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Brazil Broadens IOF Tax to Stem Surging Inflows

On Mar 28, the Brazilian central bank imposed a 6% levy on short-term foreign borrowings and debt sales by corporations and banks. The measure raises to 6% the current 5.3% tax on short-term borrowings, and expands its reach to include deals with average tenors of less than 360 days. Previously, only those with tenors of up to 90 days were taxed. Finance Minister Guido Mantega said the increase of the so-called IOF tax on foreign borrowing aims to avoid further appreciation of the real while reducing the exposure of companies and banks to debt in a foreign currency.

However, the real strengthened for 3 trading days after the announcement. It appreciated 2% against U.S. dollar. Mantega decided to extend the tax on foreign based loans. Starting from Apr 7, banks and companies will have to pay a 6% tax when borrowing overseas for up to two years. Will this bring negative effects to the economy and stock market?

On April 20, policy makers, led by central bank President Alexandre Tombini, voted 5-2 to raise the Selic rate by a quarter point to 12% from 11.75%. Since the central bank expected the inflation rate for 2011 is 5.6%, the real interest rate is about 6.4%.

The interest rate gap between Brazil and other countries encourage the arbitrage activities. Local banks increase the borrowings from abroad (with low interest rates) and used the money to buy Brazilian government's bond or lend to local customers. The former can reduce the government's financial burden, whereas the latter could increase the credit risk for banks.

Total outstanding credit in Brazil's economy rose 21% from a year earlier in February, to 1.74 trillion reals. Tombini told lawmakers Mar 22 that growth in consumer credit of more than 15% needs to be monitored very carefully to avoid excessive risks.

According to Moody's Weekly Credit Outlook on 4 April 2011, the new tax is credit negative for Brazilian banks because it will reduce arbitrage opportunities and increase their cost of funding, with negative implications for their profitability. From our point of view, the policy can reduce the chances for the boost of the credit bubbles. In December, the central bank raised banks' reserve requirements to slow credit growth, and in April the Finance Ministry doubled to 3% the so-called IOF tax on consumer credit. We expect the policy makers will continue to implement the tightening policies in coming months.

On April 4, Fitch Ratings has upgraded Brazil's Ratings from "BBB-" to "BBB". The upgrade reflects Fitch's assessment that the sustainable potential growth rate of the Brazilian economy has increased to 4% - 5%, supporting the medium-term fiscal outlook and the continued strengthening of its external liquidity position, which increases the country's shock-absorption capacity. The new government's announcement of spending cuts in 2011 and a modest increase in the minimum wage as well as a steady reduction in the Treasury's loans to the Brazilian Development Bank, BNDES are supportive of a gradual improvement in the overall fiscal stance.

Capital inflows support the appreciation of real. The central banks stated that Brazil received net inflows of \$36 billion for the first quarter this year, compared with \$24 billion for the whole of 2010. The bank estimates that Brazil's economy will attract a record \$55 billion in foreign direct investment this year.

We believe that Fitch upgrade the Brazil's rating can increase the demand for the government bonds. The measures adopted by the government cannot change the direction of either capital inflows and appreciation of real. They can only reduce the scale.

The yields for 1-year and 2-year Brazilian government bonds are 12.44 % 12.7 respectively on April 21, which is very close to current official rate. Assume the government raise rate at 0.5% each time, the rate hike could be done for one more time shortly. Besides, the 10-year yield is about 12.74%, which is similar to 2-year yield. We expect this cycle of interest rate increases may come to an end soon.

We expect the real interest rate of Brail will increase from 6.4% to 6.9% by the end of 2011. Unless the interest rates raise quicken or the inflation rate fall largely in other countries, Brail is likely to maintain its yield advantage.

Interest rate cycle come to an end and inflation growth moderately may become the catalyst for the driving force of Brazilian equities market.

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