Report N. 42677-BR

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION

THE WORLD BANK

Country Partnership Strategy Brazil

2008-2011

The last Country Assistance Strategy Progress Report No. 36116-BR was discussed by the Board on June 6, 2006.

CURRENCY AND EQUIVALENTS

The Brazilian *Real* (R$)

R$1.74 = US$1 (April 2008)

WORLD BANK FISCAL YEAR

July 1 – June 30

ABBREVIATIONS AND ACRONYMS

AAA	= Analytic and Advisory Activity	Atividade Analítica e de Aconselhamento
CAS	= Country Assistance Strategy	Estratégia de Assistência ao País
BNDES	= Brazilian Economic and Social Development Bank	Banco Nacional de Desenvolvimento Econômico e Social
BOVESPA	= São Paulo Stock Exchange	Bolsa de Valores de São Paulo
CAF	= Andean Development Corporation	Corporação Andino de Desenvolvimento
CGIAR	= Consultative Group on International Agricultural Research	Grupo Consultivo para a Pesquisa Agrícola Internacional
COFIEX	= Commission on External Financing	Comissão de Financiamentos Externos
CPS	= Country Partnership Strategy	Estratégia de Parceria ao País
DPL	= Development Policy Lending	Empréstimo para Desenvolvimento de Políticas
FY	= Fiscal year	Ano Fiscal
GDP	= Gross Domestic Product	Produto Interno Bruto
GEF	= Global Environmental Facility	Fundo para o Meio-Ambiente Mundial
IADB	= Inter-American Development Bank	Banco Interamericano de Desenvolvimento
IBRD	= Institutional Bank for Reconstruction and Development	Banco Internacional para a Reconstrução e o Desenvolvimento
IFC	= International Finance Corporation	Corporação Financeira Internacional
IIRSA	= South American Regional Infrastructure Integration	Iniciativa para a Integração da Infra-estrutura Regional Sul-americana
IPEA	= Institute for Applied Economic Research	Instituto de Pesquisa Econômica Aplicada
FRL	= Fiscal Responsibility Law	Lei de Responsabilidade Fiscal
NGO	= Non-governmental Organization	Organização não governamental
MIC	= Middle Income Country	País de Renda Média
MIGA	= Multilateral Investment Guarantee Agency	Agência Multilateral de Garantia de Investimentos
MSMEs	= Micro, Small and Medium Enterprises	Micro, Pequenas e Médias Empresas
PAC	= Growth Acceleration Program	Programa de Aceleração do Crescimento
PPA	= Multiyear Plan	Plano Plurianual
PPP	= Public-Private Partnership	Parceria Pública e Privada
SIAFI	= Integrated System of Financial Administration of the Federal Government	Sistema Integrado de Administração Financeira do Governo Federal
SIL	= Specific Investment Loan	Empréstimo de Investimento Específico
SWAp	= Sector Wide Approach	Abordagem Setorial Ampla
TAL	= Technical Assistance Loan	Empréstimo de Assistencia Técnico

MANAGERS AND STAFF RESPONSIBLE

IBRD

Regional Vice President	Pamela Cox
Country Director	John Briscoe
Sector Leader / Task Team Leader	Deborah Wetzel

IFC

Vice President, Operations	Farida Khambata
Regional Director, LCR	Atul Mehta
Country Manager	Andrew Gunther
Task Manager	Pierre Nadji

ACKNOWLEDGEMENT

The World Bank Group greatly appreciates the close collaboration with the Brazilian authorities in the preparation of this Country Partnership Strategy. The preparation of the document involved extensive discussions with Government representatives and represented a team effort, which included hands-on involvement from all the sector units of the LAC Region, as well as IFC. The team would especially like to thank Kathy Lindert, Jennifer Sara, Mark Lundell, Mary Sheehan, Massimiliano Paolucci, Bradley Correa and Cristina Perez for their work on the CAS Completion Report and the CPS itself.

BRAZIL - COUNTRY PARTNERSHIP STRATEGY

TABLE OF CONTENTS

BOXES

TABLES

FIGURES

BRAZIL – COUNTRY PARTNERSHIP STRATEGY

EXECUTIVE SUMMARY

The 2004-2007 CAS identified four major challenges that Brazil faced in achieving inclusive and sustainable growth. On two of these – improving macro foundations and equity – Brazil made great progress. On the other two – improving competitiveness and environmental sustainability – progress was uneven. Thus, economic stability was consolidated and growth was fast for the poor, although there is still room for improvement in terms of economic growth.

During the CAS period the Bank consolidated its reputation as a valued partner for Brazil, providing valuable financial, knowledge and technical services. Perhaps inevitably, Bank support was effective in areas where Brazil did well and less effective where Brazil was less successful.

This CPS represents both continuity and change. Continuity in that the CPS positions the Bank as a partner for Brazil as it strives to meet its societal goals. And change because the perception of the Government on these goals, and the way in which the Bank can help, has changed.

The highest priority set by President Lula for his second term is to accelerate growth. The Government's flagship program, the PAC (Accelerated Growth Program) recognizes that investment in growth-supporting infrastructure has become a critical constraint to growth. While the PAC is the highest priority, the Government is also committed to consolidation and further improvement in the other major areas of macro and public sector foundations, equity and environmental sustainability.

This CPS is the Bank's response to a changed and evolving Brazil. The underlying philosophy is that, in a large and sophisticated middle income country:

- The Bank Group should not be engaging in areas where Brazil has the knowledge and capacity to manage by itself;
- The Bank Group cannot act as though it is a "shadow government" in Brazil, attempting to respond to every challenge that Brazil faces;
- The Bank Group should be engaging primarily with the long-run, path-setting challenges where Brazil has not yet devised solutions and where international experience can be of particular value. Brazilian leaders have identified such "desafios paradigmaticos", or paradigmatic challenges;
- The IFC and IBRD should work in a much more integrated fashion in addressing these challenges; and
- Bank analytic work needs to focus less on the "what," more on the "how," and on better integration of knowledge, lending and trust-funded activities.

In the last CAS period, IBRD lending was dominated by lending to the Federal Government and by large DPLs. With rapid growth in reserves, the Federal Government wants the focus of the IBRD program to change to one in which there is: (a) a strong technical assistance program of modest size with the Federal Government; and (b) a major lending program with states, on state priorities and in compliance with the Fiscal Responsibility Law. This emerging state-dominated program is branded as one based on "principled opportunism," in which Governors who are interested in working with the Bank define their priorities, and in which the Bank brings a set of well-articulated principles (based on analytic work and experience in Brazil and elsewhere) to the table. Initial experience is that this modus operandi leads to Bank support of high quality on "paradigmatic challenges" and that the strong political backing means that many long-standing implementation barriers are reduced. In this rapidly-evolving environment a "four-year plan" makes little sense. The CPS thus focuses on defining "rules of engagement" and describes some of the major operations which are expected in the next two years.

The evolution of the IFC program is similar. The IFC has moved away from financing Tier 1 companies, except in cases where: i) such financing is having a major demonstration effect, ii) it is helping to create new standards with regards to corporate governance and the environment, or iii) there is a significant south-south component. IFC may also resume funding of tier I companies should there be a need for counter-cyclical financing. Otherwise, the trademark for IFC involvement will be with Tier 2 companies, with an emphasis on improvement of corporate and social and environmental quality. In a substantial number of cases, detailed in this CPS, the IFC and the Bank will work together, one on the private side and one on the public side.

Finally, Brazil sees strong synergy in the Bank's focus on "inclusive globalization" and Brazil's emergence as a regional and global leader. For Brazil this means Bank partnership in regional development in South America, and for Bank, partnership in putting Brazil's leading role in critical issues such as conditional cash transfers, agricultural research, clean energy and climate change. And it means the IFC working as a partner in taking Brazilian companies global. For the Bank Group it means that Brazil is also a provider of ideas, experience and even financing (as an IDA donor, for example) for other members of the cooperative that is the World Bank Group.

The CPS identifies four types of risk, and measures to address these. The first is that the shift to a State focus might weaken engagement with the Federal Government. Initial experience, however, shows that engagement with the Federal Government has, if anything, increased. The second possible risk is that Brazil's recent successes might reduce the appetite for addressing some long-run challenges such as tax reform and social security. Here the Bank has no option but to put the "principled" part of "principled opportunism" to work, and to make sure that we are alert to, and engage, whenever opportunities for addressing these difficult structural issues arise. Experience to date has shown that doing this in a quiet, supportive-of-reformers mode can be effective. The third risk on the domestic front relates to the quality of spending, especially of the government's major infrastructure investment program. Here the Bank has been asked to engage, and is engaging, in helping to improve the quality of public spending and planning. External risks are not currently perceived as a major threat, given the excellent quality of Brazil's debt, monetary and fiscal management practices. Finally, the risk to the Bank of not pursuing a new and more flexible approach in one of our major MIC clients is that of irrelevance. The flexibility and approach of the proposed CPS strategy aims to help the Bank address this risk.

BRAZIL

COUNTRY PARTNERSHIP STRATEGY

I. A COUNTRY PARTNERSHIP STRATEGY FOR A "BRIC"

Like other continental countries (Russia, India and China), Brazil is a sophisticated middle income country for the World Bank Group in light of:

- Its achievements in many areas that are of great relevance to other countries of the world: it is a world leader in many areas – agriculture, biofuels, hydropower, mining, its AIDS program, conditional cash transfers, community driven development, forestry management, the Fiscal Responsibility Law (FRL);
- Its emerging leadership in the region and in the developing world;
- For its central role in dealing with many global challenges (including AIDS, climate change, biodiversity and clean energy);
- The fact that it is a demanding borrower that "pushes the Bank Group to the next level", by insisting that the Bank Group enter areas where it has been reluctant to participate; that the Bank Group engage primarily with long-range, complex development challenges; that the Bank Group develop new lending and financial instruments to meet Brazil's evolving demands; that the Bank engage with global challenges from the perspective of the developing world; that the IFC and IBRD work in a more integrated way; and that the Bank become more flexible, faster and less bureaucratic.

