Brazil's Surging Foreign Investment: A Blessing or a Curse?

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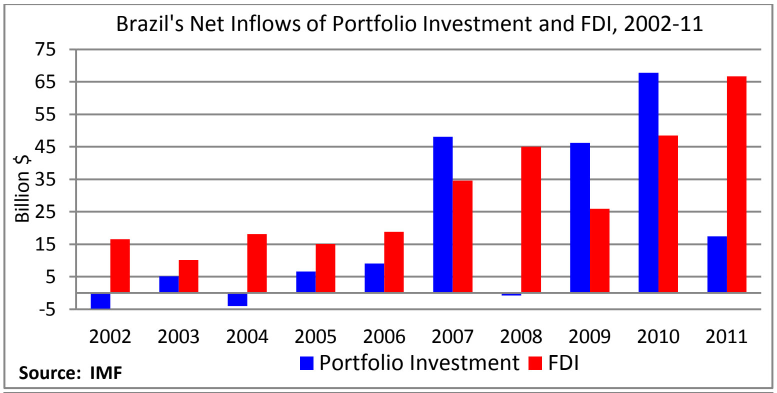
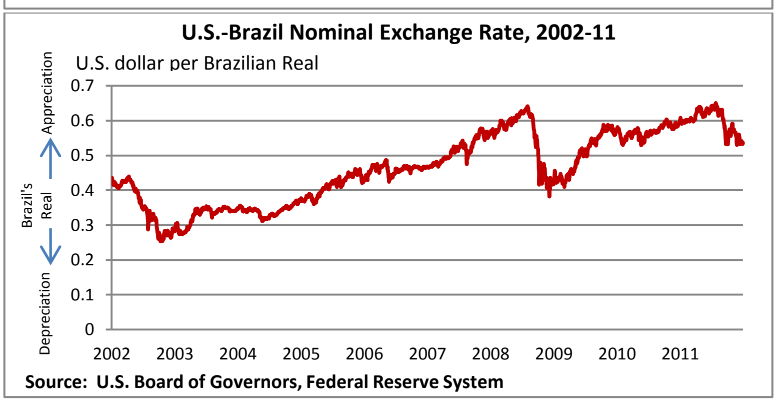
A recent surge in both foreign direct investment (FDI) and portfolio investment in Brazil has fueled an appreciation of Brazil's currency, the real, to historic levels, which has threatened Brazil's international competitiveness.[1] Major investors have included some European Union (EU) countries and the United States, but in 2010, China became Brazil's largest investor. In response to the real appreciation, Brazil has adopted a variety of measures, including a program to support its exports—the Bigger Brazil Plan—and capital controls.

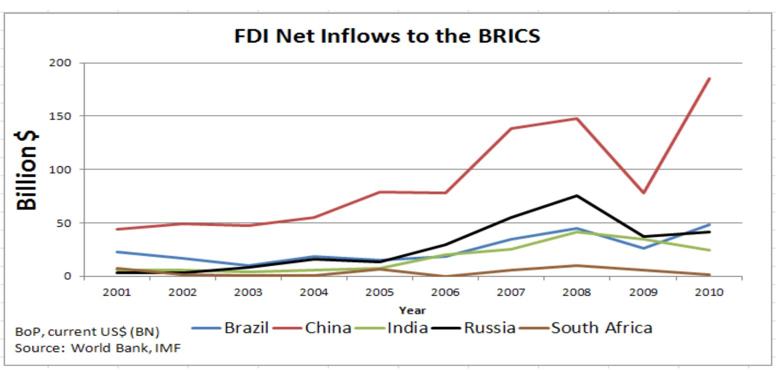
Since 2007, Brazil has been an important destination for FDI, driven by its economic and political stability, growing middle class, and market opportunities, particularly in natural resources—agriculture, energy, and mining. In addition, slow growth and low interest rates in the United States and the EU have encouraged foreign portfolio investment in Brazil, which suffered only a minor economic contraction during the global economic crisis.





