HARVARD LAW SCHOOL AND FUNDAÇÃO GETULIO VARGAS
Present

THE 2013 SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY: AN AGENDA FOR BRAZIL AND THE UNITED STATES

THE RENAISSANCE • SAO PAULO, BRAZIL • DECEMBER 5-7, 2013

AGENDA

THURSDAY, DECEMBER 5

6:30 p.m. **COCKTAIL RECEPTION** Pantanal-Abrolhos

7:15 p.m. **GREETING AND OPENING ADDRESS (VIA VIDEO)** Pantanal-Abrolhos

- Hal S. Scott, Nomura Professor on International Financial Systems and Director, PIFS, Harvard Law School
  Introduction by: Laura Alfaro, Warren Alpert Professor of Business Administration, Harvard Business School

7:45 p.m. **KEYNOTE ADDRESS** Pantanal-Abrolhos

- Julio Cesar Maciel Ramundo, Managing Director, BNDES
  Introduction by: Oscar Vilhena, Dean, DIREITO GV

8:15 p.m. - 9:30 p.m. **DINNER** Pantanal-Abrolhos

FRIDAY, DECEMBER 6

8:45-9:30 a.m. **MORNING KEYNOTE ADDRESS** Yukon Room

- H.E. Henrique Meirelles, Chairman, Lazard Americas, Chairman, J&F Investimentos, and Chairman, Olympic Public Committee
  Introduction and greetings by: Rodrigo Vianna, Dean, FGV DIREITO RIO

9:30-9:50 a.m. **PANEL SESSION** Yukon Room

Implementation of regulatory reform and reduction of regulatory complexity in Brazil and the U.S

- Marcos Lisboa, Director-Vice President, Insper Instituto de Ensino e Pesquisa
- David Gruppo, Managing Director, Head of Latin America Corporate and Investment Banking, The Bank of Tokyo-Mitsubishi UFJ, Ltd.

9:55-11:05 a.m. **SMALL GROUP BREAKOUT SESSIONS**

Group	Room	Facilitator	Reporter
1	Pantanal	David Bunce	Bill Grimes
2	Abrolhos	Steven Bipes	Patricia Sampaio
3	Juréia	Gordon Kingsley	Melina de Souza Rocha Lukic
4	Iguaçu	Ary Oswaldo Mattos Filho	Rich Mattione

11:05-11:20 a.m. **REFRESHMENT BREAK** Yukon Room

11:20-11:45 a.m. **PANEL SESSION** Yukon Room

Monetary policy in Brazil and the U.S. its impact on inflation

- Ilan Goldfajn, Chief Economist, Itaú Unibanco
- Laura Alfaro, Warren Alpert Professor of Business Administration, Harvard Business School

11:50-1:00 p.m. **SMALL GROUP SESSIONS BREAKOUT SESSIONS**

Group	Room	Facilitator	Reporter
1	Pantanal	Dave Shuler	Bill Grimes
2	Abrolhos	Jose Augusto Martins	Patricia Sampaio
3	Juréia	Laura Alfaro	Melina de Souza Rocha Lukic
4	Iguaçu	Alberto Kiraly	Rich Mattione

1:00-1:40p.m. **BUFFET LUNCH** Havana Club

1:45-2:45 p.m. **KEYNOTE ADDRESSES** Yukon Room

- Luiz Pereira da Silva, Deputy Governor for International Affairs and Corporate Risks, Banco Central do Brasil
- William Murden, Counselor to the Assistant Secretary of the Treasury, International Financial Stability and Regulatory Policy, U.S. Department of the Treasury

2:45-4:00 p.m. **PLENARY SESSION** Yukon Room

Tax reform in Brazil and the U.S., and for cross-border transactions

- Chair: Francisco Antunes Müssnich, Senior Partner, Barbosa, Müssnich & Aragão
- Devon Bodoh, Principal in Charge, Latin America Markets, Tax, KPMG
- Ary Oswaldo Mattos Filho, Senior Professor, Fundação Getulio Vargas, School of Law
- Carlos Eduardo Toro, Partner, KPMG LLP

4:00-4:15 p.m. **REFRESHMENT BREAK** Yukon Room

4:15-5:00 p.m. **KEYNOTE ADDRESS** Yukon Room

- Otavio Yazbek, Commissioner, Comissão de Valores Mobiliários (CVM)

5:00-6:00 p.m. **COCKTAIL NETWORKING RECEPTION** Andes/Pampas Room

6:00-8:00 p.m. **REPORTERS MEETING** Juréia

SATURDAY, DECEMBER 7

8:30-9:30 a.m. **P R E S E N T A T I O N & D I S C U S S I O N** Yukon Room

The Financing of Infrastructure Improvements in Brazil and the U.S

- William Lindquist, Financial Attaché for South America, U.S. Treasury
- Alberto Zoffmann, Project Finance, Itaú BBA
- Leonardo Lima Chagas, Secretário Adjunto, Secretaria de Acompanhamento Econômico – SEAE, Ministério da Fazenda

9:30-10:30 a.m. **P R E S E N T A T I O N & D I S C U S S I O N** Yukon Room

Implementation of regulatory reform and reduction of regulatory complexity in Brazil and the U.S

- Roberto Belchior, Chief Legal Officer, BM&F Bovespa
- Carlos Emmanuel Ragazzo, General-Superintendent of Conselho Administrativo de Defesa Econômica (CADE) - Professor of FGV- Direito Rio

