André Soares Loureiro and Fernando de Holanda Barbosa
May, 2004

André Soares Loureiro † Fernando de Holanda Barbosa‡

Abstract

The goal of this paper is to identify the determinants of the risk premium on Brazilian government debt traded in the emerging markets bonds. The empirical evidence presented does not reject the hypotheses that fiscal solvency and the size of the public debt affect the risk premium as measured by the spread over treasury securities of the Brazilian C-bond.

Keywords: risk premium, government debt

JEL Classification: E44, E62, F32, F34

∗ The views expressed here are those of the authors and do not reflect the institutions they are affiliated to.

† Graduate School of Economics, Getúlio Vargas Foundation. E-mail: andre@fgvmail.br

‡ Graduate School of Economics, Getúlio Vargas Foundation. E-mail: fholanda@fgv.br
1 Introduction

Government liabilities issued by emerging market countries are not considered to be risk free assets since they pay a risk premium above these assets. The risk premium is the difference between the yield on a security that has a default risk and the yield on a corresponding security that is free of such a risk, usually the American Treasury securities.\(^1\) Thus, this risk premium should be explained by the variables that affect the default risk of the security that has a probability of being in default. The model we use in this paper attempts to explain the risk premium through the following set of variables: i) market coefficient of risk aversion, ii) relative supply of the security, iii) degree of government solvency, and iv) degree of country solvency. We use the most liquid bond issued by the Federal Republic of Brazil, the C-Bond, to test this model for the period 1996-2002. Muinhos, Alves and Riella (2002) and Muinhos and Alves (2003) also modeled C-Bond spread over treasury securities, using fiscal, external trade and solvency/liquidity variables. As most of these series showed up to be integrated of order one, they worked with them in first differences. Here we use a cointegration procedure based on Johansen’s methodology and found evidence that fiscal solvency and the size of the public debt affect the risk premium as measured by the spread over treasury securities of the Brazilian C-bond.

The principal instrument used by the market to measure the risk premia for emerging markets bonds is the JP Morgan Emerging Market Bond Index Plus (EMBI+).\(^2\) Figure 1 illustrates the behavior of the indexes EMBI+ Brazil and EMBI+ Emerging Markets, since 1999, when Brazil adopted a floating exchange rate regime. Although Brazil has a high share in the EMBI+ Emerging Markets (about 28 \%), the behavior of the indexes shows that the risk premium on Brazilian government securities is strongly correlated with the risk premium on securities of other emerging economies, except for moments of domestic crises like the change in the exchange rate regime in 1999 and 2002 electoral cycle.

---

\(^1\)This difference is computed over securities of equal duration.

\(^2\)The Emerging Markets Bond Index Plus (EMBI+) tracks total returns for traded external debt instruments in the emerging markets. The instruments include external-currency-denominated Brady bonds, loans and Eurobonds, as well as U.S. dollar local markets instruments. The EMBI+ expands upon Morgan’s original Emerging Markets Bond Index, which was introduced in 1992 and covers only Brady bonds.
This paper aims at identifying the factors that explain the movements of the risk premium on Brazilian government debt traded in emerging markets bonds. It is organized as follows: Section 2 presents a model where the risk premium is a function of the debt size and a set of variables that could trigger a confidence crisis in the sustainability of the public and external debts; Section 3 describes the data and presents the empirical evidence based on the econometric analysis; Section 4 concludes the paper.

2 Model

The basic model is based on Dornbusch’s version of the CAPM portfolio selection model (1983) and its extension to the Italian case by Cottarelli and Mecagni (1990). The former captures the relative supply effect while the latter introduces the default probability in the expected yield of a government security.

2.1 Relative Supply Effect

The model is a two-period expected utility maximization for an individual faced with two securities with random real returns. The random returns on these securities are characterized in terms of their means and variances-covariances and the portfolio composition can be stated in terms of the parameters of risk aversion and the structure of returns.
Let $w, r, r^*$ and $x$ be the initial level of real wealth, the random returns on the benchmark and government securities and the portfolio share of government securities respectively. End of period wealth is random and equal to:

$$\tilde{w} = w(1 + r) + xw(r^* - r)$$  \hspace{1cm} (1)$$

Utility is function of the mean and variance of end of period wealth:

$$U = U(\tilde{w}, \sigma^2_{\tilde{w}})$$  \hspace{1cm} (2)$$

The mean and variance of end of period wealth are defined as:

$$\tilde{w} = w(1 + \tilde{r}) + xw(r^* - \tilde{r})$$  \hspace{1cm} (3)$$

$$\sigma^2_{\tilde{w}} = w^2[(1 - x)^2\sigma^2_r + x^2\sigma^2_{r^*} + 2x(1 - x)\sigma_{rr^*}]$$  \hspace{1cm} (4)$$

where $\tilde{a} = E(a)$. Maximizing utility (Eq. (2)) with respect to $x$ yields the optimal portfolio share:

$$x = \frac{(r^* - \tilde{r}) + \theta(\sigma^2_r - \sigma_{rr^*})}{\theta\sigma^2}; \sigma^2 \equiv (\sigma^2_r + \sigma^2_{r^*} - 2\sigma_{rr^*})$$  \hspace{1cm} (5)$$

where $\theta = -\frac{U_{2w}}{U_1}$ is the coefficient of risk aversion and $\sigma^2$ the risk premium variance.

