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BRAZILIAN FINANCIAL CRISIS IN THE 1980S: HISTORICAL PRECEDENT OF AN ECONOMY GOVERNED BY FINANCIAL INTERESTS

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ABSTRACT: Beyond representing coordination or government failures, the Brazilian financial crisis in the 1980s characterized the dominance of financial interests on public policies. This paper shows that such dominance began with the external debt negotiations in 1982, which put international creditors' interest first. It argues that the imposed external adjustment – specially the exchange rates devaluation, public investment cuts and the hike in real interest rates – generated recession and financial instability (notoriously inflation), which would threat depreciating private wealth. Therefore, both the external adjustment and the private wealth protection only turned possible due to the increasing public deficits and debts – including by transferences of debt from private to public sector. The dominant perspective, found in the literature on the period, blaming government deficits and debts for the financial instability of the 1980s is wrong. Economists, even heterodox ones, still believe that Brazil's financial crisis in the 1980s resulted from budget deficits and public debts. This paper shows, contrary to the dominant view, that once the public sector had to allow private wealth adjustment to the external conditions imposed by foreign creditors, public deficits were the only possible outcome in that conditions.

KEYWORDS: external debt negotiations; financial instability; net transfer; budget deficits; public debts; financial interests.

JEL CODES: E6; E61-E65; H5; H6.

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A CRISE FINANCEIRA BRASILEIRA NOS ANOS 1980: PRECEDENTE HISTÓRICO DE UMA ECONOMIA GOVERNADA PELOS INTERESSES FINANCEIROS

RESUMO: Mais do que representar falhas de coordenação ou de governo, a crise financeira brasileira nos anos 1980 representou a predominância de interesses financeiros nas políticas públicas. Este artigo mostra que esse domínio começou com as negociações da dívida externa, em 1982, que colocaram o interesse dos credores internacionais em primeiro lugar. Argumenta que o ajuste externo imposto – especialmente a desvalorização das taxas de câmbio, cortes nos investimentos públicos e o aumento das taxas de juros reais – gerou recessão e instabilidade financeira (com destaque para a inflação) que ameaçariam desvalorizar a riqueza privada. Portanto, tanto o ajustamento externo quanto a proteção à riqueza privada apenas tornaram-se possíveis devido aos crescentes deficit e dívidas públicas – inclusive por transferências de dívida do setor privado para o público. A perspectiva dominante, encontrada na literatura sobre o período, culpando os deficit e dívidas do governo pela instabilidade financeira da década de 1980 está errada. Economistas, mesmo heterodoxos, ainda acreditam que a crise financeira do Brasil nos anos 1980 resultou de deficit orçamentários e dívidas públicas. Este artigo mostra, contrariamente à visão dominante, que uma vez que o setor público teve que permitir o ajuste da riqueza privada às condições externas impostas pelos credores estrangeiros, os deficit públicos foram o único resultado possível nessas condições.

PALAVRAS-CHAVE: negociações da dívida externa; instabilidade financeira; transferências internacionais; deficit público; dívida pública; interesses financeiros.

1. INTRODUCTION

The emergence of the Latin American external debt crisis in 1982 ended 30 years of uninterrupted economic prosperity in Brazil and brought a long lasting economic downturn.[1] Neoliberal economists have blamed government deficits for the poor economic performance and high financial instability of the 1980s. Even some heterodox economists have argued that government 'populism' (synonym for public deficits) was behind the financial troubles of the 1980s. Others identify a 'fiscal crisis' that would have impaired economic growth, although they do not blame government deficits for the crisis. Unsurprisingly, neoliberal thinkers advocate retrenchment of government deeds pointing to the troublesome years of the 1980s. Surprisingly, though, some heterodox economists seem also to believe that the level of public deficits and debts were the problems impairing economic growth.

This paper analyses the troubled years Brazil experienced in the aftermath of the debt crisis of the 1980s. Its main object is the institutional forces that generated instability and low economic growth during those years. This includes the austerity policies established by the IMF and the foreign creditors as the ultimate political determinant of the policy choices available to policymakers in Brazil. Therefore, it takes a political economy stance to analyse the stock and flows of the institutional sector financial balance to show that the adjustment happened at the cost of financial instability and slowing economic growth to comply with the net transfer to pay the debt servicing to foreign creditors. Rather than viewing the state as an exogenous force that interferes with stabilizing market forces, a view often held by neoliberal thinkers, this approach sees the state as having a unique role as guarantor of wealth for domestic as well as foreign rentiers. In particular, instead of viewing the public deficits as a problem *per se* as all neoliberal economists hold and some heterodox follow, it shows that public deficits and debt were an inevitable consequence of the policies that warranted private, domestic and external, financial surpluses.

The second section argues that the guiding principle for the settlement of the external debt crisis was to impose a regime of net transfer from debtors to creditors. The brief digression on the international political economy of restrictions prevailing in the 1980s is intended to serve as a background for the analysis of the policies adopted in Brazil.

[1] Between 1950 and 1980 *per capita* income increased 5.5% in average per year. Such performance came, of course, with a rapid structural change with manufacturing growing 8.7% annually in average.

