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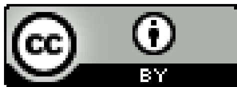

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Chapter Six

BRAZIL

Macro at the Corners: Economic Policy in Stormy Waters

For several years Brazil was considered an outstanding outsider in the Latin American region due to its excellent economic record from the mid-sixties to the early eighties.[1] Those were the 'Brazilian miracle' years, with GDP per capita continually increasing by a yearly rate of over 6 per cent from 1968 to 1980. Until the early nineties, the country followed the ISI model,[2] with the strong involvement of multinational (market-seeking) companies (MNCs),[3] which permitted Brazil to definitively leave behind a backward economy. In sum, foreign investors in tandem with local companies and the national government recreated a so-called *triade* (Evans, 1995), which was highly successful in converting Brazil into Latin America's industrial powerhouse and rapidly transforming the local society and the state.

As widely observed in other Latin American countries at the time, the Brazilian state adopted a more proactive role, and the society (or some portions of it) began to enjoy the emergence of the 'welfare state'. From the start, the substitutive model profited from instruments and policies tools available in the developmental large class, including a multiple exchange rate policy and a crawling peg scheme, which periodically adjusted the local currency to the US dollar (Canuto and Holland, 2001).

The large degrees of freedom in policymaking were, certainly, highly correlated to the capital account foreclosure alternative being adopted. Isolation, in turn, granted

1. Brazil exceptional status basically relates to its colonial legacy and the different historical path it has adopted since its independence from the Portuguese rule.
2. The first attempt to industrialize the country was observed during the First World War, but this was reversed once the war finished and coffee remained the mainstay of the economy. The decade of the 1930s saw a plethora of political changes, beginning with the revolution that ended with the 'Old Republic' (1889–1930), politically controlled by the agrarian oligarchy (fazendas owners). The 1930s were also represented by a series of economic transformations which introduced Brazil to an industrialization path. The Estado Novo finally installed the ISI model, and economic policy was reinforced in the aftermath of the Second World War.
3. MNCs became attracted by the promise of the internal market rather than any legal protection available (i.e. Law 4131/62), and in spite of the existence of some sectorial restrictions consistent with the ISI model, foreign investors were obliged to register with the central bank in keeping with existing foreign exchange and tax controls. However, the government passed legislation (Law 4131) guaranteeing MNCs the 'right of return' and of profit remittances (Carvalho and Souza, 2010).

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monetary authorities important degrees of freedom in their design of monetary policy.[4] Nonetheless, this highly autonomous environment presented some negative side effects, particularly for those at the central bank: monetary policy became highly dependent on the *fisc*. Furthermore, as industrialization advanced, the country became more nor less dependent on foreign inputs, pushing the economy to a recurrent balance-of-payments crisis – a pattern also observed in Argentina. Last but not least, and in order to bypass the increasing saving gap imposed by the model, the government began to rely on foreign credits.[5]

The rise in global interest rise coupled with a sharp rise in oil prices (at the time, Brazil was an oil importer country) exposed Brazil's large structural weakness. In the mid-1980s the external debt crisis aggravated the fiscal and financial gaps of the balance of payments, whereas the collapse of the demand of the internal market put a damper on foreign investors' expectations (Bacha, 1990). All the country' macroeconomic *gaps* were suddenly appearing by the time democracy returned, which hardly affected the economy and Brazilian society. A perfect storm of mounting social demands and diminishing degrees of freedom magically emerged to challenge those administering the economy and trying to overcome poverty and record inequality.[6] Tensions like this became apparent in the Brazilian treatment of FDI. Decree-Law No. 1986/82 introduced important restrictions for foreign companies in order to operate in the local capital market. Two years later, a constitutional amendment would introduce further restrictions, including a ban on foreign investors participating in the local banking industry. The new scenario would put the economy into an inflationary vicious circle lasting until the mid-1990s, despite several deregulatory initiatives and liberalization measures undertaken under both the Fernando Collor de Melo and the Itamar Franco government.[7]

Unsolved tensions forced the government to monetize the mounting fiscal deficit, thus pushing the society to an annual rate of inflation exceeding 100 per cent every year from 1981 to 1994. Henceforth, for those aiming to obtain public support at the ballot box, combating inflation came to the centre of the political agenda, and politicians affirmatively responded. Thereafter a series of heterodox programmes were introduced (1985 Plan, 1987 Bresser Plan and 1989 Summer Plan), which initially helped reduce inflation

4. Monetary authorities introduced OMOs as early as in the 1970s – alongside the creation of the central bank reserves market. Two decades later, OMOs would be replaced as the government preferred to rely on intermediate targets in order to control monetary policy. The mid-1996 movement also discontinued OMO operations in the secondary market (BCB, 1999, p. 81).
5. Commercial lending was mainly attached to oil imports, although loans were also directed to finance public investment.
6. Brazil has always been described as a highly unequal country, even by Latin American standards. At the time of the miracle, some observers were describing this contrast as 'Bel-India' – that is, as affluence favouring a tiny sector of the society but with the rest falling below poverty levels.
7. Among other measures, the Brazilian government opened the domestic securities market to foreign investors and granted companies permission to transfer financial resources abroad without proof of previous internment through the so-called CC5 results.

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rates, but pressure caused it to resume sooner rather than later.[8] Consequently, at the beginning of the 1990s inflation was again out of control – surpassing an annual rate of 5,000 per cent in June 1994 (CBB, 1999). The situation motivated policymakers to act, and bravely.

Playing at the Corners: How Sustainable Can a Fixed ER Scheme Be?

On July 1994, the government introduced the Real Plan aimed at curbing the inflationary problem by committing itself to maintaining an exchange rate ceiling of one-to-one parity with the dollar.[9] A few months earlier, Brazil had achieved an agreement with the international banking sector on the external debt issue (i.e. Brady Plan), normalizing its international financial relations. Authorities now decided to install a more liberal and market-friendly approach towards national development and foreign investors' involvement.[10] The Real Plan was fully successful in settling the inflation down, putting an end to indexation and the chronic high inflation observed in the past. The architect of the plan, Fernando Henrique Cardoso (or FHC, for short, as he has famously been known in Brazil), was at the time Minister of Finance and later twice elected president of the Federal Republic of Brazil from 1994 to 2002.[11] During his term in office, Brazil would attract numerous foreign investors (Mortimore and Stanley, 2010).[12]

The success of the Plan generated some complications, however, including an important bias towards exchange rate appreciation,[13] demand expansion (pulling for

8. As observed in other countries in the region, notably Argentina, the central elements associated with a freeze in the main macro prices (including wages), prohibiting financial indexation and fixing the exchange rate regime.
9. In contrast to the Convertibility Plan in Argentina, the monetary authorities in Brazil did not explicitly state the relationship between changes in the monetary base and foreign reserves movements, thus allowing for some discretionary leeway – a crawling peg scheme.
10. Brazil, as other countries in the region, embarked on an ambitious privatization programme, which attracted several firms – particularly from Europe and also the United States.
11. FHC is also a leading intellectual figure in Latin America. A sociologist, he would in the 1960s become one of the founding fathers of the dependence theory. On his return to Brazil, he began his political career, being twice elected to the Senate (1982 and 1986). He took part in the 1987–88 National Constituent Assembly that drafted and later approved the (new) Brazilian Constitution. Before becoming head of the Ministry of Finance, he served as Minister of Foreign Affairs (from October 1992 to May 1993) – both charges under President Franco.
12. Capital inflows increased spectacularly in the nineties, in both FDI and financial flows: whereas in 1990 capital flows represented 0.9% of Brazilian GDP, ten years later they totalled 3.8%. Regarding the 1990–2000 period, mid- and long-term inflows totalled US$ 95.8 billion – mostly commercial notes (71.0%), followed by inter-firm credits (17.1%), bonds (5.9%) and commercial papers (4.3%). Short-term flows, in turn, were important until 1995, and thereafter monetary authorities began to bet hard against speculative capital, reintroducing controls (Terra and Sohiet, 2006, pp. 728–31).
13. As observed by E. Cardoso, 'despite minor devaluations between 1995 and 1998, the REER at the end of 1998 was still as high as it was at the beginning of 1996. There was no structural changes or anticipated growth to justify such a significant real appreciation.' The slow growth of exports is another sign of the plan bias towards appreciation' ('Brazil Currency Crisis: The

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increasing imports)[14] and, unfortunately, the persistence of a lower savings trend. Trade liberalization plus currency appreciation turned the current account into deficit from 1995 to 1999. The Plan was also incapable of untangling old fiscal problems, inducing instead an external debt rise – which proved necessary to maintain the economy at work. Despite the evident fiscal problems, the Banco Central do Brazil (BCB) (the Brazilian central bank) decided to play it tight – yet increase the interest rate differential. Unable to alter the exchange rate in the event of external shocks, the government left aside the bulk of the adjustment on the interest rate policy (Canuto and Holland, 2001), a decision whose consequences are still challenging Brazil.

