most favoured development strategy, which is an extension of the free market ideology to the international environment (David 1985, p. 10). These orthodox views of development support the methodological and ideological viewpoint which sees development as a rational process governed by certain universal laws of change (which occur in a gradual, harmonious, and mechanical process of adjustment) in a world of perfect equilibrium (David 1985, p. 10).

#### Theoretical Influences of the IMF Macroeconomic Stabilization.

David (1985, p. 33) explains that the demand management focus of the IMF paradigm is based essentially on an eclectic mixture of Keynesian and Monetarist doctrines. From these traditions comes the IMF approach to BOP which is based on the assumption that BOP disequilibria and inflation in developing countries are generally caused by unsustainable expansion in aggregate demand (David 1985, p. 33). From this premise, a well known IMF position is to call for a policy of demand management. The restoration of macroeconomic equilibrium therefore involves either (David 1985, p. 33): "1) the short-term stabilization or restructuring of domestic demand through complementary use of monetary, fiscal, and exchange rate instruments, and/or 2) reducing domestic 'absorption' in relation to income."

With regard to the monetarist influence on the IMF stabilization programs, the main influence comes from the monetary approach to BOP. According to David, the IMF version of the monetary approach to BOP relies on the following considerations (1985, p. 55):



- 1) the quantity theory of money identity;
- 2) the money supply is defined as being equal to domestic credit plus foreign exchange reserves;
- 3) the BOP is equal to the trade balance and capital imports, in which the variable "capital imports" is independent of the money stock and money incomes;
- 4) the trade balance depends on income via the propensity to import, and not on expenditure;
- 5) nominal income is determined by the money stock, in which changes in money stock depends on changes either in the domestic credit creation or in foreign exchange reserves.

Thus, the main elements of the IMF policy prescription for structural adjustment are based on the diagnosis that the principal causes of disequilibria are internal excesses (David 1985, p. 12). However, as is shown in the Brazilian case analysed in the second part, disequilibria for a country such as Brazil are mainly associated with exogenous variations in trade, and financial markets. Therefore, the BOP and other important disequilibria in Brazil are associated to a large degree, with its industrial and trading structure. In spite of this situation, it is also important to recognize that in the period of the 1970s in particular, the government, in its domestic economic policy made serious mistakes of analysis by adopting measures which aggravated the external causes of domestic and external disequilibria.

#### Causes of Internal disequilibria and the Role of Macroeconomic Policy.

While aggregate demand is an important cause of disequilibria, developing countries show that there are other important causes of internal disequilibrium such as supply bottlenecks in terms of market fragmentation, imbalances of intersectoral supplies and demands, problems of resource mobility, etc. In the past, these problems did not receive a great deal of attention, particularly from the IMF. However, since the 1970s, the IMF and the World Bank are giving more recognition to these problems. In this context, a new view about the

need for "an optimal mix of demand and supply management policies, as well as the lengthening of adjustment" has emerged (David 1985, p. 107). However, strong disagreement about the origins of these structural rigidities and the factors which perpetuate them remains (David 1985, p. 107).

The discussion about the origin of the factors causing the structural imbalances has been held between economists in the structural tradition, – some of whom work for the UNCTAD and the Economic Commission for Latin America (ECLAC)– on the one hand, and monetarist economists and the IMF-World Bank views, on the other hand. The structuralists view structural rigidities "as externally induced, and as a by-product of the external reliances that have accompanied the evolution of the dependent capitalism in its modern form" (David 1985, p. 107). On the other hand, the IMF- World Bank type of analysis, recognizes the influence of external factors, but they place the greater emphasis on the internal economic factors (David 1985, p. 107). This controversy has remained at the center of the different policy options in Brazil since the 1950s. The recognition of the structural constraints of the Brazilian economy seems to be a necessary element in the elaboration of a complete set of policy options for the stabilization and adjustment needs of the 1980s.

In order to understand the IMF stabilization and adjustment programmes, it is necessary to study the monetary approach to Balance of Payments (BOP), as well as the monetarist view about the causes of external and domestic disequilibria, which are important theoretical bases of the IMF analysis and policies.

#### The Monetary Analysis of Balance of Payments.

The view about the influence of monetary aspects on Balance of Payments (BOP) goes back to David Hume's work in 1752 (Villarreal 1984, p. 187). The modern theoretical foundation of the monetary approach to BOP has been developed mainly by James Meade, Harry Johnson, Robert Mundell, Jacob Frenkel, Blaford Putman, and Sykes Wilford (Villarreal

1984, p. 187). At the practical and policy level, J.J. Polak, a staff member of the IMF, in 1957, developed a financial framework which was based on the monetary analysis of the BOP, and which was used as the analytical tool of the IMF missions when they visited foreign governments to negotiate financial agreements (Taylor 1987, p. 33).

CHAPTER 1.  
THE MONETARY APPROACH TO BALANCE OF PAYMENTS  
AND EXTERNAL DISEQUILIBRIUM.

The modern theoretical foundation of the monetary approach to BOP was developed mainly by R. Mundell and H. Johnson of the University of Chicago (Villarreal 1984, p. 187). They interpreted external disequilibrium through the classical and monetarist theoretical approaches. Thus, the policy to correct external disequilibria which are derived from the monetary approach of BOP, are based on the classical analysis of free market conditions and the monetarist view that BOP disequilibrium is a monetary phenomenon.

The main purpose of the monetary approach to BOP is to develop a theory based on the assumption that the BOP is a monetary phenomenon, which requires analysis in terms of monetary concepts; in particular, the concept of money as a stock, and monetary adjustment as adjustment of actual to desired stock, is used, rather than international money flows as residuals of real flows determined by real relative prices and incomes. Thus, BOP deficits or surpluses are considered to be stock-adjustment disequilibrium problems, and not flow equilibrium phenomena (Johnson 1977a, pp. 259, 260).

### 1.1. INTERNATIONAL MONETARY MOVEMENTS AND STOCK DISEQUILIBRIUM.

One fundamental proposition of the monetary approach is that BOP deficits and surpluses are monetary disequilibria that will correct themselves without need for a government BOP policy (Johnson 1977a, p. 265). Considering a fixed exchange system, the latter proposition originates from the definition of BOP as international reserve flows, and not as imbalances in the different accounts of the BOP. Accordingly, in the monetarist view, the analysis of BOP disequilibrium has to be concentrated on the reserve flows, or the money account, and not on the movements of the other BOP components, trade and current accounts. In this way, by analysing the money account (rate of decrease or increase in the country's international reserves), the monetary approach focuses on one of the determinants of the excess domestic demand for money.

The main idea of this argument is that BOP disequilibrium must be considered as the outcome of stock disequilibrium between the supply and demand for money, and, therefore, that it can be corrected by monetary adjustment, which eliminates the stock disequilibrium between the demand for and supply of money. Referring to the origin of payments disequilibria, Johnson (cited in Villarreal 1984, p. 190) defines it in the following way (1977b, p. 227):

all balance of payments disequilibria are monetary in essence. So-called 'structural' deficits or surpluses, such as the deficits described as 'inevitable' for 'underdeveloped' economies, simply cannot exist, unless one includes in the concept of 'structure' an unalterable propensity of governments to rely on inflationary finance of development programmes that should be accepted and paid for by contributions of aid from more developed countries.

Thus, according to this analysis, the external disequilibrium is viewed as being a monetary phenomenon at any time and place. This generalization comes from another monetarist generalization which is that inflation is essentially, in any time and in any place, a monetary phenomenon (Villarreal 1984, p. 190). Consequently, the monetarist approach to BOP

simplifies and reduces all the causes of BOP disequilibrium to solely monetary phenomena; it considers that international monetary movements are the result of stock disequilibrium between the demand and the supply of money. In this process, surplus is caused by excess demand for money, which has led to an inflow of international reserves; and BOP deficit is caused by an excess supply of money, which has led to the loss of reserves (Thirlwall 1980, p. 170).

## 1.2. BASIC ASSUMPTIONS OF THE MONETARY APPROACH TO BALANCE OF PAYMENTS.

H. Johnson (1977a, p. 259) mentions that the essence of the monetary approach is most easily understood by reference to Walras Law. According to Walras Law, the sum of excess demand for goods, securities, and money is identically zero, and an excess demand for or a supply of money must be matched by an excess supply or demand somewhere else in the market system (Johnson 1977a, p. 259). In an open economy, according to Johnson, excess demands and supplies can be eliminated by net purchases or sales of goods or bonds for money in the international market; full equilibrium is not reached until net flows of bonds and money become zero (Johnson 1977a, p. 259). Within this classical framework of analysis, Johnson postulates the two fundamental assumptions of the monetary approach of BOP: that there is a stable demand for money, and that the supply of money is determined independently of demand (1977b, p.225-226). He asserts that

the monetary approach rests on two fundamental empirical assumptions: that there is a stable demand function for money, and that the supply of money –more accurately, in the context of an open economy, the amount of domestic bank credit– is determined independently of demand and is subject to policy control.

Given these two assumptions, the monetarists based the analysis of an open economy

on five major tenets (Villarreal 1980, pp. 188-190):

1. the use of fixed exchange rates are assumed;
2. in the long-run, there is a fully-employed economy;
3. the aggregate demand for money is a stable function of income;
4. changes in the money supply do not affect real variables; and
5. domestic prices and interest rates are functions of international prices and interest rates.

As we are going to see, these monetarist assumptions have important analytical and policy implications for the understanding and correction of external disequilibria. First of all, the central assumption that the demand for money is stable, does not take into consideration important factors that determine the demand for money such as changes in the supply of money; level of income; wealth; and rates of return on financial assets (as postulated by Keynes and J. Tobin). In a given period, there can be important changes in income with changes in the quantity of money, making it impossible to predict movements in the BOP from changes in the money supply alone; also, there is no direct relation between changes in the domestic money supply and the level of reserves (Thirlwall 1980, p. 114). According to von Whitman (1975, p. 536), the monetarist focus on the long-term general equilibrium characteristics, and the particular assumption that real output is determined exogenously and that money is neutral\*, provides the wrong answers for the short-term problems of BOP and makes irrelevant the macroeconomic tools of monetary and fiscal policy. Thirlwall (1980, pp. 114-115) also questions the basic monetarist assumption that changes in the international reserves on the domestic money supply cannot be sterilized, so that BOP deficits must

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\* an idea from the classical view that money does not affect real variables.

represent stock disequilibrium which will be self-correcting. In addition, Thirlwall observes that the monetary authority can and does promote open-market operations to neutralize the effects of changes in the international reserves on domestic money supply.

For the monetarists, changes in international reserves affect the domestic money supply. Therefore, according to their view, the BOP deficit, considered as stock disequilibrium, will be self-correcting, as market forces reduce reserves and domestic money supply. That is, the process as described by the monetarists, establishes a direct link between the stock of international reserves and domestic money supply. However, there appears to be no such obvious connection between the stock of international reserves and the domestic money supply, particularly when the monetary authorities intervene, through open market operations, in the process by playing an essential role in the regulation of the supply of money in the economy. Also, the government can regulate the changes of international reserves (particularly the drop of reserves) by acquiring external loans in order to avoid any shortage in the level of reserves. In fact, the Brazilian government was very active in using the overliquidity in the international financial markets in the 1970s to acquire foreign debt. This debt compensated for the imbalances in the Brazilian international reserves during that period. Therefore, the monetarist understanding of the connection between reserve changes and domestic money supply (understood by them in a mechanical fashion), does not reflect the different possibilities of regulating the supply of money. It is government intervention in the open market operations, or the increase of international reserves through external debt, that is causing the accommodation of the stock of money.

By focusing on the long-term general equilibrium characteristics, the monetary approach can simplify all the constraints that a developing economy faces, such as the difficulty of absorbing the growing labor force, the lack of technologies and capital, among many other constraints. Villarreal (1980, p.189) has illustrated this type of theoretical simplification through the monetarist assumption of full employment. Thus, for Frenkel and H. Johnson

(1976, p. 25), the use of the full employment assumption is explained by the following statement:

That the monetary approach largely assumes a fully employed economy is partly the result of the fact that in the context of a growing world economy in the long run the assumption of wage rigidity and variable employment becomes uninteresting; either employment expands into the full employment range and quantity adjustments yield to money price and wage adjustment, or it contracts and people either starve to death and go back to full employment numbers, or there is a revolution on Marxist lines, or more likely the public simply votes for the other political party than the one in power, since all of them promise to maintain full employment and the public expects them to do it.

Since the monetarist method focuses on the long-run, general equilibrium conditions, it does not consider all the specific and real conditions of external and domestic disequilibria of market imperfections of the developing economies and of the international economy. This leaves the analysis without a framework of real time and economic reality for the relevant BOP disequilibria.

In addition, A. Rabin and L. Yeager (1982, pp. 3-4) have observed the following basic errors in the strong version (the monetarist version of BOP based on a fixed exchange rate assumption) of the monetarist BOP approach:

1. It omits the market for nontraded goods and services in its analysis of the BOP. Yet excess supply or demand in that market can coexist with an excess demand for or supply of money, and this possibility breaks the supposed link between imbalance in the "money market" and in the BOP.
2. It is an error to assume that money actually acquired must also be demanded. Money balances can rise and fall unintentionally. Because the medium of exchange is routinely used and accepted in all markets, changes in money balances do not necessarily correspond to changes in the demand for money "to hold".
3. It fails to distinguish clearly between an excess demand for or supply of the home money on the foreign-exchange market and an excess demand for or supply of cash balances to hold.
4. It fails to distinguish between the demand for assets denominated in a particular currency and the demand for holdings of that currency as a medium of exchange.
5. Holdings of cash in excess of desired holdings are the proximate cause of the increased spending that bids up nominal prices. The strong version disregards this mechanism in analysing the international transmission of inflation.



### 1.3. POLICY IMPLICATIONS.

The theoretical core of the monetary approach to BOP is linked directly to a set of policy implications for external disequilibria (see Johnson 1977a pp. 265-266, 1977b pp. 226-228).

These implications can be summarized in the following statement (Johnson 1977a p. 265):

... balance-of-payments deficits and surpluses (under a fixed rate system...) are monetary symptoms of monetary disequilibria that will cure themselves in time without any inherent need for a government balance-of-payments policy. If the natural process of adjustment to a deficit cannot be allowed to work themselves out, because of inadequacy of international reserves, the policy indicated to speed the natural adjustment process is deliberate monetary contraction. Devaluation, or alternatively import restrictions and export-promoting policies, is a substitute for monetary contraction, logically having the same effect but achieving it by deflating the real stock of money backed by domestic credit through raising the domestic price level rather than by deflating the nominal stock of money through open market sales, and its effect is a transient one of accelerating the inherent natural process of adjustment to equilibrium.

In the monetarist view, the central policy consideration is that there is a natural adjustment mechanism that corrects any BOP disequilibrium, which implies no role for government BOP policy. All of this takes place in the context of a system of fixed exchange rate, and without long-run domestic control on money supply, prices, and interest rates; that is, according to this analysis, domestic prices and interest rates are determined at the international level. The only control that a domestic economy has is on the expansion of credit, which is the portion of international reserves in the form of money. It is from this fact that monetary policy is specified as the control on credit expansion which affects directly the BOP (Villarreal 1984, p. 193). Accordingly, the logic and objective of the monetarist policy implication is clear: countries with BOP deficits must stop the credit expansion and must eliminate market intervention and regulations. There is a direct link between these analyses and the IMF economic analysis and policy, which centers its approach of adjustment policy on the contraction of domestic credit and the reduction of the public sector in the economy.

To sum up, we can say that the monetarist approach of BOP builds its analysis on the assumptions of the classical school from which the following conclusions and policy implications are deduced: BOP changes are caused by monetary stock disequilibrium between the supply of and demand for money; the BOP disequilibrium is a transitory phenomenon with self-correcting forces; if the natural process of adjustment cannot be allowed to work themselves out, the policy indicated is monetary contraction; devaluation, tariff policy, and other policies are only substitutes of monetary contraction, and they will succeed in correcting BOP disequilibrium, only if there is no policy of credit expansion.

This type of restrictive monetary policy, as recommended particularly by the IMF in its adjustment programmes for developing countries, and its orthodox application in the case of countries with BOP problems, will be analysed. Essentially, the IMF package, based on that monetarist approach, is made up of the following policies (Taylor 1987, p. 34):

- Restrictions on credit to be made available from the domestic banking system, especially to the central government and public enterprises.
- Specific targets for the public sector deficit to back up credit restrictions, sometimes with agreements about which programs are to be cut (or revenue sources increased) so that the deficit targets can be attained.
- A program for depreciation of the local currency (either gradually or once-for-all in a maxi-devaluation). And
- An agreement to 'liberalize' by removing restrictions on external trade or capital movements, or on international prices and transactions.

These policies and their underlying monetarist theories have formed the main framework or context in which the IMF has tried to solve the problems of external disequilibria of developing countries.

CHAPTER 2.  
THE IMF APPROACH TO EXTERNAL DISEQUILIBRIUM  
AND ADJUSTMENT POLICY.

Adjustment to Economic Changes in the Process of Growth.

Economic growth is characterized by a continuous process of change in structures, institutions, economic behaviour, etc. The flexibility and adaptability of an economy to such changes —both structural and temporal change— depend mainly on the degree of economic development, the degree of national integration of the domestic economy, and the degree of vulnerability to external factors. Streeten (1987, p. 1469) explains how economic changes can be favorable or unfavorable ( which are often unexpected) to the set of objectives pursued by a government: in the case of favorable changes, the challenge is to obtain maximum benefits; in the case of unfavorable changes, the challenge is to adapt with the minimum social cost, and generally, the adaptation to unfavorable changes for developing countries is often forced upon them. When changes are slow and gradual, the price mechanism is one of the best mechanisms in the sense that it combines a decentralized system of signals and incentives for the allocation of resources, but for large and sudden changes, the price mechanism is less well suited (Streeten 1987 pp. 1469-1470).

Adjustment, then, is the process of adaptation to the different types of economic change, which can come from the domestic or the international economy. The evaluation of the appropriateness or otherwise of the adjustment policy depends on the objectives being pursued, the interests behind them, and the resources available.

Throughout the postwar period, developing countries have been participating increasingly in the international market with new challenges in technologies, new markets, the presence of multinational corporations, external shocks, international financial markets, etc.

Changes in the international economy in the last 50 years –such as different forms of trade, cyclical changes of the international market, and variations in the international interest rates– have particularly influenced the BOPs of developing countries. The IMF was established in 1945 as the international monetary organization to deal with problems in the BOPs of its members, and to propose adjustment programmes to correct BOP disequilibrium. The IMF approach to BOP disequilibrium is based on the monetary view of BOP. Since the outset, the IMF adopted this orthodox monetarist view that external disequilibrium is a consequence of excess aggregate domestic demand caused by excessive credit expansion. Essentially, its adjustment programme consists of the use of BOP as the adjustment criteria to external disequilibrium. Loans given by the IMF to correct BOP problems are subject to certain conditions which must be adopted by the borrower country in its adjustment programme. This is the topic to be examined in the next section.

## 2.1. CONDITIONALITY AND THE ROLE OF THE IMF.

### The Tendency Towards Policy Symmetry between the IMF and the World Bank.

According to David (1985, p. 27), the shift in the IMF's philosophy of loans, together with the new types of international adjustment problems, have led to the conclusion that one cannot any longer make the conventional distinction between stabilization and adjustment, on the one hand, and development, on the other (David 1985, p. 27). Thus, many adjustment programs are structural in nature which require a longer period to show results. An immediate result of this is the IMF-World Bank policy symmetry, and the "recognition of a need for structural adjustment lending" with "an increased emphasis on liberalization strategies" (David 1985, p. 27). In the context of this policy-symmetry, the IMF then shifted more toward supply management, and the World Bank more in the direction of structural adjust-

ment lending.

A more recent influence of the IMF programs, according to David (1985, p. 63), has been a "new orthodox policy paradigm predicted on the need for liberalization of the trade and exchange regime of the developing countries." This has come from the need to combine short-term demand management with long-term policies designed to improve the supply capacity (David 1985, p. 63). This has shifted the IMF policy orientation towards the type of supply management policy which has moved closer to the World Bank's structural adjustment lending. The "liberalization" approach has been mainly concerned with the optimal mix of trade and exchange policies. Therefore, the new liberalization orthodoxy departs from "the standpoint of efficiency and cheapness", price incentives are interpreted "in terms of those prices that would exist if essentially free domestic markets were to interact with international markets without constraint" (David 1985, p. 64). Thus, the policy recommendations that come out are based on the free market norm of "efficiency prices". David cites one example of the use of this liberalization philosophy: the use of the concept of "shadow" or "accounting" interest rate, which is essentially in the "analytical black box of both the world Bank and the IMF" (David 1985, p. 80).

Since the 1970s, unfavorable conditions of the international economy have affected the industrialized and the developing countries differently. The industrialized countries have experienced recessive tendencies in their economies, but these were manageable through macroeconomic policy. At the same time, the developing countries have faced protectionism, high interest rates, a deterioration in the terms of trade in the late 1970s and the problem of the external debt, problems which were largely exogenous to their economies. These factors forced most developing countries to look for the financial assistance from the IMF and the World Bank (WB).

The huge demand for financial help gave a very important role to the IMF and the World Bank in the global problem of adaptation and adjustment to those new conditions of the international economy. The IMF conditionality, the principle on which it based its services, then became a central factor in the direction of the developing countries' adjustment process that has been taking place in the world economy. IMF conditionality is divided into low and high conditionality (Williamson 1983, p. 607). Low conditionality is used when the IMF establishes that a country has a BOP need (deficit), and declares that it is taking measures to correct the deficit. High conditionality requires that the country design a specific set of measures (the adjustment programme) to eliminate the deficit, that the IMF has to approve the programme's efficiency, and that the country is committed to the implementation of that programme (Williamson 1983, p. 607).

The IMF recognizes three types of deficits: temporary deficits, excess demand, and fundamental disequilibria (Williamson 1983, p. 607). For the temporary deficits, caused by factors such as weather conditions or cyclical variations in the terms of trade, no adjustment action is needed; only some financing will be required because it is expected that these types of problems reverse themselves (Williamson 1983, p. 607). For excess demand deficits, the IMF recommends that they should be adjusted by eliminating the excess demand without any financing, though the IMF could provide temporary liquidity. For other types of permanent or fundamental disequilibria, which means deficits that would persist over the whole cycle even in the absence of excess demand, a devaluation policy is recommended with the objective of improving efficiency and competitiveness. This measure, which is accompanied by contraction of aggregate demand, provides financing if the deficit persists during the period of adjustment (Williamson 1983, p. 607).

During the 1970s, the existence of overliquidity in the international financial system permitted many developing countries to have access to the private capital markets, thus they saw the IMF as a lender of last resort. Only the group of poorest countries (with no easy

access to private capital markets) still saw the IMF as one of the main sources of financing (Williamson 1983, p. 608). Under normal conditions in the international economy, two general groups of countries are identified as the users of the IMF funds: the group of middle-income countries, and the group of the poorest countries. For the latter group, to have access to low conditionality is an essential need. A Compensatory Financing Facility (CFF) was created with the purpose of giving low-conditionality credit to some countries in order to finance their deficits coming from problems beyond the countries' own control (Williamson 1983, pp. 609-610).

One central consideration in the IMF idea of adjustment is that a country which has been subjected to a permanent adverse payment shock, has to adjust according to a certain pattern of adjustment. However, as J. Williamson (1983, pp. 611-612) points out, it has been the case that the IMF does not achieve the best possible adjustment for two reasons:

- 1) "the CFF does not deal with many exogenous shocks presumed to be temporary" (for example, the terms of trade deterioration in 1981), and the IMF as an adjustment institution, has failed to delineate where adjustment ought to be leading so as to ensure consistency in the objectives of all countries; and
- 2) "countries should first have the right to decide for themselves how they wish to adjust when confronted with a permanent adverse shock", for the IMF does not have a monopoly on the knowledge of the steps necessary to secure adjustment.

A special type of lending called "extended facility", was created by the IMF in 1974 to deal with structural problems which were defined as (Williamson 1983, p. 613): 1) serious imbalances relating to structural maladjustments in production and trade, where cost and price distortions have been widespread; and 2) an economy characterized by slow growth and an inherently weak BOP position. Therefore, in view of these considerations, the IMF view centers only on price distortions and its understanding of BOP problems, not on the role played by investment needs and the time required to develop productive capacity, although

these are two problems which are central to structural adjustment.

After the first oil shock of 1973, a problem of the definition of objectives appeared in the roles played by the IMF and the World Bank. The former was as an adjustment institution to provide finance for short-term BOP problems, whereas the latter was a development institution to finance development projects. The "Extended Facility" created by the IMF in 1974, began to involve the IMF in adjustment programmes for the promotion of structural change; this facility concentrated on incentives to develop infrastructure, microeconomic analysis of efficiency in investment projects, and investment priorities, all areas that were traditionally the concern of the WB (Williamson 1983, pp. 617-618). The World Bank also experienced some changes in its tasks, particularly with the creation of Structural Adjustment Loans (SAL) that deal with aspects of development and adjustment. The WB also manages the criteria of conditionality in its lending function, but, according to Williamson (1983, p. 619), "the Bank's conditionality was not less stringent, but was markedly different in character, relating to a set of agreed policy actions rather than to obligations to achieve specific numerical outcomes." The type of conditionality attached to the structural adjustment lending of the World Bank can be described by four elements (Stern 1983, cited in Williamson 1983, p. 618):

- 1) rationalization of prices or "restructuring of incentives", covering pricing policy, tariff reform, taxation, subsidies, and interest rates; 2) the revision of public investment priorities; 3) budgetary reform; and 4) institution building.

