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## Brazilian Response to International Financial Crisis, the Pre-SALT Discoveries by Petrobras and the New Free Trade Areas in the Cities of Brazil

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# BRAZILIAN RESPONSE TO INTERNATIONAL FINANCIAL CRISIS, THE PRE-SALT DISCOVERIES BY PETROBRAS AND THE NEW FREE TRADE AREAS IN THE CITIES OF BRAZIL

*Marcos Valadão\* and Nara Galeb Porto\*\**

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### I. RESPONSE TO INTERNATIONAL FINANCIAL CRISIS

#### A. ECONOMIES AND ECONOMIC CRISIS

**B**Y July 2008 an unbelievable financial crisis started to provoke a debacle in the US economy. The crisis that initiated in the mortgage and housing loans sector, and would subsequently damage almost all sectors of the U.S. economy, is rooted basically in factors such as lack of market regulation, unsafe credit practices, bad risk evaluation policies, and other unsound financial practices.<sup>1</sup> The United States is the

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1. The G-20 Declaration, issued in Nov. 15, 2008, 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 coun-

world's biggest economy, and as a result the crisis spread abroad, affecting all economies, rich, poor, and emerging countries. The way the crisis spread abroad as an economic tsunami was irregular. Some countries did suffer a lot, others lesser. Brazil is in the second group.

In general, rich countries (mostly United States and European countries) seemed to suffer the biggest impact of the crisis. Subsequently they started to adopt measures to remedy the financial crisis, such as helping banks with cash-flow problems, and buying junk portfolios from banks with financial problems, in order to provide liquidity to capital markets.

Financial crisis leads to economic crisis, impacting the purchase power of the market (aggregate demand) due to lack of credit. Financial crisis thus will lead to unemployment, investment decrease, and growth stagnation. Countries which depend on exports to developed or emerging countries will face problems because these countries will have a decrease in consumption, impairing their internal market and imports.<sup>2</sup> The crisis now is global, thus it demands global solutions.

By July 2008, Brazil was prospering in terms of economic growth, running sound public economic policies, with strong macro economical fundamentals, and enjoying strong international confidence.<sup>3</sup> Nevertheless, the eruption of the financial crisis would also affect Brazilian economy. But, the Brazilian economy and financial market, due to strong economic features is deemed to be less affected than other economies.<sup>4</sup> It is worth mentioning some aspects: huge international reserves (roughly US\$200 billion in Dec. 2008, which remains stable since then), investment rate growth rate is higher than aggregate demand growth, bank sector with better Basle index than the Basle recommendation,<sup>5</sup> and public debt

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tries, 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).

2. 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 [http://www.cepal.org/noticias/noticias/1/34991/2009-16-The\\_reaction\\_of\\_LAC\\_governments\\_WEB.pdf](http://www.cepal.org/noticias/noticias/1/34991/2009-16-The_reaction_of_LAC_governments_WEB.pdf) (last visited Feb. 08, 2009), [hereinafter ECLAC].
3. See *Special Report: Brazil*, FINANCIAL TIMES (London), July 8, 2008, at 1-2.
4. See Mauricio Cardenas, *Global Financial Crisis: Is Brazil a Bystander?*, THE BROOKINGS INST., Oct. 15, 2008, available at [http://www.brookings.edu/opinions/2008/1015\\_financial\\_crisis\\_cardenas.aspx](http://www.brookings.edu/opinions/2008/1015_financial_crisis_cardenas.aspx) (last visited Feb. 20, 2009).
5. The Basle index indicates bank assets risk exposure. Average Brazilian bank sector Basle index is 6.5 % while Basle recommendation is eight percent. See Ministro Guido Mantega, *Atravessando a Crise Mundial Conselho Politico* [Minister Guido Mantega, Presentation Before the Political Council of the Republic: A Way

under control (thirty-two percent of GDP in 2008). But this does not mean that Brazilian economy is not suffering the consequences of the crisis. Indeed, the rate of economic growth decreased in the last three months of 2008, and other symptoms are present that the economy is slowing down.<sup>6</sup> Situation may get worse if specific measures are not taken to fight the crisis.

## B. SOLUTIONS TO FACE THE CRISIS

The Brazilian government has adopted a set of measures to attack the crisis. It encompasses the measures aiming the credit market itself, i.e., the bank system, tax breaks to let more resources in family's hands, tax breaks to ease investments, export support measures, and promotion of domestic market. In a recent report by the Economic Commission for Latin America and the Caribbean (ECLAC–United Nations),<sup>7</sup> Brazilian measures were divided 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 that are detailed below.