As external imbalances intensified, the economy remained at the mercy of financial speculators.[15] Therefore, in order to reduce volatility, and despite the liberalization path being initiated, economic authorities decided to introduce a series of controls on capital inflows.[16] On the one hand, authorities decided to introduce price-based schemes including explicit taxes on capital flows on stock market investments, foreign loans and certain exchange transactions.[17]

On the other hand, the government also maintained different administrative controls as outright prohibitions against (or minimum maturity requirement for) certain type of inflows (*sand in the wheel* provisions). An institutional view would observe that the legal framework regarding the issue still contained some old norms and rules, all of them dated from the Vargas administration and originally focused on preventing capital outflows (Carvalho and Garcia, 2006).[18] Independently of legal enforcement, the regime became

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Shift from an Exchange Rate Anchor to a Flexible Regime', chapter 4 in *Exchange Rate Politics in Latin America*, ed. Carol Wise and Riordan Roett (Washington, DC: Brookings Institution Press, 2000), p. 80.

14. The enthusiasm generated by the boom, led economic authorities to raise minimum wages and government wages and salaries.
15. In might be important to emphasize the low interest rate level observed among industrialized countries in the nineties. Henceforth, lower interest rates in DCs (developed countries) induced investors towards some EMEs like Brazil, whose economy was then characterized by open capital accounts, a fixed exchange rate and an important interest rate differential (carry trade). During the Asian crisis, Brazil lost US$ 11 billion in reserves in three months, forcing the central bank to raise interest rates from a 19% annual average to 46% in November 1997. A few months later, high interest rates pulled foreign investors back, although 'temporarily': the Russian crisis pulled them out again (Carvalho and Souza, 2010).
16. As an example, Terra and Sohiet (2006) mentioned the approval of two resolutions (No. 1832/91 and No. 1482/92) reducing the short-term capital stance, along with the CBB Resolution No. 2388 constituting the foreign capital fixed-rent fund. Since 1997, the FHC government had introduced a series of rules and measures, resuming the opening of the capital account. The Asian crisis and the increase in capital outflows that resulted thereafter, however, caused authorities to discontinue this trend.
17. The so-called tax on financial operations (or Imposto sobre Operações Financeiras – IOF) was introduced in June 1994 through Law No. 8.894. Inflows were mostly charged at 2% – although some operations were exempted, such as those involving the state (local, regional or national) and their related companies and payments accruing to import and exports operations.
18. The Brazilian legal framework included (in 2006) the following requirements: foreign exchange must be converted into the national currency; export revenues and resources secured offshore

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highly contested by mainstream pundits/experts], which tilted capital controls to be ineffective in keeping speculators at bay.[19] In sum, although controls increased policymakers' space, the country remained exposed to global capital flows as some legal leaks permitted investors to arbitrage. As in the Argentinean case, the strategy of using the exchange rate as an anti-inflationary anchor remained highly vulnerable – and investors became well aware of this.

The End of an Affair: Inflation Targeting as a New Anchor

In order to maintain the exchange rate, the government profited from an IMF syndicate loan in late September 1998, which, unfortunately, proved incapable of restoring market confidence.[20] International reserves were almost exhausted, and financial flows remained negative. As the macroeconomic environment worsened, economic agents began to transform their holdings from BRL (Brazilian reals) to US$ dollars. Incapable of maintaining the peg, the re-elected president (FHC) decided in January 1999 to allow the real to float, convincing both politicians and public opinion that the currency would be less vulnerable to future speculative attacks if it were flexible. To settle down economic agents' expectations, economic authorities introduced an inflation-targeting regime along with adding more pressure to achieve a primary fiscal surplus (Fiscal Responsibility Law, approved by the National Congress in May 2000).

Thereafter, the economy grew at very low rates, a phenomenon that could be explained by several factors, among them, a contractive fiscal policy, very high real interest rates impeding new investment financing and, last but not least, the maintenance of high external volatility. All these factors were adding stress on the macro front. A series of external shocks (Russia, Argentina, the dot.com bubble in the United States) would come to aggravate the external front, whereas the perspective of Luiz Inácio Lula de Silva's victory in the presidential election affected the internal one.[21] Confronted with a fresh crisis, new economic authorities acted similarly to the previous ones: raising interest rates and causing the economy to contract (Carvalho and Souza, 2010).

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must be brought back into the country; and private exchange rate transactions were prohibited (Carvalho and Garcia, 2006).

19. A series of papers analyse this period, including the effectiveness of capital controls: Cardoso and Goldfajn (1997); Sohiet (2002); Paula, Oreiro and Silva (2003); Carvalho and Garcia (2006). Costa da Silva and Cunha Resende give a more optimistic opinion – promoting the necessity to reinforce these types of controls with more restrictive measures (2010). Cardoso and Golpin (1997) introduce an index of capital controls describing all legal transformations affecting capital inflows, including all the norms and rules introduced by the central bank of Brazil. Scholars classified the rules affecting the capital flows as being pro-market (liberalize) or anti-market (restrictive).
20. The package was orchestrated among the IMF, the World Bank, the Inter-American Development Bank (IDB) and a group of industrialized nations, with the BIS articulating it. As compensation for aid, the agreement stipulated an adjustment programme.
21. Lula finally won the Brazilian presidency in the 2002 elections, after three unsuccessful runs (1989, 1994 and 1998).

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Table 6.1 Brazil IT, evolution since 1999

BRAZIL inflation- targeting evolution (1999 to 2015)						
Year	Target	Tolerance interval (p.p.)	Upper limit (%)	Lower limit (%)	Actual inflation (IPCA,% p.a)	Difference
1999	8	2	10	6	8.94	–0.94
2000	6	2	8	4	5.97	0.03
2001	4	2	6	2	7.67	–3.67
2002	3.5	2	5.5	1.5	12.53	–9.03
2003	4	2.5	6.5	1.5	9.3	–5.3
2004	3.25	2.5	5.75	0.75	7.6	–4.35
2005	4	2.5	6.5	1.5	5.69	–1.69
2006	3.75	2.5	6.25	1.25	3.14	0.61
2007	5.5	2	7.5	3.5	4.46	1.04
2008	4.5	2	6.5	2.5	5.9	–1.4
2009	4.5	2	6.5	2.5	4.31	0.19
2010	4.5	2	6.5	2.5	5.91	–1.41
2011	4.5	2	6.5	2.5	6.5	–2
2012	4.5	2	6.5	2.5	5.84	–1.34
2013	4.5	2	6.5	2.5	5.91	–1.41
2014	4.5	2	6.5	2.5	6.41	–1.91
2015	4.5	2	6.5	2.5	10.67	–6.17

Source: BCB

Once again authorities were pushing monetary policies too far: stabilization become a strong mandate for the BCB (and a weak one for those covering the fiscal front). Certainly, an important number of academics posed the problem on the monetary front. But, unfortunately, Brazil real interest rates are among the EMEs highest – particularly when compared with Asian EMEs. The Special Clearance and Escrow System (SELIC) is the basic rate dictated by the government in order to alienate demand and supply of money. Being settled by the central bank's Monetary Policy Committee (hereinafter referred as COPOM), this overnight rate indexes the Brazilian Treasury notes, or Letras Financieras do Tesouro (LFTs).[22] As the notes are automatically indexed by SELIC, its guarantees investors zero *Maculay* duration.[23] As a consequence, by guaranteeing high liquidity and

22. Treasury Indexed Bonds were originally introduced in 1964, and particularly directed at enhancing OMO' liquidity (Branco and Paula, 2015, p. 111). LFTs were introduced by the 1988 Constitution, as it prohibited the federal government from obtaining (direct or indirect) financing throughout the BCB. The new law granted the federal government a unique account at the central bank, permitting the BCB to introduce the notes in the monetary toolkit (Oreiro et al., 2012, p. 568),
23. Macaulay duration is used to measure how sensitive a bond price is to change in interest rates. Thus, bonds have zero interest rate risk, reducing the wealth effect of monetary policy.

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limited risks, LFTs remain the most preferred financial instrument among federal government domestic debt (Oreiro et al., 2012), at the cost of perpetually postponing the fiscal problem solution. An increase in SELIC automatically raises the public debt; however, it generates a contagion effect of public debt that 'changes the term structure of interest rates' (Holanda Barbosa, 2006) and prevents the creation of a long-term market for government bonds.

Whereas prior experience showed how vulnerable a monetary – *fisc* –liaison might be in a closed economy context, the situation is aggravated further when the economy is open to the world as foreign investors are now entitled to mediate monetary instruments. This explains why LFTs are in Brazil highly correlated with foreign reserves, as the BCB uses them (reserves) to sterilize operations with indexed Treasury notes.[24] This correlation, in turn, generates an extreme interest rate dependence on exchange rate movements (Oreiro, 2014, p. 214). In short, the LFTs exhibit high negative effects on the Brazilian economy, particularly affecting the effectiveness of BCB monetary policy under an inflation-targeting scheme (Oreiro et al., 2012). Nevertheless, and despite all commented limitations imposed by high real interest rates, the scheme proved successful in preventing the Brazilian economy from dollarizing during the hyperinflationary years (Holland Barbosa, 2006), certainly 'an object of desire for many EMEs' (Bacha et al., 2007, p. 16).

