



Monthly Report  
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# Tax results rekindle concerns about public debt financing sustainability

THE DISCLOSURE OF TAX RESULTS OF THE PUBLIC SECTOR REGARDING JULY 2009 REKINDLED THE DEBATE – ALREADY ONGOING – ABOUT RECENT IMPACTS OF POST-CRISIS SPENDING INCREASES AND THE SUCCESSIVE DECREASES IN FEDERAL COLLECTION ON SUSTAINABILITY AND THE BALANCE OF THE DEBT/GDP RATIO IN THE MEDIUM AND LONG TERMS.

FROM JANUARY TO JULY 2009, THE ACCUMULATED PRIMARY SURPLUS REACHED 2.25% OF GDP – EQUIVALENT TO R\$38.4 BILLION – A REDUCTION OF 3.38 PERCENTAGE POINTS COMPARED TO THE SAME PERIOD IN 2008 AND BELOW THE TAX TARGET IMPOSED FOR 2009 (2.5% OF GDP). FURTHERMORE, ALTHOUGH THE NOMINAL INTEREST RATE HAS DECREASED 0.98 PERCENTAGE POINTS OF GDP OVER THE SAME PERIOD IN THE PREVIOUS YEAR, REACHING 5.56%, THE NOMINAL DEFICIT WAS 3.31% OF GDP, 2.4 PERCENTAGE POINTS HIGHER THAN THE YEAR-TO-DATE FROM JANUARY TO JULY 2008.



The net debt of the public sector reached R\$1.283 trillion in July, or 44.1% of GDP.

In December 2007 and 2008, this ratio amounted to 43.9% and 38.8%, respectively.

Former director of Monetary Policy of the Central Bank of Brazil and current director of JGP Gestão de Recursos and ANDIMA, Economist Rodrigo Azevedo believes that, given the significant decrease in debt/GDP ratio over the past six years, the tax impairment occurred in 2009 can be absorbed without jeopardizing the solvency perspective of the public sector in the medium term. “What concerns, however, are uncertainties as to the possibility of reversal of a tax policy strongly expansionary and continuity of the decrease perspective in the Brazilian public indebtedness as from 2010”, said Azevedo. He added that “the levels of relation between Brazilian debt and GDP are still very high for countries under development similar to Brazil. In this context, the decrease in primary surplus of the federal government of 2.5% of GDP in December 2008 to 1.1% in the 12-month period up to June 2009 and the likely additional decrease to only 0.6% of GDP by December” stand out.

The 2009 results reflect the expansionary measures adopted by the government to reduce the effects of the international credit crisis on the level of domestic activity – especially spending increases and tax exemptions applied as from the end of 2008 – and there is consensus among market analysts that such a behavior was expected in public accounts.

A recent study released by FMI details the impacts of the crisis on public finances of G20 members, with the forecast that during 2009 and 2010, the tax deficit of these countries can be 5.5 percentage points of their GDP above the levels presented in pre-crisis period.

These results are a consequence of both tax incentive, measures adopted more quickly by the countries, such as the increase in public expenses, these ones adopted more slowly, due to the restrictions suffered by existing budget controls and delay in the adoption of new incentive programs, exactly as observed in the Brazilian case.

The study also highlights that an improvement in public accounts is expected with the recovery of the worldwide activity level over the next years, but it points out that for some countries, the impairment of the tax scenario and excessive increase in public indebtedness may bring more pronounced implications with regard to levels of risk and interest rates practiced in the medium term, in the event effective tax control measures are not adopted in the forthcoming periods.



Also according to the study, for the G20 average, the public indebtedness should be stabilized at 85% of GDP in the period from 2010 to 2014 – 23 percentage points above the pre-crisis level. However, the trajectories of advanced and emerging economies will be differentiated, with the former presenting indebtedness levels of 120% of GDP compared to 80% in the pre-crisis period, much higher than the level of Brazilian debt.