Equation (5) shows that portfolio selection depends on yield differentials, risk aversion, and the variance-covariance structure of the returns. As pointed out in Kouri [(1978a) apud Dornbusch], the portfolio share can be divided into two components:

$$x = \frac{(r^* - \tilde{r})}{\theta\sigma^2} + \alpha; \alpha \equiv \frac{(\sigma^2_r - \sigma_{rr^*})}{\sigma^2}$$  \hspace{1cm} (6)$$

The first is a speculative component and the second component corresponds to the share of a minimum variance portfolio. It is readily shown that $\alpha$ is the share of the government

---

3 The same results could be obtained if we use a CARA utility function defined over the end of period wealth and if the returns follow a bivariate normal distribution. In that case, end of period wealth would be normally distributed and utility function of the mean and variance of that variable.

---
security in a portfolio chosen to minimize the variance of wealth.\textsuperscript{4} Thus, investors allocate their wealth to a minimum variance portfolio and issue one of the securities using the proceeds to hold another as a speculative portfolio.

The optimal portfolio share in Eq. (6) is for an individual asset holder. To proceed to the condition of market equilibrium we have to aggregate across investors, all of whom share the same information, but may differ in their wealth or risk aversion. Nominal demand for asterisk-type bonds (government securities) is $x_j W_j$.\textsuperscript{5} Denoting the nominal supply of government bonds by $V$, the market equilibrium condition becomes $V = \sum x_j W_j$. Using the definition of aggregate nonmonetary wealth, $\bar{W} = \sum W_j$, the equilibrium condition can be expressed as:

$$V = \left[ \frac{(\bar{r}^* - \bar{r})}{\theta \sigma^2} + \alpha \right] \bar{W} = \theta \sigma^2$$

where $\theta = \sum \frac{\theta_j}{W_j}$ now denotes the market coefficient of relative risk aversion, being a wealth-weighted average of the individuals coefficients. Equation (7) can be solved for the market equilibrium real yield differential:

$$\bar{r}^* - \bar{r} = \theta \sigma^2 \left( \frac{V}{\bar{W}} - \alpha \right)$$

This yield differential has three determinants. The higher risk aversion, $\theta$, the larger the yield differential. In the same direction works an increase in relative yield variability, $\sigma^2$. The third determinant is the relative asset supply. It takes the interesting form of a yield differential proportional to the difference between the actual relative supply, $V/\bar{W}$, and the share of the asset in the minimum variance portfolio, $\alpha$.

Following the mean-variance approach to portfolio choice, the increase in the yield differential required to accomodate a change in relative supply may also be interpreted as an increasing risk premium because it offsets the utility loss occurring when investors

\textsuperscript{4}Speculative holdings of the other security are $-\frac{(\bar{r}^* - \bar{r})}{\theta \sigma^2}$ so that across assets the speculative portfolio sums to zero. The minimum variance portfolio is independent of risk aversion, of course, and its composition depends only on the relative riskiness of the two bonds.

\textsuperscript{5}Here $x_j$ depends on the investor’s risk aversion and $W_j$ denotes her nominal, nonmonetary wealth.
move away from the minimum variance portfolio. Clearly, however, this risk premium has a
different nature from a default risk premium.

2.2 Default risk

When there is a positive default probability, the expected yield on any security \( i \) can be
expressed as \( E(r_i) = r_i^{Ne} - p_i t_i \), where \( r_i^{Ne} \) is the expected yield in the absence of default
and \( p_i t_i \) the expected cost of default. Since \( \bar{r} = E(r_g) \) is the expected yield on a emerging
market government security and \( \bar{r} = E(r_a) \) is the expected yield on American security,
equation (8) can be rewritten as:

\[
r_g^{Ne} - r_a^{Ne} = \theta \sigma^2 \left( \frac{V}{W} - \alpha \right) + p_g t_g
\]

This equation shows that the yield differential under the hypothesis of no default is a
function of the expected cost of default, \( p_g t_g \). The default probability \( p_g \) is not observed
but it is supposed to be correlated to a set of default risk indicators that could trigger
a confidence crisis. The literature suggests the average maturity of government debt, the
amount of debt coming to maturity in each period, the deficit to GDP ratio and the debt to
GDP ratio as indicators that would capture the behavior of economic fundamentals.\(^6\) The
average maturity and the amount of debt coming to maturity are not good indicators because
they are in large measure a consequence of the confidence crisis. The size of the deficit per se,
as well as the debt ratio, does not say much about the financial ability of the government to
pay its debt. Instead of using these variables, we assume that the probability of government
default depends upon the solvency conditions for the public sector and external debts. Thus,

\[
p_g t_g = \lambda_0 - \lambda_1 DSG - \lambda_2 DSE
\]

where the signs of the coefficients \( \lambda_1 \) and \( \lambda_2 \) are positive, and \( DSG \) refers to the degree
of government solvency and \( DSE \) to the degree of external solvency, to be defined in the
next section. By substitution of (10) into (9) we obtain the risk premium on a government
security:

\(^{6}\)See Cottarelli and Mecagni(1990) and the references cited there.
\[ SPR = r_g^N e - r_a^N e = \varphi_0 + \varphi_1 \frac{V}{W} - \varphi_2 DSG - \varphi_3 DSE \]  
\[ (11) \]

where \( \varphi_0 = \lambda_0 - \alpha \theta \sigma^2 \), \( \varphi_1 = \theta \sigma^2 \), \( \varphi_2 = \lambda_1 \) and \( \varphi_3 = \lambda_2 \).

