

THE CARNIVAL IS OVER IN BRAZIL



John-Paul Burke's
Market Views

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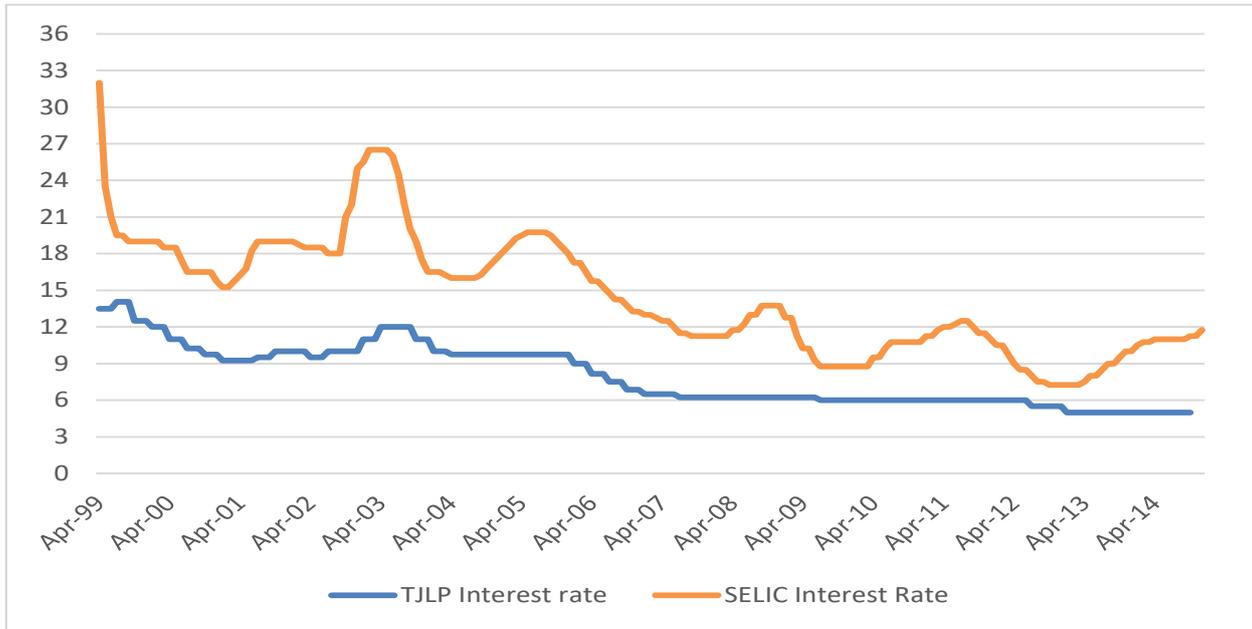
I would like to thank Angel Simbaev, our summer intern, who assisted in the production of this note.

It's no secret that Brazil has suffered immensely since the financial crisis and China's economic orientation away from ever-greater commodity consumption. Real GDP growth in Brazil trended upwards for ten years, peaking at over 8% until mid-2010 when the abrupt slowdown began.

