



Present:

**ECONOMIC-FINANCIAL REPORT n. 2 Latin America
April 2010**

Latin America Area Director: Mr. Antonio Curia

Brazil and India add to pressure on China

China is facing growing pressure from other developing countries to begin appreciating its currency, providing unexpected allies for the US in the diplomatic tussle over Beijing's exchange rate policy.

Speaking ahead of a meeting of finance ministers and central bank heads from the Group of 20 countries which starts on Thursday in Washington, Indian and Brazilian central bank presidents have made the most forceful statements yet by their countries about case for a stronger Chinese currency.

While most of the public pressure on China has come from the US, the comments underline that a number of developing economies feel that China's dollar peg has imposed costs on their economies.

Henrique Meirelles, head of the Brazilian central bank, said that a stronger Chinese currency was "absolutely critical for the equilibrium of the world economy". He said there were "some distortions in world markets, one of them is a lack of growth and another is China".

Duvvuri Subbarao, governor of the Reserve Bank of India said that an undervalued renminbi was creating problems for countries, including India.

"If China revalues the yuan, it will have a positive impact on our external sector," Mr Subbarao said. "If some countries manage their exchange rate and keep them artificially low, the burden of adjustment falls on some countries that do not manage their exchange rate so actively."

Lee Hsien Loong, prime minister of Singapore, added his country's voice to the debate last week, saying it was "in China's own interests" with the financial crisis over to have a more flexible exchange rate.

Some in China have fended off US pressure for a stronger currency, describing it as a distraction from the real causes of the financial crisis. However, criticism from developing countries is not so easy to bat away. "If the rich and emerging economies are united in asking China to revalue, it would be harder to dismiss the request as an example of superpower arrogance," said Sebastian Mallaby at the Council on Foreign Relations.

CONFIDENTIAL

The increase in criticism of China comes at a time of relative calm between Beijing and Washington over the issue, with many US officials and analysts assuming China has already decided to abandon its peg with the dollar over coming months.

The impact of China's currency policy on other developing countries is not clear-cut, however. Although a number have seen their currencies appreciate sharply over the past year, putting pressure on their exports and exposing them to fiercer competition from China, the economic recovery in China has also provided a boost, especially for its neighbours in Asia as well as commodity-producing countries such as Brazil.

[From Financial Times print edition]

A special report on business and finance in Brazil

Survival of the quickest

Frequent crises have made for strong banks and nimble financiers

BRAZILIAN businessmen often say that the country's recent economic past has strengthened companies, and especially banks. The argument goes like this: you need to be good, or at least inventive, to survive and make money when you.

BRAZILIAN businessmen often say that the country's recent economic past has strengthened companies, and especially banks. The argument goes like this: you need to be good, or at least inventive, to survive and make money when you have no idea whether inflation next year will be 50% or 500%. Bankers and finance directors have had to be particularly nimble. One example is Souza Cruz (a subsidiary of BAT), Brazil's largest tobacco company, which in the days of high inflation did no better than break even on its cigarette sales. Its profits came from the interest on the cash it held between being paid by retailers and paying tax fortnightly. Companies used to operating in such unusual circumstances flourished when life became more predictable.

There is some truth to this argument, even though it brushes aside the fact that until the 1990s Brazilian companies did not have to worry about foreign competitors. No big companies went bust in the recent financial crisis, despite losses on foreign-exchange derivatives that the Bank for International Settlements estimates at \$25 billion. Moreover, no big banks wobbled, let alone had to be rescued, though there were some mergers.

One reason was that a previous round of bank failures, in 1994, had already cleared out the bad ones. Until then banks made their profits by taking deposits from customers, lending the money to the government overnight and pocketing the difference. With inflation at several hundred per cent a year, many banks' balance-sheets were hard to decipher. When inflation came down, it became clear that a number of them were insolvent. These folded or merged with other banks, leaving only the stronger ones.