The World Bank has also been dealing with other areas of IMF concern such as negotiations of policy reforms in export incentives, import liberalization, tariff reform and the exchange rate (Williamson 1983, p. 619). The potential and actual overlapping of responsibilities between the IMF and the World Bank in the last years, has called for more cooperation between the two institutions (joint or simultaneous negotiations with the IMF and WB by a country applying for extended loans, for example). That coordination has consolidated the link between short-term programmes of stabilization-adjustment and the long-term requirements of structural change and development. Thus, the programmes of adjustment of the



principal international institutions are based on a generally orthodox paradigm of free-market solutions to the problems of stabilization, adjustment, and development, all by means of macroeconomic monetary and fiscal discipline to promote equilibrium in the BOP, noninflationary growth, and efficiency.

### The IMF Approach to Adjustment.

Two periods may be identified in the adjustment policies implemented by the IMF: a) between 1947 and 1973, the Special Drawing Rights (SDR) were used to correct external disequilibrium; and b) after 1974, when different types of services were created to recognize the other factors affecting the BOP (see Williamson 1983). Even though different types of services were introduced to address other clear causes of external disequilibrium, the IMF approach has remained essentially the same. E. Bacha (1982, p. 1457) maintains that the single most important issue that has always damaged the relationship between developing countries and the IMF is the IMF's position that "external disequilibria are always a consequence of excess aggregate domestic demand, caused by excessive credit demand", and, that therefore, the "cure for such disequilibria must involve a purge of such an excess". Thus, the central aspect of its stabilization program is domestic demand contraction through the restriction of credit.

G. Grellet (1987, p. 9) notes that this view has its sources in the orthodox theory of adjustment which is based on three implicit premises (see IMF 1977):

1. all external disequilibrium originates in an excessive aggregate demand over the aggregate supply;
- 2) The correction of any disequilibrium requires the decrease of the nominal demand and a reallocation of the production factors in order to increase the aggregate supply. This also requires a readjustment of the exchange rate in order to re-equilibrate the supply of and demand for foreign currency, and a

- reallocation of resources in order to increase exports and/or to decrease imports;  
and
- 3) the adjustment policy is not deflationary. Its objective is to obtain an external equilibrium with full employment by modifying the price system and allocation of resources. The costs implied are only temporary and adjustment will permit a reorientation of the economy towards long-term growth.

Thus, the orthodox view of adjustment considers external disequilibria to be always a consequence of aggregate demand, which in turn is considered to be caused by excessive credit expansion. Consequently, the IMF sponsored stabilization programmes center on demand contraction through credit restrictions, and other stricter domestic goals in order to achieve BOP objectives. The conditionality system then is established in two ways (Bacha 1987, p. 1469): one is composed exclusively of foreign exchange denominated variables (BOP), and the other, is composed of domestic currency denominated variables.

A particular goal of the monetarist orientation of the IMF analysis and policy is to pursue the reduction of the role of the public sector in the economy (Villarreal 1984, pp. 192-194). This is done primarily through demand contraction policies of decreasing public expenditure, cutting productive investment of the public sector, setting ceilings on credit to the government sector, and emphasizing positive supply-side aspects of the market. That is, the ideology of that approach is intended to eliminate the economic role of the State. The theory and ideology of this approach are based on three main ideas: a) the efficiency of the pure free-market economy in allocating resources; b) scepticism about the economic intervention of the State, and c) the emphasis on money as the central factor causing inflation.

One of the central concerns of the monetarist analysis is to reject public economic policy as a tool to influence the levels of employment and output. Villarreal (1984, p. 98) has

pointed out that the main assumptions on which those conclusions are based are: a constant velocity of money, a constant demand for money, price and wage flexibility, existence of equilibrium in the labor market (natural rate of unemployment), and the inefficacy of public policy to change employment and production levels. The implications of such assumptions for economic policy are (Villarreal 1984, pp. 98-99):

- 1) if the velocity of money and the rate of growth of output are constant, then the monetary changes are the cause of inflation. Economic policy will be ineffective in changing the natural rate of unemployment and the output level.
- 2) Given perfect price and wage flexibility, there is no need for State regulation and control of market mechanisms.

Therefore, according to that analysis, there is no need for an economic role of the State in the economy. The monetarists see that the only effect of government participation in the economy will be to cause inflation (through expansive monetary policy), and to hinder or prevent the possibilities of technical progress (by eliminating market stimulus to production and innovation) (Villarreal 1984, p. 99)

## 2.2. ADJUSTMENT POLICY AND THE DOCTRINE OF AUSTERITY.

One important influence on the IMF adjustment programmes is the doctrine of austerity. The doctrine of austerity, as found in Hayek's work (Guillen R. 1985, p. 279), was formulated in order to interpret and to give practical solutions to the problem of economic crisis. Guillen R. (1985, p. 279), following the analysis of the French Keynesian school (see Parguez 1983), mentions the three central principles of the doctrine of austerity:

- 1) the society has to follow the path of austerity, and all agents have to adjust their budgets without using credit;
- 2) the false (fictitious) means of expenditure that cause deficits have to be elimi-

nated; and

- 3) members of society have to accept a drop in their standard of living in order to correct budgets which will permit greater wealth in the future.

According to the doctrine of austerity, the crisis occurs when deficits are accumulated by households, firms, and government. This overspending is said to lead to more disequilibrium (inflation, unemployment, etc). Consequently, according to the austerity view, the anti-crisis strategy (Guillen 1985, pp. 279-280) would be as follows:

- 1) to avoid using money for purposes other than to exchange (in order to stop the increase of deficits), that is, to discourage free recourse to money for unnecessary spending; and
- 2) to eliminate the deficits in the agents' (government, households, firms) accounts, that is:
  - a) decrease the public deficit by decreasing public expenditure, and particularly, by cutting social programmes and increasing taxes;
  - b) decrease the households deficits by forcing them to repay their debts, and if possible to encourage savings; and
  - c) decrease accumulated deficits of firms.

Therefore, according to its proponents, for the doctrine of austerity to be "effective", it is essential to decrease consumption in order to eliminate deficits, which they view as the "disturbing cause" of economic crisis. That is, they believe, that saving determines investment in the capitalist economy.

Underlying the doctrine of austerity is the controversy over the saving-investment identity, the role of consumption over investment, and the importance of prices or real output as the most relevant variables in economic analysis (Blaug 1985, p. 540). Blaug explains Hayek's view, which is in the tradition of the Austrian theory of capital, that "a rising level of consumption must after a certain point reduce rather than increase the rate of investment" (Blaug 1985, p. 540). Hayek's view was intended to oppose Keynes' view that it is consumption which

plays an essential role in the determination of investment.

The quantity theory of money also focused on the role of saving and investment in the determination of national income. In the quantity theory of money, the focus was on the determination of prices and not on national income (output) (Blaug 1985, p. 654). That is, the monetarist tradition, and the austerity doctrine, do not assign any central role of the real sector in the determination of income and the process of growth. Instead, by focusing on monetary variables and prices, the austerity doctrine considers saving to be the determinant of investment and output (income). Keynes, by focusing on the real sector, demonstrated how the analysis of the neoclassical tradition limited the study of the determination of investment and income to monetary variables and prices, and thus, he showed how that analysis was partial and misleading for the macroeconomic study of employment and income. Blaug (1985, p. 654) points out that Keynes changed the focus of the analysis from prices to real output as the central variable to be explained. From that perspective, he established that variations in output (income), rather than variations in the rate of interest, is what equates saving to investment. Thus, Keynes established the real link between investment and income (Blaug 1985, p. 654):

it is investment and not saving that sparks off changes in income: instead of starting with the public's willingness to save and then showing how investment adapts itself to saving via the interest rate, Keynes posited a largely autonomous flow of investment and shows how savings will be generated via the multiplier to satisfy that level of investment.

If one accepts one of the premises of the doctrine of austerity that saving determines investment, then it follows that the elimination of the agents' deficits will be the solution for the conditions of disequilibrium. However, the austerity doctrine, far from being a solution, creates more conditions of disequilibria. By making reference to a profit equation postulated by M. Kalecki and restated by H. Minsky, Guillen R. (1985, pp. 280-281) explains how the policy of austerity deepens the crisis instead of solving it. Kalecki's and Minsky's equation is

as follows:

net profits = net investment + export surplus + public deficit - workers' saving + capitalist consumption.

Assuming that workers do not save and that the trade account is in equilibrium, we have:  $P = I + C_c$  ;(where  $P$ = profits,  $I$ = investment,  $C_c$ = capitalist consumption), from which it can be deduced that a policy à la IMF of high interest rates, reduction of public deficit, voluntary or forced savings, will all depress profits, reduce consumption, and deepen the economic and social crisis (Guillen R. 1985, p. 283). This is aggravated also by the fact that an important part of the capitalist consumption, as is the case in Brazil, takes place outside of the country (Guillen R. 1985, p. 283).

Considering that net profits depend on net investment and capitalists' consumption, the austerity prescription of decreasing public expenditure has a strong recessionary effect in times of crisis when private investment is declining. The reduction of public expenditure has been, since 1982, a central demand of the IMF missions to Brazil, a country in which public expenditure (both productive and current expenditure) has been a central factor promoting the high rates of growth of the Brazilian economy.

The austerity doctrine's recommendation to increase saving (voluntary or forced savings), also can have the contradictory effect of depressing profits. Guillen R. (1985, p. 281) points out that, contrary to the austerity view, saving, in the capitalist economy, means money which is being taken away from firms, and which cannot be used during a certain period. This results in depressing the process of expenditure (investment and consumption).

Also, the policy of high interest rates to promote savings, has the effect of depressing investment (particularly in conditions of depression when the rate of return on investment is low), by increasing the cost of capital and decreasing profits which will decrease investment further.

The austerity doctrine has also been used in the formulation of the export-oriented policies for the highly indebted developing countries. The generation of a large trade surplus to be used to service the external debt, was achieved through the reduction of the domestic absorption of external resources (decrease of imports). This implied a reduction of domestic consumption and the allocation of more resources to the export sector. That is, it was implied that society "agreed" to accept austerity measures in order to service its external debt, even at the cost of more internal imbalances.

In Brazil, the policy of the pursuit of a large trade surplus was forced upon the country after the 1982 debt crisis. The severe contraction of imports and the promotion of exports after 1982 had a profound impact on reducing consumption in the middle-class and working-class sectors, and reducing all types of social expenditure. The large trade surplus generated through that scheme, however, was not recycled within the economy; instead it flowed out of the economy as payments on the external debt. Furthermore, austerity has meant a significant deterioration of future Brazilian manpower in terms of the present conditions of education and general welfare of large sectors of the population (particularly among children).

A central feature of the austerity doctrine used by the IMF is the prescription of decreasing real wages\* as a means of resolving the conditions of crisis. This was clear in the negotiations between Brazil and the IMF during the 1982-85 period, when Brazil presented seven letters of intent to the IMF. The IMF applied pressure for wage de-indexation, and this became an important impediment in reaching agreement.

Austerity measures also include other policies such as real wage compression, reduction of subsidies, increases in the price of goods and services from the public sector, devaluation, reduction of imports and promotion of exports, and restrictive monetary policy.

Grellet (1987, p. 21) notes that austerity policy can work only in a country where there is no

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\* under the assumption that reduction of real wages decreases cost of production, and increase efficiency and profits.

deterioration in the terms of trade, where there is a very diversified and productive economy, where there is a possibility to implement an import substitution strategy, and where exports have high demand elasticity; the paradox is that in such an economy, there would be no need for adjustment. The reality of the economies of the developing countries, such as the Brazilian economy, bears no relation to the economic conditions described above.

### 2.3. DESIGN AND STRUCTURE OF IMF ADJUSTMENT POLICIES.

#### The Development of the Financial Framework.

In 1957, the IMF's model of financial analysis was devised according to the monetary approach when J. Polak (1957) formulated the financial framework for the IMF economic missions. Polak's analysis starts from the condition of an open economy operating under a fixed exchange rate regime; the money supply is an endogenous variable influenced by surpluses and deficits in the BOP, and not an exogenous policy instrument as in the closed economic model (IMF 1987, p. 12). The contractionist domestic policy is established by linking the reserve account of the BOP and the domestic credit. As a result, the model begins to be defined with a monetary identity which states that the change in the stock of money is the sum of the changes in the international and domestic components (IMF 1987, pp. 13-15):

$$\Delta M = \Delta R + \Delta D \quad (1)$$

where M is the stock of money, R is the domestic currency value of net foreign assets (international reserves), D is domestic credit, and delta ( $\Delta$ ) indicates one period change.

Following that, the model sets the nominal demand for money equation with a constant income velocity of money:

$$\Delta M^d = f(\Delta y, \Delta p, \dots) \quad (2) \text{ or}$$

$$\Delta M^d = k \Delta Y \quad (3)$$

where k = inverse of income velocity of M, a constant.



$$\Delta M_d = m \quad (4)$$

combining (1), (2), (4), the system treats BOP as the difference between the change in the money stock and in domestic credit:

$$\Delta R = \Delta M - \Delta D = f(\Delta y, \Delta p, \dots) - \Delta D \quad (5)$$

This states that there will be a BOP surplus if changes in the stock of money exceed the change in domestic credit. The model regards real income as exogenous, and the domestic price level as being determined by foreign prices (purchasing power parity); therefore, the money demand is independent of domestic credit (increases of domestic credit above the increase in money will be offset by decreases in reserves).

The IMF financial framework, then, is principally an application of the monetary approach to BOP. According to Bacha (1987, p. 1464), the design of the IMF program is incomplete as a financial exercise because of the following reasons: it lacks a growth perspective; it has a partial and unspecified view of demand switching, of inflation determination, and of the role of credit in production. All of this shows the model's anti-growth bias and the particular monetary assumptions on which it is founded. In contrast, Bacha requires a consideration of a growth programme in the adjustment scheme. His view (Bacha 1987, p. 1464) is that in order to provide the IMF's programmes with a growth perspective, "growth exercises" should be a prerequisite to the IMF financial analysis. He suggests that from the growth exercises the amount of foreign credit will be determined according to the needs of a growth-oriented stabilization programme, in which the interaction among different variables should be specified under explicit assumptions.

Thus, the IMF model fits well within the austerity perspective which attempts to solve the economic crisis by reducing growth and by restricting credit and consumption. In Bacha's view (1987, p. 1464), then, a growth alternative to the IMF model would determine the amount of foreign credit necessary to support a growth-oriented stabilization programme. Such a programme would show how the following variables interact (Bacha 1987, p. 1464):

- 1) exchange rate variations and their effect on the balance of payments and on inflation; and

2) the effects of credit restrictions on international reserves, the inflation rate, and output levels.

The IMF experience with the developing countries has demonstrated that it follows a similar general analysis for all the countries for whom it arranges financial support. Irrespective of the causes of the deficits, the policy prescription is the same, which is one of contraction of aggregate demand, wage restraint, adjustment of exchange rates, contraction of domestic credit, reduction of the public deficit, and liberalization of the external market. These policy recommendations are to be achieved in the context of free-market solutions. Despite the IMF's acknowledgement in recent years, concerning the different factors influencing external disequilibria and the need to analyse each country separately, the IMF's central consideration is the monetarist view that external disequilibrium has to be corrected in the short and medium-term through demand contraction (Villarreal 1984, p. 205). Real experiences of adjustment programmes show little consideration of other causes of disequilibrium. Also the experiences of different countries which have had to follow this adjustment scheme in order to have access to international credit or to reschedule their external debt repayments, have demonstrated the risks (particularly in the short term) of such an orthodox view, in terms of some of the outcomes observed: higher rates of unemployment; higher inflation; higher concentration in the distribution of income; increased external vulnerability; de-industrialization; and social and political unrest (Villarreal 1984, p. 220).

#### Economic Cost of Adjustment Policies.

The evaluation of the economic cost of adjustment policies seems to be a complex task which has to be done both on theoretical and empirical evidence. However, the actual experience of the IMF adjustment policies in developing countries in the last fifteen years provides enough basis for making some general remarks.

Three types of problems can be noted as usual consequences of the IMF adjustment policy

for developing economies: a) increased vulnerability of the economy to external factors; b) recession; and c) inflation.

The first usual consequence is the increased external vulnerability of an economy by increasing openness to external markets. This implies greater vulnerability to variations in the terms of trade and international interest rates, to cyclical variations of the international market, and to changes of macroeconomic policy of the industrialized countries. As will be explained in Part II, these external factors were very important in the weakening of the Brazilian BOP position. Another important feature of the adjustment programmes sponsored by the IMF and the World Bank is the promotion of export-oriented economies. These programmes lead to the possibility of the oversupply of commodities on the international market when a number of countries are encouraged to increase production or exports of certain types of commodities. This results in the decrease in the price of those commodities and the fall of income through exports and the strong concentration of resources on that type of production. Therefore, the export promotion strategy could be counterproductive on the global level.

The contractionist policy recommendations come from the evaluation that disequilibria are caused by excessive demand and credit, and therefore, the re-equilibrating measures are thought to be restrictive fiscal and monetary policy, devaluation, and real wage compression. Finally, the IMF policies are designed to fight inflation as an important priority; however, very often they introduce new high inflationary factors through cuts in subsidies on basic goods, increase in the prices of goods and services from the public enterprises, and devaluation policy (which increases prices of imported capital, and of intermediary, primary, and basic goods).

Another problem about the cost of the IMF adjustment programmes relates to the distribution of the burden of adjustment. The distribution of the burden of adjustment is highly inequitable between countries. Keynes, during the 1930s, pointed out that the process of adjustment is compulsory for the debtor and voluntary for the creditor (cited in Dell 1981, p.

16). In the 1930s, during the context of the Great Depression, the policy of "beggar-my-neighbor" was used by the more powerful countries to shift the burden of adjustment of the depression to other more vulnerable countries (Dell 1981, p. 16). The evidence shows (Dell idem, p. 16) that the deficit countries, under serious pressures in the last fifteen years, have had to assume the burdens of adjustment, whereas surplus countries (Hong Kong, Taiwan, South Korea, Japan as some examples) have not been pressed seriously to adjust. Thus, the burden of global structural adjustment has been borne mainly by the developing countries, as Dell (1981, p. 17) points out:

Experience since Keynes's time amply confirms his assessment. Strong international pressure has frequently been brought to bear upon deficit countries, while surplus countries have been under little or no pressure to adjust. Developing countries that are in deficit are frequently accused of 'mismanagement' of their affairs, but the same term is never used to describe the policies of surplus countries. Surplus countries may be faulted for unwillingness to share the burden of adjustment but never for mismanagement. On the contrary, recent years have seen a revival of mercantilist policies among the industrial countries aimed at the attainment of surplus positions all round.

To summarize, it could be said that the theoretical basis of the IMF approach to stabilization and adjustment applied in an orthodox way has important limitations in the study and understanding of developing economies. The monetary approach to BOP maintains that all BOP disequilibria are monetary in essence. As such, the monetarist approach in its assumptions ignores the real sector of the economy, and it ignores also the real structural trade imbalances as the essential determinants of external disequilibrium. The monetarist focus on long-term general equilibrium characteristics, and the particular assumption that real output is determined exogenously and that money is neutral, provide an inappropriate understanding of the short-term problems of the BOP and ignore most of the policy action to intervene in the correction of external imbalances. By focusing on the long-run equilibrium, the monetary approach can simplify all the relevant short-term constraints that a developing economy faces (the deterioration of terms of trade, the need of capital and technology, the excess supply of labor, and others). Considering that monetary view to BOP, the IMF further develops that

approach on the consideration that external disequilibrium is the consequence of aggregate demand, which in turn, is considered to be caused by excessive credit expansion. Consequently, the IMF stabilization programme, founded also on the austerity doctrine, centers on demand contraction through credit restrictions and the reduction of the public sector in the economy. This approach, instead of presenting real solutions, creates more conditions of disequilibria (with its prescription of high interest rates, reduction of public expenditure, liberalization of the external sector and prices) by slowing down the economy and increasing unemployment, inflation, and by reducing investment and consumption.

Also, in the monetarist approach, no consideration is given to the different conditions of developing countries in the world market. Thus the monetarist approach ignores completely the international division of labor in which a developing economy is conditioned.

PART II.EXTERNAL DEBT ACCUMULATION, DEBT CRISIS,  
AND ADJUSTMENT EXPERIENCE IN BRAZIL 1968-1986.

## Introduction.

The monetarist theoretical and policy approach to external disequilibrium has been one of the factors in the discussion of the economic causes of the Brazilian external disequilibrium for the past four decades. Throughout this period, Brazil has tried different types of adjustment policies to correct external imbalances. A general trend in policy has been to try to maintain high rates of economic growth in spite of the different types of problems (inflation, current account deficits, public deficits) which that policy generates. The understanding of the causes of external disequilibrium is of fundamental importance to the adoption and implementation of the adjustment strategy within the process of growth.

As was seen in Part I, in the monetarist view of the BOP, all BOP disequilibria are essentially monetary in nature. The monetarist approach to the BOP is based on the more general theoretical framework of the neoclassical school. According to the neoclassical theory, external disequilibrium is a short-term type of problem, caused particularly by excessive investment or overvaluation of the exchange rate (Villarreal 1976, p. 8). However, this monetarist approach seems to be particularly inappropriate in the study of the Brazilian type of external disequilibrium which is more structural\* in nature. The nature of external disequilibrium in Brazil, as well as for the developing countries in general, is explained as an intrinsic or inherent phenomenon in the process of economic growth: that is, the external

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\* for the theory of the structural type of external disequilibrium, see Villarreal 1976, El Desequilibrio Externo en la Industrialización de México (1929-1975). Un Enfoque Estructuralista.

disequilibrium is of a structural type. In Brazil, structural disequilibrium between 1968 and 1981 was explained by the different characteristics of the import substitution strategy of industrialization which had been adopted. During the 1960s, the import-substitution strategy was concentrated on the production of durable goods; this caused an accelerated increase of imports of intermediary and capital goods, and it also caused a less dynamic growth of traditional exports of primary commodities. During the 1970s, the import-substitution strategy concentrated more on the substitution of intermediary and capital goods. The dependency on foreign intermediary and capital goods continued and the economy suffered external shocks (increase of oil prices, deterioration of terms of trade, increase of international interest rates, and increased protectionism in the industrialized countries), which further aggravated the external disequilibria.

During the 1970s, Brazil adjusted to external shocks by developing further the import-substitution strategy, and balancing its BOP by contracting foreign debt, in the context of international overliquidity and low levels of real international interest rates. This process came to an end in the early 1980s when high international interest rates and the contractionist policy of the industrialized countries made it impossible for Brazil to service its external debt. This period marks the beginning of the orthodox approach of adjustment to the conditions of the debt crisis. Both Brazil and the IMF have implemented different contractionist programmes of decreasing aggregate demand, cutting public expenditure, monetary restriction, opening up of the external sector, and other austerity measures which have not succeeded in correcting the fundamental causes of external disequilibrium in Brazil.

#### Historical Background.

External debt in Brazil has been an historical reality since 1825. That year, Portugal, the former colonial power, transferred to Brazil a debt contracted in London in 1823 (Marques 1986, p. 7). Since then, and throughout the nineteenth and twentieth centuries, the long

history of the Brazilian external debt began by acquiring loans with merchant banks in the London market. External capital was used primarily to consolidate the previous debt; to compensate for public deficits caused by fluctuations in commodity exports, especially coffee and sugar; to finance the expansion of the public infrastructure (ports, railroads); and to finance holdings of coffee stocks (stabilizing price schemes after 1908)\* (Marquez 1986, p. 7).

Since 1914, American capital, rather than British, has been the source of major loans. The first important problem in this process of external financing appeared with the Great Depression of the 1930s, particularly because of the drop in coffee prices. In 1937 after a coup d'etat, Brazil suspended all payments on its debt, and it was not until 1943 that Brazil signed a restructuring agreement covering the public debt (Marques 1986, p. 7). World War II brought about an increase in Brazilian exports and in its international reserves; under these conditions, Brazil experienced some relief from its foreign debt commitments.

With the creation of the World Bank and the IMF at the Bretton Woods Conference in 1944, a new period of external financing was opened. Contrary to the European case, Brazil and the rest of developing countries did not receive the massive financing through programs such as the Marshall Plan (Marquez 1986, p. 7). The main source of external financing continued to be external loans and more foreign investment. Acceleration of economic growth and inflation during the 1950s ended in a liquidity crisis in 1961, which forced Brazil to negotiate the rescheduling of its debt (Marquez 1986, p. 7). In the following years, inflation reached the 100% level annually, and investment, rates of growth, and employment fell sharply. All of these factors caused political instability and the installation of an authoritarian military regime in 1964. The first measures of that government were to control inflation by demand contraction, and the restructuring and modernization of the financial institutions. Souza and Afonso

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\* Coffee represented 70% of Brazil's exports until the 1950s.



