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An abundance of oil is good news — but how to avoid the "resource curse" and manage the revenue effectively? The contemplated Social Fund of the Pre-salt Oil Revenues is one option. By stabilizing oil revenues and offsetting their inherent volatility, such sovereign funds are a form of self-insurance. Rules on investment and spending can also minimize political problems. But much depends on what those rules are, who puts them into practice, and how independent the funds are.

IBRE Outlook 2010: The best performance of the decade

Although this year is likely to be the best so far this century, IBRE's experts explain to Liliana Lavoratti that there are still many unanswered questions — such as whether the goal of a primary surplus of 3.3% of GDP can be reached without major sacrifices.

Interview: A bank for Brazil

Banco do Brasil (BB) plans soon to become one of Brazil's three largest real estate lenders. Its CEO, Aldemir Bendine, tells Klaus Kleber how the bank plans to go about this; how it is integrating its most recent domestic acquisition, Nossa Caixa; and what its international plans are.

The 2010 elections

After reviewing how the Brazilian economy reached its current status, Fernando de Holanda Barbosa says that in the 2010 elections, "The voter will not be asked to choose between economic models but rather to choose who will best manage the one we have had for three administrations."

Rising Brazil: Implications for the United States

Foreign policy commentator Matias Spektor explains that "Brazil and the US are not natural allies — shared interests on their own do not automatically produce alliances." That is why "A working partnership, if it is to exist at all, must be engineered."

Brazil's economic and financial indicators

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Program Administrators: Kevin Kellbach and Ray Marin

Address
Duquès Hall, Suite 450
2201 G Street, NW
Washington, DC 20052
Tel.: (202) 994-5205 Fax: (202) 994-5225
ibi@gwu.edu

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Klaus Kleber
Fernando de Holanda Barbosa
Matias Spektor
Aloísio Campelo
Salomão Quadros



Claudio Conceição

Managing Editor
claudioconceicao@fgv.br

Since the financial crisis spread throughout the world in 2009, Brazil appears to have met the conditions necessary to return to the path of growth. This year, when it completes nine consecutive years of GDP growth, the rate should be the best of the decade at about 6%, according to forecasts from economists at the Brazilian Institute of Economics (IBRE), Getulio Vargas Foundation. Expansion will continue to be fueled by private and public consumption but will also need to count on larger investments from now on. Investments have been recovering since the last quarter of 2009, according to IBRE's statistical models; the investment-to-GDP ratio will return to the 2008 level of about 19% by the end of this year. However, for solid and sustainable growth, Brazil's investment-to-GDP ratio should be around 22%.

According to IBRE forecasts, the manufacturing industry should attract the most investments, with growth of 8.30% this year compared with 5.10% for agriculture and 5.90% for services. More encouraging data: installed capacity utilization increased for the ninth consecutive year in December, highlighting progress in the last half of 2009 from 79.9% in July to 83.8% in December. At the same time, the capital goods sector increased from 77.9% to 80.9%.

The decrease in real interest rates and the strengthening of the intermediate and capital goods sectors is likely to push industrial capacity utilization to about 86%, which is above its historical average. In addition, low unemployment and creation of formal jobs will expand incomes and thus household consumption. A key question in an election year remains: Will price increases lead the central bank to raise interest rates, which would slow growth? It is possible that this year's elections could have a negative impact on growth.

A complete analysis of the outlook for 2010 is the main theme of this issue.

Social fund for oil revenues: Valid option, but not a panacea

The discovery of giant pre-salt offshore oil reserves brings to Brazil the traditional dilemma of countries that are major oil producers: On the one hand, an abundance of oil is good news; on the other, it requires an institutional framework that minimizes the significant fiscal and exchange rate risks that characterize the "resource curse." One major component of the institutional framework to manage oil revenues in Brazil is the Social Fund of the Pre-salt Oil Revenues that draft law 5,940 of 2009 would set up. The fund would be a stabilization sovereign wealth fund like those established by several countries that enjoy significant revenues from oil or other natural resources.

Fiscal policy must take into account the fact that oil prices — and therefore revenues — can vary widely, but public expenditure tends to be stable, with a high degree of inertia. Since the end of the 20th century Brazil's public spending has been increasing. A government heavily dependent on oil revenues is subject to periods of alternating financial abundance, with the associated risks of waste, and penury, which presents fiscal problems. At all three levels — federal, state, and local authorities — Brazilian government revenues from oil are projected to reach 1.6% of GDP in 2024 and 2.7% when production peaks in 2034. Such large and potentially volatile oil revenues raise considerable fiscal risks that should be addressed beforehand.

Insurance — Sovereign funds are used to stabilize oil revenues and offset their inherent volatility. In other words, they are instruments of self-insurance. The fund ensures that revenues do not fall when oil prices decline, preventing drastic cuts in government spending. Also, the funds promote intergenerational redistribution of oil resources. Since oil and other minerals are nonrenewable resources, the fund makes it possible to accumulate savings for future generations.

Sovereign funds help to manage Dutch disease — the loss of international industrial competitiveness that results from exchange rate appreciation caused by large oil-related inflows of US dollars. The funds often use part of the oil revenues to buy foreign assets to help relieve exchange rate appreciation.

Political cycle — Political competition tends to lead the government to pursue a looser fiscal policy. When oil revenues are exceptionally large, the administration of the day may seek to spend at a faster pace than is ideal. The opposition, with the prospect of coming to power, will seek to suppress use of those resources to a level below the ideal. Thus because of the policy cycle, intertemporal competition for resources will lead to suboptimal public spending. This problem becomes worse the less political stability a country has and the less mature its institutional development, the fiercer the competition between political groups, and the less social control and transparency there is in the collection and use of resources.

Sovereign wealth funds aim to minimize such problems, segregating oil revenues in an account where they are subject to rules on investment and spending that seek to balance

conflicting political and group interests. They can be structured in a variety of ways. Some may have rigid rules for both investment and end use of funds resulting from oil revenues; others are more flexible.