Brazil's financial system got a further boost from reforms carried out when Arminio Fraga was governor of the central bank from 1999 until the start of 2003 (he is now at Gávea Investimentos, an investment firm). The country's bank-settlement system now operates in real time, so all banks know their cash positions at any given moment and the central bank has an overall picture of what is happening. Before this system was introduced the central bank often ended up honouring the debts of banks that went bust, creating a dangerous incentive to be careless. Both Mr Fraga and his successor as governor, Henrique Meirelles, have made sure that banks report what is going on in any off-balance-sheet vehicles they have funded. This has helped to keep under control the

special investment vehicles, conduits and other mysterious creatures that have caused so much damage in other countries.

This transparency extends to financial markets too. All fund managers must disclose the net asset value of their funds to Brazil's Securities and Exchange Commission (CVM) daily, though with a 48-hour delay. At the end of every month funds must disclose what they were holding 90 days ago. Anyone can go to the CVM's website and look up these numbers. Fund managers may grumble about too much disclosure, but most are happy with the rules. Maria Helena Santana, who chairs the CVM, explains that they make it harder to pull off a scam of the sort run by Bernard Madoff, whose pyramid scheme was hidden behind a veil of secrecy.

Created equal

Equity investors, for their part, have benefited from new rules for publicly traded companies brought in by the São Paulo stock exchange (Bovespa) in 2002. Big Brazilian companies used to be notorious for abusing shareholders with minority stakes. Under current guidelines, it is illegal to issue shares that pay out different amounts to different holders in the event of a takeover. Any disputes between shareholders are judged by the CVM. With these rules in place, foreigners have been happy to buy shares and Brazilian companies that were unable to borrow in capital markets are now able to finance their expansion.

A boom in initial public offerings (IPOs) followed. At its height, in 2007, 80% of the money for IPOs came from foreign investors. This undoubtedly led to some excesses: at one point there were more listed housebuilders in Brazil than in America. But some of the companies that floated will do well. And the message conveyed by the new rules—that better corporate governance allows people to make money by selling bits of their companies on the stock exchange—has been good for the family businesses that make up the bulk of Brazil's medium-sized firms.

Reuters

Plenty to celebrate

Santander Brasil's recent IPO was a test of whether investors' appetite for Brazil had returned. It proved to be the world's largest IPO this year, valuing the bank's Brazilian subsidiary at more than the whole of Deutsche Bank worldwide. The government is so worried about foreign portfolio investors pushing up the value of the real that it imposed a 2% tax in October to discourage them. IPOs have a wider benefit because companies that want to float all or part of their stock need to get their accounts in order, pay their taxes and make sure their workers are not part of the black economy.

All this has brought sophistication and liquidity to Brazil's financial markets. São Paulo's futures and options market is one of the five largest in the world by volume traded. Well-developed markets have been good for consumers too. High interest rates, high inflation and dysfunctional courts once made consumer credit rarer than snow. Thanks in part to a series of reforms carried out in Lula's first term, credit has grown steadily. Loans for bigger items, such as cars and apartments, have become available for the first time, thanks to a new law under which a lender remains the owner of the asset acquired with the loan until the last repayment is made, whereas previously the money would have had to be chased up through the courts.

Lula's first administration also introduced a new bankruptcy law that is credited with making it slightly easier to salvage something from companies that go under. There was room for improvement: a few years ago a World Bank study found that bankruptcy proceedings in Brazil took an average of ten years and left creditors with just two cents in every dollar owed.

Yet for all this progress, two glaring problems with Brazil's financial system remain. First, credit is very expensive. Second, only the government will lend for long periods, and not to everyone.

Tax and lend

CONFIDENTIAL

Brazil has a hybrid retail banking system, with state-controlled and private-sector banks competing directly. It is highly concentrated: Itaú Unibanco, the largest private bank, is among the world's 15 biggest on several measures and yet has almost no presence outside Brazil. Banco do Brasil, the largest state-controlled bank and one of the world's oldest financial institutions, vies with it for the title of the country's biggest bank. All told, credit from state-controlled banks makes up 37.6% of the total and has recently been growing.

