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Brazil's Enormous Interest Rate Tax: Can Brazilians Afford It?

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Executive Summary

Brazil is currently paying a very high price, in terms of its economic growth, employment, development, and social progress due to its exorbitantly high interest rates. Interest payments on the public debt for 2016 are estimated at 7.6 percent of GDP. This is the fourth-highest interest burden in the world (out of a total of 183 countries). Other countries with a similar burden, such as Yemen and Egypt, are plagued by civil conflict and other risk factors that would be expected to increase the probability of default. Brazil, by contrast, has little risk of default, and with 360 billion USD in international reserves, there is not much likelihood of balance of payments crises that could lead to runaway inflation.

The largest component of government debt consists of bonds tied to the Selic rate, which is the overnight lending rate set by the Central Bank. These bonds make up 44.4 percent of government debt. Since January of 2003, the nominal Selic rate has averaged 13.25 percent and the real rate (adjusted for inflation) has averaged 6.1 percent. This is an extremely high real interest rate over this period, which also appears to be unexplainable by known risk factors.

For 2003–2015, Brazil's real policy interest rate (the Selic rate) was the fifth-highest in the world (out of 68 countries that have five years of data). Again, the few countries with higher interest rates, such as the Democratic Republic of Congo or Tajikistan, are not in the same category as Brazil for the various factors expected to affect interest rates.

The evidence presented in this paper indicates that Brazil's exorbitantly high interest rates are a policy choice, rather than a result of structural factors such as chronically low savings rates. The high interest rates are part of a policy of inflation targeting that has often worked by using interest rates to raise the value of Brazil's currency (the *real*), thereby lowering the prices of tradable goods. This policy has often been procyclical, thus adding to the damage to employment and growth during downturns.

Brazil's largest banks may use both their market power and political power to support Brazil's high interest rate regime. Their share of assets has increased from 53 percent in 2003 to 70 percent today. Between mid-2012 and 2016, the spread between the banks' average (commercial and consumer) lending rate and their cost of funds increased from 12.8 to 23.9 percent. This was at a time when the economy was slowing and then went into deepening recession, which has become Brazil's worst downturn in more than three decades.

It appears that banks were able to make up for the decline in credit growth not only by the higher and risk-free yield from government bonds, but by increasing the spread between their lending and borrowing rates. This could be due to the relative lack of competition in the financial sector.

The safe guaranteed return from government bonds — not only the high Selic rate, but other bonds that offer protection against inflation or changes in the exchange rate — are an enormous source of profitability for Brazil's financial sector. For the years 2003–2015, the profits of the four biggest banks rose by 460 percent — from 5 billion *reais* to more than 28 billion reais.

In the immediate present, one of the most damaging aspects of Brazil's high interest rates is the weight of interest payments in the national budget, in the context of the highly dysfunctional national debate over Brazil's central government budget deficit. The increase in the interest burden of the debt since 2012 accounts for about half of the increase in the central government budget deficit, which has risen from 2.5 percent of GDP to a projected 10.4 percent of GDP for 2016.

Lower interest rates could open up fiscal space for a sizable stimulus that could help bring about an economic recovery. However, the government has gone in the opposite direction, achieving the passage of a constitutional amendment to hold real (inflation-adjusted) federal spending constant for the next 20 years.

As can be seen in **Figure 4**, Brazil had very little GDP per person growth for the entire 23-year period of 1980–2003, less than 0.2 percent annually. From 2003–2011, per capita GDP growth rebounded sharply for an annual average of 3.3 percent. But growth began to slow in 2011; for 2011–2016, we have a projected average fall in per capita GDP of 1.3 percent annually. Brazil is now more than halfway to reproducing — or, at this rate, doing much worse than — the lost decade of the 1980s.

Like the unprecedented long-term growth collapse of 1980–2003, the current slump is the result of macroeconomic policy errors. Brazil's unique interest rate policies are a major part of the policy mistakes that, if not subject to serious and long-term change, could condemn the country to another very long period of profound economic failure.

Brazil's Enormous Interest Rate Tax: Can Brazilians Afford It?