The third section presents the analytical framework of the paper based on simple macroeconomic accounts. It argues, however, that the sectorial financial balances that emerge from expenditure-income flows may help to interpret portfolios changes in historical time in a Keynesian and institutionalist perspective. It sets the main argument that public deficits and debt were not a choice for Brazilian authorities at the time – it was the sole result of the creditor's required austerity otherwise. Besides, given the external debt agreed payments, private financial wealth could only grow towards public debts.

The fourth section shows that the external debt negotiations entailed a heavy burden of net transfers abroad from Brazil, redolent of the reparations paid by Germany after the First World War. In such conditions, budget deficits are the only expected consistent result.

The fifth section discusses the domestic portfolio adjustment to the net transfer conditions. It argues that the adjustment disrupted previous conventions and introduced great uncertainty into the economy, impaired sustained economic recovery and fuelled huge financial instability. This did not result in financial loss for the private sector just because the government turned its policies to support the private sector portfolio restructuring. Therefore, the ever-increasing public deficits and debts were instrumental in maintaining the net transfers abroad and in guaranteeing profitability for the private sector. The concluding section presents a general synthesis of the analyses deployed.

2. EXTERNAL DEBT NEGOTIATIONS, THE POLITICAL ECONOMY OF THE ADJUSTMENT AND ITS CONSEQUENCES TO PUBLIC AND PRIVATE FINANCIAL BALANCES

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

In the management of the 1980s external debt crisis there emerged what Suter and Stamm (1992, p. 647) called 'the actor structure on the creditor's side', which constituted of 'strong cooperative networks among creditors [capable] to exert far-reaching influence on debtor countries and to enforce hard terms of debt settlements against the interests of debtor countries'. This actor structure operated at three levels. First, multilateral intervention cooled off the crisis by adopting three immediate steps like bridge loans. Second, creditor banks organized themselves into cartels, which came to be known as 'Creditor Bank Committees', headed by the largest commercial banks, to negotiate on behalf of all creditors. Third, a coordinated solution to the external debt depended on the cooperation of Latin American countries that chose adjustment over default.

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

Such debt settlement was grounded on the typical IMF stabilisation programme, which derives its economic policies from the national accounting identities, by which the national product (GDP) equals domestic expenditure in addition to trade surplus.[2] On the assumption that demand-switching towards foreign markets (by devaluing exchange rates) is sufficient to compensate for domestic demand-reducing policies (by reducing real wages, investment and public deficits), a country could reverse current account deficits into surpluses and still maintain economic growth.

All this is redolent of the monetarist approach to the German transfer problem of the 1920s (HUDSON, 1992). Keynes (1929) reproaches to this approach centred in the fact that net financial transfer would rend too excessive a reduction in domestic consumption and investment, which would impair long-term productivity and hence Germany's ability to generate future trade surpluses. It is important to note that the monetarist approach to the balance of payments adjustment assumed that domestic demand reduction does not affect income, and that declining private demand does not push public budget into deficit.

The effective demand principle establishes that one person's spending determines another person's income. The same is true for sectorial level. Following well-known macroeconomic accounting identity, one can show the sources of total spending arranged by three institutional sectors: the private sector; the government and the rest of the world. The private sector is made up of workers and firms. Workers spend

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[2] For details of the IMF's model of balance of payment adjustment, see Mussa and Savastano (1999).

mostly in consumption goods (C) and firms invest (I). The private financial balance is the difference between investments (I) and savings $(S = Y - C)$. The government balance comes out of its outlays less tax revenues (T). Finally, the rest of the world sector has its financial balance determined by the difference between exports (X) and imports (M). Therefore, as long as the effective demand principle holds, that is demand determines incomes, then:

$$C + I + G + (X - M) = Y \tag{1}$$

The last simple equation shows the expenditure-income by sector basis. We can rearrange this equation to show that the sum of the financial balances for each sector must equal zero. Thus, equation (1) can be rewritten as follows:

$$(PFB) + (GFB) + (BACC) = 0 \tag{2}$$

The first term of (2) shows the private financial balance (PFB) as the difference between private savings and private investments. The second term is the government financial balance (GFB), and the third term is the rest of the world balance (current account balance, *BACC*). That follows that one sector's surplus (deficit) is by accounting identity offset by another sector's deficit (surplus) – or a combination of the other two deficits (surplus). For the purpose of this paper, it should be emphasized that private financial wealth can only be accumulated over time if public sector runs into deficits and/or the current account balance runs into surplus continuously. So, the equation (1) may be modified to:

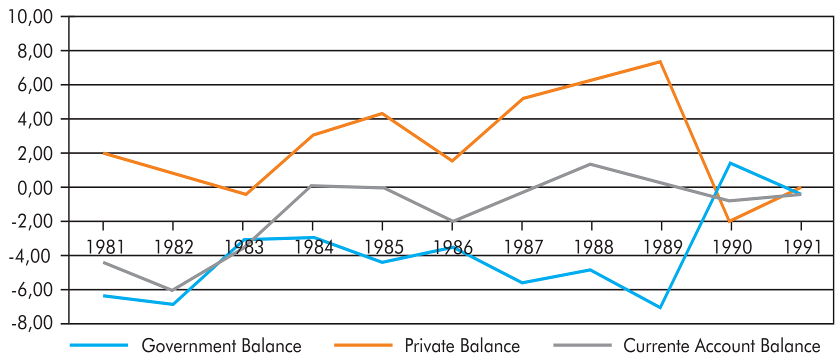
$$(S - I) = (G - T) + (X - M) \tag{3}$$

As it is well known, accounting identity, as those above, is not a theoretical statement. Therefore, we need to complement it with 'behavioural assumptions'. As argued before, instead of making general statements about behaviour, we take a political economy institutionalist perspective by looking at the institutional forces that conditioned each sector agents' behaviour in the Brazilian historical experience in the 1980s.

