

de Paiva Abreu, Marcelo

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On the memory of bankers: Brazilian foreign debt, 1824-1943

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DEPARTAMENTO DE ECONOMIA

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TEXTO PARA DISCUSSÃO

Nº 194

ON THE MEMORY OF BANKERS:
BRAZILIAN FOREIGN DEBT, 1824-1943

Marcelo de Paiva Abreu¹

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Abstract

This paper examines the first Brazilian long cycle of indebtedness which extends from 1824, just after independence from Portugal, to 1943 when a permanent settlement of the old foreign debt which adjusted debt service to the country's capacity to pay was reached with the creditors. The pre-1931 period is analysed with emphasis on the dynamic links between indebtedness and capacity to pay. The negotiations between 1931 and 1943 are studied and an evaluation of relative gains and losses resulting from renegotiations and default is made.

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The pre-1931 period, during which foreign debt was contracted, is studied in the first long section. Global data on debt stock, yearly inflows of capital and service flow statistics are presented and a rough reconstruction of the balance of payments is undertaken. Certain characteristics of the pre-1930 international financial market are compared to those of the present financial market. The links between the world economy cycles and the inflow of foreign capital are examined. Finally, an analysis is undertaken of the dynamic links between indebtedness and capacity to pay in different periods of the Brazilian debt history. In the second section Brazilian policy concerning the public foreign debt in the first half of the 1930s is examined. Both the 3rd Funding Loan and the 1934 debt service payment scheme are considered. The third section analyses Brazilian default in 1937 and the return to normalcy entailed by the 1940 debt service payment scheme. In the fourth section the permanent Brazilian public foreign debt settlement of 1943 is described and assessed. The concluding section includes an evaluation of relative gains and losses resulting from renegotiation and default as described in the previous sections.

1. Brazilian Public Foreign Debt before 1931

There is a dearth of adequate analysis of Brazilian indebtedness during the Imperial period -- that is up to 1889 -- and the Old Republic until 1930. The existing contributions such as Carreira (1889), Cavalcanti (1923) or Bouças (1955) are clearly inadequate even if the objective is so modest as merely to describe what really happened between the first Imperial loan of 1824 and the 1931 Funding Loan. Classical general works on international capital flows such as Jenks (1927) or Feis (1930), or modern contributions such as Edelstein (1982), are written from the point of view of creditors or the main debtors among which Brazil is not included.

Data on portfolio investment are reasonably good [see table 1]. Until the mid-1890s the non-British share was insignificant, growth of foreign debt being regular -- annual growth rates between 2 and 6% -- until the mid-1870s, falling until the mid-1880s, then recovering in the next decade. From the mid-1890s the share of other European capital increases but it is still of only 16% in 1914. Between 1895 e 1913 outstanding debt increases faster than previously at rates around 5-6% a year. From 1913 this rate falls down as the First World War interrupts the inflow of foreign capital. The United States as latecomers as exporters of capital became an important source of capital only during the 1920s: the US share of public foreign debt in 1930 was of 30%. During the foreign capital markets boom of the mid-1920s,

which for Brazil lasted from 1925 to 1928, outstanding debt increased at nearly 12% a year. The share of non-British European capital, on the other hand, fell to 5% basically due to the devaluation of the French franc.

Table 1
Public Foreign Debt, 1825-1931

In millions of pounds

	1825	1840	1865	1875	1885	1895	1905	1913	1930	1943	1945
Federal	4.1	5.6	13.0	20.4	23.2	35.7	70.0	103.5	142.0	118.1	110.7
British	4.1	5.6	13.0	20.4	23.2	35.7	70.0	90.6	101.7	96.5	78.4
American	-	-	-	-	-	-	-	-	30.1	35.1	29.3
Other	-	-	-	-	-	-	-	12.9	10.2	3.6	3.6
State and Municipal	-	-	-	-	-	3.3	18.3	48.2	77.0	66.4	45.0
British	-	-	-	-	-	1.8	13.3	38.5	35.5	32.6	21.8
American	-	-	-	-	-	-	-	-	39.3	32.7	22.1
Other	-	-	-	-	-	1.5	5.0	9.7	2.2	0.5	0.5
Coffee	-	-	-	-	-	-	-	-	33.9	19.5	13.6
British	-	-	-	-	-	-	-	-	25.8	15.9	10.7
American	-	-	-	-	-	-	-	-	7.2	3.6	2.9
Other	-	-	-	-	-	-	-	-	0.9	-	-
Total	4.1	5.6	13.0	20.4	23.2	39.0	88.3	151.7	252.9	220.5	169.3
British	4.1	5.6	13.0	20.4	23.2	37.5	83.3	129.1	163.0	145.0	110.9
American	-	-	-	-	-	-	-	-	76.6	71.4	54.3
Other	-	-	-	-	-	1.5	5.0	22.6+	13.3	4.1	4.1

+ 1914.

Sources: Bouças (1942) and (1955); Abreu(1974); Finanças do Brasil, vols.3 and 19; Stone (1977). As figures have been presented in millions of pounds sterling, year to year variations of outstanding debt can be the result of either actual variation of the outstanding debt or variations of the exchange rate of sterling in relation to other currencies, or both.

Until the mid-1880s Brazilian public foreign indebtedness involved only the Central government. From the last years of the Empire, however, state and municipal loans gained importance: in 1895 they corresponded to 8% , in 1905 to 21% and in 1913 to 32% of total debt. In 1930 an important share of total debt -- more than 13% -- was related to the so-called coffee loans to finance coffee price support operations: state and municipal loans answered for 30% and federal loans for the residual 57% of total debt. The share of state and municipal loans in total American loans was rather important reaching more than 50% in 1930; in the case of British loans it oscillated between 16% and 30% of the total. The first non-British European loans -- mainly French -- were state and municipal; only after 1905 the federal government started to borrow in Paris, the state and municipal share of total non-British European loans falling from 100% to 17% in 1930.

As coffee loans could not be floated in the United States due to the Sherman Act they tended to be denominated in sterling: by 1930 more than three quarters of coffee loans were denominated in pounds sterling ².

Systematic reliable information on public foreign debt interest and amortization is practically non-existent. It was decided to use IBGE data in spite their well known deficiencies ³. This information was complemented by Central Bank data for the more recent period. This rudimentary set of data together with the existing foreign trade statistics make it possible to generate rough estimates of the main items of the Brazilian balance of payments ⁴. FOB imports could have been reconstructed ⁵ but it is well known that the Brazilian contribution to the import carrying trade was insignificant in the period. The use of CIF import data does not require adjustments often based on incomplete information and reflects a "balance of trade" concept which includes freight and insurance paid by Brazil. The residue, baptized "direct investment minus capital exports" in fact corresponds to private capital inflow and outflow, dividend payments, personal remittances including those of immigrants as well as other minor items.

Available data suggest a markedly cyclical behaviour of the inflow of public foreign capital into Brazil. Grosso modo the inflow of foreign capital followed the trend of British capital exports ⁶. The share of British capital which was directed to

² The interchangeable use of the expressions British and sterling -- or French and French franc -- loans is not of course strictly correct as many sterling loans were held outside Britain, but very little is known about the actual national distribution of holders which were always represented by British -- or French -- bondholders associations.

³ Preliminary tests for the early period point out to important discrepancies if compared to contractually defined debt service or to Bouças (1955).

⁴ Some adjustments are required as foreign trade statistics referred to the fiscal year ending on 30 June between 1833 and 1887, must be converted to current pounds for all the period and import values should be converted to a FOB basis. It is known that trade statistics are inadequate -- see, for instance, Lago (1982) -- but there is no alternative corrected series for the whole period. In spite of the well known seasonal behaviour of exports the lack of data forced the adoption of the simple criterion of dividing yearly trade values evenly between semesters generating new trade series compatible with financial statistics.

⁵ Estimates of CIF-FOB ratios can be obtained in Woodruff (1966), p. 256 and IBGE (1961), p. 93.

⁶ No reliable comprehensive data are available on movements of other than British capital. For a fuller treatment of the links between cycles in the world economy and capital inflow into Brazil see Abreu (1985), section 3.

Brazil was extremely variable. It was especially relevant before 1825 because of the Independence loans; in the first half of the 1860s when Brazil experienced an export boom and from 1886 to 1913 due to the boom and of foreign debt reconversion in the second half of the 1880s as well as during the post-1908 boom. The cyclical features of the international economy, of course, also affected Brazilian foreign trade flows.

Though the resource gap in early days of the Empire had been positive -- i.e. corresponded to a net inflow of foreign resources -- between 1830 and 1885 only in three five-year periods (1856-60, 1861-65 e 1871-75) such a situation recurred; in the other subperiods the gap was negative: there is a net outflow of resources. The Brazilian case does not fit well the indebtedness cycle paradigm according to which in developing countries an initial period of growing indebtedness as a result of the recurrence of resource gaps would be followed by negative resource gaps in a second period not sufficient to entirely outweigh interest payments so that outstanding debt continues to rise and finally, in the third period negative resource gaps would be sufficient to compensate interest payments and outstanding debt would consequently start to fall ⁷. Only from the 1880s the Brazilian economy fits into the "classical" paradigm as positive gaps occur until the beginning of First World War. The position is then reversed until the mid-1920s when, once again, positive gaps recur in the 1925-28 foreign investment boom.

The pre-1931 foreign debt was accumulated through the flotation of bonds in the main international financial markets by merchant bankers operating under instructions of federal, state and municipal governments. These bonds carried fixed nominal interest rates and were held by the public at large but not normally by the issuing houses themselves. The operation of such a system was possible in a world where the return on consols oscillated within very narrow limits: between 2.5% and 3.8% a year in the 1824-1914 period and not higher than 4.6% between 1914 and 1930.

Market evaluation of the risks entailed by each specific loan in the moment of flotation was reflected in larger or smaller discounts which reduced actual loan proceeds and considerably increased actual interest rates paid by borrowers. Though in some extreme early cases discounts reached almost 50% as a general rule they did not exceeded 20% of nominal loan value. In fact, in spite of assertions to the contrary ⁸, the additional costs related to

⁷ See Simonsen (1983) e Simonsen (1984).

⁸ Sachs (1982), p. 14, for instance, mentions the "notably small spreads of the 1970s". It should be noted that the present method of taking risk into account by adding up spread to base interest rate leads to extremely perverse results: while it would be reasonable to suppose that a rise in the interest rate would increase default risk the present practice implies that the spread is relatively reduced as a share of interest service. A risk provision which varied as an increasing proportion of the interest rate would certainly make more sense as it would vary in direct proportion with default risk and not inversely as today.

risk evaluation in the present capital market and in the nineteenth century are not very different: a, by Brazilian standards, modest spread of 2% added to a rate of interest of 6% -- conditions which prevailed in the market in 1976-77 - was equivalent to a discount of 15% on the nominal value of loans which is higher than the discount applied to the majority of Brazilian Imperial or Old Republic loans.