For many years, Brazil has ranked at or near the top of all countries in terms of both its real interest rates and the interest burden on its public debt. **Table 1** shows the top seven countries in the world in terms of the percentage of GDP they are estimated to pay on their public debt in 2016. Chronically high real interest rates can have many costs, including the slowing of investment, economic growth, and development, and all of the attendant effects of reduced employment and upward redistribution of income and wealth. The annual interest payments on the public debt do not encapsulate these broader impacts, but they are one important measure of the immediate burden of high interest rates. They are also particularly important in a time when there is political pressure to reduce government spending, as is the case currently in Brazil. Brazil ranks fourth of 183 countries for which data is available, allocating 7.63 percent of GDP for interest payments on the debt.

TABLE 1

Comparison of Countries with Highest Interest Burdens

Country	Interest Burden (% of GDP)	Gross Debt (% of GDP)	Net Debt (% of GDP)	International Reserves (in months of imports)	Current Account Balance (% of GDP)
Lebanon	9.15	143.87	137.67	32.23	-16.03
Gambia	8.81	99.44	99.44	1.54	N/A
Yemen	8.36	82.38	81.31	5.12	-8.02
Brazil	**7.63**	**78.28**	**45.83**	**22.68**	**-3.32**
Egypt	7.63	94.63	86.17	2.73	-1.98
Jamaica	7.60	118.85	N/A	6.51	-0.14
Ghana	6.36	65.97	64.18	3.79	-1.90

Source and notes: Interest Burden data, authors' calculations, IMF (2016d). Gross and Net Debt data from IMF (2016d). Current Account Balance data, authors' calculation based on data from IMF (2016a) and IMF (2016d) (data for 2015, except Egypt 2014). International reserves data, authors' calculations based on data from World Bank (2016) and IMF (2016b). For International Reserves, all data is from 2015, except for Gambia.

A large interest burden from the public debt, as a percent of GDP, is a result of some combination of a large debt (relative to GDP) and high interest rates on the outstanding debt. For example, Lebanon ranks first in Table 1, paying more than 9 percent of GDP annually on its public debt. But it has a much larger public debt than Brazil; with a gross debt of 144 percent of GDP, the implied nominal interest rate on its debt is about 6 percent, as opposed to about 10 percent for Brazil. Also, Lebanon is running an enormous current account deficit of 16 percent of GDP, which carries some risk of a balance of payments crisis. In such circumstances, we would expect higher interest rates in order to keep capital in the country. Balance of payments crises can also lead to very high inflation, which poses risks to bondholders.

The other countries with interest burdens comparable to Brazil also have serious problems that could be expected to increase the risk of default and/or to raise the interest rate on their debt. Yemen is currently engulfed in a brutal civil war and has suffered from considerable political instability for many years. Egypt, with an interest burden the same as Brazil's, has also been politically unstable, especially in the past six years; and as recently as 2009, before the political unrest heated up, its interest burden was just 3 percent of GDP. Jamaica has long suffered from an unsustainable debt burden even after two debt restructurings, the last one in 2013.[1] It has had negative per capita GDP growth over the past 20 years, partly because of the burden of its unsustainable debt.[2] Jamaica is currently operating under an IMF agreement, which, like previous agreements, commits the government to a monetary policy that is acceptable to IMF authorities.

We can see that Brazil is not comparable to any of these countries with high debt burdens in terms of its circumstances and the risk of default. Although Brazil's congress has recently impeached President Dilma Rousseff, the whole process and result never contributed to any increased risk of default. In fact, the financial markets reacted with great enthusiasm to the impeachment process and its results, with the Brazilian currency rallying by more than 25 percent since the beginning of 2016,[3] and the stock market climbing by 50 percent so far this year — one of the best performances in an emerging market country over this time period for both the currency and the stock market.

Brazil's current account deficit was 3.3 percent of GDP for 2015. The government holds more than 360 billion USD in foreign exchange reserves, an amount equivalent to nearly two years of imports. This is a very large amount of international reserves; normally reserves that would pay for a few months of imports for a country like Brazil would be considered sufficient. Brazil does not appear to be vulnerable to serious balance of payments problems in the foreseeable future.

