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THE (NOT SO) GREAT DEPRESSION OF THE 21ST CENTURY AND ITS IMPACT ON BRAZIL

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The (Not So) Great Depression of the 21st Century and Its Impact on Brazil

Marcos Aurélio Pereira Valadão*
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Abstract:

At this point there are many papers discussing how the Great Depression of the 21st century came to be, its causes and the things that need to be changed in the world's financial market in order to overcome and prevent it from happening again. We would like to contribute to the debate by sharing some of the experiences we had in our own country that may shed some light on how it really affected developing countries, especially Brazil. This is the main purpose of the present paper, to discuss how the sub-prime international crisis affected the Brazilian economy, the counter-cyclical measurements the Government took and how the country reacted so far.

Key-words: Financial Crisis, Brazil, Latin America, Legal Measures, Recovery.

Table of Contents

1. Introduction	I
2. International Expectations and the Brazilian Economy during the Crisis	I
2.1. Unemployment, poverty and hunger	IV
2.2. Growth deceleration and potential economic contraction	V
2.3. Trade balance and balance of payments	VII
2.4. Dwindling levels of foreign direct investment – FDI.....	IX
2.5. Large and volatile movements in exchange rates.....	X
2.6. Growing budget deficit, falling tax revenues and reduction of fiscal space..	XII
2.7. Contraction of world trade.....	XIV
2.8. Increased volatility and falling prices for primary commodities.....	XV
2.9. Declining remittances to developing countries	XVI
2.10. Sharply reduced revenues from tourism.....	XVI
2.11. Massive reversal of private capital inflows	XVII

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2.12.	Reduced access to credit and trade financing.....	XVII
2.13.	Reduced public confidence in financial institutions.....	XVII
2.14.	Reduced ability to maintain social safety nets and provide other social services, such as health and education.....	XVIII
2.15.	Increased infant and maternal mortality	XIX
2.16.	Collapse of housing markets.....	XIX
3.	Brazilian response to international financial crisis	XX
3.1.	Monetary and Financial Policy.....	XXI
3.2.	Exchange-Rate and Foreign-Trade Policy.....	XXIII
3.3.	Sectoral Policies	XXIII
3.4.	Labor and Social Polices	XXV
3.5.	Fiscal Policy	XXV
3.6.	Investment and production financing	XXVII
4.	Final Comments.....	XXVIII

1. Introduction

At this point there are many papers discussing how the Great Depression of the 21st century came to be, its causes and the things that need to be changed in the world's financial market in order to overcome and prevent it from happening again. We would like to contribute to the debate by sharing some of the experiences we had in our own country that may shed some light on how it really affected developing countries, especially Brazil. This is the main purpose of the present paper, to discuss how the sub-prime international crisis affected the Brazilian economy, the counter-cyclical measurements the Government took and how the country reacted so far.

In order to better contextualize Brazil's situation, we will follow the international expectations for the crisis crystallized at the U.N. "Conference on the World Financial and Economic Crisis and Its Impact on Development"¹. This approach is adopted not because we believe that these expectations are necessarily the best approach to study the crisis in any specific country, but because they adequately represent the broader international community expectation on what should be anticipated in general from the crisis.

In the first part of this paper we shall review each of the possible identified effects of the crisis on countries in general and discuss whether or not it really happened in or affected Brazil. We will also discuss why and try to associate specific policies implemented by the Brazilian Government connected with the aforementioned effect. At the second part, we will evaluate Brazil's current economic situation and its perspectives in the world post-crisis. Finally we will present some conclusions regarding Brazil's future challenges.

2. International Expectations and the Brazilian Economy during the Crisis

Beginning in 2007 an unexpected economic crisis surged around the globe. Starting from the sub-prime financial market in U.S., it gradually spread to the American financial market to contaminate its productive economy, dragging along most countries in the world. There is still some debate on whether it was created by lack of regulation, excess of regulation or simply lack of adequate public policies in a frustrated tentative to provide houses for those who could not afford them. However, most scholars and authorities would agree that it is probably rooted in the combination of lack of regulation in some markets with bad regulation in others, speculative rational

¹ Outcome of the Conference on the World Financial and Economic Crisis and Its Impact on Development, was adopted as Resolution by the UN General Assembly in 13 July 2009, 95th plenary meeting (Doc A/RES/63/303), at 4 [hereinafter U.N. Conference].

individual risk assessments that made no sense systematically, all that combined with clearly unsound banking and financial practices².

Independently of its origins, the truth is that the crisis hit hard the United States economy, until then the most important economy in the world, and quickly contaminated the other countries, rich, poor or developing. At the beginning, more closed economies like Brazil were relatively less affected by the crisis and some even ventured to talk not only about a decoupling effect³ but also about a reverse-coupling effect. According to this hypothesis, raising economies, including China, would become the locomotive that would drag back the rich countries from the economic black hole they got into. At the moment this line of argument has been largely abandoned. The crisis hit almost everyone and what a hit it was. However, until now, notwithstanding the fact that it destroyed richness equivalent to one year of work of the whole world, it does not rival in any aspect the chaos generated by the Great Depression of the 20th century. Many economies faced recession, but very few if any entered in complete disarray.

In fact, it has not affected all countries in the same matter nor with the same intensity. Some countries did suffer a lot, others less. So far, Brazil is unmistakably in the second group⁴. In general, rich countries (mostly the United States and European countries) seem to have endured most part of the devastating effects of the crisis. Since the crisis had financial roots, most countervailing measures were financial, such as assisting and financing banks with confidence and cash-flow issues to restructuring their debts and buying toxic assets from those overexposed to them. By providing liquidity and a bail-out assurance, the general goal was to prevent a credibility crisis and the feared downfall of the whole financial market. Gradually, this strategy seems to have worked, but the effects of the crisis will be long felt and the future fiscal costs of the bail-outs are unclear.

² For example, the G-20 publicly assumed that the causes of the current financial crisis are rooted in inadequate appreciation of the risks taken in an economic expansion period, failure in exercising proper due diligence; and “weak underwriting standards, unsound risk management practices, increasingly complex, and opaque financial products, and consequent excessive leverage”. In addition, “[p]olicy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions”. Other fundamental factors were “inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms”. See G20 Declaration: Full text Summit on Financial Markets and the World Economy, BBC News, Nov. 15, 2008, available at <http://news.bbc.co.uk/2/hi/business/7731741.stm> (last visited Feb. 17, 2009).

³ Although, as soon as November 2007, the President of the Brazilian Central Bank was already stating that no country, including Brazil, was immune to an international crisis, even though it was much more prepared to face this specific crisis than the previous ones. See “Brasil não está imune à crise, diz Meirelles”, Folha de São Paulo, 23/11/07, available at www1.folha.uol.com.br/folha/dinheiro/ult91u347977.shtml (last visited Feb. 8, 2009).

⁴ See Marcos Valadao & Nara Galeb Porto. *Brazilian Response to International Financial Crisis, the Pre-Salt Discoveries by Petrobras and the New Free Trade Areas in the Cities of Brazil*. 15 L. & BUS. REV. AM. 673, 674 (2009).

For Latin America the main problem with the crisis was that it affected foreign demand for its products and services, while drastically reducing the excess international liquidity that financed a substantial part of the investments and expansion of those markets in the previous years. The same excess liquidity was responsible for the general valuation of stock markets in those economies. In addition, once the insecurity associated with the crisis was installed, the natural flow of capital from these emerging economies to supposedly safer harbors put extra pressure on their balance of payments. All that combined with a sudden drop of commodities international prices sure announced a bleak future for those countries⁵.

As a result, the United Nations General Assembly recognized that “[t]he crisis has produced or exacerbated serious, wide-ranging yet differentiated impacts across the globe. Since the crisis began, many States have reported negative impacts, which vary by country, region, level of development and severity, including the following”⁶: (i) rapid increases in unemployment, poverty and hunger; (ii) deceleration of growth, economic contraction; (iii) negative effects on trade balances and balance of payments; (iv) dwindling levels of foreign direct investment; (v) large and volatile movements in exchange rates; (vi) growing budget deficits, falling tax revenues and reduction of fiscal space; (viii) contraction of world trade; (ix) increased volatility and falling prices for primary commodities; (x) declining remittances to developing countries; (xi) sharply reduced revenues from tourism; (xii) massive reversal of private capital inflows; (xiii) reduced access to credit and trade financing; (xiv) reduced public confidence in financial institutions; (xv) reduced ability to maintain social safety nets and provide other social services, such as health and education; (xvi) increased infant and maternal mortality; and (xvii) collapse of housing markets.

Notwithstanding these undisputed dreary scenario, until now, most of these effects did not occur in Brazil or did occur, but in a much lower intensity than expected. Brazil’s resistance in entering the crisis and its swiftness in leaving it is somewhat remarkable for a country known for constantly living in crisis. We would like to discuss at this point the crisis expected effects and its real impact in Brazil to illustrate our argument.

⁵ Addressing the LA situation the ECLAC-UN report stated that: "As a result of the global economic crisis, the countries of Latin America and the Caribbean are faced with a marked fall in external demand for their goods and services exports and, with the exception of some Central American and Caribbean countries, with deteriorating terms of trade. Access to international financing is increasingly difficult to obtain, and currency markets are coming under strong pressure from capital outflows." U.N. ECLAC, The reactions of Latin American and Caribbean governments to the international crisis: an overview of policy measures up to 30 January 2009, 3, available at www.cepal.org/noticias/noticias/1/34991/2009-16-The_reaction_of_LAC_governments_WEB.pdf (last visited Feb. 8, 2009), [hereinafter ECLAC].