(1976, pp. 27-29), following the theory of the State of James O'Connor\*\*, characterized the role of the Brazilian military government after 1964 as follows:

1) To administer, to drive, and to negotiate the internationalization of the Brazilian economy. That meant:

- a) to guarantee the efficient operation of foreign firms within the national economy;
- b) to act as a complementary agent in the needs of the foreign capital through credit and fiscal policy, develop the heavy industry (steel), develop the infrastructure, freeze wages and salaries, and maintain social and political control; and
- c) to mediate and to conciliate the conflicts between the domestic and international economic interests.

2) To administer and develop the large investments in the industrial sector and the necessary infrastructure (transportation and production of electricity).

3) To harmonize the alliance of the foreign capital and the domestic economic interests.

4) To maintain the hegemony of the multinational firms and the subordination of the other sectors marginalized from the benefits of the economic growth.

Under the conditions of the first half of the 1960s, Brazil did not participate to a considerable extent in the fast growth of the international economy. Foreign debt between 1960 and 1968, grew by less than 3% (Marquez 1986, p. 10). It was only in the last years of the 1960s, when the project of the new government had been consolidated, that Brazil was more fully integrated into the international market. This period also marks the beginning of a very accelerated process of external indebtedness, a process which has entered into a serious crisis since the 1980s. The following pages analyse and describe four main periods which characterized this accelerated process of debt accumulation. These periods are: 1968-73; 1974-78;

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\*\* J. O'Connor's theory of the State (Corporations and the State (1974); Fiscal Crisis of the State, 1973) is based on historical research about the origin and nature of the government revenue, and about government expenditure in terms of its distribution according to social classes. That is, the analysis is based on the role of the State in the process of capital accumulation.

1979-82; and the post 1982 period. But before that, one must have a general outline of the recent history of the mechanism of controlling real wages. For that was one of the conditions which permitted a continued process of high rates of growth because it allowed the rates of profits and investment to increase.

#### Recent History of Wage Policy in Brazil.

In Brazil, consistent government regulation of wages started in the 1930s with the establishment of the minimum wage, by the government of Getulio Vargas. In the mid 1960s, wage legislation was extended for the public and private sector (Saboia 1987, p. 197). According to Saboia (1987, pp. 197-198), the wage policy in Brazil has always depended on the political forces of each period, and despite the measures to protect minimum wages against inflation, the situation of minimum wages has depended on the vicissitudes of the political situation. Thus, after the fall of the Vargas' government in 1945, minimum wages were not adjusted for seven years; it was not until 1952 when Vargas returned to power that minimum wages were adjusted again (Saboia 1987, p. 198). In the second half of the 1950s under the democratic government of Kubitschek, the labor unions strengthened their political organization which permitted some improvement of minimum wages (Saboia 1987, p. 198) as graph 1 shows. With the installation of the military government after the coup d'etat in 1964, there was a policy of compressing real wages (see graph 1) . After 1964, the military government changed the wage policy radically. In 1965, the government specified and defined strict rules of wage adjustment which were said to be for the short-term (Saboia 1987, p. 198), but which prevailed as the measures to depress wages until 1979, the year in which changes in the labor legislation were introduced. Saboia mentions that in 1965, the military government pretended that they were introducing a wage indexation according to the growth of the rates of inflation and productivity. However, the statistical data used to calculate wage indexation did not reflect the growth of inflation and productivity (Saboia 1987, p. 199). Thus, the result was a

generalized reduction in wages until 1973. A central consequence of such a wage policy was a skewed income distribution, which, for the Brazilian government, was necessary in order to implement the model of economic growth based on durable consumer goods.

The resurgence of the labor movement through different strikes in 1978-79, permitted wage indexation to change from being annual to biannual and to be more favorable for the lowest levels of wages (Saboia 1987, pp. 199-200). However, the relative conquest of the labor movement did not last very long. The deterioration of the BOP from 1981, the contractionist orthodox policy implemented by the Brazilian government since 1980, and the IMF recommendations adopted since the end of 1982, depressed the economy, and increased unemployment and inflation. In the negotiations with the IMF since 1982, there were strong pressures to de-index wages. Thus, in 1983 the President and the Congress passed the Bills 2012, 2024, 2045, 2064 and 2065 (Saboia 1987, p. 200), which introduced stricter wage regulation and depressed real wages even further (in a context in which inflation rate had reached 200% in 1983).

The austerity and adjustment measures undertaken in the 1980s were in keeping with the policy of depressing real wages carried out since 1964. Thus the 1980s was a period in which one of the main rationales of structural adjustment seems to have been the adjustment of the economy in the context of severe wage controls.

By 1984-85, the economy had experienced some recovery (particularly from the growth in external markets), the first civilian government was in power since 1964, and the labor movement obtained important achievements in strikes in 1985 (Saboia 1987, p. 200). All of these factors permitted some improvement of wages after 1985. By 1986, the high inflation rate led to the adoption of a heterodox anti-inflation plan, the Cruzado Plan, in which wages and prices were frozen. The plan succeeded in the short-term to stop inflation, but after eight months, the pressure to increase prices introduced the process of wage deterioration once more (see table 15).

CHAPTER 3.THE BRAZILIAN PROCESS OF DEBT ACCUMULATION 1968-81.3.1. FOREIGN BORROWING DURING THE "ECONOMIC MIRACLE" 1968-1973.

At the end of the 1960s, Brazil began to borrow heavily on the international market. The period between 1968 and 1973 was characterized by high domestic growth with controlled inflation (Batista 1987, p. 3). Medium and long-term external debt began to increase especially after 1968 (see table 1); the amount of debt incurred changed from US\$ 3,780 billion in 1968 to US\$ 12,572 billion in 1973, that is, there was an increase of 70% over the period. In addition to this significant increase in the amount of debt, there was a change in the structure of the debt as shown in Table 2: the private sources of loans became the main suppliers of loans to the public sector (Batista 1987, p. 4), which in 1968 was 33.6% and 64.1% in 1973.

The phenomenon of the combination of the high rates of growth and the rapid expansion of external debt in the 1968-73 period has been interpreted in different ways. For Albert Fishlow (1980, pp. 102-108), what occurred was a type of "debt led" growth (cited in Batista 1987, p. 5). However, for P. Nogueira Batista (1987, p. 5), debt growth had relatively little to do with the financing of economic growth at the time. He maintains that aggregate expenditure exceeded domestic output by a small margin in the period, so that in 1970-73, net absorption of real resources from abroad (defined as the excess of total consumption and investment over domestic output), was only 1.45% of GDP (see table 3); domestic demand was 101.4% of GDP. The data of table 4 seems also to confirm Batista's argument that during the "miracle", the "high rates of capital formation were almost entirely financed by internal resources, that is, by an excess of GDP over total consumption" (Batista 1987, p. 5). The trade and

service accounts show that this situation was being managed to an important degree by internal resources (see tables 4 and 6). The BOP position, then, was not moving according to pure monetary forces, but instead it was being managed through the policy of external debt and the performance of exports.

In terms of the domestic situation, the high rates of capital formation and rates of growth show that the severe policy of wage control was one of the central factors of the dynamic increase in profits and investments, and, therefore, a central element in the overall process of growth (see table 14, graph 1). Essentially that was the basis on which the "miracle" was financed.

#### Inconsistencies of the Model 1968-73.

At the political level, the "miracle" of 1968-73 was possible because the military government was able to implement the wage policy. According to Theotonio dos Santos (1974, p. 467), the government's strategy in that period is explained by the fact that:

The essence of the economic 'boom' experienced by Brazil after 1967 was contained in the capacity to raise the rate of profits by lowering the real value of wages. This policy was complemented by State intervention designed to raise the level of profits and to stimulate investment, and by the creation of various mechanisms to channel all the surplus generated in Brazil towards the financial system dominated by the big national and foreign companies. The surplus was transferred into different kinds of financial holdings which were needed to find investment outlets and markets to stimulate investments. This market was not to be found among wage earners because their low salaries were the bases for the investments.

One important goal of the government since 1964 was to modernize the conditions (economic, social, institutional, and political conditions) for industrial growth. Thus, as it was pointed out before, the main aspects of the military government's project were: the creation of a new institutional structure to contain wage demands; the rationalization and centraliza-

tion of the public sector in the economy; the reform of credit to promote the demand for consumer goods; and the export promotion policies which increased and diversified exports, increasing the integration of Brazil into the world market (Hurtienne 1983, p. 117).

Public investment increased significantly which contributed to the consolidation and expansion of the internal market, particularly in the industrial central and southern regions, around durable goods. In contrast, other sectors and regions of Brazil (the northeast, for example), participated very little in the growth process started in the 1960s (textiles, food-stuffs, clothing, shoes, furniture, beverages grew only 1% annually during the 1962-71 period) (Dos Santos 1974, p. 470). Thus, the significant foreign debt contracted to complement part of the intense growth, was at the expense of mass consumption and social equality. Also, during the 1960s and 1970s, the external sector of Brazil was particularly affected in terms of its increased vulnerability to the international market.

Foreign investments in Brazil were increased throughout the 1960s and the 1970s due to the political conditions imposed by the military government, and the promising prospects for Brazilian products in the world market. The annual rates of growth in world trade increased three times from the beginning of the 1960s to the end of the decade. In this context, foreign capital contributed to investment in Brazil (see tables 3, 4), but they also caused an important loss of capital in the form of repatriation of profits. As Peter Evans has pointed out (1983, p. 145), as the external environment changed, so did the nature of capital flows to Brazil; in 1973, inflows of direct investment were two and a half times larger than outflows of profits, but in the late seventies, profit outflows climbed to double or triple earlier levels. Since then, "profit outflows came to represent an increasing proportion of capital inflows and the role of direct foreign investments in alleviating balance of payments declined." (Evans 1983, p. 145). Given this failure of foreign investment to provide more capital, the government began to see increasing foreign borrowing as an alternative to have a sound BOP position, given that monetary factors of the BOP would not resolve the increasing Brazilian exter-

nal needs.

The process of industrialization reached its highest achievement between 1967 and 1973 when the GDP grew by an average of 11.3% per year. By this period, Brazil had attained significant industrial development: the internal process of capital accumulation was clearly divided between a consumer goods industry and a basic capital goods industry, and the former role of Brazil as primary exporter changed to an industrial exporter during the 1960s and 1970s. In 1972 and 1973, Brazil reached the highest level of growth of the postwar period: the capital goods sector grew by 29.4% between 1971 and 1972 and 31% between 1972 and 1973, and total industrial production increased 18.2% and 15.8% respectively for those years (Hurtienne 1983, p. 122). However, that growth was based on important potential limitations as Thomas Hurtienne explains (1983, pp. 122-123):

The crisis of a half industrialized country is, in contrast, modified by the insufficiently developed means-of-production sector. The demand for capital goods grows rapidly at the end of the boom, and high proportion of these goods must be imported and paid for in foreign exchange. The boom can therefore break off prematurely when exports proceeds and foreign debt do not increase at the same pace as capital goods imports. The balance of payments bottleneck is the form in which the particular contradictions of a disproportionate structure of accumulation appear. ...In 1973, the physical limitations of the accumulation process in Brazil became apparent and were reflected in a shortage of semifinished products. The beginning of the world economic crisis in 1974 was immediately reflected ...in a breaking of the Brazilian boom.

Brazil's high growth in this period can be seen by comparing it with the historical level of growth both in Brazil and in the OECD. The growth of real GDP at market prices in Brazil was 11% in 1968 and 13.6% in 1974; in the OECD countries, it was 5.4% in 1968 and 6.1% in 1973 (see table 5). But this growth implied a significant increase in imports as can be seen in tables 6 and 7. Between 1967 and 1973, imports increased 18.3% in volume and 27.5% in value. According to Batista (1987, pp. 8, 59), this increase in imports was due both to high domestic growth and to import liberalization (the average tariff declined from 13% in 1969 to

less than 8% in 1974).

The BOP (table 6) also shows that between 1967 and 1973, exports increased significantly (13.1% in volume and 24.6% in value), that is, there was an improvement of 18.8% in the terms of trade\* for the 1968-73 period (Batista 1987, p. 8) (see tables 6, 7). The success of the Brazilian export economy was made possible in a context of growth of the international economy, and through export promotion measures. In that period, BOP showed an equilibrium in the trade account (table 6). The observed average current account deficit of US\$ 1 billion per year is connected to the service of the account deficit caused by interest payments and profit remittances with no significant increase in direct investment (Batista 1987, p. 8). Thus, the foreign debt increased only US\$ 530 million per year on average, while increased exports permitted an improvement in the debt/export ratio and the other debt indicators (see debt indicators in table 8 and graph 4). The experience of the improvement of the economic situation of Brazil in this period showed the dependency of Brazil on the favorable conditions of the world market (the world market and the international financial markets were both expanding).

According to Batista (1987, p. 11), one conclusion about the external debt expansion between 1968 and 1973 is that, debt increase was due in particular to a policy of increasing international reserves from the low levels in which they were at the beginning of the period. This policy of increasing reserves had to be implemented in order to keep up with the increasing import needs. Such a policy even permitted a high level in the accumulation of reserves that later led Brazilian authorities to increase the cost of credit in order to control the BOP surplus (Batista 1987, p. 12). Once again, this suggests that the monetary position of the BOP was moving according to the structural needs of the Brazilian economy in the period.

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\* The terms of trade are calculated by the quotient: value of exports divided by the value of imports, all multiplied by 100.



Batista (1987, p. 12) has pointed out that the increased Brazilian involvement in the international financial market with private sources of capital, was established at generally higher interest rates and shorter maturity. The average cost of foreign debt\* rose from 4.7% in 1968 to 9.6% in 1973 as shown in table 9, and graphs 2, 3. The medium and long-term maturity fell from 5.6 years in 1970 to 5.3 years in 1973. The proportion of loans with variable interest rates contracted by the public sector increased from 15.6% of the total public debt in 1971 to 34.3% in 1973, and concessional loans went from 35.8% to 20.5% (World Debt Tables, 1981; Batista 1987, p. 12). In spite of those increases, however, favorable conditions such as expanding world trade, expanding international credit, and manageable levels of interest rates, permitted the Brazilian Government to control the process of external indebtedness during the period.

Overall, the "miracle" period of 1968-73 reached a high growth level which permitted the development of a significant industrial sector, but it also had important contradictions. Carneiro (1987, p. 30) has pointed out three features of the period:

It seemed necessary to maintain a highly unequal income distribution in order to generate the structure of consumption demand in line with the continuous expansion of the durable goods sector, as well as to provide savings compatible with the increasing share of investment income.

The role of the State, ... was to keep an increasing share of the State in the process of investment -saving intermediation so that it could channel the necessary savings into infrastructure investments and the provision of basic inputs, as well as to mobilise cheap capital for private projects.

... The option of an outward-looking strategy had a double goal: to avoid the worst distortions of import-substitution industrialization and to maintain a steadily rising import capacity to prevent foreign exchange scarcity from checking the continuity of a pattern of industrial growth increasingly dependent on imports of intermediate and capital goods.

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\* The average cost of foreign debt is given by the ratio of net interest payment to outstanding net debt.

## 1974. The Weakening of the "Miracle".

By 1974, increasing global rates of profits and investment were still present, but the rates of growth of the consumer goods industry were already on the decline (Pereira 1984, p. 164), a decline which rapidly affected the other sectors of the economy. The slowdown of economic activity was first felt in the consumer goods industry, particularly in the automobile industry. As Bresser Pereira (1984, p. 164) has indicated, there was a problem of domestic underconsumption, because not only were the workers' wages very low, but, the salaries of the "technobureaucratic middle class" increased less than did profits during the boom. He points out that this is a clear result from the understanding that if consumption depends on wages and salaries, and investments depend on profits, then, though the purchasing power of workers and the salaried middle class (which was, for example, the basic market for the automobile industry) was growing, the production of these durable consumer goods was increasing at a faster rate. A problem of oversupply became clear in the fact that the durable consumer goods industry grew at the high annual rate of 23.6%, whereas average wages grew at 3.1% (Pereira 1984, pp. 164-165). In this sense, the industrial base built during the miracle had important limits within this structure of income distribution and consumption. Some areas of industrial production then became to be more oriented towards external markets.

According to Maria Conceição Tavares (cited in Pereira 1984, p. 166), tendencies towards a recession appeared first in the nondurable goods sector, given the fact that the majority of wages increased much less than output. Overall, it seems clear that the basis of the "miracle" was the tendency to decrease real wages as the main source of profits and investment, but such a model of growth had implied important limits for the development of the domestic market, and the necessary tendency in future periods was to look for external markets given that the political conditions did not allow for changes in the domestic distribu-

tion of income, and the subsequent expansion of the domestic market.

The BOP position during the period reflected the structural causes of BOP disequilibrium as opposed to other types of monetary imbalances, which remained more as the expressions of the structural developments in the economy.

## 3.2. THE PERIOD 1974-78.

## CHANGES IN THE CAUSES OF DEBT GROWTH.

## NEW EXTERNAL SHOCKS INFLUENCING THE DEBT GROWTH.

## Changes in the Causes of Debt Growth.

In 1973, the prospect of continuing the economic growth initiated in 1968 was very optimistic. This optimism was lost in December 1973 when the country was hit by the shock of the rise of oil prices to almost five times their price in 1972 (Fraga 1986, p. 11). This was the beginning of a series of external shocks which showed the structural fragility of Brazil and its BOP to external conditions. The oil shock meant, at the beginning of 1974, a rapid deterioration in the trade balance of US\$ 4.6 billion as a consequence of oil price increases even though exports were increasing (Fraga 1986, p. 12) (see table 10). The oil bill increased from US\$ 0.7 to 2.8 billion (see table 7). The new government decided in March 1974, to adjust to these conditions by continuing the process of growth instead of slowing down the process, and the alternative of depreciation of the cruzeiro also was avoided (Fraga 1986, p. 12). This policy had important implications for the future. On the one hand, it allowed the development of an important industrial base, and on the other hand, it resulted in the postponement of adjustment measures in order to deal with the external shocks. No compromise of continuing public investments, but at lower rates, was taken. A devaluation policy, together with internal measures to protect wages, could have helped to correct the trade deficit resulting from the external shocks.

Given this scenario, the only choice by which to accomplish the policy of continued high growth, was by increasing foreign borrowing. This option was available at that time because of the access to the liquidity in international financial markets. Mario H. Simonsen, Minister of Finance of the new government, had to deal with conditions of repressed prices, commod-

ity shortages, and a huge deficit in the trade balance (the result of higher oil prices). He attempted a compromised solution for the following five years of the Geisel administration with the following objectives (cited in Fraga 1986, p. 12):

- i) to adjust the BOP and to keep a good international credit standing; ii) to keep real product growing at its historical pace; iii) to control the inflation rate within acceptable limits by Brazilian standards; and iv) to promote exports growth and to reduce the foreign dependence of the country through a new program of import substitution.

The objectives of such a plan had conflicting aspects, particularly in relation to the contradiction between the reduction of inflation, on the one hand, and the reduction of the current account deficits on the other (Fraga 1986, p. 12). This type of adjustment programme was basically an overly-optimistic plan to develop a domestic infrastructure with the long-term objective of reducing the dependency on manufactured imports. But the short-term objective to have a balanced BOP, and the objective of maintaining the growth rates, were contradictory. Therefore, the only realistic possibility of carrying out the government's project was through foreign borrowing (Fraga 1986, p. 12). Thus, the orientation of the first policy to respond to the oil shock was not based on the orthodox view of adjustment. This occurred mainly because of the importance for Brazil to continue with the growth project initiated in the late sixties, and also because there was foreign capital available to finance the type of adjustment strategy based on continued growth. Thus, in part, the conditions of the international capital market permitted the postponement of an adjustment based on purely market solutions.

But in the 1974-75 period, reserves dropped because of the insufficiency of foreign exchange coming into Brazil, particularly in the form of loans. As a consequence, tight monetary policy was adopted, which together with insufficient demand from wages and salary earners, caused the sharp drop in GDP in 1974-75 (Fraga 1986, p. 12).

Since then, the emphasis has been placed on growth again, particularly through public

investment. Simultaneously, increased aggregate demand and wage indexation accelerated inflation. Tight monetary policy was adopted again in 1977 through credit limits (Fraga 1986, p. 12). The results were again a fall of 5.7% of GDP in that year. Reductions in imports and some improvement in the terms of trade, permitted the trade account to balance in 1977; yet investment fell from 25% of GDP in 1975 to 21.3% of GDP in 1977 (Fraga 1986, p. 12). In 1978, the trade account was reversed by the deterioration in terms of trade (table 7) which strongly influenced a trade deficit of US\$ 1 billion. These variations in the trade account were financed by increasing external debt. Medium and long-term debt went from US\$ 9.5 billion in 1972 to 32 billion in 1977, loans which were contracted mainly with floating interest rates (Fraga 1986, p. 13). The main characteristic of the period then, was the increased vulnerability of Brazil to variations in international interest rates, oil prices, and terms of trade.

#### The Role of External Shocks in the Increase of Foreign Debt.

Starting in 1973 with the first shock of oil price increases, Brazil underwent a process of serious deterioration of its BOP. By 1973, Brazil imported 80% of the oil it consumed (Martone 1987, p. 4). The increases in the price of oil and in the price of capital and intermediary goods added an extra US\$ 6,500 to the bill of imports (Carneiro 1988, p. 159). These factors changed the trade account from a surplus of US\$ 7 million in 1973 to a deficit of US\$ 4,690 in 1974. The Brazilian government reacted to this situation emphasizing two particular factors:

- a) the availability of capital in the international financial system with relatively low levels of real interest rates (see graph 2); and
- b) the willingness of the banks to lend, and the perspectives of future growth of exports taking into consideration the strong growth in trade in the previous five years (Carneiro 1988, p. 159).

The result was the development of an overly-optimistic view about favorable external conditions such as liquidity, low real international interest rates, and higher demand for exports. Later, this view led to the adoption of a series of policy mistakes which deepened the difficult situation brought about by the external shocks. Thus, the government planned to concentrate resources on investments (investments in productive capacity and infrastructure) in order to accelerate the import-substitution strategy, which was supposed to avoid or alleviate external shocks. The scheme was implemented, thanks to the international liquidity and the willingness of foreign banks to finance it (Carneiro 1988, p. 159).

Relatively favorable conditions were present in the 1974-78 period for the development of the scheme, (with the exception of the 1974-75 recession), because some recovery from the oil shock of 1973-74 was taking place in the domestic and world economies. During the period of high investments between 1974-78, exports grew at 13.9% per year (US\$ 7.9 billion in 1974 to 12.1 billion in 1978; see table 12) and imports were kept almost constant (Carneiro 1987, p. 34). This permitted the trade deficit to fall from US\$ 4,700 million in 1974 to 100 million in 1977 (table 10). The government was managing the BOP position according to a policy of acquiring external loans. The workability of this policy in the short run and under normal conditions of the international interest rates, was the main factor controlling the Brazilian external financial position.

Severe shocks from oil price increases, rises in international interest rates, and some decline in export rates, caused the acceleration of the debt growth. The US\$ 6.4 billion increase in the value of imports in 1974, and the fall of export growth rates from 24.6% in 1968-73 to 15.3% in the 1974-78, caused a radical change in the trade balance; it went from a position of equilibrium during 1968-73 to an average annual deficit of US\$ 2.3 billion in 1974-78 (Batista 1987, p. 15). There was also a sixfold increase of current account deficit of US\$ 972 in 1968-73 to US\$ 5,978 in 1974-78. The BOP table (table 10), shows how direct foreign investment was a weak element in the financial needs of the period. These events,

together with the extension of the growth strategy, caused a significant net foreign debt expansion from US\$ 6,156 in 1973 to US\$ 31,616 in 1974 as shown in Table 11. Batista (1987, p. 15) has pointed out that the unprecedented net debt expansion\* in the period 1974-78, was partially due to the relatively limited contribution of direct investment; net debt between 1974-78, grew at a high average rate of 38.7% per year (from US\$ 6.2 billion in 1973 to 31.6 billion in 1978), which meant a growth three times faster than the growth of the current account deficit in the 1968-73 period. Similarly, gross external debt\*\* grew faster (25.1% per year during 1968-73 and 28.2% in 1974-78) due to the rapid growth of net debt and the increase in the reserve level (Batista 1987, p. 15), see tables 1, 11.

Brazilian public sector borrowing became the most important element of the higher total debt (through the borrowing of public enterprises, federal government, public agencies). The share of public and publicly-guaranteed debt in medium and long-term debt went from 51.7% in 1973 to 63.3% in 1978 (Batista idem, p. 23). Favorable factors such as international liquidity and relatively low interest rates, were not advantageous in the medium and long-term because the higher participation of private sources (commercial banks) became the main lending source, and, with that development, the cost of foreign debt increased (Batista 1987, p. 24). As table 8 shows, the debt indicators deteriorated given the size of the debt and the conditions mentioned above.

The basic changes in the nature of external indebtedness (Batista idem, p. 18) after 1974 were as follows:

- 1) the high increase of net debt (net debt represented 82% of the increase in the

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\* Increases in net foreign debt are basically excess of current account deficits and net lending to nonresidents (including capital flight) over net direct investment.

\*\* Increases in total foreign debt are:  $GD = CA + L - DI + R$   
 where GD = gross foreign debt; CA = current account deficit; L = net lending to nonresidents (including capital flight); DI = net direct investment; and R = international reserves of the monetary authority.



gross medium and long-term debt in 1973-78);

- 2) external debt increases also were strongly influenced by the shock of oil prices;
- 3) the deterioration of the terms of trade; and
- 4) the slowdown of international trade.