Simonsen (1983) e (1984) has studied the dynamics of Brazilian indebtedness in the recent past for countries such as Brazil. The same type of analysis can be used to study pre-1930 indebtedness.

Simonsen refers to the classical indebtedness cycle examining the stability conditions of the debt-export ratio.

$$\text{From:} \quad dD/dt = iD + G \quad (1)$$

where: dD/dt = derivative of outstanding debt with respect to time
 i = rate of interest
 G = resource gap
 D = outstanding debt

It is possible to obtain:

$$dz/dt = (i-x)z - h \quad (2)$$

where: $z = D/X$
 dz/dt = derivative of z with respect to time
 X = value of exports
 $x = dX/dt \cdot 1/X$, rate of growth of value of exports
 $h = -G/X$

For any positive h if $x \geq i$ a weak solvency test is satisfied as the debt will be paid off within a finite period and the debt-export ratio will not increase. If $x < i$ the resource gap cannot be permanent or the debt-export ratio will rise indefinitely. In this case the condition for $dz \leq 0$ is that $h \geq (i-x)z$.

It can be shown that (1) is equivalent to:

$$dD/dt = D(i - h/z) \quad (3)$$

The third phase of the indebtedness process -- of falling outstanding debt -- will only be reached if $i - h/z \leq 0$, or $h \geq zi$, that is if a much stronger solvency test is satisfied.

How to apply such paradigmatic notions -- in the sense that they were generated during a "well behaved" indebtedness period between 1971 and 1982 (phase I) followed by the 1982 crisis (beginning of phase II?) -- to the Brazilian pre-1931 debt? The rate of growth of exports was generally lower than interest rates. Export growth rates before 1931 were higher than interest rates only in the following periods: 1831-36, 1846-55, 1891-95, 1901-1906, 1916-20 and 1926-30.

When would the more strict solvency condition when $x < i$, $h > (i-x)z$, apply? An initial period marked by the inflow of real resources was followed by a long period of capital outflow only exceptionally interrupted. The condition is satisfied for a surprising number of periods of the mid-nineteenth century: from

1826 to 1855 (1841-45 excepted). The accommodation of the Brazilian economy to the initial excessive indebtedness depended on the generation of negative resource gaps which actually reduced the debt-export ratio but were not as a rule sufficient to compensate interest payments and reduce outstanding debt.

The strict solvency test $h > z_1$ is satisfied in the periods during which total outstanding debt was reduced, not so few as would be supposed by a believer in the classic paradigm for Brazil: 1831-35, 1846-50, 1851-55, 1866-70, 1876-80 and 1881-85 *.

The dynamics of Brazilian indebtedness between 1824 and 1931 is in clear conflict with the three-phase model found in the literature -- implicit in Simonsen (1984) or in Chenery and Strout (1966) -- basically defined in the light of the US experience. The evolution of the Brazilian foreign debt contradicts the classical paradigm: the outstanding debt series has a cyclical behaviour which underlines the importance of international capital supply conditions.

In spite of the usefulness of the three-stage debt cycle as a stylized analytical device it really does not model history very well. Supply conditions are much more important than acknowledged by such modelling efforts: or would it be a surprise if Brazil in the midst of phase II suddenly returned to phase I if foreign banks so decided?

* In Abreu (1985) some of the problems entailed by the use of five-year moving averages in the context of debt dynamic analysis were not properly taken into account. This does not however affect the main thrust of the argument.

2. The early thirties: the 1931 Funding and the 1934 Aranha Scheme

The deterioration in the Brazilian foreign exchange position after 1929-30 made it clear that it would not be possible to keep on fully servicing the public foreign debt, as this would absorb an intolerably large proportion of the foreign exchange cover (see tables 2 and 3), even if the unfavourable impact of profit and interest remittances related to private foreign capital operating in Brazil -- which was not compensated by an inflow of fresh capital -- is disregarded. The crucial difficulty concerning foreign portfolio interest was that loans carried a fixed rate of interest which did not adjust over time to the ruling rates in the international money markets ¹⁰. Payment of the full public debt service would, indeed, exceed the considerably increased balance of trade -- resulting from the much compressed level of imports which more than compensated the fall in the value of exports. A readjustment of debt service payments to bring them in line with the economy's reduced capacity to generate foreign exchange was required. The ratio of interest payments (related to public foreign debt only) over export earnings, if default had not occurred, would have increased to a maximum of about 25% in 1932. The ratio of total service payments (related to public foreign debt) would have increased to 45%. The comparative data available suggest that the Brazilian ratio was considerably in excess of those of any other country which did not default.

¹⁰ The economy's capacity to pay was also limited by the fall of public revenues associated with the depressed level of economic activity. The characteristics of the pre-depression international economic system which implied the cyclical occurrence of transfer problems are examined by Nurkse (1944), pp. 203-4.

Table 2
Brazilian Balance of Payments, 1928-45
in millions of pounds

	(1)	(2)	(3)= (1)-(2)	(4)	(5)	(6)= (5)-(4)	(7)= (4)/(3)	(8)=(4)/ (3)+(5)
	Exports FOB	Imports CIF	Balance of Trade	Public debt service	Amount of new loans	Net inflow	Debt service as % trade balance	Debt service as % total inflow
1928	97.4	90.7	6.7	16.9	23.5	6.6	252.2	56.0
1929	94.8	86.7	8.1	17.3	2.5	-14.8	213.6	163.2
1930	65.7	53.6	12.1	19.7	18.0	- 1.7	162.8	65.4
1931	53.8	30.1	23.7	20.4	-	-20.4	86.1	86.1
1932	51.2	30.5	20.7	6.8	-	- 6.8	32.9	32.9
1933	52.8	41.5	11.3	6.2	-	- 6.2	54.9	54.9
1934	58.0	41.9	16.1	7.1	-	- 7.1	44.1	44.1
1935	55.0	45.9	9.1	7.5	-	- 7.5	82.4	82.4
1936	64.5	46.7	17.8	7.9	-	- 7.9	44.4	44.4
1937	70.2	66.9	3.3	8.5	-	- 8.5	257.6	257.6
1938	60.3	60.2	0.1	-	-	-	-	-
1939	68.8	58.8	10.0	-	-	-	-	-
1940	65.2	62.1	3.1	3.4	-	- 3.4	109.7	109.7
1941	89.7	68.9	20.8	4.1	-	- 4.1	19.7	19.7
1942	100.0	58.1	41.9	4.0	-	- 4.0	9.5	9.5
1943	116.4	75.9	40.5	3.9	-	- 3.9	9.6	9.6
1944	143.0	108.4	34.6	18.8	-	-18.8	54.3	54.3
1945	162.6	116.6	46.0	10.8	-	-10.8	23.5	23.5

Sources: IBGE (1948); Bouças (1955); Banco do Brasil (1939) and United Kingdom, Department of Overseas Trade (1945).

Thus one of the major problems which economic policy-makers had to face in Brazil during the 1930s and early 1940s was to decide how to deal with the public foreign debt, in particular policies had to be devised concerning the service of the outstanding debt, in face of the chronic scarcity of foreign exchange which was prevalent during the period.

As mentioned in section 1, by the end of 1930, 65% of the total outstanding Brazilian public foreign debt corresponded to British loans, 30% to American loans and the residual mainly to French loans. The maintenance of British pre-eminence in stock terms -- in spite of much greater American involvement in Brazil after the War -- can be explained both by the relatively longer terms of the British loans and by the suspension of amortization payments by Brazil between 1898 and 1910 (of the loans covered by the 1898 Funding Loan) and between 1914 and 1927 (of the loans included in the 1914 Funding Loan) ¹¹.

¹¹ While it is true, as argued by authors such as Hilton (1975), p. 132., that the onset of the depression marked the beginning of a British withdrawal from Brazil, one expression of which was a decline in British investment in the following years, it was after the First World War that the British relative

Not only, as already mentioned, the British tended to have a more important stake in federal and coffee loans which were better secured but the less well secured American loans which had been contracted during the 1920s tended to carry higher rates of interest and heavier sinking fund provisions than those typical of the older British loans. This is made clear by the fact that service (interest plus amortization payments) of American loans corresponded in 1930 to more than 35% of the total debt service, contrasting with the American share of only 30.3% of the total outstanding debt. These imbalances were to become major sources of conflict between the creditors during the ensuing negotiations.

After 1931, the requirements related to public debt service as a proportion of the balance of trade were generally kept around 50%. When it increased above this as was the case in 1933 and to much larger extent in 1935 and, especially, in 1937, due to a contraction of the trade balance caused by a considerable expansion of imports, Brazil had either to negotiate commercial arrears agreements or to default on debt service payments.

economic importance in Brazil started to decline. The United States, indeed, became the main supplier of public and private capital to Brazil.

Table 3
Public Foreign Debt Service Statistics, 1929-1945

	Total Service as % of Total Exports*	Federal Service as % of Federal Revenue**	Total Service Deflated by Capacity to Import, in Millions of Pounds (Capacity to Import in 1937=100)***
1929	18.3	19.2	12.1
1930	30.0	31.2	20.9
1931	38.0	32.4	21.6
1932	13.3	4.1	8.2
1933	11.7	5.6	6.6
1934	12.2	12.8	6.5
1935	13.6	14.1	8.3
1936	12.2	13.5	7.8
1937	12.1	10.9	8.5
1938	-	-	-
1939	-	-	-
1940	5.5	3.7	4.5
1941	4.9	4.2	4.4
1942	4.2	4.0	4.6
1943	3.6	3.0	4.5
1944	13.9	7.1	18.0
1945	7.0	5.6	9.4

* Data from table 2.

** Federal service does not include coffee loans. Revenue includes taxes earmarked for Plano Especial de Obras Públicas e Aparelhamento da Defesa Nacional (1939-43) and Plano de Obras e Equipamentos (1944-46). Federal revenue data from Anuário Estatístico do Brasil 1939-40, pp. 1268 and 1410 and Anuário Estatístico do Brasil 1947, p. 459.

*** Capacity to import from Abreu(1977) table III.1.

Once a country depends on the inflow of foreign capital either to expand the infrastructure related to the export sector or just to avoid the alternative of having to face the outflow related to debt service and profit remittances, without a countervailing inflow of foreign capital, there is an important incentive to avoid default, if the suppliers of capital are willing to go on lending. If, however, as was the case after 1930, due to circumstances affecting the international financial market as a whole, the traditional lenders are not willing to go on lending, the best policy from the debtors' point of view is to default, even if the reduction in the economy's capacity to generate foreign exchange, caused by the outflow of private foreign capital and the fall in export prices, coupled with the need to maintain an "adequate" level of imports required to maintain an adequate rate of economic growth, is not taken into consideration. Political considerations have influence as well as

the possibility of being hurt by retaliation especially in the commercial field. Retaliation fears, however, have proved to be rather unfounded, especially when the economic involved in debt questions are not the same involved in trade or in trade finance.

