A SUMMARY OF RECENT DEVELOPMENTS AND ACHIEVEMENTS IN BRAZILIAN DEBT MANAGEMENT

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The year of 2003 has been a favorable year for reaching significant developments in debt management practices. Policy decisions taken by the new government towards a strong fiscal stance and strict control over inflationary pressures have provided a sound environment giving way to a new scenario of increasing stability and substantial improvements in debt management practices.

This document summarizes the main developments and achievements in Brazilian debt management in 2003. The objective is to show on a consolidated basis the measures that have been taken to foster the development of Brazilian debt markets aiming at enhancing liquidity, reducing costs, improving the debt profile and diversifying the investors base.

The text is organized as follows. Section one presents an overview of some selected impacts of the soundness of the new government economic policy. Emphasis is given to the gains obtained due to macroeconomic improvements. The second section describes the strategic measures taken by the Treasury towards the development of debt markets. Section three lists some improvements in debt indicators, while the last section presents some concluding remarks.

1. Impacts of the soundness of the new government economic policy:

- Significant reduction in the Brazilian risk premium (EMBI Brazil was 2.443 bps in September 2002 and reached 601 bps in October 2003) – graph I;

- Enhanced credibility allowed for the resumption of issuance in the international markets: Global 2007, Global 2011, Global 2013, Global 2024-B, and Global 2010 – all with collective action clauses CACs. Net issuance totaling US$ 4.6 billlion;

- Significant reduction in inflationary expectations with a direct impact on futures market rates (graph II), creating better conditions for the **reduction in newly- issued debt premium**.

    - Lower **floating-rate discounts** were responsible for a reduction in refinancing costs of around **R$ 595 million**, while for **fixed-rate bonds** such reductions reached **R$ 1.1 billion**, since the beginning of 2003;

- Constant reduction in the Selic rate and appreciation of the exchange-rate was also translated into finance gains for the public debt. Positive results were obtained both in the stock and cash flows. The total gain obtained since the beginning of 2003 is of approximately **R$ 110 billion** (see Table I).

    - Regarding the **Selic rate**, the gains obtained since June, when this rate started to decrease, indicate that at the end of 2003 the results in the debt stock and cash flow will be positive;

    - The impact of the **Real appreciation** allowed a financial gain of around **R$ 12 billion in the debt cash flow**. In addition, there was a significant reduction of **R$ 65 billion in the debt stock** (R$ 48 billion in the external debt and R$ 17 billion in the domestic debt);

    - Regarding the **dollar/Selic swap operations**, the financial gain is of approximately **R$ 31 billion**. Even though these operations do not impact directly the federal public debt, the gain is reflected in the Central Government result (National Treasury + Central Bank) and consequently in the Net Public Sector Debt;

    - Finally, **the total impact** of the improvement in the macroeconomic indicators, from January to October 2003, compared to the expectations at the end of 2002, was around **R$ 54 billion for the external public debt** and **R$ 25 billion for the domestic public debt**. Considering the indirect impact of dollar/Selic swap operations in the Central Government accounts and in the Net Public Sector Debt, the total gain is even higher (around R$ 110 billion).

TABLE I

R$1000

Domestic Debt	
Reduction in the Cost at Issuance - Impact on Selic Debt	594.619,01
Reduction in the Cost at Issuance - Impact on Fixed-Rate Debt	1.117.916,63
Selic Cash Flow	(12.644,34)
Selic Stock	(320.219,30)
Exchange-rate Cash Flow	6.045.073,23
Exchange-rate stock	17.336.791,24
Total Impact of Domestic Debt	**24.761.536,47**
External Debt	
Exchange-rate Cash Flow	5.937.999,94
Exchange-rate Stock	47.809.916,87
Total Impact of External Debt	**53.747.916,81**
Dollar/Selic Swap	
Swap Cash Flow	9.671.873,62
Swap Stock	21.508.884,33
Total Impact of Dollar/Selic Swap	**31.180.757,95**
Total Impact	**109.690.211,23**

Source: Monthly Report/October 2003 – Risk Management/
Public Debt Strategic Planning Department/National Treasury

2. Improvements in debt management strategic measures & development of debt market

2.1. Strategic Measures - Supply Side

Good macroeconomic fundamentals have allowed the National Treasury to adopt strategic measures that aim to improve public debt profile and develop public securities market.

The following items describe some implemented measures.

- Creation of benchmarks

  - Fixed-Rate Bonds - concentration of issues through reopenings to stimulate liquidity. Moreover, to enhance demand and liquidity for these bonds they have been placed so that their maturity dates coincide with maturity dates of future market contracts;
  - Floating–Rate Bonds – concentration of issues at longer maturities and in different months from those established for fixed-rate bonds;

- Control of refinancing risk

  - Conduct of exchange auctions (every Friday) of short term for long term securities – graph III;
  - Building up of cash reserves – Since the beginning of 2003, the National Treasury has been issuing more than its financing needs (current position equivalent to more than 3 months of future payments);

- Implementation of a new dealers system. It now includes two groups:

  - Primary dealers – aimed at primary offers and money market operations, with up to 12 institutions;
  - Specialists - aimed at outright operations in the secondary market, with up to 10 institutions.
    The introduction of this group created incentives for deepening the transactions in the secondary market. A new set of obligations and benefits that dealers have to comply with has enhanced the efficiency of the new dealers system compared to the previous one;

- Support for improved trading environment - launching of a clearing mechanism and of an electronic trading platform for public debt securities to be implemented by the Futures Exchange (BM&F) in the first months of 2004, which will play an important role in improving efficiency and helping the development of the secondary market;

- Introduction of a buyback program of inflation-linked long term securities – decision taken after discussions with long term investors. This measure is aimed at reducing transaction costs of long term investors due to the still limited liquidity of such bonds. By creating the possibility of reducing eventual costs that investors are exposed to when adjusting to their cash flow needs, the Treasury is at the same time stimulating the demand for these long term securities and helping in the development of a more liquid secondary market. As market develops this kind of program will no longer be necessary;

2.2 Strategic Measures- Demand Side

Historical background has shown that supply side measures while important are not enough to achieve, on a sustainable basis, all the objectives of public debt management. Structural improvements in debt profile need to be accompanied by the development of debt markets, reducing the risk of abrupt changes in the Treasury refinancing policies in moments of market volatility. To this extent, diversifying the investors base plays a major role. Debt holdings are still concentrated with few types of investors (mostly banks and mutual funds) – graph IV.