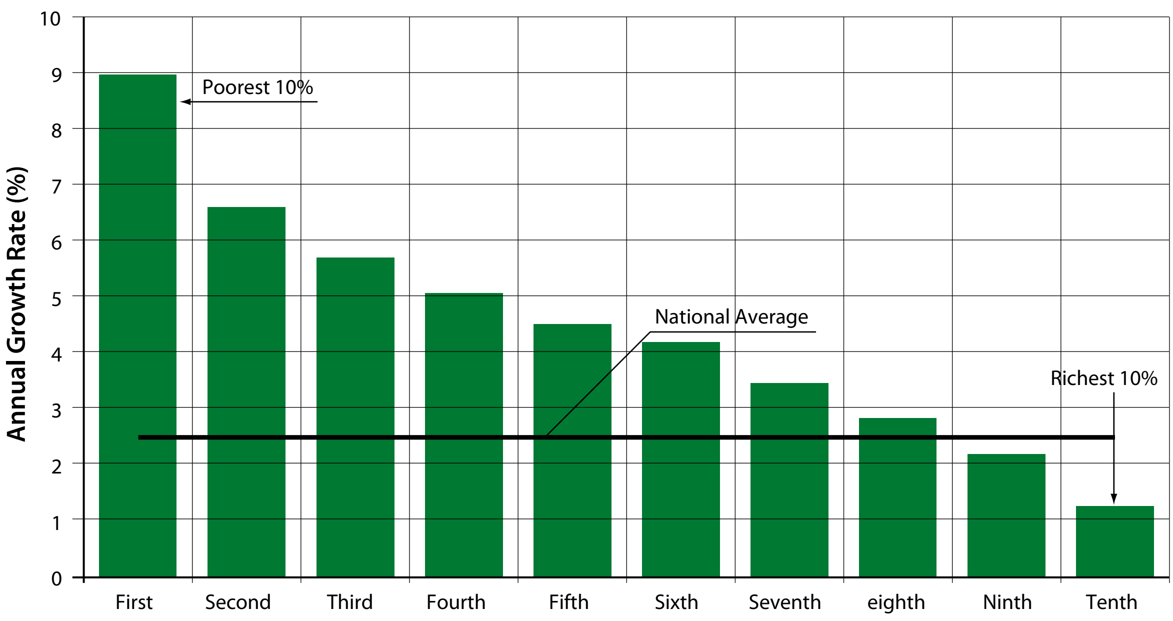
As the Bank Group has responded well to these demands in the past, other Bank's borrowers have benefited as Brazil-induced innovations have become general practice. An effective response to Brazil's evolving challenges means that the Bank Group is now seen by Brazil as a valued partner, with which Brazil wants to retain an important partnership. This Country Partnership Strategy needs to be seen in this context: a) as the result of an intensive process of joint work between the Government of Brazil and the World Bank Group (with consultations with many other partners), and b) as the manifestation, in one major MIC, of the ways in which the Bank Group can use its instruments – lending, knowledge, seal of approval and convening power – to continue to be a valued partner to the Bank's MIC owners.

II. BRAZIL'S ACHIEVEMENTS SINCE THE LAST CAS

In 2004, when the last CAS was developed, President Lula's newly-elected government faced several major challenges. There was deep concern (reflected in the "risco Brasil" being 2300 points after his election in September 2002) regarding the commitment of the Government to fiscal stability; Brazil had relatively low foreign exchange reserves and was thus vulnerable to external shocks; and it was unclear how the government would develop programs to meet its election commitment of attacking inequality. Brazil's progress over the CAS period has been impressive in terms of meeting these challenges. The country's fiscal outlook, debt situation and financial sector health are far different than they were five years ago. The Government has consolidated the country's commitment to fiscal responsibility, with the "risco Brasil" down to about 200 basis points. On April 30, 2008, Brazil obtained an investment grade rating from Standard & Poors, opening the way for a further acceleration of investment.

Brazil's reserves have grown to $190 billion, sufficient to cover 18 months of imports and 280 percent of short-term foreign debt. The commitment to a high primary surplus and improvement of debt management along with reduction of the debt/GDP ratio has helped to significantly reduce the vulnerability of public finances to adverse shocks. The vulnerability of public debt to exchange rate fluctuations has reduced dramatically, the share of fixed-rate instruments and average maturity increased substantially, and the external debt linked to foreign currency has been gradually substituted by local currency fixed-income instruments debt issued both in the domestic and Eurobond markets. The recent merger of the São Paulo Stock Exchange (BOVESPA) and the BM & F (Commodities, Futures and Derivatives Exchange) makes Brazil' consolidated exchange one of the top five in the world. While overall growth has been slow until recently, the incomes of the poor have grown very fast – at Chinese-level rates of 9 percent a year since 2000 (Figure 1, See also Annex 2 on poverty reduction and recent economic developments and sustainability).

FIGURE 1: Recent economic growth has been strongly pro-poor
Average growth rate of household income by decile of income distribution during 2001-2006



Fiscal consolidation at the state level has also contributed to a stronger macroeconomic situation. Implementation of the FRL, in conjunction with a prudent fiscal stance on the part of states and municipalities has resulted in a significant decline in sub-national indebtedness.

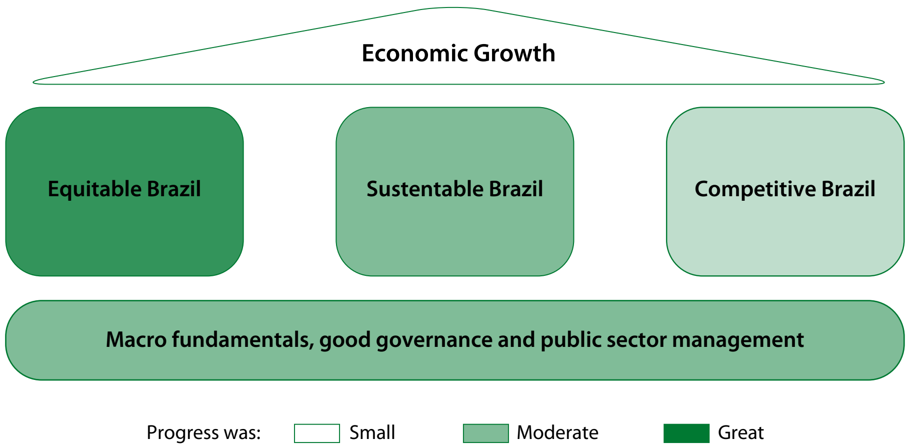
However, as with most other countries, the glass is also half empty. Despite highly favorable external conditions and historically high commodity prices, economic growth has been slow. And there has been mixed success in dealing with deforestation and other major environmental challenges.

III. THE BANK GROUP'S CONTRIBUTION

The World Bank Group played a supporting role beyond its small financial contribution (an annual average of about $500 million of IFC lending – including financing raised from commercial banks, $50 million of MIGA guarantees and $1500 million of IBRD lending, in a $1,000 billion economy.) Arguably the most important factor of the Bank Group's strategy for Brazil was its commitment to the priorities of the Government of President Lula. The Bank also played a central advisory and financial role in Brazil's flagship poverty program (Bolsa Familia), adding both credibility and knowledge (and some finance). In 2003-2004, IFC played an important role in helping to reactivate trade financing lines and in keeping confidence in the private sector.

The World Bank's program was organized in the form of four pillars (Figure 2). Mirroring Brazil's successes (and failures), the Bank's program was successful in supporting social programs that helped initiate a long overdue move towards a more equitable Brazil and was more mixed in terms of sustainability and improving the performance of the public sector. The Bank did not contribute greatly to making Brazil more competitive. (See Annex 9 for the 2004-2007 CAS Completion Report).

FIGURE 2: CAS 2003–2007 How Brazil did and how the Bank helped

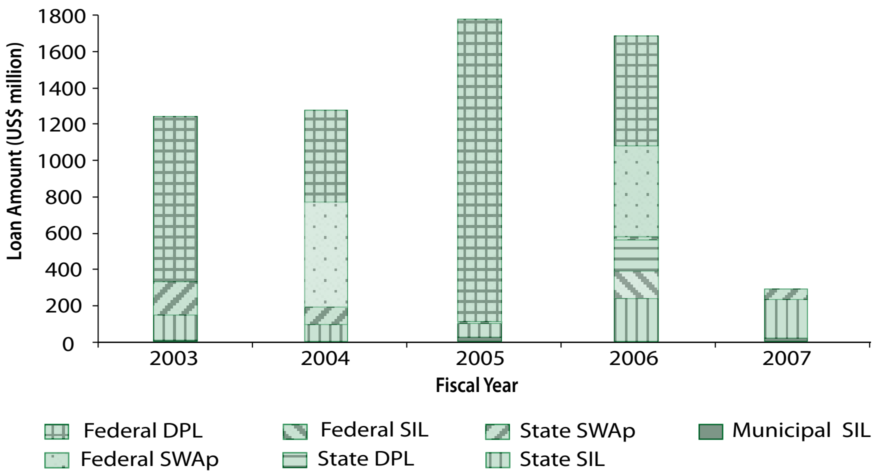


Digging slightly deeper into the Bank Group's lending program (Figures 3 and 4), the following additional conclusions emerge:

- The Bank's program was primarily a Federal Program, dominated by quick-disbursing loans. There was substantial innovation in developing instruments (the "Brazilian-style SWAp") whereby the Bank supported Government programs. Lending was low in the last year of the CAS, as the new government re-visited and revised its strategy.

