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Address
Rua Barão de Itambi, 60 – 5º andar
Botafogo – CEP 22231-000
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Tel.: 55 (21) 3799-6799
Email: ibre@fgv.br
Web site: http://portalibre.fgv.br/

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Contributors to this issue
Lilliana Lavoratti
Klaus Kleber
Angelica Wiederhecker
Riordan Roett
Aloísio Campelo
Salomão Quadros



Claudio Conceição

Managing Editor
claudioconceicao@fgv.br

In the excitement about the potential of the Pre-salt oil fields, Congress may not be seeing all the implications of the government's proposal to change Brazil's regime for oil exploration and production. Since 1997 Brazil has managed its oil by concession, as is common in developed countries. The proposed regime would make the government a much more active player through not only the state-owned oil company,Petrobras, but also a new state-owned company, Petro-Sal, which would oversee production costs, reimburse operators, and take ownership of the government's share of profits, which would be in the form not of cash but of barrels of oil, which Petro-Sal would be responsible for selling. The economic ramifications of numerous provisions of the proposed law are staggering. Perhaps that is why lawmakers are so reluctant to actually confront them.

It has been suggested that international reserves should be sufficient for governments to face simultaneous banking and currency crises. Brazil's reserves certainly proved useful in the recent global crisis, allowing the Central Bank of Brazil to provide liquidity in foreign currency for international transactions. But is it possible to have too much of a good thing? Could Brazil find other uses for at least some of the money it has tied up in reserves? The question is worth thinking about.

Immediately after the earthquake that devastated Haiti in January 2010, the Brazilian government responded with a series of humanitarian initiatives. While the immediate humanitarian crisis must be addressed, the longer-term need for national reconstruction must not be neglected. Riordan Roett (Johns Hopkins University) argues that this is an opportunity for Brazil to take a leading role as the reconstruction of Haiti is planned. The possibility of providing leadership in Haitian reconstruction would advance Brazil's new foreign policy effort to build institutions to reflect the new global realities.

This issue also looks at how one of our fellow BRICs, China, is faring, having posted robust growth even during the global crisis. But the huge volume of resources the government plugged in to stimulate the economy may contribute to an inflation backlash that could cause real problems for the Chinese economy in the next few years.

Time to review international reserves policy

Now that Brazil's international reserves have gone over US$240 billion, it is reasonable to ask whether this level of reserves is excessive, whether the policy of accumulating reserves needs to be changed, and how the optimal level of reserves can be determined.

Robert Heller first put forward the idea that international reserves can be used to smooth out adjustments in the trade balance.[1] Thus, a country that does not have a convertible currency but does have substantial reserves need not tamp down consumption if the terms of trade turn against it because it could use its reserves to avoid a sharp contraction of imports. The alternative would be to change the exchange rate to balance the trade account, but abrupt movements in the exchange rate disrupt production and cause unemployment, generating adjustment costs that penalize such changes.

In the second half of the 1970s, the trend of liberalizing external capital accounts shifted the focus of discussions on international reserves from the trade balance to external imbalances resulting from the rollover of foreign debt. In the late 1990s, according to the well-known Guidotti-Greenspan rule,[2] reserves should be sufficient to repay at least the external debt maturing in one year.

Brazil's current international reserves appear to be greater than any model or empirical evidence would recommend.

In the current view, reserves provide various benefits. First, they prevent currency and financial crises. Second, they attenuate crises when they are inevitable. On these occasions, spending some reserves lets a country maintain its consumption when terms of trade or international financing deteriorate. Third, they reduce the cost of a country's international borrowing because sovereign risk falls as reserves build up.

Recently, Obstfeld, Shambaugh, and Taylor have suggested that international reserves should be sufficient for governments to face simultaneous banking and currency crises.[3] In that case, the government would act as lender of last resort in foreign currency. Indeed, it is not enough to have sufficient reserves to cover a country's import needs and service external debt for a reasonable time. Financial liberalization and large capital flows raise the possibility that businesses and citizens of a country can withdraw their local domestic currency deposits in domestic banks in order to acquire convertible currencies like the dollar and the euro. In this scenario, where capital flight combined with currency and banking crises is likely and could reduce international reserves substantially, it is necessary to have a much larger reserve cushion. Brazil's reserves certainly proved useful in the recent global crisis, allowing the Central Bank of Brazil to provide liquidity in foreign currency for international transactions.

Any discussion of international reserves, however, must also examine their costs and must distinguish between the fiscal cost and the

cost to society. The first cost is the difference between the interest earned on international reserves and the interest the government pays on borrowing in the domestic market in domestic currency. This interest differential combined with exchange rate variations adds up to the profit or loss for the central bank (or treasury) in maintaining the level of international reserves.

The fiscal cost, however, is not equal to the cost Brazilian society bears for holding international reserves. One way to estimate this cost is to imagine that the reserves were used to liquidate public external debt. If the debt servicing cost is higher than the yield obtained on international reserves, not paying down debt in order to build up and maintain reserves is the cost that Brazilian society bears.

Brazil's current international reserves appear to be greater than any model or empirical evidence would recommend. Models based on the assumption that international reserves are accumulated to avert flight of capital, sudden stops in the current account deficit, and banking crises suggest an optimal level of reserves lower than those of emerging market countries. One model estimates an optimal value of total reserves as equivalent to 7.7% of GDP.[4] An empirical analysis found that both trade balance and financial stability determine changes in the accumulation of reserves. Adopting this approach, the optimal level of reserves for Latin American countries should be about 12% of GDP.[5] Both estimates for optimal reserves are less than Brazil's current 15% of GDP.

Besides insuring against crisis, large reserves allow the central bank to intervene to smooth out exchange rate variations by buying dollars when the national currency is appreciating dramatically and selling when it depreciates. However, in Brazil in recent years Central Bank intervention has become asymmetric: the bank buys foreign currency much more often and in much larger volumes than it sells it. This reflects the Central Bank objective of increasing reserves.

If reserves already far exceed any level that has been found justifiable theoretically or empirically, Central Bank intervention to accumulate more reserves is pointless. There is especially no reason to increase reserves further considering the fiscal costs and the costs to society as a whole. It is time for the Central Bank to review its policy of intervention in the exchange market so that it effectively corresponds to the official claim that it does so to smooth fluctuations in the exchange rate. If that were so, certainly the asymmetry of its current activities is questionable. Intervention should smooth out variations in the exchange rate without affecting the trend or setting an implicit target for the nominal exchange rate. In short, Central Bank intervention in the foreign exchange market needs to become more balanced.

It is time for the Central Bank to review its policy of intervention in the exchange market so that it effectively corresponds to the official claim that it does so to smooth fluctuations in the exchange rate.

[1] Heller, H. Robert, 1966, "Optimal International Reserves," *Economic Journal*, 76 (June): 296-311.

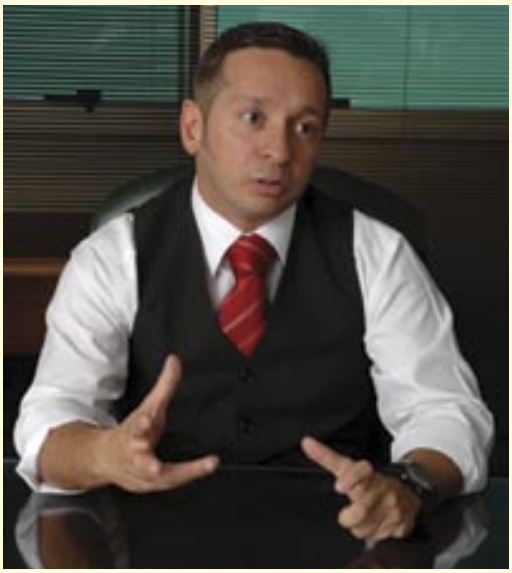
[2] Named after Pablo Guidotti, former Deputy Minister of Finance of Argentina, and Alan Greenspan, former chairman of the Federal Reserve.

[3] Obstfeld, Maurice, Jay C. Shambaugh, Alan M. Taylor, "Financial Stability, the Trilemma, and International Reserves," NBER, Working Paper 14217, August 2008.

[4] Jeanne, Olivier, 2007, "International Reserves in Emerging Market Countries: Too Much of a Good Thing?," Brookings Papers on Economic Activity 1: 1-79.

[5] Maurice Obstfeld, Jay C. Shambaugh, Alan M. Taylor, "Financial Stability, the Trilemma, and International Reserves," NBER, Working Paper 14217, August 2008.