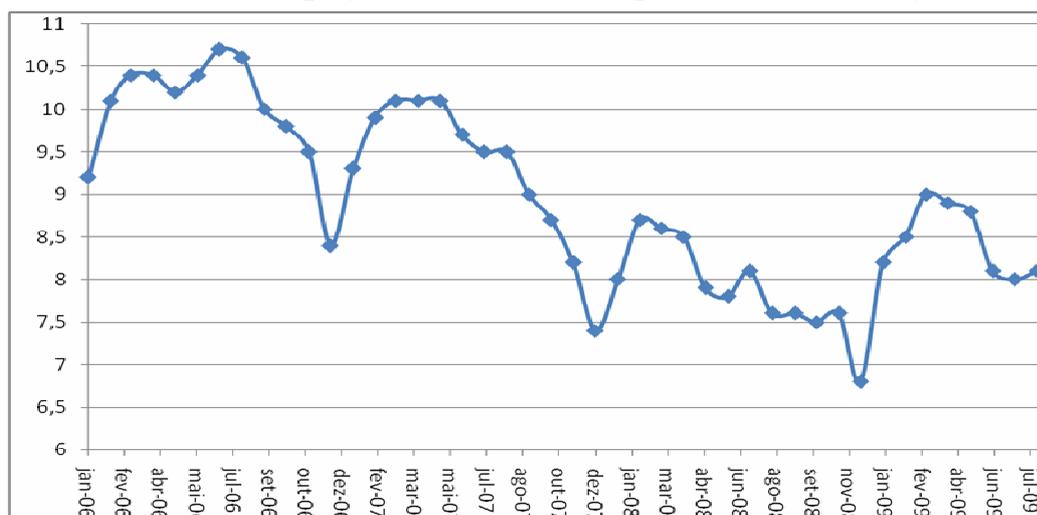
⁶ U.N. Conference at 3.

2.1. Unemployment, poverty and hunger

The first effect associated with the crisis is the increase in unemployment, poverty and hunger in the countries affected⁷. It is always important to stress that circa half of the Brazilian economy is conducted under shadow markets, in other words, through informal channels like non-personified business. However, since the formal and informal sectors are intrinsically interconnected, the formal rate of employment is a good proxy for the actual employment rate, which would be at least equal to the formal rate.

As we can see from Table 1, unemployment rate in Brazil varies substantially across the years, but has show a descendent tendency in the last three years that is common with the Latin America region trend. In fact, as a later comer to the crisis, unemployment rate in 2008 was substantially lower than in 2007, when the crisis started. Actually, during the crisis the rate reached its lowest value (6.9 %) in six years. We can also see that when the crisis finally hit Brazil, at the end of 2008, there is a sharp increase in the unemployment rate, though already in March, 2009, it resumed its descendent tendency.

Table 1: Unemployment Rate in Metropolitan Areas (30 days)

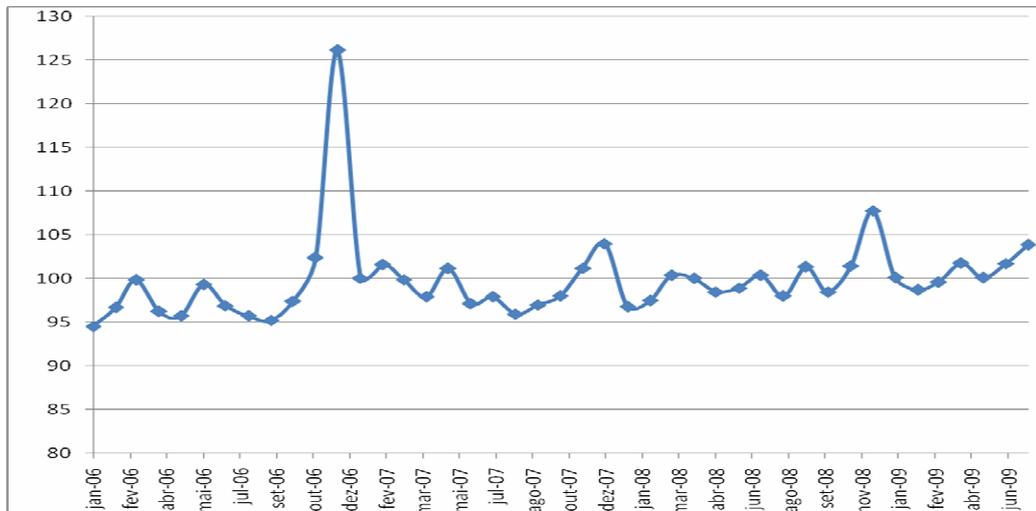


Source: IBGE/PME

Most importantly, current unemployment rate are still below the pre-crisis levels what indicates that although the crisis may have disturbed the historical descendent tendency, it did not reverse it yet. As a result, there is no sign of a rapid increase in unemployment in Brazil.

⁷ U.N. Conference at 3.

Table 2: Average Real Salaries in Industry



Source: FIPE

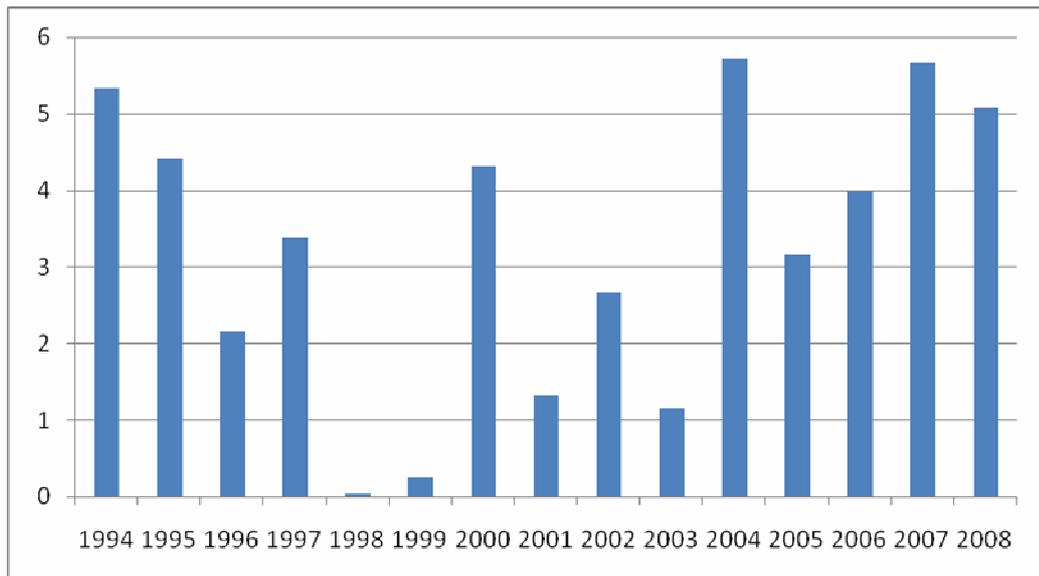
In addition, since unemployment rates are not increasing, we may expect no substantial effect on the income of the lowest-income workers. Actually, as Table 2 indicates, there is a historical trend in Brazil of increase in the real wages workers receive and this trend has not been affected by the crisis until now. Therefore, we expect this last-10-years pattern to continue what implies that other things equal, increased poverty is not an expected issue in Brazil. Note that real income has increased in 2008 for all social classes in a proportional manner and the income distribution has gradually improved since 2004. We all hope that the crisis does not interrupt this most-welcome tendency.

The combination of steady or decreasing unemployment rate and increasing real salaries desauthorize any expectation of rapid increase of hunger, although the challenge to maintain the growth pace without the global bonanza and the income increment with better distribution is a difficult puzzle to be solved.

2.2. Growth deceleration and potential economic contraction

It took so long to Brazil to show the impact of the crisis that some considered to be testifying a decoupling effect while others hoped for a reverse-coupling effect. Although Brazilian resilience to the crisis proved strong, there are clear signs of substantial harm to growth and some questions about the future. Most commentators would agree that the financing model based on foreign capital will have to be tipped off to a domestic demand one, a historical challenge for Brazilian Governments.

Table 3: Annual GDP Variation in Real Terms



Source: IBGE/SCN

As we can see from Table 3, since 1994, when the Real Plan was introduced, a date that normally works as a benchmark for policy evaluation, Brazil's economy appeared to have taken off a few times. However, growth was repeatedly interrupted by external shocks like the Tequila Effect in 1994 (Mexico's reserve crisis), Asian financial crisis in 1997 combined with the subsequent Vodka Effect in 1998 (the Russian's rouble crisis), that ended up with the Real abrupt devaluation in 1999 (the so called Samba Effect) followed by the Tango Effect in 2001 (Argentina's default crisis). All these events affected international capital flows and raised doubts about other developing countries, severely affecting Brazil. To this pattern of taking off and sudden landing Brazilians got used to call "chicken fly growth".

Unfortunately, growth has been dramatically affected by the current crisis and it seems that history may have just repeated itself in 2009. Brazilian GDP growth in 2009 is expected to be zero or close to zero (either lightly negative or positive), in other words, we may be experiencing just another chicken fly. The good news is that just like in the other international crisis, Brazil is quickly recovering and the expected GDP for 2010 may surpass 5%.

Although the Brazilian economy grew more than 5% in real terms in 2008, in the last quarter it already faced a substantial economic contraction, primarily caused by a sudden drop in the industrial sector that foresaw a substantial decrease in world's demand for its products. Even though with a slighter intensity, contraction repeated itself in the first quarter of 2009 indicating that Brazil was technically in economic recession. The contraction was substantial and cannot be easily dismissed as just a bump.

