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Public Debt Control in Brazil

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INTRODUCTION

The legal framework plays a key role in the enforcement of government policies. The question whether the law effectively embodies the basic objectives aimed by general policies must be always considered by policy makers. Hence, an ongoing reevaluation of the consistency between policies and the enforced legislation is crucial.

One of the main issues concerning the recent changes in the Brazilian economy addresses the imbalance of the public debt. There is an overwhelming consensus in Brazil about the need for a fiscal adjustment. The reforms proposed by the government encompass both the expenditure and revenue sides. In what concerns the expenditure side, the ability of debt contracting and management presents one of the fundamental challenges.

This paper will present some of the historical changes in legislation with regard to the Brazilian public debt focusing in their relation to Government policies. With respect to the domestic public debt, the mechanisms of public indebtedness have experienced a real evolution through the last 20 years. Several problems that hampered the debt management no longer exist.

On the other hand, an important source of financing, the Brazilian participation in the international markets has experienced many obstacles that only recently have been overcome. This paper will provide a brief overview of the reasons that contributed to keeping Brazil out of the international securities market for long periods during this century, emphasizing on the policies and laws that played an important role in the external debt crisis.

There will follow a discussion about some of the current aspects about debt control in Brazil as well as the current features of the indebtedness mechanisms with regard to domestic and external debt.

By presenting the changes in the public indebtedness mechanisms, this paper will seek to further the ongoing discussion of the Brazilian legal framework and the measures that might be taken in order to improve it.

2- The Historical Evolution of the Brazilian Federal Securities Market

The turning point of the Brazilian public securities market can be tracked down to 1964, when a financial reform took place. Brazil had not participated in the market expansion experienced by developed countries in the aftermath of World War II. This happened mainly due to the unstable inflationary environment of the 1950's that hindered government savings and limited market expectations to the short term. The financial reform removed this impediment by allowing for the indexation of government bonds.

The primary public debt instrument introduced in 1964 was the OTN, an indexed National Treasury bond. Because these bonds offered an inflation-immune option and usually yielded above the market average, they gradually won larger stakes of the market. The increasing public acceptance of these bonds eventually lead to longer redemption periods, resulting in a positive shift of the public debt profile.

In the 1970's, pushed by the surge in economic growth and the inflow of international capital, the government securities market in Brazil underwent a real expansion. The first problems in controlling the Brazilian public debt, however, date from this period.

First, in the domestic securities market, a new instrument, the National Treasury bill, LTN, was created. The LTNs offered preset earnings and enjoyed great liquidity. These characteristics, conjugated with a permissive legislation, helped to make them largely used as a monetary policy instrument.

However, the abusive use of a non-monetary instrument for monetary policy and the lack of a well-structured public debt control policy resulted in excessive public debt growth. This practice had a profound impact in public debt growth especially in the second half of the 1970's. In this period, the Central Bank, aiming at attracting foreign capitals to equilibrate the balance of payments, steadily increased interest rates. A more perverse effect than the public debt growth by itself, however, is the fact that it became impossible to identify the monetary and fiscal components of the debt.

The enforcement of Complementary Law 12, in 1971, contributed to worsen this situation. This law, aiming at providing the necessary environment for the creation of financial markets and the development open-market operations, increased the authority of the Central Bank over the public securities debt. It made possible the issue of treasury securities for purposes of rolling over the debt or simply for monetary policy needs independently of annual budget estimates of public revenues and expenditures. As a consequence, it furthered the discretionary power and freedom of the Central Bank at the expenses of budgetary control over the fiscal deficit, and thus contributed to the random increase of the latter.