### 1. *Monetary and Financial Policy*<sup>8</sup>

#### a. “Reduction in effective legal reserve”

Rediscount operations streamlined (September 2008). Authorization to acquire portfolios of small and medium-sized banks, and to extend loans in foreign currency (September 2008).

Broader powers for the central bank to intervene in failing financial institutions. Banco do Brasil and the Federal Economic Fund authorized to buy struggling financial institutions, as well as insurance and social security enterprises.

Announcement of the creation of an investment bank within the Federal Economic Fund to buy the stock of real estate firms, as well as other sectors (this bank will have start-up resources of between US\$880 million and US\$1.09 billion). This replaces the process used by these firms until recently to raise capital, through share issues.

Central bank authorized to grant loans to banks secured by loan portfolios.

The central bank has offered loans to companies to facilitate refinancing of their external debts (allocating up to US\$20 billion of the country's reserves). This measure is expected to benefit around 4,000 enterprises. On January 21, 2009, the central bank cut its basic rate by 100 basis points (from 13.75% to 12.75%).”<sup>9</sup>

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Through the Global Crisis] (Feb. 18, 2009), available at <http://www.fazenda.gov.br/portugues/documentos/2009/p180209-conselho-politico.pdf> (text in Portuguese) (last visited Feb. 20, 2009) [hereinafter Guido Mantega].

6. *See id.*

7. ECLAC, *supra* note 2.

8. ECLAC, *supra* note 2, at 10, 12.

9. ECLAC, *supra* note 2, at 12.

Most of these measures were authorized by Provisory Measure n. 443/2008.<sup>10</sup> It enabled Banco do Brasil, and Caixa Economica Federal to buy financial institutions.<sup>11</sup> Provisory Measure n. 443/2008 also authorized the Government to establish a Federal Economic Fund, which is a federal institution (CAIXA-Banco de Investimentos S.A), to buy the stock of real estate firms.

## 2. *Exchange-Rate and Foreign-Trade Policy*

Use of forex reserves to finance exports, by reverse auction of bank securities to backstop foreign trade. The contracts tie in the repurchase of these instruments, thus maintaining the current level of reserves. . . Central bank allowed to grant foreign-currency loans directly to private banks, exclusively to finance foreign trade transactions.<sup>12</sup>

Brazilian export sector, specially the agro industrial sector, was facing financial problems due to financial leveraging through derivative instruments attached to U.S. dollar and Brazilian currency (real) exchange rate (the exchange rate in July 2008 was roughly 1/1.6, and turned to 1/2.3 in Dec. 2008).

## 3. *Sectoral Policies*<sup>13</sup>

### OIL

Expansion of borrowing capacity of PETROBRAS and the National Bank for Economic and Social Development (BNDES) (US\$5.3 billion) to keep up planned investment levels.

### AGRICULTURE

US\$6.5 billion in support for the agricultural sector:

US\$2.2 billion in advances of resources from Banco do Brasil.

US\$2.4 billion increase in resources that banks earmark the agricultural sector.

Increase in rate for compulsory rural savings deposits from sixty-five percent to seventy percent, which represents US\$1.1 billion.

Use of Forex reserves to finance the rural sector through the intermediary of trading companies.

Use of US\$200 million in resources from constitutional funds.

US\$400 million in assistance for agricultural cooperatives.

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10. Medida Provisória No. 443, de 21 de outubro de 2008, D.O. de 22.10.2008 [Provisional Measure, No. 443, of 21 October 2008] (Brazil).

11. Banco do Brasil bought a fifty percent stake in Banco Votorantim (institution specialized in car loans and credit to businesses).

12. ECLAC, *supra* note 2, at 11.

13. ECLAC, *supra* note 2, at 11.

Allocation of US\$150 million to family agriculture using resources from the Workers' Protection Fund (FAT)<sup>14</sup>.

#### 4. *Labour and Social Policies*<sup>15</sup>

A twelve percent increase in the minimum wage is planned (including the police and armed forces) and wages in the health and education sectors will rise by fourteen percent. . . Maintenance of expenditure levels in the Bolsa Familia programme,<sup>16</sup> adjustment of the minimum wage (estimated at over twelve percent in 2009) and works included under the Growth Acceleration Programme (PAC).<sup>17</sup>

#### 5. *Fiscal Policy*<sup>18</sup>

Reduction in primary surplus target for 2009, from forty-three percent to 3.8% of GDP, as a way of freeing up resources and increasing overall expenditure. The government is currently considering the possibility of reducing it further, to 3.3%. . . Public investment capacity may be increased by US\$8.8 billion in 2009.