A first overview of the main argument emerges from Figure 1 below. It presents the financial balances, as a percentage of the GDP, of the three sectors for the Brazilian economy through the 1980s.

It shows that the Brazilian economy adjusted its balance with the external sector very rapidly from current account deficit to domestic current account equilibrium just in the first years of the debt crisis. Whereas the external sector adjustment came because of increasing trade surpluses, it cannot explain by itself private financial surplus observed throughout the 1980s. As Figure 1 shows, the private financial balance was well beyond 2% of GDP from the inception of the crisis onwards, whereas current account never reached 2% of GDP throughout.[3] Actually, the private sector financial surpluses mirrored the government deficits. When the government reduced its deficits, private financial surplus shrunk. Moreover, when the government deficits increased, the private financial balance swelled. Furthermore, government deficits have also helped export sectors to boost their surpluses. The rest of the paper aims to provide detailed analysis of the institutional factors, which determined an adjustment that preserved both foreign rentier income and domestic private financial wealth.

Figure 1 – The sector financial balance, 1981-1991 (in % of GDP)



Source: Author's elaboration based on data extracted from the Brazilian System of National Accounts (IBGE, 2018).

3. THE BRAZILIAN EXTERNAL DEBT NEGOTIATION AND THE PROBLEM OF THE NET FINANCIAL TRANSFERS

A couple of principles have materialised in the agreements signed by Brazil and its creditors throughout the 1980s: (i) a rapid settlement of the external debt, in order to avoid the disruption to the international financial markets that a Brazilian default was likely to provoke; and (ii) a coordinated reduction in exposure of foreign banks and

[3] One should be cautious when thinking that private sector financial balance mirrored trade surplus. It only should happen if current account operated in surplus with nil public balance. As explained below, the Brazilian economy would hardly produce current account surplus under the external debt conditions of the 1980s. True, export private sectors profited from the export subsidies and incentives government gave in the 1980s. However, we cannot exaggerate the influence of trade surplus on private balance as export represented less than 10% of the GDP (peaked at 14% in 1984). Therefore, gains for the export sector, however great, were not sufficient to explain the bulk of financial wealth private sector accumulate in the 1980s.

little, if any, debt forgiveness, to force Brazil to generate enough resources to pay debt servicing in full. Besides all efforts were made to make the Brazilian government comply with the IMF adjustment programme and surveillance. The speed of the negotiations was conducted rapid enough to avoid default declarations. As Brazil faced difficulties in servicing its external debt in the wake of the financial turmoil, international multilateral organisms and creditor governments offered a bridge loan of US$ 4.2 billion until Brazil reached a definite deal with creditors. On the other hand, the amount of resources advanced by multilateral institutions was sufficient only to maintain debt servicing. A further US$ 4.5 billion was drained from Brazil's international reserves, leaving the country practically without reserves. These conditions put Brazilian negotiators under pressure to begin official rescheduling agreements with the IMF and creditor banks in November 1982, a situation which favoured the imposition of conditionality by the IMF.

Second, Brazilian policymakers accepted the so-called 'reverse' adjustment, which meant first to estimate the amount of resources the creditors would be willing to grant and then the amount of trade surplus needed to close the gap of current account. The terms of the rescheduling resulted in stringent conditions for Brazil's payments with high interest rates and short periods of consolidation, maturity and grace (CERQUEIRA, 1996). Paralleled negotiations were also conducted with official creditors, a group of 16 developed countries organised within the Paris Club. As a rule, the Paris Club only accepted open negotiations with Brazil when the country had already stroked a deal with the IMF. Therefore, Brazil's conditions to pay the external debt services were stringent throughout the decade, resulting on small renewal of credit and high payment of services.

Table 1 – Financial flows by creditors, 1982/1989 (in US$ million)

	1982-1984	1985-1987	1988-1989
Official Sources			
Financing	11,528	5,763	2,779
Amortisation	2,976	7,439	6,802
Interest	2,894	5,552	4,346
Net	5,658	- 5,513	- 6,745
Private Sources			
Financing	25,429	1,377	5,028
Amortisation	8,019	1,312	3,055
Interest	27,172	19,177	15,912
Net	- 9,762	- 19,112	- 16,359

Table 1 – Financial flows by creditors, 1982/1989 (in US$ million) ***(Cont.)***

	1982-1984	1985-1987	1988-1989
Other Sources			
Financing	5,516	2,167	2,028
Amortisation	4,118	1,443	1,535
Interest	4,197	1,394	868
Net	- 2,799	670	- 375
Total			
Financing	42,473	9,307	10,258
Amortisation	15,113	10,194	11,392
Interest	34,263	26,123	21,126
Net	- 6,903	- 27,010	- 22,260

Source: Carneiro (2002, p. 132).

