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ECONOMIC FACT 3

CNI
National Confederation of Industry
Brazil
CNI. THE STRENGTH OF THE BRAZILIAN INDUSTRY

What changes with the replacement of the Long-Term Interest Rate (TJLP) with the Long-Term Rate (TLP)

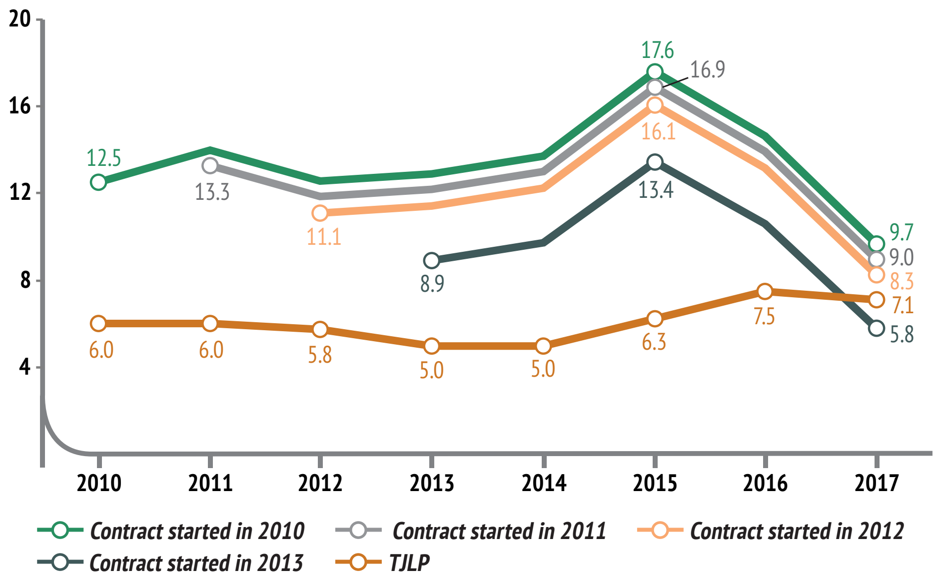
New rules will impact financing and investment in Brazil

THE MATTER

On September 25, the Central Bank of Brazil (BACEN) published Resolution No. 4.600, which regulates Law No. 13.483 of 2017 – dealing with the conversion of provisional presidential decree (MPV) No. 777/17 – which in turn establishes the Long-Term Rate (TLP) to gradually replace the Long-Term Interest Rate (TJLP) currently applied to loans granted by the National Economic and Social Development Bank (BNDES).

Comparison between TJLP and TLP, contracts started in 2010, 2011, 2012 and 2013 and due in 2017

Average interest rate for the year (% per year)



Average Financial Transaction Rate (% per year)

Contract started in	TLP	TJLP
2010	13.5	6.1
2011	12.9	6.1
2012	12.1	6.1
2013	9.7	6.2

Source: Prepared by CNI based on data provided by IBGE, Anbima and BACEN.

The TLP will come into effect in January 1, 2018, and will be composed of two factors: i) a fixed rate based on the 5-year National Treasury Note - Series B (NTN-B); and ii) the inflation rate, as measured by the Broad Consumer Price Index (IPCA). All the details about this calculation are set out in BACEN's Resolution No. 4.600.

The TLP will remain stable in real terms during the entire period of the contracted financial transaction, meaning that the fixed real rate will be defined at the beginning of the contract and will remain constant throughout the period of the transaction. On the other hand, the nominal rate actually paid by the borrower will vary on a monthly basis according to the inflation rate (IPCA).

The TJLP will not be immediately fully replaced by the TLP, as it will follow a five-year transition period. In the first year (2018), the TLP will be equivalent to the TJLP, and loans will only begin to be determined exclusively by the TLP in 2022.

THE FACTS

1. THE BRAZILIAN BENCHMARK INTEREST RATE IS ONE OF THE HIGHEST IN THE WORLD

The Selic rate, which currently stands at 7.5% per year, is higher than the rate seen in countries with a level of development similar to that of Brazil, such as Chile (2.5%), Colombia (5.0%) and South Africa (6.75%).

