

## **SOVEREIGN DEBT CONFERENCE – DALLAS**

Henrique de Campos Meirelles  
Governor, Central Bank of Brazil

In this short presentation I would like to run over a few issues, starting with an overall (and somewhat simplified) look at the competing views about the nature and origin of the emerging countries debt crises of recent years. I would then try to convey our view of the issue, and explore the Brazilian experience to indicate how our perception fits the facts. Next I should try to focus a bit more on sovereign debt policy guidelines for Brazil, distinguishing between foreign and domestic debt. As a conclusion, I would like to put forth some ideas about International Financial Architecture.

There are currently at least two distinct views on nature and causes of emerging markets (EM) countries, expressed typically as a sharp drop in asset prices, in particular sovereign debt prices. One view emphasizes the possibility of crises being the result of self-fulfilling expectations, akin to bank runs, in which – for reasons not exactly clear – agents can shift from “good” to “bad” equilibria and, in the process, drive a country into a crisis. Not surprisingly, given the similarities between this view and the “bank-run” models, the major policy recommendation that stems from this perspective is the presence of a lender of last resort (LLR), whose presence would inhibit runs, and hence assure stability in the sovereign debt market.

Yet, this notion, chiefly the role of the LLR has come under fire, in light of the problems that affected many EM economies, despite the financial assistance given by the IMF, who played a role analogous to a LLR in this process. Based on the notion that crises result from inconsistent macroeconomic policies – wrong “fundamentals” – the alternative view suggest that some form of Private Sector Involvement (PSI) would be more efficient to hamper emerging markets – and hence sovereign debt – crises. PSI can take various forms, from outright defaults to softer rollover agreements, but the underlying notion is that the presence of a LLR actually makes the problem worse, for it encourages the maintenance of inconsistent policies (debtor moral hazard) and overinvestment (creditors’ moral hazard), under the belief that the debtor would eventually be bailed out.

That said, we believe that these views are not necessarily mutually exclusive, but can be complementary. Crises can originate from either very poor fundamentals or self-fulfilling expectations in the presence of fundamentals that are not perfect, nor would justify a crisis in any circumstance. If this is true, though, the policy response must be conditioned on the nature of the crisis, that is, we need a discretionary approach: when the crisis seems to originate from a liquidity problem - a run against the debt – “catalytic finance” might be the appropriate response. When the crisis results from fundamentals beyond repair, then the moral hazard argument gets traction again, and some form of PSI must take place.

In short, we think that precautionary facilities and other forms of liquidity assistance still do have a role to play, provided the country in question does not display hopelessly weak fundamentals and that access to assistance requires strengthening of these fundamentals.

Indeed, as we should have opportunity to learn in the next sections of this conference, debtor moral hazard is not a necessary outcome in the presence of liquidity assistance or a LLR. Not only access would be limited to those who engage in consistent economic policies, but also – in some cases – liquidity insurance might just create the positive incentives for responsible policies. In this is true, it could be hasty to try to cover all

possibilities under a single rule. The analysis would still need to be done in a case-by-case basis.

The Brazilian experience of the recent year, we believe, reinforces this perception. One year ago, Brazil was under a severe debt crisis, with sovereign spreads on the vicinity of 2,400 bps, the Real dropped from R\$ 2.30 to almost R\$ 4.00/US\$, and asset prices reached the doldrums. More recently, the Brazilian component of the EMBI+ has hovered around 600 bps, reaching actually below that level in the past few days, and the country was able to place US\$ 1.5 billion in new debt at single digit costs for the first time since April 1998. Consistent with that the currency strengthened back to R\$ 2.85-2.90/US\$, and asset prices in general reached levels well above those recorded immediately prior to the crisis. In all accounts, Brazil recovered very quickly from a crisis that seemed – to the eyes of many – a terminal crisis.