Table 1 above synthesizes the flows of resources to and from creditors according to their official or private feature. Clearly, there is an increasing gap between the resources Brazil received throughout the 1980s and those Brazil paid. To avoid a default, in the first two years after the crisis, the capital inflow financed all the amortization and part of the interest paid in those years. It is also evident that in this period the resources provided by multilateral official sources bailed out part of the private sector withdrawal. However, as the decade went on, the creditors were providing fewer resources, whether private or official. Hence, financing plummeted and became insufficient even to cover interest payments. Things got worse as from 1985 onwards the contribution of multilateral official sources was reduced to amounts below amortization. Hence, Brazil's resources guaranteed creditors' exposure reduction (see SACHS and HUIZINGA, 1987).

The third aspect of the external debt settlement was the Brazilian policymakers' compliance with the conditions of the negotiation. In the letter to the IMF, in December of 1982, the government announced an economic programme which promised to 'reduce considerably the external and internal disequilibria' which would be achieved by augmenting

> significantly the domestic savings, *especially in the public sector*, and to make the economy more efficient, objectives which will be attained by correcting the relative prices of many sectors of the economy, getting rid of subsidies, and reducing the government's direct and indirect intervention in the economy. (BRAZIL, 1983, p. 140)

Table 2 – Net resources transferred abroad, 1981-1989 (in US$ million and in % of GDP)

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

Note: Real transfers is defined as the result of balance of trade plus non-factors services; financial transfers is defined by income transfers from factors services (interest, profits, dividends and wages) less capital inflows.

Source: Author's elaboration based on data extracted from Annual Reports by Banco Central do Brasil (BCB, various years).

Whereas the IMF approach was effective in reducing creditor banks' exposure to Brazil by warranting increasing net financial transfers (see Table 2), it was less effective in reducing the country's debt burden. Table 3 below shows indicators of Brazil's external debt and Brazil's creditworthiness during the 1980s. Despite the striking transference of resources abroad, the Brazilian external debt kept on growing over 1982-1987, as the transfers only paid for interest on old debt. Net debt as a proportion of GDP, the debt to export and debt service to export ratios worsened through the mid-1980s and returned to the same pre-crisis levels late in the decade. The trend of these ratios indicates that the management of the debt crisis did not improve the external creditworthiness of the country, contradicting the usual IMF's and creditors' argument that the sacrifices would be awarded with a quick return to the international financial market.

Since the inception of external debt negotiations in 1982, Brazil generated enough trade surpluses to pay for the interest on external debt without recurring to new money. However, nominal debt reduction happened only after the Brazil's moratorium in 1987.[4] Although the Brazilian moratorium had failed to get support from domestic political forces, it led the foreign banks to accept losses of capital in external debt and the government of creditor countries to propose reductions in the external debt (PALMA, 1995; TOYE, 1993).

[4] See Cerqueira (1996) and Biasoto Jr. (1992) for a full accounting of the terms and conditions of Brazilian external agreements.

Table 3 – Indicators of external debt, 1981-1989

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

Note: Numbers may not add due to rounding.
Source: Author's elaboration based on data extracted from Annual Reports by Banco Central do Brasil (BCB, various years).

Aside issues about external debt size, the adjustment costs were unevenly burdened by the domestic debtors. Table 4 shows data on external debt by debtors in Brazil, from which a clear picture emerges. Public external debt grew sharply as a share of the total net external debt throughout the decade. Since mid-1970s, the Central Bank enacted regulations (Circular Letter 230 and Resolution 432), which provided coverage for foreign currency remunerated deposits (DMRE) made in the Central Bank against exchange rate changes. These were mechanisms by which private sector directly transferred its external debt to public sector.[5] Sharpe public external debt growth happened also as a direct result of the negotiations with the creditors and the IMF, in 1982, which made the Central Bank and Central Government primarily responsible for the management of the external debt (BATISTA JR, 1988; BIASOTO JR, 1992). The additional resources for refinancing public or private external debt had been deposited in the Central Bank, which became the guarantor for the debt. Debtors, in turn, could pay their foreign debt making deposits in domestic currency in the Central Bank, while the latter remained responsible for making them good along with the final creditor. Moreover, when the adjustment imposed permanent exchange devaluations from 1982 onwards, public external debt grew even further relatively. In short, the Central Bank became the only debtor in foreign currency of the resources renegotiated with the creditors, being responsible for the interest and other costs incident on the deposits accorded with the creditors.

[5] In the 1970s, the external debt nationalisation refers to the relative increase of public external obligations to the private obligations (see DAVIDOFF CRUZ, 1984). Here one points out to direct mechanisms by which the private sector transferred external debt to public sector.

Table 4 – External debt: public and private, 1981-1989

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

Note: Numbers may not add due to rounding.

Sources: Author's elaboration based on data extracted from Annual Reports by Banco Central do Brasil (BCB, various years) and Ipeadata (IPEA, 2018).

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

Thus, despite the free-market rhetoric of the foreign banks and the governments of developed countries, they nevertheless called on the Brazilian state to play a central role in adjusting the Brazilian economy to the debt crisis. By placing the responsibility for the private debt on the government, creditors reduced the risk of default and shared transaction costs with the Brazilian government.

Most of the literature on the period recognises that the nationalisation of the external debt in the aftermath of the debt crisis had important consequences for public finances (see, for example, LOZARDO, 1987; BRESSER-PEREIRA, 1990; BATISTA JR, 1988; BIASOTO JR, 1992; CRUZ, 1995). First, the stock dynamic of public external debt was dominated by the mechanisms of transference of external debt to public sector. In addition, interest payments on external debt became an extraordinary cost for the public sector. Second, the adjustment of the public finances required by foreign creditors came through reductions in public spending, especially in capital formation and social outlays. Because of insufficient effective demand, recession reduced tax revenues.

