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THE INTERNATIONAL FINANCIAL MARKETS**

Document prepared by Renato Baumann, Officer-in-Charge of ECLAC Brasilia Office for presentation at the Conference "Brazil in the World Context" (London, February, 1998). The views and opinions expressed in this document are those of the author and do not necessarily reflect the official position of ECLAC.

FOREIGN INVESTMENT IN BRAZIL AND THE INTERNATIONAL FINANCIAL MARKETS

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I - Introduction

As in several other developing economies, foreign investment has reached historically high record levels in recent years in Brazil, both as direct and as portfolio investment. The Brazilian case is particularly remarkable because in comparison to other developing economies the country was the major absorber of foreign resources until the late 1970s and presents perhaps the largest stock of foreign-owned capital. In spite of these credentials, Brazilian access to international capital markets remained rather limited for more than a decade.

Reasons for these recent changes are to be found in the favorable international scenario as well as in the various policy measures implemented since the late 1980s but more intensely after 1991 (mostly portfolio) and 1994 (direct investment). Easier access to capital flows had remarkable effects on the Brazilian economy by reducing the financing cost of economic agents, financing current account imbalances, helping domestic price stabilization and fostering growth, among other benefits. But as most policy strategies, reliance on external financing has provoked sharp domestic criticism, in particular from those who fear the vulnerability associated with an increasing exposure to the variability of the international capital market.

Forecasts regarding the near future are hence not clear. Optimists tend to stress the attractiveness of an economy that offers expressive opportunities for investors, whereas pessimists put emphasis in the likely effects of the recent Asian crisis and on the weaknesses of the international monetary system as a whole.

This paper aims at discussing these points. Next section presents some basic characteristics of recent trends of investment in developing economies in general and the third section discusses the major characteristics of foreign investment in Brazil, the fourth section presents the major pessimistic and optimistic views with regard to investment (actually, access to capital markets as a whole) in the coming years and the fifth section presents some final remarks. The paper contains also an Annex with recent Brazilian policies towards foreign investment.

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II - An Overview of Recent Trends of Foreign Investment into Developing Economies

The 1980s were a decade of financial hardship for most developing economies, specially in Latin America and Africa. The limited access to the international capital market was a major constraint on growth throughout the decade and had to be overcome in part by unprecedented use of bilateral public credit and financing programs from multilateral agencies.

Since the beginning of the 1990s private capital has replaced public sector aid as the major lubricant of economic activity. The reasons for such change are varied but most analysts would emphasize: a) the adoption of consistent macro-economic policies, in particular with regard to successful price stabilization (specially in Latin America); b) the spread of market economies, including an accelerating deregulation of private capital flows; c) privatization policies; d) increasing portfolio diversification by foreign firms and institutional investors; and e) the very liberalization of world trade - both regionally and at a multilateral level - as well as the liberalization of foreign investment regimes.

The renewed access to private capital markets was favored by changes in policy approach at the same time that led developing countries into a dispute around creating the most favorable domestic climate for private investors. Qualification of human resources, availability of infrastructure, socio-political stability, and a well-functioning judiciary system have become common universal goals for policy-makers in these countries.

The new scenario led also to unprecedented changes in the sources of capital. As different from previous bilateral relations with other countries or multilateral agencies (with clear political components) private capital markets now depend heavily on the profit-maximizing strategies of economic agents such as pension funds, transnational corporations and banks. These flows are therefore highly sensitive to arbitrage opportunities as well as to expectations.

Adjustment efforts by developing countries would not be sufficient, however, to generate foreign investment of the magnitude that has taken place recently. It is arbitrage opportunities and favorable expectations more than anything else what has driven investors towards emerging markets. With these markets providing higher long-term returns than mature economies, the decision to invest there is appealing (Calvo/Leiderman/Reinhart (1993), Peyman (1996)).

The expansion of international production and investment was also strengthened by the ongoing liberalization of direct investment regimes. The trend towards greater liberalization is illustrated, for instance, by the 98 changes that took place in the direction of investment liberalization and promotion in 1996, out of a total number of 114 changes in investment regimes introduced during that year in 65 countries. Over the period 1991-96 some 95 per cent of a total of 599 changes in the regulatory FDI regimes of countries were in the direction of liberalization, according to UNCTAD (1997).

The liberalization of direct investment is also reflected in the increase in the number of bilateral investment treaties. As of January 1997, there were 1,330 such

treaties in the world, involving 163 countries, a threefold increase in half a decade, and around 180 such treaties were concluded in 1996 alone (UNCTAD (1997)).

Thanks to the pronounced differential of returns, the expressive changes in recent policy-making in developing countries and other favorable factors these economies have attracted an increasing part of the available resources: in 1996 some 37% of global foreign direct investment flows went to developing countries (compared to 17.4% on average in 1985-90), with a high concentration of these flows (China accounted for about one-third of all direct investment to developing countries in 1996).

Evidence suggest a good relation between the inflow of foreign capital and economic growth, although the *type* of capital flow and its *domestic channeling* do matter. Take, for instance, the two major experiences of Latin American countries with capital inflow. In the 1970s regional GDP grew on average some 5.6% per annum and investment 7.3%. In the second half of that decade the investment rate was the highest ever. In the early 1990s average GDP growth was 3.6% between 1990 and 1994 (compared to only 1.2% in the 1980s). But this growth has hardly led to any increase in investment: investment growth was much less than the inflow of capital, indicating that a good part of the latter actually financed consumption and there is evidence that easier access to external savings has actually contributed to reduce domestic savings (Ffrench-Davis/Griffith-Jones (1997), Ffrench-Davis/Reisen (1997), Uthoff/Titelman (1997)).

A boom of foreign investment is therefore by and large determined primarily by the actual international conditions; it helps to overcome structural constraints and thus helps the recipient economy to achieve higher growth output rate, but may be a mixed blessing when there is no concern with the type of resources and the actual use the economy makes of them.

The international scenario that has allowed such increase in capital flows is better understood with a bit of historical perspective. The end of the so-called Bretton Woods monetary system (when the rather fixed parities among the most important currencies led policy-makers to concentrate on domestic variables, taking the exchange rate as given) led - after some experiments like the European "snake" and several agreements among the members of the G-7 - to the present "non-system", where the US dollar remains the most important currency, inflation rates are rather low in historical terms, there is moderate growth in the industrial countries, international capital flows are intense, but bilateral exchange rates fluctuate with unprecedented intensity.

In such economic environment the international markets demand higher discipline from local authorities, since macro-economic disequilibria are bound to be punished by the market via capital flows¹, the differences of domestic conditions in various economies give margin to intense profit-seeking speculation with currencies, and the private sector on its turn is forced to hedge against the costs of fluctuating exchange rates.

As part of the conditions imposed by this new context, countries were led to liberalize domestic legislation regulating the access to foreign capital, at the same time that a number of international agreements have been signed facilitating the conditions for capital mobility: some two-thirds of the nearly 1,330 treaties existing in January 1997 were concluded in the 1990s. Issues typically dealt with at the regional level include the

¹ With direct effects on reserves, the exchange-rate and hence trade and domestic output.

liberalization of investment measures: standards of treatment, protection of investments and dispute settlement, and issues related to the conduct of foreign investors (UNCTAD (1997)).

From the viewpoint of developing economies there was less concern in terms of diversifying portfolios. Given the structural shortage of foreign currencies the aim was to maximize the renewed access to the international capital market, assuring cheaper financing to the domestic economic activity.

This double set of perspectives - from profit-seeking investors and from capital-needed developing economies - led to a set of varied expectations regarding the new scenario². It was hoped that a) some kind of international transfer of resources would take place, to the benefit of capital-poor countries; b) freer capital movements would enhance opportunities to savers and reduce costs to borrowers, thus improving efficiency; c) risk management was supposed to improve, as a by-product of the development of derivatives; d) externally-imposed macro-economic discipline would improve overall allocative efficiency; e) flexible exchange rate management would act as a buffer, allowing policy makers to concentrate their targeting on domestic monetary and fiscal policies.

The resulting increase in international capital movements - facilitated by technical progress in telecommunications and data processing - is quite impressive. By 1980, according to the BIS, foreign exchange trading had reached a daily average of US\$ 80 billion, and the ratio of foreign exchange to world trade was about 10/1. In 1995 daily trading averaged US\$ 1.3 trillion, a ratio to world trade of nearly 70/1, equal to the entire world's official gold and foreign exchange reserves (Eatwell (1996)).

There has also been strong growth of foreign investment flows, largely influenced by the process of mergers & acquisitions (in the US and Europe operations of this kind corresponded in 1996 to about half the total amount of direct investment). Some developing economies also started to present significant flows of investment overseas (UNCTAD (1997)). Traditionally transnational companies tended to invest in "greenfield" sites and such ventures remain important. However, other forms of investment, particularly joint ventures and non-equity cooperative alliances, are of growing relevance. These are largely utilized as a means of gaining access to markets, sharing complementary technology and speeding up innovation in research and development. Such trends also reflect firm's attempts to become less vertically integrated (IDB/IRELA (1996)).

