FOREIGN DIRECT INVESTMENT AND EXPORT-LED GROWTH:
A CHALLENGE TO BRAZIL

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ABSTRACT

Foreign Direct Investment (FDI) has figured prominently in the recent economic history of most developing countries, specially since the 1980s, when FDI flows to those countries has been directed increasingly at export-oriented projects. Since then, developing countries have been competing aggressively to attract foreign investors. Virtually all countries, through changes in their regulatory environments, have facilitated the expansion of foreign investment.

Developing countries around the world have been liberalizing their trade regimes and moving away from importing-substitution investment regimes to export-promotion development policies. Simultaneously, many firms have been adopting a global strategy in which production might be centralized in one location, design in another, research in another, and so forth. In this approach, a firm’s operations can become highly specialized.

In light of these trends in the area of trade liberalization and the associated changes in the investment strategies of firms, much of the investment that has sought entry into developing countries in recent years has been investment oriented toward export markets. Empirical studies proved that these investments oriented to export markets are more likely to create net benefits for the economy of the host country than investments oriented for domestic markets.

China, Mexico and Malaysia are examples of countries that have been able to attract export-oriented FDI and profit from it. Brazil has been somewhat of an anomaly. The country attracted more foreign direct investment last decade than any other developing nation except China. However, because FDI went largely to services, namely telecommunications, the impact on Brazil’s manufactured exports was muted. Transnational companies treat Brazil as a stand-alone market, rather than as an export platform like Malaysia, Mexico or China.
FDI should be (and can be) more deeply involved in a process to make Brazil more competitive and more integrated into the global economy. Brazil must create and maintain conditions that stimulate private investment, domestic as well as foreign. Private investment will take place only when and where the right conditions are in place.

This study focus its analysis in some of the many areas that require policy and procedural changes in Brazil, and lists recommendations of actions to be taken in those areas in need of reform, all of which are equally important.
1. FOREIGN DIRECT INVESTMENT

1.1. Overview

Foreign Direct Investment (FDI) has figured prominently in the recent economic history of most developing countries. Until the early twentieth century, this investment principally took the form of investment in the extractive, mining, and agricultural industries in these countries. Extractive investment tended to be coupled thereafter with investment in industries in these countries designed to satisfy local demand for particular goods and services, including infrastructure such as electricity and telephone systems. Since the 1980s, FDI in developing countries has been directed increasingly at export-oriented projects.

Eager to gain some share of these flows of FDI, developing countries have been competing aggressively to attract foreign investors. This competition to attract foreign investments stands in sharp contrast to earlier eras when developing countries sought to close their economies to foreign investment or impose onerous regulatory conditions on foreign investors that sought entry to their countries.

Since the 1980s, there has been a dramatic shift in the orientation of government’s relations with foreign investors. Where governments in developing countries once regulated foreign investment, they now seek to promote their countries as sites for foreign investment. They do so in a number of ways. They change investment policies, regulations, and procedures to make investment easier; although admittedly, investors often find that the rhetoric of government differs from the reality and that, despite liberalization of policy, screening procedures and institutions continue to live on as vestiges of former eras.

However, governments do seek to provide incentives to foreign investors, such as tax holidays, reduced tax rates, and rebates on customs duties. Governments also
promote their countries by engaging in active marketing efforts that include advertising and personal selling to prospective investors in the world’s major capital markets.

Virtually all countries through changes in their regulatory environments have facilitated the expansion of foreign investment. Over the period 1991-1999, 94 percent of the 1,035 changes worldwide in the laws governing FDI created a more favorable framework for FDI (see Table). Complementing the more welcoming national FDI regimes, the number of bilateral investment treaties – concluded increasingly also between developing countries – has risen from 181 at the end of 1980 to 1,865 at the end of 1999. Double taxation treaties have also increased, from 719 in 1980 to 1,892 at the end of 1999. At the regional and interregional levels, an increasing number of agreements (most recently between the European Community and Mexico) are helping to create an investment environment more conducive to international investment flow.

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a Including liberalizing changes or changes aimed at strengthening market functioning, as well as increased incentives.

b Including changes aimed at increasing control as well as reducing incentives.

Other developments have also affected the increased demand for FDI. The debt crisis of the early 1980s and its aftereffects have foreclosed for many developing countries the option of using private financing or government bilateral financing in their efforts to acquire capital for development. The increased movement toward privatization of state-owned enterprises in developing countries has also contributed to a demand for FDI.
1.2. Changes in External Financing

Perhaps the most important lesson for the 1990s centers on the new global economic environment in which the developing as well as the industrialized countries must operate. Simply put, the rules of the game have changed, especially in the ways external investment capital can be obtained by developing countries. In the 1970s, commercial banks from the U.S., Europe, and Japan were active in foreign lending, as the profit potential was perceived to be great in relation to the risks involved. The troublesome legacy of the 1980s — the period during which the debt crisis brought painful adjustment programs to the borrowing countries and major losses for many banks — meant that major commercial banks were reluctant to engage in large amounts of foreign lending in the 1990s.

Direct government-to-government assistance was readily available during the 1960s and 1970s. During the cold war, East-West competition for influence in developing countries led the U.S. and other Western governments to provide significant amounts of aid to the Third World. Similarly, the countries of the Warsaw Pact and other Soviet allies benefited from large amounts of Soviet aid and other financial support. With the collapse of the Soviet Union and demise of the Warsaw Pact, the countries of Central and Eastern Europe are now turning to the West for the financing necessary to support their transition to market economies. However, the major Western governments — the United States, Japan, and Germany — faced or are facing domestic economic difficulties that constrain their ability to provide as much direct assistance as in the past.

Faced with a decline in traditional external financing (commercial-bank loans and foreign aid), which was typically channeled through the public sector, and in many cases, with a budget deficit, developing countries now have to rely on other sources of investment capital to sustain the investment level of 20-25 percent of gross domestic product (GDP) generally deemed necessary for sustained economic growth. Private foreign investment is by far the most important available source.
Because the demand for such investment is strong throughout the developing world and in Eastern Europe and the former Soviet Union, these countries are being forced to compete for the resources that investors are willing to risk in foreign markets. This competition will be very important for potential host countries as they strive to meet the challenge of becoming integrated into the global economy. Countries that are able to attract foreign investment will develop more competitive industries and will therefore enhance their prospects for exporting successfully and creating economic growth. Countries that do not attract sufficient foreign investment will become less competitive and more marginalized; these countries will inevitably face reduced rates of economic growth and lower standards of living. The formation of regional trading arrangements such as MERCOSUR in South America and Mexico’s participation in the North American Free Trade Agreement (NAFTA) reflect the efforts by developing countries to enhance their competitiveness and cement their integration into the global economy through expanded market size and reduced trade barriers.