Flexible quantitative rules make it easier to adjust to unexpected shocks. If a natural disaster or social upheaval occurs, the system can respond much more quickly. In such situations very rigid rules for investing the funds could prevent their socially optimal use. Also, rigid rules cannot stand up to governments (especially those with great popular support) that are willing to bend the rules. The risk then is that the institutional environment and the protection of agreements will become even more unstable. It is also clear, however, that quantitative rules that are too flexible would destroy the main function of the fund, which is to balance the spending of oil revenues over time.

Qualitative rules define the destination of resources, limiting the power of the government to allocate resources according to its own political priorities. The intention would be to ensure a continued flow of revenue to previously agreed priorities based on social and political consensus.

With regard to fund management, the inclusion of other partners in the decision process makes it more difficult to favor certain groups over others. Some possible schemes for power-sharing on sovereign wealth funds are to abide by rules and guidelines approved by a parliamentary majority, ensure opposition participation in or endorsement of some types of decisions, and adopt quantitative and qualitative rules that disperse decision-making among different spheres of government.

A critical point is the independence of the stabilization fund. There are several ways to address the issue. The fund may, for instance, have legal and institutional independence, as it does in the US state of Alaska. Another possibility is appointing staff that is already part of the state bureaucracy — as in Norway and Chile — to manage the fund's resources and set the spending ceiling. In some cases — like Chad and São Tomé and Príncipe — civil society has a decision-making and supervisory role.

Social fund draft law — The goals of Brazil's Pre-Salt Oil Social Fund draft law are to stabilize revenues, increase public savings, and finance social development through programs in education, culture, public health, science, and technology, in addition to fighting poverty and climate change. Funding will come from both government oil revenues (signing bonus, royalties, and the marketing of oil and gas) and the income earned from investing those revenues. The fund would be directly subordinate to the Presidency of the Republic.

A government heavily dependent on oil revenues is subject to periods of alternating financial abundance, with the associated risks of waste, and penury, which presents fiscal problems.

Fund activities will be carried out by two separate bodies. The Financial Management Committee of the Social Fund (CGFFS) and the Advisory Board of the Social Fund (CDFS). The CGFFS must define the annual amount to be drawn from the fund and assess the risks and the distribution of the fund's investment portfolio. The CDFS will define priorities and allocate the resources drawn annually from the Social Fund.

The main quantitative rule of the draft law at first seems rigid: only the income earned on

fund assets can be spent. However, the law creates a loophole by making it possible to draw on the fund's principal when it is being formed. Although Congress is involved in defining for how long and how much could be drawn from the fund beyond earned income, clearly that loophole could considerably undermine the quantitative rule. It is crucial that the government act in good faith when proposing to Congress the final rule of the Social Fund, so that there is a balanced distribution of oil revenues over time.

Another critical point is the management model, which seems to concentrate too much power in the executive branch — more specifically, in the party and political group that controls the government. This is clear from the fact that the composition of both management bodies, the CDFS and CGFFS, will be defined by presidential executive orders, without any mandated involvement of Congress or civil society. The management of large oil revenues raises delicate dilemmas of political economy. One way of ensuring that these issues are addressed satisfactorily is to disperse the decision-making process among government, Congress, and supervising agencies as well as society and political forces, including opposition parties.

No funds and no rule on the use of funds can replace the commitment of society and the government to macroeconomic and fiscal stability and economic rationality.

Experience suggests that sovereign funds are not a fiscal panacea. There is no guarantee that they will actually stabilize income despite variations in commodity prices. In fact, indications are that there is no substitute for a commitment of government and society to general economic stability, including control of public spending and inflation. A government that opts for populist spending policies when oil prices are soaring probably will find ways to circumvent or even repeal the limits set by the sovereign fund law.

Sovereign funds may in fact not really be necessary. The countries that are best able to implement sound institutional frameworks for sovereign funds are those that are already committed to economic stability — in other words, countries that do not need an institutional framework to tie the government's hands. Moreover, it is perfectly feasible that for a country highly dependent on oil revenues, the government increases public debt when commodity prices fall and buys it back when prices recover, thus smoothing out public spending.

Yet in practice even countries that are mature in terms of institutions and governance and that could address fluctuations in commodity prices with proper public debt management have opted to establish sovereign funds even though such funds are not essential for sound fiscal policy. Norway and Chile are notable examples. A possible explanation is that by segregating oil revenues in an account and creating rules for their use, a country draws attention to the fiscal problem of fluctuating oil revenues and educates society about the fiscal risks. Moreover, sovereign funds make it easier to manage the exchange rate in the face of strong oil-related inflows.

Brazil does well to establish a sovereign fund in connection with the exploitation of pre-salt oil reserves. But we should bear in mind that no funds and no rule on the use of funds can replace the commitment of society and the government to macroeconomic and fiscal stability and economic rationality.

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IBRE Outlook 2010

THE BEST PERFORMANCE OF THE DECADE

Liliana Lavoratti, from Rio de Janeiro

After a near miss by the storm that triggered the recent major global recession, Brazil has everything in place to return to the growth path it embarked on at the turn of the millennium. In 2010, after nine years of progressively better gross domestic product (GDP), GDP growth will achieve 6% — the best performance of the decade. The only deviation from the growth path was 2009, when growth decreased slightly by about 0.47%.

However favorable this scenario, though, the country will have to deal with risks from the side effects of the economic stimulus that was used to vaccinate us from the global financial contagion. The government's expansionary fiscal and monetary policies — the increase in government consumption and the reduction of interest rates — together with the resumption of investment and the prospect of presidential elections next October, raise the possibility that rapid growth will have an unwelcome companion: high inflation, and with it the rollback of the lowest interest rate in Brazil's history (an annualized 8.75% last December).

"We are beginning to reap the fruits of 16 years of stable government led by Fernando Henrique Cardoso and Luiz Inácio Lula da Silva. This favors sustainable growth. A step back now would have a very high cost for all Brazilians," says Fernando de Holanda Barbosa Filho, a researcher at the Center for Economic Growth of the Brazilian Institute of Economics of Getulio Vargas Foundation (IBRE-FGV) in Rio de Janeiro.