3 Empirical evidence

The model presented in the last section shows that the risk premium on government debt depends upon country economic fundamentals and the relative supply effect which measures the size of the stock of public sector securities in relation to some benchmark. This section describes the data and the econometric methods we use to test this model.

3.1 Data

We use C-Bond spread over the American treasury securities as a measure for risk premium, since this is the most liquid bond issued by the Federal Republic of Brazil in international capital markets. We use monthly data from January/96 to May/02 (see Figure 2) and this sample was chosen due to availability of the data.\(^7\)

Our risk premium measure is supported by a recent study by Araújo and Guillén (2002). In their paper they decompose three possible measures of Brazilian risk premium (deviation from uncovered interest parity, C-Bond spread over treasury bonds and deviation from covered interest parity) into transitory and trend components, following Vahid and Engle (1993) methodology. They conclude that C-Bond risk premium is greatly influenced by the behavior of the trend component. Thus, if this long run component is associated with economic fundamentals, the authors suggest that these fundamentals would be the main determinants of C-Bond spread over treasury.

\(^7\)The FLIRB “C” (known as C-Bond) was issued on 04/15/1994 and has the following characteristics: Maturity: 04/15/2014; Original value: US$ 7,407,002,000.00; Term: 20 years; Grace Period: 10 years; Amortization: 21 six-month payments; Interest rate (six-month coupon): 1st and 2nd years – 4% per annum; 3rd and 4th years – 4.5% ; 5th and 6th years – 5% ; from 7th year on – 8%. 
We define variables that embed public sector solvency condition and external debt solvency condition of the Brazilian economy to take into account country economic fundamentals. The solvency condition of the public sector is obtained from the government intertemporal budget constraint and it implies that the present value of the primary surplus \( S \) should be equal to the initial debt \( D \):

\[
\sum_{i=0}^{\infty} \frac{S_{t+i}}{\prod_{j=1}^{i} (1 + r_{t+j})} \geq (1 + r_t) \cdot D_{t-1} \quad (12)
\]

When interest rates are constant \( r_{t+j} = r_t \), output grows at constant rate \( g_{t+j} = g_t \) and the rate of interest is greater than the rate of output growth \( r_t \geq g_t \), the above equation as a percentage of GDP can be written as:

\[
(1 + r_t) \cdot \frac{D_{t-1}}{Y_t} \leq \sum_{i=0}^{\infty} \frac{S_{t+i}}{Y_t \cdot (1 + r)^i} = s_t \cdot \sum_{i=0}^{\infty} \frac{(1 + g_t)^i}{(1 + r_t)^i} = s_t \cdot \frac{1 + r_t}{r_t - g_t} \quad (13)
\]

Thus, the constant primary surplus that attends the solvency condition is given by:

\[
s^* = \frac{(r - g) \cdot d}{(1 + g)} \quad (14)
\]

We capture the effect of this solvency condition over government debt risk, measured by C-Bond spread over treasury securities, building a variable called degree of public sector debt
sustainability defined as the difference between the actual primary surplus and the constant primary surplus required by the solvency condition:

\[ dsg = s - s^* \]

We proceeded as follows to build this variable: i) For the real interest rate, \( r \), we consider two cases which result in two distinct series for this variable. In case 1, \( r \) is constructed from Selic (overnight interest rate) adjusted by IPCA (consumer price index), where inflation is calculated as the mean of this month and the three previous months inflation rates in order to avoid seasonal adjustment problems; in case 2, \( r \) is equal to 20.75 % per annum from Jan/96 to Dec/98 (fixed exchange rate regime) and is equal to 11.80 % from Jan/01 to May/02 (floating exchange rate regime). ii) Faced by the difficulty of calculating a monthly GDP growth rate, we used the mean of the period, approximately 2.5 % per annum. iii) Our variable \( d \) was defined as total net public sector debt as a percentage of GDP while \( s \) was defined as primary surplus accumulated in 12 months as a percentage of GDP. Figure 3 shows the behavior of this variable for both cases we consider in this paper.

Similarly, we can derive an external solvency condition for the Brazilian economy, considering balance of payments’s trade balance, \( cc^* \), required to maintain Brazilian external

---

8The primary surplus is the net cash flow available to be used by the government to service the debt. We assume that the price of government debt depends upon the expected value of this cash flow. Thus, the assumption underlying this variable is that it provides information for this expected value.

8
debt in a sustainable path.\(^9\)

\[
c^{*} = \frac{(r - g) \cdot d^e}{(1 + g)}
\]

(15)

where \(d^e\) is net external debt as a percentage of GDP.\(^10\)

In the same way we construct a variable called degree of external solvency, \(dse\), as shown in Figure 4, incorporating the condition stated above:

\[
dse = cc - cc^* ,
\]

which measures the difference between effective balance of payments current account (accumulated in 12 months as a percentage of GDP), \(cc\), and the one required by the external solvency condition, \(cc^*\), in each period of time.\(^11\)

![Figure 4: Degree of external solvency (des)](source: IPEADATA)

We had to construct a proxy variable to capture the relative supply effect because we do not have information regarding the benchmark used to measure the C-bond spread. We use the ratio between Brazilian public sector securities held by the private sector and Brazilian money supply defined by the M1 concept as a proxy for the relative supply effect (see Figure 9).