This practice would only be reversed later on, in 1986, with the enforcement of a series of measures. First, the National Treasury Secretariat, STN, was created and the public debt management was passed on to it. Other legal measures were then enforced to ensure this transference. One of them was Decree no. 2376/87. As established by this Decree, the operational results of the Central Bank were transferred to the National Treasury and an account settlement between the two institutions took place. These changes represented the first important move towards the separation of the fiscal and monetary components of the debt. Also, in 1988, the National Treasury Secretariat restricted the scope of Central Bank discretion in carrying out open-market operations, allowing only for the use of Treasury financing bills (LFT) as a monetary instrument. Finally, the 1988 Constitution prohibited the Central Bank's direct or indirect financing of the Treasury, and thus increased the possibility of a more efficient public debt management policy.

Another important change relates to the extinction of the monetary and social security budgets that resulted from the budget consolidation established by Law 7420, in December 1985. Although this consolidation was not complete, since some expenditures such as the "deposits registered in foreign currency" and the "expenditures related to external debt renegotiation" still remained with the Central Bank, it laid the foreground for a more effective budgetary control. Also crucial for this control was the 1988 Constitution, that conferred to Congress the authority for annually defining ceilings on public debt growth.

Another measure that curtailed one of the remaining distortions between monetary and fiscal policy was the "Operação Caixa-Preta." That measure addressed the reduction of the portfolio of Treasury securities that still remained with the Central Bank. Keeping this portfolio provided huge operational results for the Central Bank at the expenses of the Treasury. It also hindered a more efficient debt management by the Treasury.

Together with this latest change, it is important to mention the creation of the Central Bank bill (LBC) and Central Bank bond (BBC) in 1985. Until then, Treasury securities, LTNs and OTNs, had been the only instrument for open-market operations. At this moment, the LBCs represented a more market-attractive instrument for monetary policy than Treasury papers, since they tendered earnings defined by the average rate of overnight operations and offered shorter terms.

It is important to notice that although the internal public debt has immensely increased from 1986 to 1996, the legal mechanisms of public debt management have undergone a positive shift in the same period. During the 1960's and 1970's, the need for creating and consolidating the securities market lead to a series of lenient laws that resulted in debt growth as mentioned above. Contrarily to that, the debt growth in the following two decades was mainly related to changes in the macro-economic environment and economic policy choices.

Furthermore, the inflationary environment that permeated the Brazilian economy in the course of these years largely contributed to make the administration of the debt a difficult task. Finally, the recurrent crises in the balance of payments in the post-64 period provoked monetary expansion and steady increases of the public debt, worsening public debt management policies.

2 - Brazilian Participation in the International Markets in the Early 20th century

The participation of Brazil in the international financial markets has been a history of credibility crisis and recovery. Unlike the domestic debt, the fundamental reason for the external debt growth was not so related to the internal regulation and limits to external indebtedness as to the ability to adapt to changes in the international environment.

In the beginning of the century, the Brazilian government enjoyed enough credibility to issue bonds in foreign markets, especially in France and in England. The proceeds of these operations usually were employed to finance specific projects such as the construction of railroads or hospitals. At this time, each operation had to be submitted for Congressional approval. That, however, did not represented a major issue, since the approval was relatively easy to obtain.

In 1934, under President Getulio Vargas' Government, Brazil began to repay its external debt. Although in 1937 these payments had experienced a halt, at the end of Vargas' first term, the external debt decreased by 30%.

What could have represented a positive shift in Brazil's credibility and enhanced its participation in foreign markets was overshadowed by the Latin American external default in the 1930's.

Eventually, Brazil also defaulted on its foreign bond obligations what contributed to the end of this kind of financing for a long period.

3 - The Increase of Foreign Capital Flows to Brazil

As stated in the last section, the issue of government foreign bonds had completely ceased after the 1930's debt crisis. This kind of financing was then substituted by foreign direct investment, as well as official and private bank loans.

In fact, in the 1940's and 1950's the bulk of the Brazilian external debt had resulted from loans granted by official organizations, closely followed by private bank loans. The latter, however, were limited to short-term trade financing and did not represent full exposure to the country risk by the financial institutions.

The outstanding increase in foreign financial capital inflows to Brazil observed in the late 1960's had its roots both in supply side factors and in shifts in the domestic legislation.