The overall evaluation of Brazil's public foreign debt policy in the 1930s suggests that while in the earlier years of the decade Brazil paid (or increased the debt) more than could have been expected on the basis of actual economic conditions, the contrary was true of the 1940 and, especially, the 1943 agreements when total payments would seem to have been lower than the country's "capacity to pay" allowed. This is not surprising, as it is safe to say that, as a rule, economic arguments are not that crucial when "capacity to pay" is judged, and, in the end, settlements tended to reflect political considerations ¹².

The readjustment of payments to capacity to pay was gradual: a partial funding loan was negotiated in 1931 for three years; in 1934 a four-year scheme of reduced payments was agreed upon; in 1937 Brazil defaulted completely; in 1940 a new four-year scheme of reduced payments was negotiated and, finally, in 1943 an agreement was reached concerning a permanent settlement of Brazil's public foreign debt.

2.1 The 1931 Funding Loan and its aftermath

The Brazilian authorities decided to suspend sinking fund payments on all foreign loans, except the 1898 and 1914 previous Funding Loans, on the 1st of September 1931. Shortly after asking Rothschilds for their suggestions -- which were to take Sir Otto Niemeyer's ¹³ views into consideration -- for a plan to regulate reduced payments of the foreign debt service, Brazil decided to suspend interest payments related to all loans, with the exception of Funding Loans. The bankers suggested, by the end of September, that total debt should be divided into three categories: the first including the funding loans, the second all secured loans and the third all unsecured loans. The first category would receive full service, the second would receive contractual interest only, and the third, 25% of contractual interest. Unpaid interest would be settled by the emission of "arrears certificates". The scheme would be adopted for three months only, after which it would be reassessed in the light of new developments. This suggestion was not accepted by the Brazilian authorities whose counter-proposal formed the basis of the final agreement ¹⁴.

¹² See Borchard (1951) p. 322.

¹³ Sir Otto Niemeyer, the well known Bank of England financial expert, had just produced his famous report -- dated 4 July 1931 -- on the Brazilian economy, where, among other things, he advised the return to the gold exchange standard and the creation of a truly independent Central Bank. See Abreu (1974), *passim*.

¹⁴ See Whitaker (1933), pp. 61-71 and Reis (1934) for the Funding Loan "negotiations".

The Brazilian Government undertook to provide foreign exchange for the full service of the previous Funding Loans as well as for the payment of French arrears related to the Hague Court of Justice decision concerning the payment of service of some French loans in pre-1914 francs. Sinking fund payments concerning all other Brazilian loans were suspended and interest payments funded for three years through the issue of 5% funding bonds. These funding bonds were to be serviced normally. This arrangement worked to the advantage of bondholders holding British or French loans to the detriment of American bondholders as the funding loans of 1898 and 1914 covered only the older British and French loans. Moreover, the British managed to extract from the Brazilians that the service of the guaranteed sterling loans should be paid in "dollar equivalents", that is, gold pounds instead of pounds sterling ¹⁵. The discrimination against American interests -- it seems that they were not even heard by the Brazilians -- was possible because of the rather unsatisfactory state of Brazil-US political relations at the time. Moreover, Niemeyer's influence in Brazil was at its peak at the time service payments were suspended, since this was just two months after the publication of his report on the Brazilian economy. His correspondence with Whitaker, the Brazilian Finance Minister, suggests that his personal influence goes a long way to explaining Britain's success in extracting a favourable settlement from Brazil ¹⁴.

From Brazil's point of view, the funding loan arrangements would appear *ex post* to have been unsatisfactory, as they involved a mere postponement of the short-run problem of finding foreign exchange to pay the service and resulted in an increased outstanding total debt. The agreement did not involve a reduction of interest charges, as 5% was roughly equivalent to the average contractual rate of interest on the total outstanding debt. On the other hand, it did not compare unfavourably with the very high rates of interest which prevailed in the leading international financial markets -- the United States excluded -- during the second half of 1931. The "dollar equivalent" clause, operating in

¹⁵ This concession was obtained after sterling had gone off the gold standard and was effective until the dollar was devalued in 1933. See United States of Brazil Funding Bonds, London, 14.3.32, (Announcement by N.M. Rothschild & Sons).

¹⁶ Morgan, the American Ambassador, had a lot to be blamed for as he insisted with Washington that there would be no discrimination against American loans, tels. 68 and 73, Rio to Washington, 5.10.31 and 13.10.31, 832.51/627 and 636, United States National Archives (NA):Record Group (RG) 59. On Whitaker-Niemeyer relations: memo Irving to H.M. Ambassador, 4.4.31, A2659/283/6 tel. 107 London to Rio 5.10.31, A5892/283/6 and tel. 104 Rio to London 8.10.31, A5985/283/6, British Public Record Office (PRO) Foreign Office (FO) 371.

favour of some sterling loans was, of course, most damaging to Brazilian interests ¹⁷.

The scarcity of foreign exchange cover created contradictions not only between Brazil and her creditors and among creditors of different nationalities, but also between financial and commercial creditors of the same nationality. The British Ambassador noted in early 1932 that "Rothschilds's representatives are not anxious that anybody should get exchange except the financial groups; both they, and I cannot help thinking, Niemeyer too, have their eyes solely in finance, not on trade..." ¹⁸.

Relief brought about by the reduction of service payments entailed by the 1931 scheme was not sufficient [see table 3]: in 1933-34 Brazil had to negotiate agreements concerning arrears related to the settlement of commercial bills and profit remittances (which could not be transferred because of the lack of exchange cover) with the United States, Great Britain and France, involving a total of 8.6 million pounds.

2.2 The Aranha 1934 Scheme

In 1934, when the funding loan arrangement was expiring, it was decided by the Brazilian Government and the main creditors that negotiations should be opened with the objective of reaching an agreement which would involve higher total yearly payments as it would involve the resumption of service payments on loans other than those receiving full service under the provisions of the 1931 schemes. This would be in the interest of both the majority of the creditors - who would receive something instead of nothing -- and debtor -- who wanted to avoid further increase in the outstanding debt. Negotiations were to develop in order to seek agreement both on the determination of Brazil's capacity to pay and the distribution of the reduced payments between the various loans, which would respect, in principle, their relative rights as to priority in payment stated in the original contracts. The protection of British interests was once more assured by the intervention of Niemeyer who, on his way back home after inflicting his report on central banking on the Argentinians, stopped over in Rio and suggested to Aranha, the Finance Minister, the main ideas which were to form the basis for the discussion ¹⁹. The proposed scheme's main feature was the division of all loans

¹⁷ For rates of interest see League of Nations, World Economic Survey, 1931-32, pp. 186-8.

¹⁸ Seeds to Craigie, 18.2.32, A1494/308/6, PRO:FO 371.

¹⁹ "Niemeyer is evidently the paid and permanent adviser of the Brazilians. His position as such is a definite asset to British interests -- for while he fights stoutly and impartially for the Brazilian interest, he is very accessible and friendly and willing to give information", Lomax to Harvey, 21.8.35, A6769/855/6, PRO: FO 371.

into seven grades according to their standing: the lower the grading, the lower the level of interest payments provided under the scheme (according to the percentage of interest contractually due): in the case of low-graded loans this percentage would increase in each of the four years covered by the scheme. Grades 1 (Funding Loans) and 2 (1930 Coffee Loan) for example, would receive full contractual interest payments while, at the end of the scale, grade 7 loans would receive nothing. Grade 1 would receive 100%, and grade 2, 50% of their contractual sinking funds, while the other loans would receive no sinking fund payments **.

In fact the division of the spoils between the creditors proved to be a much harder nut to crack than the determination of Brazil's capacity to pay, which every party seemed to agree should be around \$8-9 million yearly ²¹. The Americans felt, with reason, that the proposed scheme favoured sterling loans and used all the pressure they could to redress what they thought would be an unfair settlement. Their Ambassador was instructed to tell Aranha that the American Government "has no desire to invoke the fact of the strong unfavourable balance of trade of the United States with Brazil as an argument ... and hopes it will not be compelled by developments to have recourse to the growing practice of bilateral compensation agreements" ²². Bouças, a pro-American Ministry of Finance official, when discussing Niemeyer's proposal with Clark agreed that American loans should be better treated especially in the light of British policy in Argentina ²³. During the negotiations Clark took Sir Henry Lynch, Rothschild's representative in Brazil, to task for having claimed that the Brazilian Government had been "fortunate in having had the assistance of Sir Otto Niemeyer" and that the plan had been "based on his impartial advice". He argued that while Sir Otto was indeed a man of recognized capacity and integrity the fact that he was one of the Governors (sic) of the Bank of England made him

²⁰ See, for details, Abreu (1975). Generally speaking loans were graded in the following order: Federal, Coffee, State of São Paulo, other Southern or Central States, São Paulo Municipals, Northeast States, other Southern or Central Municipals, Northeastern Municipals, Northern States and Municipals.

²¹ This was obtained using the rule of thumb that debt payments should correspond to 50% of the balance of trade, Correio da Manhã, 1.7.33, reporting a meeting of the Conselho Técnico de Economia e Finanças, 30.6.33.

²² Caffery to Gibson, Instruction no. 23, 24.10.33, Foreign Relations of the United States (FRUS) 1933, pp. 83-7. See also for American protests, memo by Clark, 24.11.33, 832.51/874, NA:RG 59, which is an extremely detailed report on the negotiations by the representative of American bondholders.

²³ Clark's memo, 11.1.34, 832.51/874, NA:RG 59.

"presumably aware of, directly interested in and concerned over the business and foreign investments of the British Empire, of which the Brazilians bonds form a not inconsiderable portion"²⁴.

In the final agreement the American negotiator was able, after considerable difficulty, to obtain relatively minor changes which involved increased total payments: 7.3 million pounds in the first year rising to 9 million in the fourth year. These changes, however, resulted in a net improvement in interest payments of only 0.5 million pounds over the four years of the agreement ²⁵. The Americans also managed to convince the Brazilians to reduce the amount of 20-year 1931 funding bonds, which they had promised to the British they would redeem from 1.2 to 0.6 million pounds, but this was a dead promise anyway. British actual losses, resulting from the introduction of the American-sponsored modifications, were negligible but the British negotiator was able to obtain, as a compensation for the improvement of the American position, an undertaking from the Brazilians that 0.4 million pounds would be spent over the four years in redeeming, at market prices, low-graded sterling bonds. The Brazilians succeeded in introducing into the final agreement a provision which allowed, when and if foreign exchange became available, the redemption of bonds at market prices in spite of the partial default. This was used extensively in the case of the coffee loans.

