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Policy Note

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## The Brazilian Swindle and The Larger International Monetary Problem

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The postwar liberal trading framework has become hopelessly distorted during the past two decades by the hegemony of the U.S. dollar, high interest rates, debt deflation, and capital flight; the asymmetries of a world so structured are proving intolerable. The economist John Maynard Keynes recognized this issue with characteristic clarity in the design of the Bretton Woods institutions--the World Bank and International Monetary Fund--in 1944. Keynes favored free markets and liberal trading arrangements insofar as they could be made to work, but he was also well aware that free markets are inherently unstable and prone to collapse. Keynes also understood that the characteristic structure of unregulated international finance placed bankers and creditors in the dominant position, and so would inevitably force adjustment by debtors. But what was locally rational in a financial transaction would prove disastrous for the system as a whole. As individual debtors contracted their economies in order to meet their interest payments, their demand for imports would diminish, and so would the exports of their suppliers. The entire economic system would contract, and in the end no one would be further forward in their ability to pay their debts.

THE INTERNATIONAL MONETARY FUND (IMF) has offered Brazil a \$30 billion loan, most of it reserved for next year, on condition that the country continue to run a large primary surplus in the government budget. In this way the IMF maintains a strong arm over Brazil's next government, almost surely to be drawn from the left. Any significant move toward fiscal expansion would trigger revocation of the promised loan, followed by capital market chaos. Or so one is led to suppose.

Right now, Brazil is in the grip of recession. With declining demand for imports, the country has a surplus in its trade account (outflows less inflows of goods and services). It has, nevertheless, a substantial deficit in its current account (outflows less inflows of financial assets), most of which must be interest payments on external debts. These outflows are offset by capital inflows, which are not, however, mainly new investments--currently low, owing to the depressed state of internal demand--but operating loans to existing businesses and the sale of existing national assets to foreigners. In short, Brazil's external balance today is a matter of mortgaging or selling property to pay interest, meanwhile hoping that things will somehow get better.

The IMF's requirement that Brazil maintain a primary budget surplus amounts to a prohibition against fighting recession by increasing domestic demand, an action that would raise domestic investment and move the trade balance back into deficit (and the current account even more so), which in turn would require that foreign investors be found who are actually willing to bankroll new activity. Of course, such investors do not exist. If they did, the IMF would not be in the picture.

Conversely, the pressure to maintain a trade surplus is a device for balancing the existing willingness of foreigners to buy Brazilian assets against the existing burden of debt service. In part because of the political climate, that willingness is eroding more rapidly than Brazil can manage by shrinking real activity and curtailing imports. Panic therefore threatens from day to day. The short-run purpose of the loan is merely to shift the *timing* of panic so that it occurs under the new government instead of the old. A report in the *New York Times* on August 21, 2002, makes this clear:

American and European banks have all been scaling back their lending to Brazilian exporters and manufacturers in the last six months. Most are refusing to comment on their willingness to jump back into that market on the heels of the fund's big loan deal.

In the medium term, if the new government respects the conditions of the loan, the effect must be to finance a continuing reduction in private capital inflows, substituting debt to the IMF for exposure to private external investors while maintaining external debt payments to satisfy older creditors. It is probably not accidental that the net IMF loan for next year is roughly the same size as the present surplus on the capital account.

Nothing here holds out any hope that Brazil's high indebtedness and interest obligations can be reduced. There is no amortization plan. Therefore, unless something does turn up (for instance, massive price increases for orange juice and coffee, which are not very likely), the outlook is for another IMF loan, and another, and another, into the indefinite future, until the private foreign sector is safely divested of its Brazilian holdings.

There is also nothing in the loan that holds out the prospect for economic progress in Brazil itself. Neither increased public spending nor increased imports can be financed from it. Hence the loan represents no new money that would benefit Brazilians, except to the extent that wealthy Brazilian nationals also transfer their assets abroad, and that locals purchase durable imports while they can. It is a standstill, not a progressive package, whose purpose is to keep the wheels of finance spinning, aimlessly, on the Brazilian beach.

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Who benefits? In the first place, private holders of Brazilian assets, who have an opportunity to escape before a severe devaluation. In the second place, foreign bankers, whose loans will receive interest longer than would otherwise be the case. And in the third place, domestic political forces inside Brazil that oppose growth in public services and social reform.