Brazil's gross debt is now estimated at 78.3 percent of GDP, with net debt at 46 percent. Brazil's high interest burden is the result of the high interest rates that it pays on its gross debt; this is much higher than the interest that it receives on its assets, e.g., the 360 billion USD in international reserves. These are mostly invested in relatively low-yielding, liquid assets such as US Treasury securities. We estimate the average interest rate on Brazil's general government gross debt to be about 10.4 percent in 2016.[4]

1 See Johnston (2013) and Johnston (2015).
2 See Serrano and Summa (2015) and Weisbrot, Johnston, and Lefebvre (2014).
3 Banco Central do Brasil (BCB) (2016g).
4 This is from interest payments in the 12 months until August 2016 divided by general government gross debt as of August 2016. See BCB (2016d), Quadro III and Quadro XIX. This is in line with IMF calculations and projections. See IMF (2015), p.7.

In any case, the persistent high interest rates on Brazil's debt cannot be explained by a risk of default, inflation risks, or the risk of balance of payments crises. About 95 percent of Brazil's public debt is in domestic currency. Although inflation spiked last year to 10 percent, it has since receded and more importantly was within its target range of 2.5–6.5 percent from 2004 through 2014.[5]

Table 2 shows the composition of this debt since 2006.

TABLE 2

Composition of Brazil Debt by Year

(percent of overall debt)

	Exchange Rate Index	Price Index	Selic Index	Pre-Fixed	Other
2006	11.85	20.20	35.55	30.03	2.37
2007	7.66	22.29	37.61	30.28	2.17
2008	8.52	22.49	43.35	23.97	1.67
2009	5.63	21.17	47.20	24.41	1.59
2010	5.34	23.16	39.14	30.67	1.69
2011	4.79	23.98	38.73	30.80	1.70
2012	4.91	26.55	35.97	30.83	1.73
2013	5.36	26.73	33.35	32.25	2.30
2014	5.82	24.65	37.72	29.15	2.66
2015	6.88	23.23	39.20	28.06	2.63
2016	5.53	22.13	44.41	25.51	2.41

Source and notes: End of year data, except for 2016 (August). BCB (2016d).

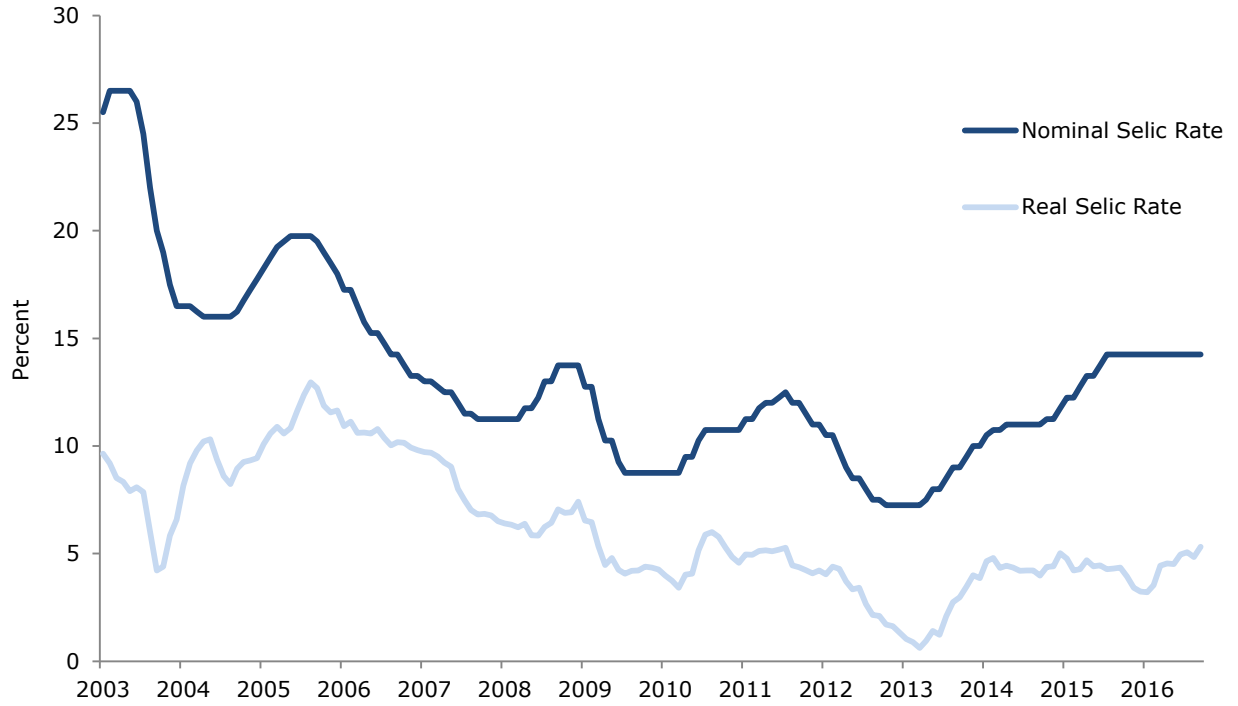
The biggest component of the debt, at 44.4 percent, has interest rates determined by the Selic rate. This is the overnight rate, or policy rate set by the Brazilian Central Bank.

