Introduction

Public debt is an often misunderstood theme. However, given its sweeping effect on a country's economy and social well-being, it must be explored. Thus, the book's authors, mostly public debt managers, describe the way Brazil handles its foreign and domestic debt, as well as the sequence of events that led to current practices, which are recognized on the international scene as highly effective.

Public debt functions: an overview

Just as citizens' prudent use of credit can help them improve their welfare – acquiring assets such as homes - so too can countries use public debt to improve social well-being and ensure economic stability.

Experts point to the importance of public debt in government investments and services and greater equity between generations – since revenues and expenditures are subject to cycles and frequent shocks. Indeed, without public credit, governments would have to increase taxes or massively cut expenditures, which could punish part of the population – often the most vulnerable.

Besides helping governments stabilize their levels of social services, access to public debt also allows them to cover emergency expenses (such as related to natural disasters or wars) and ensures that large projects with medium and long time-frames (say, for infrastructure) can be pursued. Thus, the widespread use of debt by every country in the world is hardly surprising.

Moreover, public securities assume an even broader role for achieving a sound economy as it is an instrument for devising monetary policy and consolidating the financial system: They are essential to central banks which use them daily to control market liquidity and stabilize the currency. Also, they are vital to the private sector, since they serve as key benchmarks for issuing corporate bonds. Thus, a well-developed public and corporate bond market can improve a financial system's efficiency in allocating funds and stabilize a country's finances and macroeconomy.[1]

The basic lesson from this discussion is the critical nature of public credit. Again, the analogy to individuals is useful: With sound credit, people can reduce the cost of borrowing and enjoy longer re-payment terms. The same is true of governments, whose borrowing conditions affect their credibility and payment capacity, which, in turn, are strengthened by good economic foundations linked to prudent fiscal, monetary and foreign exchange policies. Indeed, it is through balanced fiscal policies that governments secure a sustainable debt trajectory. Likewise, sound monetary and foreign exchange policies increase economic stability, reducing the costs and risks of public debt.

The way governments manage their debt is also critical, since good foundations alone will not ensure the quality of public credit or a country's capacity to absorb adverse shocks that jeopardize economic stability and public policies. Thus, governments should build capacity of debt managers to make key, sound decisions about financial instruments and optimal debt profiles, including maturity, indexation and types of credit.

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[1] See Eichengreen. *Rationale and obstacles to the development of bond markets in emerging economies*. Gemloc Advisory Services Guest Commentary, 2008. Available at: www.gemloc.org.

The global process to professionalize public debt management

While the public debt management profession is not new, efforts to professionalize its role gained momentum at the end of the 1980s. Since then, many countries have implemented institutional reforms and trained managers to design debt strategies to minimize the cost of government debt in the medium and long term and adopt prudent risk levels.

According to Wheeler (2004),[2] it was fitting that the first countries to substantially develop their debt management capacity – such as Belgium, Ireland and New Zealand - were precisely those with a history of fiscal missteps, high debt-to-gross domestic product (GDP) ratios, and high levels of foreign currency debt. He notes that these countries agreed, since the late 1980s and early 1990s, on the need for more professional debt management along with a sound debt structure (and not just its level); also, that poor debt management decisions could jeopardize the government balance sheet.

In the late 1990s and early 2000s, developing countries, including Brazil, followed the same path to improve professionalism, particularly after the Asian crisis and other economic shocks. Indeed, the advantage of better debt management, so as to improve countries' capacities to monitor risks and absorb domestic and international economic shocks, was abundantly clear. Thus, besides a global wave of institutional reforms in debt management agencies, significant progress was made in debt planning and risk management tools and techniques.

The impetus to develop governments' domestic debt markets was closely linked to the process of improving debt management; both themes have been explored. Indeed, the importance of issuing debt through domestic capital markets - as an alternative to borrowing from the banking sector - and of reducing reliance on international markets, was even more apparent after the Asian crisis of 1997.

While debt managers built technical capacity and models to support supply side decisions - i.e., on the optimal profile of government debt, including types of financing instruments, their indexation, maturity and currency - it was apparent these were linked to domestic debt markets. Also, good debt management would involve identifying opportunities and constraints on the demand side. Not surprisingly, countries such as Brazil, Canada, Korea and Thailand include an efficient domestic market for government securities among their debt-management objectives.