2. HIGH FINANCING COSTS HAVE A DIRECT IMPACT ON THE BRAZILIAN ECONOMY'S COMPETITIVENESS

Out of 63 countries, Brazil ranks 59th in the "credit" ranking prepared by the IMD World Competitiveness Center.

3. PRODUCTIVITY AND ECONOMIC DEVELOPMENT IN BRAZIL ARE NEGATIVELY AFFECTED BY LOW INVESTMENT LEVELS

In the second quarter of 2017, the investment rate fell to 15.8% of GDP, down from a recent peak of 21% in the third quarter of 2013. High financing costs discourage and often hinder investment projects, thus limiting the productivity of the Brazilian economy.

4. BNDES PLAYS A CRUCIAL ROLE AS A CREDIT OPERATOR IN LONG TERM LOANS

In contrast, the private long-term financing system is still incipient and does not meet the needs of companies.

5. MARKET RATES LIKE NTN-B ARE MORE VOLATILE IN GENERAL, MAKING CAPITAL COSTS UNSTABLE AND UNPREDICTABLE

The TLP will inevitably accompany the changes in NTN-B bonds – despite the fact that its calculation considers the average for the last three months, as required by law. This is not case with the TJLP, which is determined every three months by the National Monetary Council (CMN). Throughout 2016, for example, NTN-B bonds with a five-year maturity – the real component of the TLP – ranged from 7.3% to 5.9%. Meanwhile, the TJLP remained at the same level throughout the year.

6. HYPOTHETICAL CONTRACTS INITIATED IN DIFFERENT YEARS AND DUE IN DECEMBER 2017 WOULD, ON AVERAGE, YIELD A HIGHER RETURN AT THE TLP THAN AT THE TJLP

This result was found in a simulation conducted by CNI[1] intended to compare TLP-based contracts with those based on the TJLP. As an example, a contract initiated in 2013 and ended in 2017 would yield, on average, a return of 9.7% at the TLP and of 6.2% at the TJLP. (See the comparative chart on page 1).

7. HIGH NATIONAL TREASURY SUBSIDIES IN BNDES CREDIT OPERATIONS

In 2016, explicit and implicit subsidies – resulting from the equalization of interest rates on loans granted under the Investment Sustainability Program (PSI) and from the spread between the TJLP and the National Treasury's funding costs – totaled R$ 38.3 billion, contributing to pushing up the public debt.

1 – This simulation was based on the rules set out in BACEN's Resolution No. 4,600. For this purpose, the following simplifications were adopted: all months were considered to have 21 business days, the conversion factor (five-year transition rule) was disregarded, and CNI forecasts for the IPCA for the October-December 2017 period were used. The forward structure of the NTN-B interest rate used in the simulation was prepared by Anbima.

THE IMPLICATIONS

The change introduced by Law No. 13.483 of 2017 implies a possible increase in financing cost of BNDES contracts. In addition, the instability of the nominal rate caused by the inflation component may negatively affect investment decisions.

The proponents, however, believe that this change will reduce the cost of implicit subsidies in BNDES credit operations and thus contribute to keeping the public debt under control, as it would bring the cost of loans granted by BNDES closer to the National Treasury's funding costs. They also argue that the TLP improves the effectiveness of the country's monetary policy by increasing the acting power of the basic interest rate, which would allow for the Selic rate to be kept at lower levels and lead to a universal reduction in financing costs.

It is worth noting, however, that for these expectations to materialize without affecting the productive sector, authorities must be committed to the goals of fiscal and monetary policies so as to keep inflation at low levels and avoid pressures on the perception of country risk, which are quickly incorporated into government bonds such as NTN-B.

Finally, it should be stressed that the change to the TLP needs to be accompanied by changes in BNDES funding and by measures to boost the private long-term financing market with the aim of reducing capital costs and increasing the volume of funds available for investment.

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