Figure 1 shows the evolution of the Selic rate, both nominal and real, since January of 2003. The nominal rate has averaged 13.25 percent and the real rate 6.1 percent. This is an extremely high real interest rate over this period, which also appears unexplainable from any known risk factors.

5 See Weisbrot, Johnston, and Lefebvre (2014).

FIGURE 1

Nominal and Real Selic Rate Over Time



Source: BCB (2016f).

Table 3 shows the ten countries with the highest real policy interest rates in the world for the period 2003–2015. Brazil ranks fifth with 6.35 percent, behind the Democratic Republic of Congo.

TABLE 3

Highest Real Policy Interest Rates, 2003–2015

(percent)

Country	Real Policy Rate
Gambia, The	12.82
Tajikistan	12.67
Belize	10.19
Congo, Democratic Republic of	9.11
Brazil	**6.35**
Ghana	3.66
Kenya	3.49
Bahamas, The	3.08
Sao Tome and Principe	3.00
Senegal	2.51

Source and notes: Data for 68 countries that have at least the last five years of data available. IMF (2016c).

Francisco Lopes recently examined a number of possible theoretical explanations for Brazil's excessively high interest rates, including fiscal deficits, "inflation bias," excess demand for investment, and a structural deficiency in private savings.[6] He finds that none of them seem likely.

6 Lopes (2014).

On the other hand, the Central Bank's high interest rate policy is part of a system of inflation targeting. This is a deliberate policy program, rather than a structural cause such as a chronic deficiency in private savings. Inflation targeting in Brazil means that the Central Bank strives for just one policy objective, which is to keep inflation within a certain target range. But inflation in Brazil is mainly a "cost-push" phenomenon, with costs coming primarily from external changes, rather than being driven by domestic demand. This means that when the Brazilian Central Bank raises interest rates it appreciates the value of domestic currency, and thus keeps inflation in check by lowering the prices of tradable goods. From 2004–2010, for example, the Central Bank was able to keep inflation within its target range mainly through the influence of its monetary policy over the exchange rate.[7]

There is evidence that the inflation targeting regime leads to higher average interest rates because of an asymmetry in the Central Bank's moves. When inflation is rising, the Central Bank will tend to act quickly and raise interest rates, thus appreciating the *real*. But when inflation is falling, there is less incentive to lower interest rates, because there is not much of a perceived threat from deflation. There is also a general bias in the inflation-targeting regime toward prioritizing the inflation target and not worrying as much about fluctuations in output and employment.[8]

It is worth noting that this bias toward higher interest rates is also related to the procyclical bias of monetary policy that developing countries with open capital markets generally face. For example, when there is an outward flow of capital due to some external shock from the international economy, the Central Bank will raise interest rates in order to stem the outflow. This adds to the slowdown of the economy that has already begun. On the upswing, if the Central Bank lowers interest rates in response to excessive capital inflows, this is also procyclical, as it stimulates an economy that is already getting a boost from incoming investment.

