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Ann Bernadette Simeo

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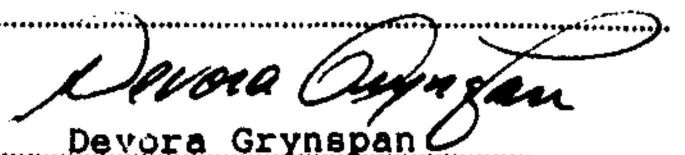

Devora Grynspan
Instructor in Charge

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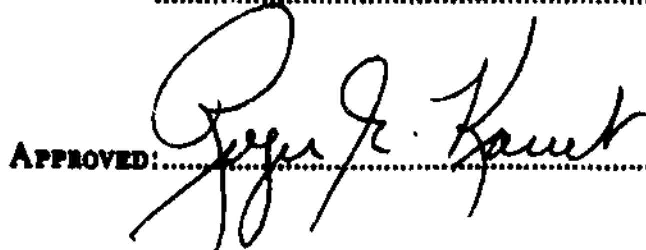

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# THE BRAZILIAN DEBT CRISIS

BY

ANN B. SIMEO

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THESIS

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Brazil is the Third World's largest debtor, owing nearly $107 billion to industrialized nations. The debt crisis has had a severe impact on Brazil, changing it from, "a society that has been generally defined by optimism and high standards of economic achievement to one now dominated by pessimism and lack of perspective."[1] All sectors of society, especially the banks, businesses, and government officials have been seriously affected by the debt crisis. The Brazilian people in particular have suffered as percapita income levels have fallen back to 1976 levels.[2] The debt crisis has placed a great strain upon the economic system and has now become the main obstacle to economic development.[3] Because of their lack of foreign reserves, Brazil has suspended interest payments until better terms are reached with banks. The prospects for Brazil getting out of the present crisis are uncertain. Whether economic recovery is in store for Brazil remains to be answered. It is therefore necessary to examine the crisis to understand its background and the possibility of resolving it.

It is commonly believed that the Brazilian and world debt crisis began in the 1970s with the massive bank lending and subsequent world recession and oil crisis. However, long before Brazil made headlines in the 1970s, they had already been experiencing balance of payments difficulties and debt problems. In fact, by the beginning of the 1960s, Brazil's foreign debt had

already reached more than $2 billion.[4] It is therefore necessary to examine Brazil's past economic policies in order to understand the current crisis. Of particular importance is the Import Substitution Industrialization policy which caused serious economic distortions and imbalances that policymakers later had to contend with in order to insure continued growth and development.

Prior to 1930, Brazil's role in the international economy was as an exporter of primary products such as coffee, cocoa, sugar, tobacco and cotton. Brazil assumed this role because of the small scale of its internal market and the insufficient technological and cultural base inherited from the colonial period.[5] As a result of this position in the world economy, Brazil's economic prosperity became tied to the performance and demand of industrialized countries. In fact, Brazil's dependence on its export sector was of such magnitude that changes in the earnings of the country's principal exports had strong positive or negative effects on the entire economy.[6] During the 1940s, however, the outlook for Brazil's future export markets worsened as an unfavorable worldwide trend for primary products developed. In addition, Brazil's share of the world market for its main export products declined. This decline was due to the increased number of competitors who entered the international market because of the high coffee prices after the postwar period when Brazil dominated the world market.

As a result, Brazil found itself not only among the nations whose exports steadily lost in the share of world trade, but also

among those countries whose exports had little chance of regaining their former preeminence.[7] Policymakers realized that high growth rates could no longer be achieved by relying on the export of primary products. It was in this context that the government decided to change the economic structure by promoting import substitution industrialization.

By implementing an import substitution industrialization strategy, Brazil's growth would supposedly become less dependent on the industrial centers of the world. It was hoped that a Brazilian industrial revolution would lead to greater economic independence as well as further economic and industrial growth.

Under this policy, Brazil's approach to development became "inward looking," emphasizing the development of a domestic productive capacity for as many formerly imported manufactured products as possible.[8] Specific attention was focused on the internal production of more sophisticated consumer durable goods and basic inputs. In order to protect domestic industrialists, the government built extremely high tariff walls around the domestic market. By the 1960s, for example, tariff rates for manufactured products became as high as 184% in Brazil.[9]

As tariff and exchange barriers were imposed, foreign companies were faced with two choices: they could either make large industrial investments in Brazil or they could lose Brazilian markets altogether.[10] Because of the large and protected market, foreign companies chose the first option. Increased foreign investment also resulted from the government's economic policy which favored foreign enterprises over domestic ones through

major exchange, tariff, fiscal, and credit incentives.[11] As a result, direct foreign investment became an important source of economic growth for Brazil through the 1960s.[12]

The industrialization process brought about by import substitution industrialization resulted in high economic growth rates for Brazil. Economic development occured as per capita income increased and real wages and levels of consumption grew as well.[13] Between 1940 and 1961, Brazil's Gross Domestic Product grew 232 percent, more than tripling.[14] Brazil's economy experienced much growth during this period.