International organizations such as the World Bank and International Monetary Fund (IMF) have played important roles in improving debt management practices and encouraging international discussions with managers from different countries. Besides presenting the debate in "Guidelines for Public Debt Management," they produced "Developing Government Bond Markets: A Handbook," which have become a benchmark for debt managers.[3] They also provide important technical assistance and training and organize seminars where international managers share their experiences and major challenges.[4]

Brazil participated actively in the process, adopting important institutional reforms and training debt managers. As a result, procedures were improved, sophisticated decision-making tools were developed, and transparency was enhanced by clarifying the goals of the debt profile in the Annual Borrowing Plan (ABP). At the same time, the country developed its domestic debt market and improved its domestic and external debt structure.

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[2] Wheeler, Graeme. *Sound practice in government debt management.* World Bank, 2004.

[3] See for example World Bank and IMF, *Guidelines for public debt management*, 2001a; D*eveloping Government bond markets: a handbook*, 2001b; *World Bank, Managing public debt: from diagnostics to reform implementatio*n, 2007a; *Developing the domestic government debt market: from diagnostics to reform implementation*, 2007b

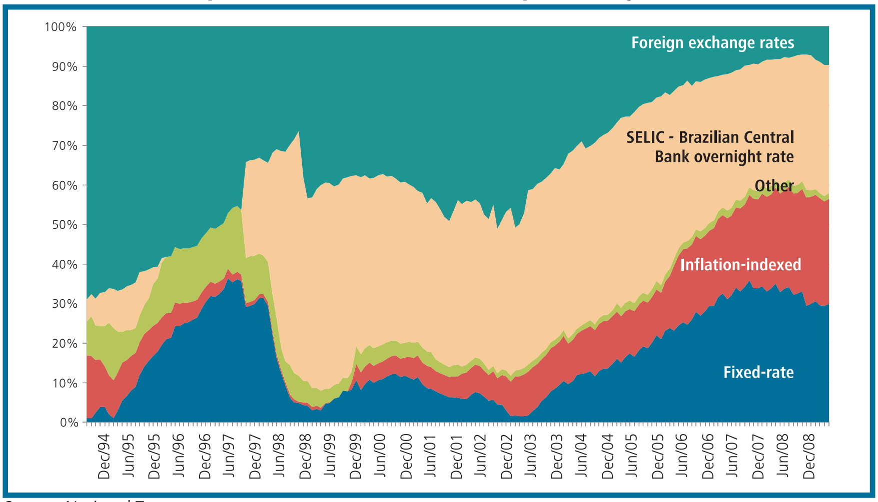
[4] Some examples of events are the *Sovereign Debt Management Forum* jointly organized by the World Bank and the *Global OECD-WB-IMF Bond Market Forum.* Brazil has participated in these events and is frequently invited to describe its experience.

Brazil's improved economic foundations and public debt management

It is axiomatic that the absence of sound foundations limits the scope of public debt management and improvements in the debt structure for which it is responsible. Hardly a theoretical argument, the Brazilian experience demonstrates the close connection. Thus, since the mid 1990s, its improved debt management coincided with successive institutional and macroeconomic advances. This combination, i.e., sounder foundations and qualified debt management, was the backdrop against which Brazil's public credit practices achieved greater credibility and scored high ratings.