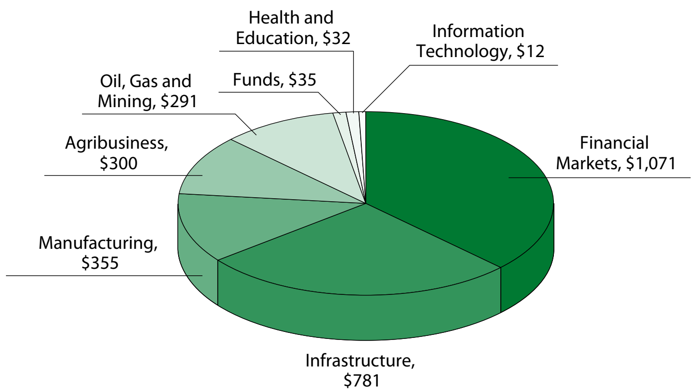
- While IBRD lending to states was moderate, it grew in the latter years of the CAS, and started to address some complex development issues such as the quality of public sector management using highly-innovative, results-oriented instruments.

FIGURE 3: Brazil IBRD Lending Profile (2003-2007)



- IFC's program focused on four main areas – development of financial markets, infrastructure, manufacturing and agribusiness, in addition to promoting sustainability as a cross-cutting theme.
- MIGA had a small and focused program, with a total of $170 million, all in electricity transmission.

FIGURE 4: IFC Lending Profile (2003-2007) US$M



NB: Amounts include money raised from the commercial banks via IFC's syndication or "B loan" program - a total of US$1076 million.

IV. BRAZIL'S CURRENT CHALLENGES

All challenges are not of equal importance and not all challenges can be addressed at once. The Brazilian electorate delivered a clear message in 2006 confirming that there was broad support for the Government's demonstrated commitment to fiscal responsibility (and resulting low inflation) and to support for the poor. The Government interpreted the mandate to be "consolidate the gains (in fiscal stability and poverty reduction) but move aggressively to get the economy growing again". President Lula has characterized his second term as one in which he will be "obsessed by growth".

There is recent evidence that the sound macroeconomic management and improvements in debt sustainability are helping to reinvigorate growth. However, primary fiscal surpluses have been based on very high levels of taxation and sharp reductions of public investment. There is currently no more space for tax increases and the Government has had difficulty in curbing current expenditures. On the external side, the situation appears much stronger with high levels of foreign reserves, a net creditor position and trade and current account surpluses. For the time being, appreciation of the Real has had positive effects (increased productivity as a result of increased purchases of machinery and equipment from abroad), but further appreciation may eventually begin to affect the competitiveness of Brazilian exports. Finally, there is some possibility that volatility in international financial markets will have an influence on both interest rates and inflation, making the environment for growth slightly more difficult.

Nevertheless, over the CPS period (2008-2011), Brazil is likely to sustain the growth rates at the 4-4.5 percent range (see Table 1). On the external side, the strong exchange rate appreciation and weaker international demand are likely to reduce trade and current account balances. In addition, with greater domestic absorption it is expected that the current account will shift from surpluses to small deficits in the coming years. However, the solid external position characterized by very low external indebtedness and high international reserves will guarantee Brazilian external sustainability. Weaker global growth over the CPS period is not expected to affect commodity prices significantly enough to change this assessment. In addition, the flexible exchange rate would cushion any possible adverse external shocks, and ongoing diversification of exports should diminish negative impacts of growth deceleration in developed economies.

On the fiscal front, the Government is committed to maintaining the robust primary surpluses achieved in the last eight years. The maintenance of primary surpluses, higher growth prospects and declining interest rates will continue to reduce total deficits. Public debt should continue to shrink. However, since taxes cannot be increased much further, in the absence of reforms to curb current expenditure growth the Government could face increasing difficulties in achieving these targets. Nonetheless, higher growth and reduction of interest payments would reduce the necessity of tax increases and would slightly broaden the fiscal space for government investment while guaranteeing fiscal sustainability. Inflationary prospects are also favorable and inflation should converge to the mid point set at 4.5 percent by the Central Bank for the next three years.

Table 1: Brazil's Key Macroeconomic Indicators

	Actual				Forecast			
Indicator	2004	2005	2006	2007	2008	2009	2010	2011
Real Growth Rates (percent)								
Gross Domestic Product (GDP)	5.7	3.2	3.8	5.4	4.5	4.5	4.5	4.5
Per capita GDP	4.2	1.4	2.3	4.0	3.2	3.2	3.2	3.2
Private Consumption	3.8	4.5	4.6	6.5	4.7	4.5	4.5	4.5
Exports of Goods and Services	15.3	9.3	4.7	6.6	3.5	4.0	4.0	4.0
Percent of GDP								
Gross Fixed Capital Formation	16.1	15.9	16.5	17.6	20.0	20.5	21.0	21.5
of which Government	1.6	1.7	1.8	1.8	2.0	2.0	2.0	2.0
Gross National Saving	18.5	17.3	17.7	17.7	19.7	19.9	20.2	20.5
External Current Account Balance	1.8	1.8	1.3	0.3	-0.3	-0.6	-0.8	-1.0
Nonfinancial Public Sector Balance	-2.3	-2.8	-2.9	-2.2	-2.0	-1.8	-1.5	-1.5
Primary Balance	4.2	4.4	3.9	4.0	3.8	3.8	3.8	3.8
Net Public Debt	47.0	46.5	44.7	42.7	41.6	39.9	38.1	36.8
Other								
Inflation (consumer prices)	7.6	5.7	3.1	4.5	4.4	4.5	4.5	4.5
Gross Reserves (months of imports)	10.1	8.8	11.3	17.9	13.5	12.0	11.0	11.0
Unemployment Rate	11.5	9.8	10.0	9.3	9.0	9.0	8.5	8.5

Source: World Bank staff calculations based on Central Bank of Brazil and IPEA

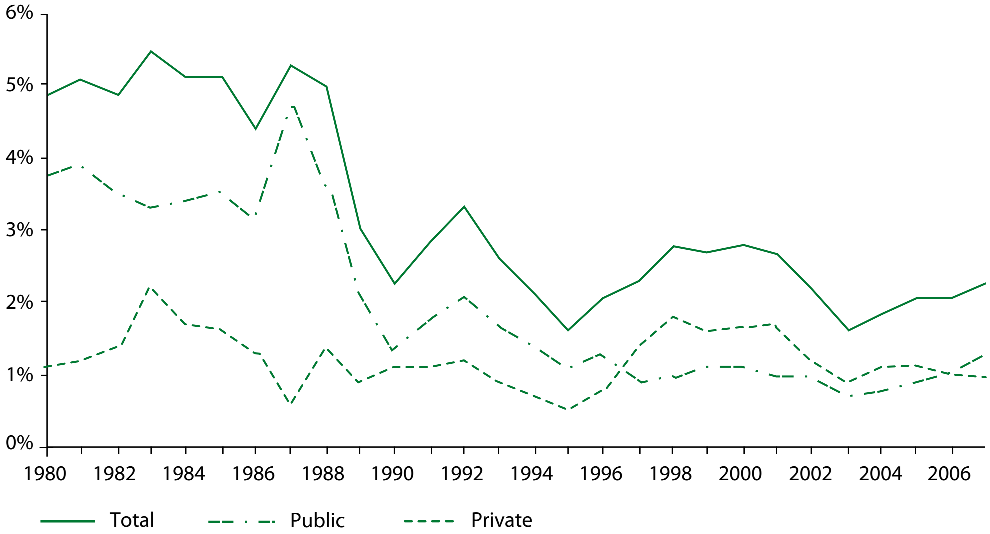
The structural causes of Brazil's relatively slow economic growth are varied and relate to a variety of issues that affect total factor productivity. There is broad agreement that critical areas for reforms are:

- The high level of taxation and low quality of public spending. The high tax burden provides strong disincentives to private investment, formal sector employment, and economic growth. The quality of government spending in Brazil suffers due to weak public sector management and institutional arrangements (where Brazilians, in the words of a former Vice Minister of Finance "pay for five stars, and get a three star service").
- Inadequate labor institutions and legislation. The Brazilian labor market is affected by relatively inflexible labor legislation. Labor legislation in Brazil is heavily biased towards job security, resulting in low growth of employment and productivity in favor of growth of the informal labor market and low labor productivity.
- High interest rates. Average lending interest rates remain high in Brazil and were close to 30 percent in real terms in 2007 (one of the highest in the world). There are still barriers to a more efficient financial intermediation, including the large size of government borrowing, directed credit schemes that account for about a third of total bank lending, and less-than efficient public banks.

- Business environment. Starting a business, registering property and paying taxes in Brazil are more time consuming and costly than the average for Latin America (and even higher than other regions). Some states in Brazil have already started to simplify procedures for registering businesses, including one-stop shops, but the overall process remains costly and lengthy in most states.
- Lack of investment and poor quality of infrastructure, where spending and service have declined dramatically. Total public investment has fallen to less than one percent of GDP in the period 2001-2007 from about 4 percent of GDP in the 1980s. (Figure 5).

