Recent Capital Flows into Brazil

Since adhesion to the Brady Plan in the early 1990s, the Brazilian economy has become increasingly integrated into international financial markets. This movement has been clearly conditioned by internal and external economic cycles with periods of significant inflows of foreign capital and others in which there is an interruption or even reversal of these flows. This box analyzes foreign capital flows into the Brazilian economy in recent years and assesses the impact of government measures recently adopted to regulate these inflows.

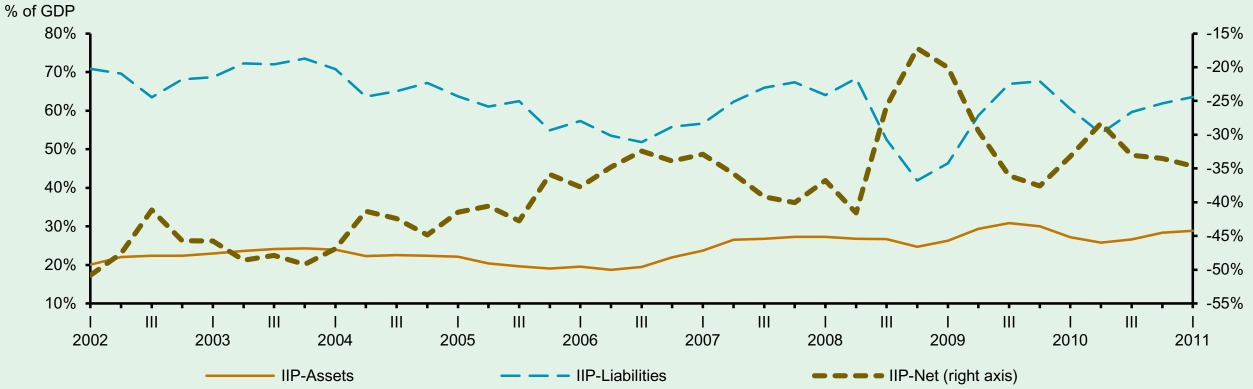
After the effects of the 2008/2009 crisis were overcome, net inflows of foreign capital into the country tended to resume from mid-2009. This partly reflects the very positive domestic economic outlook which confirms the view of a double speed world economy, with strong growth in emerging countries and below potential results in mature ones. From a different perspective, the international economic outlook remains encouraging for international capital flows toward emerging economies due to abundant international liquidity, favored by extremely accommodating basic interest rates in mature economies

Within this context, the projection of net private capital flows to emerging countries is still expanding, according to the Institute of International Finance (IIF)[1]. In 2011, these flows should exceed US$1 trillion according to the latest estimates, US$81 billion above the projection made in January. In the specific case of Brazil, the projection rose by US$31 billion.

1/ Capital Flows to Emerging Market Economies, June 1, 2011.

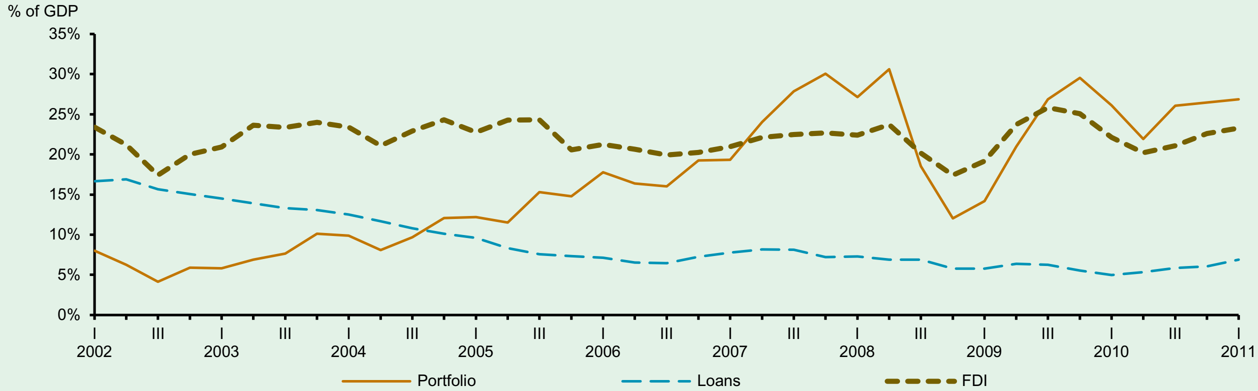
An analysis of the stock of the country's foreign assets and liabilities from the International Investment Position (IIP) statistics, measured as a percentage of the Gross Domestic Product (GDP) in Figure 1, shows that net debt remains in the five quarters from the beginning of 2010 until March 2011, steady around -33% of GDP. Note that the increase in external liabilities, which totaled 63.6% of GDP in March 2011, while remaining below pre-crisis rate, is close to the average for the 2002-2011 period.

