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Short-Term Capital Inflows Increase Risk in Brazil

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Evidence indicates that Brazil’s current account deficit is being financed primarily by short-term investment flows. If these reverse course, it could pose a substantial risk to the value of the real.

We expect Brazil, along with other emerging-market economies, to make a significant contribution to demand growth in the global economic recovery. This will likely take the form of higher imports, which will create current account deficits that must be financed by capital inflows.

We’ve assumed that much of the financing would come from foreign direct investment—the highest-quality and most stable of capital inflows—or at least from relatively stable long-term portfolio flows. But if a growing share of the financing comes from short-term sources, as appears to be the case in Brazil, it creates much greater risk that these flows will at some point reverse course, putting sudden downward pressure on Brazil’s currency.

High Interest Rates Stand Out

Short-term interest rates in Brazil are near 11%, among the highest in the world, which helps the country attract short-term investment flows. Offsetting these exceptionally high yields is the risk of a decline in the Brazilian currency, but the yield advantage versus the dollar is so

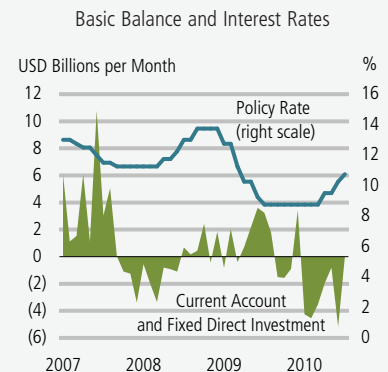
great that it provides a buffer against some loss in the value of Brazil’s real. In a global environment in which financial shocks seem less likely, short-term investment in high-yielding currencies like the real becomes an attractive proposition.

Investors appear to be taking advantage of this opportunity: short-term positions in the real are on the rise, as evidenced by the balance of payments, local reports on bank funding and market-price distortions. All three indicators point to inflows of short-term capital via derivative markets, which allow foreign investors to assume the well-compensated short-term risk in the real that’s ultimately financed by local banks. Let’s take a closer look at the signs of rising short-term capital inflows.

Evidence of Short-Term Capital Inflows

First, Brazil’s current account deficit is rising, and that deficit must be financed by corresponding inflows of foreign capital, which can come from direct investment, long-term portfolio investment or short-term portfolio inflows. Our analysis

Display 1
Short-Term Capital Attracted by Rates



Source: Banco Central do Brasil and Haver Analytics

Display 2
Banks May Be Funding Derivative Positions



Source: Banco Central do Brasil and Haver Analytics

shows that foreign direct investment is stagnant and that longer-term foreign investments in stocks and bonds have slowed, yet foreign-currency reserves continue to build at Brazil's central bank. The implication is that short-term inflows must be rising to balance inflows and outflows (**Display 1, previous page**).

Second, local Brazilian banks have sharply increased their dollar borrowing over the last few months. Banks' short positions in the US dollar last peaked in September 2008. When the collapse of Lehman Brothers and the onslaught of the global financial crisis triggered a wave of financial shocks and a flight to safety, these positions were hurriedly reversed. Brazilian bank short positioning is now at a record level (**Display 2, previous page**), suggesting that large customer positions are again being funded by banks.

Bank customers don't actually buy the Brazilian currency to invest locally, since they don't want to incur various taxes and charges. Instead, they buy futures contracts in the currency, with the bank as their contract counterparty. The bank has easy access to both the dollar and local money markets, takes no risk, and

executes the underlying trade on behalf of the risk-bearing customer in exchange for a fee. Brazilian banks effectively borrow the dollars, buy Brazilian currency and invest in the local money market on behalf of their derivative customers, who pay a small fee for the service.

The third and final indication of the predominance of short-term capital inflows is growing distortions in nondeliverable currency-futures markets. In theory, the pricing of these futures should reflect the difference in money-market rates between the two currencies. If Brazilian rates are much higher than US dollar rates, contract prices would reflect an expected *decline* in the value of the Brazilian currency to balance the higher interest rate in Brazilian money markets. If this weren't the case, the inefficiency would create an arbitrage opportunity for investors.

But so many investors have apparently piled into derivative contracts that the real's forward value has been driven *upward*, above what's implied by the difference in money-market yields. This, in turn, has created anomalies in certain money-market segments. Nonbank Brazilian investors, for example, now pay

2.0% for three-month US dollar funding, compared with only 0.40% in the Eurodollar market.

Why such a distortion? We suspect it's because Brazilian banks that normally act as a bridge between dollar and Brazilian money markets are constrained by their capital and counterparty limits. As these banks near these prudential limits, they begin to charge higher fees for increasing their balance-sheet risks. This means raising the price of the derivatives they offer—in this case the nondeliverable currency futures contracts from which the distorted funding rates are derived.

Greater Risk of a Currency Sell-Off

On balance, we believe that by raising rates and then intervening to stop the real from rising, the Brazilian central bank has facilitated a surge in short-term investor positions into its currency, largely in derivative instruments. While there's no automatic limit to these positions, they do entail risk: the higher they climb, the greater the risk of a sudden currency adjustment. By accumulating reserves as the current account deteriorates, the central bank increases the risk of a sudden sell-off in Brazil's currency. ■

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