Table 7 shows the terms of trade for Brazil which changed from a period of improvement during 1968-73, to a complete deterioration from 1977 to 1983, when the terms of trade fell from 100 in 1977 to 63 by 1983. Under these serious conditions in the external sector, economic policy continued to be focused on the growth project. Thus, for many economists, the fast growth of external debt was also due to the type of economic policy adopted (Batista 1987, p. 20); that is, expansion of net debt was also a result of the decision to spread adjustment to external shocks over time following a "gradualist balance of payment policy." (Batista 1987, p. 20). In the overall period, 1974-78, the rates of growth of Brazil and the OECD countries showed a significant process of deceleration, falling from 11% and 4.8% respectively, to 7.1% and 2.6% (see table 5). However, the Brazilian rates were seen as being very high in the context of a depressed international economy. Table 4 shows how gross capital formation was financed with more external resources. That is, the ratio given by imports minus exports over gross capital formation, went from 5.3 in the 1970-73 period, to 7.9 in the 1974-78 period. The absorption of real resources then changed significantly from 1968-73 (1.4%) to the 1974-78 period (2.4%).

The model of growth and industrialization used in 1968-73 which was based on keeping real wages low so as to increase profits and investments, worked well under conditions of improvement in the external sector of the Brazilian economy. But, when these conditions were no longer present in 1974-78 due to the strong external shocks, such a model, having most of the sources of capital formation in the domestic economy, was no longer feasible.

Thus, the prerequisite for Brazil to continue its industrialization and growth (under the conditions of 1974-78), was to increase the financing of the process through external

resources. External resources became one central source of economic growth in the period (in fact, the rate of investment rose from 26.3% in 1970-73 to 29.6% in 1974-78). But that high rate of capital formation was possible, not only through increasing external debt (table 2), but also possibly through a reduction of aggregate consumption (Batista *idem*, pp. 21, 23); aggregate consumption was reduced from 75.1% of GDP in 1970-73 to 72.8% in 1974-78. The main goal of the growth strategy of 1974-78 was to expand and diversify the industrial sector in order to substitute the dependency on imports of capital goods and raw materials. Thus export promotion policies did not have the top priority in the period. In fact, Brazilian exports fell from an average of 7.1% of GDP during the 1970-73 period to 6.7% in the 1974-78 period. The policy to contract more external debt (particularly by the public sector) led to a serious increase of the external debt. This was particularly dangerous in the hostile external environment of the period when international interest rates started to increase, protectionism was increasing, the international economy was slowing down, and terms of trade were deteriorating for Brazil. All of this, plus a total debt that had reached US\$ 46,467 millions in 1978 resulted in the fact that, "by 1977-78, external indebtedness had become a largely self-reinforcing process, with net interest payments accounting for almost 50% of the deficit on current account" (Batista 1987, p. 24).

One of the consequences of adopting the policy of structural adjustment for long-run growth, was the resurgence of a potentially highly inflationary economy similar to what Brazil had experienced during the 1950s and 1960s. Thus, the effectiveness of the strategy of adjustment (which was to increase internal productive capacity through external debt) had two main limitations:

- a) the increased vulnerability of the domestic economy to the international market; and
- b) the possibility of developing hyperinflation through the huge external and internal public debt, which were increasing the public deficit, and the high international interest rates were the main factor causing the instability of such a model of growth.

The monetarist view failed to recognize that there was a self-reinforcing process of high

inflation through the policy of high interest rates. That is, the high level of interest rates were increasing the public deficit, and, through that, came the higher pressures to increase money supply.

The particular characteristics of inflation and unemployment experienced in the world economy in the seventies, were also present in the Brazilian economy in the early 1980s. But in Brazil's case, the causes of those problems were mainly exogenous to the country. In particular, the level of economic activity was strongly determined by the international interest rates, the macroeconomic policy of the major industrialized countries, and the contraction of international trade. High international interest rates caused a serious increase in the Brazilian public deficit needed to service the large public debt, which, in turn, was a central factor pushing inflation and other imbalances in the economy. This will be analysed later.

#### Consequences of Inflation.

High levels of inflation caused important changes in the Brazilian economy. An indexation policy was adopted in the 1960s to correct the effects of inflation on savings and financial instruments. This was done by an increased financial role of the government by fixing limits of monetary correction on financial assets. The complete monetary correction for holders of financial assets meant giving special subsidies when the inflation rate increased above the fixed levels (Carneiro 1988, pp. 160,161).

Through indexation, inflation became an autonomous problem, that is, previous inflation rates increased current prices via the indexation programmes. Also inflation was growing exogenously because the monetary aggregates were essentially exogenous as the government was issuing bonds and money according to its increased financial needs (Carneiro 1988, p. 161). All of these increased the financial instability of the economy.

Given that the reduction of public investments could drive the economy towards a very deep recession and unemployment, a policy of control of aggregate demand was adopted instead of cutting public investment (Carneiro 1988, p. 161). Demand management policy was not used in the sense of traditional stabilization programmes, but rather as a way to rationalize expenditure. However, the economy received recessionary impacts from other factors. As a result of the inflationary pressures introduced into the economy by the exogenous factor of high international interest rates, these high rates set off a chain reaction in the Brazilian economy: they caused higher debt service which reduced domestic funds and international reserves; as a result, devaluation was accelerated which increased domestic interest rates, which in turn increased the international and domestic burden of the debt. Also, the financial system was developed in the sense of increasing financial investment rather than productive investment.

The 1974-78 period was very important in that it marked the beginning of a series of external shocks that were going to hit the Brazilian economy, and the beginning of the adjustment policy which was implemented in that period. In the view of many analysts, Brazil made a fundamental mistake in its adjustment policy by not slowing down its rates of growth given the oil shocks. However, the Brazilian answer to further develop the import substitution strategy by increasing investment in the area of intermediary and capital goods, was very difficult to avoid. Given the strategic importance of Brazil developing those areas, and given the conditions of liquidity and low (even negative) international interest rates (see graph 2), it appeared justifiable to expand the external debt to develop the productive capacity of the country, that later proved to have enormous potential. However, important policy mistakes were made in terms of the expectations about trade, interest rates, and the high rates of growth targeted. The fundamental weaknesses of such a process were the high vulnerability of Brazil to external factors (the deterioration in the terms of trade, the changes in international interest rates, and the level of activity in external markets for the demand of Brazilian exports), and the highly unequal distribution of income.

### 3.3. THE 1979-82 PERIOD.

#### SECOND ROUND OF EXTERNAL SHOCKS.

#### THE DETERIORATION OF EXTERNAL CONDITIONS.

##### General Conditions in 1979.

In 1979, a second round of oil price increases hit the Brazilian economy and created a very unfavorable external environment which resulted in a considerable deterioration of the BOP position. Given the inflationary pressures on most of the OECD countries, the developed countries adopted anti-inflationary policies which further worsened the recessive conditions that were appearing in the international economy. Thus, the period starting in 1979 with the second oil shock, was characterized by higher international interest rates (particularly in the USA), deterioration in the Brazilian terms of trade, higher domestic and international rates of inflation, and increasing protectionism in the industrialized countries. Also, at the domestic level, the labor movement was pressing for a wage increase (particularly in the Sao Paulo region), in the context of measures of pre-announced exchange rate devaluation exceeding inflation rates (Carneiro 1987, pp. 35-36).

The second oil shock and the unfavorable external conditions made the way in which Brazil was planning its growth questionable. After the shock in 1979, the Planning Minister, Mario Simonsen, tried to adopt a restrictive macroeconomic policy consisting of real devaluations, increases in agricultural prices, and limits to wage increases (Carneiro 1987, pp. 35-36). The main goals of these measures were to arrest the deterioration of the country's rating on the international financial market. Another objective of the new government of President Figueiredo, who came to power in 1979, was the transition from the period of military governments to a democratic civilian system (Carneiro 1987, p. 35). This important political need of the Brazilian system was a central factor which limited the adoption of the orthodox anti-inflationary programme in 1979, because of its highly unpopular characteristics.

The opposition to the orthodox stabilization programme was fully expressed when Del-fin Netto replaced Mario Simonsen as Minister of Planning. Simonsen favored the orthodox approach of stabilization, whereas Netto proposed a growth strategy as the main goal of economic policy, which could also lead to the correction of the BOP disequilibrium (Carneiro 1987, p. 36).

The new economic team headed by D. Netto seemed to be heterodox in its approach (Carneiro 1987, p. 38): initially they maintained that inflationary pressures would not justify contractionary economic policies, and that the government would tolerate higher current account deficits of the BOP if international finance was available. All of this aimed at accelerating investment which would lead to import substitution (to increase the domestic production of oil) and the expansion of the export capacity. Also, the new programme tried to stop labor strikes through increasing the degree of wage indexation.

The pre-announcement of the exchange-rate correction and indexation were measures aimed at reaching two objectives (Carneiro 1987, p. 39): 1) to bring down expected inflation, and 2) to promote a real devaluation. Exchange-rate correction was targeted at 40% and indexation was targeted at 45% for the coming year of 1980. However, by the second half of 1979, the economic policy of the new economic authorities had not kept inflation under control. Prices increased from 56% in the first half of 1979 to 101.3% in the second half and the currency was devalued by 22% at the end of the year. According to Carneiro (1987, pp. 39, 63), this macroeconomic policy had resulted in a "tragic blunder". It was tragic in the sense that its failure strengthened the position of those favoring an orthodox programme based on a recession, as the means to fight inflation and to stop the growth of the external debt. Thus, the monetarist view and the austerity approach were gaining ground as "alternatives" to the heterodox programmes.

The trade deficit increased about US\$ 1 billion per year after 1979-80, and there was a deficit in the current account over US\$ 11 billion for that period (Batista 1987, p. 32). In 1982, the deficit of the current account rose to US\$ 15 billion mainly as a result of the increase in

international interest rates (see graph 2, and tables 9, 13), and the sharp deterioration in the terms of trade between 1978 and 1983 (table 7).

### The Role of Changes in International Interest Rates.

One of the most destabilizing factors for Brazil in the 1979-82 period was the increase of international interest rates to historically high levels. These rates were one of the most important problems in the period, not only in terms of increasing the domestic public deficit and the need for more capital to finance that deficit, but also in terms of the drain of capital from the domestic economy going abroad in the form of payments of interests on the debt. According to Batista (1987 pp. 27, 28), the basic difference between the external shocks of 1974-78 and those of 1979-82 was the behavior of international interest rates. For example, the interest rates on Eurodollar deposits rose in nominal terms from 8.1% in 1974-78 to 14.0% in 1978-82, or from 0.7 to 5.3% in real terms. Those rates were the main destabilizing factor for Brazil after 1979 because of their direct impact on interest payments, and their numerous negative effects on (Batista 1987, p. 28): i) the prices of primary products exported by Brazil; ii) the level of economic activity in industrialized countries; and iii) the import capacity of developing countries and East European countries for Brazilian products (see table 5 for growth rates of OECD countries in the period).

The increase in international interest rates was caused, particularly, by the monetarist policy of the industrialized countries which was to fight inflation in their economies through high interest rates. In this sense, this policy itself was a central factor determining higher public deficits and inflationary pressures. Thus, another influence of that policy of high interest rates was to affect the markets of Brazilian exports negatively.

As was indicated earlier, the increased vulnerability of the Brazilian foreign debt to variations of international interest rates after 1979 was associated with a larger share of floating

or variable interest rates of commercial banks, which had become the main source of credit, see table 2, and to the concentration of the debt, about three-quarters of which was borrowed in US dollars (Batista 1987, p. 28). Table 9 shows the important effects of higher interest rates on increasing interest payments from US\$ 2,696 million in 1978 to 11,353 million in 1982; that is, the average cost in real terms\* changed from 3.3% in 1978 to 14.2% in 1982 (Batista 1987, p. 28). As a consequence of this sharp increase in the interest payment, the current account deficit continued to rise. The overall impact of the external shocks --recession, changes in the terms of trade, interest rates, and exchange rates-- on the developing countries was devastating and asymmetrical (compared with their impact on developed countries) (Miller 1986, p. 103). For Brazil, the oil and interest effect (cumulative effect in billions of US dollars) was 3.6 in 1979, 11.7 in 1980, 23.5 in 1981 and 34.8 in 1982 (Miller 1986, p. 106).

### 3.4. BRAZIL'S OWN ORTHODOX STABILIZATION PROGRAM 1980-82.

In order to correct the imbalances caused by high international interest rates, a new stabilization policy was adopted. The adoption of an orthodox type of stabilization policy without IMF surveillance, at the end of 1980, was possible according to Bacha (1983) and Carneiro (1988) because of two main factors: 1) the Brazilian Government was afraid that the IMF option required drastic changes in the long-run structural adjustment strategy which would have reduced the degree of freedom of the economic policy; and 2) the negotiations

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\* N. Batista mentions that these estimates only include interest related to short-term debt, if the short-term debt of Brazilian residents is included, the average cost of debt would be 9.5% in 1978 and 16.8% in 1982 in nominal terms, and 2.0% to 10.2% in real terms (Batista 1987, pp. 28, 62).



with the IMF could endanger the domestic political support for the Government which was already very weak. According to Bacha, this action of adopting an orthodox stabilization policy without IMF support, cost about US\$ 400 million because the Brazilian Government had to pay higher interest rates to the private banks than they would have paid the IMF.

Chacel (1985, p. 71) explains the emotional view with which a large proportion of the Brazilian society views the role performed by the IMF. Brazilian society has mistrusted the IMF since the late 1950s. At that time, there was a dramatic break-up of negotiations between President Kubitschek and the IMF about an IMF's orthodox program, which was contradictory to the plans of fast economic growth of Brazil (Chacel 1985, p. 71). Since then, the general view of the IMF within Brazilian society is that it is an organization under the policy of the developed countries, and which carries out restraining aggregate demand and austerity programs that lead to recession, even in countries with already high unemployment (Chacel 1985, p. 71). That has also been interpreted as a demand for the surrender of national sovereignty. Thus, in the view of a large proportion of Brazilian society, who believe that the State plays an essential role in sustaining the process of economic growth, the IMF policies represent a radical economic, political, and social option to establish complete free-market conditions.

#### Demand Contraction Policy in 1980.

The two main objectives of the demand contraction policy in 1980 were (Carneiro 1988, p. 162):

- 1) to control the trade account (so as to show the banks that Brazil had control of the difficult situation in the short-term); and
- 2) to keep some control on the process of expansion of the public debt. This was to permit the maturity of the long-run investment projects started earlier, in order to increase exports

and substitute imports.

This approach by generalizing aggregate demand as the main cause of inflation and the trade deficit, directed the stabilization policy in a way in which other central factors, such as external factors and, in particular, the role of interest rates, did not receive proper consideration.

The viability of the strategy of growth through foreign debt was weakened in early 1980s in both aspects of the economy: a) on the domestic side, growth was limited by the increase of inflation, the increase of public deficits, and the concentration of income distribution; and b) on the external side, it was restricted by the slowdown of international trade and exports, the deterioration in terms of trade, and the increase of interest rates (Carneiro 1988, p. 163). At the end of 1980, this situation had deteriorated further and it became more evident that Brazil's external situation depended on the availability of external finance.

The new economic team of D. Netto in 1979 considered that inflationary pressures could be solved without contractionary domestic policies, by using the foreign financing available to accelerate investment through the means of import substitution and export promotion, in addition to agricultural incentives (Carneiro 1987, p. 36). The strong labor demands also forced the Government to modify the law of wage adjustment and a higher degree of wage indexation was adopted, and, as a consequence, the inflationary pressures increased. The rise in agricultural prices, the rise in products derived from oil, the rise in prices of goods and services from the public sector, and increases in nominal wages caused inflation to increase from 56% in the first half of 1979, to 101.3% in the second half of 1979 (Carneiro 1987, pp. 38, 39). This was aggravated by the decision to pre-announce exchange-rate correction and indexation (both were implemented to stop the speculation on maxi-devaluation). The consequences of all of these policies were considerable. In addition to higher inflation, the exchange rate appreciated by 3% in 1980, imports rose US\$ 5 billion (9.2% of GDP) in 1980, the trade deficit was not reduced by the increase of exports, American interest rates rose more than 6% from the 1978 level (interest payments rose from US\$ 2.7 billion in 1978 to 6.3 billion in 1980), and the current account rose to 12.8 billion in 1980 (Carneiro 1987, pp. 39,

41, 42). An immediate result of this situation was the distrust by the international financial community of Brazilian macroeconomic policy. This caused the government to introduce a complete change to a more orthodox short-term plan before the end of 1980 (Carneiro 1988, p. 162). This was to show international banks and agencies the willingness of Brazil to follow the traditional pattern of adjustment. The orthodox approach of demand control was used through a monetary policy of control on credit expansion.

Carneiro (1987, p. 43) explains that the old-fashioned monetary policy of ceilings on credit growth, was seen as the effective anti-inflationary policy, in which there was a great concern with the size of the monetary base, and a policy of high interest rates to prevent private capital from borrowing abroad. All of these "led to a disastrous policy of financing government needs by selling more and more government bonds to the private sector" (Carneiro 1987, p. 43), and this was done in spite of the well-known resistance of an indexed economy to respond to these monetary controls. The result of this policy of monetary contraction was that all monetary and non-monetary financial aggregates fell (in real terms); the monetary base dropped by 22.9%, conventional M1 by 21%, total financial assets by 2.2%, and total loans to the private sector by 11.3% (Carneiro 1987, p. 64). However, the estimated public deficit went up from 5.1% to 9.1% of GDP in nominal terms, and from 0.9 to 5.2% of GDP when adjusted for inflation (Carneiro 1987, p. 64).

By 1981, the restrictive demand policy without IMF surveillance for the 1981-82 period, was composed of the following elements of macroeconomic management (Carneiro 1987, p. 43):

- i) state enterprise capital expenditure was to be cut in order to control the broadly-defined government deficit as well as to adjust public sector imports to a predetermined budget\*;

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\* Carneiro (1987) and Wernek (1985) mention that state enterprises had been used as absorbers of foreign finance needed for balance of payments reasons in the previous period and were induced to borrow far beyond their individual needs. The attempts to

- ii) loans to the private sector were subjected to a ceiling of 50 percent over nominal value of December 1980 (over their nominal value in December 1980)
- iii) lending interest rates were freed from controls except for loans to the agricultural sector and special credit to exporters;
- iv) the nominal growth of means of payments and the monetary base were limited to 50 per cent;
- v) tax incentives to manufactured exports that had been removed since the exchange devaluation of December 1979 were reinstated.

The particular concern of the 1981-82 stabilization program was the reduction of domestic absorption of foreign resources in order to reduce the foreign exchange needs and to control domestic inflation (Carneiro 1987, p. 43). However, these restrictive policies could not reduce the levels of inflation from 1981 to 1982. Instead, the general index of prices went from 95.2% in 1981 to 99.7% in 1982 (and to 211.6% in 1983). A good performance of the agricultural sector in 1981 permitted a decline in agricultural prices which also contributed to a decline in industrial prices (Carneiro 1987, p. 44). The restrictive monetarist policies of reducing the monetary base and reducing domestic credit in the 1980-81 period, had practically zero effect on reducing inflation, but they did push the economy into a deep recession. Industrial output fell 5.4% in 1981, and the rates of real growth of GDP fell from 7.2% in 1980 to -1.6% in 1981, 0.9% in 1982, and -3.2% in 1983. Carneiro (1987, p. 45) points out that "doubts as to the usefulness of the recession were raised even in conservative minds", particularly when capital inflows decreased and foreign reserves hardly increased. The limitations of the restrictive orthodox policies became more evident during the 1982 world recession, which was also accompanied by the re-emergence of inflation in Brazil.

In spite of the considerable role played by the external shocks in forcing Brazil into the payment crisis of 1982, it is also important to recognize the central role played by the

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control their deficits or borrowing requirements after 1981 were a repeated menace to the continuation of investment programs that were urgently needed for the adjustment of the Brazilian productive capacity (Carneiro 1987, p. 64).

domestic policy. For these were the essential factors of the process: the combination the external shocks which were out of domestic control, together with the domestic policy of trying to sustain growth, and the domestic inflation which brought about a highly indexed economy. Such external and domestic problems were also the conditions which generated the most serious recession in Brazil since the Great Depression of the 1930s.

### 3.5. THE OUTWARD TRANSFER OF REAL RESOURCES FROM BRAZIL.

In the period 1979-82, more external debt was required to finance the higher current account deficits. The fall in the reserves made the net debt increase faster ( 20.3% for 1978-82) than the gross debt (12.7%) (Batista 1987, p. 32). The ratio net debt/exports increased from 249.8% in 1978 to 328.1% in 1982, and the ratio net debt/GDP increased from 15.2% in 1978 to 23.5% in 1982 (tables 8, 11).

#### The Sharp Decrease of Transfer of Real Resources to Brazil 1978-82.

It seems that the financing of current account deficits in the 1978-82 period was a transfer of real resources to Brazil. However, this view does not reflect the reality of net transfers because in fact the increase in the current account deficits was not the absorption of real resources from abroad. Rather, the factors increasing the current account deficits were as follows (Batista 1987, pp. 39,40):

First, variable interest rates and relatively high dollar inflation meant that total nominal interest payments included a compensation to the lenders for the erosion of the real value of the debt; current account deficits were therefore significantly inflated by the

fact that repayments of principal were partly transferred from the capital account to the current account. Second, higher current account deficits were largely associated with substantial increase in factor payments to nonresidents and not to higher net imports of goods and nonfactor services. Third, the increased current account deficit also reflected the deterioration in the terms of trade. As a result of increasing factor payments and declining terms of trade, domestic income diminished significantly as a proportion of GDP in this period.

Thus, between 1979 and 1982, Brazil did not benefit from the real transfer of resources from abroad. Tables 4 and 13 show how financial flows and current account deficits were not only used for domestic absorption in Brazil, that is, for consumption or capital formation. Instead, they represented also the outflow of capital to industrialized countries\*, and so Brazilian capital formation in that period was financed principally with domestic resources. Batista has also calculated that "the outward transfer of resources effected in 1981-83 was much more significant as a proportion of domestic output than the inward transfer, obtained in the mid-1970s"(1987, p. 40). Table 4 shows that fixed capital formation had declined from 27.9% of GDP for the 1974-78 period to 23.5% in 1979-83 period, as the result of the reduction in the absorption of resources and an increase in consumption as percentage of GDP, 72.8% for 1974-78 and 74.5% for 1979-83.

#### Outward Transfer of Resources by Export Promotion.

The adjustment view adopted in these difficult conditions after 1979, was to increase exports as much as possible and to reduce imports (the 1974-78 period, exports were 6.7% of GDP and increased to 8.7% for 1979-83, whereas imports were 9.1% in 1974-78 and were

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\* Outward transfer of resources are measured by the excess of exports over imports of goods and nonfactor services in constant prices (it increased from 0.4% of GDP in 1980 to 3% in 1981-82 and to 5% in 1983) (Batista idem, p. 40).

decreased to 6.7% for 1979-83). Also, Brazilian exports, as a share of world exports of manufactures grew from 0.26% in 1968-73 to 0.55% in 1974-78 and 0.90% in 1979-82, and its share of total world exports went from 1.18% to 1.09% and 1.17% in the same periods (GATT, IMF, Batista 1987, p. 43). However, this increase in the volume of exports for the 1979-82 period occurred in the context of deterioration in its terms of trade, and this is why it did not represent a short and medium-term alternative for the BOP crisis of 1979-82.

This shows that the revenue from the export of manufactured goods has tended to decline, as more and more countries have been entering into the production of traditional manufactured goods for domestic and external markets. This has caused a tendency to depress the prices of manufactured goods and to decrease the revenue from exports of that type. In the Brazilian case, this also suggests that the increase in the volume of exports of manufactured goods barely compensated for the decline in revenue from exports of traditional manufacture. The IMF policy of export promotion, then, not only has the possibility to produce an oversupply of certain traditional manufactured goods, as more and more countries are forced to follow such scheme, but it can also accelerate the declining tendency of revenue from the exports of traditional manufactured goods.

Since the end of 1981, different factors triggered the debt crisis of 1982: exports fell from US\$ 3,118 million between 1981 and 1982; the amount due on payments of interests and other services rose; the current account deficit thus rose from US\$ 10,993 in 1981 to US\$ 14,755 in 1982 (table 13); international reserves fell to almost zero; and international credit declined as result of the Mexican debt crisis in 1982. As a consequence, Brazil was in fact unable to service its external debt and, therefore, required an immediate rescheduling of its debt and access to new credit by the end of 1982.

#### CHAPTER 4.

#### 1982: THE DEEPENING OF THE DEBT CRISIS AND THE RESULTING ADJUSTMENT PROCESS.

Between 1981 and 1984, during the crisis of payments, there were two phases in the adjustment policy of the Brazilian Government:

- 1) between 1981-83, a policy of reduction of imports was adopted; and
- 2) after 1984, when international markets were favourable, a stronger policy of export promotion was implemented. (Martone 1987, p. 22). This strategy resulted in a net transfer of real resources from Brazil to the creditor countries at a time when there was a sharp drop of most of the capital inflow into Brazil. In this sense, the adjustment policy of 1981-84 meant an increasing transfer coefficient (Martone 1987, p. 22).

