Brazil's Debt Crisis and the Elections[1]

To join ALBA, Brazil's government must repudiate its debts.

Brazil is Latin America's largest country and accounts for around 40% of the continent's economic product. It suffers from all the notorious social diseases of Latin American capitalism, including extreme and rising inequality, staggering levels of public debt, ecological destruction, and endemic state violence and corruption. Widespread discontent with these ills propelled Workers Party leader Luiz Inácio da Silva ('Lula') to victory in the October 2002 presidential elections. Widespread disappointment with his first term means that re-election in October 2006 is not certain.

Da Silva's government is an important test of whether a reformist, social-democratic project is possible in Latin America. Is there a capitalist solution to the continent's problems? Can da Silva serve the interests of wealthy private investors and also of those who elected him? Brazil's political and economic direction has great significance for the efforts of Cuba, Venezuela and Bolivia to construct a continent-wide challenge to imperialist domination, namely the Bolivarian Alternative for the Americas, or ALBA. Does da Silva's social-democrat project converge with ALBA, or does it clash? What are the prospects of Brazil joining it?

To answer these questions, we must understand the nature and the current stage of Brazil's chronic debt crisis, unquestionably the biggest constraint upon its national sovereignty and on its government' freedom of action.

Months before Brazil's voters queued up to give 'Lula' da Silva a decisive victory in the October 2002 presidential elections, investors in Brazilian financial assets voted – with their feet. Alarmed at the prospect of a Workers Party government, flight capital flooded out and Brazil's currency, the *real* (BRL) fell 40% to an all-time eve-of-election low of 3.95 to the dollar. Brazil's risk premium – the difference between the rate of return on loans to the Brazilian and US governments – rose from an already sky-high 7.85% to 24%. A meltdown was only averted by an emergency IMF loan of $30.4 billion, announced in August, the largest single loan ever extended by the IMF. Lex (Financial Times, 2 August 2002) described what this 'rescue package' contained: *"US and European banks with Brazilian exposure have effectively won a get out of jail free card."*.

Liberating foreign investors from the risk of losing money was not the only thing in the package. It also contained a straitjacket for da Silva to wear under his presidential sash. The IMF's harsh terms locked his incoming government into continuing with the neoliberal recipe of pro-market reforms and austerity for the many. Its centrepiece was a promise to maintain a 'primary surplus' – a budget surplus before debt-servicing – of 3.75% of GDP, or 10% of government revenues. Actual payments are higher still: once debts have been serviced, the 2002-2006 budget deficit averaged 3.6% of GDP.

The Wall Street Journal (9/8/02) commented "*the IMF loan is structured to induce the... presidential front-runners… to continue the conservative economic policies of the outgoing president*". Da Silva went along with this assault on Brazilian sovereignty, describing the IMF agreement as "*inevitable… [It] allows the markets to calm, and with that, gives a chance for the country to return to growth if the right measures are taken.*" His meek consent meant that the debt crisis – the most important political issue facing Brazil's people – did not even make it as an election issue.

In 2002, da Silva was faced with a choice between defiance and submission. Unlike in Venezuela, the gigantic size of Brazil's public debt far outweighed the capacity of any resources windfall to finance it. Defiance, or any hint that da Silva had a less market-friendly plan up his sleeve, would have provoked an exodus of flight capital, a banking collapse, hyper-inflation and an economic slump.

There was no middle road. Da Silva decided that only by placating private investors could Brazil hope to

