International Structure, Cooperation, and Sovereign Debt Crises: The Brazilian Debt Restructurings of 1898, 1931, and 1983

By

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A thesis submitted in conformity with the requirements for the degree of Doctor of Philosophy
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Abstract
In this dissertation, I offer three main contributions to the literature on sovereign debt. First, I make the case for a structurally-oriented perspective on debt crises. The social institutions that comprise the finance and production structures of the international economy act as conduits for the transmission of crises from developed countries to the periphery of the system, as they increase the relative scarcity of capital through mechanisms such as capital and trade flows. I argue that defaults and moratoria are thus better understood as reactions to the relative scarcity of capital at the international level and not as opportunistic strategies adopted by utility-maximizing politicians who want to avoid the costs associated with repayment. Second, I reevaluate the relationship between debtors and creditors and how they cooperate. I argue that they cooperate by means of positive-sum debt restructuring processes whose results fall within a continuum between full repayment and full repudiation. In other words, cooperation is based on a compromise and not on the enforcement of the original terms of debt contracts by creditor countries or the creditors themselves. Finally, I offer a deeper and more nuanced analysis of the role that the structural power of creditors and creditor countries play in the sovereign debt market, and I argue that they shape the social arrangements that regulate their relationship with debtor countries. I support my claims with qualitative historical studies of three past cases of Brazilian moratoria and debt renegotiations – the Funding Loans of 1898 and 1931, and the Financing Program for 1983.
Acknowledgements

This dissertation reflects my work and life experiences in Brazil, where I was born and lived until moving to Canada in 2007 to pursue my PhD. I experienced first-hand the Brazilian debt crisis of the 1980s and although I was still too young to fully comprehend its impact, I remember the sense of unease in my family with the future of the economy. Almost two decades later, when I was working in a Brazilian hedge fund, I witnessed once more the impact that the developments in international markets have on the economy of developing countries. In 1999, due to unrelenting speculative attacks, Brazil abandoned the fixed exchange-regime that had been established in 1994 as part of the currency reforms that led to the creation of the contemporary Brazilian currency, the real. It dodged the bullet, but Argentina, its neighbor and most important trading partner, was less lucky. The default and crisis that followed, which included two debt restructurings and a judicial dispute with holdout creditors that still lasts to this day, left many wounds in the country and in Latin America.

It would be redundant to say that this is a deeply personal project. I would like to thank the members of my dissertation committee, Professors Steven Bernstein, Louis Pauly, and Albert Berry, for their support and guidance in transforming my passion about the topic of sovereign debt into a coherent dissertation. Steven Bernstein was generous with his time, offering constructive advice, support, and encouragement. Louis Pauly provided invaluable advice on my theoretical framework, helping me to improve on early drafts. Al Berry graciously provided feedback on how my ideas intersected with formal economic theory, keeping a check on some of my theoretical excesses. I would also like to thank Professors Steven Clarkson and Randall Germain for accepting to serve as the internal and external readers of the dissertation and for their support and comments. Naturally, any remaining mistakes are my own.

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Chapter One: Introduction

1.1) The Sovereign Debt *Problématique* and the Cooperation Puzzle

Debt crises are common and recurrent phenomena. It is almost a truism to say that they are as old as the international sovereign debt market itself.¹

There have been journalistic accounts and isolated academic studies about particular crises in the past, but a coherent research program on the phenomenon of sovereign debt only took form after the debt crises that rocked most of Latin America and the developing world in the 1980s. Since then, this research program has generated a sizable academic literature, mostly in Economics (although some works cross disciplinary lines), united by a common *problématique* — the phenomenon of debt issued by political communities abroad — and by a particular research puzzle: why do sovereign debtors cooperate with their creditors by repaying their debts?²

While the conventional view reflected in the “cooperation” puzzle deduces the causes of defaults from axiomatic assumptions about the behavior of sovereign debtors and over-emphasizes the strategic and conflictual elements that might motivate their behavior, I argue the opposite: that debtors generally prefer to cooperate with creditors, and when they do consider or threaten a default or moratorium it is usually owing to structural conditions in the international economy that highly constrain their ability to keep servicing their debts. These constraints are especially severe for developing countries which are considerably disadvantaged vis-à-vis developed countries and foreign creditors due to the operation of the international financial market and the international market for commodities. Therefore, I argue that the main issue in the sovereign debt *problématique* is not the willingness of a debtor (or of its policy-makers) to repay, but how much and on what terms capital is available in relation to its needs. In other words, capital can become scarce at the international level,

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² It is important to note that the literature is not monolithic. Some authors challenge specific assumptions behind this research puzzle, but I have not found a comprehensive analysis similar to the one I do in this dissertation. See section 2.1.
affecting the balance of payments of a debtor, due to the operation of the structures of the international economy and independent of the debtor’s domestic political dynamics or the policies adopted by its policy-makers.

Three key implications follow from my alternative account of the sovereign debt problématique. First, the research program on sovereign debt can benefit from a structurally-oriented perspective on debt crises, as the social institutions that comprise the structures of the international economy act as conduits for the transmission of crises from developed countries to the periphery of the system, and provide the context for understanding the behavior of sovereign debtors. Second, the research program can also benefit from a deeper and more nuanced analysis of the role that the power of creditors and creditor countries play in the sovereign debt market, shaping the social arrangements that regulate their relationship with debtor countries. Third, the literature can also benefit from a less dichotomous view on cooperation, as creditors and debtors cooperate when they compromise during processes of debt restructuring.

My account shows that the cooperation puzzle, the assumptions on which it rests, and the hypotheses it generates are theoretically problematic and historically inaccurate. They depend on a set of assumptions about the nature of the international economy, the rationality of its actors and how debtors and creditors cooperate that have serious flaws. First, in a similar way to how the assumption of anarchy is traditionally described in the discipline of International Relations (IR), the literature on sovereign debt assumes that the international economy lacks an overarching authority capable of legitimately arbitrating disputes and legal institutions capable of protecting creditors’ rights. Second, it generally understands rationality in narrow terms, assuming that rational actors always act in ways that

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3 See Waltz (1979, 104–107).
maximize their utility and that a debtor can derive more utility from non-repayment than from repayment. For this reason, opportunistic defaults are seen as a viable strategy in view of the costs associated with repayment. Finally, the literature also understands cooperation in narrow terms, assuming that debtors cooperate with their creditors when they repay according to the original terms of debt contracts. It thus hypothesizes that cooperation depends on the enforcement of contracts (or the threat thereof) by the creditors or by their governments.

Although in principle the cooperation puzzle makes sense in view of the assumptions above, it begs important questions. If creditors can enforce debt contracts and make the actions of uncooperative debtors costly, why would rational debtors (or rational policy-makers in sovereign debtors) default opportunistically? On the other hand, if actual or threatened enforcement of debt contracts is not a deterrent to defaults, why would rational creditors tolerate repeated defaults, allowing debtors to return to the market if they would default again given the chance? Moreover, if cooperation depends on the actual or threatened enforcement of contracts, what is the connection between coercion and cooperation? Are the two related phenomenon? Is cooperation effectively limited to the preservation of the status quo?

In chapter two I review the literature on sovereign debt, the assumptions of anarchy, rationality, and cooperation, and the different explanations it provides for the cooperation puzzle. I also present in more detail my hypothesis and my contributions to the research program on sovereign debt. In the subsequent chapters I conduct qualitative case studies of three episodes of debt renegotiation conducted by Brazil and its creditors that show that my structural explanation offers a better account of Brazil’s behavior and the outcomes of those episodes. In chapter three I cover the first case, the so-

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7 The examples are too numerous to cite here. See section 2.2 for an overview of the different explanations and different enforcement mechanisms presented in the literature.
called First Funding Loan (also known as the Funding Loan of 1898), a debt restructuring agreement negotiated and signed in 1898, at the end of the administration of President Prudente José de Morais Barros, in the context of an acute international economic slowdown known as the “Depression of the Nineties”. In chapter four I analyze the Third Funding Loan (also known as the Funding Loan of 1931), negotiated and signed between 1931 and 1932 in the early years of the authoritarian regime led by President Getúlio Dornelles Vargas against the backdrop of the Great Depression. In chapter five I review my third and final case, the “Brazilian Financing Program for 1983”, a broad restructuring plan announced by the administration of President João Baptista de Oliveira Figueiredo at the end of the military regime that governed Brazil from 1964 until 1985, in the context of the economic impact of the second Oil Shock and the Latin American debt crisis.

1.2) Summary of My Hypothesis and the Contributions of My Dissertation

My dissertation offers three main contributions to the literature on sovereign debt.

First, I show that a structural analysis of the sovereign debt problématique offers a much needed counterbalance to the voluntarism and reductionism that prevails in current research on the topic. The structures of the international economy shape the relative scarcity of capital for developing sovereign debtors, limiting the policy options available to sovereign debtors and constraining their decision-making autonomy. Developing countries usually borrow abroad in currencies other than their own and must obtain the funds they need to repay their debts by trading, by further borrowing, or by securing capital inflows. They tend to enter moratoria or attempt debt restructurings when capital becomes scarce due to the operation of the structures of the international economy, and not because they are generally unwilling to repay and the anarchic nature of the international economy imposes low costs on opportunistic defaulters.

8 A number of scholars have been making a similar case, pushing for the study of systemic factors in the field of International Political Economy (IPE). See Drezner and McNamara (2013), McNamara (2009), and Phillips (2005).

9 Some debtors, such as Argentina, Brazil, Colombia and Mexico, have in the recent past issued bonds abroad in their own currencies, but this is unusual (Tovar 2005).
Following the framework developed by Susan Strange, particularly in her book *States and Markets* (1988), I define “structure” as a set of social arrangements that shape the interactions of actors operating in a system (Strange 1988, 24–25, 30). Although Strange did not use the terminology herself, I understand such “social arrangements” as sets of social institutions that regulate behavior and shape the very possibilities of action open to an actor under certain circumstances. Institutions can be defined in turn as sets of norms and rules that are “persistent and connected”, and that “prescribe behavioral roles, constrain activity, and shape expectations” (Keohane 1988, 383).

Two of the structures identified by Strange, the finance and the production structures of the international economy, which respectively govern the international distribution of capital (Strange 1988, 26, 88) and the production of goods and services and their international distribution (Strange 1988, 26, 62), are particularly important in the context of the sovereign debt problématique and debt crises. Their institutions, for instance those related to the gold standard and free trade, can influence the scale and direction of capital flows, determine the costs of capital, determine who can have access to it and on what conditions, and influence the price and demand for a country’s export products. In other words, they can affect the relative scarcity of capital at the international level by setting the terms under which sovereign debtors must engage with their creditors and creditor countries in order to obtain the capital they need for both repayment and to meet their development needs.

Based on Lindblom, I define relative scarcity as the availability of a good in relation to the needs of actors (2001, 33). Relative scarcity is not a function of the supply and demand ratio of a good or its total quantity in a given system, but refers to how much of it is distributed in connection to the needs of different actors. The concept of relative scarcity is very useful in indicating the social context, conflicts and power relations that shape the international distribution of important social goods, such as capital. It also puts into perspective the assumption of narrow or instrumental rationality common to the

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Strange identifies four main structures (security, knowledge, finance, and production). In this dissertation I will focus on the latter two due to their importance for developing sovereign debtors, particularly in Latin America (Abreu 2002, 515, 516).
literature, particularly the idea that repayment depends on the willingness of debtors to repay, as opposed to their ability to do it.

I use the term “creditor countries” to designate the countries in which private creditors are domiciled, but which may not be lenders themselves (Buchheit 2005, 333, 337), reflecting the fact that historically they have been exporters of capital and net creditors in the international capital market. For simplicity’s sake, I also use the terms “sovereign debtor” and “debtor” interchangeably. Furthermore, when I refer to “sovereign debt” or “debt” throughout this dissertation I mean an obligation incurred by a government to repay a certain amount to foreign private creditors in a currency other than its domestic currency and under the laws of a creditor state or jurisdiction (Borchard 1951, 3; Reinhart and Rogoff 2009, 13).

My second contribution is a more nuanced and empirically informed definition of cooperation than the one shared by the literature. Historically, creditors and debtors have often cooperated during debt crises by compromising and renegotiating the original terms of their debt contracts. Based on the work on cooperation by Keohane (1984), Oye (1986), and other liberal institutionalists in International Relations (IR), and on historical studies by scholars such as Aggarwal (1989), Eichengreen and Portes (1986, 1989b), and Fishlow (1989), I argue that cooperation between creditors and debtors means more than the narrow notion of the preservation of the *status quo ante* or the enforcement of debt contracts. Cooperation is better understood as a process of adjustment of the original terms of debt contracts by creditors and debtors, whose outcome may fall in different parts of a continuum between the poles of harmony, an extreme in which none of them have any incentive to change the terms of the agreements and they are satisfied with the *status quo*, and discord, an extreme in which debtors are absolutely unwilling to pay and creditors are absolutely unwilling to accept any amendments to those contracts.

For this reason, borrowing from Eaton, Gersovitz and Stiglitz, I define a default as a situation in which a borrower “gives resources to the lender that are less than the fixed amount that he is committed to pay the lender” (1986, 483). At first glance, this is very similar to the legal definition that
equates defaults to any breach of the original contractual terms of a bond or a loan agreement\textsuperscript{11} and seems to reinforce the connection that the literature makes between cooperation and the preservation of the status quo. However, it is in fact more flexible and can be used to show how moratoria and debt restructurings can be contextually different from defaults, which are in effect debt repudiations. While in the latter there is a clear rupture in the relationship between creditors and debtors, by contrast moratoria are temporary suspensions of debt payments, and restructurings are negotiation processes in which the creditors must acquiesce to any changes made to the original contracts. In both cases, and differently from debt repudiations, debtors do not unilaterally and permanently break the terms of their bonds or loans. I thus reserve the term default to debt repudiations, treating moratoria and debt restructurings as actions that are conceptually and contextually different from defaults.

My final contribution is to provide a richer understanding of power than the one existing in the literature, which either ignores power altogether or mischaracterizes its operation in the sovereign debt market as primary relational. In the rare occasions in which it analyzes power more explicitly,\textsuperscript{12} the literature generally assumes that power is exercised by creditors or creditor countries directly “over” debtors, in line with Dahl’s traditional definition: “[actor] A has power over [actor] B to the extent that he can get B to do something B would not otherwise do” (1957, 202). However, in the context of the international economy, I argue that structural power, which Strange defines as the ability “to choose and to shape the structures of the global political economy within which other states, their political institutions, their economic enterprises, and (not least) their professional people have to operate” (1987, 565), is more important than the coercive, direct, or relational power described by Dahl. Power is thus manifested in the ability of certain actors to “extend or restrict the range of options open to others” (Strange 1990, 259), and thus control, or at least influence, the relative scarcity of capital and its distribution at the international level.

\textsuperscript{11} See Borchard (1951, 116) and Sturzenegger and Zettelmeyer (2006, 3).
\textsuperscript{12} For exceptions, see Mitchener and Weidenmier (2005, 2010).
Financial intermediaries and experts who lack the power capabilities available to states can also wield structural power, guiding the behavior of creditors and debtors by using a discursive strategy known as “framing”. Following authors such as Entman, we can define framing as a strategy based on “[selecting] some aspects of a perceived reality and [making] them more salient (...), in such a way as to promote a particular problem definition, causal interpretation, moral evaluation, and/or treatment recommendation” (Entman 1993, 52). The strategy of framing is particularly important during processes of debt restructuring. Based on their technical expertise and authority in financial matters, financial intermediaries and experts can be enlisted to determine whether debtors are negotiating in good faith and whether they are pushing for excusable or un-excusable outcomes given the state of the international economy. Counterintuitively, this disciplinary role can also be brought to bear on creditors, particularly those who threaten to destabilize restructuring processes and put in risk the stability of the broader international economy.

In summary, I offer a view of the sovereign debt problématique that is more theoretically robust, realistic, and nuanced. Due to its atomistic perspective, the literature tends to over-emphasize the policy autonomy of sovereign debtors and the political will of their policy-makers to default. In contrast, by highlighting the role that the finance and production structures of the international economy play in shaping the relative scarcity of capital at the international level, my goal is to show that the space for autonomous decision-making in developing sovereign debtors is in fact very limited, particularly during debt crises, which tend to coincide with the receding periods of the business cycle in the economies of major creditor countries and, by extension, in the broader international economy. Events such as moratoria, restructurings, and even defaults are not always the outcomes of pure utility maximization on the part of the debtors, but instead may reflect their difficulty in overcoming the negative effects of structural factors at the international level that are beyond their control.

My arguments and contributions are supported by the three case studies I investigate in the chapters that follow, whose choice is justified in the next section. They all happened in the context of
international economic crises that affected capital flows and international trade, leading to serious balance of payment crises in Brazil and elsewhere. They also show that the Brazilian government pursued a debt restructuring only after going to great lengths to avoid a default, including by exhausting its own international reserves of gold or foreign currencies. Finally, they show that the Brazilian government and its foreign creditors cooperated by negotiating amendments to the original terms of debt contracts. In this regard, the structural power of financial intermediaries such as the N. M. Rothschild and Sons banking house, the financial agents of the Brazilian government in London from the early nineteenth century up to the 1940s, and the staff of the International Monetary Fund (IMF), was instrumental in enabling cooperation.

1.3) Scope of the Dissertation, Choice of Case Studies, Methodology, and Research Validity

Governments can borrow either domestically or abroad and both types of debt can be relevant during a debt crisis, but in this dissertation I bracket the domestic side and focus on the foreign debt of the Brazilian government. Although Reinhart and Rogoff (2009, 2011) have called attention to the role that domestic sovereign debt may play during debt crises, foreign debt poses a bigger challenge to developing sovereign debtors, for two reasons. First, although this measure is politically sensitive, governments can ultimately “inflate” their way out of excessive domestic debt by increasing their monetary base, a policy they cannot follow when debt is denominated in foreign currencies. Second, foreign debt may be more significant than domestic debt as a source of capital for many debtors, as their domestic financial markets may lack the liquidity and depth of financial markets in developed countries.

I focus on cooperation between sovereign debtors and private creditors, and on the role that the latter play in the international sovereign debt market, because they have historically provided the bulk of foreign lending to Brazil and other sovereign debtors. I also bracket private external debt and the debt contracted by sub-state actors, such as states and municipalities. Although both can be important
in the context of a debt crisis, in developing sovereign debtors they are usually dwarfed (although not always) by the size and importance of the debt of the central government.\footnote{This is true even in my third case study. The central government in developing countries can crowd out other domestic actors. Companies or local governments may face challenges in getting access to the international markets. When they do so, they may benefit from the support of the national government, and may be particularly vulnerable to “contagion” from shifts in market perceptions about the safety of the sovereign debt of their home countries (Arteta and Hale 2008, 54; White 2002, 298). In the Brazilian case, that usually meant that the central government acted as the guarantor for the loans taken by the sub-state-level actors in question, whether the provinces under the Empire, states, cities or railroad companies during the Old Republic, or public enterprises during the military dictatorship of the late twentieth century (Singer 1997, 400).} In the particular case of Brazil, my focus on the federal government is also justifiable given its prominence in comparison to states and municipalities and the centralist orientation of the country’s political architecture since its independence.

My focus on Brazil is justified for three main reasons.

First, Brazil is a crucial or critical case of the “most-likely” type for the literature on sovereign debt. While a crucial case is “very likely to validate the predictions of a model or hypothesis” (Gerring 2007, 213), a most-likely crucial case is one that, “in all dimensions except the dimension of theoretical interest, is predicted to achieve a certain outcome, and yet does not” (Gerring 2007, 115). According to Levy, “[i]f one’s priors suggest that a case is likely to fit a theory, and if the data confound our expectations, that result can be quite damaging to the theory. (…) [L]ack of support from a most likely case provides substantial theoretical leverage, and induces a significant shift in our confidence in the theory” (2008, 12).

Brazil clearly fits the requirements of a most-likely or typical case and provides a strong test to the hypotheses in the literature. It has been a regular participant in the international sovereign debt market since its independence in 1822. It depends on borrowed capital, capital inflows, and positive trade balances in order to acquire the foreign currency it needs for its developmental, budgetary, and repayment needs. It has participated in multiple processes of debt restructuring\footnote{Brazil is usually included by the literature among other examples of “serial defaulters”. See Reinhart and Rogoff (2009), Sturzenegger and Zettelmeyer (2006), and Tomz (2007). Depending on the author, it has declared moratoria or restructured its debts four or five times during its history. Besides the three cases I analyze here, it} and, like other
developing debtors elsewhere, it is a major importer of capital. Another important element is the country’s geopolitical position in the international system. As it is one of the biggest developing country debtors, and a regional power in South America, we could expect Brazil to be able to assert its policy autonomy more easily than smaller or weaker sovereign debtors. Although my hypothesis could benefit from an extension of my analysis to other cases, we can reasonably assume that if a structural explanation is applicable to the Brazilian case, it should also be applicable to smaller, less powerful, developing country debtors elsewhere.

Second, the Brazilian involvement in the international sovereign debt market since the early nineteenth century allows interesting comparisons across a relatively long, and uninterrupted, time span. There is also a considerable amount of reliable data available on the Brazilian economy, its political system, and its debt crises, some of it easily accessible through online databases. The same wealth of data may not be available for most other sovereign debtors.

Finally, my personal knowledge of the Brazilian language, culture, and history allowed me to carry out the type of qualitative historical research that I believe is more conducive to revealing the complexities of the sovereign debt problématique, offering an important complement (and correction) to large-N statistical studies.

I chose my three cases based on how strongly they could test the cooperation puzzle and the explanations provided in the literature as well as my own hypothesis. I will not cover in this dissertation the potential “default” of 1826 and the Second Funding Loan of 1914. The former is a particularly problematic case. Although the large-N case study conducted by Sturzenegger and Zettlemeyer mentions a default in 1826 (2006, 7), the country did not repudiate or restructure its debts that year. Reinhart and Rogoff (2009) and Tomz (2007) do not acknowledge any defaults before 1898.\footnote{Sturzenegger and Zettlemeyer may have got the date wrong. As a result of negotiations held by Brazil, Portugal, and Great Britain on the recognition of Brazilian independence by the European powers, the Portuguese crown demanded that Brazil assume part of its debts with British bankers in exchange for its official recognition of what may have defaulted on interest payments in 1826 (or 1828), and it restructured its debts in 1914 with the negotiation of the Second Funding Loan (Abreu 2002, 524).}
Second Funding Loan happened in the context of the international liquidity crisis that followed the start of the First World War (Abreu 2002, 524), which was a structural problem happening at the international level that clearly deviates from the predictions in the literature and conforms too easily to my hypothesis. In addition, my three cases allow me to analyze and compare political and economic variables at both the agent and the structural levels for three distinct periods in Brazilian and international history. Brazilian policy-makers operated under different political institutions in the period covered by each case (a classical liberal representative regime during the 1890s, a personalist dictatorship inspired by European fascism in the 1930s, and an institutionalized military dictatorship undergoing a process of transition to civilian rule in the early 1980s) and under different institutional arrangements at the international level (the classic gold standard in the 1890s, the breakdown of the gold standard and international trade during the Great Depression, and the transformation in the classic Bretton Woods system in the 1970s and 1980s).

When conducting my empirical research, I focused on the qualitative analysis and interpretation of primary and secondary sources available both in Brazilian historical archives and online databases. Contemporaneous primary sources were particularly invaluable, as they helped me understand the context behind particular policy decisions, the range of alternatives open to Brazilian government officials at the time, their possible motivations, the self-understandings and narratives employed by key actors, and the pressures and constraints to which they were subject during each crisis. The material I uncovered during my research shed light on my hypothesis and on the alternative explanations I analyze in more detail in chapter two.

was, for all purposes, a *fait accompli*. In any event, the newly established Brazilian monarchy agreed to the proposal, also guaranteeing some loans that the Portuguese claimed had been made to fund the independence war effort. In 1828, Portugal defaulted on interest payments while it was engulfed in a civil war. Subsequently, there was a debate in the British press on whether Brazil should be responsible for paying Portugal’s debts under the terms of the independence treaty, but there was also uncertainty as to the extent of Brazilian obligations in this matter (Dawson 1990, 169–171).

16 For a review of the importance and advantages of archival research, see Wood (2007).
For the first case study, covering the First Funding or the Funding Loan of 1898, I analyzed contemporary official documents, along with the correspondence exchanged by Brazilian President Prudente José de Morais Barros, his Ministers of Finance Francisco de Paula Rodrigues Alves (1894-1896)\textsuperscript{17} and Bernardino José de Campos Jr. (1896-1898),\textsuperscript{18} the Governor of the state of São Paulo and President-Elect Manuel Ferraz de Campos Sales,\textsuperscript{19} other politicians and government officials,\textsuperscript{20} and the bankers from N.M. Rothschild & Sons, the financial agents for Brazil in London. For the primary sources related to the first case I visited and consulted a number of archives in Brazil: the official historical archives of the Brazilian Ministry of Foreign Affairs (Acervo do Arquivo Histórico do Itamaraty no Rio de Janeiro), which covers the activities and official declassified correspondence of the Ministry up to the 1960s; the Brazilian National Archives (Arquivo Nacional), which consolidates the official declassified documents of the federal government and a number of personal archives donated by the families of Brazilian politicians; the archives of the Brazilian Historical and Geographic Institute (Instituto Histórico e Geográfico Brasileiro), which holds parts of the personal archives of Brazilian policy-makers from the monarchic and early republican periods; and the archives of the Rui Barbosa’s House Foundation (Fundação Casa de Rui Barbosa), with a similar profile.

I also accessed a number of online databases containing digitalized documents and official statistics about the Brazilian economy. One invaluable source of official memoranda and reports prepared by policy-makers in the decades leading to the Funding Loan of 1898 can be found in the “Brazilian Government Documents” digital collection, available through the website of the Center for Research Libraries.\textsuperscript{21} Other important primary sources were the digital historical archives of the British magazine \textit{The Economist}. I also had the opportunity to consult the online database of the Rothschild

\textsuperscript{17} Alves also served as Minister of Finance between 1891 and 1892 and was elected to the presidency in 1902.
\textsuperscript{18} Campos Jr. was a Congressman and a Governor of the state of São Paulo before he was appointed to the Ministry by President Barros.
\textsuperscript{19} Sales was Minister of Justice during the Republican Provisional Government constituted after the fall of the Monarchy, a Senator of the Republic, a Governor of the state of São Paulo, and President after Barros (1898-1902).
\textsuperscript{20} Unless otherwise noted, this correspondence and the works by Brazilian historians quoted throughout this chapter are in Portuguese and were freely translated into English by me.
\textsuperscript{21} Available at www-apps.crl.edu/brazil.
Archive. Finally, the websites of the Brazilian Institute of Geography and Statistics (Instituto Brasileiro de Geografia e Estatística), Institute of Economic Research Foundation (Fundação Instituto de Pesquisa Econômica), Brazilian Economics Institute (Instituto Brasileiro de Economia), Getúlio Vargas Foundation (Fundação Getúlio Vargas), and the Brazilian Central Bank also provided historical macroeconomic data and statistics, although there was less data available on the Brazilian economy during the nineteenth century than on more recent periods.

For the second case study, covering the Third Funding or the Funding Loan of 1931, I analyzed contemporary official documents, the diaries and correspondence of President Getúlio Dornelles Vargas, the correspondence of his Ministers of Finance José Maria Whitaker (1930-1931) and Osvaldo Euclides de Sousa Aranha (1931-1934), the correspondence exchanged by the Rothschild bankers with Brazilian officials, and other primary and secondary sources. I conducted most of my research for this period in the personal archives of Vargas, Costa and Aranha, held by the Center for Research and Documentation of Brazilian Contemporary History (Centro de Pesquisa e Documentação de História Contemporânea do Brasil), at the Getúlio Vargas Foundation. I also visited some of the other archives I mentioned above, including the official historical archives of the Brazilian Ministry of Foreign Affairs, the Brazilian National Archives, and the archives of the Brazilian Historical and Geographic Institute. The online digital archives of The Economist and the digital collection of the Rothschild Archive were also useful, as were the online databases from the Brazilian Institute of Geography and Statistics, the Institute of Economic Research Foundation, the Brazilian Economics Institute, and the Brazilian Central Bank.

For the third case study, covering the Brazilian Financing Program for 1983, I focused on pronouncements by Brazilian government officials such as the Minister of Planning Antônio Delfim

22 Minister Whitaker was a banker from the state of São Paulo. Previous to his appointment by Vargas, he served as the president of the Bank of Brazil during the administration of President Epitácio Lindolfo da Silva Pessoa (1919-1922). He returned to the Ministry of Finance in 1955.
23 Minister Aranha was one of the main civilian supporters of Vargas before and after the Revolution of 1930. He served as Minister of Justice during 1931, Minister of Finance from 1931 (after the resignation of Minister Whitaker) until 1934, Ambassador to the United States from 1934 to 1937, and Minister of Foreign Affairs from 1938 to 1944. He also served as the head of the Brazilian mission in the United Nations in 1947 and again as Minister of Finance in 1953.
Netto (1979-1985),²⁴ the Minister of Finance Ernane Galvêas (1980-1985), and the President of the Brazilian Central Bank Carlos Geraldo Langoni (1980-1983). Unlike the other two cases, I could not rely on the private correspondence and documents left by relevant policy-makers since most of those involved in the debt restructuring negotiations are still alive. Those who are not, such as President Figueiredo, did not make their documents publicly available. In addition, many of the internal documents prepared by the Brazilian government at the time are still classified. My visits to the archive of the Ministry of Foreign Affairs in Brasilia (which holds the official declassified documentation and correspondence from the 1960s onwards), to the Brazilian National Archives, and to the Center for Research and Documentation of Brazilian Contemporary History uncovered little that was useful on the period.²⁵

Some government officials, as for instance Minister Netto, wrote personal accounts of their tenure in office, to which I refer in reconstituting the events of the period. I did not conduct interviews with the surviving Brazilian officials involved in the Brazilian Financing Program as they would not significantly add to the public knowledge of the events in the same way that the private correspondence and diaries of Brazilian policy-makers from the nineteenth century and the 1930s, which were not meant for public release, do for the First and Third Funding Loans. I relied instead on published interviews, such as those by President Ernesto Beckmann Geisel, and journalistic accounts of the crisis and negotiations, which can be found both in domestic and international publications. I also relied

²⁴ Before serving under President Figueiredo, Minister Netto was appointed the Minister of Finance (1967-1974) in the administrations of both President Artur da Costa e Silva e Emílio Garrastazu Médici. He began his last stint in power as the Minister of Agriculture for Figueiredo, eventually ascending to the Planning portfolio in 1979, becoming in practice the Brazilian “economics czar”.

²⁵ I did my best to fill this gap by using materials from other primary and secondary sources. The Brazilian Access to Information Act (Lei 12,527), passed and enacted in 2011, guarantees freedom of access to any information that may be of public interest and that has never been classified or has been declassified. Although this system applies to any area of public administration, its main goal was to guarantee individual access to any personal data and information related to human rights violations committed by public officials during the military regime. Moreover, the ability of each department or public agency to fulfil the legal obligations contained in the Act may be limited due to budgetary and personnel constraints. My request to access the documents held by the Brazilian Central Bank was denied on the grounds that it involved an unwieldy number of documents and would require manpower they could not afford to spare. My only recourse would be to appeal the decision, and the Act is vague on which agency is legally competent to review such appeals in this case.
heavily on *The Economist* and on the Brazilian magazine *Veja*. Their digital historical archives can be easily accessed online. Finally, I used the online databases from the Brazilian Institute of Geography and Statistics, the Institute of Economic Research Foundation, the Brazilian Economics Institute, the Brazilian Central Bank, and the United Nations Conference on Trade and Development as sources for the macroeconomic data I cite throughout chapter five.

There are three main criteria by which we can judge the quality of archival evidence and the validity of my conclusions (McCulloch 2004, 42–5; Scott 1990, 6–9). The first is its authenticity: is the evidence genuine and of unquestionable origin (McCulloch 2004, 42; Scott 1990, 6)? This seems to be the case for the material I found in the archives I visited. The macroeconomic data may be less reliable due to problems with missing data or its faulty collection. Although this may be especially true for the period covered by my first case study, when the Brazilian federal government struggled to collect statistics in an efficient and professional manner, data is more abundant and reliable for the second and third cases. Moreover, occasional errors in numbers and data series should not have a strong biasing effect on the general macroeconomic trends that arise from my analysis of the data, as I show in the following chapters.

The second criterion cited in the literature is the credibility of the sources: is the evidence reliable and free from error, distortion, and evasion (McCulloch 2004, 42–3; Scott 1990, 6)? This is more difficult to assess, and it is reasonable to expect that official documents will be biased, partial, or uncritical of events (Scott 1990, 59–60). The authors of the primary sources might not have been entirely honest in their reports and correspondence, attempting to justify their own failures by blaming foreigners and creditors for their problems or using the finance and trade structures of the international

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26 *Veja* is the biggest weekly magazine in Brazil, occupying a niche that is comparable to that of *Time Magazine* or *Newsweek* in the United States. Its editorial line has historically leaned towards the center-right of the political spectrum, although it has increasingly moved to the right in the last decade, particularly during the Lula and Rousseff administrations. Still, it provides an invaluable record of facts and opinions by Brazilian policy-makers and other societal actors in the period.
economy as an excuse for their own political ends. This could weaken the utility of the primary sources for my case studies.

One way to identify and circumvent these problems is to triangulate official sources with other archival primary sources (Wood 2007, 126, 137), such as period newspapers and private documents, thus incorporating into the research voices and perspectives that may be marginalized by official accounts. I attempted to do this in all three cases. We should also consider that most policy-makers I cite in this dissertation were experienced politicians at the apex of their political careers, most of them the real power-brokers in Brazilian politics, who were active during oligarchic or autocratic regimes and had little reason to fear a backlash from the public. This may not have been the case for some officials in the Figueiredo administration, as many were civil servants and could have a strong incentive to preserve their careers, but they were also relatively insulated from the push and pull of politics due to the nature of the military regime, as I will show in chapter five. Moreover, the letters and most of the documents I analyzed were private and not intended to be read by the public or by a large audience.

The third, and related, criterion is that of representativeness: is the evidence typical of its kind, or is it unrepresentative due to limited availability or a low survival rate (McCulloch 2004, 43–5; Scott 1990, 25)? Is it possible to know the extent to which important documents, which could have provided different perspectives or insight, have been destroyed or lost (Scott 1990, 27)? This is certainly difficult to ascertain, especially in the context of the first two case studies. I attempted to counter this problem by triangulating my research with other sources.
Chapter Two: International Structure, Cooperation, and Power: a Theory of Sovereign Debt Crises

2.1) Shared Assumptions in the Literature on Sovereign Debt

As I mentioned in the previous chapter, the academic literature and scholarship on sovereign debt shares a particular set of assumptions about the anarchic nature of the international economy and the sovereign debt market, the instrumental rationality of its actors, and how debtors and creditors cooperate when debtors repay their debts in accordance with the original conditions of debt contracts. With few exceptions, scholarly work in the literature takes these assumptions for granted. In his study of rational choice, Hindmoor (2006) refers to this tendency when applied to rationality as the “axiomatic” approach: “[it is] axiomatic in the sense of having ‘only to be stated to be recognized as obvious’ (...). Rationality, far from being a controversial assumption requiring a great deal of [careful] justification, is entirely self-evident and in no need of further discussion” (2006, 186). The axiomatic approach follows an “instrumental” view of science, according to which scientific theories and models must be judged by their explanatory power and the accuracy of the predictions they generate, rather than by the realism of their assumptions (Green and Shapiro 1994, 31; Hindmoor 2006, 188–9). In Economics, this view was most famously espoused by Friedman in his influential essay The Methodology of Positive Economics (1966).

The axiomatic approach has some advantages. It allows researchers to rigorously simplify reality while sidestepping difficult practical issues, as for instance those involved in knowing the real content of the preferences of individuals (Hindmoor 2006, 186–7). However, it can also lead to oversimplification and reification. In the case of the cooperation puzzle, we should care about the realism of the assumptions in the literature because they constitute the cooperation puzzle at the center of its research program: the phenomenon that is puzzling and worth studying (debt repayment), which questions should be asked about it (why would debtors ever repay?), why it is puzzling (rational maximizers are self-interested opportunists who would not voluntarily repay their creditors in an
anarchic environment), and what explains it (cooperation is predicated on the enforcement of contracts by the creditors or their governments). As Dow notes, “the way in which meaning is attached to concepts and terms, in which the objects of study’s frames are represented, and in which questions are posed and answered, depends on the methodology employed” (2008, 14). The literature thus privileges a certain way of looking at and understanding the sovereign debt problématique that is inaccurate and can be even harmful, especially when its models and hypotheses trickle down to or are distilled for the consumption of pundits, commentators, journalists, and policy-makers.

In this chapter I analyze these theoretical foundations in more detail. Granted, the literature is not monolithic. Most authors diverge on what type of enforcement mechanism explains cooperation and repayment, and offer different hypotheses ranging from the actual or threatened use of force to the influence of domestic interest groups over policy-makers in debtor countries. Moreover, a number of authors challenge some of the assumptions in the literature. For instance, Eichengreen and Portes (1989a) and Suter and Stamm (1992) show that throughout history creditors and debtors have cooperated by restructuring their debt contracts, and other authors relativize the concept of cooperation, hypothesizing that it involves some measure of debt readjustment or strategic bargaining (Bowe and Dean 1997; Datz 2009; Eichengreen 1999; Fernandez and Rosenthal 1990; Porzecanski 2003). Cole and Kehoe (1995), Cole, Dow, and English (1995), and Tomz (2007) work with the possibility of limited information on the part of the creditors. Alfaro and Kanczuk (2005), Grossman and Van Huyck (1988), and Levy (1997) offer an alternative view of reputations, arguing that creditors connect reputations to different “states” of the world and are able to differentiate excusable moratoria and restructurings from un-excusable debt repudiations. Ferguson and Schularick (2006), James, Mitchener and Weindenmier (2005), Jessop (1976) Lipson (1985), and Mclean (1976), relativize the assumption of
anarchy. Lipson questions the concept of anarchy as the absence of structure (1981, 606), although his understanding of structure is aligned with neo-realist conceptions. Authors such as Soederberg (2005, 2013) approach the study of sovereign debt from critical perspectives that challenge the predominant understanding of markets as frictionless or normatively neutral spaces for the distribution of capital.

However, even when providing meaningful corrections to the main thrust of the literature, these accounts focus on specific issues or topics, for instance the availability of complete information on the preferences of the debtors or the average bond yields received by creditors in the event of a restructuring, and do not offer a systematic analysis of the phenomenon of sovereign debt or of its main theoretical tenants. They also tend to share the other problematic traits in the literature, especially its over-reliance on the assumption of instrumental rationality, thus contributing to a narrow understanding of the sovereign debt problématique as an analysis of the political risks behind defaults.

The remainder of the chapter is structured as follows. In section 2.2 I analyze the assumptions of anarchy, rationality, and cooperation and how they constitute the cooperation puzzle. In section 2.3 I analyze the puzzle in more detail and present the different explanatory hypotheses advanced in the literature. In section 2.4 I present my hypothesis and my understanding of the concepts of anarchy, cooperation, and power, and analyze how they can contribute to a more empirically sound study of the phenomenon of sovereign debt. Finally, in section 2.5 I present and assess some of the validity conditions for my hypothesis.

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27 Such works usually refer to an “informal empire” or to the “empire effect”, the observation that borrowing costs for British Dominions such as Canada, New Zealand, and Australia were historically lower than those for independent countries elsewhere.

28 This is made clear by the policy prescriptions that usually follow from them, focusing on the promotion of institutional reforms that can make a debtor more “resilient” to crises. See for instance Eichengreen (2002). The many proposals for the creation of supranational restructuring mechanisms do offer a more nuanced view of restructuring, but they tend to be agnostic about the “need” for reforms. There is a huge body of literature on the topic which I cannot cover in this dissertation, but see Helleiner (2008), Rieffel (2003), Roubini and Setser (2004), and Sachs (2002).
2.2) Challenges to the Core Assumptions in the Literature

2.2.1) Anarchy in the International Economy and Sovereign Debt Market

The first important assumption in the literature is that the international economy and the sovereign debt market are anarchic. Writing from the perspective of IR, Tomz offers the most conceptually clear example of this assumption: “Without a world government to enforce commitments (...), why should anyone take foreign leaders at their word? (...) [T]he anarchical nature of world politics makes third-party enforcement of commitments unlikely” (2007, 3). Most authors do not use the term as explicitly, but their descriptions of the international environment are very similar to how anarchy is traditionally defined in IR, particularly by neo-realists and liberal institutionalists: as a space in which there is no authority superior to that of the states (Lake 2009, 1; Milner 1991, 68; Waltz 1979, 103–4). Lindblom, in his book The Market System, summarizes this view of anarchy pointedly: “there exists a global market system but no world state” (2001, 41).