The Government's statements that there were no negotiations with the IMF prior to the elections of the Brazilian Congress in November 1982 (Carneiro 1987, p. 48), later proved inaccurate when they announced on November 20, that they had presented a letter of intent to the IMF and that an agreement had been reached with a group of commercial banks. The agreement consisted of the rescheduling of payments due in 1983 and new lines of short-term credit. The four projects of the agreement were (Chacel 1985, p. 73):

- a) New loans to the amount of US\$ 4.4 billion to be granted by foreign commercial banks in proportion to their share of the pre-existing debt;
- b) the automatic renewal of US\$ 4 billion due to be amortized during the year 1983;
- c) the preservation of short-term commercial credit lines estimated by the central bank to be of the order of US\$ 8.8 billion; and
- d) the restoration of 10 billion of inter-bank credit lines for Brazilian banks abroad.

Carneiro (1988, p. 167) explains that after 1982, when the voluntary borrowing had disappeared, the relationship between Brazil and the international financial community had



changed. At first, Brazil had to demonstrate the use of austerity measures in order to calm the concerns of the commercial banks. Later on, Brazil was pressured to agree with the IMF about macroeconomic and commercial policies (Carneiro 1988, p. 167). This development opened a new period of negotiations between Brazil and the international financial community. In this new period of negotiations, Brazil had to agree with the IMF about a package of macroeconomic policies, and only after that, was a general agreement with the commercial banks going to be reached (Carneiro 1988, p. 167).

The rescue package which was based on the four points listed above, provided funds according to forecasts for the current and capital accounts of the BOP. Such projections were established considering Brazil's commitment to generate an unprecedented US\$ 6 billion trade surplus and a reduction of over 50% in the current account deficit in 1983. It is generally agreed that such a forecast constituted a key weakness of the program, as it was based on the unrealistic assumptions that:

- a) foreign banks were going to maintain and increase their short-term lending, and
- b) that Brazil was able to accomplish all the goals it had set (Batista 1985, pp. 283, 284).

But neither the goals were achieved nor were the medium and long-term financial resources enough, and the dependency on short-term emergency loans was increased. For the Brazilian authorities (as for the Mexican Government), the problems of the country in 1982 were short-term or temporary liquidity problems. Suspension of bank credit was also understood as a temporary measure. But at the end of 1983, it was recognized that a more substantial problem was present when in December of 1983, US\$ 2.3 billion in payment arrears had accumulated and the need for new money was even more urgent (Batista 1987, p. 44). A trade surplus of US\$ 6,470 million in 1983 was achieved (from an 8.8% increase in exports in 1982 as percentage of GDP to 10.3% in 1983, and a decrease in imports from 6.2% in 1982 to 5.3% in 1983 as shown in table 7, 13; graph 5). This trade surplus helped to avoid a worse liquidity crisis, but it caused a strong reduction in domestic expenditure compared to domestic output. As a result, there was an outward transfer of resources equivalent to 5% of total domestic

output going abroad as factor payments (Batista 1987, p. 45). For the most part, these factor payments were payments of interests on the debt (Batista 1987, p. 45). The magnitude of this problem was very strong and contradictory: national income declined, inflation increased from 96.5% in 1982 to 144.5% in 1983, and the growth of real GDP fell from 0.9% in 1982 to -3.2% in 1983\*. Given these results, negotiations for a new type of package began by mid 1983, to be implemented in 1984 (Batista 1987, p. 45). Consequently, these negotiations –the first such negotiations on the debt crisis both for Brazil and the IMF–, proved to be highly experimental and errors in judgement were made about the nature of the debt crisis (see Batista 1985).

In addition to the structural problems of the Brazilian external sector, the new factor destabilizing the BOP position was the burden of servicing the debt. Thus, Brazil's external disequilibrium became a more complex problem for which the orthodox approach to stabilization was offering a narrow and limited analysis.

#### 4.1. 1983-84 'THE MUDDLING THROUGH SCHEME'.

##### The First Letter of Intent to the IMF.

By the end of 1982, the short-term critical conditions caused Brazil to seek solutions through a negotiation process instead of looking for short-term market measures (Carneiro 1987, p. 48). The need to prevent debt repudiation or other types of radical measures by the debtors moved the IMF to adopt a "muddling-through" strategy of case by case negotiations with each individual debtor country. The participation of Brazil in this strategy was essential

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\* for the first time after many years of sustained and high growth, Brazil experienced such a sharp recession.

for the IMF and the banks, due to the size of the debt and its repercussions on the international financial system (Carneiro 1987, p. 48).

The negotiations between Brazil and the IMF illustrated a difficult process of confrontation between two opposing views. On the one hand, the Brazilian government had followed a policy of sustained growth based on the central role of the State in the economy, both at the investment and policy levels. Inflation was accepted as a natural price to pay for the enormous requirements of growth, and that generated a highly indexed economy. On the other hand, the IMF had an orthodox view of stabilization which was based on a high conditionality of its financial assistance, and the special package of macroeconomic policies based on the neoclassical paradigm of free market solutions. The view implicit in the IMF adjustment policy is essentially based on the belief that the mechanism of free-market competition drives the economy along a stable path of growth. That is, it is the mechanism of market prices in free market conditions of perfect competition which allocates resources in the most efficient manner.

The IMF supervision of macroeconomic policies in Brazil between 1982-85, is a history of difficult negotiations in which seven letters of intent were presented by the Brazilian Government (Carneiro 1987, p. 49), all of which proved to be unrealistic in their assumptions and expectations.

The first letter was presented by Brazil to the IMF on January 3, 1983 (Carneiro 1988, p. 168). In it, Brazil requested new credits within the IMF Extended Financing Facility, and assumed the commitment to adopt a stabilization program to eliminate the external and domestic disequilibria for the period 1983-85, by controlling the internal absorption, that is, by reducing consumption and investment. There were a number of problems within this first letter, as Carneiro (1988, pp. 168, 169) has pointed out:

- 1) the three year program (1983-85) was a structural adjustment program which was narrow in scope because it was based only on orthodox considerations of cutting public investment, a

series of minidevaluations, and liberalization and correction of domestic prices, as measures to increase exports. In that program, there was no consideration of the fact that the fall in exports in the previous period was due to the international recession.

2) There was no consideration of the problem of the indexation of the economy, and of the failure of the 1981-82 orthodox anti-inflationary program of demand contraction. Therefore, once again the Government adopted the policy of domestic credit control by setting limits to credit for the public sector.

3) The goals for loans to the public sector and for growth of domestic credit were arbitrary and inadequate.

4) By far, the fiscal objectives were the most serious problems. The objectives of public expenditure were not realistic and viable. Here, there was a serious problem in the unwillingness the IMF staff to consider the implications of a public debt, which was indexed to high inflation rates, in order to set realistic objectives of cuts in the public deficit. Also the IMF staff worked under the assumption that demand control policies were effective, and in accordance with that, their long-term goals of lower inflation and a reduced public deficit did not take into account the reality of an economy which was not responding to the stabilization policies (Carneiro 1988, pp. 168, 169).

As a consequence, the program proved to be ill-conceived and unrealistic. The assumption about both the performance of the domestic and the international economies was inappropriate. In particular the programme was unrealistic in not giving proper consideration to the fact that the huge public debt was indexed to the inflation level (Carneiro 1988, p. 170). The treasury bonds and the other debt instruments of the government, had to be indexed to inflation in order to survive as financial instruments. This caused the huge public debt to grow at a very accelerated pace. Yet, within the IMF programme, only the need to reduce the large public deficit was given adequate consideration, while the attention given to the factors which increased the public deficit was not far-reaching enough. The IMF approach also seemed to lack proper understanding of the fact that, in the conditions of a highly indexed economy, the

effectiveness of the anti-inflation policy of demand control decreases (Carneiro 1988, p. 170).

#### Devaluation and Second Letter of Intent.

Since 1968, Brazil adopted a minidevaluation scheme (defined from the purchasing power criterion) in order to keep relative prices in a constant relationship with the US dollar (Martone 1987, p. 14). Between 1968 and 1972, the real exchange rate remained stable, and it appreciated after the 1973 period (when minidevaluation was used to stabilize inflation) due to the following factors: the depreciation of the US dollar (between 1971-78); the availability of external financing; an increase in trade taxes and subsidies after 1974 (Martone 1987, p. 16). After 1974, an activist commercial policy (of increased tariffs on imports and tax premiums on manufactured exports) permitted a multiple exchange rate regime until 1983, when a multiple exchange rate was used to move resources from the domestic to the tradable sector (Martone 1987, p. 16). An active exchange policy, which removed barriers and tax premiums on exports, and which was achieved through maxidevaluation by 30% in 1979, failed to stabilize the external sector; after that experience, a devaluation policy more or less equal to inflation was followed (Martone 1987, pp. 16, 17).

Due to the crisis of payments in 1982, there was a maxidevaluation of 30% on February 18, 1983, to accelerate the adjustment of the external sector (Carneiro 1988, p. 170). This devaluation moved the government to present a second letter of intent to the IMF one week later, on February 24, which took into account the conditions after the devaluation. The maxidevaluation introduced certain changes in the economic policy: first, the public debt was indexed to the devaluation of the exchange rate; and secondly, the government tried to de-index wages in order to maintain the effects of the devaluation (Carneiro 1988, p. 170). In the government's view, indexed wages would be an offsetting factor of the devaluation policies. Thus, that policy not only tried to cut imports and promote exports through a devaluation

policy, but it was also trying to increase the competitiveness of Brazilian exports by reducing real wages.

A central element of this policy was to increase interest rates in order to avoid capital flight. High interest rates on public bonds kept capital in the domestic economy. This policy succeeded in avoiding capital flight, which was a central difference between Brazil and other Latin American countries, the Mexican case being a clear example, after 1982. However, the policy of high interest rates had negative consequences in increasing the service of the domestic and external public debt, in increasing the public deficit (and through that, increasing inflationary pressures), as well as producing recessive effects on the economy.

All of these conditions were particularly negative for wages, which, together with the policy of wage de-indexation, caused a real wage decline; according to Carneiro (1988, pp. 170-171), real average wages of the industrial sector fell 14% in 1982-83 alone (see table 15 and graph 1 to observe the declining trend of real minimum wage in Sao Paulo since 1982).

#### 4.2. THE ROLE OF WAGE DE-INDEXATION IN THE NEGOTIATIONS OF FINANCIAL AGREEMENTS.

##### The Third Letter of Intent.

Wage de-indexation seemed to be a very important element in the negotiations between Brazil and the IMF, even though it was not officially recognized as a topic of negotiation (Carneiro 1988, p. 171). In fact, throughout 1983, Brazil had met all the external goals set for the agreement with the IMF. However, for the IMF that was not enough. In its view, a higher wage de-indexation was necessary. Only after the Brazilian President introduced some changes in labor regulations, after the publication of Bill 2045 (to reduce wage de-indexation), the

directory of the IMF approved the third letter of intent on September 15, 1983 (Carneiro 1988, p. 171).

#### Fourth Letter of Intent.

#### 1983-84 'Muddling Through' Recovery.

The fourth letter of intent, presented on November 14, 1983 had less strict domestic targets (Carneiro 1988, p. 171). By 1983, GDP fell by 3.2% and industrial production by 5.5%; that is, the contractionary policy was 'working', but without stopping inflation, which increased from 99.7% in 1982, to 211% in 1983 (Carneiro 1988, pp. 171, 172). The negotiations throughout 1983, were based on an adjustment program of real devaluation, export promotion policies, and import restraints, all of which had two main objectives:

- 1) to raise domestic savings, especially in the public sector, and thereby reduce current account deficits; and
- 2) to increase the efficient allocation of resources in the economy by promoting relative price adjustments and eliminating subsidies (US Department of Commerce 1987, p. 56).

The main goal of the IMF stabilization programme signed in 1983 was to control inflation through the contraction of the domestic economy. This was to be achieved in conjunction with the compression of real wages as the central element of the stabilization policy. Thus the IMF contractionary measures in the three-year stabilization programme were (Korner; Maas; et al. 1986, p. 77):

- 1) a reduction of the BOP deficit in 1983 from US\$ 14.7 billion to about US\$ 7 billion (2% of GGP) and by 1985 to about US\$ 4 billion (1% of GDP) (see graph 6);
- 2) a reduction of the public deficit from 16.9% of GDP in 1982 to 8.8% in 1983; and
- 3) a reduction of inflation from 100% in 1982 to 85.9% at the end of 1983.

The policy of monthly devaluations of the currency by one percentage point higher than the

rate of inflation, was adopted in order to increase exports, cut imports, reduce public expenditure and increase government revenue (Korner; Maas; et al. 1986, p. 77). This approach to stabilization, as was seen in the first part of the paper, targets credit expansion as a central factor of disequilibrium. Thus, the programme for 1983 restricted the supply of credit, increased domestic interest rates, and cut subsidies for basic goods (wheat and sugar), and for oil derivatives. The overall objective of this contractionist policy was to stop inflation by means of wage contraction\* (Korner; Maas; et al. 1986, pp. 77-78):

As the IMF regarded the periodical adjustment of wages to inflation as the main cause of the inflation spiral it demanded the abandonment of wage indexation. The IMF thereby made the reduction of real wages the central element in its stabilization policy. The government had already moved towards the IMF objective of keeping wages significantly below the level of inflation, when it decreed that wage adjustment for the lower wage earners were to be cut from 110% to 100% of the annual rate of inflation. The standard of living of the poorer sections of the population deteriorated rapidly because as a result of devaluations prices rose twice as fast as the IMF demanded.

The adoption of these restrictive demand policies caused a drop of 3.5% of GDP in 1983 (the largest decline since the Great Depression), a drop in the operational public deficit from 6.2% of GDP to less than 2%, and a drop of 20% of real capital outlays by public enterprises (US Department of Commerce 1987, p. 56). That is, the restrictive demand policy caused a real disinvestment in the economy, particularly by cutting public expenditure. That was reflected in the fact that gross domestic investment as a proportion of GDP fell from 21.2% in 1982 to 16.9% in 1983, to 16.4% in 1984, and to 16.3% in 1985 (Cardoso and Fishlow 1987, pp. 87, 91). Investment averaged 26.6% of the gross domestic product in 1980-82, which fell to 17.7% in 1984-86 (Cardoso and fishlow 1987, pp. 87, 91). This policy of compressing the domestic economy gave important results in the external sector: there was a US\$ 6.5 billion trade surplus in 1983 (from a target of 4 billion) (see graph 5), which was made possible by

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\* The immediate result of such a contractionary policy as well as wage restrictions, was the increase of unemployment and food riots in the major cities in April 1983.



cutting imports by 20.5% and by increasing exports by 8.5% (US Department of Commerce 1987, p. 56). The two major problems for the continuation of that stabilization scheme were the increase in inflation and the public deficit, which were increased even more by the maxi-devaluation. Interest payments on the debt were financed partially by monetary expansion. By May 1983, Brazil suspended the payment of over US\$ 400 million of interest payments, and commercial banks reacted by stopping the supply of funds until a new agreement was reached (US Department of Commerce 1987, p. 56). Again it seemed that the demand for wage de-indexation was one central element of negotiation.

#### 4.3. THE NEW PHASE OF NEGOTIATIONS IN 1984.

In 1984, the nature of the negotiations had changed. The experience of negotiations after late 1982 made negotiations in 1984 more direct and quicker. Certain rules were made clear (Carneiro 1988, p. 172):

- 1) there would be no return in the short term to normal market conditions between debtors and creditors;
- 2) a global solution was not probable, and instead the case by case approach was accepted as the basic framework of negotiations; and
- 3) since the crisis of 1982, the negotiation succeeded in avoiding unilateral actions which could lead to a major crisis.

The 1984 negotiations included the three major players on the creditors' side: a representative committee of 800 commercial banks, the governments of the industrialized countries, known as the "Paris Club" which had provided some lines of credit during the first phase of negotiations, and multilateral organizations (FMI, WB, BID) (Carneiro 1988, p. 172). The new package negotiated for 1984 included the following (US Department of Commerce 1987, p. 57):

- a) the rescheduling of nearly US\$ 4 billion in obligations to creditor governments through the Paris Club;
- b) US\$ 6.5 billion in new lending from commercial banks; and
- c) the rescheduling of US\$ 5.5 billion in amortizations maturing in 1984 over a 9 year period. Negotiations were also initiated to reschedule all principal payments on medium-term loans falling due over 1985-90.

This new period of negotiations continued the same line of thinking about restructuring as the previous negotiations had; that is, the negotiations continued emphasizing the elimination of interest payments in arrears through the generation of a larger trade surplus, and in this sense, the solution sought was the kind of adjustment measures which would force Brazil (as well as the other LDC debtors) to generate a large and increasing trade surplus to solve the debt-servicing difficulties (Batista 1987, p. 46). In the solution, the emphasis was placed on the liquidity and profit needs of commercial banks without much consideration of the economic and social consequences, particularly short-term effects, placed on the debtor countries. Essentially, domestic consequences of decreasing imports and increasing exports did not matter; the main goal was the simple generation of a trade surplus to continue the service of the debt. The 1983-84 new phase of negotiations, therefore, opened a new period in the Brazilian economy, in which the interest payments on the foreign debt, were paid through this generation of a large trade surplus.

However, this type of solution, because it increases a net transfer of resources\* from

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\* The resource transfer implied by abnormally high real interest rates can be analysed in the next debt-export ratio proposed by Martone (1987, p. 21):

$$D_t = \frac{1+r}{1+x_t} d_{t-1} + \left( \frac{1}{a} - 1 \right)$$

where;

d: debt export ratio;

r: interest rate paid on debt;

x: annual growth of exports of goods and nonfactor services.

a: transfer coefficient (ratio of exports to imports of goods and nonfactor services).

Brazil, cannot be maintained over the long-term, without draining the economy. Martone (1987, pp. 21, 22) has indicated that the possibility to continue with such a transfer of resources depends on the performance of exports compared with the level of interest rates. That is, the long-term stability of the debt/export ratio requires a higher rate of growth of exports than the rate of interest on debt, and if this condition is not met, either the ratio increases through continuous interest capitalization, or the transfer coefficient must rise. Therefore, the limits of an increasing transfer coefficient are: the capability to shift resources to the export sector, the growth of the world trade, and the depth and length of recession that the economy can afford (Martone 1987, p. 22). In the Brazilian case, the measure to transfer resources to the export sector was successful because of the political possibility of favoring the export sector, instead of concentrating resources for the needs of domestic demand. These factors permitted the implementation of the model of channelling export surplus to foreign creditors.

This approach, therefore, is based on the strategy of a massive transfer of resources from Brazil to the banking system of the industrialized countries, in order to obtain the payment of interest and to reduce the exposure of the banks to Brazil's possible default in payments (Batista 1987, p. 46). As a result, commercial bank lending fell dramatically: the World Bank estimates a negative net transfer from private sources to developing countries of US\$ 7 billion in 1982, and 21 billion in 1983. This fall in loans stopped the transfer of resources from industrialized countries to Brazil, and started the transfer of resources from Brazil to the creditor countries. The World Bank calculates that in 1983, the net transfer from the thirteen major borrowers among the developing countries to private lenders was the equivalent to 2% of their national income. As it can be seen, the net transfer of resources from LDC debtors to industrialized countries is a highly contradictory process as a long-term model of dealing with the external debt problem.

Especially for Brazil, a country with traditional needs of high rates of growth, this pro-

gram has been excessively demanding and contrary to the historical trends of investment, saving and consumption. According to Batista, The 1983 scheme of outward transfer caused, for the first time in many years, aggregate expenditure on investment and consumption to be considerable lower than the gross domestic product (Batista 1985, pp. 288, 289). The excess of GDP over aggregate domestic expenditure financed the income transfer under the form of interest payments, profit and dividends (Batista 1985, p. 293). Therefore, the post 1983 schemes of negotiations left Brazil with the full burden of the BOP crisis, which was caused largely by external factors\*.

One particularly negative effect of the transfer problem was the need of the Brazilian government to generate a large fiscal surplus in order to pay for the transfer (Martone 1987, p. 26). The resource transfer of about 4.5% of GDP in 1983-84 fell heavily on the public sector, since the government held about 85% of the foreign debt and 50% of the domestic debt. Then, the need for a fiscal surplus was enormous (the interest cost of the external and domestic public debt represented about 8.5% of the GDP (Martone 1987, p. 26). The implications of servicing this magnitude of public debt, 8.5% of GDP, produced serious macroeconomic imbalances in the domestic economy (among them, higher inflation, a recessionary bias coming from high interest rates, and financial speculation).

Exchange-rate guarantees given to the private sector and to public enterprises have been another factor which contributed to the growth of the public deficit (Martone 1987, p. 27). Martone (1987, p. 27) explains that in 1977, the government passed resolution 432 which allowed private and public dollar debtors to deposit the domestic currency (Cruzeiro) equivalent in the Central Bank at any time. Furthermore, during the period of the deposit, the Central Bank was responsible for full service of the foreign debt. This was one means by which

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\* Recapitulating, these external factors were: shocks of oil price increases (1973, 1979), historically-high international interest rates, restrictive macroeconomic policies of industrialized countries, world recession, deterioration in terms of trade, reduction in the inflow of foreign bank loans since mid 1982, and increased protectionism.

part of the private debt was being transferred to the public sector. In addition, since 1980, the problem of the public deficit has been aggravated through two other means of transferring private foreign debt to the public sector (Martone 1987, pp. 27, 28), which are listed below:

1) first, when the Federal Government gives full loan guarantees on foreign funds borrowed by State and municipal governments and by public enterprises. In the case of defaulted loans or financial difficulties, the Central Bank has covered interests and amortizations on these debts.

2) This process of "statization" of the foreign debt was also expanded by two aspects of the annual negotiations of the Brazilian debt starting in 1983:

a) under Project IV of the 1983 agreement, by which foreign private banks agreed to provide short-term funds to foreign branches of Brazilian banks (about US\$ 6 billion), the Central Bank of Brazil gave full guarantee of these funds;

b) the funds from the new money facility for 1983 and 1984 were deposited at the Central Bank, and given the high foreign exchange risk. There was no private demand for those funds which meant that they just remained deposited at the Central Bank (Martone 1987, pp. 27, 28).

#### 4.4. OVERVIEW OF THE ECONOMIC POLICY AFTER 1980.

After the domestic and external conditions began to deteriorate, the Brazilian government followed different types of policies characterized by a lack of consistent objectives. This view is illustrated by the radical change from the growth scheme of D. Netto in 1979, to the restrictive demand policies of 1981-82, and by the record of presenting seven projects (seven letters of intent) for negotiation to the IMF in two years.

The necessary condition for a stable public debt/GDP ratio within the policy adjustment model\*, adopted by the government after 1980 (in which the public debt was indexed to the domestic price level or to the exchange rate), was, according to Martone (1987, p. 31), that the rate of growth of real output ( $q$ ) be greater or equal to the average interest rate  $r$  (in real Cruzeiros), ( $q \geq r$ ). Considering a budget constraint of the private sector and an overall (private and public) budget constraint\*\*, Martone (1987, pp. 31, 32) shows that the stability condition  $q \geq r$  was not met for 1982-84. So that the only way to stabilize the debt/GDP ratio was to adopt the following measures (Martone 1987, pp. 31, 32):

- 1) reduce the public sector absorption  $g$  through expenditure cuts and tax increases (a tight fiscal policy);
- 2) reduce private absorption -  $a$  - through high interest rates (tight monetary policy), tax increases, wage controls and real devaluation.

These demand and monetary contractions were expected to increase exports and to reduce inflation; however, the scheme failed to control the inflationary process, in particular because the high interest rates offset the public expenditure cuts, and the high indexation of the

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\* Martone (1987, p. 30) has proposed an analysis of the policy adjustment model through the following budget constraint of the public sector:

$$d_t^G = g - \frac{m}{v} + \left\{ \frac{1 + p + r}{1 + p + q} \right\} d_{t-1}^G$$

where:

$g$  = public sector deficit (except interest payments) as % of GDP

$p$  = inflation rate

$r$  = average interest rate (in real cruzeiros), paid on domestic and foreign debt  $d_t^G$  as % of GDP

$q$  = rate of growth of real output

$m$  = rate of monetary expansion

$v$  = income velocity of money.

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\*\* The budget constraint of the private sector (Martone 1987, p. 31):

$$d_t^P = a + \frac{m}{v} + \left\{ \frac{1 + p + r}{1 + p + q} \right\} d_{t-1}^P$$

$a_p$  = private absorption relative to income

$d$  = net private debt

and the overall budget constraint (public and private):

$$d_t^* = (a + g) + \left\{ \frac{1 + p + r}{1 + p + q} \right\} d_{t-1}^*$$

economy caused a process of inertial inflation (see the section "Cruzado Plan" for the definition of inertial inflation). As a consequence, the Brazilian financial market grew in this period, but with serious distortions which had the following characteristics: statization, indexation, dollarization, and monetization (Martone 1987, pp. 33, 34):

Statization ... In 1985, the domestic public debt of the nonfinancial public sector represented 57 percent of total gross financial assets and 21 percent of GDP. Most of this is short-term debt and is being rolled over at an average annual real interest rates above 20 percent. ...On the other hand, the government has extended the indexation system (monetary correction) to almost all financial assets, short and medium term. Therefore, financial assets have been freed of inflation risk. ...With real interest rates on liquid financial assets well above the rate of return on physical capital, there has been a reshuffling of assets in the portfolio of the private sector toward indexed financial assets and away from real assets and money. ...At the same time, asset monetization has been on the rise.