The Federal Government has chosen to focus its "obsession with growth" on one of the determinants of slow growth – the quality and quantity of infrastructure. The Government's flagship Growth Acceleration Program (PAC) is an infrastructure program. The PAC attempts to address the issue of slow economic growth through increased public investment in infrastructure and increased public credit. Public infrastructure spending during 2007-2010 has been projected by the Ministry of Finance to reach over R$500 billion (more than half going to energy projects). Since most of this would go through public (federal) enterprises this increase will not affect general government fiscal targets, as such transactions are not included in general government accounts. The PAC focuses on stimulating public credit for housing and long-term infrastructure investment. In addition, PAC measures include an increase in Federal Government funding through the Caixa Economica Federal (CEF) for housing and sanitation and through the National Bank of Economic and Social Development (BNDES) and the creation of a Infrastructure Investment Fund (Fundo de Investimento em Infra-Estructura), again with no impact on general government accounts.

FIGURE 5: Brazil Infrastructure Investments: Long-Term Trends 1980-2000



Note: Investment in infrastructure will rise substantially as a result of the Government's flgship Accelerated Growth Program

Source: WBAAA and Frischtak, 2007

At the State level, Brazil's twenty-seven governors face widely differing challenges, and have formulated different responses to these challenges. Nevertheless, there are some discernible similarities among priorities at the Federal and State levels. Most governors are equally concerned with growth, inclusion, and improving the quality of the infrastructure in their states. In some regions (most notably the Northeast) this concern is coupled with concerns about getting small farmers to market. In other regions (notably the Center-West and the Amazon) a major concern is how to reconcile development with conservation. Many governors, inspired in good part by the innovative, results-oriented Bank-supported programs with Ceará and Minas Gerais, are also giving high priority to improving the quality of public sector management.

The prudent fiscal stance adopted by both states and municipalities, combined with improved revenue growth performance, resulted in a significant decline in subnational indebtedness and has opened space for the recovery of government investment at the subnational level[1]. The effectiveness of the set of controls on subnational fiscal performance (debt renegotiation contracts, FRL constraints and the restrictions affecting domestic credit supply) has led to a pronounced improvement in subnational indebtedness indicators since 2003 (Table 2). Subnational debt fell from 18 percent of GDP in 2003 to 14.6 percent of GDP in 2007. The reduction of debts covered under the refinancing agreements of 1989, 1993 and 1997) will lead to a strong reduction of debt service obligations and will permit subnational governments to access to credit operations (that were drastically restricted in recent years). Thus, lower debt service obligations and greater access to new borrowing would lead to a more robust increase of investment.

Table 2: Net Consolidated Debt by Level of Government, 2000-07 (in percent of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007
Public Sector Net Debt	45.5	48.4	50.5	52.4	47.0	46.5	46.0	45.1
Federal Gov.	28.5	30.2	32.1	33.2	29.5	30.8	31.7	32.0
State Enterprises	2.0	1.4	1.6	1.0	0.2	-0.5	-1.4	-1.6
Subnational Governments	**15.0**	**14.9**	**16.8**	**18.2**	**17.2**	**16.2**	**15.7**	**14.6**
of which:								
Renegotiated Debt 97/01*	12.5	12.8	12.5	13.9	13.6	13.4	12.8	12.3
Renegotiated Debt 93	2.2	2.0	1.7	1.8	1.5	1.4	1.2	1.0
Renegotiated Debt 89	0.4	0.9	1.1	0.8	0.6	0.5	0.3	0.2
External	0.9	1.0	1.3	1.1	0.9	0.7	0.6	0.5
Other	-1.0	0.2	0.3	0.5	0.6	0.3	0.3	0.1

Source: Central Bank of Brazil

1 Investment of state and municipal governments represent more than 60 percent of general government investment.

V. HOW THE BANK GROUP IS ASKED TO HELP

A. AREAS OF FOCUS

The Bank Group is a niche player in Brazil, providing about $2 billion of financing a year in an economy of $1,000 billion. To get some perspective, the National Development Bank (BNDES) provides about $35 billion of financing each year. The central challenge for Bank Group engagement is selectivity. There are several principles that provide guidance for areas where the Bank Group should, and should not, engage:

- The Bank should not be engaging in areas where Brazil has the knowledge and capacity to manage by itself;
- The Bank cannot act as though it is a "shadow government" in Brazil, engaging in every challenge that Brazil faces;
- Bank analytic work needs to focus less on the "what", more on the "how", and on better integration of knowledge, lending and trust-funded activities; and
- The Bank Group should be engaging primarily with the long-run, path-setting challenges where Brazil has not yet devised solutions and where international experience can be of particular value. Brazilian leaders have identified "desafios paradigmaticos", or paradigmatic challenges.

In the preparation of this CPS there have been extensive discussions with Government, the private sector and others on which "desafios paradigmaticos" should be the focus of Bank Group engagement, and of the higher-value targets within the "desafios" that will be the particular focus of Bank Group attention (See Annexes 3 and 4).

Some examples in important areas illustrate how the Bank will engage in the higher value-added end of these paradigmatic challenges (and disengage from those where Brazil does not need Bank engagement).

First consider the challenge of education. In the last CAS, the focus was on extending coverage. In part due to the substantial achievements in this area by Brazil, the Bank will no longer focus on expanding the coverage of education. Now the focus of the Bank work will be on the challenges of improving education systems (building on widely-acknowledged AAA work in this area) and on aligning federal and state interventions in states. The Bank will support a focus on improved performance and accountability, as well as on improving the contribution of education to innovation and growth, again at both the Federal and State levels.

Second, consider the challenge of reducing endemic poverty in the Northeast. Over the past decade the states of the Northeast, with Bank support, have developed a model of community development which is based on passing funds directly to community associations, and having these associations set priorities for use of these resources. These projects have been successful, both in building social capital and in enabling poor communities to get access to water and electricity. The overwhelming demand, now, from the communities (and the governors of the Northeast) is for economic inclusion. The focus of Bank Group engagement in this next CPS period is thus on strengthening community-level productive activities and their integration into the economy. The core approach for the Bank Group is to identify demands from major firms (such as supermarkets and others – both in Brazil and abroad), and then to specify productive arrangements, which will enable communities to provide the required products at scale, with reliability and with quality assured. An important start has been made, building on the social capital of these 37,000 communities, and bringing the full range of IBRD and IFC expertise to bear.

Third, consider the challenge of urban development. In the last CAS period an important focus of the Bank was on upgrading of specific slums and financing of specific water and drainage interventions. In part because of the availability of large sums of Federal money (via the PAC) for such investments, but in larger part so that the Bank engages at the "higher value end" of this challenge, Bank Group engagement with cities will now focus on improving city management, city competitiveness and on introducing results-oriented mechanisms for providing urban services. It is also foreseen that there will be a focus on those cities that are central to broader economic growth (such as port cities). IFC will complement the Bank's role by bringing private sector investment in the cities via housing finance, PPPs in infrastructure, health and education. Furthermore IFC advisory services together with FIAS, will help improve the business environment and municipal fiscal prospects via administrative simplification.

Fourth, consider the Bank's engagement in the Amazon. As described in Box 1, the Bank Group will reverse its de facto decades' long withdrawal from the financing of development in the Amazon, and will become a full-service partner to the Federal Government, the states and the private sector in reconciling conservation with development. Similar principles will be applied to Bank engagement in other sensitive biomes such as the Pantanal.

Fifth, consider the example of public sector management, a pervasive and fundamental challenge where, in the words of a former Vice Minister of Finance, "Brazilians pay for five-star service and get three-star service." There is a strong demand, especially from the States, but also from some parts of the Federal Government, for systemic institutional approaches that will improve the performance of the public sector and the quality of public spending. The Bank has developed a strong brand-name in this area in Brazil, and is working with state-of-the-art, large-scale operations on results-based management with several states; with the social ministries that have very large constitutionally-earmarked funds on improving the quality of spending; and with the Ministry of Planning on modernizing budget procedures. In all cases the Bank is invited in "at the high end" – to bring international experience and "how-to" knowledge to bear. Intrinsic to this work is helping governments put into place the structural underpinnings for public systems that will be more effective, efficient and that reduce opportunities for corruption.

Finally, it is important to note that there is a large degree of convergence between the Bank's perception of areas where progress has been relatively slow (see Figure 2) and the perception of the Government of Brazil. This means that "addressing areas where performance was relatively weak in the last CAS period" takes place more or less automatically since these are "desafios paradigmaticos" areas that the Federal and State governments are focusing on and where there is a consequent demand for Bank .

BOX 1: The Bank Group's Amazon Partnership Framework

There were large controversies surrounding the Bank's work in the Amazon in the 1980s, including the building of roads in the northwest, and mining in Carajas. In response, the Bank withdrew from engagement on productive activities in the Amazon, and concentrated its interventions on conservation, primarily through the use of trust funds and GEF grants. In the intervening twenty years there have been massive changes in knowledge, perception and policy regarding the Amazon. The "desafio paradigmatico" is now how to reconcile conservation (vital for both biodiversity and climate change) with development (how to meet the needs of the 23 million people who live in the Brazilian Amazon, how to use the immense mineral and natural resources of the region in a sustainable manner, and how to build the energy infrastructure and transport corridors necessary for the region's development.)

