STATEMENT T0 THE ANNUAL MEETING OF GOVERNING BOARD OF THE WORLD BANK AND IMF

Washington, September 30, 1987

It is an honor to address this meeting of the Governors of the International Monetary Fund, on behalf of Argentina, Bolivia, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, the Philippines, Suriname, Trinidad and Tobago, Uruguay, Venezuela, and my own country, Brazil.

In the 1980s, the external debt, which has risen to a level of about US$ 400 billion in Latin America, has become the principal concern of our countries.

The feasibility of the strategy adopted to deal with this problem — and which was initially conceived as a way of getting through a supposedly short period of illiquidity in the debtor countries — depended on three basic premises: first, adjustment in debtor countries; second, vigorous growth in the industrialized economies coupled with increased international trade; and third, adequate financing. These premises were crucial for the debtor countries to be able to reduce domestic imbalances, expand their exports and, at the same time, obtain the financing required for investments and continued medium and long-term economic growth, without excessively increasing the total debt. Unfortunately only adjustment in debtor countries took place, while the other two conditions indeed did not materialize, The industrialized economies did not expand as forecasted; our exports did not increase as necessary; external financing dropped from an average of US$ 30 billion per year in the 1979/82 period to an annual average of just US$ 6 billion in the last four years.

Thus, instead of fostering adjustment with growth, our countries have had to embark on a painful process of adjustment with recession and inflation, based on cutbacks in consumption and investments and on successive real devaluation of our currencies. All of this has resulted in enormous sacrifice for our population and in increasing political loss for our governments, since the results from these policies have been recession, unemployment, and dramatic reductions in living standards.

As if the sacrifices of the past were not enough, cutbacks in the rate of investments, caused fundamentally by growth in real transfers and reductions in the capital flow, have seriously jeopardized growth potential and, consequently, debt service capacity.

From the point of view of the debtor nations of Latin America, the evolution of the international situation has been extremely adverse. Thus, it is no surprise that, as a consequence of these factors, an increasing number of countries in the region have been forced to limit or to suspend external debt service payments.

As a matter of fact, full payment of interest has been shown to be incompatible with sustained growth, control of public finances, and price stability. In other words, and paradoxically, debt service became incompatible with the adjustment process that was supposed to lead to a solution of the debt problem. This fact can be shown in several ways:

a) Transfers of real resources — measured by the trade and non-factor service surpluses — required to pay the interest bill have depressed investment capacity. From 1983 to 1985, average growth in real transfers from Latin America (5.3 percent of GDP) was roughly equivalent to the average drop in investments (5.8 percent). This means that the countries of the region have been postponing essential investments in order to service their external debt. Investment level in Latin America has fallen by 40 percent.

b) In many Latin American countries, the major share of the external debt is held by the public sector (70 percent in the case of Brazil). In such cases, interest payments require domestic transfers from the private to the public sector to enable the Government to acquire —from the export sector — the foreign currency needed to service the debt. Normally, these transfers require additional borrowing, thus raising domestic interest rates and, consequently, the public deficit. On the other hand, interest on the public external debt represents a large share of the public deficit. In Brazil, for instance, public deficit in terms of public sector borrowing requirements, was 3.9 percent of GDP in 1986 while interests on the external public debt represented 2.3 percent of GDP. In other Latin American debtor countries, interest payments, as a percentage of GDP, reach even higher figures. In other words, the interests on public external debt accounts for more than fifty percent of the public deficit. We know quite well that higher public deficits affect public investment, while higher interest rates discourage private investment.

c) The attempt to expand trade surpluses through successive real exchange devaluation has led to predatory competition among debtor countries and to further deterioration of the terms of trade. Devaluation has two additional negative effects: they tend to increase the public deficit, since a larger amount of local currency is needed to pay for the same amount of interest, and they have a perverse impact on price stability. Actually exchange devaluation tend to accelerate inflation.

These factors certainly explain why in spite of an enormous adjustment effort the results have been far below expectations and a return to the system of voluntary loans is beyond the reach of a large majority of debtor countries. Banks have already limited their efforts to financing, in a very inadequate manner, part of the interest owed to them.