1.3. Types of Foreign Direct Investment

Foreign Direct Investment can take many forms, depending on the type of investor, the investor’s investment objective, and the degree of risk the investor is willing to assume. Anyway, in making direct investments in foreign companies and countries, investors are foregoing the advantage of rapid exit, which investors describe as liquidity. They are willing to make a longer-term commitment, which involves a higher degree of risk, because they anticipate returns on their investment to exceed the costs implied in the higher risk. FDI usually involves greater amounts of capital than indirect investment (such as through country funds). Combined with the higher degree of commitment and longer investment time horizon (i.e., the length of time investors are willing to risk their capital in anticipation of the expected returns), these types of investment usually bring greater benefits for host countries than indirect investments and, therefore, are the investments that recipient countries are most eager to attract. FDI can take many forms:
— Minority stakes in host-country firms, for example, through the direct purchase of shares on the local stock exchange. These investments are often referred to as passive or portfolio investments, because the investors do not assume control of the firm's operations and may have very little input into how the firm is managed. Minority stakes in foreign firms are often obtained through privatization of state-owned enterprises and debt-equity swaps of both private and state-owned firms.

— Licensing agreements with host-country firms. The transnational companies (TNC) may transfer the rights to use a specific technology to a local firm, which would be responsible for production and marketing in the local market. The local firm would pay the TNC for the right to use its technology. This type of arrangement offers the TNC a low-risk way of entering a foreign market. TNCs sometimes acquire shares of local firms with which they enter into licensing agreements.

— Joint ventures are firms that are established and jointly owned by foreign investors in conjunction with local partners, usually private firms, but sometimes state-owned enterprises or even government agencies. Foreign investors may assume minority or majority positions as well as varying degrees of operational control. Combinations of foreign investors sometimes establish joint ventures in host countries to reduce the start-up costs of establishing solely owned operations. For example, Ford (U.S.) and Volkswagen (Germany) created an automobile assembly joint-venture operation in Brazil known as Autolatina.

Joint ventures give foreign investors the advantage of a larger presence in the local market, but with less risk than would be involved in the outright purchase of a local firm or the establishment of a wholly owned subsidiary in the host country. Joint ventures are often used by TNCs to enter new markets that are perceived as having great potential, but also as having relatively high risk. They give TNCs a chance to gain firsthand knowledge and experience in local markets as the basis for deciding whether they want to make a full-scale commitment.
— Majority stakes in host-country firms, through share purchases, privatization, debt-equity swaps, or other techniques. This option requires a greater level of commitment from the foreign investor as well as a longer time horizon regarding expected returns. TNCs that invest in local firms provide major benefits for the firms and an economic stimulus for host countries as well. Usually, such investments will reflect the TNCs global production and distribution strategy and, as such, will accelerate the host country’s efforts at integration into the global economy.

— Wholly owned subsidiary in the host country. This option represents the highest level of risk and commitment by the TNCs and is usually reserved for the local markets seen as having the greatest profit potential. Major transnational companies usually have large presence, primarily through wholly owned subsidiaries, in the major emerging markets. These operations are usually vital components in their global production and distribution strategies.

It is interesting to note that the largest share of global foreign direct investment still goes to the major industrialized countries, primarily because of the greater earnings potential of their markets. However, these markets are mature and are characterized by increasingly stiff competition. Given these economic trends, coupled with the greater population growth of developing countries, emerging markets will become more important for TNCs in the 21st century.

Driven by the recent wave of cross-border mergers and acquisitions (M&As), global FDI outflows reached a record $1.3 trillion in 2000, an increase of 18 percent over the previous year, according to the United Nations Conference on Trade and Development (UNCTAD). FDI flows to developing countries have maintained their growth trend. In 2000, developing countries received $265 billion in FDI, an increase of 9 percent over 1999 and an all-time high. The share of developing countries in global FDI inflows has, however, fallen, going from 38 percent in 1997 to 21 percent in 2000. Developed countries attracted $1 trillion in FDI flows in 2000 - an all-time high -, more than three-
quarters of the world’s total (the United States and the United Kingdom were the leaders as both investors and recipients).

1.4. FDI and Development

The debate about the role of FDI in development has been a relatively intense one. Much has been discussed about the alleged costs and benefits of this investment.

Advocates of the critical role that foreign investment can play in development point to a series of benefits they suggest emanates from this investment. According to this view, FDI provides capital. Since many development theorists view a capital gap as an impediment to development, then business transactions that lead to capital flows to developing countries should be encouraged. Additionally, FDI provides technology that can also assist in the development process, access to overseas markets through the business connections of the investing firm, access to “state-of-the-art” management expertise, and employment opportunities for local workers. Further, with these advantages, FDI is able to assist a country with its export drive and thus enhance the country’s balance of payments position. Eventually, FDI could, operating as a catalyst, be the engine of growth for an economy as the management practices, technology, and market connections are diffused from their starting point in particular foreign investments throughout the economy.

This, others claim, is a picture that is not nearly as rosy in practice as it appears in theory. While acknowledging that FDI will provide capital inflows, they argue that the eventual outflows will exceed this inflow. Of course, such an argument could be made with respect to bank loans, and it would suggest that a rational individual would never take a bank loan. In fact, one must go beyond the outflows and inflows of capital and examine the use to which capital is put within an economy and the fact that a particular quantity of capital can differ in value to a country, depending upon the country’s current economic position.
Another criticism relates to the use of the technology brought to the country by foreign investors. Some argue that this technology is rarely diffused to local entities and, in some cases, that it is inappropriate to the local environment in any case. In some instances, the inappropriateness of technology has resulted in the transfer or highly capital-intensive production processes to countries with significant supplies of unemployed labor. The inappropriateness of technology, in these instances, has also reduced considerably the employment benefits of FDI. Critics would also point to the fact that foreign investors tend to be particularly heavy users of imported inputs. Thus, they can prove to be a drain on a country’s exchange reserves not only when they seek to remit profits but also in their ongoing commercial operations.