In addition to the evidence that Brazil's inflation-targeting regime leads to chronically and excessively high interest rates, there is also evidence that the political and market power of the country's banking and financial sector plays an important role in keeping interest rates too high.

The four largest banks in Brazil, two of which are public banks, control 70 percent of the commercial banking system's total assets.[9] This is up from 53 percent when the Workers' Party presidency began in 2003.[10] These banks and other financial institutions benefit enormously from

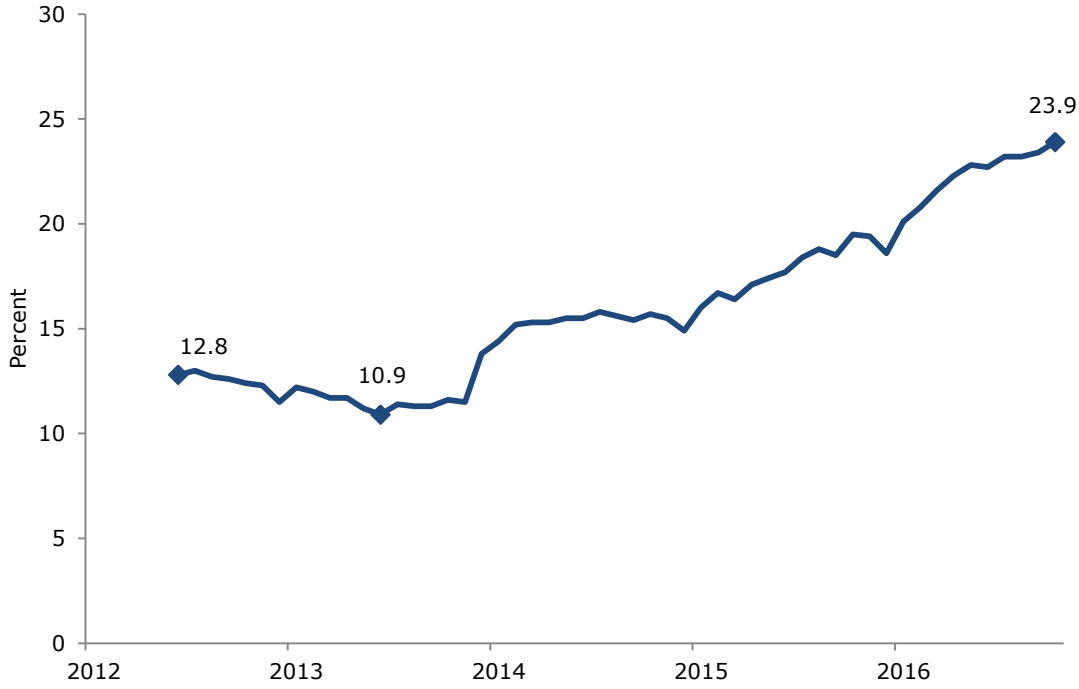
7 See Serrano and Summa (2015) for more detail.
8 See e.g., Libânio (2008).
9 BCB (2016b).
10 Ibid (2016a).

Brazil's extraordinarily high interest rates. This is true even when the economy is slowing or in recession, a fact that may further contribute to the procyclicality of monetary policy in Brazil.

Figure 2 shows the spread between banks' average (commercial and consumer) lending rate and their cost of funds between mid-2012 and 2016 (first 10 months). It increases from 12.8 to 23.9 percent. This is at a time when the economy was slowing, then went into recession at the beginning of 2014, which then deepened into Brazil's worst downturn in more than three decades.

FIGURE 2

Bank Spread Between Lending Rates and Cost of Funds, 2012–2016



Source: Author's calculations, BCB (various years), "Monetary Policy."

The safe, guaranteed return from government bonds — not only the high Selic rate, but other bonds that offer protection against inflation or the changes in the exchange rate — are an enormous source of profitability for Brazil's financial sector. In **Table 4**, we can also see the increase in banks' income from government bonds from the end of 2012 to mid-2015. It rises from 50.7 billion to 67 billion reais, or by 32 percent — more than any other banking operation. Since the administrative and other expenses associated with investment in government bonds are very low, the contribution of government bonds to the banks' profits is much greater than its proportion of total revenue.