10:30-10:45 a.m. **R E F R E S H M E N T B R E A K**

10:45-11:45 a.m. **P R E S E N T A T I O N & D I S C U S S I O N** Yukon Room

Monetary policy in Brazil and the U.S. its impact on inflation

- Marcelo Kfoury, Chief Economist, Citigroup, Brazil
- Rich Mattione, Retired Partner, GMO

Symposium on Building the Financial System of the Twenty-First Century: An Agenda for Brazil and the United States

The second Brazil-U.S. Symposium was held in São Paulo, Brazil from December 5-7, 2013. Sessions addressed post-crisis regulatory reforms, impacts of changing monetary policies, prospects for tax reform in Brazil and the U.S., and infrastructure finance in Brazil and the U.S. Participants were generally optimistic that the two countries were not facing financial instability and judged that growth was returning in the developed countries. Still, they expressed concerns over the slow pace of global growth, the potential effects ~~of~~ the tapering of US Federal Reserve bond purchases on Brazil's currency and economy, a still high inflation rate in Brazil, weak Brazilian productivity growth, and effects of regulation on credit creation. The importance of improving Brazil's infrastructure was a recurring theme throughout the Symposium, as was the importance of addressing trade-offs between financial stability and innovation.

Session 1: Implementation of Regulatory Reform and Reduction of Regulatory Complexity

Session 1 addressed post-crisis regulatory reform. Participants discussed reforms at both the global and national levels. They noted that, while the G20 had created a clear agenda for global financial regulatory reform, some important aspects of that agenda remained uncertain even in the U.S. and Europe. They also discussed financial regulation in the U.S. and Brazil, including the extensive regulatory reforms in the U.S. since the global crisis and the prospects for market-oriented reforms in Brazil. Throughout the session, there was considerable attention paid to the trade-offs between costs and benefits of new financial regulations.

Global Regulatory Reform

Participants discussed the status of global financial regulatory reform since the crisis. One of the major institutional innovations in global financial governance in the wake of the crisis was the emergence of the G20 as the main locus for creating a global financial regulatory agenda. With the inclusion of a variety of emerging economies, including Brazil, the G20 was seen as more representative of the global economic system than the G7/G8-centered system that preceded it. The interests and practices of emerging economies were represented in some of the post-crisis global regulatory reform agenda; however, many participants observed that in fact much of that agenda was focused on the needs of the most developed economies. Moreover, in practice the largest and most complex changes in financial regulation were occurring in the U.S. and Europe. Although these regulatory changes were seen to be responding to domestic needs, they would inevitably have global implications, including for Brazil.

Many of the key elements of the G20 agenda were seen to be based on an analysis of what had gone wrong in the developed economies of the U.S. and EU. Key elements included increasing the amount and quality of risk-weighted capital for banks, increasing liquidity and restricting leverage for banks and some other financial institutions, centralized clearing and reporting for derivatives, enhanced supervision of systemically important financial institutions (SIFIs), and enhancement of resolution regimes for financial institutions to prevent contagion. The specifics of these elements were still being worked out in the Financial Stability Board, Basel Committee, and other international regulatory bodies, even as national regulators were already adopting parts of the agenda domestically.

Nearly five years after the G20's initial agreement in 2008, participants noted that the agenda was not fully implemented, not only for non-bank financial institutions and for derivatives but also for the banking sector, where new capital and liquidity standards were being implemented gradually and important aspects of structural remedies (Volcker Rule in the U.S. and Vickers and Liikanen Report proposals in the UK and EU) remained undecided. A number of participants argued that uncertainty about the ultimate shape of regulation and style of supervision was making financial institutions behave more conservatively, putting off major decisions and potentially reducing the supply of credit to the real economy around the world. Moreover, there remained significant disparities between implementation in different jurisdictions, with potentially negative implications for global financial transactions. In particular, differences between U.S. and EU rules on derivatives trading and substituted compliance threatened to balkanize derivatives markets. For Brazil, this threatened to raise the cost of hedging of both commodities price volatility and currency risk. Finally, a number of participants pointed out that differences in the timing and details of regulatory reform in different countries, particularly between the U.S. and EU, would create opportunities for regulatory arbitrage, advantaging some financial institutions and jurisdictions unfairly over others.

Beyond the issues of incomplete implementation and uncertainty, participants debated whether the global regulatory agenda would contribute to economic growth and financial stability. A number of participants agreed that it was the right approach to financial regulation. Pointing to the experience of countries such as Brazil and Canada, they argued that strict regulation of capital, liquidity, risk-taking, and hedging had spared those economies from the worst of the crisis. Given the extremely high costs associated with financial crises, they argued that the G20 agenda was focusing on the right factors.

Others expressed concern over the global reform agenda. Several argued that regulators were "fighting the last war." They felt that regulators were so intent on preventing a repeat of the last crisis that they were not thinking seriously about emerging threats (including, for example, cybersecurity or gaps in IT management). Many also expressed concerns that heavier regulation of banks and insurance companies would shift more financial transactions to the less-regulated "shadow banking" sector. Some felt that regulators should therefore extend more bank-like regulation onto non-banks. Others worried that this would further reduce the availability of risk capital; some also noted that the shadow banking system had in fact not been the epicenter of the financial crisis, and questioned whether stricter regulation on it would reduce systemic risk. With regard to derivatives, there was no clear consensus on the importance of central clearing, but most participants did agree that at a minimum there should be centralized trade reporting (as had already existed in Brazil) to improve transparency and macroprudential supervision.

Many participants also expressed concerns that the global regulatory agenda would lead to overregulation, which would mean increased costs and decreased innovation. There was a debate, which remained unresolved, about the relative value of innovation versus stability. Some participants emphasized that increased regulatory oversight would inevitably mean that some beneficial new financial products would not be introduced; others countered that new products or practices should properly be evaluated by regulators to prevent contagion as part of their responsibility for macroprudential supervision.