A more subtle criticism of FDI in developing countries is that, because of the potential disjuncture between the benefits and costs of a project to a private firm and the social costs and benefits of a project to the nation at a large, many projects are initiated in developing countries that creates profits for the firm while proving detrimental to the nation at large. This is possibly largely because of distortions in pricing systems so that prices do not accurately reflect the resources used up and because of costs or benefits that accrue to society because of an investment project but that are not captured in the firm’s finances. These costs and benefits are described as externalities.

Since there is this disjuncture between private and social costs and benefits, some effort at reconciliation must be made if governments in developing countries are to have any sense of the impact of foreign investments on the nations they govern. In recent years, approaches have been developed for conducting such reconciliation. These approaches, often described as social or economic cost-benefit analyses, are imperfect. They simply cannot capture all the nuances of cost and benefit, but they do seek to reconcile those glaring differences that can be quantified.

Indeed, adopting these approaches has provided information on the types of FDI that typically assist in the development process in developing countries. Based on an
analysis of one sample of projects, researchers have indicated that foreign investment that take place behind the protection of high tariff walls in developing countries and are oriented towards the domestic markets of these countries are quite likely to be detrimental to the country. Investments oriented towards export markets, on the other hand, are likely to be of benefit to the country that hosts them.

FDI has clearly been the engine of growth in the development of the Singaporean economy. The government of this country could legitimately state that “foreign investments have largely been responsible for our rapid progress and modernization” (Report of the Economic Committee, The Singapore Economy: New Directions). This country began promoting itself as a site for export-oriented investment in the 1960s, when most developing countries, many having just gained independence, were more interested in asserting their economic sovereignty over foreign firms. Singapore has certainly made the most of its “first-mover” advantage.

Thus, to return to an assessment of the costs and benefits of FDI, it is clear that any such analysis should seek to desegregate FDI into different forms of investment. Investment for domestic markets is likely to prove costly to the country’s economy if tariff protection is high, unless that investment can generate highly positive externalities in the form of diffusion of technology that leads to the creation of other firms that are likely to become competitive on world markets. Investments oriented to export markets, on the other hand, are likely to create net benefits for an economy.

The conclusion about the differing cost/benefit ratios of various forms of FDI has not escaped the world’s developing countries. It is possibly one of the reasons why there has been renewed interest on the part of developing countries in the investments to foreign firms. Developing countries around the world have been liberalizing their trade regimes and moving away from importing-substitution investment regimes to export-promotion development policies. Simultaneously, many firms have been seeking to consolidate their production operations. Many firms have been moving away from an investment strategy in which they replicated production facilities in each market, a
strategy known as \textit{multidomestic strategy}. Instead, they have been placing production facilities in each region to cater to the regional market. Indeed, some firms have gone so far as to completely centralize operations for the firm’s entire global market – a strategy described as a \textit{global strategy}. In these global strategies, companies do not necessarily centralize all elements of their production in one location; rather, they centralize particular elements along the vertical chain of the company’s operations in particular locations. Thus, production might be centralized in one location, design in another, research in another, and so forth. In this approach, a firm’s operations can become highly specialized.

In light of these trends in the area of trade liberalization and the associated changes in the investment strategies of firms, much of the investment that has sought entry into developing countries in recent years has been investment oriented toward export markets.

The location-specific production and distribution decisions of global transnational firms are often critical in determining the future export success of the host nation, particularly concerning manufactured products.

Clearly, major foreign investments by companies like Motorola and Intel capitalize on local comparative labor advantages and create jobs; increase the volume and sophistication of exports; and reinforce both export prowess and industries’ competitive success in various host countries. And the United Nations and the World Bank have performed statistical analyses that positively link FDI and manufactured export performance. Further, as transnational companies’ international division of labor tilts toward the developing nations, new manufacturing leaders are being created among them, while developed nations seem destined to fall behind.

The leaders and laggards among global manufactured goods exporters are clear. China has had a stunning rise, with exports growing from $44.3 billion in 1990 to more than $172 billion by 1999. During the decade, China moved from 16th to 7th among the world’s top manufactured goods exporters, and first among the developing nations. As more
companies from industrialized nations like the U.S., the U.K., Japan and Germany expand their production networks there, China will likely move up further in the ranks.

Mexico’s similar evolution over the 1990s is equally noteworthy. In 1990, the nation’s manufactured exports totaled only $25.3 billion, well below those of its Asian competitors like Taiwan ($62 billion in 1990), Hong Kong ($75.6 billion), South Korea ($60.6 billion) and Singapore ($37.6 billion). However, NAFTA trade and investment linkages have radically reshaped Mexico’s industrial landscape and export composition. Mexico’s manufactured exports grew at a stunning 18.4 percent compound annual rate over the 1990s, among the fastest growth rates in the world.

Malaysia and the Philippines were other export growth leaders among the developing nations in the 1990s, being relatively successful in attracting FDI from global technology leaders. Yet mounting competition from China and India, and skilled labor shortages in Malaysia, cast a repeat performance this decade into question. Thailand, South Korea, Taiwan and others in developing Asia face similar competitive pressures.

Brazil is somewhat of an anomaly. The country attracted more foreign direct investment last decade than any other developing nation except China. However, because FDI went largely to services, namely telecommunications, the impact on Brazil’s manufactured exports was muted. Also, transnational companies treat Brazil as a stand-alone market, rather than as an export platform like Mexico or China.

Yet despite a sizable jump over the 1990s, the developing nation’s share of world manufactured exports is not large. At roughly one-quarter in 2000, that was up more than seven percentage points from 1990, but still small, rebutting the common perception that US and European transnational firms have long preferred to locate production in low-wage, developing nations to realize lower local labor costs and export product back home.
The liberalization of world trade and the reemergence of globalization have led to greater "international specialization" – companies locating various steps of production in different countries to capitalize on local manufacturing attributes. Since the beginning of the 1990s, a handful of developing nations have come to play an increasingly important role in transnational companies’ international division of labor. The sharp increase in manufactured exports from the developing nations supports this fact.

The bottom line is that the current wave of FDI, of global corporate downsizing and shift in production to low-cost sites will accelerate the overseas manufacturing trends of the past few years. China and Mexico are at the top of the list of preferred destinations, and are likely to remain ahead in the years to come, while developed markets will likely move down in the ranks.

