External crisis and public spending reform

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Brazil was one of the countries that benefited most from the global financial bonanza in 2002–2008. Globally, this favorable period was brought about by excessive monetary expansion in developed countries and disproportionate expansion of the real estate market in the US and other countries, combined with excessive leverage (the ratio between borrowed funds and equity), particularly in developed countries with weak financial supervision.

In the wake of this bonanza, the Brazilian economy was the recipient of an unprecedented volume of foreign resources, and the global boom led to a rapid rise in the price of our export commodities. In this context, even as the Central Bank purchased an enormous volume of dollars (foreign reserves), it was possible to significantly increase our imports, particularly capital goods, while the exchange rate and interest rates fell markedly. As a consequence, domestic investment expanded rapidly, leading to considerably higher growth of the Brazilian economy.

Tax revenues bonanza

In the public sector this prosperous period brought in substantial tax revenues that, despite continuing high growth of current expenditure, since the end of the 1980s made it possible to increase primary surpluses (cash surplus less interest). Against a background of significant increases in international reserves, higher growth of the economy, increased primary surpluses, and falling interest rates, net foreign public debt (gross debt less international reserves) declined continually, to the point where in June 2006 it vanished. It has since consistently shown increasing large negative values. In other words, in relation to the rest of the world, the Brazilian public sector went from being a debtor to being a net creditor. In spite of the crisis, this situation continues to this day. This transformation brought about a drop in the country’s risk assessment and an increase in the inflow of foreign resources, at least until the current crisis emerged.

It was also possible to substantially increase the Federal government’s investment in transportation, despite the
well-known sluggishness of the public administration. Granted, because of the excessively depressed comparison base in 2003, this increase has barely allowed investments to surpass the average of 1990–2006. In fact, in 2007 expenditures accounted for 0.22% of GDP, compared to the average of only 0.19% registered in 1990–2006. It is worth noting that, according to estimates of the Ministry of Transport, at the end of the 1970s investment in transportation was nine times higher as a share of GDP than today.

To sum up, even though the share of current government expenditure in the country’s aggregate expenditure continued to be as high as before, it was possible to reduce the public debt-to-GDP ratio and substantially improve the solvency of the public sector because of ample tax revenues.

**Foreign currency scarcity**

The global crisis will bring about an accelerated and expressive reversal of the conditions that produced such positive effects on the Brazilian economy in recent years. At present, the major effect of the crisis, now hitting the country with full force, is the severe scarcity of foreign currency as a consequence of the halt in foreign capital flows. This will be worsened by the plunge in commodities exports due to the significant drop in their international prices.

It is estimated that the “deleveraging” process that is on course particularly in the United States will lead to a US$7.7 trillion drop in the volume of loans in the U.S. financial system—the equivalent of 52% of U.S. GDP. These estimates assume the average leverage of the system will drop from 12 to 8. The extent of the debt rollover in the American financial system would, under these circumstances, decline to 66% of total repayments, which would result in a substantial financial tightening on debtors without parallel in recent history.

Obviously, foreign deleveraging would also hit in full Brazilian debtors owing to the international financial system. Currently the extent of rollover of the private sector’s foreign debt is estimated to be only 20% of the total repayments.

In view of the decline of commodity exports and the higher deficit in the capital account of the balance of payments, the trend points to a sharp exchange rate devaluation (already the case), new inflationary pressures, a possible hike in the central bank policy rate, and finally a severe drop in economic activity. These adverse effects may be aggravated in the coming months, which makes forecasting the economy and fiscal variables enormously risky.

As far as the Federal budget is concerned, on the one hand, the issue is a severe drop in the growth of tax revenues, which would lead to a significant fall in Brazil’s high primary fiscal surplus, if the excessive increase in primary current expenditures continues. On the other hand, there is the risk of a significant increase in the cost of public debt.

The drop in the growth of tax revenues would come about as the GDP growth rate slows down, as well as
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The major increase expected this year in Federal primary current expenditures will be in two areas, social security and the civil service, which correspond to almost 70% of the total. A case in point is the impact of the new minimum wage for 2009, which accounts for almost 40% of social security expenditure. According to the draft budget, the minimum wage will be raised by R$50 (US$25), or 12% of the current wage, well above the expected yearly inflation over the 12 months before the minimum wage adjustment. In addition, the adjustment of civil service salaries and new hiring already approved by the federal government are expected to produce a significant impact on the government's wage bill in 2009.

The fall

The government and the Congress continue to express optimism about the future of the economy. However, the expectations expressed on December 12 by the domestic financial markets seem to indicate that the rate of growth of GDP in 2008 (close to 6.5% a year up to the third quarter) will fall to approximately 2.5% in 2009. Indeed, since mid-October 2008 all the GDP growth forecasts produced by domestic financial markets, as published in the Central Bank Bulletin, have been declining.

Furthermore, due to pressures from certain constituencies to obtain government assistance, new measures have been taken to give up taxes that will result in a loss of tax revenues of approximately R$8.4 billion (US$4 billion) in 2009.

A drop in the primary surplus combined with a hike in the cost of debt and reduced GDP growth means that the solvency of the Brazilian public sector has deteriorated—a problem that has recently not been among our serious concerns.

These factors should prompt the government to introduce a comprehensive program of adjustment for the public finances, without which it will be very difficult to cope with the severe crisis already affecting the world and the Brazilian economy. In addition to public sector solvency risks, there is a need for the administration to lead the unavoidable process of cutting domestic spending by means of reducing non-financial current spending in order to reduce the current account deficit of the balance of payments and inflationary pressures, which are likely to worsen.

In this context, it would absolutely be prudent to once again open up debate on spending reforms, which are completely absent from the list of priorities of the Federal government, including reforms of the social security system and public administration. The government should, in summary, make efforts to pass its own draft supplementary legislation to limit the maximum increase of the civil service payroll to the INPC price index plus 1.5%, which at the moment enjoys no support in the Congress.

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