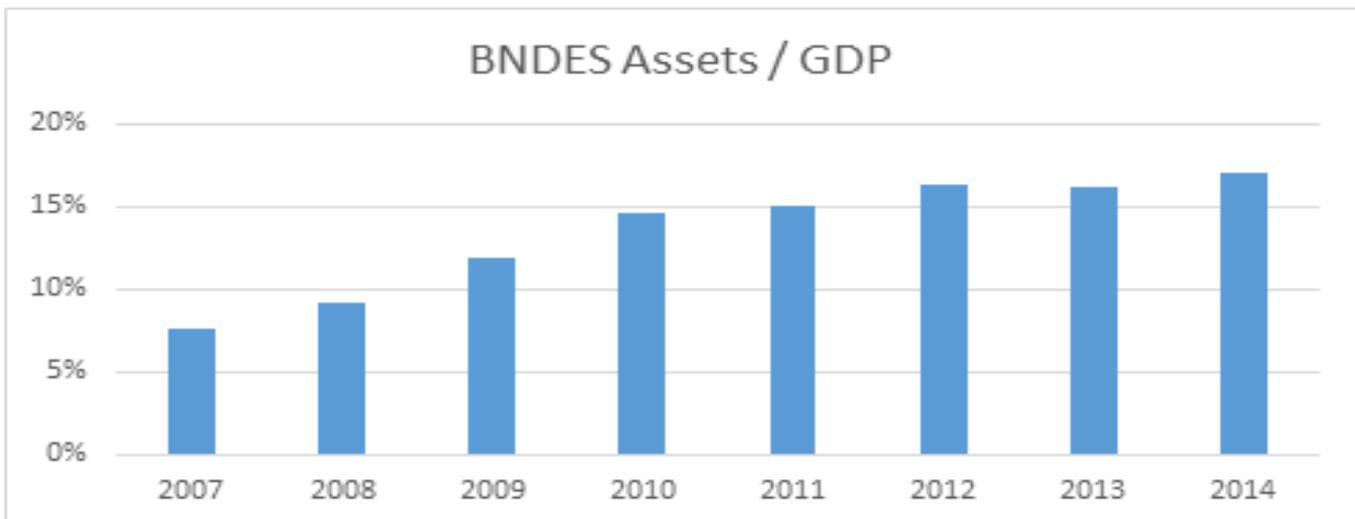


What is far less appreciated is the meaningful involvement of BNDES, Brazil's large state run development bank, within the economy over this time to try to prevent the economic malaise.

Publicly funded BNDES has access to capital at the long term interest rate of 6.5%, called the TJLP. However the Government (BNDES' principal benefactor) must itself raise funds at the SELIC rate of 14.25%, the central bank rate, when it issues sovereign bonds. The difference of 7.75% is the cost to the Government for providing BNDES' capital, and therefore is ultimately the burden of the taxpayer.



In the lead up to the financial crisis BNDES' presence in the economy was more limited, its loans made up approximately 10% of GDP. However since 2008 its balance sheet has increased over 3 times and now represents over 17% of Brazil's GDP.

