

The Brazilian SWF: a misplaced idea

> The ministry of Finance announced yesterday its intention of creating a Sovereign Wealth Fund (SWF) and will send to Congress a proposal with this objective in coming weeks. The Fund will purchase hard currency in the market and use these resources to invest in offshore assets, including assets issued by Brazilian companies. Minister of Finance, Guido Mantega, said explicitly that one of the purposes of this fund is to support the internationalization of Brazilian companies.

> We see this announcement negatively, and there are two basic issues we would like to discuss. The first is: should Brazil create a SWF?

> The answer in our opinion is no, essentially because Brazil lacks the fundamental characteristics of other economies that created SWFs. More specifically, these funds were usually created in economies where i) domestic savings are large, implying structural current account surpluses, and ii) fiscal accounts show nominal surpluses. Brazil definitely does not meet those requirements: domestic savings are extremely low (below 20% of GDP) and the country has posted current account deficits on average for several decades. Thanks to positive shocks on terms of trade, there were surpluses in the last five years, but the current account is back to negative territory in 2008, and further deficits should be seen in coming years. As for fiscal accounts, nominal deficits have always prevailed, although they have decreased in recent years. As a result of that, purchases of hard currency to constitute the SWF will demand the issue of domestic debt, which are a costly liability, since interest rates in Brazil are still high by international standards.

> The second issue is: assuming that the SWF will be created, what types of assets should it purchase? In other countries the SWF are a mechanism of risk diversification. Countries in which fiscal revenues and exports are largely affected by the price of a specific commodity, for example, will use the SWF to invest in assets which have a negative correlation with the price of this commodity. In this sense, we deem it is a bad idea to use the SWF to invest in assets issued by Brazilian companies. Obviously, prices of those assets have a positive correlation with the overall economic performance of Brazil, and therefore the idea of supporting the internationalization of Brazilian companies does not respect the basic principle of risk diversification. In addition to that, it is not clear whether investment policies will actually pursue the maximization of expected returns and minimization of risk. If this is not the case, there would be implicit subsidies, which would be particularly unwelcome given the lack of transparency.

> In all, although we acknowledge the successful experiences of other countries with SWFs, we think that this idea is misplaced in Brazil. Our sense is that, apart from creating a mechanism to support Brazilian companies, the other objective is to create a mechanism through which the ministry of Finance will have the ability to intervene in the FX market. In this sense, the SWF potentially magnifies lack of coordination of economic policies between Central Bank and Ministry of Finance.

> Although negative, however, we believe that the practical impacts of SWF are likely to be relatively small. Apart from the fact that the proposal must be approved by Congress, and therefore its full implementation is likely to take some time, we deem that scope for interventions in the FX market is likely to decline in coming quarters, essentially because balance of payments surpluses will shrink. As we argued several times in recent opportunities, we see relatively fast current account deterioration, and this trend eventually will have an impact on exchange rate expectations and also on capital inflows. If this view proves correct, the SWF may have a more limited scope, although it is still true that its creation represents an institutional setback.

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