Figure 1 – International Investment Position (IIP)



According to Figure 2, among these liabilities, are the Foreign Direct Investments (FDI) and the actions, each corresponding to approximately one third of total liabilities. It should be noted that the relative stability of FDI to GDP saw an average of 23% in the last eight quarters, while foreign investment in stocks – the main component of portfolio investments – had multiplied over the last decade, even as a proportion of GDP, and turned in a more visible volatility. Finally, it should be pointed out that the decrease in foreign liabilities in total loans, 16.4% of GDP in December 2001 to at least 5% of GDP in the first

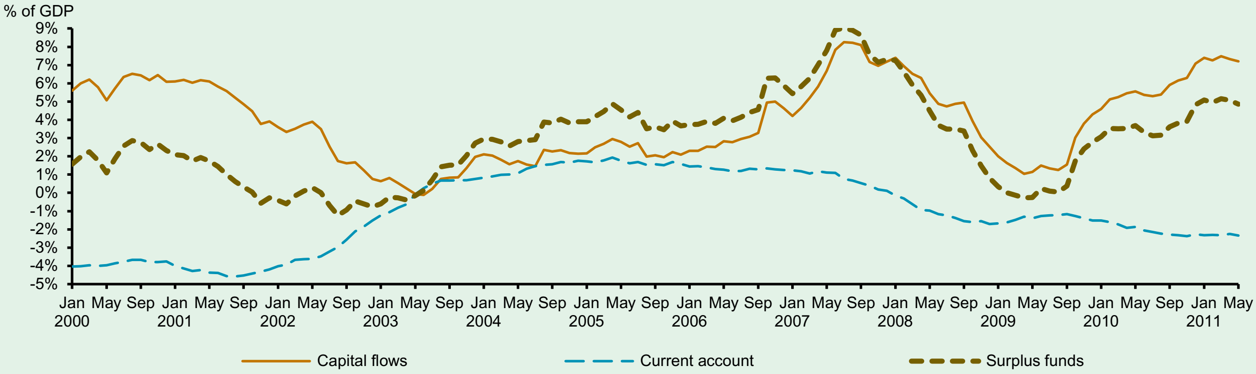
Figure 2 – International investment position – Liabilities



quarter of 2010, recovered to 6.9% of GDP in March 2001 when it was equivalent to 10.8% of liabilities[2].

These capital flows have allowed a comfortable financing of current account deficit for the country after overcoming the international financial crisis, with surplus funds - capital flows minus the current account deficit - reaching 3.6% of GDP in 2010 and 5 % of GDP in the first five months this year, as seen in figure 3.

Figure 3 – Balance of payments financing
12-month cumulative flows



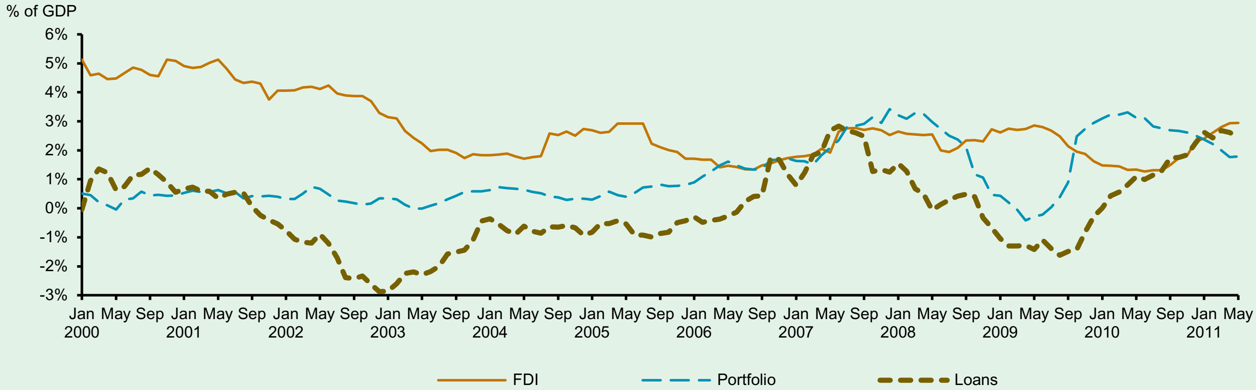
This performance, which is essential to strengthening international reserves and the country's main line of protection against external financial crises, has also partially been used as funding for the expansion of domestic credit. This characteristic of recent flows generates impacts both from the prudential standpoint and when considering the increased aggregate demand. In the former case, because it contributes to the expansion of credit at rates higher than recommended and can cause equity imbalances in non-financial companies due to their exchange rate exposure. In the latter case, because external flows have a potential inflationary impact.

