

The Urgent Need of a (Difficult to Achieve but Immensely Profitable) Higher Primary Surplus

On the Macroeconomic front, the beginning of President Lula's administration has been as good as one could hope for. None of the worst fears entertained by the market — which produced a continuous depreciation of the BRL that peaked over 70% last year — became true. On the contrary, default on the debt — a political issue that the Worker's Party (PT) helped to push for through a "referendum" just a couple of years ago — was completely ruled out by the new administration. The macroeconomic pillars of the previous administration — floating exchange rate, inflation targeting regime and primary fiscal surplus targets — have all been reaffirmed. Early attempts by a few new state governors to renegotiate the already many times renegotiated debt with the federal government — a move that, if allowed, could seriously jeopardize the primary fiscal surplus target — have also been rebuffed. Even important projects that were previously opposed in Congress by the PT are now being revived, as Social Security reform and Central Bank independence (in Brazil, the preferred term is autonomy, but it basically boils down to the same thing). As a result, the BRL has significantly appreciated, as financial institutions and large exporters were again granted access to international financial markets, although at still very high spreads.

Despite the significant improvement, it is still very early to say that Brazil is out of the woods. Even though it is no longer seen as an immediate possibility, the key macroeconomic problem remains the perceived high probability of some sort of a future default on the public debt, which entails a very high credit risk premium. The conditions for a default not to be perceived as an important risk are determined mainly by four variables: the current DEBT/GDP ratio, the primary fiscal surplus (i.e., the surplus before interest payments), the real interest rate paid on the debt, and the GDP growth rate. Good conditions for fiscal sustainability are: a low initial DEBT/GDP ratio, a high primary surplus, a low real interest rate and a high GDP growth rate. Conversely, a high initial DEBT/GDP ratio, a low primary surplus, a high real interest rate and a

low GDP growth rate are bad to fiscal sustainability.

In Brazil — given the fact that the great majority of the public debt is linked either to the exchange rate or to the short-term rate (the Selic rate) — the real interest rate on the debt varies positively and strongly with the Selic rate and with the nominal exchange rate. The Selic rate is determined so as to achieve the inflation target. This monetary policy regime has required in the recent years very high real interest rates. In the floating exchange rate regime, the exchange rate is completely out of control of the Brazilian authorities, and the almost 200% depreciation during the period 1999-2000 (compared to a CPI inflation below 40%) prove that one should not count on it to ensure debt sustainability.

If one assumes that the current market conditions will remain unchanged in the years to come — with a domestic real interest rate above 10% and with the spread-over-Treasury of foreign Brazilian bonds around 1200 bps — the public debt would explode. And with the perception that there is substantial risk of some sort of public debt default in the future, real investment will remain subdued and growth will falter. Given the already high Net Public Debt/GDP ratio in Brazil, with low growth and high real interest rate, the vicious circle is completed.

Of the four variables that impact the DEBT/GDP ratio, the only one under control of the government is the primary surplus. It is thus only natural that a lot of emphasis be placed in setting that variable at the necessary level to break this Gordian knot.

To be sure, the calculations needed to establish what fiscal surplus is needed to dispel the fears of debt default are imprecise in nature. This is because they depend on the future path of random variables, as the interest rates and the exchange rate. However, with reasonable hypotheses, one can figure out the range in which the public surplus has to be to achieve fiscal sustainability. Most such calculations point to a primary fiscal surplus around 5% of GDP, higher than the current 3.75% target.

The good side of this story is that unlike in standard macroeconomic manuals, such fiscal contraction would probably be expansionary. This is because the higher fiscal surplus, by virtue of dispelling the fears of default, would

entice a reduction in the real interest rate. This in turn would spur growth, which would further help achieve fiscal sustainability, thereby reducing even more the default risk premium of interest rates. I.e., the vicious circle could turn into a virtuous one.

As most things in life, this is easier said than done. Even if this administration is able to pass Social Security reform, which is very tough call, many other very tough actions will be required in the short and medium runs to maintain the current primary surplus, let alone increase it as previously suggested. But, without doing it, the vicious circle of high interest rates and high unsustainable debt will not be broken, precluding sustained growth from resuming, which, in turn, will make the social goals of the current administration much more difficult, if not impossible, to achieve.

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