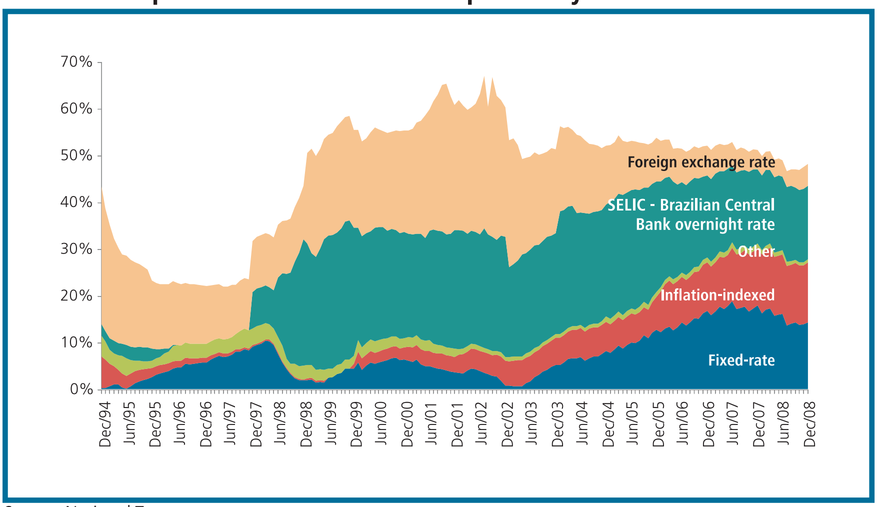
A review of the recent evolution of public debt structure and its relation to advances in macroeconomic policies illustrates this lesson, which is further explored in Part I, Chapter 2 and Part III, Chapter 1.[5] Graphs 1 and 2 show the evolution in the profile and stock of Brazil's Federal Public Debt (FPD)[6] since December 1994.

Graph 1. Federal Public Debt profile by index



Source: National Treasury

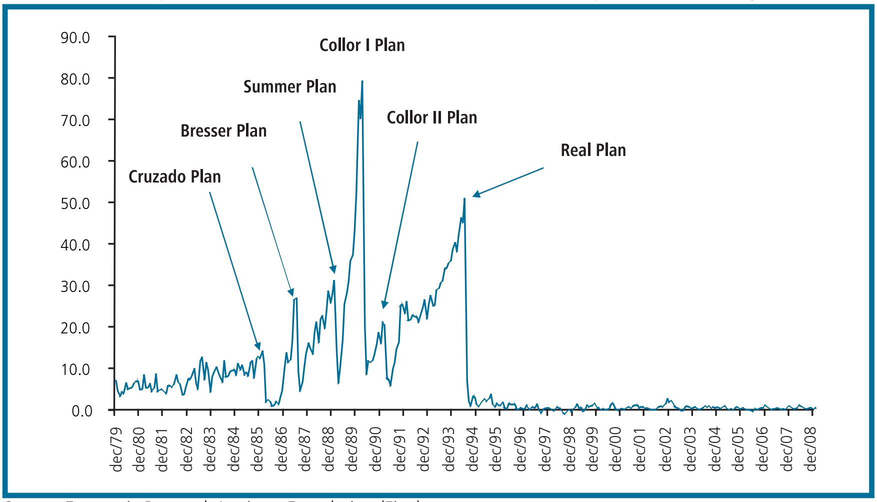
Graph 2. Federal Public Debt profile by index - GDP %



Source: National Treasury

This period is relevant, for it depicts the advances and occasional setbacks since the break with the historic inflation levels of 1994, due to the Real Plan (see Graph 3). An analysis of the FPD profile shows it was essentially formed by exchange and floating-rate debt, while the share of fixed-rate securities was nearly zero and the few that were issued had short maturities, usually no more than two months.

Graph 3. Evolution of inflation – CPI (Fipe) – monthly



Source: Economic Research Institute Foundation (Fipe)

The drop in inflation allowed authorities to stop indexing the debt and led to a continuous increase in fixed-rate debt, which reached 36% of FPD in August 1997. Due to the turmoil that began in Asia during the second half of that year, as well as the increasing confidence crisis that affected emerging economies, Brazil experienced the first major test for the soundness of its economic foundations: The strong pressure on the currency along with the fear of uncontrolled inflation turned debt de-indexation into a difficult and costly process. These events translated into a hike in exchange-indexed debt as well as in floating-rate debt, known as SELIC. In December 1998, the share of fixed-rate securities had dropped to less of 5% of FPD.

In fact, part of the setback in the debt de-indexation process was due to debt managers' greater focus on reducing the refinancing risk. While they continued to issue fixed-rate securities for a few months (with shorter maturities), signs that the crisis was serious and its extension uncertain indicated the need for a temporary change in strategy. At that point, the fear was that debt maturity could become too short[7] and entail maturity concentrations that would negatively affect the government's payment capacity and thus aggravate the crisis even further.

