INTER-AMERICAN DIALOGUE'S
LATIN AMERICA ADVISOR

FEATURED Q&A

How Will a Capital Inflows Tax Affect Brazil's Economy?

Q Brazil's government last week announced a 2 percent tax on foreign investment in local stocks and fixed-income securities in a bid to slow the appreciation of Brazil's currency. Was the tax the right move for the country's economy? What will be the short- and long-term effects of the measure, and what are the downsides? Could Brazil's new tax divert investment flows to other emerging markets in the region?

A John Williamson, senior fellow at the Peterson Institute for International Economics in Washington: "Last time it was Chile, this time around it is Brazil that has taken the lead in the attempt to maintain a competitive exchange rate when faced by a surge of capital inflows. Specifically, Brazil has reimposed, extended and increased the tax rate on capital attempting to enter the country. In the future, anyone bringing in money to invest in either the equity or the fixed-income market will be required to pay a 2 percent tax rate to the government. Economists have never agreed on whether the Chilean encaje was effective in reducing the weight of money attempting to enter Chile, and hence whether it gave additional latitude to the Chilean government to run a tight monetary policy without making the exchange rate hopelessly uncompetitive. (They did manage to agree that it did something to lengthen the maturity of the debt, so let us be grateful for small mercies.) Doubtless there will be a similar never-ending dispute about the effectiveness of the Brazilian measures. No one expects them to work perfectly, but they don't have to in order to have a worthwhile impact on the policies that countries are able to pursue. Assuming that the measures have an effect, they are exactly what Brazil needs at this time. The exchange rate is overvalued; demand threatens to expand so much as to throttle investment; foreign demand for assets is pushing their prices out of reach of ordinary Brazilians. All these problems will be addressed to some

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Correa Arrives in Russia For Talks With Medvedev, Putin

Ecuadorean President Rafael Correa (R) arrived Wednesday in Moscow for talks with the country's president and prime minister. The visit comes as the South American country is seeking financing from Russia. See story on page 2.

Photo: Ecuadorean Government.

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NEWS BRIEFS

Argentina's Fernandez Proposes Controversial Political Reforms

Argentine President Cristina Fernandez on Wednesday proposed a controversial package of political reforms, Dow Jones reported. The measures would require political parties to have open primaries and prohibit private campaign financing. Also, it would require parties to maintain a minimum number of members. Fernandez said the package would "promote transparency and guarantee equality for all parties," but opponents say it is an effort to consolidate power before the 2011 presidential election.

Brazil's Vale Boosts Earnings in Third Quarter

Brazil-based **Vale**, the world's largest iron ore producer, said Wednesday its net earnings in the third quarter more than doubled from the previous three-month period, reaching $1.7 billion on higher iron prices, larger sales volumes and exchange rate gains. Net earnings per share totaled 31 cents, while operating revenue jumped 35.6 percent over the previous quarter to $6.9 billion.

Pemex's Loss for Third Quarter Narrows on Lower Import Costs

Mexican state oil company **Pemex** posted a net loss of 3.7 billion pesos in the year's third quarter as oil sales and crude production decreased from the same period last year. Total sales fell 21 percent to 293 billion pesos, while crude production dropped 6.8 percent to 2.6 million barrels per day, led by a decline in the Cantarell field, Pemex said in a statement to Mexico's stock exchange. The company's third-quarter loss narrowed from the 14.4 billion pesos posted last year due to lower costs of imported products and a decrease in taxes.

Political News

Foreign Minister: Cuba Ready For Talks With United States

Cuba is ready for broadened talks with the United States, the island nation's foreign minister told the Associated Press in an interview Wednesday. "We are prepared to have a dialogue with the government of the United States at any level," Bruno Rodriguez told the wire service, adding that Cuba is waiting for a response from the U.S. government. Rodriguez made the comments after the United Nations voted for the 18th consecutive year in opposition to the 47-year-old U.S. trade embargo against Cuba. Only Israel and the island nation of Palau sided with the United States in the 187-3 vote. The Marshall Islands and Micronesia abstained. Since taking office in January, U.S. President Barack Obama has relaxed restrictions on Cuban-Americans' travel and remittances to the island. In July, Cuba offered to hold talks with U.S. officials on topics including fighting terrorism, drug trafficking and natural disasters. In a speech to the U.N. General Assembly, Rodriguez said the embargo has cost Cuba tens of billions of dollars since it was implemented in 1962. "The blockade is an uncultured act of arrogance," said Rodriguez. He called the embargo "an act of genocide" and "ethically unacceptable." Susan Rice, the U.S. ambassador to the U.N., called Rodriguez speech to the General Assembly "hostile" and "straight out of the Cold War era," the AP reported.

