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It's a Cold War, Not a Currency War: Additional Weapons

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- **Increasing costs on FX derivatives is a new weapon in the government's toolkit to contain the BRL.**
- **However, for structural reasons we believe that the current FX intervention strategy looks more like a "Cold War" rather than a "Currency War," as the government is using a threat-based strategy that is unlikely to result in a "nuclear option," as urgently needed FDI will continue to rise.**
- **Renewed intervention efforts are likely to increase volatility for a while as markets adjust to the new regulation. Were it not for the external uncertainty, we would feel more comfortable recommending short USD/long BRL positions above 1.56.**

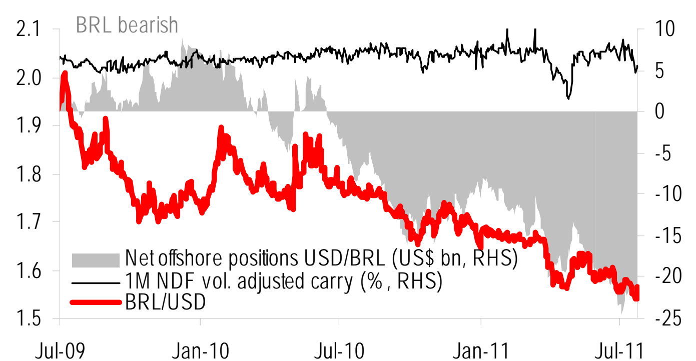
The measure: Increasing costs on FX derivatives

Today the government's Monetary Council published in the "Diário Oficial" a measure that authorizes the CVM (the regulatory agency for the securities market) to define the trading rules for derivatives markets (margin, collateral, leverage, tenors, etc.) and to collect an IOF tax that could reach as high as 25%, but has been initially set at 1%. The tax will apply to the notional value of FX related derivatives equivalent to short USD positions if there is an increase of at least US$10 million from the previous trading day. The tax will apply when investors buy and sell the contract or when the derivative expires on new trades, and it is not retroactive. This suggests to us that there is no incentive for current positions to be unwound, which limits BRL downside. By taxing the notional of the derivatives, the government highlights its efforts to contain BRL appreciation. This is a new weapon in the government's toolkit to combat BRL appreciation. However, for structural reasons detailed below, we believe that the current FX intervention strategy looks more like a "Cold War" rather than a "Currency War."

The current 1% tax on FX derivatives applies to both locals and offshores, suggesting that the government not only wants to make it more expensive for foreigners that play directly in the FX market, but also to those foreigners that have 2689 accounts (and are treated as locals) a well as local players that have bets against the USD. However, it is unclear to us how the measure will not affect exporters, who are the supposed beneficiaries of the FX intervention strategy that aims to contain some of the loss of competitiveness abroad. Additionally, we do not believe that government will increase the tax as far as 25%, as this would very likely destroy the derivatives markets, which represent an essential tool for price discovery in Brazil. In other words, the government wants to use the threat of increasing the rate to 25% rather than actually increasing it to 25%, as that extreme scenario would be very negative for the Brazilian economy.

The government also decided to close a loophole in the 6% IOF tax affecting international bond sales with minimum maturity of up to two years, by taxing bonds that had been exempt that are prepaid before the 2Y or longer original maturity. This is probably directed to local banks and companies that left some room to play around with their balance sheets in favor of net short USD/long BRL positions.

Aiming to contain BRL exuberance via increasing costs of derivatives



Sources: BMF, Bloomberg, and Santander.

The government's urge to curb the FX derivatives market seems quite clear given that the overall market remains short the USD. The players' exposure as per BMF and Bacen data as of July 22 was as follows: offshores were net short US$22.2 billion in the futures market, while locals were net short US$7.7 billion (short US$8.1 billion in spot and long US$0.4 billion in the futures market).

Despite the fact that FX intervention has been a quite ubiquitous since October 2010, it is a bit surprising to see the latest measure amid great global uncertainty (the U.S. debt ceiling debate and the Euro zone debt crisis), especially after President Rousseff seemed to assuage fears of further intervention just a few days ago, at least in the short term until global uncertainty clears up. This shows two things: (1) Finance Minister Mantega still has power in the administration to direct policy; and (2) Mantega's intervention rhetoric, when sufficiently insistent, is usually followed by actual measures.

