ANALYSIS OF FOREIGN DIRECT INVESTMENT CLIMATE IN BRAZIL
Abstract
This thesis concerns the environment of Foreign Direct Investment in Brazil with the purpose of determining the biggest hurdles and incentives for establishing a business in the country. The study is analysed in the context of the Diamond model of national wealth, first introduced by Porter (1990) and is based on secondary source research and data. The main motives are outlined as resource-seeking, market-seeking and non-marketable asset seeking and assessed by using a number of determinants that is commonly used when investing whether a country is competitive in role of attracting investments from abroad. Found was that Brazil has a competitive advantage in terms of market size and a population growing purchasing powers that stems from recent economic growth. The main obstacle for Brazil is now to regain economic stability since the country currently is undergoing recession and invest in infrastructure which is currently one of the largest barrier for foreign (and domestic) businesses.

Keywords: International trade, Sweden, Brazil, Foreign Direct investment, trade facilitation
Innehållsförteckning

1. Introduction 5
   1.1 Background 6
   1.2 Problem specification 8
   1.3 Delimitations 8
   1.4 Structure of the report 9

2. Frame of reference 10
   2.1 International trade and globalisation 10
   2.2 Emerging markets 10
   2.3 Foreign Direct Investment 11
   2.4 FDI trends 12
   2.5 Motives for FDI 13
      2.5.1 Resource seeking 13
      2.5.2 Market seeking 14
      2.5.3 Non-marketable asset seeking 14
   2.6 Determinants of FDI inflow 14
      2.6.1 Market Size 15
      2.6.2 Macroeconomic stability 15
      2.6.3 Trade openness 16
      2.6.4 Infrastructure 17
      2.6.5 Labour cost and productivity 18
      2.6.6 Clustering effects 18
      2.6.7 Tax incentives 19
      2.6.8 Investment and business climate 19
   2.7 Porter’s Diamond model 19

3. Method 23
   3.1 Scientific approach 23
   3.2 Secondary research 23
   3.3 Data sources and collection of data 24
   3.4 Working process and analysing method 25
   3.5 Quality criterion 26

4. Case: Brazil 28
   4.1 Demographics 28
   4.2 History of FDI in Brazil 29
   4.3 Recent development 30

5. FDI determinants in Brazil 32
   5.1 Market size 32
   5.2 Macroeconomic stability 33
   5.3 Labour costs and conditions 35
   5.4 Trade openness 35
   5.5 Business environment 37
   5.6 Infrastructure 38
   5.7 Tax incentives 41

6. Analysing the motives 43
   6.1 Resource seeking 43
   6.2 Market seeking 44
   6.3 Non-marketable asset seeking 45

7. Discussion: Porter’s Diamond 46
   7.1.1 Factor conditions 46
   7.1.2 Demand conditions 46
7.1.3 Supporting industries 47
7.1.4 Firm strategy, structure and rivalry 47
7.1.5 Government and chance 47

8. Suggestions for further studies 49
   8.1 Generalisation of the results 49

9. Conclusion 50

10. Bibliography 51

Appendix A – List of variables

List of abbreviations
BRIC – Brazil, Russian Federation, India, China
BRL – Brazilian Real (Currency)
FDI – Foreign Direct investment
MNE – Multinational Enterprise
UNCTAD - United Nations Conference on Trade and Development
USD - United States Dollar (Currency)
Introduction

Nowadays, globalisation is a term well-known to the general population, and expressions such as world economy and international trade is commonly used in academic papers and articles. Following the waves of globalisation, impacts can be noticed in several areas such as economic policy, culture, politics and social development, just to mention a few. When we talk about globalisation we talk about a process where national borders become less important as a boundary for business and nations become more entangled economically, politically and even culturally. We drink coffee from Brazil, wear clothes made in Bangladesh while listening to American music, and in that sense cultures become more indistinct. International trade globalisation is today maybe more relevant than ever and it is not unusual that products are made in one part of the world before they are shipped and sold in another. Countless studies have been conducted with the intention to analyse this new environment providing knowledge about the opportunities and drawbacks. And it is not an exaggeration to claim that some countries have adopted and have managed to take advantage of this environment more than others. As for almost all kinds of phenomena there are both positive effects and negative effects. Advocates for globalisation argue that it has given an opportunity for developing countries to prosper and develop socially and economically by taking part in trade. On the other hand, opponents debate that globalisation has a negative effect on the equal distribution of welfare and that it allows for rich multinational companies, mainly from western developed countries, to take advantage of poorer countries and at the expense of smaller local businesses. This will, according to the opponents of globalisation, in the end make rich countries even richer and poor countries poorer (de Soysa and Vadlamannati 2011, cited in Hauge and Magnusson, 2012).

In this thesis, the focus will lie on Brazil as a player in our globalised world. Brazil is a country that has been a subject of interest for many economic studies in the past couple of decades and still is due to its position as the biggest economy in Latin- and South America, and the 9th largest economy in the world. It belongs to the countries that have managed to adopt to the globalisation and have managed to benefit from it, but not without effort. The country which was historically characterized as closed off to foreigners, suffering from a highly unstable economic environment and ruled by a military dictatorship has in recent times started to clean up their state and open to the world. In 1985 the military was forced to step down and democracy was reinstated. With a new economic plan in 1994 called Plano Real, Brazil managed to stabilize their currency which was suffering from hyperinflation and volatility and the population could enjoy a period of high growth and better living standards. In the process of opening the country up to the outside world with new policies of trade liberalization and privatization, the outside world turned its gaze to Brazil. Foreign companies started to become interested in what Brazil had to offer. Naturally, this would happen as Brazil has many advantages that sticks out to foreign investors from which the size of the domestic market is one of the most prominent (Santander, 2017). A market is attractive for investors for a variety of reasons, reasons depending on motives of that specific firm. FDI is usually not casually undertaken and the potential host market is carefully evaluated by
characteristics of the consumer market, availability and abundance of resources, a healthy competitive environment and room for future potential growth.

In the beginning of the new millennium Brazil experienced an economic boom, lasting until 2014. The boom lifted 29 million people out of poverty and bridged some of the inequality gap between the poorest and the richest, incomes rose with about 4.4% for the population in whole (World Bank, 2016). But this boom, explained as “the growth miracle” landed Brazil amongst the BRIC countries; Brazil, Russian Federation, India and China, first identified by Jim O’Neill of Goldman Sachs in 2001 and then again in 2003, as the four countries projected to grow the fastest and become an important opportunity for foreign expansion. However, after 2014, the tables have turned and Brazil has once again landed in a deep recession, with declining growth rates, increased inflation rates and increased unemployment. Part of the economic crisis is rooted in a global decline in raw material prices, to which Brazil is vulnerable due to their position as an exporter of raw materials. The economic crisis is closely intertwined with a deep political crisis in the beginning of 2016. At the time the sitting president Dilma Rousseff was accused of covering up budget deficit by taking loans from state owned banks and thus not having to pass the deficit through congress. Noted should be that this method has been quite common even before Rousseff’s presidency. This political crisis made the government paralysed and without the ability to take concrete actions to dig out of the economic crisis. In addition to both economic recession and political turmoil a large corruption scandal concerning Brazil’s state owned oil company Petrobras and several construction companies was exposed, undermining trust and creating more political turbulence. During this time a new downward trend has been noticed in Brazil’s economy where inflation rates are one again increasing while GDP growth rates are decreasing (Sveriges Radio, 2017).

That being said, this thesis takes off at a quite turbulent point in Brazil’s history, where the country’s economic future, according to the World Bank (2017) will depend on the success of policy adjustments and growth-enhancing reforms. The main challenge is how to raise productivity and competitiveness as well as creating a more stable environment that can make investments flourish.

1.1 Background

Globalisation has meant a lot to the world and how companies run their businesses. With the support of technological advancements companies find it easier than ever before to move their operations abroad and reach international markets and cheaper resources, with the optimal goal of competitiveness and profit. Making these types of investments in other countries is referred to as Foreign Direct Investment, or FDI in short. FDI can be done in several ways and serving different purposes which will be explored in this thesis. Companies making these types of investments are Multinational enterprises (hereafter MNEs) signified by their ownership and control over production in more than the home country. The location choice of FDI is influenced by many factors that are directly linked to the specific MNE’s operations and needs. The choice is not taken casually and potential host markets are carefully evaluated with several determinants considered, factors relating to upstream production and downstream
market characteristics. The competitive nature of the host market, potential rivals and the existence of educated labour, supporting industries and business environment are investigated before the decision to establish is made.

FDI is not static and the flows are affected by many things; economic stability, politics, rules and regulations and many other things which explains the dynamics of FDI flows, where it origins and which countries it directs to. Hence, attributes of the host market are of great importance as foreign firms want to invest in markets where they expect gains that allows them to compete more effectively on the global market. In that sense the government in the host country has a vital role in creating a desirable environment for foreign investors by facilitating the processes required to open and operating business in the country. Clearly, good government policies are not the single factor that attracts foreign companies to a certain market, but it plays an important role in creating better conditions in many areas such as research and development incentives and an educated workforce that can be of interest for MNEs looking for especially skilled workers in certain sectors. An important theory developed by Porter (1990) states that countries gain competitive advantage through their ability to upgrade and innovate, in which the government plays a key role in creating the underlying environment. As stated before, developed countries tend to attract a bigger part of FDI, which makes the ability to innovate important.

In recent years FDI has increased globally by a massive amount. Only in 2015 total FDI flows grew with 38 % from 2014, amounting to a total of approximately 1.7 trillion USD, which was the highest growth rate since 2007 (UNCTAD, 2016). Due to the economic crisis in 2008-2009 the world saw a drop in FDI flows but has been recovering since. Most FDI flows move from developed countries to other developed countries and in 2015 developed countries’ FDI amounted to 55 % of the world’s total. But also, FDI flows to developing countries has recovered again since the economic crisis increasing with most of the FDI, with Asian countries as the principal receiver. The increase in FDI inflows to developing Asia, with Hong Kong as the largest receiver, has led to a decline of FDI flows to other developing countries in Africa and Latin America and Caribbean. The reason for the increase in FDI directed to Asia at the expense of other developing regions may for example be explained by a slowing domestic demand in Latin American countries, while mainland China has seen an increase in FDI within the service sector and India managed to double their FDI inflows. Hence, the host market’s demand and the overall structure of the market plays an important role for a firm’s success. A demanding market with high purchasing power may lead to more innovations from firms to stay competitive.

Spreading out business operations to several markets is often a strategic choice and may have different reasons depending on the individual company and host country characteristics. In this thesis three main motives will be outlined: resource seeking FDI, market seeking FDI and non-marketable asset seeking FDI. These are the motives mainly referred to in FDI research. The first, resource seeking FDI is realised when firms invest in countries where resources used in production is easily achieved and readily available. In that case, firms tend to make their location choice based on the attributes in the host market that facilitate production, transport and labour costs. On the other hand, when engaging in market seeking FDI,
companies choose to locate close to their end consumers where they sell their products. Once again the consumer base, demand and characteristics are evaluated. The third reason is that of non-marketable asset seeking FDI which means locating strategically so that firms’ operations can be run with higher efficiency, for example by locating in industrial clusters where advantages of support industries or especially skilled personnel can provide spill-over effects (Franco, Rentocchini, and Marzetti, 2008). The differences between the three objectives and host country factors will be elaborated further in chapter 2.

