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MARKET COMMENTARY

Ashmore

Brazil removes the IOF tax: What does it mean?

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Last night the government of Brazil slashed the financial transactions tax (IOF) from 6% to 0%. We briefly summarise the facts and put this development into its broader context.

The IOF tax was originally introduced in 2010 to counter-balance potential inflows to Brazilian government bond markets arising from Quantitative Easing policies in the US, Europe and Japan. According to Finance Minister Guido Mantega, last night's removal of the IOF tax is justified, because he expects "the [US] Federal Reserve to reduce its expansionist policies".

This news is very positive, in our view. The decision to remove the IOF tax follows the Brazilian central bank's 75 basis points hike over the last two meetings, which surprised the market as the latest 50 basis point hike occurred on the same day that 1Q GDP surprised on the downside. We believe these are clear signs that Brazil is intent on controlling inflation and is the right policy priority.

A number of analysts have argued that the removal of the IOF tax could be potentially negative, for example by increasing incentives for foreign investor already in Brazil to leave now that they can get back in more easily. We do not agree with this argument for two reasons. First, such investors are likely to have been FX hedged already, so any such flows would likely not materially impact the currency. Second, the same investors are likely to be at the short end of the yield curve, where the lower duration has less of an impact on bond prices. According to the Brazilian treasury, foreign investors' participation in Brazilian bonds is currently at 14.5%, lower than the Emerging Markets average. We expect this participation to increase over time.

Brazil's decision to remove the IOF tax also illustrates a very important general insight about the political reality in most Emerging Markets. Most ordinary people (voters) in Emerging Markets do not have access to inflation hedges or unemployment benefits. This means that policies that result in inflation and recessions have large and often rapid negative political ramifications, ensuring that they are often reversed in relatively short order.

India is another country that illustrates the same point. India also recently embarked on fiscal austerity, reforms and local market liberalisation following a period of weaker growth and higher inflation, despite the proximity of elections. Similar developments occurred in Russia, Mexico and other Emerging Markets.

This pattern of reverting to orthodoxy in Emerging Markets stands in sharp contrast with the typical policy responses observed in developed economies, where reforms are extremely unlikely close to elections and periods of macroeconomic weakness typically result in greater deficit spending and rising debt.