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[5] See Part I, Chapter 2: "History of public debt in Brazil: from 1964 to present"; and Part III, Chapter 1: "Recent Developments in the Federal Public Debt market".

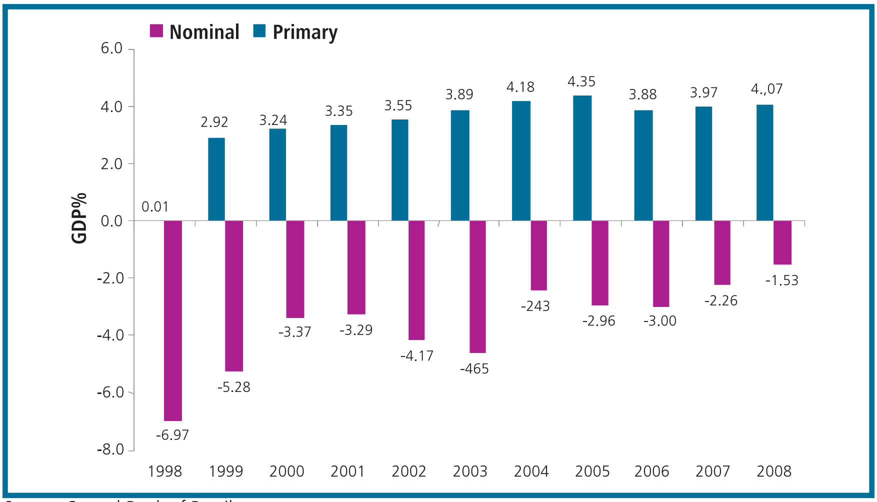
[6] FPD, which is the central theme in several chapters of this book, includes the domestic and external, marketable and contractual debt for which the National Treasury and the Central Bank are responsible. As stated in the Fiscal Responsibility Law, after 2002, the Treasury became the only agency issuing FPD bonds. As an indication of its importance, in December 2008 the FPD accounted for 70% of liabilities in the public sector which, besides the FPD, also included the liabilities of states, municipalities and state-owned companies.

[7] The average maturity of the FPD, which had remained below 12 months for over a decade, finally reached levels above one year in 1997. For managers, this advance in debt structure could not be missed, even if it meant "sacrificing" the composition (more floating and exchange-rate debt) at that point and then recovering it. For more details on the evolution of public debt indicators see the Statistical Annex at the end of the book.

The severe setback in fixed-rate debt and resulting increase in floating rates and exchange-indexed debt promoted a debt strategy based on macroeconomic foundations: The importance of an economy anchored in sound fiscal policies and solid external accounts was once again evident. These foundations would strengthen resistance to exogenous shocks, increase credibility regarding the country's debt payment capacity, and ensure greater stability to its profile.

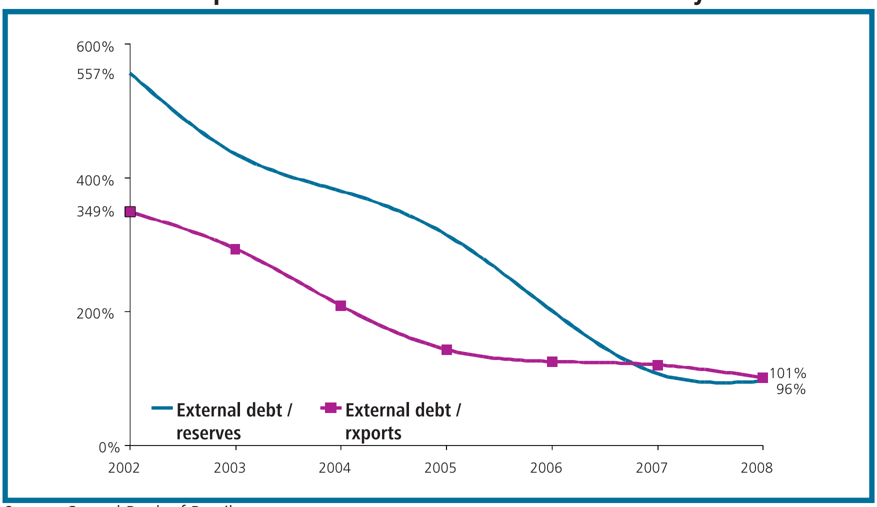
In a long, consistent path towards improving economic foundations, Brazil's fiscal policy gained credibility from successive primary surpluses starting in 1999 (see Graph 4) and the Fiscal Responsibility Law passed in 2000, which introduced greater discipline in public finance management at all government levels.[8] External accounts, in turn, went through major adjustments that considerably reduced the country's international vulnerability: For example, the external debt-to-international reserves ratio plummeted from 557% to 96% from 2002-2008[9] (see Graph 5).