Along with the flexible exchange-rate-cum-inflation-targeting regime, and in order to limit volatility shocks, Brazilian authorities began to use derivatives instruments (FX options). In particular, the BCB decided to intervene in the domestic market via the use of derivative swaps to maintain the ER parity within a certain range of value – and without necessarily being forced to alter the country's FX reserves![25] This policy tool, be that as it may, proved problematic to manage as economic agents converted it into a highly speculative weapon.[26] In addition, the increasing importance of the derivative market altered the normal exchange rate determination process: instead of being formed at the spot market, it was the futures market which determined the ER value determined not by the spot but rather (or strongly affected) by future market operations (Franco, 2000; Dodd and Griffith-Jones, 2007; Ventura and Garcia, 2009).[27] Besides this undesirable bias, FX derivatives (coupled with the

24. Treasury notes are used to regulate market liquidity. If the market exhibits excess demand of LFTs, then the central bank is forced to grant liquidity in order to maintain the monetary base in equilibrium. However, if the market is exhibiting an excess supply of LFTs, authorities are forced to use their reserves in order to liquidate them (Oreiro, 2015, p. 112).
25. Monetary authorities first commercialized the dollar/real future contracts in November 1996, with the BCB trying to defend the crawling peg. As, due to legislation, FX futures are non-deliverable, the central bank is not forced to use its international reserves.
26. Speculation might not be bad if it is bidirectional, but economic agents' bets turned unidirectional (Rossi, 2015).
27. As, for example, in August 2013, the daily turnover of the futures market was four times greater than the spot market: US$ 27.0 billion against US$ 6.4 billion (Rossi, 2015)\, p. 718.

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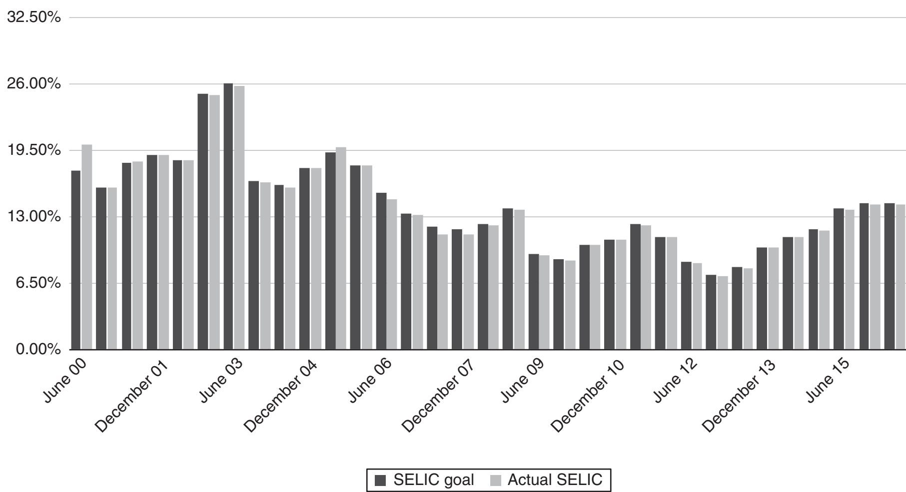

Figure 6.1 Brazil, SELIC rate
Source: Central Bank of Brazil

presence of assets indexed to foreign exchange) permitted to install 'a barrier that strongly attenuated the transmission of financial instability to the economy' (Prates and Farhi, 2015, p. 16).[28]

The arrival of Lula to the presidency did not lead to alteration of FHC's macroeconomic programme, but orthodox measures further expanded – which received important criticism from the heterodox Keynesian camp. The BCB maintained the inflation-targeting scheme almost intact, reinforcing the tightening approach on monetary policy.[29] The exchange rate regime continued untouched, although the real was not left at the mercy of market forces as monetary authorities began to periodically intervene. Fiscal policy became more ambitious, as authorities were now pushing for a primary surplus of 4.25 per cent of GDP (Williamson, 2010). It might be remembered that Lula's first term began in January 2003. At that time the effects of the EME crisis were still latent, but external conditions would become favourable soon and some heterodox policies begin to gain space.

After 2003, the external front would become more generous to Brazil, as commodity prices improved and exports continued to rise (the China factor). This boom transformed Brazil's pattern of commerce, introducing a new normal as the balance quickly moved from deficit to surplus.[30] The always-problematic fiscal front became less traumatic as

28. Liquidity, in turn, is explained by the BCB's attitude of continuing with the selling of US$ dollars.
29. In his first year in office, the SELIC averaged 15.4% per year.
30. Brazil's main exports to China were concentrated in a small batch of commodities, particularly soybeans and other seeds, iron ore and concentrates, oil and derivatives, pulp and waste paper and meat.

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Table 6.2 Brazil international reserves and basic indicators (1990–2015)

Year	Total Reserves (includes gold, current millions of US$)	Total Reserves to GDP ratio (%)	Total Reserves in months of imports	Total Reserves to Short-Term Debt	Total Reserves to M2	GDP PPP (current millions of US$)
1990	9,199.60	1.99	2.6959	257.7820	15.2623	461,951.78
1991	8,748.60	1.45	2.7053	300.7501	24.1386	602,860.00
1992	23,264.50	5.81	7.5251	103.5314	10.4921	400,599.25
1993	31,746.90	7.25	8.1952	98.6635	12.9158	437,798.58
1994	38,491.70	6.90	8.4307	83.5785	6.4513	558,112.00
1995	51,477.30	6.55	7.9343	60.6502	4.8493	785,643.46
1996	59,685.40	7.02	8.5729	59.5602	5.0038	850,425.83
1997	51,705.50	5.85	6.4080	66.5250	6.3141	883,199.44
1998	43,902.10	5.08	5.3244	68.0615	7.7381	863,723.40
1999	36,342.30	6.06	5.0955	80.4308	7.0608	599,388.88
2000	33,015.20	5.04	4.2562	93.8145	9.2285	655,421.15
2001	35,866.40	6.41	4.5473	78.8293	9.1098	559,372.50
2002	37,832.10	7.45	5.5186	61.8389	7.3911	507,962.74
2003	49,297.20	8.83	6.9927	49.8897	6.3526	558,320.12
2004	52,934.80	7.91	6.1843	47.7323	7.1347	669,316.24
2005	53,799.20	6.03	5.1330	44.5972	10.0129	891,629.97
2006	85,842.80	7.75	6.7141	23.6747	8.3321	1,107,640.33
2007	180,333.60	12.91	10.8977	21.7630	5.4084	1,397,084.38
2008	193,783.30	11.43	8.5080	18.9098	6.3479	1,695,824.52
2009	238,539.40	14.31	13.1785	16.6790	5.5221	1,667,020.11
2010	288,574.60	13.06	10.5444	22.6951	6.0660	2,208,872.21
2011	352,010.20	13.46	10.6835	11.9713	6.0930	2,614,573.17
2012	369,565.90	15.02	12.2090	8.7316	5.6810	2,460,658.44
2013	358,808.00	14.55	11.6298	9.3381	5.7561	2,465,773.85
2014	363,551.00	15.04	11.3669	16.0016	5.9269	2,417,046.32
2015	356,464.00	20.09	14.3830		4.7374	1,774,724.82

Total Reserves: Total reserves comprise holdings of monetary gold, special drawing rights, reserves of IMF members held by the IMF and holdings of foreign exchange under the control of monetary authorities.

Total Reserves to Imports: This item shows reserves expressed in terms of the number of months of imports of goods and services they could pay for (Reserves/(Imports/12)).

Total Reserves to ST Debt: Short-term debt includes all debt having an original maturity of one year or less and interest in arrears on long-term debt.

Total Reserves to M2: Broad money is the sum of currency outside banks; demand deposits other than those of the central government; the time, savings, and foreign currency deposits of resident sectors other than the central government; bank and traveller's cheques; and other securities such as certificates of deposit and commercial paper.

Source: World Bank

the economy recovered and the government's revenues increased. Favoured by the new external scenario, Brazil also began to increase its gross international reserves up to US$ 200 billion in 2008. Last but not least, local interest rates began to diminish, albeit at very slow rates. All this set the Brazilian economy on a more relaxed path. Additionally,

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the discovery of the pre-salt oil fields in the seabed off the southern coast increased the government's confidence in the foreseeable future.[31] The new international environment backed the Lula administration in adding a social content to his previous market-oriented economic model. The China effect led those in the government think that Brazil's grand destiny was now firmly installed.[32] Unfortunately, some confused the success of these short-term policies and the apparent resilience of the Brazilian economy as a guarantee of a sustainable development path.[33] In sum, this 'social-developmental' (but populist) programme would, unfortunately, prove unsustainable (Bresser Pereira, 2015).[34]

Brazil, the GFC and Beyond: A New *Caiphirina* Moment?