Eaton and Gersovitz present the assumption of anarchy in their foundational work in the following way:

[d]omestic bankruptcy laws prohibit an agent from shedding his liabilities while maintaining full control of his assets. The situation is quite different in the case of international lending. Unless the governments of private creditors are willing to coerce debtor governments into repaying loans, there is no explicit mechanism deterring a government from repudiating its external debts. (1981, 289)

Eaton, Gersovitz, and Stiglitz offer a more refined explanation of the assumption:

[o]ne problem in all lending is enforcement (...). The major difference between domestic and international debt is that the former are legal obligations, enforceable in courts. Another difference is that, domestically, debtors who cannot meet their obligations have the option of filing for bankruptcy. Repayment of international debt, however, is largely voluntary; the penalties to be imposed on a country that does not honor a contract are, at best, indirect. On the other hand, there is no systematic procedure, corresponding to bankruptcy, by which a country that has undertaken an excessive amount of debt can discharge its obligations and proceed on its way. (1986, 484)
Kletzer offers yet another example:

[t]he absence of a supranational legal authority to enforce the terms of agreements between governments or between nationals of one country and the government or nationals of another restricts the opportunities for intertemporal exchange. The history of lending to sovereigns demonstrates the consequences of lender’s inability to enforce the repayment obligations of debtors specified in loan contracts. Repayments of loans to sovereigns during the nineteenth and twentieth centuries have not approached the contractual obligations in an overwhelming number of cases. Many loans went into default as identified by historians. (1994, 439)

Kletzer and Wright note that:

[res]pect for sovereign immunity has long been recognized as a crucial constraint facing lenders to sovereign states (...). Intertemporal exchange is restricted by the absence of a supranational legal authority to enforce the terms of agreements. The history of lending to sovereigns show the consequences of lenders’ inability to enforce repayments specified in loan contracts. (2000, 621)

Finally, Fuentes and Saravia argued more recently that:

The fact that in sovereign markets there are no analogues to the bankruptcy laws and procedures that exist in domestic debt markets raises a number of interesting issues. One is the well known question of why countries ever repay their debts given that their creditors don’t have expeditious tools to recoup the defaulted amount and impose a penalty on the defaulter. (2010, 336)

There are many more examples. They show that the literature represents the international economy and the sovereign debt market as arenas of “self-help”, environments with minimum to no institutionalization, in contrast to domestic markets, where the state is seen as the legitimate authority, able to protect the property rights of creditors and to settle conflicts over the distribution of capital. This vision is exemplified by some of the theoretical models used in the literature to explain the cooperation puzzle. For instance, an author describes his model in this way: “[f]irst borrowers offer contracts to lenders, then lenders decide which loan contracts to accept, then borrowers who get loans choose their

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projects, then they observe the return on their projects and decide how much to pay to lenders” (Diamond 1989, 835). This rather extreme way to depict the relationship between creditors and debtors is not far from the bulk of the theoretical works in the literature. It also highlights one of the major implications of the assumption of anarchy: if debtors can freely choose the conditions of their loans, responding strategically to changes in borrowing costs arising from the unimpeded operation of the price mechanism and the laws of supply and demand, then they can also freely choose whether or not to default. These views confer an excessively atomistic and reductionist character to the cooperation puzzle, isolating debt instruments from the social-economic context in which they are embedded, and fail to grasp how the structures of the international economy contribute to the relative scarcity of capital at the international level.

2.2.2) The Instrumental Rationality of Creditors and Sovereign Debtors

A second major assumption, also common to the broader literature on rational choice and collective action, is that actors are instrumentally rational, so that when faced with different ways to achieve a certain goal, they will choose that which is the most efficient or most conducive to the achievement of that goal. In this formulation rationality refers narrowly to the choice of means made by actors, as they attempt to maximize their own goals and ends (the pay-offs or their own “utility”), and is not concerned with the ends being maximized or with any cognitive or other psychological processes or factors that can lead to deviations from expected utility maximization.

30 For an in-depth discussion of the assumption of rationality, see Caporaso and Levine (1992, 132), Green and Shapiro (1994, 14), and Hindmoor (2006, 181, 184). For a review of the impact that the assumption of rationality, and its corresponding auxiliary assumption of self-interested actors, had in Political Science and the study of politics more broadly, see Mansbridge (1990).

31 Behavioral psychologists, behavioral economists, and political scientists have challenged this traditional view on rationality since the mid-twentieth century. See Hirschman (1985), Jones (1999), Kanheeman (2002), Ostrom (2000), Odell (2002), Simon (1985), and Tversky and Kahneman (1986). Some works in the literature on sovereign debt have tried to circumvent the problem by specifying the conditions behind their models more narrowly, including by assuming that both borrowers and lenders are “risk-neutral” (Arellano 2008, 691; Bulow and Rogoff 1989a, 160; 1989b, 43; Chowdhry 1991, 127–8; Cole, Dow, and English 1995, 371; Eaton and Gersovitz 1981, 292). In any case, such ad hoc additions make the models even less realistic. So far, I have not found any works in the literature
The assumption of instrumental rationality is further dependent on four auxiliary assumptions.\(^{32}\) First, rational actors are capable of identifying and ranking their preferences in a consistent and stable way over time. Second, they generally have full information on their own preferences, on the choices available to them, and on the costs and benefits related to those choices.\(^{33}\) Third, rational actors are self-interested, promoting their own interests over those of others. Finally, the behavior and choices of an actor reveal its true preferences.\(^{34}\)

Although both debtors and creditors can be understood to be rational in this narrow sense, the literature tends to focus on the analysis of the behavior of debtors, its policy-makers, or interest groups within them. For this reason, many of the academic works start by asking why developing country debtors would borrow to begin with. According to Eaton, there are two main reasons, both associated with the scarcity of capital at the domestic level: “one is to allow consumption to grow permanently at a different rate than the [country’s resource] endowment. Another is to smooth consumption in the short run if endowments fluctuate” (1993, 142). It follows that debtors borrow in order to postpone the economic adjustments that would be necessary in view of their limited resources or the downturns of the business cycle. Eaton adds:

> In the short run, foreign debt can allow countries to experience uneven endowments or to exploit uneven investment opportunities without concomitant unevenness in consumption. In the longer run, foreign


\(^{33}\) Although the assumption of full or complete information is not universally accepted (Green and Shapiro 1994, 19), and has been criticized in the literature of sovereign debt by Cole and Kehoe (1995, 46) and Tomz (2007, 10), many of the models and explanations I analyze either implicitly or explicitly assume that rational actors possess complete information and are thus fully capable of distinguishing and choosing among different ways to maximize their own preferences. Even the models that admit the existence of asymmetries of information between creditors and debtors tend to assume that they reflect incomplete information about the preferences of the other, not one’s own. See Cole, Dow, and English (1995, 371), Diamond (1989, 830), and Tomz (2007, 14–8).

\(^{34}\) Cole, Dow, and English provide one of the clearest formulations of the assumption of “revealed preferences” in the description of their model: “[w]e assume that [lenders] cannot directly observe the borrower’s type; nor can they observe when a transition [from one type to another] occurs. They can try to infer the borrower’s type from its actions” (1995, 371). See also Tomz (2007, 17).
debt can allow countries to undertake long-term investment projects without the sacrifice of current for future consumption that would otherwise be necessary. (1993, 170)\textsuperscript{35}

This narrow understanding of rationality is complemented and supported by the assumption of anarchy. If debtors operate in an institutional vacuum and are considered to be free to react to external conditions and the price mechanism operating in debt markets, then it is in principle logical to assume that the main determinant behind decisions to borrow, repay, or default is the instrumental calculus of whether they are conducive to better pay-offs compared to the alternatives. As such, defaults are not only a viable strategy but a dominant one in view of the anarchy of the international sovereign debt market and the costs associated with repayment.\textsuperscript{36} Hatchondo, Martinez, and Sapriza comment that: “[i]f there were no costs of defaulting [ie., no enforcement], the sovereign would default under all circumstances” (2007, 168). In their foundational work, Eaton and Gersovitz provide a typical view: “a decision not to default [in a] period is not a decision never to default, but only a decision to wait one period to reconsider whether default is optimal” (1981, 293).

Levy provides a more detailed explanation of this rationale:

[a]s suggested by the debt-overhang hypothesis, an indebted country’s investment, and consequently economic growth, might be adversely affected by its debt-service payments through the depletion of financial resources available for investment and expected and actual increase in tax rates (...). (...). In view of this adverse effect, internal pressures, and the fact that a country’s public external debt is a sovereign one and as such it is not subject to bankruptcy law, a highly indebted sovereign might have a strong incentive to repudiate. (1997, 69)

Debtors are perceived to be inclined to default, only avoiding it due to the costs associated with potential retaliations by the creditors: “[i]n a hypothetical scenario in which sovereign defaults were costless, governments would always default” (Hatchondo, Martinez and Sapriza 2010, 294). Eaton and Gersovitz put it bluntly when describing their mathematical model of repayment: “[o]ne peculiar

\textsuperscript{35} As this line of reasoning goes, sovereign debtors borrow to compensate tax shortfalls and budget deficits, instead of cutting expenses and making the “hard choices” a responsible debtor would make in “hard times”. See Bulow (2002, 235–6) and Reinhart and Rogoff (2009, xxv, xxxii) for examples.

attribute of all borrowers is that they are inherently dishonest in that they will default if it is to their
benefit” (1981, 290). We can find others examples in the literature.37

As a major consequence of the assumptions of instrumental rationality and anarchy, the
sovereign debt problématique is reduced to the dichotomous and binary questions of whether and how
a debtor can muster the willingness or political will to repay. Sturzenegger and Zettlemeyer provide an
illuminating summary:

(...) [T]hese two ways of looking at debt crises are to some extent equivalent. Countries may not be
“willing” to pay because this would require unacceptable sacrifices in light of a reduction in their “ability”
to do so (their resources). Conversely, they may not be “able” to pay in the sense that repaying would not
be an equilibrium given the resources and political economy constraints that shape their willingness to
take measures that would enable them to repay. (2006, 38)38

According to Saiegh, “repayment is not necessarily connected with the ability to repay. (...) [A]n
country may have the technical ability to repay a debt but still adopt a political decision not to do so”
(2005, 368). His view is echoed by Eaton, Gersovitz, and Stiglitz: “[L]ong before a country’s ability-to-pay
would become relevant, its willingness-to-pay constrains its access to credit” (1986, 499). Tomz goes a
step further:

[T]he fate of an international loan ultimately depends on the borrower’s willingness to pay. With no
global Leviathan to prohibit breaches of contract, even governments with ample funds can choose to
default. In debt, as in other spheres of international relations, governments uphold their commitments
when the benefits of compliance outweigh the costs of reneging. (2007, 15 - original italics)

Reinhart and Rogoff provide a defense of the willingness thesis that summarizes the issues I
enumerate above and is worth quoting at length:

and Kaluzny (2005, 238), Reinhart and Rogoff (2009, 51), Sandleris (2008, 267), and Tomz (2007, 3). This view is
reinforced by the observation that defaults are common at the international level. See Arteta and Hale (2008, 53),
Sturzenegger and Zettelmeyer (2006, 4, 9), and Van Rijckeghem and Weder (2009, 388).
38 There are other examples. See Catão and Sutton (2002, 4) and Manasse and Roubini (2009, 6).
If the reader has any doubt that willingness to pay rather than ability to pay is typically the main determinant of country default, he or she need only peruse our earlier table 2.2. The table shows that more than half of defaults by middle-income countries occur at levels of external debt relative to GDP below 60 percent, when, under normal circumstances, real interest payments of only a few percent of income would be required to maintain a constant level of debt relative to GDP (...). The centrality of willingness to pay rather than ability to pay is also clear when one look back several hundred years (...).

(2009, 54)

The voluntarist perspective that prevails in such accounts is problematic. First, few historical cases of default can be explained predominantly by the unwillingness of the debtors to keep servicing their debts. Second, the idea that a debtor can repay “if only” it is willing to make sacrifices ignores the fact that practical economic issues may be as important as political ones in leading to moratoria and restructurings. For instance, policy-makers in sovereign debtors may have trouble generating surpluses in the balance of trade because they cannot completely cut the import of essential goods or because they may be bound by the rules of international trade, and cuts to government spending required by the creditors may cause a contraction in the economy of the debtors, generating a fiscal crisis instead of propping up their solvency. Third, the voluntarism in the literature presents a dichotomous choice between willingness and ability to pay that precludes a more nuanced view of policy-making and of the role played by power in the international economy. I will return to these issues in section 2.4.1.

2.2.3) Cooperation Between Creditors and Debtors

Although most authors do not discuss it explicitly, the literature assumes that debtors and creditors cooperate when the latter lends capital and the former repays it according to the terms

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39 The cases we could cite as motivated primarily by political reasons or a “pure” unwillingness to repay are the “revolutionary” defaults of Mexico in 1914, Russia in 1917, China in 1949, Czechoslovakia in 1952, and Cuba in 1960 (Borchard 1951, 129; Sturzenegger and Zettelmeyer 2006, 4). However, even in these cases defaults can be explained by the fact that these debtors had already been excluded from the sovereign debt market due to the conflicts that anticipated the takeover of power by the revolutionary powers.

40 As I will show in chapter five, Brazilian policy-makers in the 1980s were concerned that they could not intervene too much to prop up the balance of trade due to the norms of the General Agreement on Tariffs and Trade (Veja 1982, 156, 157).
specified in the original loan or bond agreement.\textsuperscript{41} This understanding of cooperation rests on the auxiliary assumption that the sovereign debt market promotes the efficient allocation of capital from areas in which it is abundant to areas in which it is scarce, increasing overall welfare.\textsuperscript{42}

This functionalist view of the operation of financial markets is closely connected to the assumption of instrumental rationality and the explanations for why debtors borrow abroad. As it focuses on the advantages that sovereign debtors may derive from market access (whether by smoothing the business cycle or covering budget deficits), the mainstream literature sees the relationship between creditors and debtors in dichotomous, zero-sum, terms. Either debtors cooperate with their creditors by repaying their debts in accordance with the original terms of their loan agreements, a situation that is conducive to an efficient allocation of capital at the international level, or they defect from cooperation when they departure from the status quo, a situation that leads to an inefficient allocation of capital. In this limited sense, cooperation (or repayment) can be seen as a Pareto-optimal situation,\textsuperscript{43} since the position of any debtor cannot be individually improved without negatively affecting the position of its creditors (which would lose their invested capital plus transaction and opportunity costs).

The pervasiveness of this understanding is reflected by the research puzzle at the center of the literature. Tomz most clearly summarizes it as one about compliance and repayment: “why do governments ever repay their debts to private lenders in distant countries? There is, of course, a deeper puzzle here (...): how does cooperation emerge in a condition of anarchy?” (2007, 4 - my italics). The implication from the puzzle is that cooperation must involve the return of the relationship between creditors and debtors to the status quo ante by the application of an enforcement mechanism. For

\textsuperscript{41} As I mentioned in the introduction to this chapter, there are exceptions to this view. See Bowe and Dean (1997), Datz (2009), Eichengreen (1999), Eichengreen and Portes (1989a), Fernandez and Rosenthal (1990), Porzecanski (2003), and Suter and Stamm (1992).

\textsuperscript{42} See Obstfeld and Taylor (2004, 5). For examples in the literature, see Bulow and Rogoff (1989b, 44), Cardoso and Dornbusch (1989b, 1388–9, 1404), Eaton (1993, 143), and Reinhart and Rogoff (2009, xlv). This assumption is also behind some explanations for the purpose of international financial institutions such as the IMF (Sturzenegger and Zettelmeyer 2006, 21). Surely, this view is not unchallenged (Soederberg 2005; 2013).

\textsuperscript{43} For a critical assessment of the concept, see Sen (1993).
instance, Eaton and Gersovitz note in their paper: “unless the governments of private creditors are willing to coerce debtor governments into repaying loans, there is no explicit mechanism deterring a government from repudiating its external debts” (1981, 290).

This view of cooperation is misleading and casts debt crises as a zero-sum conflict between trustful creditors whose rights need protection and corrupt, incompetent, or weak-willed debtors whose sovereign privilege needs checking. Debtors are presented as having a dichotomous choice between maintaining the *status quo* and defecting from cooperation, while creditors are presented as having a dichotomous choice between losing their capital by acquiescing to a default and enforcing the terms of debt contracts by all means necessary. However, this is challenged by both the cyclical pattern behind debt crises (Eichengreen and Lindert 1989, 3; Ramphal 1989, 68, 70), illustrated by figure 2.1 and table 2.1, and by historical cases of debt restructuring which involved concessions from both creditors and debtors, as the ones I analyze in the following chapters.

Figure 2.1 – Number of defaults (1824-2004)

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Table 2.1 – Defaults by Latin American countries (1824-2004)

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>1830</td>
<td>1890</td>
<td>1915</td>
<td>1930</td>
<td>1982</td>
<td>2001</td>
<td></td>
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<tr>
<td>Bolivia</td>
<td>1874</td>
<td></td>
<td></td>
<td>1931</td>
<td>1980</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>1826</td>
<td>1898</td>
<td>1914</td>
<td>1931</td>
<td>1983</td>
<td></td>
<td></td>
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<tr>
<td>Chile</td>
<td>1826</td>
<td>1880</td>
<td></td>
<td>1931</td>
<td>1983</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Colombia</td>
<td>1826</td>
<td>1879</td>
<td>1900</td>
<td></td>
<td>1932</td>
<td></td>
<td></td>
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<tr>
<td>Costa Rica</td>
<td>1827</td>
<td>1874</td>
<td>1895</td>
<td>1937</td>
<td>1983</td>
<td></td>
<td></td>
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<tr>
<td>Cuba</td>
<td></td>
<td></td>
<td></td>
<td>1933</td>
<td>1982</td>
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<tr>
<td>Dominica</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2003</td>
<td></td>
<td></td>
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<tr>
<td>Dominican Republic</td>
<td>1869</td>
<td>1899</td>
<td></td>
<td>1931</td>
<td>1982</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ecuador</td>
<td>1832</td>
<td>1868</td>
<td></td>
<td>1911, 1914</td>
<td></td>
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<tr>
<td>El Salvador</td>
<td>1827</td>
<td></td>
<td>1921</td>
<td>1931</td>
<td></td>
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<tr>
<td>Grenada</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2004</td>
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<tr>
<td>Guatemala</td>
<td>1828</td>
<td>1876</td>
<td>1894</td>
<td>1933</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Honduras</td>
<td>1827</td>
<td>1873</td>
<td>1914</td>
<td></td>
<td>1981</td>
<td></td>
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<tr>
<td>Mexico</td>
<td>1827</td>
<td>1867</td>
<td>1914</td>
<td></td>
<td>1982</td>
<td></td>
<td></td>
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<tr>
<td>Nicaragua</td>
<td>1828</td>
<td>1894</td>
<td>1911</td>
<td>1932</td>
<td>1980</td>
<td></td>
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<tr>
<td>Panama</td>
<td></td>
<td></td>
<td></td>
<td>1932</td>
<td>1982</td>
<td></td>
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<tr>
<td>Paraguay</td>
<td>1827</td>
<td>1874</td>
<td>1892</td>
<td>1920</td>
<td>1932</td>
<td>1986</td>
<td>2003</td>
</tr>
<tr>
<td>Peru</td>
<td>1826</td>
<td>1876</td>
<td></td>
<td>1931</td>
<td>1978, 1983</td>
<td></td>
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<tr>
<td>Uruguay</td>
<td>1876</td>
<td>1891</td>
<td>1915</td>
<td>1933</td>
<td>1983</td>
<td>2003</td>
<td></td>
</tr>
<tr>
<td>Venezuela</td>
<td>1832</td>
<td>1878</td>
<td>1892, 1898</td>
<td></td>
<td></td>
<td>1982</td>
<td></td>
</tr>
</tbody>
</table>

Source: Sturzenegger and Zettelmeyer (2006, 7–8).
As a consequence of the reduction of the concept of cooperation to the enforcement of contracts, the study of the sovereign debt problématique is also reduced to finding which enforcement mechanisms or variables explain repayment: “a central issue is whether and how banks can credibly punish badly behaved borrowers and, thus, why a country has an incentive to repay” (Özler 1993, 608). This is where we can find most of the impetus behind academic research in the literature on sovereign debt.

2.3) Research Puzzle and Explanatory Hypotheses in the Literature

If we take for granted the assumptions above, cooperation does seem puzzling. Why would a rational debtor cooperate by respecting its commitments if it is inclined to default and, in an anarchic environment without an enforcer of creditors’ rights, the costs associated with defaulting are low in comparison with the costs associated with repaying?

The explanations to the puzzle assume that cooperation is possible under the shadow of some kind of constraint or enforcement mechanism unilaterally imposed by creditors or creditor governments in order to increase the costs, for the debtors, of their opportunistic defaults. However, there is little agreement on which mechanisms or variables better explain the phenomenon. Rose provides a very illustrative summary of this plurality of explanations: “[w]hy do countries pay their international debts? Three reasons are typically proposed. First, countries (...) may have their overseas assets seized by foreign creditors. Second, countries (...) may be cut off from capital flows in the future. Third, delinquent countries may suffer reduced benefits of international trade” (2005, 189). Taking our clue from Rose, it is possible to organize the different views in the literature into four main groups.

The first set of explanations prioritizes the use of force, or the threat thereof, as the explanatory variable or mechanism for the cooperation puzzle. Creditor governments will come to the support of private creditors to protect their property rights and to militarily coerce debtors into respecting their
original contractual obligations. “Pacific blockades”\(^45\) in turn offer a potentially cheaper policy alternative to direct military intervention, as they allow creditor countries to inflict heavy costs on debtors by bringing international trade to a halt. The works of Mitchener and Weidenmier (2005, 2010) are the most representative in the set of coercion-based explanations.

A second set of explanations focuses on the use of sanctions and issue-linkages by creditors and creditor countries. Both aim at changing the behavior of a target by linking unrelated policy issues such as trade and debt repayment, and sanctions differ from pure coercion in that they avoid the direct use of force (Bayard, Pelzman, and Perez-Lopez 1983, 74, 76; Cohen 1985, 129; Eaton and Engers 1999, 409; Lacy and Niou 2004, 26–6; Morgan and Schwebach 1997, 29). The most cited types of sanctions in the literature are the suspension of trade financing, the freezing and collecting of debtor’s assets located on foreign jurisdictions, the suspension of aid and development loans, the imposition of diplomatic sanctions, and the establishment of clearing arrangements.\(^46\) We can find examples of this explanation in Borchard (1951), Bulow and Rogoff (1989a, 1989b), Dalmazzo and Marini (2000), Rose (2005), and Rosenthal (1991).

A third set of explanations focuses on iteration or “repeat play” as the main variable or mechanism in explaining repayment. Repeat play strategies are cheaper than either coercion or sanctions and can be employed by creditors independently of the assistance of any state or political authority. Since sovereign debtors must return to the markets for capital, they would have an incentive to “behave” and keep servicing their debts for fear of an interruption in the future inflow of credit, as creditors may follow either a strategy of tit-for-tat or the “grim trigger”, the permanent exclusion of the defaulting debtor from the market, in response to defaults. We can find examples of the repeat play hypothesis in Atkeson (1991), Chowdhry (1991), Cohen and Sachs (1986), Eaton and Gersovitz (1981),

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\(^45\) According to Davis and Engerman (2003, 188), pacific blockades are instances in which naval force is used by one state against another but the action falls short of a generalized armed conflict. 
\(^46\) In a clearing arrangement, capital flows coming in and going out of a country are centralized by the government. According to Eichengreen and Portes (1989, 21), the British imposed a clearing arrangement on Germany in the 1930s, allowing the transfer of resources for the payment of German exports only after they were netted against German debt-service obligations to British creditors.
Reputation-based explanations are a subset of the broader iteration and repeat play group. They elaborate on the iteration mechanism and challenge the auxiliary assumption of complete information common to those hypotheses, focusing instead on the role that reputations, characterized as beliefs that private creditors hold about government “types” and their preferences about repayment, play in the international sovereign debt market. In this way, bad and good reputations respectively increase and decrease the borrowing costs faced by the debtors and may even determine their future market access. Reputations are thus decentralized market answers to the asymmetry of information that can affect creditors in an anarchic setting, and to the broader problem of the credibility of any promises made by debtors in relation to their contractual obligations. The most prominent examples of this set of hypotheses are Cole, Dow, and English (1995), Cole and Kehoe (1995), Özler (1993), and Tomz (2007).

A final set of explanations focuses on domestic actors and political institutions when explaining the cooperation puzzle. Reflecting commonly held expectations about the influence of economically powerful actors in policy-making and the competition among societal groups for scarce resources, these explanations move beyond the unitary actor model that informs many of the works in the previous groups. Since decisions to either default or repay may have dramatic domestic redistributive consequences (Eichengreen and Lindert 1989, 6; Hatchondo, Martinez, and Sapriza 2007, 164), and those in turn may affect the electoral prospects or the ability of politicians and political parties to stay in power, policy-makers in sovereign debtors should tend towards repayment or default depending on the

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47 See Milgrom, North and Weingast (1990) for the standard account of the role played by such decentralized institutions in the enforcement of contracts in anarchic environments.

48 Domestic-politics explanations do not focus on the costs that can be imposed directly by the creditors, but on the reactions of domestic actors to the distributive consequences that those costs may have when eventually imposed on their country.

49 See Mansbridge (1990) for a review of the development of this literature in the study of American politics and political institutions.
preferences of their constituents, powerful interest groups, or “selectorates” (Block and Vaaler 2004, 924; Chang 2007, 2411; Vaugirard 2005, 82).\(^5\)

Following Gourevitch (1996, 350), we can further classify domestic politics explanations in two subsets, depending on the variable which is emphasized by their proponents. Explanations in the first subset rely predominantly on “preference-driven models” to explain either repayment or default as the direct output of the preferences of certain actors in society such as exporters, domestic bondholders, or rentiers. We can find examples in Dixit and Londregan (2000), Fishlow (1989), Guembel and Sussman (2009), Hatchondo and Martinez (2010) and Tabellini (1991). Explanations in the second subset rely predominantly on “institution-driven models” to explain either repayment or default as the result of domestic institutions or institutional processes such as government turnover, number of veto players, the existence of institutional constraints to executive power, or regime type. We can find examples in Balkan (1992), Block and Vaaler (2004), Chang (2007), Citron and Nickelsburg (1987), Cuadra and Sapriza (2008), Hatchondo and Martinez (2010), Hatchondo, Martinez, and Sapriza (2007), Kohlscheen (2010), North and Weingast (1989), Rijckegehem and Weder (2009), Schultz and Weingast (2003), Stasavage (2007), and Vaugirard (2005).

However, as I anticipated in chapter one, the cooperation puzzle, the explanatory hypotheses it motivates, and their underlying assumptions beg important questions. Why would instrumentally rational debtors, with full information on their preferences, on the strategies most conducive to their maximization, and on the costs thereto, default if they know that creditors and creditor countries will compel them into compliance by making a default a costly strategy? In addition, if the political opportunism of debtors is so pervasive, why would rational creditors put up with the “serial defaulters” identified by the literature, tolerating their return to the international sovereign debt market after they

\(^5\) Selectorates are defined by Bueno de Mesquita, Koch and Siverson as “the set of people with a say in choosing leaders” (2004, 257), and may include actors and veto players other than voters, such as the military.
had defaulted for opportunistic reasons, and knowing that they will default again given the chance? Is there really a connection between cooperation and coercion?

These questions point towards problems not only with the assumptions shared by the literature, but also with the cooperation puzzle at its base. A critical analysis of its theoretical underpinnings and a careful study of historical cases of default reveal that the puzzle itself is misguided, as what it depicts as a recurrent phenomenon — defaults or debt repudiations motivated by the political expediency or the unwillingness of the debtors to repay — is quite rare and what it depicts as rare — cooperation — is actually much more common and not really puzzling.

2.4) My Hypothesis

By reducing the sovereign debt problématique to the willingness or political will of policy-makers in debtor countries to repay, the literature embraces a voluntaristic and atomistic perspective that disconnects debt crises from the international social-economic context in which they are embedded. As I foreshadowed in chapter one, my hypothesis diverges from that approach. I argue that the structures of the international economy, over which policy-makers in sovereign debtors have little to no control, and specifically its finance and production structures, play a crucial role in shaping the relative scarcity of capital for developing sovereign debtors. The relationship between creditors and debtors is mediated by social structures whose effects are important both in the period leading up to crises and during debt restructurings, as they limit the decision-making autonomy of developing sovereign debtors by affecting their ability to obtain the capital they need to repay, often in drastic ways. For this reason, debtors tend to enter moratoria or attempt debt restructurings when capital becomes scarce at the international level, and not necessarily because they are opportunistic and inclined to default. Moreover, differently from the predictions by both preference-driven and institution-driven explanations in the literature, domestic politics do not play a significant role in decision-making during debt crises, precisely due to these external structural pressures.
The social structures of the international economy can also explain cooperation between creditors and debtors. Some holdouts notwithstanding, creditors are able to differentiate between excusable moratoria and restructurings and non-excusable repudiations based on the state of the international economy. The Brazilian cases I analyze in the following chapters show that creditors can compromise and agree to changes to the original terms of debt contracts when debtors negotiate in good faith and demonstrate that they act under duress caused by negative economic conditions at the international level. This willingness to negotiate can be explained both by the pragmatism of the creditors, as it is usually better to agree to some form adjustment than to face the prospect of a default, and by the role that norm-following (Ostrom 2000) and expectations about behavior (Lipson 1981) can play in such processes. For this reason, although they can be protracted and difficult, renegotiations and restructurings are much more common than what we could expect based on the cooperation puzzle and its underlying assumptions.

Finally, I argue that power plays a very important role in the sovereign debt problématique, but not in the direct way that is implied by the enforcement view of cooperation. The idea that creditors are bond vigilantes, coercing opportunistic debtors into repaying, is not historically accurate. In the context of the international economy and the sovereign debt market, structural power is crucial. It is manifested in the ability of creditors and creditor countries to shape the institutions that comprise the finance and production structures and influence their operation, affecting the relative scarcity of capital, its distribution at the international level, and the range of policy options open to developing sovereign debtors. It is also manifested in the ability of financial intermediaries to frame the behavior of creditors and debtors. Due to their claims to expertise and know-how in financial matters, bankers and other financial actors can help promote cooperation by determining when the parties are negotiating in good faith and by defining either excusable restructurings or un-excusable defaults, and connecting that behavior to the state of the international economy.
This is not to say that an individual sovereign debtor could not gain by potentially defaulting or negotiating better debt conditions with its creditors. However, by adopting a more nuanced perspective on the assumptions that inform the literature on sovereign debt, we can better understand the real dilemmas faced by policy-makers in developing debtor countries such as Brazil. They do not take decisions to restructure or default lightly (Kaletsky 1985, 13) and the recurrent nature of debt crises suggests that there is more than simple opportunism at play. Seen from my alternative perspective, defaults and debt renegotiations acquire a less calculated character, connected to factors beyond the control of the debtors. The idea of opportunistic defaults presupposes a level of knowledge about the trade-offs involved in repaying or defaulting that is not vindicated by the careful analysis of historical cases of debt crises.

In other words, cases of default motivated by the debtors’ inability to pay, even when it is willing to, may be much more common than cases of default motivated by their unwillingness to pay. In the following sections I present the theoretical underpinnings of my hypothesis in more detail.

2.4.1) Anarchy and the Structures of the International Economy

The literature usually represents the international economy as an environment with minimum to no institutionalization, contrasting it to highly institutionalized domestic environments in which the state is the ultimate guarantor of the property rights of creditors. Although this is not the place for a thorough review of the concept of anarchy as it is used in international relations,\(^{51}\) Wendt’s path-breaking paper *Anarchy Is What States Make of It: the Social Construction of Power Politics* (1992), and Strange’s analysis of the structures of the international economy in her book *States and Markets*, challenge that dichotomous understanding of anarchy. Whether internationally or domestically, social institutions, norms and rules that “create and instantiate one structure of identities and interests rather

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51 For a classic account of the concept of anarchy, see Waltz (1979, 104–107). For a divergent but mainstream view, see Lake (2009). For a critique of mainstream IR theories from a critical and post-modern perspective, see Ashley (1988).
than another” (Wendt 1992, 395) shape the terms of the relationship between creditors and debtors. Borrowing from Wendt, I argue that the international economy is not an institutional vacuum where actors interact as if they were similar to “billiard balls” in a self-help system, empty of social institutions, but rather that it is structurally organized in ways that shape how they relate to each other. The observation that in an anarchic environment there is no overarching authority capable of enforcing the property rights of creditors does suggest that institutions and social norms are weaker at the international level, but it does not provide a definitive answer about the nature of the relationship that sovereign debtors and their creditors develop under those weaker rules.

Strange’s definition of structure as social arrangements that shape the interactions of the actors in a system (1988, 24–25, 30) is crucial in this context. It suggests a more complex meaning for the concept of structure than the one usually associated with traditional paradigms in IR. It adds a social dimension to the international system and accounts for the power relations that shape and permeate it, going beyond the more mechanistic view of the balance of power and the distribution of capabilities among state actors. Thus, while neo-realism relies on a definition of structure that is summarized by the principle of anarchy and the distribution of hard power capabilities among states (Waltz 1979, 104–5), and authors such as Lipson (1981, 606) define structures as sets of incentives and constraints, Strange’s definition highlights their social nature and the presence of institutions, norms and rules that mediate the relationship between creditors and debtors in significant ways.

Two international structures are particularly important in the context of the sovereign debt problématique. The first is the finance structure, which is constituted by the institutions, norms, and rules that govern the, the distribution of capital and the terms under which one national currency is exchanged for another (1988, 26, 88). The second is the production structure, which is constituted by the institutions, norms, and rules that govern the production of goods and services and their distribution in the world economy (1988, 26, 62). I defined institutions in chapter one, citing Keohane’s view, as sets of norms and rules that are “persistent and connected”, and that “prescribe behavioral roles, constrain
activity, and shape expectations” (Keohane 1988, 383). Norms and rules in turn constitute institutions and perform different functions. While the former have constitutive effects, “[generating] agents, [endowing] them with certain capabilities and powers, [determining] their underlying identities, interests, and preferences (...) [and] also [defining] social activities and categories of action” (Duffield 2007, 7), the latter have prescriptive effects, as they can be defined as “statements that forbid, require, or permit particular kinds of actions” (Duffield 2007, 5), building on norms to prescribe acceptable or unacceptable behavior. In other words, both the finance and the production structures and their institutions, norms, and rules are important as they shape the identities and interests of creditors and debtors, determine whether and on what terms debtors can obtain the foreign currency they need to finance their funding and repayment needs, determine whether and on what terms debtors can trade the commodities they produce at the international level, determine how the benefits or costs of these interactions are to be allocated, and define the sanctions for those who deviate from the established norms and practices.52

In the context of the Funding Loans of 1898 and 1931, the institutions and norms of the gold standard, such as the convertibility of national currencies into gold at a fixed rate (Eichengreen 1996, 20, 26; Frieden 2006, 6), also known as the “gold parity”, and the freedom of capital flows (Eichengreen 1996, 26), formed the cornerstone of the finance structure. Eichengreen and Flandreau note that as a result, “each country’s money supply was linked to its gold reserves, and balance-of-payments adjustment was accomplished by international shipments of precious metal” (1997, 2). Even so, they also note that reality was more complicated, and the operation of the gold standard required a considerable amount of direct management by monetary authorities:

[t]he experience of industrial economies was more satisfactory than that of countries specializing in the production of primary products [, and] international creditors had happier experiences than debtors. The gold standard did not prevent the international transmission of financial crises (...). Discretionary actions

52 Remember that developing sovereign debtors depend on foreign capital in order to bridge gaps in domestic investment, to cover their governments’ budget deficits, to service their debts, and to pay for imports. For a summary of these issues, see Easterly (2002) and Hönke and Lederer (2013).
by national authorities featured prominently in the gold standard’s operation in both normal periods and times of crisis. (Eichengreen and Flandreau 1997, 2)

By using such “discretionary actions” as the control of interest rates, monetary authorities in creditor countries attempted to steer capital flows (represented by flows of gold or gold-based currencies such as the British pound sterling), counter strong movements in their balance-of-payments, and protect the level of their domestic bullion reserves in order to ensure the convertibility of their currencies (Bordo and Rockoff 1999, 318; Eichengreen 1987, 10; 1996, 30; 1997b, 145; Franco 1988, 3). This practice of policy interventions shows that although the finance structure of the international economy also shaped the agency of creditor countries, their structural power, or their ability to shape the arrangements or institutions under which other actors have to operate (Strange 1987, 565), gave them more policy-space or autonomy, as they could “shift” the costs of adjustment to other states.53 For instance, at least until the First World War, Great Britain had the advantage of being the main banking center in the world, the jurisdiction where most developing countries held their international reserves, and it benefited from capital inflows even when facing significant trade deficits (Eichengreen 1997, 146). The United States occupies a similar position today (Helleiner 2009, 75; Jackson 2015; James 2009, 25; Marte 2015; Norrlof 2009).

In comparison, the position of developing sovereign debtors was (and is) much more limited and illustrates the power differential between debtor and creditor countries. When British authorities increased the discount rate, domestic investment opportunities in Britain became more attractive in comparison with riskier government bonds and investment opportunities elsewhere. Central banks in other creditor countries could have felt pressured to follow suit in an attempt to discourage gold outflows from their own economies. As the rates charged from other sovereign borrowers were based on the prime rates in Great Britain (Eichengreen 1987, 7, 9, 10, 13; 1996, 31), a rise in Britain would cascade down to other countries, resulting in increased borrowing costs across the board to debtors.

53 For a summary of the concept, see Cohen (2006).
such as Brazil, regardless of the behavior of their policy-makers and the macroeconomic fundamentals of their economies. We can observe a similar dynamic in the interwar years, when the center of the international economy shifted from Great Britain and Europe more generally to the United States.

The institutions that made up the finance structure of the international economy had changed considerably by the time of the Brazilian Financing Program for 1983. The most important changes were the end of the gold standard, the creation of international organizations such as the IMF, the preponderant international role attributed to the U.S. dollar by the Bretton Woods system, and the consolidation of the privileged position of the United States as the main financial center in the international economy (Eichengreen 1996, 97–9; Gilbert 1997, 210; Helleiner 1994, 5, 8, 13; Resende 1982, 44; Strange 1987). The Bretton Woods system itself had also changed during the 1970s. While it was originally characterized by the prevalence of fixed exchange rates pegged to the U.S. dollar and by the extensive use of capital controls (Eichengreen 1997a, 224), a number of structural and geopolitical disruptions in the 1960s and 1970s undermined the institutional underpinnings of the system. As a result, the convertibility of the U.S. dollar to gold was suspended by the Nixon administration in 1971 and officially ended in 1973, while fixed exchange rates were abandoned in 1973 by a number of European countries in favor of a regime of floating rates.

In summary, the finance structure of the international economy during the 1970s and early 1980s was marked by the resumption of free movements of capital, fueled by the rise of the Eurodollar markets and the surpluses accumulated by the oil-producing countries after the first oil shock in 1973.

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54 The dollar was in turn pegged to gold at the value of 35 dollars per ounce (Eichengreen 1996, 129; Gilbert 1997, 210).
55 For a summary, see Eichengreen (1996), Frieden (2006), and The Economist (1979f, 1979i).
56 See Helleiner (2010, 625). For a contemporaneous account, see The Economist (1979f, 1979i). In the same year, the Second Amendment to the Articles of Agreement of the IMF “legalized floating and eliminated the special role of gold in the international economy” (Eichengreen 1996, 141).
57 See Helleiner (2010, 626). The term “Eurodollar” and “Euromarkets” refer to the development of “offshore” credit markets in London and other jurisdictions, which allowed deposits, transactions, and lending in currencies other than the national currency of the country where the deposits were located. A sovereign debtor could thus borrow in U.S. dollars or Deutsch Marks in Great Britain or Luxembourg. See Lipson (1981). For contemporaneous accounts, see The Economist (1979g, 1980f).
The surpluses were invested with European and American banks, which lent these so-called Petrodollars to non-oil-producing countries in the periphery of the system, generating the pattern of “capital recycling” that marked the decade (Boughton 2001, 269; Economist 1980g; Frieden 2006, 370).

Moreover, despite the challenges it faced, the United States retained its structural power in the international economy throughout the period. The political control over the currency internationally used as both unit of exchange and reserve of value provided U.S. policy-makers with a broader set of options than those available to policy-makers in other countries (Cohen 2006, 45). Their policy decisions and actions, and the subsequent reactions of private creditors, could increase the scarcity of capital despite its absolute availability in the system and regardless of the behavior of the debtors (Borensztein and Panizza 2009, 694, 699). Contrary to what is assumed in the literature, particularly by iteration and reputation-based explanations to the cooperation puzzle, sovereign debtors can be de facto excluded from the markets due to an increase in borrowing costs or “sudden stops” in lending triggered by changes in the monetary policy of the United States and other creditor countries.

The relative scarcity of capital in all three periods was also compounded by the operation of the production structure of the international economy. International trade was (and still is) important for many sovereign debtors as an alternative source of the foreign currency they need to repay their debts. However, it is subject to what de Alejandro calls the “commodity lottery”, a combination of factors including the resource endowments of a country, the international demand for commodities and their prices, and how specialized they are in the production of certain export products (de Alejandro 1984, 20; 1985, 181).

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58 Besides impacting the relative scarcity of capital at the international level by, for instance, raising their own domestic base interest rates, they could also shape the content of institutions and norms. The U.S. consciously adopted pro-market policies, including the liberalization of capital flows and the adoption of convertible currencies, while pressuring allies to do the same. See Helleiner (2010, 627). According to Strange, this was part of a “broader US postwar strategy of creating a more open, liberal world market economy that that of the post-depression 1930s (1990, 263–4).

59 Creditors attempt to anticipate market movements in order to make a profit or avoid losses, and therefore can be indiscriminating in the shutoff of credit (Borensztein and Panizza 2009, 690, 699; Bulow and Rogoff 1989a, 158; Cline 1995, 99; Easterly 2001, 6; Eichengreen and Lindert 1989, 5; Lindert and Morton 1989, 232, 233; Saiegh 2005, 378). These sudden stops may cause the very crisis creditors fear (Aggarwal 1989, 140; Borensztein and Panizza 2009, 693; Eichengreen 2002, 21–2, 55, 114; Jorgensen and Sachs 1989, 58; Vaugirard 2005, 94).
Bértola and Williamson 2006, 22). Research on the “terms of trade” affecting developing countries (Easterly 2002; Ocampo and Parra-Lancourt 2010, 12–16) support De Alejandro’s point by suggesting that international prices for commodities, particularly for tropical agricultural commodities, historically followed distinct trajectories from those of manufactured goods and fuel commodities. Ocampo and Parra-Lancourt (2010) identify a long-term decline in the average terms of trade for commodities in general and, especially, in the terms of trade for tropical agricultural commodities during the twentieth century. Prices also showed increased volatility, even during periods in which they rose in average (Ocampo and Parra-Lancourt 2010, 19). Cashin and McDermott also show that price amplitude increased after 1899 (2002, 193), while the frequency of large price movements increased after 1970 (2002, 193).