Despite their different owners, the state-controlled and the private banks seem to be behaving in a remarkably similar way. Aldemir Bendini, the chief executive of Banco do Brasil, talks enthusiastically about international expansion. The bank will soon open five agencies in America to serve Brazilian expatriates. It also wants to help Brazilian multinationals abroad with local-currency financing. Meanwhile it will keep up its role as an instrument of public policy that does the bidding of the federal government, its biggest shareholder, and also look after the 22% of its shareholders who own traded stock. It looks like an incongruous mixture, but it appears to work. Itaú Unibanco too is keen on expansion abroad, but makes so much money at home that it does not seem to be in a rush.

In theory, all this should provide plenty of competition, with the two types of bank keeping each other honest and making sure that Brazilians have access to credit. In practice it does not quite work like that. Even though Itaú alone has 25,000 cash points, more than 500 municipalities in Brazil lack even a single bank branch. The two kinds of bank compete most fiercely in the comparatively wealthy south and south-east of the country. Banco do Brasil recently added to the geographical concentration by buying Nossa Caixa, a São Paulo state savings bank, and a large stake in Banco Votorantim, a private-sector bank.

The government has raised the limit for foreign participation in Banco do Brasil to 20% to attract more capital, but the state-controlled banks are not as well run as the private-sector ones, so the hoped-for competition has not materialised. The clearest sign of this is spreads—the difference between a bank's cost of borrowing and lending. The Institute for Industrial Development, a lobby group, calculates that average lending rates are 35% higher than deposit rates, against less than 10% in the other BRIC countries. The bankers' lobby disputes these figures, but nobody thinks that banks' spreads are thin.

Among the things that make them fatter are a curious tax on bank funding that increases costs, and high reserve requirements which mean that banks must squeeze more revenue from what they are able to lend. Bad-loan provisions are high too, reflecting the fact that consumer credit is concentrated among people who are already stretched. And a lot of credit is subsidised, which pushes up costs for the rest.

Brazil's banks have many things to recommend them; indeed they seem to exemplify what might happen if regulators elsewhere got their every wish. They are safe and their lending is well-capitalised and profitable. Two-thirds of Brazilian deposits are in local banks, which is unusually high for Latin America and a big change from the past, when anyone who had money kept it out of the country and in dollars. The banks also offer some things that would surprise American or European customers. Many ATMs provide a wide range of financial services, from dispensing cash to providing loans. Even so, for now credit is likely to remain too expensive for the country's good.

For companies trying to get credit, the problems are much the same. To make up for the absence of a market in long-term debt Brazil created a giant development bank, the BNDES, with a balance-sheet larger than the World Bank's. This is financed by an impost on labour and lends predominantly to Brazil's biggest companies—the opposite of what you would expect from a left-leaning country.

Because its large loans to Brazil's big names carry so little risk, the BNDES is profitable. It also does some more adventurous lending, although trickier credit assessments are farmed out to private banks, which collect a fee for their pains and also assume the risk of loans going bad. The

BNDES was useful to Brazil during the recent crisis as a stable source of funding, but its scale as the lender of choice for Brazil's best credit risks is probably impeding the development of markets in long-term debt, and the way it is funded seems fundamentally unjust.

Still, compared with the bank failures, frauds, market manipulation, volatility, disregard for contracts and near-absence of credit of the past, Brazil's financial sector has come a long way. Foreign investors have noticed, and have recently started pouring money into the country.

(from The Economist print edition)

Brazil sells contract to build power plant

By Jonathan Wheatley in São Paulo

Brazil's government successfully sold a contract to build a controversial hydroelectric power station in the Amazon jungle on Tuesday in spite of last-minute delays from legal injunctions and nationwide protests at its alleged social and environmental costs.