Diversification and innovation



Alessandro Teixeira

Chairman of Brazil's
Agency for Promotion of Exports and Investments (Apex-Brazil)

Klaus Kleber, from São Paulo

In reaction to the international financial crisis that began in September 2008, Brazilian exports fell by 22% in 2009. The decline would have been worse but for the diversification of Brazilian export markets, for which much credit goes to Brazil's Agency for Promotion of Exports and Investments (Apex-Brazil). The head of the agency, Alessandro Teixeira, talked with *The Brazilian Economy* not only about diversification but also about its new business centers in Moscow, Beijing. and Dubai, and other sales promotion initiatives — such as inviting businesspeople from 29 countries to watch the samba school parades. That initiative alone could translate into US$22 million in business.

***The Brazilian Economy* — This year Apex-Brazil's Carnival Project brought 150 businessmen and investors from 29 countries to Brazil. What have been the results so far?**

Alessandro Teixeira — We invited people who already do business with Brazil or with whom we formerly had a relationship, either as importers of our products or as investors. They would probably not be visiting the country otherwise but Carnival in Rio enjoys tremendous international recognition. The idea was to strengthen our bonds and intensify their business with Brazil, promoting personal contact with domestic exporters. One of the guests was James Charles Greenwood, Chairman of the Biotechnology Industry Organization. All biotechnology products the country exports will from now on bear the brand name, Br-Biotec, which will be launched at Chicago Bio 2010 next May. Within the next few weeks, we expect to complete business deals totaling US$22 million with other guests.

Foto: Credito da foto

At the World Economic Forum in Davos, French President Nicholas Sarkozy called for social and environmental standards for foreign trade. Could that bring about an escalation of protectionism? Will that affect Brazilian exports?

To some extent, yes. Brazil has made progress in adapting its exports to environmental sustainability criteria, but social and environmental standards apply to some countries, like Brazil, but not to others. What is needed, therefore, is to enforce environmental protection criteria and social protection schemes in all exporting countries without exception. The exceptions constitute protectionism.

The value of Brazilian exports in 2009, US$153 billion, was 22% less than in 2008. What is the forecast this year? Do you anticipate a healthy recovery in manufactured goods exports?

From January through the third week in February, Brazilian exports totaled US$20 billion — a 23% increase over the same period in 2009. Sales of manufactured goods increased by 9.5% in January and 10.7% in the first three weeks in February. Last year, Brazilian manufactured goods lost competitiveness primarily in the US and Europe, where markets contracted severely, but there is a manifest improvement in the US thanks to the recovery. However, the euro is losing value because of problems in the "PIGS" countries (Portugal, Italy, Greece, and Spain), so no improvement is expected in the European Union before the second half of the year. Our export target for 2010 is US$170 billion. It is unthinkable that we can even come close to the US$200 billion registered in 2008.

The decline in foreign trade has not been more severe because our markets are more diversified. What is Apex-Brazil's role in that?

Diversification and innovation are essential in our work. No longer are most of Brazil's exports going to the US, Europe, and Argentina. Although China has become our largest trading partner, today Brazilian goods reach all continents. Because of our broad range of products, we have been spared the crisis.

Of all Apex-Brazil international business centers, which is the most promising?

We have closed down the Lisbon and Frankfurt business centers. But we are active in Brussels, the seat of the European Commission, and Warsaw, because of its central geographical location. The new business center in Cuba is intended to cover not only Cuba but the entire Caribbean. When US sanctions on Cuba are lifted, that center should become a bridge to the US market. We have also opened business centers in Beijing, Moscow, and Dubai, in the United Arab Emirates.

Do you consider Eastern Europe promising?

From January up to the third week in February, Brazilian exports totaled US$20 billion, a 23% increase over the same period in 2009... . Our export target for 2010 is US$170 billion.

Yes, in particular for our manufactured goods. In our business center in Moscow, the idea is to promote trade not only with Russia but also with other former Soviet Union countries. We feel that there are good opportunities in the Ukraine, Kazakhstan, and Azerbaijan, to begin with.

Brazil is in general a democracy; but in the particular aspect of the partisan relationship with the economy, there appears to be a trend toward state intervention.

The Brazilian business community often refers to the exchange rate as a major stumbling block to exports. What other factors affect the "Brazil cost"?

Brazilian businessmen will have to learn to live with an overvalued currency, which most likely will not change in the medium term. In my opinion, it is not the value of our currency that most hampers exports but the volatility of the dollar. I also believe that Brazil has critical infrastructure deficiencies which must be addressed by PACs [Growth Acceleration Programs]. Brazilian exports are also in need of tax relief, an issue that the Brazilian Foreign Trade Council (Camex) is currently debating. We expect a package of measures to come out soon.

What kinds of agreements does Apex-Brazil sign with companies or business associations to promote exports?

We have signed agreements with 74 sectors of industry, agribusiness, and services, up from only 48 in 2006. Our intention now is to include the dairy industry, because Brazil is one of the world's major dairy production centers. The number of businesses covered by those agreements has grown to 10,000, representing US$24 billion in Brazilian exports.

Where have you seen the best results?

The results have in general been very positive, but if I were to highlight a single sector, it would be the meat sector. Weekly data reveal a 43% increase in Brazilian exports of fresh meat this year. That is an 18% increase in volume terms, and a 21% increase per ton in dollar terms. The major importers of Brazilian meat are Russia, Iran, Hong Kong, Venezuela, Algeria, Israel, Saudi Arabia, Italy, and Lebanon.

Can you give some examples of projects Apex-Brazil supports?

One of the most recent is the Brazilian Hereford & Bradford (BHB) project, a partnership between Apex-Brazil and the Brazilian Hereford and Bradford Association to promote the genetics of those breeds at internationally. An event in São Borja and neighboring towns in Rio Grande do Sul state brought 21 guests from Paraguay and Bolivia. Another project is Brazilian Publishers, our partnership with the Brazilian Book Council, CBL. The Paris Cookbook Fair awarded prizes to two Brazilian publications: *Copos de Bar e Mesa* by Edmundo Furtado (published by SENAC), and *Brasil a Gosto* by Ana Luiza Trajano (published by Editora Melhora-

mentos). The presence of Apex-Brazil at international events is an important part of our efforts to promote Brazilian products and services.

Because of a shortage of ethanol to supply the domestic market, reducing customs duties on imported ethanol is being considered. Is this an isolated problem, or do you foresee difficulties for Brazil to establish itself as a world-level ethanol exporter?
I hope it's just a temporary problem. Weather conditions have affected production, and as sugar prices soared the processing plants chose to produce sugar instead. Brazil has to tackle ethanol as a strategic issue; the sugar and ethanol industries must work in accordance with this view. If there is adequate planning, Brazil has all it takes to become a world player in ethanol.

How much do small- and medium-sized companies benefit from Apex-Brazil support?
Nearly 70% of our projects target micro and small businesses. Adding in medium-sized companies, that percentage would increase to 80%.

What options are available to small — and medium-sized companies to access credit from the National Bank for Economic and Social Development (BNDES)?
BNDES — I am on the management board — has lent fundamental support. The smaller businesses that use the BNDES card receive loans for working capital at a lower cost and have access to financing with longer maturities to modernize their production processes.

What is your assessment of the work being done to integrate export promotion and FINEP (Studies and Project Financing)?
FINEP has been extremely innovative, notably with regard to the design of exported goods, and has been an active partner of Apex-Brazil. During last year's year-end dinner, President Lula and other federal authorities and the exporting community were introduced to "The Best of Brazil," a presentation featuring Brazilian products and services recognized for their quality, innovation, and design. Instruments, jewelry, footwear, wine, food products, software, and medical and hospital equipment were produced with the support of Apex-Brazil's PISs (Integrated Sector Projects) in partnership with trade associations. Some of those products received design awards abroad, such as the IF Design Awards and the International Design Excellence IDEA Award.

Brazilian businessmen will have to learn to live with an overvalued currency, which will most likely remain unchanged in the medium term.

Does Apex-Brazil activity include support specifically to information technology exports?
We have been very active in the IT area, in partnership with its associations, by supporting initiatives to develop software, data security, electronic

games, etc. Apex-Brazil supports the Integrated Sectoral Program for the Segment of Software and Related Services developed by Softex (Brazilian Association for the Promotion of Software Excellence). This year we also joined the Brazil Project IT Emerging Players. The goal is to introduce Brazilian software and services in the international market and to promote the single brand, Brazil IT+. With this brand, Brazilian exhibitors expect to expand their presence in the most important showcase for these products in Hannover, Germany, in March. Brazil will have two stands, one for software companies, and the other for telecom companies. Softex, Softsul (Association Supporting Software Development in the State of Rio Grande do Sul), and Anprotec (National Association of Entities Promoting Innovation Projects) will be present.

What Apex-Brazil initiatives are there in the area of labor training, particularly for smaller businesses?