In Brazil, the results released by the Brazilian Internal Revenue Service related to July show another decrease in tax collection – a situation that is already repeated for nine consecutive months. Between January and July 2009, the total collection volume reached R\$380 billion, a 7.4% decrease over the same period of 2008 in actual terms, taking into consideration the IPCA (Extended Consumer Price Index) variation. The results increased the expectation on the moment when there will be a reversal of the decreasing trend of collection in response to the expected economic recovery as from the second quarter of 2009.

Also according to the Brazilian Internal Revenue Service, tax releases in the period from January to July totaled R\$15 billion. Considering revenues managed, IPI decreased 33.8% compared the same period in 2008 in actual terms; Cofins – PIS/Pasep, 12.3%, and Income Tax of Individuals and Legal Entities and CSLL (Social Contribution on Net Income), 10.7% and 9.7% respectively.

However, the biggest challenge in the tax policy conduction, and its subsequent effect in the medium and long terms, is the composition of public expenses and the government's capacity to release not only consumption, but also investments. Concern as to the scope of tax balance in future periods lies on the persistent increase in current expenditures, especially those related to personnel and security benefits.

Data disclosed by the Brazilian Treasury for the period from January to July 2009 show that the primary result of the Central Government was R\$20.1 billion, compared to

R\$68.6 billion recorded in the same period last year. While net revenues show a 5.4% decrease in actual terms, expenditures grew by 11.7%, mainly driven by spending on personnel, which rose 14.8%, also in actual terms.

In this regard, Rodrigo Azevedo believes that, despite the expected decrease in the cyclical component of revenues and small tax releases, the government accelerated the growth of federal expenses, which went from an actual increase of 6.6% in December 2008 to 9.1% up to mid-2009, composed mostly by strict



spending such as expansion of transfers and wages, factors more difficult to be reduced in the future. “This way it will be more difficult for us to return to the level of primary surplus observed in the pre-crisis period, which in the current context, would allow a virtuous circle led by a rapid reduction of public indebtedness over the next five years.” The advantages of this movement would be clear: reducing public

dis-savings would help more domestic resources to become available to finance investments; the Central Bank of Brazil would have its space expanded to reduce the level of actual interest of balance; and the pressure on the Checking Account deficit and the real appreciation would decrease. For Azevedo, the inevitable result would be to increase Brazil’s growth potential, which in his opinion, will be “a crucial subject to be debated in the 2010 presidential race”.

Accordingly, ANDIMA’s Committee for Macroeconomic Monitoring provides for the recovery of the Brazilian economy for the second half and projects a GDP growth of 4.2% in 2010. However, Azevedo considers that, even if it is concretized, such a scenario would not guarantee the generation of high primary surplus: “Working with an elasticity of collection of 1.5 in relation to GDP, and even considering a 4.5% growth in 2010, the primary surplus of the federal government should not be higher than 0.8% of GDP next year”. Among the main factors that will contribute to this, he highlights the rise in public functionalism and the rule for minimum wage increase, much higher than the inflation, among other expenses already contracted this year. “The most important is: trusting only in tax collection would be to insist on a drained adjustment model without an effective commitment to the rational control of expense increasing”, he says. “Given the high tax burden for the country, it is clear that this is not what Brazil needs”, he concludes, adding that “again, the commitment of candidates for President in 2010 seems to be the key for what should occur in the country in the medium term”.