By the mid-1960s, however, import substitution industrialization began to lose its dynamism. It began to fail as a viable economic policy because the number of import substitution possibilities diminished. Until the 1960s, it was relatively easy to start a new industrial enterprise in Brazil.[15] Investors only needed to find a product that had previously been imported and acquire the technology required to make it. After saturating the Brazilian market with domestically produced goods, the number of products that could be produced by ISI decreased. This was a result of the limited number of remaining imported goods that could be produced efficiently in Brazil or else could not be produced because of the huge investments needed by entrepreneurs. As a result of the lack of new investment possibilities, foreign and domestic investment decreased substantially. The amount of gross investments fell from around 16.5% of the national income at the beginning of the decade to 10.7% or 12.8% respectively, in 1965 and 1966.[16] Since Brazil

and other Latin American countries became short of local investment capital, they sought foreign funds in the belief that increased investment would lead to economic prosperity.[17] Brazil eagerly took advantage of the readily available and relatively inexpensive foreign bank loans in the 1970s because of the shortage of investment capital.

The ISI policies thus left a legacy of economic problems that seriously affected Brazil's balance of payments position. By the 1960s, the neglect of international trade during the ISI years had placed the country in a dangerous situation.[18] The ISI policies, in effect, were detrimental to the export sector as exports were neglected during this period. Long periods of exchange rate overvaluation were said to have acted as a restraint on the expansion of both traditional and new exports as well.[19] The significance of this neglect of exports is that it placed Brazil in a dangerous balance of payments position, since a decline in export earnings necessitating a reduction of imports led to industrial stagnation.[20] The result of this was a massive accumulation of account deficits and foreign debt.

After twenty years of ISI, Brazil's debt had grown tremendously for another reason. The increased debt also resulted from the increase in imports for parts, technology, raw materials, and oil that was needed for industrialization. These imported intermediary products had to be paid for with dollars. However, because of the decrease in exports, not enough foreign exchange was earned to pay for these imports. Brazil was then forced to borrow money in order to finance imports . The result was a massive

increase in Brazil's foreign debt.

Thus, Brazil's foreign debt began growing in the 1960s, long before the crisis of the 1970s. Brazil's balance of payments problems resulted from the growth in the 1950s which was financed in large part by foreign capital consisting of direct investments and loans. Many of the loans were short-term, and both interest and amortization payments produced increasing balance of payments difficulties.[21] The foreign debt had already reached more than $2 billion by the 1960s. Because ISI policies had been so one-sided, the Brazilian economic system was already in crisis by the end of the 1960s, even before the 1970s world debt crisis.

It is from this general bac kground that the 1970s and present crises can be examined. During this period, foreign bank lending to Latin American countries increased dramatically. The oil shock was one of the events which led to this explosion of bank lending. The surplus funds from OPEC price rises meant that more money was recycled through the western-controlled world financial system. Most of the surplus money was channeled from the oil-rich nations to the private commercial banking sector. The international capital markets experienced an explosive growth--from $20 billion in 1973 to $2,000 billion in 1982--becoming the single most important channel for the transfer of savings from surplus to deficit countries.[22] These banks were eager to put the capital to productive use and readily extended loans to Brazil.

In light of today's crisis, many question the reason why bankers made such huge loans which turned out so badly. One

explanation for the loans is that banks exploited loopholes in federal regulations designed to limit the amount of money they were permitted to lend any one borrower in order to make profits.[23] For example, loans were made to the Brazilian government and state-owned oil company, Petrobras, arguing that since they were legally distinct entities, each was entitled to borrow up to the legally permissible limit.[24] The result of such interpretations by the banks was that they boosted their loans to Brazil far above the limits prescribed by U.S. regulations.

Another explanation for the frenzied bank lending claims that the information about borrowers was limited and flawed, and because of the pressure of excess liquidity - "too much money and intense competition" - bankers did not pay much attention to the data that was available.[25] Likewise, loan applications were only hastily reviewed to see if the project was economically sound and if the borrower could at least pay interest. Bankers' salaries, promotions and bonuses were awarded on the basis of how many loans were made, not by how many loans were repaid.[26] Thus, it was in the bankers' interests to make as many loans as possible.

Others have argued that at the time, the banks' approach to lending did not appear unreasonable. Whether or not banks would lend a country money depended on an assessment of that country's credit-worthiness which was calculated by examining the ratio of debt service payments to exports. Because developing countries were growing rapidly and maintaining healthy export levels, their debt service to export ratio did not change

over the course of the decade.[27] Thus, Brazil and other nations were able to borrow heavily after being deemed "credit-worthy." Optimism that the economic conditions and high export levels of the 1970s would continue was an underlying rationale for the enormous amounts of bank lending.

Brazil's increased borrowing during this period can also be explained by several reasons. By borrowing abroad, capital could be channeled to local businesses and economic growth could be achieved without losing control of the local economy to foreign corporations. Foreign finance was also expected to spur industrial expansion; to build new productive facilities; develop natural resources; produce basic inputs (steel and energy); fuel modern industry; and provide cheap, often subsidized supplies to domestic industrial firms.[28] Foreign loans would enable industries to increase the production of goods and thus raise the output of products which could be sold on overseas markets. As industry and exports expanded, part of the increased export earnings could be used to service the debt.

