

Brazilian Alternative Proposal of Foreign Debt Crisis Restructuring

Finance Ministry, June 1987

INTRODUCTION

1.1 Summary

The Brazilian Government is presenting through this Circular a proposal for its long-term commercial bank creditors, aiming to suspend its moratorium on interest payments and to restructure its external debt in such a way as to ensure that it is serviced and repaid in a time frame that is realistic. The proposals are set out in details in this document.

The Brazilian Government is also seeking an agreement of similar nature with the Export Credit Agencies at the Paris Club. To facilitate the required external debt restructuring, the Brazilian Government has initiated discussions with the World Bank and the International Monetary Fund and is currently submitting to these agencies a formal presentation of this proposal.

1.2-Background (1973-1987)

The major part of Brazil's medium and long term debt originates from the years 1973-1982, when crude oil prices rose to in good standing, indicating foreign exchange reserves of US\$ 6 billion and a foreign debt of US\$ 12 billion. Despite the formidable performance of Brazilian exports during the period comprised between the years 1973 and 1982, growing at an annual rate of %, the significant increase of crude oil prices from US\$ 2.54 per barrel in 1973, forced many oil importing countries like Brazil to spend up to 80% of the value of their exports just to import crude oil.

The first (1973) and the second (1979) oil shocks have caused severe difficulties to the Brazilian economy which reacted promptly with the following policies:

- Export promotion programs, aiming expansion and diversification of Brazilian exports, through the implementation of programs such as Befiex, drawback, the Trading Companies Act, export finance schemes (FINEX), daily mini devaluation of the cruzeiro, export bonus incentive, etc.
- Import control and import substitution program, specially oriented towards basic raw materials, such as non-ferrous metals, petrochemicals, steel products, paper and pulp as well as capital goods.
- Energy conservation and oil import substitution programs, which substantially reduced the vulnerability of the Brazilian economy from oil process increases. These programs reduced Brazilian dependency from imported oil from 86% in 1973 to 50% of total oil consumption in 1987.

However, to finance these vital adjustment policies, the Brazilian Government has made a significant use of foreign savings through voluntary commercial banks lending, Export Credit Agencies and multilateral organization credits. By the end of 1982, a combination of unusually high real interest rates and the refusal of most commercial banks to follow re-scheduling the existing foreign debt on a voluntary basis, have obliged Brazil, as well as many other developing highly indebted countries to negotiate IMF adjustment programs and a compulsory re-scheduling agreement with the private commercial banking community.

During the ten years period 1977-1987, Brazil has made debt service payments amounting to US\$ billion, which were generated almost exclusively by trade surpluses on the range of US\$ 12 billion per year since 1984. This trade surplus is equivalent to 4% of GNP. Over the past four years Brazil has paid an average of above US\$ 8.0 billion a year as service on private and bilateral debt.

Nevertheless, Brazil has experienced a sustained growth all over these years of crisis and uncertainty, showing an average rate of growth of GNP of % per year during the same ten-year period starting at 1977 and ending in 1987. However, the unsolved international debt crisis seems to be a threat to the financial system and to economic growth of developing nations since 1982. Successive and exhausting re-scheduling agreements since 1982 have extended the maturity of these debt obligations at a cost of increased interest rates and a shrinking real investment

available to promote growth.

Another disturbing factor observed in the last few years (1982-1986) is the important economic interaction between inflation, trade surpluses and economic growth. Having the trade surpluses since 1983 as a major source of the necessary foreign exchange to meet the external debt obligations, the Brazilian economy has made as impressive adjustment through a massive reallocation of resources from the fulfillment of domestic demand to the production of exports and imports substitutes.

The recent experience of the "Cruzado Plan", launched in February, 1986 to eliminate the indexation of the Brazilian economy, and to reduce the continuously increasing inflation, has showed very clearly the conflicts of interest which remains in the Brazilian economy with respect the external debt service, the trade surpluses, and the domestic consumption.