Aranha, trying to pre-empt unfavourable domestic criticisms of the settlement, claimed that Brazil would pay 33.6 million pounds in four years instead of the contractual 90.7 million, the real "gains" being 57.1 million pounds over four years ²⁶. This claim has been repeated by economic historians without adequate qualification ²⁷. It is clear that Aranha was wrongly claiming as gains both actual reduction in interest payments and mere postponement of sinking fund payments.

The British Press, besides criticizing the agreed terms as too favourable to Brazil, resented, surprisingly, what was considered the preferential treatment given to certain American loans, to the detriment of sounder British loans but was ready to recognize the far stronger bargaining position of the United States and the similarity between American behaviour in Brazil and British behaviour in the Argentine ²⁸. There were also some criticisms in the City of Niemeyer's stand during the negotiations because of his alleged protection of the interests of some issuing houses -- Rothschilds in particular -- to the detriment of

²⁴ Clark's memo, 23.1.34, enclosure 18, Clark to Stevens, 1.2.34, 832.51/834, NA:RG 59.

²⁵ For details memo, undated 832.51/886, NA:RG 59.

²⁶ Ministério da Fazenda, Exposição de Motivos, no. 56, 3.2.34, Brazilian Ministry of Finance Archives (MF).

²⁷ Finanças do Brasil, vol. 10 and Bouças (1955); Lemos (1946) and Villela and Suzigan (1975), p. 190.

²⁸ The Times, 10.2.34 and The Economist, 17.2.34.

Lazards, which were interested in the downgraded São Paulo Coffee Institute loan ²⁷.

Niemeyer thought that the offer was the best that bondholders could hope to get ²⁸. The Foreign Office strongly resisted all the pressures to intervene, the Secretary of State, Sir John Simon, arguing that "my predecessor Lord Palmerston, who is not generally regarded as having been backward in the defence of British interests, laid down the doctrine that if investors choose to buy the bonds of a foreign country carrying a high rate of interest in preference to British Government Bonds carrying a lower rate of interest, they cannot claim that the British Government is bound to intervene in the event of a default" and that the Foreign Office would only consider intervention if there was evidence of discrimination against British interests ²⁹.

On the whole, one would tend to agree that the British had grounds for satisfaction. The basic outline of the plan had been of British conception and, after the Americans had been able to obtain relatively minor concessions, the British were able to redress the balance by extracting counter-concessions from the Brazilians. Moreover, this was achieved without the immensely strong bargaining power which the Americans had in Brazil because of their deficit in the Brazilian trade. The Americans, on the other hand, in spite of the Foreign Bondholders Protective Council's apparent satisfaction with the settlement at the time, resented very much, as would become clear during future negotiations, their exclusion from the early stages of the negotiations, which had resulted in a scheme which was "rigged to favor unduly sterling loans" ³⁰. The American stick in the end had been used, but not ably enough.

The operation of what became known as the "Aranha" scheme was not without its problems, in view of the stiff competition for foreign exchange which persisted throughout the 1930s. There is little doubt that Vargas would have decided to default in 1935, if agreements concerning the progressive liquidation of commercial arrears had not been reached. Strong pressure was exerted by government officials who thought that it would be preferable to declare a moratorium on the foreign debt rather than face a permanent shortage of foreign exchange cover needed to settle commercial payments ³¹.

²⁷ Law to Sargent, 16.2.34, A1620/147/6, PRO:FO 371.

²⁸ Broad's minute, 16.2.34, A1503/147/6 and Niemeyer to Waley, 1.3.34, A1768/147/6, PRO:FO 371.

²⁹ Draft, Simon to Leather, 7.3.34, A1440/147/6, PRO:FO 371.

³⁰ Rio to Washington, tel. 14, 25.1.34 and Clark to FBPC, 25.1.34 FRUS 1934, pp. 615-6.

³¹ Dantas to Costa, 6.1.35, Vargas to Aranha, 9.1.35, quoted by Silva (1969) pp. 49-50. In mid-1935 Vargas proposed to Aranha that the public foreign debt should be nationalized but met with his disapproval, Vargas to Aranha, 13.8.35, Archives of the Getúlio Vargas Foundation-CPDOC (FGV): Vargas Archives (GV).

3. The 1937 Default and the 1940 Sousa Costa Scheme

The foreign debt question was discussed by Sousa Costa, the Finance Minister, and the Foreign Bondholders Protective Council (FBPC) during the summer of 1937 when a Brazilian mission visited the United States. No agreement was reached, however, on the general lines of a new settlement to replace the Aranha Scheme in 1938, and it was decided that the Brazilians would draw up a proposal which would be taken as a basis for discussion ²⁴.

3.1 The 1937 Default

After the coup d'Etat of November 1937, however, the Brazilian Government announced the suspension of all public foreign debt payments. Vargas argued that Brazil had been forced to default because it was impossible both to service the debt and pay for imports, which were essential for the re-equipment of the railway system and of the armed forces. The alternative course of entering into a new funding scheme was considered to be unacceptable, as it would increase the outstanding debt which was already considered to be out of proportion with the country's capacity to pay ²⁵.

The Economist's assessment of the default is representative of the British Press reaction: "the Brazilian default ranks among the most cynical that the London market remembers" ²⁶. The reaction of the Americans was relatively mild, fitting well with their basically defensive tactics concerning the foreign debt question, i.e., letting the British appear as the villains and do the spade work and then press their specific claims, generally concerning the distribution rather than the level of payments. Their special concern seemed to be with the possibility that any retaliation against the default could lead Brazil to impose new restrictions on trade, which would be against their primary foreign economic policy objectives ²⁷.

²⁴ Lindsay to Eden, no. 699E, 2.8.37, A5744/316/6, PRO:FO 371 and enclosure no.2, Rio to Washington, no. 25, 10.9.37, 832.516/255, NA:RG 59.

²⁵ Vargas (1938-43), vol. 5, pp. 26-8, speech of 10.11.37. The American Consul in London, reported that at Rothschilds it was mentioned that "the President's decision to default might have been a shrewd move in view of the increasing xenophobia in Brazil and the need for army support, the commanders of which hadn't a gleam of understanding in regard to the repercussions abroad of default", no. 33, London to Washington, 18.11.37, 832.51/1220, NA:RG 59.

²⁶ The Economist, 13.11.37.

²⁷ Hull to Caffery, tel. 80, 16.11.37, FRUS 1937, pp. 353-4.

The Americans, in fact, did not need to worry too much about defending their bondholders as the task was being most ably performed by Aranha, who, after some years in Washington, as Brazilian Ambassador, had turned into an enthusiastic supporter of a foreign policy involving much closer ties with the United States. He denounced default as a communist policy and thought that "the default will cost more in dollars and pounds than it would have cost to pay" and that in "the United States alone there were almost a million people who depended on the Brazilian payments for their means of livelihood ... mostly poor and to make enemies of them would be an economic and political mistake, especially in view of the fact that the American people consumed half of Brazil's exports" ³⁶.

The main reason for the mildness of the American reaction, however, must be sought neither in the context of the defence of multilateral as opposed to bilateral trade nor of Aranha's pro-American utterances, but more likely within the context of Roosevelt's overall political strategy concerning the role of Brazil in the realm of the Good Neighbour policy ³⁷.

Costa had returned from a mission to the United States in mid-1937 with the feeling that the United States would not retaliate if Brazil stopped debt payments, and this was certainly taken into consideration when it was decided to default ³⁸. After the default, the Americans went as far as putting pressure on the French to block their attempts to retaliate by means of a ban on coffee imports from Brazil ³⁹. The British, on the other hand,

³⁶ Gurney to Eden, no. 401, 30.12.37, A222/25/6, PRO:FO 371 and Aranha to Vargas 24.11.37, FGV:GV.

³⁷ Morgenthau, the American Secretary of the Treasury, attributed the promises of American financial assistance to Brazil in 1937 to Roosevelt's desire to counter German influence on Latin American dictators and to keep Vargas a Pan Americanist in spite of his personal distaste for the man. Blum (1959), p. 493. FBPC's suggestion that the US Government should not recognize the new Brazilian Government because of the default was rejected by the State Department: "the Department recognizes no adequate grounding either in law or in policy for following the suggestion ... It does not believe that the best interests of American bondholders would be served by this Government threatening coercive measures ... even were such measures consistent with the policies of this Government in protecting and promoting American interests in general", Welles to Clark, 16.11.37, 832.51/1199, NA:RG 59.

³⁸ See McCann Jr. (1967), p. 45. In mid-1937 both Vargas and Aranha favoured an agreement covering only the American loans. Vargas would not hear the British proposal of just renewing the 1934 agreement for one or two years: he thought that there should be a solution which would make the agreement more favourable to Brazil. Vargas to Aranha, 17.6.37 and Aranha to Vargas 30.7.37, FGV:GV.

³⁹ Hull to Caffery, tel. 80, 16.11.37, FRUS 1937, pp. 353-4 and Washington to London, tel. 436, 29.11.37, A8591/795/6, PRO:FO 371.

would, in theory, be quite prepared to make use of a clearing under the Debts Clearing Offices Act 1934 to deal with the Brazilian default but "unfortunately ... in the case of Brazil, the balance of payments is not such as to make the threat of a clearing effective". The British authorities, on the other hand, had a very clear perception of the fact that "if the United States were to exercise all the pressure on Brazil which they are in a position to exercise, they could secure the payment of the dollar bonds in full and leave nothing for the sterling bondholders" ⁴².

In early 1938 The Economist returned to the subject of the Brazilian debt without mincing words: "Brazil's policy is putting an almost unbearable strain on her ultimate interests: for though the London market has always been willing to give temporary accommodation to hard-pressed debtors, it does not forgive high-handed default". Provided "the Government plays its part in restraining tendencies to extravagant imports" -- and taking into consideration both the fast expansion of import-substituting industrial output and the campaign to increase the cultivation of wheat -- "Brazil needs not make a rigid choice of destroyers (for the Navy) or debt service", as, after the liquidation of the commercial arrears in 1940, some exchange cover would be freed. If "extravagant imports" are taken to mean consumer goods imports, the argument is quite irrelevant as these were on average only 1.3 million pounds higher during the default period (1938-39) than they had been between 1933 and 1937. The British lack of interest in the Brazilian market was in any case in marked contrast with American interest not to lose ground in this market for "extravagant" imports ⁴³.

