

Brazilian Tax Hikes: A Band-Aid Solution to Currency Appreciation?

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Last month Brazil's National Monetary Council raised the level of tax on financial transactions (known as the IOF in Portuguese¹) to 6%, the hike coming a mere two weeks after Finance Minister Guido Mantega announced an increase in the tax on portfolio inflows into Brazilian fixed income instruments to 4% from 2%. Concerns about the elevated level of the Brazilian real have led to the government undertaking two interventions into the country's foreign exchange market in rapid succession, surprising some investors. We asked two of our emerging market investment experts, BNY Mellon ARX's economist Solange Srou, and Javier Murcio, deputy portfolio manager and senior sovereign analyst at Standish Mellon Asset Management Company LLC, to explain the impact this might have on foreign direct investment flows into Brazil, and on the value of the Brazilian real.

Brazilian finance minister Mantega stated that upward adjustments of the IOF, first to 4% and then to 6%, from the initial 2% rate at which it was imposed in October 2009, were aimed at reducing short-term speculative inflows, as well as reducing volatility in the foreign exchange market. The margin on derivative contracts by non-residents in BM&FBovespa,² Brazil's multi-asset exchange, will also be taxed at 6%, which represents a significant increase from the previous 0.38% rate. Effectively, foreigners will be forced to pay more in taxes when trading currency derivatives. BNY Mellon ARX's Srou explained that "by taxing the margin on derivative contracts the government is most likely seeking to reduce the amount of leverage in the market."

"With economic fundamentals pointing to a continuing appreciation in the value of the Brazilian real," she continued, "we think that introducing new intervention measures in such quick succession poses high risk. We expect the Brazilian government to continue adopting measures to reduce US dollar inflows, mainly in relation to short-term investments, and to avoid measures that could harm the current investor optimism about Brazil and the Brazilian stock market." She added: "These measures are consistent with the authorities' concern about the elevated level of the Brazilian real."

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¹ Imposto sobre Operacoes Financeiras.

² Bolsa de Valores, Mercadorias & Futuros de São Paulo.

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Their likely effect will probably be that of reducing liquidity in local markets and of impairing an important source of long-term financing for the government. We see these measures essentially as just a palliative to the underlying currency appreciation issue.”

“The fundamental drivers of inflows,” Srouf said, “reside in the consistently higher rates of economic growth Brazil exhibits relative to its trading partners, as well as the relatively higher interest rates it offers. At BNY Mellon ARX, we believe that Brazil will continue to remain attractive for global investors, as developed economies continue to maintain unprecedentedly low interest rates. In our view, Brazil, as Latin America’s largest economy, will continue to lead the growth of the region. We also believe that the carry trade will remain abnormally high in Brazil amid global divergences in interest rates, in a world where the search-for-yield remains primary.”

Standish’s Murcio noted that in his opinion “heavy inflows of foreign direct investment have contributed to a strengthening of the Brazilian real against the US dollar during 2010. The Brazilian real has become one of the most expensive currencies in real trade-adjusted terms.³ Expectations of further policy action designed to slow down the appreciation of the Brazilian real had been mounting, in view of the failure of previous IOF measures to contain the rapidly appreciating value of the currency.”

He noted, however, that “the four main forces that have led to Brazilian real appreciation remain in place: monetary policy in the US, which has loosened with quantitative easing announced in November; Brazilian growth vastly exceeding that of the G-7 this current year and next year; favorable terms of trade; and a large interest rate differential between local Brazilian rates and those of other countries.”

“For this reason,” he believes, “more measures are likely to be introduced in the foreseeable future, as the impact of the new tax rate is once again expected to be temporary and insufficient for preventing further appreciation of the Brazilian real. In the meantime, some adjustments of the currency exchange rate and some minor sell-off in local currency bonds are likely.”

“At Standish,” Murcio said, “we expect the immediate impact on local bond yields and the currency to be relatively contained. We continue to like the economic fundamentals of the Brazilian economy and will continue to watch further developments with a keen eye, as we seek value selectively in local currency investments in that country.”

³ Bloomberg analytics.

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