## Interview – Otávio Yazbek

### **Crisis increases debate on regulation trends**

HAVING THE MOST CRITICAL PHASE OF THE FINANCIAL CRISIS THAT HAS ROCKED THE ECONOMY WORLD BEEN OVERCOME, THE ATTENTION TURNS TO THE DEBATE ON THE ADOPTION – ESPECIALLY BY GOVERNMENTS OF MOST AFFECTED COUNTRIES – ON MEASURES CAPABLE OF PREVENTING FURTHER TURMOIL IN THE FUTURE. IN AUGUST, WITH THE PURPOSE OF KNOWING THE PROPOSAL TO REFORMULATE THE US REGULATORY STATUS, ANDIMA’S SUPERINTENDENT OF PRODUCTS AND INSTITUTIONAL RELATIONS LUIZ MACAHYBA PARTICIPATED IN A PROGRAM OF VISITS TO MAJOR US FINANCIAL MARKET REGULATORS ORGANIZED BY THE US CONSULATE IN RIO DE JANEIRO WITH THE SUPPORT OF THE STATE DEPARTMENT. THE PROGRAM INCLUDED VISITS TO THE FEDERAL RESERVE BANKS OF CHARLOTTE AND NEW YORK, SEC – SECURITIES AND EXCHANGE COMMISSION, CFTC - COMMODITY FUTURES TRADING COMMISSION AND THE TREASURY DEPARTMENT. IN BRAZIL, THE DISCUSSIONS HAVE BEEN ACCOMPANIED BY THE CVM – BRAZILIAN SECURITIES AND EXCHANGE COMMISSION. IN THIS REGARD, IN ORDER TO ANALYZE TRENDS IN THE US REGULATORY FRAMEWORK, REFLECTED IN THE DOCUMENT FINANCIAL REGULATORY REFORM: A NEW FOUNDATION, FONTE ANDIMA INVITED THE OFFICER OF CVM OTÁVIO YAZBEK, WHO HIGHLIGHTED: “WE MUST BE AWARE OF THE IMPROVEMENTS THAT THESE DISCUSSIONS TEND TO GENERATE IN THE REGULATION, BUT BE CAREFUL NOT TO SIMPLY COPY SOLUTIONS BEING PROPOSED TO SPECIFIC PROBLEMS IN A VERY PECULIAR SYSTEM SUCH AS THE NORTH-AMERICAN ONE”.

**Lack of transparency, greater indulgence as to risks, especially in new products, over-reliance on rating agencies and weakening of control in structuring processes are some of the problems mentioned in the document released by the US Treasury. In your opinion, which are the most relevant problems to explain the crisis?**

In fact, the current crisis resulted from a combination of several factors which, in a very concrete plan, are outlined in the Treasury document. I believe it is important, however, with this more precise diagnosis, to seek to understand the “macro” determinants of the entire event. Thus, in general, all those elements are linked to the effects of financial innovation processes, to stimulus resulting from them to economic agents and the failure of regulations to deal with these



processes. This inability results both from the dynamics of innovation processes, which are much more agile than the response of the regulator and often occur in “gray areas” not yet regulated, as from some policy options (the choice for not regulating certain markets, such as the OTC derivatives, for example). It is interesting to highlight that almost the entire debate on regulatory structures, since the 1990s, already sought to deal with many of these difficulties – some countries have sought to respond to this debate, with the reformulation of their market regulation models; others, perhaps because of ideological positions, preferred to keep state regulators off those processes.

**With regard to the amendment itself, the document sets out five basic lines of action. The first two lines concern the expansion of regulation and supervision mechanisms for financial conglomerates and markets. What is your opinion on the initiatives proposed by the Treasury developed to achieve these two goals?**

It seems to me that the initiatives are based on a correct diagnosis – before the complexity of the market organization and the emergence of non-regulated products and agents, there is a gap to overcome, and this has to be a dynamic process. Many analysts expected the response from the US government to start from an extension of the competence of the agencies and the consolidation of some of these agencies, with a reduction in their number. With a lower number of regulators, with well-defined competences, the risk of “regulatory arbitrage” (that is, management of that variety by market agents to escape from more strict regulators) is reduced. Thus, for instance, in England it was chosen to create a single regulator (FSA) and, in Australia, the Twin Peaks model. The response from the US government frustrated many analysts while at the same time it proposed the strengthening in competence of some agencies and suggested the creation of new regulators. The possible competition between these regulators and the emergence of gray areas would be managed at another level in a Council of Supervision of Financial Services. I believe that without prejudice of not being the solution expected by many, if the model presented can overcome the differences among existing regulators, with the integration of procedures and sharing of information, and dynamically respond to the innovation processes, avoiding the creation of “gray areas” – two declared concerns of the Treasury involving political commitment – the purpose will have been achieved.

