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SWF: Saving starts at home

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Finance Minister (FM) Guido Mantega officially announced today that the government will send to Congress a bill creating Brazil's Sovereign Wealth Fund (SWF). At the same time, the FM announced that the government will save this year an additional 0.5% of GDP beyond the existing 3.8% of GDP primary surplus target.

Earlier indications suggested that the SWF would be legally constituted outside the non-financial public sector (NFPS), implying that resources deposited there – even if they remained idle, or if it were used to acquire treasury bonds – would be counted as primary spending and not as an addition to the NFPS primary surplus. It is not clear whether this feature will be maintained. If it is, a greater effort will be needed on the part of analysts to monitor continuously whether resources deposited into the Fund are indeed being "saved" in an economic sense – being thus equivalent, for net debt dynamics and/or aggregate demand management, to a higher primary surplus – or if they are being used in ways that, from the same economic point of view, would be indeed tantamount to ordinary primary spending.

Transparency (and, as a consequence, signaling impact) may thus suffer by comparison to the solution of directing the same amount of resources to increase the NFPS primary surplus and to the outright retirement of public debt. Indeed, the most transparent use of the resources within the SWF, so as to ensure its economic equivalence with an increase in the primary surplus target, would be the acquisition of treasury bonds by the fund. Of course, that policy would beg the question of why to set up the SWF in the first place rather than regularly retire debt, unless the point is exactly to produce an increase in primary surplus that does not dare say its name (given its unpopularity in certain political circles).

Despite these potential transparency issues, a positive note came with the upfront commitment to a specific size for the extra savings. There were concerns that the government might choose to work on a best efforts basis, simply indicating that it intended to save some more and to direct the proceeds to the SWF, but without committing to hard quantitative targets. Then again, greater clarity on the design of the SWF will be required to ensure that the commitment cannot be bypassed by a leakage from the SWF into uses that would be economically equivalent to primary spending (besides being treated as such by the official accounting). Some such leakage needs to be allowed in certain circumstances if the SWF is indeed meant as a countercyclical transfer of resources across time. The question is to ensure that the sign and the absolute size of the fiscal impulse can be clearly read in the Fund's financial reporting.

A true extra saving of 0.5% of GDP is a welcome effort, even if it is mostly a reflection the cyclical revenue boom. After all, demand management would be more problematic if, instead, the government prevented the “automatic stabilizers” from working by finding a way to spend these monies. Taking into account the recent fiscal performance, we expected the primary surplus to decline towards the end of the year, eating into the safety margins built so far, to reach 4% of GDP by year-end. Therefore, we read the news as implying that the primary surplus over-performance we were forecasting (with respect to the 3.8% target) will now be directed to the SWF, and the extra savings will also about offset the expected decline in the primary surplus from the current levels (4.23% of GDP). Yet a greater contribution to domestic demand moderation would be given if there was a clear tightening of the cyclically adjusted fiscal stance, relying more on expenditure restraint than on revenue over-performance and on the reinstatement of the extinct CPMF tax.

With regard to the foreign exchange (FX) policy ramifications of the SWF, according to the FM’s announcement today there will be none, at least, at first. In the format originally conceived, the SWF would acquire FX in the local spot market in a bid to contain the appreciation of the BRL. According to today’s announcement, the FX intervention activity will be in abeyance until macroeconomic conditions allow – presumably until the inflation outlook clears, opening greater room for attempts to keep BRL appreciation in check. Greater clarity about whether, when and how the fund could start acquiring foreign assets may come as the congressional discussions of the SWF bill progresses.

FX markets have been paying a great deal of attention to the potential implications of the SWF for the BRL. We are skeptical about the effectiveness of such intervention even once it materialized – as it would inevitably be sterilized by the Treasury itself or by the Central Bank, in order to keep overnight Selic rates in line with COPOM-set targets. We are even more skeptical about the effectiveness of the mere threat of such intervention – a highly uncertain prospect all along – in keeping the BRL depreciated. Markets seemed to be worried, though, that the operational practices of the SWF might be considerably more aggressive than those followed by the BCB in its reserve acquisitions. Even if its effects on the BRL were not sustained, there was the perceived risk of short-run mark-to-market losses on long BRL positions. This source of risk, if not entirely removed, has apparently been deferred.

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