The tendency towards a global integration had thus a financial component closely related to new kinds of movements in the productive sectors.

As far as the original expectations are concerned, however, some doubts remain.

The original hope of resources being transferred towards capital-poor countries was only partially satisfied, as most resources still go to industrial countries: in 1996, for instance, inflows of direct investment into developing economies reached (a record of) US\$ 130 billion, whereas inflows into developed countries surpassed US\$ 200 billion,

² For an interesting discussion on this matter see Eatwell (1996).

according to UNCTAD³. Instead of a frustrating outcome, however, it is the original expectation what seems rather ambitious. The argument can be disputed on the basis of: a) the record rates of growth of net capital flows into developing countries and b) the relative dimensions of the two group of countries (it could be reasonably expected that the catch-up of the amount of resources absorbed by each group would take some time).

Also, it is estimated that from all stocks held by investment funds, mutual funds and pension funds in the world the share of assets related to emerging economies corresponds to only some 3.5%. The so-called market capitalization (market value) of all stock exchanges from developing countries corresponded in 1996 to 11% of the total market value of the stock exchanges in the world. The international market for securitized credit (excluding domestic markets) was worth a total of US\$ 2.5 trillion in 1996, of which the share of developing countries was only 12%. The share of developing countries in the international flow of bonuses and notes in 1996 was 14%, and it is expected that this share might have increased in 1997 to something over 15%, even with the reduced issuance in the last quarter of the year (SOBEET (1997)).

For some analysts the actual gains that accrued to borrowers in the international capital market have apparently being surpassed by the gains that accrued to savers. Among the factors that contributed to the impressive performance of capital markets are the sharp current account imbalances in major industrial countries in the 1980s-90s, which led to large flows of funds from surplus to deficit countries (the US in particular), with institutional investors playing an increasingly dominant role in world capital markets. Therefore, while gross capital flows into developing economies have been of unprecedented magnitude, net flows have been rather small and have tended to flow towards the developed countries, particularly the United States (Teunissen (1992), Eatwell (1996)).

Financial innovation coupled to deregulation has apparently increased instead of reduce systemic risk. Financial markets have become increasingly integrated, with their size and influence increasing markedly for all countries. Associated to this there has been an important trend for dissolution of functional boundaries, particularly between banking and securities activities, increasing the risks of the financial system because securities provide additional risk-taking opportunities for aggressively managed banking institutions. Also, the integration of banking and securities's firms could create conditions for a shock coming from the securities market being transmitted to banks and back into the securities markets (Griffith-Jones, Papageorgiou (1993)).

This has proved to be in accordance with some interpretations of the recent Asian crisis (Krugman (1998)) that identify the behavior of financial intermediaries with the origin of most of the troubles: excessive risky lending created inflation of goods and asset prices, which on its turn served as a basis for the proliferation of additional risky lending.

This suggests that whatever the improvement made in allocative efficiency of domestic resources by means of more flexible legislation, net private capital flows into developing economies do not just depend on conditions and policies in those countries. Determining external factors are the savings and investment balances in the rest of the

³ Foreign direct investment into Latin America and the Caribbean increased threefold between 1990 and 1995, from US\$ 8 billion to US\$ 24 billion, whereas for the total world the figures are US\$ 200 billion and US\$ 310 billion respectively.

world, interest rate differentials, and efficiency and stability in international financial and capital markets.

Furthermore, from the viewpoint of developing economies the flows of finance do not necessarily correspond to flows of real investment. Recent literature on the timing and sequencing of reforms in developing economies often stress the trajectory to be followed by policies that lead to an economic environment that favors the attraction of foreign investors and tend to not consider other domestic underlying conditions.

But as Ffrench-Davis (1997) reminds us, international trade and foreign direct investment are still significantly less important than domestic trade and domestic investment. Total foreign direct investment corresponds to only between 5% and 10% of total investment, and external trade corresponds to between 15% and 20% of all world output.

As a consequence, it is important to take into account domestic policies and the efforts leading to regional integration: on average the world exports some 20% of all that is produced yearly (if we take into account the import component of domestic production that figure would come down to some 15%). This means that some 85% of what is produced is not traded. Furthermore, the 15% that are traded are more intensely traded in intra-regional terms.

In 1994 the total amount of direct investment from 140 countries was worth US\$ 250 billion, compared to US\$ 25 trillion of world output. This means that the flows of direct investment corresponded to only some 1% of world GDP. The same is true in terms of domestic capital formation. As far as developing countries are concerned, the average participation of foreign direct investment in their capital formation is close to 7%: most of the effort to increase productive capacity depend on domestic sources, and hence there should be no alternative to fostering domestic saving efforts.

This is reinforced by the fact that a major part of the external financing received by developing countries does not go directly to productive investment, but goes instead to financial markets. From there it can either go to investment or consumption, depending on the macro-economic environment and the policies that are adopted by the country.

In addition to that, the most dynamic part of international financial flows being associated to continuous changes in portfolio composition makes the variation of short-term capital rather independent from the domestic business cycle, as different from long-term capital flows. This lack of synchrony raises the possibility that the effects on the variation of a country's reserves and on its domestic liquidity might be felt independently from the level of activity, simply as an outcome of the differences between domestic and international interest rates, exchange rates and the prices of stocks and bonds (Miranda (1997)). Recent capital flows are portfolio investment guided by a speculative logic, and oriented by the perspectives of return in the short-run and not necessarily by economic fundamentals. Given the increasing magnitude of the flows⁴ they can and have been of lately a major disturbing element for the recipient economies.

⁴ In rough terms in 1996 US\$ 330 billion of private resources were destined to developing countries, three times as much as in 1992: US\$ 140 billion in terms of direct investment flows, and US\$ 190 billion as securitized credit, syndicated loans and stock issuance (SOBEET (1997)).

In the last 15 years the mechanisms of financial intermediation have experimented significant changes, with a new role played by institutional investors and the constant process of portfolio diversification, which are likely to remain. It is hence important to identify whether the favorable scenario of the recent years can be counted with in the future and if so, what share of the resources will developing countries be able to attract.

III - Recent Foreign Investment in Brazil

Before entering the discussion about investment flows it is helpful to specify more precisely the object of analysis. As Tanzi/Coelho (1991, p.155) put it: “The dividing line between direct and portfolio investment is somewhat arbitrary [although it can be said that the latter usually faces lower restrictions]. Direct - risk or equity - investment often involves foreign control of the production process and marketing strategy, the use of brand names marks and patents, and the use of new - relative to local - technology either embodied in equipment or as knowledge of techniques and processes.”

Portfolio investment is often dealt with as mostly short-term flows, responsive to international differences in interest rates and exchange rates (arbitrage), and highly sensitive to domestic regulations and tax structure.

The difference between short- and long-term capital is, however, increasingly related less to the maturity of assets traded than to the decision of agents to maintain and increase their investments in a given economy: investors have been led to adopt strategies according to which all the instruments and markets are continuously analyzed having in mind opportunities for gains in the short run. There might be instruments of long maturity, but only some of them are purchased to be kept for a long time (Aurelio (1997))⁵.

In Brazil the Central Bank considers as portfolio investment: a) foreign capital invested in depository receipts and b) foreign capital invested in securities issued by residents and traded in the domestic financial market. This distinction allows for a separate analysis of both types of foreign investment.

III.A. Portfolio -

As shown in the Annex, the opening up of the economy to international capital flows had a turning-point in 1991, represented basically by Annex IV to Resolution 1289/87 which allowed foreign investors to operate in domestic stock exchanges, coupled to larger facilities to attract foreign resources via bonuses, notes and other means, what led to sharp changes in the Capital Account of the Balance of Payments. During 1985-91 the capital account had deficits every year (except in 1988), thanks do the large amounts of amortization of the external debt. Almost all the loans were destined to repayment of

⁵ The imposition of capital controls to the inflow of short-term capital is therefore not an efficient substitute for policies that indicate - to foreign investors - a stable macro-economic environment.

the debt outstanding. Portfolio investment were almost nil and only in 1988 were direct investment of some significance. With the policy changes in 1991, in 1992 the Current Account became positive once again (a surplus of US\$ 25 billion)⁶.

Table 1 illustrates the sources of Balance of Payments financing since 1993.

Historically current account deficits were financed by bank loans and, to a lesser extent, by direct investment. Today loans are still expressive, but correspond almost entirely to the issuance of bonuses and notes by private enterprises⁷, and not to bank loans: as different from previous debt cycles in 1996 net inflows of resources via bonuses and notes corresponded to 73% of total loans. This means that almost all the increase in the external debt in 1996 was due to “new” forms of financing, and this debt is mostly from the private sector (IPEA (1997)).