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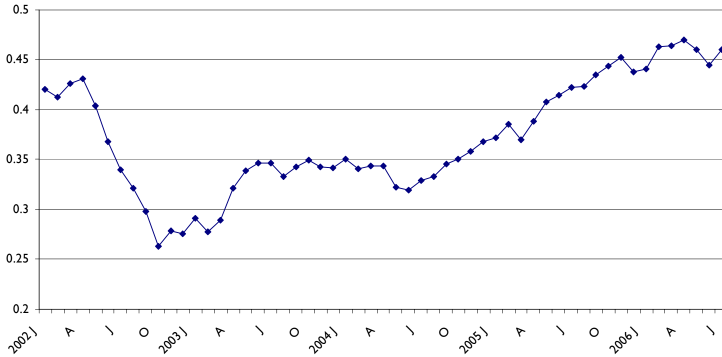
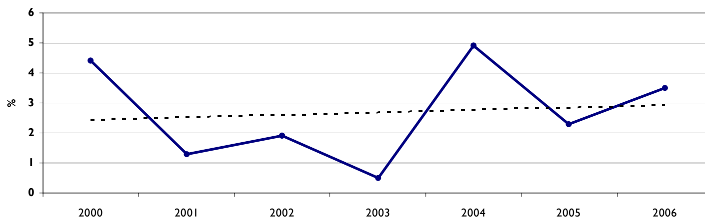
[1] This article appeared in 'Frontline Latin America' Vol 2 No 4 (September-December 2006), published by the Colombia Solidarity Campaign

massage interest rates downwards, stimulate growth and release some resources to improve the wretched conditions of its people.

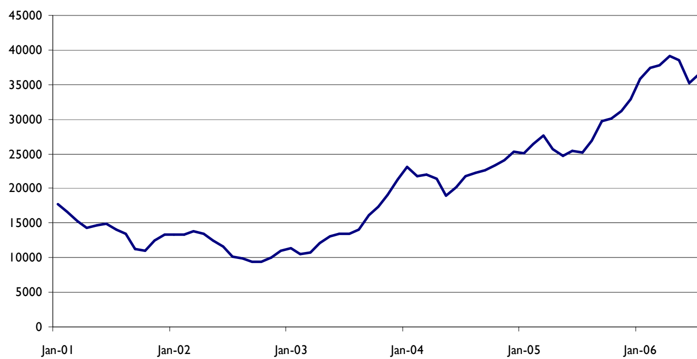
$ vs. Brazilian Real
2002-2006



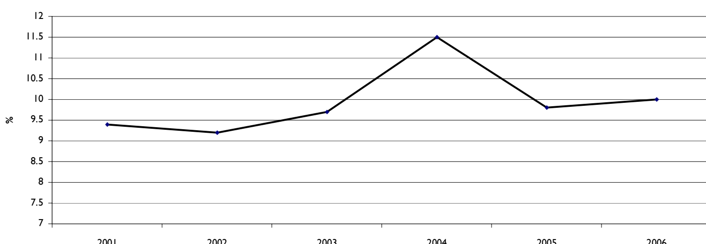
Brazil: GDP growth
(source: IMF)



Ibovespa Stock Index, 2001-6



Brazil: Unemployment rate
Source: LABORSTA, Banco do Brasil



Da Silva stated on July 7, 2006 that *"it is many, many years since Brazil has enjoyed the kind of tranquillity over the economy that it is enjoying now"* Brazil has stayed on the rails thanks to investor approval of da Silva's obedience, and – critically – to two major shifts in global conditions: surging demand for Brazil's commodity exports such as iron ore, soya, meat and sugar; and investors' hunger for Brazilian bonds and shares.

The vast influx of finance capital is attracted by the superprofits being made from trading in Brazilian debt. This hot money dwarfs foreign direct investment – foreign investors cannot easily break into the dynamic sectors, agribusiness and the state-controlled oil industry. As a result, Brazil has become "*the world's reining beauty queen… everyone wants to own its debt*" (Global Money Trends, March 21, 2006) The BRL has almost doubled since its low point in 2002, producing huge capital gains for foreign investors and for wealthy Brazilians, 11,000 more of whom became dollar millionaires in 2005 alone (CapGemini World Wealth Report 2006).

This combination of factors has reduced inflation from the high teens to 4.5% in March 2006, and has allowed the state to channel some resources into anti-poverty programmes. In 2003, around 15 million of Brazil's 180 million people were defined as 'extremely poor' – living on less than one PPP dollar per day. Da Silva claims to have moved three million of them above this line. Because of the size of the informal sector, social exclusion etc., unemployment figures are even more unreliable in Brazil than in the UK. Despite the commodity boom and the profit bonanza, unemployment, officially 10% of the workforce, has risen during da Silva's presidency Female unemployment is at least 50% higher than men's, and its recent decline is shallower.