Current account was used as a proxy for the amount of output the Brazilian economy would transfer to foreigners (trade balance).

This variable includes financial and non-financial public and private sectors debt.

Real interest rate, \(r\), and GDP growth rate, \(g\), are defined in the same way we did when we stated the public sector debt sustainability condition.
5). This is a good proxy for the relative supply effect as long as the ratio between the money supply and the aggregate nonmonetary wealth does not change during our sample period.

![FIGURE 5](Public sector securities held by private agents / M1)

Source: Central Bank of Brazil

The idea behind this variable is that when it increases, asset holders are giving up present liquidity for future liquidity, and to do so they demand higher interest rates, as noticed by Martins et al. (1980). Since risk premium is one of the determinants of interest rate it should be positively correlated with our proxy variable that measures the relative supply effect.

### 3.2 Econometric Analysis

The variables we use in the econometric analysis are defined as follows: i) $SPR = \ln(1 + spr/100)$, where $spr$ is C-Bond spread over treasury bonds (in basis points). ii) $DSG = \ln(1 + dsg/100)$, where $dsg$ is the degree of public sector debt sustainability (percentage). iii) $DSE = \ln(1 + des/100)$, where $dse$ is the Brazil’s degree of external solvency (percentage), and iv) $TM = \ln(tm)$, where $tm$ is defined as the ratio between public sector securities held by the private sector and money supply (M1).

Firstly, the Augmented Dickey-Fuller unit root test, reported in Table 1, shows that, at 1% confidence level, we cannot reject the unit root hypothesis for each variable defined above. This means that our variables are non-stationary according to the critical values

---

12 This idea is also implicit in Tobin (1956)’s theory of money demand.
tabulated by MacKinnon. In order to test the presence of only one unit root, we tested the first difference of the series as well, and the hypothesis that the first difference of the variables has a unit root was rejected.

**TABLE 1**

**ADF Unit Root Test**

<table>
<thead>
<tr>
<th></th>
<th>SPR</th>
<th>TM</th>
<th>DSG Case 1</th>
<th>DSG Case 2</th>
<th>DES Case 1</th>
<th>DES Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADF Test Statistic</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>level</td>
<td>-2.18</td>
<td>-2.23</td>
<td>-1.87</td>
<td>-0.78</td>
<td>-2.41</td>
<td>-1.85</td>
</tr>
<tr>
<td>first difference</td>
<td>-6.05</td>
<td>-8.74</td>
<td>-7.77</td>
<td>-7.24</td>
<td>-8.30</td>
<td>-8.25</td>
</tr>
</tbody>
</table>

Critical values**

<table>
<thead>
<tr>
<th></th>
<th>1%</th>
<th>5%</th>
<th>10%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-3.52</td>
<td>-2.90</td>
<td>-2.58</td>
</tr>
</tbody>
</table>

* All tests include an intercept and lags were selected by AIC criteria
** MacKinnon critical values for rejection of the unit root hypothesis

Before the application of Johansen cointegration procedure, we have to choose the order of the vector autoregression (VAR). We use the information criteria of Hannan-Quinn, Schwarz and Akaike as reported in Table 2 to determine the lag lengths. With the exception of case 1, where real interest rate was constructed from Selic rate adjusted by IPCA inflation rate, convergence in terms of best lag was the rule. We also use the Likelihood Ratio test (LR) for case 1 that suggested 2 lags as the order of the VAR. Taking into account diagnosis tests (from residuals) which indicated no serial correlation, we decide to use two lags in case 1 and one lag in case 2.

**TABLE 2**

**VAR Selection**

<table>
<thead>
<tr>
<th></th>
<th>LR</th>
<th>HQ</th>
<th>SC</th>
<th>AIC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Case 1</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Case 2</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>
After having defined the lag lengths of the VAR, the next step was to test the hypothesis that there is a long run relationship amongst the four variables through cointegration procedure. Johansen test results indicated that our variables did not cointegrate when jointly analysed. Next, we separated the four variables into two sets and we applied Johansen test to each of them alternating $DSG$ and $DSE$ as proxies for Brazilian fundamentals.\(^\text{13}\) In the set that includes $DSG$ cointegration was not rejected as shown in Tables 3 and 4.