The GFC seriously affected the Brazilian economy, both on the real and the financial side. External markets were suddenly depressed; GDP contracted by 0.6 per cent on a yearly basis; and the ER experienced a harsh depreciation, as investors were leaving the country en mass. This flight-to-quality phenomenon involved portfolio investors but also MNCs' subsidiaries, which unexpectedly began to increase their remittances and payments abroad. What proved more destabilizing, however, was the unrestricted access obtained by investors in both the spot and derivative segments of the Brazilian financial market (Prates, 2014, p. 155). Attitudes like this just added pressure to the real exchange rate, forcing economic authorities to lead the market initiative in order to avoid a sudden devaluation of the real. The prudent macro policies being followed until the financial crack did not help immunize the national economy nor did the vast FX reserves that had been previously accumulated.

Despite the storm and in order to gain initiative, the Lula government introduced an ambitious stimulus package while altering government's policies on the monetary, fiscal and industrial fronts. Among the measures undertaken were an important motivation for credit expansion, including both (direct) monetary instruments[35] and the enactment

31. Petrobras, Brazil's leading oil company, made a series of important discoveries in 2007 and 2009. Although the reserves are important, so are the associated costs of extraction.
32. Brazil was now included in a selected group of emerging giants, the so-called BRICs group (Brazil, Russia, India, and, China). Originally given this name by Jim O'Neill in 2001 (by then, chairman of Goldman Sachs), they finally assembled as a group and had their first formal summit in 2009 in Yekaterinburg. South Africa would join the group in 2010, henceforth becoming known by the BRICS acronym.
33. An important increase in the minimum wage was among the principal measures benefiting the lower class, but they were also gained from two additional policies introduced by the Lula administration: the *bolsa familia* and an increase in the share of GDP devoted to social spending.
34. 'We will have more oil to face up to this financial crisis', Lula da Silva said after Petrobras discovered the pre-salt reserves in 2008 ('Pre-Salt Oilfield Creates Biggest Challenge Yet for Petrobras', *FT*, 22 October 2013).
35. In order to push financial institutions towards credit, the government introduced penalties in the reserve requirement of time deposits. Another important set of measures was related to the development of the discount windows procedures and of the Credit Guarantee Fund (CGF). The creation of a special type of time deposit (six months, backed by the Fundo Garantidor

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of new credit lines at the Brazilian Development Bank (BNDES) (Sobreira and Paula, 2010).[36] The government was assigning a countercyclical role to most federal public banks (Banco do Brasil; BB, Caixa Economica Federal; CEF and Banco Nacional de Desenvolvimento Econômico y Social; BNDES) (Moreira Cunha, et al., 2011, p. 705). On the monetary front, the BCB started with an easing policy in order to lower the policy target rate and simultaneously increase market liquidity (Moreira Cunha et al., 2011). Liquidity qualms were avoided by the BCB through a series of measures, including the reduction in the SELIC rate and reserve requirements on cash deposits and time deposits, and auctions of loan reserves. Monetary authorities also rushed to shield the financial system from a systemic crisis, including new rediscount lines and the enactment of renewed regulatory rules and prudential measures. Finally, a swap agreement was negotiated with the US Fed, which was highly valuable in relaxing pressures on the exchange rate (EX) market.

On the fiscal front, actions were oriented towards incentivizing both consumption and investment expenses, introducing a more adaptable position over the previous more orthodox approach.[37] Finally, Dilma Rousseff, the first female president of Brazil and the resident at the Palácio da Alvorada since 1 January 2011, reintroduced capital controls by issuing a 2 per cent annual tax on foreign loans.[38]

According to Mesquita and Torós (2010), the main lesson to be extracted from the GFC experience is that a country characterized by inflation targeting, prudential monetary policy and conservative banking rules and practices enters into a crisis later and exits sooner, all along with lower price volatility. Certainly, Brazil entered into the crisis exhibiting strong fundamentals (international reserves, fiscal accounts, external front and so on). As noted by Wise and Tedesco Lins (2015, p. 177), many observers were happy to proclaim a triumphal narrative, but resilience towards the GFC was ultimately confounded by an indefinite future of prosperity.

Nevertheless, induced by the Fed's policies, capital continued to arrive in Brazil, and in a massive way. These new massive inflows of capital plus the funds available after the stimulus package would generate important effects over the macro (exchange rate appreciation, increasing deficit in the current account, mounting inflation and so on). The local stock market was now the main destiny of inflows, fuelling a credit boom that particularly

de Credito (FGC), or CGF by its English acronym) became another valuable instrument introduced by monetary authorities (Mesquita Toro, 2010).

36. According to Silva (2009), the BCB avoided to install a tight monetary policy thanks to the availability of FX reserves and by the use of FX derivative swaps.

37. In order to stimulate demand, the fiscal package introduced several measures, including (1) an expansion of the PAC; (2) a construction programme (Minha Casa, Minha Vida); (3) budget transfer to municipalities; and (4) an expansion of unemployment benefits (Moreira Cunha, 2011).

38. In her inaugural speech Dilma Rousseff stated that Brazil would protect 'the country from unfair competition and from the indiscriminate flow of speculative capital' ('Dilma Rousseff Inauguration Speech: Brazil's First Female President Addresses Congress in Brasilia', *Huffington Post*, https://www.huffingtonpost.com/2011/01/03/dilma-rousseff-inaugurati_1_n_803450.html, 3 January 2011).

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Table 6.3 Brazil fiscal indicators (2002–15)

Key macro indicators after the 2008 crisis (2008-2015)														
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real GDP change (%)	2.7%	1.1%	5.7%	3.2%	4.0%	6.1%	5.0%	-0.2%	7.6%	3.9%	1.8%	2.7%	1.0%	–3.5%
Primary result (% of GDP)	3.2%	3.2%	3.7%	3.7%	3.2%	3.2%	3.3%	1.9%	2.6%	2.9%	2.2%	1.8%	–0.6%	–2.1%
Nominal result (% of GDP)	–4.4%	–5.2%	–2.9%	–3.5%	–3.6%	–2.7%	–0.2%	–3.2%	–2.4%	–2.6%	–2.3%	–3.1%	–6.2%	–11.1%
Gross General Government Debt (% of GDP)	66.7%	60.9%	56.2%	56.1%	55.5%	56.8%	56.0%	59.3%	51.8%	51.3%	54.8%	53.3%	58.9%	69.0%
Net Public Debt (% of GDP)	59.8%	54.2%	50.2%	47.9%	46.5%	44.6%	37.6%	40.9%	38.0%	34.5%	32.9%	31.5%	34.1%	33.0%
Net Tax Revenue (% of GDP)	17.7%	17.2%	18.0%	18.6%	18.7%	18.9%	18.8%	18.3%	20.0%	18.7%	18.7%	19.2%	18.4%	18.7%
Primary expenditure (% of GDP)	15.5%	14.9%	15.4%	16.1%	16.6%	16.7%	16.0%	17.2%	18.0%	16.5%	17.1%	17.7%	18.7%	19.0%
Foreign Public Net Debt (% of GDP)	15.6%	11.0%	7.8%	3.1%	–1.2%	–7.3%	–10.7%	–8.8%	–9.3%	-12.3%	–12.9%	–13.4%	–13.8%	–19.5%

Source: Own elaboration, based on Holland (2015), World Bank and Brazilian Central Bank

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benefited Brazilian households and kept stimulating sales in both the retail and the auto market. In sum, quantitative easing policies have strong spillover effects on the Brazilian economy (Barroso et al., 2013, p. 30), certainly benefiting households' consumption but disruptive to manufacturing and real investment.

One would say that when dancers perceive the music will stop soon, they begin to exit. This pattern was observed among savvy investors after they perceived the end of the Fed QE programme – the so-called taper-tantrum moment which began in May 2013.[39] They smelled Brazil's (macroeconomic) weakness and, thus, helped transform a (once qualified) rising global star into an inconsistent example of macro populism. The Brazilian macro was, once again, confronting a series of disruptions on the fiscal, monetary and exchange rate fronts.