Mr. Chairman,

The facts clearly demonstrate that the strategy pursued since the outbreak of the external debt crisis failed. This strategy merely avoided an even greater crisis in the international financial system by dangerously postponing a definitive solution. For the developing countries, it represented stagnation and inflation' for the industrialized countries, loss of exports. Only the creditor banks have been strengthened, reducing their exposure to the highly indebted countries. But even for them the situation began to deteriorate, as the financial community realized that the debt strategy had failed, that all debt ratios deteriorated, and, consequently, that the paying capacity of debtor countries was diminishing instead of increasing. The emergence of larger and larger discounts in the secondary market and the evaluation of bank shares in proportion to their exposure to highly indebted countries have been the result of this realistic acknowledgement.

Today, the challenge faced by creditors and debtors alike is that of finding a long-term, definitive solution to the external debt problem, a solution that recognizes the need for a direct relationship between the debt service and the effective capacity of our nations to pay. No longer can a solution be postponed, nor should merely palliative alternatives to the present strategy be sought.

There is a growing consensus on the need for, and the feasibility of new approaches to the debt problem. Responsibility for finding a formula that will lead to a solution does not fall only on the debtor nations. If the industrialized world does not shoulder its responsibility for reducing its structural imbalances, fostering international economic growth, and clearing away protectionist barriers, no truly lasting solution can be found.

I believe that this Annual Meeting of the IMF and The World Bank initiates a new phase in the discussion of the debt problem. The first phase — 1983-84 — was the phase of austerity. The second phase — 1985-86 — the years of adjustment with growth and structural reform. In

1987 we begin a third phase, where the reduction of the debt through lower rates of interest will be the main emphasis.

This is an area in which a more symmetrical IMF surveillance is needed. The next GATT negotiations also have an important role to play in ensuring increased access by Latin American exports, particularly those from smaller countries, to industrialized country markets.

On the other hand, if we are to find an adequate long-term solution to a debt that already exceeds the payment capacity of the debtor countries, it is essential that, in addition to the adoption of austere, responsible policies of internal economic adjustment, the interest rates paid by the debtor countries be reduced and that longer maturity terms be set for payment of the debt.

However, we cannot wait till the moment when market interest rates will decline. There are no prospects that this might occur in the medium term. Thus, creditors and debtors will have to come to an agreement on real and nominal interest rate levels that are compatible with the effective payment capacity of each country. In most cases, what these countries require are real interest rates in line with historical levels.

The reduction of interest rates, longer maturities, and the establishment of adequate credit lines to the debtor countries will make possible reduced transfers of resources. It will thus be possible to achieve the minimum growth rates needed by each country, according to particular circumstances, specially the requirements of its labor market. This is the way for a gradual improvement of debt indicators as well.

To achieve these objectives, it is necessary to restructure the debt so as to bring it into line with the real payment capacity of the countries in question. A return to the market will only become reality when the debt stock has been brought down to levels which are compatible with medium-term payment capacity.

The market judgment is that part of the existing debt, from both middle and low income countries, is not worth its nominal value. This new market reality opens the way for the adoption of new instruments, such as buy-back mechanisms and debt into equity conversions, which will permit a sharing of the discount between debtors and creditors.

Another innovative mechanism for an effective reduction in total debt is the gradual conversion of this debt into bonds. This is a promising option. The conversion bonds should have full face value, fixed interest rate, and the assurance that there will be no restructuring of the principal nor new money requests for the payment of interest. These bonds would be subscribed on a voluntary basis, in accordance with the convenience of each bank.

If these bonds receive limited but effective guarantee for payment by government agencies or multilateral banks, their market position would be enhanced and the long-term solution to the debt problem would soon become reality.

For countries that are not in need of debt rescheduling, there is a clear need for improved access to international capital markets at more reasonable lending terms and conditions.

In the present situation, adequate external financing is a condition for internal economic stabilization and the adjustment to external realities. It is, therefore, essential that government and multilateral credit agencies provide satisfactory financing for the economic and investment programs of the developing nations.

In this respect, Latin America countries consider that is now time for a review of some Paris Club procedures. There is need for a more flexible approach also in regard to official debt rescheduling, particularly as far as the requirement of formal IMF involvement is concerned. Countries which are heavily indebted with official creditors need multi-year rescheduling and longer maturities. Interest rates on restructured debt should be reduced. Official agencies should shorten the time for resuming coverage and improve terms and conditions for new loans and guarantees.