What is *not* clear is why a Brazilian government of the left, elected with a mandate to rule in the interest of the working population, should sacrifice its freedom of maneuver to these interests. It would be one thing if the loan held out a prospect of an early return to net new borrowing in support of state policy and private activity, but this is not the case. Instead, the loan is more properly thought of as a form of blackmail. The IMF promises, in effect, to help maintain an illusion of business as usual, during which interval the new government can occupy its offices in Brasilia and enjoy the perquisites of power, but *only so long as* no actual changes of policy are made. The threatened alternative, if the terms are broken, is financial chaos, no doubt accompanied by concerted efforts to destabilize the new regime.

In particular, has Luiz Inacio Lula da Silva worked for so many decades to build the Workers Party only to govern on such diminished terms? Or is he prepared seriously to consider an alternative strategy? If so, of what should it consist? And although disapproval by the U.S. government is a foregone conclusion, what should be the attitude of the people of the United States to such an alternative approach?

### The Myth of "Sound" Financial Policies

Brazil is a large, resource-rich, industrialized developing country with a history of interventionist policies in several industrial areas, including aerospace, computers, and energy. It is the economic center of gravity in Latin America. The country's notorious flaw lies in income and wealth inequalities higher than virtually anywhere on earth, and a ruling elite very much aligned with the sectarian interests of the wealthy. A weak regulatory regime persists, particularly with respect to newly privatized sectors. Taxes have never been raised sufficiently to finance satisfactory mass urbanization, and the country's vast national resources have not been protected or developed in a sustainable fashion. Capital, moreover, has been free to take flight whenever policy threatened to move in these directions.

A case could once have been made for capital market openness in Brazil on the grounds that the country was short of capital resources and that these could only be acquired abroad. But that case was valid for the extremely short period between 1973, when the old Bretton Woods institutions were dismantled, and 1982, when the resulting explosion of private debt culminated in economic collapse. During the oil shocks, Brazil did manage to finance growth and its import bill from abroad, but of course it could not do so on a sustainable basis. Since then, Brazil and the rest of Latin America have labored under the dead hand of past debt, unpayable except by selling off existing capital assets. There is no serious case to be made that airlines, roads, power grids, and telecommunications networks actually function better under foreign ownership. At present the entire case for privatization is financial: it raises resources to permit the continued servicing of past debt.

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*For what purpose?* The rationalizing argument behind current IMF programs is that countries that follow "sound" financial policies--balanced budgets, tight money, deregulation, and privatization of capital assets--will be rewarded with a stamp of creditworthiness. They should then benefit by being able to borrow from private capital markets on favorable terms, relative to their own histories and the record of countries who are less responsible. In principle this should mean they can run deficits on their trade accounts, loan-finance the purchase of capital goods imports to support development, and maintain high levels of economic growth and job creation. They should be able to do all of this and still attract inflows of direct foreign capital investment.

It has been clear for several decades, however, that this argument is a myth, that the promised land it envisions is a mirage. If it were not, would Brazil be able to complain? The country has a trade surplus and a primary surplus on the government budget. The only source of deficits in both accounts relates to the payment of interest on past debt. To run a surplus on the current account--reducing imports by another \$20 billion or so--would require massive further deflation of the real Brazilian economy. This would destroy the tax base and greatly worsen the public budget. Thus, there is no way to improve Brazil's accounts from their current position, short of an export boom--which depends on external demand, over which Brazil has no control--or a write-down of past debt. But of course the very purpose of Wall Street's interest in Brazil is to be paid as much as possible for the past loans.

The Brazilian particulars illustrate a general point. The running of "sound" policies does not translate into favorable treatment on Wall Street. Instead, private investor judgments are driven largely by considerations over which national policies in developing countries have no influence at all. Most notably, these considerations include conditions in other developing countries and in the United States.

The rationalizing argument behind current IMF programs is that countries that follow "sound" financial policies--balanced budgets, tight money, deregulation, and privatization of capital assets--will be rewarded with a stamp of creditworthiness. It has been clear for several decades, however, that this argument is a myth, that the promised land it envisions is a mirage.