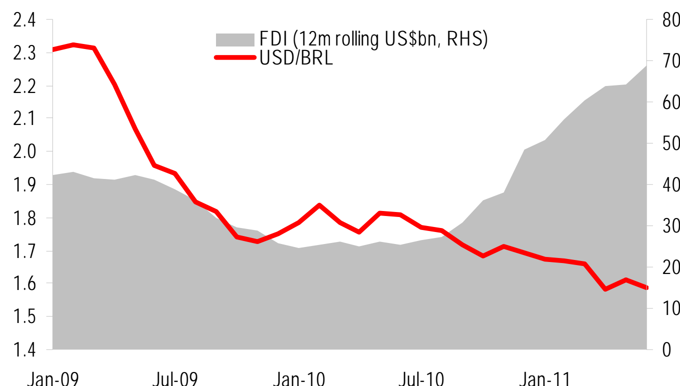
Although we continue to see a massive interest rate differential, a pipeline of strong FDI inflows, and relatively elevated commodity prices as the main drivers of a stronger BRL, the government's piecemeal and erratic intervention strategy that mostly relies on the threat of using ever more aggressive measures may create uncertainty among investors and may continue to exert pressure on the BRL in the very short term. In fact, the implementation of the measures has been frequent, and they usually lack enough specificity that market players move in disarray (remember the April Cupom crisis was consequence of the March capital control announcements and other particular developments). Although we would expect some more tinkering with the new tools such as the IOF tax on FX derivatives or changes in the margin, collateral, or leverage as potential candidates to combat BRL appreciation, we do not expect any excessively harsh measures.

The real driver of BRL strength will be FDI

Brazil is a country with a current account deficit that has hovered around 2.0-2.5% of GDP over the last year, which would be much higher were it not for the commodity boom of the last few years. Also, investment as a percentage of GDP is below 20% compared with close to 30% in Chile, Colombia, and Peru, which have managed to increase their respective potential GDP rates over the last few years. If Brazil's government really wants to steer the investment rate toward the levels seen in Andean LatAm peers, it will have to leave a door open to FDI, especially given the low savings rate and the massive infrastructure needs ahead of the World Cup and Olympics. In our view, these structural features ensure that Brazil will never be able to play hard ball against foreign investment, at least not with FDI inflows.

The most relevant problem that the Rousseff administration will have to face in the medium term to contain BRL appreciation will be FDI inflows rather than portfolio or credit flows. FDI has steadily increased from a recent low of 1.27% of GDP in June 2010 (before the October 2010 IOF tax increase on fixed income investments) to a nine-year high of 3.06% in June 2011. In dollar terms, 12-month rolling FDI almost tripled in that period. Brazil moved from being number 15 in the global ranking of biggest FDI inflows in 2009 to the number 5 in 2010 and was the fourth most attractive country as reported by the UN Conference on Trade and Development report release in September 2009.

FDI flows are surging to record levels



Sources: Bacen, Bloomberg, and Santander.

We see a 'Cold War' rather than a 'Currency War'

That is why we continue to see Mantega's "currency war" as a "cold war" – the main tool to contain appreciation is really the threat of more measures rather than the implementation of the nuclear option, which would be the equivalent of a complete closure to portfolio inflows and FDI inflows. This is simply not likely to happen because of Brazil's structural dependence on foreign savings to finance local investment and infrastructure. Both the government and Bacen are keenly aware of this and see the ongoing FX intervention as something temporary that should reverse once international monetary conditions normalize. So the strategy seems likely to remain a piecemeal approach of constant threats and occasional announcements of measures that are usually greeted by markets with a knee-jerk reaction, but are then followed by a gradual stabilization of the market and subsequent smooth appreciation of the BRL.

We do not rule out, however, the possibility of some foreign portfolio investors simply giving up on the BRL given that understating the plethora of measures has just become too costly and cumbersome, which makes trading the currency so much more challenging. Also, the way that the measures are usually implemented triggers a disorderly reaction in markets that impacts liquidity, bid-offer spreads, and the price discovery mechanisms, which in the end are the key requirements for investors to be able to wage bets on any given currency. However, the nature of the "cold war" and the fact that FDI is only likely to escalate in the next few months should ensure a relatively resilient BRL, which is likely to feel some pressure in the next few days, but may later stabilize. We would expect some sort of stabilization within a week or so, and were it not for the external uncertainty in the U.S. and Europe, we would have recommended short USD/long BRL positions at levels above 1.56.

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