Table 4: Quarterly GDP Variation (seasonally adjusted)

Economic Sector	2008.II	2008.III	2008.IV	2009.I	2009.II
Agriculture	4,2	(-) 1,5	(-) 2,0	(-) 1,4	(-) 0,1
Industry	1,1	1,6	(-) 8,0	(-) 3,2	2,1
Services	0,6	1,0	(-) 0,5	0,6	1,2
GDP at market prices	1,5	1,3	(-) 3,4	(-) 1,0	1,9*

Source: IBGE⁸. * Preliminary numbers.

However, if in one hand it is clear that Brazil faced recession and all decoupling theories have been dispelled, the preliminary number from 2009's second quarter may indicate that a quick recovery is imminent. If the numbers repeat themselves, Brazil may resume its growth path unexpectedly faster already in 2010. Obviously, this highly dependent on world recovery and another bump in U.S. and other trading partners may take down Brazil again.

In any case, Brazil is much stronger to face a world recession now than in the previous years. According to the Central Bank, even after the crisis first wave, the foreign reserves amount to more than US\$ 223 billion⁹ and public debt nominated in dollar has been largely eliminated. This means that for the first time in the last decades, Brazil actually has some leeway to implement counter-cyclical policies, as we will discuss further in Item 3 that actually alleviated the short-term impact of the crisis

In short, Brazil was hit right in the jaw by the international crisis, but the many prior fights taught us how to take a punch without touching the floor. The blow was quickly absorbed and an adequate response was implemented. The degree of which we will be able to recover depends not only on the recovery of the world economy, including commodities price levels, but also and maybe more importantly, the next Government ability to carry-out the necessary micro-reforms that long wait to be tackle with as we move to a internal demand model of financing growth.

2.3. Trade balance and balance of payments

The effects of the crisis in the trade balances probably was the most obvious effect of the international crisis, due to the eminent economic contraction of the

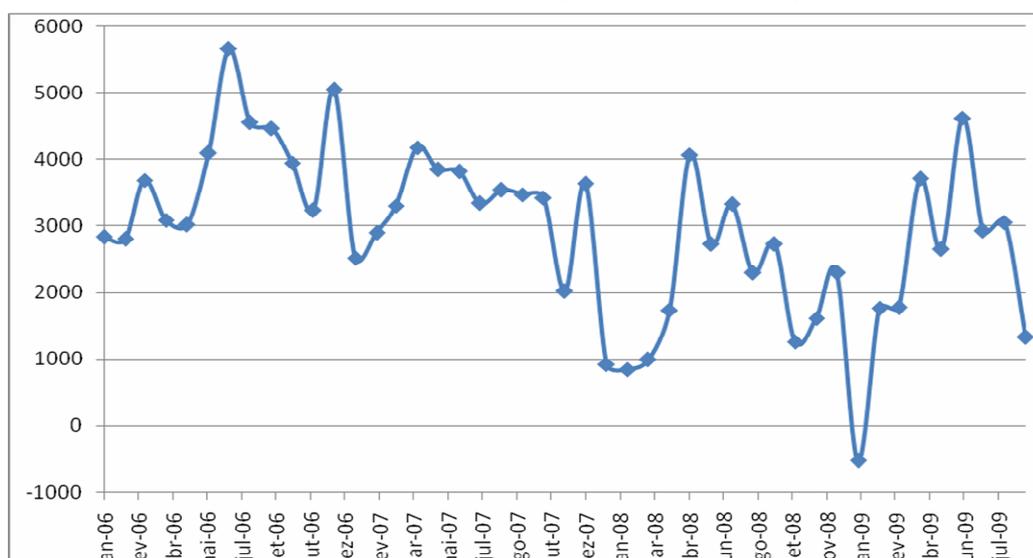
⁸ Brazilian Institute of Geography and Statistics (IBGE), available at www.ibge.gov.br/home/estatistica/indicadores/pib/pib-vol-val_200902_7.shtm, last visited Sept 2, 2009.

⁹ Brazilian Central Bank (BACEN), available at www4.bcb.gov.br/?RP20090928, last visited at Sept. 30, 2009.

developed countries, the decrease of imports of these countries would provoke a contraction of world trade. For this reason, countries which could find room to push internal market to tackle the crisis would have to adopt this strategy.

The trade balance may be a topic of concern for Brazilian authorities, but not the most pressing one. It is clear from the table below that trade flows were highly affected in the beginning of 2008 and 2009, when it was negative for the first time in years. It also threatened a quick recover in 2009, but the numbers volatility does not allow us to make any predictions except that trade balance will not be as positive in 2009 as it was in the previous years. This single fact may put some pressure in a country that has historically financed its public debt with export dollars, but the positive inflow of FDI (see Item 2.4 below) coupled with the growing foreign reserve (see Item 2.2 above) has largely mitigated this concern.

Table 5: Trade Balance (FOB) in US\$ (Million)



Source: BACEN, CBC Boletim/BP

Brazil has enjoyed a positive trade balance with the rest of the world in the last years – to a large extent – due to the substantial increase in commodities prices. We say to a large extent because commodities are a very important element of Brazilian export portfolio (48%), the world average is 26%, but its portfolio is more diversified than other commodities specialized countries like Argentina (68%), Australia (62%) or Russia (71%)¹⁰. However, the crisis seems to have affected this distribution at least temporarily. The basic products share within Brazilian export portfolio increased from 35% to 42% in the first six months of 2009, while manufactured products share fell from 48% to 43% in the same period. Although some have argued that this was a

¹⁰ Numbers from 2005 obtained at Fernando Puga. A especialização do Brasil no Mapa das Exportações Mundiais. Visão, nº 36, 10/set/07, BNDES.

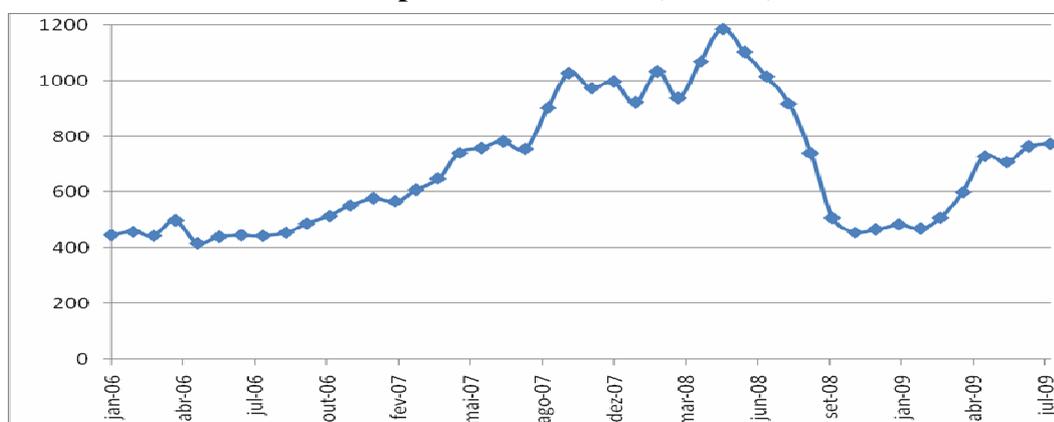
potentially dangerous movement to export commodities dependence, it looks like much more as a difference in elasticity of commodities and industrialized products markets, combined with the fact that Brazilian greatest commodity client, China, is doing well, while most industrialized products buyers, like U.S. and the rest of Latin America, are not doing so well.

Aware of these happenings, the Government is working to tackle the emerging threat, though worldwide competitiveness is an issue highly discussed and little worked on since remote times. In any case, it is clear that Brazil has enjoyed a positive trade balance most of the time in the last years, but it was highly affected at the beginning of the crisis and just after its climax, at the turn from 2008 to 2009. We can also see that a quick recovery may be on the way, but this recovery is unwarranted and will be somewhat dependent on the performance of Brazilian trading partners and their own ability to recover from the crisis. All the above mentioned facts combined with a large foreign currency stock available at the BACEN indicate that the trade balance may be still an issue for long-term growth, but it was positive in 2008 and remains so in 2009¹¹, what may indicate that the bump did not represent a trend change.

2.4. Dwindling levels of foreign direct investment – FDI

Anyone that observed Ibovespa's sharp decline from May to September, 2008, when it reached its historical peak only to lose more than 60% of its value, will have to agree that the market did not believe that Brazil was immune to the crisis. In addition, it is tempting to affirm that there was a major capital exodus from Brazilian stock market as the crisis reached its climax. However, as wearisome as the situation may look like, the actual results for FDI were not so substantial or clear-cut.

Table 6: Ibovespa's Value in US\$ (Billions)



Source: IBOVESPA.

¹¹ See BACEN - Brazilian Central Bank, available at <http://www.bcb.gov.br/pec/indeco/ingl/ie5-01i.xls>.

Indeed, Brazil initially suffered from a reduction in its FDI inflow as the crisis showed its amplitude in the turn of 2008 to 2009, however, the stock market behavior does not seem to have been motivated by fundamentals. As a matter of fact, in May, foreign direct investment in the productive sector totaled US\$ 2.483 billion, the highest result ever recorded by the Central Bank for May in more than 60 years of monitoring¹². Although the authorities expect a lower result for the following months, there are clear signs that FDI inflow is going to be substantially positive in 2009 (US\$ 25 billion). Some private analysts estimate the FDI result for the year as the third highest in the decade, only lower than in 2007 and 2008, when the volume of funds was record. As it seems, the herd reaction of 2008 only created great business opportunities for those investors that were quick and brave enough to take advantage of it.