The measures listed below represent some of the main actions that the Treasury has been pursuing to deal with this limiting factor on the demand side.

- Introduction of a program envisaging a closer relationship with pension funds, which are natural investors of long-term instruments. After several meetings between Treasury officials and pension funds managers, a set of possible measures to stimulate investment in long-term securities was raised, in line with ALM objectives of pension funds and debt management goals. From these discussions, a program of NTN-B issuance - price-index (IPCA) securities - was successfully implemented in September 2003, with excellent perspectives for 2004 and beyond.

- Treasury Direct – the program of bond sales through the Internet was enhanced with the launching of an advertising campaign as from September 2003. Its impact has been extremely positive: the sales increased 84.4% in September compared to August, while the number of registered investors in the program increased 23.0% in the same month, as observed in the following table II– (see graph V in Annex);

Table II

Month	Monthly Sales (R$)	Registered Investors (Per Month)
Jan/2002	4,644,684.87	2,390
Feb/2002	7,725,164.04	610
Mar/2002	5,875,562.73	353
Apr/2002	4,341,606.17	218
May/2002	3,118,590.94	217
Jun/2002	2,389,846.14	223
Jul/2002	3,738,220.63	429
Aug/2002	5,198,533.13	129
Sep/2002	6,173,725.22	192
Oct/2002	10,935,406.94	254
Nov/2002	9,801,661.16	282
Dec/2002	12,141,017.47	323
Jan/2003	17,352,987.10	399
Feb/2003	11,828,570.46	569
Mar/2003	11,406,446.83	440
Apr/2003	26,114,990.11	1,295
May/2003	20,195,794.90	1,458
Jun/2003	20,154,920.46	1,102
Jul/2003	17,327,478.53	1,109
Aug/2003	18,200,769.55	1,259
Sep/2003	33,562,344.17	3,040
TOTAL	**252,228,321.55**	**16,291.00**

Implementation of the investment account. This account intends to exempt investment turnover of Financial Transfer Contribution – CPMF with the objectives of: (i) offer similar treatment for the investment industry as the one given to exclusive investment funds, which are exempt of CPMF; and (ii) increase the competition in the investment fund industry and the trading volume in the secondary market.

3. Improvements in Debt Indicators

As a consequence of the improvements in the macroeconomic environment and the adoption of debt management measures, debt indicators presented significant positive results.

- Gradual increase in the maturity of newly-issued bonds – graphs VI (LFT – floating-rate); VII (LTN – fixed-rate – longest maturity is July 2005); VIII (NTN-C – inflation-linked), as well as reduction of the discount rates required by the market –graphs IX and X.

- The resumption of the lengthening process significantly decreased the percentage of debt maturing in 12 months (from 40.2% in January 2003 to 32.1% in October 2003) – graph XI;

- Significant increase in the participation of fixed-rate instruments from only 1.9% in January 2003 to 9.9% in October. The amount issued monthly of these securities has now become the most representative across the different instruments used by the Treasury to refinance its debt – graphs XII and XIII;

- Lower exposure to exchange rate risk. Considering the share of dollar-linked securities in the total domestic debt, the decrease was from 22.4% in December 2002 to 11.4% in October 2003, while including swap operations the share of exchange-rate exposure significantly decreased from 37.0% to 24.7% in the same period – graphs XIV, XV and XVI;

- The volume of government securities traded in the secondary market rose significantly in 2003 (approximately 71.2%, from R$ 5.2 billion in January to R$ 8.9 billion in October), with future contracts of interbank deposits (DI) also increasing from 578 thousand in January to 1.4 million in October 2003 (increase of 134%). These figures are to a great extent a consequence of good macroeconomic fundamentals coupled with the aforementioned measures taken by the Treasury to enhance liquidity in the public debt securities market.

Final Remarks

The Brazilian Treasury has clearly stated its debt management objectives focusing on minimizing the cost of the debt under prudent risk levels. Given the current debt profile, this calls, especially, for reducing the debt maturing in the short term and reaching a better debt composition with lower exposure to adverse shocks in interest and/or exchange rates.

Nevertheless, it is widely acknowledged that preconditions to effective debt management practices are a sound macroeconomic environment and a developed debt market. Previous experience in Brazil has shown that the lack of a developed market can severely affect the refinancing strategy adopted by the Treasury in the event of market turbulence.