\textbf{TABLE 3}

\textbf{Johansen Test: Case 1}

<table>
<thead>
<tr>
<th>Hypothesized No. of CE(s)</th>
<th>Eingenvalue</th>
<th>Trace Statistic</th>
<th>5 Percent Critical Value</th>
<th>1 Percent Critical Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>None*</td>
<td>0.22</td>
<td>32.30</td>
<td>29.68</td>
<td>35.65</td>
</tr>
<tr>
<td>At most 1</td>
<td>0.14</td>
<td>13.91</td>
<td>15.41</td>
<td>20.04</td>
</tr>
</tbody>
</table>

Normalized cointegration coefficients: one cointegration equation

<table>
<thead>
<tr>
<th>SPR</th>
<th>TM</th>
<th>DSG</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>-0.13</td>
<td>0.27</td>
</tr>
<tr>
<td>(0.02)</td>
<td>(0.07)</td>
<td></td>
</tr>
</tbody>
</table>

* (**) denotes rejection of the hypothesis at the 5% (1%) level

\textbf{TABLE 4}

\textbf{Johansen Test: Case 2}

<table>
<thead>
<tr>
<th>Hypothesized No. of CE(s)</th>
<th>Eingenvalue</th>
<th>Trace Statistic</th>
<th>5 Percent Critical Value</th>
<th>1 Percent Critical Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>None*</td>
<td>0.23</td>
<td>30.20</td>
<td>29.68</td>
<td>35.65</td>
</tr>
<tr>
<td>At most 1</td>
<td>0.11</td>
<td>10.07</td>
<td>15.41</td>
<td>20.04</td>
</tr>
</tbody>
</table>

Normalized cointegration coefficients: one cointegration equation

<table>
<thead>
<tr>
<th>SPR</th>
<th>TM</th>
<th>DSG</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>-0.12</td>
<td>0.30</td>
</tr>
<tr>
<td>(0.02)</td>
<td>(0.14)</td>
<td></td>
</tr>
</tbody>
</table>

* (**) denotes rejection of the hypothesis at the 5% (1%) level

\(^{13}\)Once again, Var order selection criteria indicated two lags for case 1 and one for case 2.
The trace statistics of Johansen procedure does not reject the hypothesis that the series cointegrate with one cointegration vector in each case at a 5% confidence level. The following estimated cointegration equations present significant statistics and results that support the model presented in the last section:

\[
\begin{align*}
SPR &= 0.13TM - 0.27DSG + z \\
SPR &= 0.12TM - 0.30DSG + z
\end{align*}
\]

where \( z \) is the cointegration error term.

The coefficient of the variable \( TM \) supports the results obtained by Martins et al. (1980) that agents demand higher interest rates when government increases the stock of public debt. Robust results for the \( TM \) variable coefficient suggest that a decrease in the stock of public debt reduces risk premium, highlighting the presence of relative supply effect in Brazilian risk premium during the period analysed here. The results for the \( DSG \) coefficient do not reject the hypothesis that when country fundamentals improve, risk premium on public sector debt decreases. In particular, a positive fiscal shock, which increases the primary surplus above the minimum level required to maintain public sector debt to GDP ratio at a sustainable path, reduces risk premium.

In the set which contains \( DSE \) variable, we were not able to reject the hypothesis of no cointegration. Although we expected that this variable would influence risk premium behavior, the absence of cointegration only indicates that there is no long run linear relation among \( DSE \)' stochastical trend and other variables' stochastical trends. Thus we decided to apply Johansen test to \( SPR \) and \( DSE \) variables only, where we noticed cointegration relations in case 1, as shown in Table 5.\(^{15}\)

\(^{14}\)LR test indicated that all coefficients of the estimated cointegration vector are statiscally different from zero.

\(^{15}\)VAR order selection criteria suggested two lags as the best specification.

Muinhos, Alves and Riella (2002) found evidence that the current account is significant as an explanatory variable to model C-bond spread over treasury securities.
Despite the fact that Johansen test shows two estimated cointegration relations among the variables (given by the trace statistics test at a 5% confidence level), only one has economic rationale:\footnote{Again, LR test indicated that all coefficients of the estimated cointegration vector are statistically different from zero.}

\[ SPR = -0.36 DSE + z \]  \hspace{1cm} (18)

This equation shows that current account sustainability influences risk premium level, but this hypothesis is sensitive to the confidence level chosen.\footnote{We also tested the possibility of \( DSG \) and \( DSE \) be cointegrated. In the light of Mundell-Fleming model, budgetary deficits should induce trade balance deficits. In this case, we applied Engle-Granger methodology, which consists of two steps. In the first one, we estimated long run relations through OLS method. In the next step, we applied a unit root test to residuals obtained in step 1; if this series results to be stationary, variables are cointegrated. We obtained the following results:

\[ DSG = 0.05 + 1.31 DSE \]

\[ (0.01) \quad (0.17) \]

Clearly, our results indicated a spurious regression. Applying to residuals, \( \hat{c} \), a unit root test of the form \( \Delta \hat{c} = a_1 \hat{c}_{t-1} + \varepsilon_t \), we could not reject the null hypothesis \( H_0 : a_1 = 0 \), i.e., residuals present a unit root and variables are not cointegrated.}

\begin{table}
\centering
\caption{Johansen Test: Case 1}
\begin{tabular}{llllll}
Hypothesized & Eingenvalue & Trace Statistic & 5 Percent & 1 Percent \\
No. of CE(s) & & & Critical Value & Critical Value \\
\hline
None* & 0.14 & 17.33 & 15.41 & 20.04 \\
At most 1 & 0.07 & 6.03 & 3.76 & 6.65 \\
\hline
\end{tabular}
\caption*{Normalized cointegration coefficients: two cointegration equations}
\begin{tabular}{ll}
SPR & DES \\
1 & 0.36 \\
& (0.20) \\
\end{tabular}
\footnote{(**) denotes rejection of the hypothesis at the 5% (1%) level}
\end{table}
public sector fiscal effort would be the best strategy to reduce risk premium on public sector debt. We do not disregard actions that would reduce the external vulnerability through current account improvement, but the empirical evidence we present in this paper is not robust to this hypothesis.