1.2 Problem specification

Considering the overall subject of this thesis the aim is to investigate the Brazilian economy in the eyes of a foreign investor, by assessing Brazil’s strong points and weaknesses, risks and possible gains. To do this, we must clarify what factors are important when considering FDI, the motives of investors and the behaviour of MNEs. By looking at past and current economic factors the hope is to raise insight to these issues. In this subject Brazil is an interesting player on the global market by the role it has in the global economy.

Hence, the purpose of this study is to, in a theoretical manner, investigate and analyse the factors that attract companies to engage in foreign direct investments (FDI) in Brazil as well as discussing advantages, challenges, competitiveness and opportunities in the country regarding FDI. This by answering two basic questions:

- What are the motives and determinants relevant for firms when engaging in foreign direct investment?
- What are Brazil’s strengths and weaknesses as a destination for foreign direct investment?

1.3 Delimitations

Delimitations are important for this paper as the concept of FDI as broad and can take several interesting directions. Directions that cannot be thoroughly investigated due to time limitations and the preservation of overall comprehensiveness of the thesis. Hence, his study will be limited to only considering FDI in Brazil, and no other countries and regions. It will also be limited by not comparing the determinants of FDI in Brazil with them of other emerging markets that may serve as opponents in the attraction of FDI nor weighing the determinants and their significance against each other. Nonetheless, in some cases values will be compared with those of other countries, regions and income groups for reference. There are several determinants that have proven to affect the choice to invest in foreign countries and this study will delimit itself to bring up and discuss a choice of those that have been shown significant in other studies. The study will also take on a relatively general approach to FDI in Brazil by not separating industries and regions within Brazil that may have been affected differently from foreign investments. The author however acknowledges that there are great regional differences in the country, a fact more described in chapter 4, however the analysis will be based on aggregated data for the whole Brazilian market.
1.4 Structure of the report

The thesis will be structured in the following way:

Chapter 1 introduces the subject and the background, explains the problem and the aim as well as the delimitations necessary for the scope and comprehensiveness of the thesis. In Chapter 2 the theoretical framework of this thesis is presented. The concept of emerging markets will be explained briefly. The focus will lie on motives and determinants of FDI and Porter’s diamond. Chapter 3 describes and motivates the scientific approach, the literature and data sources are explained as well as a discussion on the reliability and validity of sources. Chapter 4, presents the case of Brazil as an emerging economy, the demographics and other background issues are raised, it will provide the reader with an introduction to the Brazilian FDI inflows. Each of the suggested determinants in the Brazilian context will be further studied in chapter 5. Analyses of the findings in the context of FDI motives will be presented in chapter 6 and discussed with support of Porter’s diamond in chapter 7. The thesis will be concluded in chapter 8 followed by the bibliography.
2. Frame of reference

In the Frame of Reference chapter the theoretical framework of this thesis is presented. The concept of emerging markets will be explained briefly. The focus will lie on motives and determinants of FDI and Porter’s diamond of National Competitive Advantage.

2.1 International trade and globalisation

International trade; the exchange of goods and services between people or entities across international borders, is not a new phenomenon but has existed for centuries. Nowadays all countries are more or less engaged in international trade and have a play in the global economy (Morgan and Katsikeas, 1997). Even though trade has been a common factor in human affairs for a long time the long-distance commerce that we see today has not. International trade has been facilitated as the development has moved forward. In previous times moving goods long distances was hard and costly. Since then communication technology and transportation methods have developed and the potential of international trade has increased tremendously. Today goods and services can be shipped almost anywhere at any given time (Hauge and Magnusson, 2012). A consequence of this new, more intertwined global marketplace nations and firms face an increased competition and will seek advantages. The aim of exploring the reasons to why some will have greater advantages on the new market has led to several theories of international trade. The classical theories were developed to describe global trade from a country-based perspective (Carpenter, Dunung, 2013). These country-based theories describe a situation where countries will produce goods in which they have an advantage in production; the surplus of the production that is not consumed in the country will be exported internationally (Ricardo, 1817 and Smith 1776; cited in Morgan and Katsikeas, 1997). During the twentieth century, assumedly as an effect of globalisation, there was a focus shift in the new trade theories from a country perspective to more firm-based theories. These modern theories came because of the progression of multinational enterprises (MNEs) and the increased level of intra-industry trade. In the firm-based theories other aspects of trade are incorporated that the classical theories do not cover such as brands and customer loyalty and quality (Carpenter, Dunung, 2013).

2.2 Emerging markets

As described in the introduction and in the previous section globalisation has changed the way of doing business and by that countries on the global market have become increasingly interesting. Generally, studies of global trade flows divide countries into two categories depending on the level of development: either a country is defined as developed or developing. The term emerging market is commonly used to denote a country in transition from developing to developed.

To further clarify what an emerging market is, the definitions of developed and developing markets needs to be outlined. World Trade Organization (WTO) uses these two categories in the classification of member countries. Even though WTO lists the countries in these categories they do not have a formal definition, the countries declare themselves as
developing or developed. The declaration can be challenged by other members and does therefore prevent countries from using the provisions available to developing countries (WTO, 2015). However, the characteristics of developed countries are high income per capita, competitive industries, good infrastructure and high life expectancy. Developing countries tend to have a lower income to spend on nonessential goods. Previous researches have used different classifications for developing and developed markets, often depending on who is doing the analysis. Due to this inconsistency in definitions, emerging market is not clearly defined either but are countries somewhere between developing and developed in terms of development (Carpenter and Dunung, 2011).

"A developing country, in order to evolve into an emerging market, must (1) seek to implement transparency in its government as well as in its political and economic institutions to help inspire business confidence in its country, (2) develop the local commercial infrastructure and reduce trade barriers to attract foreign businesses, and (3) educate the population equally and create a healthy domestic workforce that’s both skilled and relatively cheap."

(Carpenter and Dunung, 2011, p. 176)

The emerging markets share many similarities in terms of changes in the business environment, trade policies and the local commercial infrastructure. Also, investments in the overall wellbeing of the population such as education leads to increased incomes and greater purchasing powers, which attracts investments (Carpenter and Dunung, 2011).

### 2.3 Foreign Direct Investment

In the search for economic advantage and enhanced productivity investments abroad have become increasingly common for MNEs. There are two categories of investments that can be done internationally: Portfolio Investment and Foreign Direct Investment. Portfolio investment refers to investments in foreign stocks, bonds or assets without the intent of controlling them. The second category of international investment, and the one of interest for this thesis, is known as Foreign Direct Investment (FDI). FDI refers to the investment or acquisition of assets in another country with the intent of controlling it. This can be done in different ways; buying assets or equipment of a foreign company or engaging in collaborations with local companies, so called joint ventures. Moreover a firm can undertake what is referred to as greenfield FDI which simply is to build a local establishment from the ground. Typically, a FDI is a part of a long-term strategic plan where a firm seeks to increase their production or gain market access. Foreign direct investments have the possibility of bringing forth many positive economic effects both for the “hosting” economy and the “home” economy such as creating long term collaboration between economies, enhance the competitive position and the opening of new markets for the investors, a fact that is especially true for developing and emerging markets (Franco, Rentocchini, and Marzetti, 2008).

Over the past couple of decades the world has experience a rapid increase in FDI and even though most FDIs flows move between developed countries there has also been a large share
of FDI flowing into developing countries. And today FDI is a very important element in the
global economy. For emerging markets FDI plays a particularly important role for the
economic development, as it facilitates the exchange of skills, technology and brings access to
international markets. Because of the possible benefits of FDI, developing and emerging
markets undertake actions to become more attractive for FDI (UNCTAD, 2000).

2.4 FDI trends

On the global scene investment by foreign investors are highly concentrated to high-income
countries attracting more than 75% of all FDI inflows in 2015 as can be seen in figure 1
whereas the low-income countries merely received around 0.89%. This enormous difference
between low income countries and high income countries gives a perspective of how some
countries can reap the benefits while others cannot as easily enter the global market. From
figure 1 there is also a sharp drop in inflows during the financial crisis that hit the world in
2008. The countries in the high-income group were hit hardest by the crisis and over all the
FDI inflows are more volatile in the highest income group when comparing to the other
groups. In this situation we find that the emerging markets, which often land in the middle-
low or middle-high income countries, received quite a lot of the FDI inflows; 39.8 % in 2015
where the major part where flows to China. Within that category the BRIC countries received
around 14.5 % of the global inflows.

![Figure 1: FDI inflows, global and by group of economies, 1995-2014 (Billions of Dollars)
(Source: UNCTAD statistics, 2015 that in turn sources data from World Bank)](image)

As can be seen from Figure 1 the developing world has seen an increase in FDI inflows for
the past decades. In 2014 the developing world received 55 percent of the FDI, for the first
time more than the developed world. In 2014 there was also a decrease in FDI in the
developed and transition economies as a response to the fragility of the global economy. The FDI inflow to the developing economies remained at the same levels. However, the global FDI levels are projected to recover in coming years. FDI inflow to Latin America and the Caribbean decreased by 16 percent in 2014. Another trend that was spotted was that the investments done by developing countries reached an all-time high (UNCTAD, 2015).

2.5 Motives for FDI

The fundamental motive for investing in another country is to attain some kind of advantage over competitive firms. This issue was perhaps first discussed by Dunning (1993) who introduced a new model for internationalisation motives including four sub-categories (Hansson and Hedin, 2007):

- **Resource seeking** (or vertical FDI) is defined as a Multinational Enterprise (MNE) investing in the host market to acquire resources at a lower cost than in the home market.

- **Market seeking** (or horizontal FDI) refers to MNE investing in foreign markets with the motive of exploiting a new market or in other cases uses the host market as a platform to reach nearby markets and expand in the area (Franco, Rentocchini, and Marzetti, 2008).

- **Efficiency seeking** is often done by large MNEs to take advantage of differences in factor endowments, cultures, institutional arrangements and economic systems etc.

- **Strategic resource seeking** occurs when companies are investing abroad to get access to knowledge and competences that does not already exist within the company (Dunning, 1993).

Franco, Rentocchini, and Marzetti (2008) conducted a study of the motives for companies to engage in FDI. Found were two main reasons, resource seeking and market seeking, similar to those presented by Dunning (1993). However, Franco, Rentocchini, and Marzetti, identified a lack of clarity in Dunning’s definition and instead of efficiency seeking and strategic resource seeking added another category for FDI motives called non-marketable asset seeking.

- **Non-marketable asset seeking** refers to an acquisition of assets that are not directly transferable via market transactions. For example, companies establishing in industrial clusters to take advantage of especially skilled labour force or technological spill over effects.

2.5.1 Resource seeking

The location choice of resource seeking FDI is dependent on several factors concerning the specific industry in which the investing firm is operating. Indicators concerning the specific resource that the firm requires such as the cost of the resource, the scarcity of the resource and the absolute productivity of the resource. Optimally, for a location to be attractive the cost of
the resource should be relatively low and abundant. Also the relative productivity of the resource should have a positive association with FDI inflows. When considering resource seeking FDI Franco, Rentocchini, and Marzetti (2008) refer to both scarce natural resources but also labour resources, both unskilled and skilled.