2. EXPORT-LED GROWTH

For the last two decades, the less developed countries (LDC) have been encouraged by the major development agencies simply to open up their markets to imports and to export whatever products they can produce relatively cheaply in the sort-term. Many forms of development assistance, ranging from the World Bank structural adjustments loans to International Monetary Fund (IMF) assistance to debt relief under the Brady Plan, have been made conditional on this type of “trade liberalization”. The operating assumption behind these policies is that successful export-led development can be achieved simply by eliminating LDC government intervention in markets and allowing world market prices to dictate domestic economic incentives.

It is possible to challenge the historical and factual basis for the view that trade liberalization “per se” is the key to successful export-led growth in developing countries. Based on detailed case studies of the most successful newly industrializing countries (NICs) – South Korea, Taiwan, Singapore, Hong Kong, and Thailand – it is possible to affirm that in every case (except Hong Kong) governments have actively intervened in
various ways to promote specific types of investments focused in production and exports of ever-increasing technological sophistication. Far from supporting the extreme trade liberalization view, the actual record of these countries demonstrates that successful export-led growth has generally been based on activist trade and industrial policies.

It not to question the importance of promoting exports (in general) for successful development in today’s highly integrated world economy. But this does not imply that countries should concentrate only on exports of whatever product lines in which they happen to have a current comparative advantage. In fact, it matters what kinds of products a country exports, and under what conditions. The contrasting experiences of East Asian NICs and the commodity-exporting LDCs suggest that it makes a big difference whether a developing country promotes exports of primary commodities or manufactured goods. It makes a difference not only because of the recurring problem of gluts resulting in falling prices in commodity markets, but also because of the greater potential for raising technological capabilities and increasing total factor productivity in manufacturing industries.

The systematic, well-planed promotion of manufactured exports of steadily increasing sophistication seems to lead to the greatest sustainable long-run growth. A number of factors contribute to making the manufactures-export strategy more effective than a commodities-export strategy: the stimulus given to economy-wide technological progress, the absorption of advanced technology from abroad, the accumulation of human capital (labour skills as technical and managerial expertise), the construction of infrastructure which reduces future development costs, the ability to take advantage of scale economies, and the relatively stable terms of trade (relative prices) for manufactured goods. In economic terms, manufacturing offers more “externalities” or “spillovers” – economy-wide benefits that do not accrue to the private producers who generate them.

It is also critical to distinguish a country’s static comparative advantage (what it can produce relatively more efficiently and export successfully in the short run) from its
dynamic comparative advantage (what it can develop the potential to produce relatively efficiently and export in the long run). All the evidence about the East Asian NICs supports the view that most of them deliberately altered the market incentives through trade and industrial policies which favored manufacturing activities of increasing technological content, and which placed long-run development goals over short-run comparative advantage.

In Brazil, the interventionist promotion of manufactured exports has resembled the policies of the East Asian NICs. But since the sunset of the debt crisis of the 1980’s, it has been engaged in a desperate search for any exports to bring in foreign exchange to service the debts. It has acted under the pressure of the crisis and in the absence of a well-conceived industrial policy program capable of taking a long-term view. As a result, the policies recently followed by the country have conformed more closely to the liberalization theory of development than to the actual policies that the East Asian countries have followed. The results have been in marked contrast to the outcomes in East Asian.

This is not to say, of course, that any kind of government intervention, however inefficient, can be justified by appeal to long-run development objectives. As the history of import substitution policies demonstrates, there is ample room for government intervention to overpromote certain industries to the detriment of long-run efficiency, competitiveness, and growth. This makes it all the more important to understand exactly what kinds of trade, industrial or commercial policies have worked and what kinds have not.

There are numerous evidences that government can improve on the unaided market in achieving development by focusing in specific market failures, especially those associated with the corrections needed to create a good environment to business, as well as technological and skill development. These interventions are recognizably important where government can potentially undertake a “one time policy” action that can push the economy to a better equilibrium, which can then be self-sustaining without further
intervention. Once this “big push” has been undertaken, government coordination may no longer be needed.

No statement has been made that such policies as have been used effectively in Korea and Taiwan could be transplanted universally to other countries, where government failure and rent seeking might be more endemic, and administrative capacity may be weaker. But certainly many of these “principles” could bring benefits to other developing countries, including Brazil.

However, differently from East Asia countries, which relied mostly on their own high rates of savings and investments, Brazil has to be able to create a good environment for business in order to attract the desirable export-oriented FDI. This requires many steps that Brazilian government can and must do in order to achieve that goal.

3. FOREIGN DIRECT INVESTMENT IN BRAZIL

3.1. Overview

FDI has grown quickly in Brazil during the second half of the 1990s, responding to changes in Brazil's economic situation as well as worldwide and regional trends. Macroeconomic reforms, deregulation and privatization have considerably changed the economic environment in Brazil and increased the attractiveness of the country as host to foreign companies, which for a long time have been interested in Brazil's large domestic market. Brazil has been a world leader in attracting FDI, in both absolute amounts and even in proportion to its large economy. It has few equals among developing and transition countries. From its peak of import substitution in the 1950s when in one year it attracted about a third of all the FDI going to developing countries at the time, through its lagging during Latin America’s “lost decade” of the 1980s as Asian and other countries caught up, to regaining its position among the top recipients in the second half of the 1990s with FDI inflows amounting to over US$ 33 billion in 2000, Brazil is a player to be considered.
The recent very high FDI flows to Brazil are a response to privatization and opening up of sectors previously closed to foreign companies, the attraction to Brazil’s large market, and also a reflection of the improved economic and policy environment that has been put into place in Brazil. Empirical results show that bringing inflation under control may have been a crucial issue in attracting recent foreign investment. Among the other elements of this improved environment are restoration of national treatment of foreign investment; lower corporate taxes including elimination of withholding taxes on dividends paid to foreign investors and reduction of tax on interest and royalties paid abroad to 15 percent; the opening to foreign investment of important parts of the service sector; a new informatic’s law; a new industrial property law; some (albeit back and forth) reduction in protection and further opening of the economy; and, since 1999, a new and better macro-economic strategy based on sound fiscal and monetary policies and a market-determined exchange rate that will avoid appreciation devaluation cycles. Long-overdue progress to a single unified exchange rate and elimination of all restrictions on transfers of long-term capital has been made, although not quite completed. All this has laid the basis for long-term enhancement of Brazil’s competitive standing in the world.