Thus, with the new imported capital borrowed at low interest rates, Brazil was able to finance a major program of industrial expansion. For example, the international banking community lent money to Brazil's state-owned steel industry. This industry was able to expand its capacity, increasing the number of orders it placed with local private industry. Part of the production of the steel mills was exported in order to service the foreign debt. This boost to the steel industry provided new impatus for the shipbuilding industry and resulted in Brazil

entering the top ranks of the world shipbuilding industry. In addition, Brazil built up its state-owned petroleum industry by expanding plants' existing capacities and constructing new ones. Brazil also undertook construction of a Fiat car plant in Betim in 1974. In the south of the country, they built the Itaipu hydroelectric power plant, the largest in the world. Foreign capital also went toward the Carajas mining complex. Brazil also modernized its transportation system in the cities. Millions of dollars were pumped into its alternative fuels program, proalcool, as thousands of distilleries were set up. By far the biggest Brazilian debtor was Electrobas, the national electric energy holding company, which accounts for nearly one-tenth of all domestic investment, half of which is financed abroad.[29] Foreign finance thus accounted for nearly one-sixth of all Brazilian domestic investment in the 1970s.[30]

Foreign financing thus spurred dramatic advances in industrial production and economic development. Between 1960 and 1980, Brazil's GDP quadrupled.[31] Brazilian exports also increased from $1.7 billion in 1967 to over $20 billion in 1980. Exports of manufactured goods in particular increased from virtually nothing to over $10 billion during the same period.[32] Overall economic growth ensued in the 1970s, bring rising productivity, the growth of capital, and industrialization to Brazil.

Despite the expansion of Brazilian industry, economic growth did not last for long. The continued success of this system rested upon Brazil's ability to increase exports and keep debt payments within reasonable limits.[33] In 1979, several factors emerged

which sabotaged these two prerequisites of continued growth.

A major factor leading to the decline in Brazil's growth rate and debt crisis was the North American and Western European recession during the late 1970s which led to a slowdown in the volume of growth of world trade and in Latin American exports.[34] Because 70% of Latin American exports are bought by industrialized nations, their economies are vulnerable to the demand in the developed countries. The world recession thus led to falling prices for most non-oil export commodities and a decrease in demand for imported goods. The European Economic Community's declining demand for Brazilian steel meant, for example, that sales of foundry products dropped from 254,000 tons in 1980 to 157,000 tons in the first ten months of 1982.[35] At the same time, protectionism in the industrialized countries increased in order to keep out Latin American imports. Since exports were the most important source of finance for Brazil, the cost of servicing the debt drastically increased as the number of export markets diminished.

Overall, the Brazilian economy as a whole faltered around 1979 because of the world-wide recession. By 1981 the industrial sector recorded its first and largest decline in about 20 years. The car industry and machinery and equipment sectors saw negative growth at the onset of 1981. The gross domestic product (GDP) also declined, falling from 11.3% between 1967 and 1973 to 5.4% during 1974 and 1983.[36] Industrial output also fell, dropping from 12.7% in the first period to only 5.4% between 1974 and 1983.[37]

Another factor which worsened Brazil's economic situation during this period was the high interest rates on borrowed money which affected the amount Brazil had to find to service their debts and made new borrowing more expensive. Much of Brazil's outstanding debt was composed of short term finance, lent at floating interest rates, so that interest increases showed up quickly in debt service figures. The increase in the U.S. prime lending rate went from 11% in 1979 to over 20% by 1981 which meant disaster for Brazil as their interest payments on their debt soared.[38] The $11.5 billion of required interest payments swamped its $6.3 billion trade surplus.[39] By 1982 Brazil's economy was increasingly burdened as their debt service ratio (interest and principal payments as a share of export earnings) increased to 78%.[39] There was also less recycling of petroleum dollars by western banks after 1979 which meant that less surpluses of money were entering the banking system and there was less to lend out.[40] This worsened the situation because it became increasingly difficult for Brazil to pay back debts due to the high interest rates and also affected their ability to borrow money.

The 1970s crisis also stems from the debts Brazil accumulated from their policy of rapid industrial expansion. They were able, however, to offset part of the debt incurred from their industrial expansion by a strengthening of their export performance and the growth of international reserves held by the government.[41] However, the expansion of industry increased the demand for petroleum-based products. Brazil's fuel alcohol

program helped substitute for petroleum but could not completely replace it. The remainder of the oil Brazil needed had to be imported from oil producing countries. Thus, the high oil prices meant that they were faced with an increased oil bill, and by 1981, petroleum products accounted for over one half of Brazil's import bill. The import bill increased as the price of oil increased, resulting in a worsening of the debt.

As a result of the above circumstances (the fall in exports, increased interest rates, the world recession and the oil shock), Brazil's balance of payments situation became considerably more serious after 1979.[42] Consequently, Brazil's foreign exchange position was already quite unfavorable at the beginning of 1982. By the end of 1982, Brazil's international reserves were negative by several billion dollars, falling from $7.5 billion in December 1981 to only $4 billion by December 1982.[43]

Between 1977 and 1983, the debt increased by $57 billion from $35 to $92 billion, making Brazil the world's largest debtor. 85% of this increased debt represented borrowing to pay interest. By the fall of 1982, it had become nearly impossible for Brazil to continue servicing its foreign debt. In November the government declared its intention to seek access to IMF funds.

Since the debt cris in 1982, Brazil has been involved in rescheduling its external debt. Two-thirds of the debt is owed to foreign commercial banks and several hundred individual credit institutions from the United States, Europe, Japan, and other countries.[44] The problems of coordinating and keeping all these interests in balance has been a major challenge for Brazilian

authorities. The negotiating process has been difficult at best as Brazil remains the world's largest debtor. Because of the importance of this issue for Brazil in the short and long-run, it is necessary to examine Brazil's economic policies in order to understand why the debt problem persists today.