Both political and economics forces were, one more time, pushing the country towards recession and a tremendous devaluation. The local currency plunged from a high of about $1.5 to the dollar in July 2011 to $3.83 in September 2015 ('Dilma in the Vortex: Brazil's Economic and Political Crises Are Reinforcing Each Other', *The Economist*, 1 October 2015). The real economy contracted fast, as confidence began to reduce households' consumption plans alongside destimulating firms' investment plans. Furthermore, inflationary pressures were back, with rising prices in food, electricity and transport adding pressure on the BCB target range. Inflation forced monetary authorities to tight interest rates,[40] but, unfortunately, the movement also led to a new debt spiral.[41] In any event, the situation put the fiscal front back into the scene, and the government now became forced to rebalance its budget after the overspending bias generated by the prolonged fiscal stimulus. As authorities evidenced weak enthusiasm for disentangling the fiscal burden, leading rating agencies ended up downgrading Brazilian external bonds to the junk category in September 2015. To sum up, depreciation and recession induced a huge contraction in the national economy, which contracted by nearly a quarter that year in dollar terms.[42] Despite the storm, foreign investors remained interested in National

39. Tapering is a system of slowly reducing the amount of money the Fed puts into the economy, which, in theory, gradually reduces the economy's reliance on that money. However, if the public hears that the Fed is planning to engage in tapering, panic can still ensue; that panic is called a taper tantrum (investopia: http://www.investopedia.com/terms/t/taper-tantrum.asp#ixzz4vo3wQSKW). See also Gerald D. Cohen, 'Emerging Markets' Taper Tantrum', at Brookings.edu, 29 January 2014.
40. Considering the period from October 2014 to early June 2015, the SELIC rate increased by 275 basis points ('Brazil Raises Rates for Sixth Straight Time', *FT*, 4 June 2015), to finally reach 14.25% at the end of July – its highest level since August 2006 ('Brazil Raises Rates to 14.25% to Combat Inflation', *FT*, 30 July 2015).
41. With a 64.5% debt-to-GDP ratio, it reached a new plateau in September 2015, but forecasts predicted the ratio would surpass 70% soon ('Brazil Struggles to Fix Fiscal Crisis', *FT*, 2 September 2015). Private sector debt also jumped to 55% of GDP in recent years, from a mere 25% level observed in 2005 ('The Crash of a Titan', *The Economist*, 28 February 2015).
42. From a figure of US$ 2.353 billion in 2014, Brazilian GDP was expected to reach US$ 1.812 in 2015 ('Brazil Economy to Contract Nearly One-Quarter This Year in Dollar Terms', *FT*, 25 May 2015).

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Treasury Finance (NTF) notes, as Brazilian bonds continued to offer one of the most attractive yields in the world.[43] Some other actors, however, were rather pessimistic regarding the monetary tightness, arguing that the government was pushing further this contractive phase of the cycle.

For some academics and policymakers, the latest news came to confirm the challenges posed by incomplete modernization (Wise and Tedesco Lins, 2015), or the changes introduced under the Rousseff government that reversed prior market-friendly measures.[44] However, other academics would assert that these 'end-of-the-party' sorts of problems showed their historical roots in Latin America, as those countries cyclically observe a highly volatile macro scenario. Still others highlighted the challenges posed by the massive arrival of capital, the appreciation bias and the strong deindustrialization path followed in last decades (Bresser Pereira, 2015).[45] To make the scene worse, wages kept increasing despite the weak performance in labour productivity recently observed (Oreiro, 2015a).

The Financial System and the Trilemma: New Actors, Renewed Constraints

Until the mid-eighties, Brazil's financial system was characterized as a repressed model. As observed in Argentina, the state was fixing prices (interest rates) and rationing quantities (credit). Likewise, the presence of foreign banks was severely limited, whereas public sector/state-owned banks were warmly embraced. In particular, this reflected highly restrictive legislation covering banking, with foreign banks entry being considered only on a reciprocal basis and subject to special capital requirements (Freitas, 2009).[46]

Thereafter, the Brazilian financial system underwent profound changes, including the end of the 'floating' scheme after the introduction of the Real Plan.[47] Once Brazil left behind

43. In June 2015 non-residents owned R$ 480 billion, or 20.5% of Brazil's local currency government debt ('Foreign Ownership of Brazil's Local Debt Hits Highest Ever Level, EM Squared', *FT* 5 June 2015, https://www.ft.com/content/7981d1bc-0aa8-11e5-a8e8-00144feabdc0).
44. As, for example, by augmenting state involvement in the economy by reducing BCB independence, by increasing trade protectionism or, finally, by lowering the tax basis (Oreiro, 2015).
45. He also blames Rousseff's irresponsibility on the fiscal front. Additionally, Bresser Pereira considers unacceptable the narrow inflationary target maintained by her government, which misunderstands 'two other goals of good macroeconomic policy: growth and financial stability' (Bresser-Pereira, 2015, 'The Macroeconomic Tripod and the Workers' Party Administrations'. Paper prepared for book edited by Lauro Mattei, March 2015).
46. Article 192 of the Brazil Federal Constitution and supplementary laws – approved at the National Congress under by a qualified quorum – are rules for foreign participation in domestic financial institutions. Authorization, originally granted in reciprocity or in the interest of the government, was subject to BCB analysis and approval.
47. Under the inflationary regime, an agent's lending capacity was basically directed towards buying governmental bonds. Indexation of contracts permitted Brazilian authorities to recreate a domestic reserve asset competing with massive dollarization of private agents portfolios (Carvalho and Souza, 2010).

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the old macro scenario, the banking industry was pushed towards a tough dilemma: either sell their share in the market to other players (either new entrants or competitors) or maintain their stance and become competitive in this new environment. The new financial scenario turned more unpredictable, certainly, and particularly affected small and medium-size banks and public entities (Hermann, 2010).[48]

Henceforth, and in order to solve the dilemma, the Brazilian government introduced a series of measures aimed at attracting foreign investors (Carvalho and Souza, 2009).[49] Bankers from Europe or the United States were seen as more solid (both in terms of capital and liquidity provisions), along more efficient and, certainly, technologically on the front line. Consequently, since the mid-nineties foreign banks had begun to arrive, launching an important trend towards concentration and (partial) denationalization in the Brazilian banking industry.[50] Institutionally, the government removed former legal restrictions placed on foreign participation – including those introduced by the Brazilian Constitution.[51] In the same direction, the government decided to open the fixed-rent market to foreign capital (Annex VI, Resolution 1289/1993).[52] Thereafter, equity markets gained in relevance, although now with the important participation of foreigners.[53] Additionally, with the retreat of inflation Brazil recreated the debt market.

48. Only three big national banks were affected by the crisis (Banco Nacional, Banco Económico and Bamerindas). BANERJE and BANESPA were the two biggest public-regional banks distressed by the mid-nineties crisis.
49. Two measures were particularly important. One is the creation of the PROER (Program of Incentives to the Restructuring and Strengthening of the National Financial System), whose objective was to assure the liquidity and solvency of the national financial system. In order to achieve this, the programme introduced a merger and acquisition policy, including important tax incentives and credit facilities for those interested in participating. The second one relates to the implementation of the PROES (Program of Incentives for the Reduction of the State´s Participation in Banking Activities), whose primary goal was to reduce the number of public sector participants in the financial system.
50. Foreign banks' entrance was mainly made throughout the acquisition of both public entities and (local) private banks. The purchases of Banco Meridional, Banco Bozano-Simonsen and Banco do Estado de Sâo Paulo by Spanish Banco Santander transformed it into one of the most relevant entrants. Other European banks were also entering the Brazilian market in the late nineties, such as the Dutch ABN AMRO or the French Société Générale. The participation of foreign-controlled banks among the 15 largest banks increased from 6.5% to 34.0% between 1994 and 1998 (Fernando J. Cardim de Carvalho, 2002, 'The Recent Expansion of Foreign Banks in Brazil: First Results'. University of Oxford Centre for Brazilian Studies Working Paper Series. Working Paper Series CBS-18-01, pp. 22–23).
51. The issue was certainly unclear under the 1998 Federal Constitution. Foreigners with an interest in operating in the Brazilian market were obliged to ask for a special authorization from Congressional authorities.
52. The first steps towards attracting foreign investors were undertaken in the late eighties by introducing a special vehicle to participate in the market. In 1991, foreigners were allowed to operate without intermediaries.
53. Primary and secondary purchases made by this group of investors reached 71.2% of total primary and secondary markets in 2005 (Carvhalo and Souza, 2010, p. 27).

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Monetary authorities were also introducing important changes on the regulatory front, and regulatory measures affected all financial markets.[54] In 1994, the National Monetary Council (NMC; Conselho Monetario Nacional)[55] adopted the 1988 Basel Accord (NMC Resolution 2099), permitting financial institutions to adopt the new rules including the new capital requirement ratio of 8 per cent, although opinions on the adjustment phase remain debatable (Arienti, 2007; Carvalho and Souza, 2010).[56] Prudential regulations were further expanded under the FHC government, introducing a new deposit assurance scheme (Fundo Garantidor de Créditos) along with an increase in the capital requirement ratio up to 11 per cent. Despite new rules aimed at shielding Brazilian banks from liquidity shortages, the system's fragility increased as profits began to diminish, and holding extra capital became a 'luxury that struggling institutions could not afford' (Sobreira and Paula, 2010), and, henceforth, system strength was confronted with market competition (Arienti, 2007). As a result, the 'rules of the game' introduced via the privatization programmes (PROER and PROES) and the new regulatory scheme (FGC) permitted foreign banks to increase their share in the local market.