Rodriguez

File Photo: Granma.

Featured Q&A

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extent, though it remains possible that further measures—like an increased tax rate at some time in the future—will prove desirable."

A Guillermo Calvo, professor of economics, international and public affairs at Columbia University and former chief economist at the Inter-American Development Bank: "Several empirical studies show that taxes on capital inflows have little effect on total flows and, therefore, are unlikely to succeed in slowing down the appreciation of Brazil's currency. Part of the reason is that there is a variety of tricks multinational firms, for example, can employ to bypass the tax. Why not intervene in the foreign exchange market in order to prevent nominal appreciation in the short run? I suspect that the answer is fear of inflation in an election year. This is unfortunate because, without capital controls, exchange-rate pegging ensures that there is no sudden real appreciation and, most importantly, there is no discrimination between sectors or firm sizes. Moreover, unless widespread indexation mechanisms are triggered, a capital-inflow episode gives rise to a one-off price rise, not inflation. Typically, however, capital inflows bring about a sharp acceleration of bank credit and lax credit standards. This sets the stage for domestic bank crises when capital flows in the opposite direction. These crises could be very costly because they might seriously impair the domestic payments system or force a massive bank bailout and a major hike in prices and wages. Therefore, it would be prudent for the central bank to implement policies that would help to slow down bank credit, such as an increase in banks' liquidity requirements or a tax on credit expansion, like in Spain. These policies will not prevent a large increase in credit but will help to

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>
> *— Guillermo Calvo*

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Economic News

Ecuador Seeks Loan From Russia as Correa Heads to Moscow

Ecuador, whose financing options became more limited after the government defaulted on a portion of its sovereign debt last year, is seeking a loan from Russia, Russian Finance Minister Alexi Kudrin told reporters Wednesday, Reuters reported. The request comes as Ecuadorean President Rafael Correa arrived Wednesday in Moscow. He is scheduled to meet with Russian President Dmitry Medvedev and Prime Minister Vladimir Putin today. Energy and defense issues are also among the topics expected to be discussed. Each day, Ecuador produces 500,000 barrels of crude oil and Russia produces about 20 times more. Ecuadorean officials have said they are interested in inviting Russian companies to drill for oil in the country. It has discussed the possibility with companies including Russia's state-controlled **Zarubezhneft**. Ecuador is also looking to bolster its defenses. Venezuelan President Hugo Chavez, a Correa ally, has been building up Venezuela's arsenal with weapons from Russia. Kudrin, who said talks between Quito and Moscow about the loan had not yet started, did not specify the size of the potential loan. Ecuador has already agreed to provide China oil in a $1 billion deal and Correa has said more bilateral agreements are on the horizon. Russia, which holds approximately $400 billion in gold and foreign reserves, has received loan requests from several countries.

Company News

Brazil's Cetip Plunges in First Day of Trading in Sao Paulo

Brazilian clearing house **Cetip** plunged 9.5 percent Wednesday, the first day its shares began trading in Sao Paulo as a new tax on capital inflows sapped demand, Bloomberg News reported. Shares of Cetip, the fourth company in Brazil to sell shares this year in an initial public offering, dropped 1.24 reais to 11.76 reais after falling to a low of 11.21 reais during trading. Brazil's benchmark Bovespa index fell 4.75 percent to close at 60,162. "Clearly the first thing massacred by the lack of foreign investors are IPOs and Cetip had really bad luck in its timing," Paulo Possas, chief executive officer of **Eagle Capital** in Sao Paulo told Bloomberg News. Brazil's new tax sends the message to foreigners that "you're not welcome here," he added. The Bovespa has declined 8.1 percent since last week when the government announced the new 2 percent tax on equity and fixed-income assets by foreign investors. [Editor's note: See related Q&A on page 1.] The government hopes the new tax slows the real's rise against the U.S. dollar. Brazil's currency has soared 32 percent this year against the greenback, the largest gain among the 16 most-traded currencies in the world. Foreign investors have purchased more than half of the shares offered this year in Brazilian initial public offerings. Shareholders of Cetip are raising as much as 881.4 million reais ($U.S. 509 million) through the offering. As many as 67.8 million shares were offered at a price of 13 reais each.