At the end of 1982, Brazil declared a moratorium on the principal of its debt yet continued paying interest and dividends while negotiating with the IMF and main creditors. Brazil began negotiations with the IMF despite its aversion to the institution. Since the fifties, the IMF has been considered by Brazilians as a "representative of the international financial system, incapable of understanding the characteristics of underdeveloped countries."[45] It was felt that the IMF's stabilization plans which use severe monetary and fiscal policies, tend to induce recession or solve the problem of inflation at a social and economic cost that is not proportionate to the results achieved.[46]

Brazil had two alternatives at the end of 1982: to declare a complete moratorium or to declare a moratorium of the principal and continue paying the current interest and dividends while negotiating with the IMF and main banks.[47] As previously noted, Brazil chose the second alternative. Thus, in order to meet their repayment obligations, Brazil had to go to the IMF to get its "seal of approval" which would unlock larger amounts of new finance from governments and private lenders. In January of 1982, Brazil signed a letter of intent with the IMF which promised $6 billion of trade surplus, a cut in the public deficit to half its

size, and a 90% inflation rate.[48] In order to achieve a trade surplus, however, Brazil was forced to follow an IMF austerity plan which reduced domestic consumption and workers' living standards in order to free resources for export so that hard currency export earnings could be applied to the debt service.[49] In exchange for these targets, Brazil would receive new loans from the IMF and the main international banks. It was hoped that this money would be sufficient to pay the interest or current accounts in 1983. By April, however, it became apparent that this proposal would not be met as initially planned. The $6 billion trade was achieved but only because of a very strong recession that cut imports. Inflation, on the other hand, increased from 100% to 180% by the end of the year because of the maxidevaluation of the cruzeiro and other price measures recommended by the IMF.[50] The target for reducing the public deficit was also not reached. Likewise, the new money given from international banks was not enough for Brazil to meet its balance of payments in 1983. This was due to foreign banks' reluctance to increase short-term financing because of growing doubts concerning Brazil's trustworthiness.[51] As a result of Brazil's failure to meet all the planned targets, the IMF demanded further austerity measures and a new round of negotiations was started halfway through 1983.

During the second round of negotiations, new financing was designed to meet the credit requirements for 1984 and cover the shortfalls of the 1983 program. One change that was made was the application to the Paris Club to reschedule amortizations and interest due on loans from foreign governments.[52] Previously,

only medium- and long-term amortizations were rescheduled. Despite these changes, the new agreement with the IMF basically retained all the major characteristics of the first agreement. For example, the second agreement continued the IMF's demand for a lessening of the current account deficit and decreased inflation. Like the first program, this one did not allow an appreciable increase of international reserves.

The IMF's austerity programs have had a significant impact not only on the Brazilian economy but on the people as well. Brazil's Finance Minister Dilson Funaro severely criticized the austerity measures imposed by the IMF which were designed to stop inflation and manage the debt crisis. These policies, he claims, have "led to a recession where the jobless cannot buy milk or meat and malnutrition and infant mortality have increased."[53] Laborunions, local businessmen, and others whose income and consumption were reduced by the austerity measures have opposed the plan. Food riots sta: ed in Brazil as slum dwellers on the outskirts of the cities were driven to near starvation. Better-off workers in the modern industrial sector were also negatively affected by the austerity measures. The industrial depression stemming from such measures resulted in a wave of labor combativeness. The urban middle class was also affected since they became prosperous primarily as government employment grew.[54] Since the austerity programs cut state spending, government employees' salaries and jobs were cut. Much of the middle class turned from conservatism to protest to defend the public sector against attacks by foreign creditors.[55] Thus, it was widely felt

that Brazil's financial policy was being conducted with an eye toward ensuring that banks get repaid, irrespective of what happened to the local economy or domestic standards of living.[56]

The severest criticism, however, came from the business community. Manufacturers of goods had prospered during the previous years of expansion. As government spending was cut, however, orders for capital goods were cut, and industries suffered. Opposition to Brazil's economic policy grew as more and more once prosperous firms became bankrupt and massive unemployment ensued. Brazilian businessmen's new revulsion to the consequences of foreign borrowing and the governments that encouraged such policies made them leading critics of the regimes in power.[57] And Brazil's leading business group declared in 1983 that, "it is reckless to subject Brazil to a repressive adjustment of uncertain duration...the prolonged shrinkage of productive activity will inevitably lead to the destruction of Brazilian private industry and could even threaten the continuance of the free enterprise system."[58] The Brazilian government, as a consequence, found itself torn between making debt payments and meeting the needs of its people.

Burdened with debt, unemployment, and rising inflation, several plans were initiated in an attempt to confront the world and Brazilian debt crisis. The Bradley in particular did not resolve the Brazilian or world debt crisis. Senator Bradley's plan advocated a large write-off: 3% of the outstanding principal on the debt for the largest 15 debtors in the next 3 years, and reduction in interest rates paid to service the debt by 3%.[59]

In return, Latin American countries would ease trade restrictions. This plan, however, may have provided temporary debt relief if implemented, but only at the banks' expense. The reduction in outstanding principal and interest rates would result in a $50 billion loss for banks.[60] These banks would also not be compensated for these by industrialized countries' governments. In addition, this plan did not take into consideration the fact that there is no legal mechanism which can force international banks to give up their claims on repayment of principal and interest.

