The politics of Brazilian debt dynamics in the light of Argentina's default[1]

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The political and economic decisions of Brazilian President Luis Inacio "Lula" da Silva in connection with the country's public debt and the evolution of its administration are crucial for the future of Latin American economies. President Lula was the left-of-center candidate who took office, after eight years of the so called "neo-liberal policies" carried out by Fernando Enrique Cardozo.

Three years earlier, Fernando De la Rúa had been elected President of Argentina, supported also by a left-of-center coalition, to replace Carlos Menem, whom, like Cardozo in Brazil, was considered "the father of neo-liberal policies" implemented in Argentina. In both cases, the incoming presidents inherited significant fiscal deficits that were generating an unsustainable debt dynamics.

After two years of politically costly fiscal adjustment and an attempt to restructure the public debt, President De la Rúa was ousted and formal declarations of default on its debt drove Argentina to economic chaos.

In order to restore debt sustainability in Brazil, President "Lula" da Silva is following the advice of his economic team and has decided to make a further fiscal adjustment with the aim of getting significant interest rate reductions as a subsequent market response. However, some voices argue that debt restructuring is inevitable.

What can be learned from the Argentine experience to asses the probability of Brazil finally defaulting on its public debt as a way to force a debt haircut?

Growth performance and debt dynamics

As opposed to the 1980s, the 1990s constituted a favorable decade for Latin America. During the 1980s, the only economy that achieved stability and growth was Chile. The key to their success was an open economy coupled with fiscal and market reforms that generated positive productivity growth.

Throughout the 1990s, similar reforms brought stability and growth to most Latin American Economies. The different performances of countries closely relate to the magnitude of the reforms effected. Productivity growth can be taken as one clear indicator of the depth of the reforms. And productivity levels were significantly higher in Chile and Argentina than in Brazil and Mexico.

Productivity increase clearly correlates with the increase in investment. In terms of increased levels of investment, Chile ranked first on the list, where Argentina's second

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place came far behind. In Chile, investment grew thanks to the expansion of the local financial and capital markets that benefited from an increasing savings rate. In Argentina, the expansion of the domestic financial and capital markets was due to the return of savings that had fled the country during the unstable 1980s. Those savings were attracted back to Argentina and new ones were generated and kept in the country after the convertibility law was enacted. In the cases of Argentina and Chile, the inflow of foreign capital was only complementary and not a substitute for increased domestic savings.

While in terms of investment and productivity growth, Argentina looked more like Chile, and Brazil resembled Mexico, in terms of fiscal discipline and public debt dynamics, Chile and Mexico applied a much more conservative strategy than those adopted by Argentina or Brazil. That is why, in spite of their different growth and exports performance, Argentina and Brazil generated a similar debt problem over the time. The Argentine debt difficulties started to be sensed by the markets during the 1999 presidential campaign, at the end of Carlos Menem's government. Similarly, Brazil's debt problem was initially noticed during the 2002 presidential run-up, at the end of Fernando Enrique Cardozo's administration.

The experience of Fernando De la Rua's government

Fernando De la Rua's Government decided to find a sustainable path for public debt dynamics through fiscal adjustment. Such decision undermined his political capital, particularly because the President's political constituency expected to receive immediate social benefits, and most of the members of his political coalition advocated the suspension of debt payment as an alternative to fiscal adjustment.

During 2001, Argentina struggled to avoid defaulting on its public debt. Some very conservative American economists, namely Allan Meltzer and Charles Calomiris, suggested in April of that year that Argentina should formally announce the default on its obligations, and then attempt to get a significant "haircut" on the debt. Many market participants related this piece of advice to the "Private Sector Involvement" (PSI) that the IMF had started to mention as their pre-requisite to support countries facing debt problems. Actually, the IMF had not explained what PSI meant in practice. So there was room to assume that it implied forcing a haircut on the debt after formal default.

By the second half of 2001, the Government of Argentina had agreed to seek an "orderly debt restructuring" scheme, as it had been strongly recommended by the US Treasury. The process should have meant halving the annual interest costs of the public debt and lengthening the amortization terms. The Argentine government found this suggestion more reasonable than the default-induced debt haircut proposed by Meltzer and Calomiris.

The IMF was undecided about how to help Argentina conduct the "orderly debt restructuring" process. Instead of working together with Argentina to develop a methodology which could solve the ongoing debt crisis and gain experience for the future, it chose to work on a "Sovereign Debt Restructuring Mechanism" (SDRM) to provide for future debt crises after an international treaty ratified the new rules. It is important to note that this SDRM would not be applicable to the then current Argentine debt crisis but to future ones.

The lack of IMF support for the debt restructuring process launched by the Argentine government encouraged populist politicians that had been opposing fiscal adjustment and advocating formal default on the public debt, to overthrow De la Rúa and to suspend repayments on the public debt.