1.3 - Current Measures-1987

After experiencing a brief period of hyper-inflation early this year, which marked the failure of the "Cruzado Plan", the Brazilian Government has taken in the last few months, a number of new measures aiming to restore the stability and confidence in the domestic sector of the economy, to reduce the inflation to more acceptable levels, to assure an economic growth of 5% in 1987, and to keep the public sector deficit below 4% of the GNP in this fiscal year. As far as the external sector is concerned, the Brazilian Government has stimulated a fast recovery of exports which will probably generate a trade surplus of approximately US\$ 9 billion this year. For this purpose, the external trade figures forecast is US\$ 14 billion of imports. This result is large enough to increase the foreign exchange reserves and to re-establish the debt servicing ability.

The Brazilian experience on the external debt negotiation has showed that it is not just a problem of foreign exchange liquidity, but a much more complex issue which involves other major problems such as the monetary policy of the developed nations, the trade imbalance between major industrialized countries, the foreign exchange rates fluctuations against each other, the high level of interest rates applicable to major key-hard currencies and finally, the resistance of foreign commercial banks and Export Credit Agencies to resume financial and equity investment flow to debtor nations.

The Brazilian Government understands that it is time to start a new and realistic approach to its external debt constraint, comprising a debt-restructuring scheme which simultaneously reflects prevailing market conditions, as well as reduces the vulnerability of both the Brazilian economy and the creditor institutions under a long-term arrangement. It is a firm commitment of the Brazilian Government to restore payments related to the services of the long-term debt and re-establish its credit worthiness under the terms of this proposal.

1.4-Summary of the Proposal

This Circular contains particulars of an (the "Exchange Offer") made by the Central Bank of Brazil (the "Banco Central") aiming to restructure the outstanding long-term debt obligations to the private commercial foreign banks. The proposed restructure provides several options designed to meet the varying requirements of creditors.

- (i) to ensure that future debt service payments contribute to the repayment of the principal amount of the debt outstanding
- (ii) to end the continuing cycle of rescheduling of existing debt, freeing the financial authorities to concentrate on the expansion and efficient administration of the economy.
- (iii) to reduce, or even eliminate uncertainty and tension on both sides, debtor and creditors, re-establishing the normal and regular relationship between the Banco Central and the international financial community.

Upon the term and subject to the conditions set forth in this offer, Banco Central, through Banco do Brasil S/A (New York, London, and Tokyo Agencies), as Principal Exchange Agent, hereby offers to deliver in exchange for any or all outstanding Debt Notes (the "Existing Notes") related to medium and long term finance (Banco Central denominated "Project 1 and 2") with foreign commercial banks or financial institutions its "New Notes" to be issued pursuant to a "Fiscal and Paying Agreement" among Banco Central, Banco do Brasil, as Principal Exchange Agent, and the Federal Reserve Bank of New York and the Bank of England, as Fiscal and Principal Paying Agents, under

two optional serial Notes as follows:

THE PROPOSAL

The proposal is directed to all creditors with the exception of multilateral institutions. The terms of the obligations offered to such creditors are set out in Appendix 1. They can be summarised as follows:-

- (i) all existing medium-and long-term debt outstanding will be replaced as at, say, 1st. January 1988, by a unified issue to creditors of a single tradeable instrument with a twenty-year life;
- (ii) the issue will be denominated in US\$;
- (iii) the debt service payable on the existing debt will be fixed at the equivalent or not more than US\$ 8 billion million per annum for the next twenty years;
- (iv) Accordingly, the issue will be for a principal amount of a maximum of US\$ 90 billion equivalent and will carry a fixed interest rate of 7 per cent per annum, absorbing a maximum of US\$ 8.3 billion per annum. This would be fixed rate serial note proposal. (The figures would be per cent per annum, absorbing a maximum of US\$ 4.6 billion if Brazil was only willing to set aside 2.5% of GNP). Alternatively, the issue would be for a principal amount of US\$ 63 billion equivalent, with debts of face value of \$ 100 being exchanged for a note of face value of \$ 63, and will carry floating rate of interest of LIBOR + 7/8% per annum. This would be the floating rate serial
- (v) an annual transfer of 2 per cent of the principal outstanding will be made into a redemption fund managed by a trustee, preferably a multilateral institution. Such transfer would absorb a maximum of US\$ 1.8 billion per annum.
Transfers into the redemption fund will be effected by means of a systematic deduction from the sale proceeds of certain exports from Brazil. Redemption fund payments will be invested to accumulate a sufficient balance at the end of twenty years to redeem the issue in full;
- (vi) in the event that the export earnings of Brazil are significantly higher than presently forecast, arrangements will be made to increase the level of payments into the redemption fund and to accelerate the maturity of the obligations accordingly.