The Brazilian economy lesser exposure to the international crisis was largely due to its low foreign debt nominated in dollars, thus the volatility of international market has a reduced impact on public finance. As recognized by some analysts, the variation of Brazilian international payment flow is much more connected with changes in its industries business cycle vis-à-vis the rest of the world than to its need of external financing¹³. As previously mentioned, Brazil's substantial influx of FDI inflow has contributed to maintain the international reserves above USD 200 billion (about 13% of GDP).

As discredited as rating agencies are after the crisis, it is interesting to note that Moody's rating agency has announced in September that Brazil has achieved Investment Grade category. Now the three most relevant rating agencies classify Brazilian Treasury bonds as investment grade and this may reinforce the positive flow of FDI to the country.

2.5. Large and volatile movements in exchange rates

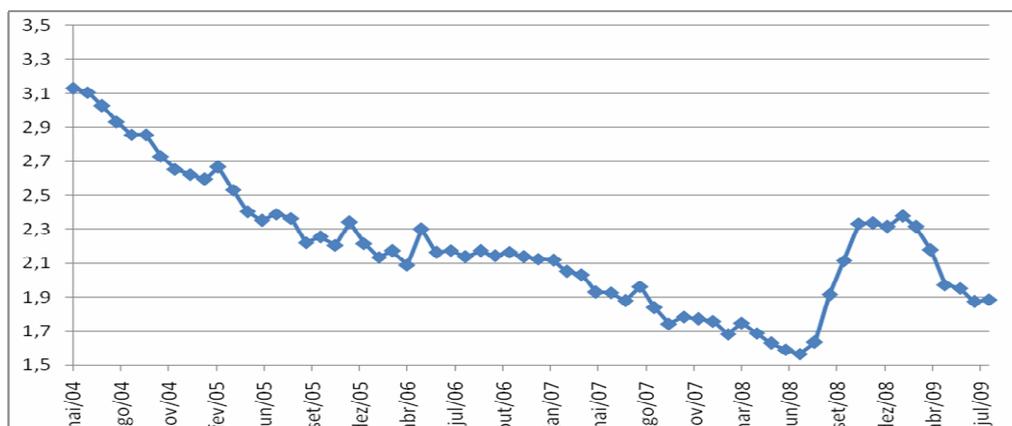
As we can see, from July 2008 to July 2009, Brazilian Real exchange rate behavior resembles a rollercoaster. The table below shows that the appreciation tendency of the last three years was abruptly interrupted in July, 2008, only to resume

¹² Id.

¹³ "A change in the composition of Brazil's foreign liabilities – a phenomenon that predates the global crisis – is affecting the country's international payment flows. A sustained fall in foreign indebtedness has led to a gradual decline in interest payments (Figure 1.5). At the same time, increased attractiveness to foreign direct investment since macroeconomic stabilisation in the 1990s, initially motivated by the government's large privatisation programme, has led to an increase in profit and dividend remittances. Rising overall service payments can be attributed to the greater openness to trade and investment. As a result, because profit and dividend flows are much more sensitive to the business cycle than interest payments on debt, Brazil's current account is becoming increasingly sensitive to the business cycle and the difference between domestic and global cyclical positions." OECD ECONOMIC SURVEYS: BRAZIL 2009, OECD, 2009, p. 18-19.

its course a few months later. Note that the higher volatility period largely coincides with the bear market at Ibovespa (see Table 6 above).

Table 7: Exchange Rate Brazilian Real X US Dollar



Source: BACEN¹⁴.

Curiously, some have argued that the recent appreciation of Real before the dollar has also been a deteriorating element for the balance of payment. Nevertheless, as we can see from the table, it is true that the Real had a substantial appreciation in 2008; though it was followed by an almost equally quick depreciation in the following year that kept the real exchange rate at a lower level than in many years prior to 2007. Therefore, as much as Brazilian export associations keep complaining, the exchange rate does not seem to be an adequate argument to explain the change in the export portfolio discussed in Item 2.3.

Of course, this high volatility affected Brazilian companies, mostly those that depend on foreign trade. In these cases those that did not properly have set up hedge operations to protect against exchange rate exposure faced some difficulties. Indeed, some Brazilian companies like Sadia, a food tycoon, reported financial difficulties resulting from the exchange rate volatility, but actually it was more affected by a financial bet it took against the dollar than from the impact of the exchange rate on its sales itself¹⁵.

As it is common in situations like this in Brazil, the companies involved took advantage of the situation to create positive political momentum to try to obtain antitrust clearance to a merger with its primary competitor, Perdigão, which for years was

¹⁴ See Brazilian Central Bank, available at www.bcb.gov.br/pec/indeco/ingl/ie5-28i.xls.

¹⁵ As commented Keneth Rapoza: "The merger of Perdigão and Sadia, announced in May, came about after Sadia took a beating in last year's stock-market mayhem. It was hurt when the dollar went from a weak BRL1.56 in July 2008 to as high as BRL2.60 in the post-Lehman Brothers chaos late last year. Sadia posted the first loss in its 64-year existence and reported a staggering first-quarter debt, a result of hedging against the U.S. dollar. Perdigão essentially become Sadia's white knight." Kenneth Rapoza, Brazil's New King of Food. BARRON'S, Monday, July 13, 2009, available at <http://online.barrons.com/article/SB124727518474926343.html>.

considered monopoly-resulting. The same pattern can be identified in the Unibanco-Itaú merger, a transaction involving the third and the fiftieth Brazilian banks that has been negotiated for a long time and posed major antitrust issues. Regretfully, the ever present National-champion “theory” gain additional power within the present Government and no political opposition was shown to either transaction, just the contrary.

In any case, although volatile exchange rate is a reality, it seems that the Central Bank spot interventions have worked well enough to make the re-adjustment process less traumatic. Atop of that, the same general decrease in commodities prices that may negatively affect the balance of payment may, at least partially, prevent or mitigate the appreciation of Real. A more competitive exchange rate, in turn, may boost exports in manufactures and that is a general trait of the diversified Brazilian economy. Most changes in economic environment have positive and negatives effects. Whether or not the exchange rate will favor or undermine exports remains to be seen.

2.6. Growing budget deficit, falling tax revenues and reduction of fiscal space

Fiscal revenues are directly connected with economic activities vigor. As the GDP dropped dramatically in the last quarter in 2008 and in the first quarter of 2009 (see Table 4), so did tax revenues, as we can see from the graph below. The main sources of revenue losses were identified by the Federal Revenue Secretariat as the reduction in industrial production, companies’ turnover and profit, as well as a decrease in retail sales¹⁶.

Nonetheless, the amount of revenue losses cannot be explained wholly by economic slowdown since Brazilian GDP already recovered some growing pace at the second quarter of 2009 (see Table 4), but revenues continue to decrease. A complete explanation must go beyond a mere economic slowdown. In our view, the significant sustained revenue losses result primarily from the many counter-cyclical measures the Government implemented in order to fight recession (see Item 3 below). Many of these measures involved substantial tax breaks for sectors considered strategic to overcome recession (discretionary tax breaks). These tax breaks largely benefited the automotive industry, domestic appliances sector, construction materials, financial transactions, loans, and money exchange.¹⁷

¹⁶ Federal Revenue Secretariat of Brazil. Federal Revenue Collection Analysis – August 2009 (text in Portuguese), at. 2-3. Available at www.receita.fazenda.gov.br/Publico/arre/2009/Analisemensalago09.pdf.

¹⁷ It is estimated in R\$ 17,3 billion. Id. at 2-9.

In addition to that, the Federal Revenue Secretariat attributes the revenue decrease to other additional factors such as an increase in tax compensation (due to tax offset for overpayment of corporate income tax in previous years)¹⁸. One may also add to these explanations the usual tax default trend (illegal withhold of taxes by debtors) that usually happens in Brazil during economic crisis, even though this cannot be measured or confirmed.

**Graph 8: Federal Revenue Evolution during the Crisis
(Real Value Y/Y Comparison – IPCA)**



Source: Federal Revenue Secretariat of Brazil - RFB

The decline in federal revenues obviously imposes some budgetary restrictions to the Government if additional deficit is to be avoided and will negatively impact the overall fiscal result. Indeed, the fiscal result for the public sector for 2009 is expected to be worst than 2008 and 2007¹⁹. A recently increase in the Tax on Financial Transactions (*Imposto sobre Operações Financeiras – IOF*) levied on foreign investment in the Brazilian financial and capital markets from zero to two percent, due to October, 2009, although called a regulatory tax, was said by some to be aimed at reducing fiscal deficit. However, we believe the estimated amount to be collected is not substantial enough to make a difference. Additional measures to increase tax revenues are expected.

As the countercyclical measures wear out and the economy recovers, a recovering of the Government's numbers is expected. In any case, Brazil has one of the

¹⁸ Id. at 3.