Although resources for labor training are limited, we offer the PEIEX (Project for Industrial Extension) in 26 centers in nine states and the federal capital. The project, launched a year ago, has been extended to 3,500 businesses, for a total investment of US$8.9 million. In 1,100 of those businesses, work has already been completed to build up the production process, product development, and management, so as to prepare the companies for the foreign market.

Brazil has to tackle the issue of ethanol as a strategic one; the sugar and ethanol industries, in turn, must work in accordance with this view.

Have the funds allocated to Apex-Brazil been increased? What is your assessment of trade promotion in Brazil compared to other countries?

Institutions like UNCTAD, the World Bank, and the International Trade Conference have recognized Apex-Brazil as one of the best governmental bodies promoting exports based on the concept of trade intelligence. Our current US$122 million budget is not expected to increase in the short term; however, trade promotion around Brazil definitely tends to expand.

How does Apex-Brazil apply the trade intelligence concept?

This process, which we are fully dedicated to, goes beyond mere data collection and systematization. Basically, it consists in the organization and in-depth analysis of business data from different countries, adding qualitative factors to turn them into knowledge that can guide companies and make them more competitive internationally. The purpose of the Apex-Brazil Trade Intelligence Unit is to integrate information from domestic and international imports and identify opportunities for Brazilian industry and products. We analyze the economies of trading partners, the prices offered by companies, logistics, structure and market access conditions, possible strategic partnerships, and potential clients. This wealth of trade information is made available to our partners through the Apex-Brazil website.

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NEW REGULATION FOR THE OIL SECTOR
a salty debate

Liliana Lavoratti, Rio de Janeiro

The National Congress is considering the government's proposal to alter the regulatory framework for oil and gas in the Pre-salt oil field the same way the government produced it: silently. The four draft laws being considered would radically change the regime of oil exploration and production in Brazil. Even though the oil reserves constitute over 50 billion barrels — four times current reserves — so far questions about how the new legislation would affect the country's industrial policy toward oil exploration and introduce more government interference in the economy have failed to interest the legislators. Instead, the heated political debate has been about the distribution of royalties to be paid on Pre-salt resources.

The new regime is about to become law with little involvement of either lawmakers or the public. The draft laws introduce sharing agreements for Pre-salt and other areas considered strategic to secure government control and grants market privilege to the government-owned oil company, Petrobras, as sole operator, with a



guaranteed minimum stake of 30% in those oil fields.

According to the production-sharing agreement in the draft law, the government is to be directly involved in exploration and production; it will reimburse investment costs to operators; and the profit accrued to the government will not be part of the public budget but will go to a Social Fund.

Changes

Since 1997, when the monopoly was broken, Brazil has managed its oil by concession: winning bidders are authorized to explore the fields against payment of a subscription bonus and presentation of a minimum exploration program, both based on risks, and payment of royalties when production starts. This model, which is common in developed countries, will be maintained for all the other oil fields, but not for Pre-salt.

The draft law introduces a new player, the state-owned Petro-Sal (Brazilian Oil and Natural Gas Management Company). The company will oversee production costs and reimburse operators; it will not only represent the government on operational committees but will have veto powers in these committees. The draft law also includes additional capitalization for Petrobras to allow it to invest in the Pre-salt fields without compromising its investment grade classification.

The draft laws Congress is debating raise issues about the transparency (or lack of it) of the new oil exploration model, which is unique in the world — a sort of "sharing the Brazilian way," says Paulo César Ribeiro Lima, legislative consultant to Congress on mineral, water and energy resources, who has analyzed the legal and economic implications of draft law No. 5.938/2009. He sees the

There are some worrying details in the new regulation, such as the privilege extended to Petrobras.

Sebastião do Rego Barros (Chairman of the IBRE's Advisory Board)

sharing agreements as unique because Petrobras is the sole operator, with a minimum stake of 30% in all Pre-salt areas. "Thus, the traditional international oil companies would only participate as financial investors," he points out. This could significantly reduce the subscription bonuses.

Another unusual feature is that the federal government will receive its share of profits in barrels of oil, to be sold by Petro-Sal. Another innovation has to do with the share of oil that goes to the Brazilian state — the current law calls for 60% but the draft law leaves the government's share open.

Criticism

"Very few times in the country's history has Congress been called to vote on a bill of such great economic magnitude," says Ildo Sauer, PhD in nuclear energy, professor at the University of São Paulo (USP), and former director for gas and energy at Petrobras (2003–07). If the estimates of 100 billion barrels over the next 30 years are confirmed, he says, revenues could be something like US$1 billion a day. Sauer, who is critical of the regulatory proposal, says that "the draft laws seek to defend the interest of economic groups, as occurred in the previous administration," and recommends a plebiscite during the presidential election later this year asking Brazilians whether they support reintroduction of the state oil monopoly. He says, "The central issue here is that the colossal oil revenues over the next two or three decades should be allocated to a new

The new model is a tool to promote social and economic development, based more on public policy than on the free market.

Sérgio Gabrielli (CEO of Petrobras)

Conventional sharing	"Sharing Brazilian way"
Minimum government's share	
Determined by the law (in general, more than 60%)	Not determined by the law
Royalties	
It is not common as government revenue is a percentage of the profit	Determined by the law
Petrobras as a sole operator	
It is not common as the government keeps most of the profit without investing	Determined by the law
Regulatory agency participates in the contract	
It is not common as the regulatory agency supervises the contract. It is common that a state-owned company participates in the contract on behalf of the government	In non-strategic areas, the regulator participates in the contract. In the Pre-salt, Ministry of Energy participates in the contract
Oil revenues	
The government can choose either barrels of oil or the equivalent monetary amount	The government will receive its share of profits in barrels of oil, to be sold by Petro-Sal

Source: Paulo César Ribeiro Lima

Government income estimates

Proposed sharing model	US$	Concession model	US$
Price per barrel	75.0	Price per barrel	75.0
Production cost	15.0	Production cost	15.0
Royalties	11.3	Royalties	7.5
Government excess (30%)	14.6	Special share (38%)	20.0
Contracted excess (70%)	34.1	Concessionaire	33.0
Government income	25.9	Government income	27.5

Source: Paulo César Ribeiro Lima

economic and social development program that could change the profile of the country."

The timing for this new regulatory framework could not have been worse. This year there are elections not only for president but also for all members of Congress, part of the Senate, and state governors and state legislators, so political parties are busy trying to secure seats for their candidates. Success in the October polls will depend on how satisfied are voters who have a vested interest in what their own state or municipality will receive from the oil revenues. "Money flowing into the state and city coffers is the most palpable aspect of this regulation." Ribeiro Lima points out.

The government intends to fast-track the draft law through Congress for approval in record time — the drafts were submitted to the legislature only in August and the government is hoping to conclude voting by July, before the legislature recesses for the election. Meanwhile, popularity ratings for President Lula's administration have surpassed 80%, and his succession candidate, Dilma Rousseff (PT, Workers' Party), is surging in the polls, increasing the likelihood that the proposed law will pass. Moreover, Michel Temer (PMDB, Brazilian Democratic Movement Party), speaker of the Congress, is being touted as the PT vice-presidential candidate. And there is the increasing power of Petrobras, which will only be reinforced by the privileged treatment for it proposed in the draft law.

Opposition

The opposition is in a tight spot because the Lula administration has resurrected the nationalist discourse from the campaign that created Petrobras in the 1950's: "Pre-salt oil belongs to us." The *tucanos* (PSDB, Brazilian Social Democratic Party) have been protesting that submission to government has become so overwhelming that anyone against the Pre-salt sharing agreements is considered to be in effect capitulating to foreign interests. Yet behind the scenes even lawmakers from the government's bloc find it improper

The government acts like someone trying to save someone from lynching. But the issue is not to legislate for this or for that government but to legislate for Brazil.

Alvaro Dias
(Senator, PSDB)

The draft laws seek to defend the interest of economic groups, as occurred in the previous administration.

Ildo Sauer
(University of São Paulo)

We have discovered a type of area for which [concession] agreements are not the best for defending national interests

Haroldo Lima
(Director of the National Oil Agency)

I can see no technical argument to convince me of the need to rush approval of the four draft laws now on the eve of a presidential election.

Adriano Pires
(Director of the Brazilian Center for Infrastructure)

to alter the regulatory framework just a few months from the elections, when there is still a chance that the governing party (PT, Workers' Party) may lose.

But in public not even the opposition wishes to risk this debate. Their strategy is to let the draft laws pass, and if he is elected, José Serra (PSDB), Governor of the State of São Paulo and leader in the polls, might push for its amendment. Though Serra and Rousseff have avoided addressing the issue openly, it is well known that the tucanos prefer carrying the current regime of concessions over into the Pre-salt era. They suggest that the draft law fits the leftist program that the PT presidential candidate supports for the economy, in which the government builds up state-owned companies to have a larger share of the country's GNP.