Table 1 - Balance of Payments Financing (US\$ Billion)

	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997*</u>
Requirements	-11.07	-15.07	-29.81	-38.84	-57.12
Current Account	-0.59	-1.69	-17.97	-24.35	-33.84
Amortization	-10.47	-11.13	-11.07	-14.5	-23.28
Brady Bonds	0	-3.05	-0.77	0	n.a.
Sources of Financing	11.07	15.07	29.81	38.84	57.12
Changes in Reserves (- = increase)	-8.71	-7.22	-12.92	-8.67	7.11
Import Financing	2.38	1.94	2.83	4.3	14.07
Loan Disbursements	10.79	10.42	14.74	22.80	32.62
Direct Investment	0.61	1.89	3.93	9.44	17.05
Portfolio Investment	6.65	7.28	2.29	6.04	5.30
Short-Term Capital	-0.66	1.56	18.94	4.92	-19.04

Source: Central Bank of Brazil (*) preliminary data

Current Account deficit having increased from US\$ 600 million in 1993 to US\$ 34 billion in 1997 (4.2% of GDP) has meant increasing financing requirements, as

⁶ The first bond issuances were made by large State-owned firms, such as Petrobrás, Vale do Rio Doce and BNDES. In 1991 they corresponded to 56% of total issuances authorized by the Central Bank. By 1993 that share had already been reduced to 19%.

⁷ In 1996 almost three-quarters of Brazilian bonds were issued by the private sector, compared, for instance, to only 28% in Argentina and 16% in Colombia.

indicated in Table 1. Most of the resources come from loans, but an increasing share of the financing corresponds to investment: in 1997 almost 40% of the financing needs were provided by direct and portfolio investment together.

The relative importance of portfolio investment flows is illustrated by Table 2.

Table 2 - Aggregate Portfolio Investment Flows

Year	Net Inflow(*) (US\$ million)	Portfolio Investment as % of Total Capital Inflow (**)
1993	6650	33.6
1994	7280	31.5
1995	2294	5.4
1996	6039	12.7
1997	5300	10.6

Source: Central Bank of Brazil

(*) comprises Annexes I to IV, Fixed Income Fund, Privatization Fund, Fund for Emerging Firms and Fund for Real Estate Investment

(**) Import Financing, Loan Disbursement, Direct Investment, Portfolio Investment, Short-Term Capital

According to Figures in Table 2 there was a sharp increase in the amount of portfolio investment up to 1994 (reaching an amount four times higher than two years earlier). In that year portfolio investment corresponded to almost 60% of all foreign investment in Brazil and almost half the increase in the country's foreign reserves. Since then the growth of direct investment flows reduced the relative importance of portfolio to about one-tenth of total capital inflows.

As indicated in the Annex at the end of this paper, most of the portfolio investment in Brazil is related to the Annexes to Resolution 1289/87, as indicated in Table 3⁸.

As different from other Latin American countries, in Brazil the presence of foreign investors is allowed only in the Stock Exchange: financial opening hardly reached the primary stock market, deposits and loans denominated in foreign currencies are not allowed, and credits indexed to the dollar have a reduced (5% in late 1996) participation

⁸ Annex I refers to Investment Societies formed in Brazil; Annex II deals with Investment Funds formed in Brazil; Annex III regulates the operation of Investment Societies from abroad and Annex IV allows foreign institutional investors to operate in domestic stock exchanges even when they do not correspond to the conditions of the other three Annexes.

in total bank loans and cannot be provided to individuals. Furthermore, the share of dollar-indexed bonds in the stock of domestic debt was only about 12% in 1997 (SOBEET (1997b)).

Table 3 - Portfolio Investment Inflow by Type (US\$ million)

Year	Annexes I to IV	Fixed Income Fund	Other Funds (*)	Total Net Inflow
1992	3864	3864
1993	14971	80	...	15051
1994	21600	1434	1939	24973
1995	22559	211	1955	24725
1996	24684	12	876	25572
1997	37190	327	1267	38784

Source: Central Bank of Brazil

(*) comprises Annexes I to IV, Fixed Income Fund, Privatization Fund, Fund for Emerging Firms and Fund for Real Estate Investment

The literature often associates the access by developing countries to the international private capital markets with stabilization processes and the adoption of liberal reforms. This was so in Chile, Argentina and in Mexico, just to mention some Latin American countries. In Brazil the adoption of liberal policies started - as already referred - in 1990, but price stabilization has only been achieved since 1994. This would be an indication, therefore, that external factors have played a significant role in the determination of investment flows. Next section presents some empirical evidence.

Notwithstanding the facilities of access to private international capital, portfolio investment cannot be considered as a source of financing to long term growth: it does not normally induce an investment cycle in the domestic economy and the limitations of the domestic financial sector make portfolio flows not easily recycled to meet the demand by the productive sector. Direct investment plays a determining role.

III.B. Direct Investment -

Brazil has a long standing tradition of dealing with foreign investors, its origin dating from the early days of industrialization. Typical surveys of the industrial sector

indicate a participation of about 40% of foreign-owned companies in total sales⁹. An estimate of that share for the year 1995¹⁰ indicates its distribution by sectors, as shown in Table 4.

Table 4 - Share of Foreign-Owned Firms in Total Sales (selected sectors)- 1995

	(%)
Processed Food,	
Beverages and Tobacco	43.8
Automobile Industry	92.0
Chemical & Petrochemicals	23.5
Electronics, Telecommunication &	
Electrical Appliances	56.4
Pharmaceutical	58.8
Pulp and Paper	16.5
Textiles & Footwear	9.3
Metallurgy & Machinery	31.4
Total Manufacturing	46.8

Source: Chudnovsky/López (1997), Cuadro 7, Anexo Estadístico

In some sectors - such as transport equipment, metal products, machinery and electrical and electronic goods - transnational corporations play a leading role, determining most of the value-added and taking the decisions regarding investment, whereas in another group of sectors, such as food and beverages and commodities these companies play a supporting role, often operating in association with local firms¹¹.

Brazil has traditionally ranked high in foreign direct investment flows to developing countries: 5th place in 1994 (US\$ 3 billion); 4th in 1995 (US\$ 4.8 billion) and 2nd in 1996 (US\$ 9.5 billion) (SOBEET (1997)). In 1996 the Brazilian economy absorbed 2.7% of total world direct investment (6.7% of the amount invested in developing economies). This corresponds to about half its share in total world direct investment flows observed in the early 1970s but more than three times as much as its participation in the late 1980s.

The evaluation of these figures call for a broader perspective, seldom considered in the literature. As Table 5 shows, the Brazilian share of total world direct investment

⁹ This characteristic is rather limited to the non-financial sector. A study (SOBEET (1997b)) of the 500 largest firms found transnational companies accounting for roughly 37% of total sales, domestic private firms 39% and state-owned firms 24% , whereas the distribution of total loans among the 50 largest banks indicated a participation of 14% for foreign-owned banks, 32% for private domestic banks and 54% for state-owned banks.

¹⁰ From a sample of the 360 industrial firms ranked among the largest 500 firms.

¹¹ See Bielschowsky (1995) for an analysis of recent performance. In the last 2-3 years certainly the most significant movement has been the massive increase of foreign capital in two sectors traditionally dominated by local firms, processed food and autparts.

fell sharply throughout the 1980s and remained low in the early 1990s, with a significant recuperation after 1996. The figures on both columns of Table 5 indicate furthermore that: a) total world direct investment flows boomed in the 1980s - hence Brazil clearly missed that opportunity; b) the increase in the Brazilian share of total direct investment takes place when the amount of total world direct investment is about twice as high as in the late 1980s - and hence is of great significance in itself.

Table 5 - Total World Foreign Direct Investment and Brazil's Share - 1970-1996

	Brazil/Total World FDI (%)	Total World FDI (US\$ billion)
1970-75	5.09	19.85
1976-80	6.29	43.26
1981-85	4.38	47.98
1986-90	1.20	169.66
1991-95	1.32	245.70
1996	2.72	346.80

Source: UNCTAD, World Investment Report

Table 6 - Brazil: Selected Indicators and Foreign Investment - 1991- 1996

	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
GDP Growth Rate	0.1	-1.1	4.5	5.8	3.9	3.1	3.5*
Consumer Prices	476	1172	2498	929	22	9	4.4
Interest Rate in Foreign Currency	30.2	40.8	27.0	54.6	33.9	18.5	29.1*
Foreign Direct Investment	1103	2061	1292	3072	4859	9500	17050
Portfolio Investment	778	1704	6650	7280	2294	6039	5300

Source: UN/ECLAC, Economic Survey of Latin America and the Caribbean 1996-1997, UN/UNCTAD, World Investment Report, Central Bank of Brazil

(*) Estimates; interest rates in foreign currency = saving deposit rate (as of November/97) deflated by domestic consumer prices (INPC) and by the variation in the exchange rate

Furthermore, as figures in Table 6 suggest, interest arbitrage movements apparently explain only part of portfolio investment: the amount of investment reaches a peak in 1994, when the domestic rate of interest measured in US\$ dollars was also at a maximum, but variations in that rate have no correspondence to portfolio investment in 1993 nor in 1995 to 1997.

Foreign direct investment flow seems more consistent with what theory would predict. Net investment flow increased in direct proportion to GDP growth and to domestic price stabilization.