Brazil is returning to the levels of GDP it had reached before the global crisis but no one knows how far it can grow without inflation again threatening. "The uncertainty around the potential growth of the economy at this stage leaves some questions unanswered as this year begins," says the economist Samuel Pessôa, coordinator of the IBRE Center for Economic Development. Forecasting how the strength of economic activity will affect prices, he says, is the real art of monetary policy in a country that has only had reliable data on economic indicators for a relatively short time, since the

economic stabilization in 1994.

It is particularly difficult to predict the trajectory of interest rates and the primary surplus of the public sector in an election year. In October voters will choose not only the president, but also senators, congressmen, and state governors. Would the government have the courage to raise the interest policy rate back to 13.75%, as in January 2009? "The Central Bank's position in trying to anticipate the market is at the very least delicate," says Pessôa. In an election year it is easier to justify increasing the interest rate once there are clear signs of increasing inflation, rather than increasing rates preemptively. In the opinion of Salomão Quadros, head of price studies for IBRE, Brazil's economy can grow 6% in 2010 without missing the 4.5% official inflation target.

Revenue and expenses

The government has stated several times that it does not intend to expand the tax incentives granted to the economy last year to heat up the domestic market and diminish the effects of the global crisis on Brazil. But it has signaled it will not remove the tax incentives until the time is right. That clouds the future of the primary surplus — revenues less expenditure, excluding the payment of interest on debt.

The primary surplus was 3.92% of GDP in 2007 and 4.07% in 2008. The Central Bank estimates that the consolidated public sector closed 2009 with a primary surplus of 2.5% — excluding 0.5% of GDP in public investment in the Acceleration Growth Program (PAC) and Pilot Program Investment (PPI). The Finance Minister Guido Mantega is confident that the government does not need to use investment exclusions to achieve a primary surplus of 3.3% of GDP in 2010.

Brazil's economy is likely to grow 6% in 2010 without missing the 4.5% official inflation target.

	Weights	12-month change		
		2008	2009	2010
Headline official inflation (IPCA)	100%	5,9	4,3	4,5
Food	20%	11,12	3,29	4,5
Consumer goods	25%	4,26	2,72	3,5
Services	25%	6,38	6,42	6,5
Utilities	30%	3,28	4,51	3,5

Sources: Brazilian Institute of Geography and Statistics (IBGE) and IBRE-FGV.

"The Central Bank's position in trying to anticipate the market is at the very least delicate."

Samuel Pessôa

"Industrial businesses are more optimistic about the coming months."

Jorge Ferreira Braga

"The fast recovery of formal employment means sustained income and ultimately economic growth,"

Regis Bonelli

For Pessôa, it is not yet clear whether the fall in revenue in 2009 is a purely cyclical phenomenon resulting from the tax cuts to support domestic demand, or whether there is a permanent decline in revenues. Will the resumption of growth bring tax revenues back to the levels of 2007 and 2008? "There are many open questions," he says.

The specialist in public finance, Amir Kahir, believes the federal government's loss of revenue in 2009 must have reduced the tax-to-GDP ratio to 34.5%, compared to 35.8% in 2008 and 37.3% in 2007.

It remains to be seen whether the primary surplus of 3.3% of GDP can be reached without major sacrifices. "Most likely the task of building a bigger primary surplus in 2011 will be left to the next government. It is less difficult for a government to face this kind of problem at the beginning of its term than at the end," says Barbosa Filho. The next president may be helped by the minimum wage policy that will see the end in 2011 of consecutive years of increases in the minimum wage above inflation; thereafter increases will simply replace inflation. "Without doubt, this rule will support the new government's program of fiscal adjustment," he added. In recent years, according to the Ministry of Finance, the increase in recurrent spending (salaries of civil servants and income transfers) raised total central government spending from 15.71% of GDP in 2002 to 18.72% in 2009.

We must pay attention to what happens from now on, Barbosa Filho observes. The latest Central Bank projections are that net public debt increased from 39.1% of GDP in 2008 to 43% in 2009 but should fall to 41% in 2010. At the same time, the consolidated public sector nominal deficit (including interest payments) was 4.14% of GDP in the 12 months to November 2009. This nominal deficit — double the 2008 deficit — makes the government's claim that it will reach the end of 2010 with a zero nominal deficit something of a stretch. That would mean taking in enough revenues to pay for all public expenditure, including interest payments. Barbosa Filho thinks that "much of the increase in spending came to stay, such as wage increases, assistance benefits, and the public works of the PAC."

Engines of growth

GDP growth of around 6% in 2010 will continue to be fueled by public and private consumption but from now on will also count heavily on larger investments. "A panoramic look indicates that the industry will continue to react well, as will trade," says IBRE economic researcher Regis Bonelli. "Data from the third quarter of 2009 compared with the previous quarter show positive developments in both production and final demand, except for agriculture." He says that uninterrupted future growth also depends on permanent recovery of investment, which has been becoming stronger since the last quarter of 2009, according to IBRE statistical models. The decrease in real interest rates and the firming

up of the intermediate and capital goods sectors will push industrial capacity utilization to about 86%, which is above its historical average. In November it had already reached 83%, the average for the last ten years.

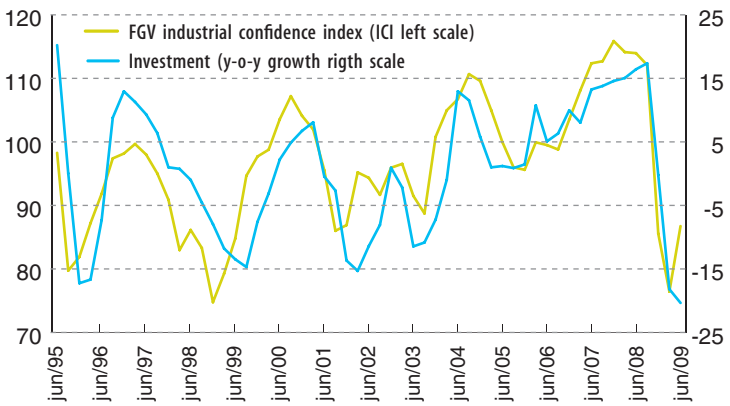
According to the coordinator of the IBRE Center of Methodology and Solutions, Silvia Maria Matos, the investment-to-GDP ratio will return to the 2008 level of about 19% of GDP by the end of 2010. If that is to happen, investment growth will have to be 15% to 20% in 2010 — higher than the 13.4% in 2008. Even if companies recently restarted projects postponed at the beginning of the crisis, investments in 2009 will be about 10% less than in 2008. "Even with all the progress expected, investments will still be below what is considered ideal to support solid accelerated growth," Matos points out. For an economy like Brazil, investments should be about 22% of GDP. Matos adds that both investment and GDP growth rates in 2010 will be distorted because the low 2009 base of comparison tends to magnify growth rates.