Although he denies that he is one of the main architects of Rousseff's management approach, Sérgio Gabrielli, CEO of Petrobras, admits that the proposed law would give the government a more prominent production role. "The new model is a tool to promote social and economic development, based more on public policy than on the free market," he says.

Gabrielli challenges the opposition to join the political and economic debate: "The National Congress is the true representative of the Brazilian people. The fact that congressmen are solely concerned about the distribution of royalties reflects the lack of alternative proposals. The opposition should explain why concession, which will remain the rule for the other areas, should be extended to Pre-salt oil."

According to Adriano Pires, director of CBIE (the Brazilian Center for Infrastructure), a private consultancy, the four draft laws have one feature in common: they increase the government's power. He says,

"I can see no technical argument to convince me of the need to rush approval of the four draft laws now on the eve of a presidential election. I can only see it as a political project of the government to guarantee greater decision power to the state and make the federal government the major beneficiary of the Pre-salt oil revenues."

Too much haste

Senator Álvaro Dias (PSDB), a leading opposition spokesman, is convinced it would be "more ethical and prudent" to wait for the results of the elections before defining Pre-salt oil regulation: "No one knows who will head the country in 2011, and oil exploration will not begin until after 2015. The government acts like someone trying to save someone from lynching. But the issue is not to legislate for this or that government but to legislate for Brazil." Despite being stronger and better prepared than Congress, the Senate opposition recognizes that it is not powerful enough to delay the vote. But it will try to overturn the call for fast-track approval likely to come from the government coalition to get the law passed before the electoral recess. "The government wants to pass the bill to use it as an election trump card," the *tucano* senator says.

Delcídio Amaral (PT), a dedicated government-coalition senator, believes the Senate will introduce a few changes:

> "We are going to fight for delimitation of the areas in which Petro-Sal company will have veto powers in the operational committees .... Furthermore, we will demand that the executives named for the new state-owned company be heard by the Senate, following the same procedures as for executives in regulatory agencies."

Amaral also says that the mandatory 30% Petrobras stake in all Pre-salt oil fields could overburden of the state-owned company as well as reducing opportunities for other oil companies.

Inconspicuously, senators have already raised a series of issues. After four public hearings last year, the Senate Infrastructure Committee concluded that "almost all the objectives to be achieved through the sharing agreement regime for the Pre-salt oil can be achieved under the regime established in the Oil Law, namely the concession regime." The report notes nonetheless that the sharing agreement regime seems to be better suited to the lower risk and higher operational predictability that the Pre-salt areas offer to businesses.

Privilege

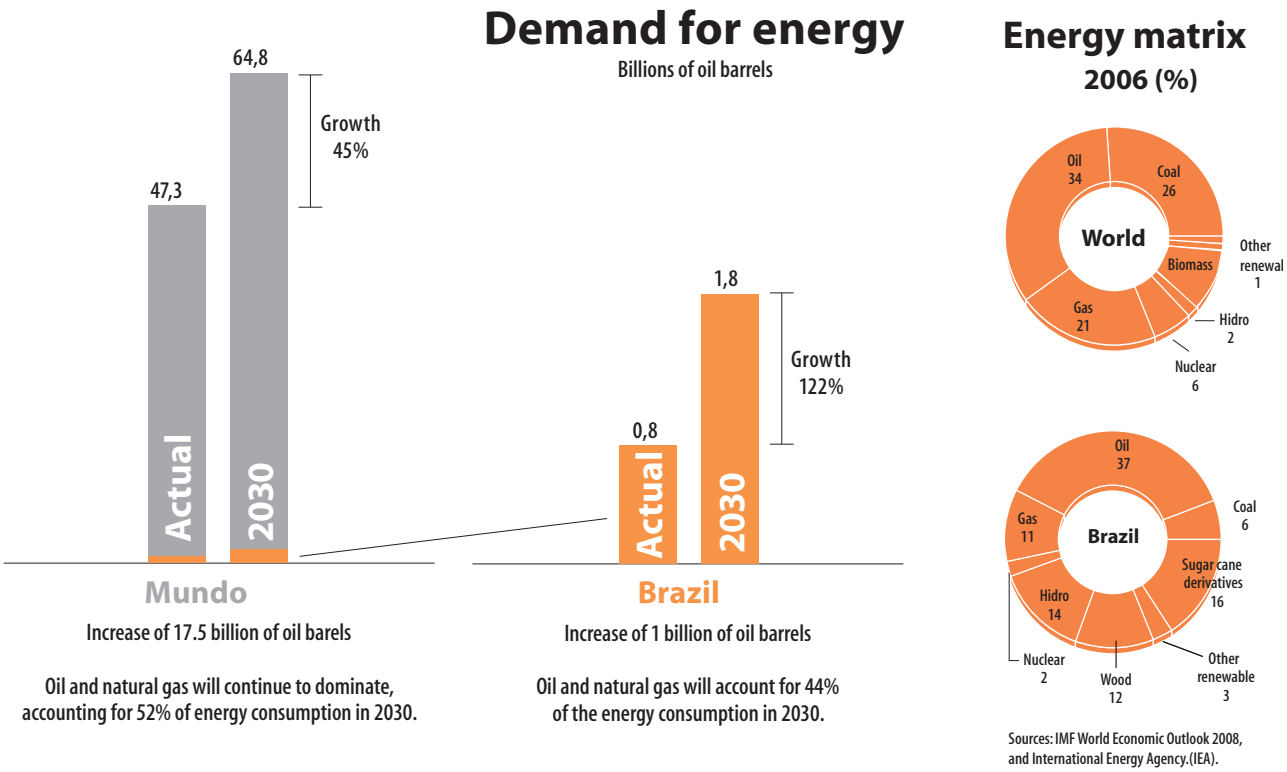
Ambassador Sebastião do Rego Barros, former chairman of the National Oil Agency (ANP, from 2002 to 2005) and current chairman of the Advisory Board of the Brazilian Institute of Economics (IBRE), says that "Adopting the sharing agreement regime is not a necessity, because adjustments for Pre-salt oil could be introduced in the current Oil Law. And there are some worrying details in the new regulation, such as the privilege extended to Petrobras."

Rego Barros says that investors in those ventures will have to take risks yet submit to Petrobras's rules. "This will diminish private companies' appetite for investing as they will have to live under the excessive control of the Petro-Sal operational commit-

Oil blocks by sedimentary basin

	Petrobras participate in the block (%)	Petrobras does not participate in the bloc (%)	Total number of blocks
Amazon Basin	75	25	4
Barreirinhas Basin	86	14	7
Camamu-Almada Basin	69	31	16
Campos Basin	71	29	45
Ceará Basin	100	0	2
Espírito Santo Basin	60	40	80
Amazon River Mouth Basin	100	0	22
Jequitinhonha Basin	89	11	9
Paraná Basin	0	100	2
Parecis Basin	83	17	6
Parnaíba Basin	40	60	10
Pará-Maranhão Basin	50	50	16
Pernambuco-P Basin	100	0	3
Potiguar Basin	50	50	153
Recôncavo Basin	19	81	107
Rio do Peixe basin	8	92	12
Santos Basin	70	30	98
Sergipe-Alagoas Basin	46	54	65
Solimões Basin	19	81	26
São Francisco Basin	19	81	48
Tucano Sul Basin	39	61	28
Total	49	51	759

Source: ANP, Center of Economy and Oil, IBRE-FGV.



tees," he fears. He points out that the Mexican state-oil company, Pemex, holds the monopoly "and has been losing a lot." Moreover, he says, the new rules will add to the management burdens on Petrobras.

The Senate Infrastructure Committee sees in the draft law a risk of curbing Petrobras's business development: "The company risks losing its current freedom to choose its priorities and commercial targets because it will be forced to go into a partnership with all the winners in tenders even if they fail," the committee's 2009 report said. As a sole, state-owned, operator, the committee suggested, Petrobras should have a more reasonable 5% share.

Petrobras

Sérgio Gabrielli of Petrobras explains that his company "will be a sole operator, but will not work alone. The operator is in charge of selecting the best technology and of managing the development program. It has to be a company with a profound knowledge of the activity." The main deep water operator in the world is Petrobras, which holds a 22% international market share; the second largest has 14%. Besides its deep-water experience, Gabrielli says, Petrobras also knows the most about Pre-salt oil because it conducted much of the research and technological development in the area. It also has the most infrastructure in service. "Why then select a different operator?" Gabrielli asks.