The government has of lately emphasized the role Brazil has traditionally played, as one major attraction for foreign investors by: a) providing new macro-economic environment (low inflation rates and moderate growth); b) fostering constitutional amendments favoring the end of State monopolies and the privatization program; c) stimulating initiatives related to regional integration and as Giambiagi/Reis (1997) put it, by d) a renewed role of the President as a “country salesman” to attract foreign capital.

The ratio between net foreign direct investment and gross capital formation has increased significantly: from an average of 2.3% in 1984-89 (and varying between 1-1.4% in 1990-93¹²) that ratio reached 3% in 1994, 3.5% in 1995, 7.9% in 1996 and it is estimated that it has come close to 10% in 1997¹³.

As regards the origin of foreign capital, Chudnovsky/López (1997) estimate that as of 1995 investors from the US accounted for 26% of the registered stock of foreign capital, followed by investors from Germany with 18%, Japan with 11%, France with 7%, Italy with 6%, and the UK and Switzerland with 5% each.

The latest detailed figures available relative to recent flows of foreign direct investment by sector refer to 1996, when total direct investment totaled US\$ 9.6 billion. The distribution of direct investment¹⁴ by sectors in that year (SOBEET (1997a)) point to manufacturing industry absorbing 24% of the total, and agriculture and mining only 1.3%. The services sector accounted for more than 60% of the direct investments in 1996. The high participation of services in recent investment flows is associated to the privatization program, to be considered later on.

As far as direct investment as a whole is concerned one of the major determining factors is the rate of return to non-residents. The average cost of investment (net profits and dividends + reinvested profits) remitted to the rest of the world was 6.3% of capital in 1980-97, much less than the average interest rate in that period (Libor of 7.7% per year, plus spread)¹⁵. This has allowed for significant return for investors, as indicated, for instance, by the reported rates of return of US firms. Figures in Table 7 indicate a rising trend of the rates of return to foreign investors in Brazil, with a peak in 1993-94. Investing in the country has become highly attractive, in comparison to other developing countries, not to speak in global terms. Even in regional terms, the Brazilian market looks

¹² Except in 1992, when it reached 3%.

¹³ Estimates by Chudnovsky/López (1997) and Giambiagi/Reis (1997). In GDP terms the latter estimate that FDI increased from 0.3% on average in 1991-95 to 1.3% in 1996 and 2% in 1997.

¹⁴ For investments worth more than US\$ 10 million, or 80% of the total.

¹⁵ Giambiagi/Reis (1997).

quite competitive when compared to other countries, like Argentina, Mexico and Chile, that have been very active in attracting foreign capital.

Recent investment falls into three categories. The first involves new entrants (or returnees) to the market (Renault in Paraná, several producers of autoparts); the second kind involves modernizing existing plants to bring them closer to world standards (Fiat launching its Palio); thirdly, the market leaders are expanding capacity to keep up with demand (GM in Brazil) (The Economist (Dec.6, 1997)).

Such attractiveness has been improved recently by two additional factors - the privatization program and the consolidation of a regional common market.

Table 7 - Yearly Rate of Return (%) by US Firms in Selected Countries and Regions

	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>
Brazil	10.1	6.6	15.6	30.3	28.1	18.4
Argentina	18.2	20.5	18.7	19.8	21.1	14.3
Mexico	22.3	22.3	20.0	18.4	16.0	10.1
Chile	23.8	17.0	18.7	10.1	24.0	23.5
Total Latin America	14.1	12.5	15.8	15.6	15.5	13.2
Developing Countries	16.1	14.5	16.5	15.7	15.1	15.5
World	15.1	12.0	11.0	11.8	11.7	13.8

Source: ECLAC (1997)

III.B.1 - The Role of Privatization

Between 1990 and 1996 Brazil has sold 73 companies for a total of US\$ 15 billion. For 1997 that total came close to US\$ 20 billion and it is expected that in 1998 sales of public firms could surpass US\$ 30 billion. It is the most significant set of investment opportunities in what remain of the present century.

The Brazilian privatization program in its early days was rather peculiar in comparison to the privatization experience in other Latin American countries, such as Chile, Argentina and Mexico: most of investment originated from local pension funds and local entrepreneurs. This seems to be changing, largely due to new sectors being

included in the program. Foreign multinationals have come to see privatization as a way into the market, often in alliance with local firms.

It is estimated (SOBEET (1997a)) that US\$ 2.3 billion of the total invested in 1996 were investments linked to the privatization program, what by and large explains why the services sector (electricity, telecommunications and railroads) absorbed most of the flows - some 32% of all direct investment over US\$ 10 million¹⁶.

Between July/94 and June/97 some 16% of the US\$ 24.5 billion of direct investment that entered the Brazilian economy were linked to privatization (SOBEET (1997b))¹⁷. When considered in terms of countries of origin, the flows of direct investment into Brazil in 1996 indicate a significant predominance of investments from the US (26%), followed by France (13%), Spain (8%), and The Netherlands (7%), a clear indication of the importance of the privatization program: most of these resources were associated with the acquisition of public enterprises (mainly in the services sector).

III.B.2 - Regional Integration

It has become by now widely accepted that recent regional integration in general has stimulated investment. Firms (mostly multinationals but also some local firms) in sectors traditionally concerned with the domestic market started to look for scale gains by the specialization in some productions stages. Particular importance in such context is to be given to intra-firm transactions and the creation of stable links with geographically dispersed suppliers.

Brazil has since the beginning of the decade participated in the formation of a common market - Mercosur - with other three South American countries (Argentina, Paraguay and Uruguay) and more recently with the partial adhesion of Chile and Bolivia. This broader market has stimulated a number of investment decisions, via several mechanisms: a) it attracted investors aiming at the regional market, b) it led firms concerned with the domestic market to look for scale gains¹⁸ and c) specific regional agreements led to the formation of bilateral companies with Brazilian and Argentine capital.

The importance of the process of regional integration goes therefore well beyond the estimates of bilateral (or regional) investment flows; a number of projects belonging to

¹⁶ The services sector corresponds to 30% of total foreign-owned capital stock, but absorbed in 1996 62% of the investments worth more than US\$ 10 million.

¹⁷ For the year 1997 it is estimated that some 30% of the inflow of direct investment is related to privatization. Notice, however, that this figure underestimates the volume of resources attracted via the sale of public firms, as it does not comprise syndicated loans and other inflows of capital. I owe this point to Octavio de Barros.

¹⁸ As indicated, for instance, by the answers given by several firms surveyed in CNI/CEPAL (1997): the share of Mercosur in their total sales is likely to increase significantly in their investment projects being implemented.

firms concerned predominantly with the domestic market have also been positively affected by the perspectives of the enlarged market¹⁹.

IV - Perspectives

IV.A Pessimistic Perspectives

A pessimistic analysis of the perspectives regarding the near future would stress: a) the decision problems that follow from a global economy, b) the differentiated role of the US economy for the international capital markets, c) the probable consequences of the recent Asian crisis, d) the joint effects of these two latter elements and e) the external effects of the domestic public sector borrowing requirements.

The recent crisis that has affected so markedly several Asian economies has shown also one of the harsh characteristics of a global economy. World markets operating around the clock expose policy makers of any country to an unprecedented situation. Decisions to deal with speculative attacks against the national currency have to be taken in real time, but the time lag between the operation of a foreign market and the domestic market might act against the effectiveness of domestic policy measures. Authorities face the challenge of being able to anticipate market behavior. The exposure to such market synchronization is, for a given country, a direct function of the degree of tradability of its currency, bonds and stocks in foreign markets. It is therefore feared that the very rhythm and intensity of market operations might have negative impact on the economy, if policy makers take the wrong course of action to deal with it.

Another type of concern with regard to the coming years has to do with the consequences of the recent Asian crisis for emerging economies as a whole. The argument is centered in two aspects: a) the sharp devaluation of Asian currencies coupled to their traditional trade aggressiveness will have negative effects on the trade balance of other emerging economies, both by reducing their competitiveness in international markets and by reducing import prices (thus making them less attractive to foreign investors); b) international investors will become increasingly skeptical with regard to developing countries in general, increasing the difficulties these countries face to have access to financial markets.

¹⁹ It is estimated (CEPAL (1997a)) that joint investment by Brazilian and Argentinian firms will surpass US\$ 2 billion in the next couple of years.

For the Brazilian economy - with trade deficit estimated to reach US\$ 4-5 billion in 1998 - and a current account deficit over 4% of GDP this certainly is a matter for concern.

The magnitude of real devaluation²⁰ with regard to the US dollar in Asian developing countries in 1997 has been quite significant: Indonesia (116%), Korea (89%), Thailand (73%), The Philippines (54%), Malaysia (53%) and Singapore (20%). This in itself would pose a challenge to Brazilian traders, to the extent that exports from these countries compete with Brazilian products, and to the extent that imports from these countries might enter the Brazilian market.

The skeptical argument with regard to foreign exchange rate goes one step further. Estimates indicate an approximate 15-20% overvaluation²¹ of the Real, on a parity basis. Furthermore, in 1997 it was not only Asian currencies that have devalued in significant proportions. Other competitors, such as former socialist countries and OECD members have also had their currencies devalued in relation to the dollar: Hungary (9%), Australia (24%), Germany, France and Italy (about 16% each), and Japan (12%).