Figure 4 breaks down capital flows observed permitting recovery in both loans and portfolio and FDI. This year, however, there are decreased flows in equity and fixed income securities traded in the country. In the twelve-month period up to May, the FDI net inflows amounted to 2.9% of the GDP, while

2/ In this box, capital flows are defined as the sum of net flows in the balance of payments (or stocks, in the case of PII) items relating to FDI, portfolio (considered investments in equity and fixed income securities traded on country), and direct loans (including foreign debt securities excluding the bonds of the Republic).

loans reached 2.5% of GDP, comprising 1.6% of the GDP in long-term operations and 0.9% of the GDP in short–term operations. During that period, foreign investments in stock and fixed-rate securities in the country totaled 1.5% of GDP and 0.3% of GDP respectively.

Figure 4 – Capital flows – 12-month cumulative



Looking at the strong growth scenario of capital flows to Brazil in all forms, generating a surplus of external financing, measures have been adopted to regulate these inflows, trying to moderate its amount and change its profile. Even before the aggravation of the international crisis with the bankruptcy of Lehman Brothers, the Brazilian government levied taxes on financial transactions (IOF) from 1.5% in external inflows in fixed-rate investments into the country. This measure, adopted on March 2008, was revised in October of that year. On October 2009, with Brazilian full recovery and return of foreign capital, a 2% IOF tax was levied on fixed-rate investments and, additionally, in stocks traded in the country.

The prolonged capital inflows in sizeable amounts have generated a new set of measures in the last quarter of 2010. The IOF tax on fixed-income inflows was raised to 4% on October 4, and 6% on October 18. In a corresponding measure, was also levied a 6% IOF rate on collateral security in negotiations on exchange or futures markets. In the funding inflows of external loans – which include, in accordance with CMN Resolution nr. 3,844, the issuance of securities abroad and intercompany loans – whose average maturity be less than 90 days was instituted an IOF at the rate of 5.38%.

The impacts of such measures resulted in more intense flows to fixed-rate securities, which after registering average monthly net inflows of US$1.5 billion from January to October 2010, averaged monthly net outflows of US$135 million in the seven subsequent months, up until May this year.

Then, in March 2011, the definition of the average maturity of external borrowings for the IOF levying was extended, as well as the rate levied in these operations. Initially elevated from 90 days to 360 days and then to 720 days, inflows stemming from external borrowings began to be taxed at a rate of 6%. The immediate impact of this measure was the elimination of new funding under the established terms, which implies net outflows of short-term loans with consequent reduction in short-term external debt and improved external indebtedness profile of the country. Some of these borrowings had their maturities lengthened, increasing the long-term net inflows. However, this did not represent a reduction in total funding inflows of external borrowings.

Thus, in the first quarter of the year, net inflows of borrowings amounted to US$19.3 billion for a monthly average of US$6.4 billion, comprising US$9.7 billion in long-term operations and US$9.6 billion in short-term[3] operations. In the April-May period, there were net outflows of US$7.1 billion in short-term operations and US$13.8 billion net inflows in long-term operations, for an average monthly net total of US$3.3 billion.

The evidence so far, based on the statistics shown above, indicate the actual and measurable impact of foreign investments in fixed income and the contracting of foreign loans. The measures, however, maintain external funding sources such as direct investments, borrowing operations with longer maturities and those tied to external trade, which are essential for financing the current account deficit, increase investment in the country and to maintain the conditions of access to the international market for residents.

3/ Here there is a conceptual difference between the rules governing the IOF and the balance of payments statistics. While in the first case, there are adjustments in the definition of short-term, moving from 90 days to 360 days and thereafter to 720 days, the balance of payments always considers as short-term operations up to 360 days, with the remaining being recorded as long-term.