TABLE 4

12 Month Accumulated Income, Before Tax, From Selected Operations

(billions of reais)

Date	Credit	Treasury	Services
December 2012	108.9	50.7	87.6
June 2013	115.6	48.1	92.3
December 2013	115.9	46	96.6
June 2014	113.5	54.6	99.5
December 2014	116.9	59.1	104.3
June 2015	116.6	67	108.7

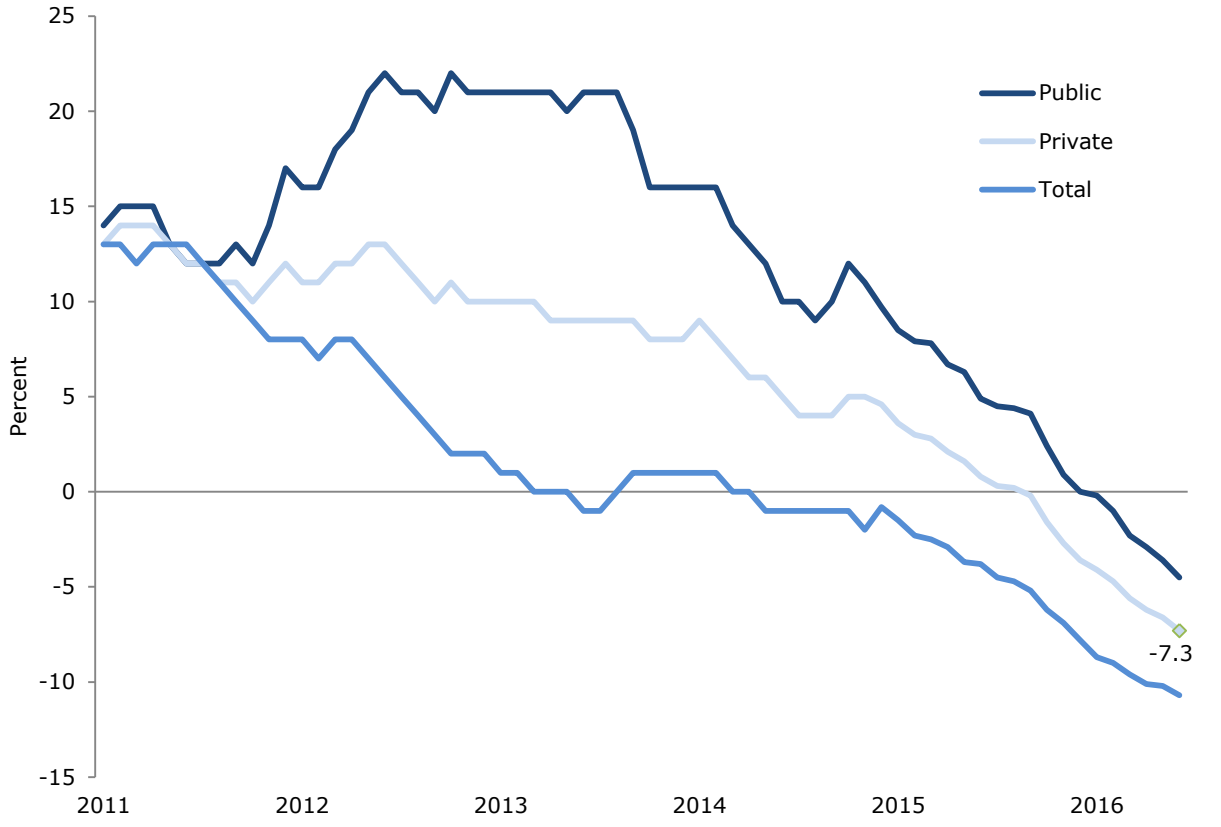
Source: BCB (2015), Table 2.4.3

For the years 2003–2015, the net profits of the four biggest banks rose by 460 percent — from 5 billion reais to more than 28 billion reais.[11]

It is worth noting that the banks' spread increases at the same time that the banks' lending drops off during the recession. As can be seen in **Figure 3**, the real rate of growth of credit falls from an average monthly rate of 12.25 percent in 2011 to a negative 5.75 percent for 2016 (first six months).