The term “lottery” implies automaticity, but De Alejandro’s definition does not preclude the possibility that social arrangements at the international level can impact the demand and prices for commodities. The policies adopted by creditor countries have an impact on prices, while sovereign debtors have little to no input over such processes (Cashin and McDermott 2002; Easterly 2002). For example, British and U.S. monetary policy during the gold standard had a “pro-cyclical” effect, attracting gold from the world and increasing its relative scarcity during global declines in the business cycle (Eichengreen 1996, 39; Friedman and Schwartz 1963, 106–7). Changes in discount or interest rates impacted international trade by cooling down domestic economic activity in the main consumer markets for the commodities exported by developing sovereign debtors such as Brazil. In addition, lower demand for commodities and lower international prices made them less attractive as an asset class for foreign

60 The concept can be defined as the ratio of export to import prices for a given economy. The term is controversial. Some authors minimize the problem posed by the deteriorating terms of trade to agricultural producers in Latin America. Bértola and Williamson argue that the terms of trade improved and almost doubled between the 1820s and the 1890s (2006, 33) but acknowledge that the prices of commodities fell in relation to those of manufactured goods after 1895 (2006, 42). Glade adds that the terms of trade for primary products improved in the early 1900s (1989, 8). Not surprisingly, the deterioration in the terms of trade for developing countries, which are usually exporters of agricultural commodities and importers of manufactured goods, has been a major theme in the works of the Dependencia school. See Santos (1996) and Bresser-Pereira (2006).
investors, further dampening the flow of foreign capital from creditor countries to the commodity producers (Eichengreen 1996, 39). A similar pattern can be seen during the Bretton Woods system.\footnote{Kaminsky, Reinhart and Végh argue that capital flows to developing countries tend to increase as a share of GDP in “good” times and to decrease in “bad” times (2004, 31). They define capital flows as pro-cyclical when “[t]he economy borrows from abroad in good times (i.e., capital flows in) and lends/repays in bad times (i.e., capital flows out). (...) [The] definition (...) focuses on whether capital flows tend to reinforce or stabilize the business cycle” (Kaminsky et al. 2004, 14).}

By pointing to the social arrangements that shape the international economy, Strange’s conception of structure avoids the automatism and voluntarism that traditional perspectives attribute to the operation of the international economy. Moreover, her structural theory provides a clear starting point for the study of how power relations mold the structures of the international economy and interfere with the distribution of costs and gains without the problems introduced by hierarchical accounts such as Lake’s (2009). I agree that the prevalence of power and power relations in the international economy challenges the traditional definition of anarchy in the literature and in the discipline of IR, suggesting instead the existence of a hierarchical structure at the international level, but Lake’s account exaggerates the extent to which the current hegemonic power, the United States, has control over many of the actors in the international economy. Although its immense structural power provides a number of benefits and expands the range of options available to its policy-makers, it cannot completely shield the United States from the operation of the structure of the international economy. Lake’s contractual-functionalist take on hegemony is also problematic as it is based on a two-way relationship between the hegemon and the subject states that is dependent on the acceptance, by the latter, of the former’s privileged position due to the “services” it provides to the international community, including the stabilization of the international economy and the policing of the international system (Lake 2009, 3). The characteristics of structural power, which I analyze in more detail in section 2.4.3, and particularly the fact that it can be employed unconsciously by its wielder, challenge this idea of an implicit “social contract” setting up the basis for the hegemony of the United States.
In contrast to Lake’s, Strange’s conception of structure allows us to see more clearly the social arrangements that constitute the structures of the international economy, and to move past the dichotomous functional separation between the domestic and the international spheres. It highlights the hybrid nature of the international economy, which includes elements common to both anarchic and hierarchic systems and multiple and competing centers of power. State and non-state actors alike can wield structural power depending on the issue and issue-area in question. In fact, this can be true even of domestic environments. The state is not always the final adjudicator of domestic disputes, and there may be competition between the authority and the rule-making powers of the state and non-state actors in finance and other areas.62

However, such a structural account begs the question of what role domestic political factors play in sovereign debt crises. Most hypotheses in the literature treat sovereign debtors as unitary actors, avoiding opening the “black box” of the state. I agree that this may be unsatisfactory. At a very basic level, all decisions to default or repay are the result of a domestic political decision, and we can understand Sturzenegger and Zettelmeyer’s argument that inability and unwillingness to pay can be considered as two sides of the same coin (2006, 38) in this narrow sense. However, domestic-politics explanations tend to over-emphasize the causal relationship between the particular interests of individuals, groups, and political parties, or the formal configuration of political institutions in a country, and decisions to either repay or default. They suffer in general from three main shortcomings.

First, their models ignore the asymmetry in power that separates creditor from debtor countries. Domestic institutions or interest groups are less relevant in explaining economic policy-making towards external debt when we consider the lack of structural power of developing sovereign debtors. I will return to this issue in section 2.4.3, but no amount of agitation or pressure by one domestic group or another may be enough to change policies when the markets are closed, the

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international economy is in crisis, and debtors have no foreign currency to keep their commitments to their creditors.

Second, and relatedly, it is unrealistic to assume that during a crisis debtors can derive more utility from defaults than from repayment. It may be impossible in practice to calculate the potential costs and benefits of each decision, and both can be equally costly. Decisions to restructure or to default may be imposed on the debtors by the circumstances, even when they are unwilling to do it.

Third, domestic-politics explanations tend to rely on models designed to account for the behavior of interest groups in liberal pluralist societies and their influence over formal political institutions whose operation is presupposed, in a circular manner, on the activity of those very groups, but Lindblom reminds us that “no straightforward relation holds between what citizens want and the policies they get” (1980, 62). This “fuzzy” connection between interest groups, policy-making, and policy outcomes holds true not only in pluralist, democratic, political systems but also in less democratic ones. Even if we admit that certain actors may have a disproportional influence over policy-makers (Lindblom 1980, 74), the policy-making process is still subject to a number of complexities, such as overlapping authorities, conflicts between different bureaucracies, incomplete specification of the policies to be pursued, ignorance of the concrete measures to be taken pursuant to the policies determined from “above”, ignorance of the preferences of one’s constituency, and even practical difficulties in setting up any policy agenda (Lindblom 1980, 58, 65, 67, 86). In fact, domestic-politics explanations cannot properly account for the empirical finding that different sovereign debtors with different configurations of political regimes and socio-economic institutions have faced debt crises in similar periods, as for instance during the Great Depression or the early 1980s.²⁴

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²³ These models tend to predominate in the disciplines of Political Science, Economics, and IR as practiced in the United States. See Mansbridge (1990), Geddes (1995), Ole Waever (1998), and Azari and Smith (2012) for critiques of their influence in Political Science and IR.

²⁴ The 1980s witnessed defaults by debtors as diverse in terms of political and social-economic institutions as Angola, Argentina, Brazil, Chile, the Dominican Republic, Egypt, Jordan, Mexico, Nigeria, Pakistan, the Philippines, Poland, South Africa, Uganda, Vietnam, and Yugoslavia.
The three case studies I analyze in the following chapters offer a compelling example. Brazil renegotiated its debts with foreign creditors during the 1890s, when it was organized as a classic liberal republic with very limited franchise and almost no formal political participation by popular groups. It defaulted and renegotiated its debts repeatedly during the 1930s, when in the space of a few years it moved from a revolutionary regime with support from the armed forces, popular elements, the middle class, and some oligarchic groups, to a personalist dictatorship molded on European fascist regimes. Finally, it attempted to renegotiate its debts and eventually announced a moratorium during the early 1980s, in the middle of a delicate transition from a military regime to a civilian democratic government.

In summary, external structural factors can better explain moratoria, debt restructurings, and even defaults by debtor countries. The relative scarcity of capital, capital flows, and their impact on the Brazilian capital account and foreign exchange reserves were the main mechanisms by which the finance structure of the international economy affected the Brazilian economy and shaped the policies available to Brazilian policy-makers. In all three case studies that follow, Brazil was particularly vulnerable to higher borrowing costs, to diminished capital inflows, and to increased capital outflows stemming from defaults by other debtors or from changes in the monetary policies of creditor countries. Lower terms of trade, lower commodity export prices (until the mid-twentieth century, coffee prices were particularly important for the Brazilian balance of trade), and trade imbalances (as caused by higher oil prices in the 1970s and early 1980s) were the main mechanisms by which the production structure of the international economy negatively affected the Brazilian current account and balance of payments.

Finally, the finance and production structures of the international economy also play a role in the process of cooperation between creditors and debtors. Creditors are more willing to accept a renegotiation of debt contracts when they can connect the payment difficulties of a debtor to negative states of the international economy. Naturally, whether such justifications will be accepted depends on the views that the creditors hold about the international economy and the ability of a debtor to repay,
but these can be influenced by financial intermediaries and experts. I further explain this point in the following section.

2.4.2) Cooperation

As I discussed above, the literature usually associates the concept of cooperation with the preservation or enforcement of the original contractual terms of loan agreements, but the empirical record calls for a rethink of this predominant view in the literature. The work of liberal institutionalist scholars in IR provides a good starting point.

In this tradition, Keohane (1984, 51–52) and Oye (1986, 6–7) argue that cooperation is better understood as a process of policy coordination or behavior adjustment by two or more actors, falling between the two extremes of harmony, in which case no behavior or policy adjustment is needed, and discord or deadlock, in which case conflict is inevitable and no adjustment is possible. In the context of the sovereign debt market, cooperation between debtors and creditors can likewise be understood as a process of mutual adjustment falling between the two extremes of the preservation of the status quo ante with full compliance by the debtor and no loss to the creditors, and debt repudiation with the loss of the whole investment, along with both transaction and opportunity costs, by the creditors.

Cooperation may result in different outcomes falling between the poles of harmony and discord. It is not an outcome of the interactions between creditors and debtors per se, but a process of mutual adjustment that may result in an outcome which is actually different from the original conditions of loan contracts. As Ostrom notes, “[a] substantial gap exists between the theoretical prediction that self-interested individuals will have extreme difficulty in coordinating collective action and the reality that such cooperative behavior is widespread” (2000, 138). For this reason, creditors have historically been more willing to accept a departure from the original terms of debt contracts if the debtor state could demonstrate in good faith its inability to repay and that it aimed at limited changes during the
negotiations (Aggarwal 1989, 165; Borchard 1951, 119–120, 230; Buchheit 2005, 340; Eichengreen and
Portes 1989, 18). Borchard makes a similar point when discussing the legal nature of defaults:

[a] distinction has to be made as to the nature of the default. Only acts which purport to wipe out the
obligation permanently and in its entirety, such as repudiation or cancellation, may be classified as
confiscatory and contrary to international law... The situation, however, is different if the debtor state,
without repudiating its debt, temporarily suspends the service payments or in some other way defaults on
its obligations. (1951, 119–120)

There are many historical examples. Suter and Stamm argue, for instance, that debt
reschedulings and restructurings were common during the nineteenth and the first three decades of the
twentieth centuries, resulting in substantial debt relief for the debtors (1992, 668). Their finding is
supported by Aggarwal (1989, 166, 169), Eichengreen and Portes (1989, 17–18), Fishlow (1989, 87), and
Porzecanski (2003, 20). Processes of debt restructuring may even have guaranteed positive returns on
average to the creditors (Eichengreen and Portes 1986, 629–631; Jorgensen and Sachs 1989, 73; Lindert
show that creditor countries' governments encouraged renegotiations between banks and their debtors
in a very active way during the debt crises of the 1980s and 1990s.

My view of the concept of cooperation leaves two related questions open for a future analysis.
The first is about the nature of the rationality of creditors and debtors (and their policy-makers). A
growing corpus of research has been challenging the traditional view of instrumental rationality which
predominates in the literature, and its auxiliary assumptions of consistent preferences, full information,
and revealed preferences.65 Actors may be constrained in their ability to act as maximizers due to
“[cognitive] limitations of both knowledge and computational capacity” (Odell 2002, 170). Simon
describes the concept of “bounded rationality” in more detail:

[it] describes a person who is limited in computational capacity, and who searches very selectively
through large reams of possibilities in order to discover what alternatives of action are available, and

and Kahneman (1986).
what the consequences of each of these alternatives are. The search is incomplete, often inadequate, based on uncertain information and partial ignorance, and usually terminated with the discovery of satisfactory, not optimal, courses of action. (1985, 295)

This does not mean that actors are irrational, but that “[r]ather than consider all conceivable alternative courses of action, [they conduct] a limited search for a few alternative courses, often following standard operating procedures or incremental adaptation, [making] use of subjective beliefs, social norms, and cognitive shortcuts” (Odell 2002, 170). In the context of the international sovereign debt market, bounded rationality lends a much less calculated character to defaults. As policy-makers may have a hard time calculating or predicting the consequences of a default vis-à-vis those of repayment, they are much more cautious when making such crucial decisions. Policy-makers are thus prone to “satisficing” behavior (Odell 2002, 174). They will generally attempt to “muddle through” a crisis, whether because they are unable to decide among different alternative policy options (Blyth 2007; Lindblom 1980) or because they hope that by increasing the bet on past policies they will be able to stay afloat long enough for the crisis to resolve itself.

Although I will not attempt to answer this question in this dissertation, its implications for the study of the sovereign debt problématique and the literature are very interesting. If we consider the principle of bounded rationality as an empirically accurate description of the rational faculty of creditors and debtors, the definition of cooperation as a process of compromise and policy adjustment can also be understood as rational, albeit not necessarily in the narrow sense attributable to the assumption of instrumental rationality. In this sense, cooperation and reciprocity can be understood as guiding satisficing behavior on the part of creditors and debtors. My hypothesis is thus agnostic on whether or not cooperation depends on the internalization of certain norms by actors. While Ostrom argues that “[s]ome [players] bring with them a set of norms and values that can support cooperation” (2000, 146), cooperation can also be a rational response based on a strategy of “tit-for-tat”, guiding cooperative behavior on a quid pro quo basis.
Moreover, if all actors are challenged by their cognitive limitation, then crucial elements related to the finance and the production structures of the international economy, such as fluctuations in borrowing costs and commodity prices, reversals in capital flows, and “sudden stops” in the availability of financing may also be explained by the limited cognitive capability of creditors, policy-makers, and consumers in creditor countries. According to Odell, “observers of financial markets have often noted herd behavior, suggesting that decision makers’ judgments and preferences can be changed by influences other than market fundamentals” (2002, 176). This reinforces my claim that the relative scarcity of capital results from more than the mere operation of the price mechanism and the laws of supply and demand in the capital markets.

The second question my approach leaves open is whether the outcome of cooperation is Pareto-optimal. The institutionalist definition implies that the cooperating parties receive gains or rewards when negotiating (Milner 1992, 468), but cooperation, understood as a process of adjustment, does not preclude the possibility that the gains will be unequally distributed. As Milner notes, cooperation can even be “negotiated in an explicit bargaining process” (1992, 469). Whether that is empirically the case will depend on the context of the debt renegotiations and even on the level of analysis we choose to examine them. For instance, if we treat creditors as a class, the outcome of a renegotiation may in fact be considered Pareto-optimal, but these processes tend to favor professional investors who have deeper pockets, longer time horizons, and better organizational capacity, to the detriment of small, individual, investors.

One of the advantages of my approach is that it can account for the existence of power relations in the sovereign debt market and their effects on the outcomes of the renegotiation between creditors and debtors. On the other hand, it also has the advantage of not overplaying the power card by

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66 The literature on financial crises and investment “manias” supports Odell, showing how the bounded rationality of investors, bankers, and policy-makers may contribute to the volatility of business cycles. For examples, see Kindleberger (1996) and Chancellor (1999).

67 Historical accounts of past speculative bubbles and financial crises provide numerous examples of how small investors tend to be disproportionately affected by these events. See for instance Blustein (2005), Chancellor (1999), Galbraith (1997), and Kindleberger (1996).
assuming *a priori* that any strategic interaction between creditors and debtors will necessarily result in an outcome in which the creditors are (or should be) the only “winners”, as the traditional “enforcement” approaches to cooperation in the literature tend to do. I agree with Milner when she notes that “[t]he more asymmetric the power relationship, the more unequal the distribution of gains is likely to be. But it does not follow that the asymmetries of gains will always favor the stronger state” (1992, 470 - original italics). Any answer to the proverbial question “cui bono?” will always depend on the analysis of historical cases of cooperation.

Finally, it is important to note, debtors and creditors may defer to the knowledge of financial intermediaries and experts to mediate their relationship during debt crises and renegotiations. Through a strategy of framing, these intermediaries may help determine the parameters of the negotiations, as for instance whether debtors are acting in good faith, whether they are justified in seeking a debt readjustment in view of the state of the world economy, and so on. In this sense, the alleged possession of technical know-how is an important power resource that financial experts can wield over both creditors and debtors. I argue that the N.M. Rothschild & Sons banking house, the London-based financial agents and bankers to the Brazilian government played such a role in both the First and Third Brazilian Funding Loans. The IMF and other experts participated more indirectly in the negotiations between Brazil and its creditors during the Brazilian Financing Program for 1983. I will now turn to the issue of power, and how it is exercised, in the international economy.

2.4.3) Power

With the exception of coercion-based hypotheses, most explanations for the cooperation puzzle in the literature avoid explicit analyses of the concept of power or of its role in the international economy, even though the concept of cooperation is rooted in the very idea of creditors and creditor countries wielding their power to enforce debt contracts. Hence, whether explicitly or implicitly, the predominant view is that of power as a “direct” or “relational” force that creditors can wield to make
debtors repay their debts, or “do what they would not otherwise do”, in Dahl’s classic definition (1957, 202). An actor can employ direct power as the initiator of an action or in response to an action initiated by someone else, but in this limited, direct sense power is always used consciously over others, as noted by Barnett and Duvall (2005, 45), Guzzini (1993, 456), Helleiner (2006, 74), and Strange (1990, 270–271).

When applied to the context of the sovereign debt market, this traditional view of power is problematic for three reasons. First, it assumes that creditors will mostly employ their power *in reaction* to a prior action by the debtors, since employing power can be costly. This provides the basis for the logic of cooperation as enforcement, but also serves as a justification for the “benign” use of power as a “correction” to some wrongdoing by the debtors. As a result, it fails to recognize the possibility that creditors and creditor countries can also act preemptively, wielding power in anticipation of an action by the debtors. Second, it assumes that the power capabilities are fungible and easily transferable across different policy contexts. The problem is not solely a matter of efficiency, as when an actor attempts to transfer military power to an economic or market context, but that even the direct use of economic power may be costly and may backfire, whether because it might fail to cause the intended effects or because it could trigger the resistance of the target. Finally, the literature overlooks the important role that structural, indirect forms of power play in the international economy.

Strange defines structural power as “the power to choose and to shape the structures of the global political economy within which other states, their political institutions, their economic

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68 Baldwin (1979) has noted the same tendency in the broader discipline of political science. See Keohane and Nye (1987, 727–8; 2001, 10) and Nye (1990) for a detailed explanation of the problem with the assumption of the fungibility of power. Nye even coined the term “soft power” to describe new forms of power dissociated from military capabilities. However, for a classical defense of the inseparability of economic and military (or political) power, see Carr (Carr, 1939, 113–32).

69 For instance, this issue is at the forefront of debates about the effectiveness of sanctions. See Bayard, Pelzman, and Perez-Lopez (1983, 75), Elliott (1998), Morgan and Schwebach (1997), and Pape (1997).

Two characteristics of structural power are thus relevant to my argument in this dissertation.

First, an actor can wield power over others indirectly through the creation, transformation, operation, or reproduction of these structures (Strange 1990, 266). In the context of the sovereign debt problématique, structural power is represented by the capacity that creditors and policy-makers in creditor countries have to “extend or restrict the range of options open to others” (Strange 1990, 259) by shaping and influencing the institutions that comprise the finance and production structures of the international economy. For instance, they wield structural power when they restrict the ability of a debtor to access credit denominated in foreign currencies, along with the costs thereof (Strange 1987, 568; 1990, 260–1). They can also wield power by “deflecting” the costs of adjustment related to economic policies to other actors (Andrews 2006, 16; Cohen 2006, 46). Commenting on the end of the Bretton Woods system in the 1970s, Strange noted that:

Indeed, to run a persistent deficit for a quarter of a century with impunity indicates not American weakness, but rather American power in the system. To decide one August morning that dollars can no longer be converted into gold was a progression from exorbitant privilege to super-exorbitant privilege; the U.S. government was exercising the unconstrained right to print money that others could not (save at unacceptable cost) refuse to accept in payment. (Strange 1987, 569)

Creditor countries can also wield their structural power “unintentionally” or, in other words, without aiming at producing effects over others. As I mentioned in section 2.3.2, during the gold standard Great Britain and other creditor countries attempted to counter gold outflows and protect the convertibility of their currencies by changing their domestic interest rates. Their “discretionary actions” (Eichengreen and Flandreau 1997, 2) reverberated through the international economy and affected the

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71 Strange stops short of providing a detailed taxonomy of forms of structural power, but her definition is broad enough to incorporate three of the four different types Barnett and Duvall present in their paper (2005): institutional power, which they define as “the control actors exercise indirectly over others through diffuse relations of interaction” (2005, 43); structural power proper, which they define as “the constitution of subjects’ capacities in direct structural relation to one another” (2005, 43); and productive power, which they define as “the socially diffuse production of subjectivity in systems of meaning and signification” (2005, 43). For the sake of simplicity, I use the general term “structural power” to refer to all three types identified by Barnett and Duvall.
relative scarcity of capital even when their immediate goal was to tackle a domestic problem. After the Second World War, the creation of the Bretton Woods system enshrined the U.S. dollar at the center of the international economy, reinforcing the structural power of the United States to a similar effect:

America has the ability to control the supply and availability of credit denominated in dollars, and thus to exert predominant influence for good or ill over the creation of credit in the world’s monetary system. (...) [T]he United States is the only government capable of creating dollar assets that are accepted and saleable worldwide. (Strange 1987, 568)

The second important characteristic of structural power is that it can be exercised through claims of expertise and know-how. The possession of technical know-how in financial or economic matters is an important power resource at the disposal of certain actors, providing them with legitimacy and authority. As Barnett and Finnemore argue, this “legal-rational” authority gives experts and bureaucrats “power over politicians due to their specialized technical knowledge, training, and experience that is not immediately available [to the former]” (1999, 708). Borrowing from Blyth, we can say that structural power is wielded by experts when they deploy “‘causal stories’ about the economy that provide (...) an interpretive framework within which they can define, diagnose, and explain a crisis as an event which necessitates a particular set of actions” (2007, 762). These causal stories allow financial experts and intermediaries to exercise their structural power through a strategy known as “framing”. According to Dow, framing refers to “[t]he way in which meaning is attached to concepts and terms, in which the objects of study’s frames are represented, and in which questions are posed and answered” (2008, 14). In other words, it refers to the way in which something is presented and thus perceived” (2008, 14). Entman defines framing more specifically: “[selecting] some aspects of a

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72 In fact, it is possible that British and other national authorities did not even consider the impact that their policies could have for the economies of less developed countries.
73 I depart from Strange’s use of knowledge in her work, especially in relation to the Knowledge structure she identifies in States and Markets (1988).
74 Sinclair provides an example in his study of the authority of credit rating agencies in capital markets: “[m]arket actors are overwhelmed with data (...). A typical form of knowledge output is some sort of recommendation, ranking, or rating, which ostensibly condenses these forms of knowledge. This knowledge output becomes a benchmark around which market players subsequently organize their affairs” (2005, 15). See also Blyth (2007; 2006), Dow (2008), Porter (2005), and McKeen-Edwards and Porter (2013).
perceived reality and [making] them more salient (...), in such a way as to promote a particular problem
definition, causal interpretation, moral evaluation, and/or treatment recommendation” (1993, 52).

In the context of the sovereign debt problématique, this strategy gains particular relevance
during processes of debt restructuring. Based on their perceived knowledge and expertise in financial
matters, financial experts and intermediaries can be enlisted to determine whether debtors are
negotiating in good faith (reciprocating, being truthful about their inability to pay, and so on), whether
they are justified in asking for a restructuring given the state of the international economy, or whether
they are adopting institutional reforms that can restore their economic prospects and ability to repay.75
In this way, they limit what debtors and creditors can or cannot do when negotiating, help creditors
differentiate between “states” of the international economy that may or may not justify a process of
debt restructuring, and may even help shape the reputations of the debtors in accordance with the
conceptions of reputation provided by Alfaro and Kanczuk (2005), Grossman and Van Huyck (1988), and
Levy (1997). Naturally, this is not to say that the role of financial intermediaries and experts is
uncontroversial or universally accepted. Quite the contrary, as the burgeoning literature on private rule-
making and international governance attests.76 Although framing can be a powerful strategy, it can also
be resisted and challenged (Dow 2008, 15). Even so, financial intermediaries can use frames to create
the basis for cooperation.77

The concept of structural power is not without problems.78 One possible criticism is that it is
vague and hard to operationalize in contrast to the conceptualization of power as “capabilities”, which
underlies the traditional understanding of relational power. This is certainly not helped by Strange’s

75 For analyses and critiques, see Best (2007), Mueller (2011), and Woods (1999). For a contemporary example, see
Birdsall at al (2010).
76 See Büthe (2010), Fuchs (2007), McKeen-Edwards and Porter (2013), Porter (2005), Sinclair (2005), and Underhill
and Zhang (2008).
77 Financial intermediaries and experts provide more than an objective assessment of the situation, and they do
not promote cooperation out of their own altruistic tendencies. However, even if they act out of their own self-
interested to serve as an arbiter between creditors and debtors, the end result may still be conducive to
cooperation.
78 See Guzzini (1993) and Ward (1987) for in-depth analyses of the advantages and disadvantages of the concept.
See also the edited volume by Lawton, Rosenau, and Verdun (2000), especially chapters 1 through 7.
theoretically thin definition of structural power. Yet another problem is the possible conflation of the structural and the agent levels of analysis involved in the concept. Who wields power? What is the role of structure in this process? Finally, it can be said that structural power, as the concept of structure itself, is too rigid, not only excluding agency (and, consequently, the possibility of resistance) from the analysis of social phenomena but also obscuring how power is exercised at the “micro” or interpersonal level.

Still, I argue that structural power is a very useful concept for the analysis of the international economy. It is not less vague or contested than other concepts in the social sciences, including that of power itself. Moreover, as I show in the following chapters, we can clearly distinguish the agents who wield it and the structures that are constituted or reproduced by it. Finally, as I also show later, the proper conceptualization of structural power does not preclude the possibility of resistance by those that are subject to its employment, although how effective it can be, and what it means in practical terms, will depend on the concrete case.

In summary, power is important in the international economy and the sovereign debt market, but not only when explicitly employed by creditors to coerce debtors and enforce the original terms of debt contracts. Indirect and structural forms of power are crucial because they restrict the options that are available to policy-makers in sovereign debtors and affect the debtors’ economy via the operation of crisis-transmitting mechanisms such as capital flows and shifts in international trade patterns. In this sense, power may even be more important in the build-up to crises then during their resolution.

2.5) Validity Conditions for My Hypothesis

Based on my hypothesis, we have as a general rule that the scarcer capital becomes internationally due to disruptions in the finance and production structures of the international economy, the stronger the pressure will be on the debtor to attempt to renegotiate the status quo, but this does not say much about the possibilities of cooperation between creditors and debtors. In other
words, between the two extremes of harmony and conflict, the range of possibilities is potentially very large.

We can refine this rule slightly to say that the scarcer capital is internationally, either due to the closing of the international sovereign debt market or to a contraction in international trade, and the more transparent policy-makers in sovereign debtors are about their problems when they approach their debtors, the farther from the discord pole the final outcome of the negotiations will be. On the other hand, the less transparent those efforts are, or the less scarce capital is internationally, the closer to discord the final outcome will be. Finance experts and bankers may also help to shift the balance in either direction by using their power in support of debtors or creditors. For instance, they may help determine what conditions at the international level warrant a debt restructuring, they may frame and define which debtor policies or behavior are to be considered to be in “good faith” in relation to its creditors, or may even lend their prestige to a debtor by endorsing a renegotiation or its positions.

We can assess the internal coherence and theoretical consistency of my hypothesis by checking for two main conditions when evaluating my three case studies in the following chapters. First, none of the independent variables employed by the different explanatory hypotheses in the literature should be able to offer a better and empirically tested explanation for the cooperation between Brazil and its creditors. Second, my case studies must be real examples of policy adjustment, resulting in or at least aiming at outcomes that are different from the status quo ante. This condition should not be necessarily invalidated by failures, provided that the breakdown in negotiations followed demonstrable attempts by both sides at a compromise.

As I will show, the two conditions are met by my three case studies, even though the negotiations behind the Brazilian Financing Program for 1983 did eventually break down and failed to wield a substantial compromise.
Chapter Three: The Funding Loan of 1898

3.1) Introduction

The Funding Loan of 1898 (also known as the First Funding Loan or the First Funding), was negotiated by Brazil and the Rothschild banking house during the administration of President Prudente José de Morais Barros (1894-1898) against the backdrop of an international economic depression (also known as the “Depression of the Nineties”) that followed the financial and banking crisis of 1893 in the United States. Although it is usually described as a loan, the First Funding was in fact a broader restructuring agreement, suspending amortization payments for a number of years and swapping interest payments for new debt. 79

Based on the assumptions in the literature on sovereign debt, we could infer that President Barros and his Ministry chose to restructure the country’s foreign debts because they were unwilling to bear the political and economic costs of repayment, and that they were eventually forced back into cooperating (or repaying) by their creditors (or by the governments of creditor countries). However, as I argued in the previous chapter, that view is historically inaccurate. An analysis of the primary and secondary sources on the First Funding shows that the finance and production structures of the international economy impacted the relative scarcity of capital at the international economy in the period under analysis and limited the ability of the Barros administration to acquire the funds it needed to keep repaying the country’s debts. Similarly to other developing sovereign debtors, Brazil borrowed abroad in gold and other hard currencies convertible into gold, such as the British pound, and depended on capital flows, borrowing, and trading for the funding of its many financing needs. Both the finance and the production structures impacted these activities in negative ways, as I will show below. The sources support my hypothesis that sovereign debtors default or restructure their debts when they are

79 Brazilian historians and economists have traditionally used the term “Funding Loan” to refer to the agreement, although contemporaries sometimes called it a “funding scheme”, a term that better reflects its broader scope. In order to avoid contradictions, I will defer to the established usage throughout the dissertation. I will analyze the terms of the First Funding in more detail in section 3.4.
unable to pay due to structural factors at the international level, and not because they are opportunistic, unwilling to pay, and prone to default.

Moreover, considering the primary sources and the composition of political forces during the first decade of the Republic, we can also see that domestic political factors did not play a significant role during the negotiations behind the Funding Loan, challenging the strong claims of domestic-politics explanations for the cooperation puzzle. The last decade of the nineteenth century, the first in the life of the Republic, was marked by tensions among political elites from different Brazilian states and by serious clashes between the civilian republicans and radical members of the military, who saw themselves as the protectors of Republican virtues against the corruption of civilian politicians. The different groups jousting for power posed a threat to the survival of the Barros administration and made the decision-making climate more difficult, but were too fragmented to effectively lobby or push for any specific policies regarding the country’s international debt.

The analysis of the primary sources also supports my hypothesis that cooperation in the international sovereign debt market involves compromises and policy adjustments by both creditors and debtors. Contrary to the view of cooperation that prevails in the literature, the First Funding shows that the Barros administration managed to extract concessions from its international creditors with the intermediation of the Rothschild bankers, and that the agreement did not depart significantly from the terms of existing Brazilian debt obligations. Brazilian policy-makers were clearly willing to maintain good relations with foreign creditors and never considered a full repudiation of the foreign debt. In other words, more than an opportunistic strategy, the First Funding can be explained by the fact that the Barros administration lacked the gold it needed to fulfill its payment commitments due to the acute relative scarcity of capital that followed in the wake of the Depression of the Nineties.

This chapter will proceed as follows. In section 3.2 I discuss the impact of the finance and production structures of the international economy and the mechanisms through which they affected the Brazilian economy during the first decade of the Republic, with particular emphasis on shifts in
international coffee prices and the operation of the gold standard. In section 3.3 I offer an analysis of the Brazilian domestic political context in the last decade of the nineteenth century. In section 3.4 I describe and analyze the negotiations held between Brazilian policy-makers and the Rothschild banking house, explaining why the First Funding is an example of cooperation and highlighting the structural power wielded by the bankers at the time. I finish the chapter in section 3.5 by explaining how, in light of the First Funding, my hypothesis fulfills the two validity conditions I raised in section 2.4.

3.2) The Finance and Production Structures in the Late 1890s: Capital Flows and International Commodity Prices

The institutions of the gold standard and the institutions of the international market for commodities constituted respectively the finance and production structures of the international economy in the context of the First Funding.

As I explained in chapter two, the gold standard was characterized by a set of persistent and connected institutions, norms, and rules that prescribed behavioral roles, constrained activity, and shaped expectations (Keohane 1988, 383) pertaining to the freedom of capital flows at the international level (Eichengreen 1996, 26) and the convertibility of national currencies into gold at fixed rates at the domestic level (Eichengreen 1996, 20, 26; Frieden 2006, 6). Monetary authorities in Great Britain, the United States, and other creditor countries frequently intervened in the regular operation of those institutions, manipulating the level of their domestic interest rates in an attempt to steer gold flows towards their economies and counter strong movements in their balance-of-payments (Bordo and Rockoff 1999, 318; Eichengreen 1987, 10; 1996, 30; 1997b, 145; Franco 1988, 3). Such actions usually resulted in an increase in the relative scarcity of capital at the international level, independently of the behavior or macroeconomic fundamentals of developing sovereign debtors. In the Brazilian case, this effect was made worse by the fact that Britain was the sole source of its foreign capital until the early
twentieth century (Abreu 2000, 386). Monetary policy in Great Britain also had a “pro-cyclical” effect, exacerbating the periods of economic contraction in the global economy by attracting gold from the world and increasing its relative scarcity during periods of decline in the business cycle (Eichengreen 1996, 39; Friedman and Schwartz 1963, 106–7). It could thus impact international trade by cooling down domestic economic activity in the main consumer markets for the commodities exported by Brazil and other developing sovereign debtors.

As Franco noted, the same policies designed to support the gold standard in Great Britain and other creditor countries promoted macroeconomic instability elsewhere (1988, 1, 7; 1990, 13), a connection that highlights their structural power and their position at the center of the system. Instead of allowing their monetary base (and their economies) to contract as a consequence of gold outflows, creditor countries could discourage such flows, deflecting the potential policy adjustments (the contraction of the monetary base) to less developed or less powerful countries in the periphery of the system. Tellingly, in contrast to their peers in Great Britain, policy-makers in Brazil had no effective options to mitigate the effects of the liquidity pull from the center at the time (Eichengreen 1987, 11; Furtado 1959, 184). Besides lacking the policy instruments to attract and retain capital in a system founded on the unimpeded mobility of capital, Brazilian policy-makers had few economic resources at their disposal due to the relative underdevelopment of the country’s domestic capital market. As

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80 Abreu estimates that the total stock of British investment in Brazil in 1895 (including both direct and portfolio investments) surpassed 78 million pounds (2000, 385).
81 See Flandreau and Zumer (2004, 17).
82 Even the small needs of plantation owners during the harvest season could “dry” the liquidity from the underdeveloped Brazilian banking system based mainly in the capital, Rio de Janeiro (Franco 1990, 16–17). The abolition of slavery in 1888 and the arrival of European immigrants increased the urban and rural salaried workforces, placing yet more strain on the banking system (Franco 1990, 22; Furtado 1959, 202; Villela and Suzigan 1973, 30). Although Imperial officials had acknowledged the existence of the problem (Pereira 1884, 62), they failed to implement any long-term solutions (Franco 1990, 18, 21). The new Republican leadership attempted to ameliorate the contractionary effects of the domestic scarcity of capital by issuing unconvertible paper currency, but instead of conferring the desired depth to the Brazilian financial markets, the quick and dramatic expansion of the monetary base inflated an asset bubble that burst during the final years of Marshal Floriano Vieira de Araújo Peixoto’s administration (1891-1893) (Franco 1990, 22–23; Furtado 1959, 203; Villela and Suzigan 1973, 33), leaving a problematic legacy for President Barros.
Minister Campos Jr. bluntly admitted, “a gold-based currency is not for those who want it, but for those who can have it” (1898, 9).

Although Brazil was not officially on the gold standard, it emulated some of the features of the gold-based system. Brazilian citizens or residents could convert the Brazilian currency to gold at a fixed rate of 27 pence per mil-réis, the currency “parity” set by the Monarchy in 1846, while the foreign exchange rate floated according to the movements in the market. The mismatches between the parity and the exchange rate offered speculators very profitable opportunities for arbitrage. For instance, foreign banks with branches in Brazil could buy the Brazilian currency at a depreciated market rate (for instance, at 7 pence), then convert the mil-réis to gold at the parity of 27 pence (thus getting the equivalent in gold to 27 pence, instead of the 7 they originally spent to bring their money to Brazil), and ship the gold out of the country. This process caused a hemorrhage of gold on top of the foreign exchange commitments that were already draining the Brazilian reserves (Fritsch 1988, 6). President Barros wrote to Minister Campos Jr. about those very problems in early 1897: “(...) as you know, our worst enemy is the really bad financial situation against which we fight (...). Today, the [exchange rate] fell even more and it may fall below 7 – [and that] will be very bad. It seems to me that there is a great deal of speculation to push the rate down – headed [by the banks]” (Barros 1897).

The capital outflows and the depreciation of the mil-réis also contributed to the persistent budget deficits of the federal government, compounding the problems experienced by the early Republican administrations. Figure 3.1 provides a glance at the fiscal situation in the decade prior to the First Funding Loan:

83 The pence (plural for penny), is a subdivision of the British currency, worth at the time 1/12 of a shilling (which was worth 1/20 of a pound). A mil-réis (notated as 1$000) was equivalent to a thousand réis, the Brazilian domestic currency. For all practical purposes, it was the most used denomination of the currency, since the réis were of too low a value for most economic transactions. A thousand mil-réis was called one conto de réis, or simply a conto (notated as 1:000$000).
84 See Eichengreen (Eichengreen 1996, 10–1) for an explanation of this type of arbitrage in the context of countries with bi-metallic systems (silver and gold).
It is true that the budget deficits were not new and can be attributed in part to the increased military expenditures incurred by the federal government throughout the decade (Alves 1896, 5; Campos 1897, 5). However, a breakdown of the expenditures per ministry shows a more complex picture:

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85 The Monarchy had a fiscal surplus in only eleven of its 67 years of existence (Schneider 1991, 54).

86 The heavy-handedness with which the first two republican administrations treated any opposition to their rule sparked a number of revolts and insurrections. A Navy revolt in 1893 culminated in the blockade of the port of Rio de Janeiro, the bombardment of the city, and a civil war in the Southern state of Rio Grande do Sul that lasted until the first years of the Barros presidency. The paranoia of radical members of the military and their witch-hunting also blew out of proportion a messianic religious movement in the hinterlands of the Northeastern state of Bahia, igniting a local popular revolt in 1896 that was suppressed a year later at a high cost to the Barros administration (Iglésias 1993, 212; Schneider 1991, 83).
Although the expenditures by the Ministries of War and the Navy increased between 1893 and 1895, those by the Ministry of Finance increased at an even higher pace, dwarfing all the other federal ministries in 1898. The increase can be traced to an account called “exchange rate differential”, which registered in the federal budget the impact of the exchange rate (and the devaluation of the mil-réis) on the price of gold (or gold-based foreign currencies) that the government had to buy in the open market whenever it had to make a remittance abroad. In his annual report to Congress, Minister Campos Jr. noted the problem:

(...) the evil influence [that] the relationship between the paper-currency and gold [has] over the budget is clear. The “exchange rate differential” fund, which we set at 10.000:000$000 a few years ago, was raised to 50.000:000$000 and later to 110.000:000$000 because it was insufficient (...). [We] suspend services, cut expenditures, increase the [government’s] revenue, but the windfall that comes from such policies (...) is not enough to balance [the budget], because the difference between our currency and gold, in which we make our international payments, increases at a higher rate than that in which we can increase the revenue. (1898, 9)

Brazilian policy-makers had to contend with such effects and the impact of the finance structure of the international economy right from the beginning of the Republic. Capital became scarcer in the aftermath of the debt repayment moratorium declared by Argentina in 1890, which almost caused the Baring Brothers banking house, its British financial agent and one of its main creditors, to fail. The bank was eventually saved by the combined efforts of the Bank of England and other major financial houses, but the sovereign debt market was affected by the liquidity crunch that followed (Fishlow 1989, 88; Mitchener and Weidenmier 2008, 467). Brazil was practically cut off from its traditional sources of financing (Fritsch 1988, 5; Triner and Wandschneider 2005, 201) due to the Argentine “contagion” effect. For example, *The Economist* wrote at the time that “this action of the Bank [Argentina’s National Bank] has raised anew great doubts as to its stability and its ability to get through the present difficulties without shipwreck. All other issues such as Uruguay, Brazilian, &c, have given way sympathetically” (1890, 869 - my italics). When market access was finally normalized, the borrowing costs charged by foreign creditors from Brazil remained higher than they were before the crisis, setting a new plateau of
borrowing costs for all Latin American countries (Mitchener and Weidenmier 2008, 467; Triner and Wandschneider 2005, 208).