The new obligations will thus have a maximum twenty-year bullet maturity backed by a redemption fund and pay per cent interest per annum in US\$ or LIBOR + per annum on a discounted face value. These obligations will have the following additional characteristics.

(i) Transferability

Holders will be free to negotiate the sale or transfer of such obligations to others, both inside and outside Brazil

(ii) Equity Conversion

Holders will have the option, for a limited period after their issue, of surrendering their obligations to the Banco Central in exchange for cruzados at a premium of 12 per cent, over the then ruling exchange rate. Thereafter, surrender will be permitted at a premium of 8 per cent, over the then ruling exchange rate. In each case it will be required that the cruzados paid to holders are invested for an approved purpose, in which case such investments will be regarded by the Brazilian authorities as having been originally made in foreign exchange. Holders will thus have a debt to equity conversion option similar to that available in a number of other countries.

Detailed regulations for such conversions will be developed by the Brazilian authorities and may include incentives designed to encourage investment in specified sectors or regions. The total amount of such conversions will also be subject to certain overall limits.

(iii) Export Funding (FINEX program)

Holders will have the option of surrendering their obligations to the Banco Central for cruzados at any time to provide the finance to facilitate exports from Brazil defined as supplemental by reference to the specific product or service's prior export level. Such surrender will be at the then ruling exchange rate plus a 6 per cent premium.

Measures will be designed to enable the authorities to prevent undue arbitrage and uncontrolled flows resulting from this procedure whilst maintaining simple administration and real incentives to creditors to reduce external debt whilst helping growth of exports. The effect of this option on the domestic money supply will be closely monitored by the Brazilian authorities.

(iv) Principal Recovery Insurance

Holders may, at their own expense, insure their obligations to render them more easily tradeable. This insurance will be carried out under an umbrella policy negotiated on behalf of all creditors with the principal insurance markets such that a single premium payment by the obligation holders of approximately 30 per cent of the face value of the obligations would provide a guarantee through the insurance markets or principal repayment after twenty years of the face value of the obligation so insured plus the premium payment of 20 per cent incurred. This will have the result of rendering the notes more valuable in the financial markets and more easily tradeable.

Holders opting to join this insurance scheme would have the further option of requiring that interest paid on their obligations would be at the agreed rate plus 2 per cent per annum. No contribution to the redemption fund would then be made in respect of such holdings.

(v) Guarantees by holders

In order to make the obligations more easily tradeable, at prices close to par, certainly holders may opt to place their own guarantees on the interest payable on obligations, and then sell such obligations in the international capital market. Arrangements will be made to facilitate this process.

EFFECTS OF THE PROPOSAL

The effects on the debt service payments due by Brazil of this proposal are illustrated in Table 5. If the proposal is acceptable to those medium-and long-term creditors to whom it is made, the external debt of Brazil owed to such creditors would carry a debt service obligation which the country could afford, the debt would be repaid at the end of twenty years in full and any further need for the time-consuming annual rescheduling would be eliminated.

Certain of the options listed under the proposal would also have the effect of reducing the total of the debt outstanding to the extent that they are taken up, particularly the floating rate serial note. It is also anticipated that a significant number of creditors will over time take up the debt for equity conversion option, which will have the effect of increasing foreign direct investment in the economy.

It is also proposed that the obligations should be listed on a major stock exchange.