FIGURE 3

Real Credit Growth, 2011–2016



Source and notes: BCB (2016e), Table 2.3.2.

11 BCB (2016a).

It appears that the banks were able to make up for the decline in credit growth not only by the higher and risk-free yield from government bonds, but by increasing the spread between their lending and borrowing rates. This could be due to the relative lack of competition in the financial sector.

In 2012, the government engaged in a public, political battle with the private banks to try to force them to lower interest rates. The government succeeded in getting the two largest public banks, Banco do Brasil and Caixa Econômica Federal, to lower rates but then had problems getting the largest private banks to follow suit. On May 1, Labor Day in Brazil, President Dilma Rousseff took the fight to national TV and radio: "It's unacceptable that Brazil, with one of the most solid and profitable financial systems, maintains one of the highest interest rates in the world. They can't be so high. Today's Brazil does not justify them," she said.[12] But two-and-a-half months later, finance minister Guido Mantega noted that the private banks were still "doing very little to expand credit" and that banking spreads (the difference between interest rates paid by banks to investors and the rates they charge to borrowers) were "way too high and there is no justification for it."[13]

The Selic rate was lowered from 12.25 percent in June 2011 to a low of 7.25 percent in December 2012. Then, beginning in June 2013, a new round of procyclical tightening began, bringing the Selic rate up to 14.25 percent over the next two years, then lowered to 13.75 percent today.

There is an upside to the banks' access to excessively high and safe returns during downturns, as well as their concentration and market power. As a number of observers have noted, this means that the financial system in Brazil is much less vulnerable to systemic financial crises than in many other countries. Brazilian banks are able to have the best of all worlds: liquidity and high-yielding, safe assets. With zero-risk government bonds making up a large part of their portfolio, and the government offering protection against devaluation and inflation, it is easier for the Brazilian banking system to meet risk-weighted capital requirements. The Brazilian banking system did relatively well during the 2008–2009 financial crisis and recession. Part of this is due to a number of structural changes, including important regulatory reforms in the mid-1990s, as well as emergency measures to increase liquidity during the 2008 crisis.[14] But part of it is also due to the consolidation of the financial sector, which was encouraged during the 1990s reforms, as well as by the banking system's access to safe, high-yielding government bonds.

12 Folha de São Paulo (2012).
13 BBC Worldwide Monitoring Service (2012).
14 See Sobreira and Paula (2010) for an overview.

Conclusion

Whatever the advantages to the stability of the banking system that are provided by its consolidation and oligopoly structure, and the exorbitant interest rates on safe returns provided by government securities, the cost to the Brazilian economy of this system is far too high. Despite a large expansion of credit from 20 percent of GDP to 49 percent of GDP from 2004 to 2012, Brazil's credit relative to the size of its economy remains low as measured by comparable countries.[15] Brazil's high interest rates limit credit growth; this was clear in consumer borrowing (including mortgages) during the recent expansion, when the high interest rates soon led to unsustainable debt payments as households acquired more debt.[16] Annual interest rates for nonearmarked loans as of March 2016 were 71.4 percent for individuals, and 30.6 percent for corporate borrowers.[17]

Most immediately damaging today, however, is the weight of interest payments in the national budget, in the context of the highly dysfunctional national debate over Brazil's central government budget deficit. The increase in the interest burden of the debt since 2012 accounts for about half of the increase in the central government budget deficit, which has risen from 2.5 percent of GDP to a projected 10.4 percent of GDP for 2016.[18] Much of the rest of the increase in the deficit is the result of falling revenues and some automatic expenditures due to the recession/depression; and of course the increase in the deficit looks bigger as a percent of GDP because of the reduced growth of nominal GDP due to recession. But even if we simply look at the difference between the government's interest payments of 2016 and 2012, as a percent of GDP, it is 3.2 percentage points of GDP. This would be enough to provide a healthy stimulus without any increase in the federal deficit, under a lower interest rate regime.