This brief chronicle provides a context for the remainder of this article, which examines the recent evolution of Brazil's public debt. It has two particular aims.

To give a glimpse of the social relation which the debt expresses, between the debtors who produce Brazil's wealth and the foreign and domestic creditors who produce nothing.

And to investigate how much they are siphoning off.

The domestic debt explosion in Brazil

Domestic debt, public and private, in 15 'emerging economies' home to more than 70% of the population of all such nations, has this year reached $3156.7bn, gaining 50% in two years. $2064bn of it is sovereign debt. (Source: Bank of International Settlements)

Three senior IMF economists (Reinhart, Rogoff & Savastano in *Debt Intolerance,* 2003) were the first to blow the whistle about *"the rapid expansion in domestic, market-based debt…. [which] has become… a trigger for generalized debt and financial crises… [It] presently accounts for the lion's share of public debt in Brazil and Turkey and will ultimately determine the fate of those countries' efforts at financial stabilization."* They concluded that its rise *"arguably overshadows the progress… in containing their external debt burden… a wave of restructuring or outright default on domestic government debts looms large on the horizon for many emerging market economies".*

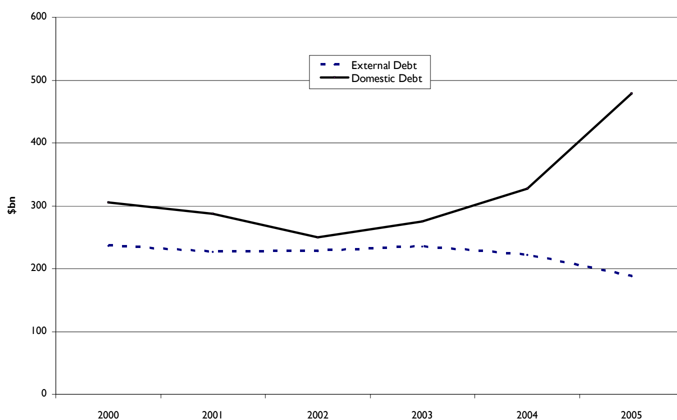
The Brazilian government's external debts drifted lower to $88bn in 2005, while domestic sovereign debt soared to $409bn, 50% of GDP, up from $247bn two years earlier – a 30% increase, after adjusting for the appreciation of the BRL. Total sovereign debt, the sum of the government's internal and external debt, totaled $500bn at the end of 2005, virtually all of it owed to private investors. The private sector's domestic debt reached $130 billion and now also exceeds its $106bn external debt.

Brazil's domestic debt is exceeded only by S Korea and China. S Korea's domestic debt exceeds 90% of GDP but 'only' one third of this debt is owed by the government, the rest by the private sector. Thailand and Malaysia exhibit a similar profile to S Korea, while Indonesia is like Brazil: 87% of its $50bn domestic debt is owed by the government.

In June 2006 the IMF praised Brazil for *"debt management operations [which] have eliminated exchange rate-linked domestic debt and almost doubled the maturity of new domestic issues of floating-rate and fixed-rate debt"*, yet short-term debt, to be repaid in less than one year, reached 67% of total domestic debt in 2005, up from 49.7% in 2003.

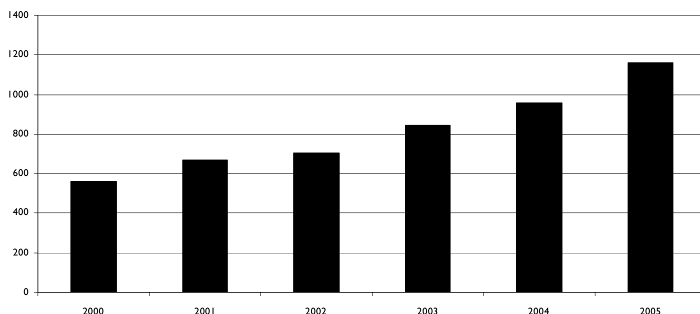
The Bank of Brazil reported in April 2006 that