4 Conclusion

The paper provides evidence that the fiscal policy stance, as measured by the primary surplus, and the size of the public debt affect the risk premium on Brazilian government debt. The results show that, although current account affects risk premium, the effect of fiscal variables is statistically more robust and quantitatively more important.

These findings have implications for fiscal policy and debt management. In order to reduce risk premium, the fiscal adjustment must be sustained over time, so as to allow for the proper adjustment in the stock of public debt.
References


### Banco Central do Brasil

#### Trabalhos para Discussão

*Os Trabalhos para Discussão podem ser acessados na internet, no formato PDF, no endereço: http://www.bc.gov.br*

#### Working Paper Series

*Working Papers in PDF format can be downloaded from: http://www.bc.gov.br*

<table>
<thead>
<tr>
<th>No.</th>
<th>Title</th>
<th>Authors</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Implementing Inflation Targeting in Brazil</td>
<td>Joel Bogdanski, Alexandre Antonio Tombini and Sérgio Ribeiro da Costa Werlang</td>
<td>Jul/2000</td>
</tr>
<tr>
<td>2</td>
<td>Política Monetária e Supervisão do Sistema Financeiro Nacional no Banco Central do Brasil</td>
<td>Eduardo Lundberg</td>
<td>Jul/2000</td>
</tr>
<tr>
<td>6</td>
<td>Optimal Interest Rate Rules in Inflation Targeting Frameworks</td>
<td>José Álvaro Rodrigues Neto, Fábio Araújo and Marta Baltar J. Moreira</td>
<td>Jul/2000</td>
</tr>
<tr>
<td>7</td>
<td>Leading Indicators of Inflation for Brazil</td>
<td>Marcelle Chauvet</td>
<td>Sep/2000</td>
</tr>
<tr>
<td>8</td>
<td>The Correlation Matrix of the Brazilian Central Bank’s Standard Model for Interest Rate Market Risk</td>
<td>José Álvaro Rodrigues Neto</td>
<td>Sep/2000</td>
</tr>
<tr>
<td>9</td>
<td>Estimating Exchange Market Pressure and Intervention Activity</td>
<td>Emanuel-Werner Kohlscheen</td>
<td>Nov/2000</td>
</tr>
<tr>
<td>10</td>
<td>Análise do Financiamento Externo a uma Pequena Economia</td>
<td>Carlos Hamilton Vasconcelos Araújo e Renato Galvão Flóres Júnior</td>
<td>Mar/2001</td>
</tr>
<tr>
<td>12</td>
<td>A Test of Competition in Brazilian Banking</td>
<td>Márcio I. Nakane</td>
<td>Mar/2001</td>
</tr>
</tbody>
</table>
13 Modelos de Previsão de Insolvência Bancária no Brasil
Marcio Magalhães Janot
Mar/2001

14 Evaluating Core Inflation Measures for Brazil
Francisco Marcos Rodrigues Figueiredo
Mar/2001

15 Is It Worth Tracking Dollar/Real Implied Volatility?
Sandro Canesso de Andrade and Benjamin Miranda Tabak
Mar/2001

16 Avaliação das Projeções do Modelo Estrutural do Banco Central do Brasil para a Taxa de Variação do IPCA
Sergio Afonso Lago Alves
Mar/2001

17 Estimando o Produto Potencial Brasileiro: uma Abordagem de Função de Produção
Tito Nícias Teixeira da Silva Filho
Abr/2002

18 A Simple Model for Inflation Targeting in Brazil
Paulo Springer de Freitas and Marcelo Kfoury Muinhos
Apr/2001

19 Uncovered Interest Parity with Fundamentals: a Brazilian Exchange Rate Forecast Model
Marcelo Kfoury Muinhos, Paulo Springer de Freitas and Fabio Araújo
May/2001

20 Credit Channel without the LM Curve
Victorio Y. T. Chu and Márcio I. Nakane
May/2001

21 Os Impactos Econômicos da CPMF: Teoria e Evidência
Pedro H. Albuquerque
Jun/2001

22 Decentralized Portfolio Management
Paulo Coutinho and Benjamin Miranda Tabak
Jun/2001

23 Os Efeitos da CPMF sobre a Intermediação Financeira
Sérgio Mikio Koyama e Márcio I. Nakane
Jul/2001

24 Inflation Targeting in Brazil: Shocks, Backward-Looking Prices, and IMF Conditionality
Joel Bogdanski, Paulo Springer de Freitas, Ilan Goldfajn and Alexandre Antonio Tombini
Aug/2001

25 Inflation Targeting in Brazil: Reviewing Two Years of Monetary Policy 1999/00
Pedro Fachada
Aug/2001

26 Inflation Targeting in an Open Financially Integrated Emerging Economy: the Case of Brazil
Marcelo Kfoury Muinhos
Aug/2001
Complementaridade e Fungibilidade dos Fluxos de Capitais Internacionais
Carlos Hamilton Vasconcelos Araújo e Renato Galvão Flôres Júnior
Set/2001