In recent FDI, there has been a shift towards services, which contrasts with Brazil’s traditional situation as a host mainly to investment in manufacturing industries. They have also extended into public utilities and infrastructure services, long the province of the public sector. These dramatic developments have a number of important implications for the development of the contemporary Brazilian economy. Positively, the growing presence of foreign capital across a whole range of sectors has been exercising an important influence upon the development of Brazil’s international economic competitiveness. After a period in which Brazil has faced serious problems in meeting the competitive challenges set by intensifying international integration, this is of special significance. In second place, the rising tide of foreign investment has also been generating significant macroeconomic impacts, not least in the critical area of Brazil’s external accounts.
However, despite the magnitude of these achievements, many challenges remain to be faced if Brazil is to finally embark on a path of sustainable, non-inflationary growth. Among the most pressing is the need to generate even greater levels of international competitiveness within the industrial sector. The achievement of this objective would not only allow for improved trade performance but also for the provision of badly needed long-term employment opportunities. In fact, Brazilian economy as a whole is still not as well integrated into the world economy as it could be, and therefore does not benefit from the efficiency gains such integration can bring. Transnational companies’ investments in Brazil are still overwhelmingly focused on the domestic market. They export a bit more than do locally owned companies, but much less than do their counterparts in other countries. Chronically low, trade as a percentage of GDP remains about where it was at the beginning of the 1990s – 8.9 percent of its GDP in trade in 1998 –. In manufacturing, the export propensity (exports as a ratio of total output) of Brazil is half that of India and China and one-fifth that of Mexico.

**FDI AND THE BALANCE OF PAYMENTS**

As shown in the following table, the composition of the stock of FDI underwent a major change in the latter half of the 1990s, with investment in services replacing investment in manufacturing as the dominant share.

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The growing importance of FDI in services gives rise to a concern, for some, that this shift may carry the seeds of future macro-instability, since the output of the service sector does not, for the most part, enter into trade. In a scenario where FDI inflows declined sharply, the rising claims for foreign dividends and remittances, not balanced by additional net exports, could move Brazil’s trade and current account balances back into dangerous territory with attendant problems for sustainable growth. In fact, FDI inflow to Brazil, in the first semester of 2001, totaled $ 9.88 billion, a 26.3 percent fall when compared to the same period of 2000 ($ 13.4 billion). Brazilian Central Banks estimates that FDI inflow in 2001 will total $ 20 billion, well below the $ 33 billion of 2000 (also, below the $ 24 billion estimation in the beginning of the year 2001, before the energy crisis). The sum is needed to cover part of the external deficit, which may total US$ 24 billion in 2001. FDI is considered the best source of financing to the current account deficit. Differently from the foreign loans, FDI is less sensitive to changes in the financial markets’ moods. Their main disadvantage is that, in the long run, the higher the FDI inflow, the higher the outflow (payment of dividends and remittances). In the first semester of 2001, that outflow totaled $ 2.6 billion, a 38.8 percent rise in comparison to the same period of 2000.

FDI should be (and can be) more deeply involved in a process to make Brazil more competitive and more integrated into the global economy. The unwillingness of multinationals to export more from the country can be an implicit signal that Brazil’s investment climate is not so good when compared to what other countries have to offer – (also when compared to what Brazil should be able to offer). The challenge is to change the climate to business so that foreign companies, as well as Brazilian investors, will shift away from their long-standing preoccupation with the domestic market and invest more for exports — making the entire economy more competitive and better able to generate and sustain real growth in the future.
Simply put, Brazil must create and maintain conditions that stimulate private investment, domestic as well as foreign. Private investment, whether local or foreign, will take place when the right conditions are in place. Export-oriented FDI, in particular, is essentially synonymous with efficiency-seeking FDI. A country’s ability to attract this form of investment, with its great freedom of choice over location, is a clear evidence of a strong, competitive investment climate. This kind of private investment has a role in further strengthening the investment climate, driven by the pressing of global competition. A more appropriate business environment would attract more investments by transnational companies with long-term strategic exporting orientation; and more of such investments would further build up the business environment, in a virtuous positive-feedback cycle. Its presence can accelerate the introduction of state-of-the-art technologies and international good practices, with beneficial catalytic effects for the host economy as a whole. Besides that – and extremely important to developing countries in general, Brazil in particular – it’s important to consider that the more competitive the production, the greater the option of directing more output into international trade, an “asset” that can be of great value in sustaining a desired level of growth at less risk to balance of payments constraints.

Of course, the overall climate for FDI in Brazil, including export-oriented FDI, is far from being bad. Macro-economic policies have been a powerful and positive force in attracting FDI, but less effective in re-orienting the output of FDI, or of the economy in general, toward the export sector. They were necessary, but not sufficient to create a good business environment for exporters. And that is why so little export-oriented FDI has been located in Brazil.

There are many policies and customary ways of doing things – usually referred to as the *custo Brasil* – where reforms can make a major contribution to encourage exports and export-oriented FDI. The actions needed to accomplish this ambitious goal are well known. They are almost common sense’s judgment as to the highest priority steps to take, urgent needed measures. Our study will address some of the main impediments that may be keeping Brazil from realizing its fullest potential as a location for FDI in
general and for manufacturing, export-oriented FDI in particular. These further needed steps are called by some as “second stage reforms”, in complement to those already in place.

It is essential to recognize that Brazil features a number of factors that make it inherently more costly for business to operate, measured against several competitor countries. Apt to persist because of tariff and non-tariff barriers, these costs have not caused great harm to domestic industries or to FDI, as long as both were primarily focused on the domestic market. However, a change in policy objectives in the direction of enhancing the global competitiveness of Brazil’s industry and attracting more export-oriented FDI means that the measures to extinguish these higher costs can no longer be procrastinated. They pose a serious comparative disadvantage for realizing these goals. While barriers to trade have been reduced significantly in recent years, the costs of doing business have changed little. Therefore, the government has to pay meticulous attention to reducing these cost factors to ensure that any further trade liberalization does, in fact, turn into improved competitiveness and expanded export volumes.