IBRE is forecasting that investments in manufacturing should soar, with growth of 8.3% this year compared with 5.1% for agriculture and 5.9% for services. In December the FGV

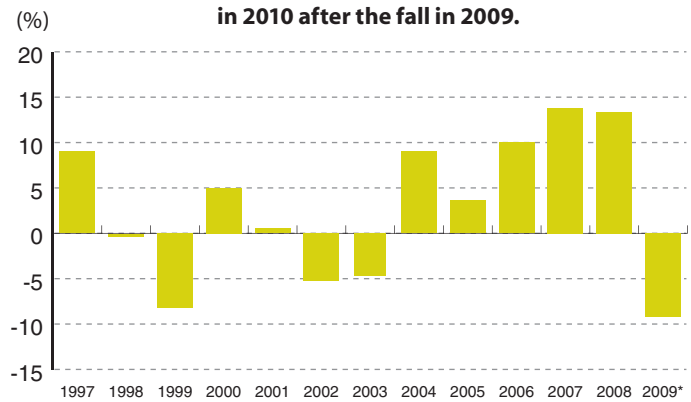
"Even with all the progress expected, investments will still be below what is considered ideal for solid support with the fastest growth."

Silvia Maria Matos

The latest FGV survey shows industrial businesses are more optimistic about the coming months...



... as a result investments in manufacturing should soar in 2010 after the fall in 2009.



Sources: IBGE and IBRE-FGV . * Estimate

"The federal government's loss of revenue in 2009 must have reduced the tax-to-GDP ratio to 34.5%, compared to 35.8% in 2008 and 37.3% in 2007."

Amir Kahir

"Brazil's economy can grow 6% in 2010 without missing the 4.5% official inflation target of 4.5%."

Salomão Quadros

"We are beginning to reap the fruits of 16 years of stable government led by Fernando Henrique Cardoso and Luiz Inácio Lula da Silva. "

Fernando de Holanda Barbosa Filho

Confidence Index of Industry (ICI, seasonally adjusted data) grew 3.5% — a return to pre-crisis levels. "Industrial businessmen are more optimistic about the coming months," says Jorge Ferreira Braga, head of economic cycles for IBRE. Of 1,110 companies surveyed, 46.9% said they had plans to expand between December and February, only a 2.8% reduction from the previous year. Another positive finding is that utilization of installed capacity in December had its ninth consecutive increase, highlighting the progress in the second half of 2009 from 79.9% in July to 83.8% in December. At same time, utilization in the capital goods sector increased from 77.9% to 80.9%.

Household consumption completes the positive outlook of the economy for 2010. Low unemployment and more formal jobs will expand salaries and thus incomes. From January to October last year 1.2 million new jobs were created – 2.1 million less than in the same period of 2008 but nevertheless a good sign given the global economy. "The fast recovery of formal employment means sustained income and ultimately economic growth," Bonelli says. He adds that part of the consumption increase is related to income transfers from the federal government.

According to the Central Bank this process will also be encouraged by a 20% expansion in credit this year, well above the 16% in 2009. Thus, total credit should increase to 48% of GDP in 2010, compared to 45.3% in 2009 and 41.1% in 2008. Increased credit, domestic and external, will have a positive effect on, for example, vehicle production, which is expected to rise 11% above last year, reaching 3.5 million units.

In this favorable moment, nobody is talking about structural reforms. "The adjustments to improve the current model and help make development sustainable will not depend on half a dozen cautious economists but on the political process," says Samuel Pessôa. "Voters do not vote for 15 or 20 years in the future. They vote for now." For him, tax, Social Security and labor law reforms will come only when the Brazilian state can no longer afford all its commitments.

As the last issue of *The Brazilian Economy* emphasized, low domestic savings, public and private, mean that foreign savings will be required to finance investments. The external current account deficit is expected to rise from 1.3% of GDP in 2009 to 2%. As long as Brazil remains a safe haven for investors' profits, foreign capital will continue to offset external current account deficits.

"The current model, resulting from 16 years of stability, is creating the conditions for Brazil to grow at 6% a year," notes Barbosa Filho. "With structural reforms, our potential could skyrocket. But among the presidential candidates there is no one who would be prepared to make changes of the necessary magnitude."

A bank for Brazil



Aldemir Bendine

Banco do Brasil CEO

Klaus Kleber, from São Paulo

Banco do Brasil (BB) accounts for 20.2% of domestic credit today and plans to become one of the three largest lenders in the real estate market by 2012. The board is negotiating the acquisition of Banco de Brasília and Banco Patagônia from Argentina; it also plans to open new branches in the USA, where it has recently created BB Money Transfers. So Banco do Brasil CEO Aldemir Bendine tells us. To strengthen the bank's capital structure, he says, the bank has issued US$1.4 billion in perpetuity bonds and US$570 million in subordinate debt and may offer shares in the primary and secondary markets. "Our commitment to the BM&FBOVESPA's New Market is to increase our free float from 21.5% to 25% by June 2011," he adds. BB shares are also traded on the New York Stock Exchange. Today foreign investors hold 11% of BB capital, but in principle that could go as high as 20%.