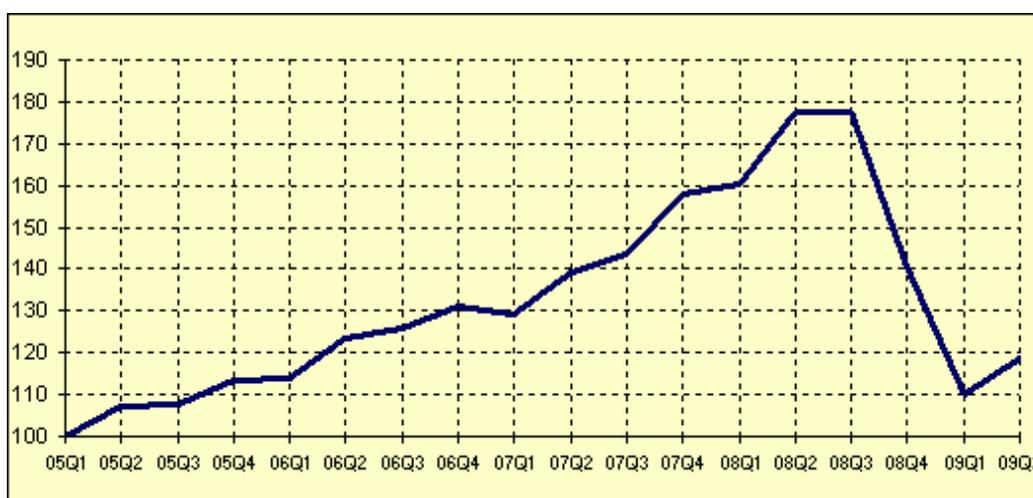
¹⁹ See BRAZIL, SUSTAINABLE ECONOMY, Brazilian Ministry of Finance/EXAME, bilingual edition, April 2009, at 11.

lowest levels of nominal debt in comparison to other countries such as the U.S., UK, Saudi Arabia, India, Russia, Japan, France, Italy, Germany and China²⁰ and fiscal debt seems to be an issue under control (see Item 3.5 below).

2.7. Contraction of world trade

The crisis clearly decreased world trade. Graph 9 below shows how the world trade, measured by scale merchandise export, had a massive reduction from the third quarter of 2008 to the second quarter of 2009.

Graph 9: Quarterly world merchandise export developments (2005-09)



Source: WTO²¹, (2005 Q1=100, in current US dollars), not seasonally adjusted.

The abrupt reduction in the world trade volume as a whole indeed had some effect on the Brazilian economy, but surprisingly for some the impact was actually very limited. Despite the fact that Brazil has a growing participation in the world trade in the recent years, the truth is that the country is still very closed when compared to other countries. Brazil was responsible for barely more than 1% of world trade in 2007²². And this fanned scenario is expected by some to either stabilize or decrease in the following years²³. When it comes to commercial services, Brazilian share is even

²⁰ *Id.*, at 9.

²¹ WTO, Short-term merchandise trade statistics, available at www.wto.org/english/res_e/statis_e/quarterly_world_exp_e.htm.

²² WTO, World Trade Developments, 2008, at 3, available at www.wto.org/english/res_e/statis_e/its2008_e/its08_world_trade_dev_e.pdf.

²³ ERNST & YOUNG. Brasil Sustentável: Horizontes da competitividade industrial, 2009. Available at: [www.ey.com/Publication/vwLUAssets/Brasil_Sustentavel_-_Horizontes_da_competitividade_industrial/\\$FILE/Brasil_Sustentavel_-_Competitividade_industrial.pdf](http://www.ey.com/Publication/vwLUAssets/Brasil_Sustentavel_-_Horizontes_da_competitividade_industrial/$FILE/Brasil_Sustentavel_-_Competitividade_industrial.pdf).

smaller²⁴. In a country so closed to international trade it is not difficult to see why the sudden drop in world trade volume had very limited economical impact.

To make the world trade downfall even less relevant to Brazil, it is important to remember that our export portfolio is highly spread around the globe. The crisis is somewhat concentrated in the United States and in some European countries, but these countries represent only about 50% of Brazilian foreign customers. The rest of our production is shipped to Latin America, Africa, Asia and other countries. In 2007, Brazil exported US\$ 32 billion to North America, US\$ 38 billion to South and Central America, US\$ 43 billion to Europe, US\$ 9 billion to Africa, US\$ 6 billion to Middle East, US\$ 4 billion to CIS and US\$ 26 billion to Asia²⁵. This diversification eased some of the impact of the trade retraction and clearly worked as a positive factor to partially insulate the Brazilian economy from the crisis.

2.8. Increased volatility and falling prices for primary commodities

Accordingly to the IMF report on the implications of the global financial crisis for low-income countries, particularly in Latin America, Africa, and the Middle East, commodity exporters countries would have to deal with a sharp decline in commodity prices. Also, in Latin America, growth is also to be restricted by decrease in external demand (notably from the United States) and worse financial conditions, expecting to slow from 4.5 % in 2008 to 1% in 2009²⁶. The IMF Report also states that food prices are likely to be less affected by the crisis because food demand is less income-elastic than other commodities²⁷.

On one hand, since 1978, Brazil has exported more manufactures than commodities and this may indicate that the decrease in the commodities price level may have an adverse impact on Brazil, but again of limited intensity. On the top of that, the second item in the commodities export portfolio is food, what may help alleviate the impact of price degeneration. On the other hand, as discussed in Item 2.3 above, the demand reduction for manufacture was substantial enough to tip the export portfolio in favor of commodities for the first time in more than 30 years.

The portfolio modification is considered by the export sector and the Government as a potential problem and some counter-acting measures are being considered. Nonetheless, we believe that this temporarily portfolio modification is much more related to the contingency that manufactures consumers (United States and Americas) were more affected by the crisis than the commodities consumers (China and

²⁴ WTO, World Trade Developments, 2008, at 15.

²⁵ WTO, World Trade Developments, 2008, at 4.

²⁶ IMF, The Implications of the Global Financial Crisis for Low-Income Countries. March, 2009, at 3.

²⁷ WTO, World Trade Developments, 2008, at 3.

Asia). As a result, it is unclear whether or not Governmental measures may be effective.

2.9. Declining remittances to developing countries

As any other developing country, Brazil is expected to receive less portfolio investment as the world gets more restricted. However, this general trend has been highly mitigated or even blocked by the fact that Brazil was upgraded to investment grade by the three major rating companies in 2008/2009, in despite of the crisis, and that the economy quickly recovered from the recession. This perception was clearly reflected in Bovespa impressive recover, as we can see from Table 6 above. As a result, even if the portfolio investment in Brazil decreased, foreign direct investment was more than sufficient to sustain the balance of payments²⁸.

2.10. Sharply reduced revenues from tourism

Once more, although the phenomenon was somewhat felt, its relevance is much more limited than expected for the Brazilian economy. A sharp decline in revenues from the tourism sector is expected due to the high income-elastic of tourism-related activities, which applies to leisure in general. Even if that would be the case, the tourism share in Brazilian GDP is restricted to 3.6 %²⁹. Beyond the limited relevance of tourism for the Brazilian economy, a large part of the tourism activities is composed by internal tourism, that were not highly affected by the crisis as income was not severely effect, as discussed in Item 2.1 above.

In addition to that, income shortage in developed countries may have reduced the inflow of international tourists, though Real's temporary depreciation may have mitigated this effect for a while. It also reinforced Brazilian tendency to travel within the country. Summing up, the decrease in tourism resulting from the crisis may adversely affect Brazil, but the impact is expected to be small, with very little repercussion on the economy as a whole.

²⁸ Accordingly to the OECD Report: "Its [balance of payments] continues to be financed comfortably by robust FDI inflows, which more than offset the decline in portfolio investment as the global financial environment weakened in the second half of 2008. As a result of a positive balance of payments position, international reserves continued to be accumulated until late in 2008, when the central bank launched a number of liquidity enhancing measures and intervened sporadically in the foreign exchange market [...]. International reserves stood at close to USD 200 billion in February 2009 (about 13% of GDP)." See OECD Economic..., supra note 14, at. 18.

²⁹ See Pedro Soares, Turismo representa só 3,6% do PIB, Folha de São Paulo, Dinheiro, June 04, 2009, available at <http://imprensa.spturis.com/imprensa/clipping/files/090604/3.pdf>.

2.11. Massive reversal of private capital inflows

Please refer to Items 2.4 and 2.9 above.

2.12. Reduced access to credit and trade financing

This was the most evident outcome of the crisis which was triggered by unsafe credit practices that finally was proven to be more than a credit bubble. It would also affect Brazilian credit market, even though Brazilian banking system is not too much “internationalized”. Brazilian Central Bank and the Ministry of Finance adopted appropriate measures (see comments on this issue in section 3)³⁰ that have been enough to substantially mitigate the crisis effects so far.

2.13. Reduced public confidence in financial institutions

Wherever felt, the reduced confidence in financial institutions was a phenomenon intrinsically attached to the crisis. Since some financial institutions went bankrupted abroad, and many threatened to, a feeling of insecurity spread among the population of many countries where those banks acted more heavily. The same thing did not happened in Brazil.

Brazilian banking sector is extremely more concentrated than in most developed countries. In addition, an environment of hyperinflation, constant change of currency and financial rules combined with many international crises forged one of the most flexible and technologically sophisticated banking systems in the world. The system is still largely centered on national capital, either private or public, with little activity abroad. Most international banks entered the market through mergers and acquisitions and their importance is growing steadily, though they are still responsible for only around 25% of lending and hold only 20% of the deposits³¹.