Conditions in other developing countries periodically affect Brazil through contagion in financial markets. Upheaval and financial crisis in Russia in 1998 directly affected the risk exposure of many emerging markets funds. Forced to account for the rising risk in Russia, they reacted by reducing exposure in other "risky" markets, such as Brazil, even though there was no connection between the Brazilian and Russian economies at that time. Similarly, contagion from Argentina--itself only recently a "model country" from the standpoint of the IMF--is affecting Brazil now. Brazil is being punished by the financial markets because of the failure of the IMF's sound-money prescriptions as they were applied in Argentina--even though Brazil did not follow the Argentine road of full acquiescence to the IMF's neoliberal schemes. The irony is, well, Latin American.

U.S. policies and internal conditions affect Brazil through their influence on relative rates of return facing investors. In the late 1990s, with a "flight to quality" compounded by the bubble mentality of the technology sectors, capital flowed into the United States and away from developing economies such as Brazil. Now that the bubble has collapsed, so has the appetite for emerging-country risk, and perhaps also the capacity to purchase Brazilian assets. This too is beyond Brazilian control.

It follows that the only route available to Brazilian policymakers *acting on their own* to restore growth and expand public goods and services in the short run must involve a reduction of debt payments. The easiest way to achieve this is straightforwardly to cut back on payments while imposing strict controls over capital flight. Alongside these measures, the real would be devalued, and interest rates reduced to accommodate both exporters and import substitution. This is the model followed by Russia in 1998, and the result was, in fact, a modest revival of domestic production after a terrible crash. Since that time, the crisis in Russia has eased, even though the vast damage done since the advent of shock therapy has not been overcome.

The case against a policy of debt reduction comes in two parts. One is specious, but the other must be taken more seriously. The specious argument holds that capital markets will punish Brazil for its defiance. The difficulty with this argument is straightforward: Brazil presently enjoys no benefit from its participation in world capital markets. Even the IMF package serves, from the standpoint of ordinary Brazilians, merely to keep up appearances. It is self-evident that to interrupt the recycling of IMF loans into debt service would change nothing in real terms, while the effective imposition of capital controls--if technically possible in Brazil's case--would slow the exit of private investors, and so the decline of domestic asset prices. It does no harm to a bankrupt entity to declare bankruptcy. The main effect is to halt the outflow of inside money. Although affected investors obviously do not welcome this sudden loss of freedom, there is no moral or ethical basis on which they can claim a greater "right to escape" than that of ordinary workers and other citizens to whom the market grants no such opportunities.

The more serious objection is that Brazil's internal political stability may be threatened by a policy undertaken in the national interest. This is the danger of subversion from the outside. The interests of international finance protect themselves by the means at their disposal. There is a long history of this in Latin America, including Brazil in 1964 and extending to present-day Venezuela, where the complicity of the U.S. State Department and doubtless other services in recent and continuing events is clear. In the Russian case, such risks are much smaller because the government rests on the bedrock of its security services, whose defects are well-known but whose loyalties do not seem to be in question. How well a new Brazilian government may be able to meet this danger is a matter of internal politics on which a distant observer cannot speak with any authority. But it is there--in the "crisis of confidence"--and not in the supposed power of a market that the true danger lies.

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### Is There a Better Way?

Is there a better way, for Brazil and the world, than a complete rupture between countries in the North and South on financial matters? And are the national interests of the United States absolutely congruent with those of our leading financiers, so that policy with respect to international development can be safely left to their judgment and in their hands? Or is it possible that, to borrow a phrase, another world is possible after all?

*Surely it has to be.* The liberal economic vision--with multilateral clearing, relatively free and open trade, easy flow of technology, travel, migration, and human learning--has a core of virtues. It has helped to create a far more open and attractive world, in many important respects, than could ever have been achieved under the previous regimes of colonialism and empire. The world is today safer from global war than it was in the first half of the last century. Trade and peace do go hand in hand--most of the time. There are reasons why the enduring success of such a system remains an ideal for many intelligent and well-meaning people.

Particularly over the past two decades, the postwar trading framework has become hopelessly distorted by the hegemony of the U.S. dollar, unsustainably high interest rates, debt deflation, and capital flight. The asymmetries of a world so structured are intolerable.