A number of participants also worried about the costs of complying with new rules. A number of participants complained that many of the new regulations, including a number of key U.S. rules, were being decided and imposed without sufficient cost-benefit analysis. Going beyond the concerns of financial institutions, many argued that excessive costs would be an obstacle to credit creation and thus a drag on overall economic growth. Some participants argued that the regulatory burden would be particularly onerous for smaller financial institutions, which could accelerate trends toward concentration and problems of "too big to fail." As one participant put it, the global rules could simultaneously create problems of "too big to fail" and "too small to survive."

Several participants also expressed concern that the new global rules, which aimed to reduce systemic risk by restricting innovation and risk-taking behavior by financial institutions, could actually be destabilizing, by encouraging herd behavior. For example, stricter rules for risk-weighting by banks would encourage them to concentrate on holding a limited set of "riskless" or low-risk assets, such as government bonds. A crash in one of those markets would affect banks across the board, with potentially serious impact on the real economy. Even if there were no increase in systemic risk, many participants agreed that the result would be tighter credit for smaller firms and developing countries, while continuing to provide easy credit to sovereigns, public corporations, and large firms.

A number of participants were skeptical about whether the global regulatory agenda met the needs of emerging markets. They felt that the agenda mostly reflected the needs of developed economies. For example, bank capital and liquidity requirements appeared to be predicated on a model of sophisticated banking conglomerates and light-touch supervision rather than on the more typical emerging market reality of traditional banking and significant state guidance, intervention, and/or ownership. (At the same time, a number of participants pointed out that the global agenda accorded closely with existing Brazilian financial regulation.) Another significant concern that participants raised was that new rules might reduce lending to emerging markets—one example was requirements for consolidation of global balance sheets for multinational financial institutions, most of which were based in the developed economies.

Finally, participants raised the question of whether global standards required global enforcement. Several pointed out that global finance had no analogue to the World Trade Organization, which had autonomous enforcement powers in the form of the Dispute Settlement Mechanism. The FSB, Basel Committee, and other financial regulatory bodies, in contrast, had limited means to constrain national enforcement regimes or to adjudicate differences in interpretation. Most participants agreed, however, that global enforcement would not be feasible, given national differences in financial systems and the important role of financial systems in providing public goods.

U.S. Regulatory Reform

There was considerable discussion of U.S. regulatory reform. Participants agreed that post-crisis U.S. reforms had been far-reaching, with thousands of new rules that would affect nearly every type of financial institution. There were differences of opinion as to whether these comprehensive reforms would be beneficial, however. There was close to a consensus in favor of some items, such as trade reporting for derivatives (and to a lesser extent, for central clearing and exchange trading of derivatives). Other aspects were more controversial. Some participants applauded the shift to more conservative regulation, pointing to the damage that had been done to the U.S. and global economies as a result of excessive financial risk-taking in the lead-up to the crisis. They argued that it was appropriate to put stricter controls on the types of risk that financial institutions—particularly banks and insurance companies—could take on and to ensure that they had sufficient capital and liquidity to weather any surprises, so that taxpayers would not have to bail them out. They pointed to the success of economies such as Canada and Brazil in the face of the global financial crisis, and suggested that U.S. authorities were wise to take a more cautious view of risk and innovation.

Others disagreed with this assessment. Several argued that U.S. reforms had gone too far in trying to reduce risk. They worried that risk-capital for start-ups and SMEs would become scarce and expensive as a result of the new rules, with negative effects on U.S. economic potential, employment, and dynamism. At the least, they saw a need for more conscious cost-benefit analysis to ensure that any benefits in terms of financial stability would not be overwhelmed by costs to the economy. Others went further, arguing that the reforms would not in fact reduce financial volatility or the likelihood of crises. They pointed out that financial crises could arise from virtually any source, and that many of the financial institutions most devastated in the crisis were banks like Northern Rock or the German landesbanks that were primarily engaged in traditional lending practices. The Volcker Rule came in for particular criticism by these participants, who felt that it addressed a practice that had had no role in the crisis. Several argued that, rather than being based on a clear analysis of a source of excessive risk-taking, it was "misplaced nostalgia for a world that will never exist again." Others focused on the problem of interaction effects—even if each of the new rules on its own would contribute to a more stable and efficient financial system (which many did not see as necessarily the case), there would be no way to predict the effects of thousands of simultaneous rule changes on the behavior of financial actors or the stability of the system. Finally, a number of participants bemoaned the fact that U.S. financial reforms had left the country's fragmented regulatory system intact. They argued that the crisis had shown a clear need for more a unified regulatory and supervisory system, and expressed concern that the U.S. system would remain vulnerable to regulatory arbitrage, conflicting mandates, and tunnel vision.

Turning from the substance of U.S. regulatory reform, many participants expressed concern about its long and drawn-out nature. They agreed that uncertainty over the final content of rules, as well as their timing, was problematic for financial institutions and for the U.S. and global economies. Uncertainty would discourage financial institutions from taking new initiatives and would add to compliance costs. Moreover, the differences in timing between reforms in key markets (particularly the U.S. and EU) would open up opportunities for regulatory arbitrage. While participants were grateful that it appeared that the end was nearly in sight for major regulatory changes, they were remained frustrated by the how long it had taken. Moreover, the prospect of lawsuits over specific rules and findings would continue.