In a surprise to many observers, the race to build the Belo Monte power station was won by a consortium led by Chesf, a government-controlled electricity generator, with Brazilian construction companies Bertin, Queiroz Galvão, J Malucelli, Mendes Júnior, Serveng and Cetenco.

Belo Monte will be the third-biggest hydroelectric power station in the world, able to generate 11,000 megawatts, although its average output is expected to be about 4,500 megawatts over the year.

The winning consortium promised to charge a lower tariff than its rival for the 70 per cent of the power station's energy that will be sold into the national distribution system. It said it would charge R\$78 (US\$44) per megawatt hour, a discount of about 6 per cent to the stipulated maximum of R\$83 per megawatt hour. The remainder will be sold at unregulated prices to big industrial users.

The bid from the losing consortium – consisting of Andrade Gutierrez, a big construction company; Neoenergia, an energy company; Vale, the miner; Votorantim, an industrial conglomerate; and Eletrobras, the state energy company – was not revealed.

Several environmental groups staged protests around Brazil on Tuesday, saying the power station would have disastrous social and environmental consequences. Among protesters, Greenpeace, the environmental group known for its direct actions, placed piles of manure outside the national electricity agency in Brasília where the auction took place.

The auction also faced a series of injunctions granted to public prosecutors on the grounds that a preliminary environmental licence was invalid and that the project was being auctioned in contravention of Brazil's constitution. But government lawyers managed to overturn all legal challenges, including one that was granted when the auction had already been concluded on Tuesday.

Vladimir Pinto, an analyst at Bradesco, a large Brazilian bank, said the question now was whether, at such a low tariff, the project would be economically viable. "If the amount they have to invest is close to R\$19bn, then it will be viable," he said. "If it is closer to R\$30bn then it is more complicated. Everything will depend on what kind of finance they raise."

Many analysts have said the project, which involves enormous earthworks, cannot be built for less than R\$30bn.

The government made several changes to the auction rules over the past week to make it more attractive to investors. The BNDES, the government-controlled development bank, will offer up to

L&B Partners

(Research dept)

Monitor n. 2 Brazil Apr 10

80 per cent of the project's finance needs, and repayment terms were adjusted to deliver a better rate of return on investment.

The consortium is likely to face more legal challenges as it applies for a second environmental licence needed to begin construction. Protesters say the project will destroy the livelihoods of people living beside the Xingu River where Belo Monte will be built.

SÃO PAULO - Considered one of the main thermometers in investor confidence in the Brazilian economy, the EMBI +, calculated by JP Morgan Chase Bank, closed today for 175 points, 2,44% less than last month that was 204 points.

On the EMBI + Brazil

The Emerging Markets Bond Index - Brazil is an index that reflects the behaviour of Brazilian foreign debt securities. Corresponds to the weighted average of premiums paid for those securities for securities of equivalent term U.S. Treasuries, considered the most solvent country in the world, from virtually zero risk.

The indicator measures the surplus to be paid for the return of bonds guaranteed by the U.S. government. Means that every 100 points expressed by Brazil risk, the securities of the country pay a surcharge of 1% on the roles of the U.S..

Basically, the USA market the EMBI + to measure the ability of a country meet its financial commitments. The interpretation of the investors is that the higher the score indicator of risk, is applied in the most dangerous country. Thus, to attract foreign capital, the government considered "risky" to offer high interest rates to persuade outside investors to finance its debt - to what is called the risk premium.

More infos to be required at brasile@lawandbusiness.it

Best regards

L&B Partners



Disclosures:

This document is being provided on a confidential basis by L&B Partners Consulenza Italia ("L&B Partners") solely for the information of those persons to whom it is transmitted. This document is neither advice nor a recommendation to enter into any transaction with L&B Partners. This document is proprietary information of L&B Partners and may not be reproduced or otherwise disseminated in whole or in part without L&B Partner's written consent. Opinions offered constitute our views and are subject to change without notice. We believe the information contained herein is reliable, but do not warrant its accuracy or completeness.

CONFIDENTIAL