The Economist's views were fully representative of the views current in London about the Brazilian default, both in the Corporation of Foreign Bondholders (CFB) and in the Foreign Office. On the other hand, both the British Ambassador in Rio and Sir Henry Lynch -- Rothschilds resident representative in Brazil -- tended to adopt a view which was much more sympathetic to the Brazilian version of the reasons behind the default. While it was relatively easy in London to discount Lynch's views by suggesting that he was "rather going native", the Ambassador's influence was such as to block or soften some of the blunter CFB's protests. It is interesting to note that the American Ambassador was also a "liberal" as far as the debt question was concerned, in comparison with the views held in the State Department ⁴⁴.

⁴² Waley to Holman, 29.12.37, A9412/3505/6, PRO: FO 371.

⁴³ The Economist, 12.2.38 and 12.3.38.

⁴⁴ Busk's minute, 1.6.38, A4219/25/6 and Gurney to Balfour, 6.7.38, A5526/25/6, PRO: FO 371. The Economist's views were milder than those of Sir David Waley: "of course, I agree that the Brazilians are dirty dogs, but ... I do not think it would help the bondholders to tell them so", Waley to Balfour, 2.8.38, A6040/4176/6, PRO:FO 371 and Caffery to Hull, 7.3.38, and Hull to Caffery, 25.3.38, FRUS 1938, pp. 375-6.

3.2 The Sousa Costa 1940 Scheme

Representations made by the creditors throughout 1938 to convince the Brazilian Government to take the appropriate steps to reconsider its position were in vain. The negotiations which eventually started in September 1939 were the direct result of Aranha's -- now Minister for Foreign Affairs -- visit to the United States early in the year to negotiate a wide range of commercial and financial questions.

Aranha assured Hull that Brazil would resume service related to American loans on the 1st of July 1939. This commitment, which exceeded Aranha's instructions, was strongly criticized in Brazil leading to Costa's veto concerning service resumption by the promised date. Aranha's undertaking, however, made it impossible to avoid opening negotiations; on the 1st of July, the Brazilian Government made a token payment of US\$1 million in New York and informed the creditor nations of their intention to resume payments in the future, inviting the associations of bondholders to send representatives to discuss the matter in Rio. In the meantime, Aranha was reassuring the American Ambassador, that Vargas had decided to adopt a policy of full cooperation with the United States. His plan was "to lay down a policy that Brazil will pay debts out of her commercial capacity to pay having regard to her balance of trade with each separate country. The result would be, of course, to favour the American bondholders, the French also to some extent and the British not at all" ⁴⁵. The foreign negotiators did not arrive in Rio before August, and, by then, it became increasingly clear that the Brazilian Government had to wait and see what would be the impact of the war on the export trade before entering into any commitment concerning debt payments.

After the Brazilian generous use of dilatory tactics, which led the Americans to send their representative back home, Costa hinted in November to the British that 3 million pounds yearly was the maximum that Brazil could afford to pay: equivalent to about one third of the payments set under the Aranha scheme in its last year. The Americans kept aloof of these preliminary negotiations and limited their intervention to advising the Brazilians that they expected equitable treatment. When, however, the Americans heard that the Europeans were talking with Costa in terms of a permanent settlement of the federal debt only, the Ambassador was authorized by the State Department to take part in

⁴⁵ Rio to Washington, tels. 205, 209, 211 and 219, 30.6, 1.7, 5.7 and 18.7.39, FRUS 1939, pp. 361-8.

the discussions ⁴⁴. American pressure changed the atmosphere in their favour, Vargas being reported as saying that he was interested in doing something for the American and Portuguese bondholders only. While it would be inappropriate to claim that the decision to resume debt payments was the result of pressures related to the supply of credits, especially those for building the steel mill at Volta Redonda, it is undeniable, in spite of American assurances, that even if the two questions were "not tied in American minds", the Brazilians took the implications into consideration ⁴⁷. Implicit or explicit, these pressures were effective as Costa in January 1940 communicated to the creditors' representatives a proposal for a temporary settlement of payments at 50% of the payments under the Aranha 1934 scheme which was deemed as worthy of consideration as a basis for discussion.

The Americans were able to improve their position by convincing the Brazilians to take only the last year of Aranha's plan (which provided for more generous payments for their low graded loans) as the basis for the new scheme. Total payments would rise from 4 million pounds in the first year to 4.3 million in the final year, 0.6 million more, over the four years, than in the Brazilian proposal. The British negotiator's acceptance of this American proposal, which involved relatively smaller payments for the prime sterling bonds which had been successfully protected in the past, was facilitated by a Brazilian undertaking to spend no less than 1.6 million pounds in the redemption of British bonds at market prices. The agreement was to run for four years.

⁴⁶ The Brazilian Ambassador in Washington made clear to Welles that there was strong opposition to Aranha's undertaking, especially among the military. Welles agreed that the matter should be treated with care but insisted that it would be difficult to extend credits to Brazil while public foreign debt was in default, Welles's memo, 5.7.39, 832.51/1479 1/2, NA:RG 59. The FBPC showed, on the other hand, a consistent lack of understanding of the difficulties faced internally by Aranha, Duggan's memos, 1 and 24.7.39, 832.51/1515 and 1565, NA:RG 59. This led to constant friction with the State Department even if it had less leverage than the CFB had with the Foreign Office. Morgenthau thought that the bondholders had excessive influence in the State Department and insisted that private debts should not be taken into consideration when discussing financial assistance to Brazil, see minute of 16.1.40, MP, book 236, pp. 1-6; Gaston to Morgenthau, 18.1.40, Morgenthau Papers (MP), book 236, pp. 235-7; Morgenthau to Hull, 20.1.40, MP, book 236, pp. 387-8 as well as Blum (1965), pp. 51 and ff.

⁴⁷ Tel. 461, Rio to Washington, 30.12.39, FRUS 1939, pp. 378-9; Phillimore to Phillip, 13.1.40, CFB 341/14; Phillimore's memo, 4.4.40, A2967/43/6, PRO: FO 371 and tel. 25, Washington to Rio, 22.1.40, Itamaraty Historical Archives (AHI)/Brazilian Diplomatic Missions (MDB).

During the negotiations there was a clear clash of views between Phillimore, the British negotiator, and the British Embassy on one side and the CFB on the other. Phillimore in fact found the Council's ideas about Brazil's capacity to pay entirely unrealistic "as the whole question does not hinge on Brazil's capacity to pay but on the political difficulties which the Government had to face in order to reinstate payments if confronted with the extremely low standard of living and chaotic deficiency of transport and other equipment". The British Ambassador in Rio, added that CFB's insistence in selecting as its measuring rod the level of contractual payments should be qualified by the recognition that some loans had for a long time been in default and that service in the past had been met with the proceeds of new loans rather than out of revenue and balance of trade. He thought that the Council "appeared to be in the clouds" and recommended that they "should possess their soul in patience" as "bluff and bluster would only indispose the Brazilians and do not good" ⁴⁶. Niemeyer, however, was still prepared to indulge in a typical peroration: "I am quite sure that Brazil cannot expect to get away in the end without making a more adequate recognition of her obligations. If she does not, she will merely be written off in disgust as a fraudulent bill" ⁴⁷.

The American improvement of their position in the debt settlement can be seen as a specific manifestation of a general turning-point in Brazilian foreign economic policy from the beginning of 1939 onwards. Even before the outbreak of the war American economic and political influence in Brazil had been increasing, following Aranha's visit to Washington. Since then the American bargaining power had been further strengthened by the loss to the Brazilian export trade of many European markets.

⁴⁶ Tels. 143 and 144, Rio to London, 12 and 13.12.39, A8715 and A8747/136/6, PRO:FO 371.

⁴⁷ Niemeyer to Phillimore, 8.2.40, Archives of the Corporation of Foreign Bondholders (CFB) 241/15. This can be contrasted with Mr. Dalton's speech to the Brazilian Chamber of Commerce on the 6th of May of 1947 on the problem of blocked sterling balances owed by Britain to her war suppliers (Brazilian balances amounted then to 65 million pounds): "the vast accumulation of debt by Britain represents an unreal, unjust and unsupportable burden. If Lease-Lend and Mutual Aid had been applied among all members of the Grand Alliance as they were between the USA and the British Commonwealth, by far the greater part of these debts would never have been charged up against us. Sooner or later this mass must be very substantially scaled down. Britain is strong, but one sign of her strength must be the refusal to take on fantastic commitments which are beyond her strength and beyond all limits of good sense and fair play": Keatings's Contemporary Archives 1947, May 3-10, p. 8587.

The Americans were almost certainly helped when Aranha took over from Costa as the Minister in charge of negotiations when these reached the crucial stage. While it is true that Aranha in many instances favoured American interests, it is necessary to qualify this assertion by mentioning that the situation was not without ambiguity as he was thought to be under a certain amount of conflicting pressure through his family links with Olavo de Souza Aranha, who represented Schroeders and had been involved in the compensation mark trade with Germany. From 1940 onwards Souza Aranha's interests turned to the supply of cotton to Great Britain and neutral countries as well as to financial deals related to the nationalization of certain British investments in Brazil ⁵⁰.

The main opponents of the foreign debt settlement were some sections of the armed forces as uncertainty about the result of the war still allowed them to show their pro-German sympathies. This led Vargas to take a rather obstructive stand, requiring the combined persuasive efforts of Costa and Aranha to sign the agreement ⁵¹. Whatever was the strength of the pro-German faction in Brazil the fact remained that Germany did not control either shipping or shipping routes. Left without the German market as an outlet for her exports and uncertain about the level of future Allied purchases, Brazil had no alternative but to continue to move more and more towards the United States. To the economic facts must be added no less important political considerations within the Pan-American context, involving growing friction between Argentina -- pro-German enough to remain neutral for a long time but ironically "protected" by the British from American pressure as its foodstuff exports were vital to the British war effort -- and Brazil -- where pro-German leanings at the political level found a progressively more hostile environment due to the country's increasing economic integration with the United States ⁵².

⁵⁰ See Hilton (1969), chapter 10; Charles to Scott, 11.2.43, A2506/2506/6; F16522/01/3 and F18535/01, PRO:FO 371.

⁵¹ Phillimore's memorandum, 4.4.40, A2967/43/6, PRO:FO 371.

⁵² American influence during the war indeed grew to such a point that the State Department advised the Foreign Office that they regarded the United States Ambassador in Rio "in the same light" as the Foreign Office regarded H.M. Ambassador to Egypt. See Charles to Scott, 5.2.42, A2764/2764/6, PRO: FO371. There is a good deal of interest in the comparative study of Brazil and Argentina in the 1930s and 1940s concentrating on the different reactions in each country to changed conditions in the international economy, associated to the distinct nature of their economic structure and international relations. Argentina moved politically to the right in the 1930s while oligarchical political influence was weakened in Brazil; the success of the nationalist officers movement in Argentina is followed by Vargas's downfall; relations between Argentina and the United States deteriorated while political and economic ties between Brazil and the United States became much closer; British influence in Argentina remained important while declining in Brazil. Abreu (1984) studies some of the contrasts of international economic policies and their impact on economic performance.