The bank industry started on the route to a process of market concentration and denationalization, a path observed in several emerging countries at the time, particularly in Latin America and Eastern Europe. Foreign bank performance, however, did not match expectations, with their attitude towards credit lending and risk management being not dissimilar to what was observed among local private banks. Some facts are important to mention, which also differentiates this experience from others. First, and despite the arrival of new financial players from abroad, local players were also very active in the process of banking consolidation, since an important number of Brazilian private banks (including Bradesco, Itaú and Unibanco) decided to play an active role in the privatization process (Arienti, 2007). Secondly, foreign bank entry remaining bureaucratically restrained by different measures enacted by the government as well as by the BCB policy of permissions acting on a case-by-case basis (Paula and Sobreira, 2010).[57]

The banking internationalization process initiated in 1997 was suddenly discontinued after 2001, however, as foreigners become scared of the new political

54. With this stance the Brazilian government moved away from the Glass–Steagall- type organizational model introduced in the mid-1960s. Since 1988, have authorities recognized universal or multiple banks (Resolution 1524).
55. The CNM's resolution 2099 defined four risk 'buckets', with weights 0%, 20%, 50% and 100%. Brazil also adopted Basel II rules in 2004. It is important to note that, whereas financial regulation and supervision is conducted by the CMN, the BCB is in charge of monetary policy.
56. To be weighted by the risk of the bank's asset operations.
57. See previous footnote describing the role played by the BCB. In legal terms, Circular N 3317/2006 listed the information to be fulfilled by foreigners interested to enter. Six years later, Resolution N 4122/2012 and its further amendments implemented by Resolution N 4279/2012 and Resolution N 4308/2014, set down the requirements and procedures concerning the authorization for establishing and operating all types of banks (universal, commercial, investment, development and foreign exchange), and financial companies (credit, financing and investment, real estate credit, mortgage, development agencies, leasing, securities brokerage, securities distribution and foreign exchange brokerage).

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and macroeconomic situation.[58] The new scenario induced public banks to reappear but, fundamentally, allowed local private banks a new opportunity to expand (an option from which Bradesco and Itaú profited). Among the SOBs, their revival involved a triad of giants: BNDES,[59] Caixa Economica Federal and Banco do Brasil.[60] Public banks, particularly the BNDES, were called in to help rescue big companies seriously affected by the FX derivative market (Farhi and Zanchetta Borghi, 2009).[61] In sum, nationally owned banks (private and public) gained in presence in the financial system, with some firms undertaking their initial steps towards internationalization, a process particularly relevant on a regional basis.

Brazilian Capital Markets: A Brief Guide

In the mid-nineties Brazilian authorities rediscovered capital markets and their role in economic development. Thereafter, the equity market started its meteoric rise in the *grand ligues*, and BOVESPA, the Brazilian main open market (actually BF&M-Bovespa), exploded (Russo and de Oliveira, 2015).[62] The transformation also has an institutional chapter, with the Security and Exchange Commission of Brazil (Comissao de Valores Mobiliários; CVM) introducing a series of new rules protecting minority stakeholders and others norms encouraging the adoption of higher standards for corporate governance.[63]

There are two main stock markets operating at the BF&M-Bovespa: the old one, where around 370 companies are listed, and the one at the Novo Mercado, where 134

58. Whereas in 2001 local financial institutions participated with 27% of total assets, five years later their share was at the level of 53.8% (Sobreira and de Paula, 2010, p. 86).
59. BNDES would become an artifice of the new development plan introduced by Lula's administration, although its relevance would increase after the GFC as the stimulus package gave federal public banks a leading role.
60. In June 2009, among the ten largest banking groups operating in the country, three were institutions owned by the federal government (occupying positions 1, 5 and 6), four corresponded to private domestic banks (positions 2, 3, 8 and 9) and the remaining three corresponded to foreign groups (positions 4, 7 and 10) (Fernando J. Cardim de Carvalho and Francisco Eduardo Pires de Souza, 2010, 'Financial Regulation and Macroeconomic Stability in Brazil in the Aftermath of the Russian Crisis'. Mimeo, p. 22, available at Research Gate https://www.researchgate.net/publication/264878765_Financial_regulation_and_macroeconomic_stability_in_Brazil_in_the_aftermath_of_the_Russian_crisis.
61. In the end, benefits were accruing to about 200 companies, not just those affected by the bet.
62. The boom occurred in 2004–6. In that period the number of primary emissions tripled to a total of U$ 28 billion, whereas the number of operations in the secondary market reached U$ 182 billion (Hermann, 2010, p. 269).
63. A complete list of prudential measures can be found at Hermann (2010). Independently of these measures, the Brazilian legislation still classifies shares into two different types: PN and ON. In particular, although those in possession of PN shares are entitled to have a minimum dividend to be paid before ON shares, they do not have voting rights. This makes the PN market more liquid but less protected from companies' owners (holding ON shares).

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are quoted.[64] Local institutional investors (pension funds, insurance companies, mutual funds) are highly active.[65] Yet foreign investors explain between one-third (Hermann, 2010) to one-half of the operations (Larson, 2014), with most of the investors being domiciled in the United States and Europe (Park, 2012).[66]

Foreign investors are also very active in the bonds and derivatives markets. In terms of the former, there exist four different markets (local currency or US denominated) (sovereign or corporate bonds), with varying foreign relevance in each of them. Local residents, in turn, are the majority in the local currency sovereign bond market, where Brazilian leading companies are among the main issuers.

Finally, there is the market for futures and options, where trade is transacted at two main markets: the Bolsa Mercadeorías e Futuros (BMFBovespa), one of the world leaders in the field. There is also an OTC market, whose operations are required to be reported, either with BM&F or at CETIP, where the majority are registered, the latter being the most important in term of registered operations.[67]

Market contracts are basically associated to FX derivatives and local interest rate futures, offering a wide range of maturities. One of the leading products being commercialized by the BMFBovespa is the 'Cupom Cambial', a contract priced in basis points as an interest rate equal to the spread between the overnight interbank deposit rate and the exchange rate variation prior to maturity of the contract – an equivalent to the onshore US dollar interest rate (Dodd and Griffith-Jones, 2007). The presence of high interest rates raises local investors' minimum required returns, increasing volatility in equities and creating a bias towards fixed income. Certainly, a highly inflationary environment and the reliance on dollar funding has helped developed the derivative market (Stone, Walker and Yasui, 2009). Brazil's uniqueness also explains the importance of the non-deliverable forwards (NDFs) market, foreign exchange forwards that are 'cash settled' in one currency (reals if traded in Brazil or US dollars if traded offshore), but also the relevance of the future market in exchange rate determination (see below).

As observed in other regions, a few large dealers are dominating the OTC market – particularly, large multinational banks from the United States, the EU or Japan.[68]

64. Companies listed at the Novo Mercado are exposed to stricter standards of corporate governance than those determined by Brazilian corporate law.
65. However, investors' priorities are safe and liquid assets – as government bonds and repo transactions.
66. Notice that the Brazilian legislation does not discriminate between foreigners and local participants, as the former are entitled to acquire and invest in the same securities (equity, debt) as those that are available to local domestic investors (Russo and Oliveira, 2015).
67. This is a publicly held company located in Rio de Janeiro, which offers services related to registration, central securities depository (CSD), trading and settlement of assets and securities. The company is also Latin America's largest depositary of fixed income securities and Brazil's largest private asset clearinghouse (for more information, see https://www.cetip.com.br/?lang=en-us).
68. Foreigners' participation in the domestic derivative market, however, was originally restricted. When the government introduced Fixed Income Funds To Foreign Capital (FRFCE), these

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Foreigners are active participants in the onshore market (explaining around one-third of the market's volume) and the majority in offshore ones. In terms of governance, Brazil's derivative market is differentiated from other ones as being more transparent and by the fact that most of their inter-dealing trading is conducted through exchange trading (Dodd and Griffith-Jones, 2007).

The GFC and the Financial Market

New measures were introduced in the aftermath of the GFC, which particularly affected banks' reserve requirements and liquidity provisions, including those oriented to reducing ER mismatching.[69] As a result of the crisis and investors' desire for liquidity, Brazil experienced an important shortage of US dollars – ultimately affecting local currency liquidity. Part of the problem, however, resided in the (relative) high exposure to derivatives products experienced by the corporative sector.

Economic policy was oriented towards a virtual separation between the monetary policy and liquidity administration (Mesquita e Torós, 2010). On the one hand, the National Monetary Council (CMN) introduced a series of measures aimed at protecting system liquidity, including the issuance of compulsory recognitions, the (re)introduction of a special fund and an aggressive policy of rediscounts.[70] Furthermore, according to BCB reports, capital coefficients were maintained well above the minimum required (Carvalho and Souza, 2010; Tabak et al., 2010),[71] along with reducing interest rates to historical levels (Tabak et al., 2010).[72] On the other hand, authorities had to keep an eye on the monetary aggregates, keeping (always present) inflationary expectations under control.