However, the current model — under which Petrobras became one of the world's major oil companies —

gave Brazil its oil sufficiency and built the industry from 2% to 10% of GDP. So why should there be a change? Gabrielli says that the Pre-salt oil fields brought about significant changes to exploration risks:

> "Because the production potential is substantial due to the sheer size of the reservoirs, the share of oil revenues has become a vital issue. With production sharing, the government will absorb the largest portion of the revenues and will have greater control of production than in the concession model; at the same time, companies are not discouraged, because they will know from the start what the division will be between cost and profit."

Of the 41 wells drilled in the Pre-salt field, oil was found in 36. In the 13 wells at the Santos Bay, the success rate was 100%. "Is that likely to continue? No. But taking into account that the world success average in other Pre-salt fields is 25%, our risk is very low," Gabrielli says. He explains that

> "When Brazil decided to explore the sea, Petrobras was a state monopoly, assigned the right to act on behalf of the government. And Petrobras assumed all the risks. In the late 1990s, however, the country decided to alter the rules of the game and established a system of concessions, according to which those who take more of the exploration risks get more of the revenues, paying the Special Government Share, a subscription bonus, and defining the minimum exploration program. However, if oil is found, the company owns the production, which can be traded freely. The concession, therefore, pays well because risks are high."

Mixed regime for oil

Haroldo Lima, Director of the National Oil Agency (ANP), has adopted the same rationale:

> "The changes have nothing to do with the performance of the current concession contracts. They have worked well. The issue is that we have discovered a type of area for which [concession] agreements are not the best for defending national interests. Several countries around the world with this type of fields — low exploration risk and high potential — use this type of agreement. So much so that concession contracts will be maintained for the remainder of our oil fields. We have an area of almost 7 million square kilometers where there is a possibility of finding oil and gas; the total Pre-salt area is only 2% of that total."

Lima has been in touch with executives of the large international oil and gas companies operating in Brazil:

> "All of them have stated their intention to continue investing in the country. What they want is speedy approval of the rules. Ours will be a mixed regime, sharing agreements for the Pre-salt oil areas and concession for areas where the risks are higher. The fact that Petrobras is the sole operator generates benefits to the country, as it is the company that has the best knowledge of Brazilian geology and the best exploration technology in deep waters."

We are going to fight for the delimitation of the areas in which the Petro-Sal company will have veto powers in the operational committees.

Delcídio Amaral (Senator, PT)

Pre-salt oil and Dutch disease

Lilliana Lavoratti, from Rio de Janeiro

What is industrial policy for oil and natural gas? and what are its costs and benefits? The government seems to favor deepening the sector's productive chain with the exploration of the Pre-salt oil field, as evidenced by initiatives already underway within the National Bank of Economic and Social Development (BNDES) and Petrobras, the government-owned oil company. But no government policy is yet to be found on paper. It should only become a reality after studies by the Brazilian Export Promotion and Investment (Apex), the Institute of Applied Economic Research (IPEA), BNDES, and Petrobras are completed.

The early signals in terms of what is already being practiced raise fears that Brazil may face the same problem as other countries that discovered large oil and gas reserves: Dutch disease. That is the risk of deindustrialization resulting from the concentration of investments in the oil sector to the detriment of others, and of exchange rate appreciation resulting from the large inflow of foreign currency from oil exports, which makes imports very competitive relative to domestic industrial production.

It happened in Holland (hence the name), where the discovery of oil in the late 1950s, when international prices were high, channeled all public funds into oil production and export. As a result, other industrial segments contracted and the Dutch began to import a lot, so the share of industry in GDP fell from 23% in 1970 to 17% in 1990.

Diagnostics

The economist Regis Bonelli, a researcher at the Brazilian Institute of Economics (IBRE / FGV), says that for deindustrialization to occur, Brazil would have to alter the structure of production in favor of mineral commodities, and this would have to coincide with a period of exchange rate appreciation. That, he says, is not currently the case. In fact, industry is recovering after the problems caused by the international crisis. Moreover, he points out, "our economy is still relatively closed, which increases import costs."

The current existence of factors that defend against deindustrialization, however, does not guarantee the country immunity from Dutch disease. That will depend primarily on a combination of factors. Bonelli notes that "Oil and gas from Pre-salt are simply a promise of new com-

modities; we still do not know when they will be sold, in what quantities, and at what price. Another unknown is whether all the technological innovation effort will actually be directed to this segment, as some think."

According to the economist Mansueto Almeida Junior, director of Research and Innovation of the Institute of Applied Economic Research (IPEA), the fear that Brazil — and BNDES — will focus industrial policy on oil and gas and forget other segments of the economy has arisen because the government has not yet made its policy clear. Public investments are reportedly being channeled to the oil sector. "The government has defended a change in the law to increase the BNDES loans to Petrobras, resulting in substantial financing to the Petrobras group," Almeida said.

Current policy cost

BNDES provided US$25 billion to Petrobras in 2009. "Since the Bank did not have that money, these operations have a cost, which is the interest differential between what the Treasury pays to borrow and the rate the BNDES pays the Treasury," Almeida explains. "We cannot do everything."

Almeida thinks the government has another option in mind. He cites the Program for Modernization and Expansion of the Fleet Transpetro (Promef), established to revive shipbuilding in Brazil:

> "We know that the construction of oil tankers is a large-scale, capital-intensive activity. Here we are trying to create the industry, which is risky. Building the whole production chain could result in a slower pace of oil extraction from the Pre-salt, and the country would miss the opportunity to use oil revenue in education, health, innovation, and even industrial policy for other sectors."

He also points out that industrial policy is not changing the production structure — nor Brazil's comparative advantage:

> "Today, measured by the trade balance, Brazil has a trade structure very similar to that of the mid-1990s, in which primary products and low technological content have considerable weight in total exports. Our industrial policy seems to be consolidating this structure."

Currency appreciation

When the wells of the Pre-salt fields are up and running, oil exports will bring in a large flow of dollars. For the economist Samuel Pessoa, head of the Center for Economic Growth (IBRE / FGV), a consequence will be increased demand for imported goods and domestic services. "Relative prices will change, making domestic services, which cannot be imported, more expensive and imported manufactured goods cheaper," he says.

Pessoa adds that Pre-salt will require huge investments in a country that saves little (less than 20% of GDP). "If we opt to attract foreign savings and buy everything abroad, this will not interfere with other domestic industrial sectors. But if we opt to do everything with local production, it will be necessary to

One way to mitigate the appreciation of the exchange rate would be to increase domestic savings to avoid having to use foreign savings to finance domestic investment.

Samuel Pessoa (Center for Economic Growth IBRE-FGV)

There will be no competition because the only buyer is Petrobras, and national suppliers will have priority.

Adriano Pires (Brazilian Center for Infrastructure)

One way to mitigate the appreciation of the exchange rate would be to increase domestic savings to avoid having to use foreign savings to finance domestic investment.

Samuel Pessoa
(Center for Economic Growth IBRE-FGV)

Building the production chain could result in a slower pace of oil extraction of the Pre-salt.

Mansueto Almeida Junior
(Institute of Applied Economic Research, IPEA)

use local currency, Brazilian reais. So foreign savings will have to be exchanged for local currency to buy domestic supplies and hire employees. This will make prices go up and the exchange rate appreciate." One way to mitigate appreciation of the exchange rate, says Pessoa, would be to increase domestic savings to avoid having to use foreign savings to finance domestic investment.

Competitiveness

Adriano Pires, director of the Brazilian Center for Infrastructure (CBI), a private consulting firm, has a negative view of what will happen. While agreeing with the policy of national content that has been practiced for some time in the oil and gas production chain, he believes it could make domestic industry less efficient. There will be no competition because "the only buyer is Petrobras, and national suppliers will have priority," he says. According to the policy of local content, goods and services in the oil and gas production chain must be produced by Brazilian companies, with targets for nationalization indexes.

However, Sérgio Gabrielli, CEO of Petrobras, is adamant that the nearly US$174 billion in investment needed to explore the Pre-salt fields will not cause problems: "The major limitation on Pre-salt exploitation is the capacity of suppliers to deliver equipment — rigs, pipelines, support ships, etc. — at reasonable prices and on time."

The policy of national content reflects the goal of producing in Brazil to generate employment and income, Gabrielli says. "If the cost of the first ship built by a shipyard contracted by Petrobras is not in line with international prices, the cost of the tenth ship will be," he emphasizes.

Partnerships

Another way to enhance competitiveness is to encourage Brazilian companies to associate with foreign companies to install plants in Brazil. The scale and diversity of investments in the Pre-salt fields would thus stimulate local industry. Roberto Zurli Machado, superintendent of the Basic Inputs Area of BNDES, said the role of the BNDES in financing the development of national industry will increase with the Pre-salt, enabling national industry to compete in the global market.