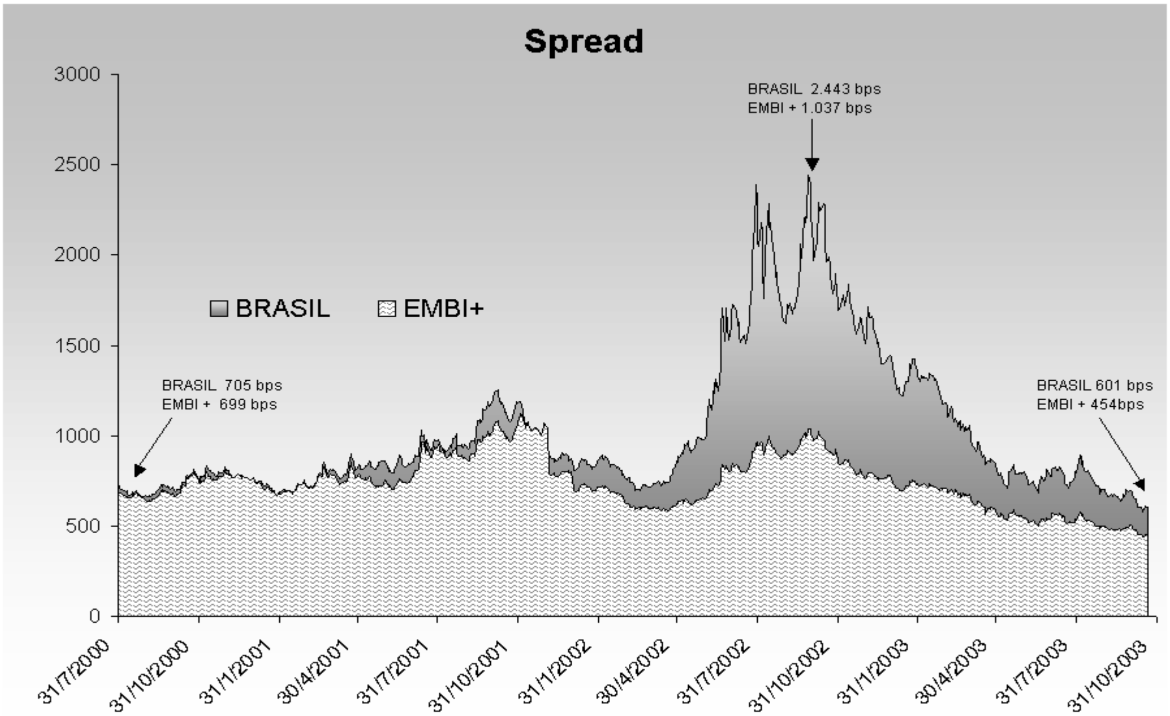
Strict and transparent measures on both the fiscal and monetary policy fronts helped to reestablish a favorable environment for Treasury debt managers to conduct a set of actions to develop the debt market. These actions encompass not only key changes in the way debt management strategy is being conducted but also measures to foster liquidity and the diversification of the investors base. This text shows that substantial gains have already been achieved with excellent perspectives for the next years.

For further information, please access Brazilian National Treasury site: www.tesouro.fazenda.gov.br

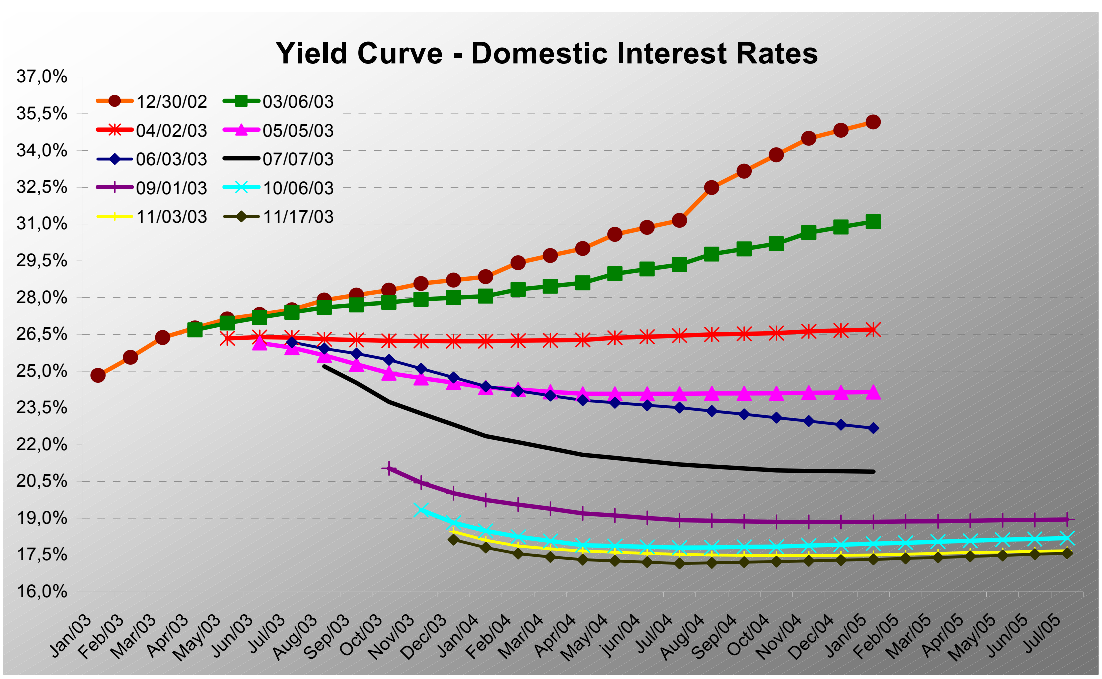
Or contact Institutional Relations Area: stndivida@fazenda.gov.br.