3.2. Recommendations

From the perspective of international investors, improvements in the competitive environment would certainly help to achieve very promising opportunities in Brazil. Against this background, this study intends to focus its analysis in some of the remaining challenges and point to possible policy remedies. It is challenging to set priorities among the many areas that require policy and procedural changes. This report lists many recommendations and areas in need of reform, all of which are equally important. Some recommendations would take more time to design and implement. Others can be implemented relatively quickly and easily. Considering the intricate agenda ahead of the Brazilian government to engage in the suppression of administrative barriers to investment, the proposed areas to action are:
Government Regulations and Legal Framework

The regulatory climate, a term used to describe how government regulations affect business operations, may have a very significant impact on operating efficiency and cost and therefore on firms' profitability and competitiveness. An attractive regulatory climate is an important consideration in the investment-site decision. Local laws and regulations that grant or do not unduly restrict a firm's access to local markets may enhance its earnings potential and profitability. Countries where the state exerts a large degree of control over economic activity and restricts the private sector's freedom to conduct business are not attractive to potential investors. The regulatory environment must also allow foreign companies to compete on an even footing against local companies.

Of course, some degree of government regulation is essential in protecting the interests of producers and consumers and thereby ensuring the integrity and smooth functioning of the marketplace. However, from the standpoint of foreign investors — indeed, of all economic actors — too much regulation can create distortions that raise costs and cause markets and firms to function less efficiently.

Government regulations in other areas also discourage potential investors. Policies may dictate interest rates and/or designate priority sectors where available capital should be invested. Governments may create numerous procedures for getting foreign investments approved or establish other bureaucratic requirements or restrictions that may hamper investors' ability to move their capital and/or profits into and out of the country quickly. Again, investors seek flexibility to enable them to respond to rapidly changing market conditions, a consideration that is of growing importance in the competitive world economy. Regulations that hamper firms' flexibility thus serve as a deterrent to investment. Restrictions on firms' activities, such as when governments reserve specific sectors for state-owned enterprises, have the same effect.

The Brazilian legal framework, specifically for FDI, has evolved over time and has
undergone numerous changes. As it stands today, existing laws and regulations should not be considered a serious impediment to most FDI. It is true, however, that the entire framework is excessively complex, and it is not an easy task for an outsider to develop a clear understanding of legal rights and obligations for investors. There is an urgent need for a better packaging of the various legal requirements to ensure that potential investors have complete access to all the relevant information.

The Brazilian tax system, for example, is very complex. There are continuous changes in laws, regulations, and in tax rates. The corporate tax system has an enormous number of rules as well as administrative and court proceedings. The tax authority/taxpayer dispute involving the transfer of merchandise between establishments owned by the same party is an example of the countless inconsistencies and changes in regulations.

? **Bureaucracy and Administrative Procedures**

While there are many parts of public administration in Brazil that seem to work well, business executives often complain about the judiciary, various regulatory agencies, offices responsible for anti-trust procedures, and the office for patents and other intellectual property standards.

Export-oriented investment can go elsewhere, and such investment requires a government administration that regulates only where necessary, and does it quickly and without undue rigidity where flexibility would not harm national interests.

Administrative bottlenecks are likely to present one of the most serious obstacles to attracting those types of FDI that are less dependent on the country as the final market or as a provider of rare natural resources. Reducing and/or eliminating all counter-productive procedures are crucial to reduce investment cost, risk, and uncertainty. The actions needed to remove administrative barriers are often not costly in financial terms, but involve the much harder task of suppressing grounded behavior among government officials. Removing administrative barriers that do not advance the
national interest can make the difference on this issue.

Trade Policies and Regulations

Trade policies affect the cost and ease or difficulty of moving imports into and exports out of host countries. This ability is important for transnational companies who use foreign facilities to export to other markets as part of their global production and distribution strategy, thereby maximizing their efficiency on a global basis. As an example, part of the appeal of regional trade agreements for a foreign country centers on the access to neighboring countries that would come with investment in a member country.

The cost of imported products is affected by the applicable tariff rate as well as by the local currency exchange rate. Import costs are important for manufacturers who use imported inputs in producing a finished product. Tariff rates that are higher compared to those in other countries raise the cost of finished goods. Since cost is a crucial factor in the competitiveness of exports on international markets, high tariffs make countries unattractive to foreign investors. Similarly, quotas, burdensome licensing or approval procedures, and other nontariff barriers for imports may also raise costs or slow the production cycle and consequently dampen competitiveness and investment.

A study by the American Chamber of Commerce (AMCHAM) in Brazil revealed that delivery times in the customs clearance processes, which should be short and reliable, are longer and more variable than desirable. This is one of the important factors that could prejudice national exporting efforts, as international customers give preference to companies that can provide rapid and timely delivery. Based on the AMCHAM analysis, import and export processing times could be reduced by 45 percent from 99 days to 55 days on average. Reducing the lead-time would result in better control on operating costs, as it makes it possible to reduce bureaucratic procedures, storage and transport costs, and financial costs by limiting inventories. It is estimated that for an average production and delivery cycle of 120 days, a 50 percent reduction in the total import and export cycle would amount to a 50 percent reduction in current stocks.
This would represent a significant reduction in costs for large and medium-sized export companies.

Licensing procedures also affect the ability to export goods out of the Brazil. Exporters are required to go through several steps before they can ship their products. For example, they may have to get permission from the central bank, clear their goods through customs, or secure other approvals. Fees may also be charged for exporters to obtain the necessary licenses and permits. These requirements may raise costs and delay the appearance of the finished products at the market; given the intense competition among global producers in numerous industries, higher costs and delays make the country less competitive and less attractive.

When designing trade policies and regulations, Brazilian government has to bear in mind that efficiency in exports is closely related to efficiency in imports. In order to be competitive in exports, in a globalized world, it’s mandatory that a company is able to import the necessary inputs to an export-oriented production. A bottleneck in the import side is, ultimately, a bottleneck in the export side.

? **Taxation**

A key factor in the investment decision involves how taxation affects a firm's normal operating environment. Excessive tax burdens on investments and profits will discourage foreign companies from investing in a prospective host country. The tax burden involves not only tax rates, but also the tax treatment of dividends, royalties, remittances, and other transactions between local subsidiaries and their parent companies.

Investors focus on the regulations affecting their ability to take invested capital and profits out of the host country, but also to reinvest in the host country. With over 50 separate taxes, duties, withholdings, compulsory loans, and other charges – imposed by all three levels of government – the complexity of the Brazilian tax system is part of
the *custo Brasil* that seems highly resistant to improvement. It is not said “highly resistant to change” because it does change; in fact instability is one of its negative features. But significant improvements in its complexity for businesses do not occur.