This allows for some concern about the potential of the Brazilian economy to reduce its external gap in a sustainable way, not as dependent upon foreign financing as in the last three years: uncertainty about the actual effects of the recent Asian crisis for the access by other developing countries to the international financial market would translate into greater vulnerability of the Brazilian (and other) economies.

Skepticism has also risen from the present characteristics of the international monetary system as a whole.

Foreign investment into the US reached US\$ 480 billion in 1996, being US\$ 384 billion in bonds and US\$ 96 billion in direct investment, leading the stock of foreign-owned capital to US\$ 2.4 trillion. At that same year, the amount of US Treasury bonds belonging to non-residents reached US\$ 1.1 trillion, almost one-third more than the previous year; this corresponds also to some 32% of all Treasury bonds in private hands.

The relevance of these figures is that such huge amount of resources in Treasury bonds has become since the early 1980s the major instrument by the US to attract international liquidity and to channel Japanese and European capital into the US market. The US deficit has become in fact the anchor for the stabilization of the world monetary and credit market. By absorbing so many bonds the world is actually financing not only the US Treasury, specially its financial component, but also US investors and consumers. There is a 'real savings transfer' and not only transfer of credit, liquidity or speculative capital (Tavares (1997)).

The utilization of the US interest rate as a reference rate provides unique opportunities for huge arbitrage gains whenever there are significant differences between international interest rates and the corresponding fluctuations of the exchange rate of local currencies in relation to the dollar (Tavares/Merlin (1997)). The predominance of the markets for foreign exchange is in itself an indication that the risk of exchange transactions loses ground to the risk of credit. The lack of transparency in the payment systems and the possibility of credit exposure of significant magnitude are symptoms of

²⁰ Deflating by the domestic consumer price index (Batista (1998)).

²¹ Estimates vary according to the price index and to the reference (US dollar or a basket of currencies). See FUNCEX (1997).

the potential instability of such systems. This is why the number of mergers and acquisitions has increased sharply in recent years as well as the number of Central Banks interventions as lenders of last resort (Miranda (1997)).

Such scenario of devalued European and Asian currencies in relation to the dollar, coupled to this built-in characteristic of the monetary system to present systematic instability of parities might have negative impact also on the projected amount of resources Brazil expects to attract associated to the privatization program in the coming years.

After the Asian crisis the dollar appreciation might have important negative effect on the dollar value of European and Japanese investment flows. It is still unknown the magnitude and net result of such effect, but with the devaluation of certain currencies the direct investment flow associated to mergers & acquisitions (about $\frac{3}{4}$ of investment operations in the world) will be affected in terms of the value of the transactions and even in terms of the very attractiveness to potential sellers of assets that were probably overvalued. In Brazil the dollar appreciation has already made local assets to be privatized more expensive for Europeans and Japanese investors. This partially explains the high participation of US investors in the foreign investment associated to privatization (48.5%) in 1997 (SOBEET (1997)).

Another component of pessimism associated to the privatization program is its simultaneity with similar programs elsewhere. It is feared that an accelerated privatization program might be risky, as the simultaneous sale of public enterprises in East and Western Europe in 1998 might provoke a dispute for the available resources, precisely at a time when investors are to become more cautious and premiums to be obtained from the sale of such enterprises are likely to be smaller than in recent years.

Furthermore, some reduction can be expected in the share of emerging countries in the portfolios of investment funds in the short run. The market share of emerging economies (measured by the relative importance of stock exchange transactions) is bound to be reduced after the crises in the stock exchanges and the important currency devaluation by several emerging economies in Asia.

One scenario feared worldwide would be a bank crisis in Japan leading to the sale of Japan's stock of US Treasury bonds and hence to increase in the interest rates with all its foreseeable consequences. The less dramatic effect would be an increase in the premiums required by investors and the destruction of the recent positive track records of firms and governments from developing countries, with the international market becoming more selective (SOBEET (1997)).

Finally, pessimists fear also the effects that the financial imbalance of federal²² and local state governments as well as the social security system deficit²³ might have on the external accounts. Public sector borrowing requirements are largely determined by the resource needs of local state governments and by the social security deficit. These structural components of public deficit are by and large creatures of constitutional conditions and hence unlikely to change in the short-run²⁴. The pessimist argument is

²² The dollar-denominated component of the federal government alone is close to US\$ 25 billion (11% of total internal debt). Amortization of foreign debt is scheduled to reach US\$ 13 billion in 1998.

²³ Total fiscal deficit reached 5% of GDP in 1997.

²⁴ Even more so in an election year.

therefore that such imbalances are binding constraints for the reduction of the domestic interest rate, with negative impact on the productive sector that might frighten risk-averse foreign investors.

IV.B Optimistic Views

The perspectives for the coming years with regard to access to international capital markets are determined by at least three elements: the actual effects of the recent crisis affecting Asian emerging economies, the perspectives with regard to access to financial resources and the potential of attraction of direct investment flows.

One favorable view with regard to the actual effects of the Asian crisis for Latin America would stress the fact that Asian countries are going to increase significantly their trade surplus, by reducing their imports as well as stimulating exports via the sharp devaluation they experimented.

This will mean higher hard currency gains which might a) increase their foreign reserves or b) foster investment by these countries elsewhere. In either case the additional money will be transformed into conservative investment, probably US Treasury bonds. This will mean additional liquidity in the US²⁵, which will on its turn increase the demand by US investors for investment with higher return, benefiting the emerging economies.

Another favorable factor according to this view is that several investment funds that dealt with emerging economies are highly liquid. With market normality they are likely to invest again in these economies, and also investors who have come out from Asian markets will look for opportunities in Latin America (Pinto (1998)).

As has been stressed elsewhere (SOBEET (1997)), markets with higher liquidity - such as Brazil - are more vulnerable during crisis but offer some advantages during recovery. In the recent episodes emerging economies have suffered most, as investors fly towards safer, less volatile markets. In the long run, however, the tendency to invest in emerging markets seems to be well defined, thanks to the structural diversification of portfolios, competition among funds searching for opportunities with high rates of return and the relative importance of these economies in the world scenario. Crises have led administrators of investment funds to look for higher specialization, with better information about market specifics: this is one of the reasons why the recent events have affected in different ways the Asian and the Latin American emerging markets, as indicated, for instance by the stock exchange performance in these countries²⁶:

²⁵ The magnitude of this effect depends clearly on what happens to the Japanese economy as well as to the Chinese exchange rate: a devaluation of the yuan might eliminate the competitiveness of other Asian economies.

²⁶ For the sake of comparison the corresponding variations of stock exchanges in the major industrial countries in the same period were: Frankfurt - 26.35; New York - 22.76; London - 20.36; Paris - 11.37.

Selected Stock Exchange Performance (% variation - Jan-Dec) in 1997:

Mexico - 52.0; São Paulo - 34.9; Buenos Aires - 5.9

Hong Kong - (-20.2); Seoul - (-67.4); Singapore - (-43.0);
Manila - (-61.2); Kuala Lumpur - (-69.1)

As far as Brazil is concerned it is estimated (SOBEET (1997)) that the relative importance of the country in the market value of all stock exchanges of the emerging economies has actually risen from 8% in 1994 to 12% in November/97, reinforcing the perception that the recent crisis has affected the set of emerging economies, but with different intensities.

So far for the consequences of the recent turmoil in Asia. A second source of optimism stem from the projected trend in the participation of emerging economies in the international financial market.

The first optimistic argument has to do with the actual participation of these economies in world financial markets. It is estimated²⁷ that the participation of developing countries in the market value of stock exchange transactions (12%), and in the amount of resources acquired via bonuses and notes in the international market (14%) is much lower than their corresponding share of world GDP (18% in 1996), population (16%) and exports (34%).

If there were to be any correspondence between such shares, thus, it could be expected a very significant expansion of the involvement of these economies in total financial transactions²⁸.

As an indication of such potential, in 1997 Latin America set a new historical record in attracting foreign resources, US\$ 115 billion in fresh international financing, an increase of 9% over 1996. For the first time since 1994 issuance of depository receipts from emerging economies surpassed those from industrialized countries (57% versus 43%) and forecasts point to an even higher number in 1998 thanks to the privatization programs. Issuance of Brazilian ADRs increased 350% in 1997, reaching US\$ 2.2 billion²⁹. Furthermore, originally Brazilian firms negotiated ADRs level-one or via Rule 144-A, not traded in stock exchanges. In 1997, however, most firms have issued ADRs directly through stock exchanges³⁰.

There is hence a favorable scenario for developing economies - including Brazil - and the extent to which the recent Asian crisis might have so far affected such positive trends does not seem to have been very expressive. This perception is apparently

²⁷ SOBEET (1997).

²⁸ Notice, however, that this same argument might lead to some pessimism with regard to direct investment, since in 1996 the developing countries absorbed some 40% of world total, a percentage that surpasses their relative economic importance.