³⁰ The OECD Report states: “The central bank took decisive action to enhance liquidity in the domestic money market by reducing compulsory reserve requirements for banks, which have traditionally been tight, by some 3.5% of GDP during September-December 2008. The authorities also created incentives for larger financial institutions to purchase the loan portfolios of smaller banks, which were affected particularly adversely by the deteriorating credit environment. As in previous periods of financial distress, interventions in foreign-exchange markets were carried out in a transparent manner; they were aimed at ensuring liquidity in periods of thin trade and geared towards smoothing excessive volatility in the exchange rate. The relaxation of the monetary stance as from January 2009 has been appropriate; it has brought real *ex ante* interest rates to historically low levels. *There may well be room for some further monetary easing in the near term, depending on the strength of the recovery and the evolution of inflation expectations over the coming months.*” See OCED Economic..., supra note 14 at. 7

³¹ Since the debacle of hyperinflation, Brazil has faced an aggressive concentration process in the banking system. In the last 11 years, the number of operating banks dropped 32.2%. For the sake of illustration, in 2007, Brazil had only 156 banking enterprises, while Germany registered 2,130 and the United States

The fact that the Brazilian banking system is one of the most regulated in the world combined with a local focus explains in a larger measure why the financial crisis did not hit Brazil so hard in the financial sector. As a general rule, the local banks were much less exposed to risks than their North-American and European counterparts (better Basle index than the standard recommendation³²) and almost none took part in the derivatives festival. Obviously some confidence disturbance was felt and some deposit transfers from private to public banks happened (there is a general believe that public banks and financial institutions are less likely to bankrupt), but general confidence was not really shaken.

Notwithstanding the fact that the Brazilian financial sector was healthy, almost free of toxic assets, some bank used the threatening environment to conduct mergers that would normally raise antitrust concerns (e.g. Itaú-Unibanco merger) and the Government created very strong incentives for the larger banks to buy the portfolio of medium or small banks, furthering the historical trend for concentration, including in the credit market. In any case, to close the argument it is enough to say that Brazilian banks closed 2008 with large profits, only 2.8% lower than in 2007, and behind only Petrobras³³. Therefore, we may say that confidence in the financial institutions is not an issue in Brazil right now.

2.14. Reduced ability to maintain social safety nets and provide other social services, such as health and education

As we have showed, public finances were adversely affected by the crisis (see Item 2.6 above) and the revenue losses clearly will impose some budgetary constraints on the Brazilian Government. However, as discussed, the Brazilian economy is already reacting and we are no longer in recession. Now, most of the revenues losses are attributable to counter-cyclical measures that probably will no longer be in place in 2010 (see Item 3.5 below).

On top of that, Brazilian social security net is very extensive and to a large extend imposed by the Constitution with earmarked contributions (in lieu of “taxes”),

7,282. IPEA. Transformações na indústria bancária brasileira e o cenário de crise. Comunicado à Presidência, nº 20, 4/7/09, available at www.ipea.gov.br/sites/000/2/pdf/09_04_07_ComunicaPresi_20_Bancos.pdf (last visited 10/29/09).

³² The Basle index indicates bank assets risk exposure. Average Brazilian bank sector Basle index is 6.5% while Basle recommendation is 8%. See Ministro Guido Mantega, Atravessando a Crise Mundial Conselho Politico [Minister Guido Mantega, Presentation Before the Political Council of the Republic: A Way Through the Global Crisis] (Feb. 18, 2009), available at www.fazenda.gov.br/portugues/documentos/2009/p180209-conselho-politico.pdf (text in Portuguese) (last visited Feb. 20, 2009) [hereinafter Guido Mantega].

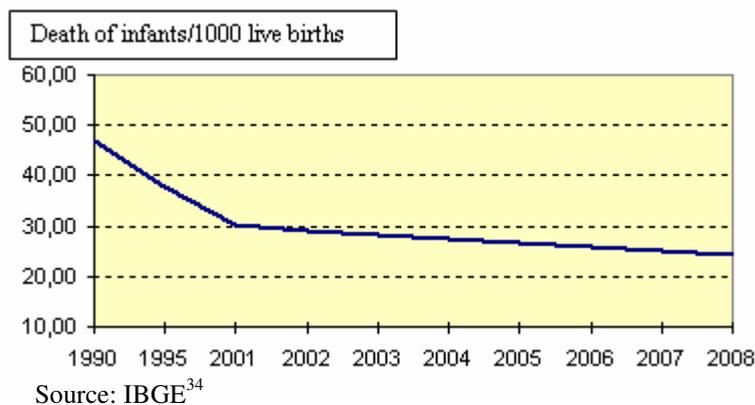
³³ See, ESTADÃO, Petrobras tira bancos do topo dos lucros em 2008, <http://veja.abril.com.br/agencias/ae/economia/detail/2009-04-03-341661.shtml> (available at 10/25/09). The substantial profits for 2009 can be monitored at www.febpr.org.br/lucroban.htm.

which fund the system, encompassing public health and education systems. This strait-jacket policy to a larger extent refrains any conjuncture temptation to reduce social expenditures and, with the reemerging economy, funding will be available again. In sum, the decrease in public revenues was not sufficient to cause any serious damage to social safety nets.

2.15. Increased infant and maternal mortality

The expected increase in infant and maternal mortality is also linked to the expected scarcity of public resources to fund social programs aimed at reducing these events. As explained above (see Item 2.14 above), to our knowledge, there was no substantial budget cut in any program associated with such mortality and since revenues are likely to return in 2010, no future cut is foreseeable. In fact, the rates for infant and maternal mortality in Brazil have been declining steadily in the last years and will probably not reverse its trend due to the crisis. For illustrative purposes, Graph 10 below shows the continuous decrease in infant mortality from 1990 to 2008:

Graph 10: Infant Mortality in Brazil



2.16. Collapse of housing markets

Since the crisis originated in the sub-prime market interconnected with the housing bubble in the United States, it is reasonable to expect that the crisis would adversely affect the housing market elsewhere. However, this expectation does not apply to Brazil. The dismal of the housing market did not happen primarily because there was no such bubble locally. The banks were not involved either directly or indirectly in the financial festival of the derivatives. In addition, Brazil still has a large

³⁴ Available at www.ibge.gov.br/brasil_em_sintese/populacao09.htm.

habitation deficit that will take years to be reduced substantially. This deficit puts considerable pressure on the demand side and prevents price levels decreases.

In any case, since the crisis affected the economy as a whole, some effects were felt at the construction sector in general, housing inclusive, that was growing substantially in the previous years and generating work positions. Aware of this negative impact, the Government quickly put in place big stimulus packages for constructions companies to finance their activities and gave discretionary tax breaks for inputs. In addition, the public financial institutions expanded rapidly their lines of credits to compensate the growing risk aversion in the market, mainly for the housing segment, maintaining and creating demand for this strategic sector (see Item 3.3 below).

All of this combined with the lowest interest rates in decades was sufficient to prevent a substantial deterioration of the housing market in Brazil that remains sound and growing.

As we can see, in many aspects, the anticipated impact of the crisis was either non-existent or much more limited in Brazil than in other countries. Sometimes due to historical limitations that now offered strategic advantages, sometimes due to sound political reforms that took place prior to the crisis, like the restructuring of the public debt profile and the raising of foreign reserves. Notwithstanding, the Government actively took some measures to reduce the impact of the crisis, as Brazil is not isolated from the rest of the world. We would like to discuss some of them in the next section.

3. Brazilian response to international financial crisis

As we have discussed, the Brazilian economy was very resilient in showing the effects of the financial crisis³⁵. Even when the crisis was already affecting many strong economies around the globe, by July 2008, Brazil was still considered to be prospering in terms of economic growth, running sound public economic policies, with strong macro economical fundamentals and enjoying growing international confidence³⁶. Regretfully, it did not last forever. After the second quarter of 2008, the crisis started aggravating and to show its ugly claws to the country, though this time, Brazil was wearing more than just studded leather armor, it was wearing a full plate.

It is worth stressing some aspects of the Brazilian economic armoring: huge and still growing international reserves of more than US\$223 billion (see Item 2.2), investment rate growth rate is higher than aggregate demand growth, bank sector with

³⁵ See Mauricio Cardenas, Global Financial Crisis: Is Brazil a Bystander?, The Brookings Inst., Oct. 15, 2008, available at www.brookings.edu/opinions/2008/1015_financial_crisis_cardenas.aspx (last visited Feb. 20, 2009).

³⁶ See Special Report: Brazil, Financial Times (London), July 8, 2008, at 1-2.

better Basle index than the Basle recommendation³⁷ and controlled and decreasing public debt³⁸.

At first, all these gleaming figures were not sufficient to insulate Brazil (it looks like that even full plates have holes). Indeed, the rate of economic growth dropped vertiginously in the last quarter of 2008 and remained so in the following quarter. Nevertheless, by the second quarter of 2009, growth resumed its pace (GDP was 1.9% higher than the previous quarter)³⁹. It certainly does not necessarily mean that the crisis is over for Brazil, but it is strong evidence that the Brazilian locomotive is getting back on track again.

It is important to note that the Brazilian Government adopted many measures and that there is no single place or official document where we can find all of them duly identified and explained. In the overall, they seem to have worked very well, but as scholars we are left with a bitter taste that we cannot really identify all of them and scrutinize to learn for the future.

In any case, in the previous sections we mentioned some of the adopted measures and we would like to further discuss them here. The ECLAC report⁴⁰ depicts most measures implemented organized into five major fields of action: monetary and financial policy, exchange-rate and foreign-trade policy, sectoral policies, labor and social policies and fiscal policy.

3.1. Monetary and Financial Policy

The crisis deepening in October 2008 threatened developing countries with a substantial retraction of capital flows and foreign investment, what was expected to adversely affect the exchange rate and external accounts. The resulting increase in risk aversion increased volatility and, as a result, reduced liquidity. In order to alleviate this problem, the Government tried to partially compensate the reduction in foreign capital with public funds. In addition, since the banking legal reserve in Brazil is very conservative when compared to world standards, liquidity could be easily created as the Central Bank saw fit just by relaxing the restrictions and that is what was basically done⁴¹.