There was also considerable discussion of the impact of U.S. reforms on other markets, particularly Brazil's. Participants noted that a number of aspects of U.S. financial reform had extraterritorial legal implications. The main focus of the discussion in São Paulo was on derivatives rules, although some participants brought up additional issues such as the Volcker Rule. Participants noted that most cross-border derivatives around the world could be subject to U.S. regulation, either because they had a U.S. counterparty or were based on a U.S. asset. This would in principle lead to U.S. regulators having a global reach, and require non-U.S. financial institutions doing business outside the U.S. to comply with both local and U.S. rules, which might disagree. While much of the global focus had been on efforts to surmount issues between the U.S. and EU (which accounted for the bulk of cross-border derivatives transactions around the world), this was seen as a major concern for Brazil, given its export dependence on agricultural and mineral commodities. Participants placed most of their hopes on substituted compliance as a mechanism for avoiding double regulation. Given Brazil's high-quality derivatives regime, most participants were optimistic that Brazil would qualify for substituted compliance, but uncertainty remained. Also, it was noted that some Brazilian firms and financial institutions operating in the U.S. could be subject to both U.S. and Brazilian rules. Participants called on U.S. and Brazilian authorities to work cooperatively to ensure that negative effects would be minimized, allowing financial institutions and exporters to continue to hedge their currency and other risks.

Financial Status Quo in Brazil

In contrast to the ambitious global agenda and U.S. regulatory reform, participants agreed that Brazilian financial regulation had changed little in response to the crisis. Brazil's financial system had remained stable while much of the rest of the world was in crisis, which confirmed for many participants the wisdom of the country's conservative approach to financial regulation.

Participants identified several key characteristics of Brazilian financial regulation that predated the crisis and remained in place in its aftermath. Many of these mirrored elements of the global agenda that were being introduced since 2008 in jurisdictions around the world, including the U.S. and EU. A central element of Brazilian financial regulation was strict capital and leverage rules, which helped to keep Brazilian banks solvent even in the face of recession or global financial crisis. These rules were reinforced by a conservative approach to risk assessment, as Brazilian financial institutions were given little leeway in evaluating risk of assets. Moreover, they were largely restricted to traditional business models, with a limited set of financial instruments in which they could invest or hedge; given the role of misjudgment about risk of new financial products in the U.S. subprime crisis, many participants saw this as having reduced Brazil's vulnerability to crisis. Brazilian authorities had also emphasized the importance of liquidity. As participants noted, the vast majority of Brazilian derivatives contracts were exchange-traded and centrally-cleared. Thus, Brazilian financial institutions did not face the same problems of illiquidity that U.S. and EU holders of collateralized debt obligations and other OTC derivatives faced in 2008. Brazilian authorities emphasized liquidity in other ways as well. For example, several participants argued that the requirement that banks keep substantial reserve deposits in the Banco Central do Brasil had been crucial in allowing BCB to provide enough liquidity to prevent payments problems in the banking system during the global crisis. As important, the crisis proved for many participants the wisdom of BCB maintaining high levels of foreign currency reserves, which allowed external commerce to proceed with minimal disruption during the crisis.

Participants also pointed to the importance of institutional characteristics of Brazilian financial regulation. A key characteristic was the emphasis on transparency and accountability, as seen for example in electronic trade reporting for derivatives, as well as electronic reporting of all taxable transactions. This was seen by many as a model for trade reporting to which other jurisdictions should aspire. Participants also spoke highly of the quality of financial infrastructure, such as the use of gross real-time settlement. Many praised what they saw as the effective and non-political nature of Brazil's main regulatory bodies, the BCB and Comissão de Valores Mobiliários (CVM), as well as the quality of the main exchange, BM&F Bovespa. A few participants expressed concerns that BCB and CVM were becoming more subject to political influence in recent years (especially the BCB in the implementation of monetary policy), and argued that legislation to make the central bank independent would be essential to ensure that monetary policy and financial regulation remained apolitical and problem-focused. Others felt that there had been little if any erosion of autonomy. There was also some skepticism about the importance of formal central bank independence, with some participants arguing that political influence could best be prevented by competence, transparency, and public accountability.

Participants did note one post-crisis regulatory change, which was the establishment of compensation clawbacks for incentive pay. This was meant to reduce the discrepancy between institutional and individual incentives, in order to ensure that bank executives and traders did not take on excessive risks in order to gain personally. Clawbacks accorded with the global agenda promulgated by the G20; however, some participants were skeptical that they would have much of an impact in Brazil given the significant existing disincentives to risk-taking, in particular the personal accountability of directors for corporate losses. Several participants noted that personal assets could be immediately frozen until the case made its way through the courts, which could take 7-10 years. Brazil also had several existing restrictions on performance compensation, including the requirement that half must be in stock options (some of them deferred) and that stock options would be taxable as income if no performance criteria were specified.

Despite the generally positive evaluation of Brazilian financial regulation, participants did raise some concerns. A major one was the costs of conservatism. While acknowledging that conservative financial regulation and supervision had helped Brazil to avoid serious financial impact during the global crisis, many participants argued that there was insufficient attention given to the costs of that regime. They argued that the disincentives to innovation and to risk were having a negative impact on credit availability to SMEs and individuals. The difficulty of obtaining credit was seen as a major obstacle to SME growth. They saw this as not only reducing the dynamism of the economy, but also limiting the potential for employment growth throughout the economy. A number of participants further argued that labor productivity (and thus wages) would be limited by SMEs' ability to obtain credit for capital investment. Opinions were more mixed on the issue of household credit access. Some participants expressed concern that limited consumer credit markets were reducing demand. Others countered that Brazilian households were not saving enough, and that many were already taking on too much debt in the form of vehicle loans and installment credit. They worried that if constraints on consumer borrowing were lowered, it might lead to excessive borrowing and problems for lenders.

