Santander

# ECONOMICS

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## Brazil — Monetary Policy

### TJLP: Rules and Discretion


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- **The upcoming decision on the long-term interest rate (TJLP — the main parameter in BNDES loans), to be announced on June 30th, may provide yet another signal in terms of economic policymaking.**
- **Although the rate is formally set by a rule, the National Monetary Council (CMN) had been exercising discretion in its quarterly decisions on the rate, keeping it lower than the rule would have placed it, with important fiscal implications.**
- **Now with new members, the CMN will have the opportunity to signal how it weighs the fiscal costs and the economic activity benefits of the TJLP. Although we see some room for a modest increase in the TJLP (with potential fiscal benefits), we believe that concerns about economic activity will lead the CMN to maintain the TJLP at 7.5% pa at this meeting.**
- **Looking ahead, despite the expected substantial cuts in the target overnight rate (Selic) until end-2017, we do not envisage a similar decline in the TJLP – at least in the absence of a relevant improvement in country risk and/or a reduction in the inflation target.**

An important tool for economic stimulus or a fiscal problem awaiting a solution? Over the coming days, the new economic team will have a chance to clarify to markets how it views the operation of BNDES, the state-owned development bank. There are two important variables in this equation: the size of BNDES operations and the implied subsidy in the interest rate it charges its borrowers. The economic team wants to reduce the size of BNDES operations: that much was made clear at the outset, with the announcement – as one of the very first fiscal measures – of the pre-payment, over the course of 2016 through 2018, of BRL100 billion lent by the National Treasury to BNDES in recent years.

However, there is still the matter of the implicit subsidy: BNDES is only able to charge low interest rates because it has a very low funding cost, thanks to specific sources of financing that cannot be tapped by its competitors in the private sector. Among these sources, the National Treasury stands out not only for the huge amount of resources transferred to the bank, but also because of the fiscal cost of such operations: the National Treasury itself has a funding cost close to the target overnight rate (Selic, currently at 14.5% pa), well above the rate it charges BNDES for those loans (TJLP, currently at 7.5% pa). In this sense, it is worth monitoring the upcoming decision on the level for TJLP – to be made when the National Monetary Council (CMN) reconvenes, next June 30th –, as it can offer some hint on what concern is going to prevail in the decision-making process: the real-economy implications of the rate, or its fiscal cost.

In this note, we look at the evolution of the TJLP over time and how it compares with its theoretical formula. For most of the recent years, the CMN has used discretion rather than the rule in setting the TJLP. The question is, looking ahead, whether the new members of the CMN will go back to the rule or whether they will make discretionary decisions as well. We argue that, should they stick to the formula, they would have room for a (modest) increase in the TJLP, which would reduce the fiscal cost of BNDES operations. We also argue that, if they opt to abide by the rule, any future cuts in the TJLP will require a substantial improvement in Brazil's risk perception and/or a reduction in the inflation target. In either case, in all most likely scenarios, the Selic-TJLP gap seems bound to close over the coming quarters.

**All in all, although we see some risk of a slight increase in the TJLP (50bps), we believe the most likely scenario is one where the CMN will maintain the TJLP at the current 7.5% pa for quite a long time – even after the BCB starts cutting the Selic. With that, the Selic-TJLP gap will gradually narrow, diminishing the fiscal costs of BNDES operations.**

## Rules vs discretion

The long-term interest rate (TJLP) is set on a quarterly basis by the National Monetary Council (CMN), always at the end of each quarter, with validity for the following three months. Therefore, when the CMN convenes next Thursday, it will set the TJLP for July, August and September. The interesting point regarding this specific meeting is that it will be the premiere of a new composition of the CMN: the council is composed of the Minister of Finance, the Minister of Planning and the President of the BCB, all of whom have changed since the last TJLP-setting meeting at end-March. In this sense, their decision may convey hints on their position regarding two relevant questions: will the new CMN use rule or discretion in setting TJLP, and will the fiscal costs of a low TJLP influence their decision?

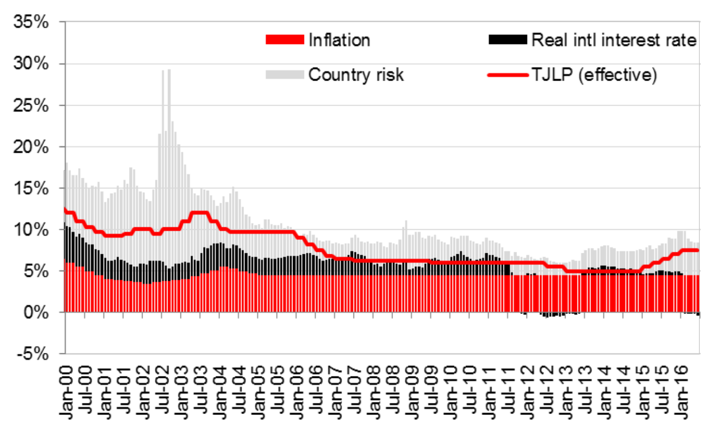
In theory, the TJLP is supposed to be set according to a rule[1], which intends to emulate an interest rate compatible with international levels, but adjusted for Brazilian levels of risk and inflation. As such, the rule predicts that the TJLP will reflect a combination of three components: (1) an international interest rate, in real terms, (2) some measure of country risk for Brazil, and (3) some measure of inflation for Brazil, all of which are *evaluated from a medium- to long-term perspective*.

