Finance Minister Guido Mantega has announced the main guidelines for the Brazilian Sovereign (BS) Fund. According to the minister:

1. Resources for the fund should come from the excess primary surplus relative to the official target (3.8% of GDP);

2. The government should aim, unofficially, for a primary surplus of 4.3% of GDP, which should warrant some 0.5% of GDP (BRL13 billion; US$8 billion) for the BS Fund;

3. Although the BS Fund could, in principle, constitute foreign currency assets (purchasing hard currency in the FX market), at the beginning it should invest only in domestic assets;

4. The National Treasury should be in charge of the BS Fund management.

We have already advanced our opinion that the BS is not, all things considered, positive news. We would note the following points:

* Whereas it is good news that the current level of the primary surplus (4.2% of GDP) will not be pushed toward the target, thus not generating a fiscal impulse of nearly 0.5% of GDP, the truth is that maintaining the primary surplus at the levels observed recently should not be of much help in terms of containing inflation. After all, inflation has accelerated even with a primary surplus hovering around 4.3% of GDP since January 2007.

* A meaningful fiscal adjustment at this point would require increasing the primary surplus to well above 4.3% through lower spending, not simply allowing cyclically higher collection to do the job.

* The decision to increase the primary surplus is actually independent of the constitution of the BS Fund (i.e., the government could raise the target in the absence of the BS Fund). The BS Fund is, thus, an alternative to allocate the primary surplus relative to a faster reduction of the domestic debt.

* Given that, the opportunity cost of the resources invested in the BS Fund is the cost of the domestic debt. The challenge BS Fund managers face, then, is to generate assets whose yields should beat the cost of the debt, a task that, as many experienced hedge fund managers in Brazil can attest, is easier said than done.

* Assets in the BS Fund should be highly correlated with local business cycle, meaning that they should do well when collection is booming, and not so well when collection dwindles, a feature that is unlikely to get any high praise in terms of financial soundness.

* It is good news that the BS Fund should refrain from further intervention in the FX market at this point, given that the last thing inflation needs now is an impulse coming from a weaker currency (even though our take is that all intervention would be sterilized, and therefore its impact on the FX level, if any, would not last long).

That said, the proposal came to light significantly watered down relative to initial versions circulated some time ago, which is, perhaps, the best part of the story.

--Alexandre Schwartsman