The supply-side factors relate basically to availability of foreign resources and to the adoption of variable rate loans that curtailed the developing countries' risk. This was possible because the rate loans were set according to an international rate, usually the LIBOR or the U.S. Prime rate. Therefore, the rate already incorporated approximately the expected inflation in the lender country. Also, since these rates were revised periodically, usually every six months, the risk was limited to the short term.

With respect to domestic factors, the bulk of external indebtedness was turned over to foreign bank loans partially because the legislation of the time made this the most attractive kind of financing.

Foreign direct investment had been largely desincentivated by the profit remittance rules in vigor after 1964. Although the new regime had eased the rules to profit remittance enforced by the President João Goulart's Government, some obstacles still remained. The problem stemmed from the fact that the new rules failed to address the question about the adjustment of the investment to the inflation in the investor's country. Consequently, the real return on foreign direct investment in Brazil bore an inverse relation with the inflation rate in the currency in which the investment was registered. As a result, this kind of financing became less attractive to investors.

These hindrances to foreign direct investment, although affecting mostly the private sector, had indirect effects on the government indebtedness in the following years. This occurred mainly because a large portion of investment, that could have been financed through foreign resources, fell into the hands of the Government. Furthermore, the existence of restraints to the investment of foreign capital in sectors regarded as strategic, such as telecommunications, created the same perverse side effect.

The distortion observed in the treatment of foreign direct investment was not present in relation to foreign bank loans. The nominal interest rates vinculated to these operations already expressed the inflation rate of the lenders' home country, as mentioned above. Beside that, the enforcement of Law 4131 in 1962, amended in 1964, facilitated the access to financial foreign loans. This law required each operation to be submitted to the Central Bank of Brazil for approval. Once the approval was granted, the borrowers could deal directly with foreign lenders. As the Central Bank seldom denied the approval, the access to foreign financing under Law 4131 was relatively easy.

Another legal instrument that encouraged foreign borrowing was Central Bank Resolution 63. Under this regulation, financial institutions could make loans abroad and reloan the resources to domestic lenders. There was a provision that required the registration of the initial loan in the Central Bank, but the final borrower was not subject to the same requirement. Consequently, the final destiny of the resources remained unknown.

The borrowing under these two instruments provided resources for both the private and the public sector. State-owned enterprises largely used these resources to finance investments and current expenditures. In fact, the public sector largely increased its participation in the total loans, as its borrowing needs increased. It is possible to observe peaks in the public sector share of borrowings corresponding to the financing of current account deficits. This occurs especially in relation to the more easily traceable increase in resources granted under Law 4131.

The loans granted under these two instruments were responsible for the majority of the resources that have entered the country in the period from 1967 to 1982. As a matter of fact, the external debt crisis may be partially explained by the increase in the international rates to which these loans were vinculated. This will be further discussed in the next section.

4 - The External Debt Crisis and the Brazilian policies from 1973 to 1982

The external debt crisis in Brazil relates primarily to the imbalance of the Balance of Payments that followed the outstanding rise of international interest rates that occurred after the oil shocks in the 70's. Until the first oil shock, Brazil was one of the major exporters and recipients of international capital among developing countries.

After the shock, the developed countries adopted restrictive monetary policies in order to adjust to the increase of oil prices. As a consequence, developing countries had to adjust not only to the oil prices but also to a decrease in exports.

On the other hand, the crisis brought new players to the international scene: the oil exporting countries. The increase of oil prices generated huge superavits for these countries. The resulting capital was mainly applied in short-term investments in the international financial markets. This generated excess liquidity that made banks more willing to lend to less developed countries. These countries, by their turn, welcomed the opportunity as a way of counterbalancing the losses on exports.

Brazil's strategy at this time belonged to the aforementioned group. Instead of following the model adopted by developed countries, which used a restrictive policy to balance the deficit at the expenses of diminishing the growth level, Brazil opted to sustain growth rates by means of government financing. The enforcement of this policy was made by the II National Development Plan.