Given those developments, it seems quite clear that public debts and deficits should increase as a mirror of the external debt settlement with the creditors, regardless of which fiscal stance the government followed. However, the odd economists' consensus (even amongst heterodox ones) is what they called the 'fiscal crisis' (budget deficits). It was even more strikingly to identify the fiscal deficits as 'the fundamental cause of the Brazilian economic crises' at the time (BRESSER-PEREIRA, 1990, p. 20). In reality, budget deficits were only a mandatory consequence of the external debt negotiations as showed above.

The next sections substantiate the claim that the government finance stance reflected the consequences of the IMF austerity package. That is, as the austerity programme threw the economy into a state of permanent low growth and financial instability, public deficits and debts should increase.

4. FINANCIAL INSTABILITY AND FRAGILITY RESULTING FROM THE ADJUSTMENT POLICIES

The price 'corrections' aimed at inducing greater net exports, and the restrictive fiscal and monetary policies aimed at reducing domestic demand, producing awkward financial instability expressed in the increasing volatility of inflation, exchange rates and interest rates.

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

The second and complementary leg of the adjustment policies was the maintenance of high real interest rates. The typically negative interest rates of the 1970s and the great deal of subsidised credit provided by public financial institutions as earmarked funds came under great pressure from the IMF in 1983. The IMF technical note of its staff mission to Brazil in 1983 asserted that 'the chief fault in Brazil's economic policy management continues to be the official position in relation to interest rates.' It then stressed that 'it is time to abandon the huge subsidies in the interest rates enjoyed by some economic sectors and carry through the liberalisation of interest rates across the financial system… It has also to be permitted that the higher financial costs to the producer be passed on to costumers' (IMF, 1983, p. 154). Indeed, the real interest rates charged on public securities (Selic) began their ascending trend in 1980, became positive in 1982 and went to levels of 10% to 15% per year by 1985. Similarly, the real interest rates charged on firms' borrowings for financing working capital showed the same trajectory although on a much higher level (see Table 5).

Table 5 – Annual interest rates, 1980-1989 (in %)

	Nominal Annual Interest Rates		*Actual Annual Interest Rates*
	Selic	**On Working Capital Loans**	**Selic**
1980	46.3	87.5	- 26.7
1981	89.3	141.7	-2.2
1982	119.3	159.8	9.5
1983	199.7	265.5	7.8
1984	255.5	346.5	15.0
1985	275.6	309.8	11.1
1986	66.5	58.9	4.6
1987	352.9	491.3	- 8.4
1988	1057.6	1105.6	5.9
1989	2407.3	2529.4	27.7

Note: Deflated by the National Consumer Price Index (INPC).

Source: Author's elaboration based on data extracted from Ipeadata (IPEA, 2018).

Despite the hikes in interest rates and reduction in demand for money, inflation kept on rising. The austerity programme was clearly inadequate to deal with the institutional setting of the Brazilian economy. The high instability of the exchange and interest rates perverted the conventions sustaining normal pricing practices within the Brazilian economy as financial and production costs became unpredictable (TAVARES and BELLUZZO, 1986, p. 52-53). So, past inflation was abandoned as a guide for forming expectations about the future supply prices and demand prices. The IMF's diagnosis that excessive demand caused inflation was unwarranted as the risk firms run of under-pricing and of losing profits per unit of produce sold became higher than the risk associated with sales lost. Accordingly, firms in Brazil used their market power to protect their wealth and profitability by increasing their mark-ups irrespective of the decrease in their sales. Inflation in turn more than doubled achieving 235% per year in 1983, rapidly approaching hyperinflation levels.

From a conventional point of view, Brazil's institutional structure established a bewildering relation between price formation and interest rates. The existence of the indexed money established a positive correlation between higher real interest rates and faster growth in prices. Therefore, the orthodox control inflation by increasing interest rates in fact had the opposite effect, fuelling inflation hikes.

Theoretical beliefs and unawareness of the problem aside, the economic policy was stuck in the foreign currency trap established by the net transfer abroad. With the net transfer regime, foreign currency became *the* liquid asset in the Brazilian context so that any easing of monetary policy – a reduction in the real interest rate – would threaten the economy with bondholders converting their liquid financial assets into foreign currency and press the Central Bank's scarce foreign holdings.

In the conditions of the exchange and monetary policies prevailing in the 1980s, the government financed the restructuring of financial and non-financial companies at the expense of public deficits. Indeed, the public sector ended up financing the emergence of the rentier behaviour of the private sector.

4.1. PUBLIC FINANCING OF PRIVATE PORTFOLIO ADJUSTMENT

The government's attempts to switch market outwards and to reduce domestic demand created cumulative public deficits. First, given the huge public external debt, the maxi-devaluation in 1983 produced an additional increase in the public sector indebtedness. Secondly, by making the public sector the main external debtor the adjustment created a link between public external debt and public internal debt. Deposits made in the Central Bank by exporters generated by the private sector would expand money supply. With restrictive monetary policy in view, the Central Bank had to increase public internal debt. As Table 6 shows, public debt increased by 20% of GDP in only two years from 1982.