At the same time, however, the world we inhabit fails to rise to the standard set by the liberal ideal. Particularly over the past two decades, the postwar trading framework has become hopelessly distorted by the hegemony of the U.S. dollar, unsustainably high interest rates, debt deflation, and capital flight. The asymmetries of a world so structured are intolerable, as they lead to unprecedented prosperity in the rich countries and deepening crisis for the poor. It is a minor miracle that they have not long since led to a full-scale revolt against U.S. global leadership. But the fact is, such a revolt may not be very far off. There already exists widespread rejection of American world leadership by the populations of developing countries worldwide, and the reputation once enjoyed by the United States as a pillar of multilateral order, having respect for differences and fair play, has long since been squandered. This cannot fail to translate into political terms sooner or later.

The British economist John Maynard Keynes had already recognized this issue with his characteristic clarity in the design of the Bretton Woods institutions--the World Bank and the IMF--in 1944. Keynes, as the third volume of Robert Skidelsky's biography makes especially clear, was an economic and a political liberal. He favored free markets and liberal trading arrangements insofar as they could be made to work. But he also had not forgotten the fact, which the Depression had driven home to all observers, that free markets are inherently unstable and prone to collapse.

Keynes understood that the characteristic structure of unregulated international finance placed bankers and creditors in the dominant position, and so worked to force adjustment by debtors. This was locally rational in financial transactions, but disastrous for the system as a whole. Individual debtors would be forced to contract their economies in order to meet their interest payments. Their demand for imports would diminish, and so

would the exports of their suppliers. In the end, the entire economic system would contract, and no nation would be further forward in its ability to pay its debts.

The purpose of the Bretton Woods institutions, in Keynes's plan, was to evade this trap. The substantial mechanism was to be a multilateral clearing union, with authority to issue overdrafts to debtors--in effect, to print international money. Under Keynes's scheme, it would be creditors who would have to adjust by expanding their domestic economies, their employment, and their absorption of imports until their consumption of imports rose to match their sale of exports. Otherwise, creditors would face legitimate discrimination against their exports. In this way, the system would balance at high levels of employment (and the principal economic risk, of course, would be international inflation rather than global slump). No member country would, in Keynes's vision, be required to contract domestic economic activity and forgo full employment simply in order to meet international clearing obligations or pay debt service to foreigners.

Keynes did not get his way in the negotiations. The American side, led by Harry Dexter White, insisted on a system dominated by lender interests. As a result, the Bretton Woods institutions contributed almost nothing to postwar reconstruction until calamity threatened in 1948 and the Marshall Plan was put in place to avert it. After that, development largely proceeded under the impetus of cold and hot wars; one in Korea, which jump-started the recovery of Japan, and one in Vietnam, which provided a similar service for Korea and much of southern Asia.

The IMF began developing its modern regimens of debtor adjustment--devaluation plus deflation--for imposition in Europe in the late 1960s. There followed a brief moment, in the aftermath of the oil shock of 1973-74, when the IMF might have emerged as the principal conduit for the recycling of petrodollars to the oil-importing countries of the developing world, but the Nixon administration blocked this. Instead, the job of financing development was turned back to the major commercial banks, along with their European and Japanese colleagues. They made the necessary loans on commercial terms and at variable interest rates keyed to the London Interbank Offer Rate (LIBOR). Development from that point forward was to proceed on commercial terms and "free market" principles, at interest rates determined after the fact by the monetary authorities of the United States.

These arrangements were doomed from the beginning. They collapsed even sooner than they might have otherwise, when Paul A. Volcker and the Federal Reserve pushed American interest rates past 20 percent in their 1981 campaign against inflation. The result was a global crisis of debt, insolvency, and perpetual debtor adjustment that afflicts the entire developing world (except for India, China, and a handful of south Asian city-states) to this day.

The original authors of the IMF and World Bank generally supposed that the United States would remain in its immediate postwar position as a strong surplus country and creditor to the rest of the world. Thus dollars could be "scarce" and, if they were, international liquidity would have to be issued in some other medium. This rather soon proved to be a colossal misjudgment. Instead, the United States went into deficit and eventually became the world's largest debtor. The world became so awash in dollars that the proposed international unit of account--originally the *bancor* and in its etiolated modern form, the Special Drawing Right--faded into insignificance. Today, the dollar is the world's reserve currency, and the international position of the United States depends on this.

