

Flash Comment

Brazil imposes tax on foreign capital inflows

Brazil imposes a 2% tax on foreign capital inflows toward equities and fixed-income investments. The tax will not apply to foreign direct investment, but only to “hot money” flows. Brazil’s finance minister Guido Mantega said last night that the levy will be effective as of today. We expect a negative sentiment when Brazilian markets open later today.

The new tax aims to reduce the current pace of appreciation of the Brazilian real rather than to improve public revenues. In recent months the Brazilian real (BRL) saw very strong performance – especially against the US dollar. More specifically the real gained almost 43% against USD since the beginning of March 2009, and USD/BRL is now trading close to the lows seen last summer when commodity prices peaked.

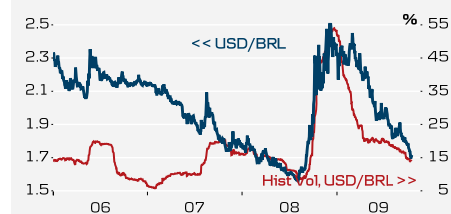
Naturally, surging commodity prices have been a key factor behind the strengthening of the currency. Meanwhile the Brazilian economy has performed remarkably well since end of Q1. During Q2 GDP expanded almost 2% y/y in real terms and final demand has been robust. External balances improved and capital inflows rose sharply in recent months. The Brazilian central bank (BCB) intervened in FX markets to curb excessive appreciation of the real, but the real has been unstoppable lately.

This new tax should clearly be viewed as negative for real (BRL) and maybe other LATAM currencies, as it could induce some profit taking following a very good run since the beginning of March. However, we will not overestimate the impact from this levy. The real might be overbought in the short term, but fundamentally the Brazilian economy is moving in the right direction and the economic performance has indeed been remarkably during this crisis. In our updated FX-forecast for the emerging markets we factored in some short-term weakness of the real, as we thought it looked somewhat overbought. We stick to that view and project USD/BRL at 1.75 on a three-month horizon. Longer term we still see room for a lower USD/BRL – read more in our EM Briefer, see [web link](#). This view is supported by our expectation of several rates hikes from the BCB.

Similarities with Turkey

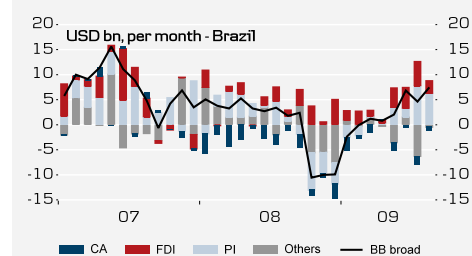
Note the levy has some similarities to the Turkish Constitutional Court who last week ruled in favour of a case filed by the opposition CHP, which said that foreign investors and locals should be treated equally on the application of the withholding tax on bonds and shares. Since locals pay 10% in withholding tax and international investors pay 0%, the speculation is that foreigners will have to pay 10% if the proposal is approved. Such a tax on foreigners could create negative spill-over to foreigners’ appetite for Turkish markets. In Turkey this could be viewed as yet another attack on the government from the judiciary rather than curbing excessive strengthening of the Turkish lira. This itself is negative for the perception of Turkish political stability and hence demand for Turkish assets. **All-in-all we are more concerned about the Turkish tax discussions than the Brazilian ones.**

Real strengthening has been massive



Source: Reuters

Hot money is back



Source: Reuters

And the economy sees robust demand



Source: Reuters

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Disclosure

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