Table 6 – Net public debt, 1982-1990 (in % of GDP)

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

Source: Author's elaboration based on data extracted from Annual Reports by Banco Central do Brasil (BCB, various years).

Such increase in the public debt resulted in growing public current deficits because of the interest payments, which climbed to 7% of GDP in 1985 (Table 7). In the first years of the adjustment, the government tried to compensate for this increase in public deficits with a mixture of tax increases and spending reductions. Indeed, it shrank public operational deficits by 4 percentage points of GDP.

This policy was, however, clearly counterproductive in sorting out the deficits due to the by-products of the restrictive policies. First, the interest payments on public debt were increasing with the interest rates. Second, high interest rates reinforced inflation and recession and both tended to reduce tax revenues and then increase budget deficits. In short, whereas the monetary policy tended to produce reinforcing effects on public deficits and indebtedness, public finances became increasingly dominated by the interest of the rentiers.

Table 7 – Public deficits in alternative concepts and actual interest burden, 1981-1989 (in % of GDP)

	Primary	*Actual Interest*	*Operational*	*Nominal*
1981	--	--	- 6.3	- 12.5
1982	- 0.8	- 5.8	- 6.9	- 15.8
1983	1.7	- 4.7	- 3.1	- 19.9
1984	4.2	- 6.9	- 2.8	- 23.3
1985	2.6	- 7.0	- 4.4	- 28.6
1986	1.6	- 5.2	- 3.6	- 11.3
1987	- 1.0	- 4.6	- 5.6	- 32.3
1988	0.9	- 5.8	- 4.9	- 53.0
1989	- 1.0	- 6.1	- 7.1	- 83.1

Note: All levels of government and public enterprises.

Source: Author's elaboration based on data extracted from Ipeadata (IPEA, 2018) and Conjuntura Econômica, Aug. 2003 (FGV, various years).

Between 1986 and 1989, the public deficits increased whereas the economy approached hyperinflation. The Central Bank was forced to introduce institutional innovations that not merely protected bondholders against inflationary depreciation, but also constituted profitable mechanisms for them. It introduced a public bond – first called Central Bank Bills (*Letras do Banco Central* – LBC), and then, in 1987, Treasury Bills (*Letras Financeiras do Tesouro* – LFT) – which was indexed to the daily interest rate (*overnight*). With indexation, those public securities embodied inflation expectations for the next month, making the value of government debt almost immune to rises in inflation. Moreover, these public bonds possessed high liquidity as they served as second-order banking reserves and were 'automatically' negotiable with the

Central Bank (SILVA, 1983; PAULA, 1996). In addition, those indexed bonds and the mechanism of daily repurchase agreement guaranteed the bondholders enough flexibility to evade attempts by the government to lower public debt by expelling monetary correction. In a nutshell, those mechanisms concurrently protected the real value of bondholders' wealth and warranted high liquidity, features which maintained the attraction of public bonds *vis-à-vis* other speculative investments, especially foreign currencies, even under hyperinflation condition.

Again, it seems an odd claim in the literature that the public sector had had difficulties to finance its deficits. Looking from the quantitative point of view, such claim goes against the fact that public debt climbed from 33% to 55% percent of GDP between 1982 and 1985.

Be as it may, few economists would consider 50% of GDP as a dangerous level of public debt by any measure. Moreover, apart from the period of transference of private external debt to public sector, throughout the 1980s, the level kept relatively stable and tending to decrease towards the decade closing. Therefore, the cost of the debt seems not to be related to its risk of default, but rather to the austerity programme itself.

4.2. THE 'SECURITISATION' OF THE WEALTH OF THE PRIVATE SECTOR

Because of the increasing financial instability caused by the adjustment policies, financial and non-financial corporations developed new methods for evaluating good performance that can be described as *financialisation*. The measurement of performance in both sectors became accordingly dominated by short-term financial gains. The aforementioned public indebtedness played a central role in all that, as those indexed financial assets were either public daily indexed bonds (e.g. LBC) or backed by them (e.g. any overnight bank deposits). In other words, the adjustment of the private sector was symmetrical to the public sector's indebtedness.

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

Table 8 – Some indicators of financial posture and performance of the thousand largest firms in Brazil (by ownership of capital), 1978-1989 (in %)

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

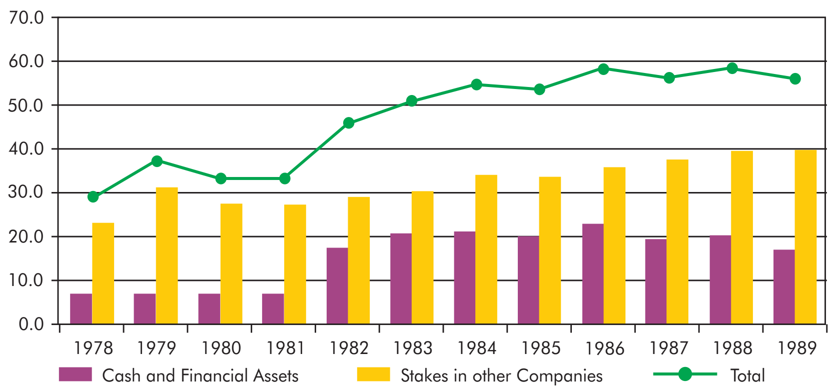
Notes: Profitability - profits after tax/net worth; mark-up - (revenue – prime cost)/prime cost; indebtedness - debt/net worth; financial costs - financial expenditures/operating income; prime costs - cost of production/operating income.