So long as the world is willing to take and hold U.S. assets, including liquid dollars, this system works--and shamefully to the interest of Americans. The resulting high value of the dollar means that we consume comfortably, and in exchange for very little effort, the products of hard labor by poor people. We live on the interest skimmed from the meager living available to factory workers in São Paulo, in exchange for providing otherwise unavailable liquidity to the world system. (Our situation is akin to that of, say, Australia in the late 19th century when gold fields were discovered, except that, in our case, no actual effort is required to extract the gold.) And meanwhile, we are not obliged to invest unduly in maintaining our own industrial base, which has substantially eroded since the 1970s. We could afford to splurge on new technologies and telecommunications systems whose benefits were, to a very great extent, figments of the imagination. And even when the bubble burst in those sectors, life went on, for most Americans, substantially undisturbed--at least for now.

But for how long will the system of dollar hegemony endure? There can be no definitive answer; the few economists who have worried about this issue are far from being in agreement. On one side, it is argued that the dominant currency holds a "lock-in advantage"; that is, there are economies associated with keeping all reserves in one basket. The United States in particular is in a strong position to oblige foreign central banks to absorb the dollars that private parties may not wish to hold, at least within elastic limits. Control of oil by U.S. allies and satellites will require other importers to buy dollars in order to buy oil, though it is not obvious that such control requires anyone to hold those dollars very long, except as a hedge against price increases or home-currency devaluations.

Against this, the question remains: Will foreigners be willing to add to their holdings of U.S. assets at a rate consistent with the U.S. current account deficit at full employment? The amount to be absorbed is in the range of half a trillion dollars per year. This was easily handled when asset prices were rising, but now that they are falling, dollar assets are not as safe as they once were. If foreigners are not willing to absorb them at the requisite rate, and if asset prices do not quickly fall to the point where stocks appear cheap, dollar dumping is, sooner or later, inevitable. Otherwise, the United States must slow the rate at which liquidity is issued by restricting its imports, which it can only do by holding down economic growth and keeping incomes well below the full-employment level. In that situation--which may already have arrived--the United States joins Brazil and other developing nations as a country effectively constrained by its debts. Indeed, the world prognosis from that point forward becomes grim, since high levels of American demand have been just about the only motor of growth and development (outside, perhaps, of China and India) in recent years.

### **The United States as a Debtor Nation**

There are economists who advocate dollar devaluation, believing that the richer countries of the world would quickly rally to purchase increasing quantities of made-in-America exports, thus reversing the manufacturing decline of the past 20 years. But this is very unlikely. Exports to the rich regions may not be very price-sensitive.

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And exports to the developing regions are very sensitive to income and credit conditions, which would get worse. At least in the short and medium term, there is no foolproof adjustment process to be had by these means. Where a high dollar provides U.S. consumers with cheap imports and capital inflows to finance domestic activity, a falling dollar would have opposite effects. A falling dollar would raise the price of imports into the United States, especially from the richer countries. Meanwhile, a declining dollar would hit at the value of developing countries' reserves, and so work, on that account, to diminish their demand for our exports. The most likely outcome from a dollar devaluation is therefore a general deepening of the world slump, combined with pressure on American financial institutions as global investors seek safer havens in Europe.

This "elasticity pessimism" (very much shared by Keynes in his day) and the specter of financial vulnerability mean that for the United States, the combination of falling internal demand, falling asset prices, and a falling dollar represents a threat that can best be described as millennial. (My colleague Randall Wray has called it the "perfect fiscal storm.") The consequences at home would include deepening unemployment. There would be little recovery of privately financed investment, amid a continued unraveling of plans--both corporate and personal--that had been based on the delirious stock market valuations of the late 1990s. The center of the world banking industry would move, presumably to continental Europe. Over time, the United States could lose both its position as the principal

world beneficiary of the financial order and its margin of maneuver on the domestic scene. This would be not unlike what happened to the United Kingdom from 1914 to 1950.

It is not obvious that senior financial policymakers in the United States have yet grasped this threat, or that there is any serious planning under way to cope with it--apart from a simpleminded view among certain strategic thinkers about the financial advantages of the control of oil. Instead it appears that the responsible officials are confining themselves to a very narrow range of debt management proposals, whose premises minimize the gravity of the issue and whose purpose is to keep the existing bonds of debt peonage in place as long as possible.