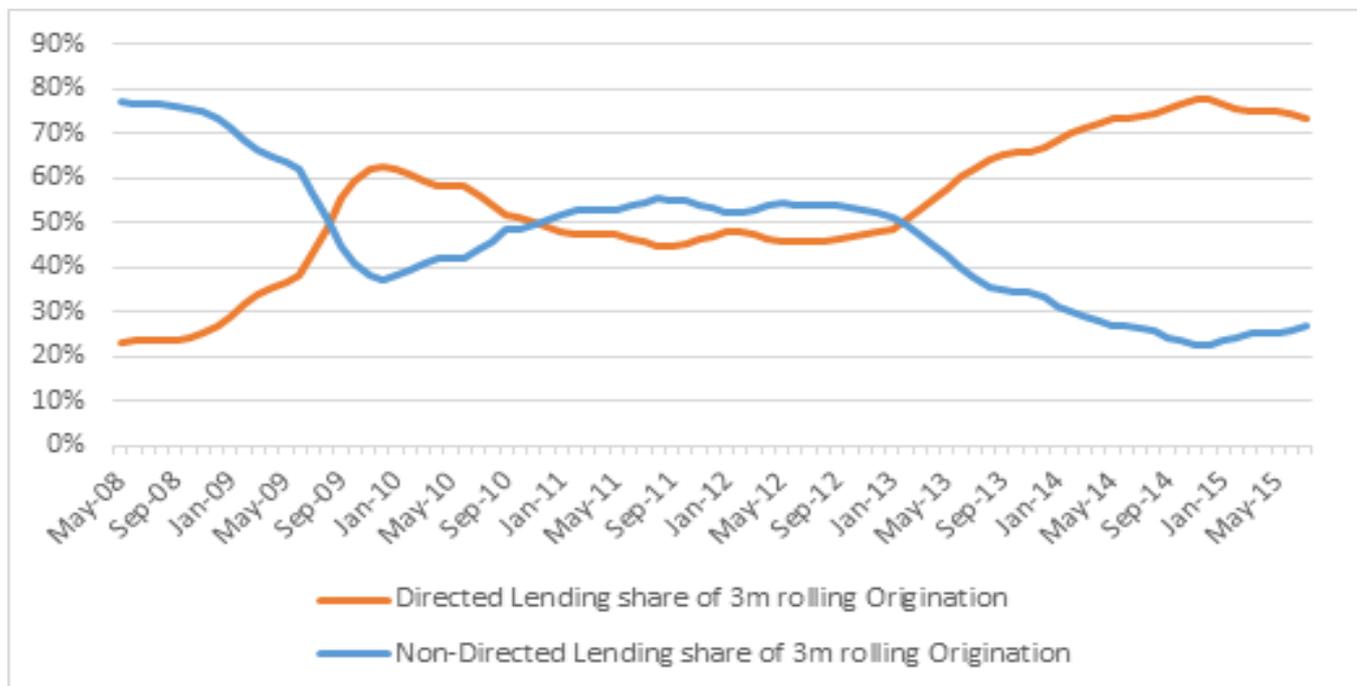


Indeed as private sector banks naturally slowed down their lending in response to economic conditions, BNDES stepped in. "Earmarked loans", as these state directed bank loans are referred to, now represent over 25% of GDP making them the same size as all private sector loans within the Brazilian economy.

Given the size of development banks within the economy, BNDES' credit risk for Brazil is considerable. Worryingly, corporate profitability in Brazil has declined over the period resulting in the lowest return on equity for a decade and the highest corporate leverage, which does not bode well for the health of loan books.

It is possible BNDES itself could experience credit concerns as the bank claims its non-performing loan ratio is currently only 0.01%, surely a cyclical low. Equity at BNDES only represents 10% of the loan book, so a government capital call is not beyond reason should non-performing assets increase as they have for private sector banks as unemployment rises from the cycle lows.

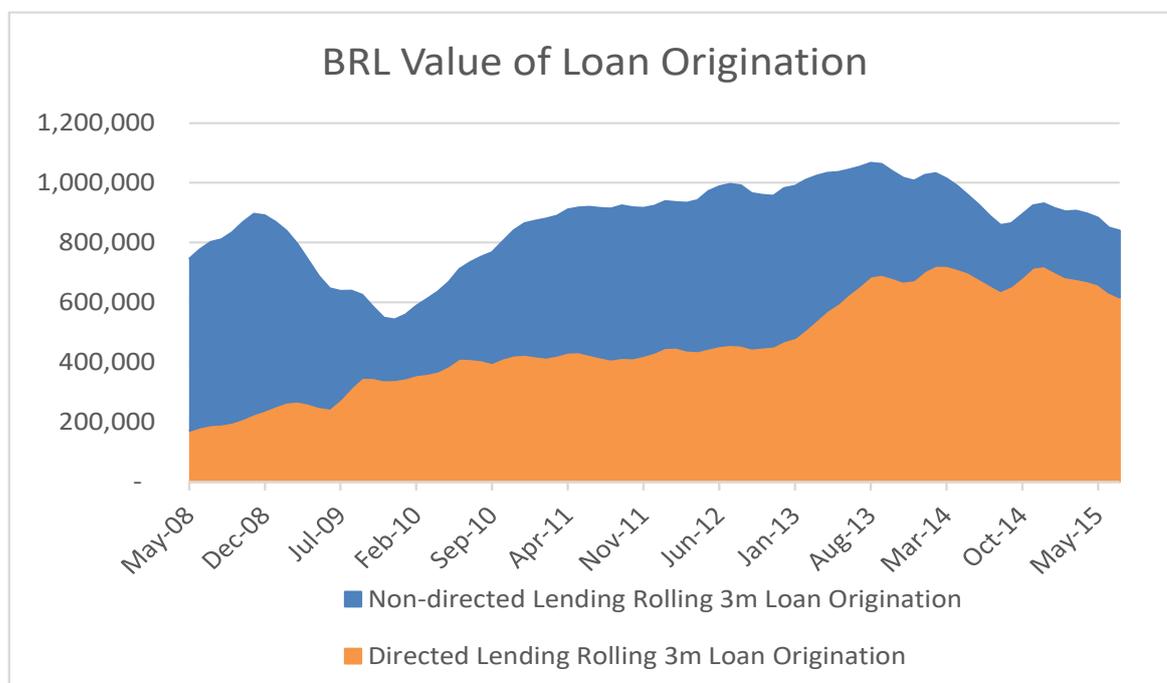
BNDES is important for Brazil because it's lending has contributed substantially to economic growth in recent years. Looking at the split between directed and non-directed annual growth in 3 month loan origination, makes clear just how dependent the Brazilian economy has been on banks like BNDES. At the peak almost 80% of new lending came from directed lending versus just over 20% in 2008.