The immediate impact suffered by Argentina's economy came not so much from the foreign debt default but mainly from the decision to suspend domestic debt repayments. The arbitrary and compulsory "pesification" of contracts originally denominated in US dollars together with the flotation of the exchange rate had the clear purpose of forcing domestic creditors to accept a drastic haircut on the domestic debt of both, the public and the private sectors. But this imposition on depositors, domestic bond holders and pension funds generated thousands of lawsuits against the State and financial intermediaries, and shook the confidence of savers. This may have lasting negative effects on investment and productivity growth.

Could the course of events be somewhat similar in Brazil under President "Lula"?

The economic and political situation of Brazil as of the beginning of "Lula" da Silva's government is very similar to that of Argentina's, when Fernando De la Rúa took office. Brazil's president and his economic team have apparently decided to make a significant fiscal adjustment, leading towards a sustainable public debt dynamics. But such course of action may mean to President "Lula" the same political costs that former President De la Rúa had to bear in Argentina.

The expectations of instantaneous social benefits for his constituency and the rejection of economic orthodoxy by his political peers are even higher than those of De la Rua's supporters. So, in order to predict what may happen in Brazil, should markets fail to respond fast enough to reinforce Lula's initial approach, it is important to watch the attitudes of the IMF, the US Treasury and the conservative economists that seek to ideologically influence both institutions.

If Brazil is advised to implement a default-induced debt haircut "à-la-Meltzer", and the IMF continues to devote its intellectual efforts at designing the future "Sovereign Debt Restructuring Mechanism" but does not work side by side with Brazil to carry out an orderly process, the outcome may be as chaotic and costly as the one seen in Argentina, throughout 2001-2002.

Those proposing default induced-debt write-downs will probably argue that Brazil's situation is different from Argentina's, because that country does not have dollar denominated domestic debts. It will not be necessary to force the "realization" of contracts and, therefore, property rights of savers and investors will be less affected than in Argentina. That is not true, because Brazil has a domestic debt problem which is even larger and costlier than Argentina's.

To reduce the cost of the domestic debt, a default strategy in Brazil would require exchange controls, a managed exchange rate and a large monetary expansion to generate negative interest rates. Such conditions will fuel inflationary pressure that could be probably restrained for some time by means of strict government controls on the markets.

Eventually, inflation would accelerate and savings would be significantly eroded. In terms economic organization, the picture would look very much like that of Argentina throughout 2002 -an economy with plenty of government-determined prices and thousands of conflicts originated in the struggle between domestic creditors and debtors. Of course, the Brazilian economy would be financially detached from world capital markets and local and foreign savings would exit the country.

Investment and productivity growth prospects would deteriorate as badly as in Argentina. Their influence on future growth may be even worse than in Argentina, because Brazil's performance in the 1990s was poorer and, therefore, the country would probably face harder infrastructural bottlenecks than those of Argentina.

Circumstances that could help Brazil find better ways to achieve debt sustainability

Fortunately there are circumstances that could help Brazil avoid defaulting on its debt. On the one hand, if Brazilian leaders -particularly those of Lula's PT party- analyze the Argentine experience carefully, they should come to the conclusion that the social and economic costs of pursuing a default-induced debt haircut are much higher than the expected benefits.

In Argentina, the same political leaders that had strongly opposed fiscal tightening and bitterly criticized a 13 percent nominal cut in public sector salaries and pension benefits, actually induced a 30 percent real reduction in the salaries and pensions of both the public and private sectors by lobbying for and eventually achieving the default on the public debt. The provincial governors, who had put pressure on the Federal Government to get more financing for their expending, had to accept very large expenditure cuts in real terms after the default. This experience should persuade Brazilian political leaders that debt default may end up backfiring.

On the other hand, the G7 governments and multilateral lenders should be aware by now that indebted emerging economies in practice have more expensive domestic debts than foreign ones, and that default-induced debt haircuts generate such a destruction of domestic financial wealth that instead of helping countries to restore sustainable growth, they condemn them to long term stagflation. Even if the purely financial contagious effects may be limited, for an economy as important as that of Brazil, stagflation may spread significantly, at least around South America.

If, instead of concentrating their efforts on the creation of a Sovereign Debt Restructuring Mechanism for the future, the IMF together with the other multilateral lenders and the G7 governments helped Brazil find orderly ways to reduce the burden of its debt by averting the chaotic process that followed the formal announcement of default in Argentina, the course of events in that country could be very different and the results much better than in Argentina.

Having suffered the perverse intellectual support that some of Washington's conservative default advocates offered to the leftist politicians of my country, I use every opportunity to draw from our sad experience lessons that may prevent leftist leaders of Brazil from making the same mistakes that President Eduardo Duhalde, backed by former President Raúl Alfonsín, made in Argentina.