³⁷ See note 32 above.

³⁸ See Valadao & Porto, *supra* note 4, at 674-675.

³⁹ See Item 2.2 above and, for more details, Brazilian Institute for Geography and Statistics - IBGE at www.ibge.gov.br/home/estatistica/indicadores/pib/pib-vol-val_200902_10.shtm.

⁴⁰ ECLAC, *supra* note 5.

⁴¹ The following measures were listed in an official publication (BRAZIL, SUSTAINABLE ECONOMY, *supra* note 19, at 23) as measures adopted to assist the financial sector: **Inter-banking market:** Reduce compulsory deposit and speed up rediscount operations, injecting US\$ 45.5 billion into the economy; **Stimulus for Market Solution:** (i) Reduction of the bank compulsory deposit conditioned to the acquisition of loan portfolios; (ii) Authorization for BB and CEF to be shareholders in financial

In September 2008, four days after the Lehman Brothers went down, credit was scarce and the Real faced a sudden depreciation in front of the Dollar. The Central Bank had to inject half a billion dollars on the table to calm down the market. The lack of foreign credit was perceived as affecting medium and small banks that faced difficulties finding financing capital. Foreseeing the potential necessity of a quick intervention, the Central Bank powers to intervene in failing financial institutions was substantially broadened. The major two federal financial institutions, Banco do Brasil and Caixa Econômica Federal, were also authorized to buy struggling financial institutions, as well as insurance enterprises and social security enterprises without having to follow the public procurement law.

The creation of an investment bank within the Caixa Econômica Federal (CAIXA – Banco de Investimentos S.A) to buy the stock of real estate firms in trouble, as well as other sectors was announcement. This bank would start with about a billion dollar capital to invest and this allowance would be valid until June 30, 2011. These investments were meant to substitute IPOs or issuing shares as a capitalization mechanism. The Central Bank was authorized to grant loans secured by loan portfolios to banks and other forms of financing were offered, including loans, to companies to facilitate refinancing of their external debts (allocating up to US\$20 billion of the country's reserves). Around 4,000 enterprises were expected to benefit from these measures. Most measures were authorized by Provisory Measure n° 443/2008 (Oct 2008) that was converted into law in March, 2009⁴².

On January 21st, 2009, the central bank cut its basic interest rate by 100 basis points (from 13.75% to 12.75%)⁴³. The decreasing trend remained until the lowest historical level was reached by September 2009 (8.75% p.y). Although the market is already foreseeing some interest rate increase in 2010, this reduction has substantially helped mitigate the effects of the crisis and – we hope – could signalize a new low level trend in interest rates for Brazil.

Many measures were taken during the previous months as the crisis developed. It is not our purpose here to list all of them, but the ones mentioned above represent well how the crisis was fought in the financial sector.

institutions (MP 443); (iii) Creation of the company Caixa- Banco de Investimento.(investment bank); (iv) Support to small and medium banks with extension of guarantees from US\$27 thousand to US\$ 9 million in CDB/RDB.

⁴² Although Brazil is a Presidential country, the Constitution allows the President to issue law-like decrees in cases of urgency and relevance that are immediately legally enforceable. These decrees, called Provisional Measures, must be submitted hitherto to Congress for referral. The measures mentioned above were largely regulated by Medida Provisória n° 443, October 21st, 2008 (Brazil). This PM was transformed into law by the National Congress: Law n° 11,908 of March. 3, 2009], available at www.jusbrasil.com.br/legislacao/43342/lei-2004-53.

⁴³ ECLAC, supra note 5, at 12.

3.2. Exchange-Rate and Foreign-Trade Policy

The lack of liquidity represented some difficulties to Brazilian exporters that need to carry out transactions in dollar. To mitigate this concern, Forex reserves were used to finance exports through reverse auction of bank securities to backstop foreign trade. The contracts tie in the repurchase of these instruments, thus maintaining the foreign reserves levels. Indeed, even after the crisis has started affecting Brazil, the level of foreign reserves has been steadily increasing and reached its historical level of \$ 225 billion in by October 6⁴⁴. The Central Bank was also allowed to grant foreign-currency loans directly to private banks, exclusively to finance foreign trade transactions⁴⁵.

Brazilian export sector, specially the agro industrial sector, was facing financial problems due to financial leveraging through derivative instruments attached to Dollar and Real exchange rate (the exchange rate in July 2008 was roughly 1/1.6 and turned to 1/2.3 in Dec. 2008)⁴⁶. Although the exchange rate is already returning to the pre-crisis levels, many exporters are still facing some difficulties in dealing with the natural volatility and to have access to financial instrument required to effectively export. Some of these measures are being taken to mitigate these difficulties while markets return to normal activity level.

3.3. Sectoral Policies

In the oil & gas sector, Petrobras and the National Bank for Economic and Social Development (BNDES) borrowing capacity was expanded in around US\$5.3 billion to keep up planned investment levels⁴⁷.

In the agriculture sector, US\$6.5 billion was allocated to specific policies⁴⁸: (i) US\$2.2 billion as advances of resources from Banco do Brasil; (ii) US\$2.4 billion increase in resources that banks must earmark the agricultural sector; (iii) increase in rate for compulsory rural savings deposits from 65% to 70%, which represents US\$1.1 billion; (iv) use of Forex reserves to finance the rural sector through the intermediary of trading companies; (v) use of US\$200 million in resources from constitutional funds; (vi) US\$400 million in assistance for agricultural cooperatives; and (vii) allocation of

⁴⁴ Brazilian Central Bank website, "Reservas Internacionais", at <http://www4.bcb.gov.br/?RP20091006>.

⁴⁵ ECLAC, supra note 5, at 11.

⁴⁶ The following measures were listed (BRAZIL, SUSTAINABLE ECONOMY, supra note 19, at 23) as measures adopted to assist exporters: **Exchange Market and Export:** (i) Dollar auction in currency and in the future market (swaps); (ii) Dollar auction directed to the financing of Pre-shipment export financing (ACCs); (iii) Investment of part of the international reserves in the expansion of financing sources of Brazilian companies abroad.

⁴⁷ ECLAC, supra note 5, at 11.

⁴⁸ ECLAC, supra note 5, at 11.

US\$150 million to family-based agriculture using resources from the Workers' Protection Fund (FAT)^{49,50}.

For the automobile sector, US\$ 1.8 billion from Banco do Brasil was made available to manufactures banks for financing sales; motorcycle sales were busted with fiscal incentives trough discretionary tax break on financing (IOF reduction), acquisition (PIS/ COFINS reduction) and ownership costs (decrease in the IPVA) of motorbikes⁵¹. In addition, a credit line of US\$ 182 million (US\$ 91 million from FAT and US\$ 91 million from Banco do Brasil) was opened to finance working capital of used car dealers, upon guarantee of employment level maintenance. For the autoparts dealers and manufacturers, a credit line of US\$1.4 billion was also made available to finance working capital⁵².

As per the housing market, one of the main instruments used by the Government was it traditional company Caixa Econômica Federal. It created a credit line for working capital of US\$1.4 billion and simplified the collateral requirements for lending and increased the amounts limits for acquisition of building material (from US\$3.2 thousand to US\$ 11.4 thousand). In addition, the Government changed regulation to allow up to 5% of the savings deposits to be invested in working capital operations for housing; reinforced real estate financing for the Federal Government employees by creating a credit line of US\$1.8 billion for Banco do Brasil and Caixa Econômica Federal; created a new Housing Program with subsidies directly from the Treasury in the amount of US\$7.3 billion; changed regulation to allow the use of workers resources at the FGTS to acquire housing that represented US\$ 1.1 billion from the Treasury and US\$3.4 billion from the FGTS itself⁵³; created a credit line of US\$2.3 billion from the Treasury to finance infrastructure; created a credit line of US\$ 0.9 billion from the Federal Union Grantor's Fund, and created a credit line of US\$ 0.5 billion from BNDES

⁴⁹ The Workers' Protection Fund (FAT) is public fund composed by taxes (social contributions) mainly aimed at payment of unemployed workers benefits.

⁵⁰ The following measures were listed (BRAZIL, SUSTAINABLE ECONOMY, supra note 19, at 23) as measures adopted to assist exporters: **Agribusiness Financing**: (i) Anticipation of BB (Bank of Brazil) disbursements (for agricultural loans); (ii) Additional resources for various funds (US\$2.3 bi); (iii) Increase in directed credit with compulsory; (iv) a US\$227 million line for Center-Western producers; (v) expansion of the PGPAF (Price Guarantee for Family Agriculture Program) for the investment operations beginning on the 2008/2009 harvests; (vi) creation of the LEC (Special Commercialization Line) during the 2008/2009 harvests; and (vii) extension of term for renegotiation of rural debts (after Law 11.775/2008).

⁵¹ IOF is a federal tax on loan transactions. IPVA is a state tax on property of vehicles. PIS/COFINS is a federal tax on sales of goods and services.

⁵² BRAZIL, SUSTAINABLE ECONOMY, supra note 19, at 23.

⁵³ The Time of Service Guarantee Fund – FGTS is a fund formed with compulsory contributions from each worker in the private sector that is used by the Government to finance civil construction in general. The employee used to be allowed to withdraw his resources from FGTS only in specific cases, but mainly when and if his labor contract is terminated by the employer.

to finance productive enterprises; and, finally, it reduced the federal tax on manufactured products (IPI) on construction materials⁵⁴.

