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SOVEREIGN INSOLVENCY EXPERIENCES
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SOVEREIGN INSOLVENCY: THE BRAZILIAN EXPERIENCE

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1. Background

The oil shock of the 70's resulted in huge liquidity. These resources were deposited by the oil producing nations in the Western banks, which in turn had to find investments for them. Within this context, lending to Brazil and other Latin American countries became a neat and profitable game. Borrowers in Brazil were generally government controlled companies, which, by law carried a sovereign guarantee. At the time, a sovereign guarantee was considered risk free. The oil shock produced inflation which in turn produced a dramatic increase of the Libor rate: the Mexican debt crisis occurred and Brazil and many Latin and Eastern European countries went broke. The Western banks were totally unprepared for this (their lending to Latin America exceeded by far their capital and reserves), and the issue then was to save the banks, while hiding the financial troubles of their borrowers. This was achieved by a relaxation of banks' accounting practices, and by means of light restructurings whereby the indebted countries received new loans which were barely sufficient to pay the interest due on them, while austerity programs were implemented through IMF liberalization programs. These programs were embodied in the famous or infamous "commitment letters". Between 1982 and 1986, from being net importers of capital, Latin American countries ended up remitting amounts to their creditors which netted an average of US$ 60 billion dollars a year, at a time when this was still considered money. One of the consequences of this scenario was that the region's imports fell dramatically, hurting other sectors of the Western economies. Thus, along came the Brady Plan, a menu of options which allowed debt relief to debtor countries, in order to allow them back into the markets.

2. The Brazilian Experience

From 1900 to 1980, Brazil was the fastest growing country in the world, exceeding even the Japanese growth rate. The debt crisis of the 80's paralyzed the country for 25 years. During these lost decades, Brazil adopted seven economic plans (the Cruzado Plan I, in February 1986, the Cruzado Plan II, in November 1986, the Bresser Plan, in June 1987, the Summer Plan, in January 1989, the Collor Plan I, in March 1990, the Collor Plan II, in February 1991, and the Real Plan, in 1994). Brazil changed currencies five times (cruzado, cruzado novo, cruzeiro, cruzeiro real and real) and each time cut countless zeros from its currency. Exchange rates were prohibitive, hard currency was scarce, commodity prices were down, foreign trade suffered. Income distribution indices became horrible by any measure, as inflation bred inequality. During this time, the IMF "commitment letters" had to be amended 9 times. Brazil was only able to control its hyper inflation in 1994, through the Real Plan, 12 years after the debt crisis began.

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If Brazil had recognized its insolvency in 1982, adopting a sovereign restructuring plan which allocated losses where they belonged, instead of playing along with the politically attractive light restructurings favored by the IMF and the banks, it could probably have resumed growth much earlier and could have spared its population the miseries of ineffective plans and solutions, which resulted in inflation and other non intended collateral damage.

3. Comparing Sovereign Insolvency with Corporate Insolvency

There are some common features in a sovereign and a corporate insolvency:

(a) in any insolvency, there are losses which have to be allocated among the stake holders: creditors, tax payers, workers, health care and pension beneficiaries, etc. Until losses are duly arbitrated and distributed, a restructuring (in the case of a business) or the resumption of growth (in the case of a country) will not occur;

(b) in a corporate insolvency, the key factor to be agreed upon by the stakeholders is the future cash flow of the company, regardless of the nominal value of the credits. If an asset is only capable of generating a certain amount of cash, creditors and other stake holders have to realize that they have incurred losses and that all they can hope for is their share of whatever is generated. In a sovereign insolvency, as we learned in Brazil, austerity has limits as well, because it will tend to reduce the economic activity and thus the tax income and therefore the ability to pay back debts. Although politically difficult, once losses are recognized and allocated, it is possible to allow a growth pattern that will generate the funds which can foreseeably be paid to the creditors.

There are also differences between a corporate and a sovereign insolvency:

(a) the exercising of the sovereign's taxing authority;

(b) the possibility of devaluating the currency (not applicable to the Euro);

(c) creating inflation (a politically effective way of dealing with the allocation of losses issue, although generating sizeable negative side effects);

(d) monetary restraints such as the *corralito* in Argentina and the blockage of funds instituted by the Brazilian Collor Plan, or price, wage and interest freezes;

(e) developmental and regulatory policies encouraging growth;

(f) foreign trade regulation;

(g) macroeconomic policies relating to interest rates, bank lending activities, etc.

On the other hand, corporate insolvencies are generally less influenced by political pressures which shape the decisions of the sovereign debtors.

4. Conclusion

Debt crises are the direct result of poor public policies. As can be witnessed from the situation in Europe, the world economy is facing a huge sovereign insolvency problem, which is different in some respects from the Lehman fiasco and the Japanese banking crisis, but also involves many of the circumstances found in the Latin American debt crisis of the 80's. Even the US, facing a US$ 16 trillion debt in a politically polarized society with rising inequalities, and presently paying a negative interest of 0.25% per year, is not immune from a future sovereign debt crisis. Within this context, it is hoped that in this globalized world we will be able to learn from past mistakes and experiences, recognizing that insolvencies are only avoided or mitigated if they are recognized as such early enough to establish an organized and fair system of allocating the losses which were already incurred or which may be incurred among the stakeholders. Such a system should allow the affected countries to maintain a growth pattern which is required by a healthy and expanding world economy, in which the emerging markets are now playing such a decisive role.