The financial burden of corporate taxes is also on the high side. The estimated effective tax rate on corporate income is around 35 percent for manufacturing enterprises in general, and 29 percent for exporters of manufactures. Both numbers are higher than in countries or regions that compete for the best investments. Especially for export-oriented projects they are high enough to be considered on the negative side of the scorecard when different sites are considered for location decisions.

In Brazil, abolishing some of the minor taxes, especially those that are not related to net income, and removing the restrictions on the amount of losses that can be carried forward could do much. It’s important to remember that in order to improve their attractiveness relative to others, many countries offer packages of tax and other incentives for foreign investors. These incentive programs may be helpful for host countries in attracting investment, once the other key investment criteria are in place. Simplifications alone can make life a lot easier for taxpayers, while reducing the financial burden on businesses to an extent that they benefit moderately while total government revenues are scarcely affected.

**Labor Force**

Many governments have labor laws designed to protect workers' jobs by making it difficult for firms to dismiss workers despite changing market conditions. Other laws may dictate wage rates for workers (such as the minimum wage law) or may require firms to provide a host of benefits. These laws may raise costs for foreign investors, who often look for competitive edges in labor costs in assessing potential investments. Thus, laws intended to help workers may actually hurt them by discouraging investors from investing their capital and creating jobs.
In many industries, particularly those that use a high amount of labor to create a finished product (e.g., textiles, apparel), foreign companies seek to establish plants in developing countries to take advantage of their lower wage rates. As part of their overall global strategy, these companies may locate the labor-intensive phases of production, for almost any type of product, in low-wage countries.

The total costs of labor in Brazil can be high, including a lot of taxes and mandatory benefits. Moreover, productivity, measured either as labor productivity or total factor productivity, is low in comparison to benchmark countries. At present, the Brazilian labor force is not the competitive attraction that it should be in a highly competitive international market place. Further progress in reducing over-regulation of labor markets, labor taxation and mandatory benefits would be welcome. It is important to note, however, that pay scales are not the only determinant of the attractiveness of the labor force. The major steps to be taken to solve problems of the cost-effectiveness of Brazilian labor have to do with raising productivity. Useful steps would include facilitation rather than interference with technology transfer, a stronger regime for the enforcement of intellectual property protection, and of course long-term improvements in education.

Foreign investors examine the quality of the local labor force because they must recruit their potential employees from that labor force. Investors look at the quality of education in the host country, because better-educated workers will be easier to train and will reach their peak output sooner than workers who are not as well educated do. The costs and productivity of labor are key ingredients in product competitiveness in the international marketplace.

Protection of Intellectual Property Rights

Intellectual property refers to a company's ownership of the intangible as well as tangible products of its research. These include its manufacturing processes, software, and marketing techniques. In the major industrialized countries, a company's ownership rights are protected through the use of patents, copyrights, trademarks,
protection of trade secrets, and other laws covering proprietary technical data. Given that a significant proportion of their assets consists of intangibles, the protection of intellectual property is a high priority for foreign companies, particularly in dynamic industries such as computers, telecommunications, and pharmaceuticals, in which technology is a major competitive weapon in the development of new products and markets. Moreover, for the host countries, the attraction of these types of industries is of the highest priority, because they offer the highest potential benefits in terms of technology transfer and the development of a local high-technology industrial base. However, to attract investment in these industries, host governments must ensure the effective enforcement of intellectual property rights, avoiding the compulsory licensing of registered technology and other interventions in technology-licensing agreements between private firms.

FDI that employs its best technology and that is free to draw on the services of its best qualified staff (nationally or from overseas) will be better positioned to compete in international markets with exports from the host country. At present, however, 40 percent of the companies in a recent survey said they did not use their most advanced technology or processes in their Brazilian-based operations. Respondents felt that patent protection and the climate for intellectual property generally had improved greatly during the 1990s; a notable landmark was the passage of a new Industrial Property Code (Law 9279) in 1997. However, problems remain. The ability of the patent office, INPI, to process patent applications remains slow and needs to be speeded up by some combination of more efficient procedures (involving less examination of information that is not relevant to the decision to grant the patent) and better staffing.

Because of the stakes involved, the protection of intellectual property has become a major issue between countries. It is clear that the regulation of intellectual property protection and technology transfer needs to be improved, for the benefits of Brazilian firms as well as transnational companies.
Political and Economic Stability

These elements are fundamental aspects of the investment decision: investors simply will not risk their capital in an environment that is perceived as unstable, because the risk of losing their investment will be perceived as too high. Stable political and economic environments give investors confidence that the "rules of the game," or laws and regulations governing their investment and the markets in which they operate, will remain basically the same over the long term. This confidence is important, because when capital is risked in a direct foreign investment, a long-term time horizon is usually required for the investment to generate the expected profits. Investors' confidence reflects not only their perceptions of the current climate but the expectations about the political as well as economic outlook over the medium and long term.

Business executives are averse enough to instability when they are aiming at domestic sales; it makes planning both more difficult and more necessary, and requires, in one way or another, either incurring costs of hedging or accepting increasing risks. But if all of one's competitors face the same situation, a company can muddle through. For exporters, however, the effect is much worse, precisely because one's competitors do not all face the same situation. They are in other countries, and if a particular country is too unstable it will not receive many long-term strategic export investments – as Brazil has not.

It is an adage of business that executives can deal much more easily with imperfect but stable systems, than with unstable and therefore unpredictable systems. For world-competitive export investments, instability in policy, laws, regulations, and administrative practices can be a killer.

Brazil's low export propensity in manufacturing reflects, among other things, the riskiness inherent in the instability of the legal and economic framework for doing business. Things have become more stable since democratic governments replaced the military; it was easier to change the rules when there was no independent
legislature, and the military governments did so. But the instability of the macro economic environment, with protection falling and then rising and then falling again, and the exchange rate governed by different strategies every few years and suffering too many cycles of overvaluation followed by the inevitable “maxi” or other large devaluations explains, in part, why Brazil has been lagging behind in the attraction of export-oriented FDI.

Many other reforms are necessary to improve the business climate in Brazil, which would deserve deeper analysis in future studies, such as: combat of corruption (in all the three branches of government), reform in the judicial system (mainly to improve the enforceability of contracts), better infrastructure, as well as improvement of public security (violent crime against people is a problem that constraints Brazil’s competitiveness), better education, better income distribution, decrease of social inequality and reduction of poverty.