3.4. Labor and Social Policies

The current Government has been steadily increasing the real value of the legal minimum wage in the last years as an income redistribution strategy. Within this context, a 12% increase of the minimum wage was planned – before the crisis – to take place in 2009 (it would increase to US\$ 211)⁵⁵ and the wages in the health and education of public servants were expected to rise by 14%. These wage increases were maintained, though interrupting them was seriously considered. As previously discussed (see Item 2.14 above) the expenditure levels in social programs like Bolsa Família⁵⁶ and investments within the Growth Acceleration Program (PAC) continue largely unaltered⁵⁷. Truth be told, with all the other measures and the quick recovering of the economy, no additional social measures were required nor implemented.

3.5. Fiscal Policy

In order to amplify the leeway for governmental policies to mitigate the effects of the crisis, initially, a reduction in the primary surplus target for 2009 from 4.3% to 3.8% of GDP was considered. However, due to the fiscal results much worse than expected (see Item 2.6 above), the primary surplus target for 2009 was reduced to 2,5% and could be reduced further to 1.56% of the GDP. Obviously this is not very positive news, but since Brazilian public debt grew very little during the crisis (it went from 41.8% of the GDP in August, 2008 to 44% in August, 2009) – probably the lowest increase in the world – and the target for 2010 is 3.3% (albeit it may be reduced to something between 2% and 2.2%), the Brazilian position is much more comfortable than the position of many of its trading partners⁵⁸.

Although we would all want to see the target go up again, as a sound fiscal policy, the time for saving is not right now. The freed resources can be used to fuel

⁵⁴ BRAZIL, SUSTAINABLE ECONOMY, *supra* note 19, at 23.

⁵⁵ *Id.*

⁵⁶ On the Bolsa Família program see generally Anthony Hall, From Fome Zero to Bolsa Familia: Social Policies and Poverty Alleviation under Lula, 38 *J. of Latin Am. Studies* 689 (2006).

⁵⁷ On the Growth Acceleration Programme (PAC) see Marcos Valadao & Nara Porto Galeb, Brazilian Update, 13 *L. & Bus. Rev. Am.* 715, 717-719 (2007). See also Governo Federal, Programa de Aceleração de Crescimento 2007-2010, 5 (Official brochure in Portuguese) (2007), www.fazenda.gov.br/portugues/releases/2007/r220107-PAC-integra.pdf (last visited Feb. 14, 2009).

⁵⁸ VALOR ECONÔMICO. Governo pode reduzir meta fiscal de 2010. 10/16/2009.

anti-cyclical policies and to increase overall expenditure, and that is what the Government has been doing. These resources have been used:

- (i) to inject over US\$43.8 billion in the economy to keep up consumption levels;
- (ii) to guarantee that Ministries are able to bring forward spending and to ensure a parallel budget of at least US\$11.4 billion;
- (iii) to make possible fresh tax cuts and more resources to the sectors more vulnerable;
- (iv) to protect US\$9.2 billion already earmarked for the Growth Acceleration Program (PAC) in the 2009 budget;
- (v) on projects to maintain overall demand with resources from the Sovereign Fund (US\$6.3 billion);
- (vi) by Federal State enterprises to release at least US\$17.5 billion in investment in providing inputs and raw materials for the industry; and
- (vii) to finance an advertising campaign to stimulate consumption⁵⁹.

From the revenues perspective, the Federal Government and some State Governments extended the time allowed for monthly tax payments, thus easing pressure on corporate cash flows. On top of that, as already discussed, a series of tax cuts have been announced, totaling around US\$3.7 billion, in order to boost consumption:

- (i) the tax on financial operations will be cut from three percent to 1.5% for direct consumer credit operations and the overdraft credit line;
- (ii) the tax on processed products was temporarily cut, until March 2009; for the purchase of motor vehicles with cylinder capacities of up to 1,000 cc., the tax will be cut from seven percent to zero percent, and for those up to 2,000 cc., from thirteen percent to 6.5%; and
- (iii) income tax tables for physical persons were revised⁶⁰ effectively creating lower rates (7.55% and 22.5%) that favored the middle class, that is, those who earn up to US\$875 per month⁶¹.

⁵⁹ ECLAC, supra note 5, at 10-12.

⁶⁰ The tax rates changes are depicted below:

Income tax rates - Individuals - Annual basis		
Taxable Income brackets (US \$)	Current tax rate	New tax rates
Not over \$7,825.03	Exemption	Exemption
Over \$7,825.03, but not over \$11,727.27	15%	7,5%
Over R\$11,727.27 but not over R\$15,636.	15%	15%
Over R\$15,636.54 but not over R\$19,538.18	27,5%	22,5%
Over R\$ 19,538.18	27,5%	27,5%

Note that there were only two tax rates before the change. It entered into force in Jan. 1st, 2009. Medida Provisória nº 451, de 15 de dezembro de 2008, D.O. de 16.12.2008, art. 15 (Assumed exchange rate US\$ 1.00 x R\$ 2.2) (Brazil).

Finally, regarding taxes, some other measures were adopted such as the postponement of tax payments, acceleration in credit return procedures and 1.5% IOF reduction for foreign capital in fixed rate funds and bonds.

All measures mentioned above were implemented by the Government to foster production and consumption, mitigating the effects of the crisis. They were very successful in sustaining economic activities (see Item 2.2 above), though their impact on revenues is still very present (see Item 2.6 above) and may present an issue if growth does not turn to revenues in the near future.

3.6. Investment and production financing

In respect of investment and production financing, the main measures were:

- (i) maintenance of the Long Term Interest Rate (TJLP) on 6.25% p.y., which is low for Brazilian standards;
- (ii) capitalization of the BNDES (in US\$ 45.5 billion) and transference of a line of credit of US\$2.3 billion from the World Bank;
- (iii) creation of a line of credit of more than US\$2.7 billion for working capital, pre-shipping export and swing loans;
- (iv) making ready to use of more than US\$4.5 billion of the Merchant Marine Fund;
- (v) 2nd Phase of the Revitalize Program involving US\$1.8 bi for special financing credit lines for working capital, investments, exports (pre-shipping) that normally benefits shoes, leather, textile, cloths and furniture companies⁶²;
- (vi) increase in Petrobras' investment program; and
- (vii) continuity in the expansion of investments in infrastructure (PAC: additional US\$64.6 billion in 2010)⁶³.

In the area of government investment, an increase of US\$4.2 billion in expenditures was established (adding up to the US\$16.6 billion already planned). The creation of a sovereign fund with an initial amount of 0.5% of GDP (around US\$5 billion) was agreed. The government is aiming to use these funds to provide the country with savings to compensate for any future economic fluctuations and finance

⁶¹ ECLAC, supra note 5, at 10-12.

⁶² More information on this at www.mdic.gov.br/sitio/interna/interna.php?area=2&menu=941.

⁶³ ECLAC, supra note 5, at 10-12.

the internationalization of Brazilian companies through issuance of Treasury bonds. The FGTS is also planned to release up to US\$2.5 billion for infrastructure investments⁶⁴.

4. Final Comments

We would like to initiate our final remarks by quickly comparing Brazil to the country source of the financial crisis, the United States. While in the US measures to face the crisis included restrictions to home loans to make them more secure to credit companies, in Brazil, measures were adopted to make them easier. While in the US concerns with inflation were put aside due to the urgency to push the economy out of recession, in Brazil the Central Bank was controlling the interest rates still with focus on the inflation rate, though the interest rate dropped substantially to help the country mitigate the crisis effects.

In Brazil, the Governmental financial enterprises are responsible for a large share of the banking activities (Banco do Brasil, Caixa Econômica Federal, BNDES, and other public banks), what granted some additional leeway for governmental actions. This tool was not available to our American counterparts. Furthermore the banking sector is highly concentrated and banking activities are heavily regulated by the Central Bank making them less exposed to risks. These features are not encountered in the US. The financial systems are strikingly different and the perception of the banking system is different. Indeed, there is no need for the bank systems to be equal, or even similar, in other words, there is no one-size-fits-all financial system⁶⁵. Different institutional arrangements within different institutional context led to different results. Though all of this is true, it is also clear now that even with different institutional arrangements, coordination is necessary for world stabilization.

The US was where the serpent's egg blossomed, but it is undeniable that the crisis effects spread to all countries, Brazil included. Some were more affected, some less. The crisis became global. The scenarios for each country are different and so were the remedies to tackle it. Brazil has done its homework and has constructed a financial system that is stronger now than before the crisis. It remains to be seen if the developed countries will take the opportunity to face their entrenched interests and construct a better international financial order. This may require restructuring the role and the effectiveness of the international financial institutions, specially the IMF and World Bank Group, and maybe the creation of a formal international law based institution to

⁶⁴ Id.

⁶⁵ See UNITED NATIONS. THE GLOBAL ECONOMIC CRISIS: SYSTEMIC FAILURES AND MULTILATERAL REMEDIES: REPORT BY THE UNCTAD SECRETARIAT TASK FORCE ON SYSTEMIC ISSUES AND ECONOMIC COOPERATION. UN, New York and Geneva, 2009, p. 20.

deal with the internal and international regulation of the financial sector, replacing the current Basle Committee and to enforce universal accounting standards.

As far as we can see from the recent events, Brazil was rewarded for being highly responsible in its public policies and in regulating its financial system. Whether or not it will actually be able to enjoy a windfall source of public income in the near future (the pre-salt oil resources⁶⁶), the fact is that the whole world would benefit greatly if the lessons of the past would be learned and exploited into creating a better international financial order. Brazil is working on its part of it. The future will tell us how well the lessons of the past were learned.

⁶⁶ See Valadao & Porto, *supra* note 4, at 679-680.