A paper issued this year by the Derivatives Study Center, a Washington-based study group, outlines three major proposals for dealing with the problems of sovereign debt. One of these is the work of Anne Krueger of the IMF; the second, Treasury Undersecretary John B. Taylor; and a third, a group of private economists associated with the global debt relief campaign headed by Kunibert Raffer.

The IMF and Taylor proposals provide alternative ways of addressing a very narrow issue in debt negotiations, namely the incentive for renegade creditors to resist a write-down of their own assets and so to hold out for full payment. This is a classic free-rider issue, since the possibility of paying off any one creditor at face value rises as other creditors accept smaller payments. The IMF would deal with this problem via a new formal restructuring mechanism that would bind all creditors to terms acceptable to a majority. The Taylor proposal would accomplish much the same thing (though in a much more distant future) by providing that new debt contracts carry a collective action clause permitting the will of the majority of creditors to bind the entire group.

Neither the IMF nor the Taylor proposal addresses the systemic problem of excess and unpayable debt. Their thrust is merely to prolong the present prebankruptcy stage of financial relations for as long as possible--shaving and stretching out debt repayments so as to match the ability to pay to the willingness of foreign capital to acquire developing-country assets through liberalization and privatization. In this way, they implicitly assume what has already proven to be impossible, namely, that private capital markets will eventually produce "development" to which poor countries aspire. Nothing in either protocol would protect the populations or the public programs of any developing country.

The Raffer proposal makes an effort along these lines by proposing the creation of an international adjustment mechanism akin to the municipal bankruptcy proceedings available under Chapter 9 of the U.S. bankruptcy code. This proposal for "restructuring with a human face" would give citizens of debtor countries a legal right to be heard in debt negotiations, and so would permit countries to protect some of their social services and core infrastructure investments from disruption in the restructuring process. This proposal has an undoubted claim to enlightened sympathy, and would very materially ease the burdens of adjustment on poor countries in debt restructurings. But no more than the other proposals does it address the larger problem facing the world economy today, namely, the breakdown of a functional finance in support of the development process.

But *if*, as a result of a widespread diversification away from the dollar as a reserve asset, the United States runs a risk within, say, a decade or two, of joining those countries for whom the discipline of the international monetary order means continuous debtor adjustment, a new element will enter the picture. It would become part of the national interest of the United States, if not necessarily that of its financial industry, to collaborate in the reconstruction of a global order that serves the interests of debtors at least as well as creditors. It will become the American interest to switch sides in the debt wars and join forces with the developing countries whose interests lie in rebuilding a multilateral international monetary structure, thus providing a safe path to the orderly liquidation of the dollar overhang and the restoration of autonomy to growth-oriented national development policies.

What would this mean in practice? In broad terms, it would mean that the negotiations antecedent to Bretton Woods, so admirably recounted by Skidelsky, would have to be recreated. But this time, the United States would have to take the role that Britain, anxious to protect its national autonomy in difficult financial conditions, took in 1944. (In that environment, Britain spoke for all the habitually indebted nations of the world in favor of a global order that would force creditors to bear the burden of adjustment.) The role played by the United States would be taken on by the world's emerging creditor power, the European Union.

There is every good reason to think that the outcome of such a revisited negotiation would be more favorable to the world's beleaguered debtors than was the case in 1944. The United States remains today a dominant diplomatic and military force, which the European Union is not. And the U.S. economy is far more globalized, with more natural links of trade and investment to the developing countries, than are the Europeans. Should the United States one day switch sides in the global financial struggles, remarkable things might happen in a fairly short time.

Such a change is difficult to imagine today. The political processes of the United States would first have to be thoroughly overhauled--the money changers once again would have to flee their positions in the temple. But circumstances have a way of dictating political position, sooner or later. It has only been a bit more than a century since the U.S. did in fact stand as the world's premier representative of debtor nations. It was only some 70 years ago that Franklin Roosevelt inaugurated the Good Neighbor Policy, acknowledging the sovereign right of Latin American countries to escape from the burden of unpayable debts. It may not take that long before we come full circle once again, if motivated by practical necessity in the pursuit of full employment. Perhaps the oncoming clash between Brazil's people and the global financial order will help motivate ordinary Americans to rethink on which side we should now stand.

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