***The Brazilian Economy* — How relevant have the acquisitions of Banco do Brasil been in boosting Brazil's capacity to overcome the international crisis? What share of credit does BB hold today?**

Aldemir Bendine — Our acquisitions have undoubtedly been important to both BB and the country. In recent months we have completed the incorporation of Banco do Estado do Piauí (BEP), Banco do Estado de Santa Catarina (BESC), and Banco Nossa Caixa and have secured a 50% capital share of Banco Votorantim. Today, BB has over 50 million clients; it has the largest network of branches in the country and, as a result of the acquisition of Nossa Caixa, in the state of São Paulo. Our exceptional funding structure both in Brazil and abroad gives us an advantage over our competitors. Furthermore, BB acts as the banker for 15 states of the Federation, which translates into countless business opportunities; we are responsible for paying wages to 1.9 million state and 2.1 million local civil servants. To illustrate our organic growth, BB's credit portfolio grew 22% in the 12 months ending in September 2009, while average growth in the national financial system was 16.9%. We hold 20.2% of all credit available in the country, a historic record.

Has BB reduced interest spreads? Can this downward trend continue with the yearly base interest rate at 8.75%?

We took advantage of the policy rate reduction period to introduce an aggressive policy of reducing rates and expanding credit. Continuity of this policy will depend on macroeconomic conditions and on other variables beyond our control. We are obsessive about working efficiently. We will relentlessly pursue operational efficiency, cost reduction, and responsible high-quality lending.

Has the reduction of spreads affected BB's default ratio?

Even during the crisis and with the reduction of financial margins, BB managed to keep its overdue loan ratio below the market average. In September 2009, the ratio of BB borrowers more than 90 days overdue was 3.6% — the National Financial Service (SFN) ratio was 4.4%. Our average risk was also better: 5.7% compared with the SFN's 7.2%. This is a clear proof that the excellent performance of BB's loan portfolio this year was the result of responsible management that preserved our assets and the earnings of our shareholders.

How much will BB credit operations increase in 2010, when expansion of Brazilian GDP is expected to be between 5.5% and 6%?

We are projecting 20% growth in our credit portfolio, which in September 2009 surpassed the US$170 billion mark. With the resumption of economic growth and the confidence the productive sector and the market as a whole have demonstrated, we believe that 2010 will be highly favorable to credit operations. We will resume investment and expansion projects that were postponed in 2009. With economic stability and the improved employment and income indicators seen in the last few months, consumption credit tends to grow significantly. There will also be the launch of large projects related to the 2014 World Soccer Cup, the 2016 Olympic Games, and the pre-salt oil field, as well as the conclusion of public works of the PAC (Growth Acceleration Program). BB will definitely be supporting these investments.

When do you expect the operations of Nossa Caixa bank to be fully incorporated into BB? Will there not be an overlap of branches in the State of São Paulo countryside? If so, is there a plan to close branches or service centers?

Operations will be integrated gradually during 2010. Nossa Caixa branches will migrate by groups, in a smooth process to avoid any negative impact on our clients. Starting in February clients will be offered BB's operational platform, with its entire product and service portfolio. There will be no overlap of the Nossa Caixa and BB networks. We are already the largest service network in São Paulo, where we operate 1,340 branches, and we will continue investing in improving services state-wide. Our plan is to open 83 new branches in 2010, of which 7 are already being set up. We will also increase the number of branches dedicated to high-income clients. That means 23 additional branches in the State of São Paulo next year. In other good news, in 2010 we will hire 1,500 new employees in São Paulo alone to meet the challenges we will be facing in the most competitive market in the country.

We are projecting 20% growth in our credit portfolio, which in September 2009 surpassed the US$170 billion mark.

Foto: Credit de foto

Banco do Brasil and Nossa Caixa each has a pension fund. Will BB's take over the other fund?

This issue is currently being studied. For now nothing changes from the point of view of BB's support to Nova Caixa's pension fund.

Foreign investors hold 11% of BB capital … In principle, foreign investors may hold at the most 20% of bank capital.

By issuing perpetuity bonds amounting to US$1.5 billion and US$570 million in subordinate debt, BB has increased its capital adequacy ratio to 13.9%, above the 11% required by the central bank. Do you plan to issue any more bonds?

Issuing bonds or acquiring any other type of debt depends to a large extent on market conditions. Taking advantage of a window of opportunity that opened in October, BB managed to issue a unique bond in the foreign market, and demand surpassed US$14 billion. The operation has been an unquestionable success. We have been recognized as the year's best deal by several specialized periodicals. BB is constantly watchful for opportunities as long as the cost is attractive. It is worth remembering that BB's liquidity is very comfortable. Thus, we resort to the market only when conditions are ideal.

How and when is new stock to be issued in 2010? It has been said that the free float — bank shares circulating in the market — will be increased. What will be the size of the offering?

We have recently informed the market that we have begun negotiations with the National Treasury to increase BB's free float to 25%; it is currently 21.7%. This is a commitment the board made when BB went public in the New Market. BM&FBOVESPA has given us a deadline of June 2011 to reach that goal. We have not yet concluded studies but the discussions are considering both a secondary offering — a sale of shares belonging to the controlling shareholders — or a primary offering, which would be the issuance of new shares. It is still too early to determine how we will increase the free float. Likewise, it is premature to discuss the size of the offering, whether it will be a primary or secondary offering, and even the final schedule.

What is the share of foreign investors today in BB, and how much could that share grow?

Currently foreign investors account for 11% of total BB capital. In Brazil, the share of foreign investors in bank voting capital is regulated by the constitution. Any changes to the ceilings require presidential authorization. A new decree has increased the ceiling for foreign participation in BB capital from 12.5% to 20%. In principle, foreign investors may hold at the most 20% of bank capital.

In addition to offering new shares, the Treasury, which holds 66% of BB shares, and the National Bank of Social and Economic Development (BNDES), which holds 2%, could also sell some shares in the secondary market. Is that a possibility?

Yes, if the current studies recommend a secondary offering of BB stock as a way of increasing the free float. This would mean that the controlling shareholders would sell part of their shares. Shareholders that the

BM&FBOVESPA considers part of this controlling block are the National Treasury, the BNDES, and the BB employees' pension fund.