**The third line of action provides increasing investors protection, including the creation of a new regulatory agency. Drawing a parallel with the local market, this function is carried out in Brazil essentially by the CVM.**



**In your opinion, are there lessons from the current crisis that can improve the investor's defense mechanisms in Brazil?**

The CVM has sought in recent years to follow all international discussions on the matter, in the various forums in which it participates. It is worth pointing out, among recent initiatives, the suitability or the public hearing dealing with the improvement of disclosure of mechanisms of FIDC co-obligation or repurchase, considering that the latter is a theme which was highlighted in this recent proposal by the US government. My impression is that many of the responses of the Treasury regarding consumer protection tend to converge to standards that are discussed at these international forums. Thus, I think we should be aware of improvements that these discussions tend to generate in regulation patterns, but we must be careful not to simply “copy” solutions that are being proposed for very specific problems in a very peculiar system, such as the North-American one.

**Increasing the number of instruments available to face future crisis and enhance international cooperation schemes are the two latest guidelines. Concerning the second one, what are the main challenges of multilateral regulatory entities, such as Iosco and BIS?**

These are two different themes. The first one concerns availability for local governments, of instruments for crisis management, of systemic regulation itself. The second one concerns international cooperation schemes and is related to the fact that, today, in view of the globalization of financial activities, crises are no longer local. With regard to this second issue, I believe we are living the great time to international instances appreciation. On the one hand, the performance of those entities has always paid the price of any supranational entity – its recommendations are not binding, and should also be applied to very different realities. Today, it seems that the consensus around the importance of these entities and forums is much higher, so I think it is a great time to value them. Another topic that seems to be important is that, increasingly, these groups have been opened to the participation of emerging countries, which before had practically no voice. It is time for these countries to show some of the solutions that have been successfully adopted over the past years. I believe that Brazil, for instance, has a lot to show in terms of market transparency.

**One of the items specified in the proposal concerns the compulsory registration of derivatives transactions processed in the OTC market in environments with a central counterparty. What is your opinion about this idea?**

This issue was taken up in more detail in recent weeks, with the presentation to the Congress of the proposal of the Over-the-Counter Derivatives Markets Act. It



is interesting to observe that, by the proposal, derivative transactions gain much more in terms of transparency: or they are traded in trading systems (an execution facility) or registered in registration systems (a trade repository), or, in the event of difficulty in registration, in one of those systems, directly reported to the regulator. This model is very similar to that adopted in Brazil since at least the early 90s, and for which we have been often criticized. What was said was that the obligation to record in a centralized system reduces market flexibility and its ability to innovate, which to some extent may be true. On the other hand, the centralization of information provides greater transparency to regulators and it is an important support for prudential and conducts regulations. We deal here with a tension that is always present for regulators, between the flexibility demanded by the market and the required security and transparency. I believe it is important, in view of the scenario presented with the crisis, to value the mandatory registration of transactions, not only as support for regulators, but also as a source of information for market agents themselves, for better risk management.

**Although acknowledging the fragmentation of the US regulatory system as a problem, the document proposes the creation of a Council of Regulators and two new agencies. Wouldn't the consolidation of the system be more appropriate in this case, eventually in the direction of a model such as Twin Peaks?**

This was what many expected and it would be a coherent response with the international debate. However, the adoption of solutions related to regulatory structures and competencies is always connected to market local structures and political determinants. Most likely, the model proposed was the one which was possible, which does not always match the ideal model.