After an extensive consultation process, the Bank Group has developed an Amazon Partnership Framework, which has been widely acknowledged as sound by the Federal and State governments, by NGOs, by the scientific community, by the private sector and by bilateral partners. The Framework (described in detail in Annex 3) describes how the Bank Group is becoming a full-service partner. This means supporting basic services for the people of the Amazon. It also means working to increase the returns from agriculture in deforested areas, working to manage the large protected and indigenous areas, and working to provide incentives (through sustainable forestry and payments for environmental services) for preservation of forests that will not be protected. And it also means supporting the planning and implementation of major energy and transport infrastructure which is central to the development of the region. This will require the use of a wide variety of tools in a consistent manner. This means continuing to mobilize grant funds – including those available from bilateral partners and the GEF, as in the past - and developing new funds such as those being constructed to address issues of climate change. It will also entail conventional IBRD lending: to the States (already to Para and Amapa, and in the first years of the CPS also to Amazonas and Acre); to the Federal Government (the Ministry of Environment already, and potentially with the Ministries of Energy and Agriculture and the BNDES). And finally it means IFC engagement with companies engaged in sustainable agriculture, infrastructure and forestry—in particular through the proposed IFC Brazilian Amazon Initiative – BAI.

These examples illustrate how the Bank is preferentially engaging with the "desafios paradigmaticos" and with the higher-complexity areas where the global knowledge and independence of the Bank are of greatest value to Brazil. Figure 6 provides an overview of areas where the Bank will do more, and Figure 7 an overview of where the Bank will do less. (Annex 3 presents specific strategies which will guide Bank engagement on particular elements of the pillars.)

The end result of this partnership is that the Bank aspires, at the end of the second administration, to contribute to a Brazil in which there is continued progress in strengthening those areas where we were effective in the last CAS (the macro foundation, and continuing progress in the equity and sustainability), and to redouble our efforts in those areas where there was less progress (some aspects of public sector management, competitiveness, overall growth and environmental sustainability).

Figure 6: Main Features of the CPS II: Where the Bank Group will do More

Equitable Brazil	Sustainable Brazil	Competitive Brazil
• Improving quality of education and health expenditure; • Strengthening accountability and performance-based monitoring; • Greater engagement with education and health at the sub-national level; • Support Bolsa Familia including complementary programs for economic inclusion; • Access of small farmers in the Northeast to land and technology; • Focus on bottom of the pyramid, such as urban/rural poor and lower and mid income groups - access to finance and basic services Investing in frontier regions with high concentrations of poverty – Amazon, Northeast	• Support for protected areas and indigenous lands; • Support for implementation of forest concessions; • Contribute to the power network and logistical corridors in sensitive biomes; • Develop and implement mechanisms for payment for environmental services; • Private sector engagement in major environmental challenges; • Certification for sustainable agribusiness and forestry; • Animal health in Brazil and region • Improving the environmental and social quality of infrastructure lending.	• Education for innovation and growth; • Improving corporate governance; • Improving business climate; • Capital market development; • Support Tier 2 companies; • Take Brazilian companies global; • Improve planning and regulatory framework for infrastructure; • Public-Private Partnerships (PPPs and concessions); • Linking small farmers in the Northeast to markets; • Just in time TA for complex issues, such as hydropower and nuclear energy, civil aviation and bullet train.

Macro fundamentals, good governance and public sector management

- Studies, on demand, on key issues including social security and tax reform
- Public management efficiency and effectiveness
- Improving quality in public expenditures
- Engagement with states in results-oriented public sector reforms
- Working closely with sectors on public sector management issues.

Figure 7: Main Features of the CPS II: Where the Bank Group will do Less

Equitable Brazil	Sustainable Brazil	Competitive Brazil
• Less focus on coverage of education and health programs • Fewer isolated programs to support single disease strategies without links to strengthening overall health system; and • Less provision of basic water supply and sanitation to rural communities in the Northeast.	• Less provision of basic urban infrastructure and slum upgrading in isolated areas; • Less lending to small municipalities; • Fewer stand-alone demonstration projects in the Amazon and other sensitive biomes; • Provision of basic services in the rural Northeast; and • Fewer repeater projects for sustainable resource management in the Southeast.	• Less IFC financing of Tier 1 companies; and • Less financing of inputs-focused projects.

Macro fundamentals, good governance and public sector management

- Fewer Federal DPLs for reserve accumulation.

B. GREATER FLEXIBILITY AND SPEED

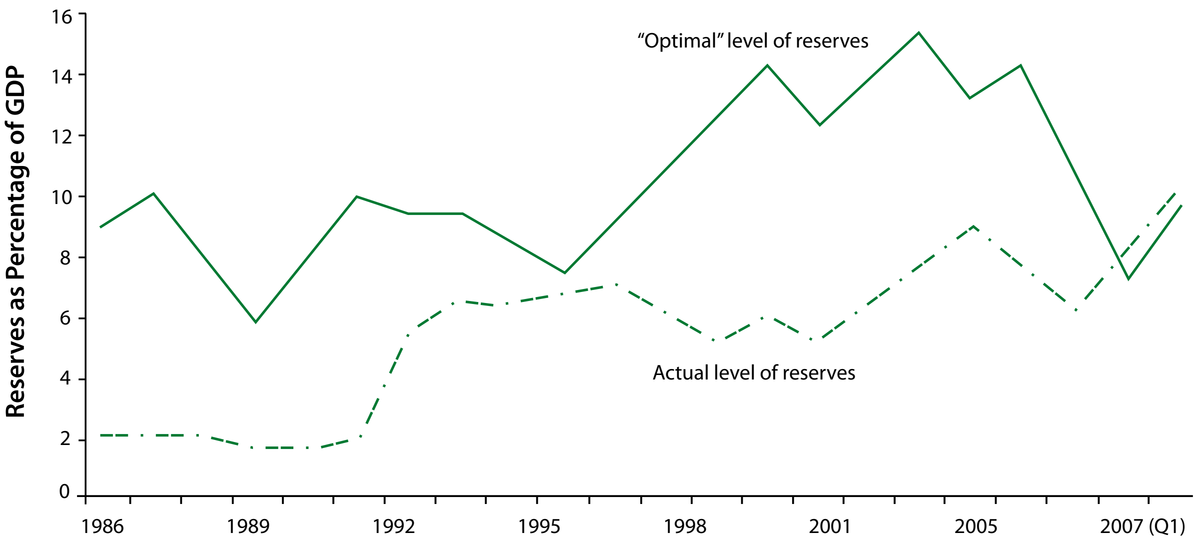
As Brazil's circumstances change, the Government – through the mechanism of COFIEX -- necessarily and appropriately reviews forms of Bank Group engagement, taking into account long-term priorities, the comparative advantage of the Bank and the areas where the Bank can add value. When vulnerability to external crises was a concern, Finance Ministry officials wanted a Bank program which would consist primarily of large Federal DPLs. A year later, with Brazil's foreign exchange reserves adequate for the first time in decades (Figure 8), the Finance Ministry wants a small Bank-financed Federal Program. The implication is that the Bank needs to be nimble and flexible in responding to these changes in demand.

This means that defining a detailed four-year lending program makes little sense. In the just-ending CAS period only 53 percent (18 of 34) of projects defined for the first two-year period materialized, a figure which dropped to 15 percent (4 of 26) in the second two-year period. Accordingly, this CPS defines a potential lending program only for the first two years and proposes criteria for selecting the areas for longer term engagement.

A related dimension is the need for flexibility vis-à-vis political cycles, a factor which will become much more important as the bulk of Bank lending switches to the state level. Governors and mayors are elected for four-year terms. It often takes them several months to formulate their programs (which means that there is usually little prospect for lending in the first year of their terms). They then want fast responses, with programs signed and being put into place in the second and third years of their mandates, for two reasons. They want to show voters that they are producing results, but also are limited at the back end because Brazil's election laws prohibit the signing of loans in the last nine months of the terms of elected officials. This means two things for the Bank – first, that commitments are going to be uneven in CPS periods, with much more lending in the first and second years of the CPS (which correspond to the second and third years of political terms of state administrations) and less in the third and fourth years. And second that the Bank and Government have to greatly shorten the very long (on average 30 months) lag between approval of the project concept by the Federal Government, and signing of the loan.

FIGURE 8: Brazil's Foreign Exchange Reserves

Brazil's level of reserves compared to the benchmark (3 months of imports and 100% of short-term external debt)



Source: IMF

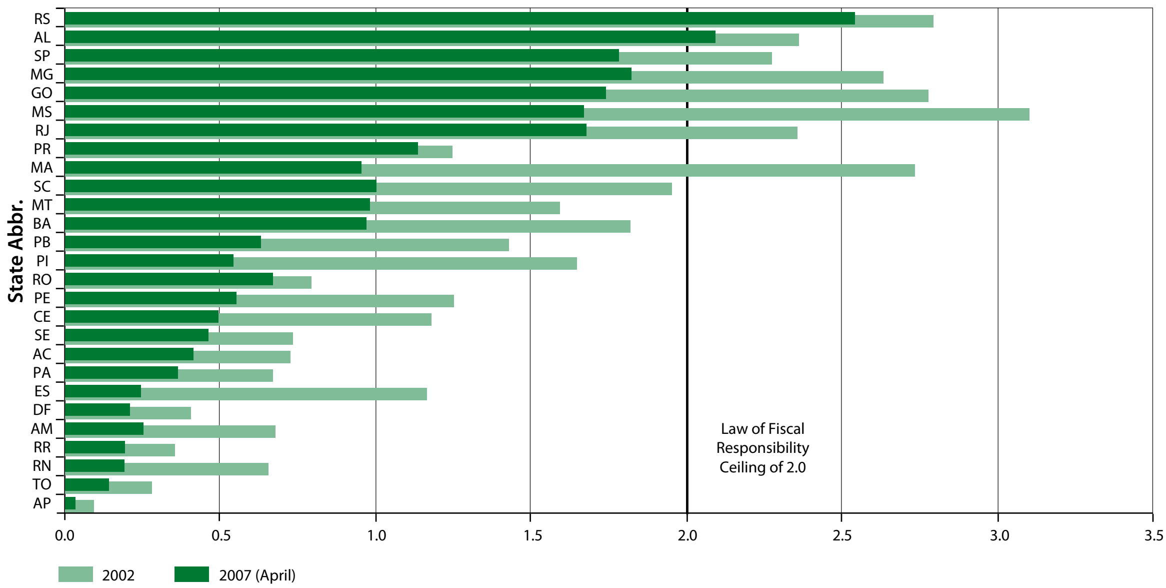
C. MATCHING DEMAND AND SUPPLY THROUGH "PRINCIPLED OPPORTUNISM"

The broad parameters of IBRD engagement are defined by the Ministries of Finance and Planning. It is they who define: the balance between federal and sub-national lending; the priority to be given to the many demands for lending and technical assistance by the 39 ministries of the Federal Government; the rules of the game for Bank engagement with state and municipal governments. The operating idea of the IBRD and IFC programs is now one of "principled opportunism". "Opportunism" inasmuch as it is the Government and private sector which define the areas where Bank Group engagement is requested; and "principled" in that both the IBRD and IFC bring views to the table of where and how, within the universe of opportunities, they should (and should not) engage.