The acquisition of Banco do Estado do Espírito Santo (Banestes) did not materialize, but there is talk of BB acquiring Banco de Brasília (BRB). Is BB considering new acquisitions in the Brazilian market? How are the negotiations proceeding?

For the time being we are not planning any domestic acquisitions. Obviously, if a good opportunity comes up, and if it is a sensible opportunity from a business point of view, one that complements the bank's activities and generates value to its shareholders, we will consider it. We are currently directing our efforts toward the absorption of Nossa Caixa, which must be carried out with prudence, serenity, and professionalism, so that both clients and employees are spared any impact from the change in management. As to Banco de Brasília, negotiations are still under way.

Exports of manufactured goods fell drastically in 2009. Does BB foresee growth in its financing of foreign trade?

Although projections indicated a reduction in Brazilian exports in 2009, our foreign trade operations went in the opposite direction. The total of all credit lines to exports amounts to US$18 billion — 18.6% higher than in 2008. In 2010 the economic scenarios point toward 18% growth in Brazilian exports. At the BB, the projection is for a 25% increase in the volume of export credit, from US$18 billion to US$23 billion.

In December our real estate loan portfolio totaled US$460 million. …BB's real estate portfolio should close 2009 with 16% growth compared with 2008.

BB's presence in real estate financing is still modest. How much can it grow in 2010?

We entered the real estate financing market just over a year ago, when we were granted authorization by the National Monetary Council and the Central Bank to do so by using part of the funds raised through our Golden Savings Accounts. In 2009 we financed both clients purchasing homes and developers building new homes. In December our real estate loan portfolio totaled US$460 million, the same amount as in the Nossa Caixa portfolio. Even given the consequences of the world financial crisis, BB's real estate portfolio should close 2009 with 16% growth compared with 2008, using funds raised from savings accounts alone. In 2010 that market is expected to grow by 40%, and BB intends to double its current portfolio volume. We have approximately US$4 billion immediately available to the market. In 2010 we will expand the credit supply through specific agreements, with special conditions and rates for our clients; additionally, we would give more emphasis to developers and real estate companies.

Our retail strategy also foresees financing of projects for the construction of lower-cost housing for the "My House, My Life" program. Because the construction cycle of those homes is very short, in 2010 the projects supported by BB will be able to finance tens of thousands of residential units with Workers' Guarantee Fund (FGTS) resources. Our intent is to become one of the three major real estate financing institutions in Brazil by 2012.

Foto: Credito da foto

What about financing for agriculture, where the BB presence is fundamental?

We are very proud to be the major lender to Brazilian agrobusinesses. We work with all segments: small, medium, and large producers; cooperatives; equipment and input suppliers; and agro-industry. We have a customized methodology to assess the risks of production activities. Furthermore, Aliança do Brasil, a company of the Banco do Brasil Group, is the leader in rural insurance, and our Ourocard Agrobusiness card is a new instrument to provide rural credit. Between January and September 2009, BB disbursed US$17 billion to rural and agroindustrial operations, reaching a US$38 billion balance as of September 2009. For 2010 BB is projecting disbursements of US$26.5 billion, targeting a year-end balance of US$44 billion.

How are the negotiations coming along for the acquisition of Banco Patagônia in Argentina?

We are negotiating with several financial institutions in Argentina; Banco Patagônia is one of them. I cannot reveal the content of the negotiations, but as soon as we have concrete results, we will let the market know.

Are there any other international operations in sight?

Historically, BB has been the Brazilian bank that enjoys the most solid international presence. We are present in 23 countries with 44 units, including subsidiaries, branches, and offices. Our strategy is to take our business in three directions: expansion of the country's trade relations, internationalization of Brazilian businesses, and concentration on Brazilian communities abroad. BB will plant its flag where those conditions are present and where there is enough volume of business. We are looking for those opportunities.

In the USA, we have submitted an application to the local regulator to open bank branches to operate in the retail market. Because the American market already meets all three conditions, it is one of our priorities. Recently, we established a money transfer company in that country, BB Money Transfers; the idea is to serve the Brazilian community living in the USA, which is estimated at 1.4 million.

How does BB support Brazilian multinationals?

Wherever there is a domestic company or a consistent foreign trade flow of appropriate size, BB will certainly be there to offer the financial guidance those clients require. To give you an idea of our presence, 185 large Brazilian business groups that enjoy international exposure are BB clients. In Latin America there are excellent opportunities in Chile, Paraguay, Uruguay, and Colombia. In Argentina, for instance, Brazilian companies have a significant presence; about 20 Brazilian businesses employ over 160,000 workers there. We want a bigger role in Argentine retail bank business — why not?

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[1] The Brazilian Securities, Commodities and Futures Exchange — BM&FBOVESPA — is the third largest stock exchange in the world in market value. The BM&FBOVESPA' New Market is a listing of companies that undertake, on a voluntary basis, to adopt corporate governance practices and accept other legal obligations.

The 2010 elections

Fernando de Holanda Barbosa

The most important political event this year will be the election of President Lula's successor. Since Governor Aécio Neves has abandoned the race, the crucial dispute will be between Governor José Serra and Minister Dilma Rousseff, despite the possible candidacies of former minister Marina Silva and Congressman Ciro Gomes. Will there be any significant changes to the current model of the Brazilian economy after the elections?

The first major watershed for the Brazilian economy was the first presidential election after the country was re-democratized, when Fernando Collor de Mello came out a winner. President Lula's victory then would have meant a step backward for the country — at the time his experimental mulatto socialism as supported by the Workers' Party (PT) was a Bolivarian version of socialism, Hugo Chávez-style. The results not even PT could have guessed.

Whether moved by conviction or opportunism, Fernando Collor de Mello established the economic agenda that prevails to date. It includes opening up the economy, stabilization, privatization of state-owned companies, and reform of public administration.