As Brazil struggled to find an answer to its economic problems, they implemented the Cruzado plan in an attempt to stop inflation and stimulate the economy. In order to avoid the crippling IMF austerity programs, Brazil needed a plan that would foster economic growth and pull the economy out of recession. Jose Sarney hoped that the Cruzado plan would help Brazil expand its productivity and create jobs in order increase exports, the only source of foreign exchange for financing the debt. It was also hoped that this plan wouldcontrol the runaway inflation that distorted prices and purchasing power. The end result of the Cruzado plan turned out much differently than anticipated. The long term effects of this plan were not foreseen as it caused the debt crisis to reaach a new unmanageable level by the end of 1986.

Until this reform, inflation had been running at a 250% annual rate.[61] The Cruzado plan contained four main parts designed to achieve its intended goals: a total price freeze, an end to Brazil's cost of living indexes, increases in minimum wages, and the replace-

ment of the cruzeiro with the cruzado as the new unit of currency.[62] In the short run, the plan was successful as expectations were for the most part satisfied. Inflation was held to less than 5% and price stability became a reality. One million new jobs were added, the GNP surged at a 10% annual rate, and a large trade surplus was bestowed upon Brazil.[63] Interest rates also fell to less than 50% annually. Although this plan was successful in the short run, the government did not foresee the economic problems it would exacerbate as Brazil is now unable to meet payments on its $107 billion foreign debt.

Under the plan, prices were frozen across the board on items ranging from raw materials and consumer goods to durable goods and services. Consumers reacted with a consumption spree which changed the whole thrust of the economy from speculation to production. Factories which ran at half capaacity in the severe recession of the 1980s could not keep up with the new demand.[64] As interest rates were lowered by savings institutions, people began to withdraw their savings to buy durables and luxuries that they could not previously afford.[65]

The Cruzado plan differed considerably from previous IMF austerity plans. The Cruzado plan sought to increase consumption in order to stimulate economic growth. They achieved this goal by increasing wages and decreasing prices which stimulated buying. The result was an increase in industry's production that could not even keep up with consumer demand. IMF plans on the other hand involve decreasing consumption in order to free this exchange for servicing the debt. Under IMF policies,

businesses suffer greatly from austerity measures which cut state spending and dry up foreign finance. As a result, industry that had expanded as a result of government orders suddenly finds that these orders have dried up. The people suffer perhaps the most as they are forced to accept reductions in wages and consumption. The IMF also insists on import controls to achieve more favorable balance of payments positions. The Brazilian people eagerly embraced the Cruzado plan since it improved their standards of living immensely.

Enforcing the plan was difficult, however, as the government relied on Brazilian citizens to monitor prices and make sure stores were complying with price freezes. Any violations were to be reported to federal and state authorities. According to President Jose Sarney,"the prompt reaction of the people to price controls aroused a popular movement without precedent in Brazilian history."[66] This popular support soon died down as the second more stringent stage of the program was implemented. This part of the program drastically increased taxes in order to curb consumer buying power which was pushing up prices despite official restraints. Taxes almost doubled prices for cars, fuel, cigarettes, and alcohol.[67]

Opposition to the Cruazdo plan grew among other sectors as well. Agricultural and industrial interests both sought an end to the price freeze. Businessmen withheld their goods rather than sell them at fixed prices. Farmers, for example, refused to sell their herds and produce at fixed prices which led to a beef shortage for the first time in two decades.[68] Other shortages

of consumer goods occured simply as a result of excess demand and the unwillingness of suppliers to sell at low prices. The excess of demand manifested itself through the emergence of black markets which permeated the economy.

By February of 1987, it became apparent that the Cruzado plan was," an extraordinarily mistaken policy."[69] Eleven months after its inception, under the forces of shortages and a growing black market, the Cruzado plan collapsed. Although the Cruzado plan brought inflation to zero, it did not eliminate its causes. According to economist Forto Goncalves of the Getulio Vargas Foundation, "Inflation can not be eliminated through decree or through price freezes."[70] Triple digit inflation is now on its way back since the plan's demise. The government lifted the price freeze and inflation rates are predicted to reach 500% this year.

The most important consequence of the failure of the Cruzado plan is that the country's debt crisis has flared up again. Six months ago when the economy began booming under the Cruzado plan, it appeared that Brazil was overcoming its debt problems. The monthly trade surplus during this period averaged more than $1 billion and foreign exchange reserves exceeded $11 billion.[71] It appeared that Brazil would also get significant concessions from its creditors and be a credit-worthy borrower once again. This hope, however, proved illusory as trade surpluses fell significantly during the later part of the Cruzado plan. Along with the unprecedented consumer spending boom came an increase in imports and exports being channeled instead into the local economy.

This made the country's foreign exchange reserved and trade surplus plummet, bringing back the debt crisis. The trade surplus fell to between $150 million and $200 million since October, while reserves used to cover debt payments reportedly have slumped to under $4 billion.[72] In January 1987, Brazil's monthly trade surplus fell to $129 million, the lowest in four years.[73] This decline of trade surpluses significantly affected Brazil's ability to service its debt payments. It is expected now, however, that with the end of the Cruzado plan the government will allow exchange rates to stabilize at a level that will promote increased foreign trade.[74] There will hopefully be an increase in Brazil's trade surplus which will make it easier to make payments on its $107 billion debt.