If anything, Brazilian payments as agreed under the terms of the 1940 agreement were on the low side, as acknowledged by Costa to Phillimore, because the Americans took care not to overmilk their Pan-American ally and because both the British and the French were eager to receive some payments, however low, from Brazil. Moreover the British underestimated their requirements for Brazilian raw materials which resulted in a reversal of the Brazilian sterling position after 1941. While before 1941, Britain had to expand her purchasing programme in Brazil artificially to assure the payment of Brazil's sterling commitments, from 1941 there was a progressive accumulation of sterling in the Brazilian special account. Had this been anticipated in London it would have certainly resulted in upgraded British claims.

4. The Permanent Public Foreign Debt Agreement of 1943

Costa felt in early 1943 that time was ripe to begin talks with the British concerning the renewal of the 1940 agreement, which would expire by the end of the year. This Brazilian move was prompted by the rapid rate of accumulation of blocked sterling balances in London and the likely continuation of this trend. Costa anticipated that after the war Brazilian exports would have problems adjusting to competition in a normalized world market and that heavy demands would be made on the existing foreign exchange reserves to import essential capital goods for which there was considerable repressed demand. Thus, the moment was ideal to settle once and for all the public foreign debt question by means of a permanent settlement. He was prepared to spend 7.5 million pounds in total yearly payments as well as 26 million for special amortization of as much as possible of the outstanding debt ⁵³.

After three months of negotiations -- without the Americans -- this offer was improved. Two options were offered to the bondholders. Under option A, there would be no reduction of the outstanding debt and payments would be at 70% of the level of the last year of Aranha's scheme involving total payments of 7.3 million pounds (4.4 million interest and 2.9 million sinking fund payments) if all bondholders opted for this option. Under option B, a proportion of the outstanding debt would be redeemed through cash payments while the residual debt would be converted into new 4% Federal bonds in the case of all loans in substitution of previous Federal, Coffee, State and Municipal bonds. Cash payments would total 20.7 million pounds, redeeming 85.6 million pounds of outstanding debt -- almost 40% of total debt, at the average price of 24% -- while yearly payments would total 8.1 million (4.4

⁵³ Tels. 93 and 94, Rio to London, A1383 and A1397/473/6, PRO:FO 371. See Costa to Vargas, 6.2.43, FGV:GV, suggesting that negotiations should be opened to forestall attempts by creditors to ask for integral service in face of the position of Brazilian reserves.

million interest and 3.7 million sinking fund payments), always on the assumption that all bondholders opted for this option. It must be noted that contractual rates of interest varied between 4% and 8% ⁵⁴.

London's reaction to the Brazilian proposal was unfavourable, as it was considered to be out of proportion to Brazil's favourable exchange position. Phillimore was dismayed with what he considered to be London's unrealistic line, based on the lack of appreciation that the foreign exchange position was the result of a wartime export boom, coupled with the inability to obtain imports, and that this was unlikely to continue after the war ⁵⁵.

Costa's disclosure to the Americans in June, that negotiations had been proceeding since the beginning of the year with the British, caused a lot of embarrassment to the CFB and was an important reason for American ill-feelings towards the British during the following joint negotiations. After a long delay, the Americans decided to send representatives to Rio. Their instructions made clear the intention to settle for good their differences with the British concerning what was regarded as the grossly discriminatory and unduly favourable treatment of high-graded loans in the past. A re-grouping of grades was wanted, which would fundamentally change the framework of Aranha's plan to the detriment of sterling loans. Their first proposal to Costa mentioned payments of 9.7 million pounds yearly. The Brazilians found the proposal unacceptable and avoided becoming entangled in the re-grouping controversy, claiming that it was an Anglo-American question ⁵⁴.

After protracted negotiations, all parties agreed to a permanent settlement which would offer to the bondholders two options, no mention being made as to the classification of loans by grade as had been the case in previous settlements: a move designed to cover up the damage done to sterling loans. The final framework of the settlement followed the lines of the Brazilians' offer. Under option A, the original bonds would not be substituted by Federal bonds and yearly payments of initial 7.7 million pounds (of which 5.2 million interest) would be made, on the assumption that all bondholders would choose it. Option B would involve an

⁵⁴ Phillimore to Niemeyer, tel. P183, 7.2.43, CFB 241/20.

⁵⁵ Tel. 349, Rio to London, 10.6.43, A5520/473/6, PRO:FO 371.

⁵⁶ For details on the negotiations see enclosures, no. 12846, Rio to Washington, 24.9.43, 832.51/2199; enclosure no. 12927, Rio to Washington, 30.9.43, 832.51/2210; enclosure no. 12988, Rio to Washington, 7.10.43, 832.51/2215; Mc Cormick to Munro, 27.10.43, 832.51/2242; tel. 5067, Rio to Washington, 29.10.43, 832.51/2235; Mc Cormick to Munro, 5.11.43, enclosure no. 13328, Rio to Washington, 832.51/2246; Orton to Munro, 26.11.43, 832.51/2291; Mc Cormick to Munro, 9.10.43, 832.51/2218, 14.10.43, 832.51/2221 and 21.10.43, 832.51/2232, NA:RG 59.

initial service of 8.4 million pounds yearly (of which 4.9 million interest) of the new 3.75% Federal bonds, as well as cash payments of 22.9 million pounds redeeming 79 million of outstanding debt at an average price of 29%, also on the assumption that all bondholders would choose this option ⁵⁷.

Old grade B loans would be redeemed at 12% of the outstanding principal and the bulk of the interest arrears -- those corresponding to the 1937-40 default -- would be liquidated at 25% of the 1940 agreement rates (that is, in the "best" case at 12.5% of contractual rate of interest ⁵⁸. The settlement meant a partial abandonment of the principle that better secured loans (mainly British) should get priority in the event of a partial default. All British attempts to move the Americans from their position failed.

That the settlement was not favourable to the British is clear from a comparison between the press releases of the CFB and of the State Department. The CFB made clear that "the allocation of available money between the various Bonds revealed marked differences of outlook not only between the creditors' representatives and the Brazilian government but between the British and the Americans and that they could not pretend to be satisfied with the resulting differentiation between the various Bonds". The State Department stated that "the proposal is a manifestation of Brazil's earnest desire to meet its foreign obligations within the limits of its capacity. This Government is extremely gratified that an arrangement of this far-reaching and definite nature has been reached between the Brazilian authorities and the United States and British bondholders ⁵⁹. Officials in the Foreign Office, while not particularly unhappy with the outcome of the negotiations, were, however, very critical of the CFB's secretive methods, keeping the Americans in the dark for so long, and blamed Niemeyer, who believed he held "some special position in Brazil as the G.O.M. of finance ⁶⁰. There was a clear unwillingness to give due credit to Niemeyer's influence as an important reason for British achievements in 1931 and 1934.

Phillimore ascribed the behaviour of the Americans throughout the negotiations to their tendency "to regard Brazil as

⁵⁷ Present values generated by options A and B were equivalent at 4% a year. At rates of discount higher than 4% alternative B would be more attractive. Risk entailed by option B moreover was lower as responsibility as the debts were contractually taken over by the Federal Government.

⁵⁸ See Decree Decree Law 6019 of 23.11.43, Diário Oficial, 25.11.43 for details on specific loans

⁵⁹ CFB announcement, 26.11.43, A10774/473/6 and tel. 5376, Washington to London, 28.11.43, A10846/473/6, PRO: FO 371.

⁶⁰ There was even talk -- by Sir Edward Peacock of Barings -- of Sir Otto's "idiotic behaviour", Mather-Jackson's minutes, 27.11.43 and 31.12.43, A10714/473/6 and A577/77/6, PRO: FO371.

their own backyard" and their being inclined "to be upset when anyone else comes and plays in it uninvited". Costa's irritation with the unreasonable American demands had led to his appointing Bouças, his main adviser, to proceed with the negotiations, and this had worked to the disadvantage of the British as "though Bouças may know how to handle the Americans, he also derives his income from that quarter". He found the unfavourable reaction of the London market to the settlement inconsistent with the quotation of Brazilian bonds on the Stock Exchange but that the market had come to realize that "there is a political factor too and that Brazil's will to pay is in a less healthy condition than her capacity" ⁴¹.

The Economist, once again, reacted very unfavourably to the settlement as payments were found to be too low considering the Brazilian capacity to pay and priority should have been given to loans with a specific security as opposed to loans generally secured: "to have offended Brazil by asking for more would have run counter to the Good Neighbour policy ... to put the matter quite bluntly, the British holder of Brazilian obligations has been made a sacrifice to Pan-Americanism" ⁴². Phillimore, not unreasonably, took exception to this line of criticism, pointing out that it was useless to insist that Brazil should have to pay more when in the past she had paid out only 2.6 million pounds net yearly (average 1901-41) and her other financial commitments were estimated as between 5 and 20 million pounds yearly. The Brazilian theoretical debt service often mentioned in the press included some loans which no responsible banker should ever have made. He argued that the American loans, which were entitled to 41% of total interest and 46% of total sinking fund payments, would get considerably less than this in the case of both options offered to bondholders. The superior status of the secured loans had, thus, been maintained. He avoided to mention, however, that the superior status of the secured loans had been less respected in 1943 than in previous agreements. He added that Brazil was offering the settlement not because of any compelling sense of moral obligations but for strictly material reasons. Because her economic position was not prosperous, some of the more conservative government officials recognized that her future depended largely on her ability to attract foreign capital. If the settlement did not produce the desired effect of restoring her tarnished credit, Brazil "may well decide that these many millions of much-needed cash are too high a price for such dubious publicity". He would therefore favour efforts to put the criticisms right and to present the facts fairly ⁴³.

⁴¹ Phillimore to Elliot Butler, 8.12.43, A16/16/6, PRO: FO 371.

⁴² The Economist, 25.12.43.

⁴³ He added in a post scriptum: "I am thinking of sending you a series of snapshots, for publication in the press, of cross-sections of the population of Rio disporting themselves during Carnival. Any bondholder who saw them could be guaranteed to take Plan B and to take it quick; and instead of sighing for that mythical 23 million pounds a year which he never in fact received, he would marvel with me at the magnitude of what he is now being offered", Phillimore to Powell, 26.2.44, PRO:FO128/425 (7).