Source: Banco Central do Brasil

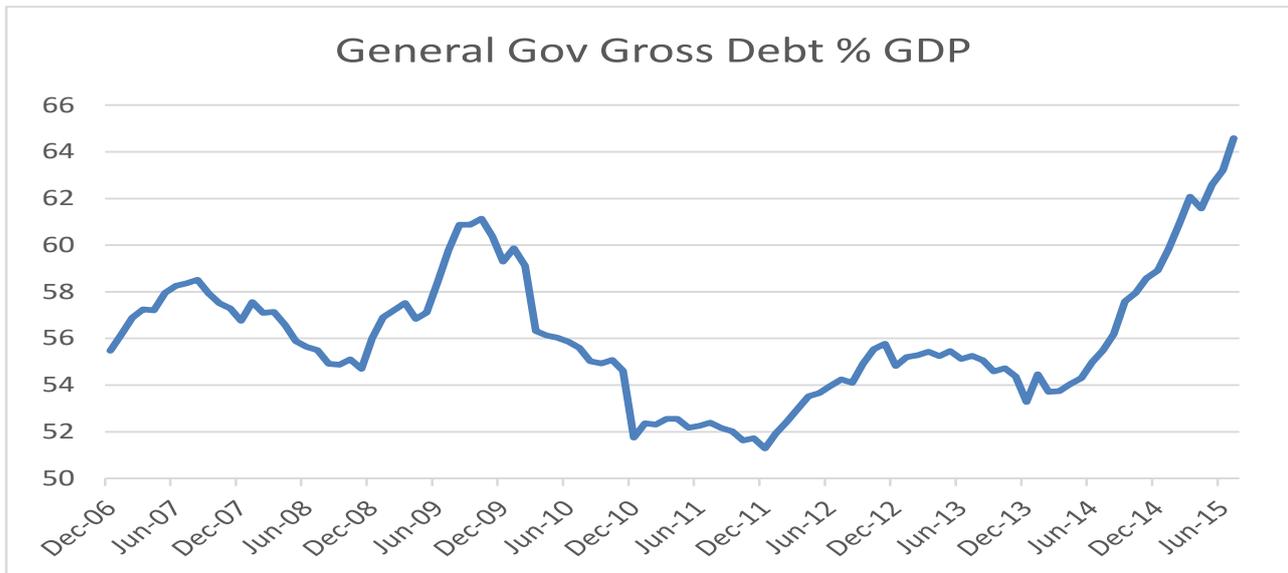
BNDES’ balance sheet has compounded at 22% for the past 6 years. In contrast, in real terms freely allocated credit has been negative year on year in Brazil since December 2013. Therefore development bank earmarked loans have been the only credit flowing in real terms for the past year and a half. These funds have been vital for the little amount of growth the Brazilian economy has achieved.

However even BNDES has recently started to pare back lending as the Brazilian economy shrinks and it struggles with its debt dynamics. In absolute terms, origination of directed lending is now falling, as it has been for non-directed lending since August 2013.



Source: Banco Central do Brasil

Ultimately, treasury sovereign debt issuance fuels BNDES. As gross government debt rapidly increases, the Government will continue to pull back on BNDES funding rather than further contribute to its burgeoning indebtedness, in my view. Gross government debt now stands at 65% of GDP and borrowing costs exceed nominal GDP growth – a dangerous condition because debt levels are growing faster than the economy.



BNDES' withdrawal is compounding Brazil's economic weakness and will likely result in private sector banks having to share a larger burden of the economic fallout through rising non-performing loans.

Brazil is left in an unenviable position. The current level of BNDES lending is unsustainable but without it, growth in Brazil is unsustainable. There is no easy way out for Brazil.

INFORMATION

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