The failure of this plan has led to Brazil's present economic situation. President Jose Sarney announced in February that Brazil would suspend interest payments on its $67 billion medium and long-term debt owed to private banks for an unspecified period of time. Sarney did not repudiate Brazil's debt but said that interest payments would not be resumed until banks gave Brazil better terms. Brazil will thus continue paying interest on the $40 billion it owes to international lending institutions such as theWorld Bank and foreign governments. Brazil became unable to meet its debt service payments because of the decline in foreign reserves brought on by the dramatic decrease in Brazil's trade surplus. Sarney issued this moratorium because he does not want Brazil to pay its debt by sacrificing development and provoking internal imbalance. According to Sarney, "We cannot

pay the debt with the hunger of our people."[75]

Instead, Sarney is asking for a restructuring of the debt on more favorable terms in the next round of debt negotiations in New York. Unlike other debtor countries, Brazil wants to negotiate directly with creditor nations' governments to resolve its debt problems. In past negotiations, Federal Reserve Board chairman Paul Volcker held together the international debt structure by getting creditor banks to agree to new terms and financings. This time, however, Volcker may not be able to handle the situation as was previously done since banks are divided over what approach to take towards restructuring. Citicorp, for example, insists that the terms of restructuring be made as strict as possible, allowing few concessions for debtor countries. Sovran Financial Corporation and 35 to 40 other regional banks do not plan on giving additional funds to Brazil or other debtors. "Why should we when we don't think it will be paid back?" asked James Kirkpatrick, a Sovran senior vice president.[76] Most banks however prefer a softer approach than Citicorp and the big regionals to guard against the possible collapse of Third World economies.

The position of the banks is even stronger today because they are in a better bargaining position than they were during the 1982 crisis. Some banks feel they are able to resist further concessions sought by debtor countries because of the extensive reserves that they have built up. Even the threat of global financial ruin, once a powerful incentive to keep Third World loans current at any cost, has dimmed.[77] This is true because many banks, especially European and Japanese ones, have built

reserves and capital and seem capable of preventing a sudden collapse. European banks in particular are "less inclined than before to throw good money after bad to keep credit alive," says MIT's John Dornbusch.[78] Some banks are taking losses rather than loaning new money. The Republic Bank of New York, for example, took $40 million of losses on a mixture of sovereign Mexican, Brazilian, and Argentinian debt.[79]

Despite the relatively better position of some banks, U.S. banks' profits may be drastically affected. In the short run, if Brazil's debts are unpaid for over 90 days, U.S. banks can by law no longer count the anticipated interest payments on these loans as actual income, affecting their bottom lines. In the long run, there would also be an effect on banks' bottom lines if the debt goes unpaid. At the Institute for International Economics in Washington, William R. Cline, an international debt expert estimates that if the Brazil problem is not resolved by the middle of next year, it will probably knock about 40% off big bank profits.[80]

Another feared result of Brazil's declared moratorium is that other Latin American countries will follow suit. Paul Volcker said that the possibility that Brazil's action could influence other debtor nations, "is always a potential problem."[81] Argentina, for example, said that it may follow Brazil's lead and declare a moratorium unless commercial banks provided more than $2 billion in new financing.[82] The Dominican Republic as well may suspend payments on its $5 billion debt. President Alan Garcia of Peru supported Brazil's move, saying that it confirmed the correctness of their own decision to limit payments on its debt.

The debt crisis has had a very destabilizing effect not only on Brazil's economy but on the United States as well. In particular, U.S. workers have suffered from the debt crisis. Over one million jobs have been lost due to Third World austerity measures which swelled exports and decreased imports.[83] The crisis has added half a percentage point to U.S. unemployment each year and billions to the budget deficit.[84] The Latin American market for U.S. exports has also seriously declined because of the curtailment of imports, resulting in an $11 billion loss of exports to Latin America between 1981 and 1985.[85] Because of the serious impact of the crisis on U.S. and Brazilian economies, it is in their interest to find a solution to the debt problem.

At present, there are no easy solutions for managing the debt and it remains the foremost challenge facing Brazil. Until a new renegotiation plan is reached between Brazil and the banks, the present moratorium will continue to adversely affect both parties. Brazil needs short-term policies to deal with the crisis in the immediate future and must also formulate long-term developmental policies to deal with the debt. The outcome of the situation depends upon several factors including the willingness of Brazil and the banks to work together to reach a debt relief plan.

In the immediate future, Brazil must arrange a new debt renegotiation plan with its creditors. Restructuring the debt is necessary to extend current and approaching maturities; this allows billions of dollars in new money to be available for debt service payments. Thus, Brazil is currently seeking $20 billion in

loans in the next five years to finance debt payments.[86] This would be an effective way to deal with the repayment problem, but only in the short run. Since Brazil lacks the foreign currency to pay back both the interest and principal of the debt, this policy would enable them to repay part of the debt, but only by borrowing more. There are several problems with this approach. One problem is that it calls for banks to reschedule the debt and lend new money, yet it has become increasingly difficult for Brazil to get new loans. Banks are hesistant to "throw good money after bad" and increase exposure to bad credit risks.[87] The U.S. Congress and taxpayers are also extremely unwilling to come up with even small sums of extra money to grant short-term relief.[88] The effects of such a bailout on the U.S. economy would be uncalculable as inflation and heavier taxes would be the expected results.[89] In addition, no new loans are likely to be made until the present stalemate between Brazil and the banks is broken and payments are resumed.