ANNEX

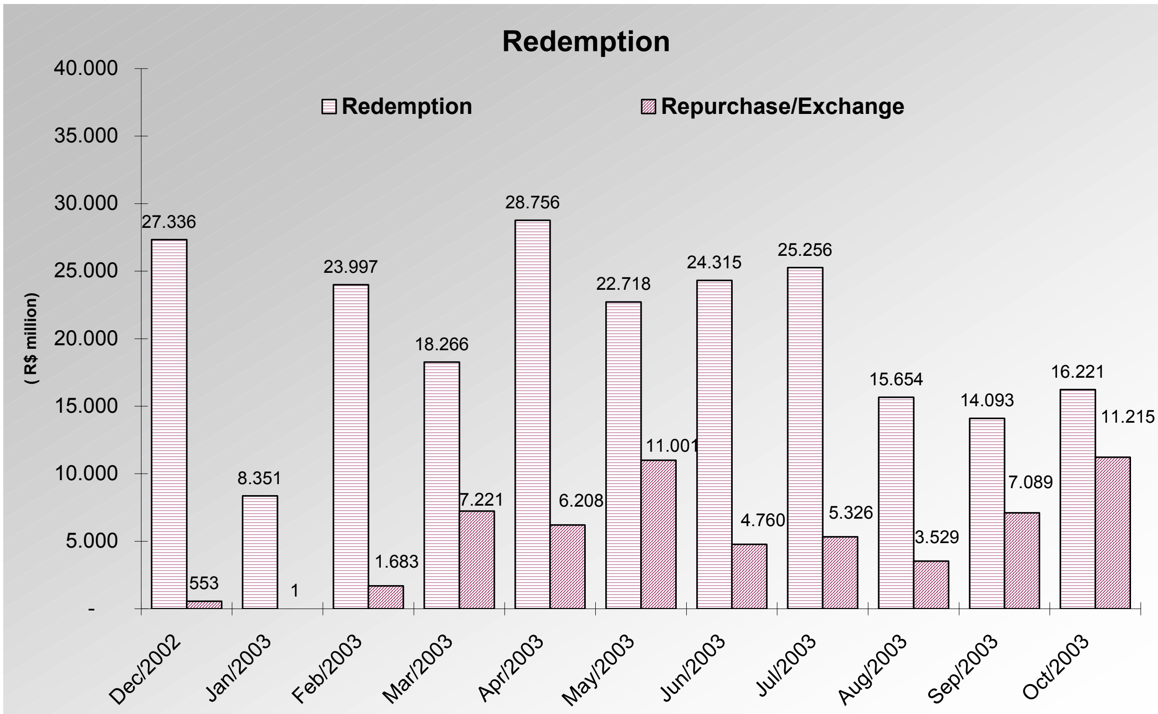
Graph I



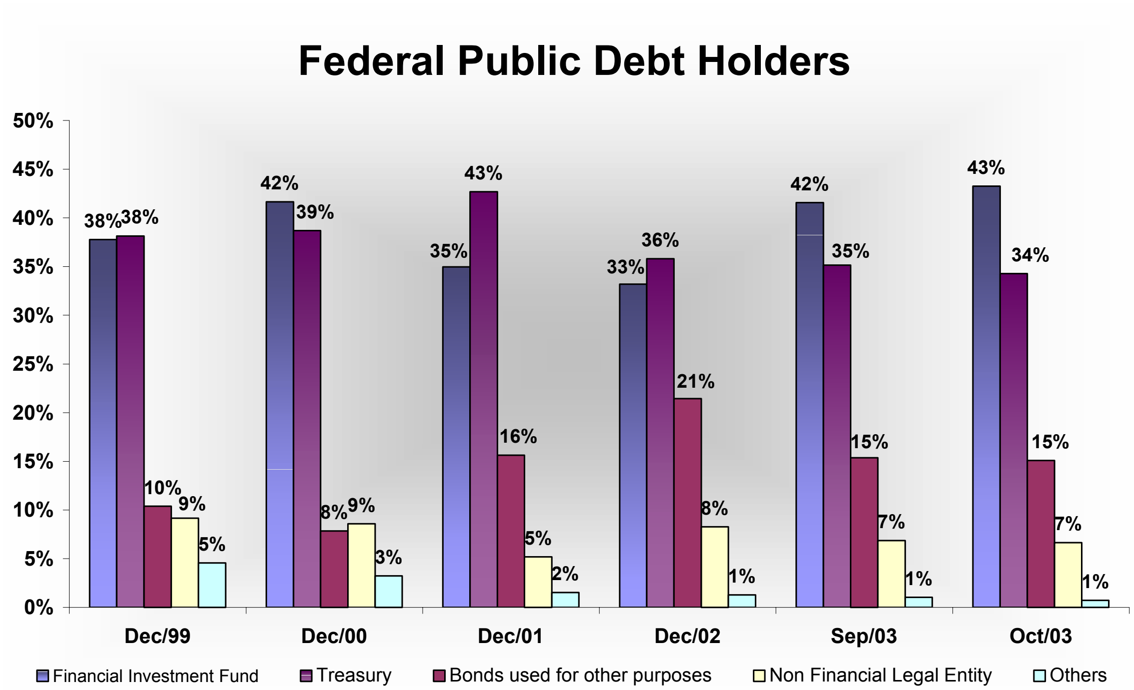
Graph II



Graph III