Graph 4. Public sector balance



Source: Central Bank of Brazil

Graph 5. Indicators of external vulnerability



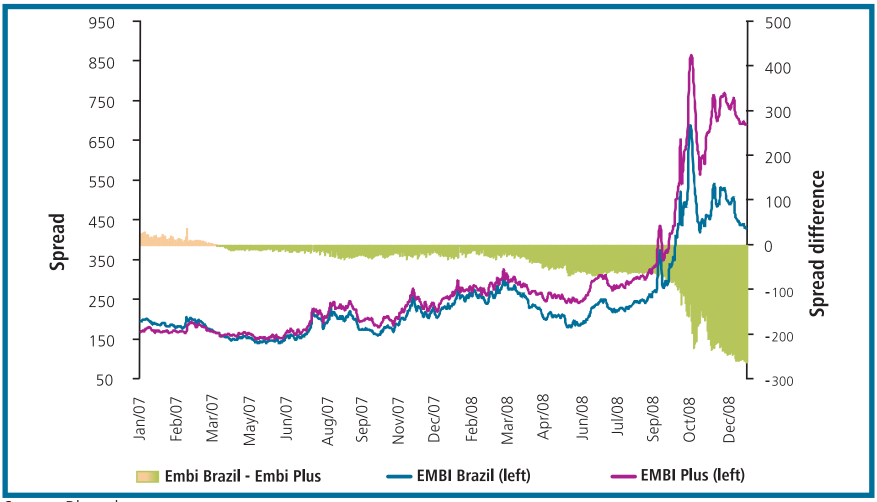
Source: Central Bank of Brazil

Such economic gains ensured an environment conducive to good debt management. Under a carefully developed strategy disseminated through annual borrowing plans, the National Treasury consistently improved the structure of public debt by greatly reducing exchange-rate liability and gradually increasing the share of fixed-rate and inflation-linked debt.[10]

These improvements are also part of the Treasury's proactive debt management strategy, which includes swap and-buyback operations that help improve the debt profile and reduce the economy's vulnerability to shocks.

The combination of sound macroeconomic foundations linked to efficient Federal public debt management scored significant gains, as shown by the risk indicators (see Graph 6) and the sound (BBB-) investment grade established by Standard & Poor's, on April 30, 2008, which also noted that pragmatic fiscal policies and debt management[11] had allowed Brazil to earn that rating for the first time in its history.

Graph 6. Spread performance – Brazil and emerging countries



Source: Bloomberg

Book organization and summary

The book is organized into three parts: Part I – Understanding the Brazilian Public Debt; Part II – Managing the Brazilian Public Debt; and Part III – The Public Debt Market in Brazil.

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[8] For more information on the Fiscal Responsibility Law, see the chapters on budget and audits (Part II, Chapter 4 and Chapter 5).
[9] This is an important indicator, for it shows that foreign currency funds deposited in the Central Bank would be sufficient to pay the country's external, public and private debt. To illustrate the relevance of the present level, the external debt (public and private)-to-international reserves (1952-2008)-ratio started at 1.3 and reached 20 during the crisis of the early 1980s and then dropped gradually to as low as 0.96 in December 2008 - the lowest value in the series. For details, see the Statistical Annex at the end of the book.
[10] According to studies, these securities are ideal to make up most of the outstanding debt, with due regard for cost and risk criteria. For details,see Part II, Chapter 3.
[11] See Standard & Poor's report "Brazil's long-term foreign currency rating raised to investment grade BBB- Outlook Stable," April 30 2008.

Part I - UNTERSTANDING THE BRAZILIAN PUBLIC DEBT

Part I provides an historical and conceptual analysis of Brazil's public debt, exploring its main concepts and sustainability, and offering a view of its progress from its inception to the present. It is divided into four chapters, summarized below.