2.5.2 Market seeking

While resource seeking FDI focuses on the availability of resources, market seeking FDI is attracted to host markets that have some appeal to the company. The firm is looking to supply the host market with their goods and/or services. Franco, Rentocchini, and Marzetti (2008) divides this motive into two types: either the firm wants to exploit the host market and sell their products or the host market is used as an export platform with the aim to export to the surrounding area and neighbouring countries. For the first motive, exploiting the host market, companies are attracted to large markets and markets that are expected to grow. Correspondingly, the absolute and comparative advantage is an important factor.

The second motive under the category of market-seeking FDI is using the host country as an export-platform to reach surrounding markets. In this case the country is valued against other countries in the region. If that is the case determinants such as regulations, norms, taxation and labour costs are more central in decision-making.

2.5.3 Non-marketable asset seeking

The third motive listed by Franco, Rentocchini, and Marzetti (2008) is the non-marketable asset seeking motive, which according to the authors, are factors that are not directly transferable via market transactions. More specifically these assets are only accessible within the host market and are closely linked to the local context. This could for example mean making the location choice to invest in agglomerations economies to access possible spillover effects and specialised labour or technology. When motives are non-marketable asset seeking, the companies will, according to Franco, Rentocchini and Marzetti, locate in markets with adequate infrastructure. Roads, transport possibilities but also communication technology infrastructure are important.

2.6 Determinants of FDI inflow

As the main motives for FDI is divided into either resource seeking or market seeking (or non-marketable asset seeking) there is a need to evaluate what specific factors that create an attraction of FDI. There have been several attempts to summarize which determinants are relevant in FDI situations and which factors make some countries more attractive than others. The determinants are of different importance depending on the host market and the motive of the FDI. The combination of determinants used has varied among studies with various results (Demirhan and Masca, 2008).

The United Nations Conference on Trade and Development (UNCTAD, 2009) created a framework divided into three categories of determinants: policy, economic determinants and business facilitation. The economic determinants where in turn divided into three motive-based subgroups: Market-seeking, Resource-seeking and Efficiency-seeking. The
determinants of UNCTAD are found in most of the empirical studies. Similar definitions by UNCTAD were used on a study by Ranjan and Agrawal (2011) specially focusing on FDI determinants in the emerging markets of Brazil, Russia, India and China, also known as the BRIC countries. It is important to note that the importance of the determinants depend on the motive of the FDI. For example, market size, which has significantly larger dependence for Market-seeking than Resource-seeking FDI (Lim, 2001). Some of the most commonly used determinants are listed below:

2.6.1 Market Size

According to Lim (2001) market size, as a determinant is one of the most important in a market-seeking FDI context, however it is irrelevant in cases of resource-seeking FDI. The fact that market size has a positive significant effect on market seeking FDI is agreed upon by several studies (see Wadhwa and Reddy S, 2011; Artige and Nicolini, 2010). A large, expanding market with great purchasing power, is attractive for companies wanting to sell their products and will attract foreign investors looking to serve the local demand for goods (Artige and Nicolini, 2010). Demirhan and Masca (2008) investigated the relationship between market size and FDI inflows in developing countries. In their regressions, several measurements of market size were tested. The results showed that using growth of real GDP per capita as proxy for market size there was a positive and significant link to FDI. Hence, market size can be considered as a significant factor that affects FDI. Still, when testing alternative measurements of market size such as absolute GDP and GDP per capita there was no significant effect on FDI. The conclusion was that foreign investors preferred growing economies to large economies. A study made by Wadhwa and Reddy (2011) found significant results between GDP and annual FDI using a fixed effects regression analysis. The study included both GDP (taken in logs) and population growth as dependent variables for market size in a study on several developing countries in Asia. However, population growth did not show any significant results.

2.6.2 Macroeconomic stability

Creating a macroeconomic environment that is predictable and stable is one of the key ingredients to become competitive on a global scale. A stable economic environment draw new investors to a country and stability of the host country’s economy is a possible determinant in the attraction of FDI. Host markets in lack of macroeconomic stability are more uncertain and less predictable, which is of high concern for investors. In some instances, there is a trade-off between economic stability, educated workforce often found in developed countries and low wages and cheap input prices that are often the case in developing countries (Yu and Walsh, 2010). The unpredictability linked to macro instability hampers effective resource allocation and investments and may consequently have a negative impact on FDI. The relationship between macroeconomic stability and FDI has been thoroughly examined by Alguacil, Cuadros and Orts (2011) where a negative correlation between inward FDI (referring to FDI flow into the country of concern) and instability at the macro level for all income groups using inflation and external debt as explanatory variables.
To assess macroeconomic stability the rate and volatility of growth, level and stability of inflation and the current account deficit is commonly used as key variables. Noted is that high and volatile inflation creates uncertainty of the value of long term contracts which in turn increases risk premiums (The Reut Institute, 2006). Most central banks set their inflation targets around 2% as inflation rates higher than that can be very costly for the country. High inflation can be damaging for a country in terms of global competitiveness as investors become unsure on what to spend their money on due to uncertainties in returns on investments and costs (Miles and Scott, 2004). Current account deficits will prevent the government debt from growing and low government debt will let governments spend revenue on domestic needs instead of foreign creditors (The Reut Institute, 2006). External current account deficits are according to Adrogué, Cerisola and Gelos (2006) a decent prediction of future stability. If the deficit is excessively large it is unsustainable in the long run, and may culminate into an economic crisis. On the contrary a stable macroeconomic environment is, according to Neuhaus (2006), signified by low and stable inflation, low exchange rates, low unemployment rates, sustainable economic growth, fiscal discipline and reserve coverage.

2.6.3 Trade openness

Trade and FDI are related, both as substitutes as well as compliments as companies producing goods often both imports (inputs such as raw materials and components) and exports finished goods to other markets. In many cases governments intervene with trade by facilitating or creating barriers in forms of tariffs, subsidies, import quotas, local content requirements, antidumping rules or financing export of domestic products. The reason for these types of government actions are motivated by many economic, social, cultural or political factors. A government may for example intervene to protect jobs or certain industries that serve a purpose for the national security (e.g. telecommunications and defence). Special trade agreements can be established as well as free trade zones to support trade (Carpenter, Dunung, 2011).

There are two main theories regarding the effect of trade openness and FDI: theoretically high trade barriers can either encourage FDI or discourage FDI. FDI would be encouraged as a way for foreign MNEs to get access to the market as a substitution to exports to lower costs, so called tariff-jumping FDI. The evidence for this type of FDI has been mixed and experienced a lack of robustness (Blonigen, 2005). On the contrary, several studies have found a positive and significant correlation between openness to trade and FDI inflows. Martens (2008), compared 21 studies that have aimed at clarifying the relationship between trade and FDI. Liargovas and Skandalis (2011) found a positive and significant correlation between openness to trade and FDI inflows in developing countries, using several measurements of openness in their regressions. Other studies have also shown that trade openness as a determinant is proven significant to attract FDI inflows (see Liargovas and Skandalis, 2012; Ranjan and Agrawal, 2011). There is a general understanding that trade openness concerns trade barriers and the range of measurements used in studies are wide and at times questioned whether appropriate. A simple and extensively used measurement of openness is the level of trade or trade intensity (imports and export divided by GDP per capita) (Liargovas and Skandalis, 2011)
2.6.4 Infrastructure

Infrastructure includes both the physical infrastructure such as roads, railways, ports and telecommunications as well as institutional infrastructure such as legal services and accounting. The general view is that advanced infrastructure provides a platform and cost-effectiveness for foreign investors and therefore it attracts FDI inflows to the country. For developing countries lack of good-quality infrastructure is often seen as one of the major constraints (Demirhan and Masca, 2008). The impact of infrastructure as a determinant has been researched on different levels: Fung et. al. (2005, cited in Abu Bakar, Che Mat and Harun, 2012) concludes that soft infrastructure (e.g. more transparent institutions, deeper reforms) is a more important determinant of FDI than hard infrastructure (e.g. roads, railways etc.). The study covered several countries such as United States, Japan, Taiwan and parts of China. Overseas Development Institute (ODI) (2007, cited in Demirhan and Masca, 2008) argues that poor infrastructure may also, however, be considered as a good opportunity for foreign investments. So-called hard infrastructure or physical infrastructure can be measured in quantitative ways, for example electricity generation, kilometres of roads (paved and unpaved), railways or waterways. These types of indicators however do not measure the quality of the infrastructure for example how well maintained the roads are and how well metropolitan areas and business centres are connected. In this case, it is argued to use different measurements of quality to complement the analysis of the entire state of the infrastructure (García-Escribano, Góes and Karpowicz, 2015). According to Asiedu (2002, cited in Demirhan and Masca, 2008) the most used standard measure of infrastructure development is the number of telephone lines per 1000 inhabitants, albeit adding the note that this measure does not consider the quality and reliability of the infrastructure or the number of cellular telephones as substitutes for ordinary telephones.

The quality of soft infrastructure is difficult to measure since the definition of institutions is quite broad. In conclusion institutions are defined as the “rules of the game” not only including government organisations but also social norms, behaviour and influences. Due to this difficulty, researchers tend to narrow the concept of institutional quality down. For this reason, the World Bank has developed some indicators that supposedly reflects the quality of institutions in a country. The indicators relate to 6 central themes (Miles and Scott, 2004).

1. **Voice and Accountability (VA)** – Aims at capturing the extent to which the citizens of a country can freely express themselves, their freedom of association and free media as well as the opportunity to select the government.

2. **Political Stability and Absence of Violence/Terrorism (PV)** – measures the likelihood of political instability, politically motivated violence and terrorism.

3. **Government Effectiveness (GE)** – aims at measuring the perception of quality within the public- and civil services and the degree to which they are independent from political pressures. It also concerns the quality and effectiveness of the implementation of new policies and the commitment from the government to uphold such policies.
4. **Regulatory Quality (RQ)** – provides information on the government’s ability to create high quality policies that promote development of the private sector, as well as how effective these policies are implemented.

5. **Rule of Law (RL)** – relates to the perceptions of how well the rules of society are abided, concerning in particular the qualities of contract enforcement, the police and court system and property rights. It also captures the likelihood of violence and crime.

6. **Control of Corruption (CC)** – capturing the level of corruption where public power is exercised for private gain. This includes both small and large forms of corruption. (Miles and Scott, 2004).

In the last theme, control of corruption, the data relies heavily on the Corruption perception index is a scoring system developed by Transparency International that evaluates the perceived level of corruption in the public sector on a scale of 0 (highly corrupt) to 100 (very clean) (Transparency International, 2015). In a survey by the International Monetary Foundation (IMF) about FDI determinants in developing economies investors stress the need for good infrastructure, particularly access to telecommunications, electricity and water.) 70 percent of the investors asked ranked availability of infrastructure as the most important determinant when considering FDI (IMF, 2003)

### 2.6.5 Labour cost and productivity

Labour costs as a determinant is closely linked to the resource-seeking motive for FDI where MNEs seeks specific resources that are not available in the home market, or available but to a higher cost. MNEs may see benefits of investing in a country where the cost of labour is cheaper (Franco, Rentocchini, and V. Marzetti, 2008).