Regras Monetárias e Dinâmica Macroeconômica no Brasil: uma Abordagem de Expectativas Racionais
Marco Antonio Bonomo e Ricardo D. Brito
Nov/2001

Using a Money Demand Model to Evaluate Monetary Policies in Brazil
Pedro H. Albuquerque and Solange Gouvêa
Nov/2001

Testing the Expectations Hypothesis in the Brazilian Term Structure of Interest Rates
Benjamin Miranda Tabak and Sandro Canesso de Andrade
Nov/2001

Algumas Considerações sobre a Sazonalidade no IPCA
Francisco Marcos R. Figueiredo e Roberta Blass Staub
Nov/2001

Crises Cambiais e Ataques Especulativos no Brasil
Mauro Costa Miranda
Nov/2001

Monetary Policy and Inflation in Brazil (1975-2000): a VAR Estimation
André Minella
Nov/2001

Constrained Discretion and Collective Action Problems: Reflections on the Resolution of International Financial Crises
Arminio Fraga and Daniel Luiz Gleizer
Nov/2001

Uma Definição Operacional de Estabilidade de Preços
Tito Nícias Teixeira da Silva Filho
Dez/2001

Can Emerging Markets Float? Should They Inflation Target?
Barry Eichengreen
Feb/2002

Monetary Policy in Brazil: Remarks on the Inflation Targeting Regime, Public Debt Management and Open Market Operations
Luiz Fernando Figueiredo, Pedro Fachada and Sérgio Goldenstein
Mar/2002

Volutilidade Implícita e Antecipação de Eventos de Stress: um Teste para o Mercado Brasileiro
Frederico Pechir Gomes
Mar/2002

Opções sobre Dólar Comercial e Expectativas a Respeito do Comportamento da Taxa de Câmbio
Paulo Castor de Castro
Mar/2002

Speculative Attacks on Debts, Dollarization and Optimum Currency Areas
Aloisio Araújo and Márcia Leon
Apr/2002

Mudanças de Regime no Câmbio Brasileiro
Carlos Hamilton V. Araújo e Getúlio B. da Silveira Filho
Jun/2002

Modelo Estrutural com Setor Externo: Endogenização do Prêmio de Risco e do Câmbio
Marcelo Kfoury Muinhos, Sérgio Afonso Lago Alves e Gil Riella
Jun/2002
<table>
<thead>
<tr>
<th>Page</th>
<th>Title</th>
<th>Authors</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>43</td>
<td>The Effects of the Brazilian ADRs Program on Domestic Market Efficiency</td>
<td>Benjamin Miranda Tabak and Eduardo José Araújo Lima</td>
<td>Jun/2002</td>
</tr>
<tr>
<td>44</td>
<td>Estrutura Competitiva, Produtividade Industrial e Liberação Comercial no Brasil</td>
<td>Pedro Cavalcanti Ferreira e Osmani Teixeira de Carvalho Guillén</td>
<td>Jun/2002</td>
</tr>
<tr>
<td>45</td>
<td>Optimal Monetary Policy, Gains from Commitment, and Inflation Persistence</td>
<td>André Minella</td>
<td>Aug/2002</td>
</tr>
<tr>
<td>46</td>
<td>The Determinants of Bank Interest Spread in Brazil</td>
<td>Tarsila Segalla Afanasieff, Priscilla Maria Villa Lhacer and Márcio I. Nakane</td>
<td>Aug/2002</td>
</tr>
<tr>
<td>47</td>
<td>Indicadores Derivados de Agregados Monetários</td>
<td>Fernando de Aquino Fonseca Neto e José Albuquerque Júnior</td>
<td>Set/2002</td>
</tr>
<tr>
<td>49</td>
<td>Desenvolvimento do Sistema Financeiro e Crescimento Econômico no Brasil: Evidências de Causalidade</td>
<td>Orlando Carneiro de Matos</td>
<td>Set/2002</td>
</tr>
<tr>
<td>50</td>
<td>Macroeconomic Coordination and Inflation Targeting in a Two-Country Model</td>
<td>Eui Jung Chang, Marcelo Kfoury Muiños and Joanílio Rodolph Teixeira</td>
<td>Sep/2002</td>
</tr>
<tr>
<td>51</td>
<td>Credit Channel with Sovereign Credit Risk: an Empirical Test</td>
<td>Victorio Yi Tson Chu</td>
<td>Sep/2002</td>
</tr>
<tr>
<td>52</td>
<td>Generalized Hyperbolic Distributions and Brazilian Data</td>
<td>José Fajardo and Aquiles Farias</td>
<td>Sep/2002</td>
</tr>
<tr>
<td>54</td>
<td>Stock Returns and Volatility</td>
<td>Benjamin Miranda Tabak and Solange Maria Guerra</td>
<td>Nov/2002</td>
</tr>
<tr>
<td>55</td>
<td>Componentes de Curto e Longo Prazo das Taxas de Juros no Brasil</td>
<td>Carlos Hamilton Vasconcelos Araújo e Osmani Teixeira de Carvalho de Guíllén</td>
<td>Nov/2002</td>
</tr>
<tr>
<td>56</td>
<td>Causality and Cointegration in Stock Markets: the Case of Latin America</td>
<td>Benjamin Miranda Tabak and Eduardo José Araújo Lima</td>
<td>Dec/2002</td>
</tr>
<tr>
<td>57</td>
<td>As Leis de Falência: uma Abordagem Econômica</td>
<td>Aloisio Araújo</td>
<td>Dez/2002</td>
</tr>
<tr>
<td>59</td>
<td>Os Preços Administrados e a Inflação no Brasil</td>
<td>Francisco Marcos R. Figueiredo e Thaís Porto Ferreira</td>
<td>Dez/2002</td>
</tr>
</tbody>
</table>
60 Delegated Portfolio Management  
*Paulo Coutinho and Benjamin Miranda Tabak*  
Dec/2002