One of the main lessons arising from the latest crisis relates to the relevance of local actors in dealing with the crisis (Sobreira and Paula, 2010), along with the institutional maturity shown by the financial system (Mesquita and Torós, 2010) and the renaissance of public banks (Sobreira and Paula, 2010; Tabak et al., 2010). SOBs' participation in credit operations had been increasing since 2003, although what became decisive in

investors were prohibited from investing in mutual funds and private bonds as well as operations with options (Prates and Farhi, 2015).

69. Some measures were undertaken by the BCB in 2007, well before the outbreak of the international financial crisis. Thereafter, Brazilian authorities introduced a battery of measures, including active participation in the U$ dollar futures market, introduced to minimize supply shortages. The swap agreement reached with the US administration (29 August 2008) became another important measure in the previous direction (Moreira and Torós, 2010).
70. Although scarcely used by banks in order to avoid be signalled as under stress (Mesquita and Torós, 2010).
71. With 18.2% SOBs showing the highest margin requirement compared to other financial institutions, including private domestic banks (15.2%) and foreign owned banks (11.7%).
72. The Brazilian banking industry historically showed important levels of non-performing loans (NPLs), which might eroding system security. However, and despite the crisis, NPLs diminished in recent years, reflecting a level of 3.4% in June 2008. In comparative terms, SOBs present a lower number of NPLs, a performance that denotes a different lending profile (Tabak et al., 2010).

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transforming private agents' mood was the role played by the public banks during the crisis ('Mutually Assured Existence', *The Economist*, 13 May 2010).[73] Regulatory changes were also important in the equity market, as the CMV passed a series of reforms directed at shielding firms from systemic risks posed on future operations. The Brazilian NMC introduced new legislation (Resolution N 4373/14) aimed at increasing foreign investors' legal status (Russo and Oliveira, 2015).

Authorities introduced a tax on financial transactions (IOF), which is levied on foreign exchange, securities or bonds, credit and insurance transactions. As foreign inflows resumed and became massive at the start of 2011, the government during the third quarter began to raise this tax to avoid BRL appreciation. To summarize, the crisis did not reverse prior [pro-liberalization] rules, and some financial risks would remain practically undealt with. The Brazilian financial sector is highly complex and most of it is profoundly integrated into world markets. This could be very beneficial, and indeed it might be, but it also leaves an ample room for regulatory arbitrage. The problem becomes more acute in the Brazilian context because coordination between regulatory agencies is far from good (Holanda Barbosa, 2014).

Financial Trilemma in Brazil

As introduced in Chapter 3 of this book, banking regulation remains key in Schoenmaker's financial trilemma: in the presence of cross-border funding, local authorities are incapable of guaranteeing financial stability. What is astonishing in the Brazilian case is that, although regulatory tools remained on the local regulators' side and regulations on banking flows were tough, local agents' international assets remained large. As previously observed, the Brazilian financial system presents a highly complex configuration, with participants in the FX market beyond local regulation.

Despite the relevance of foreign banks, local legislation in Brazil prevents cross-border arbitrage – at least, in the traditional sense. In particular, Brazilian laws prohibit deposits in foreign currency – and, thus, prevent non-residents from holding FX spot positions as observed in other countries (as in Argentina). A second and related explanation of why Brazilian banks were not severely affected by the GFC, lies in the conservative financial practices followed by the local regulator (i.e. by limiting cross-border flows) and reinforced by some foreign banks which opted for funding locally (see Chapter 3).

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73. The expansion after the crisis benefited, in particular, three state-owned banks: Banco do Brasil (a listed commercial lender with a bias towards agriculture), Caixa Econômica Federal (a mortgage specialist) and the BNDES. The latest figures give these three banks a share of 42% of the assets in the Brazilian financial system. As observed in China, state-owned banks' expansion abroad remains incipient, basically 'near abroad' (Fernando Ferrari Filho, 'Brazil's response: How Did Financial regulation and Monetary Policy Influence Recovery?' *Brazilian Journal of Political Economy*, 31, no. 5 (Special edition 2011): 880–88; 'Mutually Assured Existence', *The Economist*, 13 May 2010; Rogerio Sobreira and Luiz Fernando de Paula, 'The 2008 Financial Crisis and Banking Behavior in Brazil: The Role of the Prudential Regulation', *Journal of Innovation Economics* 2, no. 6 (2010): 77–93.

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The crisis, after all, hardly affected non-financial firms, particularly big-and-internationalized Brazilian ones – which were highly active in the FX derivative market, relying on highly complex financial instruments (Dodd, 2009).[74] But this practice came to alter the waters in the financial realm. Instead if relying on hedging to manage ER risk, they used (derivatives) for speculative purposes – betting against local currency appreciation (Dodd, 2009; Kregel, 2011). Once the crisis arrived and the real appreciation trend reversed, financial bets left local companies almost in bankruptcy, forcing them to enter into a vast restructuring process (Zeidan and Rodrigues, 2013).[75] Thus, and despite the practices being adopted in the realm of financial regulation, 'the operation of derivatives markets and in particular offshore derivatives market have created instability, in both the financing of firms, but also in the financial institutions themselves and in the exchange rate' (Kregel, 2011, p. 857).

As previously noted, arbitrage is intense in the derivative market as FX futures have become a leading reference to the Brazilian market. According to Rossi (2014), important loopholes in the regulatory front were key in explaining this: in contrast to *spot markets*, where only specialized institutions could participate and that are closely scrutinized by the regulatory agency, operations in the Brazilian *futures markets* remain less restrictive, whereas participant entities are weakly regulated. This regulatory bias, however, is ineffective in preventing markets from interconnecting or preventing FX's arbitrage. As previously noted, the presence of important restrictions on FX conversion forces arbitrage to be indirect (an NDF onshore market, and a derivable offshore market). By regulating the onshore market, the government is reducing arbitrage possibilities and market liquidity with it – but also transferring liquidity to the spot market (Rossi, 2014).

Foreign banks were central in the development of the futures market, and certainly they were key actors for their international connections (Prates and Farhi, 2015; Gallagher, 2015[76]). Banks are the only financial entities which benefited from the NMC to operate in the inter-banking market and, thus, to intermediate between Brazilian residents and non-residents.[77] Non-residents, in contrast, had had unrestricted access to the foreign exchange futures market since January 2000. Consequently, and from a legal perspective, they would enjoy similar rights to their Brazilian counterparts. Unfortunately, similar legal treatment would not be available for Brazilians abroad, as the Sadia/Aracruz case came to demonstrate (Gorga, 2015). In particular, both companies were confronting private

74. Among others the so-call Sell Target Forward (STF) contract.
75. Sadia S.A. and Aracruz Celulose were among the most-affected local companies, suffering billion dollar losses and leaving them almost bankrupt (as they were heavily participating in the futures market).
76. Ten banks controlled almost 80% of the FX derivatives market, but half of the market is controlled by just four: Deutsche Bank, Citigroup, Barclays and UBS (Gallagher, 2015, p. 77). Not only did banks intervene as dealers but also some of them were involved on their own account: Santander (with 60 firms as clients), Unibanco (33 firms), and Itaú (96 firms) (Kregel, 2011, p. 856).
77. As previously observed, local legislation prevents FX bank deposits. Therefore, in order to have access to short-term external credit lines in the international interbank market and to hold FX

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litigation in the United States and Brazil, yet only American investors were able to obtain financial recoveries.[78] Moreover, as noted by Gorga (2015), the legal implications of the approach adopted after *Morrison v. National Australia Bank Ltd.* would have far-reaching consequences, eventually affecting the settlement of class actions in other jurisdictions or limiting foreign firms' benefits for participating in the American Deposit Receipt (ADR) market. The same author highlights, 'the fact that investors holding securities from the same companies suffered similar damages but were subject to such distinct legal remedies raises efficiency and fairness concerns for international securities markets' (Gorga 2015, p. 137).

Although prudential measures had been observed in the market since 1994 (Dodd and Griffith-Jones, 2007; Prates and Farhi, 2015), the crisis increased the demand for market transparency (Farhi and Zanchetta Borghi, 2009).[79] The government introduced a series of measures to tackle the transparency issue, including the issuance of new accounting rules.[80] Furthermore, and in order to gain in transparency, monetary authorities made mandatory the registration of financial derivatives linked to foreign loans. Private banks had also moved to increase market transparency, establishing the Centre for Exposure in Derivatives (CED) (Prates, 2014).[81] Whereas in the past, Brazilian OTC markets operated with no collateral requirement or standards (Dodd and Griffith-Jones, 2007), a transaction clearing and settlement scheme has been recently introduced which, under specific circumstances, acts as a central counterpart.[82]

In sum, the derivatives market risks opening the door to evading regulation, a challenge that neither CARs nor MPRs were originally designed to tackle. In the case of Brazil, and given the NDF characteristic of OTC contracts, non-financial agents and banks could circumvent the prudential objectives – which, for example, arise in the event

positions (in US$ dollars), banks need special authorization: an authorized dealer status. Only 17 banks are in this category, most of them MNC entities (Prates and Farhi, 2015).

