

The Politics of Brazil's Financial Troubles

This year—and particularly since midyear—Brazil has suffered heavy financial pressures and large increases in the interest rates it must pay for foreign capital. In real-time economic terms, the reasons are difficult to analyze. Under the administration of President Fernando Henrique Cardoso, the nation's primary fiscal balance has improved markedly in recent years. Brazil's Fiscal Stability Program, which established goals for primary budgetary surpluses each year, has been in place since 1998. In each of the last three years, Brazil has exceeded its surplus target. Brazil is currently running a primary surplus of 3.75 percent of GDP, exceeding what would be required to stabilize the debt-to-GDP ratio.

In 2000, Congress enacted the Fiscal Responsibility Law, which forces public administrators to manage revenues, expenditures, assets and liabilities according to a set of clear and obvious rules. It imposes spending limits on public debt and personnel and sets fiscal targets for each year. It establishes rules to control public finance in election years, since that is when the temptation to run deficits is highest. Moreover, it imposes permanent fiscal discipline not just on the national government but on all levels of government.

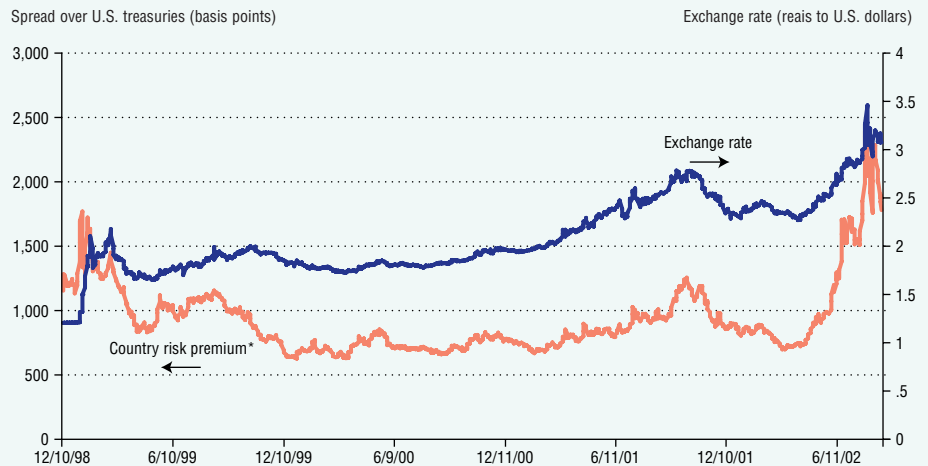
Nevertheless, stresses are evident (*Chart 1*). Country risk differentials—the interest rate spreads between dollar-denominated Brazilian long-term debt and U.S. government debt of comparable duration—are higher now than they were during Brazil's 1998–99 crisis. And it now takes 34 percent more Brazilian currency to buy a dollar than at the beginning of 2002.

Elections Bring Political Uncertainty

What, then, is the problem? Declines in U.S. equity markets have increased risk premiums across the world. The current Argentine crisis and other Latin

Chart 1

Brazil's Interest and Exchange Rates



*JP Morgan Emerging Market Bond Index.
SOURCES: Pacific Exchange Rate Service; JP Morgan.

American economic problems may have had some generalized increase of risk perceptions across the region, but Mexico's country risk differential increase has been tiny in comparison with Brazil's. The reason, as we will explain, is that investors are concerned about the possible future spending of whoever wins Brazil's October 2002 presidential election.

Understanding the impact of political uncertainty on Brazil's financial situation is a simple matter of accounting. Governments service their debt by issuing more debt, generating primary surpluses (holding spending other than interest payments below fiscal revenues) or issuing more currency. Nations unable to generate sufficient primary surpluses must eventually default on their debt or resort to inflationary finance. Like most Latin American countries, Brazil did both throughout the 1980s. The result was a "lost decade" of seemingly endless debt renegotiations and devastating hyperinflation.

But today's Brazil differs markedly from its lost decade version. As we have mentioned, the Cardoso administration

has managed to generate primary surpluses in excess of 3 percent of GDP since the end of 1999. In spite of these achievements, Brazil's debt-to-GDP ratio has yet to begin declining. It far exceeds its value at the beginning of the early 1980s. It also exceeds Argentina's ratio at the onset of its recent crisis.

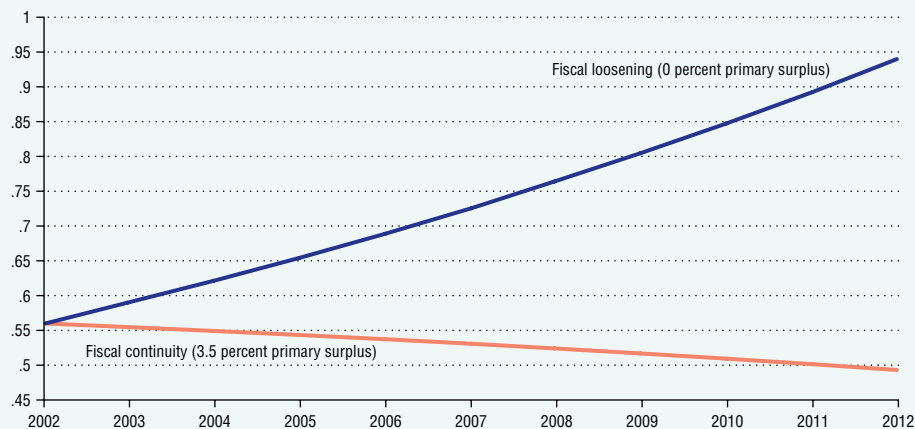
But as Central Bank of Brazil economist Ilan Goldfajn points out, the steady rise in this key ratio since 1999 is due to the recognition of heretofore unrecorded government liabilities and to adverse movements in the real exchange rate. (About a third of Brazil's public debt is indexed to the exchange rate.) In fact, Goldfajn calculates that under "reasonable and even conservative hypotheses," maintaining current primary surplus levels should more than suffice to make Brazil's debt sustainable.¹

