ECONOMICS: LATIN AMERICA PERSPECTIVES

BRAZIL: PROGRESS ON REFORMS

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The government has managed to shut out the political noise and concentrate on key reforms. Social security reform remains elusive. But the authorities have succeeded in deregulating the interest rates that the Brazilian Development Bank (BNDES) can charge on loans.

There's been no shortage of news from Brazil lately. The wide-ranging investigation into political corruption, known as operation Car Wash, has resulted in accusations and arrests of leaders in multiple political parties. That includes President Michel Temer, who survived an impeachment attempt in Congress only to face new charges from an outgoing prosecutor general (most expect Congress to dismiss these charges, too).

Despite the political turmoil, the government has managed to make progress with many ambitious structural reforms. Among some of the most important are a 20-year cap on real public spending increases, the deregulation of labor markets and the deregulation of interest rates that can be charged by the Brazilian Development Bank (BNDES).

By passing these and other reforms, the government has exceeded market expectations and boosted Brazilian asset prices. In addition, the central bank has seen its credibility rise as inflation falls, clearing the way for a drastic reduction of the policy rate—in nominal and real terms (*Display 1*).

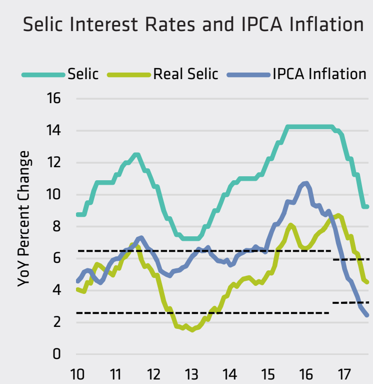
Still pending, however, is the all-important reform of the social security system. This reform is critical for improving the medium-term sustainability of Brazil's fiscal accounts. While the finance ministry is still optimistic about completing pension reform this year, uncertainty remains—largely because that reform requires approval from a qualified majority in Congress.

Interest Rate Reform

The central bank lowered the TJLP rate, the long-term rate BNDES charges on its loans, in March by 50 basis points to 7%. The move caught markets off guard; many participants expected the central bank to leave it unchanged so as to reduce the gap between TJLP and the target Selic rate, which at the time was 12.25%.

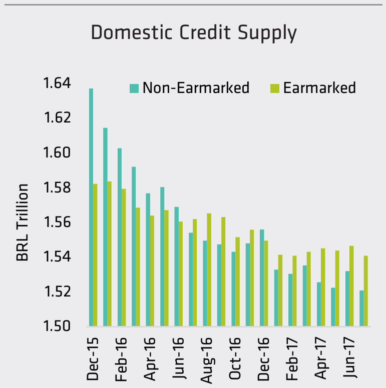
At the same time, the central bank and finance ministry issued a joint press release indicating their plan to gradually phase out the TJLP, with new contracts to be ruled by a new long-term rate called the TLP. Starting January 2018, the TLP would be composed of the real yield of the five-year NTNB securities plus IPCA consumer price inflation and reset monthly. Existing contracts will continue to be

Display 1
Disinflation Process Has Consolidated



Real Selic = nominal Selic adjusted by 12-mo.-forward expected IPCA inflation
Through September 29, 2017
Source: Banco Central do Brasil and AllianceBernstein (AB)

Display 2
A Segmented Credit Market



As of September 29, 2017
Source: Banco Central do Brasil

based on the TJLP, which will still be calculated as usual and adjusted on a quarterly basis.

Initially, the new TLP will be equal to the ongoing TJLP to avoid discontinuities that could create market instability. Within five years, the new TLP is expected to converge fully to NTNBs. The government submitted a provisional measure to Congress to create the new rate, and the initiative received final parliamentary endorsement last week.

Growing the Credit Supply

Amid the deep recession of the past couple of years, Brazil's credit supply shrank from almost 54% of GDP at the end of 2015 (R$1.64 trillion) to less than 48% of GDP in July 2017 (R$ 1.52 trillion) (*Display 2*, *previous page*). Total credit was roughly split between managed credit and credit that was tied to market rates. The average interest rate charged on the former averaged some 10% during the period, while that on the latter was above 40%.

Historically, what interest to charge on managed credit was largely a political decision; changes in the Selic policy rate had little effect on the interest charged by BNDES. This created a misallocation of resources and diminished the power of monetary policy. In other words, to dampen demand pressure, the Selic rate had to be increased substantially, since it affected only half of the credit supply. Therefore, segmentation in the credit market ended up choking off market-rate loans because the interest that had to be charged on them was very high.

Therefore, we believe that the deregulation of the TJLP is very good news and has far-reaching implications for the Brazilian economy over the medium and long term. It amounts to a structural reform in itself.

We think the decision will increase the predictability of contracts, improve the efficiency of credit and encourage long-term private financing because interest on loans will be market determined. BNDES could expand its operations but only in the context of the broader Brazilian capital market, while private banks will gradually play a bigger role in determining the supply of credit.

Deregulation is also likely to improve the fiscal bottom line, as it should reduce the implicit subsidy from the Treasury to BNDES, which historically resulted in a quasi-fiscal deficit.

The main investment implication, however, is that the move should contribute to a structural reduction in average interest rates. It should make the Selic rate a more powerful policy instrument. That's good news for assets linked to it.■

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