Opening the economy was a must after the final cycle of import substitution, which transformed Brazil from simply a coffee exporter into an industrial country characterized by dynamic and innovative businessmen. Stabilization through policies directed to macroeconomic discipline had previously been seen as right-wing policy — no matter that the helpless poor had been left to pay the bill of fiscal irresponsibility. Privatization now came stripped of ideological overtones because it was a simple consequence of financial arithmetic: a bankrupt state would be in no condition to manage companies that required huge capital investments.

The reform of the state resulted from the need to transform a state characterized by machine politics and political favors into a state capable of providing services like health and education to the taxpayers. Collor started the ball rolling, but when he put together a poor economic team, he ended up losing the match. His impeachment put a new issue on the agenda: corruption. Today corruption has become part of our daily lives; the independent press regularly presents explicit scenes of undue appropriation of public money.

President Fernando Henrique Cardoso was able to carry on with Collor's agenda without his drawbacks, and successfully implemented the Real Plan to stabilize the economy and introduce a new and stable currency. The long and sluggish adjustment of the Brazilian economy, however, made the population weary. The electricity blackout in 2001 was the last straw: it prevented FHC from electing his successor.

The second landmark in the country's recent history was the election of President Lula in 2002. Instead of following the path he had previously advocated, Lula, like Cardoso, adopted the Collor agenda for the Brazilian economy. In practice PT became a social-democratic party, giving up the mulatto socialism and other utopian ideas that had failed everywhere else.

President Lula's strategy now consists of transforming the 2010 presidential elections into a true plebiscite on his and the Cardoso administrations. The economic model is not at stake. What is at stake is how the model is managed.

Today, the role of the state is to foster rather than drive economic growth, as was the case in the import substitution model. Today, the most important activity of the state is to reduce social inequality. The political debate leading up to the 2010 elections will center on those issues. The voter will not be asked to choose between economic models but rather to choose who will best manage the one we have had for three administrations.

Professor, Graduate School of Economics, Getulio Vargas Foundation

Rising Brazil: Implications for the United States



Matias Spektor

Talk of Brazil as a rising power is not new. It first peaked, because of our breakneck growth, in the 1970s and had Secretary of State Henry A. Kissinger pushing for a strategic partnership. It then vanished in the 1980s as stagnation and inflationary pressures brought the Brazilian economy to a halt. Many joked that "Brazil is the country of the future … and will always be."

Now the view of Brazil as an upwardly mobile country is back. The economy has grown without significant inflation, fuelled both by the boom in commodity prices and by competitive industrial exports. Since 2001 shares in the Brazilian stock market have been up by 350%, and macroeconomic policies have produced consistently good results. For all the turbulence of recent months, equity markets are vibrant and healthy, and the biggest Brazilian companies are expanding abroad fast.

A member of the BRIC club (along with Russia, India and China), Brazil's is a story of structural change. Globalization has transformed it dramatically for the better. Once a laggard in opening up its economy, and a reluctant (and inconsistent) follower of the Washington consensus, it has now reaped enormous benefits from freer trade and finance. In the last decade it cut poverty by a quarter while reducing income inequality. In 2008, for the first time, the largest chunk of the Brazilian population belonged to the middle class. This is the largest economic expansion in a generation, and both Brazil and Brazilians are more affluent than ever before.

Of the four BRICs Brazil is the richest in income per person. In 2007 the United States traded with and invested in Brazil more than with either India or Russia; its investment in Brazil also surpasses investment in China if Hong Kong is excluded. According to IMF figures, Brazil's economy ranks ahead of Russia, India, and South Korea. It alone accounts for over half the wealth of South America as well as over half its population.

Brazil's geography helps, too. Ensconced in South America, it has managed to avoid too many security entanglements. It is the only BRIC that does not possess (nor aspire to acquire) nuclear weapons. Unlike China and Russia, it is a stable and resilient democracy. Unlike India, it has peacefully reconciled ethnic and cultural diversity. While its military spending far surpasses that of its neighbors, it has not sought the capability to control them. And while it shares it borders with 10 of them, it has not fought a war in its neighborhood in 140 years. Instead, it has sought to embed its relative power in a network of regional institutions, making itself the major institution builder on the continent.

It is important not to exaggerate the positives. For all its growing prosperity, there are over 33 million people (just over 15% of the

Coordinates the Center for International Studies at FGV in Brazil, where he is professor of international relations at the Social Sciences and History School (CPDOC). He is the author of *Kissinger and Brazil* (2009). In 2010 he will be a visiting fellow with the Council on Foreign Relations in New York. Matias.Spektor@fgv.br

total population) who live in desperate poverty. Brazil is one of the five most unequal societies in the world. Crime is rampant in all major cities. While the pillars behind economic growth are sound, a prolonged recession abroad could well exacerbate decay at home.

But all in all Brazil is doing better today than at any time in a generation. As a major beneficiary of accelerating globalization, Brazil exemplifies one way to take advantage of freer trade and liberal global institutions while working to reduce the pain of disruption. The current crises of global finance and legitimacy therefore have strategic significance for Brazil. They could seriously harm Brazilian interests. Major international financial turmoil, for instance, could reverse the positive economic trend.

The diffusion of power away from the West, and the dramatic expansion of international actors vying to be heard could mitigate the influence of an emerging country that lacks traditional power resources. That is why Brazil will seek to moderately reform global governance in a post-crisis, post-Bush-doctrine world. It has a stake in preserving the core principles that have underwritten its recent emergence.

As the global economic center of gravity migrates to the BRICs and other developing countries, Brazil will try to ensure that the transition is orderly and legitimate. As a mildly revisionist state when it comes to the dominant rules of the game, Brazil will seek partial adaptation rather than outright revolution. Its designs are moderate compared to those of the other BRICs, and it will operate smoothly within the new international architecture.

But if Brazil is to become a stakeholder in international society, it must engage.

From Washington's standpoint, Brazil has been an ambiguous participant in the global order. It is not a swing state in the global balance of power, nor does it aspire to become one. Its strategic emphasis is domestic: national development and autonomy in the face of liberal hegemony. Brazilians have never shared the American view that the postwar order of 1945 was about openness, inclusion, and multilateral governance. From their point of view American hegemony is not quite as user-friendly as its proponents suggest.