Conservatism was also seen by some participants as raising borrowing costs. This was particularly true for SMEs and households, but several participants argued that the problem extended through much of the financial system. For example, restrictions on the introduction of new financial products could reduce hedging opportunities, while disincentives to foreign investment reduced liquidity and thus raised costs in Brazil's capital markets. Finally, some participants expressed concern that the conservative approach to financial innovation was hampering vital infrastructure investment. This was addressed in more detail in Session 4, below.

Finally, many participants expressed concern about disincentives to foreign investors. While several of these, such as the overall regulatory and legal environment, were not directly aimed at foreign investors, others were. These included the tax on foreign operations (IOF) and some other elements of the tax regime. It was noted that various foreign actors were affected differently by taxes and regulations. For example, commodities firms and institutional investors were particularly affected by the IOF (whose effects were exacerbated by its unpredictability), while industrial companies were far more affected by restrictions on ownership and local tax rules. Participants agreed that the origins of some of these disincentives lay in Brazil's past experiences of payments crises, but there were mixed feelings about the trade-offs. A number of participants emphasized the potentially important role of foreign firms and investors in improving Brazilian infrastructure and economic growth, and argued that the costs of losing that business exceeded the benefits of the policies. While participants realized that there was a conflict between a possibly desirable use of the IOF for short-term monetary and currency policy and its negative impact on the overall investment regime, there was a high level of agreement among participants that Brazil would benefit from tax reform (discussed in Session 3, below) and business-friendly changes in the overall legal and regulatory environment.

Issues Going Forward

With the post-crisis reform agenda mostly implemented, participants discussed a number of issues that would continue to challenge financial systems and regulators. These ranged from broad issues of principle to concrete concerns for Brazil and the U.S.

Several participants raised the question of how to evaluate "success" of the global reform project. Some suggested that political leaders had unrealistic expectations that reforms would eliminate future crises and the need for taxpayer bailouts. Most felt that bubbles and crises were endemic to financial systems, but that their likelihood and costs could be reduced by ensuring adequate capital reserves and liquidity in the banking system, mandating central clearing and trade reporting for derivatives, and improving resolution regimes for financial institutions. However, there was an unresolved debate over how to weigh the costs and benefits of new regulations—a number of participants expressed a deep concern that effects such as reduced innovation, restricted lending to SMEs and households, reduced liquidity in derivatives markets, and higher costs for many financial institutions were not being adequately considered. Some raised concerns about "macrofinancial populism" that could continue to make financial institutions scapegoats for a variety of problems.

A separate concern was about complacency. Would global leaders, having implemented the most comprehensive financial regulatory reforms in generations, come to believe that their main job was done? Regulators and supervisors would need to keep monitoring risks and trying to ensure the healthy development of financial systems, but there were some concerns ~~that~~ whether they would continue to receive the resources to do so.

For many participants, the key regulatory issues going forward were prudential in nature. While there was some skepticism about the likely effectiveness of macroprudential supervision as well as about specific measures of risk, a number of participants argued that regulators should take a "macroprudential approach" to their supervision of financial institutions and markets. As one put it, "not every regulator is a macroprudential regulator, but everyone must consider the macroprudential consequences of the areas under their jurisdiction." Several participants saw this as a particularly important task for Brazil as it moved from a highly controlled financial system to more market-oriented one.

Participants also agreed that effective risk management should not be the responsibility of regulators alone. They argued that financial institutions needed to improve their internal risk assessment and risk management practices without the expectation that regulators would either have all the right answers or bail them out in a crisis. They also saw an important role for self-regulation by exchanges and other institutions, as an adjunct to the work of both regulators and financial institutions. For many participants, the key lesson of the global crisis was the need to take risk management seriously and not simply trust in models or to believe that risks can be perfectly hedged.

A final issue that came up several times was the scale of financial institutions. For the U.S., participants brought up two concerns, although they were not discussed in detail. One was that new regulations were actually creating incentives for financial institutions to get bigger, perhaps even making "too big to fail" a goal for some. The other was whether the new resolution regime, including living wills, would be adequate to manage a large multinational financial institution failure without recourse to taxpayer money. For Brazil, a number of participants raised the question of whether the major government-owned financial institutions were playing too large a role in the financial system. Much of this discussion focused on BNDES. Participants expressed mixed views of BNDES's role. While a number of them worried that private-sector financial institutions were being crowded out of potentially profitable markets by the state lenders, others argued that BNDES was generally very well-managed and that it remained an essential part of long-term financing for the time being. They also pointed to efforts by BNDES to reduce its role in the system by supporting capital market initiatives and co-financing. Several also commended the role of BNDES and other government financial institutions in providing countercyclical lending during the crisis.

Session 2: Monetary Policy in Brazil and the U.S. and Its Impact on Inflation

In Session 2, participants had a wide-ranging discussion that began with monetary policy but extended to Brazil's growth prospects, including a variety of microeconomic factors. The discussion of monetary policy focused on the effects of quantitative easing and tapering in the U.S. and Japan in terms of both contribution to global growth and the impact on Brazil. Participants expressed concern that Brazil would be unable to depend on robust export growth to promote economic expansion. The resumption of inflation, both for external and internal reasons was another matter of concern. Finally, participants called for Brazil to find a new growth model that would fit with the changing economic realities.