All of these elements are urgent reforms that Brazil must complete in order to become a better place not only for foreign capital to invest, but – not less important – for Brazilian people to live.

A FINAL REMARK

Brazil has made significant progress in facing problems that are a legacy of the past. By the end of the 1980s, Brazil’s model of inward-oriented development was exhausted. Access to foreign savings had been constrained by the unfavorable dynamics of the external debt. Indexation mechanisms had sustained high inflation and maintained fiscal revenues, but also made the economy increasingly rigid. The use of import substitution to develop an industrial base negatively affected competitiveness in the corporate sector.
Democratic institutions were re-established in 1985, and during the 1990s Brazil started transition towards a new development model based on market reforms and outward orientation. Significant reductions in tariffs and removal of other trade barriers took place. A decisive break with high inflation after 1995 brought about deep changes in the Brazilian economy, not least in stopping the regressive effects of the inflation tax that had affected the poorest segments of the population. An ambitious privatization program substantially increased the participation of foreign enterprises and banks in the economy. Indeed, foreign direct investments played a major role in the economy during the last decade, though Brazil has always been a significant recipient of foreign capital. All these elements add up to what seems an irreversible change.

Macroeconomic stabilization has been reinforced since the devaluation of the Real in 1999 and, for the first time in a decade, the economy was able to benefit from an export-led recovery. In 2000, this recovery became more broad-based, which induced a significant increase of tax revenues and softened the impact of fiscal adjustment. Nonetheless, the dependence on foreign sources of finance, and thus the vulnerability to external shocks, remains significant. Brazil now faces the challenge of pressing ahead with the reforms that are needed to sustain growth. This encompasses a number of areas, mentioned in this study, in which the government must work. Reform of the fiscal federal relations is needed, and the pension system remains fiscally unsustainable in the absence of a reduction in benefits and privileges for civil servants. The financial sector could play a more important role in financial mediation, while enhancing competitiveness requires further trade liberalization and greater competition in the domestic market, including an effective regulatory framework. Better targeting of social expenditures is needed to promote the reduction of disparities, while strengthening human capital in the priority areas of education and health.

Certainly, Brazil has reached a turning point that opens up a perspective of sustained growth. But it is also positive that there is still significant vulnerability to external shocks given the high burden of Brazil's external debt and dependence on foreign savings. As 2001 draws to a close, the global economy is slipping precariously toward
recession. Developing countries in general have seen their economic growth rates plunge. Growth in trade has undergone one of the most severe decelerations in modern times — from over 13 percent in 2000 to 1 percent in 2001. Developing countries are confronting a 10-percentage point drop in the growth of demand for their exports.

The terrorist attacks in the United States, although it is still too early to evaluate them fully, have unleashed new and unpredictable forces that have substantially raised the risk of a global downturn. The terrorist attacks and threats of further violence will likely yield a further decline in private flows to emerging markets in 2001, both capital market flows and foreign direct investment. Capital market commitments could drop to some $160 billion — a third below 2000 levels. FDI to major emerging markets had declined from $61 billion in the first half of 2000 to $56 billion in the first half of 2001, and the attacks have raised the likelihood of a further downturn: they have greatly increased the uncertainty involved in traveling to supervise foreign subsidiaries; raised the cost of globally integrated supply chains due to higher insurance rates and enhanced security measures at the border; and demonstrated that these supply chains are vulnerable to interruption.

Foreign Direct Investment in Brazil, as shown in the graphic below, were more than sufficient to cover the current account deficit\(^1\) in 1999 and 2000 (privatizations represented a large amount of the total FDI until 2000).

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\(^1\) The logic of *balance of payments* accounting implies a close relationship between the *current account* (exports and imports of goods and services, received and sent incomes, such as interests and dividends, as well as unilateral transfers) and the *capital account* (that includes FDI, loans, amortizations and use of reserve assets of central bank). In each period, the *current account balance and the capital account balance must sum to zero*. Brazil has traditionally had current account deficits (even in periods of trade surpluses), what implies that it has been forced to “finance” that deficit by using resources from the capital account.
However, the gloomier global outlook after September 11th resulted in reduced global growth estimates and the lowered availability of capital flows to emerging markets, adversely affecting countries with large external borrowing needs such as Brazil. This more adverse international scenario has compounded previous shocks, exacerbating economic pressures.

In fact, the more adverse external environment happens at a time when Brazil shows high external financing needs (current account + medium and long-term amortizations), estimated at US$ 57 billions for 2001 and US$ 51 billions to 2002. The high external financing requirements amid decline in FDI (forecasts: US$ 20 billions in 2001; US$ 13 billions in 2002) and growing risk aversion is putting pressure on the currency, which had depreciated 36% as of the end of September. This environment is requiring the maintenance of a weak real exchange ratio so as to bring (expected) external balance into place.
But the strong depreciation is threatening inflation targets, and demanded a monetary policy response. Increase in inflation expectations for 2001 and 2002 led to a monetary tightening cycle, indicating that room for easing is modest, implying lower GDP growth. Strong depreciation also puts upward pressure on public debt due to vulnerability of public debt to variations in the currency and interest rates. Therefore, in spite of fiscal discipline seen in the recent rise in primary surpluses, impact of currency and interest rates is placing pressure on the nominal deficit. Impact of currency and interest rates increase concerns among foreign investors over public debt, what may lead to pressure on Brazil risk.

This scenario synthesizes a vicious cycle of less investment, stronger depreciation of the real, more inflation, tighter fiscal policies, less growth, and so on, posing a challenging environment for policymakers. The ability to create an appropriate environment able to attract FDI is critical to assure political and economical stabilities achieved so far by the country and its society. Export-oriented FDI specially, would also create the base for stronger and permanent trade surpluses that would eventually lower the current account deficit. This would loosen the pressure over the capital account and hence the external financing dependence of the country.

While a great deal has been accomplished in recent years, much remains to be done in order to sharpen Brazil’s competitive edge sufficiently to assure its economic success in the globalized world. More is needed. The problems mentioned in this study must be addressed, and higher priority must be given to stability and predictability throughout the legal and economic framework.

This will create the necessary – although not sufficient – environment to business in Brazil, which will endow the country with the basic conditions to fulfill its strong potential for growth.
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