

Brazil Macro Update

EXECUTIVE SUMMARY:

- **Domestic drivers of the Brazilian economy face still-stretched balance sheets, which represent headwinds to a potential economic rebound. However, very low output levels in industrial production (sitting at 2004 levels) mean there is some potential for a base effect improvement.**
- **On the reform front, pensions remain the key reform, and the outlook is still highly uncertain. The long-term interest rate (TJLP) reform appears more likely to be approved, and could allow interest rates to compress, providing some relief to a widely over-levered economy.**
- **The 2018 elections remain highly uncertain.**

GROWTH

The outlook for Brazil over the next year is extremely binary. If reforms are approved, and a market-friendly candidate is elected we could see additional relief for Brazilian markets, and FDI flows gain further traction. Few places in LATAM need strong foreign investment as much as Brazil does at the moment, given the sluggishness of its uncompetitive manufacturing sector, highly levered households, and a stretched public sector balance sheet, which have led to the country's worst recession on record.

On the household front, the share of after-tax income that Brazilian households devote to debt service remains near its historic high (see chart 1)—and around (or higher than) the levels reached in the US or Spain before their respective debt crises. There is potential for some relief for households as interest rates fall—particularly if the TJLP and pension reforms are passed (as we explain later on), but our sense is that consumption will remain relatively weak until households' balance sheets improve. At the government level, the balance sheet is constrained by rating pressures, which prevent it from going on a spending spree to boost the economy (the fiscal deficit is expected to again come in around 8% of GDP, and gross public debt is nearing 90% of GDP).

The manufacturing sector could experience improvements from base effects, as industrial production remains near 2004 levels in real terms, but two factors act as constraints: 1) whatever competitiveness it got from the Brazilian real's initial depreciation was eaten away by very high inflation, which has meant the gross depreciation of the real was essentially eaten up by rising costs, and 2) a large share of corporates themselves are highly levered. The weakness in domestic economic drivers due to stretched balance sheets makes foreign investment appetite very important for any potential Brazilian rebound.

REFORMS

Although we are likely to get some good news on the reform front, most likely on the TJLP rate changes, it is far from clear if the pension reform—arguably the most important one—can pass without being materially watered down. The TJLP

CONTACTS

Eduardo Suárez, VP, Latin America Economics
 52.55.9179.5174
 Scotiabank Economics
eduardo.suarez@scotiabank.com

Chart 1: Household balance sheets remain highly levered—dampening growth prospects.



Chart 2: Brazil's industrial production currently sits near 2004 levels in real terms, offering some potential relief—if for nothing else, due to base effects.

Brazil: real industrial production
 (s.a., 2012 = 100)



reform can help the economy to the degree it can allow interest rates to fall, but pensions is arguably the make-or-break reform.

What is the TJLP rate, and why is it relevant? It's the benchmark interest rate at which the BNDES lends to the corporate sector in Brazil, and at times over recent years, this interest rate has been set over 600bps "tight" to the BCB's policy rate (the Selic rate—see chart 3). The reform seeks to move this benchmark (the TJLP) closer to being determined by market forces. This is relevant for two reasons. As [the IMF argues](#), the reasons why Brazil's market clearing interest rates are higher than most of Latin America, include:

- Fiscal considerations: high levels of public debt, as well as a history of defaults could be part of the reason why Brazil's market clearing rates are high. More recently on the fiscal risk front, one of the reasons why the country's credit ratings came under pressure over recent years (and Brazil lost its investment grade) is that the government was very aggressive in providing the private sector with financing through state-owned banks, such as BNDES. If the subsidy on the TJLP rate is cut, and the development bank's lending rates converge to market ones, we could see fiscal concerns decline—as both the subsidy declines, and the dependence of the corporate sector on BNDES drops. This could help lower market clearing rates.
- The second way in which we see the TJLP reform helping lower market clearing rates is by improving the pool of borrowers who rely on market financing. Even though the development bank's role is supposed to be covering segments of the economy that don't have access to market financing, we would argue that for much of the Partido dos Trabalhadores' (PT) administration, the BNDES was aimed at supporting "national champions" (i.e., the top corporates in Brazil—or the prime borrowers). By taking top borrowers out of the market pool, the government was leaving a lower quality pool of borrowers for market players—thus pushing up the market clearing rate. If the reform succeeds in lessening this market segmentation, we could see market rates drop in Brazil.