Money and Inflation: Global Dimensions

Discussion of monetary policy began with the post-crisis easy money in the developed countries, particularly the U.S. and Japan. Both countries had resorted to quantitative easing as short-term interest rates approached (or in Japan's case, reached) the zero lower bound. While Japan was the first country to venture into quantitative easing, its initial forays had been quite modest, whereas the U.S. Fed had tripled base money within a few months in 2009. The Bank of Japan's quantitative easing efforts had become much more ambitious since the debut of "Abenomics" in 2013, with a commitment to more than double the balance sheet and maintain zero rates until inflation hit 2% over a sustained period. Participants noted that, despite concerns by some economists and politicians, inflation and inflationary expectations remained modest throughout the developed economies despite massive injections of money. They attributed this to a dramatic drop in the money multiplier due to high unemployment and low capacity utilization rates.

While inflation appeared not to be a problem for the United States in the short to medium-term, the resumption of growth in the U.S. raised expectations that the Fed would begin to "taper" its bond purchases and thereby reduce liquidity injections into the U.S. economy. Economists predicted that the taper would begin by March 2014, but would likely be gradual. In Japan, in contrast, quantitative easing was expected to continue for several years. In general, participants agreed that easy money had had positive if modest effects on developed economy growth, but global easy money was nearing its end.

The effects of quantitative easing on Brazil and other emerging markets were seen as somewhat more mixed. On the one hand were the "currency war" effects. Massive easy money in the U.S. had led to appreciation of the Brazilian real due to both lower U.S. interest rates and a search among investors for higher-yielding investments in Brazil. The continued strength of commodities prices had created further incentives for capital inflows to Brazil. The combined effect led to loss of export competitiveness as well as concerns that inflows would reverse, leading to payments problems or even a currency crisis for Brazil. In response, Brazil had to choose among currency appreciation, higher inflation, and currency controls. The actual response was a mixed one that included both currency controls (particularly the frequent changes in the IOF) and modest appreciation. On the other hand, a number of participants argued that quantitative easing had had positive effects on developed country demand; given the dependence of the Brazilian and other Latin American economies on the health of U.S. markets, they felt that there had been important indirect benefits for Brazil.

Participants also discussed the effects of tapering. Despite the initial upset over U.S. quantitative easing, some saw Brazil as equally susceptible to negative effects of tapering. Even the announcement of expected tapering in the summer of 2013 had led to immediate effects for Brazil, including falling stock prices and currency depreciation. While much of this had been priced into the market by December 2013, participants saw Brazil as facing a challenging new reality that would potentially mean higher domestic inflation (and thus rising nominal interest rates) and more expensive access to international capital markets.

Global Economy and Effects on Brazil

Participants noted that many economists agreed that global imbalances had contributed to the global crisis, as massive surplus savings in Asia had financed equally massive deficits in the U.S. in what some observers called the Bretton Woods Two system. They also noted that, since the crisis, there had been a significant moderation of global imbalances, with considerable drops in current account deficits in the U.S and Eurozone crisis countries combining with similar drops in surpluses for China and Japan.

While the moderation of global imbalances was seen as a positive sign for global financial stability, participants expressed concerns about Brazil, whose current account deficits were actually worsening. There was relatively little concern about short-term sustainability or capital outflows. However, a number of participants worried that Brazil's ability to obtain external capital for investment-led growth would be weakened. Given Brazil's low savings rates, capital inflows would be indispensable for dealing with Brazil's needs, including infrastructure and corporate investment.

A number of participants also expressed concerns about significant headwinds in the way of Brazilian growth. They noted that global growth had slowed, along with China's appetite for imports. They also pointed to forecasts that global commodities prices were likely to decline, including the key commodities of iron and soy, which had helped to fuel Brazil's strong export record of recent years. Economic growth, therefore, would have to come from growth in productivity, particularly in the industrial sector. While some participants saw Brazil as having considerable potential in this regard, many pointed out that Chile, Peru, and other open economies in the region were outperforming Brazil despite Brazil's large domestic market and natural resources. Thus, they called for significant structural reforms to make Brazil's economy more competitive, productive, and open.

Issues for Brazil

The prospects for renewed inflation in Brazil were discussed at length. The tapering of U.S. quantitative easing was seen as one of several inflation drivers. Although Brazil would no longer have to deal with the effects of large capital inflows on the domestic money supply, the expected depreciation of the real was seen as likely to lead to some imported inflation.

Nonetheless, participants devoted much of their discussion of Brazilian inflation to domestic factors. A major concern in this regard was indexation of wages, pensions, rents, and many other prices. Many participants argued that indexation (particularly of wages, which were set on the basis of GDP growth in addition to inflation) made suppression of inflation much more difficult. However, there was little hope expressed that indexation would be eliminated, given how ingrained it had become in politics and society. Inflation was somewhat moderated through the use of "regulated prices" for energy and basic services, but these were seen by participants as further distorting the economy by disincentivizing investment in oil and electricity production.

A number of other policies were also seen as contributing to inflation. Some participants worried about the prospects for fiscally-driven inflation as deficits expanded. They focused on the problem of spending, as many felt that taxation was already excessive. In particular, these participants expressed concern about what they saw as excessive social welfare spending and the size of the government bureaucracy. A few participants also raised the question of whether the BCB was becoming politicized, and therefore deemphasizing anti-inflationary policy in order to support the government's employment goals. Some suggested formal autonomy would be important going forward. Others disagreed, arguing that Brazil's anti-inflationary consensus remained strong, and that legal autonomy was less important than that political consensus. Many participants agreed that industrial policies were another important factor in keeping prices high. They noted that import restrictions and local content rules for manufactured goods meant that Brazilians faced very high prices for goods like automobiles and capital equipment, with effects that fed through the economy.