We note that the recovery took place without fundamental change in the general orientation of economic policy. In fact, fiscal discipline was reinforced, as the primary surplus for 2003 is targeted to reach 4.25% of GDP, against actual 3.9% of GDP in 2002, in a context of declining collection as a percentage of GDP, indicating that the adjustment has actually occurred through the reduction of government expenditures. In addition to that, the monetary- exchange rate regime was maintained, that is, a floating currency coupled to a Central Bank committed to inflation targeting. Finally, an ambitious reform agenda – tackling the Social Security and Tax systems, as well as the Central Bank – took over where the previous reform agenda had stopped. In all, economic policy orientation remained essentially the same.

This observation indicates, in our opinion, that the strong turbulence suffered in 2002 was not a pure crisis of weak fundamentals. The “bank-run” model of crisis seemed at work in the Brazilian case.

If this is true, one has also to acknowledge the important role played by the IMF in helping Brazil overcome the crisis; more, one has to recognize that this role went well beyond liquidity assistance. First, in terms of signaling, the 2002 agreement indicated a higher likelihood of maintenance of the economic policy regime than seemed prevalent in the market, and the fact that all the then-presidential candidates subscribed to the terms of the agreement was instrumental as well. Second, in terms of commitment, to the extent that disbursements are contingent on economic policy performance, there was a strong encouragement to the maintenance of the policy regime.

In all, one can say that interests were aligned: a reformist-minded government found support for its economic policy and reform agenda. This, we believe, is an important factor behind the impressive recovery observed in 2003.

Moreover, we believe that reputation matters, and more so when a country is amid the process of institution building. In this sense, sticking to a policy of adjustment to sustain the sovereign debt helps construct, in our opinion, the reputation we think the country deserves.

Thus, considering all the investment in creating the current macroeconomic framework in Brazil – the Fiscal Responsibility Law, the debt renegotiation agreement between the Federation and states and municipalities, the emphasis on fiscal discipline – our opinion is that the strategy of deepening the fiscal adjustment in fact dominated all the others.

Hence, in light of these facts, we believe that the absence of the IMF financing, as well as the support for the economic policy, would have had very negative consequences. Brazil can indeed be thought of as a poster child for the precautionary approach.

As we look forward, it is important to make clear that the commitment to responsible fiscal policies remains. The primary surplus target for 2004 has been already set to 4.25% of GDP, the same as in 2003, even though real interest rates have already declined and growth is likely to accelerate, which in itself would already allow a reduction of the fiscal target. Moreover, the target for 2005 and 2006 is also, in principle, set for the same level, although there is an ongoing discussion about the possibility of reducing the pro-cyclical component of that policy, that is, the target can be adjusted upwards in years of faster growth and downwards in years of lower growth, maintaining, however, the objective of reducing the debt to GDP ratio to lower levels.

In addition to that, the sharp current account adjustment observed over the past 18 months or so, has also very positive implications. Indeed, the current account balance moved from a US\$ 13 billion deficit one year ago to a US\$ 3.6 billion surplus in the 12-month period ended in September, a US\$ 17 billion shift without a sharp reduction in economic activity. This has put much less pressure on the real exchange rate, which had effects on the sovereign debt as well, to the extent that it produced – everything else constant – a reduction of more than 3% of GDP in the debt to GDP ratio.

Finally, we still see a positive role for the IMF as Brazil consolidates its path of recovery, the last step towards full normalization of the economy after some very difficult years. Whereas the recent evolution of the balance of payments – characterized by the current account adjustment, but also by the recent pick up in FDI and improvement of the private debt rollover ratio – indicates that most likely the country should not make use of the IMF resources, we think that it remains a valuable insurance. The decision to extend the agreement with the Fund is consistent with this view.

Reaching down the details of our sovereign debt policies, I think it is important to disentangle the external from the domestic debt. Regarding the former, our strategic decision is to keep the sovereign foreign debt constant in nominal terms, allowing it to decline measured against GDP, exports, or tax collection. Hence, our new debt issuance should take place only to rollover existing amortization payments.