Several small studies that have been done to evaluate labour cost as a FDI determinant have shown mixed results and therefore no consensus to which degree labour cost is significant has been reached. In some studies, higher wages are shown to discourage FDI in others the hypothesis receives weaker support (Demirhan and Masca, 2008). In ODI (1997, cited in Demirhan and Masca, 2008) it was found that the relative cost of labour was statistically significant in labour-intensive industries and export-oriented subsidiaries. However, when cost of labour does not differ significantly between host country and home country, the skills of the labour force were more significant as a FDI determinant with respect to pure labour costs.

### 2.6.6 Clustering effects

Agglomeration or clustering effects, where FDI specialized in a certain industry (or related industries) are grouped in the same geographical area, are common in both vertical and horizontal FDI. It is also a significant factor in attracting FDI to certain areas (Lim, 2001). The reason for clustering may be access to better communication between suppliers and customers, access to specialised labour, the effects of technological spill-over (Franco, Rentocchini, and Marzetti, 2008). Clustering also occurs when firms contemplating establishment in a certain area waits for the success of another firm before entering a market.
This “following-the-leader” scenario may explain the industrial clusters in certain areas (Lim, 2001). Franco, Rentocchini, and Marzetti (2008) found a positive linkage between clustering effects in market-seeking and non-marketable asset seeking FDI, with the effect on resource-seeking FDI indifferent.

2.6.7 Tax incentives

The effects of taxes on FDI inflows have been widely discussed in the literature. Predominantly the literature seems to suggest that high taxes impede foreign investments as it has a direct impact on the return of the investing firm however there is some discussion whether tax rate can be counted as significant (Demirhan and Masca, 2008). Bénassy-Quéré, Fontagné and Lahrèche-Révil (2005) finds no significant result that a lower corporate taxation leads to a higher level of FDI inflows, however they find some evidence that a high tax levels discourage FDI. This belief that high taxes discourage FDI may lead to changes in tax policies by governments in the hunt for foreign investors. For instance, many markets have lowered their corporate tax rates to attract more FDI to the country, others have targeted tax relief to certain industries and activities. A general view is that tax does not have significant importance on market-seeking, resource-seeking and strategic asset-seeking FDI motives. In the case of efficiency-seeking, MNEs generally look for low-cost locations, logically with low taxes (UNCTAD, 2015).

In the OECD report Tax Effects on Foreign Direct Investment (2008) a negative relationship between taxes and FDI is recognised. The report also states that even though the tax rate is an important factor for investing MNEs, it is not the most important determinant and that there are examples of countries where foreign firms invest albeit relatively high corporate tax rates (e.g. USA and Japan). What characterize these countries are large domestic markets and investing in production in those markets will reduce trading costs. Hence, the investors may accept higher tax rates. Where remaining conditions such as market size and infrastructure are favourable, the location choice of investors may not be affected by high corporate taxes. On the contrary, low tax cannot compensate when conditions for FDI is unattractive. In addition to the tax rate, other factors do play a part in making the tax environment attractive for investors, including the administrative burden of doing taxes and the predictability, consistency and certainty of the tax rules.

2.6.8 Investment and business climate

According to Lim (2001) an open and friendly investment and business climate has a positive effect on attracting FDI since it can lower the cost to do business in the country. A simplification of the bureaucracy, juridical hurdles, labour regulations and issues regarding property rights can direct FDI to the country. Factors like political instability and performance requirements may discourage FDI.

2.7 Porter’s Diamond model

Michael E. Porter challenged the classical economic view in 1990 with a new theory on countries competitive advantage: that countries do not inherit their national prosperity, they
create it. He states that a nation’s competitiveness does not depend on natural endowments, its labour pools or currency’s value. Instead it depends on the country’s industry’s ability to upgrade and innovate (Porter, 1990).

In order to illustrate what attributes, typify countries that have a competitive advantage he created the four-dimensional Diamond of National Advantage (Figure 2.) to describe the different conditions that play a role in gaining this advantage.

![Figure 2. Porter’s Diamond model of National Competitive Advantage. Based on material from Porter (1990)](image)

The model presented in 1990 presented four determinants for competitive advantage:

1. **Factor conditions**
   Factor conditions as described by Porter are the positions of the competing nations in terms of production factors. The production factors are for example skilled labour or infrastructure. Porter also points out that the qualities of the production factors are more important than their pure existence. For example, having a large low-educated workforce is not supporting the national competitive advantage. Instead the industry must be supported with especially skilled labour that fits the industry’s needs. A scarcity in resources (natural resources, working force etc.) may lead the nation to upgrade and create new innovative solutions (Porter, 1990).

2. **Demand conditions**
   The demand conditions depend on the nature of the home market and the demand for the products or services provided by a particular industry. Porter means that the
character of the home market should not be underestimated since it affects how companies perceive and respond to the needs of the buyers. Demanding buyers may pressure the companies to upgrade and innovate, which may lead to a competitive advantage. The pressure from the home market buyers may have a higher effect on innovation than the pressure from rival firms. Porter also points out that the character of the home market is more important than the size of the home market (Porter, 1990).

3. **Related and Supporting Industries**
The third determinant of competitiveness is the access to supportive industries within the country. If internationally competitive supportive industries upstream in the value chain are located close to the industry, it can lead to advantages. For example, the supportive industries can deliver inputs in an efficient way fast. However, an even more important factor is that the close working relationship is a good basis for innovation and upgrading. Short lines of communications and a constant flow of information will lead to an exchange of information and feedback. The closeness of related industries brings the same positive effect on innovation (Porter, 1990).

4. **Firm Strategy, Structure and Rivalry**
The last determinants according to Porter are regarding the firms’ structure, strategies and rivalry. He concludes that there is no universal managing strategy, and countries’ managerial methods are very dependent on the social and political climate in the country. Companies are probably more likely to succeed when the nature of the industry will benefit from the national environment. Another factor is the education of the population. What schools talented people choose and where they choose to work can affect an industry’s advantage. Often the talented people choose to develop skills in the areas where the people in the country put the most prestige. The domestic rivalry is maybe one of the most important factors for gaining competitive advantage according to Porter. Having many rivals within the nation’s border cancels out any gained advantages and drives companies to continue improving to create new advantages. While rivalry between a local firm and a foreign competitor appear distant and impersonal, competition with other firms in the same country creates a more personal dimension to the competition.

5. **Government and Chance**
Porter also notes two other factors that can affect all the four parts of the diamond: the role of the government and chance. According to Porter the general view of the role of the government is either to help or support an industry, or to accept a “free market” where the economy of the industry is left to manage itself. These two views are, according to Porter, incorrect. The government should work as an encourager, catalyst and challenger to the industry to raise aspirations. Creating an environment that supports the industry to move towards innovation and upgrading is done by encourage domestic rivalry, promote change and stimulate innovation. If the government is successful, the nation can gain competitive advantages. In the early stages, before a competitive advantage is reached the government may protect the industry, however it
is important not to protect the industry for too long (Porter, 1990). Chance also affects the industry. Unforeseen events without the firm’s control may bring both positive and negative effects to an industry (Carpenter and Dunung, 2011).
3. Method

3.1 Scientific approach

The choice of scientific approach and method is dependent on the specific subject of study and could be described as the tools used to obtain an answer to the research question. It includes means to gather and analyse information with the assistance of existing theories. Ideally the method should be chosen as a response to the purpose of the study in order to obtain qualitative results. Research approaches are either qualitative or quantitative to their nature. Qualitative studies aim at outlining and understanding occurrences where the results of the study will be expressed in words and sentences, as opposed to quantitative methods that are expressed in numbers and figures (Rienecker et al., 2002). With this thesis, the aim is to study the subject of foreign direct investment in Brazil with the help of several known factors that influence the attractiveness of a market to foreign investors. This specific subject may be approached in several ways, both qualitative and quantitative approaches are feasible, however as a scientific approach for this thesis the author has decided upon conducting a qualitative study based on secondary sources. A qualitative approach would be the most suitable to analyse and understand underlying reasons for the path the Brazil has been taking economically and what factors may be interesting to foreign investors depending on the specific firm motives. As studies often takes on a rather quantitative approach by conducting regression analysis methods when it comes to economic research the understanding of the amount of influence of each variable has on the topic of trade or FDI. This is a good method; however, it may not provide a very nuanced picture and understanding of a general environment as can be done by separating variables and describing them on its own. Hence, this thesis may compile and present information in a unique way in which perhaps other discoveries can be made. The aim with the chosen approach is to with existing information describe a phenomena or situation to increase existing knowledge and create a deeper understanding.

3.2 Secondary research

The theories and data presented in this thesis are based solely on secondary sources. This means that the author has not gathered any information from primary sources but rather basing the report on other studies’ results. This method allows the processing of data that is readily available at a low cost and with high efficiency. In some cases, using secondary sources may be the only feasible way of obtaining certain information. Expected limitations of this method are the information may not address the specific question of concern, the data may not be updated or at a low quality, the data may be hard to validate and research conducted in developing countries may be skewed or have missing values due to a lack of transparency due to strict government control.

In this case, he choice of scientific approach has been made due to a number of reasons: the subject of FDI is analysed using a number of factors and the determinants range between many areas of subjects i.e. macroeconomic, political and/or cultural, hence structuring and gathering of data would be a time consuming and costly operation and beyond the scope of
this thesis. As a second argument for using already existing data on this subject is that relevant data is readily available from several reliable sources and databases.

### 3.3 Data sources and collection of data

In a secondary research, there are several ways of searching for appropriate data. Depending on the subject the data may be collected from various books, websites, journals, organisations or statistical databases. A basic method of collecting secondary data is to break the research question down into useful keywords to search online and find relevant information. During this research, keywords such as “FDI+ determinants”, “FDI+ motives” and “Porter+ Diamond model” and “Brazil” have been used in different combinations. Searches for academic journals have mainly been conducted using the university library networks BILDA and KTH Primo, but also by using Google searches for articles and papers conducted by certain organisations. The searches have been limited only to show results in mainly English but also Swedish. During the selection of data sources newer sources have been preferred over older due to the increased relevance to today’s global environment.

The literature in this study can be sorted into two main categories: written reports and journals available online have mainly been used to build the foundation of existing theories presented in chapter 2, and data collected from databases online and presented in the result part. The data is collated from large corporation’s webpages such as the World Bank, Santander, PWC and transparency international. Because of the large amount of studies that exist on trade and FDI the selection of publicised material has been an act of balancing articles in journals and facts on various webpages. As reports in scientific journals provide facts that are perhaps more reliable and objective than information on the internet there might be a trade-off between quality of facts and recent updates of the situation which was noted during the collection of data. Many scientific studies that are relevant in subject are not published as recently as information from organisations that engage in investments in the regarded country. In the cases where more recent information was needed the author has made a judgement call only extracting information from well-known webpages to ensure reliability of the information provided. One way of validating the journals used has been to see where they have been published and primary select sources published by known organisations, where facts can be checked.