Until two months ago, investors appeared to concur with this analysis. Between the end of 1999 and the summer of 2001, interest rates fell sharply as the success of fiscal reforms led investors to revise downward their evaluation of

Chart 2

Projected Evolution of Brazil's Net Public Debt

Net debt-to-GDP ratio



SOURCES: Banco Central do Brasil; authors' calculations.

default, inflation and exchange rate risks. Interest rates started rising again last fall in reaction to Argentina's woes but fell back when no signs of contagion materialized.

Since the end of May, however, interest rates have shot up to heights not seen since the 1998–99 crisis. While all emerging nations have been under some pressure, almost nowhere has the fall been so severe as in Brazil, where political uncertainty has compounded global shocks. Bond prices and the Brazilian real have dropped sharply with each new poll suggesting that José Serra, a member of the current administration who offers the best guarantee of fiscal continuity in Brazil, is falling behind in the presidential race. The two main beneficiaries of Serra's troubles—Luiz Inácio Lula da Silva and Ciro Gomes—are viewed as more likely to relax Brazil's self-imposed constraints on fiscal spending.

Chart 2 illustrates the impact of those concerns on Brazil's perceived solvency. It shows the projected evolution of Brazil's net debt-over-GDP ratio over the next 10 years under two distinct scenarios.² The first (the fiscal continuity case) assumes the primary surplus remains at 3.5 percent of GDP for the entire decade. The second (the fiscal loosening case) assumes the primary surplus falls to 0 percent and remains at that level. Like Goldfajn, we assume in both cases that the real economy grows at a 3.5 percent yearly rate and that average

real interest rates are 9 percent a year.³ We also assume no further real currency depreciation.

Chart 2 confirms that current primary surpluses would suffice to keep the public debt-to-GDP ratio from growing. But it also shows that absent those surpluses, this ratio would exceed 90 percent by 2012 under our growth and interest rate assumptions. In practice, default, inflation and exchange rate risk—and therefore interest rates—would rise with the size of the public debt, accelerating Brazil's drift toward insolvency.

In short, Brazil's public debt only appears sustainable if fiscal responsibility is maintained. The recent International Monetary Fund loan obtained by Brazil guarantees that current obligations can be met but will have no direct impact on the country's long-term solvency.

Candidates Pledge Fiscal Responsibility

There are reasons to believe that fiscal responsibility will prevail after the October election. First, not all hope seems lost for Serra. The latest polls suggest the administration candidate is beginning to make up lost ground. Debt and currency markets have stabilized accordingly.

Even if this comeback falls short, investors' concerns about the other presidential candidates may prove unfounded. Former union leader and current Workers Party candidate Lula da Silva has pledged to maintain economic and price stability.

Although his party has challenged the Fiscal Responsibility Law in Brazil's Supreme Court, Lula da Silva's own platform includes a plank to maintain the nation's primary surplus.

The other candidate, Gomes, served as Brazil's finance minister in 1994 and has been governor of the northeastern state of Ceará. He, too, has pledged a program of fiscal stability. His proposals include a move away from income taxation of business and individuals and toward more consumption taxation. He wants to transition from Brazil's current U.S.-style pay-as-you-go social security program to a Chilean-style system in which each worker is individually capitalized. Although an important basis of support for both front-running candidates has been left of center, it is possible for a candidate with much left-of-center support to maintain a fiscally responsible government, as Chilean President Ricardo Lagos Escobar has amply demonstrated in recent years.

If nothing else, Brazilians are witnessing the devastating economic effects of Argentina's financial collapse, which adds credibility to the recent claims by presidential candidates that they will honor Brazil's financial obligations. Fiscal and monetary discipline requires political courage in a nation where a litany of social needs has yet to be addressed. But the threat of another lost decade could dissuade Brazilians from giving serious consideration to the alternative.

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Notes

¹ Ilan Goldfajn, "Are There Reasons to Doubt Fiscal Sustainability in Brazil?" *Banco Central do Brasil Technical Notes*, no. 25, July 2002, www.bcb.gov.br/htms/public/notastecnicas/2002nt25fiscalsustainability.pdf.

² Like Goldfajn, we examine the evolution of net public debt rather than gross public debt. As Goldfajn explains, it is the evolution of the government's net liabilities that matters for solvency. He calculates that current general government credits amount to 21 percent of GDP. Concerns about the quality or liquidity of these credits could compound the impact of the fiscal shock we consider.

³ Real GDP has grown at an average yearly rate of 3 percent over the past two years, but the IMF forecasts a growth rate of 3.5 percent for 2003 (*World Economic Outlook*, April 2002, International Monetary Fund, www.imf.org/external/pubs/ft/weo/2002/01/pdf/chapter1.pdf).