There is hardly any reason why, in the midst of a crisis of such magnitude, multilateral financial institutions should incur in negative net disbursements. In the case of the IMF, this fact is aggravated in part by the imposition of certain conditionalities that little befits the problems and needs of the debtor nations. The challenge faced by the IMF today is that of playing a more active role in providing financial support to growth-oriented adjustment programs. To that end, quotas need to be increased, as well as the developing countries share in Fund quotas.

Growing government participation in the solution of the problem seems today inevitable and is only a question of time. The Consensus of Cartagena, which expresses the position of eleven Latin American countries, as well as the Group of 24, have dealt with the subject and offered many suggestions of both a conceptual and a technical nature, some of which are already being adopted in the negotiations now under way. Brazil, Argentina, and Mexico, which recently joined together into a new G-3 group, have also outlined some principles and mechanisms which should be taken into account in future negotiations.

It should be mentioned that the Japanese Minister Todashi Kuranari has recently proposed the creation of an independent high-level group of persons of wisdom with the support of interested countries and relevant international organizations for the purpose of examining ways and means to encourage the flow of financial resources to the developing countries. This could certainly be a useful instrument, in that it would make possible a joint analysis of the problem and discussions aimed at a lasting solution.

As an important document issued by the Vatican Commission on Justice and Peace acknowledges, "Debt servicing cannot be met at the price of the asphyxiation of a country's economy, and no government can morally demand of its people privations incompatible with human dignity. A decrease in interest rates, the capitalization of payments above a minimum interest rate, a rescheduling of the debt on a longer term basis, national currency payment facilities... they are all concrete measures to be negotiated with the debtor countries in order to lighten the debt service burden and assist in growth recovery."

The price to be paid for the servicing of the external debt cannot be recession, unemployment, hunger, nor can it be the threat to freedom and to the consolidation of democracy in Latin America.

In conclusion, a few words about the economy of my country, Brazil.

In the first half of this year, Brazil was hit by the deepest financial crisis of its history. The Cruzado Plan brought in its wake high rates of inflation, recession, the insolvency of a large number of business firms, balance of payments disequilibrium, and an interest payment moratorium on the medium — and long-term debt to private banks.

To a large extent, the crisis is now overcome. Inflation is reasonably under control, overheating of the economy has been halted while recession has been avoided, the financial crisis has been overcome, large trade surpluses have been obtained. This was possible through a combination of a new price freeze based on the theory of inertial inflation and a set of measures to control the public deficit and to avoid a new wave of excess demand. In order to adjust the economy, industrial production is expected to grow 3 percent this year, as compared to 10.9 percent in 1986.

After adoption of these emergency measures, which included two real devaluations and a price freeze, a macroeconomic control plan was adopted in July. The basic objectives of the plan are GDP growth of between 6 percent and 7 percent in the coming years, an annual trade surplus in the range of US$ 10 billion and a steady decline in the public sector deficit. The basic growth strategy is one of increased public savings in order to liberate private savings finance expansion in private investment. The basic obstacle to the attainment of this growth is the burden of infernal and external public debt interest payments on the government budget. Another basic constraint is external debt related transfers of resources. These resources represent approximately 3 percent of GDP and reduce the nation's investment capacity by the same proportion.

However, it would be misleading to blame all Brazilian problems on the external debt. We have internal problems and constraints. The danger inherent in populist policies is always present. The uneven distribution of income facilitates speculative profits that the fiscal system is unable to tax. Excess consumption by a small segment of society coexists with the precarious economic and social conditions of the majority of the population. Sound internal economic policies and structural reforms are a permanent challenge to the Brazilian government.

Brazil has no intention of confronting its creditors. Much to the contrary, the nation's intention, on the internal front, is to ensure the development process and price stability, while — on the external front — seeking its reintegration into the international financial community of which it had long been a part. These are the two objectives that will guide our negotiations of the external debt, in the pursuit of creative and long-term solutions. It would be a mistake to imagine that it is the activity of a few radicals in Brazil that hamper a further integration into the international economic system. These elements do not carry such weight. The great obstacle to Brazil's further integration is an exceedingly large external debt and the

rather unimaginative and less than daring manner in which the creditor countries have sought to resolve it.