Source: Author's elaboration based on data extracted from Conjuntura Econômica (FGV, various years).

When financial instability was at its worst, after the failure of several stabilisation plans, firms intensified their financial restructuring by increasing mark-ups and investing in indexed financial assets. Firms also adopted the daily indexed overnight interest rates to determine prices to ensure that their profit margins would cover their prime and financial costs. Belluzzo and Almeida (2002, p. 182) describe this mechanism as the 'financialisation of pricing,' a concept which reflects the detachment of pricing formation from the costs of production and from capital reposition to the emergence of speculative behaviour in price formation. As financial instability accelerated and financial costs increased with interest rates, firms sought to anticipate events by increasing their mark-ups. Indeed, from 1987 to 1989, the mark-ups resumed an ascendant trajectory at a higher speed, achieving maximums of 92% (local private capital) and 62% (foreign capital) in 1989.[6]

During the 1980s, the financial instability produced a second fundamental change in the behaviour of firms related to their preferences between productive investments and financial investments (Figure 2). The combination of weak effective demand, exchange depreciation and high interest rates brought enormous threats to the net worth of firms. Consequently, such combination of factors discouraged productive, hence less liquid, investments as well. The high interest rates, on the other hand, opened opportunities to the most liquid firms to invest in financial assets to such an extent not merely to compensate for the increase in financial costs, but also to gross the high returns paid upon financial assets.

Figure 2 – Total financial investments of firms, 1978-1989 (in % of Net Worth)



Source: Author's elaboration based on data extracted from Conjuntura Econômica (FGV, various years).

As a result of these processes of financialisation of pricing and investments, the profitability of the private companies by late 1980s were as high as before the recession of 1981-1983 (Table 8). These processes had an unequivocal conclusion: it became quite profitable to hold indexed money as well as other financial assets, and certainly much less risky than productive investments.

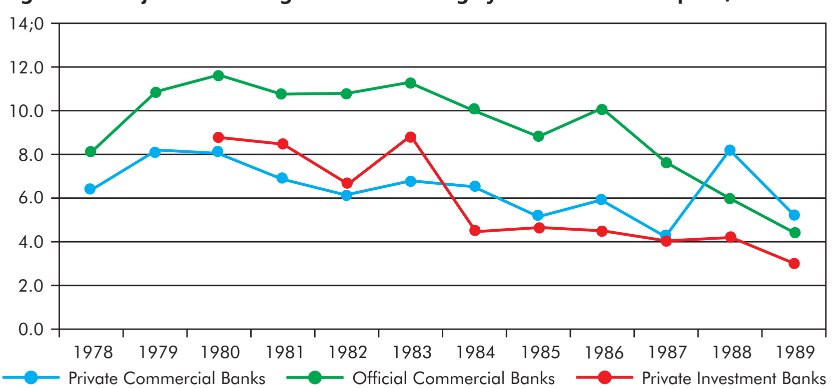
[6] This behaviour of non-financial firms led the economy to hyperinflation when by 1988-1989 inflation rates went into three digits.

4.3. RENTING SEEKERS BANKING

The growing financial institutions share in GDP – from around 8% in 1980 to nearly 21% in 1989 (IPEA, 2005) – epitomises the greatest beneficiary of the 1980s' policies. The mechanisms, by which such a performance had been achieved, were not very distinct from what took place in non-financial corporations described above. Indeed, the banks were the main agents operating the financialisation of non-financial corporation investments and became, in the process, the major beneficiary of the real interest rates increase.

Facing increasing uncertainties since the debt crisis, banks reduced their leverage measured by assets as a proportion of the bank's own capital (see Figure 3). The private banks showed greater flexibility than official banks in reducing leverage. Public banks, especially state ones, in turn, could not process such rapid reduction of leverage because they bailed out local business and governments. In this connection, it is worth noting that the bank's adjustment proceeded mostly through reductions in credit operations to private sector and reallocation of resources for financing public sector (see Table 9). With the increasing credit risk stemming from the recession, and the restrictions imposed by economic policy, the private commercial bank's credit operations decreased 4.6% yearly on average, between 1978 and 1983. Even after the economic recovery, experienced between 1984 and 1985, the amount of credit private banks conceded was still below that of 1982.

Figure 3 – Adjusted leverage of the banking system – Assets/Capital, 1978-1989



Note: Official Commercial Banks do not include Banco do Brasil.

Source: Author's elaboration based on data extracted from Annual Reports by Banco Central do Brasil (BCB, various years).

In addition to the reduction in credit operations, the private banks' strategy constituted of concentrating investments in assets issued or granted by the public sector. First, the foreign currency remunerated deposits (DMER) in the Central Bank became very popular amongst commercial banks. Second, the Central Bank promptly attended to the banks' desire to replace public risk-free securities with risky assets the banking system was carrying. The Central Bank's issues of public securities were the main reason why commercial banks' investments in shares and securities increased from 3.2% of total assets, in 1979, to around 9%, in 1983. Public securities accounted for only 17% of investments in shares and securities in 1979, whereas in 1989 they accounted for 3/4 (Table 9).