61 O Uso de Dados de Alta Frequência na Estimação da Volatilidade e do Valor em Risco para o Ibovespa  
*João Maurício de Souza Moreira e Eduardo Facó Lemgruber*  
Dez/2002

62 Taxa de Juros e Concentração Bancária no Brasil  
*Eduardo Kiyoshi Tonooka e Sérgio Mikio Koyama*  
Fev/2003

63 Optimal Monetary Rules: the Case of Brazil  
*Charles Lima de Almeida, Marco Aurélio Peres, Geraldo da Silva e Souza and Benjamin Miranda Tabak*  
Feb/2003

64 Medium-Size Macroeconomic Model for the Brazilian Economy  
*Marcelo Kfoury Muinhos and Sergio Afonso Lago Alves*  
Feb/2003

65 On the Information Content of Oil Future Prices  
*Benjamin Miranda Tabak*  
Feb/2003

66 A Taxa de Juros de Equilíbrio: uma Abordagem Múltipla  
*Pedro Calhman de Miranda e Marcelo Kfoury Muinhos*  
Fev/2003

67 Avaliação de Métodos de Cálculo de Exigência de Capital para Risco de Mercado de Carteiras de Ações no Brasil  
*Gustavo S. Araújo, João Maurício S. Moreira e Ricardo S. Maia Clemente*  
Fev/2003

68 Real Balances in the Utility Function: Evidence for Brazil  
*Leonardo Soriano de Alencar and Márcio I. Nakane*  
Feb/2003

69 r-filters: a Hodrick-Prescott Filter Generalization  
*Fabio Araújo, Marta Baltar Moreira Areosa and José Alvaro Rodrigues Neto*  
Feb/2003

70 Monetary Policy Surprises and the Brazilian Term Structure of Interest Rates  
*Benjamin Miranda Tabak*  
Feb/2003

71 On Shadow-Prices of Banks in Real-Time Gross Settlement Systems  
*Rodrigo Penaloza*  
Apr/2003

72 O Prêmio pela Maturidade na Estrutura a Termo das Taxas de Juros Brasileiras  
*Ricardo Dias de Oliveira Brito, Angelo J. Mont'Alverne Duarte e Osmani Teixeira de C. Guillen*  
Maio/2003

73 Análise de Componentes Principais de Dados Funcionais – Uma Aplicação às Estruturas a Termo de Taxas de Juros  
*Getúlio Borges da Silveira e Octavio Bessada*  
Maio/2003

74 Aplicação do Modelo de Black, Derman & Toy à Precificação de Opções Sobre Títulos de Renda Fixa  
*Octavio Manuel Bessada Lion, Carlos Alberto Nunes Cosenza e César das Neves*  
Maio/2003

75 Brazil's Financial System: Resilience to Shocks, no Currency Substitution, but Struggling to Promote Growth  
*Ilan Goldfajn, Katherine Hennings and Helio Mori*  
Jun/2003
76 Inflation Targeting in Emerging Market Economies
Arminio Fraga, Ilan Goldfajn and André Minella
Jun/2003

77 Inflation Targeting in Brazil: Constructing Credibility under Exchange Rate Volatility
André Minella, Paulo Springer de Freitas, Ilan Goldfajn and Marcelo Kfoury Muinhos
Jul/2003

78 Contornando os Pressupostos de Black & Scholes: Aplicação do Modelo de Precificação de Opções de Duan no Mercado Brasileiro
Gustavo Silva Araújo, Claudio Henrique da Silveira Barbedo, Antonio Carlos Figueiredo, Eduardo Facó Lemgruber
Out/2003

79 Inclusão do Decaimento Temporal na Metodologia Delta-Gama para o Cálculo do VaR de Carteiras Compradas em Opções no Brasil
Claudio Henrique da Silveira Barbedo, Gustavo Silva Araújo, Eduardo Facó Lemgruber
Out/2003

80 Diferenças e Semelhanças entre Países da América Latina: uma Análise de Markov Switching para os Ciclos Econômicos de Brasil e Argentina
Arnildo da Silva Correa
Out/2003

81 Bank Competition, Agency Costs and the Performance of the Monetary Policy
Leonardo Soriano de Alencar and Márcio I. Nakane
Jan/2004

82 Carteiras de Opções: Avaliação de Metodologias de Exigência de Capital no Mercado Brasileiro
Cláudio Henrique da Silveira Barbedo e Gustavo Silva Araújo
Mar/2004

83 Does Inflation Targeting Reduce Inflation? An Analysis for the OECD Industrial Countries
Thomas Y. Wu
May/2004

84 Speculative Attacks on Debts and Optimum Currency Area: A Welfare Analysis
Aloisio Araujo and Marcia Leon
May/2004