²⁹ Brazil ranked third among the countries that launched the highest number of ADRs in 1997 (13), second only to the UK (26) and Australia (14).

³⁰ According to *Gazeta Mercantil*, 12/21/97 and 01/05/98.

reinforced by the comparative analyses of the indicators with regard to Asian and Latin American emerging economies.

Latin America - and Brazil in particular - has yet another advantage in the attraction of external capital, associated to the perspectives for direct investment.

As far as the Brazilian economy is concerned, the country is seen as remaining attractive to foreign investors due to: a) its domestic market size; b) the indicators of reduced domestic consumption levels, suggesting the existence of opportunities to be explored; c) it is one of the latest countries to privatize its public enterprises; d) it offers high rates of return to capital³¹. Furthermore, the economy has gone through a process of structural changes of lately with e) the privatization process stimulating infra-structural investment in telecommunication, energy generation, railroads, etc; f) one-third of foreign direct investment is being made in the services sector, improving overall competitiveness; g) tourism has become one of the priority activities in the Northern and Northeastern States, generating yet additional opportunities for investors; h) there is a remarkable process of re-location of several industrial plants involving additional investment opportunities (Zockun (1997)).

The privatization program plays a very important role in this context: in 1998 Brazil will provide 80% of the total Latin American opportunities stemming from privatization programs, reaching an amount that might come close to US\$ 40 billion. Telecommunications will generate some US\$ 20 billion in investment, and a similar amount will come from the sale of energy generation firms. Privatization will attract mostly those investors not affected by the Asian crisis (Europeans and Americans), for whom the cost of resources has not changed and who are highly liquid.

This raises the question of what will the foreign direct investment into Brazil be after the privatization cycle, i.e., after 1999. According to one estimate³², taking into account the fact that there are fresh foreign investment announced by firms for the coming years, and the fact that the new owners of the privatized enterprises will make new investments, it is estimated that the inflow of foreign investment will go beyond US\$ 20 billion/year, even after privatization.

Official views tend to be more cautious. In IPEA (1997) it is said that the fast growth of international foreign investment flows - some 72% between 1990 and 1995 - and the perspectives of maintaining such rhythm in the coming years make it feasible to reach a ratio of 1-1.5% of GDP. This means something between US\$ 8 to 12 billion yearly. Assuming that the rhythm of world flows is to be maintained at the average rate of the early 90s³³, this would mean a Brazilian share of some 2%-3%, compatible to the historical record of the country.

³¹ The rate of return of investments by US firms in Brazil in 1992-95 was on average 23%, compared to 12% in all other countries and to 15% in Latin America and the Caribbean as a whole.

³² Giambiagi/Reis (1997).

³³ Government expectations are consistent with the perspectives of multilateral agencies. According to the World Bank (1997, Chap 1) "the global environment for developing countries remains broadly favorable. Industrial countries are seeing modest growth, low inflation and moderate real interest rates. Progress on a wide range of trade and investment liberalization initiatives should allow the faster growth in world trade and international capital flows of the past decade to continue". Also, for UNCTAD (1997) likely future trends with regard to transnational corporations comprise: a) rapid rise in the proportion of total sales generated from production abroad; b) rapid rise in the proportion of production carried out abroad; c)

Be that as it may, indicators from the projects being implemented as well as from declared investment by the largest firms in Brazil are remarkable. In a projection of investments up to the year 2003 the Brazilian Association of Infrastructure and Manufacturers of Capital Goods (ABDIB) listed 1001 projects that account for a total of US\$ 190 billion in investment, 295 of which are under way: electricity = US\$ 86 billion; petroleum = US\$ 32 billion; transportation/ports = US\$ 39 billion; Steel = US\$ 5 billion; Pulp and paper = US\$ 12 billion; mining/cement = US\$ 6 billion; sanitation = US\$ 10 billion, apart from US\$ 19 billion automobile industry declares it will invest by the next decade, and investments that will take place in telecommunications and airports modernization (some US\$ 3 billion until year 2000)]. Given the Brazilian previous experience, it is also remarkable that private capital accounts for 61 percent of the projects listed by ABDIB.

The magnitudes involved in these projections have led some analysts to consider separately a number of countries who share the characteristics of large dimensions. Natural candidates are India, China, Indonesia, Russia and Brazil. Most analyses forecast that in the short run the US economy will confirm its leading position in the international scenario, due to the Asian crisis and the European slow growth perspectives. The US market should thus concentrate most of the resources. The concentration of resources will last as long as other opportunities do not appear elsewhere. Such opportunities are bound to appear in these large emerging economies, who might attract large sums of money (Mussi (1997)). In fact, the World Bank (1997) considers that rapid growth and global integration of these five countries over the next quarter century will imply a dramatic increase in their role in the world economy, producing significant changes in global patterns of resource allocation, production, trade and relative prices.

Even in comparison to these other large economies there are grounds for some optimism in relation to the Brazilian economy. Forecasts to China, Singapore and India are unclear, depending on the extension to which they might be affected by the currencies crisis in Hong Kong, Korea, Thailand, Malaysia, Singapore and Japan. Russia presented in 1997 for the first time since 1989 positive variation of its GDP, but the Asian crisis led to smaller than projected growth rates, at least for the current year. As far as Brazil is concerned, the country has trade and current transactions deficits and fiscal debt of some importance, meaning the need for sharper adjustment efforts in the short run³⁴. But investment opportunities and the forecast growth of regional trade might play a positive role.

greater reliance on mergers, acquisitions, alliances and joint ventures as vehicles for international expansion; d) continued emphasis on developing countries; e) market access remaining the most important motive for the choice of location; f) all corporate functions experiencing greater internationalization; g) increases in investment in infrastructure, distribution, non-financial services and automobiles, all of which favors developing economies (and regional integration processes) with adequate legislation and large domestic potential markets.

³⁴ Although an often emphasized positive aspect that distinguishes the Brazilian economy from other developing countries is that half of the Current Account deficit is financed by foreign direct investment.

V - Final Remarks

Brazil has a long record of dealing with foreign investment. Domestic market size does matter as an attraction to investors. If there is also market protection against competing imports and a liberal legislation to foreign investment, the basic conditions are given to create a large basis of foreign-owned productive sector, such as the one found in Brazil.

This can be demonstrated from a historical perspective by the investment cycles that took place in the country in the second half of last century, at the beginning of this century, in the 1950s, in the 1970s and more recently since 1992, initially in the form of portfolio investment but - following price stabilization and stimulated by the privatization program - also with direct investment flows of unprecedented magnitude since 1994.

The perspectives are of a significant inflow of resources in the coming years motivated, among other factors, by the privatization of new areas, by the need to resume investment in infrastructure and - given that most of the productive investment of recent years has aimed mostly at modernizing productive plants - by the very need to increase productive capacity. Relatively low shares in world financial flows would also suggest a potential for increasing the attraction of portfolio investment.

At the time of writing, there is hence room for a cautious optimism regarding the coming years, but a number of qualifications - most of them related to the international scenario - might affect favorable expectations. This is not to say that foreign capital inflow can be taken for granted if only domestic conditions were considered. The point to stress is that developing economies - like Brazil - play a rather passive role in the international distribution of resources, in the sense that the access to such resources is largely determined by exogenous factors. Correct domestic policies do help but are often not a sufficient condition.

This paper aimed at contributing to the appraisal of the recent Brazilian situation by presenting the basic data and domestic legislation relative to foreign investment, as well as a systematic list of the major arguments underlying positive and negative expectations with regard to the coming years.

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ANNEX

Brazilian Policies Towards Foreign Investment

Brazil has - since the early days of deepening industrialization - a long standing favorable policy welcoming foreign investors. As a matter of fact, it might be argued that since the mid-1950s (Instruction No.113 of SUMOC (1955)) the barriers facing foreign capital have systematically been less significant than those met by imported goods, although

the barriers to trade in goods and services might have affected negatively the decisions of some potential investors.

The positive signs of the relation with foreign (risk) capital are to be found in many directions. Not only have domestic policies traditionally treated foreign investors in better terms than elsewhere. The very size of the internal market has also contributed to create a quite profitable environment and the country has attracted investment in larger proportions than any other developing country³⁵. Furthermore, from 1960 to 1982 net inward flows of risk capital were consistently positive and increasing. In these 22 years, in only eight (1962, 1964, 1968, 1970, 1974, 1977, 1980 and 1982) there was no increase in the net flow of foreign direct investment (although net values have always been positive) (Baumann (1991)).

In terms of stock of foreign capital Brazil ranked ninth in the world in 1996 (with an estimated stock worth US\$ 108 billion), lagging behind only of China (with US\$ 170 billion) among the developing countries (UNCTAD (1997)). This means that the stock of foreign capital in Brazil surpasses that in Mexico by 50% and is 3.7 times higher than the corresponding figure for Argentina (SOBEET (1997)).

Flows of foreign investment were mostly direct investment³⁶ until as recently as 1992, when portfolio investment surpassed direct investment. Since then portfolio flows have systematically been more significant than direct investment, reflecting by and large an overall change in the international markets as well as the effects of domestic legislation. It was only in 1997 that direct investment became once again more expressive.