Efforts will be directed to development of the production chain, with emphasis on promoting manufacturers of electric motors and generators, support systems for all platforms, and construction of ships on a much larger scale. This will facilitate emergence of a national basic engineering cadre to strengthen local projects.

"With a bigger market Brazilian industry has become to view oil and gas as a great opportunity. Industry is starting to diversify its product portfolio to meet the needs of the oil industry," Zurli says. To prevent Brazilian loss of competitiveness because of a flood of dollars and currency appreciation, he says, "The secret is to increase oil exports from the Pre-salt accompanied by investment in local production."



CHINA
fears the inflation dragon

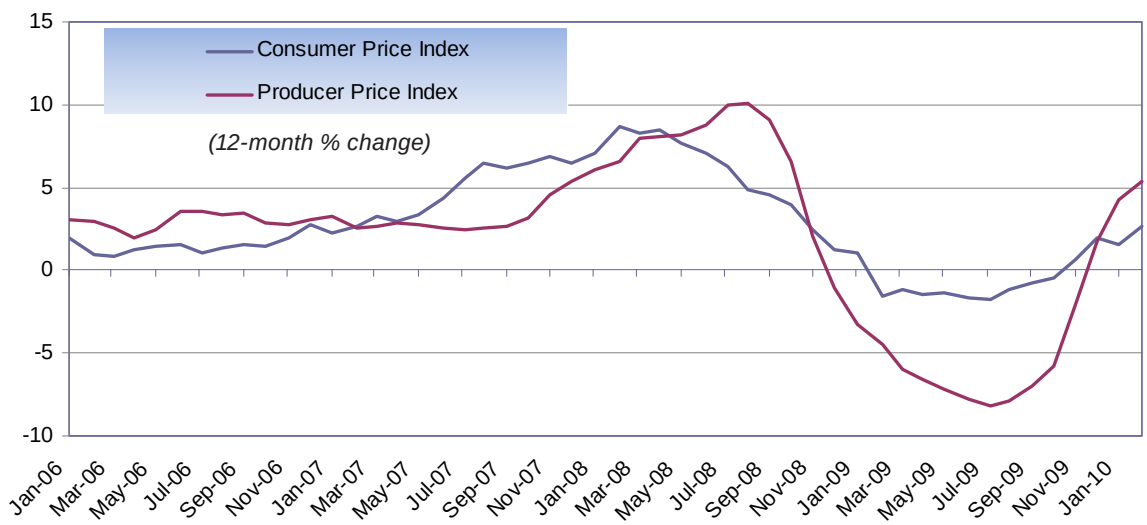
ZHOU XIAOCHUAN
(People's Bank of China Governor)
Photo: Renmin Ribao newspaper

Angelica Wiederhecker, Beijing, China

China has emerged as the country least affected by the worldwide financial collapse. While many developed countries faced harsh recession in 2009, China grew by a robust 8.7% — and by an astonishing 10.7% in the last quarter alone.

When the crisis began, the government mobilized a huge volume of resources to stimulate the economy, the bulk of it in lending by state-owned banks. As a result, new loans more than doubled last year. This year the momentum is still powerful. As developed countries begin to recover, Chinese exports will again grow, and China's heavy investment in infrastructure will continue. Yet one factor could disrupt the recovery: high inflation.

China's stimulus measures lead to a huge credit expansion and acceleration of inflation.



Source: China's national Bureau of Statistics.

Although China's Consumer Price Index (CPI) showed deflation for most of 2009, the 12-month inflation rate increased by 0.5% in November, 1.9% in December, 1.5% in January, and 2.7% in February.

Over the past two decades China has achieved an enviable combination of rapid economic expansion and only modest inflation. However, the significant increase in money supply last year could fuel inflation while the recovery in the economy is still consolidating. Changes in the structure of the labor market could also cause wages to zoom up. Because an inflation take-off could seriously slow growth, that risk has been intensely debated among top government officials.

The signs of the dragon

Although the Consumer Price Index (CPI) showed deflation for most of 2009, the 12-month inflation rate increased by 0.5% in November, 1.9% in December, 1.5% in January, and 2.7% in February. Rising food prices were the main cause; they rose 5.3% in December, 3.7% in January, and 6.2% in February. After falling 2.1% in November, the 12-month Producer Price Index (PPI) inflation also rose, to 1.7% in December, 4.3% in January, and then 5.4% in February.

Seasonal factors explain some of the recent pickup in inflation, especially heavy snows that damaged crops and hampered transport, pushing up food prices. But keep in mind that last year's stimulus measures led to a 30% expansion in the volume of credit in the economy. Chinese banks issued US$1.4 trillion (RMB 9.6 trillion) in new loans in 2009, almost double the total of 2008 and equivalent to more than 25% of GDP. In January 2010 alone, loans reached RMB 1.3 trillion. "The faster than expected CPI acceleration, combined with the banks' rush lending in the beginning of the year, is likely to reinforce inflation expectations," said Qu Hongbin, an economist at HSBC bank. He thought Beijing will have to tighten credit through higher reserve requirements, open market operations, and guidance on how much banks should lend. He added that Beijing is expected to cut back on new infrastructure projects, another effective instrument of macroeconomic tightening.

The recent numbers have fuelled the debate among economists and policymakers about how to deal with inflation risk. Officially, Beijing has been downplaying the threat. In early February People's Bank of China Governor Zhou Xiaochuan said that inflation was "relatively low," but acknowledged that it should be watched "closely." Despite such low-key official statements, however, "the problem of inflation and the pressure created by asset bubbles is causing great concern among government officials," Fan Gang, an advisor to the Chinese central bank and director of the National Institute of Economic Research of China, said in a recent interview. "I believe that the asset price bubble is the main concern for the country and an issue that we must resolve" — a reference to the current

frenzied speculation in property markets, especially in larger cities.

The huge recent expansion in credit has raised red flags, particularly because the economy had already been growing fast for many years. "The scale of credit last year was unusually large," said Zhang Weiying, professor of economics at the University of Beijing, who pointed out that excessive expansion of credit combined with low interest rates had triggered financial crises in other parts of the world, causing inflation and a surge in bad debts.

For a few months the Chinese could manage a temporary surge in inflation through monetary tightening and a dip in economic activity. The problem, however, is that structural changes in the labor market could produce longer-term inflationary pressures. Before the global crisis wages were already beginning to rise rapidly. That phenomenon is now recurring as the economy recovers. "This is not just a short-term issue — the Chinese government should seriously worry about it," said economist Arthur Kroeber, editor of the China Economic Quarterly.

Wage inflation

The number of new workers aged 15 to 20 years coming into the labor market peaked in 2005, when 125 million Chinese from that age group sought work. But China's one-child policy, initiated in the early 1980s, means that the number of new workers is now declining. That is pushing up the value of wages. Data from investment bank UBS shows that at the beginning of the 1990s salaries of internal migrants were increasing annually at about 3% a year. Since 2004, that pace has more than doubled, with salaries at the lower end increasing by 10% to 15% each year.

Moreover, a new labor law introduced early in 2008 extended the rights and benefits already granted to most urban workers to more than 100 million migrant workers, which will further elevate labor costs. During the global economic crisis about 20 million people in China lost their jobs — many without the means to return to their home provinces until they received help from local governments — so wage pressures were contained. Now the labor market is again tightening.

The rebound in exports means that "wage pressures are expected to rebound again, potentially boosting domestic demand and adding to pressure on prices," said economist Liu Ligang at ANZ Bank. A recent survey by ANZ shows demand increasing for workers in cities around the country and in most major sectors. For example, Jiangsu province (one of the richest in the country, close to Shanghai) recently raised the local minimum wage by 13% in an attempt to attract migrant workers. Liu said, "We expect other provinces,

Some economists believe that higher inflation could bring benefits — as long as it can be kept under control.

Another possibility if prices rise is that the government could decide to let the nominal exchange rate appreciate to dampen inflationary pressures.

especially those in the coastal areas, to follow suit soon."

But not everyone believes that a future of higher inflation is inevitable. Despite pressure from rising wages, China also has significant excess capacity that could dampen the pressures. Excess capacity has been one of the main reasons why inflation was only moderate for most of the last decade. With high rates of domestic savings and state-led investment, China's economy has been flooded with bank credit. Last year, total fixed asset investment was equivalent to 47% of GDP — far beyond the 20% invested by most developed economies.

"The government knows very well that the economy is suffering from overcapacity," said Yu Yongding, economist and former member of the central bank monetary policy committee, who has warned about the side effects of high investment. (Investment has been growing rapidly since 2001, when it was equivalent to 25% of GDP.) "Excess capacity will become more serious in the future," Yu said in a recent lecture. Moreover, the stimulus package has also undermined the efficiency of these investments, he said, although the government has taken measures to direct new loans to infrastructure projects rather than manufacturing plants. Professor Yu calculates that the incremental capital-output ratio has reached more than 6 in China, compared to a ratio between 1991 and 2003 of 4.1 (and to 3 in Japan in the 1960s). He predicts that this reduced efficiency "will have significant negative consequences for China's long-term growth."