This last point is key: because those components are *evaluated from a medium- to long term perspective*, there is a discretionary element even though the rate is in theory set by a rule. This is what makes it possible to insulate the TJLP (and all the long-term financing for which it is a benchmark) from short-term spikes in country risk and international rates, and from temporary inflation shocks. Nevertheless, this discretionary element has also been used in the past to "bend the rule" and deliver a lower TJLP and/or not increase the rate despite what the conditions embedded in the rule would have warranted.

What would the rule indicate as an adequate level for the TJLP today? It depends on how one assesses the medium- to long-term perspectives for its components. For inflation, there's a rather straightforward approach, which is assuming that inflation will eventually converge to the center of the target (4.5%). For the other components, some degree of judgment is inevitable. For the real international rate, if we assume the latest projections from FOMC members, US interest rates should converge to 3%pa in the longer term, whereas US inflation should stabilize around the targeted 2%, implying a long-term real interest rate of roughly 1%pa. Another possible approach would be looking at how markets are evaluating such an international rate – which, according to our estimates, would yield a lower international rate, of 0.2% pa[2].

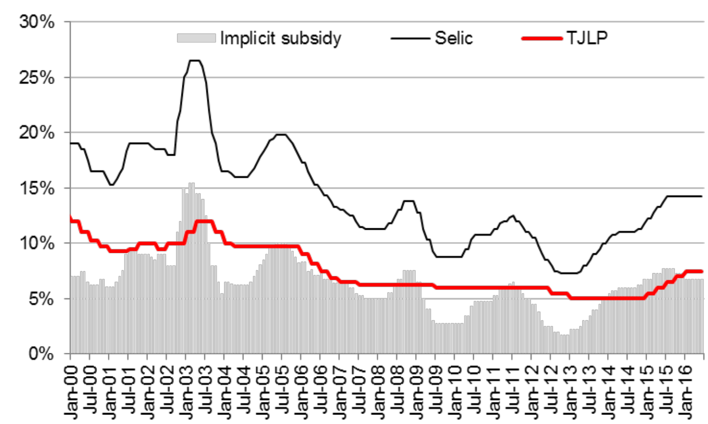
Meanwhile, the country risk component is trickier and even more prone to subjectivity. If we do assume 4.5% for inflation and 1% for the international interest rate (in real terms), a TJLP at 7.5% implies an appraisal that the "fair" country risk, from the medium- to long-term perspective, at 200bps – far lower than the current measures of 320-350bps, and consistent with a sovereign upgrade of at least one notch (to BB+). If we do assume an international real interest rate of 0.2%, the TJLP at 7.5% implies an evaluation of the country risk at 280 bps, still lower than current levels but more feasible for Brazil over the near term.

**Figure 1 – TJLP: effective vs formula**




Country risk: Brazil's EMBI+ in %, monthly averages. Real international interest rate: UST 10 years minus 12-month US Core CPI. Inflation: center of the inflation target, weighted by the number of quarters for which each target prevails. Sources: BCB, Bloomberg and Santander.

**Figure 2 – TJLP vs Selic**




Sources: BCB and Santander.

[1] Please see our note *TJLP: What it is and why it matters*, published June 27, 2012.

[2] On June 22, the 10-year US Treasury traded at around 1.7% whereas the 5-year forward inflation expectations stood at 1.47%. At the time of this writing (post-Brexit), with the rise in risk aversion, US Treasury rates were trading lower than that; however, this movement was offset by the rise in country risk. In net terms, therefore, post-Brexit conditions should not imply a meaningful change in the outlook for the TJLP, at least in a preliminary assessment and under the spirit of the TJLP rule.

**In our view, two implications emerge from this analysis, assuming that the rule will serve as a guide to the CMN. First, the TJLP is lower than the recommended level, but not by much: it would be hard to justify a substantial rise in the TJLP (more than 100bps), even under conservative assumptions for international rates and country risk. Second, should the spirit of the rule guide future decisions, a cut in the TJLP will only be possible if the country risk improves to levels consistent with regaining investment grade, and/or if it reduces the inflation target (considering that it is hard to envisage real international rates declining even further, on a sustainable basis, from the currently low levels).**

## Fiscal vs activity

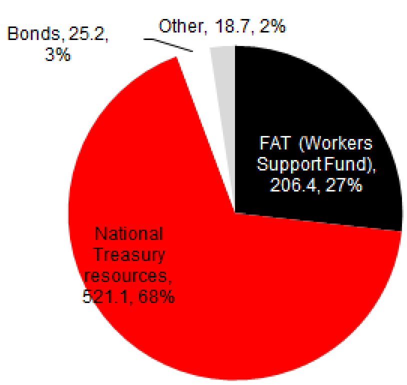
While the rule offers a reasonable guide, it is clear that it is not the only factor the CMN takes into account when setting the TJLP: its effects on economic activity and on the fiscal accounts probably weigh on the decision as well.

