



Monthly Report  
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# New IOF rate may adversely affect debt management

THE RECENT GOVERNMENT DECISION OF TAXING FOREIGN INVESTOR INCOMING RESOURCES TO BE INVESTED IN THE BRAZILIAN FIXED INCOME MARKET, CHARGING A 1.5% IOF (TAX ON FINANCIAL OPERATIONS) RATE, SHOULD NOT BE ANALYZED AS A MEASURE ISOLATED FROM THE PRESENT CONTEXT. THIS MONTH, SINOPSE ANDIMA SHOWS AN ASSESSMENT IN A MUCH BROADER CONTEXT, HISTORICAL AND INSERTED IN THE CONDITIONING ELEMENTS MAKING THE NATIONAL ECONOMY PRESENT SIGNIFICANT GROWTH RATES. THIS TURNS TO BE NECESSARY WHEN IN AN INTERNATIONAL CRISIS SCENARIO LIKE THE PRESENT ONE, SOME ANALYSTS BET ON A DECOUPLE OF THE BRAZILIAN ECONOMY FROM THE EXTERNAL TURBULENCES EXPERIENCED BY DEVELOPED INTERNATIONAL MARKETS. THIS ISSUE ALSO PRESENTS AN INTERVIEW WITH THE CHIEF ECONOMIST OF BANCO REAL FOR LATIN AMERICA, ALEXANDRE SCHWARTSMAN..



## **Institutional advance**

In the last ten years, the Government has worked to strengthen the fundamentals of the fixed income asset market structure. The strategy is due to the recognition of how important it is to the country to have a developed securities market, compatible with the size of the financial sector. The new structure has contributed to an improvement in the business environment of the domestic market and created more adequate conditions to a decrease of basic interest rates, giving room to the improvement of the internal public debt profile, combining retiming terms with a lower cost of securities placement. This change in the public debt finance pattern represented a parameter change for several segments of the economy, with impact on the financial market as a whole, including the credit volume which is making feasible the growth path of the domestic demand.

The income tax exemption for foreign investors on gains on government bonds, awarded in February 2006, was one of the factors that contributed to the improvement process of the securities market and that probably had a relevant role in the public debt management strategy in the last two years. Restrictions that penalize the entry of these agents in the domestic securities market will prone to diminish the Treasury's maneuver margin, compromising the profile of potential buyers of public bonds.

## **An assessment on the foreign investors' participation in the securities market (2006/2008)**

With the income tax exemption on foreign investors' yield on federal public bonds there was a reasonable increase in these agents' participation in the fixed income market. Between January /06 (before the exemption) and January/08, the fixed income asset inventory acquired by foreign investors went from 6.51 to 21.61% of the total of foreign investments portfolio. These figures, although significant, do not mark fixed income investments as the predominant modality in the foreign investor's portfolio in the national financial market, since investments in stocks represent about 75% of this inventory.

However, what stood out in the insertion of foreign investors in the fixed income segment was the willingness to assume fixed and longer duration positions. The improvement in the economic environment was potentiated by tax exemption to these players, who having a long-term culture have contributed to the change process in the debt profile promoted by the National Treasury. At auctions of price-pegged securities held in the five months before February 2006 (period corresponding to the beginning of the decrease path of interest rates goal), the



average duration of primary placement was 38 months. In the five months following the provisory measure (March to July), this variable reached 81 months.

Using as proxy the participation of foreign financial institutions in the auctions of NTN-B with maturities longer than ten years in 2007, we notice a significant presence of these investors, representing about 40% of these assets demand. In some months of the year, their participation accounted for 70% of the total. Therefore, the average duration of the total debt in market raised in 2006 and 2007 (from 28.8 to 36.5 months), and in this last year it even exceeded the maximum limit of 36 months forecast in the Annual Plan for Securities Debt Finance.

Foreign investors' public bonds portfolio in the domestic market is basically made of fixed and indexed bonds. The last statistics available referring to January /08 shows that 7.73 % of the LTN/NTN-F and 4.4% of the NTN-B/C are held by foreign investors, and that in this last class of bonds, the majority refers to maturities longer than five years.

The expansion of the investors base with the entry of foreign investors not only represent a qualitative change in secondary trade, but also allowed more flexibility to the Treasury in terms of trade-off between cost and duration, so that the intensive placement of these bonds would not represent a worsening in finance conditions. In addition, the consequent participation reduction in the short-term debt (up to 12 months), reduced Treasury's exposure in terms of refinance risks since it spreads maturity along the curve and acts as an important solvency indicator once it implies a more predictable scenario with less fluctuations in the debt's cost.

Changes occurred in the securities primary market due to a higher issue duration of public offers have impacted secondary market operations with a significant increase of longer term bonds in these trades, mainly NTN-F and NTN-B with maturities higher than five years. This movement allowed for better pricing of the yield curve, an essential condition for a developed domestic credit market.

### **Foreign investor taxation: a short-term debate**

The strengthening of the securities domestic market and the consequent cost reduction of the primary placement of public bonds already represent an significant gain for the government in terms of positive externalities derived from this new arrangement, both regarding the market microstructure and tax perspectives. However, even with the tax benefit granted to foreign investors in 2006 it is possible to see some 7.5% increase in income tax withholding in financial investments between 2005 and 2007, releasing the need of creating any



type of compensatory mechanism. Nevertheless, with the clear function of an economic policy instrument due to the valuation path of the national currency in relation to dollar, the government decided for a higher tax wedge on foreign investors' investments on fixed income, among them the public debt, with a 1.5% IOF rate.