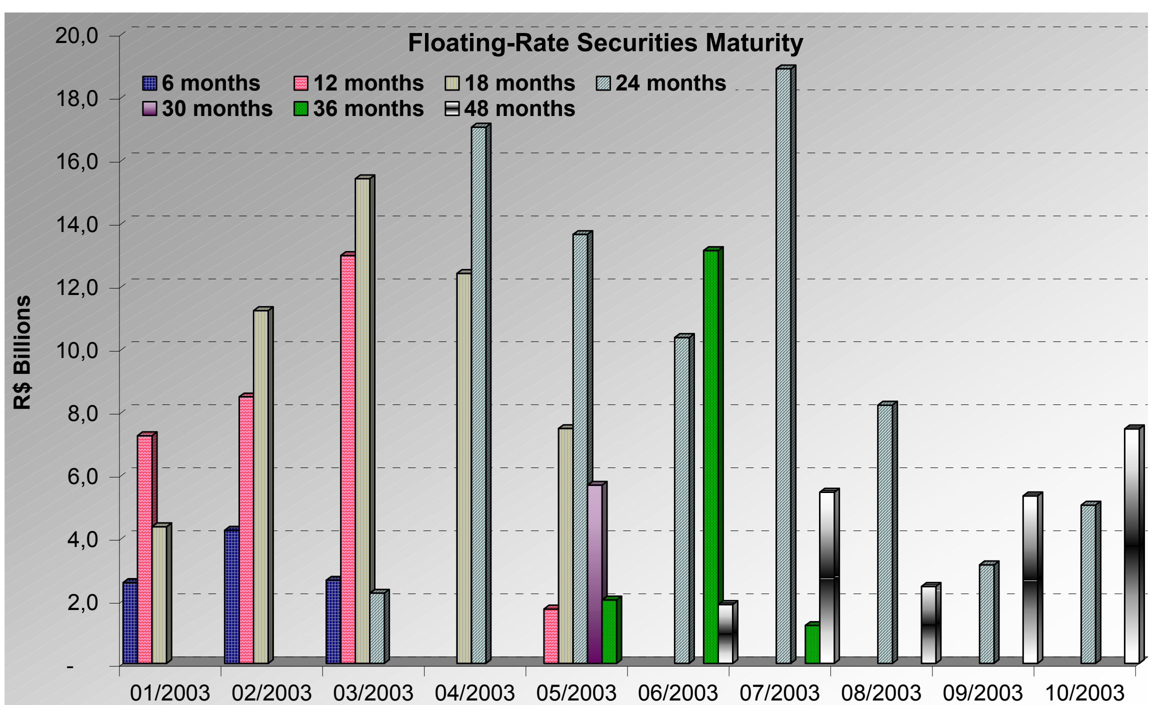


Graph IV

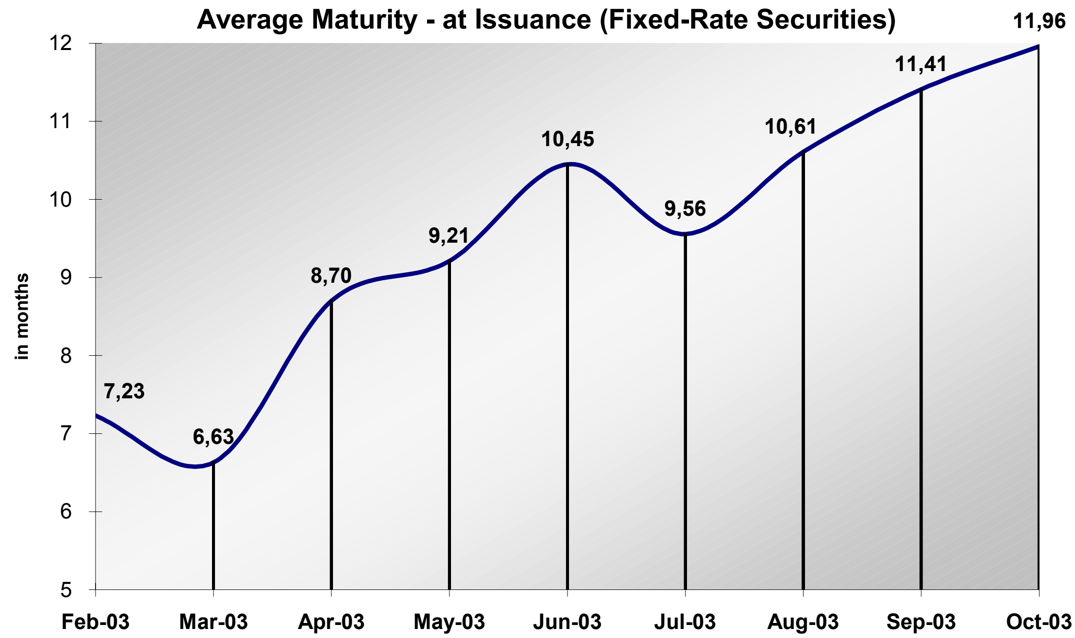


Graph V

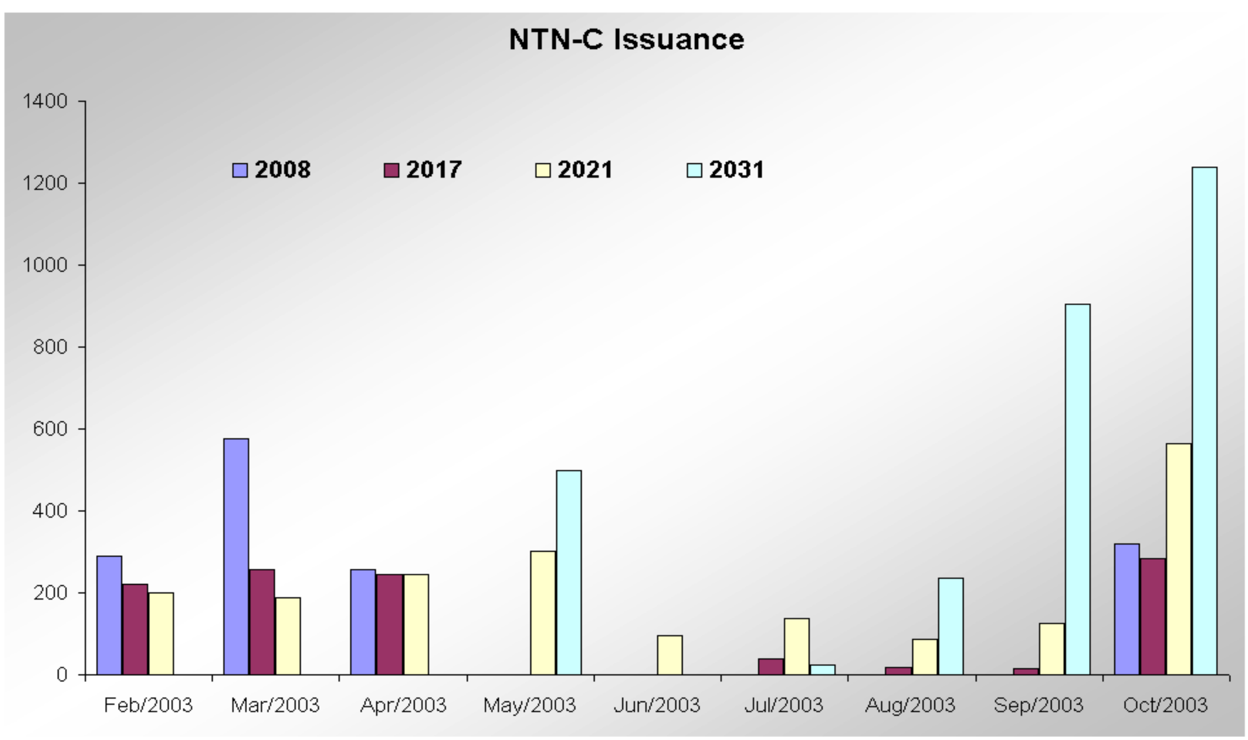
Graph VI