The broad parameters – for now – of the IBRD lending program for the next two years are as follows:

- **Federal**
    - The Federal Government has sufficient resources to finance most of its priorities. And it is unlikely to need further infusions of rapid-disbursing, policy-based loans. There is, however, a very strong demand from many ministries for technical assistance from the Bank, especially on improving conceptual design of their programs and in supporting program implementation and monitoring and evaluation.
    - To provide flexibility and to avoid the proliferation of small loans, these are likely to be aggregated into programs for major areas (such as human development, infrastructure and public sector management) and also where they promote greater linkages between the federal and sub-national governments.
    - Some allowance will be given for loans which are at an advanced stage of preparation.
    - The Federal Government may ask the Bank to provide support to the PAC.
- **States**:
    - Improvement in the fiscal capacity of States is one of the great achievements of the FRL (Figure 9 shows how the fiscal condition of states has improved over the last five years).
    - The FRL provides a transparent, predictable framework for the states.
    - The mechanism for Bank partnerships is as follows: States negotiate their Fiscal Adjustment Programs, which define the limit of credit they can contract, with the Secretary of the National Treasury (STN); Governors who wish to work with the Bank discuss their priorities with the Bank Country Management Team; the Bank responds by indicating those areas the Bank has expertise in, and how the Bank might add value (see the principles for key areas in Annex 3); the Governor submits proposed projects which fit within the assigned fiscal space to COFIEX for consideration.
    - This process works well for all – for the Governor (whose priorities are respected and who gets a value-adding partnership with the Bank); for the Federal Government (since this is done in compliance with the letter and spirit of the FRL and respects the well-structured COFIEX process) and for the Bank (which gets engaged with highly-motivated Governors on programs which are of high priority and have political support).

FIGURE 9: Evolution of State Governments' Net Consolidated Debt/Net Current Revenue



- The Federal Ministries which manage large national programs (including Health, Education, Energy, Environment, and Water Resources Management) see the emerging state-level Bank-supported programs as an excellent opportunity for drilling down their national programs, which the Bank has often played a role in designing.
- Engagement with the Federal Government (which was mainly through the vehicle of the Federal DPLs in the last CAS period) will remain intense, both on operations with the Federal Government and because all "State operations" are, in fact, operations between the States, the Federal Government and the Bank.
- The joint WB-IFC Sub-national Finance Initiative creates an opportunity for the WBG to lend directly to sub-national entities without sovereign guarantees. The Finance Ministry has taken the position that when there is lending to states and municipalities there are implicit if not explicit guarantees. It has therefore, again reasonably, stipulated that this facility can operate only with non-dependent majority state- or municipality-owned utilities or entities, to enhance their access to capital markets and commercial finance.

- **Municipalities:**
    - The Federal Government has specified that the Bank will only engage with municipalities under special circumstances (typically where there are consortia of municipalities dealing with major challenges, such as water and environment in metropolitan Sao Paulo), when there are significant externalities (such as with the port in the Baixada Santista) and when the project will generate revenues for the municipality. In general the Government does not want the Bank lending to municipalities when resources are available from domestic sources, such as from the Ministry of Cities.

- In cities where we do engage, the focus will increasingly be on improving city management, city competitiveness and on introducing results-oriented mechanisms for providing urban services.
- Synergies will be sought between the IBRD lending and the IFC TA Facility to improve the business environment at the municipal level.

- **The Private Sector:**
  - The IFC in Latin America is leading a change process within the IFC. In Brazil, access to finance has improved notably for Tier I companies. Capital markets witnessed the expansion of the Novo Mercado, the launching of the Sustainability index, and the beginning of mortgage securitization. Some Brazilian companies became leading exporters, especially in agribusiness, as the economy became more open to trade.
  - In this process the traditional, demand-responsive, transactions-oriented focus is being balanced by a stronger set of supply imperatives from IFC defined by a strategic view that sees the IFC engaging more with second tier companies, more through long-term relationships with specific clients and industries, and with a focus on issues of corporate governance and sustainability (See Annex 5).

BOX 2: One World Bank Group in Brazil – How The IFC and IBRD are Working Together

There is growing recognition in Brazil that effective development solutions involve actions by both the public and private sectors. As the IBRD side of the business focuses increasingly on the "desafios paradigmaticos" for the public sector, so the IFC increasingly focuses on areas where the private sector in Brazil needs to develop and change. There is a growing demand from clients – public and private alike – for better integrated public/private action on key themes.

Over the past two years the IFC and IBRD have started a process of exploring areas where they can work more effectively together. Preparation for this has included several working meetings bringing together IBRD a nd IFC staff, with the specific objective of identifying "low hanging fruit", where cooperation could give results in the short term.

There have been several areas in which substantial progress has been made.

Foremost among these is the Amazon, where the IFC and IBRD have developed (see Box 1) a joint partnership framework. On the one hand the IBRD works with states in improving land titling and environmental management, while the IFC works with major private firms to start a process of ensuring that agricultural and livestock activities respect environmental and social laws. Third-party certification plays an increasing role in such activities.

A second emerging example is IFC engagement with the rural poverty programs financed by the Bank in the Northeast. As the focus of these programs shifts from service provision to production, so the role of the private sector (as producer, purchaser of products, and an intermediary) becomes vital and the partnership between the IBRD (with long experience in working with 40,000 organized communities) and the IFC (which knows how to identify and develop supply chains) becomes highly productive.

A third area of growing collaboration has been via the IFC/IBRD Sub-national Facility (which, unlike normal IBRD lending to States, does not require a sovereign guarantee). The Ministry of Finance has given a cautious autorization for the Facility to explore support to independent public entities, such as state utility companies. IBRD and IFC staff are working closely on developing a portfolio of activities with state water companies, with the idea that more of these emulate the best (who are already listed on Wall Street). In doing this, priority is given to those states where the IBRD is supporting other major programs, so that this becomes another element in overall support to reforming governors. All operations by the Facility will have to be approved by the committee of the Ministry of Finance and Planning.

A fourth area is on business climate. The IFC has been active in dong business climate surveys in 13 states in Brazil. Where the IBRD works with states and municipalities involved in this process, it seeks to translate the results of the IFC surveys into practical changes.

Finally, it should be stressed that the growing IFC/IBRD collaboration, too, builds on the idea of "principled opportunism". The process has been successful because it is pragmatic, identifying a few low-hanging fruit, and showing that it is in the interests of all – the IFC, the IBRD and, most importantly, our clients – that we work together where this makes sense.

- In many ways the demand-supply negotiation is similar to the "principled opportunism" practiced by the IBRD program.
- As this strategic process takes root, strong synergies between the IBRD (which works on the enabling environment) and the IFC (which works with the private sector), are emerging (Box 2).
- An ever-more confident Brazil also looks to the Bank Group as a key partner in ensuring an inclusive and sustainable globalization, which includes IFC support for taking more Brazilian companies global.
- Supporting the Private Sector Strategy, IFC's focus includes the following six areas:
  - Increase access to finance and capital markets development: reach micro entrepreneurs, small businesses, and second-tier companies and provide long-term financing for corporations through investments in medium-sized banks, microfinance , and other vehicles designed to increase credit availability to individuals (mortgages, consumer finance), and to middle market companies;
  - Support Tier II companies, particularly in general manufacturing and agribusiness;
  - Strengthen infrastructure and logistics, including health and education by increasing private sector participation, and local currency financing;
  - Improve the business enabling environment, helping small businesses join the formal economy, and improving the country's competitiveness;
  - Promote sustainability through higher standards for corporate governance and environmental and social performance;
  - Contribute to the sustainable development of the Amazon region;

    - Support Brazilian private sector aspiration to global leadership via financing Brazilian companies investments in emerging markets, notably IDA countries, promoting sustainability and meeting the global-climate change challenge.