We have already fulfilled our program for 2003 and advanced towards the 2004 program, as exemplified by the recent US\$ 1.5 billion issue of our Global 10. The program for the end of 2004 calls still for some additional US\$ 4 billion, which we are in no rush to carry out. Also, we have no plans of massive swaps or anything of the sort.

Regarding interest payments, the recent improvement in balance of payment conditions has already allowed the National Treasury to acquire foreign currency in the market – rather than accessing international reserves – to finance these obligations.

We noted that CACs have been well received and reiterate our support for their adoption. That said, we think that aggregation is a much more complex issue, and we do not think that the idea is sufficiently mature for practical applications at the moment.

Regarding the domestic sovereign debt, we start by noting that the issues – particularly in the case of Brazil – remain rather distinct from the foreign debt ones. Even though a

substantial portion of Brazilian sovereign domestic debt is still indexed to the exchange rate, it is important to bear in mind that this debt is settled in domestic currency. Thus, even though capital account reversals can increase the value of the debt, via exchange rate depreciation, a shortage of hard currency does not impair the ability to keep the service of the domestic debt, as the experience of 2002 has demonstrated.

Moreover, the domestic debt is already subject to local law, and the concerns about sovereign immunity that have important implications for the external debt have little bearing on local bonds.

I finally note the substantial change in the domestic debt profile that has been taking place for some months now. Even accounting for the dollar swaps issued by the Central Bank – which have been progressively reduced over the course of this year – one can see that the share of exchange rate indexed debt has declined from nearly 38% of the domestic debt about one year ago to some 24% as of September 2003. That is, the Brazilian government is gradually eliminating the “original sin”.

<b>Domestic debt breakdown – %</b>					
	<b>Sep-02</b>	<b>Dec-02</b>	<b>Sep-03</b>	<b>12-month</b>	<b>YTD</b>
Floating interest	38%	42%	46%	8%	4%
Exchange rate indexed	38%	34%	24%	-14%	-9%
Overnight	7%	9%	8%	1%	-2%
Prefixed rate	6%	2%	8%	2%	6%
Price indices	9%	11%	12%	3%	0%
Other	2%	2%	2%	0%	0%

This is no the only improvement in debt composition: although the debt linked to overnight rates (the floating rate debt and the overnight itself) remains high, at about 54% of the debt, the share of both prefixed and inflation linked debt has increased, particularly if we concentrate on the progress obtained this year. Thus, the prefixed debt came from mere 2% to 8% of the aggregate figure, while inflation-linked instruments increased more modestly, from 11% to 12%.

In all, although there remains a lot to do regarding further improvement in the debt profile, the vulnerability associated to the exposure of the domestic debt to wide swings of the exchange rate has been already substantially reduced and we expect to do more in the months to come. Our intention is to keep increasing the share of prefixed notes as well.

Considering all that was said above, I would like to conclude with a few words about our belief on the main guidelines of a new International Financial Architecture. We favor an approach that would embody the following features:

1. **Pragmatism:** rather than coming with pre-set solutions, we think that the nature of the crisis has to be understood before policy measures are adopted. The nature of the crisis should determine the orientation of policy, under penalty of treating equally crises of very different origins. By the same token, we continue to encourage policies that avert crises (precautionary policies);
2. **Flexibility:** we think that the emphasis should be in guidelines for actions, rather than detailed contingent plans. Provided one sticks to some principles, as the

adoption of sound economic policies, the details can be worked out in a case-by-case approach;

3. **Evolutionary**: we do not believe that sudden changes would do much good for the system. Hence, we favor gradual, pre-announced changes, over sharp movements in the current arrangement; and
4. **Voluntary adoption**: as the example of the adoption of CACs would indicate, voluntary adhesion to mechanisms to reform the system – although slower – seem to have a better chance of consolidating over time.

A system that evolves according to these guidelines faces, in our view, an improved chance of avoiding most of the problems observed in the last few years.