In this sense, the process of external debt has also led to the growth of the financial sector of the Brazilian economy which has been sustained by the generation of a large surplus from the real sector. The production of this surplus was made possible by the domestic policy of wage contraction, and the configuration of Brazil as a leading low-cost labor economy in the international market.

One sector particularly favored by these conditions was the rentiers. It is primarily the holders of financial instruments, both local and foreigners, that have profited from these developments in the Brazilian economy. This is another reason why, as Martone (1987, p. 35) explains, it is difficult to justify the generation of a large fiscal surplus, through cuts in investment and social expenditure and tax increases, in order to transfer income to this sector.

## 4.5. THE 1984-85 RECOVERY: THE NEED FOR DEBT RESCHEDULING.

The favorable conditions for the recovery of the demand for Brazilian exports resulted in a trade surplus of US\$ 13,100 in 1984 (table 13, graph 5). This trend, together with a 12 billion debt refinancing package, enabled Brazil to increase its international reserves to over 5 billion (see graph 7), having increased them to US\$ 3.7 billion of net reserves at the end of 1984. But the foreign debt had already reached US\$ 104 billion at that time (table 2). All of this demonstrated that the adjustment effort made during the 1970s to build an important industrial base was proving to be useful in the generation of a trade surplus and the capacity of Brazil to serve its external debt, provided the world market was growing, and in spite of the deterioration in the terms of trade in the 1982-84 period.

This condition of a favorable trade surplus by 1984 strengthened the Brazilian position when negotiating with the IMF (Carneiro 1988, pp. 175, 176). From 1984, it was demonstrated that the Brazilian productive capacity and its ability to service the debt commitments in the short-run, would be possible, if world trade continued to grow. Since 1985, Brazil had to resort to the IMF, not because of short-term financial needs, but because of the need to reschedule its debt (Carneiro 1988, p. 176). The only reason to fear the restrictive orthodox policies of the IMF was the need to distribute the burden of the debt service over a longer period of time.

Thus, since 1985, Brazil could continue its growth process with less urgent needs of short-term capital from the banks and the IMF, and depended on them only for multiyear debt rescheduling. In January 1985, Brazil presented the seventh letter of intent, which tried to obtain a multiyear debt rescheduling (similar to the one agreed on between Mexico and the IMF in 1984), but the IMF did not approve it due to the non compliance with the domestic targets demanded (Carneiro 1988, pp. 175, 176). Also, the IMF waited for a new government



to take power in March 1985. The new government of Jose Sarney very soon faced two types of pressures: first, at the domestic level, it was difficult to obtain popular support to continue the negotiations with the IMF (Carneiro 1988, p. 178). A general view in Brazil was to avoid resorting to the IMF and its restrictive policies because Brazil did not need urgent external financing of its trade account. Second, on the external side, the creditor banks and their governments placed on Brazil the condition that the negotiations for a multiyear rescheduling of the external debt would be open only if Brazil first started negotiations with the IMF. Once negotiations with the IMF were started, and a commitment to adopt a stabilization program to reduce public expenditure and inflation was accepted, then the banks and their governments would negotiate the rescheduling (Carneiro 1988, p. 177).

In 1985, the Brazilian Government maintained a solid independent view in the negotiations with the IMF, that was possible only after the large trade surplus obtained in 1984. Thus, according to Carneiro, the power of negotiation of Brazil was strong in terms of the performance of the external sector of the economy, but the weakest point of Brazil, when it was trying to negotiate with the banks and the IMF, was the performance of the domestic economy (Carneiro 1988, p. 176). In the domestic sector of the economy, the high inflationary process had not been controlled with the restrictive demand policies. Within the new government, the economic team was divided into two different views of the economic policy needed (Carneiro 1988, p. 177): 1) one proposed to continue with economic growth in order to get foreign exchange resources, and 2) the other view proposed to adopt restrictive macroeconomic policies under the IMF guide. In September 1985, there were changes in the economic authorities and the approach to economic policy. The Central Bank authorities, who favored a monetary shock to stop inflation and the adoption of the IMF stabilization programme, were replaced by other authorities who favored a plan of monetary reform and de-indexation of the economy as the anti-inflationary approach. Also, Dilso Funaro was appointed as Minister of Finance, and he introduced a new approach for economic policy and debt negotiations. His view was that Brazil should follow its own way to domestic adjustment,

in which economic growth was essential, and direct negotiations with the international banks, without IMF mediation would take place (Carneiro 1988, p. 177). All the hopes of the new economic authorities were placed in the heterodox anti-inflation plan called "Cruzado Plan" which emphasized monetary reform and the de-indexation of the economy.

#### 4.6. THE CRUZADO PLAN.

The heterodox stabilization program differs from the orthodox one in that it recognizes the effects of indexation on inflation or inertial inflation. Inertial inflation refers to a feedback mechanism of rising prices. When there are contracts (especially wages) that restore their real value after a period of time, inflation is said to have become inertial (Arida; Lara-Resende 1985, p. 32). Inflation accelerates when contracts are negotiated more often; during hyperinflation, the periods of contracts are reduced to a minimum.

Based on the high inflation (over 200%) in 1985 (see graph 10), the Brazilian monetary authorities drew up the new heterodox program based mainly on the recognition of the inertial aspect of inflation in that period. The main orientation of the new stabilization policy was the de-indexation of the economy in order to suppress the links between the inflation of the last periods and price expectations. Thus the monetary reform or Cruzado Plan consisted of the following measures (Carneiro 1987b, pp. 254-255):

- 1) the introduction of a new currency, the Cruzado, which replaced the old currency, the Cruzeiro. A conversion table was used to introduce the new currency;
- 2) a general freezing of prices and wages, and the stabilization of the exchange rate at a certain parity starting on February 28, 1986, under the new currency;
- 3) a prohibition against the establishment of contracts for less than one year (saving

accounts were the only exception);

- 4) wages were converted to the new currency based on the average real wage of the previous 6 months of February 1986, and were negotiated freely once a year;
- 5) the nominal value of the indexed treasury bonds was frozen for one year;
- 6) the federal budget for 1986 was redefined based on the assumption of a 0% rate of inflation; and
- 7) special programs for the supply of food were developed, and measures against speculation were taken.

Following the introduction of the Cruzado as the new currency, the monetary authorities used the interest rate as the indicator for the level of demand for money. In view of the possibility of a reduction in banking activities due to the change in portfolio options, the government used the interest rate as the immediate target of monetary policy. The first action of the monetary authorities was the reduction of the nominal rate of interest, thinking that this was going to consolidate the zero expectation on inflation (in that situation, market and nominal rates were seen as the same), and was going to avoid a recession given the uncertainty of the new monetary conditions. In this way, the heterodox program included initially a policy of monetary expansion as a non-recessive alternative to fight inflation.

The monetary reform introduced the Cruzado as the new national monetary unit beginning on February 28, 1986. The conversion was fixed at 1000 Cruzeiros (former currency) for 1 Cruzado (Modiano 1987, p. 233). Wages were converted to Cruzados considering the average purchasing power of the previous 6 months to February 1986 (Modiano 1987, p. 234). This conversion of wages tried to look back to the past instead of looking forward to expectations of future prices; that is, it was another way to suppress the expectation on future wages and prices (Meller 1987, p.285). The total price-freeze was a central condition of this program of stabilization, because of the wage adjustment mechanism adopted each year. Otherwise, increases of prices above the real wage would introduce once again strong inflationary pres-

sures.

### Objectives of the Monetary Reform.

According to R. Dornbusch (1985, p. 51), monetary reform is used (as an alternative to common stabilization policies), in cases of severe inflation for one of three main reasons:

- 1) Most often, the fiscal system needs reform to increase real government revenue and reduce the need for money creation. Monetary reform sanctifies the often punishing fiscal reform and restores credibility to constant purchasing power of the currency and new public debt.
- 2) Monetary reform is convenient when pervasive insolvency in the financial market, including government, makes it essential to write off liabilities, both public debt and deposits. Monetary reforms sanctify the breach of contract.
- 3) A third purpose of monetary reform is to restore government seigniorage that has been lost to substitute currencies, and the issue of a new money establishes the claim and makes the inevitable legal-tender law more effective.

During the 1920s, stabilization programmes of monetary reform implemented in Europe (particularly in Hungary and Germany), were aimed at resolving the insolvency of the financial market in a hyperinflationary context. In the Brazilian experience, monetary reform pursued similar goals, but also it was defined as being neutral in terms of the distribution of income (Meller 1987, p. 283).

One potential problem introduced by the monetary reform was whether the new monetary unit would be acceptable and have the confidence of people (Meller 1987, p. 285). However, the introduction of the Cruzado was not a problem because the public recognized that it was backed by new measures of price control, and thus, it was not going to have the level of depreciation of the old currency. In this way, the remonetization of the economy was rapid.

Contrary to monetary restriction of the orthodox approach, the framework of the new heterodox stabilization program was an expansive remonetization of the economy. For R.

Dornbusch (1986), the key aim of the stabilization policies is to tighten fiscal policy and to ease money supply. In a similar way, the Cruzado Plan followed a stabilization method of reducing interest rates and increasing money supply.

#### Results of the Cruzado Plan.

February 28, 1986 was the starting point for the implementation of the plan. Inflation in February 1986, one month before the beginning of the plan, was 22.4%, and for the three previous months was 15% per month (Meller 1987, p. 286). After the beginning of the plan, for the first two months, the monthly inflation rate was reduced to 1% per month, and for the following six months (May to October) it oscillated between 1% and 2% (Meller 1987, p. 286). During these first eight months (March-October), the plan succeeded in controlling inflation, that is, in reducing a monthly rate of inflation from about 20% to 1%. However, after that, inflation again began its increasing tendency reaching 3.29% in November, 7.27% in December, and 16.8% in January 1987.

During the first year of the plan, the economy operated at a very high level of economic activity; industrial production grew 12.5% between January and October of 1986, and the unemployment rate went down from 4.20% to 3% in the same period. It seems that aggregate demand increased due to higher real wages, the elimination of inflationary expectations, more investment in the area of durable goods, and a reduction in speculative demand for money.

A central consideration in evaluating the program is to recognize the application of the heterodox program during a period of strong growth. Economists concerned with the behaviour of monetary aggregates focused their criticism on the failure of the Central Bank to control inflation. In their view, the monetary policy was excessively expansive and interest rates

were too low. Additional pressures on prices came from higher indirect taxes in July. The nominal exchange rate, kept constant until September, caused a further deficit in the commercial balance, and then minidevaluations were introduced. Favourable conditions for the monetary policy of the period came with the fall in the prices of oil and reductions in the international interest rates.

The orthodox approach to fighting inflation requires that control be established in four major areas (Meller 1987, p. 276):

- i) the monetary variables;
- ii) the fiscal deficit;
- iii) the expectations; and
- iv) wages.

Thus, because of its emphasis on monetary factors, the orthodox approach to stabilization found the Cruzado Plan to be wrong in its focus on controlling prices rather than monetary variables. That is, monetarist criticism about the limits of the Cruzado Plan focused only on the monetary aspects of the period. However, there were other fundamental factors determining inflation. The expansive monetary conditions of the period only permitted the economy to continue its growing tendency; they were not the most direct factors pushing inflation. There were some supply bottlenecks which caused supply problems and inflationary pressures (see Carneiro 1987b). At the same time, the conflict between wage-earners and the industrial producers over prices was alive. But the pressure to liberalize price controls could not be stopped, and, after the first year of the plan, price controls were eliminated.

By November, 1986, it was clear that wages were deteriorating as the Cruzado Plan had not succeeded in keeping wages on par with prices (see table 15). By January, 1987, under strong pressures, the government abandoned the price control policy, prices increased over 15% per month again, monetary correction on different assets was reintroduced, and nominal interest rates and taxes went up (Carneiro 1987b, pp. 269-270). The policy of price control

was a widely-debated policy. For some analysts, price controls needed to be more rigorous and permanent in the conditions of that period; for others, price controls were only an extreme and temporary policy. The speculative characteristic of some sectors of production, which conditioned supply to increases of prices, caused the shortage of some goods, and increased inflationary pressures on the economy.

The Cruzado Plan was a programme to bring inflation down in the short term; that was the main achievement of the monetary reform and price controls. The objective of a 0% inflation rate appears to be an unrealistic objective as a means of fighting inflation in the Brazilian conditions.

To sum up, it seems that Brazil could have developed adjustment policies more suited to the domestic economy. Instead, the orthodox package originating from outside of the country and designed primarily to correct the external sector, is limited in its scope for the Brazilian conditions analysed in this paper. The adjustment to the conditions of debt after 1982 required a type of adjustment with more concern and emphasis on structural factors causing different levels of imbalances. The potential of the Brazilian capacity of production and its resources, as well as the size of its external debt, makes Brazil a special case in which the need to search for different solutions, different from the traditional programmes of adjustment, is urgent. The orthodox application of the traditional pattern of adjustment will only lead to further confrontations in Brazil. Thus, more cooperation and understanding between the creditors –banks, their governments, the IMF– and Brazil is essential in the search for new and more realistic solutions. It is clear that a permanent transfer of resources from Brazil to the creditor countries, as well as the strategy based particularly on the rescue of the banks and not of Brazil, cannot be a long-term solution to the problem. New solutions,

different from the traditional approach to adjustment, are needed, as well as greater independence for Brazil to find its own policies of adjustment and stabilization.

One of the most important consequences of the traditional adjustment programmes in Brazil has been its effects on the poorest sectors of society, particularly, those sectors which are marginalized from the formal sectors of the economy. According to the IMF, its programmes are neutral in terms of income distribution. In the IMF's view, the cost paid by the different sectors of the population, for correcting BOP disequilibrium is not a decision of the IMF, but of each sovereign government (L'Héritau 1986, p. 211). The IMF's view about income distribution reflects controversial positions, for while they say they are neutral on income distribution, in their structuring of their packages, it is clear that most of the cost of adjustment is placed (particularly in conditions of high inflation) on wages, salaries, and the working sectors with the lowest income. Also controversial is the orthodox view about sovereign governments deciding their income distribution policies. For whenever there has been the intention of increasing real wages, salaries, or give subsidies to the sectors of low income, institutions such as the IMF has questioned the efficacy of such policies, and very often it has been one of the most serious obstacles to implement such measures.

Thus, the working sectors with low income levels, both the informal and marginalized sectors, and the wage earners in the formal sector, have been bearing most of the cost of adjustment. In particular, the informal sector —the sector which includes small scale business, the service sector, the cooperatives, workers in the private sector without minimum wage and without the right to indexation, and landless peasants— has been the most affected sector in the periods of high inflation during which it does not have the right to indexation. In this sense, the gap between wage earners with wage indexation and the informal sector has increased (only in the periods when indexation has been implemented). Thus, distribution of income has also been affected in periods of wage indexation. While for wage earners in the formal industrial sector, indexation has meant some compensation against inflation, for the



informal sector there is no such indexation (for the occupational structure of the Brazilian labor force see table 17). This situation, accompanied by the austerity measures (cuts of subsidies for the poorest sectors of the population, cuts of public expenditure in social programmes, increases in the prices of goods and services from public enterprises), has caused a dramatic polarization in Brazilian society (for the share of income by percentile groups, see table 16), and, to some extent, between the formal and informal sector.

## CONCLUSIONS.

The objectives of this paper were as follows: 1) to identify the main theoretical and policy basis of the adjustment programmes of the IMF; 2) to identify the causes of the external debt accumulation in Brazil during the 1968-86 period; 3) to study the Brazilian adjustment policy to the external shocks of the 1973-81 period; and 4) to study the IMF approach to adjustment after the 1982 conditions of the debt crisis.

Among others, two important theoretical sources of the adjustment policy of the IMF are the monetarist approach to the BOP and the austerity approach. The monetarist approach to the BOP maintains that all BOP disequilibria are essentially a monetary phenomenon. The policy implications derived from such a theoretical background are mainly demand contraction policy of decreasing public expenditure, reducing the economic role of the State, setting limits to credit, opening up the external sector of the economy, the elimination of different types of market distortions and interventions, emphasizing the positive supply side of the market. This theory and policy have been shown to have marked limitations in the understanding of important structural imbalances in the Brazilian economy. For the nature of the Brazilian external disequilibrium is far from being only a monetary one. Instead, Brazil's external disequilibrium is strongly influenced by a structural type of dependence on imports of capital and intermediary goods, technology, financial capital, and also on unstable foreign markets, which often implies deteriorating conditions for the Brazilian terms of trade.

In each of the four periods of accumulation of the Brazilian external debt that were identified, the reasons for the debt expansion were different. In the 1968-73 period, the increase of external debt was moderate, and it served to accelerate the growth process. During this period of high growth, particularly for the years 1968-70, the domestic economy was able to finance most of the needs of growth with domestic resources, particularly through the policy of wage compression. In the 1974-78 period, debt expansion was due to external shocks, in which Brazil tried to accelerate its import substitution strategy. In the period

1979-82, new external shocks hit the Brazilian economy further, and changes in the international interest rates were particularly destabilizing. Finally, after the 1982 debt crisis, debt expansion has been due to the service of the debt.

The 1968-82 period of industrial development and debt accumulation introduced fundamental changes into the Brazilian economy. The model of economic growth, implemented since 1964, has relied particularly on the capacity to raise the rate of profits and investments by lowering real wages, and by expanding public investment in infrastructure and in the capital goods sector. Had Brazil not suffered the external shocks of the 1974-82 period, the domestic economy may have been able to sustain most of the process of investment, and thereby maintain the process of economic growth. However, in the Brazilian political and economic conditions of the 1970s and the 1980s, the likely impact on wages would have been a control, similar to what took place, as the main mechanism of the increase in profits and investment. Also, the concentration of income distribution would have continued with a pattern possibly similar to the one that has been observed in the past two decades. Thus, it can be concluded that the political and social conditions since 1964, have permitted the development of any programme of growth in Brazil based on the compression of real wages.

The structural adjustment policy, implemented by the Brazilian government in the 1974-78 period to respond to external shocks, was an overly optimistic response to the conditions of the internal and external markets. The increase in productive capacity has proved to be very positive, but it has emphasized the domestic market, particularly for the middle and high income sectors, and the external markets. That has created serious problems of consumption and distribution of income in Brazil. Adjustment to the debt crisis was defined and structured (externally to Brazil) according to a model of the transfer of real resources from Brazil. That model was based on the capacity to compress imports and the expansion of exports. Such a policy has successfully generated a large trade surplus since 1984, but, in spite of that success, it has had a profound impact on the domestic economy by reducing con-

sumption, concentrating investment on the export sector, and decreasing social expenditure. Also, it has been observed that the policy of export promotion, in a global market with tendencies to oversupply, has not led inevitably to an increase in export revenue. The incorporation of more and more countries into the world market through export promotion policies, has the possibility of leading to a oversupply of manufactured goods, and the consequent decrease in the price of these goods. After 1984, Brazil obtained a large trade surplus only by cutting imports and increasing the volume of exports. In this sense, it could be argued that the global type of export-oriented policy could have important limits as a long-term solution to the external debt problem of developing countries. For these types of export-promotion policies do not take into full consideration the adjustment taking place in the global economy, such as the massive reallocation of industrial production, and in particular, the depression of the prices of export goods from the supply side.

In this type of solution, the emphasis was placed particularly on the financial situation of the creditor banks. Essentially, the domestic consequences of decreasing imports and increasing exports did not receive proper consideration; the main goal was the simple generation of a trade surplus to continue servicing the debt.

The servicing of the high public debt, in the context of historically-high international interest rates, has produced serious macroeconomic imbalances in the domestic economy such as inflation, high levels of domestic interest rates, and has increased financial investment and speculation. In particular, the process of the building up of the external debt has led to a significant growth of the financial sector in Brazil in which financial investment has become a very important source of accumulation. This has been sustained by the generation of the large surplus from the real sector based on the long period of wage compression since 1964, and that has reinforced the idea of Brazil as being a leading low-labor-cost economy in the international market through which an important part of that surplus is realized. Those who profited most from the financial development were the rentiers, both local and foreign, who have

been the main beneficiaries of the productive efforts of the Brazilian economy during the period analysed.

From the point of view of labor cost, one of the central rationales of structural adjustment has been the lowering of the real level of wages. This fact of the last two decades has put Brazil in a competitive position in the current international market in which the wage differential, among countries, is a central consideration for investment in the highly-mobile manufacturing sector in the world economy. One consequence of this has been a faster process of falling income for wage and salary earners, and workers in the informal sector. The gap between workers in the informal sector without any protection against inflation, and wage earners in the formal industrial sector with some type of indexation against inflation, has increased in periods of indexation. The overall gap of income distribution has also increased in the period analysed. The problem of external debt and the policy of servicing the debt through a large trade surplus, has also had effects on the exploitation of natural resources and on the environment, for Brazil has been destroying important ecological areas (to expand crop areas or to obtain natural resources) because of the increasing needs to generate more export revenues.

T A B L E S            A N D            G R A P H S .

TABLE 1.  
BRAZIL'S MEDIUM AND LONG TERM EXTERNAL DEBT 1965-1973.  
(US\$ millions)

| YEAR | GROSS DEBT | % change | RESERVES | % change | NET DEBT | % change |
|------|------------|----------|----------|----------|----------|----------|
| 1965 | 3,644      |          | 483      |          | 3,161    |          |
| 1966 | 3,666      | 0.6      | 421      | - 12.8   | 3,245    | 2.7      |
| 1967 | 3,281      | - 10.5   | 198      | - 53     | 3,083    | - 4.9    |
| 1968 | 3,780      | 15.2     | 257      | 29.8     | 3,523    | 14.3     |
| 1969 | 4,403      | 16.5     | 656      | 155.3    | 3,747    | 6.4      |
| 1970 | 5,295      | 20.3     | 1,187    | 80.9     | 4,108    | 9.6      |
| 1971 | 6,622      | 25.0     | 1,723    | 45.2     | 4,899    | 19.3     |
| 1972 | 9,521      | 43.8     | 4,183    | 142.8    | 5,338    | 9.0      |
| 1973 | 12,572     | 32.0     | 6,416    | 53.4     | 6,156    | 15.3     |

The data exclude short-term debt.

SOURCE: Banco Central do Brazil.

TABLE 2.  
PRIVATE AND OFFICIAL SOURCES OF BRAZIL'S PUBLIC FOREIGN DEBT 1968-86.  
(US\$ millions)

| YEAR | MEDIUM & LONG DEBT | SHORT TERM DEBT | TOTAL EXTERNAL DEBT | DEBT OUTSTANDING & DISBURSED | OFFICIAL CREDITORS | PRIVATE CREDITORS | % OF PRIVATE SOURCES ON TOTAL OUTSTANDING |
|------|--------------------|-----------------|---------------------|------------------------------|--------------------|-------------------|-------------------------------------------|
| 1968 | 3,780              |                 | 3,780               |                              |                    |                   |                                           |
| 1969 | 4,403              |                 | 4,403               |                              |                    |                   |                                           |
| 1970 | 5,295              |                 | 5,295               | 3,421                        | 2,671              | 2,224             | 65.0                                      |
| 1971 | 6,622              |                 | 6,622               | 4,201                        | 3,155              | 2,969             | 70.7                                      |
| 1972 | 9,521              |                 | 9,521               | 5,739.8                      | 2,372.4            | 3,367.3           | 58.7                                      |
| 1973 | 12,572             |                 | 12,572              | 7,530.7                      | 2,700.0            | 4,830.7           | 64.1                                      |
| 1974 | 17,166             |                 | 17,166              | 10,932.2                     | 3,473.1            | 7,459.0           | 68.2                                      |
| 1975 | 23,736.4           |                 |                     | 14,143.5                     | 4,067.3            | 10,076.2          | 71.2                                      |
| 1976 | 25,985             |                 | 25,985              | 17,643.6                     | 4,566.7            | 13,077.0          | 74.1                                      |
| 1977 | 32,037             | 5,991           | 35,120              | 22,114.2                     | 5,105.4            | 17,008.8          | 76.9                                      |
| 1978 | 43,511             | 7,068           | 46,467.6            | 30,315.8                     | 5,822.8            | 24,493.0          | 80.8                                      |
| 1979 | 49,904             | 8,634           | 51,486              | 35,621.9                     | 6,160.8            | 29,461.1          | 82.7                                      |
| 1980 | 56,773.5           | 13,526.0        | 70,299.5            | 40,168.2                     | 6,868.9            | 33,299.3          | 82.9                                      |
| 1981 | 64,725.2           | 15,321.0        | 80,046.2            | 44,933.6                     | 7,617.2            | 37,316.4          | 83.0                                      |
| 1982 | 73,575.2           | 17,451.0        | 91,576.4            | 50,451.6                     | 8,506.2            | 41,945.4          | 83.1                                      |
| 1983 | 81,327.1           | 14,204.0        | 98,175.4            | 59,815.1                     | 11,028.3           | 48,786.8          | 81.6                                      |
| 1984 | 89,589.6           | 11,500.0        | 105,274.9           | 70,289.6                     | 13,049.2           | 57,240.4          | 81.4                                      |
| 1985 | 91,094.6           | 11,017.0        | 106,730.9           | 73,894.6                     | 14,444.9           | 59,449.7          | 80.5                                      |
| 1986 | 97,164.0           | 9,010.0         | 110,675.1           | 82,522.8                     | 18,728.9           | 63,793.9          | 77.3                                      |

The data include public and publicly guaranteed debt.