78. Federal securities class actions were filed in New York (against Sadia S.A.) and Miami (against Aracruz Celulose S.A.). In brief, the US courts settled a large suit against Sadia ($ 27,000,000) and an even larger one against Aracruz ($ 37,500,000), sums accruing to US investors. Brazilian investors, in contrast, not only were not compensated but also (indirectly) bore the financial costs imposed by US courts. The US Supreme Court's decision in Morrison v. National Australia Bank Ltd. (2010) would alter the transnational securities litigation scenario by expanding the scope of the American legislation abroad (protecting local investors) yet limiting the issuance of claims in US territory (affecting foreign investors).
79. As, for example, CMN Resolution n 2042, enforcing actors to register their (swap) operations either at BM&F or at the CETIP.
80. In order to advance in data dissemination, the CVM promulgated Statement 475/08 and Resolution 566/08. The commission also intervened in the design of new accounting rules.
81. The CED lists the positions of companies that are registered with CETIP or BM&FBOvESPA, and that have voluntarily adhered to the system. It is worth noting that only the regulators have access to the data in the system, and that although participation is voluntary, the CED records cover 90% of the registered contracts in Brazil (http://www.bmfbovespa.com.br/en-us/bmfbovespa/download/BEST-BRAZIL.pdf).
82. Regardless of whether a settlement takes place in a guaranteed or in a non-guaranteed environment, the settlement model used in Brazil ensures the use of the strictest principles of

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of an increase in the IOF tax. If contracts are disrupted, the highly interconnected character of this market calls for inter-jurisdictional cooperation to avoid unequal transfers between investors.[83] Inter-jurisdictional problems cannot be left to the market nor left in the hands of local authorities but rather call for cooperation. Those entering into a similar contract (securities–FX derivatives) should face the same (company-specific) risks 'instead of pure legal risk, diminishing the ability of companies to engage in legal arbitrage at the expense of a specific group of security holders' (Gorga, 2015, p. 179).

Brazil: No Longer an Institutional Outsider?

In spite of the magnitude of FDI inflows and a clearer definition of what Brazilian authorities expected from foreign investors in terms of its impact on national development, Brazil stands out for its active resistance to various aspects of post–Second World War foreign investment protection and liberalization initiatives. First, it never ratified the Washington Convention of 1965 (the ICSID Convention), which established the basis for an international framework for the resolution of investment disputes by way of international arbitration between individual foreign investors and host country governments. Secondly, Brazilian national FDI legislation maintained several important exceptions to national treatment of foreign investment and legal provisions for compensation in the event that expropriation did not wholly meet the commonly accepted international practice of 'prompt, adequate and effective' compensation. Thirdly, Brazil negotiated 14 BITs during the pro-FDI period following the fall of the Berlin Wall in the 1990s,[84] although it never ratified them, mainly because of the risks associated with the IA-ISDS clauses.[85] Fourthly, Brazil negotiated the two fundamental foreign investment agreements of the Southern Market (Mercosur) integration scheme, one covering investments by Mercosur members (Colonia Protocol) and the other those of non-members (Buenos Aires Protocol), but never ratified either of them. Finally, Brazil actively opposed several

delivery versus payment (DvP). This scheme is essential to eliminate the principal risk, thus avoiding the possibility that any of the parties involved in the transaction might be at risk of not having fulfilled their obligations, being deprived of the acquired right as a result of the counterparty having failed to meet its own obligations (http://www.bmfbovespa.com.br/en-us/bmfbovespa/download/BEST-BRAZIL.pdf).

83. This might be particularly acute when more than one type of investor (local and foreigners) participates in the market, and they are subject to different legal responses. In particular, this problem arises when two reasons are present: On the one hand, one of the jurisdictions may be biased in protecting buyers (investors), whereas the other tends to favour those issuing the contract (firms). On the other hand, whereas theoretically all investors independently of their type can present claims, only local investors can initiate class actions.
84. With industrialized countries, such as Belgium/Luxembourg, Denmark, France, Finland, Germany, Italy, the Netherlands, Portugal, Switzerland and the United Kingdom, and others, like Chile, Cuba, Republic of Korea and Venezuela.
85. For the members of Congress, it was inappropriate to grant foreign investors the right to settle investor–state disputes via international arbitration while this was not available to national investors.

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aspects of the US RTA-like Free Trade Area of the Americas before its suspension in 2004 because it considered the initiative to be asymmetrical and to contain undesirable constraints on Latin American and Caribbean countries, including the proposed IA-ISDS procedures. In particular, its refusal to participate in the ALCA initiative can be explained by the stringent conditions introduced by the United States on the financial front, banning any sort of control on capital flows (Pudwell, 2003).[86] As a result of these actions, Brazil is not involved in any known ISDS investment disputes and carries virtually no IIA risks.

In sum, Brazil is a country that has demonstrated a welcoming approach to FDI and has accumulated a significant stock of inward FDI, thereby increasing its integration into the global economy. At the same time, Brazil has used its increasing negotiating strength, which derives in part from its attractiveness to TNCs (its large market and growing economy), to implement cautious policies that carefully limit or reduce to a minimum its IA-ISDS risks with respect to IIAs.

Rejection, however, could remain with the past autonomy (of being outside the BITs framework. Whereas the Argentinean traumatic experience with foreign investors (in the aftermath of the 2001 crisis) reaffirmed the Itamaraty's old stance, the expropriation of Petrobras/Bolivia in 2006 signalled a turning point for authorities at the Foreign Affairs Ministry to reconsider the investment treaty policy (Perrone and Cerqueira César, 2015). Interest rose as Brazil continued to gain relevance as a(n emerging) capital exporter, and as it increased its political credentials among developing countries and emerging economies.

In line with this new role, the Brazilian Foreign Office has recently begun to sign a series of investment agreements with Angola, Mozambique and Malawi – and maintained negotiations with others: Algeria, Morocco, South Africa and Tunisia. In contrast to traditional BITs, Brazil 'novo modelo de acordo de investimento' (new template/model of investment agreement) signed with African countries presents a peculiarity (IISD, 2015): a joint committee, where officials from the involved countries would be authorized to debate, monitor and expand the original contract.[87] An executive office would control directive/joint committee initiatives, including a leading role in dispute settlement. If disputes between parties cannot be resolved amicably, then an international judiciary instance is open: state-to-state schemes, which prevent private actors from directly suing sovereign states. The inclusion of a social responsibility chapter also differentiates these new agreements from traditional ones, as it tries to differentiate EMEs' TNC practices (mainly, those of older Chinese SOEs operating in Africa) from the common malpractices of MNCs – particularly Chinese involvement in Africa (Ana Garcia, 2015).[88] In sum, the

86. The signature of the FTA agreement with Chile could have worked as guidance, as Chile was forced to accept free movement of capital and rescind its former policy on the matter, which was included in all BITs signed by the country.

87. 'Side-by-side comparison of the Brazil-Mozambique and Brazil-Angola Cooperation and Investment Facilitation Agreements' (IISD, June 2015).

88. 'O Novo Acordo de Cooperação e Facilitacao do Investimento entre Brasil e Moçambique: algumas considerações' Departamento de Relação Internacionais da PUC Minas/grupo potencias medias'.

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Brazilian approach remains quite different from the widely expanded neo-liberal template associated with property rights respect but focused instead on 'consolidating economic relations with its partners and establishing political mechanisms to promote FDI' (Perrone and Cerqueira César, 2015, p. 2.

The Itamaraty historical approach, however, might soon be abandoned if the new government maintains its bet on political redemption. Following a putsch, and in order to maintain himself in office, Michel Temer is dismissing Brazil's strategic attitude towards foreign investors. As those at power remain focused on buying time and avoiding impeachment, so they are willing to offer important concessions to investors interested in going ahead with agricultural projects in the Amazon[89] – including foreigners.[90] Similarly, authorities are now backing oil investments in the Amazon Reef, the environmental consequences of which remain highly contested.[91] Finally, the government is proposing to eliminate all former restrictions on land acquisition by foreigners – in fact, a very attractive notice for foreign investors, particularly the Chinese.[92] Although most of the measures will bring real capital to the depressed economy, all of this financial capital flows could put the country's short-term development in jeopardy. If finally all these changes are undertaken, the Brazilian economic structure will be shaken and the government's decisional power will be resented.

89. As, for example, ruralists. With a large number of representatives in the Congress Deputy Chamber (230 seats out of 513), this group advocates for less lenient laws for agricultural works in the Amazon (see 'Temer Pushes Amazon Deforestation Bill in Brazil', *FT*, 18 July 2017).
90. This new legislation might find opposition from another group of foreign investors: Norway (see 'Norway Issues $1bn Threat to Brazil over Rising Amazon Destruction', *The Guardian*, 22 June, 2017).
91. 'RPT-Total's Plans for Brazil´s New Oil Frontier Snagged on Amazon Reef', *Market News*, 12 May 2017.
92. 'Brazil to Lift Limits on Foreigners' Owning of Land', *Business News*, 25 May 2017.

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