Brazilian Policies Up to 1989³⁷ - It was only in 1962, with Law No.4131, that the basic juridical principles regulating the operation of foreign capital were set in Brazil in a systematic form. Previous legal documents dealt mainly with obligations in other currencies, transfer of resources abroad and operations with foreign exchange.

There is no explicit discrimination against foreign firms in the legislation. Law 4131 defines similar juridical treatment to domestic and foreign capital. Exceptions have occurred, however, such as Law No. 4728/65 (Law of Capital Markets), by which access to the domestic capital market might be restricted in periods of crisis in the balance of payments and Decree-Law No.1986/82, which provides different treatment to domestic and foreign investors in the capital market.

Also, as of 1989, foreign investors faced legal restrictions to operate in some sectors, such as:

Oil production (State monopoly, set by the Constitution)

Mining and Hydraulic Energy (limited to local residents, according to the 1988 Constitution)

Fishing (restricted operation conditions allowed to foreigners, after certain criteria have been fulfilled - Decree-Law No.221/67, Law No.5438/68, Decree No.65005/69, Law No.6276/75)

³⁵Between 1971 and 1980 the country attracted 6% of total world FDI flows (data from Bielschowsky (1992)).

³⁶ Since the beginning of the 1980s there has been a fall in the relative share of reinvestment share in total investment

³⁷This Section draws heavily on Almeida (1989) and ECLAC (1989)

Financial Market, Capital Market and Insurance Market (same treatment as the country of origin of the investor; for insurance companies operation requires specific authorization by the President; specific regulations to be defined by the Central Bank; Law No.4728/65, 1988 Constitution)

Sea transportation (limited to nationals - ownership and staffing); ground transportation (also limited to nationals); air transportation (foreign firm requires specific authorization by the Aeronautics Ministry); Decree No.35514/54, Decree No.55476/65, Decree No.29/66, Decree-Law No.666/69, Decree-Law No.687/69, Law No. 6813/80, Law No.7565/86, 1988 Constitution

Informatics (the production of informatic goods and services that can not be supplied by domestic firms could only be made by foreign-owned firms authorized by the CONIN - National Council for Informatics and Automation; such firms must invest in R&D in the country an amount to be determined by CONIN, have an export program and develop local suppliers) - Law No.7232/84

Scientific expeditions (scientific expeditions or activities related to data gathering or recording of scientific material had to be authorized by the CNPq- National Council for Scientific and Technological Research) - Decree No.65057/69

Purchase of rural properties (purchase of rural properties by foreigners can only be made if it is intended for agricultural projects, approved by the Ministry of Agriculture) - Law No.4504/64, Decree No.55286/64, Complementary Act No.45/69, Law No.5709/71, Decree No.74965/74

Consultant Services (public agencies can only contract consultant services from foreign firms when there is no domestic firm able to provide such facility) - Decree No.64345/69, Decree No.66717/70, Decree No.73685/74

Ownership of Periodicals, Radio and Television (ownership of journals, radios and TV stations is limited to natives; it is forbidden to maintain any sort of contracts with foreign-owned firms - even the installation of equipment - for a period over six months) - Law No.5250/67, 1988 Constitution

The 1988 Constitution defines (Art.171) that it is up to ordinary legislation to determine the conditions for foreign direct investment, the incentives to reinvestment and the rules for profit remittances. It has also created the figure of Brazilian enterprise with national capital (**empresa brasileira de capital nacional**), the activities of which must be under the control of individuals actually living in the country. A distinction is made between a domestic enterprise (**empresa brasileira**), as one such created under Brazilian laws, with its administration in Brazil - and a **empresa brasileira de capital nacional**, to which temporary protection might be granted, as well as preferential treatment in the purchase of public goods and services.

It goes beyond the present purposes to make an appraisal of the adequacy of the legal concepts adopted in the Brazilian legislation. Suffice it to say that any such evaluation has to take into account, first, the very fact that significant modifications have taken place in the form of the investments. As different from the 1950s and 1960s, when investment flows were typically made via the controlling of local firms, since the 1970s one often sees associations of the joint-venture type, as well as technology agreements comprising also

participation in the firms' equity holding. In more recent years, new forms of investment are observed, such as licensing³⁸, mergers and acquisitions³⁹.

Secondly, one has to consider also that the relation of the Brazilian economy with the international capital markets is multi-sided. Brazilian legislation has contributed to stimulate relatively more loans than risk capital, as it encouraged foreign investors to report investments as debt instead of equity⁴⁰. Also, not only the lack of domestic economic stability tends to affect more intensely profit remittances than the payment of interests and amortization. As a matter of fact, in periods of normal relations with the external sector there is no limit to the payment of interests, whilst Law 4131 defines some restrictive conditions limiting profit remittances.

Together with several external factors these policy measures induced the economy, for most of the last two decades, to rely more on loan capital than fresh resources, with higher costs in terms of payment of interests and vulnerability to face debt service.

Other generic comments on the policy towards foreign investment in Brazil would emphasize the role played by the State in using its purchasing power to reinforce domestic capital. For instance, **Portaria** No.622 (19.06.78) of the Ministry of Communications determined a market reserve for telephone networks to domestically-owned enterprises. Decree No.64.345, from 10.04.69, established that technical consultancy could only be contracted from foreign-owned firms when it is proven that there is no comparable alternative provided by domestic firms. Decree-Law No.666, from 02.07.69 made it compulsory that goods imported by public agencies must be carried by ships with national flag.

Since mid-1995 a number of changes have been introduced in the 1988 Constitution, reducing several constraints to foreign direct investment flows in Brazil. Among the most important measures the following are worth noting: a) suppression of the constitutional definition of Brazilian firms of domestic capital, so that all firms based in the country are to be considered domestic, with the important consequences of improving the access to official credit and are allowed to exploit mineral resources as well as electric power supply; b) private firms are allowed to participate in the distribution of urban gas; c) private firms are allowed to participate in the oil industry, competing with the state-owned Petrobrás; d) foreign firms are allowed to participate in domestic navigation; e) the constitutional reform dropped the prohibition to private firms to participate in the telecommunication business; f) differentiation between domestic and foreign-owned capital in the financial sector has been eliminated, both in terms of limits to the participation in financial institutions and for taxation purposes (CEPAL (1997))

A central aspect in any review of the legislation of host countries is the taxation of remittances of profits and dividends. In Brazil the legislation regulating profit remittances adopts fiscal mechanisms to stimulate the reinvestment of profits rather than limit the amount to be remitted. Differentiated brackets of the Income Tax has been the instrumental tool for this purpose: regulation of remittances of dividends is rather flexible, being

³⁸See, in this regard, Guimaraes et alli.(1982)

³⁹ The yearly number of mergers and acquisitions in the manufacturing industry increased from 21 in 1992 to 94 in 1994 (when the Real Plan was launched) and 186 in 1997.

⁴⁰See Braga (1985)

determined until recently with reference to 12% of the registered capital and reinvestment. In excess of this ceiling remittances were progressively taxed⁴¹.

So far for investment in the real productive sector. A slightly peculiar approach has been adopted with regard to the banking sector.

The distinction between foreign and domestic banks appeared for the first time in Brazilian law in the Constitution of 1934. Article No. 117 of that Constitution mentions that foreign banks should be progressively nationalized. This nationalistic approach was reinforced by the Constitution of 1937. According to that Constitution, only financial institutions belonging to Brazilian citizens would be allowed to operate in the country. (ECLAC (1989).

The 1946 Constitution made no explicit references to foreign institutions in the financial sector. By the end of 1964 a radical reform on the financial sector was put forward by Law No.4595, according to which financial institutions would only be allowed to operate in the country with the previous approval of the Central Bank and foreign institutions would require the approval of the Executive.

In the early 1980s severe limitations were imposed by the Central Bank on the expansion of foreign banks. They were unable to compete for demand deposits and payments. In the second half of the decade, however, there was a strong rise in the number of foreign banks branches, indicating that the restrictions on foreign banks were somehow lowered. Since 1996 the limits imposed to the number of agencies was also eliminated, and the operation of foreign banks is now basically subject to authorization by the Central Bank and the President.

Profit Remittances and General Corporate Taxation Policy - Foreign capital may enter the country freely and usually receives treatment identical to that afforded local capital. Foreign investment must be registered with the Central Bank within 30 days of entering the country, and remittances abroad are subject to special control. Payments for technology, especially to a foreign parent company, are restricted. The percentage of foreign nationals on a firm's payroll is also limited.

A foreign firm requires no special authorization to organize a local business unless it is planned in any of the restricted industries. However, foreign takeovers via stocks purchased in the stock market may not be effected without special permission. In fact, only local firms can make tenders, since foreign funds may enter the Brazilian stock market solely through a locally established investment company. Furthermore, any incentives granted for the original investment program are not automatically extended to the enlarged operation. The investor must apply to the proper authorities.