However, economists Hong Qiao and Yu Song at Goldman Sachs argue that overcapacity in the economy has been exaggerated. If so, inflation risk could be greater than many think. They point to surges in demand for electricity, coal, transport, and metals as indications that higher inflation is a real risk. Even taking into account expected tightening measures, Goldman Sachs recently increased its forecast CPI for 2010 from 2.4% to 3.5% and predicts PPI of 5.5% for the year.

Yuan appreciation

Because high prices have provoked social tensions in the past, the Chinese authorities are usually very wary of a pickup in inflation. Many believe that high inflation was an underlying cause of the Tiananmen Square protests in 1989. Therefore, if inflation actually does head upward, there will be huge political pressure to adopt measures to control prices. The most likely response would be considerable economic tightening, including a rise in interest rates and restricting new lending by commercial banks. If the causes of inflation should be short-term, a result of the monetary excesses of

2009, the consequence would simply be a temporary dip in growth. However, if an inflation outbreak is due to structural changes in the labor market, interest rates might have to stay higher, raising the cost of capital and reducing long-term economic growth potential.

Another possibility if prices rise is that the government could decide to let the nominal exchange rate appreciate to dampen inflationary pressures. Zhang Bin and Zhang Shugang, at the Chinese Academy of Social Sciences of China, a state-run think tank, recently proposed an appreciation of about 10% to contain inflation.

Some economists believe, however, that higher inflation could bring benefits — as long as it can be kept under control. For years Beijing's plan has been to try to stimulate domestic demand, especially consumption, so that it can replace exports as the primary driver of growth and reduce the economy's exposure to shifts in international markets. Because Chinese consumers have US$2 trillion in bank deposits that earn minimal returns because real interest rates are close to zero, a sustained rise in interest rates would increase the resources available for consumption. A stronger currency might also increase Chinese purchasing power, which would again encourage consumption.

Moreover, inflation might be seen as reflecting rising labor productivity. Inflation derived from increased productivity "should be viewed positively, not negatively," Arthur Kroeber told us. "If the authorities tolerate a higher rate of inflation, it will actually help the transition from an investment-driven economy to a consumption-driven economy, because the costs of capital and relative returns on labor will rise." The experiences of Japan and South Korea suggest that GDP growth of 8% per year can be sustained for at least a decade with annual inflation of about 5%.

If China is to consider accepting a higher level of inflation, however, it will need to make some adjustments in how it manages its economic policy. Previously Beijing has focused on achieving targets for economic growth. In 2009, for instance, the state did everything it could to generate a growth rate of at least 8%. However, if inflation were higher the government would need more instruments to contain inflationary expectations so that price increases did not run out of control. One way would be to introduce a system of inflation targets, which would help reduce the risk of inflation spikes. However, this would imply that Chinese growth rates could become less predictable.

Despite pressure from rising wages, China also has significant excess capacity that could dampen the pressures.

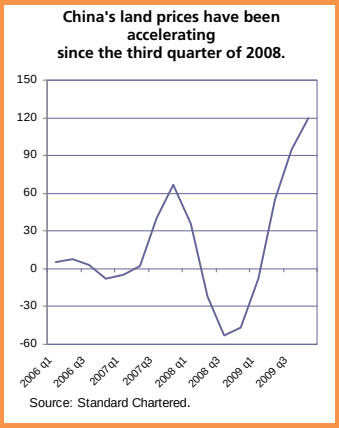
Anxiety about bursting the bubble

Dramatic price increases in the Chinese property market last year have set off alarms in Beijing about the risk of a speculative bubble in the big cities.

Prices of new apartments in 2009 rose by 68% in Beijing and 66% in Shanghai, according to the property group Knight Frank. In Shenzhen, a major city in southern China, prices rose by 51%. The ratio of house prices to average salaries suggests that China is now one of the most expensive places in the world to live. Policy-makers are worried about both the potential for social discontent about high property values and about the risks to the banking system of an abrupt correction in the market.

Many Chinese see buying a house as one of the most attractive ways of investing their money (along with equities), because they have few other options. Low domestic real interest rates reduce the returns on bank deposits, and tight government controls on flows of capital leaving the country makes it impossible to invest large sums elsewhere. Thus, the high rates of domestic savings and the trillions of Chinese yuan that have been injected into the economy as part of the stimulus package add up to excessive liquidity and repressed demand for investment alternatives.

The speculation has been particularly intense in the market for plots of land. Research by Standard Chartered found that



the average price rose from Rmb933 per square meter early in 2009 to Rmb1, 923 at year-end — an increase of 106%. The numbers cover land sold for residential, commercial, and industrial use. Although the national average was similar in 2007, the recent price increases in large cities like Beijing and Shanghai have been without precedent.

Stephen Green, chief economist at Standard Chartered in China, says there is little doubt that a bubble is building in many parts of the country: "In at least seven cities, the price of land tripled in 2009, which clearly shows that there is a bubble. If nothing is done, land prices will gradually be transformed into higher prices for residential apartments."

In a recent interview with the magazine China Business, Zhang Xin, president of SOHO China, one of the biggest property companies, warned about the consequences of overheating in the market. She said that the huge volume of funds the government has injected into the economy is the principal cause of surging prices. In particular, she noted that state-owned companies have been inundated with credit, adding that "State-owned businesses can be irrational because their executives are only in charge of the companies for a short period of time, and frequently their decisions are very much focused on the short-term.... with the objective of maximizing results... . As a result, if a plot of land is bought for a much higher price it does not matter, because the project will only be completed at some stage in the future when that person has left, which is why we are worried about the market." She said that if SOHO is bidding for a plot of land against state-owned companies, there is little chance that the company will win.

The government has already tried to slow the market down. The central bank has introduced tougher rules for getting a mortgage, requiring a 40% down payment on any second home. In some regions loans to developers are being reduced, and developers face higher penalties for sitting on large plots of unused land.

But the main worry for the government is that if its measures are too tough, the market could collapse. "The central bank is trying to slowly take the air out of the market in the most delicate manner possible, rather than bursting it," says Stephen Green.

Brazil and the challenge of reconstruction in Haiti



Photo: Biorn Maybury-Lewis

Riordan Roett

Under the administration of President Lula Brazil's international role has expanded dramatically. Among other things, the country is now recognized as a member of the emerging BRIC group (Brazil, Russia, India, and China) and was active in the most recent round of World Trade Organization negotiations. Although the negotiations collapsed at the last minute in August 2008, the Brazilian delegation signaled its willingness to work with the developed countries and World Trade Organization leadership to find a compromise solution. It is clear that there will be no return to global trade talks without the active participation of Brazil and its developing-world allies.

The international financial crisis that began in the United States in 2008 gave President Lula and Brazil's financial leaders, in conjunction with those in China and India, an opportunity to demand a greater role for the developing countries in finding solutions to the crisis. Brazil was instrumental in arguing for an expanded role for the G-20 nations (the world's largest economies) and an end to the near-veto exercised for decades by the G-7 states (the major developed countries, led by the United States). In a series of summits in Washington, London, and Pittsburgh, President Lula was adamant in calling attention to the regulatory and other failures that provoked the crisis in the United States and in Europe. Indeed, Brazil was one of the last countries to enter the crisis, which the authorities handled with skill, and one of the first to emerge, relatively unscathed, in 2010. The president has made it very clear that he expects Brazil to be part of all major decisions taken to restore the health of the world economy.

Another sign — and now an opportunity — was Brazil's decision in 2004 to

Riordan Roett is Sarita and Don Johnston Professor; Director of Western Hemisphere Studies and the Latin American Studies Program of the Paul H. Nitze School of Advanced International Studies (SAIS) of the Johns Hopkins University, Washington DC.

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assume the leadership of MINUSTAH, the United Nations peace-keeping contingent sent to Haiti after President Jean-Bertrand Aristide was overthrown. This was Brazil's first major commitment to international peace-keeping activities. By all accounts the Mission, led since its inception by a senior Brazilian Army officer, has been instrumental in reducing violence in the country.