- **Regional and Global:**
    - At the regional level, Brazil looks to the Bank to be a more active and effective partner in the production of regional public goods. An example is potential Bank support via a multi-country set of loans to help Brazil and its neighbors implement a regional approach to dealing with foot and mouth disease, avian flu, and, potentially, other challenges to animal and plant health. Equally-important is Bank engagement with specific regional infrastructure investments of the South America Regional Infrastructure Integration (IIRSA) program.
    - The Bank has also started to support Brazil in "South-South partnership" – using Brazil's cutting edge work in areas ranging from biofuels and agricultural technology, to satellite imagery monitoring and prevention of deforestation, to AIDS, conditional cash transfers and community-led development. Some instruments – linking to the Consultative Group on International Research (CGIAR), Brazil's participation in consultative groups for African countries, assistance in debt work outs, joint work by the Bank and Brazil in Haiti and other countries of high Brazilian engagement – are some first steps in these efforts. Discussion of specific modalities and instruments for strengthening such cooperation are ongoing in the Bank in general and between the Bank and Brazil. Coordination with WBI will be an important part of this effort.
    - A partnership for improving the environmental and social quality of the operations of BNDES also has potential to support regional efforts. Since BNDES is a large actor both in the region and in Africa, this engagement could become an important factor in promoting improved social and environmental performance of BNDES-financed projects outside of Brazil.
    - The Bank will engage as an active partner with Brazil with climate change, trade and other global challenges. In so doing, the Bank will help to ensure that Brazil's perspectives and interests are represented, in ensuring that the line between global goods and national ownership is not blurred, in ensuring that development needs are given equal billing. In short, the Bank's perspective will be to "level the playing field" on global challenges. The Bank will give high priority to ensuring that it uses all of the available instruments (lending, AAA, GEF, bilateral partnerships) in an integrated approach.
    - Finally, a major element in Brazil "going global" is the ever-increasing engagement of Brazilian companies abroad. This is a goal supported by the IFC's focus on assisting Brazilian companies to enter overseas markets, notably in IDA countries (e.g. CVRD in Mozambique, Odebrecht AIDS program in Angola).

- **Analytic and Advisory Work:**
    - Brazil values the Bank's analytic and advisory work. As Brazil changes, so too does the nature of this work. First, in response to consistent demand from Brazil, there will be greater emphasis on AAA work that addresses the "how" of policy implementation, and less on the "what". Second, there will be greater integration of AAA work with lending. Third, there

will be greater participation by the Ministries of Finance and Planning in definition of AAA priorities and in disseminating results. Fourth, there will be greater emphasis on joint AAA with IPEA, the Government's formidable economic research institute. Funds will also be set aside to respond to "just in time" advice on highly sensitive, politically-charged and strategic issues (for example, hydropower, civil aviation and high-speed trains, as well as strengthening debt management at the State level) where the Government of Brazil values the combination of Bank knowledge and "seal of approval". Programmatic AAA will help the Bank's AAA to be timely and relevant, as well as to allow for effective use of our convening power. The Bank will also engage in fee-for-service reimbursable TA in response to specific Government requests (as is now being done for PPPs in Irrigation and Civil Aviation).

D. INSTRUMENTS

Brazil is one of the Bank's most sophisticated and demanding clients. The Bank program in Brazil has a long-standing reputation as a leader in innovation. The just-ending CAS period has confirmed this reputation. New low-cost, fast lending instruments (such as additional financing and repeater projects) have been used to great effect. There have also been innovations in lending instruments: in the development of federal level SWAps for supporting Government programs in the health, road maintenance and welfare areas; in the development of state-level SWAps and DPLs which finance the Government's own programs and which pay for results; in an IFC program which has developed the BOVESPA sustainability index, and engages with agribusiness sustainability by using third-party certification, or develops the use of local currency financing in infrastructure and housing finance.

More recently the Bank Group is applying new tools for the use of local currency. The IFC has issued its first bond in Reais in the Brazilian domestic capital markets, the first ever foreign issuer in the Brazilian market. IFC also developed Reais lending instruments which has thus far been used to finance the financial sector and for infrastructure, but will be more widely used in other sectors. The IBRD is helping the State of Rio de Janeiro in converting parts of its debt from dollars to Reais, and is allowing borrowers to opt for currency conversion swaps to be performed by the Bank at the time of each loan disbursement.

During this CPS the Bank, under the leadership of its Treasury Department, will re-double its efforts to develop and apply financial instruments which respond to Brazil's evolving needs. At the federal level this will include offering traditional IBRD lending, guarantees, and IBRD intermediation for long dated risk management tools. At the sub-national level, where there is rapidly-growing interest in using the embedded flexibility of IBRD loans at a project and portfolio level, the Bank will offer: more flexible repayment terms to better manage the rollover risk of their overall debt portfolio; conversion of existing loans to, and or obtaining new loans with automatic conversion into, Brazilian Reais to reduce their exchange rate volatility; offer other IBRD banking products and guarantees to maximize the developmental impact of specific programs, to achieve the desired cost/risk structure of existing projects and to structure appropriate financing for new projects. The Sub-national

Finance Initiative allows lending directly to sub-national entities without sovereign guarantees. Finally, both at the federal and sub-national level they could use the guarantee products for credit enhancement to catalyze private sector investment or to help develop the state and municipality bond market.

In the upcoming CPS period it is anticipated that the Brazil program will continue to lead and innovate in the area of the use of country systems. This will include supplementing the now-standard use of Brazil's financial system (SIAFI), with larger procurement thresholds, and work with selected states on strengthening their capacity for environmental and social management, including progressive alignment of Bank and national safeguard systems. In many states such as Ceará, Minas Gerais, Pernambuco and Rio Grande do Sul, the Bank has undertaken Public Expenditure and Financial Accountability Assessments as well as OECD benchmarking exercises in procurement in order to raise the level of performance in these areas. (See Annex 7 on country systems.)

Brazil has carefully considered the issue of unbundling the Bank's knowledge and lending services. It has experimented with the fee-for-service mechanism, and sees this as a useful tool for some specific, limited cases. Overall the Federal Government has decided that it likes the "bundled model", with more range and flexibility in the technical services components.

VI. RELATIONS WITH OTHER EXTERNAL FINANCING AGENCIES IN BRAZIL

The major external financing agencies operating in Brazil are the Inter-American Development Bank (IADB), Andean Development Corporation (CAF) and the World Bank. The IADB and CAF both work to contribute to the process of economic and social development in Latin America and actively carry out projects in Brazil. CAF has concentrated its efforts on: i) supporting municipal governments; ii) regional integration; iii) socio-economic development; iv) infrastructure; and v) the private sector. The IADB is currently initiating its strategy for engagement in Brazil. On a preliminary basis the future strategy will build on the existing one with an emphasis on municipalities. Its operational strategy for the period between 2004-2007 rests on three major components, including: i) promoting sustained, stable and environmentally sustainable growth; ii) reducing poverty, promoting social inclusion, and enhancing social and regional equity; and iii) supporting institutional strengthening and promoting democracy and citizen participation. In this sense, in accordance with the 2003 Multi-year Plan (PPA), their priorities emphasized productivity and infrastructure; poverty, equity, and workforce development; living conditions and efficiency in cities; and institutional strengthening and modernization of the government.

As is appropriate in a sophisticated MIC, it is the Government that decides which agency will do what. In this sense, the Bank program does take into account what others do. With the IADB there is an informal structure. There are:

- Areas where the two banks can work together effectively (for example, in financing the Bolsa Familia program and, in the future, in helping with restructuring state debts);

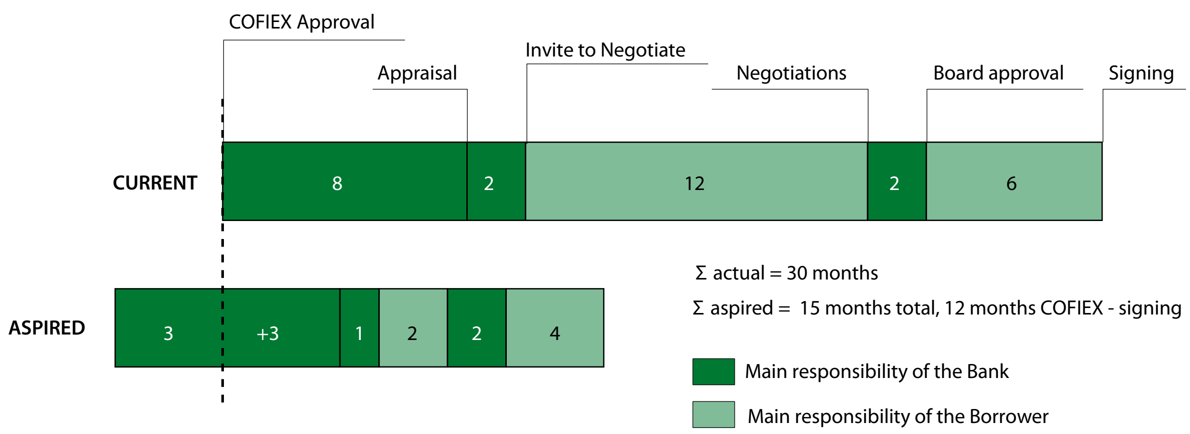
- Areas where the banks “leave it to the other” (with the IBRD specializing, for example, in rural development and the IDB in tourism); and
- Areas where demand is so large that both banks engage independently (in areas such as public sector management and infrastructure).

The Bank also works closely with several bilateral agencies – for example, the EU and Germany in conservation in the Amazon, and the UK on climate change and public sector management.

VII. IMPLEMENTATION CHALLENGES

There are a series of challenges that need to be met if the Bank Group is to be the best partner it can be to Brazil. Over the previous CAS period there was a concerted and successful effort to address a major disbursement challenge (with, for example, the disbursement ratio increasing from 17 percent to 40 percent. Nevertheless, Bank programs in Brazil are among the poorest in terms of false starts, and times between idea and action. As shown in Figure 10, on average it takes 30 months from initiation (approval at COFIEX) to signing of a loan (with the average being even longer for sub-national loans). The institutional fragility of many sub-national entities, and the processes required for confirming financial and legal capacity play an important role. All realize that this means poor performance, not least because governors cannot commit to programs that materialize only after they have left office! The Bank and IDB have formed a working group with the Ministries of Finance and Planning, with the aim being to develop procedures whereby the processing time can be reduced by at least a half, by (responsibly) advancing some processes, by shortening others, and by working in parallel where possible and where this is in accordance with approved Bank procedures. Recent experience shows that better communication between the Federal Government, the States and the Bank is reducing delays, as is the practice of ensuring that projects are initiated only if there is demonstrated high-level political support.