Capital flows to Brazil once again decreased in volume after the economic depression that followed the 1893 financial crisis in the United States (Abreu 2000, 387, 392; Franco 1990, 14; Topik 2009, 365; Triner and Wandschneider 2005, 215). This crisis was triggered by a bank panic and a stock market crash that led to the failure of more than 800 banks, the bankruptcy of many firms, and widespread unemployment reaching, at its worst, 20% per cent of the American workforce (Friedman and Schwartz 1963, 108–109; Hoffmann 1956, 138, 158). As gold was siphoned back to Europe by the actions of monetary authorities in Great Britain and other European countries, and the economic instability propagated to less developed countries (Hoffmann 1956, 152), Brazilian policy-makers had to operate under a scenario of serious relative scarcity of capital. Although the Barros administration managed to secure a new foreign loan in 1895 (Alves 1896; Franco and Lago 2011, 17), by 1897 the repayment commitments in gold, on top of continued capital outflows and the efforts of the government to prop up the exchange rate, had almost depleted the Brazilian gold reserves (Fritsch 1988, 7). Those commitments were considerable. Abreu (2002, 517) estimates that in 1890 the foreign debt load of the Brazilian government amounted to more than 35 million British pounds, or the equivalent of 117% of the country’s exports, further reaching 173% of total exports by 1900 (2002, 518). Table 3.1 provides a sense of the vulnerability of the Brazilian financial position by showing the percentage of the federal debt payable in gold each year:
Table 3.1 – Percentage of public debt payable in gold

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1889</td>
<td>45</td>
<td>1894</td>
<td>84</td>
</tr>
<tr>
<td>1890</td>
<td>56</td>
<td>1895</td>
<td>83</td>
</tr>
<tr>
<td>1891</td>
<td>75</td>
<td>1896</td>
<td>83</td>
</tr>
<tr>
<td>1892</td>
<td>85</td>
<td>1897</td>
<td>83</td>
</tr>
<tr>
<td>1893</td>
<td>82</td>
<td>1898</td>
<td>75</td>
</tr>
</tbody>
</table>

Source: Flandreau and Zumer (2004, 112).87

Naturally, the entire Brazilian debt stock was not due on the same date.88 Debt service, hovering around 5% of exports and 10% of the revenue of the federal government between 1890 and 1900 (Abreu 2002, 518), could be manageable in normal times. However, debt management is considerably harder during a balance of payment crisis and dislocations in the international economy, as was the case in the aftermath of the Depression of the Nineties, especially if we consider that the percentage of the Brazilian debt stock payable directly in gold ranged from 70% to 80% of the total debt for most of the decade.

There are no reliable statistics for capital flows during the period, but the analysis of the Brazilian exchange rate offers a proxy for the impact of the relative scarcity of gold on the country’s balance of payments. Table 3.2 depicts the fast depreciation of the mil-réis during the first ten years of the Republic:

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87 Flandreau and Zumer do not specify whether the percentages refer to the debt owed by the federal government or to the total debt of the country. In view of the prominence of the federal government at the time, it is reasonable to assume that the percentages would not change significantly if the numbers referred only to the federal government. They also do not specify whether the percentages refer to domestic or foreign issued debt, nor the breakdown of the percentages in each case. Either way, it is reasonable to assume that a majority, if not the totality, of the foreign debt would be payable in gold or in hard currencies convertible to gold.

88 The so-called cross-default clauses can accelerate the maturity of other bonds issued by the same debtor in case of default on the conditions of any bond. The Funding Loan did not incorporate any cross-default clause and, to the extent of my knowledge, they were not common at the time.
With the problems in the finance structure, international trade became even more important as a way in which Brazil could acquire and accumulate the gold it needed for its financing needs, but it was also negatively impacted by the Depression of the Nineties. The demand for tropical commodities and other goods dropped in the United States, the main market for Brazilian coffee (Hoffmann 1956, 148; Netto 1979, 20), and international agricultural prices fell to their lowest level in over three decades (Hoffmann 1956, 153). The fall in coffee prices and the sheer weight of the product in the Brazilian balance of trade worked as a significant crisis transmission mechanism to the country’s economy.

Brazil occupied a niche in the international market as an exporter of tropical agricultural commodities, especially coffee, since the times of the Monarchy. Table 3.3 offers a comparison of the three main Brazilian export products according to their share of total exports during the nineteenth century:

Table 3.3 – Share (percentage) of total exports per type of export product, 1820s-1881

<table>
<thead>
<tr>
<th></th>
<th>1820s</th>
<th>1830s</th>
<th>1840s</th>
<th>1850s</th>
<th>1860s</th>
<th>1870s</th>
<th>1881</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coffee</td>
<td>18.4</td>
<td>43.8</td>
<td>41.4</td>
<td>48.8</td>
<td>45.5</td>
<td>56.6</td>
<td>61.5</td>
</tr>
<tr>
<td>Sugar</td>
<td>30.1</td>
<td>24.0</td>
<td>26.7</td>
<td>21.2</td>
<td>12.3</td>
<td>11.8</td>
<td>11.8</td>
</tr>
<tr>
<td>Cotton</td>
<td>20.6</td>
<td>18.8</td>
<td>7.5</td>
<td>6.2</td>
<td>18.3</td>
<td>9.5</td>
<td>4.2</td>
</tr>
<tr>
<td>Total</td>
<td>69.1</td>
<td>86.6</td>
<td>74.3</td>
<td>76.2</td>
<td>76.1</td>
<td>77.9</td>
<td>75.6</td>
</tr>
</tbody>
</table>

Source: Canabrava (1997, 142).
By the 1880s coffee, sugar and cotton accounted for 75 percent of all Brazilian exports, with coffee alone reaching the staggering share of 65 percent of total exports during the first decade of the Republic (Netto 1979, 25). The long-term price decline associated with tropical agricultural commodities (Carone 1970, 31; Glade 1989, 8; Ocampo and Parra-Lancourt 2010), made worse by the Depression of the Nineties, limited the ability of the Brazilian economy to generate trade surpluses and accumulate gold. In fact, the shock was so severe that Netto, in his analysis of the importance of coffee to the Brazilian economy, noted: “Brazil watched a spectacle it had never seen before: [coffee] export volumes could not rise fast enough to compensate the fall in prices” (Netto 1979, 20).

Tables 3.4 and 3.5 show the magnitude of the deterioration in international coffee prices and its correlation with the depreciation of the mil-réis:

Table 3.4 – Exchange rate and international coffee prices

<table>
<thead>
<tr>
<th>Year</th>
<th>Exchange Rate</th>
<th>Price</th>
<th>Year</th>
<th>Exchange Rate</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>1889</td>
<td>26 7/16</td>
<td>100*</td>
<td>1894</td>
<td>10 3/32</td>
<td>92</td>
</tr>
<tr>
<td>1890</td>
<td>22 9/16</td>
<td>113</td>
<td>1895</td>
<td>9 15/16</td>
<td>91</td>
</tr>
<tr>
<td>1891</td>
<td>14 29/32</td>
<td>90</td>
<td>1896</td>
<td>9 1/16</td>
<td>69</td>
</tr>
<tr>
<td>1892</td>
<td>12 1/32</td>
<td>87</td>
<td>1897</td>
<td>7 23/32</td>
<td>47</td>
</tr>
<tr>
<td>1893</td>
<td>11 19/32</td>
<td>103</td>
<td>1898</td>
<td>7 3/16</td>
<td>41</td>
</tr>
</tbody>
</table>

Source: Netto (1979, 22). * Netto uses the 1889 price level as his benchmark.

Table 3.5 – Average international coffee prices

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>1870-1880</td>
<td>93</td>
</tr>
<tr>
<td>1880-1885</td>
<td>58</td>
</tr>
<tr>
<td>1885-1890</td>
<td>102</td>
</tr>
<tr>
<td>1890-1895</td>
<td>94</td>
</tr>
<tr>
<td>1895-1900</td>
<td>39</td>
</tr>
</tbody>
</table>


The decline in the Brazilian sugar production can be explained by a combination of factors, ranging from the competition posed by other international sugar producers to the low productivity of the Brazilian plantations (Canabrava 1997, 105; Furtado 1959, 117, 135; Glade 1989, 14). The problems in the sector continued throughout the early decades of the Republic, despite continuous official support (Lucena 1891, 6; Souza 1893, 20) and a trade agreement signed with the United States in 1891 (Topik 2009, 325–326). Differently from what happened to sugar, cotton exports declined as an increasing percentage of the production was absorbed by the nascent Brazilian textile industry (Canabrava 1997, 15; Furtado 1959, 135).
The Brazilian dependence on coffee and its specialization as a producer of agricultural commodities compounded vulnerabilities that were inherent to the Brazilian economy. Both new planters and established growers had an incentive to focus on the production of coffee and to expand its planted area, often to the detriment of crops such as beans and wheat (Netto 1979, 23). As a result, Brazilian imports of staples of popular consumption, in addition to the imports of manufactured and consumer goods the country did not produce domestically, placed even more pressure on the exchange rate and the balance of trade (Furtado 1959, 180–1, 189, 194). Brazilian policy-makers were aware that this posed a challenge to the country in the long run. For instance, Minister Campos Jr. remarked in his annual report to Congress that:

“[t]he [agriculture sector] (...) was caught by surprise by the depreciation [in the price] of coffee (...). However, (...) [it should] apply itself to the cultivation of multiple crops, as we have advised them to do (...). The cultivation of only one type of crop increases its offer and eventually causes the fall in prices. The [demand] for other crops from abroad, paid for in gold, [has] increased extraordinarily, while [no one] in the country can (...) cultivate them. (...) [T]he planters (...) are contributing to the drop in the exchange rate (...)” (Campos 1897, 20).

Another problem was the tax collection system the Republic inherited from the Monarchy (Schneider 1991, 53), too dependent on custom duties payable in mil-réis and charged on an ad valorem basis. Custom duties accounted for approximately 70% of the Monarchy’s revenue from 1865 to 1885 (Deveza 1997, 92; Schneider 1991, 53). Figure 3.3 shows that this percentage did not change significantly during the early years of the Republic:

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90 An ad valorem tariff is charged based on a fixed value per imported item or per its weight, and not a percentage of its declared value.
Figure 3.3 – Revenue breakdown for the Brazilian federal government (1889-1898, ordinary revenue)

Although the reliance on trade tariffs made sense in view of the limited administrative capacity of the Brazilian state at that time, as tariffs are usually considered to be easier to implement and cheaper to enforce than other types of taxation (Bértola and Williamson 2006, 29, 40; Tilly 1985, 180), they rendered government budgets very vulnerable to negative shifts in the balance of trade and the country’s terms of trade.91 The new Republican constitution of 1891 aggravated the problem by transferring the collection of some taxes to the states and local governments,92 leading Ministers Oliveira (Oliveira 1891, 205, 208) and Alves (Alves 1892, 3) to decry the worsening fiscal situation of the federal government.

It could be argued in view of these vulnerabilities that the Brazilian government was responsible for its own predicament. The depreciation of the mil-réis might have served the interests of Brazilian exporters, for instance, while the reluctance to make the necessary adjustments to the parity rate, which was ludicrous in view of the economic circumstances of the late 1890s, might reflect the incompetence or the corruption of Brazilian politicians. Likewise, we could attribute the depreciation of

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91 Brazilian policy-makers had been debating how to reduce the dependency on tariffs since the times of the Monarchy, and the debate continued into the first decade of the Republic, as the annual reports by Ministers of Finance Rui Barbosa de Oliveira (1891, 209) and Campos Jr. (1898, 7) show. Nevertheless, most of the proposals to diversify the sources of revenue with the creation of new types of taxes, such as the income tax, failed to garner support in Congress (Deveza 1997, 101).

92 Those included the right to tax exports and interstate commerce (Carone 1970, 250; Resende 2003, 94).
the Brazilian currency to misguided monetary policies and high domestic inflation, and we could blame policy-makers in the first Republican administrations for failing to institute political reforms.

However, the data I present in this section suggest that reforms and policy changes alone would not be sufficient to stave off a crisis transmitted by external factors. The finance and production structures of the international economy, operating together, shaped the agency of Brazilian policy-makers by decreasing the ability of the federal government to secure capital at the international level by trading or borrowing, closing some possibilities (repayment in accordance with the original terms of debt contracts) and opening others (defaults, temporary payment moratoria, debt restructurings). Their effects on the Brazilian economy were severe, as we can see in table 3.6:

Table 3.6 – Variation in Brazilian nominal GDP (in millions of mil-réis)

<table>
<thead>
<tr>
<th>Year</th>
<th>Nominal GDP</th>
<th>Variation for the year (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1888</td>
<td>640</td>
<td>-</td>
</tr>
<tr>
<td>1889</td>
<td>660</td>
<td>3.13</td>
</tr>
<tr>
<td>1890</td>
<td>860</td>
<td>30.30</td>
</tr>
<tr>
<td>1891</td>
<td>1570</td>
<td>82.56</td>
</tr>
<tr>
<td>1892</td>
<td>1960</td>
<td>24.84</td>
</tr>
<tr>
<td>1893</td>
<td>2310</td>
<td>17.86</td>
</tr>
<tr>
<td>1894</td>
<td>2630</td>
<td>13.85</td>
</tr>
<tr>
<td>1895</td>
<td>2790</td>
<td>6.08</td>
</tr>
<tr>
<td>1896</td>
<td>2910</td>
<td>4.30</td>
</tr>
<tr>
<td>1897</td>
<td>3190</td>
<td>9.62</td>
</tr>
<tr>
<td>1898</td>
<td>3260</td>
<td>2.19</td>
</tr>
</tbody>
</table>

Source: Calculated based on Flandreau and Zumer (2004, 122).93

Brazilian policy-makers were aware of those structural pressures. For instance, as the Depression of the Nineties deepened, Afonso Augusto Moreira Pena, writing to Minister of Finance

93 The data shows only the estimated nominal variation in the GDP. There are no reliable estimates for the Brazilian inflation in the period, but Franco and Lago calculate that the annual inflation rate for the first five years of the Republic alone reached 20% (2011, 16). Even if the inflation rate from 1894 to 1898 was in effect lower than that, a hypothesis that is not plausible in view of the depreciation of the mil-réis and the budget deficits of the federal government, the country probably experienced a negative variation in real GDP terms for the last years of the Barros administration, if not most of the decade.
Alves in his capacity as president of the Bank of the Republic of Brazil, commented that “(...) the Bank of England raised the discount rate to 4%. Everywhere [things] conspire to increase our difficulties (...)” (Pena 1896a). In spite of their incompetence, venality, or corruption, there was very little that Brazilian officials could actually do to accumulate gold or prevent the mil-réis from depreciating. Without significant changes to the way the institutions of the international economy operated, domestic policy reforms could not prevent or stave off the effects of an international crisis of the magnitude of the Depression of the Nineties. In fact, changing the parity rate, which would correspond to an official devaluation of the mil-réis (Franco and Lago 2011, 7), was extremely risky as it could spark a “run to the exits” with even greater capital outflows by investors trying to anticipate or avoid the consequences of such a policy change. Preserving the parity of the mil-réis was understood as the only sound policy to be pursued by the government in the context of the gold standard (Franco and Lago 2011, 7), while a devaluation was seen as an undesirable condition, never to be openly discussed in public if Brazilian policy-makers wanted to avoid “scaring” domestic and foreign market actors. As Triner and Wandschneider note, any efforts by Brazilian officials “to control domestic finance [lost] their ability to generate benefit” (2005, 214) in the context of a deteriorating external sector.

It is thus noteworthy that instead of defaulting, President Barros and Minister Campos Jr. chose to propose a restructuring to the Rothschild bankers. Their cautious and tentative approach to the debt crisis suggests that they were uncertain as to the economic situation at the international level and to the consequences of a default, casting doubt on the assumption of rational maximization common in the literature. In the next section I complement this analysis by briefly looking at the domestic political factors during the first decade of the Old Republic and explaining the role they played in the context of the negotiations for the First Funding Loan.

94 The Bank of the Republic of Brazil (later denominated Bank of Brazil, or Banco do Brasil) was the country’s main financial institution at the time. It doubled as a commercial bank and monetary authority until the creation of the Brazilian Central Bank in 1964.
95 Excerpt originally written in English.
3.3) The Domestic Context: the First Ten Years of the Brazilian Republic

As I explained in section 2.3.1, an important set of explanatory hypotheses to the cooperation puzzle argues that the preferences of domestic political actors, or specific configurations of domestic political institutions, can explain decisions by sovereign debtors to either repay or default. Since such decisions may have redistributive consequences to domestic groups and may affect the electoral prospects of politicians, or their survival in power, domestic-politics hypotheses infer that policy-makers will favor either repayment or default depending on the preferences of their constituents or selectorates. However, instead of prompting Brazilian government officials to choose those strategies that opportunistically maximized their own political survival, the actions of domestic political factions or groups during the first decade of the Republic generated high levels of instability and uncertainty, complicating the decision-making process behind the First Funding.

The Brazilian Republic, also known as the “Old Republic”,96 came into being literally overnight on November 15th, 1889, when a group of disgruntled Army officers ousted Emperor Pedro II, putting an end to the monarchy that had been in power since the Brazilian independence from Portugal in 1822.97 The Emperor was at the center of the political institutions of the Empire, controlling the government and the Imperial bureaucracy, and accommodating the demands of the different Brazilian regional elites for offices, honors, jobs, and resources in exchange for their political support (Carvalho 1980, 47, 129; Costa 1998, 462; Holanda 1997a, 263; Lessa 2001, 18, 20; Resende 2003, 94; Schneider 1991, 45, 47, 53, 55; Uricoechea 1978, 109, 113–5). This political mechanism did not always operate smoothly (Carone 1969, 67, 1970, 152, 256; Costa 1998, 464; Uricoechea 1978, 109), but it provided a set of tools that the

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96 The term Old Republic (República Velha, in Portuguese) was coined by the propagandists of the Revolution of 1930 to counterpoise the old order to the “New Republic” led by Vargas (Neto 2013, 24) and has since been used by Brazilian historians to refer to the period. Although the term “First Republic”, more neutral, can also be used, I’ll conform to the traditional usage throughout the dissertation.

97 The Brazilian monarchy styled itself as an “Empire” and the term is commonly used by Brazilian historians to refer to the monarchical period. Following this traditional usage, I will employ the terms “Empire” and “Monarchy” interchangeably throughout this chapter.
Emperor could use to diffuse the tensions and grievances that constantly flared up amongst the Brazilian elites.

The Provisional Government formed by the Republicans right after the coup dismantled the political institutions of the Empire without replacing them with any permanent alternatives (Lessa 2001, 17). The first three Republican administrations lacked an established political mechanism to mediate the tensions within their own ranks involving diverse elements such as the younger and more radicalized sectors of the Army (dubbed “the Jacobins” by the contemporaries), senior Army officers, the Deodoristas, the Florianistas, the republican civilians, the Navy, and the growing number of monarchists who changed colors to support the new regime (Bonafé 2004, 34; Carone 1969, 17, 1970, 14–6, 138, 403; Lessa 2001, 15, 32; Resende 2003, 108; Topik 2009, 126). The uncertainty that followed in the wake of the tensions and clashes among these groups is reflected in the correspondence of Brazilian contemporaries. For instance, President Barros complained to Minister Campos Jr. a few days after his inauguration in November of 1894 that he was “having trouble putting together a Ministry with competent people that do not signal hostility to the Marshal [Peixoto], who is still angry. (...) I will need to ask Rodrigues Alves to accept the Ministry of Finance, since he (...) is in the good graces of the

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98 The Jacobins were mostly junior officers, with a middle class background, and were influenced by the positivist ideology that took root in the military schools during the last quarter of the nineteenth century (Costa 1998, 461; Holanda 1997a, 355–6, 358–9, 380–1, 383, 1997b, 347, 351; Schneider 1991, 56–7, 60–1; Schulz 1997, 280–2).
99 The Deodoristas were the Jacobins who supported Marshal Manuel Deodoro da Fonseca, the leader of the Army coup and first president of Brazil.
100 The Florianistas were the Jacobins who supported Marshal Floriano Vieira de Araújo Peixoto, Marshal da Fonseca’s Vice-President and second president of Brazil.
101 During the Empire, while the Navy recruited from the political elites (many of whom remained sympathetic to the Monarchy after its end), Army careers were generally left to the middle class and to those coming from impoverished segments of the elites that could not afford the costs of a higher education, a requirement for any appointments to higher positions in the Imperial bureaucracy (Bello 1966, 50; Carvalho 1980, 60–1, 88, 148; Holanda 1997a, 380, 395–6, 400; Schneider 1991, 77; Schulz 1997, 278, 279, 281–2).
102 And there were many in this last category (Neves 2003, 33). They were jokingly called “the Republicans of November 16th”, in a reference to their “conversion” to the Republican cause the day after the Republic was established by the military (Flores 2003, 54).
103 Marshal Peixoto had prestige among the Army but was authoritarian and uncompromising in the defense of the Republic, a position that earned him the nickname “The Iron Marshal”. The Florianistas opposed the transition from military to civilian rule and President Barros feared that they planned to prevent him from taking office.
Marshal” (apud Carone 1971, 136). The death of Marshal Peixoto in 1895 brought some relief (Barros 1895), but the political instability remained. The President had to constantly push back against the Jacobins and the regional elites who agitated for more political autonomy for their states (Neves 2003, 38), while whipping into line congressmen from his own political party, the Federal Republican Party (Partido Republicano Federal, or PRF). In a 1897 letter to his antecessor in the Ministry of Finance, Minister Campos Jr. noted that “neither the [PRF] nor Congress lend to the executive the (....) systematic and sustained support that the situation demands” (Campos Jr., 1897a). A few months earlier, he had complained to President Barros about his difficulties in getting the congressional base to support the government’s own economic initiatives:

(...) we need [someone to] discuss the facts in the Senate (...). I cannot recall [the name of] one [knowledgeable Senator] who could act, replacing those unwilling but who could and should debate, due to their knowledge of the matter. (...) It is impossible for the government to abandon the finance question (...), since it is from [this issue] that originates the credit for everything. (Campos Jr., 1897b)

It should be noted that such problems did not mean that there was any organized and united opposition to the government’s economic policies in Congress. The main political elites of the Old Republic were very fragmented, were not consistently organized as pressure groups, and were not clearly identified by ideology or party lines (Carone 1970, 297). Some members of the elites from the states of São Paulo, Minas Gerais, and Rio de Janeiro had strong interests in the domestic financial and manufacturing sectors, and the interests of some of the most important financiers of the Old Republic, politicians from the time of the Monarchy such as Counselor Francisco de Paula Mayrink and the Count of Figueiredo, did not necessarily overlap with those of their oligarchic peers (Carone 1970, 106, 151–152; Topik 2009, 117). Even the powerful coffee planters from São Paulo were shaken by political rivalries and conflicting policy preferences (Carone 1970, 29, 36–38; Costa 1998, 470; Netto 1979, 13, 104)

104 Marshal Peixoto rose to the presidency upon Marshal Fonseca’s resignation in 1891. The Jacobins reached the height of their influence during his administration (1891-1894). Alves served in the Finance portfolio during the first half of President Barros’ term, while Campos Jr. was appointed to the Ministry during the second half of his administration.
In fact, the PRF, which a contemporary commentator called “a cathedral open to all faiths” (Lessa 2001, 34), epitomizes the fluid and transient character of Brazilian politics. It was founded in 1893 and was the first national political party created in the Republican period. Although politically successful, the PRF was in reality a mixed bag of regional interests and political tendencies which coalesced around three large blocs: one formed by the “radicals”, mostly Florianistas, another by the “reactionaries”, civilians who opposed the Florianistas, and a third by the “moderates”, centrists or pragmatists uncommitted to any of the other blocks (Carone 1970, 156; Lessa 2001, 34–5). Its eclecticism suggests that its members came together more for self-interested reasons than for any ideological common ground.

Consequently, we should not overstate the influence that the political elites might have had on federal policy-making in the late 1890s, especially over decisions related to the administration of the federal foreign debt. The economic predominance of the states of São Paulo and Minas Gerais did not mean that the political interests of their political elites were primarily determined by their economic position as landowners (Schwartzman 1982, 14) or that they always imposed their will to the detriment of other groups. For instance, the primary sources suggest that President Barros and Minister Campos Jr., both coffee growers from São Paulo, were more concerned with the effects that a devaluation of the mil-réis could have over the solvency of the federal government than with the boost it could eventually bring to coffee exports and to their own earnings. As Schneider points out, “[d]evaluation served to protect the income of the coffee producers, as their sales were overwhelmingly for export. At the same time, however, devaluation caused inflation and fed government deficits, for depreciation of the exchange rates made imports more expensive and reduced (...) revenues” (1991, 78).105

It is possible to apply the same perspective to the military and the Jacobins. The prominence of the Brazilian Army during the first decade of the Old Republic contrasted markedly with its political irrelevance during the Monarchy (Uricoechea 1978, 131) when, with few exceptions, its officers were at

105 Excerpt originally written in English.
the margins of the imperial bureaucracy and the political life of the country. Even so, not all Army officers were engaged in the political debates of the time and most soldiers were not politicized (Schneider 1991, 77). The military was also deeply divided, as illustrated by the rebellion of the Brazilian Fleet during the administration of Marshal Peixoto. Although very disruptive, the Jacobins were not immune to internal turmoil (the Deodoristas and Florianistas were at each other’s throats for most of the period) and were a minority group within the Army. Their divisions hampered their capacity to offer any coherent policy alternative or to effectively oppose the economic policies unveiled by the civilian policy-makers in the regime.

A default was also not in the plans of the senior officers and generals. It is telling that in the aftermath of the Republican coup of 1889, a moment of institutional breakdown that could have been used as an excuse for debt repudiation, the Provisional Government led by Marshal da Fonseca avoided a rupture with foreign creditors. In its first proclamation to the nation, the new Republican leadership stated clearly that “[t]he Provisional Government acknowledges and [will not repudiate] the national obligations contracted during the previous regime, the treaties with foreign powers [that are still valid], the domestic and external public debt, [and] valid contracts” (apud Carone 1969, 14). It is also symptomatic that a group of generals had started a campaign to collect money for the repayment of the Brazilian public debt (Carone 1971, 12) within days of the proclamation of the Republic.

Finally, the sources show that the broader Brazilian population was not informed of the negotiations behind the First Funding. It is also plausible to assume that, if informed, they would have been mostly indifferent to the debt restructuring. Naturally, this is not to say that isolated members or groups of the population did not have an opinion on the matter or were incapable of taking political action. Both the Monarchy and the Old Republic witnessed riots by underprivileged segments of the population, as well as strikes by workers (Carone 1971, 196; Carvalho 1987, 91; Deveza 1997, 96; Engel 2002, 641; Guimarães 2002, 2002; Lessa 2001, 47). Brazilian policy-makers were aware of the dangers

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106 For an account of these divisions, see Carvalho (1987).
they faced when they ignored popular sentiment. Felisbello Firmo de Oliveira Freire, Minister of Finance in the administration of Marshal Peixoto from April of 1893 to August of 1894, explained these fears in dramatic terms: “(...) [it is necessary] to act in order to avoid a social catastrophe (...). (...) The [currency] has devalued to a point never heard of, in which it still remains. As a logical corollary, the basic necessities of life have become scarce, while the rents have gone up, (...) [affecting] the poor classes (...)” (1894, 25, 27).

Even so, the formal political institutions of the Old Republic did not offer proper venues for popular participation or its representation in the formulation of economic policies. Labor, socialist and popular political parties were persecuted, unionization was limited, and most workers were at the margins of any type of formal labor organization (Pinheiro et al. 2006b, 163–4, 168, 170, 173, 185). In this sense, the Republic was not very different from the regime it replaced. Writing in 1921, Afonso Henriques de Lima Barreto, a Brazilian journalist, writer, and social commentator lamented that “[t]he revolutions follow each other, but in reality [everything] stays the same and the novelties that they bring connect themselves to the old things they replaced” (Barreto 2004, 223). As Carvalho (1987, 164) explains, the political system limited the ways in which the Brazilian population could participate in the political life of the country, channeling popular political activity towards indifference, violent outbursts of protest, or pragmatic participation in the patronage networks developed by the oligarchies, none of which allowed the people to properly voice their preferences and concerns. Restricted to the capital, Rio de Janeiro, and to the larger Brazilian cities, popular movements did not generate concrete policy alternatives to the status quo and did not target the problem of the Brazilian debt in any specific or sustained way.

Carvalho summarizes the Brazilian political panorama during the Old Republic in the following way:

The initial expectations [the people had for the Republic] (...) were frustrated. The intellectuals were disappointed by the persecutions [promoted by] Marshal Peixoto; the workers, and especially their
socialist leadership, were disappointed at how difficult it was to organize political parties and participate in the elections; the Jacobins were [eventually] eliminated. All these groups had to learn new ways to insert themselves in the system (...). The intellectuals gave up their political activism and turned to literature, accepting positions in the bureaucracy (...). The workers split into two main groups, that of the anarchists, which radically rejected the system that rejected them [in the first place], and another [comprised of] those who [were co-opted] by the mechanisms of the state. (…) As to the majority of the population, almost no venue was left for them to voice their views (...). (1987, 37)

In summary, domestic political factors in the context of the First Funding did not play the role that is usually inferred by domestic-politics explanations in the literature on sovereign debt. Brazilian political elites were not really accountable to Brazilian citizens, the divisions and tensions which affected them and the military did not allow the formation of cohesive interest groups that could influence economic policy-making in a sustained way, and President Barros did not face either organized or significant opposition to the First Funding in the Brazilian Congress. As such, the regional political elites and the Jacobins, the main political actors at the time, were more important as a source of political “noise” and uncertainty than as clearly oriented and preference-maximizing interest groups in relation to the country’s sovereign debt.

3.4) Cooperation: the Negotiations Behind the First Funding Loan

As the economic situation deteriorated, President Barros eventually acknowledged that it was “becoming unbearable” (1898b), requiring a final concerted push with the creditors. At his request, President-Elect Manual Ferraz de Campos Sales107 travelled to London to personally conclude the negotiations for the First Funding with the country’s bankers, the N. M Rothschild & Sons banking house. After months of negotiations, the Brazilian government signed the agreement on June 15th, 1898.108 According to its terms, Brazil suspended debt service on a selection of domestic and external loans until

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107 Sales had been elected to the presidency on March 1st of that year with the explicit support of President Barros.
108 A transcription of the agreement, translated into Portuguese, can be found in Sales (2007, 263–271).
June of 1901. During this time, bondholders received in exchange for their coupons\textsuperscript{109} an equivalent amount of new bonds (the United States of Brazil 5% Funding Bonds) issued by the Rothschild bank on demand, up to a global maximum total limit of 10 million British pounds. It also suspended the amortization of the old loans until June of 1911.\textsuperscript{110}

Contrary to how the literature on sovereign debt understands cooperation, the First Funding did not mean a return to the status quo ante and was not based on the enforcement of the original terms of the old Brazilian debt contracts by foreign creditors or creditor countries. It involved the issuance of new bonds and a swap of the old debt coupons for the newly issued debt securities, representing a compromise between Brazil and its creditors. Its outcome fell between the two extremes of harmony (with full repayment) and discord (with complete repudiation), resting closer to the former pole of the cooperation continuum than to the latter. In fact, its very existence supports my hypothesis that cooperation in the sovereign debt market follows the model proposed by liberal institutionalist scholars such as Keohane (1984), Oye (1986), and Milner (1992). Moreover, in line with the findings by Suter and Stamm (1992), Aggarwal (1989), and Eichengreen and Portes (1989a), the First Funding was not unique and was probably inspired by the Argentine moratorium and restructuring of 1891 (Abreu 2002, 520; Economist 1898a, 837; 1898b, 904).

As I also argued in chapter two, the analysis of the primary sources shows that President Barros and Minister Campos Jr. took pains to ensure to the Rothschild bankers that they were negotiating in good faith. For instance, just before President-Elect Sales sailed to London, President Barros wrote to Minister Campos Jr. that “[his] trip notwithstanding, it seems we can insist with the Rothschilds that [they give us] a definitive answer to our proposal – based on the exposition you sent to them” (1898). The correspondence they exchanged with the bankers also suggests that the Brazilian government was

\textsuperscript{109} The coupons represented the interest amount to be paid to the bondholder for the accruing period of the bond. At the time, the bondholders needed to detach the coupons and present them to the fiscal agent of the debtor in order to collect the interest payment.

\textsuperscript{110} Debt service is a technical term which refers to the payment of interest on a loan. Amortization is the repayment of the principal of a loan.
concerned to reciprocate some of the concessions they might obtain from their creditors with policy concessions of their own. In a cautious telegram sent to Minister Campos Jr. in October of 1897, the Rothschild bankers avoided voicing a premature opinion on the tenor of any of the proposed policies, but acknowledged the effort of the Barros administration: “[we are] happy to be informed of the many proposals your government intends to implement to increase revenues and decrease spending (...). However, such measures [will have an impact in the future] and do not provide for the immediate needs [of the country]” (Rothschild and Sons, 1897).

Although it is possible that the Brazilian policy-makers were being disingenuous, it is more plausible to assume that President Barros and Minister Campos Jr. wanted to make it clear to the Rothschild bankers that they were negotiating in good faith, that they were open to a reasonable compromise, and that the restructuring should be seen in the context of a very difficult environment created by the relative scarcity of capital at the international level. Other primary sources show that foreign creditors understood that some form of debt adjustment was unavoidable given the state of the international economy. Some form of accommodation might even have been in their immediate interest. In a letter to President Barros in January of 1898, Gabriel Toledo Piza de Almeida, Brazilian ambassador in Paris, commented that “[t]he Rothschild house (...) puts a great effort into propping up our creditworthiness, since our bankruptcy would bring them down as the bankruptcy of the Argentine Republic, a few years back, ruined the great and powerful Baring Brothers (...)” (1898). A few days before his election, President-Elect Sales wrote to President Barros in the same tone: “[i]f the [financial position] of our creditors is endangered by ours, this circumstance will bring them to our side. (...) They know that (...) an agreement will ensure our and their prosperity” (1898). A few days before Brazil and the Rothschild bankers officially announced that the Funding had been signed, The Economist acknowledged that:

[t]here appears to be no room for doubt (...) that the negotiations (...) have reached an advanced stage (...). In the case of Brazil it would obviously be in the best interest of the country, and of its creditors, that
if it is really impossible to pay the interest on the debt in full, the bondholders should consent to a temporary reduction of the amount due to them (...). (1898a, 838)

A few days later, The Economist argued again that:

[j]t has been evident for some time past that the financial position of the Brazilian government was becoming critical, and that the heavy losses incurred in providing gold in Europe for the payment of the interest on the external loans, owing to the severe fall in the exchange, would inevitably necessitate some arrangement of the debt. (1898b, 904)

The Brazilian position also contrasted with that of Argentina, which in 1893 pushed for a renegotiation of their 1891 loan and wrested new concessions for their creditors, such as the partial cancellation of accrued and unpaid interest on old debts (Abreu 2002, 520; Fishlow 1989, 91).\footnote{This new agreement came to be known as the Romero Arrangement (Arreglo Romero), after the Argentine minister who negotiated it.}

Brazilian policy-makers had a more restricted menu of choices in view of the international environment, and their relatively weak position was made clear in the opening paragraph of the First Funding: “(...) the [Brazilian] government, acknowledging that it cannot pay in cash the interest on its (...) loans (...) signs the agreement hereafter (...)” (apud Sales 2007, 263). Even so, they were not entirely powerless and the Funding was not imposed to them or negotiated out of a position of weakness. The Barros administration was capable of resisting conditions that were too onerous or too politically sensitive. For instance, a few months before the signing of the First Funding, the Rothschild bankers devised an alternative funding scheme that involved the concession of the biggest Brazilian railroad, the Brazilian Central Railways, to a foreign group. As the government dragged its feet, the bankers urged Minister Campos Jr. to take the offer: “(...) we (...) insist (...) that the proposal be accepted, as we are persuaded that no better proposal will be made in Europe to the Brazilian government” (1897). In October, they returned to the subject in rather dramatic tones: “(...) we are convinced (...) [that] no other offer can be expected from (...) Europe” (1897). The position of the Barros administration eventually prevailed.
The negotiations were certainly facilitated by the fact that they were headed by the Rothschild bankers without the input of bondholders or other creditors. *The Economist* complained emphatically at the time that: “(...) throughout the whole of the deliberations [the bondholders] have neither been advised nor consulted” (1898b, 904). The privileged role played by the Rothschild banking house highlights the structural power they wielded in the final decade of the nineteenth century. They were the nexus point for the negotiations, as shown by the letters and telegrams they exchanged with different Brazilian policy-makers, first discussing the different proposals and, eventually, coordinating the signature of the Funding itself. Their power was not dependent on material capabilities they could use to enforce the original terms of the debt contracts, but was manifest in their ability to steer Brazilian officials into finding a solution that was palatable to the country’s creditors while framing their behavior in ways that reinforced their good faith and showed their willingness to reciprocate.

We can understand the pivotal role of the bankers more clearly in a letter they wrote to Minister Campos Jr. trying to convince the Brazilian government to accept the scheme involving the concession of the Brazilian Central Railway. It is particularly interesting to notice how they framed the concept of “responsibility” by linking it to the idea of “solvency”: “we cannot believe (...) that the Brazilian government will incur in such irresponsibility as to refuse an offer that provides 5,000,000 [British pounds] in favorable conditions to and from British and German financial interests (...)” (1897). The structural power of the Rothschild banking house thus relied on its claims to financial expertise and knowledge of economic matters. In another letter which is worth quoting at length, addressed to President-Elect Sales right after the conclusion of the negotiations, the bankers made their privileged position as arbiters and interpreters of the content of norms and ideas in the financial world subtly, but undoubtedly, clear:

> [w]e used the occasion of Your Excellency’s visit to discuss in depth the state of the Brazilian finances and were very happy to see that Your Excellency understands the difficult financial situation of your country. Unfortunately, for a few years Brazil has been [suffering] both a political and financial crisis and, in these circumstances, it is not surprising that with the big fall in the exchange rate [the country finds itself in]
financial difficulties (...). (...) While we strongly lament the suspension of payments, we believe it is useful to recommend this [restructuring] project to the holders of Brazilian bonds (...). Your Excellency does not ignore that we have been for many years the financial agents of the Brazilian government in England and we have always been proud and happy to see [it] faithfully discharge all its obligations; however, the advantages of the plan to Brazil will depend on the strict observation of all its details and we do not doubt that your Excellency will see, from your short stay in our city, that (...) the credit of a country is, above all, its power. (apud Sales 2007b, 272).

Before I conclude the chapter, it should be noted that both the primary sources and the behavior of Brazilian policy-makers challenge the assumption of instrumental rationality that is at the basis of the cooperation puzzle in the literature on sovereign debt. It is plausible to assume that President Barros, Minister Campos Jr., and other Brazilian officials did not have full information on the costs that their decisions would have for the Brazilian economy and could not calculate and compare the costs associated with either repayment or default in a way that was conducive to the maximization of their own preferences. On the contrary, Brazilian officials seem to have hoped that a new foreign loan would allow the federal government to muddle through the Depression of the Nineties until an improvement in the external environment lifted the Brazilian economy and reversed the fall in the exchange rate. This is clear in a letter President Barros wrote to President-Elect Sales, a few months before the signature of the First Funding: “I and Bernardino [Minister Campos Jr.] are convinced that the safer and more efficient [course of action] is to obtain a big loan abroad that could be the base for the restoration of our finances” (P. J. de M. Barros, 1898c). Brazilian policy-makers were reacting to the events as they happened. For instance, in the months immediately preceding the negotiation of the Funding Loan, Minister Campos Jr. alerted President Barros that:

[t]he fall of our bonds in London is still going on. (...) We know nothing about what is happening there. With the promise by Campos Sales to go [to London] after the election, we keep waiting and we have no one there. (...) I think you should tell [Sales] how troubling the situation is, in order to know if it would be worth trying to find out what is going on in London. Here, I am talking to the banks to see if the foreigners reach an agreement on the exchange rate (...). (Campos Jr., 1898 - My italics)
The traditional view on rationality also pays little attention to the bounded rationality of creditors and other market actors. A plausible explanation for the relative scarcity of capital throughout the 1890s, and particularly in the aftermath of the Barings Crisis and the Depression of the Nineties, is that foreign investors and creditors over-reacted due to fears of “contagion” and attempted to anticipate market movements or prevent losses by stopping any additional lending to Brazil (Bello 1966, 73; Carone 1971, 12). As an example, President Barros complained to Minister Campos Jr. before the signature of the First Funding that “[t]he drop in [the prices of] our bonds in London, so abrupt, can be plausibly explained by the constant [rumor-mongering], both inside and outside of the country, (...) about the suspension of [our] payments” (1898a). They could also be reacting to the political instability during the Barros administration. Government officials such as Pena understood that connection very well. In a letter to Minister of Finance Alves, he confided that “the rumors about the instability of the government have caused a strong impression on the foreign banks” (Pena 1896). In any case, the reluctance of foreign creditors to “roll-over” old Brazilian debts may have contributed to the restructuring they all wanted to avoid.