Finally, labor markets were seen as a major driver of inflation, even beyond the issues of wage indexation. Labor rules added a variety of costs to hiring workers, including high social welfare payments and generous vacation and overtime provisions, as well as making it difficult and expensive to terminate them. Participants also noted that labor markets were tight, with few prospects for improvement. This was helping to ratchet up wages. Part of the reason given was demographic shifts, as the working age population was leveling off as a result of the dramatic drops in Brazil's fertility rates of the last several decades. Participants saw a lack of human capital as a more fundamental problem, however, noting that skilled labor was in particularly short supply, due to Brazil's underdeveloped education system. Thus, the crux of the problem for many participants was that demographic and legal forces were driving up labor costs, while productivity was growing much more slowly.

Participants identified several additional factors that they saw as limiting productivity growth. One was infrastructure, particularly logistics, transportation, and power generation. Participants agreed that Brazil's infrastructure was very underdeveloped and that the private sector should be encouraged to become more involved. This was discussed extensively in Session 4. Several participants also pointed to Brazil's industrial structure as limiting potential for productivity gains. They noted that, in comparison with other emerging markets, Brazil had a relatively small manufacturing sector and a very large service sector. Since industrial productivity growth tended to outstrip service sector growth in emerging markets, Brazil's overall productivity growth was seen as likely to be relatively slow. Moreover, most companies in the service sector were SMEs, many of which were credit-constrained and therefore unable to take advantage of labor-saving devices or information technology that could improve productivity. Meanwhile, productivity in the manufacturing sector was seen to be constrained by the continued influence of import substitution and protection. These policies reduced competition and increase costs, hurting the productivity of Brazilian manufacturing and its export competitiveness.

Finally, participants argued that government reforms could contribute to growth and productivity. In addition to the concerns already noted about labor laws and import substitution, they raised several additional areas for improvement. One was to reduce government micromanagement of markets, which many saw as a continuing legacy of the period of Brazil's traditional, statist model of development. Several noted that Brazil's ranking in the World Bank's Ease of Doing Business survey was extremely low, reflecting the difficulty of starting a business, enforcing contracts, etc.; others focused on factors such as the persistence of regulated prices. Another manifestation of the statist model that many participants saw as problematic was the prevalence of national champions and state-owned enterprises. These firms were seen as benefiting from restricting competition and excluding foreign investment, which inevitably led to inefficiency and low productivity. There were also calls for improvement to the court system, which was seen as overburdened, inefficient, and often anti-business. Finally, a number of participants argued for administrative reform. They argued that Brazil suffered from overlaps between the state and federal levels, as well as between line agencies and control agencies at the federal level. One positive example of administrative reform could be seen in the anti-trust commission (CADE), which had streamlined its structure and procedures in order to provide timely and consistent judgments. The success of CADE's reforms gave hope to a number of participants that further administrative reform would be possible.

Financing Brazil's Growth

A final question addressed in Session 2 was how Brazil should finance growth. As noted above, several participants made the point that external financing would be essential given Brazil's status as a deficit country, and an investment push would only increase the need for foreign funds.

At the same time, participants discussed ways of mobilizing domestic sources of finance. They argued that Brazil would benefit from encouraging private-sector financial institutions of all sorts (including not only banks and investment banks, but also private equity and venture capital) to provide funding to companies at each stage of their development. There was also a consensus that capital markets should be more extensively used, and a number of participants called for measures to encourage more companies to list on exchanges, building on the successes of the Novo Mercado. Above all, Brazil would need to pursue policies that encourage more domestic savings, not just the allocation of existing savings.

Participants also acknowledged the reality that government financial institutions, particularly BNDES, would continue to play a central role for years to come in providing long-term financing to Brazilian companies. Many participants saw BNDES as able to play a positive role in financial market development. This would be especially true if BNDES could prioritize support for infrastructure and innovation, both of which were seen as essential to Brazil's future but also generally underprovided. A number of participants also saw efforts for the BNDES to co-finance with other financial institutions and to support bond markets as important transitional steps toward a broader and deeper financial market in Brazil. However, this was tempered by concerns that the BNDES might be crowding out private financial institutions with a pattern of lending that remained skewed toward state-owned and other large firms.

Session 3: Tax Reform in Brazil and the U.S., and for Cross-Border Transactions

In Session 3, participants discussed tax reform in Brazil and the U.S. Many participants felt that there was a need for significant tax reform in Brazil, but most anticipated only incremental change. Participants also discussed cross-border tax issues, including the possibility of a U.S.-Brazil tax treaty.

Tax Reform in Brazil

Participants identified a number of concerns regarding the Brazilian tax system. They described taxes as too high, too complex, and too arbitrarily enforced. At the same time, participants praised the sophistication of the electronic tax reporting system, which several described as among the most advanced in the world.

A major complaint of participants was the complexity of the tax system. Brazilians faced three layers of tax collection (federal, state, municipal); moreover, some types of income were subject to both corporate and indirect taxes. Value-added tax continued to be levied at both the state (ICMS) and federal (IPI) levels The ICMS was further complicated by rules concerning tax incentives offered by states to preferred companies, leading to state vs. state “tax wars” in which additional tax was levied on products transported across state lines in order to neutralize the preferences. Meanwhile, IPI has been used for both short-term macroeconomic stimulus and to some extent has also been used to pick winners, both of which could undermine long-term development of the economy and capital markets. Participants agreed that Brazilian transfer pricing rules were also unique. Meanwhile, they complained that tax litigation was common and lengthy, and tax compliance was the most time-consuming in world. Finally, it was noted that the judgments of the Taxpayer Council were often contradictory, leading to confusion about how certain taxable events (e.g., stock option compensation) should be treated.