SOURCE: World Bank (World Debt Tables, 1970 and 1988 editions).

TABLE 3.  
BRAZIL - COMPONENTS OF AGGREGATE DEMAND, 1970-73.  
(as percentage of GDP)

| YEAR                 | CONSUMPTION | GROSS<br>FIXED<br>CAPITAL<br>FORMATION | CHANGES<br>IN<br>INVENTO-<br>ries | GROSS<br>CAPITAL<br>FORMATION | DOMESTIC<br>DEMAND | EXPORTS | IMPORTS |
|----------------------|-------------|----------------------------------------|-----------------------------------|-------------------------------|--------------------|---------|---------|
|                      | (1)         | (2)                                    | (3)                               | (2) + (3)                     | (1)+(4)            |         |         |
| 1970                 | 74.9        | 23.8                                   | 1.7                               | 25.5                          | 100.4              | 7.0     | 7.4     |
| 1971                 | 75.5        | 24.7                                   | 1.4                               | 26.1                          | 101.6              | 6.6     | 8.2     |
| 1972                 | 75.8        | 24.9                                   | 0.9                               | 25.8                          | 101.6              | 7.3     | 8.9     |
| 1973                 | 74.2        | 25.8                                   | 2.0                               | 27.8                          | 102.0              | 7.4     | 9.4     |
| 1970-73 <sup>a</sup> | 75.1        | 24.8                                   | 1.5                               | 26.3                          | 101.4              | 7.1     | 8.5     |

Note: Measured in 1970 prices.

a. Average.

SOURCE: Fundacao Getulio Vargas; Taken from: P.N. Batista (Opus Cit. 1987, p. 5)

TABLE 4.  
INTERNAL AND EXTERNAL RESOURCES (SAVINGS) FINANCING  
GROSS CAPITAL FORMATION IN BRAZIL 1970-83.  
(as percentage of GNP)

| YEAR                 | GROSS SAVINGS     |                  |                      |       | IMPORTS MINUS<br>EXPORTS AS<br>% OF GDP | GROSS FIXED<br>CAPITAL <sup>b</sup><br>FORMATION |
|----------------------|-------------------|------------------|----------------------|-------|-----------------------------------------|--------------------------------------------------|
|                      | PRIVATE<br>SECTOR | PUBLIC<br>SECTOR | FOREIGN <sup>c</sup> | TOTAL |                                         |                                                  |
| 1970                 | 18.8              | 5.4              | 1.4                  | 25.6  | 0.4                                     | 23.8                                             |
| 1971                 | 17.5              | 5.8              | 2.7                  | 26.0  | 1.6                                     | 24.7                                             |
| 1972                 | 17.7              | 5.8              | 2.6                  | 26.1  | 1.6                                     | 24.9                                             |
| 1973                 | 19.0              | 6.4              | 2.2                  | 27.6  | 2.0                                     | 25.8                                             |
| 1970-73 <sup>a</sup> | 18.25             | 5.9              | 2.2                  | 26.3  | 1.4                                     | 24.8                                             |
| 1974                 | 19.2              | 4.5              | 6.8                  | 30.5  | 4.1                                     | 27.3                                             |
| 1975                 | 22.9              | 3.9              | 5.4                  | 32.2  | 2.7                                     | 29.2                                             |
| 1976                 | 19.1              | 4.3              | 3.9                  | 27.3  | 2.4                                     | 29.0                                             |
| 1977                 | 19.7              | 3.9              | 2.3                  | 25.9  | 1.6                                     | 26.9                                             |
| 1978                 | 19.5              | 2.3              | 3.4                  | 25.2  | 1.1                                     | 27.0                                             |
| 1974-78 <sup>a</sup> | 20.0              | 3.8              | 4.4                  | 28.2  | 2.4                                     | 27.9                                             |
| 1979                 | 15.4              | 2.2              | 4.5                  | 22.1  | 1.0                                     | 26.4                                             |
| 1980                 | 16.1              | 1.3              | 5.2                  | 22.6  | -0.4                                    | 26.3                                             |
| 1981                 | 15.9              | 1.0              | 4.3                  | 21.2  | -3.1                                    | 23.5                                             |
| 1982                 | 15.2              | 0.3              | 5.8                  | 21.3  | -2.6                                    | 22.3                                             |
| 1983                 | 14.4              |                  | 3.3                  | 17.7  | -5.0                                    | 19.0                                             |
| 1979-83              | 15.4              |                  | 4.6                  | 20.9  | -2.0                                    | 23.5                                             |

a. Average.

b. Discrepancies between total savings and gross fixed capital formation are basically explainable by depreciation and changes in inventories.

c. foreign savings = negative balance on current account.

SOURCE: Fundacao Getulio Vargas; M. Marques (Opus Cit., p. 18).



TABLE 5  
GROWTH OF REAL GDP (at market prices) IN BRAZIL AND OECD AREA  
1968-86 (percentage changes)

| YEAR     | BRAZIL (1) | TOTAL OECD (2) | (1) - (2) |
|----------|------------|----------------|-----------|
| 1968     | 11.0       | 5.4            | 5.6       |
| 1969     | 10.2       | 5.1            | 5.1       |
| 1970     | 8.3        | 3.1            | 5.2       |
| 1971     | 12.0       | 3.6            | 8.4       |
| 1972     | 11.1       | 5.4            | 5.7       |
| 1973     | 13.6       | 6.1            | 7.5       |
| 1968-73a | 11.0       | 4.8            | 6.2       |
| 1974     | 9.7        | 0.7            | 9.0       |
| 1975     | 5.4        | -0.3           | 5.7       |
| 1976     | 9.7        | 4.8            | 4.9       |
| 1977     | 5.7        | 3.8            | 1.9       |
| 1978     | 5.0        | 4.0            | 1.0       |
| 1974-78a | 7.1        | 2.6            | 4.5       |
| 1979     | 6.4        | 3.1            | 3.3       |
| 1980     | 7.2        | 1.2            | 6.0       |
| 1981     | -1.6       | 2.0            | -3.6      |
| 1982     | 0.9        | -0.5           | 1.4       |
| 1983     | -3.2       | 2.2            | -5.4      |
| 1979-83a | 1.9        | 1.6            | 0.3       |
| 1984     | 4.5        | 4.6            | -0.1      |
| 1985     | 8.3        | 2.7            | 5.6       |
| 1986     | 8.2        | 2.5            | 5.7       |

a. average.

SOURCE: OECD Main Economic Indicators ; Batista 1987, p. 55.

TABLE 6.  
BRAZILIAN BALANCE OF PAYMENTS 1968-1973.  
(millions of US dollars)

|                                          | 1968   | 1969   | 1970   | 1971   | 1972   | 1973   | 1968-73 <sup>a</sup> |
|------------------------------------------|--------|--------|--------|--------|--------|--------|----------------------|
| A. TRADE BALANCE                         | 26     | 318    | 232    | -343   | -241   | 7      | 0                    |
| Exports (FOB)                            | 1,881  | 2,311  | 2,739  | 2,904  | 3,991  | 6,199  | 3,338                |
| Imports (FOB)                            | -1,855 | -1,993 | -2,507 | -3,247 | -4,232 | -6,192 | -3,338               |
| B. SERVICES                              | -556   | -630   | -815   | -980   | -1,250 | -1,722 | -992                 |
| Interest (net)                           | -144   | -182   | -234   | -302   | -359   | -514   | -289                 |
| Profits and dividends (net) <sup>a</sup> | -84    | -81    | -119   | -118   | -161   | -198   | -127                 |
| Other services (net)                     | -328   | -367   | -462   | -560   | -730   | -1,010 | -576                 |
| C. UNREQUITED TRANSFERS                  | 22     | 31     | 21     | 14     | 5      | 27     | 20                   |
| D. CURRENT ACCOUNT BALANCE (A+B+C)       | -508   | -281   | -562   | -1,309 | -1,486 | -1,688 | -972                 |
| E. NET CAPITAL MOVEMENTS                 | 541    | 871    | 1,015  | 1,846  | 3,492  | 3,512  | 1,880                |
| Direct Investment                        | 61     | 177    | 132    | 168    | 318    | 940    | 299                  |
| Loans and Financing <sup>b</sup>         | 583    | 1,023  | 1,433  | 2,037  | 4,299  | 4,495  | 2,312                |
| Amortizations <sup>c</sup>               | -484   | -493   | -672   | -850   | -1,202 | -1,673 | -896                 |
| Other (net)                              | 381    | 164    | 122    | 491    | 77     | -251   | 164                  |
| F. ERRORS AND OMISSIONS                  | -1     | -41    | 92     | -7     | 433    | 355    | 139                  |
| SURPLUS OR DEFICIT (D+E+F)               | 32     | 549    | 545    | 530    | 2,439  | 2,179  | 1,046                |

a. Excludes reinvested profits.

b. From 1969 to 1973, medium and long-term.

c. From 1969 to 1973, medium and long-term.

SOURCE : Central Bank of Brazil; Batista 1987, p. 9.

TABLE 7.  
INDICES OF INTERNATIONAL TRADE AND TERMS OF TRADE 1968-1983.  
(1977 = 100)

| YEAR | EXPORTS |          | TOTAL IMPORTS |          | OIL IMPORTS |          | TERMS OF TRADE |               |
|------|---------|----------|---------------|----------|-------------|----------|----------------|---------------|
|      | price   | quantity | price         | quantity | price       | quantity | TOTAL          | EXCLUDING OIL |
| 1968 | 32      | 48       | 42            | 38       | 17          | 33       | 76             | 62            |
| 1969 | 33      | 55       | 41            | 39       | 16          | 35       | 80             | 65            |
| 1970 | 38      | 56       | 42            | 47       | 16          | 42       | 89             | 73            |
| 1971 | 36      | 60       | 44            | 58       | 20          | 50       | 82             | 69            |
| 1972 | 41      | 76       | 47            | 70       | 22          | 61       | 87             | 72            |
| 1973 | 56      | 80       | 59            | 85       | 28          | 85       | 95             | 82            |
| 1974 | 71      | 89       | 91            | 115      | 93          | 87       | 78             | 78            |
| 1975 | 71      | 98       | 94            | 109      | 94          | 91       | 76             | 76            |
| 1976 | 82      | 99       | 96            | 108      | 96          | 101      | 85             | 88            |
| 1977 | 100     | 100      | 100           | 100      | 100         | 100      | 100            | 100           |
| 1978 | 92      | 113      | 107           | 105      | 101         | 111      | 86             | 84            |
| 1979 | 101     | 124      | 128           | 115      | 135         | 124      | 79             | 81            |
| 1980 | 107     | 152      | 164           | 115      | 226         | 107      | 65             | 78            |
| 1981 | 101     | 183      | 182           | 99       | 270         | 104      | 55             | 71            |
| 1982 | 95      | 67       | 176           | 91       | 261         | 100      | 54             | 68            |
| 1983 | 88      | 195      | 166           | 75       | 236         | 91       | 53             | 63            |

SOURCE : Getulio Vargas Foundation; Conjuntura Economica; R. Bonelli, P. Malan 1987, p. 16.

TABLE 8.  
BRAZIL: DEBT INDICATORS 1968-83 (Percentage)

| YEAR | Net Debt <sup>a</sup> | Net Debt <sup>a</sup> | Debt Service <sup>b</sup> | Gross Reserves | Net Reserves            |
|------|-----------------------|-----------------------|---------------------------|----------------|-------------------------|
|      | Exports               | GDP                   | Exports                   | Imports        | Gross Debt <sup>c</sup> |
| 1968 | 187.3                 | 9.8                   | 33.4                      | 13.9           | -12.9                   |
| 1969 | 162.1                 | 9.4                   | 29.2                      | 32.9           | 3.2                     |
| 1970 | 150.0                 | 9.6                   | 33.1                      | 47.3           | 14.8                    |
| 1971 | 168.7                 | 9.9                   | 39.7                      | 53.1           | 21.3                    |
| 1972 | 133.8                 | 9.2                   | 39.1                      | 98.8           | 38.9                    |
| 1973 | 99.3                  | 7.8                   | 35.3                      | 103.6          | 47.7                    |
| 1974 | 149.6                 | 11.4                  | 32.3                      | 41.7           | 28.4                    |
| 1975 | 197.6                 | 13.8                  | 42.3                      | 33.1           | 17.3                    |
| 1976 | 192.0                 | 12.8                  | 47.4                      | 52.8           | 21.8                    |
| 1977 | 204.5                 | 14.1                  | 50.9                      | 60.4           | 19.4                    |
| 1978 | 249.8                 | 15.2                  | 63.4                      | 86.9           | 26.5                    |
| 1979 | 263.8                 | 17.1                  | 69.3                      | 53.6           | 18.9                    |
| 1980 | 233.1                 | 18.8                  | 56.2                      | 30.1           | 9.6                     |
| 1981 | 231.4                 | 19.6                  | 66.1                      | 34.0           | 9.3                     |
| 1982 | 328.1                 | 23.5                  | 90.7                      | 20.6           | -3.3                    |
| 1983 | 350.5                 | 37.0                  | 85.3                      | 29.6           | 0.1                     |

a. Medium and long-term debt minus gross reserves.

b. Net interest payments plus net amortizations.

c. Medium and long-term debt.

SOURCE : Banco Central do Brazil; Fundacao Getulio Vargas;  
Batista 1987, pp. 10, 19, 37; International Monetary Fund.

TABLE 9.  
AVERAGE COST OF BRAZIL'S FOREIGN DEBT  
IN NOMINAL AND REAL TERMS 1968-83.

| YEAR | Net interest<br>Payments<br>(Millions of<br>dollars) | Net Foreign<br>Debt <sup>a</sup><br>(Millions of<br>dollars) | Average Cost<br>in Nominal<br>Terms<br>(in percent) | U.S.<br>Inflation <sup>b</sup><br>(in percent) | Average Cost<br>in Real<br>Terms <sup>c</sup><br>(in percent) |
|------|------------------------------------------------------|--------------------------------------------------------------|-----------------------------------------------------|------------------------------------------------|---------------------------------------------------------------|
|      | (1)                                                  | (2)                                                          | (1)=(1)/(2)                                         | (4)                                            | (5)=(3)/(4)                                                   |
| 1968 | 144                                                  | 3,083                                                        | 4.7                                                 | 4.4                                            | 0.3                                                           |
| 1969 | 182                                                  | 3,523                                                        | 5.2                                                 | 5.1                                            | 0.1                                                           |
| 1970 | 234                                                  | 3,747                                                        | 6.2                                                 | 5.4                                            | 0.8                                                           |
| 1971 | 302                                                  | 4,108                                                        | 7.4                                                 | 5.0                                            | 2.3                                                           |
| 1972 | 359                                                  | 4,899                                                        | 7.3                                                 | 4.2                                            | 3.0                                                           |
| 1973 | 514                                                  | 5,338                                                        | 9.6                                                 | 5.8                                            | 3.6                                                           |
| 1974 | 652                                                  | 6,156                                                        | 10.6                                                | 8.8                                            | 1.7                                                           |
| 1975 | 1,498                                                | 11,897                                                       | 12.6                                                | 9.3                                            | 3.0                                                           |
| 1976 | 1,810                                                | 17,130                                                       | 10.6                                                | 5.2                                            | 5.1                                                           |
| 1977 | 2,104                                                | 19,441                                                       | 10.8                                                | 5.8                                            | 4.7                                                           |
| 1978 | 2,696                                                | 24,781                                                       | 10.9                                                | 7.4                                            | 3.3                                                           |
| 1979 | 4,186                                                | 31,616                                                       | 13.2                                                | 8.6                                            | 4.2                                                           |
| 1980 | 6,311                                                | 40,215                                                       | 15.7                                                | 9.2                                            | 6.0                                                           |
| 1981 | 9,161                                                | 46,935                                                       | 19.5                                                | 9.4                                            | 9.2                                                           |
| 1982 | 11,353                                               | 53,904                                                       | 21.1                                                | 6.0                                            | 14.2                                                          |
| 1983 | 9,555                                                | 66,204                                                       | 14.4                                                | 4.2 <sup>d</sup>                               | 9.8                                                           |

a. Gross medium and long-term debt minus gross international reserves. Debt outstanding at the beginning of the year.

b. GNP implicit price deflator.

c. assuming i represents the average cost in nominal terms, p the growth of the GNP deflator and r the average cost in real terms,  $i=r+p+rp$ .

SOURCE: Banco Central do Brazil; US Department of Commerce; and compiled from: Batista 1987, pp. 13, 24, and 31.

TABLE 10  
BRAZILIAN BALANCE OF PAYMENTS 1974-1978.  
(millions of US dollars)

|                                          | 1968-73a | 1974    | 1975    | 1976    | 1977    | 1978    | 1974-78a |
|------------------------------------------|----------|---------|---------|---------|---------|---------|----------|
| A. TRADE BALANCE                         | 0        | -4,690  | -3,540  | -2,255  | 97      | -1,024  | -2,282   |
| Exports (FOB)                            | 3,338    | 7,951   | 8,670   | 10,128  | 12,120  | 12,659  | 10,306   |
| Imports (FOB)                            | -3,338   | -12,641 | -12,210 | -12,383 | -12,023 | -13,683 | -12,588  |
| B. SERVICES                              | -992     | -2,433  | -3,162  | -3,763  | -4,134  | -5,062  | -3,711   |
| Interest (net)                           | -289     | -652    | -1,498  | -1,810  | -2,104  | -2,696  | -1,752   |
| Profits and dividends (net) <sup>b</sup> | -127     | -248    | -235    | -380    | -455    | -561    | -376     |
| Other Services (net) <sup>b</sup>        | -576     | -1,533  | -1,429  | -1,573  | -1,575  | -1,805  | -1,583   |
| C. UREQUITED TRANSFERS                   | 20       | 1       | 2       | 1       | 0       | 71      | 15       |
| D. CURRENT ACCOUNT                       |          |         |         |         |         |         |          |
| BALANCE (A+B+C)                          | -972     | -7,122  | -6,700  | -6,017  | -4,037  | -6,015  | -5,978   |
| E. NET CAPITAL MOVEMENTS                 | 1,880    | 6,254   | 6,189   | 6,594   | 5,278   | 10,916  | 7,046    |
| Direct Investment <sup>c</sup>           | 299      | 887     | 892     | 959     | 810     | 1,071   | 924      |
| Loans and financing <sup>d</sup>         | 2,312    | 6,891   | 5,933   | 7,772   | 8,424   | 13,811  | 8,566    |
| Amortizations (net) <sup>d</sup>         | -896     | 1,920   | -2,172  | -2,987  | -4,050  | -5,324  | -3,293   |
| Other (net)                              | 164      | 396     | 1,536   | 850     | 105     | 1,358   | 849      |
| F. ERRORS AND OMISSIONS                  | 139      | -68     | -439    | 615     | -611    | -639    | -228     |
| SURPLUS OR DEFICIT (D+E+F)               | 1,046    | -936    | -950    | 1,192   | 630     | 4,262   | 840      |

a. Annual average.

b. Excludes reinvested profits

c. Net; excludes reinvestments.

d. Medium- and long-term.

SOURCE: Banco Central do Brazil; taken from: Batista 1987, p. 14.

TABLE 11  
BRAZIL'S MEDIUM AND LONG TERM EXTERNAL DEBT<sup>a</sup>(NET, GROSS) 1968-1983.

| YEAR<br>(Dec) | GROSS EXTERNAL DEBT     |                        | NET EXTERNAL DEBT      |                        |
|---------------|-------------------------|------------------------|------------------------|------------------------|
|               | Amount<br>(US millions) | Annual<br>increase (%) | Amount<br>(US Million) | Annual<br>increase (%) |
| 1968          | 3,780                   | 15.2                   | 3,523                  | 14.3                   |
| 1969          | 4,403                   | 16.5                   | 3,747                  | 6.4                    |
| 1970          | 5,295                   | 20.3                   | 4,108                  | 9.6                    |
| 1971          | 6,622                   | 25.1                   | 4,899                  | 19.3                   |
| 1972          | 9,521                   | 43.8                   | 5,338                  | 9.0                    |
| 1973          | 12,572                  | 32.0                   | 6,156                  | 15.3                   |
| 1974          | 17,166                  | 36.6                   | 11,897                 | 93.3                   |
| 1975          | 21,171                  | 23.3                   | 17,131                 | 44.0                   |
| 1976          | 25,985                  | 22.7                   | 19,441                 | 13.5                   |
| 1977          | 32,037                  | 23.3                   | 24,781                 | 27.5                   |
| 1978          | 43,511                  | 35.8                   | 31,616                 | 27.6                   |
| 1979          | 49,904                  | 14.7                   | 40,215                 | 27.2                   |
| 1980          | 53,848                  | 7.9                    | 46,935                 | 16.7                   |
| 1981          | 61,411                  | 14.0                   | 53,904                 | 14.8                   |
| 1982          | 70,197                  | 14.3                   | 66,203                 | 22.8                   |
| 1983          | 81,319                  | 15.8                   | 79,756                 | 20.5                   |

a. Excludes short-term debt.

SOURCE: Banco Central do Brazil; Chacel 1985, p. 71.

TABLE 12  
LEVEL OF INTERNATIONAL RESERVES AND OTHER EXTERNAL INDICATORS  
OF THE BRAZILIAN MONETARY AUTHORITIES 1971-1986.  
(Billion US dollars)

| YEAR | Exports <sup>a</sup> | Total<br>Imports <sup>a</sup> | Net<br>Interest | Gross<br>Reserves | Net<br>Reserves | Level of<br>Debt <sup>b</sup> |
|------|----------------------|-------------------------------|-----------------|-------------------|-----------------|-------------------------------|
| 1971 | 2.9                  | 3.2                           | 0.3             | 1.7               | 1.4             | 6.6                           |
| 1972 | 4.0                  | 4.2                           | 0.4             | 4.2               | 3.7             | 9.5                           |
| 1973 | 6.2                  | 6.2                           | 0.5             | 6.4               | 5.9             | 12.6                          |
| 1974 | 8.0                  | 12.6                          | 0.7             | 5.3               | 4.9             | 17.2                          |
| 1975 | 8.7                  | 12.2                          | 1.5             | 4.0               | 3.7             | 21.2                          |
| 1976 | 10.1                 | 12.4                          | 1.8             | 6.5               | 5.7             | 26.0                          |
| 1977 | 12.1                 | 12.0                          | 2.1             | 7.3               | 6.2             | 32.0                          |
| 1978 | 12.7                 | 13.7                          | 2.7             | 11.9              | 11.5            | 43.5                          |
| 1979 | 15.2                 | 18.1                          | 4.2             | 9.7               | 9.4             | 49.9                          |
| 1980 | 20.1                 | 23.0                          | 6.3             | 6.9               | 5.2             | 53.8                          |
| 1981 | 23.3                 | 22.1                          | 9.2             | 7.5               | 5.7             | 61.4                          |
| 1982 | 20.2                 | 19.4                          | 11.4            | 4.0               | -2.3            | 69.7                          |
| 1983 | 21.9                 | 15.4                          | 9.6             | 4.6               | 0.09            | 81.3                          |
| 1984 | 27.0                 | 13.9                          | 10.2            | 12.0              |                 | 91.1                          |
| 1985 | 25.6                 | 13.2                          | 9.7             | 11.6              |                 | 95.9                          |
| 1986 | 22.4                 | 12.9                          | 9.1             | 6.8               |                 | 101.5                         |

a. FOB

b. Registered; excludes inter-bank liabilities and short-term debt.

SOURCES : Conjuntura Economica; Banco Central do Brasil;  
E. Cardoso and A. Fishlow 1987, p. 92.

TABLE 13  
BRAZILIAN BALANCE OF PAYMENTS 1979-83.  
(millions of US dollars)

|                                          | 1974-78 <sup>a</sup> | 1979    | 1980    | 1981    | 1982    | 1983    |
|------------------------------------------|----------------------|---------|---------|---------|---------|---------|
| A. TRADE BALANCE                         | -2,282               | -2,840  | -2,823  | 1,202   | 780     | 6,470   |
| Exports (FOB)                            | 10,306               | 15,244  | 20,132  | 23,293  | 20,175  | 21,899  |
| Imports (FOB)                            | -12,588              | -18,084 | -22,955 | -22,091 | -19,395 | -15,429 |
| B. SERVICES                              | -3,711               | -7,199  | -9,741  | -12,394 | -15,527 | -12,721 |
| Interest (net)                           | -1,752               | -4,186  | -6,311  | -9,161  | -11,353 | -9,555  |
| Profits and dividends (net) <sup>b</sup> | -376                 | -636    | -310    | -370    | -585    | -758    |
| Other Services (net)                     | -1,583               | -2,377  | -3,120  | -2,863  | -3,589  | -2,408  |
| C. UNREQUITED TRANSFERS                  | 15                   | 18      | 168     | 199     | -8      | 108     |
| D. CURRENT ACCOUNT BALANCE (A+B+C)       | -5,978               | -10,021 | -12,396 | -10,993 | -14,755 | -6,143  |
| E. NET CAPITAL MOVEMENTS                 | 7,046                | 6,936   | 9,268   | 12,031  | 6,295   | 843     |
| Direct Investment (Net) <sup>c</sup>     | 924                  | 1,491   | 1,121   | 1,584   | 991     | 664     |
| Loans and Financing <sup>d</sup>         | 8,566                | 11,228  | 10,596  | 15,553  | 12,515  | 8,153   |
| Amortizations (net) <sup>d</sup>         | -3,293               | -6,385  | -5,010  | -6,242  | -6,952  | -9,120  |
| Other (net)                              | 849                  | 601     | 2,561   | 1,135   | -259    | 1,146   |
| F. ERRORS AND OMISSIONS                  | -228                 | -130    | -343    | -414    | -368    | -670    |
| SURPLUS OR DEFICIT (D+E+F)               | 840                  | -3,215  | -3,472  | 625     | -8,828  | -5,969  |

a. - Annual average.

b. Excludes reinvested profits.

c. Excludes reinvestments

d. Medium and long-term.