Finally, although it may be impossible in practice to pinpoint the position of a debt restructuring in the cooperation range between harmony and discord, the First Funding did fall closer to the former pole than the latter. As I mentioned in section 2.5, we can say that as a rule, the scarcer capital is internationally and the more transparent policy-makers in sovereign debtors are when they approach their debtors to negotiate, the farther from the discord pole the final outcome of the negotiations should fall. The First Funding represented a change in the original terms of the loan agreements, providing the breathing space that the Brazilian government needed, but did not amount to any unilateral or substantial change that could lead its creditors to refuse to negotiate. Figure 3.4 narrows down the range of estimated outcomes for the negotiations, summarizing my arguments in this chapter:
3.5) Validity Conditions for My Hypothesis

It is possible to argue that my hypothesis passes the test presented by the second condition described in section 2.5. The First Funding is an example of a restructuring in which Brazil and its creditors adjusted their policies and whose final outcome departed from the status quo. My hypothesis also passes the test presented by the first condition, to the extent that none of the variables I discussed in section 2.3 provides a better account for the First Funding. As I explained in section 3.3, domestic-politics explanations, whether based on preference or institution-driven models, do not properly account for why Brazil renegotiated its debts and cooperated with its creditors. I also did not find evidence in support of coercion-based and issue-linkage explanations. Although the First Funding was negotiated during the heyday of imperialism, the Barros administration seems to not have been concerned with any security threats coming from its creditors or creditor countries. The little evidence I could find on issue-linkages also points to the conclusion that they must not have represented a significant obstacle during the negotiations for the Funding. In the late 1890s Brazil still had not settled its borders with Great Britain and France in the Amazon region (where the Brazilian territory bordered then British and French Guianas), but these issues seem to not have posed any impediment to the deal. For instance, in a letter to President Barros, Ambassador Piza explained that the resistance of French authorities to approve the listing of Brazilian bonds in the Paris Exchange was not motivated by those foreign policy issues. He wrote: “[they] told me that the foreign policy objections [to the listing] had
been dropped, but the financial objections remained” (1898). There is no evidence that Great Britain ever attempted to link the signature of the First Funding to any other issues, whether diplomatic of financial.

I also found no evidence in support of iteration or reputation explanations. President Barros and Minister Campos Jr. were certainly concerned with maintaining Brazilian access to the international sovereign debt market, but that did not prevent them from negotiating the Funding. In any case, as I explained in chapter two, iteration and reputation explanations are problematic as they tend to assume that tit-for-tat strategies are employed by creditors in response to defaults but cannot properly account for the relative scarcity of capital that usually precede debt crises. This was the problem that led to the First Funding in the first place.

3.6) Conclusion

My analysis of the primary sources and the negotiations behind the First Funding Loan supports my argument that the traditional representations of the relationship between creditors and sovereign debtors in the literature are historically inaccurate. The literature in general fails to investigate, or even to consider, the potential impact of international economic structural factors on decisions to repay or default. As a consequence, it misrepresents such decisions as the willful acts of rational maximizers fully in control of their circumstances and thus free to choose a course of action that will maximize their utility. Relatedly, the literature also fails to capture the process of adjustment between creditors and debtors that happens in historical cases of debt restructuring, as illustrated by the First Funding Loan.

Naturally, policy-makers are not automatons and their actions are not “determined” by social structures, but as the increasingly frantic letters exchanged by President Barros, Minister Campos Jr., and other policy-makers have shown, more than simply doing what was politically expedient, they were scrambling to avoid a default while dealing with a worsening economic crisis and attempting to keep the push and pull of Brazilian politics under control. If on the one hand full compliance with the original
terms of the Brazilian loans was not possible due to the relative scarcity of capital and the problems with international trade, on the other hand a botched restructuring process or a default could have very negative consequences to the Brazilian economy and even to the survival of the Republican regime. Precisely for those reasons, they did not take the decision to restructure lightly.

The structural power of creditor countries and financial intermediaries is another element that is generally ignored by the literature but was crucial at the time of the First Funding Loan. The power which monetary authorities in Great Britain and other creditor countries had to influence the institutions of the gold standard and to deflect the costs of adjustment to other countries played a crucial role in the transmission of the Depression of the Nineties throughout the international economy. For developing countries such as Brazil, the immediate practical impact of that power was the increased relative scarcity of capital that led to an acute balance of payment crisis and, ultimately, to the First Funding. We should also not forget the structural power of financial intermediaries such as the N. M. Rothschild & Sons banking house, which, as I showed in section 3.4, were instrumental to the success of the negotiations behind the Brazilian restructuring. They were not acting out of their own altruism, as they were arguably helping to reproduce a system that benefited creditor countries and, to a large extent, themselves, but their intermediation and guidance throughout the process helped Brazil and its creditors to reach a compromise that would be more difficult otherwise.

In the end, the Old Republic survived for 40 years until the international economy came crashing down on Brazil during the Great Depression and the political order was toppled by the “Revolution of 1930” led by Getúlio Dornelles Vargas. I will present these events and discuss the Brazilian Funding Loan of 1931 in the next chapter.
Chapter Four: The Funding Loan of 1931

4.1) Introduction

The negotiations for the Funding Loan of 1931 (also known as the Third Funding Loan or the Third Funding),\(^{112}\) started almost a year after the Revolutionaries\(^ {113}\) led by President Getúlio Dornelles Vargas\(^ {114}\) entered triumphantly in Rio de Janeiro, the Brazilian capital at the time, putting an end to the Old Republic. Similarly to its 1898 predecessor, the Third Funding was a restructuring agreement that aimed to provide some breathing space to the Brazilian government by swapping the payment of accrued interest on old debts for newly issued bonds. However, reflecting the deep economic crises affecting the international economy in the early years of the Great Depression, it followed a partial unilateral moratorium declared in September 1\(^{st}\), 1931 by the Provisional Government, later extended to all debt payments in September 18\(^{th}\) (Neuhaus 1975, 109–110).

The moratorium and the circumstances behind the Third Funding Loan could lead us to infer that Brazilian policy-makers chose to stop servicing the foreign debt and pursue a restructuring because they were unwilling to bear the political and economic costs of debt repayment at a sensitive time, marked by domestic political instability and the forceful change of leadership at all levels of government. However, this view is historically inaccurate for the 1931 debt crisis. The Vargas administration was as reluctant to declare a debt moratorium as was the Barros administration in 1898. The primary sources show that the Brazilian officials did not intend to repudiate the foreign debt and preferred to muddle

\(^{112}\) The restructuring agreement behind the Funding Loan of 1931 was actually signed by minister of finance Osvaldo Euclides de Sousa Aranha in March 3\(^{rd}\), 1932. The name is commonly used by Brazilian historians and economists and, although imprecise, refers to the negotiations, which began in October of 1931 and were led by Minister Aranha’s predecessor in the finance portfolio, José Maria Whitaker. I will keep with the traditional usage throughout the dissertation.

\(^{113}\) The character of the 1930 “Revolution” is controversial. The winners were quick to claim that the movement was a popular revolution against the old order, but the oligarchical background of many of its leaders (as, for instance, President Vargas himself) points in a different direction. With this express caveat, I will keep with traditional usage and refer to the movement as the “Revolution of 1930”.

\(^{114}\) Vargas served as the Chief of the Provisional Government until his indirect election to the presidency in 1934. For the sake of simplicity, I will refer to him through this chapter as either Vargas or “President Vargas”. I will also use the terms Provisional Government and “Vargas administration” interchangeably.
through the crisis, but the adverse conditions prevailing at the international economy by the onset of
the Great Depression made it practically impossible for the Brazilian government to acquire the gold the
country needed to repay its foreign debts.

The primary sources and the analysis of the configuration of political forces in the 1930s also
show that domestic political factors did not play the role that is usually ascribed to them by domestic-
politics explanations in the literature on sovereign debt. Similarly to what happened in the first decade
of the Old Republic, political tensions and conflicts marked the initial years of the Vargas administration.
Brazilian regional elites clashed with one another and with radical members of the military who wanted
to perpetuate the regime of force established with the Revolution of 1930, but no single domestic group
was powerful enough to influence economic decision-making (or government decisions about the Third
Funding) in a decisive or direct way. As I will show, instead of prompting the Vargas administration to
behave opportunistically, the domestic political instability, coupled with the serious relative scarcity of
capital in the international economy, clouded the decision-making process, making it harder for Brazilian
officials to properly identify their policy choices and the costs associated with each one of them.

Lastly, the primary sources and the terms of the Third Funding support my hypothesis that
cooperation in the sovereign debt market is better understood as a process of mutual adjustment
between creditors and debtors. The Provisional Government was able to negotiate changes to the
Brazilian debt contracts in a process mediated once more by the Rothschild bankers. The Third Funding
Loan did not amount to a repudiation of the Brazilian debts, but since it followed a unilateral debt
moratorium it occupies a different position than the First Funding in the cooperation range, closer to the
discord pole. Naturally, this is not to say that the negotiations were easy. For several months it seemed
as if the Vargas administration would not be able to reach an agreement with the bankers, but the utter
collapse of the international financial system during September of 1931 forced the hand of all those
involved, as we will see later.
My analysis in this chapter will proceed as follows. In section 4.2 I analyze how and to what extent the finance and production structures of the international economy impacted the Brazilian economy and affected the relative scarcity of capital at the international level in the context of the unraveling of the gold standard and the early years of the Great Depression. In section 4.3 I analyze the domestic context during the transition from the Old Republic to the “Vargas Era”, with particular focus on the political events that led to the Revolution of 1930 and the instability under which the Provisional Government had to make decisions about the Brazilian sovereign debt. In section 4.4 I analyze the negotiations for the Third Funding and the structural power wielded by the Rothschild bankers and other financial experts in the context of the 1930s. In section 4.5 I explain how my hypothesis fulfills the validity conditions raised in section 2.4 in the context of the Third Funding.

4.2) The Finance and Production Structures in the Early 1930s: Capital Flows and International Commodity Prices

The institutions of the gold standard still formed the cornerstone of the finance structure of the international economy in the late 1920s. The United States, which now occupied Great Britain’s place as the main financial and commercial center of the international economy, demonstrated its increasing structural power when the Federal Reserve raised interest rates in 1928, attracting gold from the rest of the world and prompting other countries to follow suit (Eichengreen 1996, 68; Galbraith 1997, 30; Thorp 1984, 6). As a result, outflows from the United States dropped to zero in the second half of 1928 (Eichengreen 1996, 71), putting considerable pressure on the international economy and increasing the relative scarcity of capital at the international level. Similarly to the situation faced by the Barros administration in the 1890s, the Brazilian government did not have at their disposal the effective policy tools to counterbalance the pressure on the country’s balance of payments.

Part of the responsibility falls with the Brazilian government itself. After taking office, President Washington Luis Pereira de Sousa (1926-1930) introduced a new economic program to gradually prepare the Brazilian economy for the future adoption of the gold standard. One of his first measures
was to officially devalue the Brazilian currency, changing the parity rate set in 1846 at 27 pence per mil-réis to 6 pence, a number more in line with the prevailing exchange rate but that resulted almost overnight in an effective devaluation of the Brazilian currency of more than 70% (Neto 2012, 246; Neuhaus 1975, 84). In the same legislation, President Sousa also introduced one of the most important norms associated with the gold standard, namely the freedom of capital flows: “gold, whether in bars or coins, can freely enter or leave the country, subject only to the tax laws” (Decree 17.618, 1927). The measure enshrined in the Brazilian legal system the vulnerability of the capital account and effectively limited the ability of Brazilian officials to quickly institute capital controls or other measures to restrict gold outflows, without bringing long-term benefits to the Brazilian economy. According to Neuhaus, the new parity affected the exchange rate and there was a sizable inflow of capital in 1926, as Brazilian assets became relatively cheaper and more attractive to foreign investors (Neuhaus 1975, 86), but the ebullient mood among foreign investors did not last for long.

In 1928 the Sousa administration increased the bet on the gold standard by adopting a number of policies, including cuts in government spending and restrictions to the lending policies of the Bank of Brazil, that contracted the money supply and worsened the scarcity of capital in the domestic economy (Carone 1970; Fritsch 1990, 60; Neuhaus 1975, 102, 104). Even The Economist, usually supportive of President Sousa’s policies, admitted that they could have unintended contractionary consequences: “[t]he only thing to fear is a somewhat too rigid enforcement of a policy of credit facilities restriction, which might very well do as much harm as good” (Economist 1929, 269). There is some controversy among the secondary sources as to the real motivations behind the adoption of those policies,115 but their contractionary effects, weakening the Brazilian economy and decreasing the revenue of the federal government, are undisputed. Table 4.1 illustrates their consequences by showing the variation in the Brazilian GDP in the four years of the Sousa administration:

115 Fritsch (1990, 60) argues that they were informed by the rules of the gold standard and were a reaction to the deterioration in the Brazilian balance of payments. Most of the authors I consulted argue that they were designed to lay the groundwork for the official adoption of the gold standard.
Table 4.1 – Variation in the Brazilian GDP (1926-1930)

<table>
<thead>
<tr>
<th>Year</th>
<th>Variation (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1926</td>
<td>5.20</td>
</tr>
<tr>
<td>1927</td>
<td>10.80</td>
</tr>
<tr>
<td>1928</td>
<td>11.50</td>
</tr>
<tr>
<td>1929</td>
<td>1.10</td>
</tr>
<tr>
<td>1930</td>
<td>-2.10</td>
</tr>
</tbody>
</table>

Source: Instituto Brasileiro de Geografia e Estatística (2014a)

On the other hand, it is true that Brazilian policy-makers at the time could not have predicted the full impact of those policy changes, especially when coupled with the effects of the Great Depression and the radical transformation of the international economy that culminated in the creation of the Bretton Wood system after the Second World War. That was true even of more powerful creditor countries at the center of the international economy. It is revealing that Great Britain clung to the gold standard until September of 1931, despite clear signs that a convertible pound was unsustainable.\(^{116}\)

It is also noteworthy that despite the demonstrated commitment of President Sousa to the orthodoxy of the gold standard, capital flows to Brazil did not pick up speed after 1926. *The Economist* noted that: “owing to the high prestige of [President Sousa’s] Government, there should be no obstruction to the flow to this country of foreign investment capital, *although none has been sought or offered of late*” (Economist 1929a, 269 - my italics). His prestige seemed justified from a fiscal perspective. Although the Sousa administration faced a deficit in 1926 and a very weak surplus in 1927, it managed to avoid a fiscal crisis even during the difficult years of 1928 and 1929, as shown in table 4.2. Its fiscal performance contrasted sharply with that of previous administrations, as show in figure 4.1:

\(^{116}\) For a detailed account of how the Great Depression developed in the international capital markets, please see Eichengreen (1996), chapter three. For an analysis of its impact on Latin America, See Taylor (2006, 84).
Table 4.2 – Brazilian federal government – revenue and expenditures, 1926-1930 (in Contos de Réis)

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue</th>
<th>Expenditures</th>
<th>Deficits / Surpluses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1926</td>
<td>1,647,889</td>
<td>1,823,571</td>
<td>(175,682)</td>
</tr>
<tr>
<td>1927</td>
<td>2,039,506</td>
<td>2,008,654</td>
<td>30,852</td>
</tr>
<tr>
<td>1928</td>
<td>2,216,513</td>
<td>2,018,158</td>
<td>198,355</td>
</tr>
<tr>
<td>1929</td>
<td>2,399,600</td>
<td>2,224,617</td>
<td>174,983</td>
</tr>
<tr>
<td>1930</td>
<td>1,677,952</td>
<td>2,510,542</td>
<td>(832,590)</td>
</tr>
</tbody>
</table>

Sources: Instituto Brasileiro de Geografia e Estatística (2013d)

Figure 4.1 – Revenue, expenditures, and net results for the federal government, Old Republic (1901-1930)

It is thus clear that both orthodox policies and a reputation for austerity were not enough to shield the Brazilian government from the problems mounting in the international economy. In spite of the rather cautious approach of the Sousa administration, the federal government still needed to borrow regularly abroad to finance its deficits and other foreign currency needs.

The constant increase in the stock of outstanding foreign debt payable in gold (or in foreign currencies convertible into gold) throughout the Old Republic resulted in a situation in which successive administrations had to keep borrowing, or rolling-over their debts, merely to finance their debt service commitments. Brazil was thus very vulnerable to shifts in capital flows, as in fact were other Latin American countries (Abreu 1984, 145). Table 4.3 shows the loans contracted by the Brazilian government from 1900 to 1930 and the foreign debt outstanding by the time of the 1930 Revolution:
Table 4.3 – Brazilian foreign debt, in thousands of British pounds (1900-1930)

<table>
<thead>
<tr>
<th>Year</th>
<th>Loans Taken</th>
<th>Debt Outstanding</th>
<th>Year</th>
<th>Loans Taken</th>
<th>Debt Outstanding</th>
</tr>
</thead>
<tbody>
<tr>
<td>1900</td>
<td>2,869</td>
<td>44,182</td>
<td>1916</td>
<td>1,158</td>
<td>161,623</td>
</tr>
<tr>
<td>1901</td>
<td>16,031</td>
<td>59,996</td>
<td>1917</td>
<td>—</td>
<td>158,545</td>
</tr>
<tr>
<td>1902</td>
<td>—</td>
<td>59,769</td>
<td>1918</td>
<td>346</td>
<td>153,678</td>
</tr>
<tr>
<td>1903</td>
<td>8,500</td>
<td>68,269</td>
<td>1919</td>
<td>2,019</td>
<td>152,423</td>
</tr>
<tr>
<td>1904</td>
<td>2,062</td>
<td>69,866</td>
<td>1920</td>
<td>—</td>
<td>150,335</td>
</tr>
<tr>
<td>1905</td>
<td>8,814</td>
<td>78,023</td>
<td>1921</td>
<td>20,336</td>
<td>169,368</td>
</tr>
<tr>
<td>1906</td>
<td>10,290</td>
<td>87,656</td>
<td>1922</td>
<td>17,716</td>
<td>185,377</td>
</tr>
<tr>
<td>1907</td>
<td>5,650</td>
<td>91,246</td>
<td>1923</td>
<td>—</td>
<td>183,442</td>
</tr>
<tr>
<td>1908</td>
<td>23,750</td>
<td>111,599</td>
<td>1924</td>
<td>—</td>
<td>181,683</td>
</tr>
<tr>
<td>1909</td>
<td>4,300</td>
<td>113,685</td>
<td>1925</td>
<td>3,082</td>
<td>182,982</td>
</tr>
<tr>
<td>1910</td>
<td>18,200</td>
<td>128,260</td>
<td>1926</td>
<td>29,246</td>
<td>210,454</td>
</tr>
<tr>
<td>1911</td>
<td>9,900</td>
<td>132,184</td>
<td>1927</td>
<td>26,622</td>
<td>234,186</td>
</tr>
<tr>
<td>1912</td>
<td>4,200</td>
<td>131,526</td>
<td>1928</td>
<td>25,293</td>
<td>254,969</td>
</tr>
<tr>
<td>1913</td>
<td>19,620</td>
<td>144,233</td>
<td>1929</td>
<td>2,877</td>
<td>252,286</td>
</tr>
<tr>
<td>1914</td>
<td>18,702</td>
<td>160,987</td>
<td>1930</td>
<td>20,000</td>
<td>266,154</td>
</tr>
<tr>
<td>1915</td>
<td>3,530</td>
<td>161,900</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Instituto Brasileiro de Geografia e Estatística (2013g)

The payment commitments facing President Sousa were significantly larger than those of the Barros administration during the Depression of the Nineties. Abreu estimates that the foreign debt stock in 1930 amounted to a staggering 400% of Brazilian exports, with debt service compromising 30% of the country’s total export revenue and 26% of the revenue of all levels of government (2002, 518).¹¹⁷ Not surprisingly, the expenditures by the Ministry of Finance eventually dwarfed those of the other Ministries during most of the Sousa administration:

¹¹⁷ To my knowledge, there is no equivalent for the period of the Great Depression to the study conducted by Flandreau and Zumer (2004). They point out that 52% of the Brazilian foreign debt was payable in gold in 1913, and it is reasonable to assume that the percentage did not decrease significantly until the early 1930s.
The relative scarcity of capital became more serious after 1931, when the sovereign debt market effectively closed to new debt issues by Brazil and other developing sovereign debtors. Clearly, it was not a direct response by market actors to the fall of President Sousa or the end of the Old Republic. It hit most countries in Latin America (De Alejandro 1984, 20) and preceded the 1931 Brazilian moratorium. In fact, the moratorium was a response to the relative scarcity of capital, and not the other way around. Despite a 20-million-pound loan that the state of São Paulo arranged in 1930 to fund its coffee purchase program, a 6.5-million-pound short-term loan from the Rothschilds to the Bank of Brazil (Abreu 2002, 530; Neuhaus 1975, 108; Whitaker 1978, 156), and the 1931 Funding Loan, Brazil experienced net outflows of gold for most of the 1930s, as it maintained debt payments until 1937. The country’s foreign exchange reserves, which had amounted to 31.1 million pounds in September of 1929, eventually dropped to zero in 1931 (Abreu 1974, 14; 1990, 74; Neuhaus 1975, 104–7). Tables 4.4 and 4.5 and figure 4.3 provide a clear picture of the impact of the relative scarcity of capital on the Brazilian finances:
Table 4.4 – Brazilian foreign debt, in thousands of British pounds (1930-1937)

<table>
<thead>
<tr>
<th>Year</th>
<th>Loans Taken</th>
<th>Debt Outstanding</th>
<th>Year</th>
<th>Loans Taken</th>
<th>Debt Outstanding</th>
</tr>
</thead>
<tbody>
<tr>
<td>1930</td>
<td>20,000</td>
<td>266,154</td>
<td>1934</td>
<td>-</td>
<td>264,021</td>
</tr>
<tr>
<td>1931</td>
<td>18,359</td>
<td>275,966</td>
<td>1935</td>
<td>-</td>
<td>256,783</td>
</tr>
<tr>
<td>1932</td>
<td>-</td>
<td>268,430</td>
<td>1936</td>
<td>-</td>
<td>252,638</td>
</tr>
<tr>
<td>1933</td>
<td>-</td>
<td>266,430</td>
<td>1937</td>
<td>-</td>
<td>242,706</td>
</tr>
</tbody>
</table>


118 The IBGE data does not include the 6.5-million-pound short-term loan contracted by the Bank of Brazil in 1931.

Table 4.5 – Brazilian debt service and net flows, in thousands of British pounds (1929-1932)

<table>
<thead>
<tr>
<th>Year</th>
<th>Loans Taken</th>
<th>Debt Service</th>
<th>Net Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929</td>
<td>2,500</td>
<td>17,300</td>
<td>-14,800</td>
</tr>
<tr>
<td>1930</td>
<td>18,000</td>
<td>19,700</td>
<td>-1,700</td>
</tr>
<tr>
<td>1931</td>
<td>18,400</td>
<td>20,400</td>
<td>-2,000</td>
</tr>
<tr>
<td>1932</td>
<td>-</td>
<td>6,800</td>
<td>-6,800</td>
</tr>
</tbody>
</table>

Source: Abreu (1974, 8).

119 Abreu differs from the IBGE in his calculations for capital inflows in 1930, but his findings do not challenge my arguments in this section.

Figure 4.3 – Brazilian foreign debt – new loans and debt service, 1925-1937

Source: Instituto Brasileiro de Geografia e Estatística (2013g). Debt owed by the Federal government. The year of 1925 was the one immediately before the election of President Sousa. In 1937 Brazil once again suspended debt payments, only resuming payments after the Second World War.

International trade could have provided the gold and hard currency Brazil needed to fulfill its foreign currency obligations if the production structure of the international economy had also not been
negatively impacted by the Great Depression. As was the case in the 1890s, Brazil was very susceptible to fluctuations in international trade due to its dependence on coffee exports. Coffee still provided 70% of Brazilian exports and the United States alone absorbed 50% of the total Brazilian production (Abreu 1984, 147; Netto 1979, 97). As an illustration, figures 4.4 and 4.5 respectively present the Brazilian balance of trade during the first three decades of the twentieth century and during most of the 1930s:

**Figure 4.4 – Brazilian balance of trade (1901-1930) – in thousands of British pounds**

![Graph showing the Brazilian balance of trade (1901-1930)](source: Instituto Brasileiro de Geografia e Estatística (2013e))

**Figure 4.5 – Brazilian balance of trade (1929-1937) – in thousands of British pounds**

![Graph showing the Brazilian balance of trade (1929-1937)](source: Instituto Brasileiro de Geografia e Estatística (2013e))

Table 4.6 lists coffee prices in the United States during the Great Depression. Figure 4.6 shows the impact of the fall in prices on Brazilian export earnings in the period from the beginning of the Great Depression until 1937:
Table 4.6 – Coffee import prices in the United States, yearly average (in cents per pound)

<table>
<thead>
<tr>
<th>Year</th>
<th>Price</th>
<th>Year</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929</td>
<td>20.4</td>
<td>1934</td>
<td>8.8</td>
</tr>
<tr>
<td>1930</td>
<td>13.1</td>
<td>1935</td>
<td>7.6</td>
</tr>
<tr>
<td>1931</td>
<td>10.1</td>
<td>1936</td>
<td>7.7</td>
</tr>
<tr>
<td>1932</td>
<td>9.1</td>
<td>1937</td>
<td>8.9</td>
</tr>
<tr>
<td>1933</td>
<td>7.9</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Netto (1979, 246)

Figure 4.6 – Brazilian coffee exports, volumes and earnings (1929-1937)

Source: Instituto Brasileiro de Geografia e Estatística (2013h)

Abreu (1984, 148) calculates that the Brazilian terms of trade dropped consistently throughout the 1930s, bottoming out in 1937 at less than 40% of their 1928 level. According to De Alejandro (1984, 21), the exports from indebted Latin American countries were further affected by the protectionist measures adopted by countries at the center of the international economy, as exemplified by the Smoot-Hawley tariff in the United States in 1930 and by the Abnormal Importations Act and the Commonwealth preferences system adopted by Great Britain in 1931 and 1932. The adoption of trade-distorting legislation in a pro-cyclical fashion illustrates the structural power that creditor countries could wield in order to mitigate the economic effects of adjustment in their economies and to transfer most of the costs thereof to less powerful countries in the periphery of the system.
The fall in coffee prices had concerned President Sousa, followed by President Vargas and his ministers, and foreign observers alike (Economist 1929a, 1929b; Neto 2012, 246). Besides undermining the Brazilian repayment efforts, the problems in the balance of trade also contributed to the budget deficits of the federal government. Although successive Republican administrations gradually moved away from their over-reliance on import duties, these still corresponded to slightly more than 40% of total federal revenues during the late 1920s and early 1930s. Figure 4.7 provides a breakdown of the different revenue sources and how much they contributed to the federal budget between 1901 and 1930. Figure 4.8 provides their respective amounts in mil-réis. Figure 4.9 shows a breakdown of the sources of the federal revenue for the years between 1929 and 1937:

Figure 4.7 – Revenue sources as a percentage of total revenue – federal government (1901-1930)

Source: Instituto Brasileiro de Geografia e Estatística (2013b)

Figure 4.8 – Revenue – amounts in mil-réis – federal government (1901-1930)

Source: Instituto Brasileiro de Geografia e Estatística (2013b)
The problems in the balance of trade, together with the cumulative effects of the capital flight resulting from the operation of the finance structure of the international economy, contributed to the depreciation of the mil-réis and the fall in the exchange rate. The depreciation of the currency made imports more expensive and the adjustment in imports could lag the fall in exports, leading to further depreciations in a negative feedback loop. Problematically, the depreciation fueled the crisis without making Brazilian exports more competitive, as the Great Depression reduced demand for coffee in the United States and Europe, the main foreign markets for the product.

Figure 4.10 shows these developments. As we can see, the mil-réis depreciated consistently against the U.S. dollar during most of the 1930s.\(^{120}\)

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\(^{120}\) The Instituto Brasileiro de Geografia e Estatística does not provide the official exchange rate for the British pound for the years after 1930.
Brazilian policy-makers were conscious of those connections. For instance, Minister Whitaker wrote to president Vargas in January of 1931 that “(...) coffee [is] the key to our economy, our wealth, the major source of the gold we need” (1931b). In the same letter, mentioning the short-term loan that the government was negotiating for the Bank of Brazil, he further noted that: “(...) we will only be able to slow down [the fall in the exchange rate] if the Bank of Brazil eventually gets the funds we have insistently asked from the N. M. Rothschild & Sons” (1931b). In effect, *The Economist* brought attention to the weight of those factors in an edition from February of that year, arguing that: “[t]he economic ills of Brazil are those which are common, to-day, to all countries in the world whose national economy depends on the world-price of certain foodstuffs and raw materials” (1931a, 287).

In summary, Brazil suffered a massive balance of payment crisis in the early 1930s (Abreu 1984, 148). These effects were not restricted to Brazil. They were seen in the rest of Latin America and even in Europe:

The business recession beginning in 1929 severely undercut the ability of foreign debtors to provide funds for debt service in their own currency and to transfer those funds into the currencies of their creditors. Both budget and balance-of-payments difficulties arose as export prices, as well as volumes, began to fall and as the joint effects of protection, depression, and the closing of international capital markets devastated both trade and government revenues (...). (Jorgensen and Sachs 1989, 57)

The macroeconomic data above and the other primary sources show that rather than acting opportunistically by declaring the moratorium and negotiating the Third Funding Loan, Vargas and the Provisional Government were attempting to deal with the consequences of external economic

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Figure 4.10 – Brazilian exchange rate – *mil-réis* x U.S. dollar

![Exchange Rate mil-réis/USD](image)

Source: Instituto Brasileiro de Geografia e Estatística (2013f)
conditions that challenged their own preferences in terms of economic policies. That is not to say that the Brazilian policy-makers were entirely blameless in the crisis they found themselves in, but during the early stages of the Great Depression they indeed had very limited policy choices at their disposal and regarded the Third Funding as a crucial step for the stabilization of the Brazilian economy. In the next section I briefly analyze Brazilian Domestic politics in the period of the Revolution of 1930 to provide further evidence in support of my claims.

4.3) The Domestic Context: the Fall of the Old Republic and the Rise of Vargas

The primary sources on the Third Funding challenge the view that the preferences of domestic political actors in the 1930s, or specific configurations of domestic political institutions, can properly account for the decision of the Provisional Government to declare a moratorium and to seek a restructuring of the Brazilian foreign debt. While it is true that the Brazilian society was more complex in the 1930s than it was during the first decade of the Old Republic (Carone 1971, 429–430), it still did not fit the model of pluralistic society that is at the core of some explanatory hypotheses in the literature. Moreover, after the Revolution toppled the Sousa administration in October of 1930, power was concentrated on the hands of President Vargas and the executive branch. All political parties were banned, the Provisional Government exerted strict control over the press, and the existing labor unions were placed under the tutelage of the newly created Ministry of Labor (Carone 1974, 129, 131, 137; Carone 1991, 47–53). The Revolution was a de facto regime of force, and there is nothing to suggest that President Vargas faced any significant organized opposition to either defaulting or repaying the country’s foreign debts.

That is not to say that there was a policy consensus or that there was no push back against the policies implemented by the Provisional Government. However, instead of providing clear incentives to federal policy-makers based on the preferences that particular groups could have towards either repayment or default, domestic political factors generated instability during the crucial period of the
debt crisis, clouding the environment and complicating the decision-making process inside the Provisional Government. It is in this turbulent context that we should understand the relatively small role played by Brazilian domestic factors in the negotiations for the Third Funding.

After the turmoil of its early years, the Old Republic had recovered some measure of stability during the administration of President Manuel Ferraz de Campos Sales (1898-1902), one of the main negotiators of the First Funding. He adopted a series of political practices and informal institutions dubbed by Brazilian historians the “Policy of the Governors” (Politica dos Governadores). In practical terms, this political mechanism meant that the groups controlling the federal government provided financial resources and offices in the federal bureaucracy to the other regional Brazilian elites in exchange for their political support, and turned a blind eye to the repression and abuses they perpetrated in the states they ruled (Cardoso et al. 2006, 54–7; Carone 1971, 176, 302–6). In other words, the Policy of the Governors adapted the co-optation mechanism of the Empire to the Republican context (Lessa 2001, 53) while reinforcing the privileged position of the powerful elites from the states of São Paulo and Minas Gerais.121

The Policy of the Governors remained the main political backbone of the Republic. It isolated the federal government from the push and shove of state and party politics that had plagued President Barros, but it was usually contested near and during the elections (Carneiro 1999, 260; Carvalho 2001, 97–8). The elites from Minas Gerais and São Paulo were supposed to “alternate” in the presidency (Carone 1971, 405) but were constantly at odds about the appointment of the official presidential candidate,122 while lacking the strength to impose their preferred nominees without the support of

121 They were the richest and most populous states in Brazil at the time. Together, they made eight out of the eleven presidents elected between 1894 and 1930 (Carvalho 2001, 98). Presidents Barros, Sales, Francisco de Paula Rodrigues Alves (1902-1906, reelected in 1918 but died before taking office), Washington Luis Pereira de Sousa (1926-1930), and Júlio Prestes de Albuquerque (elected in 1930 but prevented from taking office by the Revolution), were members of the São Paulo elite. Presidents Afonso Augusto Moreira Pena (1906-1909), Venceslau Brás Pereira Gomes (1914-1918), and Artur da Silva Bernardes (1922-1926), were members of the Minas Gerais elite.

122 According to article 43 of the 1891 Republican Constitution, presidents could not be reelected for an immediately subsequent mandate.
other states (Carone 1971, 215). The recurrent political fights surrounding the presidential nomination increased the political stakes in moments in which tensions were already high due to the prospect of a change in the leadership of the country.

As the 1930 elections approached, the negotiations between São Paulo and Minas Gerais for the appointment of the official candidate quickly broke down. Following the informal alternation rules of the Policy of the Governors, Antonio Carlos Ribeiro de Andrada, the Governor of Minas Gerais, aspired to the nomination, but President Sousa chose instead the governor of São Paulo, Julio Prestes de Albuquerque (Carneiro 1999, 261; Neto 2012, 260; Schneider 1991, 113). The slight prompted Governor Andrada to articulate the appointment of an alternative presidential ticket and he found an unexpected ally in Vargas, then the governor of the state of Rio Grande do Sul. After protracted and convoluted negotiations, Vargas accepted to run for the presidency with the support of a loose coalition of the elites from Minas Gerais, from his state of Rio Grande do Sul, and from the Northeastern state of Paraíba, along with small opposition groups in other states.

The opposition campaign was marked by contradictions that would reverberate after the Revolution, compounding the difficult scenario President Vargas and the Provisional Government had to navigate in their first years in power. For instance, his most important backers were members of the traditional political elites of Minas Gerais and Rio Grande do Sul, and he could be counted as a member of the oligarchies that ruled the Old Republic since at least the administration of President Barros (Bello 1966, 272; Carone 1971, 411, 422). On the other hand, he managed to get the support of a group of radicalized junior Army officers dubbed by Brazilian contemporaries the “Lieutenants” (the Tenentes). The Lieutenants were predominantly soldiers, non-commissioned officers, and junior Army officers who saw themselves as the ideological heirs to the Jacobinism of the first decade of the Republic and had

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123 President Sousa had been appointed by São Paulo. The election of Governor Albuquerque meant the continuity of the control of that state over the federal government.
124 Coincidently, Vargas had been Minister of Finance in the first years of the Sousa administration. President Sousa and many in the Brazilian political elites were surprised by the announcement (Neto 2012, 319–20).
125 The Governor of Paraíba, João Pessoa Cavalcanti de Albuquerque, was Vargas’ running mate. Albuquerque was the nephew of former Brazilian President Epitácio Lindolfo da Silva Pessoa (1919-1922).
agitated against the civilian administrations throughout the 1920s (Carone 1971, 364–7, 369–80, 385–90, 396, 401; Ferreira 1993, 10; Schneider 1991, 110–1). One of Vargas’ supporters, Lindolfo Leopoldo Boeckel Collor,126 awkwardly attempted to explain these contradictions in the following way: “[w]e are conservatives and not liberals. However, as conservatives, and [considering] the fact that we want to improve [the current situation], we are [being] progressive” (apud Neto 2012, 342). Conscious of the eclecticism of his base of support, Vargas summarized his balancing act with more candor than Collor: “political issues in Brazil are solved with transitory arrangements” (apud Neto 2012, 342).

Vargas lost the elections by a considerable margin, but the victory of the official candidate did not put an end to the political crisis. President Sousa worsened the rupture between São Paulo and Minas Gerais by bringing the weight of the federal government to bear on the opposition states.127 His heavy-handedness pushed many civilians in the opposition to join the Lieutenants in planning a military coup, and the fighting was eventually triggered by the assassination of Vargas’ running-mate, Governor Albuquerque, a couple of months after the election. Although not directly connected to the electoral campaign, the crime galvanized the opposition and provided a convenient justification for forceful action. With Vargas at the helm, the Revolution started in early October of 1930 in the Southern state of Rio Grande do Sul and made its way north towards Rio de Janeiro. As support for the loyalist faction quickly declined (Carneiro 1999, 269–271), President Sousa was eventually forced to step down and go into exile by a palace coup led by a group of senior generals unconnected to the Lieutenants and the civilian rebels. Only after tense negotiations did the generals grudgingly allow Vargas to enter Rio de

126 After the Revolution, Collor was appointed the first Brazilian Minister of Labor.
127 Among other retaliation measures, President Sousa laid off federal public workers from Minas Gerais, Rio Grande do Sul, and Paraíba, pushed the Bank of Brazil to cancel or collect its loans to those states, and even barred elected senators and congressmen linked to the losing candidates from taking office (Carneiro 1999, 262, 266; Carone 1971, 408, 417). This was possible due to an institutional innovation related to the Policy of the Governors. All elected members of Congress had to validate their candidacy and election in the infamous Commission for the Validation of Powers (Comissão de Verificação de Poderes). The Commission was headed by the Congressman who had acted as President of the house in the previous legislative section. In practice, that meant that the Commission was controlled by the majority, which was in turn controlled by the President through the Policy of the Governors, and could refuse to validate any candidacy on the flimsiest of excuses (Carone 1971, 176–7).
Janeiro on October 30th and to take office as the Chief of the Provisional Government (Carone 1971, 429; Schneider 1991, 118). The picture was extremely confusing, especially for foreigners:

Owing to the immense size of the country and the number of different fields in which fighting between revolutionary forces and the Government forces was taking place, it was impossible, for some time after the revolution had broken out, to obtain any real light on how things were going. Indeed, observers at Rio itself seem to have been almost as much in the dark, up to the last moment, as observers in New York and London. (Economist 1930, 803)

Like its military predecessor in 1889, the Provisional Government closed the chapter on the Old Republic by dissolving the legislative branches at the three levels of government, banning political parties, removing from power those who had supported the Sousa administration, and dismantling the Republic’s formal and informal political institutions. President Vargas nominated his supporters, most of them Lieutenants, to “intervene” in the states and become their de facto administrators (the Interventores) (Schneider 1991, 118), antagonizing important political groups in the process. The political problem created by the nomination of an Interventor for São Paulo was a constant headache, eventually leading Minister of Finance José Maria Whitaker to resign in the middle of the negotiations for the Third Funding (Carone 1974, 28, 67; Neto 2013, 39).  

Vargas’ reliance on “transitory alliances” also left him with a fragmentary base of support that was prone to infighting. His close collaborators formed a heterogeneous group of people with different backgrounds and perspectives who tended to dislike each other and who clashed frequently for the control of the political machinery in the states (Schneider 1991, 119, 120–122). The antagonisms involving the senior military officers, the Lieutenants, and the civilians more often than not flared into dramatic resignations, shouting matches, and open revolt (Carone 1974, 301). Reflecting these problems, President Vargas wrote in his diary on January 2nd, 1931 that: “the discontent has started, revolutionaries have started to dissociate [themselves from the government]” (Vargas 1995k, 47).

The tensions between São Paulo and the Provisional Government ultimately exploded in a civil war that began on July 9th, of 1932. The Provisional Government quickly quashed the forces from São Paulo, but as a condition for their surrender President Vargas agreed to call elections and to initiate studies for the adoption of a new constitution (Carone 1974, 316–7). 

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128 The tensions between São Paulo and the Provisional Government ultimately exploded in a civil war that began on July 9th, of 1932. The Provisional Government quickly quashed the forces from São Paulo, but as a condition for their surrender President Vargas agreed to call elections and to initiate studies for the adoption of a new constitution (Carone 1974, 316–7).
The political instability inside and outside the government made it harder for President Vargas and other Brazilian policy-makers to properly assess how their choices about debt repayment could affect their political survival. Neto notes in his biography of President Vargas that “[o]ne of [Vargas’] main fears was that the political instability and the agitation inside the military could be transmitted to other areas of the government, precisely at the time when [they] were conducting a delicate financial negotiation with the international creditors” (Neto 2013, 45). That said, the problems were predominantly political. As my brief account of the Revolution shows, the survival of the new government depended on a host of political variables related primarily to the inter-elite rivalries that were a fixture of Brazilian politics since the times of the Monarchy, along with the willingness of different factions in the Army to intervene in the normal operation of the Brazilian political process. President Vargas seemed more concerned with how the political instability could affect the Ministry of Finance, delaying or even derailing the negotiations for the Third Funding, than with how different interest groups would react to a debt restructuring. The resignation of Minister Whitaker during the negotiations illustrates the point.

We should thus avoid prescribing a predominant policy role to any factions or interest groups active in the early 1930s. The regional elites that had dominated Brazilian politics throughout the Old Republic were very fragmented and there was little to guide the Provisional Government as to what they might do in case of a default. It is also historically inaccurate to assume that the economic interests of the coffee-planting elite from São Paulo overshadowed the preferences of any of the other elites, or that the interests of any groups were immediately translatable into or determined the content of the economic policies adopted by President Vargas. The Provisional Government did not shy away from pursuing macroeconomic policies that went against the immediate interests of the coffee-planters or other political elites. In fact, that happened even during previous administrations that were directly linked to the São Paulo elites, such as that of President Sousa. For instance, he ignored the pleas from São Paulo to extend federal support to the coffee valorization program coordinated by the state when
the hike in interest rates in the United States drained liquidity from the international economy and increased the relative scarcity of capital at the international level (Abreu 1974, 13; Carone 1974, 25). The Economist even lauded the President’s willingness to “do the right thing” against the power of the coffee planters: “[n]aturally, this cutting down of disbursements [due to government spending cuts] has not – nor could it have – been brought about without causing some measure of disappointment (...) and the interest of the farmers and planters have received a check” (Economist 1929, 268).