In October, 1991 the Central Bank authorized foreign companies to use profits from financial investments (in addition to those from operations) to increase their registered capital base. In trying to encourage foreign investment, in December, 1991 Law No.8383 authorized the acquisition of technology and royalty payments (formerly prohibited on

⁴¹ Until 1992 profit remittances that surpassed that benchmark paid an additional 25% as income tax. From 1993 to 1995 this additional rate was reduced (Law 8383/91) to 15% and since 1996 tax remittances are exempted from taxation (Law 9249/95).

grounds of being disguised profit remittances) by subsidiaries to their parent companies, starting from January, 1993.

Effective January 1st, 1993, a revision of Law No.4131 (Law No.8383) abolished the punitive supplemental tax formerly applicable to remittances over 12% of a company's average registered capital over the preceding three years. The legislation thus capped the tax on remittances of dividends at the 25% base rate. It also provided for a reduction in the rate for companies that could prove that a lower rate prevailed in their home countries⁴².

Until mid-1991 the Central Bank authorized remittances of dividends, but held the amounts corresponding to the parts of the firm's capital still in process of registration in the Bank. The retention was in local currency, to be converted at the date of liberation of the resources to be remitted without any monetary correction. In an inflationary environment, this meant additional costs. By the end of 1991 the Central Bank started to authorize also those remittances corresponding to the non-registered capital.

Since 1996 profits and dividends remittances are no longer taxable (Law 9249/95). As a reflection of this facility, the amount of remittances, which never surpassed US\$ 800 million from 1970 to 1984 and averaged US\$ 1 billion between 1985 and 1992, reached US\$ 2 billion in 1993 (compared to US\$ 650 million the year before) and have been rising ever since, reaching in 1997 a total of US\$ 6.5 billion⁴³.

Measures Affecting Portfolio Investment - The adoption of reforms that opened the access to private international capital initiated in 1990. It is worth recalling that trade reform had started in 1987 but experienced a significant bust in 1990. This simultaneity of trade and financial reforms goes against the recommendations of most of the literature on timing and sequencing, which advocates that the latter should come at a later stage.

Since 1967 domestic entrepreneurs have relied upon the external credit rating of some banking institutions to have access to financing in hard currencies, via the mechanisms established by Central Bank Resolution No.63. Recorded experience has proven this mechanism to be quite operative, since it was the main channel for the piling external debt. Taking into account the new trends and fashions of the market, however, in July, 1990 the Central Bank authorized (Circular No.1734) the issuance of "commercial papers" by the National Development Bank, other development banks, investment banks, and commercial (and multipurpose) banks authorized to operate with foreign exchange⁴⁴.

A second, important step to assure minimum accessibility to international markets was to de-link the external debt of the private sector from the overall negotiations of the

⁴²Tax treaties covering corporate income are in effect with 16 countries. No such treaty is in place, however, with the US, the largest source of foreign investment in Brazil.

⁴³ Notice that profit remittance figures are also affected by some recent additional facilities granted by the Central Bank: Circular 2722/96 allows the remittance of interests over investors' own capital to receive the same treatment as profit remittances, what actually inflates remittance statistics. Only recently has the Central Bank published separate figures for dividends (associated to issuance of ADRs) and profit of TNCs subsidiaries. 28% of all remittances correspond to dividends. In any case, remittances in 1997 were much higher than in the previous year: an increase of 57% for dividends and 75% for subsidiaries' profits.

⁴⁴ It is important to recall that the facility for domestic firms to issue papers in the external market existed since the 1960s. But in the 1970s bank loans were the cheapest and abundant credit facility. The issuance of euronotes and eurobonds in the international market became an actual financing alternative for Brazilian firms only during the present decade.

country's debt. Resolution No.1781 of the Central Bank (December, 1990) freed the private sector to negotiate directly its debt with external creditors. This, and the commitment to maintain public tariffs at such real levels as determined by the internal needs of these firms and market conditions, led to an access to external financing not matched since the early 1980s.

The year 1991 is a turning-point in the policy favoring foreign investment.

In January, 1991 (Circulares No. 1884 and 1885 and Carta-Circular No.2144) the Central Bank authorized the utilization of foreign resources from medium- to long-term financial operations by firms with foreign shareholders, to face losses in the internal market. These resources are to be used in proportion to the participation of the foreign investor in the registered capital of the firm and comprise also credits included in the re-negotiation of the Brazilian external debt. In February the Central Bank (Carta-Circular No.2148) regulated the investments to be made in anticipation to the resource flows accruing from the debt-equity conversion. These bridge-investments might be returned to their country of origin within 24 months, provided that the remittance be made of fresh resources from the debt-equity conversion. In May the Central Bank allowed foreigners to trade in Stock Exchanges. In July, it authorized and regulated foreign investments in shares of Brazilian firms, through the mechanisms of "American Depository Receipts" (ADR) and "International Depository Receipts" (IDR) (Resolution No. 1848).

By the new rules foreign investors are stimulated to buy stocks of local firms via the emission of ADR/IDR based on the purchase of shares traded in the domestic Stock Exchanges. There are two stimuli implicit in such measure. First, the very access to the local stock market, widely seen as presenting very low price/earnings ratios, and hence good medium- to long-term perspectives of high returns. Second, the gains accruing from the trading of shares are exempt of income tax. Only dividends and money bonuses are subject to a 15% income tax (except for residents in those countries with which Brazil has specific agreements to avoid double taxation, in which case the lowest tax rate prevails).

These measures have had important effects on the attraction of foreign resources: in 1991 most of the (significant) inflow of external funds was loan capital, mainly via commercial papers and bonds (resources attracted via commercial papers trebled between 1990 and 1991). Until mid-1991 commercial papers compared favorably with other mechanisms, due to tax exemption on capital gains. Notice that these are medium- to long-term operations (typically of two to three years). In the second semester the benefit was extended to other instruments, such as bonds, floating rate notes, fixed rate notes and export securitization.

Additional stimuli to foreign investing in local stocks were provided by Central Bank's Resolution No.1877, from October, 1991. According to the new regulations, the previous requirements concerning the need for a minimum degree of diversification of the portfolio of Investment Funds and Investment Societies do not apply to foreign investors, if it is proven that the (foreign) main shareholders are institutional investors, such as pension funds, insurance companies and mutual investment funds. This obviously opens the possibility for the local market to benefit from some of the most important investors in the world. Furthermore, there are no requirements with regard to time. This means that policy measures have originally also aimed at attracting short-term capital.

In 1991 also the Central Bank published the Annex IV to Resolution 1289/87, which regulates the creation and administration of portfolios by foreign institutional investors - pension funds, insurance companies, stock funds, etc. This Annex has become the most important source of foreign capital into the domestic stock exchange. It does not require diversification or initial capital, has no pre-defined duration and capital gains are tax exempt.

In June, 1992 the National Monetary Council authorized (Resolution No.1935) foreign investors - if organized as investment funds or investment societies - to participate in the options and future share markets, as a means to reduce the risk of their investments. In August the Central Bank authorized (Resolution No.2199) the transformation of external loans into risk capital, by allowing the conversion of the bonds, commercial papers and other papers issued by local firms to support loans into shares of the firm, to be traded in local Stock Exchanges. Also, local firms may issue non-convertible papers ("warrants") with optional clauses ruling the acquisition of shares according to prices and conditions pre-defined in the contract, thus reducing the cost of loans in the external market.

Since 1993 concern with reducing the inflow of short-term capital led to diminishing the number of instruments covered by Annex IV. Also, a new modality was created - Fixed-Income Fund for Foreign Capital - aiming at the attraction of foreign resources for investment in Treasury and Central Bank bonuses, and fixed-income papers issued by financial institutions. This has reduced sharply the attractiveness of fixed-rate papers to foreign investors, as they are taxed with Income Tax and IOF, whereas capital gains from Annex IV are exempt and the only tax is a flat 15% on the income actually distributed to investors.

In August 1995 the Central Bank increased the IOF rate on short-term capital as a means to avoid speculative movements. In 1996 the Brazilian Depository Receipts (BDR) were created, which allow for the negotiation of stocks of non-resident firms in the domestic stock exchanges, an important step towards the internationalization of the domestic market⁴⁵.

In November 1997 - as part of a preemptive set of policy measures to protect the economy from potential problems that might have arisen as consequence of the Asian economic crisis - the Central Bank provided more flexibility to the attraction of external resources by reducing the minimum time requirement for new loans from three to one year (Circular No. 2783) and by allowing commercial banks to retain a higher amount of foreign currencies (Circular No.2788)⁴⁶.

As an outcome of these measures the Brazilian economy has been able to resume the access to the international private capital market - and domestic economic agents have therefore been able to gain from cheaper financing - at the same time that the domestic Stock Exchanges became increasingly connected (via operations with Depository Receipts) with its counterparts elsewhere.

⁴⁵ In February 1996 non-residents were forbidden to purchase privatization bonds directly via Annex IV operations, but such bonds can be acquired via privatization funds (Carneiro (1997)).

⁴⁶ In April, 1997 *Medida Provisória* 1569 set new limits for import financing of less than 180 days, with the double purpose of affecting import flows as well as short-term arbitrage operations.