Table 9 – Selected assets and liabilities of private commercial banks, 1978-1989 (in % of Total)

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Assets												
Reserves	16.7	13.6	11.9	10.0	8.1	4.3	6.7	6.2	12.6	6.1	1.4	1.2
DMER*	1.6	2.8	1.6	2.9	2.8	9.2	7.4	6.4	2.3	1.4	0.5	0.2
Loans	57.0	55.5	53.1	49.6	47.5	40.1	42.5	51.0	58.5	41.8	39.7	43.1
Exchange Operations	11.5	14.7	14.5	16.1	14.9	22.9	20.9	12.1	7.6	8.8	9.0	11.3
Shares and Securities	3.5	3.2	7.8	9.2	13.9	8.8	6.8	9.8	9.7	27.9	39.6	33.2
Public	0.6	2.0	5.9	6.9	9.5	6.2	5.4	7.5	1.7	23.7	6.1	25.6
Private	2.9	1.2	2.9	2.3	4.4	2.6	1.4	2.3	8.0	4.2	33.5	7.6
Liabilities												
Deposits	46.4	45.4	40.8	32.7	29.8	23.5	27.8	37.8	59.7	28.5	50.4	39.1
Exchange Operations	26.3	32.2	36.1	42.4	43.4	56.2	53.0	41.0	22.4	24.1	17.6	18.5

Note: (*) Foreign currency deposits in the Central Bank.

Source: Author's elaboration based on data extracted from Annual Reports by Banco Central do Brasil (BCB, various years).

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

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

The financial system performed the central role in connecting the idle balances of non-financial corporations and wealthy citizens with the circuit of financial accumulation developed around the indexed public securities and other indexed financial assets negotiated in the overnight system. In addition, the inflation process nurtured those speculative gains so that the banking system and its wealthier clients became associates of the inflation hikes. Suffice to note that the banks' and their clients' portfolio adjustment was only possible due to the acceptance of the public sector to run deficits and issue indexed debts.

5. FINAL REMARKS

In conclusion, the external debt crisis management was quite successful in protecting the private financial wealth of foreign and domestic owners. International institutions – like IMF – were instrumental to enforce a pro-creditor solution to the debt crisis. Productive investments were phased out, whereas the adjustment policies favoured the financier interests.

The debt nationalisation was imposed on the state, either to guarantee foreign creditors' claims or to permit the private domestic sector to reduce its indebtedness. Unsurprisingly, most conventional analysts have identified the financial instability of the 1980s, especially its inflationary dimension, with the public deficits in a way that causality went from deficits to money supply to inflation. However, in fact, causality ran the other way around. With a highly indexed economy, in which some financial contracts had daily corrected value, exchange devaluation spread to the whole price system generating a spiral of prices. The first and foremost cause of inflationary instability in the 1980s in Brazil was therefore the external adjustment itself. The policy of exchange devaluation was the central mechanism to generate net exports required to comply with the net transfers abroad. Inflation rates trebled after two major devaluations in 1979 and 1983, and kept fuelled by permanent devaluation policy throughout the decade. As even private external debt was transferred to public sector through various mechanisms discussed in section 3, the exchange devaluation policy just reverberated as increasing public debt.

The second and complementary leg of the adjustment policies was the maintenance of high real interest rates, as it would help reducing domestic absorption. Beyond contributing to the recession in course, which depressed tax revenues, higher real interest rate policies turned interest payments the major component of public deficits – as detailed in section 4.

Beside being the major factors in rising public deficits and debts, the high instability of the exchange and interest rates perverted the conventions sustaining normal pricing practices within Brazilian economy, as financial and production costs became unpredictable. Mark-ups were not only adjusted more frequently to keep up with raw material and financial growing costs, but they were also adjusted defensively to compensate future increase in financial costs and risks that exchange and interest rates instability ensued. Therefore, financial instability and recession in the 1980s were a direct result of the sort of adjustment external creditors imposed on Brazilian economy, whose costs could not be borne by private sector.

More importantly, as recession and instability turned productive activities risky and more expensive, financial and non-financial corporations income became dominated by short-term financial gains. For that, public indebtedness played a central role through issuing daily indexed public bonds. In other words, the defensive strategy of the private sector wealth was allowed by corresponding public sector's emission of debts, which could protect corporation wealth from the main threats to it.

In macroeconomic balance, the public debt and deficit must be private surplus and wealth. Indeed, public resources had been used to protect bondholders at the expenses of one sole debtor, the state. The public finance was not in crisis because it ran into deficits and debt. Budget deficits are the expected situation when the economy is well below full employment and unstable. The private sector will desire as much public debts as the economy gets unstable. So much so if public bonds are protected against inflation.[7] The Brazilian case of the 1980s was not an exotic fruit, actually it just confirms the need of the *Big Government* when financial crisis arises. However, as Keynes (1964, p. 383) said, 'the ideas of economists and political philosophers, both when they are right and they are wrong, are more powerful than is commonly understood'. The course of events in Brazil ever since has been framed by the wrong ideas that emerged from the 1980s crisis.[8]

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7 In the mid-1990s, when foreign capital flooded the Brazilian economy, exchange appreciated and inflation sudden came to low historical levels. Budget deficits, however, were still at the level of the 1980s.

8 For example, privatization found support in the fiscal crisis argument. During the 1990s, there was a huge programme of privatization in Brazil, but public debt has jumped from from ⅓ of GDP in 1993 to ½ of GDP in 2002.

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