Like President Sousa’s, the stance of the Provisional Government towards the planters was not subservient. We can attribute the policies it adopted in support of the coffee sector to the importance that the product had to the Brazilian economy, as I showed in section 4.2 above. According to Carone, “the federal government [begun] a broad process that was crucial for the support of the tittering coffee economy: between 1933 and 1938, it [took] basic measures that [included] (...) buying the product and rolling over debts, (...) and the cancellation of part of [the coffee planters’] debts” (1974, 29). In addition, if on the one hand the government supported coffee prices through a “policy of permanent official intervention in the coffee market” (Netto 1979, 83), on the other it intervened in the organizations that the state of São Paulo created to manage the coffee sector, eventually closing them down in 1933 and transferring most of their attributions and prerogatives to a newly created federal agency (Carone 1974, 33).

As to the Army and the Lieutenants, it is true that both gained more prominence and became more politically active in the period under analysis. The Lieutenants in particular were rewarded by President Vargas with key positions in the government, and many were nominated to be Interventores in the states (Carone 1974, 392–3). However, echoing the political circumstances behind the First Funding, the Army was split among a loyalist, a revolutionary, and an unaligned faction, and even the Lieutenants were not immune to political divisions, as they seemed to have inherited the lack of political coherence that afflicted their Jacobin predecessors. Many eventually defected from the Provisional Government to either the extreme left, joining the underground Brazilian Communist Party and other
leftist groups, or the right, joining groups such as the fascist-inspired Brazilian Integralist Action (*Ação Integralista Brasileira*) (Carone 1974, 388).

Although the Lieutenants tended to be economic nationalists, there is no indication that they had a consistent position about the Third Funding, or debt repayment more generally. For instance, Agildo da Gama Barata Ribeiro, a young Lieutenant that participated in the Revolution and later joined the Brazilian Communist Party to fight against President Vargas, suggested in his autobiography that the position of the Lieutenants in economic matters did not go much beyond a vague opposition to the *status quo*: “[t]he ineptitude of the federal government [before the Revolution], its incapacity to speed up the progress [of the country] (…). [Our] argument was [this]: it is necessary to topple this government and replace it with another, because *it is impossible that it will be worse than the one that is [currently] there*” (1978, 82 - original italics). Likewise, there is nothing in the primary sources to suggest that the different factions in the Army had a clear and marked position about the country’s foreign debt.

Finally, similarly to what had happened during the late nineteenth century, the Brazilian population seemed to have been indifferent to the Third Funding, and even if particular members of the public disagreed with the prospect of either debt repayment or a default, the dictatorial nature of the Provisional Government effectively barred most Brazilians from influencing the decision-making process. This limited the possibilities for outspoken criticism of governmental policies or the proposal of any coherent alternative. In fact, the political instability of the period seemed to push everything else to the margins of the public debate:

the (...) historical agreement with the foreign bankers [was] practically ignored by the main newspapers in the country. On the *Folha da Manhã* [from São Paulo], a little note of ten lines was squeezed in a corner of the first page, obfuscated by the headlines decrying the ‘grave political situation’ [in Brazil]. In the *Correio da Manhã* [from Rio de Janeiro], [there was] not even that. The matter was relegated to an even smaller note, hiding among the small letters of the internal pages. One of the exceptions was the *Jornal do Brasil* [also from Rio de Janeiro], which in a piece of six paragraphs (...) reproduced a text written by the new Minister of Finance Osvaldo Aranha explaining the motivations for the [Funding Loan] (...). (Neto 2013, 45)
In summary, the main political actors at the time acted more as a source of noise and uncertainty than as clearly oriented maximizing interest groups that had clear positions on the economic policies implemented by the Provisional Government. Domestic politics required a great deal of attention from President Vargas at a moment in which he also had to deal with the impact of the Great Depression over the Brazilian economy and the negotiations with the Rothschild bankers. I will analyze the latter in the following section.

4.4) Cooperation: the Negotiations Behind the Third Funding Loan

Similarly to its nineteenth century predecessor, the Third Funding supports my hypothesis that cooperation in the sovereign debt market is better understood as a process of adjustment between creditors and debtors in accordance with the liberal institutionalist model of cooperation that I presented in section 2.4.2. It did not represent a return to the status quo ante or the enforcement of the original terms of the Brazilian debt contracts, and its outcome also fell in the cooperation range, although in a different position than the First Funding.

The negotiations for the Third Funding were initiated by minister Whitaker in September of 1931 and finalized by Minister Aranha in early 1932. According to the terms of the Funding, the Brazilian government agreed to keep servicing its previous Funding loans (the First and Second ones) in exchange for swapping the interest to be paid on other federal bonds during the following three years for two new bonds, both paying 5% interest and with maturities of 20 and 40 years. The bonds were to be issued by the Rothschilds for a total of 18 million pounds.

The Third Funding was preceded by several attempts by the Provisional Government to contract new loans abroad or to roll over existing ones. In January of 1931 it obtained from the Rothschild banking house a 6.5-million-pound loan to the Bank of Brazil. Minister Whitaker hoped, perhaps too optimistically, that the money would help forestall the depreciation of the mil-réis (Whitaker 1931a), but

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129 Please see Abreu (2002, 530–531) for a brief description of the terms of the Third Funding Loan.
with the sovereign debt market effectively closed due to the Great Depression the amount was not nearly enough to balance the outflow of gold from the country. The Provisional Government immediately started negotiating a bigger loan, and as a pre-condition to the talks with the bankers President Vargas agreed to receive a partly advisory, partly fact-finding mission headed by Sir Otto Ernst Niemeyer, a director at the Bank of England and well-known “money doctor” (Abreu 1974, 14).  

One of the main goals of the mission was to study the possibility of transforming the Bank of Brazil into a central bank in the mold of the Bank of England (Abreu 1974, 15). President Vargas wrote in his diary on January 12th, 1931 that “Sir Otto Niemeyer was chosen (…) to come to Brazil and help us with the reform of the Bank of Brazil, which shall become a Central Bank [with] issuing and discounting [functions]” (1995b, 42- my italics). Although he may have agreed with the idea for pragmatic reasons, it is also plausible that he saw the Niemeyer mission and the reform of the Bank of Brazil as an important step in the modernization of the Brazilian financial system, a policy concession that was at the same time useful and could be offered to the bankers in reciprocity for the loan.

After the Niemeyer mission, the negotiations reached an impasse. With few alternatives and rather unrealistically, the Provisional Government was pushing for a huge 25-million-pound loan, an amount which they hoped could stave off the debt crisis, help the Bank of Brazil repay the short-term loan it had contracted a few months before, and shore its capital, preparing it for its new functions as a central bank (Vargas 1995e, 68; Whitaker 1978, 156). Sir Niemeyer’s recommendations, officially published in July of 1931, threw the Brazilian plans in disarray. He opposed the idea of a new loan, disputed its proposed size, recommended that the Brazilian government focused instead on returning to the discipline of the gold standard by balancing its budget, and proposed the creation of a new, independent, central bank in which the Brazilian government would be barred from having a controlling stake (Abreu 1974, 15–8; 2002, 529; Neuhaus 1975, 108).

130 The visit had actually been arranged by Governor Albuquerque of São Paulo a few months before, after his victory in the presidential elections (Abreu 1974, 15; 2002, 528).
President Vargas seemed resigned to attempt to balance the country’s budget if no money was made available. He wrote in his diary that: “[I] held a meeting with the Ministry, to decide on new spending cuts [to balance] the budget (...). The country [needs] to save itself with its own means, avoiding the funding. Niemeyer’s secret report is against [it]” (1995d, 53). Minister Whitaker kept trying to mollify the British expert, but the external situation eventually led the Provisional Government to push harder for some form of restructuring: “In relation to the exchange rate, what [we need] in view of our lack of resources, the fall in [the government’s] revenue, [and] our lack of gold is the funding – or a postponement in the maturity of our external debts. This (...) [is] an unavoidable imposition of the circumstances” (Vargas 1995a, 51). Unintentionally, The Economist provided the best summary of the state of the international economy when, rather sheepishly, it acknowledged that “London will (...) watch further developments [in Brazil] with interest, (...) with the caveat that under present conditions London’s power to provide capital for financial reconstruction abroad possesses somewhat narrower limits than her willingness to render all possible assistance” (1931, 169).

As the relative scarcity of capital in the finance and production structures of the international economy worsened, the Provisional Government declared a moratorium on interest payments on September 1st, 1931 (Neuhaus 1975, 109). Minister Whitaker later met with President Vargas between September 15th and 18th to discuss the next steps they should take. The President recorded in his diary that “the [M]inister of [F]inance came to me to confess that it is impossible to continue the service of the foreign debt (...) we need to negotiate the funding” (1995g, 72 - my italics). On September 18th, the Provisional Government finally declared the full suspension of debt payments (Neuhaus 1975, 109–10). Days later, on September 21st, Great Britain suspended the convertibility of the pound to gold, highlighting how serious the scarcity of gold and capital was at the international level.

It is reasonable to assume that the deterioration of the international economy changed the perception of the Rothschild bankers and other creditors about the extent of the difficulties challenging Brazil. In this respect, The Economist remarked a couple of years after the negotiations:
The abandonment by Britain of the post-war gold standard, despite all the manifest shortcomings in both that standard and its working, has set in motion forces which have had lethal effects on the world’s monetary and commercial activities; for ever since the autumn of 1931 the debtor-creditor relationship, and therewith the obligation to maintain the long-term contractual relationships, have been slowly whittled away until, as at present, the crisis assumes such overwhelmingly unstable proportions as to render the voluntary assumption of new long-term contractual relationships virtually impossible. (1933, 1061)

According to Abreu (2002, 529), even Sir Niemeyer was eventually forced to acknowledge the seriousness of the crisis. Until then, he had failed to fully grasp the role that the structures of the international economy played in transmitting external shocks to the Brazilian economy: “by considering that the inflow of foreign capital depended solely on the good behavior of the Brazilian government, Niemeyer demonstrated an absolute misunderstanding of the true impact of the Depression on international capital movements” (Abreu 1974, 18). Abreu’s analysis is supported by a contemporaneous story in The Economist: “[t]he two outstanding features of (...) the last few years have been a catastrophic fall in prices and the closing of the international capital market. All countries have suffered (...) from the result of these events (...)” (1931d, 210).

In effect, the Brazilian government and the Rothschild bankers quickly resumed negotiations after the moratorium. The bankers pressed the Brazilian government to resume full interest payments on the previous Funding Loans and partial payments on a different set of older loans, and Sir Niemeyer defended that the new Funding should have a maturity of no more than 1 year (Abreu 2002, 529). However, the Brazilian government had more ambitious goals. Among other points, it proposed to resume interest payments only for the previous Funding Loans and asked for a 3-year grace period on service payments on the new bonds to be issued under the terms of the Third Funding (Abreu 2002, 529). It eventually achieved most of its goals. Judging by President Vargas’ diary and the notes that Minister Whitaker took of the ministerial meetings during the period, the Ministry was divided but the president’s position, favorable to finalizing the negotiations and accepting a compromise with the bankers, prevailed (Vargas 1995h, 76; 1995i, 76; 1995j, 76). In mid-December of 1931, the British and
American creditors agreed to the terms of the Funding, and the French creditors eventually adhered to the plan at the end of January of 1932.

The primary sources show that the Provisional Government was keen to establish its good faith, justifying the moratorium and the Funding Loan by connecting its difficulties to the state of the international economy during the early years of the Great Depression. Before he left the Provisional Government, Minister Whitaker defended the Brazilian position in the following terms:

To default (...) is an unhappy contingency, a disgrace (...). [Even] if we dismiss the extreme notion of suspending the service of the debt, the equivalent of the Bolshevist repudiation of any commitment (...), without any justification or disguise, it is still not easy to obtain from thousands of bondholders a moratorium that will take from them the income from which many of them depend to live. (...). That notwithstanding, the Government (...) although it has done all it can to avoid a delay [in payments], has contacted (...) the representatives of its creditors (...). We could temporarily suspend in part the amortization of [our] debt, without damaging anyone, and the Government has just concluded a negotiation to that effect (...). (1978, 156)

Minister Aranha, who replaced Whitaker in October of 1931, used similar terms:

[At a time in which all countries, maybe even those which are in a better financial situation than ours, decrease and limit] their external payments to [the amount] of their trade balance, (...) Brazil is negotiating a funding that strengthens the guarantees [available to] its creditors. (...) We have cut deeply and we are still cutting deeply (...). However, we cannot give our life at a time in which all countries are defending even their clothes. (apud Hilton 1994, 120)

Although they could be justifying their behavior on the basis that “talking is cheap”, it is telling that the Provisional Government insisted on arranging a Funding Loan instead of using the Revolution as a justification to repudiate its foreign debts. Minister Whitaker had already stressed in a letter to President Vargas that they should demonstrate their good faith during the negotiations and reciprocate any offers from their creditors with “fiscally responsible” policies of their own:

We need to trail (...) the path of sacrifices, reducing (...) the administrative expenditures and, maybe, increasing taxes that do not directly impact the poorer [classes of society]. It would be unreasonable to even think about re-establishing our finances without first managing to achieve a balanced budget,
[which] is the sine qua non condition of any contribution that our foreign creditors could give us to that end (...). (1931a - my italics)

Similarly to what happened during the negotiations for the First Funding, the power of the Rothschild bankers and Sir Niemeyer was manifested not by their capacity to enforce the original terms of the old Brazilian debt contracts, but in their position as intermediaries for the other creditors and as framers of what constituted good behavior in the sovereign debt markets. Abreu reports (2002, 530) that the Rothschild bankers withheld their official endorsement to the Third Funding until the Brazilians agreed to include in the agreement a clause allowing yearly revisions of its terms. This condition was strategically problematic and introduced legal uncertainty in the relationship between Brazil and its creditors, but it highlights how important their endorsement was for the success of the negotiations.

The primary sources also support my argument in section 2.4.3 that the structural power of financial intermediaries such as the Rothschild bankers depended on their claim to expertise and knowledge in financial matters. For instance, The Economist pointed out that the policies proposed by Sir Niemeyer to the Brazilian government after his mission were at par with the modern financial thinking at the time: “[Sir Niemeyer’s plan] makes it clear (...) that a thorough modernisation of Brazil’s financial system is contemplated in accordance with modern ideas” (1931b, 169 - my italics). In a letter to President Vargas after the publication of the Niemeyer report, Minister Whitaker echoed the opinion of The Economist: “[t]he results [of the visit] of this notable expert [Sir Niemeyer] have been published in a report that has been widely discussed in the financial world. We should be flattered, because in a general sense the policies [he] suggested are the same as those in the program of the Provisional Government” (1978, 153).

Finally, the primary sources also support my claim that the literature misses how creditors and other market actors can impact the relative scarcity of capital at the international level. As I mentioned in section 2.4.2, creditors may attempt to anticipate market movements and may over-react to changes in market expectations. The Economist offers an interesting example of how they may have contributed
to the payment difficulties affecting many Latin American countries in 1931, and is worth quoting at length:

It is, we think, true to say of the New York bond market, if not of the London Stock Exchange, that it is now valuing the bonds of all South American countries (...), on a “default” basis. This is an astonishing situation, which *prima facie* does not appear to be justified by the facts. (...). Yet, as far as the New York bond market is concerned, there appears to be little serious attempt to distinguish between those countries which have fallen and those which have so far stayed the course in the race for the bondholders’ stakes. (...). There are, it is true, technical factors to account for the *malaise* which has affected the foreign bond markets generally. The pursuit of liquidity on the part of financial houses, accelerated in Europe by the freezing up of banking credits in Germany and America by the failure of a number of small banks, has resulted in a continual stream of bond sales of all descriptions. (...). But these technical considerations are all the more reason why the investor should consider carefully whether or not the markets in New York and London are taking too conservative a view of the length of time “defaulters” are likely to remain outside, or the “survivors” to remain inside, the dividend-paying list. Everything depends, of course, upon the duration of the world slump. If it were possible to predict by 1933 a recovery in commodity prices to at least the 1929 level the bonds of all the defaulting South American countries might be thought cheap (...). (...). But if the world slump were to extend for more than another twelve months it is fairly safe to predict that all the “surviving” South American debtors would default. (Economist 1931d, 524 - Original italics)

In summary, together with the First Funding, the Third Funding challenges the traditional view in the literature that policy-makers in developing sovereign debtors act opportunistically when they pursue debt restructurings or moratoria. The Provisional Government declared a moratorium only after it had depleted the Brazilian gold reserves and had spent considerable time and energy attempting to borrow at the sovereign debt market. This strongly suggests that Brazilian policy-makers hoped to be able to muddle through the crisis and did not expect the economic downturn to be as deep and as long as it was (De Alejandro 1984, 21). Many of the economic policies adopted by the Provisional Government in its initial years are also consistent with this view, as they did not break with the past and did not differ in significant ways from those of President Sousa (Carone 1971, 411–412; Resende 2003, 96). Neuhaus notes that “[d]uring the initial years (...) [Vargas’] orthodox conception of economic policy was rather shocking in view of the abnormal economic circumstances, and [has been] criticized by historians as
incompatible with the image of a regime that declared itself to be revolutionary” (1975, 105). Brazilian policy-makers seem to have been reacting to the events as they happened and not to be opportunistically maximizing their own preferences (or those of domestic interest groups) for defaulting.

Still, the outcome for the Third Funding Loan fell farther from the harmony pole of the cooperation range than the First Funding. Although the Third Funding did not introduce a radical change in the original terms of the loan agreements and the Brazilian Provisional Government agreed to keep servicing the bonds issued under the previous Funding Loans (the reason why I depict the Funding in the left side of the continuum), the Brazilians declared a unilateral moratorium on interest payments and amortizations, which pushes the cooperation a little more toward the discord pole. Figure 4.11 narrows down the range of estimated outcomes, summarizing my arguments in this chapter:

Figure 4.11 – Possible position of the Third Funding in the cooperation range

4.7) Validity Conditions for My Hypothesis

Before concluding the chapter, we should look at the validity conditions I introduced in section 2.5 in the context of the Third Funding. The case clearly shows that my hypothesis passes the test presented by the second condition. Similarly to the First Funding, the Third Funding represents a case of cooperation, understood as a restructuring whose result departed from the status quo and in which Brazil and its creditors made compromises and adjusted their policies.
My hypothesis also passes the test presented by the first condition. As it happened with the First Funding, none of the hypotheses presented in section 2.3 offers a better explanation for the Third Funding Loan. The primary sources provide no evidence in support of coercion-based and issue-linkage explanations. Moreover, as I explained in section 4.3, domestic-politics approaches do not provide a convincing explanation for why Brazil renegotiated its debts and cooperated with its creditors in the context of the Third Funding. Finally, the primary sources do not provide evidence in support of iteration or reputation explanations. As I explained in chapter two, both are unsatisfactory as they tend to assume that tit-for-tat strategies are usually employed by creditors in response to defaults, but as it happened during the 1890s in the aftermath of the Depression of the Nineties, the relative scarcity of capital preceded the debt crises of the 1930s.

4.8) Conclusion

The evidence I gathered from the primary sources in the context of the Third Funding support my argument that the traditional representations of the relationship between creditors and sovereign debtors commonly used in the literature on sovereign debt are not historically accurate. The literature generally fails to incorporate the impact that international economic structural factors have on decisions to either default or repay, and misrepresents them as the willful acts of rational maximizers fully in control of their circumstances. As the documents and the macroeconomic data I presented above show, this was not the case. The relative scarcity of capital and the fall in international coffee prices in the context of the Great Depression limited the policy options available to President Vargas and the Provisional Government. As such, their decision to renegotiate the Brazilian debts can be explained by the impact of those structural factors.

In the end, the political and economic uncertainty remained for the rest of the 1930s. Although the Brazilian economy started to recover in 1932, it was hit by the second wave of the Great Depression around 1937 (Neuhaus 1975, 97). The effects of the Funding Loan also did not last. It was followed in
1934 by yet another readjustment plan (dubbed the “Aranha Plan”, as it was proposed and negotiated by Minister Aranha) and, eventually, by another unilateral moratorium in 1937.

President Vargas staged another coup in 1937, inaugurating an even more authoritarian regime, denominated by the official propaganda machine the “New State” (Estado Novo) which lasted until the end of the Second World War. He eventually left power under the pressure of public opinion and the military, opening the way for the re-democratization of the country and the enactment of a new constitution in 1946. He returned to the presidency one more time in 1950, now democratically elected, but committed suicide while still in office in August of 1954. Upon his death he left a troubled legacy to Brazil. Although his tenure in power marked the modernization of the Brazilian economy and the introduction of a broad social legislation that lasts to this day, his authoritarian stance and increasingly populist streak divided Brazilian society and planted the seeds of the events that led to a new military dictatorship which lasted from 1964 to 1985. This new chapter in the history of the armed forces and their direct interference in Brazilian politics is the background for the Brazilian debt crisis and moratorium of 1983, the focus of my next chapter.
Chapter Five: The Brazilian Financing Program for 1983

5.1) Introduction

The Brazilian Financing Program for 1983 (or, simply, the Financing Program), announced by the administration of President João Baptista de Oliveira Figueiredo (1979-1985) in the context of a serious balance of payment crisis and the difficult economic circumstances of the early 1980s, was an ambitious restructuring plan incorporating new emergency funding by foreign creditors (through the mechanism of “concerted lending”) and some degree of debt relief. The Financing Program is cited as a representative case of default by Brazil in the literature and offers a strong test to my hypothesis, but departs from the Frist and Third Funding Loans in two significant ways.

First, its negotiations were never officially completed. There was no formal agreement between the Brazilian government and the foreign creditors on two of its important parts, designed to ensure the access of Brazilian exporters and banks to trade and inter-banking financing. Second, the negotiations were not directly mediated by financial intermediaries such as the N. M. Rothschild & Sons banking house, as was the case with the Funding Loans. They were headed instead by major international banks who were themselves creditors of the Brazilian government, and although officials from the International Monetary Fund\(^\text{131}\) and the U.S. Treasury Department were active behind the scenes, they were not directly involved in the talks.

Still, the analysis of the Financing Program for 1983 supports my overall hypothesis in this dissertation. Although we could infer that Brazilian policy-makers chose to restructure the country’s debt because they were unwilling to bear the political costs of repayment at a time in which the future of the Brazilian military regime was at a stake, my review of the macroeconomic data available for the period, the political conditions prevailing at the time, and the public interviews and pronouncements by Brazilian government officials show otherwise. The Financing Program is better understood as a

\(^{131}\) I will use “Fund” or “IMF” interchangeably when referring to the International Monetary Fund.
response by policy-makers who were struggling to maintain the solvency of the country under the weight of the negative shocks transmitted to its economy by the finance and the production structures of the international economy, in spite of their own faults and the shortcomings of the Brazilian political system at the time. As I will show in the next section, the combined effects of the rise in borrowing costs following the changes in U.S. monetary policy at the end of the Jimmy Carter administration and the rise in oil prices following the second “oil shock” caused an acute balance of payment crisis, making it practically impossible for the Brazilian government to acquire the foreign currency the country needed to keep repaying its foreign debt obligations.

Similarly to the political context behind the Funding Loans of 1898 and 1931, domestic political factors in the 1980s did not influence Brazilian debt policy in a direct way, but increased the instability and divided the attention of government officials when they had to make difficult decisions about debt repayment and the management of the Brazilian economy. The Brazilian military was well entrenched in power, but the regime faced important challenges in two fronts. The first was a split between the hardline and the moderate factions in the Army that went back as far as the end of the Estado Novo. The appointment of General Ernesto Beckmann Geisel (1974-1979) to the presidency in 1974 and the confirmation of General Figueiredo as his chosen successor were important victories for the moderates, but by the early 1980s the hardliners could still derail the transition to civilian rule that had been initiated by General Geisel. The second challenge came from the growing civilian opposition to the regime. As I will show, the opposition was too fractured and could not influence decision-making in a direct way, but it antagonized the hardliners, adding to the political instability.

My analysis of the Financing Program of 1983 will proceed as follows. In section 5.2 I analyze how the finance and production structures of the international economy contributed to the circumstances that led to the Financing Program, focusing on the relative scarcity of capital, the rise in oil prices, and the slowdown in trade that marked the international economy during the early 1980s. In section 5.3 I provide a brief summary of the events that led to the military coup of 1964 and analyze
how domestic politics in the early 1980s increased the uncertainty under which government officials in
the military regime had to make policy decisions, comparing my findings to the predictions made by
domestic politics explanations for the cooperation puzzle in the literature. In section 5.4 I analyze the
negotiations for the Financing Program, comparing among other things the role played by financial
experts such as the IMF with that of the Rothschild bankers during the negotiations for the Funding
Loans of 1898 and 1931. Finally, in section 5.5 I show how the study of the Financing Program fulfills the
validity conditions I discussed in section 2.5.

Oil Shocks

As I explained in section 2.4.1, the finance structure of the international economy had changed
considerably since the end of the gold standard. The new system that arose after Bretton Woods also
consolidated the privileged economic position of the United States and the predominance of the U.S.
dollar in the international economy (Eichengreen 1996, 97–9; Helleiner 1994, 5, 8, 13; Resende 1982, 44;
Strange 1987). Political control over the currency used internationally as both unit of exchange and
reserve of value provided U.S. policy-makers with a broader set of options than those available to policy-
makers in developing sovereign debtors (Cohen 2006, 45).

By the time of the Brazilian debt crisis of the 1980s, the Bretton Woods system had seen its
share of change and disruption, but the United States and other capital-exporting countries still retained
considerable structural power. Similarly to the events I analyzed in chapters three and four, the rise in
interest rates in the United States in the period covering the end of the Carter and the first year of the
Reagan administrations impacted Brazil and other developing sovereign debtors at the periphery of the
international economy:
Table 5.1 – Historical changes in the Discount and Federal Funds rates (1978-1983)

<table>
<thead>
<tr>
<th>Date</th>
<th>Discount Rate</th>
<th>Federal Funds Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 1978</td>
<td>6.50%</td>
<td>6.75%</td>
</tr>
<tr>
<td>Dec 1978</td>
<td>9.50%</td>
<td>10%</td>
</tr>
<tr>
<td>Jul 1979</td>
<td>10%</td>
<td>10.50%</td>
</tr>
<tr>
<td>Dec 1979</td>
<td>12%</td>
<td>12%-14%</td>
</tr>
<tr>
<td>Feb 1980</td>
<td>13%</td>
<td>14.50%-15%</td>
</tr>
<tr>
<td>Dec 1980</td>
<td>13%</td>
<td>17%-18%</td>
</tr>
<tr>
<td>Jan 1981</td>
<td>13%</td>
<td>19%-20%</td>
</tr>
<tr>
<td>Dec 1981</td>
<td>12%</td>
<td>12%</td>
</tr>
<tr>
<td>Apr 1982</td>
<td>12%</td>
<td>15%</td>
</tr>
<tr>
<td>Jul 1982</td>
<td>11.50%</td>
<td>13%</td>
</tr>
<tr>
<td>Aug 1982</td>
<td>11%</td>
<td>12%</td>
</tr>
<tr>
<td>Dec 1982</td>
<td>8.50%</td>
<td>8.50%</td>
</tr>
<tr>
<td>Oct 1983</td>
<td>8.50%</td>
<td>9.50%</td>
</tr>
</tbody>
</table>


In the space of less than a year, the base interest rates in the United States rose approximately 46% percent, reaching 13% per year at their peak in February of 1980 (representing a valorization of 100% in two years). The change in monetary policy was a direct response by the Federal Reserve to the problems in the country’s balance of trade, to high domestic inflation, and to the depreciation of the U.S. dollar (Boughton 2001, 319; Economist 1979d; Eichengreen 1996, 143; Frieden 2006, 372).

According to Eichengreen,

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132 The Discount Rate is the base rate for short-term loans by the Federal Reserve to depositary institutions. The Federal Funds Rate is the base rate for overnight inter-bank loans.
If there had been any doubt about American priorities, it was removed by the appointment of Paul Volcker as chairman of the Federal Reserve Board in 1979 and Ronald Regan’s election as president in 1980. Volcker was prepared to let interest rates rise and the growth of the money supply fall to whatever levels were required to bring inflation down from double digits. (…) There was scant willingness on the part of the United States to contemplate (…) changes in Federal Reserve policy to bring US interest rates down and render the dollar less attractive to foreign investors. (…) Treasury Secretary Donald Regan believed in entrusting the exchange rate to the market. (1996, 147)

The policy changes increased the relative scarcity of capital at the international level, even if conceived primarily to address domestic concerns. Higher interest rates in the U.S. domestic market attracted international capital that could otherwise be oriented towards other countries (Frieden 2006, 373). Moreover, since the defense of the U.S. dollar also involved direct intervention in the currency markets by other creditor countries such as Germany and Japan (Economist 1979a; Eichengreen 1996, 143), and the rates that commercial banks charged from their clients included a considerable spread over the Federal Funds Rate, the upward change had repercussions throughout the market, impacting borrowing costs to all sovereign debtors (Frieden 2006, 373–4; Resende 1982, 46).

The international media registered the quick change in expectations following the events in the United States. While in March of 1978 The Economist had noted that “[b]ankers are disturbed by the growing tendency among international borrowers either to repay their loans early or else refinance them at much lower interest margins” (1978, 113), in November of the same year the tenor of its commentary had changed: “[m]ore worrying is the effect that high interest rates may have on the [U.S.] economy, with the discount rate at 9 ½ % and the commercial bank prime lending rate at 10 ¾ %. This has already begun to scare investors. Wall Street has seldom been more volatile” (1978b). In May of 1979 The Economist further noted that “[poorer countries] have been caught out by the dramatic rise in

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133 Helleiner argues that the change in monetary policy was also a response to the pressure of European and Arab allies, reflecting the limits of the ability of the United States to deflect the costs of adjustment to others (Helleiner 1994, 132–3). His point does not contradict my overall argument about the structural power of the United States. The fact that American policy-makers could quickly reverse market expectations, and also impact the supply of capital at the international financial markets, provides support to my view in this dissertation.
interest rates. Brazil, for example, will have to pay $1 ½ billion more a year in interest alone on the $30 billion or so it has borrowed from international banks” (1979c, 114). One year later, rates were still climbing up:

[i]nterest rates in the industrialized countries are on the move upwards again, vigorously supported by the central banks. They are in hot pursuit of inflation rates, which show no signs of levelling off. The United States led the pack this week, with the hike in the Federal Reserve’s discount rate from 12% to 13%, rapidly followed by a rise in American bank’s prime rates back up to 15 ¾ % and probably headed higher. Repercussions in other countries were soon felt. (Economist, 1980b)

Those repercussions were indeed felt by Brazil. For instance, Veja magazine pointed out in 1980 that “borrowing abroad has become prohibitive [for Brazilian businesses]” (Veja 1980b, 76). In February of 1980, following a trip by Minister of Planning Antônio Delfim Netto to the United States and Europe, journalists Jader de Oliveira and Pedro Cavalcanti, writing for Veja, raised similar concerns about the impact that rising borrowing costs could have on the Brazilian debt profile: “[t]he variable with more weight (...) will be the change in the interest rates in the American and European markets. (...) [l]nternational interest rates have reached 18% per annum – and that may represent an additional US$ 1 billion in the Brazilian debt service bill this year” (1980, 82).134 The Economist summarized the impact that the structural power of the United States had on the relative scarcity of capital at the international level in a piece from March of 1980:

[i]nternational bond markets were withered again early this week by the (...) further rise in American prime rates to 19%. (...) There is little confidence that any lasting recovery is in sight and, with the international syndicated loan market also bemused, bankers worry whether the system can cope with recycling this year’s oil surplus funds. (...) The volume of new issues has declined sharply. (...) The market for new straight dollar bonds has been dead (...). Yet countries with balance of payments problems cannot afford to wait. Brazil, eg, needs to borrow around $12 billion this year (including $7 billion to repay old debt and perhaps $5 billion of new resources). Normally, first recourse would be to syndicated bank loans. But this market, too, has declined (...). The six-month London Eurodollar offered rate has risen from less than 11% early last summer to over 19% - too costly for less developed countries. (Economist 1980c)

134 This number refers to the prevailing commercial rates, or prime rates, and not to the Discount or Federal Funds rates.
Minister Netto and his staffers made a point of conveying the appearance of “business as usual” in their interactions with the Brazilian media and foreign creditors. José Carlos Madeira Serrano, a high-rank official from the Brazilian Central Bank, emphasized the silver lining in an otherwise difficult environment: “[i]f we unemotionally analyze the inflow of resources in the first semester, when the Euromarket practically stopped, [we will realize] that the foreign banks are interested in Brazil” (Veja 1980f). He also tried to address any concerns that foreign creditors might have had on the policy preferences of the Figueiredo administration: “the possibility of a moratorium [is] totally absurd [and can be attributed] to an ignorance of the Brazilian reality” (Veja 1980c, 91). Veja magazine seemed to have been momentarily convinced by the official line: “[t]here is a reason for relief: the first half of the year was marked by quick oscillations and huge uncertainty in the international financial market. The interest rates (...), after reaching the never before seen peak of 20% per year, [now] fell to approximately half of that [number]” (Veja 1980f).

The official rhetoric notwithstanding, it is clear in retrospect that the situation of the federal government was becoming desperate and that Brazilian policy-makers were under enormous pressure. Capital flows had been falling consistently since the first year of the Figueiredo administration, as illustrated by the statistics on foreign portfolio investment compiled by the Brazilian Central Bank:

Figure 5.1 – Foreign portfolio investment in Brazil, annual volumes (1970-1984)

Source: Brazilian Central Bank (2014a). In millions of U.S. dollars.
Serrano, the Central Bank official, was not lying when he said that the inflow of capital during the first semester of 1980 was positive, but this was not the whole truth either. If we break the numbers on portfolio investment into quarters, we can easily see that the “positive” second quarter of 1980 was an exception in a very bad year, followed by even worse quarters:

Figure 5.2 – Foreign portfolio investment in Brazil, quarterly volumes (1970-1984)

Source: Brazilian Central Bank (2014b). In millions of U.S. dollars.

Figures 5.1 and 5.2 show that foreign investors were selling their Brazilian portfolios and repatriating their capital, reacting to deteriorating profit expectations in the context of difficult macroeconomic conditions in Brazil and abroad (De Alejandro 1983, 527). Other signs were similarly negative. The regular service of the foreign debt also had a negative impact on the country’s international reserves (De Alejandro 1983, 525). These had been falling consistently since mid-1979 despite the efforts of the federal government to roll over its maturing debts:
Foreign investment and lending was crucial for the Brazilian economy, as the scarcity of capital at the domestic level was still a problem, albeit not to the same degree as in the 1890s and the 1930s. After the Second World War, successive administrations created a number of financing agencies to complement private sources of capital and facilitate new domestic economic ventures, such as the National Bank for Social and Economic Development (*Banco Nacional de Desenvolvimento Econômico e Social*, or BNDES), but by the 1970s domestic private capital was still unavailable in the volume required by the large infrastructure projects devised by the military regime. For instance, Camilo Castello Branco, the dean of modern Brazilian political journalism, commented in his daily column in the *Jornal do Brasil* newspaper in March of 1979 that a plan circulating in the Geisel administration calling for the privatization of a number of state-owned enterprises raised objections from civilians and the military alike, as “[given the] scarcity of [domestic] savings, [it] would amount to a surrender of part of the [industrial] capacity under the control of the state to multinational [corporations]” (Branco 1979).

The military relied heavily on borrowed foreign capital to bridge the domestic financing gap and, although important for the Brazilian economy, the debt-fueled development program was at the root of the debt crisis that culminated with the Financing Program of 1983. In the space of roughly a decade the federal government accumulated a debt stock that amounted to 27% of the Brazilian GDP in

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135 The BNDES was created in 1952 during the second Vargas administration.

136 A host of infrastructure projects benefited from capital borrowed abroad, including hydroelectric plants, mining and agriculture projects in the Amazon and in the Brazilian hinterlands, and the first Brazilian nuclear power reactor (Baer 2008, 79; Camargo 1982, 182; Cysne 1994, 251).
1980 and reached a staggering 49.5% of the country's GDP in 1983. Figure 5.4 shows the growth in the Brazilian foreign debt stock from 1946 to 1983:

Figure 5.4 – Foreign debt stock (1946-1983)


The repayment commitments associated with the growing debt stock put considerable pressure on the Brazilian balance of payments. Annual debt service amounted to 7% of GDP and 60.7% of exports in 1983:

Table 5.2 – Foreign debt indicators (percentages)

<table>
<thead>
<tr>
<th>Year</th>
<th>Debt Service/GDP Ratio</th>
<th>Debt Service/Export Ratio</th>
<th>Debt Stock/GDP Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>2.4</td>
<td>41.3</td>
<td>16.8</td>
</tr>
<tr>
<td>1972</td>
<td>2.9</td>
<td>42.6</td>
<td>19.5</td>
</tr>
<tr>
<td>1973</td>
<td>3.0</td>
<td>40.6</td>
<td>17.7</td>
</tr>
<tr>
<td>1974</td>
<td>3.0</td>
<td>41.5</td>
<td>18.1</td>
</tr>
<tr>
<td>1975</td>
<td>3.1</td>
<td>46.7</td>
<td>19.3</td>
</tr>
<tr>
<td>1976</td>
<td>3.3</td>
<td>50.4</td>
<td>20.9</td>
</tr>
<tr>
<td>1977</td>
<td>3.7</td>
<td>54.4</td>
<td>21.4</td>
</tr>
<tr>
<td>1978</td>
<td>4.4</td>
<td>69.4</td>
<td>25.9</td>
</tr>
<tr>
<td>1979</td>
<td>5.3</td>
<td>78.0</td>
<td>25.0</td>
</tr>
<tr>
<td>1980</td>
<td>6.0</td>
<td>70.9</td>
<td>27.0</td>
</tr>
<tr>
<td>1981</td>
<td>7.0</td>
<td>78.1</td>
<td>28.6</td>
</tr>
<tr>
<td>1982</td>
<td>7.6</td>
<td>101.9</td>
<td>31.5</td>
</tr>
<tr>
<td>1983</td>
<td>7.0</td>
<td>60.7</td>
<td>49.5</td>
</tr>
</tbody>
</table>

Source: Brazilian Central Bank (Banco Central do Brasil, 2013a, 2013b, 2013c).
The problems caused by the finance structure of the international economy were compounded by the production structure, although for different reasons than those prevailing in the 1890s and 1930s. The import-substitution development model adopted after the Great Depression promoted the industrialization of the Brazilian economy, generating gains for the balance of trade due to decreased imports of consumer goods and increased exports of manufactured and semi-manufactured goods. Brazilian exports in the 1980s were more diversified and less dependent on coffee and other commodities, as we can see in Table 5.3:

Table 5.3 – Brazilian exports per product type – percentage of total exports (1971-1981)

<table>
<thead>
<tr>
<th>Year</th>
<th>Commodities</th>
<th>Intermediate Goods</th>
<th>Final Goods</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>74.8</td>
<td>9.1</td>
<td>15.2</td>
</tr>
<tr>
<td>1971</td>
<td>68.5</td>
<td>8.3</td>
<td>20.0</td>
</tr>
<tr>
<td>1972</td>
<td>66.4</td>
<td>10.0</td>
<td>22.5</td>
</tr>
<tr>
<td>1973</td>
<td>65.0</td>
<td>9.3</td>
<td>23.1</td>
</tr>
<tr>
<td>1974</td>
<td>57.6</td>
<td>11.5</td>
<td>27.0</td>
</tr>
<tr>
<td>1975</td>
<td>58.0</td>
<td>9.8</td>
<td>29.8</td>
</tr>
<tr>
<td>1976</td>
<td>60.5</td>
<td>8.3</td>
<td>27.4</td>
</tr>
<tr>
<td>1977</td>
<td>57.4</td>
<td>8.6</td>
<td>31.7</td>
</tr>
<tr>
<td>1978</td>
<td>47.2</td>
<td>11.2</td>
<td>40.2</td>
</tr>
<tr>
<td>1979</td>
<td>43.0</td>
<td>12.4</td>
<td>43.6</td>
</tr>
<tr>
<td>1980</td>
<td>42.2</td>
<td>11.7</td>
<td>44.8</td>
</tr>
<tr>
<td>1981</td>
<td>38.3</td>
<td>9.1</td>
<td>51.0</td>
</tr>
<tr>
<td>1982</td>
<td>40.8</td>
<td>7.1</td>
<td>50.8</td>
</tr>
<tr>
<td>1983</td>
<td>39.0</td>
<td>8.1</td>
<td>51.5</td>
</tr>
</tbody>
</table>


However, the gains were counterbalanced by increased oil consumption, supported by high import volumes (Baer 2008, 67). In the early 1970s Brazil imported approximately 60% of the oil it consumed (Veja 1973b, 112). This number rose to more than 70% of domestic needs by the end of the decade (Veja 1979b, 27). With such a percentage of Brazilian consumption dependent on foreign supply,

137 I treat intermediate and final goods as synonyms respectively for semi-manufactured and manufactured goods.
the oil shocks of the 1970s, followed by the Iran-Iraq War, had an inevitable impact on the balance of trade, the balance of payments, and domestic inflation (Camargo 1982, 184):

Figure 5.5 – Brazilian oil imports (1970-1983)

![Graph of Brazilian oil imports](source: Instituto Brasileiro de Geografia e Estatística (2014). In thousands of U.S. dollars.)