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>
> *— Paulo Possas*

Legal Briefs

Thompson & Knight Adds Two to International Energy Practice Group

Two new attorneys have joined the Houston office of **Thompson & Knight**, the law firm said Tuesday. William Prescott Mills Schwind, a partner, and Gabriel Salinas, an associate, are joining the firm's International Energy Practice Group. Schwind focuses on international energy and natural resources, with an emphasis on gas transactions. Much of Schwind's practice is focused on Latin America and Africa. Salinas focuses on energy and corporate matters with an emphasis on transactions in Latin America.

Andrews Kurth Among Advisors to IDB for Guatemalan Bank Loan

U.S.-based **Andrews Kurth** was among the firms advising the Inter-American Development Bank in its financing to Guatemala's **Banco G&T Continental**, the firm said Monday. The IDB closed on the $70 million loan to the bank, which will support the Guatemalan bank's loans to microfinance institutions as well as micro-, small- and medium-sized enterprises. The Guatemalan law firm of **Consortium Rodriguez, Archila, Castellanos, Solares & Aguilar** also advised the IDB on the financing.

Arnold & Porter Advises on $7.4 Billion of Capital Markets Transactions

Arnold & Porter has recently advised on four capital markets transactions collectively worth $7.4 billion, the Washington-based firm said Oct. 21. The law firm advised Colombia on its issuance Oct. 20 of $1 billion in bonds due in 2041. Earlier in the month, Arnold & Porter advised Venezuela on its issuance of approximately $5 billion in debt. It also worked with Brazil on a $1.3 billion bond sale and with the Caribbean Development Bank on a $120 million bond offering.

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improve credit quality by alleviating the strain on regulatory resources that a major spurt of credit may generate. These credit policies are advisable even if taxes on capital inflows are implemented."

A **Claudio Loser, visiting senior fellow at the Inter-American Dialogue:** "Brazil finds itself coming out of the recession early, helped by its growing links to China. In large part because of this, the real has appreciated markedly in recent months. In a situation where the world economy is still weak, and Brazil loses competitiveness against the United States and China, Brazil is concerned about its ability to continue exporting. Moreover, as the real becomes stronger, investors are betting that it will continue to do so, and more capital comes in. That is the logic behind the new tax on inflows. But the experience with these taxes is at best mixed. Chile introduced it in a somewhat different way, more than a quarter century ago. It worked there because of an enforcement system that works well. However, in the case of Brazil, the control system is considerably less effective. Thus it is very likely that there will be continued capital inflows, but in a much more chaotic way, and with winners and losers that were not intended when the measure was put in place. Brazil would be much better off if it were to liberalize its trade and capital transactions. In this way, there would be no distortions, and the currency would not appreciate so much. In the end, the world will need to accept the fact that the U.S. dollar is reflecting the significant adjustment in the country's economy. Unfortunately, countries like Brazil and China are not helping to attain a smooth process of adjustment worldwide."

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>
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A **Emy Shayo, Brazil equity strategist at JPMorgan in Sao Paulo:** "The Brazilian tax was widely publicized as a move to contain the real's appreciation, but the objective was also to deflate the asset price inflation that was forming in recent weeks. Flows in Brazilian equities have accelerated tremendously, partly due to a large volume of equity offerings and partly due to investors feeling comfortable with country's growth profile. Through the beginning of October, net foreign equity inflows this year amounted to $21 billion, while fixed income flows stood at $6 billion. The move to impose the 2 percent financial operations tax on equities (a first, considering that the tax in the past was only applicable to fixed income) and fixed income was a wake up call for investors that the market is not unidirectional. The measure should have a negligible effect on the country's economy both in the short and long term. It will not likely stem off portfolio investments, it will not lead to currency weakness and it won't make much of a difference in terms of tax collection. On the other hand, the downside is the reintroduction of regulatory uncertainty. Investors are now considering what other moves could take place if the currency continues to appreciate, or if there will be a shift on important pillars of economic policy, especially as the country is entering a pre-electoral period. The new tax brings residual benefits at best for Mexico and Colombia in terms of flows being diverted to those countries, as the investment theme in Brazil is different (and perhaps more compelling) of those for other countries in the region."

The Advisor *welcomes reactions to the Q&A above. Readers can write editor Gene Kuleta at gkuleta@thedialogue.org with comments.*

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