- (i) injection of over US\$43.8 billion to keep up consumption levels;
- (ii) ministries will be required to bring forward spending and ensure a parallel budget of at least US\$11.4 billion;
- (iii) the sectors worst hit by the crisis may be granted fresh tax cuts and more resources;
- (iv) US\$9.2 billion earmarked for the Growth Acceleration Programme (PAC) in the 2009 budget;
- (v) the government will spend the US\$6.3 billion reserved for the Sovereign Fund on projects to maintain overall demand;
- (vi) federal State enterprises to release at least US\$17.5 billion in investment to help Brazilian firms that provide them with inputs and raw materials;
- (vii) the government to launch an advertising campaign to stimulate consumption.

The federal government and some states have extended the time allowed for monthly tax payments, thus easing pressure on corporate cash flows.

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14. The Workers' Protection Fund (FAT) is public fund supplied by taxes (social contributions) which main function is to pay unemployed workers benefits.

15. ECLAC, *supra* note 2, at 11.

16. ECLAC, *supra* note 2. On the Bolsa Familia Programme *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).

17. ECLACK, *supra* note 2. On the Growth Acceleration Programme (PAC) *see* Marcos Valadão & 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), <http://www.fazenda.gov.br/portugues/releases/2007/r220107-PAC-integra.pdf> (last visited Feb. 14, 2009).

18. ECLAC, *supra* note 2, at 10-12.

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 revised, creating lower rates (7.55% and 22.5%), which favour the middle class, that is, those who earn up to US\$875 per month.

An increase of US\$4.2 billion was agreed in the area of government investment, adding to the US\$16.6 billion already planned.

As an additional source of receipts (around US\$1.1 billion), it was agreed that the assets of the Federal Railway Company, which were due to be auctioned in 2008, will be sold. The creation of a sovereign fund was agreed, with an initial amount of 0.5% of GDP (around US\$5 billion). The government intends to use these funds to provide the country with savings to compensate for any future economic fluctuations and finance the internationalization of Brazilian companies. This will be financed through the issue of Treasury bonds. It was announced that US\$2.5 billion was being released for infrastructure investments. This was funded by the Unemployment Insurance Fund (FGTS).<sup>19</sup>

Brazilian Ministry of Finance, in a presentation<sup>20</sup> delivered on February 18, 2009, explained why the financial crisis did not hit the Brazilian economy as it used to happen in the last decades and detailed the measures adopted by the Brazilian government to deal with it. The Minister also affirmed that some of the expected good impacts from the adopted measures had been confirmed by the recent numbers, such as the growth of consumer confidence, probable increase in industrial production in Jan/2009 in regard to the last months, effective response of the vehicle

19. 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\$ 15,636.54	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. 1, 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).

20. See Guido Mantega, *supra* note 5 (GDP calculations are sourced in IMF data).

manufactures sector (which is very important in Brazil), stability of the exchange rate, and Bovespa index (stock exchange index) increase. The Brazilian economy (GDP) is expected to grow from 1.5% (pessimist forecast) to four percent (optimists), while, in general, developed economies are expected to face stagnation or even negative economic growth.<sup>21</sup>

## II. OTHER ISSUES

### A. THE PRE-SALT DISCOVERIES BY PETROBRAS

In the last few years Brazil had a very strong momentum with the pre-salt discoveries by Brazil's state-run oil giant, *Petróleo Brasileiro S/A-PETROBRAS*.

Petrobras, Brazil's largest company, was created with the intention to bring oil self-sufficiency to Brazil. In 1953, after Law 2,004<sup>22</sup> was passed in Brazil, Petrobras was allowed to be incorporated to undertake oil sector activities in Brazil on behalf of the Union. The oil exploration and production operations, as well as the remaining activities connected to the oil, natural gas, and derivative sector, except for wholesale distribution and retail via service stations, were a monopoly Petrobras held from 1954 to 1997. In 1997, Brazil, via Petrobras, entered the select group of sixteen countries that produced more than a million barrels of oil per day. That same year, on August 6, President Fernando Henrique Cardoso sanctioned Law 9,478,<sup>23</sup> which opened the oil industry's activities in Brazil to the private initiative. In 2003, Petrobras doubled its daily oil and natural gas production, surpassing the 2,000,000 barrel per day mark, in Brazil and abroad. In 2007, Petrobras was rated the world's seventh biggest oil company with shares traded at stock exchanges, according to *Petroleum Intelligence Weekly (PIW)*, a publication that divulges the ranking of the world's fifty biggest and most important oil companies.<sup>24</sup>

Since its creation, Petrobras' main objective has been to discover where the oil is in Brazil and the recent pre-salt discoveries in the last few years are a validation of this dedication. For instance, its Tupi field in the Santos Basin appears to contain between five billion and eight billion barrels of oil, making it the biggest discovery in the Americas during the past three decades.<sup>25</sup>

The Tupi deposit and nearby offshore prospects probably will cost \$240 billion to exploit (Tupi alone could cost one hundred billion dollars). The prospects may hold six trillion dollars of petroleum and make Brazil one

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21. *Id.* at slide n. 6.