Even though the high and persistent Brazilian inflation rates had roots in domestic causes, the rise in oil prices contributed directly to the problem (Abreu and Fritsch 1982, 35). As an illustration, Veja calculated that by December of 1980 gasoline prices had increased by 2,437% (Veja 1980r, 124), a staggering amount for any economy, especially in the developing world. Figure 5.6 and table 5.4 show the consequent shift in Brazilian inflation levels from a monthly average and median of around 2.5% to an average and median of more than 5% after 1979:

There are two main explanations for the Brazilian inflation during the period. The “structuralist” perspective emphasizes the monopolist configuration of certain sectors of the economy and the inflationary pressures caused by external factors such as the price of oil. The “monetarist” explanation, on the other hand, emphasizes the loose monetary and fiscal policies of the military regime. Still, there is some consensus that a number of complicated indexation mechanisms, introduced since 1964 as a way to protect the purchasing power of the working and middle classes (and, later, to protect tax revenues) had some role in accelerating inflation (De Alejandro 1983, 528; Bacha 1983, 324–5; Boughton 2001, 341; Economist 1979e). Not surprisingly, this was one of the main points of contention between the Brazilian government and the IMF during and after the negotiations for an agreement in late 1982 (Boughton 2001, 341). For a review, see De Alejandro (1983), Bacha (1983), and Baer (2008 - especially chapters 5 and 6).
Figure 5.6 – Brazilian Consumer Price Index (Índice de Preços ao Consumidor, IPC) (January of 1976 to December of 1983)

Table 5.4 – Consumer Price Index (IPC) – monthly averages and medians and annual rates (1976 to 1981)

<table>
<thead>
<tr>
<th>Year</th>
<th>Average</th>
<th>Median</th>
<th>Yearly Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td>2.7%</td>
<td>2.5%</td>
<td>40.5%</td>
</tr>
<tr>
<td>1977</td>
<td>2.9%</td>
<td>2.6%</td>
<td>45.1%</td>
</tr>
<tr>
<td>1978</td>
<td>2.8%</td>
<td>2.6%</td>
<td>43.4%</td>
</tr>
<tr>
<td>1979</td>
<td>4.4%</td>
<td>4.3%</td>
<td>75.1%</td>
</tr>
<tr>
<td>1980</td>
<td>5.3%</td>
<td>5.1%</td>
<td>97.4%</td>
</tr>
<tr>
<td>1981</td>
<td>5.5%</td>
<td>5.0%</td>
<td>100.3%</td>
</tr>
<tr>
<td>1982</td>
<td>5.7%</td>
<td>5.9%</td>
<td>105.1%</td>
</tr>
<tr>
<td>1983</td>
<td>8.5%</td>
<td>8.0%</td>
<td>175.7%</td>
</tr>
</tbody>
</table>

Policy-makers in the Figueiredo administration were aware of the problems brewing in the Brazilian economy:

[According to Ministry of Planning staffers] (...) the problems [in the Brazilian economy] are related to the imbalance in the external accounts, generated mostly by the [higher] oil prices. To [these staffers], the solution [to the imbalance] should be similar to the times of the [Economic] Miracle: exporting more. (...) The rationale is simple. The country is spending this year between 6 and 7 billion U.S. dollars just to import oil. Decreasing this expenditure would put economic activity at risk. The way out, then, is to increase exports in the same proportion [to oil imports]. (Veja 1979k, 32)

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139 I chose the Consumer Price Index due to the availability of data, but other indexes would not differ considerably in capturing the jump in prices that happened between 1978 and 1979.
By the end of April, the balance of trade had accumulated a deficit of 1.8 billion U.S. dollars. According to the director of commercialization at Petrobras, Carlos Sant’Anna, the recent hike in the price of oil will push imports to 11 billion U.S. dollars (...). Even [government officials] admit that the trade deficit will reach between 2 and 2.5 billion U.S. dollars – or even more (...). (Veja 1980c)

There were similar concerns in the states at the center of the international economy. *The Economist* had been raising the alarm about slowing economic growth in the United States, Japan, and Western Europe, accompanied by rising inflation, well before the second oil shock (1979a, 1979b). After the Iranian Revolution, the climate took a turn for the worse: “[t]he ripples from Iran’s disruption were this week spreading wider in international business and banking. Western governments and oil companies are beginning to worry about oil stocks” (Economist, 1979d). After the start of the Iran-Iraq War, *The Economist* summarized the uncertainty surrounding the future of oil prices in the following way:

The danger that instability in the Gulf presents to the economy of the western world is not of total and final breakdown. (...) The danger is that a war here, a coup there, will have enough effect on the total flow through the Strait of Hormuz to keep the price of oil moving upwards jerk by jerk, with all the effects that would have on inflation and, through inflation, unemployment. (Economist 1980f, 11)

Moreover, the production structure of the international economy transmitted to Brazil and other developing sovereign debtors the economic slowdown that followed the oil shocks and the rise in interest rates in the United States and Western Europe, affecting both trade volumes and international prices (Abreu and Fritsch 1982, 34; Boughton 2001, 320; Resende 1982, 46). The consolidated trade statistics provided by UNCTAD, which I compiled in figures 5.7, 5.8, and 5.9, support this point:
Figure 5.7 – World trade (1980-1984)

Source: UNCTAD (2014b). In millions of U.S. dollars, 2013 levels. Aggregate amounts for both merchandise and service exports and imports. There are no available statistics for the years before 1980.

Figure 5.8 – Developed countries’ trade (1980-1984)

Source: UNCTAD (2014b). In millions of U.S. dollars, 2013 levels. Aggregate amounts for both merchandise and service exports and imports. There are no available statistics for the years before 1980.

Figure 5.9 – South American trade (1980-1984)

Source: UNCTAD (2014b). In millions of U.S. dollars, 2013 levels. Aggregate amounts for both merchandise and service exports and imports. The agency does not provide statistics for the years before 1980.
As we can see in figure 5.10, the Brazilian balance of trade followed the average trade performance of South America in the early years of the 1980s:

Figure 5.10 – Brazilian balance of trade (1970-1983)

Source: IBGE (2013e). In millions of U.S. dollars.

De Alejandro estimates that the Brazilian terms of trade in 1982 were 32% below those of 1979 (De Alejandro 1983, 523). *Veja* magazine reported that “(...) the current downward trend in the international prices for coffee, sugar, cocoa, and soy will cause Brazil to lose between U$ 1 and 1.5 billion this year. (...) [T]his problem does not [affect us only] – the fall in the prices of primary products is a problem for the Third World in general” (Veja 1982, 136, 138). To stave off the looming crisis, the Figueiredo administration followed the strategy defended by the Ministry of Planning and pushed aggressively to increase exports. However, the major consumers of Brazilian manufactured goods were developing countries that either suffered with balance of payment crises of their own, such as Poland, Chile, and Argentina, or were affected by geopolitical events, such as Iraq (Veja 1982g, 131). Brazilian exports to those markets suffered even more than exports of raw materials to developed countries (Abreu and Fritsch 1982, 35; De Alejandro 1983, 521–2). At the height of the crisis, *Veja* noted that:

In the first half of the year, the [value of] Brazilian exports was U$ 1 billion lower than the value for the same period of last year. (...) The fall in prices at the international level – which did not spare the ten major products in the Brazilian exports portfolio – undermined the efforts [by the government] to increase the quantity of exports. For instance, this year the country is exporting 13% more manufactured goods than last year, [but received] 5% less [for them]. (Veja 1982b)
The bad news continued the following month:

Strictly speaking, there was no surplus [in the balance of trade]: only US $ 5 million (…). It was the lowest [monthly] surplus in the last fourteen months (…). [Minister Netto] promises (…) to counter-attack in the external sector, with a [new] set of measures [designed] to stimulate exports without infringing the rules of (…) the GATT. (…) The way out is certainly difficult [to find] in the nightmarish climate (…) [prevailing] in the international economy (…). (Veja 1982f, 156, 157)

Eventually, any improvements in the Brazilian balance of trade in the period came from a fall in imports, as shown in figure 5.10. The debt crisis affecting Brazil thus had a dual (financial and commercial) nature, as The Economist explained: “[e]very time the price of oil rises by $1 a barrel, less developed countries (…) have to spend about $2 billion more on a year’s oil imports. (…) Yet some of them will be far more worried by rising American interest rates; the six-month Eurodollar rate (…) this week nudged 20%” (1980g). In the case of Brazil, the magazine added that “interest payments have this year swallowed up about 30% of total export earnings (…). (…) [A] $5-a-barrel rise in oil process takes an extra 7% of Brazil’s export revenues, compared with the 13.5% that goes on a five-point rise in Libor” (1980g). Frieden summarized the problem in a similar way:

[t]wo other shocks compounded the impact of American policy on the Third World: [t]he 1979-1980 oil price increase raised import costs for all the oil-poor LDCs, while the recession in the West reduced demand for developing country exports. The three factors – interest rate increases, oil price hikers, and recession in the OECD – increased the need for foreign money even as it became less available. (Frieden 2006, 374)

Problematically, the crisis may have also contributed to the depreciation of the Brazilian currency, the cruzeiro.\footnote{President Vargas introduced during the Estado Novo a currency reform plan that, among other things, changed the name of the old Brazilian currency, the mil-réis, to cruzeiro (a reference to the Portuguese name for the Southern Cross constellation). The military briefly changed the name of the currency to cruzeiro novo (the new cruzeiro) when they introduced their own currency reform in the early years of the dictatorship, but reverted to the old name in 1970.}
In the context of the 1980s, there was no formal parity rate anchoring the cruzeiro to gold or to other currencies, but the government tried to exert control over the exchange rates by administering an official rate. Besides a “crawling” peg that depreciated the cruzeiro against the U.S. dollar by 1 or 2% every two weeks, the government sometimes introduced corrective “maxi-devaluations” of 30% or more (Cysne 1994, 253; Economist 1979j; Veja 1979k, 120). It is thus difficult to disentangle the effects of inflation or the crawling peg from the external pressures that might have had a negative impact on the exchange rate. In any case, as we can see in table 5.5, in at least two years (1979 and 1983) the cruzeiro depreciated more than the annual inflation rate:

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141 The term “PTAX800” refers to a specific inquiry command in the SISBACEN. The PTAX is the result of the average rates collected from exchange rate dealers in the Brazilian market at four different times of the day. For an explanation of the calculation method behind the PTAX, see Banco Central do Brasil (n.d.).
Table 5.5 – Comparison between inflation and currency depreciation

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual Inflation Rate</th>
<th>Annual currency Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978</td>
<td>43.40%</td>
<td>28.70%</td>
</tr>
<tr>
<td>1979</td>
<td>75.10%</td>
<td>95.35%</td>
</tr>
<tr>
<td>1980</td>
<td>97.40%</td>
<td>49.20%</td>
</tr>
<tr>
<td>1981</td>
<td>100.30%</td>
<td>86.73%</td>
</tr>
<tr>
<td>1982</td>
<td>105.10%</td>
<td>87.94%</td>
</tr>
<tr>
<td>1983</td>
<td>175.70%</td>
<td>257.44%</td>
</tr>
</tbody>
</table>

Source: Based on data provided by Fundação Instituto de Pesquisas Econômicas (2014) and Banco Central do Brasil (2014e)

Naturally, that is not to say that Brazilian policy-makers were hapless victims or that their actions were completely conditioned by structural causes. We could blame their own policy choices for their predicament, but we should keep in mind that the dangers of foreign indebtedness are clearer in hindsight. The foreign-debt-led development strategy adopted by the Brazilian military had its advantages, as it tapped the growing pool of relatively cheap private foreign capital that became available after the first oil shock (Baer 2008, 82; D’Araujo and Castro 1997, 222, 292; Netto 1986, 4).

Moreover, in the absence of external structural shocks (and even after the first oil shock), borrowing was seen as “business as usual” for developing sovereign debtors and followed mainstream economic thinking at the time (Moreira 2001, 130–2).

After leaving the government, Minister Netto wrote a defense of his tenure at the Ministry of Planning that, although self-serving, illustrates the prevailing view that foreign indebtedness was a legitimate development tool at the disposal of developing countries: “there was an understanding that foreign borrowing was a tool to [increase] domestic savings. (...) A country borrows when, in the desire to accelerate its growth, it adds some external savings to [its own] domestic savings” (1986, 4). His view

142 For a critical account of the “financing gap approach” to development and economic growth, see Easterly (2002) and Hönk and Lederer (2013).
was shared by officials in the IMF (Boughton 2001, 271). President Geisel also justified the policies of his administration in similar terms:

> [t]he idea of [foreign] indebtedness came from the [President Emílio Garrastazu] Médici administration [1969-1974]. [Minister Netto] used to say that (...) Brazil lacked domestic savings. The domestic savings we have are not enough to be applied, in the necessary scale, to the development of the country (...). However, while Brazil lacks savings, foreigners have more than enough of them. (D’Araujo and Castro 1997, 293)

Marcílio Marques Moreira, a Brazilian diplomat and banker who served in different posts in the Ministry of Finance and other state agencies before and during the military regime, put it more candidly in an interview in 2001: “I was more concerned with how the money was spent than with how [we got it]” (2001, 127). He added: “I did not realize (...) what was at risk, which was a lot more than what I could imagine at the time” (2001, 128). The fact that Brazil was borrowing at floating rates that could change along with market expectations did not seem to have concerned Brazilian authorities, as Moreira himself admitted (2001, 128). In the same interview, he elaborated on the debt policies of the military regime:

> (...) it was not a crazy decision. (...) Despite everything, I will say once more that at the time there was no clear perception of the risks [inherent in foreign borrowing]. In hindsight, I would say that we were right about the way we managed our indebtedness, borrowing cheap and investing [the funds] (...), but in 1979, as I said, the interest rates and the U.S. dollar climbed to heaven and Brazil descended to hell.

International bankers and other market actors also had their share of responsibility not only in the events leading to the debt crisis but also during the “boom” years in which credit was easily available with very few questions asked: “all you needed to do was to answer one of the many telexes that arrived with offers” (Moreira 2001, 128). In his history of the IMF during the 1980s, Boughton noted that:

> [m]any bankers later would complain – with some justification – that they had been (...) blindsided by the Volcker shock. (...) [T]he fundamental point is that sovereign lending to developing countries was a highly

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143 Moreira was the Brazilian Ambassador to the United States in the late 1980s and the Minister of Finance under president Fernando Collor de Mello (1990-1992).
profitable activity, but the risks were inadequately assessed by lenders. Walter Wriston’s well-known defense of sovereign lending (as chairman of Citibank), that a “country does not go bankrupt,” was only the most quotable example of the prevailing view at the beginning of the 1980s (Boughton 2001, 272).

André Lara Resende, a Brazilian economist and banker who acted in the Brazilian government under different capacities during the 1980s and 1990s, offers an interesting assessment of the behavior of the bankers:

[w]e should not forget the decision-making logic [that prevails] in financial [markets]. The basic rule is to follow the majority. No one wants to fall behind and miss the good opportunities, and no one wants to go way ahead [of the pack] and be the only one to lose. (...). The behavior of the majority determines the market consensus (...) about the risks involved [in different investments]. (Resende 1982, 47)

In summary, the primary sources support my claim that the Figueiredo administration was constrained in its policy choices by the finance and production structures of the international economy. Similarly to the Funding Loans of 1898 and 1931, the moratorium and Financing Program of 1983 happened in the context of a massive balance of payment crisis affecting Brazil in the wake of the second oil shock and the changes in monetary policy in the United States. Their personal flaws notwithstanding, Brazilian policy-makers were scrambling to find solutions to problems that were not entirely of their making and could not necessarily be solved with “sufficient political will”.

Some of those solutions could have been motivated by political expediency, but they eventually had such disastrous economic consequences that we would be hard pressed to imagine that they were consciously chosen by policy-makers attempting to maximize their own survival in power. It is reasonable to assume that Minister Netto and the Figueiredo administration had an incentive to tackle the problems that undermined the ability of the government to deliver economic growth, but were prevented by the conditions prevailing in the finance and production structures of the international economy at the time. One melodramatic comment by Minister Netto soon after the news of the Mexican debt problems came to light is emblematic of the mood in the Brazilian government: “[i]n such a [disastrous] scenario no-one can do any planning (...). Only with the help of God” (Veja 1982g, 126).
In the next section I analyze in more detail the “push and pull” of Brazilian domestic politics, and the configuration of domestic political forces during the final years of the Figueiredo administration.

5.3) The Domestic Context: the Final Years of the Military Regime

Similarly to the cases of the First and Third Funding Loans, the primary and secondary sources support my claim that domestic political factors complicated the decision-making process during the debt crisis of the early 1980s. This does not mean that domestic politics did not play any role in the decisions that led to the Brazilian moratorium and Financing Program of 1983. However, rather than providing clear incentives for the opportunistic behavior of Brazilian policy-makers, they caused instability and muddled the already difficult environment under which the Figueiredo administration had to operate. In fact, this was a clear pattern in the post-war period.

President Vargas remained in power at the head of the Estado Novo until the end of the Second World War, when he came under increasing pressure to open the way for the re-democratization of the country. The opposition to the regime came from an array of different groups with contradictory tendencies, including members of the old regional political elites, former Lieutenants, and liberal elements associated with the urban middle class, but once again the protagonist role fell to the military. By signaling that they were considering forceful action if President Vargas would not voluntarily step down, they forced the dictator to leave the capital for his native state of Rio Grande do Sul, opening the way for the first democratic presidential elections since the Great Depression (Neto 2013, 453–92; Schneider 1991, 150–3).

In spite of his tactical retreat, Vargas remained the focal point in Brazilian politics. His election to a final stint in the presidency (1950-1954) further exacerbated the tensions, radicalizing the political environment and deepening the split in the military between the moderate and the hardline wings, the former more nationalist and the latter radically anti-communist and extremely suspicious of Vargas and his populism (D’Araujo and Castro 1997, 183; Schneider 1991, 156–7). The conflicts around his policies
and administration eventually exploded into the open in mid-1954 after members of Vargas’ personal guard, apparently without his knowledge, attempted to assassinate Carlos Frederico Werneck Lacerda, a journalist and politician who was a vocal critic of the government and had close ties to the hardliners (Schneider 1991, 181).\textsuperscript{144} Facing another ultimatum by the military to step down, Vargas committed suicide on August 24\textsuperscript{th}, 1954, at the height of the political crisis.

The dramatic act shocked the Brazilian population and cast a long shadow on Brazilian politics. His death made him a martyr for many groups. In fact, most political crises in the following decades, including the 1964 military coup, can be connected to his political legacy, as the different individuals or groups that competed for power either identified themselves as his political heirs or in opposition to him (D’Araujo and Castro 1997, 141; Neto 2014, 350–1; Schneider 1991, 158).

Less than a decade after Vargas’ suicide, the political instability reached a new height with the resignation of President Jânio da Silva Quadros in August of 1961 and the rise of Vice-President João Belchior Marques Goulart to the presidency. The resignation, coming out of the blue, caught everyone by surprise and plunged Brazilian politics in one of its most serious political crises, aggravated by the poor performance of the Brazilian economy and the ideological antagonisms that marked the Cold War (Schneider 1991, 206). President Goulart, who had served as Minister of Labor under President Vargas and had the support of the labor movement, took office after surviving an attempted coup by the military hardliners, but his administration eventually alienated the middle class, centrist political groups, and the Army moderates who had previously supported him.\textsuperscript{145} Increasingly isolated, he was deposed by the military on April 1\textsuperscript{st}, 1964.

\textsuperscript{144} For a detailed account of the events, see Neto (2014).
\textsuperscript{145} It is possible that he miscalculated the impact of his increasingly inflammatory rhetoric and some of his policies in the charged environment of the Cold War (Gaspari 2002, 48, 84; Schneider 1991, 215; Schwartzman 1982, 128–9). Gaspari, in the first of his four-volume account of the military regime, argues that many believed that President Goulart intended to cancel the presidential elections of 1965 and perpetuate himself in power as his mentor Vargas did during the Estado Novo (2002, 49). Gaspari’s view is echoed by Ferreira, in his biography of President Goulart (2011, 433), and by Soares, in his analysis of the causes of the 1964 coup (1994, 25).
The military coup against President Goulart was an alliance of convenience for the purpose of defeating a common enemy identified with the legacy of President Vargas (Ferreira 2011, 516).

According to Gaspari, the coup leaders agreed to “remove [Goulart] from power and discuss the rest later” (2002, 86). After achieving this objective, they constantly clashed behind the scenes for ideological and pragmatic reasons (D’Araujo and Castro 1997, 162, 168; Ferreira 2011, 528). More importantly, moderates and hardliners generally disagreed on their view of the role of the military as the “arbiters” of Brazilian politics. While the latter defended a prolonged dictatorship, a discourse very similar to that of the Jacobins and Lieutenants I analyzed in chapters 3 and 4, the former represented a generation of senior officers concerned with the professionalism of the armed forces and who wanted to remain autonomous from partisan politics (Carvalho 2005; D’Araujo and Castro 1997, 111, 166, 168, 213; Schneider 1991, 166–8), although we should not mistake their position for political alienation. The moderates’ disagreed with the hardliners not because they were committed to the preservation of democratic institutions, but because they were willing to step down and return the country to competitive politics after their intervention. As President Geisel justified decades later, “[t]he armed forces must stay out of party politics, but not out of politics. (...) [D]uring crises (…), the military may need to act (...) to drastically remove [any] manifest dangers” (D’Araujo and Castro 1997, 111).

This split between the moderates and the hardliners offers a valuable key for the understanding of Brazilian domestic politics in the context of the debt crisis of the early 1980s. The political system that resulted from this complex amalgamation of interests, and which would remain with only minor changes until the transition to civilian rule in 1985, was complex and rather curious. According to Lessa (1989a, 66-7; 1989b, 92), it was characterized by two major pillars.

The first pillar was *procedural* in nature. The military regime was authoritarian and anti-democratic, but it preserved some of the institutions of the previous order, creating power-sharing and

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146 This interpretation is corroborated by members of the military that participated in the coup, such as General Geisel (D’Araujo and Castro 1997, 162).
power-transition mechanisms that made it more difficult for charismatic and strong leaders in the mold of President Vargas to rise and perpetuate themselves in power. For instance, the Brazilian Presidents were chosen from a pool of Army generals by an electoral college, had fixed terms, and could not be re-elected. The military also preserved the federal Congress, although with limited powers, developed a token but functional party system, and in time allowed elections for the lower and upper houses of Congress, the states legislatures, city councils, and even the mayors of smaller cities. Asked why they had preserved institutions clearly associated with the prior democratic order, such as the National Congress, President Geisel said, without much elaboration, that “it was necessary (...). The nation cannot forego the legislative branch” (D’Araujo and Castro 1997, 189).

The second pillar was the economic performance of the regime. The ability of the military to legitimize their hold on power rested to a large extent on its capacity to deliver high rates of economic growth. In a sense, this “masked” the worst and more authoritarian aspects of the regime (Diniz 1994, 206). According to Schneider, “the working class [traded] liberty for jobs and (...) the middle class [swapped] acquiescence in authoritarianism for a steadily rising standard of living” (1991, 265). In effect, the economy had been growing at a steep pace, especially during the presidency of hardliner General Médici (1969-1974), prompting the government propaganda machine to coin slogans such as “the Brazilian Miracle” to describe what was expected to be the country’s big leap towards development.

Figure 5.12 illustrates the economic growth rates from the end of the Vargas presidency until 1983:
For this reason, the economic problems of the late 1970s and early 1980s eventually started to undermine the support that the military enjoyed among the middle class, workers, and business leaders (D’Araujo and Castro 1997, 398–9; Diniz and Boschi 1989, 29; Gaspari 2004, 52–3; Lessa 1989a, 74). It is in this context that President Geisel initiated a controlled process of political liberalization (the “distension”, or distensão), although the resistance of the hardliners brought it practically to a halt by the end of his administration (D’Araujo and Castro 1997, 390; Diniz and Boschi 1989a, 22; Schneider 1991, 269).

The appointment in 1979 of another moderate to the presidency, General Figueiredo, did not dissipate the tensions. His open commitment to deepening the political distension led to an even stronger push-back from the hardliners\footnote{These included a number of threats and bomb attacks, the last of which backfired and killed the security agents involved in planting the device. The hardliners wanted to blame leftist groups for the violence and perpetuate the regime, but the failed bomb plot uncovered their plans (Schneider 1991, 286; Veja 1981e). The Figueiredo administration half-heartedly investigated the events, and its covering-up undermined the government even more (D’Araujo and Castro, 1997, 435–6; Schneider 1991, 287).} while generating more agitation by the civilian opposition.

Although the government-sponsored Social Democratic Party (Partido Democrático Social, or PDS) still held majorities at the federal and state levels, by the early 1980s the oppositionist political parties held a sizable number of Congressional and state legislature seats. In the 1982 elections for state governors,
the opposition made further gains, winning the governorships of São Paulo, Minas Gerais, and Rio de Janeiro, the three most important Brazilian states (Economist 1982e; Schneider 1991, 292). Meanwhile, the labor movement found renewed strength with the founding of the Workers’ Party (Partido dos Trabalhadores, or PT) and the rise of vocal independent labor unions and leaders.\footnote{Luis Inácio Lula da Silva, who reached the presidency in 2002 at the head of the Workers’ Party, began his career as a union leader in Steel Workers’ Union in São Paulo.}

The Figueiredo administration was performing a difficult balancing act, making important decisions about the economy while ensuring that neither the hardliners derailed the political opening nor the opposition came up victorious in the 1982 elections. Therefore, we could assume that different groups had an incentive in holding him hostage, applying pressure for either the preservation of or a change in its policies related to the Brazilian foreign debt. We could hypothesize in line with preference-driven models that workers and labor unions opposed debt repayment for fear that they would bear the brunt of the economic adjustment necessary for debt service and repayment. On the other hand, groups such as exporters and the financial industry would prefer to ensure debt repayment for fear that the country could lose its access to the international capital and commodities markets. In line with institution-driven models, we could also associate either repayment or default with the existence of specific veto players in the Brazilian bureaucracy and political system, or with the existence of institutional constraints to the power of the executive.

However, the empirical analysis of the political forces operating during the period leading to the Financing Program of 1983 challenges any such simplifications. Similarly to the political environment of the 1890s and 1930s, the relationship of different social-economic groups with both the military and the civilian bureaucrats in the regime was complex and not always conducive to the type of policy-influencing pressure that is assumed by the literature on sovereign debt. In fact, even the civilian politicians and members of the political elites who had participated in or actively supported the military during the 1964 coup were not above the suspicion of the hardliners, and many were persecuted, had
their political rights suspended, and were eventually either imprisoned or forced into exile. Although the military eventually resorted to the old and tried strategy of co-optation to attract those groups back into its political base of support, they were not always docile and usually tested the limits of that partnership, especially during the Geisel and Figueiredo administrations (Carvalho 2005, 135).

The behavior of some government officials may also have strained the relationship between the Figueiredo administration and powerful interest groups in Brazilian society. As the Brazilian economy deteriorated during the early 1980s, Minister Netto and other officials many times antagonized bankers, industrialists, exporters, and middle-class consumers with a long list of measures that included price and interest rate controls, fees, and new taxes, usually following public shaming and finger-pointing (Veja, 1979b, 1979c, 1980b, 1980h, 1980j, 1981a, 1981b). Desperate measures implemented by the federal government to increase its revenues, such as special taxes on different sectors of the economy, did not improve relations (Veja, 1982c). It is reasonable to assume that those groups may have found it difficult to maintain friendly contacts with government officials, or to influence economic policy-making in any significant way.

We should also be careful not to assume that the process of preference aggregation for the different interest groups, and particularly for the regional political elites that formed the government’s political base of support, was straightforward. Similar to what happened at the time of the Funding Loans of 1898 and 1931, the political elites in the late 1970s and early 1980s were fragmented by state and regional lines and had trouble translating their own preferences into concrete action or reaching any agreement on the tenor of specific government policies. Contemporaneous journalistic accounts in Veja and by Branco show that they had conflicting interests (Branco 1980a; Veja 1980c; 1982d), while the policies of the Figueiredo administration may have even increased the existing cleavages (Veja 1981a; 1982n, 116). Moreover, after the 1982 elections, which consolidated the control of the PDS over

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149 That included right-wing civilian politicians such as Lacerda, who had conspired with the military since the years of the last Vargas administration (Schneider 1991, 259–60).
the states of the Northeast but brought the opposition to power in the Southeast and South of the
country, the regional fractures deepened to include party lines.

To further complicate matters, there were divisions even inside the Figueiredo administration
(Branco 1979c; D’Araujo and Castro 1997; Economist 1979j; 1980a; Veja 1979f; 1979i; 1979j; 1979k;
1979n; 1980a; 1981i). Branco provides an example of this difficult environment in his political column of
August 14th, 1980:

The fact is that there are [only] two homogenous teams in the administration (…), the core team, known
as the palace group, and the economy-finance team (…). In the rest [of the administration] there is
unhappiness with the scarcity of resources (…). The [other] ministers are not happy, and the mistrust and
suspicion are present in every office. (…) Seen from the outside, the image of the administration has
deteriorated, as we can deduce from the public pronouncements and what (…) politicians, businessmen,
and union leaders [say in private]. (Branco, 1980)

There were also cleavages inside the military, the government’s core group of support. The main
tensions between the moderates and the hardliners concerned the timing and pace of political
liberalization (Carvalho 2005, 127), but according to Carvalho there was also a gap between the military
personnel who served in the government and needed to deal with practical policy issues, and the
sectors of the armed forces that did not participate in the day-to-day management of the government’s
affairs (2005, 116). Moreover, the intelligence apparatus, which for either ideological or instrumental
reasons was suspicious of the liberalization process, was not completely under the control of the top
military policy-makers (Carvalho 2005, 119, 131–2). We can find an example in the different opinions
expressed by President Figueiredo and General Octávio Medeiros, the head of the National Intelligence
Service (Serviço Nacional de Informações, or SNI), about the possibility of going to the IMF for a loan. In
December of 1980, as the rumor mill over a possible IMF program started running at full steam, the
President answered the barrage of questions thrown at him by the press saying that he “did not fear or
feel shame about recurring to the IMF, if necessary” (apud Veja 1980n). General Medeiros publicly
voiced a different view: “[going to the IMF] is like giving away your affairs [to a bank]. You lose your
autonomy and [they] begin to scrutinize your life. For this reason, we will try everything possible to avoid an IMF loan” (apud Veja 1980n). In a political analysis of the danger that the hardliners posed to the transition, Veja magazine argued that “[t]oday, when (...) [politicians] speak of the ‘point of view of the military’, what [they] refer to (...) is the opinion of the Minister [of the Army] Walter Pires, that of General Medeiros [of the SNI] (...), and that of a vast intelligence community that reports to them” (Veja 1981c, 27).

However, apart from a general concern with the problem of inflation and the general state of the economy, there is no indication that any of the groups in the military had an identifiable set of policy preferences towards debt repayment. It is not even clear whether members of the military actively pushed or lobbied for any specific policies. In a recent interview, Minister Netto claimed that “no officer ever entered my office. The connection between the Armed Forces and the economic ministers was made [by] the President of the Republic” (apud Oliveira 2012). Top civilian bureaucrats seem to have been relatively insulated from outside pressures (Alejandro 1983, 516). According to Carvalho,

[t]he fact that they became the main actors in the political process [after the coup] does not mean that the Armed Forces (...) were directly involved in all [economic policy] decisions and other administrative matters. Although (...) 27.8% of the jobs in the federal administration [in] 1979 (...) were filled by military personnel (...), the privileged position of the military inside the state was translated mainly into a veto power over the big decisions, the more important of which was the presidential succession. (Carvalho 2005, 116)

The civilian opposition was also deeply divided. It was a huge tent that accommodated disparate groups and tendencies, including older politicians identified with the Republic of 1946, liberals and economic libertarians from the right, leftists who were the direct heirs of President Vargas and his populism, centrists, communists, intellectuals, artists, representatives of the middle class and the Catholic Church, independent labor unions, and union leaders with ties to the PT, such as future president Lula da Silva. Part of the opposition was formally organized under the umbrella of the Brazilian
Democratic Movement’s Party (*Partido do Movimento Democrático Brasileiro*, or PMDB), the main opposition party in Congress and the more credible challenger to the regime-sponsored PDS.

The PMDB had done well in the 1982 elections, but its coalitional nature posed an obstacle to the proposal of concrete economic policies.\(^{150}\) Although the party hinted in its 1982 economic program that it favored some form of debt renegotiation, the proposal was purposefully left vague and lacked details (Veja 1982f, 129; 1982h, 22). Some opposition economists openly defended a renegotiation, such as the celebrated Celso Furtado and Maria da Conceição Tavares (Economist 1981c; Veja 1981j, 87), but it is plausible to conclude, as does De Alejandro (1983, 530), that the PMDB avoided voicing a strong position on the foreign debt for fear of angering the hardliners and endangering the political opening of the Figueiredo administration. Indeed, Minister Netto and the president of the Central Bank, Carlos Langoni, were quick to point out that anything but the strictest orthodoxy on the matter could undermine the Brazilian economy (Economist 1981c).

Finally, there was the Brazilian population, including the middle class, workers, and the poorest in society. It is difficult to know the opinion that such a big and diverse group of people could have on the specifics of the Financing Program. Although they would eventually bear the brunt of the adjustment costs, there were not many ways in which they could participate, even indirectly, in the formulation of economic policies. The political system under the military regime did not allow the population to demonstrate their dissatisfaction in the ballot box in all levels of government and most of the regular channels for participation in political life were only beginning to be reinstated. As it also happened in the debt crises I analyzed in chapters 3 and 4, the options available to the Brazilian population still seemed limited to indifference, protest, or participation in the co-optation mechanisms of the regime, none of which allowed them to make their preferences and concerns effectively heard.

\(^{150}\) Schneider defined the identity problems in the PMDB in unflattering terms: “a disparate coalition of opposition groups that was so lacking agreement on policy issues as to border on ‘ideological schizophrenia’” (Schneider 1991, 46). See Kinzo (1994) about the PMDB at the time of the transition to civilian rule.
The sectors of the population that were better organized and politically articulated, such as the unionized workers, did show their dissatisfaction with the regime through strikes and demonstrations, many times ruthlessly repressed by the both state and federal governments (Pinto 1994, 115, 117). There were also riots and localized explosions of violence (Economist, 1981a). That said, even the powerful unions from São Paulo were divided by geographical lines (the city of São Paulo, the city’s periphery, and the rest of the state) (Pinto 1994, 118) and seemed to be mostly concerned with the rising costs of living and the flagging job market. This is not to say that they never openly criticized the regime’s policies or the ballooning foreign debt, but there is little indication that their concerns were ever translated into specific policy demands that could stand out on their own, apart from broad demands for jobs and higher wages.

In view of my analysis of the primary sources, I argue that the main concern of government officials and those groups was the impact of the high inflation on the costs of living. One anonymous government official summarized the problem by comparing it to the hardliner opposition to the political opening: “‘[i]f we could single out a general [for its opposition] to the political distension (...) it would be General Inflation’ (apud Branco, 1979a). It is telling that the Figueiredo administration tried a number of different economic plans and policies designed to curb the rise in prices, although none them had lasting effects (Branco 1979b; Economist 1979k; Veja 1980j, 118; 1980n; 1981g; 1982c; 1982e). As the Brazilian economy deteriorated, Brazilian policy-makers seemed to be scrambling both to understand and to solve the difficulties in the economy (Veja, 1981h), at times doubling down on restrictive policies, at others releasing the pressure with measures designed to make consumer credit less expensive (Veja 1981g, 102; 1982c; 1982d).

The economic failure of the regime gradually undermined its support in Brazilian society. Veja registered in 1980 the increasing frustration of the Brazilian public with Minister Netto and other policy-

151 In one of the most emblematic strikes, involving the car and metal workers from São Bernardo, São Paulo, Lula da Silva himself was arrested and sentenced by a military tribunal to 10 years in prison. The decision was later annulled (Economist, 1981b).
“[Brazilians] do not know anymore what the [Figueiredo administration] wants, nor where it is going, or why what is good today becomes bad tomorrow [and they are] beginning to suspect that it does not know what it is doing” (Veja 1980o, 148). As the dissatisfaction spread in early 1981, the government also lost the support of businesses: “the habitual rivals [businesses and banks] (...) opted to throw all the blame for the rise in interest rates on the broad shoulders of the government” (Veja 1981a, 78). Minister Netto, under great pressure, answered them in kind, further antagonizing his critics: “[w]hat they want (...) is a carnival – [anti-inflation] policies that do not raise interest rates nor affect [their profits] (...) They do not have the courage to ask it [openly], but what they really want is more inflation” (Veja 1981a, 79).

In sum, the domestic political situation in the late 1970s and early 1980s contributed to the Financing Program of 1983 and the moratorium to the extent that it increased the uncertainty and political noise under which the Figueiredo administration had to make decisions about the Brazilian foreign debt. The institutions of the Brazilian political system insulated policy-makers from the pressure of interest groups in society, and the divisions within the elites and the military, which mirrored the divisions existing in Brazilian society at the time of the Fundings of 1898 and 1931, were not conducive to the formation of cohesive interest groups that could influence economic policy-making in a sustained way. Even the stronger positions on the foreign debt, such as those voiced by economists Furtado and Tavares, focused on some form of renegotiation. There were no proposals in the political mainstream claiming for debt repudiation or an ideological default. As I showed in the previous section, the Financing Program was the result of the circumstances, which pushed the Brazilian government to attempt a renegotiation. The process that led to the Financing Program, and to the cooperation between creditors and debtors, is the topic of the next section.
5.4) Cooperation: the events leading to the Brazilian Financing Program for 1983

The Figueiredo administration was eventually pushed into restructuring its foreign debt after the Mexican and Argentine debt crises, when the relative scarcity of capital at the international sovereign debt market became more acute and the weight of debt repayment all but depleted the Brazilian international reserves. Still, it managed to avoid a default for most of 1982 with the help of emergency short-term bridge-loans from the U.S. Treasury, the Bank for International Settlements, and some private banks (Boughton 2001, 339; Cerqueira 2003, 25; Economist 1982f; Veja 1982o, 120; 1982p, 140).

In preparation (or as a condition) for any talks with its creditors, the Brazilian government started negotiating an Extended Fund Facility (EFF)\textsuperscript{152} agreement with the IMF in mid-November (Cerqueira 2003, 27; Economist 1982g, 84; Veja 1982o; 1982t, 116). Per the terms of the agreement, the IMF would disburse a total amount of 4.5 billion U.S. dollars in three years, conditioned on the adoption of stringent economic adjustment policies by the Figueiredo administration, including a drastic reduction of the public deficit (Boughton 2001, 338; Economist 1982g, 84; Veja 1982s, 101). With the IMF program on the way (although not officially approved by the Fund’s Board of Directors), the administration launched the Brazilian Financing Program for 1983 in late December of 1982 (Boughton 2001, 340; Cerqueira 2003, 26; Economist 1982f; Veja 1982t).

The Financing Program was in practice a swap-based restructuring and partial moratorium\textsuperscript{153} divided into four separate “projects” that, if fully implemented, would correspond to a total amount of 25.3 billion U.S. dollars in funding, covering different financing needs for the following year.\textsuperscript{154} The first

\textsuperscript{152} EFF programs are designed to provide funding to IMF members who experience “serious payments imbalances because of structural impediments” or “slow growth and an inherently weak balance of payments position” (International Monetary Fund, 2014), and involve the implementation of a number of structural adjustments negotiated between IMF officials and the member’s government.

\textsuperscript{153} There was some debate on its “true” nature. Ministers Galvêsas and Netto fiercely defended the version that it aimed at rolling over old debts and securing new financing and was not a moratorium. However, even Brazilian observers were skeptical of their exercise in semantics and saw the Financing Program as a partial moratorium (Veja 1982t, 21–22).

\textsuperscript{154} The Financing Program is described in detail in Cerqueira (2003).
project, the “Credit and Guaranty Agreement”, involved the concession of new money by the creditors through “concerted lending” and was signed on February 25th, 1983. The signatory banks agreed to lend 4.4 billion U.S. dollars in four quarterly tranches, the transfer of which was conditioned on the disbursement of the funds by the IMF under the terms of the EEF. For each tranche, the Brazilian government would present to its creditors a list of pre-screened domestic borrowers from both the public and private sectors. The funds not directly lent by the banks to the pre-screened borrowers were to be deposited with the Brazilian Central Bank and, if unclaimed after 18 months, automatically converted into official loans to the Central Bank. These new loans accrued different interest rates depending either on the borrower or on whether they were lent out or remained deposited in the special accounts created for that purpose by the Brazilian monetary authority.

The second project, the “Deposit Facility Agreement”, signed on the same date and covering a total amount of 4.3 billion U.S. dollars, involved a part-swap, part-rescheduling of medium and long-term debt owed by a number of Brazilian debtors, most of them government-owned enterprises and public agencies, and maturing during 1983. The Central Bank would open deposit accounts in the name of each participating creditor, where the debtors would deposit debt payments in an equivalent amount in cruzeiros on the original maturity dates. Their obligations would be discharged upon payment and subsumed by the Central Bank (with the formal guarantee of the Brazilian government) with the new maturities and interest payments negotiated under the Deposit Facility Agreement.

The third and fourth projects, totaling respectively 10 billion and 6.4 billion U.S. dollars, were designed to reopen trade financing and interbank loans to Brazilian companies and banks. The maximum maturity for the trade-related credits was 360 days, and upon repayment the participating banks were under the obligation to re-lend the funds to other Brazilian borrowers. The maturity for the interbank loans was fixed at a minimum of 30 days, and followed a similar process. Although there was
no formal agreement on these two projects, some of the banks eventually adhered to them (Boughton 2001, 343–4; Cerqueira 2003, 30).  

Overall, the Financing Program was significantly more complex than the First and Third Funding Loans and, in hindsight, too ambitious for the conditions of the international economy at the time. Due to the continuing relative scarcity of capital at the sovereign debt market, the Brazilian recession, and the problems in the balance of payments, the Figueiredo administration eventually failed to comply with the conditions set in the EFF (Economist 1983c, 79; 1983d, 90). Since the new funding negotiated in the Credit Guaranty Agreement was conditioned on the completion of the IMF Agreement, the whole Financing Program also eventually fell apart. Of the four scheduled tranches in the Credit and Guarantee Agreement, only the first two, respectively in the amount of 2.5 billion and 1.7 billion U.S. dollars, were effectively disbursed to the Brazilian government, and even so with significant delays.