The raw data used in this thesis to evaluate the existing theories is collected from several databases that contain statistics on the relevant variables assumed to influence FDI inflows. These databases are well-known in this context and as compiling the data on each of the presented influencing factors requires tremendous resources and effort most studies use these readily available datasets rather than collecting original data. Organisations providing these types of datasets are typically large and international. The main source of data comes from the World Bank which has by far the most variables and extensive number of years covered in the area of purpose. The choice of using the World Bank in favour of other similar sources is the availability and a good reputation.
3.3.1.1 World Bank
The world bank provides a large amount of time-series data with the focus on global development. Data exist on both aggregates and individual countries. The databank is open access for internet users. In this thesis, the World Bank indicators (WDI) is the main source for the data input for the graphs displayed in the results.

3.3.1.2 UNCTAD
United Nations Conference on Trade and Development (UNCTAD) started 1964 as a permanent intergovernmental body with the focus on helping developing countries to integrate in the international trade and to close the gap between developing and developed countries by promoting trade and investment. UNCTAD provides a large amount of statistics on trade and investment. As UNCTAD does not provide an as wide range of topics as the World Bank does, this source has been used mostly for data on FDI, which is very well presented in the databank. In addition to the extensive database UNCTAD has also developed a framework for determinants of FDI which has been included in the theory.

3.3.1.3 IMF
The International Monetary Fund (IMF) provides several economic and financial data indicators in their open access databank available online. The databank contains numbers on exchange rates, inflation, growth and several other relevant indicators. They also publish reports and statistical studies frequently. In this thesis, no raw data has been collected from IMF for analysing, however in published reports IMF provides good information about the FDI in developing countries and some country specific reports that have been of interest for this thesis (see Adrogué, R., Cerisola, M. and Gelos, G., 2006; Garcia-Escribano, M., Góes, C. and Karpowicz, I., 2015).

3.4 Working process and analysing method
The method of analysing is done by establishing the scientific theory, assessing general motives and determinants for FDI which is outlined in chapter 2. The implications of this theoretical background are then assessed by deriving Brazilian data, mainly from the sources listed in section 3.3, for each variable to find possible strengths and weaknesses of the Brazilian market as a destination for FDI. The analysis is then based on trends and comparisons on each of the variables, by focusing on the development throughout recent years which might indicate in what direction Brazil is headed the outlined areas of importance. In some instances, there is also comparisons between Brazil and other, similar countries by using ranking systems or data since when deciding on FDI location firm’s usually compare markets to find an optimal location that suits the needs of the firm. To facilitate the replication of the tables and graphs presented in chapter 4 and 5 a table of the variables used and sources have been added in appendix A.

The process of writing this thesis has been passing through several steps. First, a general understanding of the main topics of FDI and the Brazilian economy to find a suitable point of
departure. This required a brief search in the internet for academic sources and news articles on developing countries, FDI and Brazil. Then narrowing down the sources to those relevant to the main purpose. Next forming the theoretical background with by formulating the motives for firms to engage in FDI. In this case the motives formulated by Franco, Rentocchini, and Marzetti (2008) and described in previous chapter has been used instead of the earlier motives formulated by Dunning (1993). This because as Franco, Rentocchini, and Marzetti (2008), points out a lack of clarity and that the issue of FDI might have changed between 1993 and 2008, when the articles was written due to the process of globalisation and technological advancements which would make a more recent theory more adequate to fit today’s FDI environment. Another advantage is that Franco, Rentocchini, and Marzetti (2008) in their study provides a very clear description of the different motives and what location determinants are important depending on what the motives of firms. For example, resource-seeking firms are looking to invest in locations where necessary resources are abundant. The FDI determinants used as a basis of assessing the issue is a collection from two main sources. Primary using the study by Demirhan and Masca (2008) due to their focus on developing economies. This study however also includes some variation of the determinants as the aim is to provide a broad perspective on the subject. For example, the fact that fixed telephone lines might not be as adequate of a measurement of communication infrastructure today as earlier due to the technological advances made where more people use cell phones as a substitution for a fixed telephone subscription. For this reason, cell phone subscriptions per 100 habitants have been added in the study. Also, soft infrastructure, and business climate, which was not included in the study by Demirhan and Masca (2008), have been assessed in this study since other research have found these variables significant. Combining the theoretical determinants by finding data and written reports on each of them in the context of Brazil are presented in chapter 5 and further divided and elaborated with the division into the three main motives of resource-seeking, market-seeking and non-marketable asset seeking in chapter 6.

The theoretical background used for the discussion chapter is Porter’s Diamond model described in detail in chapter 3 (also see Porter, 1990). This theory allows an industry or a region to be evaluated as a destination for investment on different macroeconomic, political and cultural levels. By using the widely-spread Diamond model as the framework for the discussion the competitive advantage of nations this thesis aims to understand factors that serves as an advantage for Brazil on the global market as well as what may impede FDI inflows. The thesis has been analysed in accordance to the motives of resource-seeking, market-seeking and strategic asset seeking which may affect the types of business and investments that are attracted to Brazil.

3.5 Quality criterion

In order to ensure quality of the literature some attention should be made with regards to the validity and the reliability of the selected sources. Considering the quality of the data used is especially important when using external secondary or tertiary sources where the author has very little or no chance to verify the data personally. There are some factors that should be considered when using data from external secondary sources such as who collected the data
and to what purpose, how and when was the data collected and for whom. Answering these questions may help in making sure that the conclusions drawn from it are accurate. According to Bapir (2012) the reliability in qualitative researches regards the methods and an evaluation of the consistency of the methods used. Validity concerns the representation of the data and how well the conclusion represents reality. Since the author has been reliant on second source information there has been few possibilities to validate the information in person. In order to increase the reliability some points have been considered: data used in the results has been derived from large corporations with the possibility to validate the information presented on their sites.
4. Case: Brazil

In chapter four the aim is to provide an overview of the economy of Brazil and the investment trends in recent years. The political situation which is closely linked to the current economic recession is described to lay the foundation for the analysis of FDI inflows into Brazil.

4.1 Demographics

Geographically, Brazil is large, it is the fifth largest country in the world per size, only surpassed by Russia, Canada, China, and the United States. It is also by far the largest country in Latin America and Brazil takes up almost half of the South American continent. The country shares common borders with all South American countries, with the exception for Chile and Ecuador and a coast line that stretches far towards the Atlantic sea (Baer, 2008). Officially Brazil is divided into five main regions (Figure 3): North, Northeast, Centre-West, Southeast and South. The country is also divided into 26 states and federal districts and it is important to note that regions are vastly different from each other in terms of climate, demographics and economically. The northern region is sparsely populated and to a large part consisting of the Amazonas rain forest, while the southern and south-east regions are more densely populated with metropolitan cities such as São Paulo and Rio de Janeiro. It is also in these big cities most of the industry is located. These regions are also the ones with the highest level of literacy and the difference between the regions in terms of wealth is remarkable. The northern region, which is the largest and covers 45% of the land area, is also the poorest. It had a GDP of 201,511,000 BRL in 2015 compared to 2,088,221,000 BRL in the South-east region and 622,255,000 BRL in the South (Duran, 2013). This uneven dispersion of income is also notable on an individual level as Brazil has a very distinct class system separated by monthly income. This is of course important for foreign investors to consider and requires a strategic plan to target certain classes in their marketing, and locate to areas where there is a concentration of the target class. The classes are simply divided, named A to E, where the A class earns above BRL 15,760 monthly, often has high levels of education and works in the fields of banking, management, entrepreneurship or are major landowners. On the opposite side of the spectra are the lower classes D and E consisting of low-skilled workers often earning minimum wages below BRL 1,576, such as unemployed people, street cleaners and housemaids. In later years, there has been an increase in income due to several efforts put into place by the government and the growth of the economy making the “lower middle class” (or class C) grow at the expenses of the lower classes. Today, class C is by far the largest income group in Brazil, about 47.5% (Fujikawa Nes, 2016).
Figure 3 Map of Brazil's states and regions source: http://www.graphatlas.com/brazil.php

4.2 History of FDI in Brazil

The Brazilian inclusion in the well-established acronym BRIC (Brazil, Russia, India and China) has in some ways manifested a position as one of the fastest developing emerging markets in recent decades along with the other three (PwC, 2013). Historically the economy of Brazil has passed several phases, which distinctively have shaped the country. Notably is that foreign investment has been highly regulated and restricted to only certain industries all through the 20th century (Baer and Rangel, 2001). Baer and Rangel (2001), distinguish three economic major phases since World War II and until the 1990’s. According to them Brazil saw some inflow of FDI prior to WWII, especially in banking but also in petroleum manufacturing, distribution and trade. During this era, the infrastructure was enhanced with a lot of help from foreign companies. The railroad system was built by foreign companies as well as the power generation and distribution. As a consequence of the world crisis and of nationalistic flows that were common during the 1930’s stricter regulations were introduced for foreign firms and the petroleum production was declared a state-owned monopoly in Brazil. The next era began in the 1950’s where most of the FDI was directed towards manufacturing. Especially good was it between 60’s and the oil crisis in 1979 where growth rates were over the global average. During this time, many foreign companies saw an opportunity and invested in Brazil. Nonetheless, in the 80’s Brazil experienced the worst economic crisis in the 20th century with negative growth rates and high inflation rates. The local currency was devaluated and this instability led to foreign actors withdrawing their
investments or leaving the country. The factors that led to the bad economic situation was high government debts to foreign countries. As Brazil and other countries in Latin America had borrowed money for infrastructure projects that lenders were willing to give due to the booming economy at the time. When the world went into recession in late 1970’s Brazil found itself unable to repay the debts, which kicked off a spiral of negative growth and hyperinflation. The crisis hit the country hard and lasted for many years. The 80’s are until this day referred to as the lost decade. During the 90’s, the era of neo-liberalism, a wave of privatisation swept through Brazil, mainly because of new, market-friendly policies from the government. During this period, there was significant growth of FDI not only due to the liberalisation and increased openness towards the rest of the world; the macroeconomic stability improved and made it more profitable to engage in business in Brazil. (Carpenter and Dunung, 2011).

4.3 Recent development

In the beginning of the new millennium Brazil was a hot topic in the discussion of foreign investment with a booming economy that distanced Brazil from the economic instability of the past. The people could enjoy better standards of living and foreign investors was attracted to the country that had previously been closed off and hard to get access to. This increased well-being of the country lasted for several years, up until 2014 when Brazil once again found itself in a severe economic crisis. In 2015 the economy contracted again with 3.8% and many Brazilians became unemployed. The recession has continued in 2016 but with less negative growth rates than in 2015. Not only is the country under a lot of economic pressures and instability but the financial situation is also severed by a deep political crisis that has shook Brazil to the core. The financial crisis was once again rooted in unwise government spending that lead to a fiscal deficit that went from 2% of GDP in 2010 to 10% in 2015. The story here is complex and deeply entwined with the political crisis and a corruption scandal concerning the government owned oil company Petrobras.