As the Obama administration seeks ways out of the current financial and legitimacy crises, it should look at Brazil. Brazilian leaders are risk-averse. They avoid announcing new foreign policy doctrines. But in recent years they have sponsored a major transformation in the way Brazil interacts with the wider world. They are quietly reshaping South America's political and institutional landscape and have become major donors in distant lands like Haiti and Angola. Their newfound activism is apparent in global institutions old and new, from the UN to the WTO to the expanded G-8. The Brazilians have also sponsored new diplomatic connections with India, China, Russia, and South Africa with a view to affecting the global order as we know it.

As a major beneficiary of globalization, Brazil is not challenging the American worldview. But as an emerging country with a long history of frailty and dependence, it seeks protection and a hedge against risks. While Brazil will try to blunt the sharper edges of US hegemony, it will not undercut American interests. On the contrary, it may well help advance them in consequential ways.

The US administration ignores current strategic developments in Brazil at its peril. The danger is real that the Obama administration will translate the apparent lack of need for a special policy for Brazil into an attitude of benign indifference. That would be a serious strategic mistake.

If a working partnership is ever to succeed, some deeply ingrained perceptions in Brazil will have to be dislodged by continued cooperation. Brazil and the US are not natural allies — shared interests on their own do not automatically produce alliances. A partnership, if it is to exist at all, must be engineered.

Consumers' outlook remains favorable

Although the FGV consumer confidence index (ICC) fell in November and December, interrupting an upward trend since March 2009, consumers' outlook for the economy and the job market remains favorable. The decrease seems to be associated with relatively stagnant salaries and higher household indebtedness after taking advantage of temporary tax exemptions on durable goods. Despite the recent drop, the ICC continues to reflect optimism, standing at 112 points above its historical average of 107 points.

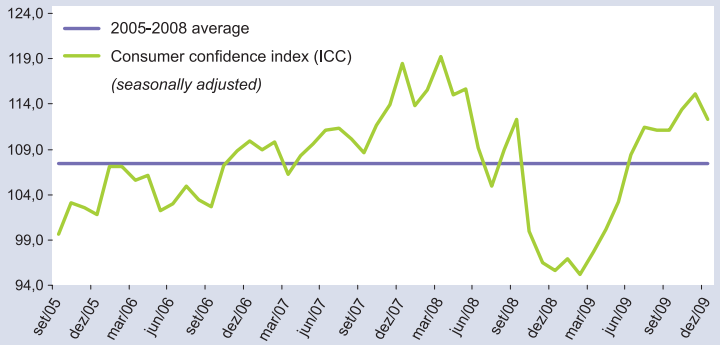
External demand remains weak

Brazilian economy has recovered on the strength of domestic demand — external demand has been sluggish. In the second quarter of 2009, exports increased as China and other countries anticipated their purchases of commodities to take advantage of low prices in the international market. Since then exports have been recovering slowly.

Fiscal policy may be at risk

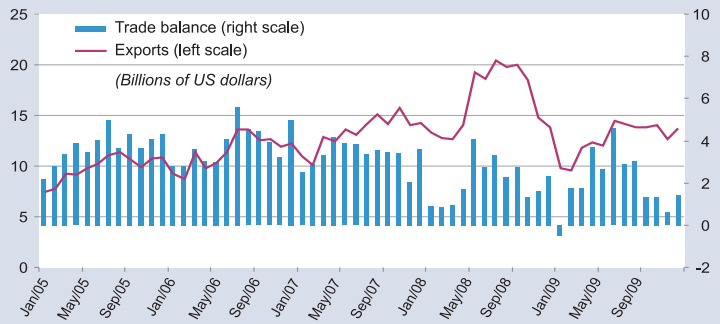
One of the anchors of Brazilian macroeconomic stability over the past decade has been fiscal policy. Between 2000 and 2008 the primary surplus of the public sector (nominal deficit excluding interest payments) of 3% of GDP became a floor, and on more than one occasion, it exceeded 4%. In 2009 the primary surplus plummeted to 1% of GDP, partly due to a decline in tax revenues, which can be reversed as the economy recovers, and partly due to an increase in current government expenditure, which is unlikely to be rolled back. The government's credibility has so far not been affected, but if the primary surplus continues at its current low for too long, the credibility arduously earned after long years of fiscal austerity could dissipate.

Consumer outlook on the economy and the job market remains favorable.



Source: IBRE-FGV.

Sluggish external demand slows recovery of exports.



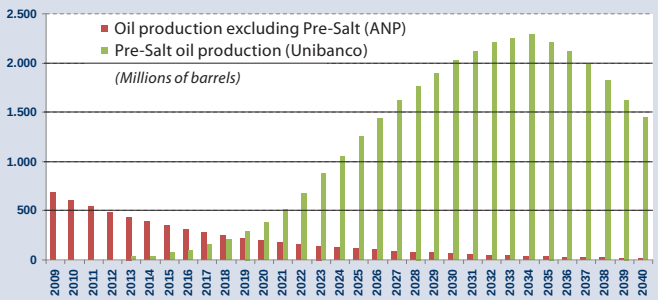
Source: Central Bank of Brazil.

The government primary surplus has fallen sharply since the global crisis hit.



Source: Central Bank of Brazil.

Brazil: Crude oil production projections, 2009-49



Sources: National Oil Agency (ANP) and Unibanco.

Brazil could become a major oil exporter

With a series of oil discoveries in 2007, Brazil now could become a major oil producer. Some estimate the oil discoveries at the equivalent of 40 billion barrels of oil, and oil production could peak at 2.3 billion barrels in 2034. Development of these resources is far from certain, however. There are many challenging technical and cost aspects of bringing new areas into production. The most pressing near-term question is about the legal and regulatory framework governing oil exploration and production. The long-term questions are about governance issues related to investment and use of large government oil revenues.

For additional series and information on methodology contact: Industry and consumer surveys: (55-21) 3799-6764 or sondagem@fgv.br; Price indexes and data bank services: (55-21) 3799-6729 or fgvdados@fgv.br.