Chapter 1 - Origin and history of Brazil's public debt up to 1963

This chapter seeks to compile and analyze key aspects in Brazil's history of public debt. Each section is divided into periods (colonial, imperial and republican) and type of debt (domestic and external), with detailed accounts. Rather than presenting in-depth analyses of debt evolution at specific points in time, the first chapter offers an overview of events and challenges. This overview is important for understanding the issues during each period, which greatly affected public debt management in recent years.

Chapter 2 - History of public debt in Brazil: 1964 to the present

This chapter describes the evolution of domestic and external debt since 1964: It presents their quantitative development and illustrates the advances made from the institutional perspective, noting the challenges at each stage.

Regarding domestic debt, the chapter presents the reasons for increases in outstanding debt during the period and the connection to macroeconomic events. Also, it illustrates relevant institutional aspects as they relate to the domestic FPD. The history is particularly interesting since it shows how past policy decisions contribute to constraints on recent macroeconomic policy. As for the external debt, the chapter describes the different stages in its evolution and explains (1) the root causes of the 1980s' debt crisis, (2) how it was overcome and (3) the way in which access to international capital markets resumed.

The last part describes the current environment of relative stability in external debt management, emphasizing qualitative issuances, the buy-back program and the construction of a yield curve in local currency (i.e. in Brazilian real) in the international market.

Chapter 3 - Public debt sustainability

Since public debt should meet its objectives, as noted earlier in this Introduction, the issuer must adopt a credible policy in which contractual values are honored. In other words, public debt must be sustainable. In this regard, the chapter presents different evaluation measures that offer disciplined ways to determine if a policy is sustainable or not. Lastly, the chapter describes how public debt management can play a fundamental role in determining sustainability over time.

Chapter 4 - Public debt concepts and statistics

The first part of this chapter presents the main aspects of Brazilian public debt, along with government statistics and reports. An interesting feature relates to the recommendations from international organizations on the form and scope of public debt and compares their numbers with data published by Brazil, suggesting improvements that would complement the progress achieved to date.

Part II - MANAGING THE BRAZILIAN PUBLIC DEBT

Part II describes all aspects of FPD management, particularly the institutional framework and recent developments, the process of designing an efficient debt-financing strategy, risk management, public budget and its link to debt management, and finally, the regulatory framework and audit process. It is divided into five chapters.

Chapter 1 - Institutional structure and recent developments in Federal Public Debt management

In its introduction, the chapter describes how public debt management has adjusted to international best practices, including (1) the importance of coordinating with fiscal and monetary policies; (2) the process of developing effective governance; (3) the relevance of a prudent debt and risk management strategy; and (4) steps taken to improve the debt managers' technical capacity and information technology systems. Also, the chapter explains the country's trajectory from introducing reforms and developing debt management capacities to disseminating the details of good practices to other countries.

Chapter 2 - Strategic planning of the Federal Public Debt

Given the importance of suitable, consistent debt management strategies that take into account the optimal debt profile over the long term, the risks associated with the strategies, and the commitment to developing a public securities market, the chapter describes the main aspects in the planning of Brazil's public indebtedness: It highlights the economic background and changes in the Treasury's institutional framework, which influenced the strategic planning of the FPD, its management objectives - including the optimal debt structure in the long term (benchmark), and the stages in the transition strategy from the short to the long term.

Chapter 3 - Federal Public Debt risk management

Following the overall risk-management activities that were essential to the financial market and prudent rules that were adopted to manage specific risks identified by capital market regulators and central banks, the National Treasury launched a program in 2002 to build technical capacity and develop risk-management tools and systems. These were subsequently validated at a seminar of specialists from different countries and representatives of international organizations.

The chapter describes the scope of activities and challenges involved in managing Brazil's public debt risks and, in particular, how the National Treasury addressed these issues. Further, it examines the tools Brazil applied, the skills needed to use them and the responsibilities that had to be assumed so as to guide researchers and countries starting to build capacity about how to improve risk management.