Another problem with increased bank lending is that by borrowing more, Brazil will only exacerbate the debt problem in the long run. Rescheduling only changes the timing and not the volume of the debt. Bankers have carried the foreign debts on their books at face value although some say that its actual value has fallen. This has been done through repeated restructurings that supply new loans to help cover interest on old ones, keeping the credits technically current, but piling more debt on the Third World's shoulders.[90] The result has been an increase in Third World debt from $752 billion to $888 billion between 1982 and 1987.[91]

The heart of the problem is that bankers must lend money so that Brazil can pay interest on old loans. 85% of Brazil's increased debt between 1977 and 1983 represented borrowing to pay interest.[91] Additional borrowing increases the total debt. New lending means higher interest payments in the future and a second round of additional lending to pay the rapidly increasing interest bills. Thus, borrowing more and more to pay interest only puts Brazil deeper in debt and no closer to servicing its payments.

Much of the increased debt therefore results from high interest rates which keep interest payments at unaffordable levels. For Brazil, the ratio of interest payments to export earnings is not expected to fall significantly below the level that sparked the crises in 1982 and 1983.[92] Brazil therefore does not benefit from achieving new trade surpluses by decreasing consumption and increasing investment since this money gets turned over to banks in the form of interest payments. Since countries must borrow to manage the debt, many Latin American debtors have proposed limiting the amount of interest they are required to pay. In particular, the Latin American Economic System (SELA) has formulated a plan calling for steep reduction in the volume of export earnings committed to interest payments.[93] This proposal calls for interest payments to be based on the ability to pay and not on some predetermined interest rate. It also recommends that Latin American countries use only 15 to 25% of their earnings to service the debt. This policy would help Brazil since they currently use 44% of export earnings for debt service payments.[94] The plan also states that if export earnings increase, the percentage paid to banks would increase proportionally.

The advantages of such a policy are numerous. Debtor nations would benefit as they would save nearly $15 billion a year from reduced interest payments.[95] They would no longer have to borrow more and increase exports to pay interest since the debt would decrease once interest payments declined. In addition, money previously used to service the debt could be used for domestic consumption and investment instead. It could also be used for expansion and modernization of the production sector, resulting in an improvement of Brazil's debt servicing capacity.[96] There costs, however, to this plan since bankers would suffer losses from decreased interest payments. Bankers would also be less inclined to make additional loans to countries that partially defaulted on payments.

Some leaders have suggested going one step further and defaulting on payments altogether. Several Brazilian officials feel that the most viable and profitable option would be total repudiation since the debt is too astronomical to be paid back.[97] They also argue that using whatever foreign exchange that can be earned to be spent on reducing the debt would simply make Brazil's economic situation more unstable.[98] This would reduce investment in development which would lead to unemployment. It would also mean curtailing imports which could bring about a scarcity of imported goods and such necessities as food. The final impact would be hardship for the Brazilian people who would suffer as a result.

This alternative, however, would only be advantageous for Brazil. They could start anew and develop economically without the burden of the debt looming over the country. Like the SELA

plan, Brazil could use the money spent to service the debt and use it instead to boost economic growth and standards of living. They would therefore be relieved of all responsibility of the debt while bankers would be burdened with the bill. This could put the banking system in jeopardy since the banks have lent 200% of their capital and reserves to the Third World, with $290 billion of it to Brazil, Argentina, and Mexico.[99] If Brazil alone were to default, many of the banks would operate in the red for years to come.[100] This policy would be rejected by industrialized nations for this reason as well as another; namely that taxpayers in the industrialized nations whose banks lent money would not be eager or willing to pick up the check for Brazil's defaulting.[101] Finally, it would destroy Brazil's credit-worthiness since no bank would want to risk lending money again. This would seriously affect Brazil's ability to borrow funds for future development projects. It would also close off larger and more valuable access to foreign reserves, assets, credits, markets, and technology.[102]

A long-term policy is therefore needed which will facilitate debt servicing while promoting economic growth. Such a solution arises from the recognition of the link between poor economic growth, high debt and international trade. Stimulating economic development through export expansion and increased private investment may offer the most effective way out of the debt crisis in the long run.[103] Simply borrowing more and more money to pay back the interest and principal of the debt only exacerbates the problem in the long run; real economic development will enable Brazil to expand the economy and earn the foreign currency necessary to repay the debt.

Export promotion in particular is a possible solution.

Without foreign trade, the foreign exchange necessary to repay the debt cannot be acquired. Countries following an outward, market-sensitive orientation for long periods have been better able to weather debt difficulties than those relying less on market forces to guide economic policies.[104] Following a switch in trade policies from ISI to export promotion, Brazil's export growth rates increased considerably. As a result of this new trade outlook, Brazil experienced an especially rapid growth of manufactured exports, an important precursor of economic growth.[105] Such an outward-looking policy may help Brazil achieve trade surpluses necessary for adjusting its balance of payments deficit.