In a simulation carried out with the new taxation (see graph on page 5), the net profitability of a LTN investment in a period higher to 30 days would be reduced from 9.2% to 8.5% with the extinction of the CPMF and the introduction of the IOF on exchange rate. For private bonds, in case of investment in debentures, this reduction would be from 7.7% to 7.0%, the result of an effective rate of operation higher than at the CPMF period. This smaller net return on operations subject to IOF may hinder the advances towards an improvement in the debt profile since the manager will run the trade-off between cost and duration on the new profitability basis (see the interview with the chief-economist for Latin America of Banco Real, Alexandre Schwartzman).

The argument that justifies the taxation of foreign investors would be the government's need to restrain the valuation process of the real, that in a medium and long term might compromise the results of the commercial segment. However, the asymmetry between domestic and external interests does not guarantee that this trend will be reverted. When comparing the curve of fixed interest rates with the American yield up to two years, the increasing differential becomes a strong source of attractiveness for foreign resources to the national market.

Even though, the results of the contracted exchange rate in the last two years show that the strong pressure on the exchange rate has been a result of the commercial flow that is presenting a systematic surplus over this period. In 2006, the net balance of the financial segment reached a negative level (US\$ -20 billion) and, in the following year, the surplus was US\$ 10.7 billion against a net entry of capital of about US\$ 76.7 billion due to the commercial flow.

### **Final considerations**

Therefore, more than just measures that might compromise the securities domestic market strengthening process, the Decree n. 6.391/08 may also represent a back step in the institutional field. For a long period, the perception of a high country risk level by investors was directly related with the history of changes in economy and market rules that did not create an environment compatible with medium and long term investments. Now, the Brazilian economic scenario lives with new paradigms where rules regarding maintenance and stability are a must to reach a sustainable economic development.



## Interview – Alexandre Schwartzman

### **Finance cost tends to increase with the new IOF**

IN AN INTERVIEW TO SINOPSE ANDIMA, THE CHIEF-ECONOMIST FOR LATIN AMERICA OF BANCO REAL, ALEXANDRE SCHWARTSMAN, ANALYZES THE IMPACT OF THE U.S. ECONOMIC CRISIS ON EMERGING MARKETS, SPECIFICALLY IN BRAZIL, AND ALSO TALKS ABOUT THE IMPLICATIONS OF THE CHANGE IN THE IOF RATE ON FOREIGN INVESTMENTS.

**With a possible slow down of the world economy, do you believe that there will be a significant decrease in resources flow to emerging markets?**

There will be, in a certain extent, but it will hardly be a reduction like in the other crisis events, such as in 1997/98 or 2001/02. At that time, the epicenter of the crisis (or epicenters) was in emerging markets. In contrast, the present crisis finds emerging countries in better situation. The majority of them (but not all) have their tax accounts in order, modest unbalances (if not surplus) in current account and a high level of reserves.

The combination of these factors suggests that, even in small volumes and higher costs, the flow of capital to emerging countries will continue because these conditions imply less risk for the investor than in past occasions. It is obvious that this observation does not apply to the whole set of emerging countries. Those that are strongly aside to this rule shall see a more significant reduction of capital inflow.

**In the Brazilian specific case, which segment tends to be more affected: commercial or financial transactions?**

In the specific case of Brazil I would expect a reduction in both flows. Higher imports due to the strong growth of the domestic demand shall reduce the balance associated with commercial transactions, while less appetite for risk assets shall reduce in a certain degree transactions that have been quite frequent last year (IPOs, purchase of local debt etc).

**In terms of DMPFi (Federal Public Debt) management strategy, what are the implications of the government decision to increase IOF to 1.5% for foreign investors in the fixed income market?**



It implies a higher finance cost and due to it a possible reduction in maturity and duration of new issues compared to what could happen in the absence of the IOF.

It is important to remember that investors do not care with the gross return rate on their investments, but with the net return rate, after taxes. Let's consider the case of an investor that brings US\$ 100 to invest in a three-year bond, willing to buy it at 12% per year. These US\$ 100 would be converted in R\$ 173.20 that when invested at 12% would represent R\$ 243.33 after three years. However, with the introduction of the IOF, these same US\$ 100 will turn to only R\$ 170.60, that at 12% would return R\$ 239.68.

In order to the net return be the same of the previous alternative (without IOF), it would be necessary the return rate of the bond to raise to 12.57% per year, 0.57% more per year, which would imply an additional cost of R\$ 2.92 for the National Treasury (R\$ 0,972 during three years), against a IOF collection of R\$ 2.60 (1.5%\*173.20).

In addition, the perception that the rules of the game can change, could add some risk premium to the debt finance rates, hard to quantify *a priori*. Anyway, due to a higher cost, the Treasury would not increase so much the debt duration because it is not interesting to "lock" a higher cost for the same period.

**In addition to taxation, what are the other factors that in your opinion could inhibit the foreign investor's exposure to private risk in the Brazilian fixed income market?**

I think that the low liquidity of the private fixed income bonds is the main inhibition factor to foreign investment in this market. Different from the derivative market, of high liquidity, even in longer terms, the reduced liquidity of private bonds decreases the appetite for this type of asset. To run the risk of carrying a bond that may charge a high cost in case there is a need to leave the position, investors require discounts that increase the cost of placement.