- Both FDI and portfolio investment surged in 2007 and have remained high, with the exception of portfolio investment in 2008, which was adversely affected by the global financial crisis.
- Net inflows of FDI and portfolio investment in Brazil totaled $400 billion during 2007–2011, compared to $79 billion during the previous 5-year period.
- In 2010 and 2011, net FDI inflows grew to record levels of $48.5 and $66.7 billion, respectively. However, in 2011 its growth rate of 37% was lower than the 2010 rate of 87%. This coincided with a slower economic growth rate in Brazil, which was 2.7% in 2011, down from 7.5% in 2010.
- Portfolio investment grew 47% in 2010, but declined by 74% in 2011. Investors took advantage of relatively high interest rates in 2010, but faced the implementation of capital controls in 2011.
- With the exception of 2008—during the global financial crisis—the real has continuously appreciated against the U.S. dollar until early 2011. From its trough in October 2002 until early 2011, the real appreciated by 60%. Since the depreciation of 2008, the real has appreciated 35%.

Over the past decade, Brazil ranked third among the BRICS with respect to FDI inflows, following China and Russia.



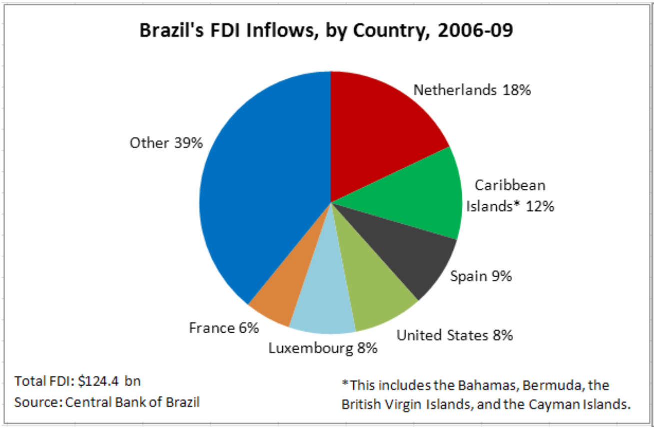
- Since 2005, FDI to Brazil has been growing, but it still fluctuated between 1/5 and 1/3 of FDI inflows to China. In 2010, FDI to Brazil surpassed FDI to Russia for the first time since 2005.

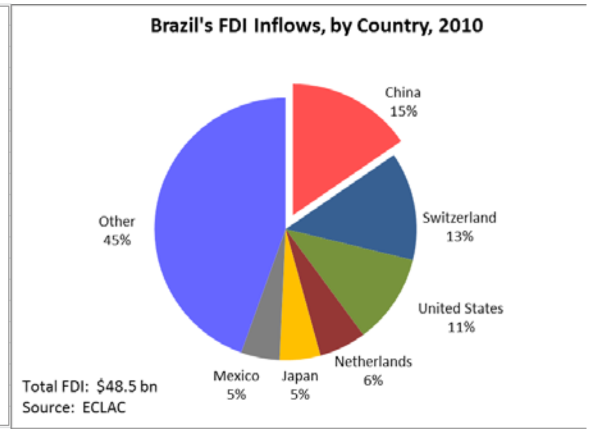
BRICS' FDI inflows during 2001-10 (billions, share of BRICS' total):

China	$902	55%
Russia	$280	17%
Brazil	**$255**	**15%**
India	$174	11%
South Africa	$39	2%
BRICS total	$1.7 trillion	
Total Global FDI	$13.7 trillion	