This unstable situation has been a concern for many investors and, as seen from Figure 4, after a sharp increase between 2009 and 2011 with a peak of around 6% the inflows decreased again as Brazil experienced the first signs of economic instability. In 2014 FDI increased again, perhaps because Brazil was hosting the world cup in Football. In 2015 the percentage fell again. This indicates that investors might have been looking at other investment locations and that the political and economic crisis discourage investors. Today’s FDI inflows mainly come from the Netherlands (20%), United states (12%), Luxembourg (11%) and Spain (11%) and the sectors, that are receiving the most is trade, oil and gas, telecommunications and automotive. The companies establishing in Brazil are mainly very large firms that engage in mergers and acquisitions (Santander, 2017). The strong points of Brazil according to Santander (2017) is the extensive resource of raw materials that can be accessed easily, a large labour pool of workers with different levels of educations and skills, diversified economy and a large domestic market. In some sectors, there have been very good developments and efforts have been made to establish industrial clusters to further enhance development and innovation. This as a national strategy to even out regional indifferences.
described in this chapter. One of these clusters is the automotive cluster, known as the ABC region, in the São Paulo region where several known car manufacturers are located together with supporting companies and technological universities. This incentive has created a specialized workforce that engage in new research projects and a well-connected infrastructure (Gray, 2015).

Figure 4 Total inflow of FDI in Brazil between 1995-2015 as a percentage of world total. Source UNCTAD
5. FDI determinants in Brazil

In this section the determinants of foreign direct investments will be analysed according to the Brazilian market.

5.1 Market size

Market size or market opportunity measured in GDP per capita is one of the more robust determinants of FDI according to the literature (Agarwal, 1980; cited in Wadhwa and Reddy, 2011). It may be self-evident that a large market has a positive effect on FDI inflows for foreign companies engaging in horizontal or market-seeking FDI since a large market brings a larger possible consumer base. The GDP per capita in Brazil has been growing rapidly over the past decades (see Figure 5); from $5,144 in 1996 just when Plano Real had been launched and the country tried to clean up their badly functioning economy, to $11,728 in 2014. The most significant increase can be noticed between 2002 and 2011 when GDP per capita more than four-folded to reach a max of 13,039 US$ in 2011.

![Figure 5 GDP per capita in Brazil between 1990-2015, measured in current US$ source: World Bank indicators](image)

After the peak in 2011 the GDP per capita sank slightly for the first time indicating that the standards of living were decreasing. This because of the economic and political crisis among other factors. As mentioned in the previous chapter one should be aware of the large social differences that lingers in Brazil where wealth is unevenly distributed between regions and individuals. Even though the standard of living has increased the annual growth rate of GDP per capita has been quite volatile since 1996 with a peak of 6.5 % in 2010. Since then the economy has slowed down reaching a negative low point of – 4.66 % in 2015.

Several studies also measure the market size with population or population growth as a proxy. The Brazilian market is large: the population is 208 million people in 2015 which makes brazil the 5th most populated country in the world after China, India, United states and
Indonesia. The population growth has been slowing down slightly from approximately 1.7% in 1990 to around 0.86% in 2015 according to the World Bank development indicators.

### 5.2 Macroeconomic stability

The Brazilian economy has been a subject of interest for macroeconomic studies for a few decades. In the 70’s the country experienced a boom and was expected by some to grow to become the world’s next economic power. During this period the country experienced high annual growth rates (Figure 6). Nonetheless in the beginning of the 80’s the economy was shook by the debt crisis that lead to falling growth rates and at times negative growth.

During the 80’s, Brazil’s economy experienced a great slowdown due to a severe debt crisis, leading to volatile and at time negative growth rates in the 80’s and 90’s. In 1996 the new currency Real was introduced and the economy improved, although affected by the economic crisis in 2008-2009 where growth rates dropped along with many other countries’ rates at the time (Adrogué, Cerisola and Gelos, 2006).

During the 1980’s Brazil experienced hyperinflation, reaching an extreme peak in 1993 of 5000%. In more recent years the inflation rate has been returning to lower rates with an average rate of 6.4 % between 1997-2015. The 2016 inflation target is 4.5 % (Banco Central do Brazil, 2017). The target has not been met as Brazil once again suffers from very high inflation rates (see figure 7). Most central banks set their inflation targets around 2 % as inflation rates higher than that can be very costly for the country (Miles and Scott, 2004). This concludes that the Brazilian inflation can be considered very high. The trend has been increasing over the past ten years reaching a peak in 2015 of approximately 9 %. And looking
at each year’s growth rate of the inflation from a longer, historical perspective, there is evidence of clear volatility (Figure 8). The driving forces behind this increase in consumer prices are realignment of regulated prices with market prices done through a depreciation of exchange rates but is expected to slow down in 2016 (Worldbank, 2017).

Figure 7 - Inflation in consumer prices (annual %) in Brazil between 2006 and 2015. Source: The World Bank - World Development indicators

Figure 8 - Inflation in consumer prices (annual change in percent) in Brazil between 1982 and 2015. Source: The World Bank - World Development indicators
5.3 Labour costs and conditions

The Brazilian average wage is 1,982 BRL in 2016. Wages of high skilled workers are 4,100 BRL, workers in manufacturing earns on average 2,010 and low skilled workers 1,200 BRL per month (Tradingeconomics, 2017). In recent years, the wage rate has increased and inequalities between income groups has decreased. Wage rates are also higher in the metropolitan areas such as São Paulo and Rio De Janeiro.

Workers have the right by national law to a minimum salary of 880 BRL/month. The work force is large, approximately 109.8 million (World bank, 2017) with a participation rate of 60.6 %, though a large proportion of the labour force is not formally registered. The resource of unskilled and semi-skilled is abundant, and however, highly skilled workers are in shorter supply. Many companies therefore offer in-house training and education for employees to reach skills that meet requirements. There are also several benefits that employees enjoy such as an additional compulsory 13th month’s salary as a Christmas bonus and many companies also provide their employees with health insurance, meal vouchers and the employer is also obliged to provide employees with transportation vouchers to and from work. (PWC 2013)

As the cost of labour is an important factor in both resource and market seeking FDI, but perhaps more so in labour intensive industries such as manufacturing, how the host country compares to other countries in terms of labour costs is important. A report made by Boston consulting group compared costs in the manufacturing industry in the world’s top 25 exporting countries, in 2004 compared to 2014. The study compared the 25 countries in terms of labour costs (adjusted for productivity), costs of electricity and costs of natural gas as well as the currency exchange rate compared to U.S. dollar. Brazil showed a sharp increase during the period, from being one of the countries with lower costs in 2004 to one of the more expensive countries in 2014. In fact, the cost of manufacturing in Brazil is similar to those in developed economies such as Belgium, Switzerland and France. The other BRIC countries all have lower costs of manufacturing mainly due to lower labour costs, which is also the case with Mexico which is the other manufacturing country in Latin America. The fact that the cost of manufacturing costs has become less competitive in Brazil has put the country under pressure. The increased labour costs is not necessarily tied to better educated workforce but to the stabilised economic environment that have more than doubled wages in manufacturing over the period and helped people escape poverty. Even though higher wages are generally a good sign of economic development there are evidence of a low productivity rate (value added per worker) that has only increased slightly over the period. The low productivity growth can be attributed to bad access to skilled workforce, underinvestment, low-quality infrastructure, and a both complex and costly institutional framework for operating businesses (Sirkin, Inser and Rose, 2014).

5.4 Trade openness

Using trade intensity (sum of exports and imports over GDP) as a measure of trade openness and comparing with countries in the same income group as Brazil (upper middle income), there is a significantly lower ratio in Brazil than in the other countries. Imports and exports
constitute roughly 25% of GDP whereas the global average is approximately 95% according to World Bank data. This makes Brazil one of the most closed economies in the world, which is evident by the fact that very few Brazilian companies export their products and the products produced in Brazil have a very high domestic value added both in raw materials and manufactured products, meaning most of the produced have a high local content.

One of the arguments for this closedness has previously been the size of the country as larger economies tend to have a lower trade share of GDP ratio, an argument that lately has been questioned as inadequate as all economies larger than Brazil have a higher rate. Similar results have been shown in OLS regressions where only 15% of the standard deviation from the mean could be explained by the size of the Brazilian economy (Canuto, Fleischhaker and Schellekens, 2015).

![Figure 9 – Comparison of trade intensity in a selection of countries in the upper-middle income group. Source: The World Bank - World Development indicators](image)

For Brazil, specifically, the amount of trade as a fraction of GDP increased steadily from 1998 and reached a peak in 2004. Between 2008 and 2009 there was a significant drop during the economic crisis and since then the trade has increased slightly.
Figure 9 – Trade density exports and imports as a percentage of GDP for Brazil period 1996-2014. Source: The World Bank - World Development indicators

There are several reasons for this situation, low import and export rates and very high domestic value added content, but mainly the explanation stems from bad integration into international supply chains, where Brazilian companies have stood alongside the second wave globalisation. But also, high transaction costs and an environment that favours locally produced content are a part of the explanation to this situation Canuto, Fleischhaker and Schellekens, 2015).

5.5 Business environment

The Brazilian business environment is known to be quite good for foreign investors as the government generally does not make any distinguishes between Brazilian and foreign companies in terms of rules and regulations. Some industries are regulated for foreign investors such as health, mass media, telecommunications, maritime, aerospace and air transport sectors. On the other hand, there are industries where investments are sought out and encouraged such as automobile, renewable energy, life sciences, oil and gas, and transportation infrastructure sectors. In these cases, there are extra favourable conditions for investing as it will boost innovation and hopefully enhance growth (Export.gov, 2016).

There are aspects that serve as barriers when opening and operating business in Brazil. For example, the time it takes to open a new business can be seen as a hurdle: on average the process takes 80 days in Brazil compared to an average of 31 in Latin America and the Caribbean and 30 in the upper middle income group (the world average is 21). This is due to a complex bureaucratic procedure. The number of procedures required to open a business is also higher than average in Brazil. On the other hand, the average cost of opening a business is lower.
Ease of doing business index indicates that Brazil is harder to make business in than average in the region, income group and world. The index ranks economies from 1 to 190. A high ranking (a low numerical rank) means that there is a good regulatory environment for business operations (see Table 1).

<table>
<thead>
<tr>
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<td>7</td>
<td>27</td>
<td>26</td>
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Table 1 – Indicators of Business regulations, cost and environment for Brazil, Latin America (average), Upper-middle income group average (as defined by World Bank) and the world average for years 2016 and 2017. Source and definition: The World Bank - World Development indicators

5.6 Infrastructure

There are several measurements of infrastructure that can vary both in amount and quality. When assessing the physical infrastructure in Brazil the country ranks poorly compared to its major competitors (Garcia-Escribano, Góes and Karpowicz, 2015). The physical infrastructure network is strongly characterized by regional differences where the most crucial mean of transport is the highway network. Highways freight alone stands for 60 % of all goods transport in the country. Metropolitan areas such as São Paulo and Rio de Janeiro and the richer southeast regions have access to higher quality roads while some regions have fewer multilane paved roads.