This plan involved a growth-cum-debt strategy. Aiming at sustaining rapid economic growth under deteriorating domestic and international conditions, the plan sought to increase inflows of foreign savings. However, the plan was not based only on external financing. It also emphasized the need for making structural changes in the economy. The objectives underlying this strategy were to increase exports, reduce imports, and internally generate enough resources to service and eventually redeem the contracted debt.

The second oil crisis in 1979, however, brought about another change in the international conditions that made Brazil's plan ineffective. While the foreign capital inflows to Brazil had surged after the first crisis, the second crisis deviated these resources to the financing of the deteriorated Balance Payments of industrialized countries. The increase of the demand for capital forced an immense rise in international interest rates. In the case of Brazil, the increase of these interest rates made the payment of the debt virtually impossible. The net inflows of capital decreased since its majority was turned to pay the debt service instead of investing domestically. As a consequence, Brazilian economy experienced a contraction.

Following these ominous conditions, Brazil's international credibility largely deteriorated. This situation was further aggravated after the Mexico moratorium. The credibility crisis led to the shortage of capital and hence the exigency of higher returns to counterbalance the risk of credit. Brazilian reserves were then exhausted to counter these adverse conditions.

5 - External Debt Crisis - The Restructuring Process

The beginning of a long strand of negotiations with international creditors dates from this period. In 1983, Brazil reached the first agreement under IMF supervision. According to this agreement, Brazil had to maintain its inflation rate under 70%. Later on, when the country failed to comply with this requirement, banks refused to grant new loans.

Also the following agreement, which was signed in 1986 and aimed at rescheduling the debt repayment, failed to succeed. Although an adjustment had been reached in the short-run, the deterioration of the balance of payments soon afterwards caused a reverse in the Brazilian external conditions. As a consequence, the Brazilian Government declared its inability to pay the principal and interest payments to commercial banks in February 1987.

The next agreements followed a debt-for-equity model. In fact, all the Brazilian debt instruments in the international market during this period resulted from debt restructuring.

The first of this type of operations occurred in 1988, and followed the model prescribed by the Baker Plan. The Baker Plan, named after former US Treasury Secretary James Baker, presented a new approach to debt restructuring operations. For the first time, the restructuring pointed not only at solving the creditors' immediate problems but also at providing the necessary conditions to stabilize the indebted countries' economy. From this standpoint, the proposed solutions encompassed a series of measures that could be applied according to the specific needs of each country in a case-by-case approach.

In the Brazilian case, the rescheduling of approximately 95% of the outstanding debt involved the grant of additional loans and the swap of debt for securities. The plan presented a menu of options for creditors. Among the options, two involved the issuance of bonds by Brazil.

As a result, two different instruments were offered for creditors the "New Money Bonds" and the "Exit Bonds" or "BiBs." The issue of New Money bonds had been the outcome of a new trend in the international financing directives. Instead of contractual debt, which had been the major means of providing funds for developing countries, the adoption of securitized debt offered a desirable alternative with regard to banks' assets. The Exit bonds, on the other hand, created the opportunity to renegotiate the debt more easily in the secondary market, and to eventually sell these instruments.

The 1988 plan failed, however, in its designed macro-economic and structural changes. The plan was aimed at improving the balance of payments' performance, curtailing inflation and promoting growth. One of the components of the agreement was the guaranteed support of the IMF and other multi-lateral organizations, that would provide capital to ensure the enforcement of the objectives of the plan. The IMF would also oversee the Brazilian economic performance in response to the plan.

When Brazil failed to achieve the public sector deficit targets established by the agreement, the IMF suspended its disbursements in 1989. Following that, the Brazilian Government decided to halt interest payments to foreign private creditors in July 1989. This decision was taken to preserve Brazil's international reserves, menaced by the flight of external capital.