Although the proposal will not of itself generate any new funds for Brazil, it is clear that if the new debt service, agreed to Brazil under such arrangements, is consistently paid in the future, the conditions will be created under which new medium-and long-term external borrowings would be possible. The economic prospects of the country would also appear much less uncertain for new investments.

APPENDIX I

Floating Rates Serial Notes (FL Serial)

SUMMARY OF TERMS

Borrower:

The Banco Central do Brasil on behalf of the Federative Republic of Brazil.

Arranger:

S. G. Warburg & Co. Ltd.

Principal Amount:

70% (seventy per cent) of the original outstanding principal value of the existing Debt Notes.

Final Maturity:

December 31st 2007.

Currency:

The Notes will be in registered form in the denomination of U S Dollars.

Repayment:

Interest Rates:

LIBOR (as defined) plus 7/8 % per annum, payable semi annually in arrears of the Principal Amount (or such other amount of the Notes which remain outstanding from time to time) until Final Maturity.

Taxation:

All payments on the Notes will be made free and clear of any withholding or other tax whether in the Federative Republic of Brazil or any other jurisdiction where applicable.

Paying Agents:

The Federal Reserve Bank of New York and the Bank of England.

Status of the Notes:

The Notes will be direct unsecured general Federative obligations of the Republic of Brazil.

Transferability:

The Notes will be freely transferable.

Export Funding Option (FINEX Programme):

Holders of the Notes will have the option of surrendering Notes to the Banco Central do Brasil for cruzados at any time to provide finance to facilitate supplemental exports from Brazil under the conditions of the "FINEX proposal" issued by Banco Central do Brasil.

Equity Conversion Option:

Holder of the Notes will have the option of surrendering Notes to the Banco Central do Brasil (at any time up in the limit of 20 % (twenty per cent) of its principal amount) for the purpose of early redemption in "Cruzados" to be invested as equity in Brazil under the conditions of the "Equity/Debt conversion Proposal" issued by the Banco Central do Brasil in this respect. Notes surrendered within X years will be exchanged for cruzados at a premium of 12% over the then exchange rate, and 6% thereafter.

Fixed Rates Serial Notes (FX Serial)

SUMMARY OF TERMS

Borrower:

The Banco Central do Brasil on behalf of the Federative Republic of Brazil.

Principal Amount:

100% (one hundred per cent) of the original outstanding Principal value of the existing Debt Notes.

Currency:

The Notes will be in registered form in the denomination of US Dollars.

Interest Rate:

This Serial Issue will be comprised of fixed interest rates Notes of 7% (seven per cent) per annum, payable semi-annually in arrears on the Principal Amount (or such other amount of Notes which remain outstanding from time to time) until Final Maturity.

Taxation:

All payments on the Notes will be made free and clear of any withholding or other tax whether in the Federative Republic of Brazil or any other jurisdiction where applicable.

Paying Agents:

The Federal Reserve Bank of New York and the Bank of England.

Status of the Notes:

The Notes will be direct unsecured general obligations of the Federative Republic of Brazil.

Transferability:

The Notes will be freely transferable.

Export Funding Option (FINEX Programme)

Holders of the Notes will have the option of surrendering notes to the Banco Central do Brasil for cruzados at any time to provide finance to facilitate supplement exports from Brazil.

Equity Conversion Option

Holders of the Notes will have the option of surrendering Notes to the Banco Central do Brasil (at any time up to the limit of 20% (twenty per cent) of its principal amount) for the purpose of early redemption in "Cruzados" to be invested as equity in Brazil under the conditions of the "Equity / Debt Conversion Proposal" issued by the Banco Central do Brasil in this respect.

REDEMPTION FUND

Currency: Denominated in US\$

Accumulation: US\$ 1.8 billion per year, paid semi annually in arrears by Banco Central do Brasil during the life of the Notes.

Manager: International Bank for Reconstruction and Development.

Trustees: International Bank for Reconstruction and Development acting on behalf of the Note holders.