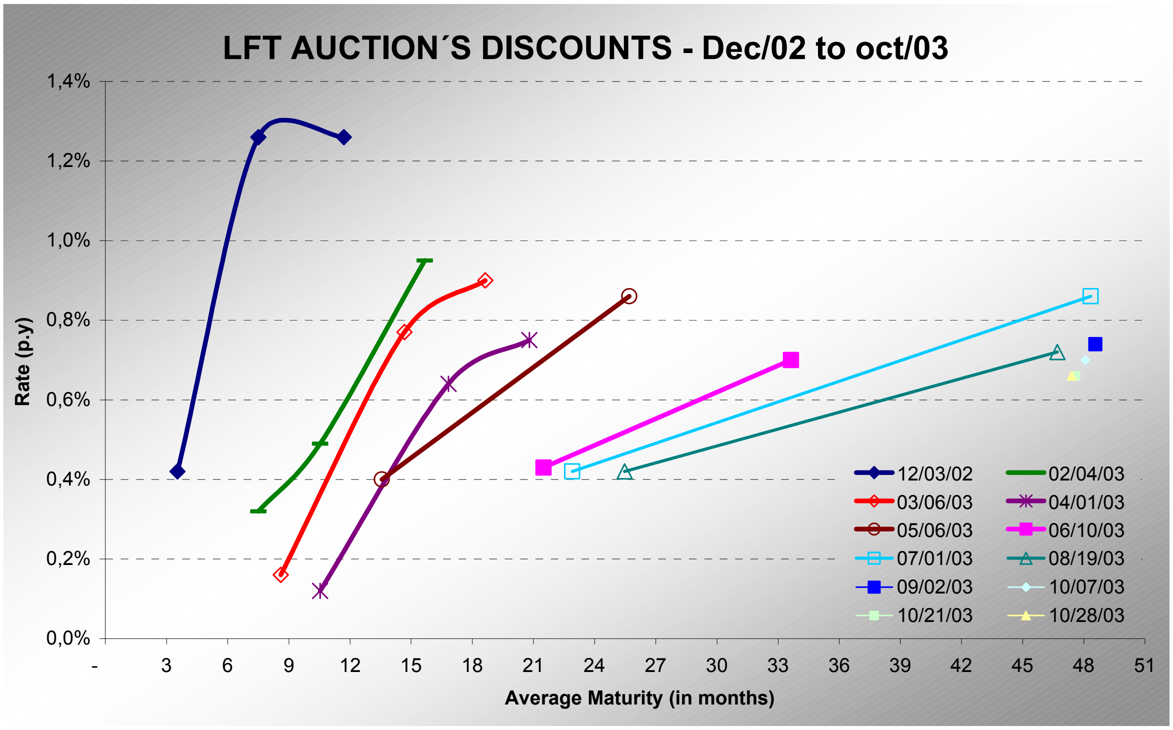
Graph VII



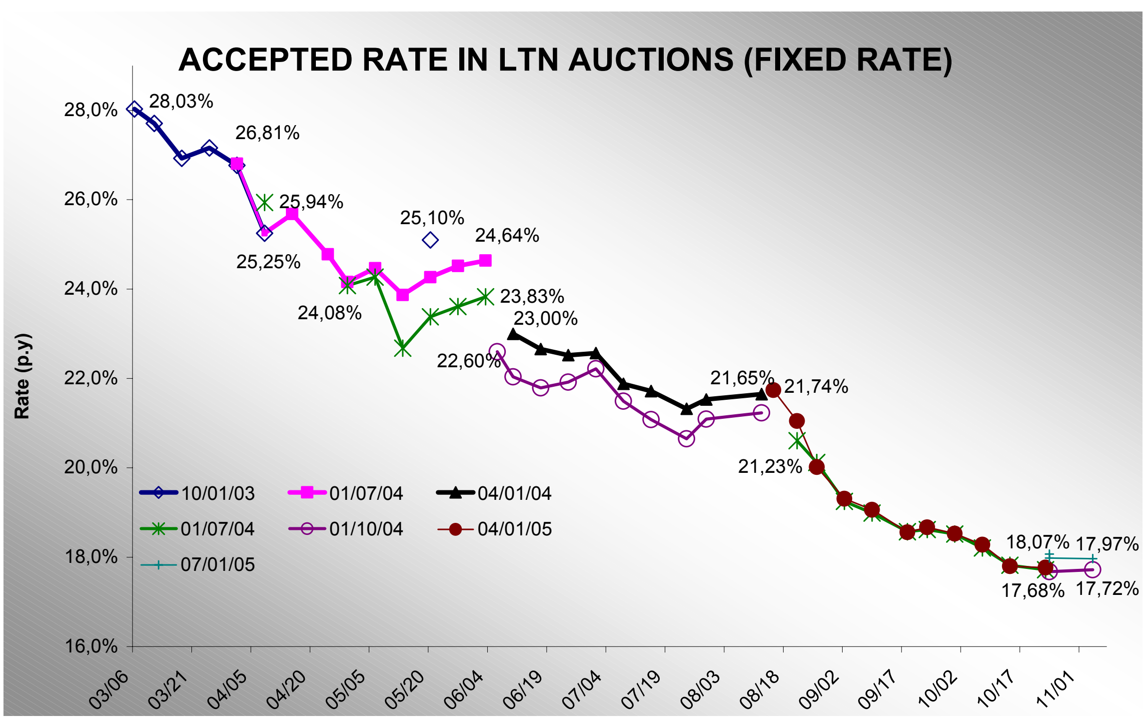
Graph VIII



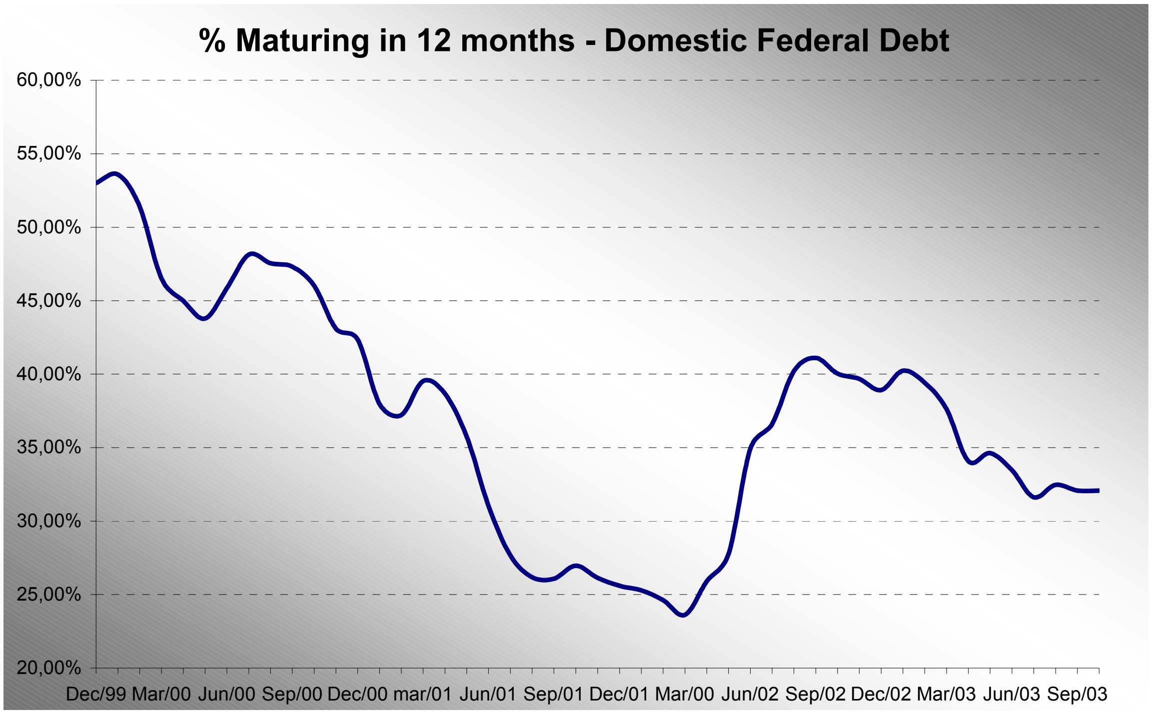