FIGURE 10: Accelerating the Project Cycle
The objective is to cut the time between project identification and approval by 50%



It also means understanding that development effectiveness (of, say, a state project) is a product of the abstract quality of the project, and the commitment of the Governor to the project. If it takes 30 months to prepare a "perfect project" (with every "i" crossed and "t" dotted), the Governor's commitment will be very low, as will development effectiveness. If it takes 12 months to produce a "pretty good project," (which complies with all Government and Bank policies, but in which some details are left to implementation) the Governor's commitment will be very high, as will development effectiveness. The Bank is committed to reducing the time it takes to prepare projects. Regional management is committed to giving a clear signal that the best should not become the enemy of the good.

VIII. THE LENDING PROGRAM FOR THE NEXT TWO YEARS

Table 3: Current Estimate of IBRD Lending Program for FY08-09

Fiscal Year	Borrower	US$(M)
2008	Federal	83.5
	Subnational	3,165.3
	Total	**3,248.8**
2009	Federal	703.0
	Subnational	1,221.6
	Total	**1,924.6**
Grand Total		**5,173.4**

Over the past year there have been extensive (and very productive) discussions with the Ministries of Finance and Planning, and multiple consultations with line ministries, state and local governments, the private sector and civil society about the Bank Group program for the next four years (See Annex 6 on the Consultation Process). In the sensitive case of the Amazon, as described in Box 1, the Bank Group has discussed multiple drafts of an Amazon Partnership Framework with the Ministry of Environment and Foreign Affairs, other ministries, states, NGOs in Brazil, international NGOs and bilateral partners in Europe, and the private sector.

An indicative lending program for the next two years is summarized in Table 3 and described more in detail at Annex B3.

As can be seen, while the portfolio includes a number of projects that are at an advanced stage of preparation and were defined under the old "rules of the game", there are sharp shifts in several respects from the program of the previous CAS:

- There is a pronounced move away from rapid-disbursing DPLs.
- The Federal program is much smaller, and largely comprises Technical Assistance Loans, some

SWAps and programs that promote synergies across federal and state lending (for example, education and water resource management).

- There is a marked shift in the focus of the program toward the States. However, all lending to the States will go forward only with a sovereign guarantee and within the overall borrowing limits of the program as set out below.
- The already appraised "carry over" municipal loans have been bundled into horizontal APLs and any new municipal lending would be for larger, more strategic projects and respond to more rigorous selection criteria.
- The State programs are far larger and correspond much more directly to the priorities of the governors (rather than only reflecting continuity with traditional sectoral constituencies).
- The program is closely aligned with the big development challenges, the "desafios paradigmaticos".
- The program uses a wide variety of instruments – TALs, SWAPs, APLs, DPLs, SILs, additional financing, repeater projects – depending on the particular type of project and the needs and capabilities of the borrower.

Simulations suggest that this level and structure of lending would leave Brazil adequate headroom below IBRD's current single borrower exposure limit of $14.5 billion. This will be monitored continuously as the lending pipeline develops.

The IFC, which operates on a much shorter cycle, has clear rules of engagement, but does not and should not have a pre-defined lending program. Overall, the Corporation expects to commit annual amounts in the $400-$600 million range, further leveraged by its syndication program with commercial banks.

The Country Financing Parameters (CFP) approved on May 21, 2004 will be slightly adjusted, as described in Annex 8. Under the previous CAS, the CFP allowed cost sharing to go as high as 100 percent and anticipated that Bank's financing share in individual projects be differentiated by government level, region and sector. In order to avoid perceptions of inequality and/or setting perverse incentives, the Federal Government requested an agreement on a consistent policy on cost-sharing for States. Since then, this has become a non-issue. For all investment lending using the traditional project support approach, the Bank has allowed 100 percent co-financing, while for all investment lending using the SWAp approach, cost sharing has been a relatively small proportion of the programs it supports, typically from about 10 percent in the large Bolsa Familia program, to up to 35 percent of the relevant eligible programs in the upcoming Minas Gerais SWAp. As the Bank's program envisages greater use of SWAps; the Bank's financing share is expected to be significantly lower than the 100 percent limit.

Under the previous CAS, the CFP included a provision that "recurrent cost financing would be temporary and based on specific criteria". This provision responded to the needs of a portfolio which included a good number of development policy loans to deal with cases of temporary fiscal distress in the context of good fiscal and budget management. The environment in Brazil and the instruments for Bank engagement have changed. Multi-sector programmatic operations using the SWAP mechanism are emerging as a major instrument in our partnership with Brazil. Under the SWAp mechanism, Bank loans finance portions of eligible expenditure programs that may include recurrent costs, and in some cases include salaries, while closely monitoring such programs. While such an approach requires continued strong expenditure management and evidence of sustainability, it does not require that the circumstances under which the funding occurs be one of "temporary fiscal distress" as defined in the previous Country Financing Parameters.

IX. RESULTS

The last CAS had an elaborate results matrix, describing high-order goals to which the program would contribute, and committing to joint monitoring of these goals. This has proved to be unrealistic. As a small player in a very large economy, the Bank has little influence on the achievements of broad social and economic objectives. No joint monitoring took place.

In this sense, the focus on results, at a realistic and practical level, has been a major feature of the last CAS, and a hugely successful feature of the Bank's evolving program. This has meant – for example in the Ceará and Minas Gerais cases, and in the engagement with the Ministry of Health – major institutional changes so that agencies and individuals have incentives to produce results. The dramatic improvement in results has been widely reported and has meant that many other states and agencies are now also moving towards results-oriented programs. In short, the results in the Bank-financed programs are important both directly (in producing better quality services, for example) and indirectly, in that the success of the results focus has meant that the approaches are being followed in many other settings. While the Bank has no pretensions to being engaged in monitoring results in all sectors, in some cases – such as Bolsa Familia and the road sector – Bank engagement is very deep and monitoring results of Bank-financed interventions coincides with overall monitoring of Government results.

This CPS will reinforce and deepen this "results orientation" both through projects and through a simplified results matrix. All Bank interventions include specific and realistic descriptions of the expected results, and a large and growing proportion of Bank activities in Brazil is specifically designed to strengthen a focus by the relevant entity on results, the measurement and evaluation of these, and the adjustment of institutional arrangements and incentives to produce better results. This approach is highly valued, and is at a level at which contribution is reasonable.

Annex 1 presents a more simplified results matrix than that prepared for the previous CAS. The focus is on identifying a few indicators that align with the Government's objectives, but that are closer to our direct interventions and can give us a good indication if the CPS is making progress in the four key pillars of the program.

X. RISKS

As one of the Bank's most important MIC clients, Brazil presents substantial opportunities, but these opportunities are not without risk.

Domestically, there are three principal risks to the proposed strategy. The first is that the Bank's engagement with the Federal Government might weaken as a result of the sharp move to a State focus and that institutional and implementation capacity may be weaker leveling some states. This risk will be mitigated by ensuring that the new state projects are conceived of, by all parties, as projects that fully engage three parties - the State, the Bank and the Federal Government. Initial experience shows that, if anything, dialogue with the Federal Government has become more intense. Detailed engagement through non-lending technical assistance and TA will help to strengthen subnational institutional capacity.

The second risk is that the political economy of reform is such that it is possible that little progress will be made in addressing the difficult structural issues that are impeding growth, such as tax reform, social security reform and labor reform. The recent upturn in growth, reaching investment grade status and impending municipal elections in 2008, suggest that obtaining the constituencies for pushing the needed reforms may be difficult. Here the Bank has no option but to put the "principled" part of "principled opportunism" to work, and to make sure that we are alert to, and engage, whenever opportunities for addressing these politically-difficult structural issues arise. Experience to date has shown that doing this in a quiet, supportive-of-reformers mode can be effective.

The third risk on the domestic front, related to the first, is that the desired public investment that underpins the Government program will not materialize, either because of lack of fiscal space, or because of the difficulty in implementing the investment projects effectively. Here the Bank has been asked to engage – and is engaging – vigorously in improving the quality of public spending, and in helping address some of the deep-seated challenges arising from the effective dismantling of investment and project planning in Brazil. In terms of fiscal space, the Government of Brazil is well aware that the healthy state of the economy is in a context of overall global stability and booming commodity markets. The Government strictly adheres to its own fiscal surplus target, and has managed its reserves effectively to provide an unprecedented cushion against external shocks.

External risks are not a major threat at this point; however, any sudden reduction in financing, or transmission of the effects of volatility from an international financial crisis could affect the economy through an impact on interest rates and inflation. If the current nominal appreciation of the Real continues unabated, the negative affects on competition could begin to outweigh the positive effects of the cheaper cost of importing capital and machinery.

These domestic and external risks are mitigated by the fact that the current policies of fiscal management, inflation targeting and the floating exchange rate are well managed and well entrenched, providing a solid anchor to the economy.

Finally, the risk to the Bank of not pursuing a new and more flexible approach in one of our major MIC clients is that of irrelevance. There are a number of non-traditional opportunities arising in Brazil and the risk of not-being competitive is real. The flexibility and approach of the proposed CPS strategy aims to help the Bank address this risk.