Unfortunately, the weight of much of the media, both Brazilian and international, as well as the analysts and commentators cited in the debate, have produced a profoundly destructive narrative. The idea, long rejected by much of the economics profession, is that Brazil's deficit spending is the primary cause of the country's economic crisis, rather than the result of both the crisis itself and of policy-induced exorbitant interest rates.

15 See IMF (2013).
16 See Serrano and Summa (2015) for more detail.
17 BCB (2016c).
18 This is an increase of 256 billion reais in interest payments, out of the 518 billion increase in the budget deficit for 2012–2016 (estimated).

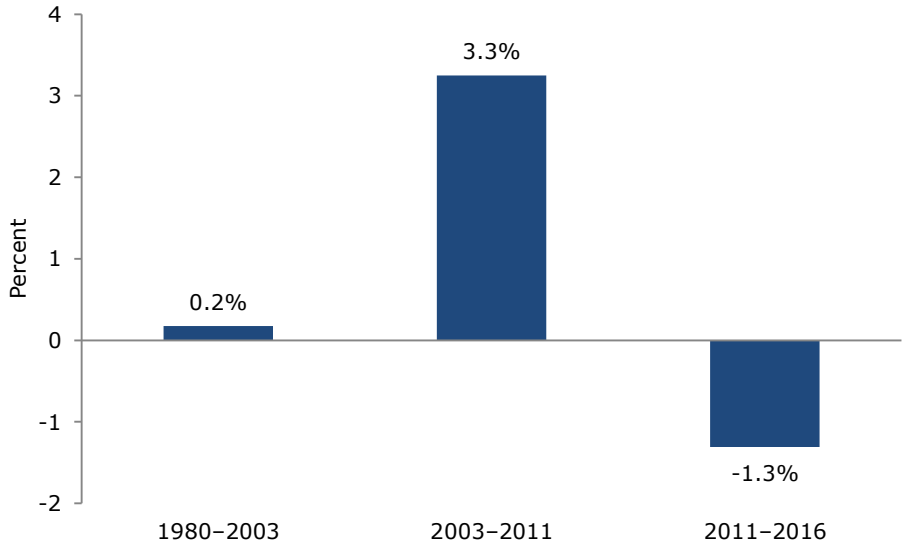
On the basis of this narrative, the Brazilian Senate has passed a constitutional amendment restricting future federal government spending for the next 20 years to 0 increases beyond the rate of inflation. If adhered to, this will certainly impede Brazil's economic recovery, which has not yet even begun.

In a downside scenario that has been experienced most recently in Greece as well as other countries implementing austerity in recession, attempts to increase the primary budget surplus as a percent of GDP can lead to a prolonged depression, as a continuing decline in GDP and falling revenues make it increasingly difficult to meet the moving target of the primary surplus/GDP ratio.

As can be seen in **Figure 4**, Brazil had very little growth of GDP per person for the entire 23-year period of 1980–2003, less than 0.2 percent annually. (This was after a 20-year period of having one of the fastest growing economies in the world.) From 2003–2011, per capita GDP growth rebounded sharply, for an annual average of 3.3 percent. But growth began to slow in 2011; for 2011–2016 we have a projected average annual fall in per capita GDP of 1.3 percent. Brazil is now more than halfway to reproducing — or, at this rate, doing much worse than — the lost decade of the 1980s.

FIGURE 4

Brazil: Average Annual Growth of GDP per capita, 1980–2016



Source and notes: IMF (2016d).

Like the unprecedented long-term growth collapse of 1980–2003, the current slump is the result of macroeconomic policy errors. These errors are now being compounded as the current government doubles down on austerity. Of course, there were external shocks to Brazil's economy in the past six years, in terms of commodity prices and exports, but these played a very small role, as compared to

macroeconomic policy errors, in the recession that has developed.[19] With foreign exchange reserves of more than 360 billion USD, Brazil is not facing balance of payments constraints on its economic recovery. Brazil's unique interest rate policies are a major part of the policy errors that, if not subject to serious and long-term change, could condemn the country to another very long period of profound economic failure.

19 See Serrano and Summa (2015) for more detail.

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