The World Economic Forum’s global competitiveness report assesses the quality of the infrastructure in Brazil 3.6 on a scale from 1-7 while simultaneously listing it as the biggest barrier for doing business in the country (Schwab, 2013).
<table>
<thead>
<tr>
<th>Indicator</th>
<th>Value</th>
<th>Rank (1=best, 148=worst)</th>
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<tr>
<td>Quality of overall infrastructure</td>
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<td>114</td>
</tr>
<tr>
<td>Quality of roads</td>
<td>2.8</td>
<td>120</td>
</tr>
<tr>
<td>Quality of railroad infrastructure</td>
<td>1.8</td>
<td>103</td>
</tr>
<tr>
<td>Quality of port infrastructure</td>
<td>2.7</td>
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</tr>
<tr>
<td>Quality of air transport infrastructure</td>
<td>3.3</td>
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<tr>
<td>Quality of electricity supply</td>
<td>4.8</td>
<td>76</td>
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</tbody>
</table>

Table 2 – Indicators of Physical infrastructure in Brazil, source: World economic forum – World competitiveness report 2013-2014 (Schwab, 2013)

Investments in telecommunications and electricity have been large in more recent years and here Brazil scores better than some competitors. Although the number of fixed telephone lines per 100 habitants seem to have stabilized around 20 (see Table 2), the number of mobile cellular subscriptions have increased rapidly since the beginning of the 90’s. There is also some evidence of a growing number of Internet users which indicates better possibilities for communication.
Following the six dimensions of institutional quality provided by the World Bank show that Brazil ranks the highest in voice and accountability which indicates that the members of society have a possibility to select their own government and the possibility of freedom expression, freedom of association and free media. The political stability has been worsened in 2014 and the government has also become less effective than in previous years. On the other hand, Rule of law has improved but still in the negatives. Control of corruption has also decreased over past years which is in line with data from transparency international corruption perception index (CPI) where Brazil has experienced an increased problem with corruption, ranking 76 among all countries in the world in 2015 with a score of 38 compared to 43 and 42 in 2014 and 2013 respectively where 0 indicates high corruption and 100 indicates a perception of low corruption (Transparency International, 2015).

Comparing Brazil with countries within the same income group (Upper-middle income) Brazil ranks higher than average in terms of Voice and Accountability (VA), slightly higher in Regulatory Quality (RQ) and Rule of Law (RL). However, in terms of Political stability and lack of violence (PV), Government effectiveness (GE) and Control of corruption (CC) places Brazil lower than average (World Bank: World Governance indicators, 2017).
5.7 Tax incentives

The Brazilian tax system is known to be complex. Various taxes are charged at federal, state and municipal levels. For this reason, foreign companies in Brazil are advised to seek professional assistance before investments in the country. There is also an extreme inefficiency of the system due to bureaucratic procedures. Simplified the Brazilian income tax is charged at 15%, adding to this is a surtax of 10% when profits exceed 240,000BRL a year. Lastly there is a social contribution imposed on corporate profits charged at 9% (EY, 2016). The time it takes to prepare, file and pay value added taxes in Brazil exceeds the average of Latin American countries by far. In Brazil, the average number of hours per year is approximately 2,600 compared to 361 in Latin America and 176.6 in the high-income OECD countries. Out of 189 countries investigated Brazil ranks on place 178 (1 best 189 worst) when it comes to the rate and administrative burden of doing taxes which is a combined score of the time, total tax rate and number of payments necessary for a local medium-size company to pay all taxes. (World Bank - Doing Business, 2016)

There are incentives that the government in Brazil has in place for foreign investors in the country. These incentives are depending on the location and industry of the investment. For example, the Manaus free trade zone, incentives for infrastructure projects, oil and gas industry and automotive industry. Incentives from the municipality level exist in the form of value-added tax and service tax incentives in the fields of energy, logistics and transportation (Teixeira Junior and Maruch, 2014)

Though, location and industry dependent tax incentives exist there are no special federal incentives to attract foreign investments and local and foreign investors are equally treated. There are no tax heavens. The incentives that exist are to be approved by government
agencies that will promote projects that contribute to the development of a region or the diversification of an industry. Brazil has negotiated tax treaties with several countries, Sweden included since 1975. These tax treaties serve the objective of relieving corporate and individual income tax from double taxation. This by stating that income derived in Brazil only should be subject to Brazilian income tax (PwC, 2013).
6. Analysing the motives

*In the following chapter the resource-seeking, market-seeking and strategic asset-seeking motives for foreign direct investment will be further explored by evaluating the determinants from chapter 5.*

The compiled information in the previous chapter provides an overview of the determinants that may be influencing the FDI inflows into Brazil. While some of the indicators are more heavily linked to market seeking FDI, for example market size, other indicators are more relevant for resource seeking FDI, such as the potential access to raw material, cheap labour and possibility to import and export components to a decent cost. Some of the factors are relevant for both motives so the type of business is relevant for the weight of each factor in the choice of location choice of investment. In the following analysis of the determinants presented in previous chapter will be analysed based on the three motives outlined by Franco, Rentocchini, and Marzetti (2008).

6.1 Resource seeking

Brazil is a country with resources of interest for many foreign investors. The country is rich in natural resources such as mining and forest products that can be exploited by foreign multinationals. However, these are not the main sectors for foreign investment, instead most inflows go to oil and gas, automotive and trade related businesses which are promoted sectors for foreign investments by the government. For resource seeking FDI labour related determinants are important for possible investors. Undoubtedly, Brazil can be of interest in this case as it has a large population and a labour force with different levels of education and skills. When examining the location choice of FDI inflows the focus is on three main factors: real cost, abundance and productivity of the relevant resource. Since this study will not go into any specific industry this analysis will focus on the labour supply as a resource. The wage rate in Brazil is ranging depending on the position and educational levels and tend to be higher in metropolitan areas. There is a minimum wage that companies must fulfil to pay the employees and additional benefits are often expected. Brazil, which for a long time has been viewed as a low-cost country for manufacturing has in recent years become more expensive compared to other countries. When more closely looking at what constitutes the increase in costs of manufacturing, it is mainly the cost of labour that is higher than in similar countries. Albeit the positive effects of a large labour pool, Brazil is in fact, close to the costs of many western countries in terms of production, more expensive than the US and the UK and only a little cheaper than France and Switzerland. This fact, the risen cost of manufacturing has eroded some of the cost advantage that Brazil previously was known for as an emerging market. The reason for this loss of cost competitiveness is the increase in wages, generally a good sign of development in a country, however a negative factor for investors in labour intensive industries. Also, Brazil has been suffering from slow productivity growth which also is considered negative for investors. Other factors that might impede investments in manufacturing sectors are the cost of electricity and costs of natural gas which has more than doubled since 2004. Brazil traditionally has restrictions on manufacturing companies in the country, complex bureaucratic procedures which may further complicate the situation.
Looking further at the productivity of manufacturing sectors, there the connection between productivity and FDI is positively linked. Investors want “value for the money” and comparing Brazil with other countries, there is a lower productivity which affects the inflow of FDI in Brazil negatively. The growth in Brazil has to a larger extent been caused by an increase in employment than productivity, and as labour is becoming increasingly expensive and supply becomes scarcer, the productivity challenge is a concern for the future of FDI in Brazil. A large labour pool is a positive attribute for foreign companies in labour-intensive industries. Depending on the type of FDI and industry, the access to labour might be either a barrier or an incentive; low and semiskilled workers with a willingness to work can be found while highly educated workers are harder to find. For companies that do not require especially skilled workers, Brazil may be attractive from a labour abundance perspective but not as much from a labour productivity perspective.

6.2 Market seeking

There is, as mentioned, a consensus that one of the most robust determinants of market-seeking FDI inflows are the size and potential of the market. A large market has a positive effect on FDI since companies considering an expansion to new markets recognize the potential of a large consumer base. In order to approximate the size of the market, measurements of the GDP per capita and population are used. Recognised is that in some instances investors may prefer growing economies to large. The Brazilian market is large, the population is large, and in recent years the standard of living, measured by GDP per capita, has increased at a relatively high rate apart from 2014 and 2015 when the growth rate not only slowed down but turned negative, indicating a decreased wealth among the population. Overall, the GDP per capita growth rate has been far from stable since 1996 with both high peaks and negative growth rates. The volatility may cause insecurity for potential investors since the economic environment is harder to predict. The main incentive for foreign investors in Brazil seems to be the potential of the market. This is evident when looking at what type of companies are expanding into Brazil and their operations in the country. There is some evidence that horizontal FDI is the dominant form where companies establish local companies in the country of the market and not only a fragmentation of the supply chain. The market potential is the biggest incentive and other than that, there seems to be more the potential of Brazil rather than the current environment that attracts foreign investors. Investigating Brazil as an export platform to reach other countries in the region, there are some benefits: Brazil has common borders to almost all the other countries in Latin America which is supposedly positive. Here also the labour cost and the differences in regulations and development compared to neighbouring countries matter and also regulations regarding trade openness.

The theoretical approach to trade openness in literature has been mixed, and some researchers advocate a theory of tariff-jumping FDI where foreign investors establish local offices in the host country to reach the market without having to pay tariffs for imports. Even though trade has been less restricted, and government policies do not affect foreign companies in a negative way compared to Brazilian, there is no doubt that Brazil still has a very low openness to trade compared to the peers in the same income group. A fact partially explained by a bad
integration into international supply chains. Even though Brazil is mostly reliant on domestic production of goods and services there are possible gains from integrating more in global trade. The World Bank states that this could increase the competitive advantage as it opens for cheaper inputs and could increase productivity, which as stated, is low in Brazilian companies. Producing goods with a competitive advantage could for a company mean a way to sell goods cheaper and hence capture a larger market share.

6.3 Non-marketable asset seeking

Investigating whether Brazil is attractive from a strategic asset seeking perspective the first point to analyse is the infrastructure where the results are a bit mixed. In terms of physical infrastructure, the regional differences are an important factor. The quality tends to be higher in the richer regions, especially in the metropolitan areas in the south and southeast. These are also the areas with the most FDI inflows. Looking at the infrastructure in place in Brazil the results are quite mixed; telecommunication and internet availability seem to be better developed than transportation infrastructure where most developments of roads, railways, ports and airports are of mixed quality. The uneveness of the development of hard infrastructure, where richer regions in the south and southwest are richer and better developed could possibly serve as a barrier for FDI. As infrastructure is ranked as the biggest hurdle for FDI and business in Brazil in general this determinant should be considered carefully. For companies that are export oriented the lack of quality infrastructure may be even a bigger hurdle. In terms of institutional infrastructure, which also is an important factor in this case, Brazil ranks worse than average in both government effectiveness and control of corruption which is currently mirroring the ongoing political crisis and corruption scandal that begun in 2014. To an even higher degree scientific infrastructure is more relevant for non-marketable asset seeking FDI such as university-industry links, exemplified by a MNE locating where there is good relationship between industries and higher education centres, that leads to investors having a larger and better educated labour pool to employ from. In Brazil, the level of education has been rising with more people attending universities theoretically increasing the level of scientific infrastructure.

Another barrier that has been lifted in the results, and affects companies independent of its incentive to operate in Brazil, are the extensive bureaucratic procedures that slows down effectiveness. Both the process of paying corporate taxes and the operation of starting a business takes a long time and assistance is advised for foreign companies to pay taxes which in that case is an extra cost for any company. The tax rate may according to literature not be of highest importance as Brazil has other factors that make the country attractive to foreign investors such as a big domestic market that may make up for a higher corporate tax.
7. Discussion: Porter’s Diamond

In this discussion, the determinants and will be discussed in the theoretical context of Porter’s diamond model.

The interest in the Brazilian market can be explained to some extent with Porter’s diamond model. The notion that a nation’s comparative advantage stems from its ability to upgrade and improve. As FDI generally flows from developed countries to other developed countries the key argument is that as Brazil improves its competitive advantage and growth and hence draws new investors into the country. Following is an analysis of each of the cornerstones of the model from a Brazilian perspective.