The Financing Program also faced a number of obstacles not present during the previous restructurings. First, the number of creditors involved in the restructuring was high, totaling 1,114 banks and financial institutions (Veja 1982p, 24), and they had to deal with a number of coordination and collective-action problems in view of their different sizes, characteristics, and nationalities (Boughton 2001, 277; Economist 1983a, 69; 1983b; Veja 1982t, 24–6; 1983, 98). It took them a month just to put together an Advisory Committee to lead the negotiations (Boughton 2001, 340). In addition, the banks in the Advisory Committee were major creditors and had a direct stake in the outcome of the renegotiations. They were caught up in complex two-level negotiations involving the Brazilian

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155 One of the explanations for the reluctance of some creditors was that they were only willing to increase their trade-financing exposure to Brazil at the expense of inter-bank loans (Boughton 2001, 343).

156 During the negotiations for the first restructuring plan, the negotiating committee was comprised of the Morgan Guaranty Trust Co., Citibank N.A., The Chase Manhattan Bank, and The Bankers Trust Co. The 669 banks involved in the Deposit Facility Agreement also created a liaison group of 18 banks to coordinate their interactions with Brazilian authorities. The liaison group eventually changed its organization and name, and the new Bank Advisory Committee for Brazil became the main communication channel during the negotiations for the second restructuring plan. Besides the four original negotiators, the Bank Advisory Committee included the Arab Banking Corporation, the Bank of America, the Bank of Montreal, the Bank of Tokyo, the Chemical Bank, the Credit Lyonnais, the Deutsche Bank, the Lloyds Bank International, the Manufacturers Hannover Trust, and the Union Bank of Switzerland (UBS). Cerqueira (2003) provides a detailed overview of the operations of the committee.
government and the creditors they represented (Economist 1983a, 69). Second, the sources show that the IMF and U.S. officials did not have the preponderant coordinating role that the Rothschild bankers had during the First and Third Fundings. Finally, and relatedly, there were regulatory constraints on the types of concessions that the banks could offer and on the possible outcomes of a debt restructuring (Economist 1980d, 63; Oliveira and Cavalcanti 1980, 81). Regulators in creditor countries were particularly concerned with the losses that the Financing Program could inflict on their banks and financial systems (Boughton 2001, 277, 331).

It could be argued that the austerity policies stipulated in the EFF were concessions that the Figueiredo administration was forced to make out of necessity, as it needed the IMF agreement as a pre-requisite to the Financing Program. In such a reading, it could also be argued that the Brazilian government never intended to fully implement its conditions and, in a demonstration of its opportunistic preferences, used the EFF to obfuscate its creditors. Many contemporaries seemed to have thought the same of the many economic initiatives and policies announced by Brazilian policymakers throughout the years. For instance, a couple of years earlier, The Economist commented that: “[m]uch of Mr. Delfim Netto’s optimism is directed at overseas observers. He knows how important Brazil’s image as an economically well-run country, offering growth and stability, is to those foreign bankers who have to decide whether they will lend Brazil [money]” (Economist 1980a).

Likewise, the explanations presented by the Figueiredo administration for its economic predicament at the time may have sounded as mere excuses. The inflated expectations and erroneous predictions that marked economic policy-making during the final years of the military regime may have led many foreign creditors to be skeptical about whether the Brazilian government was really negotiating its debts in good faith and under the duress of the effects of the finance and production structures of the international economy. A possible point in support to the “opportunistic default”

157 Revealingly, the number of active participants in the restructuring was much smaller than the total number of creditors: only 175 formally adhered to the Credit and Guarantee Agreement and 669 to the Deposit Facility Agreement (Cerqueira, 2003, pp. 26, 28).
hypothesis as proposed by the literature is the fact that the Figueiredo administration stalled the negotiations for the EFF until after the elections of November 15th, 1982. As Minister Netto offhandedly noted at the time, “I had to get to November 15th with the country still solvent” (apud Veja 1982p, 140). Years later, in an interview to the Brazilian newspaper *O Globo*, Langoni, the president of the Brazilian Central Bank at the time, confirmed that the negotiations with the IMF were politically very sensitive (Fariello, 2012). Moreover, according to former Central Bank staffers interviewed by *O Globo*, government insiders in the Figueiredo administration were skeptical of the country’s ability to avoid a moratorium even with the support of the IMF. For instance, Carlos Eduardo de Freitas, a Central Bank official who was responsible for the management of the international reserves during the height of the crisis in 1982, remembered hearing from his bosses as early as 1979 that the country would need to eventually restructure its debts (Fariello and Oliveira 2012).

The behavior of Brazilian policy-makers, who openly argued that a restructuring was in the interest of the creditors (Veja 1982t, 21), could also support the opportunistic default hypothesis. For instance, after the announcement of the Financing Program in December of 1982, Central Bank President Langoni was quoted by *Veja* saying that “[w]e are all in the same boat. (…) We have a mutual interest [in the success of the Program]: we need this money and the banks do not want to create new problems for the international financial system” (apud Veja 1982t, 24). The opportunism view is reinforced by the unilateral partial moratorium declared by the Figueiredo administration a week after the announcement of the Financing Program (Economist 1983a, 69; Veja 1983b, 44). The different plans offered to the creditors as part of the Program, in practice making any new funds mandatorily available for re-lending to Brazilian debtors, may also question the motivations of the Brazilian government (Economist 1982f).

On the other hand, the strategic behavior of the Brazilian policy-makers once the negotiations were underway does not prove, by itself, that they were opportunistically prone to defaulting. It is important to acknowledge that the Brazilian government attempted to maintain debt service by rolling
over old debts and securing additional lines of credit, despite the difficult circumstances of the late 1970s and early 1980s. They maintained frequent personal contacts with foreign bankers, foreign policymakers, and officials at the IMF and the World Bank (Garcia and Cruz 1980, 76–7; Garcia 1981; Veja 1980h; 1980o; 1982b), trying to secure on a voluntary basis the capital that the country needed to finance its growing debt service commitments, even if that meant paying higher spreads and shortening maturities (Veja 1980f, 91; 1982b, 81; 1982q). Rhetorical excesses aside, the Brazilian officials did make an effort to stress the external structural causes of the Brazilian debt crisis. Consistent with my hypothesis in this dissertation, they attempted to frame the context for the Financing Program of 1983 by alluding to the notably difficult international environment of the early 1980s, thus laying the basis for the process of cooperation with the creditors (Economist 1982f; Veja 1982t, 22).

The EFF agreement can be seen as part of the “case” that the Brazilian authorities were preparing (Veja 1982i, 125; 1982s, 100). Despite all the problems in its implementation, its timing suggests that it was perceived by the Brazilian government as “seal of approval”, a signal that the Brazilian government intended to take the process of adjustment seriously. Top officials at the IMF had a similar understanding, pushing the creditors to keep the door open to developing countries that were “doing their homework”. Boughton quotes IMF Managing Director Jacques De Larosière: “‘[commercial banks should] maintain, or even increase, exposure levels when a country is seeking to deal with its economic problems’ through adoption of appropriate adjustment programs’” (Boughton 2001, 268). It is also noteworthy that the Figueiredo administration anticipated many of the adjustment policies that were eventually stipulated in the EFF, implementing austerity policies such as higher interest rates, higher taxes, and more control over government expenditures months before the elections of November of 1982 (Veja 1982i, 124; 1982k, 116; 1982n, 117; 1982o, 120).

Would a more direct or forceful involvement by the IMF or the U.S. Treasury Department, similar to the role played by the Rothschild bankers in the First and Third Funding Loans, have made a difference for the final success of the Financing Program? It is hard to say.
On the one hand, the finance structure of the international economy had changed considerably since the Great Depression. The lending business had also changed. Instead of intermediating bond placements as underwriters or fiscal agents, financial institutions in the 1980s loaned directly to sovereign debtors either alone or through syndicated loans. There was less space for the type of leadership exerted by financial intermediaries in the heyday of the gold standard. In addition, the IMF and the U.S. Treasury Department were limited by their own institutional set-up as respectively an intergovernmental organization and a governmental agency, and by their duties towards their respective constituencies. This was a particular problem for the IMF in view of its dual role as both a creditor and a facilitator of cooperation at the international level. We also should consider that the position of Jacques De Larosière, the Managing Director at the IMF at the time, was a difficult one. He was treading a fine line, talking closely to Brazilian officials, but unwilling to force the hand of the bankers (Boughton 2001, 340). By the end of February, 1983, he started to use more forceful language in its meetings with the bankers (Boughton 2001, 343), but his role remained relatively subdued throughout the negotiations.

On the other hand, I believe that the primary and secondary sources on the Financing Program do not undermine my claim that the structural power of finance intermediaries is important for the process of cooperation between creditors and debtors. The IMF and the U.S. Treasury Department exerted their influence in indirect ways. For instance, the IMF wielded its structural power as a provider of “catalyst” financing and by means of its claims to financial and macroeconomic expertise (exemplified by its consultations with members under Chapter IV of its Terms of Agreement) (Boughton 2001, 276). In the context of the Financing Program, its power was manifested in the macroeconomic review of the Brazilian finances conducted for the EFF. Government officials in creditor countries also used their structural power to try to influence decision-making on the side of the creditors. In a meeting which also included the presence of Federal Reserve Chairman Paul Volcker, other U.S. officials, and De Larosière, Anthony Solomon, the President of the Federal Reserve Bank of New York, attempts were made to
persuade U.S. bankers not to abandon Latin America after the Mexican crisis. Boughton describes it as follows:

Wriston [from Citibank, who had previously affirmed that sovereign debtors do not default] made it clear at the onset that he saw Brazil as a poor credit risk and that his intention was to gradually withdraw credits until Citibank was completely out. The Federal Reserve officials argued, however, that the situation was too delicate for precipitous action: if Citibank started reducing its credit lines, everyone else would follow suit, no one would get his money out, and the stability of the banking system would be threatened. Wriston was not convinced that the problem was too big for the banks to handle by themselves, but he eventually agreed to participate in an advisory group to try to stabilize financial flows to Brazil. (Boughton 2001, 338)

Moreover, according to the available sources, besides providing funding of their own in the form of emergency bridge loans to the Brazilian government, the U.S. and European governments used their moral suasion to push the banks to negotiate and accept the terms of the Financing Program (Veja 1982s, 140; 1982w). U.S. government officials were later instrumental in the solution of the debt crises affecting Latin America and other developing countries, forging negotiated settlements between creditors and debtors, first through the Baker Plan, named after Treasury Secretary James Baker (1985-1988), and later through the Brady Plan, named after Treasury Secretary Nicholas Brady (1988-1993).

Although there might have been resistance to debt relief among the smaller banks, the primary and secondary sources suggest that there was some measure of consensus among the major banks on the importance of cooperation and the need to reciprocate with limited debt relief any domestic structural adjustment reforms undertook by the debtors (Boughton 2001, 274, 276). In the context of the Financing Program, the biggest creditors seemed to have understood that an adjustment in their policies and behavior was necessary as *quid pro quo* to the promises and efforts made by the Brazilian government, if for no other reason than that Brazil would not be able to remain afloat otherwise. Moreover, the Brazilian debt crisis unfolded in the wake of a number of prior foreign crises (Boughton 2001, 269; Economist 1982a; 1982b; 1982c) which provided some credence to the claim that the Brazilian problems were rooted in structural causes. Brazilian policy-makers found it increasingly difficult
to obtain financing after Poland proposed a restructuring in 1982 because “[r]escheduling Poland’s debts has been the most traumatic experience western bankers have known since the first surplus Opec dollar trickled through their fingers. It has forced them to rethink all the traditional assumptions on which they built their international lending” (Economist 1982b, 9). Further complicating matters, long-term loans to Brazil and other South American countries dried-up as a consequence of the Falklands/Malvinas War (Boughton 2001, 330; Carneiro 1982, 88; Lopes 1982, 100; Resende 1982, 48; Schneider 1991, 296). According to The Economist, “[b]ankers have always had a ‘block’ mentality. Just as the Polish crisis sent them scurrying to cut off credits to the whole of Eastern Europe, so Argentina’s crisis has set them to rethink all their South American lending” (Economist 1982c, 83). Veja offered the Brazilian perspective on the issue:

The international financial system is experiencing days of extreme anxiety. (...) Mexico, which has the biggest foreign debt among developing countries, (...) and Argentina, (...), are close to insolvency. (...) Concerned that insolvency will become generalized, (...) Paul Volcker, president of the Federal Reserve, (...) recommended two weeks ago that American banks drastically reduce their loans to sovereign debtors (...) (...) [T]he generalized [fear] tends to make it even worse for the indebted countries as banks are decreasing their loans by their own volition or under the pressure of central banks. (Veja 1982d, 108, 109, 112)

The Mexican moratorium in August of the same year practically sealed shut the doors of the sovereign debt market: “Mexico’s crisis will have wide repercussions. (...) The psychological impact of Mexico’s near default will be to make bankers even more nervous about international lending – and particularly lending to Latin America” (Economist 1982d, 58). According to Veja, “[Minister Galvêas] admitted that he has been looking to borrow money abroad for weeks but could not [find any]. (...) []f [both] the caution of the bankers and the debt crisis last too long, the Brazilian authorities (...) will also be pushed towards the negotiating table” (Veja 1982h, 119).

Finally, as we did for the First and Third Funding, we can position the Financing Program in the cooperation range. Following the guidelines I established in section 2.5, we can say that as a rule, the scarcer capital is internationally and the more transparent policy-makers in sovereign debtors are when
they approach their debtors to negotiate, the farther from the discord pole the final outcome of the negotiations should fall. The Financing Program aimed at changing the terms of the original debt contracts in substantial ways and included measures that were very restrictive to creditors, such as the deposit accounts that were part of the Credit and Guaranty Agreement and Deposit Facility Agreement. Its terms move it towards the discord or repudiation pole of the cooperation range, as summarized in figure 5.13:

Figure 5.13 – Possible position of the Financing Program in the cooperation range

5.5) Validity conditions for my hypothesis in the context of the Financing Program

Before concluding this chapter, we should look at the validity conditions for my hypothesis in relation to the Financing Program. My hypothesis passes the test presented by the first condition. Similarly to the other two cases, none of the alternative hypotheses presented in the literature on sovereign debt, which I reviewed in section 2.3, offers a better explanation for the Financing Program and the Brazilian moratorium.

The primary and secondary sources I consulted provide no evidence for the coercion and issue-linkage explanations. Although government officials in the United States and other creditor countries clearly used their influence to push international banks to the negotiating table, I found no evidence that they ever coerced, threatened, or used any linkages against Brazilian officials to obtain any particular outcome in the negotiations. Domestic-politics explanations also fail to provide a convincing
account for the Brazilian decision to announce the Financing Program and cooperate with its creditors, as I argued in section 5.3. I did not find any evidence that domestic interest groups or features of the political system had any direct influence over the decisions made by Brazilian policy-makers in connection with the country’s sovereign debt. Finally, the primary and secondary sources also fail to provide strong evidence in support of iteration or reputation explanations. As I explained in chapter two, both are unsatisfactory as they tend to assume that tit-for-tat strategies are usually employed by creditors in response to defaults, but as it happened in previous cases the relative scarcity of capital that affected Brazil preceded the debt crises of the 1980s and was tied to the structural factors I analyzed in section 5.2.

My hypothesis also passes the test presented by the second condition. The Financing Program can be described as a case of cooperation, a restructuring process whose result departed from the status quo and in which Brazil and its creditors made compromises and adjusted their policies, although the Brazilian position was certainly more forceful (and unilateral) than during the First and Third Fundings. Furthermore, although Brazilian policy-makers can be faulted for what could be seen as their instrumental approach to the restructuring, as I show in the previous section they also made a good-faith effort to negotiate with their creditors and to show that restructuring was connected to the negative effects that the finance and production structures of the international economy had on the Brazilian balance of payments and, in consequence, its ability to pay.

5.6) Conclusion

The Financing Program eventually failed to provide the briefing space intended by the Brazilian government. Due to the difficulties that the Figueiredo administration had in fulfilling the conditions set by the EFF agreement, the amount of new capital disbursed under the Financing Program did not approach the country’s financing needs. According to Boughton,

[without question, the [Brazilian] authorities had undertaken a serious and substantial adjustment effort, after the disastrous delay in the fall of 1982. The trade surplus in the first half of 1983 was above target,
and – aside from the effect of inflation on the government’s domestic interest payments – the fiscal accounts had also strengthened. To some extent, the [EFF] targets may have been misconceived in the first place, owing to the (...) quite different conceptions of the problems and the underlying economic model held by the Fund staff and the [Brazilian] authorities. To some extent, the implementation of the [EFF] program was weakened by the authorities’ conviction that inflation could not (indeed, should not) be sharply reduced in the short term. And to some extent, the management of the Fund overestimated the ability of the committee banks to deliver. Even with the strongest adjustment effort, the program very likely would have gone off track owing to delays in obtaining the promised financial support from the banks. Mistakes had come from all sides (...). (Boughton 2001, 345)

The following year, the Figueiredo administration launched a new financing program, the equally ambitious Brazilian Financing Program for 1984, but the liquidity problems remained (Cerqueira 2003, 33). In 1985, just after the election of the civilian Tancredo de Almeida Neves to the presidency, the government announced an even more ambitious “Pluriannual Rescheduling Program” focusing on 45.3 billion U.S. dollars in debts maturing from 1985 up to 1991, including the new debts Brazil had incurred with the Financing Program for 1983 (Cerqueira 2003, 39). The negotiations failed once again, in part because of the inability of the Brazilian government to fulfil the conditions of the EFF.

With the tragic death of President Neves due to natural causes right after taking office, the responsibility to administer the economic legacy left by the military regime fell to Vice-President José Sarney de Araújo Costa. His administration was challenged by the foreign debt problem and many economic woes, not least among them the persistent high inflation rates. In 1986 the government introduced a new currency, the cruzado, and an economic plan that managed to bring the inflation down for a brief period of time. In the wake of the “Cruzado Plan” wreckage, President Costa eventually officially declared a full moratorium on the payment of the foreign debt on February 22nd, 1987.158 Brazil would only normalize its access to the international sovereign debt market in 1994, after signing a rescheduling agreement under the framework of the Brady Plan (Cline 1995, 326).

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158 For a summary of the Costa presidency, see Schneider (1991).
6.1) Introduction

As I write these pages, Argentina has been locked for years in a serious judicial fight with a group of creditors (Norris 2014; UNCTAD 2014a). In Europe, Greece is in acrimonious negotiations with the European “Troika” (the International Monetary Fund, the European Central Bank, and the European Commission), trying to renegotiate its debts (Higgins 2015). These two cases may seem to be emblematic of the type of opportunistic, zero-sum relationship that the literature on sovereign debt assumes to be the norm between sovereign debtors and their foreign creditors. They also seem to suggest that creditors and creditor countries may be keen to enforce the terms of loan contracts and may not be open to compromise, challenging my claims in this dissertation.

I would need to conduct detailed studies of Argentina and Greece before I can expand my theoretical framework to their cases, but I am confident that my conclusions about Brazil hold true for other developing and developed sovereign debtors at the periphery of the international economy. Brazil is in this sense representative of other sovereign debtors that have been historically net importers of capital and depend on borrowed foreign capital and positive trade balances in order to acquire the foreign currency they need to fulfill their financing needs. Debt crises and debt restructurings tend to follow similar patterns because their underlying causes are structural and they impact debtors by means of the operation of the finance and production structures of the international economy. We can thus reasonably assume that if a structural explanation is applicable to the Brazilian case, it should also be applicable to smaller, less powerful, sovereign debtors elsewhere.

Moreover, the cases of Greece and Argentina do not contradict my hypothesis about the process of cooperation between debtors and creditors in the sovereign debt market. Although recent events appear to suggest otherwise, Greece and its creditors have compromised on some of their positions since the 2007-2008 financial crisis. Moreover, a default seems not to be in the interest of any
of the parties involved in the negotiations (Hesse and Reiermann 2015). It should also be noted that most of the creditors currently suing Argentina in the U.S. courts are hedge funds that bought old Argentine bonds at depressed prices from creditors that preferred to sell them cheap instead of participating in the previous 2005 Argentine restructuring (Economist 2014; UNCTAD 2014a). Although the terms of the restructuring were harsh towards its creditors, the fact remains that Argentina offered a compromise and chose to renegotiate its debts instead of repudiating them as it could have done after its economy imploded following the 2000-2001 debt crisis. While the majority of the creditors did participate in the debt restructuring, the hedge funds currently suing Argentina are the actors who are actually behaving somewhat opportunistically in this matter.

In the next section I offer a brief summary of the arguments in my dissertation and my empirical findings. In section 6.3 I detail the contributions of my dissertation to the study of the sovereign debt problématique and the literature on sovereign debt. In section 6.4 I finalize my dissertation with a brief analysis of future lines of research.

6.2) Brief Summary of My Hypothesis and Findings

The Funding Loans of 1898 and 1931 and the Financing Program for 1983 support my hypothesis that the finance and production structures of the international economy are particularly important in the context of the sovereign debt problématique. In all three cases, both structures played a crucial role in making capital relatively scarce at the international level, consequently limiting the range of policies Brazilian policy-makers could choose and leading to their decision to pursue a restructuring of the country’s debts.

Strange’s understanding of structure, focused on its social nature, is very relevant to my hypothesis. It points to the existence of institutions, norms and rules that mediate the relationship between creditors and debtors, and to the power relations that permeate and shape those social arrangements. Together with Keohane’s definition of institutions as sets of persistent and connected
norms and rules that “prescribe behavioral roles, constrain activity, and shape expectations” (Keohane 1988, 383), Strange’s view provides a very strong critique of the assumptions used in the literature on sovereign debt.

In the context of the First and the Third Funding Loans, the institutions and norms of the gold standard, such as the parity rate that determined the convertibility of national currencies into gold and the freedom of capital flows, were at the base of the finance structure of the international economy. One of their main effects was to restrict in pro-cyclical fashion the availability of capital to developing sovereign debtors, especially when monetary authorities in Great Britain, the United States, and other creditor countries raised interest rates to both protect the level of their domestic reserves and discourage gold outflows at times in which capital was becoming scarce internationally. As I showed in sections 3.2 and 4.2, this happened in both cases. The first was in the wake of the 1893 financial crisis in the United States (Abreu 2000, 387, 392; Franco 1990, 14; Topik 2009, 365; Triner and Wandschneider 2005, 215), when monetary authorities in Great Britain and other European countries intervened in the market to attract gold, in effect generating the economic instability to Brazil and other developing sovereign debtors and triggering the so-called Depression of the Nineties (Hoffmann 1956, 152). The second was in the wake of the rise in interest rates by the U.S. Federal Reserve bank in 1928, attracting gold from the rest of the world (Eichengreen 1996, 68; Galbraith 1997, 30; Thorp 1984, 6) and, eventually, generating the financial bubble that triggered the Great Depression in 1929.

Similarly to the events of the First and Third Funding Loans, the finance structure of the international economy also limited the access of the Brazilian government to international capital at the time of the Brazilian Financing Program for 1983. Its institutions and norms had changed considerably since the 1930s, first with the creation of the Bretton Woods system of fixed exchange rates pegged to the U.S. dollar after the Second World War, and later with its dismantling and transformation in the early 1970s into a system based on floating exchange rates and the principle of freedom of capital flows, but those norms and institutions still set the terms under which developing sovereign debtors such as
Brazil could access capital at the sovereign debt market. As I described in section 5.2, the rise in interest rates in the United States in the period covering the end of the Carter and the first year of the Reagan administrations helped to attract international capital to the U.S. domestic market (Frieden 2006, 373), increasing its relative scarcity for Brazil and other developing sovereign debtors at the periphery of the international economy.

The impact of the finance structure on the relative scarcity of capital was compounded in all three cases by the operation of the production structure of the international economy. International trade was at the time, and still is today, a crucial source of capital for developing sovereign debtors. However, it is subject to the “commodity lottery” identified by de Alejandro (1984) and to a historical trend of falling terms of trade, as identified by Ocampo and Parra-Lancourt (2010). These were particularly problematic for Brazil in the context of the First and Third Funding Loans, when its exports were concentrated on coffee and both the demand for the product and its price were affected respectively by the Depression of the 1890s (Hoffmann 1956, 148; Netto 1979, 20) and the Great Depression (Abreu 1984, 147; Netto 1979, 97). In the case of the Financing Program for 1983, the source of the crisis on the balance of trade were the oil shocks that hit the international economy and increased oil prices in the early 1980s, but the overall effects were similar. They contributed to the decision by U.S. monetary authorities to increase interest rates and also depressed international trade and economic activity in creditor and debtor countries alike, eventually hitting Brazilian exports at a time when the country already had trouble finding alternative sources of financing (Abreu and Fritsch 1982, 34; Boughton 2001, 320; Resende 1982, 46).

Strange’s definition of structure is also valuable in highlighting a new perspective on the power of creditors and creditor countries and how it is manifested in the international economy. I showed in the context of the First and Third Funding Loans that monetary authorities in creditor countries intervened in the operation of the gold standard to steer capital flows towards their economies, counter strong movements in their balance of payments, and protect the level of their domestic bullion reserves.
As a consequence of such interventions, targeted by and large at their own economies, they indirectly affected the sovereign debt market, increasing borrowing costs to all developing sovereign debtors independently of the behavior of their policy-makers or the macroeconomic fundamentals of their economies.

Their structural power, or as Strange defines it, “the power to choose and to shape the structures of the global political economy within which other states, their political institutions, their economic enterprises, and (not least), their professional people have to operate” (Strange 1987, 565), provided more autonomy to their policy-makers than that available to policy-makers in Brazil and other developing debtor countries, who had no workable options to mitigate the effects of the liquidity pull from the center (Eichengreen 1987, 11; Furtado 1959, 184). Moreover, thanks to their structural power in the context of the First and Third Funding Loans, Great Britain and the United States had the ability to “shift” some of the costs of adjustment related to the Depression of the Nineties and the Great Depression to developing sovereign debtors at the periphery of the system. British and U.S. policy-makers had more room to use their monetary policy to attract gold from the world during periods of decline in the business cycle due to the fact that they were the main banking centers in the world and the jurisdiction where most developing countries held their international reserves (Eichengreen 1997, 146). The United States used its structural power in a similar manner in the context of the Financing Program for 1983, reflecting the predominance of the U.S. dollar in the international economy (Eichengreen 1996, 97–9; Helleiner 1994, 5, 8, 13; Resende 1982, 44; Strange 1987). This was clearly demonstrated by the rise in interest rates by U.S. monetary authorities in the period between the end of the Carter and the first year of the Reagan administrations (Helleiner 2009, 75; Jackson 2015; James 2009, 25; Marte 2015; Norrlof 2009).

As I showed throughout my case studies, Brazil did not behave in the opportunistic way predicted by the literature when declaring moratoria or negotiating the First Funding, the Third Funding, or the Financing Program. The ability of Brazilian policy-makers to keep servicing the country’s foreign
debts and the choices available to them were clearly shaped by the operation of the finance and the production structures of the international economy and the structural power of creditors and creditor countries, which in turn can increase the relative scarcity of capital at the international level. In fact, the assumption that developing sovereign debtors are always attempting to maximize their own preferences for defaulting does not stand closer empirical scrutiny. In all three periods I analyzed, the correspondence exchanged by Brazilian policy-makers, the reports and other documents they prepared, the macroeconomic data, and the journalistic accounts of the period all strongly suggest that they were pushed into defaulting against their own preferences due to the more mundane reason that they cannot find the foreign currency (or the gold) they need to repay.

The three Brazilian case studies also support my final claim, based on the work by Keohane (1984), Oye (1986) and other liberal institutionalists, that debtors and creditors cooperate during processes of debt restructuring by adjusting their policies and preferences by means of negotiations that usually result in changes to the original terms of debt contracts. Cooperation between debtors and creditors in the context of the sovereign debt market can thus be described as a process of mutual adjustment falling between the two extremes of the preservation of the status quo ante with full compliance by the debtor and no loss to the creditors, and debt repudiation with the total loss of the investment by the creditors. For this reason, it may result in outcomes that are different from the original terms of the debt contracts under negotiation.

This is what happened in the three cases. In section 2.5 I argued that the scarcer capital is internationally and the more transparent policy-makers in sovereign debtors are when they approach their debtors to negotiate, the farther from the discord pole the final outcome of the negotiations should fall. The First Funding changed the original terms of older Brazilian loan agreements but not to the point of pushing creditors to refuse to negotiate. It can be situated closer to the harmony pole of the cooperation range than the other two Brazilian restructurings, as shown in figure 3.4. The outcome for the Third Funding Loan fell farther away from the harmony extreme than the First Funding, as suggested
by figure 4.11. Although it also did not change the terms of the Brazilian loan agreements in a radical way, as the Provisional Government led by President Vargas managed to keep servicing the bonds issued under the First and Second Funding Loans, it followed a unilateral moratorium on debt service and amortizations. Of the three cases, the Financing Program for 1983 fell closest to the discord and repudiation pole of the cooperation range. The negotiations between the Brazilian government and its creditors aimed at changing the terms of the original debt contracts in substantial ways and included restrictive measures that could be detrimental to the latter, such as the deposit accounts that were part of the Credit and Guaranty Agreement and Deposit Facility Agreement. Although we cannot exclusively blame the Figueiredo administration for its failures, the terms of the Financing Program did push it towards the repudiation pole and the right side of the continuum, as shown in figure 5.13. Still, this is very different from saying that creditors and debtors do not cooperate or attempt to reach a solution involving some form of policy compromise.

6.3) Contributions to the Literature on Sovereign Debt

As I anticipated in section 1.2, my hypothesis and case studies make a number of contributions to the research program on sovereign debt, shedding light on important elements that are ignored by most works in the literature.

First, my structural perspective provides an important counterbalance to the voluntaristic approach that became the mainstream way to study the sovereign debt *problématique*. The literature I described in chapter two is characterized by a very reductionist understanding of the dynamics behind sovereign debt. It focuses mostly on factors at the unit level when explaining sovereign debt crises and defaults, paying little to no attention to the impact that the structures of the international economy can have on the relative scarcity of capital and the ability of sovereign debtors to keep servicing their debts. For this reason, most works tend to oversimplify the sovereign debt *problématique* by assuming that defaults are the result of the unwillingness of debtors to repay and are the preferred outcome of
opportunistic policy-makers concerned with their political survival given the pressure of disaffected constituents and interest groups.

By reducing the sovereign debt *problématique* to the question of whether a debtor can muster the political will to repay, the literature also ignores that practical economic issues may be as important as political ones in leading to moratoria and restructurings. Regardless of the sacrifices policy-makers in sovereign debtors may decide to bear or to impose on their constituencies, they may still have trouble generating surpluses in the balance of trade or the balance of payments for reasons unrelated to their willingness to maintain debt service. For instance, they may not be able to reduce imports, while cuts to government spending may generate a fiscal crisis without propping up its solvency. These consequences may also be unconnected with the preferences of any particular interest groups.

Moreover, a more nuanced view of the sovereign debt *problématique* should not ignore that creditors and creditor countries possess structural power and can affect the relative scarcity of capital independently of the preferences and behavior of policy-makers in sovereign debtors. In other words, there is a power differential between creditor and developing debtor countries. While all countries to a large extent participate in the international economy and are subject to the effects of its finance and production structures, only a few of them have the power to resist or to shape the content of those structures. The bounded rationality of the creditors, who can withdraw from the sovereign debt market as expectations change or quickly repatriate their investments overseas in a system based on the freedom of capital flows, is also a contributing factor to debt crises. By and large, most events that can increase the relative scarcity of capital at the international level or can impact the finance and production structures of the international economy are outside of the control of policy-makers in sovereign debtors, as illustrated by the Third Funding Loan. Brazil had considerable trouble finding new loans even though the administration of President Sousa was widely regarded as fiscally responsible and orthodox on its approach to the rules of the gold standard.
The biggest contribution of my structural approach is thus to show that the distinction between the willingness and the ability of sovereign debtors to keep paying is not a matter of semantics or two sides of the same coin, as defined by Sturzenegger and Zettlemeyer (2006, 38). Naturally, at a very basic level, any defaults or restructurings are the result of a decision made by someone with the prerogative to determine whether the sovereign debtors should remain committed to the status quo or should attempt to renegotiate their debts. Norms, institutions, and structures cannot choose in the stead of real people. However, the extent to which those decisions are truly “voluntary” when made under duress, as the sources of foreign capital dry up and the operation of the structures of the international economy limit the choices available to policy-makers, is questionable. This is particularly true of developing country sovereign debtors, who lack the structural power to preserve their policy autonomy. In summary, a sovereign debtor may be pushed into suspending debt repayments or attempting a restructuring even when it goes against the preferences of its policy-makers or its most powerful interest groups, as it was the case in the three Brazilian crises I analyzed above.

My research also answers to recent calls for the study of systemic factors in the field of IPE, such as Drezner and McNamara (2013), McNamara (2009), and Phillips (2005). It is important to note that I am not making the case for a return to the structural determinism of strong structuralist accounts of the past. My main point in this dissertation is that the fluctuations in capital and trade flows are important mechanisms transmitting the shock waves of international crises from creditor countries to sovereign debtors, as is widely acknowledged (although not seriously considered) even by some of the traditional approaches in the literature on sovereign debt (Kaminsky, Reinhart, and Végh 2003; Reinhart and Rogoff 2009; Sturzenegger and Zettelmeyer 2006). As such, their focus on the unrestricted agency of sovereign debtors is clearly misguided, as there was very little that Brazilian policy-makers could do domestically to change the course of events that had their origin at the structural level of the international economy in the cases studied herein.
The second contribution of my dissertation is an alternative perspective on the nature of cooperation in the sovereign debt market. One of the problems with the assumption of cooperation in the literature is that it takes for granted the legal definition for defaults, narrowly defined as any modification to the original terms of debt contracts, and misses the fact that many instances in which debt contracts are modified are in fact the result of negotiations in which both creditors and debtors agreed to adjust their own perspectives and behavior. Cooperation should be understood in broader terms than the narrow notion of the preservation of the status quo ante with the enforcement of debt contracts by the creditors.

Naturally, this does not mean that creditors and debtors will always reach an agreement during their negotiations or be equally satisfied with the outcomes, or that they are above bargaining over the terms of repayment. My point is that, in many if not the majority of cases, some form of agreement is possible and can be pursued by the parties. In effect, this has been historically true, I argued in section 2.4.2. My interpretation for the assumption of anarchy may also explain why creditors allow debtors that have defaulted or renegotiated their debts in the past to return to the international sovereign debt market. Creditors are more willing to cooperate with debtors during times of systemic economic distress, provided that the scope of the renegotiation is narrow and that the latter negotiate in good faith in view of their ability to pay. A limited debt restructuring that aims at enhancing the long-term repayment prospects of a debtor is thus qualitatively very different from a debt repudiation and should be understood as a cooperative strategy and not as a default.

The third contribution of my dissertation is a more nuanced understanding of power than the one informing the literature on sovereign debt. In the context of the international economy, structural power is more important than the direct or relational form of power which is at the base of the assumption of “cooperation as enforcement”. It is manifested in the ability of certain actors to control, or at least influence, the relative scarcity of capital and its distribution at the international level.
The concept of structural power can be vague and hard to operationalize in contrast to the traditional understanding of power, and when poorly implemented it can lead to the conflation of the structural and the agent levels of analysis and to a rigid analysis of social phenomena that overlooks the agency of those subject to it. That said, I argue that it is still very useful for the analysis of the international economy. Building on Barnett and Duvall’s work on power, I show that an actor can wield power over others indirectly, without even intentionally seeking to produce effects over them. As such, the structural power of creditors and policy-makers in creditor countries can be crucial in the period leading up to crises, affecting the relative scarcity of capital as I showed throughout the dissertation.

To counter some of those potential drawbacks, I also offer a more detailed analysis of the concept, adding to the general definition provided by Susan Strange. I innovate on her analysis by showing that structural power can be exercised by non-state actors by means of a strategy of framing and claims of expertise and know-how. My hypothesis can thus explain the sometimes oversized role that financial experts can play in the sovereign debt market, which is missing from traditional analyses of the sovereign debt problématique. Naturally, this is not to say that they play an uncontroversial role, or that their motivations are selfless or altruistic. They benefit from their actions and may be seen as agents of the powerful, reproducing the institutions of the finance structure while advancing the position of creditors and creditor countries at the expense of developing sovereign debtors. Even so, their intermediation can help promote cooperation between creditors and debtors by connecting moratoria and defaults to the state of the international economy and vouching for the good faith of sovereign debtors during renegotiations.

As I mentioned in section 2.4.1, Strange’s structural theory and her conception of structural power provides an alternative perspective for the study of how power relations mold the structures of the international economy. Her theoretical framework also avoids some of the issues with hierarchical accounts in IR, which tend to exaggerate the fungibility of hard power capabilities across issue-areas and the extent to which the hegemon can control the operation of the international economy and the
actions of actors within it. In contrast to them, the concept of structural power is more flexible, as it moves beyond the dichotomous functional separation between the domestic and the international spheres and allow us to conceive that state and non-state actors alike can wield power depending on the issue-area in question. In addition, the proper conceptualization of structural power can clearly distinguish between the agents who wield it and the structures that are constituted or reproduced by it, and does not necessarily exclude resistance or the agency of those that are subject to its employment.

Fourth, and relatedly, my dissertation provides an alternative perspective on domestic politics in developing debtor countries. It shows that their policy-makers may be influenced by domestic political factors when deciding on whether to start negotiations with foreign creditors, but not as hypothesized by both preference and institution-driven explanations in the literature. In a very narrow sense, we could say that every policy decision touches on domestic political issues. Policy-makers can affect their own political environment with their acts and decisions, and thus may be particularly concerned with the effects thereof on the daily life of those who have a say on their stay in power.

That said, my analysis shows that no particular interest group in all three periods under study was in a position to influence decision-making about debt repayment in a direct way. Lindblom (1980, 62) reminds us that there is a fuzzy connection between interest groups, policy-making, and policy outcomes. His observation holds true in the three Brazilian cases, as the political institutions at the time of each restructuring, which concentrated power on the hands of the executive branch, and the fractured nature of domestic interest groups made it more difficult for even the most powerful political actors to articulate coherent policy alternatives. As such, domestic politics had only an indirect role in all cases, increasing instability and clouding the environment in which Brazilian government officials had to make very difficult economic decisions about the country’s sovereign debt.

In summary, my dissertation offers a view of the sovereign debt problématique that is empirically more accurate and theoretically more nuanced than the traditional explanations on the literature on sovereign debt. It also opens up interesting avenues for future research connected that
could further contribute to our understanding of debt crises and broaden the horizons of the literature on sovereign debt. I present them in more detail in the next section.

6.4) Areas for Further Research

The first area for future research follows in a rather straightforward way from this dissertation. It would involve the introduction of new case studies for comparisons with the Brazilian cases I analyzed in chapters three, four, and five. One interesting possibility would be a comparison between Brazil and other Latin American debtors, such as Argentina or Mexico. A variation here would involve either debtors from different continents, or debtors of different sizes, such as Brazil, Argentina, and Uruguay. Such a comparison could provide new insights on how foreign creditors and finance experts negotiate with debtors that are relatively less important than the usual heavy hitters such as Brazil.

A second possibility would be to investigate the structural power held by financial intermediaries and experts such as the Rothschild bankers and IMF officials (or other market actors that provide financial advice to borrowers and lenders), along with their role in the international sovereign debt market, in more detail. A third line of research, directly connected to the previous one, would focus on the normative underpinnings of the international sovereign debt market, a topic that has not been fully explored in the literature on sovereign debt despite its important policy and theoretical implications. Authors such as Best (2007) and Blyth (2006) have pointed in that direction when analyzing policies justified by financial experts and other market actors with claims to “austerity”, or by the need to provide legitimacy to organizations such as the IMF. The research I conducted for my dissertation also showed that the literature and the discourse of both creditors and debtors have strong normative undertones. Questions of legitimacy and justice thus seem to be important for the construction and reproduction of the institutions of the international sovereign debt market.

A fourth possibility would be to explore the implications of the bounded rationality of creditors and debtors (and their policy-makers) to the sovereign debt market and the international economy
more broadly speaking. As I mentioned in section 2.4.2, a growing corpus of research illustrated by the works of Hirschman (1985), Jones (1999), Kanheman (2002), Ostrom (2000), Odell (2002), Simon (1985), and Tversky and Kahneman (1986) challenges the traditional view of instrumental rationality that predominates in the literature on sovereign debt. The fact that actors may be constrained in their ability to act as maximizers due to a series of cognitive limitations turns defaults into less calculated affairs, with very interesting possibilities for our understanding of the sovereign debt *problématique*.

Moreover, the concept of bounded rationality also has very interesting, and promising, policy implications, deserving a more careful study. If defaults and moratoria are policy responses by rationally-bounded policy-makers scrambling to adjust to the economic instability transmitted to their economies by mechanisms connected to the finance and production structures of the international economy, such as capital flows and international commodities prices, and if the fluctuations in the availability of capital at the sovereign debt market can be credited to the limited cognitive capability of creditors, policy-makers, and consumers in creditor countries, any long-term solution to the problems with sovereign debt should also be structural in nature. The proposal in 2001 by then IMF Deputy Managing-Director Anne Krueger to create a “sovereign debt restructuring mechanism”, although ultimately defeated, was a right step in such direction. Moreover, some kind of mechanism to keep debtors afloat by providing some form of emergency financing or capital flows would be necessary. After all, as we have learned over and over in history, we not only miss much, but also risk much, by ignoring the important role that the finance and the production structures of the international economy play on debt crises.
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