H wever, the combination of debt problems and poor economic growth throughout the world has pushed trade in a restrictive direction.[106] The developed countries have adopted strict limits on imports and have implemented protectionist measures to keep out foreign goods. The result of this is that it has become increasingly difficult for Brazil to expand its export market. Access to industrialized nations' markets is necessary if Brazil is to lessen the balance of payments deficits and earn much needed foreign exchange. In 1983, for example, only 8% of Brazil's GNP came from exports,much less than half of the total exports of developed nations.[107]

Brazil's ability to expand exports depends upon actions of industrialized nations. The willingness of industrialized countries to adopt trade liberalizing measures will depend, in part, on the actions of developing countries. If developing countries postpone liberalization of their own markets, arguing the need to

limit imports while expanding exports, industrialized countries will face increased trade deficits. Their exports will have slowed at the same time that they must absorb increased imports from Latin American nations. Some industrializd nations may therefore not adopt such measures because they may feel they are losing export markets while being forced to absorb imports.[108]

President Jose Sarney has asked that U.S. markets be opened to Brazilian products while Brazil continues to protect some of its own markets.[109] Sarney also stated that the "U.S. must understand his country's needs because an unstable Brazil means an unstable South America, and an unstable South America, is really, a serious problem for the whole world."[110] The U.S.' willingness to accept this demand will have a serious impact on Brazil's growth since nearly one quarter of Brazil's exports are bought by the U.S. It appears, however, that international trade may be moving to a more liberalizing track as the finance ministers of the United States, European Economic Community, Japan, and Canada have been seeking such an end. They have all agreed on the necessity of reducing tariffs and removing barriers on the imports of Brazil and other lesser developed countries. The U.S., for one, boosted its imports from Brazil by 60% in 1984.[111]

Another proposed strategy for accelerating economic development is increasing private investment in Brazil. Without massive investments, Brazil cannot sustain its 7% yearly growth rate.[112] And without that growth, the country cannot attend to "the other Brazil, the marginal part, the landless rural, the jobless urban

worker, the children without families.[113] Increased private investment has several advantages over private bank lending. First, there are no fixed interest payments which are attached to private investment. This differs from bank loans which were sometimes invested in unprofitable projects and which required payments when interest came due. Some also feel that private investment is a superior method of transferring technology and managerial expertise to Brazil.[114] This is essential if developing countries are going to improve their productive capabilities, and diversify and expand their economies and international trade potential.[115]

There is no agreement, however, among leaders that private investment plays a beneficial and important role in helping resolve the debt problem. Some leaders see foreign investment as a source of economic exploitation and a threatto national sovereignty.[116] As a result, Brazil continued to maintain an investment regime that both repels and attracts investos. On the one hand, Brazil desperately wants the U.S. to buy and invest more since it recognizes the importance of the U.S. to its future development. At the same time, Brazil cannot escape a fear of economic domination going back to 1700 when Queen Maria I of Portugal ordered textile factories closed. [117] So Brazil fears foreign investors even as it courts them.

One manifestation of this fear is the "informatics law" which bans the importation of small computers or their manufacture by foreign-owned companies in Brazil. The effect of this law is that U.S. companies have been frozen out of many high-tech markets. Dow Chemical's manager of industrial products in Brazil states

that," Brazil says they want investments, but they won't get them if they go the way of the informatics law."[118] Until Brazil eases such restrictions on private investment, the investment capital needed for development will be in short supply.

Promoting exports and private investment may therefore enable Brazil to develop and earn money to service debt payments. The ability of Brazil to actually do this depends upon several factors. For instance, investment is likely to increase if Brazil maintains an investment regime that attracts rather than repels investors. In addition, exports can be promoted only if industrialized countries are willing to open their markets to Brazilian products. The result would be increased exports and foreign exchange earnings for Brazil. Even if the United States, Europe and Japan were to drop all barriers to developing country exports, such liberalization would apply to only about $4 billion of their trade initially, and even the increased exports that high debt countries could generate under such circumstances would go only part of the way toward paying off the more than $800 billion in debt now outstanding.[119] Although trade is not the sole solution to the debt crisis, it is the key to the solution.[120] Brazil must be able to sell its goods to service the debts. If access to markets abroad is impaired through protectionism, the developed world will be condemning the indebted nations to perpetual financial crisis.[121]

Brazil's $107 billion debt has had a destabilizing impact on all aspects of society and remains the biggest obstacle to economic development. Burdened by austerity measures, business and industry experienced little growth . Banks also stand to lose vast amounts of money if the present moratorium is not resolved.

The ultimate victims of the crisis, however, are the Brazilian people who suffer as recession, unemployment and inflation continuously plague the country and adversely affect their standard of living.

The current economic problems may also challenge Brazil's struggle for democracy. The economic turmoil has begun to take its toll politically as critics of the government have increased their attacks on Jose Sarney and his economic advisors. In addition, recent opinion polls indicate that the public has lost confidence in the government's ability to respond to the failure of the Cruzado plan.[122] If the democratically elected Sarney government fails to meet the present economic challenges, the possibility exists that the military could resume control.[123]

Whether Brazil will successfully overcome this crisis still remains to be seen. Several factors, some which are not in Brazil's control, will determine if economic recovery will occur. For instance, if interest rates remain high, interest payments will remain at unaffordable levels and Brazil will not be able to meet its debt payments. If the banks accept Brazil's proposal asking for $20 billion in loans over the next five years, Brazil will be able to deal with the repayment problem in the short run. However, Brazil's ability to deal with its debt payments in the long run is also contingent upon their ability to earn enough foreign exchange. Protectionism will hinder Brazil's export earning capacity; therefore, industrialized countries 'markets must be open to Brazilian exports if they are to earn enough currency to repay part of the debt. Brazil's ultimate ability to service its debt thus depends upon the successful interaction of numerous variables. The success or failure they encounter when trying to solve the debt will have a tremendous impact on all sectors of Brazil's society.

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FOOTNOTES

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