7.1.1 Factor conditions

Factor conditions are the conditions within a country that companies can exploit to create an advantage for example access to resources or labour. In terms of factor conditions Brazil has a large labour pool, however a large part of the population is low or semiskilled but concerning workers with higher degrees the resource is more scare. According to Porter advantage is gained from ability to upgrade and innovate, and thus the skill set of the population is of vital importance. Following the theory of Porter, that the quality of the factor conditions is more important than pure existence, Brazil may want to seize the opportunity to increase the skills of the labour. Hence, Brazil should put focus on that qualitative aspects and provide platforms necessary for innovation and development. The infrastructure is also an important factor when providing suitable factor conditions. In Brazil, the basic infrastructure is lacking in many places; railroads and ports are not as developed as in other emerging markets and most transports are carried out on highways. On the other hand, investments in telecommunications has created a good communication network and the broadband network is also accessible for most citizens and companies. There are also important tax incentives for investing in certain sectors that the country is in dire need of, infrastructure and energy production for instance. Following the theory of Overseas Development Institute (ODI) (2007, cited in Demirhan and Masca, 2008) where poor infrastructure may in fact be a potential opportunity for foreign companies in that sector. With regards to the efforts made by the government to attract investors to the infrastructure sector in terms of tax exemptions this, however, can be turned into an investment opportunity instead of just a barrier.

7.1.2 Demand conditions

As the standard of living has increased in Brazil it could logically increase the demand for other types of goods and a broader variation of consumer goods, which are not necessary goods or services such as food and shelter. Because of the large population the Brazilian demand market is very large and growing. This may open new types of business opportunities that foreign companies should want to access. Higher incomes create higher demands of more qualitative products and more varieties to choose from. The growth of the middle-class, and the fact that millions have been lifted out of poverty has supposedly a positive effect on the demand. There are also attractive export possibilities due to the shared
borders to most South American countries which could make firms establish with the objective to reach the whole region.

Looking at the growth of the Brazilian market in terms of GDP per capita there was a strong growth until recent years when the economic and political crisis hit Brazil which among other things for example lower demand for Brazilian raw materials in other countries.

7.1.3 Supporting industries

Supporting industries concerns local suppliers’ capabilities and in many cases the presence of local clusters have a positive effect. In this case the supporting industries differ between industries of concern. Once again there are some concerns with the lack of infrastructure that may be hindering shipments and logistics of products but may also be an incentive to locate nearby the firms upstream and downstream the supply chain. As most companies are establishing in the metropolitan areas one can expect some clustering effects where supporting industries are more developed. But also some industrial clusters are present and since there is a high level of domestic value added, indicating that there are supporting industries that can provide the necessary inputs in the country. This is for example true with the Manaus free trade zone where many companies are located and the ABC region within the greater São Paulo region.

7.1.4 Firm strategy, structure and rivalry

With high competition companies are forced to continuously improve in order to stay competitive on the market. With establishments of foreign companies, the competition will rise according to existing macroeconomic theories. The increase in competing companies is beneficial to the consumers that will enjoy a wider range of products and to lower prices. Typical structures of Brazilian companies are

This factor is hard to analyse from an aggregated economic view since different industries are subject to different types of rivalry and intensity. The environment of starting a business has both positive and negative effects in Brazil. Positively is that the government regulations do not distinguish foreign and domestic firms in terms of regulations and taxes. This creates a positive competitive environment where national and international firms compete on equal terms. There are also positive effects coming from the deregulation procedure undertaken by the government in recent years that has opened the country to MNE’s and theoretically has a positive effect on attracting foreign investors. A disadvantage in the procedure of establishment of new companies is the extremely complicated bureaucratic procedures for opening and operating in Brazil together with the tax system which is equally complicated and requires extra attention.

7.1.5 Government and chance

As Porter mentions in his diamond model there are additionally two categories that are linked to each of the four main factors; Government and chance. The government has an important role in creating a good environment where the Brazilian economy can flourish and attract potential investors. At current state with a large political crisis attached to an unstable
economic environment this might have a negative effect which can also be seen in chapter 4 and 5 where growth rates, and wealth (GDP per capita) and share of FDI inflows have slowed down significantly since the start of the crisis while inflation has increased rapidly creating an overall unstable environment economically. Without a fully working government Brazil will have a hard time improving the economic situation. The acute situation may hinder the government from focusing on encouraging innovation and create a healthy business environment even though the as mentioned in above section there has been some work towards opening the Brazilian market to foreign investors in recent years. Recent literature strongly states that there is a need for Brazil to regain the stability and as fiscal results improve and inflation starts to decrease the confidence will return as well as the growth, making Brazil attract more investors. Macroeconomic stability historically has been crucial to the country’s success. Literature suggests several budget reforms and tighter monetary policy in the future for a sustainable growth.
8. Suggestions for further studies

This study is limited to only describing the general view of the FDI climate in Brazil which opens for several interesting ways to narrow the area of focus in further research. The determinants are selected on a general level and may not be equally relevant to the Brazilian market than to other markets. As an opportunity for deeper insight each variable can be more thoroughly investigated by significance in the Brazilian context specifically. Focusing on certain areas of development in certain sectors such as infrastructure or education could also be interesting as well as the extensive corruption’s effect on investors. Knowing exactly what determinants are most important for investing firms could be studied at firm level. Similarly, the specific motives of firms investing in Brazil could be further elaborated and studied, which could give indications on what areas Brazil should focus on developing. As the Brazilian economy is currently quite volatile, the implications from the economic variables could be an interesting subject of further studies, as well as possible policy changes.

8.1 Generalisation of the results

The aim with this study is to contribute with special knowledge about Brazil as market for FDI inflow. As many studies before this has already pointed out is that the motives for foreign investors differ from case to case as well as the specific determinants for certain locations. Additionally, the case presented merely serve as an overview and the significance of each determinant is yet to be tested. It is very hard to make generalisations of the situation but may provide a view on the current situation where Brazil’s opportunities and challenges lie in the future.
9. Conclusion

This thesis aims to investigate the climate for foreign direct investment in Brazil which is one of the most discussed emerging market in recent years. The study aims to provide basic knowledge of the Brazilian market to foreign investors and policy makers by using key variables that has been proven to be important when foreign firms evaluate investment locations. The fundamental contribution to current research is the use of Porter’s diamond model in pinpointing the strength and weakness of Brazil as a host country for FDI depending on firm motives. By using a variety of economic measurements together with the current political and economic situation this study distinguish itself by focusing on several measurements on a general level as opposed to studying only one or a few key variables. The analysis has been done using the known motives for foreign investors for establishing in new markets, a selection of determinants for foreign direct investments and the Diamond model developed by Michael Porter. Found was that the Brazilian market size has potential in terms of demand conditions that mainly attracts market seeking FDI, with a large consumer base that have become richer in later years. This large population has an additional benefit creating a large labour pool of various levels of skill. During the work with this thesis there are, however some challenges that have been constantly brought up and needs to be improved in order to attract FDI to the country: first, there is a lack of qualitative hard infrastructure and where existing infrastructure is not well connected to all parts of the country. Roads, railways and ports are of mixed quality and are especially lacking in rural areas. This is an important drawback since infrastructure is concerned to be one of the most important factors when considering establishment in a new area. Qualitative physical infrastructure gives incentive not only to reach the whole market with goods and services but also to use the location as a distribution centre and reach other countries in the region. The size of both Brazil and neighbouring markets requires good infrastructure since distances are large. The benefits obtainable by a good transportation network is the ability to reach a larger part of the consumer base and lower operational costs. Through the analysis process it was this, market-seeking aspect, that seemed to attract investors to Brazil to the largest extent. Nevertheless, there are also arguments that this need for better infrastructure may be a way of attracting foreign companies in that particular sector. The second big issue is the economic stability that might deter from investing. As Porter noted in his work, the government always has an important role to play in creating a suitable environment for FDI in terms of policies. For example create platforms for innovation and exchange of knowledge, since that enhances development which in turn may attract investors. The current state of the Brazilian government does not favour any investments due to the economic crisis, partly because of unwise government spending and political scandals. This creates uncertainty that may deter investors to enter the country since the outcome of the investment is harder to predict. Overall, some changes to the tax system and facilitating the operations needed to open a business could help foreign companies to establish and remain in the country. Important to note is that today’s global economy creates unforeseen events that affects the Brazilian economy in ways that cannot be expected beforehand. External shocks in home countries or other parts of the world may increase or decrease the inflows of FDI and make demand rise or fall. Hence, the future of the Brazilian economy can never be fully outlined.
10. Bibliography


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## Appendix A - List of variables

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<th>Label</th>
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<td>Total inflow of FDI between 1995-2015 as a percentage of world total.</td>
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<td><strong>Inflation</strong></td>
<td>The World Bank, World development indicators</td>
<td>Inflation in consumer prices (annual %) between 2006 and 2015.</td>
</tr>
<tr>
<td><strong>Inflation growth</strong></td>
<td>The World Bank, World development indicators</td>
<td>Inflation in consumer prices (annual change in percent) in Brazil between 1982 and 2015.</td>
</tr>
<tr>
<td><strong>Trade intensity (comparison)</strong></td>
<td>The World Bank, World development indicators</td>
<td>Comparison of trade intensity (Trade as a percentage of GDP) in a selection of countries in the upper-middle income group.</td>
</tr>
<tr>
<td><strong>Trade</strong></td>
<td>The World Bank, World development indicators</td>
<td>Trade intensity (exports and imports as a percentage of GDP) period 1996-2014.</td>
</tr>
<tr>
<td><strong>Business environment</strong></td>
<td>The World Bank - World Development indicators</td>
<td>Indicators of Business regulations, cost and environment for Brazil, Latin America (average), Upper-middle income group average (as defined by World Bank) and the world average for years 2016 and 2017.</td>
</tr>
</tbody>
</table>
| **Physical infrastructure**  | World economic forum – World competitiveness report 2013-2014        | Indicators of Physical infrastructure which takes on values between 0 and 7. Additionally ranking countries globally.  
|                               |                                                                       | • Quality of overall infrastructure  
|                               |                                                                       | • Quality of roads  
|                               |                                                                       | • Quality of railroad infrastructure  
|                               |                                                                       | • Quality of port infrastructure  
|                               |                                                                       | • Quality of air transport infrastructure  
|                               |                                                                       | • Quality of electricity supply |
| **Communication infrastructure** | The World Bank - World Development indicators                     | Historical growth of communication infrastructure years 1997 and 2015 by:  
|                               |                                                                       | • fixed telephone subscriptions (per 100 inhabitants)  
|                               |                                                                       | • Internet users (per 100 inhabitants)  
|                               |                                                                       | • mobile cellular subscriptions (per 100 inhabitants) |
| **Institutional infrastructure** | World Bank, World Governance indicators,                          | Percentile rank of institutional infrastructure indicators in Brazil and Upper middle income group (average) 0 indicates lowest rank and 100 highest rank (best) among all countries. |
| **Tax (administrative burden)** | World Bank - Doing Business, 2016                                | Ranking of the administrative burden of doing taxes, measured in time taken (hours per year to prepare), total tax rate and number of payments necessary for a local medium-size company to pay all taxes. |