Immediately after the earthquake that devastated Haiti in January 2010, the Brazilian government responded with a series of humanitarian initiatives. Although the country had lost 17 soldiers in the calamity, as well as a prominent social worker, Dr. Zilda Arns, the Brazilian government decided to increase the number of troops participating in MINUSTAH and authorized the Embassy of Brazil in Haiti to expend US$15 million in humanitarian assistance. Brazil also made significant contributions to a wide range of UN and multilateral aid organizations. Brazilian Air Force planes were deployed to transport Brazilian disaster specialists to Haiti. Tons of food, medications, and water were sent immediately, along with rescue dogs. An emergency portable hospital was assembled. The Foreign Ministry, sent a senior diplomat the day after the earthquake to coordinate Brazil's role with other countries and agencies working to provide emergency relief. A Special Support Group (SSG) was created in the Brazilian Embassy in Santo Domingo, capital of the Dominican Republic, to forward supplies over land, since the main port in Haiti was inoperable and the Port-au-Prince airport was seriously damaged.

Humanitarian assistance will continue to be needed for some time, and Brazil will remain a major player. Reportedly U.S. President Barack Obama has spoken with President Lula and indicated that his administration in Washington looks to Brazil to play a major role now and in the future. Other conversations between foreign policy leaders in the two capitals — and the visit to Haiti of the two foreign ministers — confirm the high priority being given to a comprehensive approach to Haitian recovery. While the immediate humanitarian crisis must be addressed, the longer-term need for national reconstruction must not be neglected. This is an opportunity for Brazil to take a leading role as the reconstruction of Haiti is planned. Having operated in the country since 2004, Brazilian officials are well known to the Haitian people and the authorities. Perhaps most relevant, the US should not take the lead in reconstruction efforts. The US is unpopular in Latin America, and the history of its involvement in Haitian history is highly controversial throughout the region. Brazil is viewed

by the countries in the hemisphere as a relatively neutral actor.

What is now needed is for a country in the region to take the lead in coordinating a multilateral effort to provide guidance for the long-term reconstruction. There is no better candidate than Brazil. The country has no "imperial" ambitions of the type the US is often suspected to have. Given the impressive economic and financial management of the Lula presidency, Brazil has the resources to offer significant amounts of money — in conjunction with many other donors — as it has done not only since January but since arriving in Haiti in 2004. A real challenge in Haiti will be the physical rebuilding of the country, and Brazilian construction companies are recognized as leaders in the field. Previous reconstruction efforts have been marred by corruption, little concern for building codes, and no thought to a realistic urban plan for the capital city. Brazil has the necessary expertise to guide this reconstruction differently.

The possibility of providing leadership in Haitian reconstruction would advance Brazil's new foreign policy effort to build institutions to reflect the new global realities. IBSA group (India, Brazil, and South Africa) is a reflection of the new dynamic of South-South diplomacy. Brazil has also been in the forefront in creating UNASUR, the new Union of South American countries; and the recently established South American Security Council reflects a wider vision of Brazil's expanding commitment to multilateralism.

The world community should welcome Brazilian leadership in the daunting task of helping Haiti re-create itself. Brazil has the resources, financial and human, to do so. To accept the role of leader would reflect the other impressive developments in foreign affairs under the Lula presidency. Brazil has been influential in trade negotiations and in creating new financial architecture. An expanded role in Haiti would build on Brazil's experience since 2004 in protecting Haitian lives from widespread violence. The security role leads seamlessly into one of long-term reconstruction. The world community, and especially the United States, should move to approach the Brazilian authorities to discuss an appropriate way to carry out the reconstruction. It may be the UN. It will also require the participation of the Inter-American Development Bank and other financial institutions, and it will be crucial to coordinate the work of the many NGOs now active in the country. Lastly, effective diplomatic discourse with the government of Haiti will be essential. Brazil is uniquely prepared for this role. And it can do it with more tact and understanding than the United States.

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Fixed investment again up

High industry confidence and low inventories in the last two quarters of 2009 anticipate a continuation of robust fixed capital formation. The FGV industrial confidence index (ICI) continued to increase through January 2010, remaining above its historical level of 97. Gross fixed capital formation, a component of aggregate expenditure, recorded growth compared to the previous period of 6.7% in the third quarter of 2009 and 6.6% in the second. Besides further easing inflationary pressures, this performance suggests that prospects for the medium-term growth of the Brazilian economy have not been affected by the crisis.

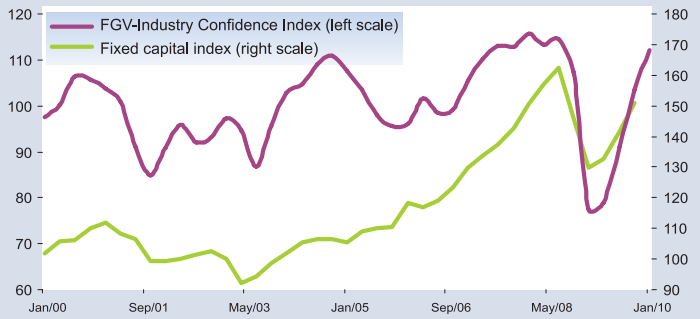
Foreign investment inflows again strong

The buoyant business climate and relatively low inflation have attracted foreign investment. Total foreign investment has been growing since the recession bottomed out in the second quarter of 2009. Foreign portfolio investment grew to US$52 billion in the 12 months through January 2010, which more than offset a fall in direct investment.

Stock market and exchange rate up

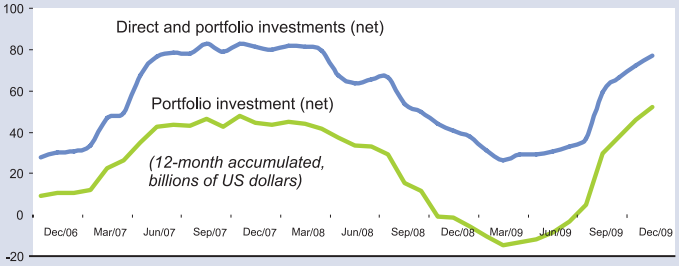
Large foreign capital inflows pushed up both the stock exchange and the exchange rate. Since the recession bottomed out in the first quarter of 2009, the São Paulo stock exchange (BOVESPA) has gone up 130%, and the exchange rate appreciated by 30%, stabilizing between R$1.70 and R$1.80 per US dollar in recent months. The large capital inflows are a mixed blessing: the appreciation of the Real has hurt Brazil's manufacturing exports, although commodities exports continue to do well.

Strong industry confidence is leading the recovery in fixed capital investment.



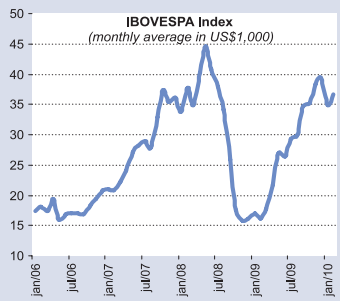
Source: IBRE-FGV and IBGE.

Foreign portfolio investment has recovered sharply since March last year reflecting Brazil's overall buoyant business climate.

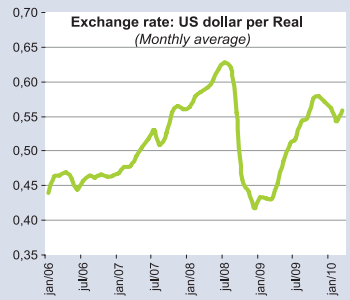


Source: Central Bank of Brazil.

Strong capital inflows pushed up stocks prices and the Real since March 2009.

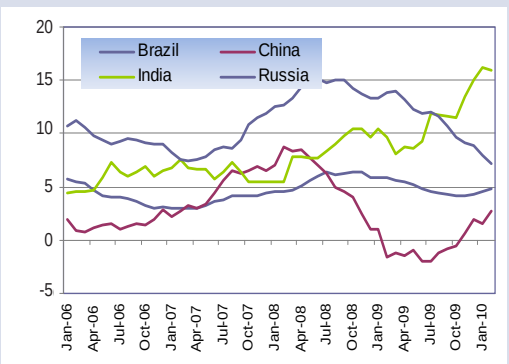


Source: BOVESPA.



Source: Central Bank of Brazil.

BRICs 12-month CPI inflation



Inflation on the rise in the BRICs

Economies around the world are recovering at two different speeds. While developed countries are still recovering slowly and inflation remains low, in the BRIC countries recovery is in full swing, so much so that inflation has become a concern. The risk of overheating in BRIC countries is currently high, although Russia has lagged behind recovery in the other BRICs. In China and India inflation has shot up so much since November 2009 that monetary authorities in both countries have moved to tighten monetary and credit conditions. The acceleration of inflation in Brazil since November has been comparatively moderate, but because of its history of high inflation and its current loose fiscal policy, there is a danger that high inflationary expectations could become entrenched. At its meeting on March 17, Brazil's monetary policy committee (COPOM) decided to keep the policy rate unchanged at 8.75%; a hike of 50 bps had been expected. The central bank may withhold a move on rates until COPOM's April decision, after central bank governor Meirelles has decided whether to resign in order to run for office in October.