22. Lei No. 2.004, de 3 de outubro de 1953 (Braz.) [Law 2,004 of Oct. 3, 1954], available at <http://www.jusbrasil.com.br/legislacao/43342/lei-2004-53>.

23. Lei No. 9.478, de 6 de agosto de 1997 (Braz.) [Law 9,478 of Aug. 6, 1997], available at <http://www.jusbrasil.com.br/legislacao/45938/lei-n-9478-de-6-de-agosto-de-1997>.

24. See Petrobras' website, <http://www.petrobras.com.br>.

25. Ultra-deep water Guara and Carioca are also other important discoveries in Brazil.



of the world's ten largest oil producers.<sup>26</sup>

While some oil companies have cut back on spending, Petrobras unveiled plans to increase investment in refineries, exploration and other businesses by about fifty percent to \$174 billion over five years. Brazil's government has pressed Petrobras to increase spending ahead of elections in 2010 and as a tonic against the economic crisis.

Petrobras intends to build two refineries in the northeastern Brazil that, together with refineries planned or under construction, would make the company the world's third-largest oil refiner. The reason for these refineries is that Brazil wants to be an exporter of refined petroleum products such as gasoline and diesel instead of raw crude oil to generate more profit from offshore discoveries.

It is important to point out that in Brazil neither environmentalists nor Brazilian politicians have raised concerns about exploiting oil in the waters off the Brazilian coast.

#### B. NEW FREE TRADE AREAS IN THE CITIES OF BRAZIL

In October of 2008, Brazil established two new free trade areas in the north of Brazil through Decree No. 6,614/2008<sup>27</sup> that regulates Law No. 8,256/1991.<sup>28</sup> These new areas are located in the cities of Boa Vista and Bonfim in the State of Roraima.<sup>29</sup>

These free trade areas are established with the purpose of promoting the development of the northernmost frontier regions of the State of Roraima and with the objective of incrementing bilateral relations with neighboring countries, in accordance with the Latin American integration policy.

The products industrialized in the Boa Vista and Bonfim areas and sold in these areas or anywhere in Brazil are exempted from the tax on industrialized products (IPI). However, such a tax exemption is applicable only to those final products primarily composed of locally raw material originating from animal, vegetal, mineral, except the ores under Chapter 26 of the Mercosur Common Nomenclature (NMC), or agrosilvopastoral,

26. Because the discoveries by Petrobras lie beneath miles of water and hardened salt off Brazil's coast and because of the size of the finds, Brazil's government has suspended auctions of exploration rights in those areas. The auctions were put on hold until the government establishes the legal framework for administering concessions in the pre-salt layer fields.

27. Decreto No. 6.614. de 23 de outubro de 2008 (Brazil) [Decree No. 6.614 of Oct. 23, 2008]. *available at* [http://www.planalto.gov.br/Ccivil\\_03/\\_Ato2007-2010/2008/Decreto/D6614.htm](http://www.planalto.gov.br/Ccivil_03/_Ato2007-2010/2008/Decreto/D6614.htm).

28. Lei No. 8.256, de 25 de novembro de 1991 (Brazil) [Law No. 8.256 of Nov. 25, 1991]. *available at* [http://www.planalto.gov.br/Ccivil\\_03/LEIS/1989\\_1994/L8256.htm](http://www.planalto.gov.br/Ccivil_03/LEIS/1989_1994/L8256.htm).

29. Today Brazil has seven free trade areas that are managed by Manaus free-trade zone superintendence ("SUFRAMA"): Brasília/Epitaciolândia and Cruzeiro do Sul (AC), Tabatinga (AM), Macapá/Santana (AP), Guarajá-Mirim (RO) and Boa Vista e Bonfim (RR).

and according with the applicable environmental legislation. This tax exemption does not apply to weapons, ammunitions and tobacco.

In addition, this tax benefit applies only to those products manufactured by industrial premises whose technical-economic projects have been approved by the Board of Directors of the Manaus Free Trade Zone Superintendence.