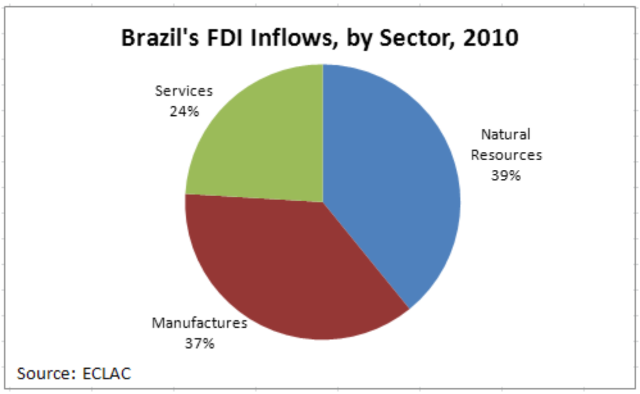
[1] Brazil's trade surplus of goods declined from $40 billion in 2007 to $29.8 billion in 2011. FDI includes equity capital, reinvested earnings, and other capital and financial derivatives associated with various intercompany transactions between affiliate enterprises. Portfolio investment includes transactions with nonresidents in financial instruments of any maturity such as corporate securities, bonds, notes, and money market instruments, other than those included in FDI. *International Financial Statistics*, IMF.

In 2010, China became Brazil's largest source of FDI. Natural resources attracted the most FDI, then manufactures and services.





- In 2010, the Economic Commission for Latin America (ECLAC) estimates that China accounted for about 15% ($7.3 billion) of total FDI inflows and was largely responsible for the surge in FDI in Brazil. The Economist Intelligence Unit (EIU) estimates FDI inflows from China were between $13 and $17 billion in 2010. (Brazil's central bank reported only total FDI data for 2010.) In 2006-09, ECLAC reported that total FDI from China to Brazil was less than $400 million, or 0.3% of total FDI inflows to Brazil.



- Brazil's inflows of FDI from China differ depending on the source cited. For instance, official FDI figures reflect the country where the investment comes from, but China often routes FDI through third countries for tax purposes, such as the Cayman Islands or Luxembourg, including FDI to Brazil. For example, ECLAC notes that a 2010 investment by China in the Brazilian oil sector that was channeled through Luxembourg is included in FDI sourced from China.

  According to Chinese government statistics, in 2010 over 90 percent of Chinese FDI in Latin America and the Caribbean was destined for the Cayman Islands and British Virgin Islands, whereas Brazil received less than 5 percent. In 2006-09, FDI to Brazil from the Caribbean islands amounted to 12%.

- In 2010, natural resources including agriculture (especially oil and gas, and metal mining) accounted for the largest share of FDI (39%). Chinese FDI was mostly in the oil, steel, and mining sectors. In 2006-09, FDI was directed mainly to manufacturing (42%), followed by services (34%) and natural resources (24%).

Brazil's surging capital inflows and accompanying appreciation of the real have occurred at the same time Brazil's trade surplus has declined. In response, Brazil's government has adopted a variety of measures to support its export industries, including the Bigger Brazil Plan and capital controls, but in an environment of higher interest rates.

"Bigger Brazil" Plan

- Aims to improve the competitiveness of national industries facing currency appreciation.
- Provides tax relief or incentives for the clothing, footwear, furniture, information and communication technology, and auto industries.
- Expands financing programs by the state development bank to promote investments and innovation projects.
- Creates new export financing and other incentives to promote exports.
- Allows 25% price preference in government procurement of certain Brazilian goods and services.

A 30% increase in Brazil's tax on autos with less than 65% local content prompted Japan and Korea to raise the issue at a WTO Committee meeting in October 2011.

Capital Controls and Taxes

- To restrict capital inflows and manage its currency appreciation, Brazil made it more expensive for foreign investors to make short-term deposits. In 2011, Brazil raised taxes on foreign investments in fixed assets, local derivatives, and margin accounts, and increased reserve requirements on short-term dollar deposits of financial institutions.

Tightened Monetary Policies

- To offset inflationary pressures, due mainly to robust domestic consumption and investment demand, Brazil recently initiated a tight monetary policy.
- In 2010, the Central Bank increased reserve requirements on time deposits from 23% to 32% and on demand deposits from 51% to 55%.
- In 2011, the Central Bank raised its benchmark policy interest rate to 11.25%, a rate significantly higher relative to other major markets.

While tight monetary policies combat inflation, higher interest rates encourage foreign investment inflows creating the conditions to maintain an appreciated real.

Sources: Banco Central do Brasil, ECLAC, EIU, International Monetary Fund, OECD, World Bank, and World Trade Organization.