The Economist was, however, not wide of the mark as far as the "sacrifice to Pan-Americanism" was concerned as the aims of H.M. Government's policy concerning Latin America had been defined earlier in the year as being "to preserve, and if possible intensify, by all suitable means, our existing good political, economic and cultural relations subject to the overriding necessities of the successful prosecution of the war and of the maintenance of the fullest unity and understanding with the United States"⁴⁴.

5. Conclusions

Throughout the negotiations concerning the Brazilian foreign debt in the 1930s and 1940s it was clear that different tactics were adopted by the American and British negotiators. The Americans tended to adopt quite a mild and conciliatory stand - paying careful attention to their strategic economic and political aims in Brazil - while the British tended to worry only about the maximization of financial payments. While this distinction can be easily understood as far as the settlements of 1940 and 1943 are concerned when Britain desperately needed cash, the different policies of the two main creditors are perhaps a bit more difficult to explain during the earlier period.

As opposed to Great Britain, which had seen a Corporation of Foreign Bondholders founded as early as 1868, the United States - because of its very limited experience as a creditor nation - faced the wave of defaults on bonds floated in the American financial market after 1930 without a bondholders' organization. During the Hoover period, the American banking houses were unable to obtain official support in their attempts to protect the interests of bondholders, being repeatedly advised to contact the Brazilian Government directly. This aloofness on the part of the State Department, contrasts with the official blessing given to the agreement signed in 1933 between the Bank of Brazil and several American companies to allow the transfer of arrears concerning profit remittances and outstanding bills. There was a clear government priority favouring the transfer of frozen commercial credits over payments to bondholders, which contrasts sharply with British policy ⁴⁵. When bondholders protested against the 1933 agreement the Federal Reserve Bank of New York took the line that the agreement was vital for the re-establishment of Brazilian credit and that full payment of the public debt service would be premature. Roosevelt, himself,

⁴⁴ Perowne's printed memorandum on the United States and Great Britain in Latin America, A2230/348/51, PRO: FO 371. In 1941 Churchill had instructed the Foreign Office to adopt as British policy towards Brazil: "petting Vargas". Churchill's minute, 27.10.41, A8705/190/6, PRO: FO 371.

⁴⁵ See Wilson (1971), pp. 171-83 and Hilton (1969), p. 38.

stressed that the United States government would interfere in transactions between American private citizens and foreign governments, only if there was discrimination between different types of creditors ⁶⁶. The Foreign Bondholders Protective Council organized was never, as an institution, as independent from the government as its British counterpart. Its increasingly semi-official character led it more readily to adapt its claims to the requirements of the American foreign policy.

In 1935, Welles was reported to have told Aranha that the United States had no material interest in the debt, as suspension of payment would revert to the benefit of American trade, but, that it was mainly the loss of Brazilian political prestige that he had in mind when objecting to default ⁶⁷. The American Ambassador in Rio made the policy quite clear to the Consul-General -- who was a critic of the Brazilian treatment of American arrears -- "if securing exchange cover was our only problem in Brazil, we might well enough send the fleet, land marines, and get what we wanted but ... we must not forget that this is only one phase of the relations between the two countries" ⁶⁸.

From the British side it is also possible to find evidence that, throughout the period under consideration, the Americans -- somewhat surprisingly for the British -- opted for a mild stand in their financial negotiations in Brazil. Niemeyer, who was not known as being either slow or very considerate when he thought that British interests were being discriminated against, recognized that "as a whole, it must be admitted that the Americans have used their complete power over Brazilian exchange with extreme moderation: changes which they finally accepted in the 1934 Plan as originally proposed by the Brazilian Government are in relation to the whole, exceedingly small" ⁶⁹. Sir William Seeds, the British Ambassador in 1934, felt that the Americans "think it more politic to let Brazil gradually realize her position vis a vis the States than to impress it on her vi et armis" refraining therefore, from using their strong bargaining position to extract full payments from Brazil ⁷⁰.

The initial over-generous Brazilian reaction in 1931 can be explained partly as a specific manifestation of the fact that overall economic policy adopted by Vargas's first Finance Minister in 1930-31, Whitaker, was under heavy British influence, and partly by the inability to recognize that the country was facing a long-term crisis in the international economy. The excessively

⁶⁶ Kent to Phillips, 28.6.33 and Phillips to Kent, 30.6.33, 832.51/780, NA:RG 59.

⁶⁷ Aranha to Vargas, 6.3.35, FGV:GV.

⁶⁸ Gibson to Wilson, 13.3.34, 832.5151/339 1/2, quoted by Hilton (1975), p. 38.

⁶⁹ Waley to Craigie, 27.3.34, A2549/170/6 and Niemeyer to Craigie, 29.5.34, A4362/170/6, PRO: FO 371.

⁷⁰ Seeds to Craigie, 5.6.34, A5053/310/6, PRO: FO 371.

favourable terms conceded in 1931, forced the Brazilian Government in 1934 to accept a scheme, inspired by the British, which was still too generous when compared with the economy's capacity to generate foreign exchange as shown by the accumulation of commercial arrears. The 1937 default marked a reversal of this policy and paved the way for the negotiation of more favourable agreements after 1939.

If an attempt is made to quantify the gains to Brazil originating from the successive settlements compared with what should have been paid according to contracts, it is important to distinguish between two very different concepts of gain related to the reduction of service payments [see table 4]. On the one hand, there are what can be called postponement gains which correspond to a postponement of payments bringing short run relief to the balance of payments position and are strictly equivalent to a forced loan. This is the case, for instance, when sinking fund payments are suspended but the debtor is still legally bound to pay in the future. On the other hand, there are permanent relief gains which correspond to a real reduction of payments, no legal obligation remaining to pay what has not been fully paid. This is the case when interest coupons are tendered by bondholders in return for an agreed reduction of contractual payment.

Table 4
Brazilian Gains from Default, 1932-1944

	in millions of pounds	
	Postponement Gains	Permanent Relief Gains
1932	16.2	0.4
1933	16.8	0.4
1934	15.9	5.7
1935	15.5	7.3
1936	15.1	6.9
1937	14.5	5.6
1938	23.0	1.4
1939	23.0	2.0
1940	19.6	9.4
1941	18.9	9.2
1942	19.0	9.0
1943	19.1	8.2
1944	4.2	38.4

* These figures result from a comparison between what was actually paid by Brazil and what would have been paid if bonds were quoted at par prices.

Postponement gains for the period under consideration were calculated assuming a theoretical (that is contractual) total service of roughly \$23 million yearly. Permanent relief gains are the result of the addition of: actual reduction of interest payments corresponding to the 1934 and 1940 settlements; interest

payments not paid on loans in chronic default redeemed at 12% in 1943; interest arrears which were not fully paid in 1943; gains related to the redemption of grade 8 loans at 12% and foregone interest on arrears, also in 1943 [see table 4]. The figures in table 4 do not include gains resulting from reduction in interest rates and principal brought about by the 1943 agreement. The immediate gains related to cash payments under option B would have been of 56.1 million pounds if all bondholders had preferred this option which is a fair approximation of what really happened. The average interest rate on outstanding debt was reduced by 3.64 % under option A and 2.38% under option B. Assessment of total Brazilian gains entailed by the agreement by computing the present values of each option as compared to contractual terms is made difficult by the lack of sufficiently detailed information on the different options. Supposing once again that all bondholders decided for option B, such gains -- in terms of reduction of present value entailed by discounting the reduced yearly payments using the original average interest rate -- amounted to 54.9 million pounds. One may think as if a total foreign debt of about 220 million pounds in 1943 had been reduced due to principal and interest rate reduction to 111 million pounds.

The importance of postponement gains is made clear by the fact that they correspond to 53% of total imports in 1932, declining to 22% in 1937 and rising to roughly 40% in 1938-39 ⁷¹. From the point of view of availability of foreign exchange, the successive reductions of service payments were equivalent to an increase in exports and made possible the avoidance of further reduction in the level of imports ⁷².

The fall in the level of economic activity -- and particularly in the level of imports -- led to an absolute fall in Federal Government revenue, which did not recover its 1928 nominal level until 1934. Even if there had been no foreign exchange constraints, it would be hardly practical to go on fully servicing the debt when this would have required more than a third of total Federal revenue. The relief brought about by the reduction of payments allowed a shift in government expenditure from foreign debt payments to the domestic purchase of goods and services with a consequent beneficial influence on the level of overall domestic activity. The share of the Ministry of Finance in total Federal expenditure fell from 42% in 1929 to 29% in 1938, while the armed forces share increased from 22% to 30% and the Ministry of Transport share from 23% to 26%. It would be interesting to know more about the breakdown of Federal expenditures, but information on this is unreliable ⁷³.

⁷¹ Straight comparisons between postponement gains and the level of imports are, however, distorted by the accumulation of commercial arrears during the period.

⁷² For details on the import structure see FGV (1968), vol. 2.

⁷³ FGV's data on government capital formation presented in Villela and Suzigan (1975) do not make sense, varying from 10.3% of Federal government expenditure in 1933 to 1% in 1937.

Some could be tempted to suggest that policy-makers could have introduced policies which would assure a much larger relative reduction of consumer goods imports during the 1930s -- in particular of consumer durable goods -- leaving more foreign exchange available for capital goods imports or to pay more debt service. On the whole it does not seem that increased consumer goods imports were made at the expense of the more essential capital goods imports. Firstly, the imports of some non-durable goods, especially foodstuffs, were particularly difficult to compress. Secondly, one should, in fact, expect an increase in the share of consumer durable imports as these goods were mainly "new" goods recently introduced in the Brazilian market. Thirdly, until 1934 and after 1937, exchange controls assured, one way or the other, the availability of foreign exchange for essential imports. Fourthly, the demand for imported capital goods was artificially reduced by the ban which was operative, between 1931 and 1937, on imports of machinery for industries producing a whole range of consumer goods which were judged to have excess productive capacity.

As far as the choice between consumer goods imports and debt payments is concerned, it is obvious that the government found it politically more convenient to court public opinion by allowing a certain level of non-essential imports than to pay more debt service, an alternative which did not involve immediate advantages. This course of action was, of course, helped by the American lukewarm policy concerning the foreign debt, partly related to the prospects of their exports of non-essentials.

The examination of the real reasons behind the decision to default in 1937, as well as of its consequences, is particularly interesting because this was the only instance when policy-makers decided that the necessity to import essential goods was pressing enough to entirely prevent payments related to the foreign debt service. It could possibly be argued that there was some similarity between the Brazilian default in 1937, as a result of the American recession, and that in 1931, as a result of worldwide recession. This would be misleading. Firstly, because Brazil managed to pay something during the early years of the decade when exports were below the level reached in the late 1930s. Secondly, while it is true that the real cost of paying debt service in terms of foregone imports -- that is debt service divided by capacity to import -- had been increasing noticeably, it was still very far from reaching 1929 levels. Thirdly, the further contraction of the balance of trade in 1938 suggests that policy-makers attached a high priority to the objective of securing a relatively high level of imports. The decision to default in 1937 was a clear reversal of the Brazilian public foreign debt policy; Brazil was defaulting not because of the fall in export earnings but because of the need to increase (or at least not reduce) the level of essential imports.