Graph IX



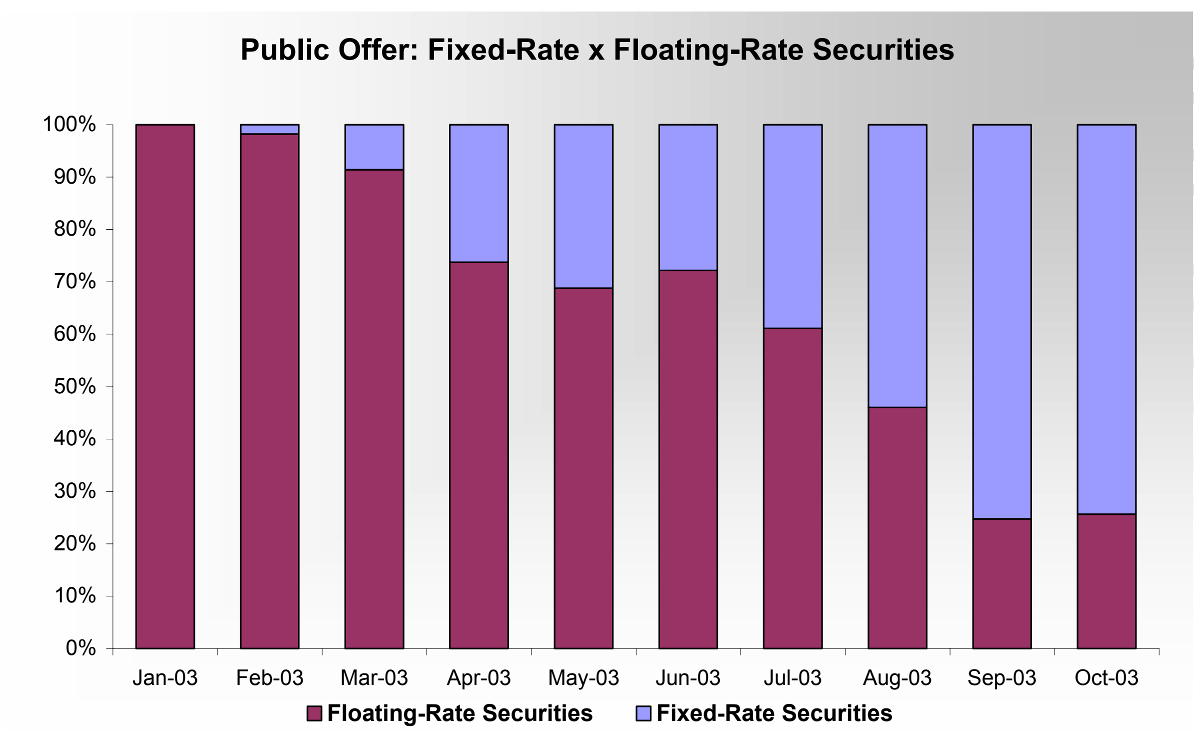
Graph X



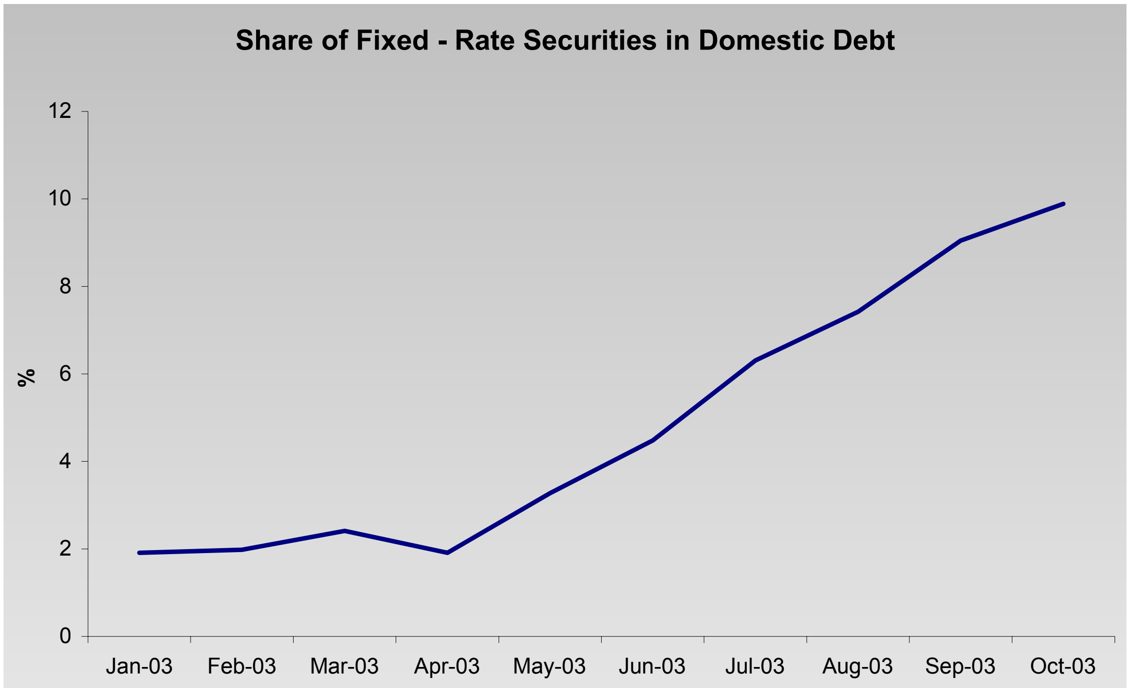
Graph XI