In the beginning of the 1990's, Brazil initiated negotiations with foreign creditors. Brazil's successive defaults had been correlated to the country's inability to pay the interests on external debt without compromising its domestic economic performance. This time the Brazilian Government's negotiations stressed the need for a plan consistent with the country's payment ability in the long run.

The decision of reinitiating interest payments served as a sign of Brazil's earnest intentions. The Government authorized the payment of all the external debt due by the Brazilian private sector and financial institutions, and of 30% of the public sector interest obligations. The repayment of the unpaid interests by the public sector started in 1991 and would involve two approaches. A part of the outstanding interest payments in the period from 1989 to 1991 was immediately settled. Another portion would be refinanced as a bond, the IDU - Interest Due and Unpaid bond.

During this period, a new idea about how to resolve the less industrialized countries' external debt problems began to take form in the international scenario. The failure of the preceding plans made a case against the restructuring with new financing strategy. A new model of debt restructuring was then presented by the U.S. Treasury Secretary, Nicholas Brady. This new model involved debt and debt service reduction or the provision of new loans, as New Money bonds, according to the choice of creditors. The reduction of debt represented a good solution for both debtors and creditors. The first benefited from the adjustment on their liabilities. The latter did not experience great losses with the agreement because the instruments that had resulted from debt restructuring operations were being traded with considerable discounts on the secondary market.

According to the Brady Plan, the restructuring involved a debt-for-equity operation. Each country would renegotiate its debt, offering a menu of options to creditors. Another important feature of the plan, that contributed to reassure the creditors, required the establishment of collateral on principal or interest to some of the instruments. U.S. Treasury Zero-coupon bonds served as collateral for the payment of the principal of certain instruments. In the case of instruments with collateralized interests, the countries engaged in the restructuring made deposits in an international institution that guaranteed the payment of the due interests.

In 1992, the Brazilian Government reached an agreement in principle with foreign banks that settled the basis for the restructuring, until 1994, of all the debt that resulted from syndicated loans. This agreement obeyed the premises of the Brady Plan and included the trade of debt for a menu of securities.

In conclusion, the external debt restructuring process produced several instruments - old New Money Bond, BIB, IDU and the Brady Bonds. These bonds are still negotiated in the international market. However, because these instruments had emerged from debt conversion operations, they can not be envisaged as a voluntary re-entry in the international market. Actually, the existence of such instruments hurts Brazilian international credibility even more and serves as a continuous reminder of the debt crisis period.

Even though one may argue against the Brazilian responses to the international crisis, one can not deny that the policies adopted were consistent with the aimed goals.

6 - The Return of Brazil to the International Market

The restructuring of the Brazilian external debt together with the macro-economic stability achieved with the Real Plan paved the way for the return to the international markets.

This return was undertaken through a Medium Term Note Program (MTN), authorized by Resolution 87/1994 and renewed by Resolution 57/1995. The MTN program consists in the issue of a series of bonds in international markets up to an established limit. The general characteristics of each issue, such as type, term, and, interest rates, *inter alia*, are to be settled at the time of the issue.

Moreover, the proceeds generated by these issues are earmarked. According to the Resolution, they must be used to repurchase internal debt securities. Consequently, the MTN program provides an efficient means of exchanging internal for foreign debt, that offers longer terms and lower interest rates.

Under the MTN program, Brazil has succeeded in making several placements of government bonds in the last two years in the international markets, namely, euroyen, euromark, samurai, caravella, eurosterling and a global bond.

The fact that Brazil has been able to re-establish this type of borrowing represents *per se* a positive shift in the country's economy.

7 - The Present System

Given the return of Brazil to the international markets and the increase of domestic indebtedness it is important to evaluate the current issues about the way by which this debt is contracted.

The primary objective of the public securities market is to provide an efficient response to the public sector borrowing needs. Several issues must be considered in order to evaluate whether the debt contraction operates in an efficient way. In this context, it is important to question whether the current legal framework provides for this efficiency.

