

Brazil's tax on capital inflows will not prevent the real from appreciating (Translated by Calyon)

By Violaine Le Gall – Oct. 22, 2009

Brazil's growth potential makes it unlikely that investment flows into bonds and equities will be slowed by the recent 2% tax

The Brazilian real has climbed 33% against the dollar and 24% against the euro since the start of the year, as the appetite for risk returns and the country's economy revives. With the currency's appreciation hurting exports, the government has just imposed a 2% tax on investments into bond and equity portfolios. Foreign direct investment is exempted, however, and Vivendi's bid for GVT will not be subject to this tax. Brazil had already introduced a similar tax in 2008, but abolished it as emerging markets plunged into crisis.

The aim is also to limit market volatility. The Bovespa index has surged 77% since the start of the year. "A steep rise in volatile capital inflows has sparked government fears of speculative buying of Brazilian securities, a trend that would reverse overnight were expectations to change," explain Natixis economists.

But the measure's efficacy is uncertain. "The tax might make Brazil less attractive, but it should have no significant impact on capital inflows," says Harpreet Parhar, a Calyon credit strategist. As a result, investors seeking high yields and growth markets will certainly remain interested in this country. Next year its central bank could well raise its target rate, currently at 8.75%. And its gross domestic product is expected to rebound by 4% to 5%.

In any case, this tax serves as a reminder to investors that Brazil is still an emerging country; "There are a lot of inherent risks to study before investing in these markets, including a sudden change in legislation, for example," says Parhar.

Moreover, other emerging countries could be prompted by Brazil's initiative to put a brake on their rising currencies. "With the growth differential between emerging and developing countries set to widen in 2010, there will be more capital flows going to emerging countries. Instead of intervening to check capital inflows completely, which could be costly, other countries – especially in Asia – could look to take their lead from Brazil, now a benchmark among emerging countries," says Thomas Fallon, in charge of emerging markets at La Française des Placements, an asset management firm.

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