Consideration of the political forces on which Vargas had to base his power in order to assure the stability of the Estado Novo, is of particular relevance to explain some of the non-

economic considerations which led to the decision to default. Placing the decision to default in terms of "either we pay the foreign debt or we re-equip the armed forces and the transport network" Vargas was able, at the same time, to mobilize military support for the new regime, to reduce the strength of internal criticisms of the decision and to make a gesture to the Brazilian fascists which were his political allies at the time and objected to the continuation of debt service payments ⁷⁴.

Evidence suggests that Vargas's claim that the inevitability of the default was linked with the need to import essential goods was partly an ex post rationalization of what had already happened during 1937. The huge increase in the value of imports between 1936 and 1937 was, indeed, even more pronounced in the case of capital goods -- particularly railway equipment imports which doubled in value -- and to a lesser extent of consumer durable goods ⁷⁵. Total imports fell both in 1938 and 1939, but it can be argued that the default prevented a further reduction -- in capital good imports especially as they remained roughly stable in value between 1937 and 1939 -- than would have been the case if Brazil had not defaulted.

It is difficult to assess the effect of capital good imports on output as there is no reliable information concerning the level of capacity utilization. It seems clear, however, that the heavy imports of railway equipment, which characterized the second half of the 1930s, are related to the rapid expansion of transport sector output after 1935. The relatively poor showing of industry in the late 1930s can largely be explained by the extremely disappointing performance of agriculture -- especially sugar cane -- during 1936-1938 (the food processing industry was responsible for more than 30% of total industrial value added in 1939), rather than by the competition of imports or the non-availability of capital goods ⁷⁶. Payments related to imports of military equipment do not seem to have been that important as a drain on available foreign exchange as they required no more than 3-4 million during 1938-39 pounds. Actual payments in hard currency related to the two main military contracts -- German field guns and British destroyers -- involved only 2.5 million pounds ⁷⁷.

One could be tempted to suggest that Anglo-American contradictions benefited the Brazilians, as negotiations tended to

⁷⁴ Fascist views on the foreign debt question cannot be dissociated from the fact that Germany was the only important Brazilian commercial partner which had no interests related to the debt question. See Arzet (1941).

⁷⁵ See FGV (1968), vol. 2.

⁷⁶ See Fishlow (1972) for sectoral industrial output.

⁷⁷ Tel. 364, Rio to London, 7.12.40, A6040/4176/6, PRO: FO 371; Waley to Balfour, 23.10.39, A5021/71/6, PRO: FO 371 and exposição no. 49, ? .1.39, Gabinete, MF.

concentrate on the distribution rather than on the level of total payments. In every negotiation, however, this was not the case as difficulties concerning the distribution of payments between sterling and dollar loans invariably involved larger Brazilian total payments to break the deadlock. This is not to say that the Brazilians avoided fostering the contradictions between creditors as was patently the case when Costa disclosed to the Americans his "secret" talks with the British in early 1943.

From the Brazilian point of view the permanent settlement came at the right time as after the end of the war it would have been difficult to avoid making larger payments when more foreign exchange reserves had accumulated. If the post-war economic policy-makers did not profit from this pre-emptive relief of the foreign exchange position this cannot be attributed to the Vargas administration's lack of foresight⁷⁰. Post-war difficulties concerning the use of Brazilian blocked sterling balances seem to indicate, however, with the benefit of hindsight that the Brazilians were possibly too timid in their offers concerning cash payments and could have further reduced their sterling debt using blocked sterling which was badly used anyway.

In 1943, as in 1940, Brazil was able to pay less than she seemed to be able to pay, because the creditor country which was in the position to exert pressure was unwilling to do so because of political considerations⁷¹ and because its economic strategy in Brazil did not primarily rely on the maintenance of this specific type of financial relationship. Great Britain, the main creditor country, was scarcely in the position to exert adequate pressure on Brazil and the Treasury would welcome a solution that

⁷⁰ Argentina used part of her much larger reserves to redeem at par more than 60 million pounds of the national government's foreign debt besides spending more than 160 million pounds nationalizing foreign owned railways. See Lewis (1948), p. 79. In Brazil, nationalization of British owned companies while a not negligible way of absorbing sterling balances after 1945 was in a much smaller scale, if for no other reason because there were less railways to be taken over. At least 22 million pounds were used in this way between 1945 and 1952. In 1950 Brazil spent more than 20 million pounds of its balances in redeeming foreign debt bonds at par in one of the most mysterious operations of Brazil's troubled financial history. See Keesing's Contemporary Archives, 1945-52 and Abreu(1982), *passim*.

⁷¹ Phillimore thought that "there had been little evidence in the last few years -- rather the contrary -- that the Americans were interested in collecting their claims in Latin America at all", Phillimore to Bessborough, 4.1.44, PRO:FO128/425(7). Mr. Phillimore confirmed to the author that the Americans tended to subject their financial negotiations to constraints related to their strategic political and economic aims in Brazil. Interview, London, 2.4.74.

would relieve the position of the Brazilian special account as excessive accumulation of sterling could lead to growing reluctance by countries exporting raw materials to go on supplying Britain without being able to satisfy their import requirements in the foreseeable future.

A discussion between the British and the State Department negotiator throws further light on the differences of approach between the main creditors. Discussing the question of how best "to avoid in future the difficulties that arose on the present occasion [1943] through divergence between the British and American points of view", they could not reach agreement. The State Department negotiator thought that the worst solution was that when the creditors, after confabulation, proceeded to negotiate as "the debtor might think that the big stick was going to be used and would accordingly withdraw to his shell". He preferred to negotiate simultaneously and sort out difficulties in loco. Phillimore preferred to negotiate separately, subject to MFN, a solution which had been successful in the past. Butler, of the CFB, however, insisted that the solution which was thought to be the worst by the Americans was "incomparably the best ... the argument about big stick may chime in with the Good Neighbour policy, but is, of course, absurd from the bondholders' point of view: it is only too evident that the majority of Finance Ministers required to be convinced of the eminence (sic) of the stick (or carrot) before they produce even their second best" **.

Both the 1940 and, to a lesser degree, the 1943 agreement involved much smaller yearly service payments. 1944 was, of course, a rather atypical year since a considerable proportion of payments was related to cash settlements under option B (see table 2). The lower payments, of course, resulted in much smaller strains both on available exchange resources and on government revenue (see tables 2 and 4) than those typical of the mid-1930s. While Brazil continued up to 1943 to enjoy considerable postponement and permanent relief gains the 1943 permanent agreement raises the question (knowing that the agreed conditions were duly respected afterwards) of the extent to which holders of Brazilian bonds lost out as a result of the succession of partial and total Brazilian defaults. Knowing in detail Brazil's actual payments as well as actual net proceeds of all loans, it is possible to calculate an internal rate of return which can be compared with alternative rates of return for prime investments and give an idea both of how well the foreign bond markets allowed for risk and of the actual losses suffered by bondholders as a group.

Bondholders only lost if actual service is compared to contractual service but surely it makes much more sense from an economic rather than legal point of view to compare the rate of return of Brazilian bonds to the rate of return of alternative

 ** Phillimore to Elliot Butler, 8.12.43, A16/16/6, PRO:FO 371.

investment in riskless alternatives such as consols. The much higher rate of interest was explained by the higher risk of such loans. To estimate the losses to Brazilian creditors as a whole entailed by successive renegotiations a computation must be made of the internal rate of return taking into account the outflow of interest and amortization payments and the actual inflow of proceeds of new loans -- deducting the relevant discounts ^{¶1}. Computation based on nominal values results in an internal rate of return of 6.6% a year which must be compared to the average rate of 3.4% on the alternative investment on consols ^{¶2}.

For Brazilian creditors as a group, the decision to invest in Brazilian bonds produced an excellent yield if compared to the alternative purchase of riskless government bonds. It is obvious that the aggregate rate of return hides important variation in the rates of return of specific loans: ceteris paribus the nearest the flotation of a given loan to 1930, the larger the losses -- or the smaller the gains -- entailed by the specific loan ^{¶3}. The losses for those who had entered the market too late resulted from the impossibility of "unloading the cost to posterity" via further loans ^{¶4}.

The present problems placed by Brazilian indebtedness have some similarity with those faced in the past. Indeed, after a period of abstinence roughly until the mid-1960s the international financial markets found ways to accommodate the needs of developing countries. Brazil indebtedness rose very rapidly, first to build up reserves then, after 1973-74, to compensate for the steep rise in oil prices. The second oil shock in 1978-79 and the contemporary increase in nominal dollar interest rates resulted in a complete loss of control of the rate of growth of indebtedness. After the Mexican crisis, moreover, voluntary private foreign capital inflow ceased entirely. In 1982 the gross foreign debt-export ratio was of 4.2 and Brazil became a net exporter of real resources. By 1984 the negative resource gap was of more than 5.4 % of GDP. The last five years were marked by dilatory moves from debtors and creditors which do not attack the core of the problem which is the conflict between contractual service of the foreign

^{¶1} It was supposed that Brazil would pay the debt up to 1987 but the Brazilian default does not affect the results as more recent service payments are extremely small.

^{¶2} Computation based on real prices results in similar rates.

^{¶3} To compare rates of return of Brazilian bonds to other investments ideally the methodology proposed by Edelstein (1982) should be followed: yearly rates of return should be computed taking into account the price of bonds, interest payments and the relevant deflators. This is, however, extremely data consuming and thus impossible to adopt comprehensively in the case of Brazil. In Abreu (1985) rates of return for sterling and dollar Federal loans are computed confirming the expected downward trend

^{¶4} Carr (1943), p. 263.

debt and the capacity to generate foreign exchange given certain minimum economic growth targets²³.

As noted by E.H.Carr towards the end of the first cycle of indebtedness in the early 1940s the problems raised by the debt crisis of the 1980s will remain with us "unless those who occupy the most privileged position within [the] international financial system will ... make deliberate sacrifices in order to make the system work; and these liabilities, like money spent on relief, must be regarded either as the discharge of a moral obligation or an insurance premium for the maintenance of civilization"²⁴.

²³ In the majority of debtor countries the 1982-84 period at least has been marked by a sharp downturn of economic activity as balance of trade maximization became the main target of economic policy.

²⁴ Carr(1943), p.264.

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