Brazil: External + Domestic Debt **(govt. + private)**



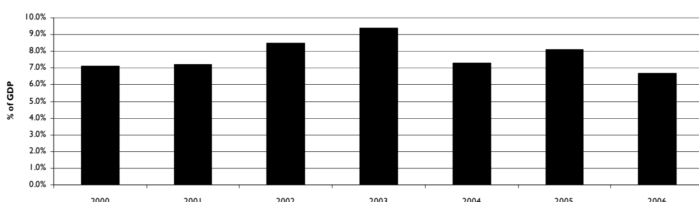
The graph above compares public and private external debt with the dollar equivalent of domestic debt. Its evolution is distorted by changes in the BRL's exchange rate.

Brazil: Total Domestic Debt (BRL)



Here, the exchange rate distortion is removed by charting domestic debt in the national currency. Values were obtained by multiplying BIS data for domestic debt in dollars by the $/BRL exchange rate.

Brazil: Govt. debt servicing as % of GDP
Source: IMF Public Information Notice (PIN) No. 06/69; WEO Database



This shows the ratio of debt-servicing to GDP to give the most accurate picture of the real weight of Brazil's public debt. Falling interest rates since 2002 are partially cancelled by rising indebtedness. While 7% of GDP is handed to private investors, the government invests just 0.7% of GDP on infrastructure – in a country where two-thirds of human waste flows untreated into rivers and coastal waters, and where millions live in favelas, or shanty-towns, defined by the absence of social infrastructure.

gross public debt equaled 72.3% of GDP; while net debt, obtained by subtracting official reserves and other financial assets, was 51.3%. Gross debt should not be hidden behind net debt, since each $ and BRL of it causes public money to stream into private purses, and the rate of return on the government's assets is much lower than on the debts they're offset against. Furthermore, some of these 'financial assets' amount to little more than accounting tricks, e.g. $50bn in the Labour Assistance Fund is counted, while unfunded pension liabilities are left off-balance sheet

Domestic debt 'earns' a much higher interest rate than dollar debt. This is because domestic debt is also local currency debt, interest rates therefore contain a 'currency risk' premium to compensate for erosion in the debt's value through domestic inflation and/or currency devaluation. But instead of devaluing, the BRL has appreciated by 67% against the dollar since 2003, depressing the domestic economy but further multiplying the profits of foreign and Brazilian investors. FTMandate reported in March 2006: *"Brazil's interest rates are still phenomenally high in real terms and unjustified in the context of low and stable inflation… monthly inflation to 10 February at 0.17 per cent… hardly justifies 17.25 per cent interest rates."* The Brazilian government has laid on a feast for finance capitalists, and has even waived the entry fee. A February 2006 decree abolished a 15% income tax on foreign investments in domestic debt, rubber-stamped by the Brazilian senate four months later.

The result of this policy is to deepen Brazil's subjection to investors and their fickle moods. Capital flight remains a permanent danger. Increased government reserves are modest compared to the growth in short-term 'hot money' inflows. As one commentator explains: *"Brazil's official balance of payments statistics are not capturing the enormous amounts of foreign portfolio inflows that are essentially being conducted "off balance sheet"…The stock of foreign portfolio investment in Brazil increased by more than US$23 billion in 2005 to $53 billion. In the first four months of 2006… [it] rose another $30 billion to $83 billion. About 25% … can be attributed to rising equity values. The remaining $40 billion of inflows represent new foreign portfolio investment into Brazil's equity market…foreign investors have also dumped money into dollar/real currency swaps sold by the central bank. These swaps give foreign investors exposure to Brazil's very high short-term interest rates. Including these currency swaps, the total stock of foreign portfolio investment in Brazil at the end of April 2006 was probably near $100 billion or about 12 percent of GDP" ('Brazil Back in the Clutches of Capital Flight'* JP Gundzik, 16 June 2006)

This data implies that foreign investors increased their holdings of government debt by $17 billion in 16 months. The persistence of high interest rates is a sign of continued risk-aversion, and the permanent threat that inflows of 'hot money' could, in an afternoon, change direction.