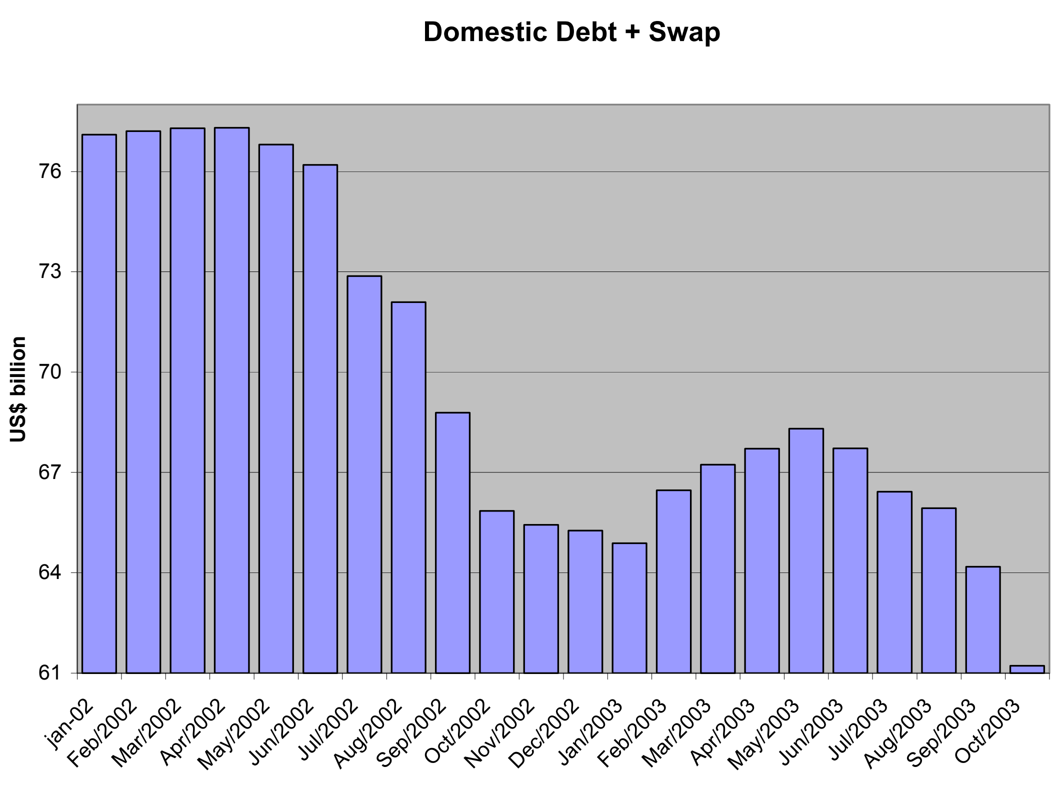
Graph XII



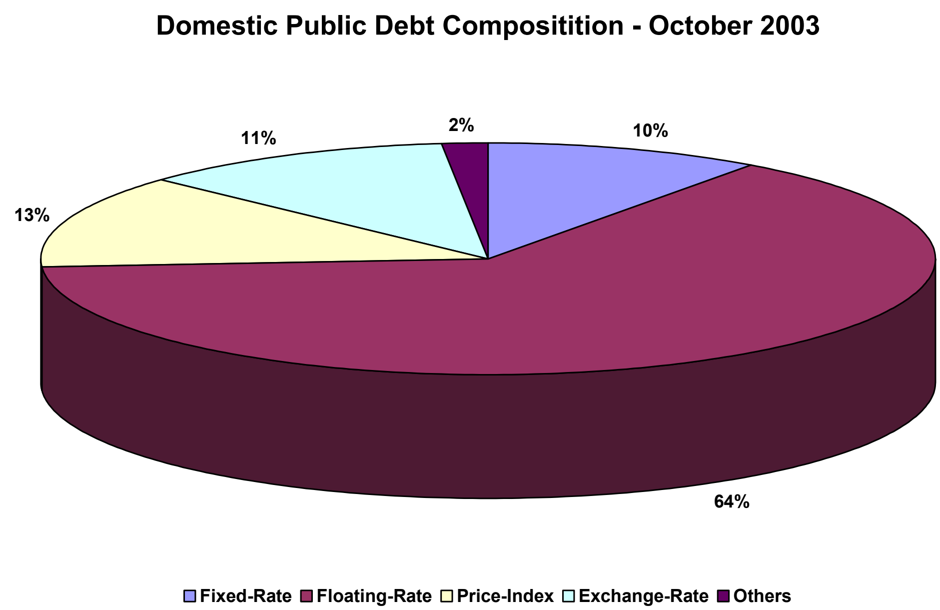
Graph XIII



Graph XIV



Graph XV



Graph XVI