

# Preface

by Murilo Portugal Filho<sup>1</sup>

Due to its baffling history, the Brazilian public debt has for long endured a negative image with the public. Public debt has been associated not only with the payment of high interest rates as a proportion of fiscal revenue and gross domestic product but also with the periodical occurrence of explicit default, problems which unfortunately have been recurrent throughout our history.

However, these negative events do not stem from a problem inherent to the essential nature of public debt. Public indebtedness is a suitable instrument for financing public investment in the construction of high cost and long lasting assets like a hydroelectric plant, a port or a road. In this case, public indebtedness enables the equitable distribution among taxpayers of the present and the future, of the costs and risks involved in the construction of assets that will generate long term benefits and earnings supposedly higher than their cost for several generations of taxpayers to come. Public debt also allows purchasers of public securities to save their income in the present and transfer to the future purchasing power, increased by the positive yields of such investment, in a way that is much safer than that usually available through private securities. When used to finance productive public investment, public debt can work both as a mechanism of intergenerational equity and a low risk mechanism to intertemporal consumption transfer, with positive social results for all. Public debt is also a very useful instrument to finance emergency expenses, even when these are not investment expenses such as the ones that occur in times of public disasters or other temporary shocks, including wars. In fact, Brazilian public debt emerged to finance the independence war.

The problems related to high interest rates and default are due mainly to the continuous misuse of public debt to finance the public deficit generated by current expenditures. Payment of current government expenses should be normally made using taxes and not public debt, which involves paying interest. Financing a large and growing share of government consumption with debts that are subject to interest payments implies destroying public wealth. The rationale of compounded interest rates leads to the inevitable conclusion that this procedure is unsustainable in the long run. As time goes by, the growing weight of interest payments on the public budget and the need to increase the tax burden of the present generation so as to bear these costs make default increasingly appealing to the political system, which usually likes to spend but does not like to tax. This temptation gets bigger when creditors are foreigners and do not vote.

The problems related to high interest rates and explicit default result mainly from abandoning the classical principles of using public debt only to finance public investment or pay for emergency and extraordinary expenses, instead of using indebtedness simply to satisfy the penchant for spending without taxing.

Obviously, there are other types of mistakes that can contribute to making public debt management a hard road to travel. The bad choice and ineffective execution of public investment projects have certainly been serious problems in Brazil, which have reduced the expected ex ante yield rates of public investment, thus increasing the weight of financing these projects on future tax revenues. Debt mismanagement is another possibility, even when debt has been originally issued based on prudent principles. However, this type of

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problem has decreased considerably as a result of the growing improvement in public debt management, as convincingly shown in this book. I, therefore, believe that it was the abuse of public debt stemming from the proclivity of the political system to spend without taxing that tarnished its reputation.

The problem is similar to the misuse, also seen in Brazil, of the Keynesian monetary financing theory. In times of recession, when the existing productive capacity is clearly underused and there is an indisputable lack of private demand, it is not only possible but also recommended that public deficits be financed, in order to increase aggregate demand, through the third form of public financing (in addition to taxation and indebtedness) available to countries with independent monetary regimes, i.e., creating currency. However, financing deficit by creating currency is only recommended in a very limited number of circumstances, and excessive issuances have historically resulted in inflation, which is an implicit form of default and taxation.

Macroeconomic instability in the form of high and volatile inflation generates, in turn, public debt management problems that are difficult to tackle. In times of high and volatile inflation, buyers of public securities seek protection from either uncertainty or the growing probability of future default demanding increasingly higher real interest rates, shorter maturities and linking public debt to variables that are subject to high macroeconomic uncertainty such as exchange rates and future interest rates. This generates a public debt structure that is highly vulnerable to shocks and exposes public finances to high costs.

It is up to the government to provide macroeconomic stability and, if it does not, it has unfortunately to bear the high costs of public debt, instead of trying to pass them on to private savers. Attempts to transfer to savers the high costs of inflation and macroeconomic instability lead to a decrease in domestic savings, with capital flight to save overseas, flight from domestic currency, and finally the “dollarization” of the economy, as has been the case in many Latin American countries. These are not problems that can be solved through public debt management, regardless of how good it might be. They require changes in macroeconomic management.

Fortunately, these difficulties have been gradually overcome in Brazil since 1994, when inflation was controlled by the Real Plan. This allowed the public debt structure to begin improving, with longer terms to maturity and less indexed debt. However, change is difficult, takes time and inflation control is just the first step. As shown in this book, the small advances made in improving the public debt structure after 1995 suffered a setback in 1997 with the Asian crisis, and in 1998 with the Brazilian exchange rate crisis, which led to an increase in outstanding public debt as well as deterioration in its profile.

The greater institutionalization of monetary responsibility afforded by the adoption of a flexible exchange rate regime and inflation targeting, coupled with the renegotiation of state debts in 1997 and enforcement of the Fiscal Responsibility Law approved in 2000 were other important steps towards improving macroeconomic management.

I believe that the importance of maintaining a sound macroeconomic management has been gradually laying roots in the Brazilian society and among voters, which have shown to be less tolerant of monetary or fiscal irresponsibility, with positive repercussion in the political system. Maintaining monetary and fiscal responsibility, as evinced by the mature posture shown after the 2002 election, ensured a significant decrease in public debt risk. This opportunity was fully used by public debt managers who, since 2003, have implemented an overarching and significant improvement in the profile of the Brazilian public debt, with a meaningful decrease in indexed debt and an increase in maturity, which have endured in spite of new shocks, as described in this book.

With macroeconomic stability, the responsibility of public debt managers will grow. But as this book, which was competently written by practitioners of public debt management in Brazil, so appropriately shows, they are prepared for this challenge.

This book is an important contribution to understanding the problems and limitations related to public debt management in Brazil. It describes the theme in an overarching and consolidated fashion, efficiently covering its different aspects and gathering information available until then only from scattered sources. It, therefore, fills an important gap in the empirical knowledge of the theme in Brazil.

The authors start by presenting a historical, theoretical and conceptual framework, which is required for understanding the theme. The history of public debt in Brazil, from its origin to date, is presented in a summarized way, which nevertheless highlights its most important landmarks. The different theoretical models that define the fiscal and intertemporal sustainability of debt are presented and discussed in a competent way. The statistical concepts and definitions used in Brazil are also described and compared with good international practices.

The original contribution of this book lies in the authors' detailed description of how public debt is addressed by the two major players in the theme: the government and the market. The book also presents the mechanisms used for managing existing government debts and the major advances achieved in this institutional structure, as well as the organization of debt markets in Brazil.

With respect to the government side, the book describes the strategic planning, risk management, budget, control, and audit mechanisms of the Brazilian public debt. The descriptions of how fiscal and monetary policies are actually coordinated, the definition of an optimal debt structure, the use of information technology systems, and probabilistic risk management models provide an important original source for researchers willing to find out how the management system operates. In many cases, the information provided here had not been publicly available in an organized, consolidated and accessible fashion until now.

The book also offers valuable information on pricing, primary and secondary market operation, composition of the investor base, the role of the main institutions responsible for maintaining the market and the development of the retail market through Treasury Direct.

This book is a valuable effort to organize and systematize information on the theme. It also has the great advantage of having been written by authors with both theoretical knowledge and practical experience on the theme. This indeed enriches the presentation. It also enables evaluating the huge progress Brazil has attained in the area of public debt management. I am absolutely certain that by bringing the theme to public knowledge the authors have substantially contributed to improve the understanding and image of the Brazilian public debt in our country as well as overseas.