SOURCE : Banco Central do Brasil; Batista 1987, p. 33.

TABLE 14.  
GDP PER CAPITA AND REAL MINIMUM WAGES 1968-1980.  
(1970 = 100)

| YEAR | GDP<br>per<br>Capita <sup>a</sup> | Min. Wage<br>Sao Paulo <sup>b</sup> | Min. Wage<br>Rio de<br>Janeiro <sup>c</sup> | Min. Wage<br>by Basic<br>Food Ration <sup>d</sup> |
|------|-----------------------------------|-------------------------------------|---------------------------------------------|---------------------------------------------------|
| 1968 | 88.5                              | 101                                 | 105                                         | 111                                               |
| 1969 | 94.6                              | 98                                  | 102                                         | 103                                               |
| 1970 | 100.0                             | 100                                 | 100                                         | 100                                               |
| 1971 | 109.3                             | 96                                  | 101                                         | 97                                                |
| 1972 | 118.3                             | 94                                  | 104                                         | 102                                               |
| 1973 | 131.8                             | 86                                  | 107                                         | 85                                                |
| 1974 | 140.8                             | 78                                  | 102                                         | 78                                                |
| 1975 | 145.1                             | 83                                  | 107                                         | 81                                                |
| 1976 | 155.3                             | 83                                  | 105                                         | 79                                                |
| 1977 | 159.8                             | 86                                  | 106                                         | 86                                                |
| 1978 | 163.4                             | 88                                  | 108                                         | 82                                                |
| 1979 | 170.1                             | 88                                  | 108                                         | 80                                                |
| 1980 | 179.0                             | 90                                  | 111                                         | 77                                                |

SOURCES: Taken from: Hasenbalg, C.A. ; do Valle Silva, N. 1987, p. 77

a. Anuario Estadístico do Brasil, FIBGE, p. 802; 1982, p. 802.

b. Joao l.m. saboia, "A racao essencial e sua utilizacao como deflato do salario minimo- 1940/1981." Texto para Discussao no. 23, Instituto de Economia Industrial, Universidad Federal do Rio de Janeiro, 1983 Table I, p. 11. For Sao Paulo the minimum wage was deflated according to the DIEESE series;

c. Saboia, p. 11, Table 1. For Rio de Janeiro the minimum wage was deflated monthly by the Rio de Janeiro cost of Living Index;

d. Saboia, p. 18, Table 8.

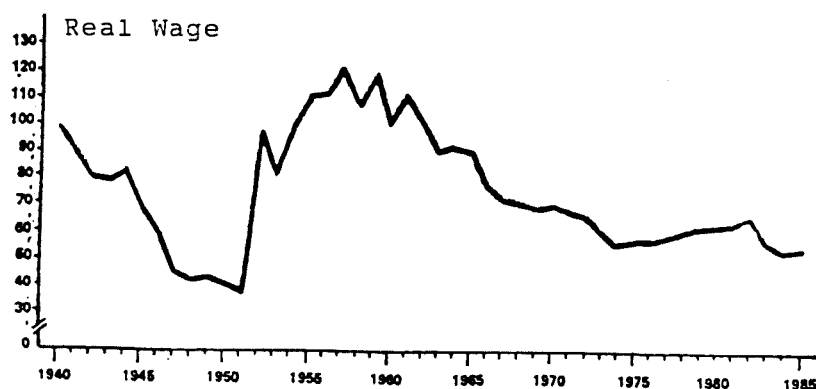
TABLE 15  
TREND OF INDUSTRIAL SALARIES IN SAO PAULO  
(% Change<sup>a</sup>)

|         | 1983  | 1984  | 1985  | 1986  | 1987   |
|---------|-------|-------|-------|-------|--------|
| Nominal | 120.0 | 191.6 | 240.1 | 157.6 | 195.0  |
| Real    | -6.6  | -0.18 | 4.34  | 5.39  | -10.54 |

a. Average percentage in last twelve months; December of each year.

SOURCE: Banco Central do Brasil; Economist Intelligence Unit 1988-89 Brasil Country Report.

GRAPH 1.  
REAL MINIMUM WAGE, SAO PAULO, 1940-1985.  
(July 1940 = 100)



SOURCE: DIEESE: Taken from Saboia, J. 1987, p. 199.

TABLE 16.  
PERCENTAGE SHARE OF INCOME BY SELECTED  
PERCENTILE GROUPS, 1960-1980.

| PERCENTILE  | 1960  | 1970  | 1980  |
|-------------|-------|-------|-------|
| Poorest 50% | 17.71 | 15.05 | 14.17 |
| Richest 10% | 39.66 | 46.47 | 47.81 |
| Richest 1%  | 12.11 | 14.11 | 18.21 |

SOURCE : C.G. Langoni, Distribuicao de Renda e Desenvolvimento Economico do Brasil (Rio de Janeiro, 1973); R. Bonelli, P. Malan 1987; L.A. Hasenbalg, N. do Valle Silva 1987.

TABLE 17  
OCCUPATIONAL STRUCTURE OF THE LABOR FORCE<sup>a</sup>.

| SECTOR                              | 1979                       |       | 1985 <sup>b</sup>          |       |
|-------------------------------------|----------------------------|-------|----------------------------|-------|
|                                     | No. Employed<br>(Millions) | %     | No. Employed<br>(Millions) | %     |
| Agriculture                         | 13.6                       | 31.8  | 15.2                       | 28.6  |
| Manufacturing                       | 7.3                        | 17.1  | 7.8                        | 14.7  |
| Construction                        | 3.0                        | 7.0   | 3.9                        | 7.3   |
| Trade, Restaurants & Hotels         | 4.2                        | 9.8   | 5.8                        | 10.9  |
| Transport, Storage & Communications | 1.6                        | 3.7   | 1.9                        | 3.6   |
| TOTAL Including Others              | 42.7                       | 100.0 | 53.2                       | 100.0 |

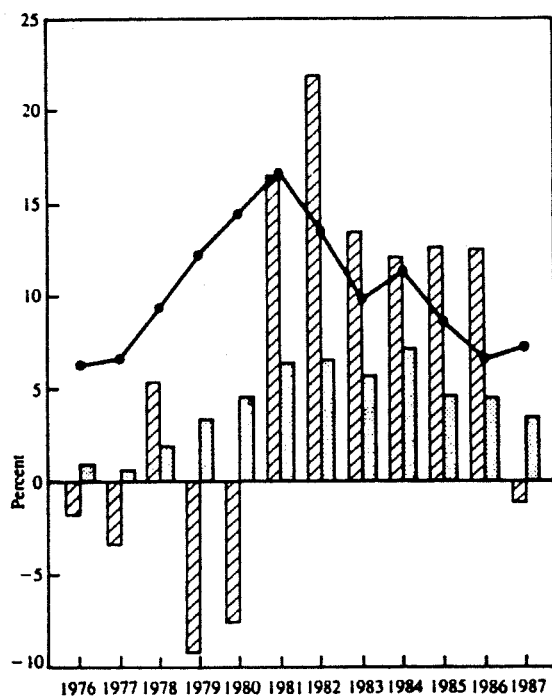
a. Civilian labor force.

b. Excludes rural population of the North.

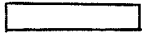
SOURCE: UN, Yearbook of Labour Statistics, 1987; Economist Intelligence Unit 1988-89, Brazil Country Report.



GRAPH 2  
REAL INTEREST RATES AND LIBOR 1976-87



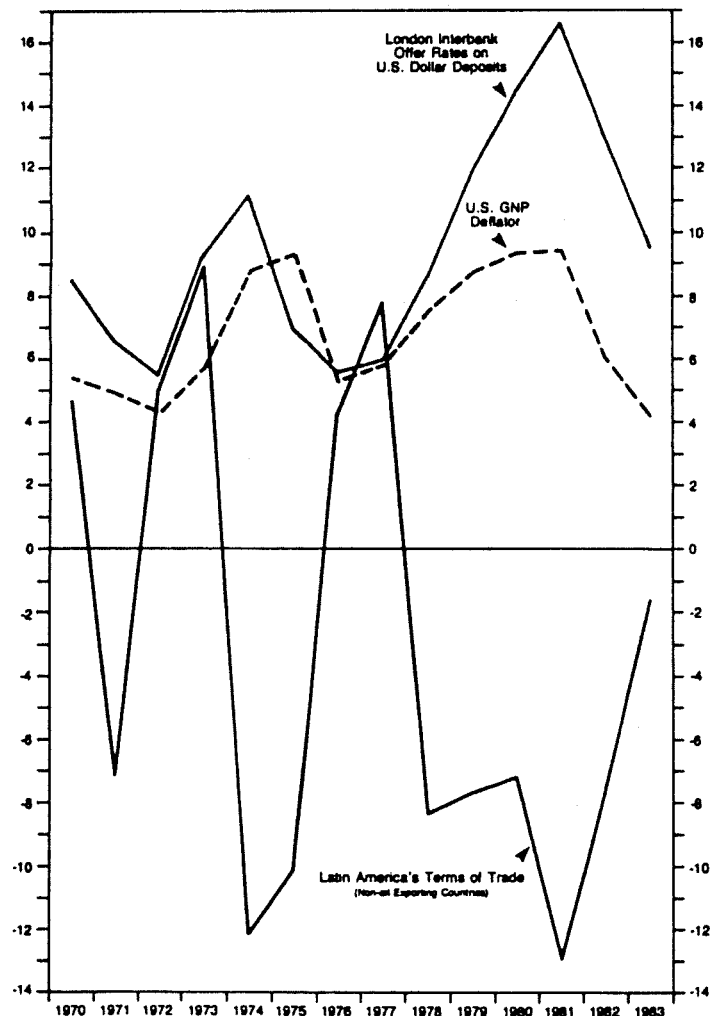
Real interest rates for:

-  developing countries.
-  United States.
-  Six month dollar LIBOR.

NOTE : the real interest rate is defined as the six-month dollar LIBOR deflated by the change in the export price index for developing countries. The U.S. real interest rate is defined as the six-month dollar LIBOR deflated by the U.S. GDP deflator.

SOURCE: World Bank, World Debt Tables, 1987 edition, Vol. I p. xv.

GRAPH 3  
INTEREST RATES, UNITED STATES GNP DEFLATOR AND  
LATIN AMERICAN TERMS OF TRADE.

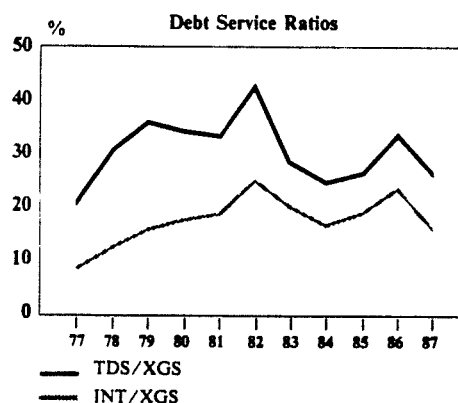
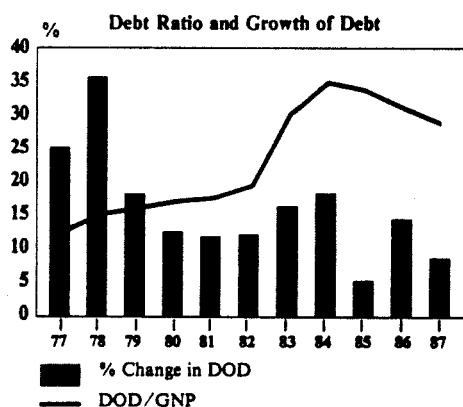
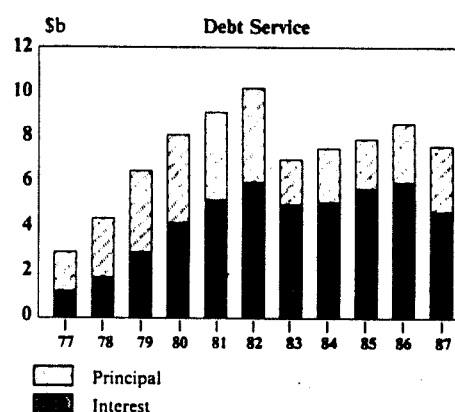
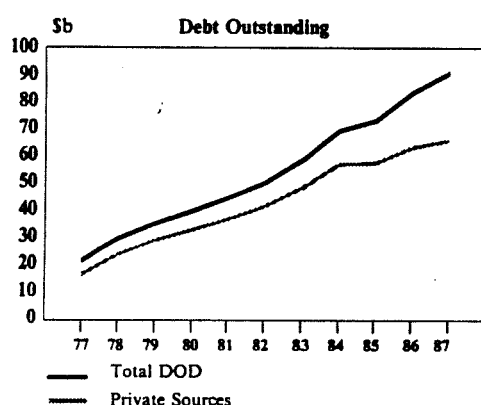


SOURCE: Inter-American Development Bank. External Debt and Economic Development in Latin America. 1984. p. 41

G R A P H 4.  
BRAZIL's DEBT INDICATORS 1977-1987.  
(US \$ millions)

|                                    | 1970  | 1975  | 1980  | 1981  | 1982  | 1983  | 1984  | 1985  | 1986  | 1987  |
|------------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| PRINCIPAL RATIOS.                  |       |       |       |       |       |       |       |       |       |       |
| TOTAL EXTERNAL DEBT :              |       |       |       |       |       |       |       |       |       |       |
| EDT/XGS %                          | -     | -     | 303.1 | 298.4 | 391.6 | 400.5 | 347.3 | 363.3 | 445.7 | 432.2 |
| EDT/GNP %                          | -     | -     | 30.4  | 31.8  | 35.7  | 50.1  | 52.6  | 49.1  | 42.0  | 39.4  |
| RES/EDT %                          | -     | -     | 9.7   | 9.3   | 4.3   | 4.7   | 11.4  | 10.9  | 6.0   | 6.0   |
| RES/MGS(month)                     | 3.6   | 2.9   | 2.3   | 2.3   | 1.2   | 1.7   | 4.7   | 4.7   | 2.7   | 3.0   |
| PUBLIC AND PUBLIC GUARANTEED DEBT: |       |       |       |       |       |       |       |       |       |       |
| DOD/XGS %                          | 109.8 | 142.3 | 173.7 | 168.0 | 216.4 | 242.9 | 231.5 | 251.3 | 333.4 | 319.6 |
| DOD/GNP %                          | 8.2   | 11.6  | 17.4  | 17.9  | 19.7  | 30.4  | 35.1  | 34.0  | 31.4  | 29.1  |
| TDS/XGS %                          | 12.5  | 17.9  | 34.6  | 33.7  | 43.3  | 28.8  | 25.0  | 26.7  | 34.1  | 26.7  |
| TDS/GNP %                          | 0.9   | 1.5   | 3.5   | 3.6   | 3.9   | 3.6   | 3.8   | 3.6   | 3.2   | 2.4   |
| INT/XGS %                          | 4.3   | 8.6   | 18.0  | 19.1  | 25.4  | 20.5  | 17.0  | 19.3  | 23.9  | 16.4  |
| INT/GNP %                          | 0.3   | 0.7   | 1.8   | 2.0   | 2.3   | 2.6   | 2.6   | 2.6   | 2.3   | 1.5   |
| RES/DOD %                          | 34.8  | 29.5  | 17.0  | 16.5  | 7.9   | 7.7   | 17.1  | 15.8  | 8.0   | 8.2   |

PUBLIC LONG-TERM DEBT INDICATORS



MAJOR ECONOMIC AGGREGATES

BASED ON PUBLIC AND PUBLICLY  
GUARANTEED DEBT

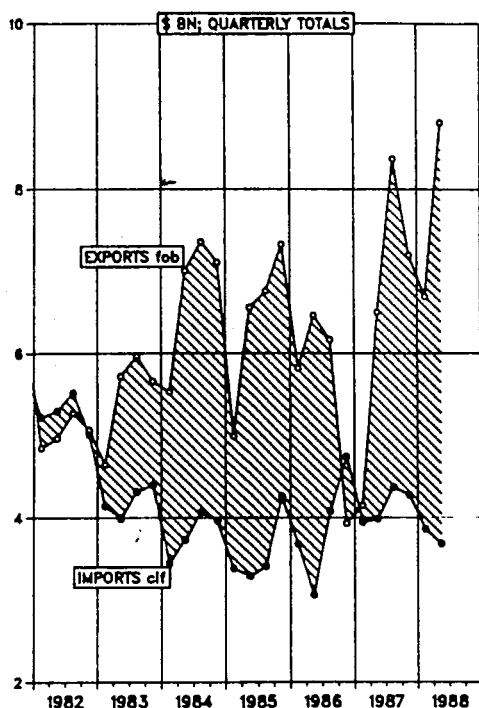
- \* debt outstanding and disbursed to exports of goods and services (DOD/XGS).
- \* Debt outstanding and disbursed to gross national product (DOD/GNP)
- \* Total debt service to exports of goods and services (TDS/XGS) the debt service ratio.
- \* Total debt service to gross national product (TDS/GNP)
- \* Interest payments to exports of goods and services (INT/XGS) the interest service ratio.
- \* Interest payments to gross national product (INT/GNP).
- \* International reserves to debt outstanding and disbursed (RES/DOD)

BASED ON TOTAL EXTERNAL DEBT

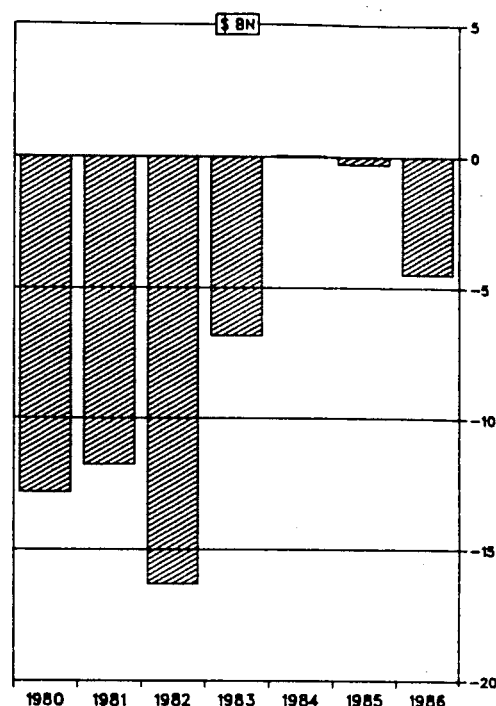
- \* Total external debt to exports of goods and services (EDT/XGS)
- \* Total external debt to gross national product (EDT/GNP).
- \* International reserves to total external debt (RES/EDT).
- \* International reserves to imports of goods and services (RES/MGS).

SOURCE: World Bank. World Debt Tables 1988-89, Edition, Vol. II, p. 45.

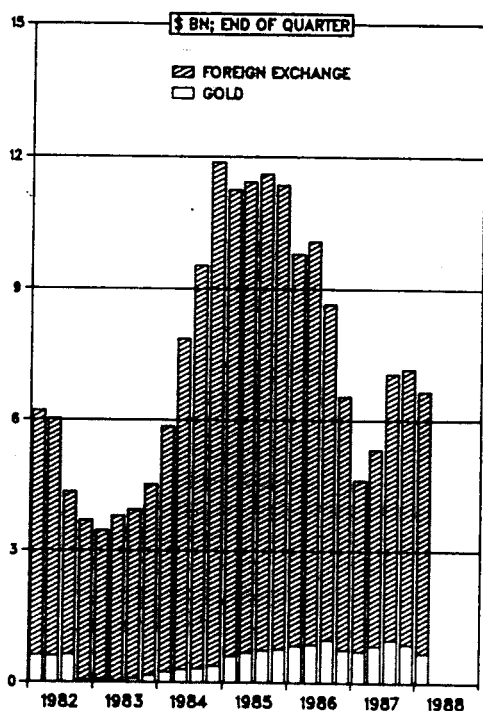
GRAPH 5.  
BRAZILIAN FOREIGN TRADE



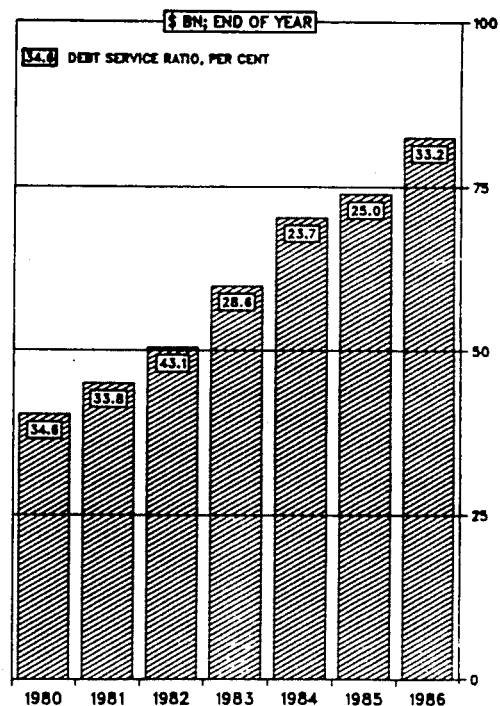
GRAPH 6.  
CURRENT ACCOUNT DEFICIT



GRAPH 7.  
INTERNATIONAL RESERVES

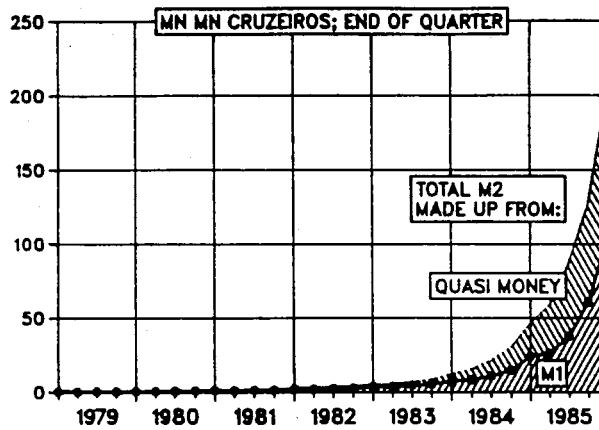


GRAPH 8.  
DISBURSED PUBLIC FOREIGN DEBT.

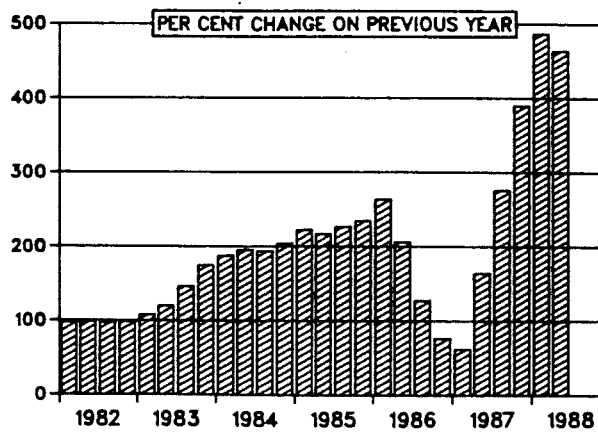


SOURCE: EIU The Economist Intelligence Unit. Brazil Country Report No. 4 1988, Economic Trends in Brazil.

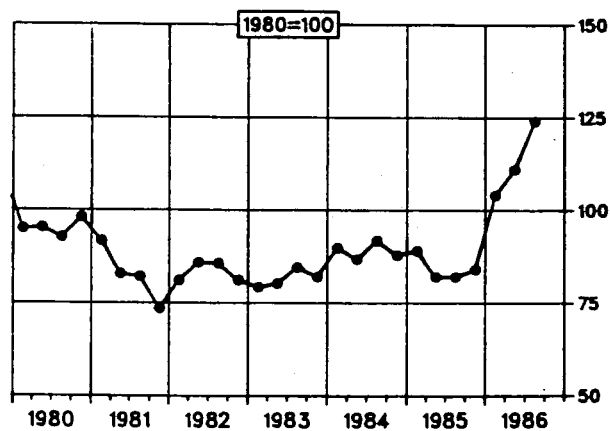
GRAPH 9.  
MONEY SUPPLY



GRAPH 10.  
CONSUMER PRICES



GRAPH 11.  
TERMS OF TRADE



SOURCE: EIU The Economist Intelligence Unit. Brazil Country Report No. 4 1988, Economic Trends in Brazil.

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