Brazil

Economic Watch

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Economic Analysis

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Brazil: a new tax increase to steam off BRL

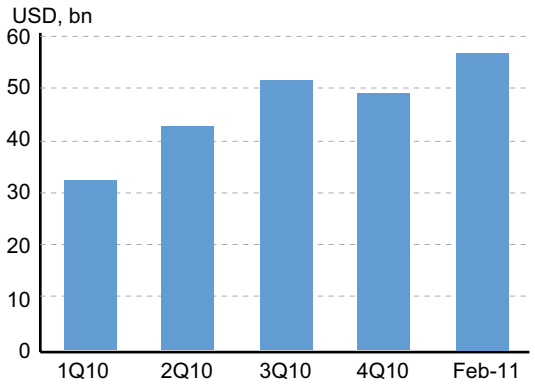
- **The government announced an increase in IOF to short term loans.** Following previous rumours, the government formalized today the increase of the IOF tax to 6.0% on foreign loans and bond issuances with maturities of 360 days or less. This tax had been cut to 0.0% from 0.38% on September of 2008 for loans from 90 days to 360 days. As of Monday, the only taxable financing operations were for loans up to 90 days which were being taxed by 5.38%. This measure adds to yesterday's announcement that credit card purchases abroad would have the IOF tax increased to 6.38% from 2.38% (and also to other measures alike announced in the end of 2010).

- **The amount of these transactions has increased significantly in the last two months.** Foreign loans have increased 55% since 2009 and reached a total outstanding level of USD 156bn by February (36% of which corresponds to short-term loans). In spite of this recent surge, foreign loans account for only 7.3% of GDP nowadays in comparison to 19.3% in 2002 (in the case of banking system this share is even less important as loans from abroad account for around 5% of total liabilities). Only in the first two months of this year, short-term loans inflows reached USD 7.7bn. This amount compares to portfolio and FDI inflows of USD 4.5bn and USD 10.7bn, respectively, in the same period.

- **The announcement is focused in external debt too.** This action must be read as a new specific tool inside a wider package of fiscal/administrative measures that have been applied in the last months and which are aimed at tempering the appreciating pressure on BRL derived from capital inflows. In this case, on top of this goal of steaming off the real, this action seems also focused on keeping external debt under control as a way to reduce potential effects that could arise in the future should these short term flows were altered.

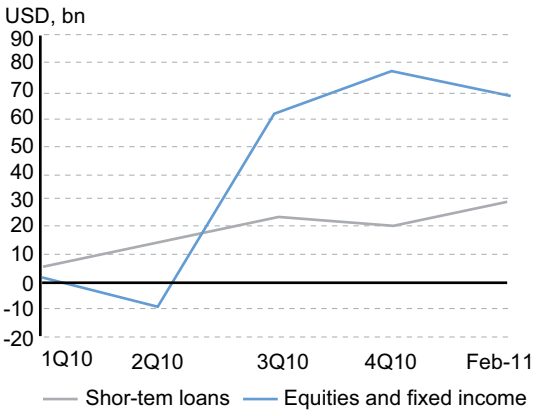
- **The BRL has not responded yet but more measures are expected.** Following today's announcement the BRL has appreciated about 0.39%, reflecting how the measure had already been priced in. In line with Guido Mantega's declarations, more measures to curb the appreciation of the BRL are expected (as an IOF increase in fixed income or equities which are currently at 6% and 2% respectively or the beginning of Sovereign Wealth Fund's interventions in FX markets). More macro-prudential measures to moderate and control credit growth are also very likely to be announced within next few months.

Chart 1
Foreign short term liabilities position



Source: BCB and BBVA Research

Chart 2
Cummulative changes in loans, fixed income and equity holdings in the international investment position



Source: BCB and BBVA Research

The measures should help in maintaining a lateral trend in the BRL and would have no significant impact on public domestic rates. Since, as said before, short term loans represented around a 34% of foreign currency inflows as of February, we would expect the measures announced this week to help keeping the exchange rate in the 1.65-1.68 range in coming months. We do not expect them to have an impact on domestic interest rates, which should keep responding –as has been the case since the end of 2010- to the monetary policy outlook, to external risks and to inflation expectations. Since October 2010, when the IOF increased from 2.0% to 6.0% in fixed income securities, foreign capital flows to domestic public debt have gathered speed. The combination of a rather stable and strong currency and high interest rates are giving enough relative value to domestic bonds to compensate the IOF. As long as the domestic monetary policy stance remains restrictive, and ahead of most other emerging markets, this relative value or carry-trade will not ease easily.

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