Hence, our take is that the TJLP reform could allow market clearing rates to fall, and consequently allow the BCB to cut rates to a lower sustainable level... giving the highly levered economy some relief.

Why is pension reform the "make or break" reform? Brazil's fiscal position is currently under a lot of pressure, with the country having lost its investment grade from all three major rating agencies. One of the weak spots of Brazil's public finances is the size of its unfunded pensions deficit. According to the OECD, if the pension issue is not addressed, the country will be facing annual payments of around 15% of GDP by 2050 (see chart 4)—making it one of the countries facing the worst pension situations of all those measured. The current proposal does not fully address the issue, but it is estimated to save a potential US\$190bn over the next decade, which could improve the country's fiscal position, and also drive yield compression. The problem is that approval of the reform remains highly uncertain.

LULA AND THE 2018 ELECTIONS

Although President Lula presided over Brazil's golden moment at the start of the 2000s, our sense from client talks is that, as the fiscal deterioration that took place under PT governments became apparent once the commodity price environment became less benign, market players have taken a much more cautious stance regarding prospects of a return to PT rule. However, next year's election remains a question mark, with not only uncertainty over whether Lula would win a presidential election in 2018, but also over whether he will be able to run given ongoing trials the former president faces. If he is not barred from competing, Lula may still be the candidate to beat given his relatively strong backing, while the latest poll released by Ipsos (August 28th), shows his popularity is once again rising.

Chart 3: The subsidy implied by the spread between the TJLP and the Selic rate got to nearly 700bps. Reducing that spread could help reduce Brazil's market clearing rates.

Brazil: TJLP rate (benchmark for BNDES lending) vs BCB Selic rate

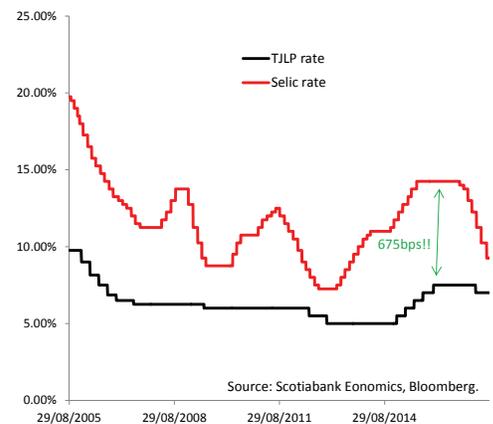
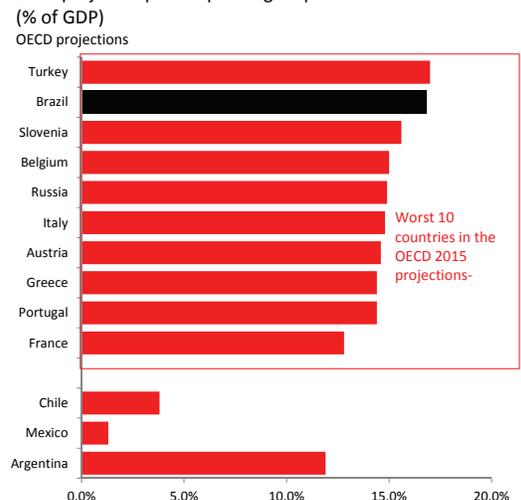


Chart 4: Brazil faces one of the worst pension deficits of any country measured by the OECD, if left un-addressed. If the current reform proposal is approved, it could alleviate fiscal pressures, and help lower the country's interest rates—a boon for the government, households, and corporates.

2050 projected public spending on pensions (% of GDP)



This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a “call to action” or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.