Of course, the regulation by itself is not enough to ensure efficient debt mechanisms. There are several macro-economic variables that play a preponderant role in the operations of the market. Therefore, what is important in the assessment of the legal framework in this context is to question if, given the macro-economic conditions, the regulation furthers the efficiency of state borrowing and does not prevent it.

As shown in the first section of this paper, these conditions were not present in the domestic federal securities market 20 years ago. The reevaluation of the role of the fiscal and monetary policies laid the foreground to a most beneficial change in the regulation of the debt mechanisms. These changes, however, do not preclude the ongoing need for reevaluate whether the present policies are the most adequate and desirable.

The participation of Brazil in the international markets presents a very different problem. The debt crisis prevented a voluntarily designed policy for external indebtedness during the last 20 years, as shown in section 2. However, since this framework has changed and other variables, such as the increase of the internal debt and the globalization of markets, have to be considered, the discussion of whether the present policies and mechanisms are consistent with the markets' needs presents a challenge that should not be overlooked.

A further study of the current mechanisms of federal public debt control in the light of the aforementioned will be undertaken in the following section.

7.1 Current Mechanisms of Control

The establishment of ceilings for the internal and external debt is a responsibility of the Federal Senate, as established by article 52 of the Brazilian Constitution. In order to set these ceilings, the Federal Senate takes into account the service of existing securities as well as the deficit forecast in each fiscal year. These ceilings may be revised if the actual deficit exceeds the anticipated one.

The authority of the Federal Senate to establish the caps for the Government debt presents one of the important features of a democratic regime. It contributes to increase the transparency of the public administration and provides an important mechanism of checks and balances between powers.

However, there is a difference in the treatment of the external and internal debt. The control of the indebtedness through securities in the domestic markets is limited to the settlement of caps and general conditions whereas each operation in the international market must be submitted to Congress' approval.

The different approach in the control of the external debt is partially due to historical reasons. For a long period, the external debt had been the object of much more concern than the domestic one. Also, the contraction of external debt exerts an indirect pressure on the monetary basis that complicates the public debt equation.

The need of Congressional approval for each operation in the international market might have disturbed the viability of recent Brazilian operations. The problem with this kind of procedure stems from the fact that it might disclose the terms of the issue. The Executive Branch temporarily overcame this problem through a Medium Term Note Program (MTN), enabled by Resolution 87/94. Since the MTN program allows for a series of issues up to a certain amount, it ends up reproducing the same mechanism observed in the domestic market, i.e., the establishment of a ceiling for the amount to be issued.

Therefore, the MTN program works as a mandate from the Legislative to the Executive Branch. If the ceiling is attained, the set up of a higher ceiling must be negotiated with Congress. This occurred in the end of 1995, when a new legal instrument, Resolution 57/95, increased the limit from US$ 2 million to US$ 5 million.

It is important to mention that the MTN program aims at substituting the domestic debt for external debt, for the latter offers longer terms and lower nominal rates. Therefore, the return of Brazil to the international market may have an important role in the accommodation of the domestic debt. This is the reason why it is important to question whether the current mechanism of setting the need for Congressional approval for each external debt operation is the more efficient one.

It is also important to mention that the Constitution had set the need, in article n. 163, for a complementary law to regulate the public finance, the domestic and external debt, the issue and repurchase of public securities and the grant of guarantees by the Federal Government. This law, however, has not been enforced yet.

8 - Conclusion

An efficient administration of the Brazilian public debt is an issue of utmost importance to ensure the stability brought by the Real Plan.

In order to halt the increase of the internal debt, the Brazilian Government is addressing several of the existent problems in the public debt management. The cut of expenditures, the tax reform and the privatization program, *inter alia*, serve as a proof of the Government strong intention of tackling the fiscal deficit.

One of the designed strategies to solve the internal debt problem involves a greater reliance on external capital. In order to fulfill this objective, however, the present structure must provide for the more adequate means of external financing.

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