Who owns Brazil?

Boston Consulting Group (BCG) and Capgemini are the source of two annual reports on the fast-growing wealth of the world's so-called 'high net-worth individuals', or HNWIs, defined as someone with more than a million dollars to invest. BCG data indicate that half a million Brazilian households, 1.2% of the population, control 66% of all investible assets in Brazil, or more than $1 trillion. As with other Latin American HNWIs, the Brazilian elite keeps the great bulk of its wealth offshore, from where it is allocated to investments of various types around the world. According to Capgemini, Brazilians with more than $1m to invest saw their combined wealth grow by $378bn between 2001 to 2006, while real GDP rose by $77bn. The rapid increase in the wealth of the super-rich, a world-wide phenomenon, reflects bubble-growth in asset values as well as accumulated revenues.

Capgemini's 2006 World Wealth Report stated that *"HNWIs continue to view Latin America as unstable, and allocated only 7% of their total assets [to it].. Latin America is the only region in our analysis in which HNWIs prefer to send their investments elsewhere rather than place them in domestic markets: wealthy Latin Americans allocate only 28% of their assets to domestic holdings and send 42% of their assets to North America."*

Latin American HNWIs have invested 28% of their $4.2tr, i.e. $1.2tr. in their own countries, mainly in public debt. At the same time, Latin America is the destination for 7% of the $33.3tr under the command of the world's HNWIs, or $2.3tr. Non-Latin Americans make up the difference, principally US, European and

Japanese investors, who've invested some $1.1tr in Latin American equities and governments bonds.

Assuming that Brazilian HNWIs behave similarly to others in the region, $300bn of their estimated $1070bn is invested in domestic assets. Unlike wealthy Asians, Latin American HNWIs allocate only a small fraction of their capital to corporate shares or bonds; the bulk is invested in government debt, indicating that around $200bn of Brazil's domestic government debt, around half of it, is held by wealthy Brazilians. The remainder is held by foreign investors and by pension funds and other domestic institutions.

Conclusion

Brazil's debt produces $1bn per week in profits for foreign and Brazilian investors. But this is only one form of effortless enrichment. According to data cited above, foreign investors in Brazilian equities reaped $13bn in profits from the increase in share prices during that year. The flow of dividends would add several more billions. Then we have the transnational corporations, whose huge stock of foreign direct investment (FDI) in Brazil is worth some $200bn. There's a multitude of ways in which foreign companies can conceal or shift profits, and reasons why they might wish to do this. If we assume a 10% rate of profit on FDI, another $20bn flows north out of Brazil. And all this takes no account of Brazil's terms of trade, of how much it gets paid for its coffee and its manufactured goods.

Readers can draw their own conclusions from the facts presented here. Here's five of my own.

First, the owner's of Brazil's debt wield far more power over Brazil's government than does Brazil's electorate.

Second, it is notable that Brazil's wealthy elite keeps the bulk of its wealth offshore, and they're just as inclined to dash for the exits as foreign investors. They have, quite literally, sold out to and merged with foreign finance capital, and only in a restricted, parasitic sense should they be considered as a national bourgeoisie.

Third, while da Silva may be permitted to burnish his left-wing credentials by maintaining friendly diplomatic links with Venezuela and Cuba, 'the markets' would harshly punish any move towards aligning his policies with them.

Fourth, a day of reckoning for Brazil's debt is both inevitable and necessary. Da Silva has succeeded in postponing this, but at the cost of demoralising and dispersing the powerful social movement which brought him to office and which could, under different political leadership, have provided Brazil's exploited majority with the means to repossess their country.

Finally, Brazil's debt bondage precludes its participation in ALBA. Repudiating this debt is the prerequisite for Brazil's considerable weight to be put behind ALBA's challenge to imperialist domination of Latin America and the Caribbean.