On the economic activity side, the TJLP is one important element to assess the economic viability of investments when these are funded (at least partially) with TJLP-linked BNDES loans. Also, it may influence the solvency of firms that have contracted TJLP-linked loans in the past. But note that the space for either a substantial rise or a relevant cut in the TJLP seems to be rather restricted by the factors mentioned before – country risk, inflation, international rates. It is hard to gauge the extent of the impact of a (small) move in the TJLP on economic activity, but it seems to be somewhat limited at this point: many firms have hedged their exposure to the TJLP, limiting the impact on their solvency; as for new investment, the outlook for reforms and growth seems to be far more important than an eventual change in TJLP levels.

In terms of the fiscal impact, however, even a small move can be meaningful. Changes in the TJLP have no implication in the primary fiscal result (i.e., they do not affect the budget, for which a BRL170 billion deficit is estimated for this year). However, they do have an impact on interest expenses: as mentioned before, BNDES funds part of its operations with loans from the National Treasury (Figure 3), with the cost of such loans set at the TJLP. However, the National Treasury raises such resources in the market, at a cost around the target overnight rate (Selic). Therefore, the gap between the Selic and the TJLP represents an implicit subsidy on these operations (Figure 2), the cost of which is borne by the National Treasury, affecting its fiscal deficit (including interest expenses).

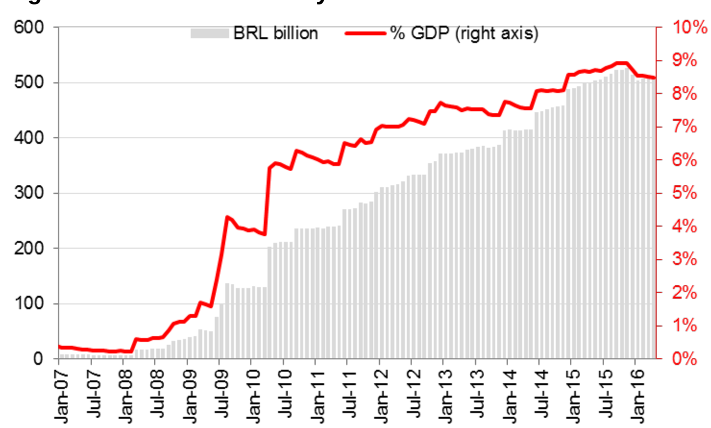
Thanks to the expansion in loans from the National Treasury to the BNDES in recent years (Figure 4), this cost is very relevant. With outstanding loans to BNDES slightly north of BRL500 billion, a rough estimate places the fiscal cost of the current 6.75pp gap between the Selic and the TJLP at BRL34 billion/year (0.6% of GDP). Every 1pp reduction in that gap reduces the fiscal cost by some BRL5 billion (0.1% of GDP).

**Figure 3 – BNDES: sources of funding**




As of June 2015 (BRL bn and % of total). Source: BNDES.

**Figure 4 – National Treasury loans to BNDES**




Source: BCB.

## Conclusion: narrow room for change, either up or down, either now or later

With little leeway in terms of short-term reduction in the huge budget deficit, it may be very tempting for the new members of the CMN to raise the TJLP as a way to signal some marginal improvement in the fiscal outlook. Considering the components of the TJLP, they could have some room to justify a modest increase in the rate – assuming FOMC projections for rates and inflation, no change in Brazil's inflation target and a country risk evolving to the 250-300bps range, the TJLP could rise to 8% or 8.5% pa, implying a fiscal saving of R$2.5 to R$5 billion/year by this decision alone.

However, concerns about private sector solvency and the reliance on investment to drive the economy out of its longest and deepest recession in decades are also likely to weigh on the decision. While the impact of a 50bps to 100bps decision may be limited, it would add to a series of already existing adverse factors in the way of an economic recovery.

**The balance of these factors will likely lead the new members of the CMN to stay put and maintain the TJLP at the current 7.5% pa, in our view. Although such an outcome would be in line with the consensus for this meeting, we argue that the same rationale may prevail in the quarters to come. Unlike previous episodes of monetary easing, when cuts in the target overnight rate were accompanied by cuts in the TJLP as well, the next round of monetary easing will probably see the TJLP stable at the same 7.5% pa, for two reasons. First, a brief look at its components suggests that there is no room to cut the TJLP unless Brazil reduces its inflation target (currently at 4.5%) or manages to have its sovereign credit upgraded to investment grade (leading to a substantial decompression in country risk). Second, but not less important, amid such low budget flexibility, reducing the Selic-TJLP gap represents a rare opportunity to improve the fiscal accounts by an executive decision. Under our forecasts, the Selic-TJLP may narrow to as little as 250bps at the end of 2016, bringing the fiscal cost of the subsidies to around BRL12 billion/year, well below the roughly BRL40 billion/year estimated for mid-2015 (when the cost peaked, according to our estimates). Such a reduction would contribute not only to reducing the annual fiscal deficit, but also toward improving public debt dynamics.**

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