Chapter 4 - The Federal Public Debt budget

This chapter explains the way in which the Brazilian budget is an essential tool for managing public funds and, specifically, the FPD. It presents the main features of the government budget as well as the processes/entities involved and Brazil's institutional financial and budget management framework. An interesting aspect is its focus on budget as it relates to the FPD which, besides operating under the same general rules as other public systems, is afforded special treatment, given the legal controls over public indebtedness and transparency: Within these legal constraints, debt managers still seek the flexibility needed to manage the debt and reduce budgetary risks.

Chapter 5 - Regulatory frameworks and government auditing of public debt

This chapter describes the regulatory framework and audit process, since consistent regulations and strong institutions are critical for managing public debt. In this regard, the text describes rules that set limits to the public debt and enforcement mechanisms such as penalties and evaluations by an independent government audit institution.

Part III - THE PUBLIC DEBT MARKET IN BRAZIL

Part III describes how the public debt market operates in Brazil. It reviews recent developments and follows with the characteristics of public securities traditionally used to finance debt, along with their pricing schemes. Next, it describes the organization of Brazil's financial markets, the operation of primary and secondary debt markets, the expansion of the investor base over time and the main holders of government securities. The final chapter describes the sale of public securities to individuals (small investors) over the Internet through the *Tesouro Direto* (Treasury Direct) Program developed by the Brazilian Treasury.

Chapter 1 - Recent evolution of the Federal Public Debt market

This chapter provides an overview of the FPD securities' market and highlights its recent developments against the backdrop of best practices reported by international organizations. The first part examines Brazil's public debt, taking into account macroeconomic developments, improvements in public debt management and the evolution of international markets, which have substantially affected both the domestic and external debt markets. Finally, it discusses the main steps taken to develop the market and the improvements achieved in light of best practices.

Chapter 2 - Pricing federal public securities

This chapter describes the main bonds the National Treasury uses to finance the FPD, their characteristics and calculation methodologies, as well as inputs that form the basis for their prices. It also highlights the institution's efforts over the years – collaborating with various market players – to simplify its instruments and ensure that investors value them correctly.

Chapter 3 - Organization of Brazil's financial market

This chapter reviews the main players within the financial market, such as class associations, clearinghouses and stock exchanges, and their relevance to the public security market and helping achieve the financial system's objectives. It also examines the roles and relevance of the agencies responsible for regulating intermediaries and investors who, in turn, are the ultimate security holders.

Chapter 4 - Primary market of the Federal Public Debt

The chapter reviews the securities the government issues through the National Treasury: It describes the institution's strategies and issuing methods in both domestic and international markets and discusses its liability management operations (buybacks and exchanges). The chapter also describes how the National Treasury adopted the principles of transparency and predictability, according to best international practices.

Chapter 5 - The investor base of the Federal Public Debt in Brazil

As noted by the World Bank (2007 and 2001),[12] countries must promote a diversified investor base in terms of investment horizons, risk preferences and motivation for asset trading, as this increases transactions, improves government bond liquidity and makes government financing feasible under different economic scenarios. To this end, Brazil has sought to expand and diversify its FPD investor base as well as increasingly improve its relations with representative groups.

The chapter describes this evolution and the composition of Brazil's investor base in public securities and examines the various groups' profiles in terms of security preferences and how these were included in strategic debt planning. Also, it discusses the main measures that were implemented, the practices adopted in investor relations, and the trends and challenges expected in the future.

Chapter 6 - The secondary market for Federal Public Debt

An efficient public financing mechanism needs a well-developed secondary public securities market through which price references for different assets are set. These, in turn, determine the financing cost of government securities. Thus, the degree to which investors can buy and sell securities in this market without high transaction costs (i.e. liquidity), is a variable that determines the extent of their interest in the assets. For this reason, debt management efforts should continually aim at improving the secondary market. The chapter describes the current features of this market in Brazil, as well as recent efforts to provide it with greater liquidity and transparency.

Chapter 7 - Treasury Direct: Internet public securities retail sales program

This chapter describes the Treasury Direct Program, an initiative developed and managed by the National Treasury, to sell public securities directly to individuals over the Internet. It reviews its growth since its inception in 2002 and its prospects, including a comparative analysis with programs in other countries.

The Editors

[12] See bibliographic references

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