In discussing the potential for tax reform, participants focused on reducing complexity rather than tax rates. Given the incentives of politicians at various levels of government, as well as the need to keep up with fiscal spending, they felt that only a plan that was at least revenue-neutral had any likelihood of passing. But given the costs of complying with tax laws, reducing their complexity could provide significant benefit to domestic and foreign companies.

So far, participants pointed out that tax reform has tended to be incremental and partial in nature. Several noted that in recent years there had been a reduction in the number of payroll taxes, as well as some tax reductions for specific sectors (e.g., chemicals) and for export promotion. Still, the unification of interstate ICMS was characterized by some as the only significant tax reform at the national level.

Most participants appeared to be rather pessimistic about the prospects of achieving comprehensive tax reform. If it were to be possible, they was argued that a president would have to put his/her weight behind the effort at the beginning of his/her term in order to have a chance of making it through the legislature. Even then, only federal level tax reform would be possible.

Cross-Border Tax Reform

Participants also discussed cross-border issues, particularly the prospect of a U.S.-Brazil tax treaty. They referenced the recent OECD Action Plan on base erosion and profit shifting (BEPS) that was created at the request of the G20. BEPS was created to address problems of international tax avoidance and tax arbitrage that had been exacerbated by development of the digital economy, growing importance of intellectual property in traded goods, and the proliferation of hybrid instruments and entities designed to take advantage of differing tax regimes. BEPS’s key points were to make sure that all income would be taxed somewhere in the world, and that hybrid enterprises could not be used as a means of tax avoidance. BEPS also created model provisions for tax treaties in order to reduce transfer pricing abuses.

It was noted that both Brazil and the U.S. had somewhat idiosyncratic elements to their international taxation. Brazil's transfer pricing rules, which used the principle of a single profit margin standard, were not OECD based (although the government took the position that Brazil had in substance partially adopted the BEPS standards. Meanwhile, the U.S. maintained a worldwide tax system, in which all U.S. residents and citizens were to be taxed on the worldwide income, with the proviso that tax could be deferred if the money remains abroad. Widely publicized abuses of the deferral rule by U.S. companies had led to the drafting of competing Senate and House proposals to close the loophole, but participants did not see sufficient political will for any serious change.

Finally, participants had mixed opinions about the prospects for a U.S.-Brazil tax treaty. Most saw such a tax treaty as a positive step for businesses and individuals, which could relieve problems of double taxation, increase exchange of information between tax authorities, and address bilateral transfer pricing. They expected that a bilateral tax treaty could lower compliance costs and facilitate cross-border transactions (although not necessarily reduce tax burdens). Some saw an important political opportunity to be opening up for a bilateral tax treaty, as the growing number of Brazilian firms doing business in the U.S. created new incentives for the Brazilian government to pursue a treaty. Others were more pessimistic. They pointed to specific disagreements, including issues regarding tax sparing and limitations on benefits. They also felt that political will was lacking on both sides to overcome those obstacles.

Session 4: The Financing of Infrastructure Improvements in Brazil and the U.S.

Session 4 addressed the financing of infrastructure improvements in Brazil and the U.S. Both countries were seen to have significant infrastructure needs that were not being fully met by government spending. Thus, participants discussed prospects for mobilizing funding from private or foreign sources. Many participants saw Brazilian infrastructure to be an attractive target for private investment if the right structure could be put into place.

Financing Infrastructure in Brazil

Participants agreed that improvement of infrastructure was essential to Brazil's economic development, as infrastructure bottlenecks were creating problems for growth. Some estimated the infrastructure gap for transportation alone to be around $500 billion. They also noted that Brazil's public asset-GDP ratio was well below the global average.

In recognition of the infrastructure gap, the Brazilian government had already introduced a number of measures and programs to encourage infrastructure investment. These included a simplification of the approvals framework and improvement of laws concerning concessions and public-private partnerships (PPPs), including a new ports law allowing third parties to handle cargo, the establishment of a public hearing system, etc.

Still, the picture for private-sector financing of infrastructure in Brazil was mixed. On the one hand, Brazil was experiencing more success in attracting private funding than most emerging markets and the government was bringing increasing numbers of projects to market bidding. Meanwhile, increasing numbers of projects were seen to be taking advantage of infrastructure bonds as an alternative funding mechanism, in addition to debt or through equity. On the other hand, a number of projects—including port terminals, highways, and rail projects—had been unable to attract bidding on concessions.

Participants cited a number of improvements in terms of financing. These included the establishment of a government guarantee fund (ABGF) to improve completion of projects, the creation of infrastructure debentures, and a variety of BNDES incentives. Indeed, several participants noted the importance of proactive financial backing from BNDES and Caixa Econômica Federal. BNDES in particular was seen as trying to promote infrastructure bonds for an increasing proportion of financing of projects in which it was involved. Meanwhile, in September 2012, legislation had clarified a number of rules involving tax incentives, expanded the number of companies allowed to issue debentures, and allowed the issuance of receivables (FIDC) as a financial instrument for funding infrastructure projects.

Despite improvements, private-sector infrastructure investment faced important challenges. The legal status of some facilities, such as ports, created potential problems for investors. Moreover, a variety of issues might delay projects indefinitely, including feasibility and environmental impact studies and resulting lawsuits. From a financial perspective, infrastructure bonds remained relatively illiquid and insurance and reinsurance markets remained underdeveloped. Although the government had improved the regulatory framework for investors in infrastructure (albeit on a sector-by-sector basis), private investors continued to face a number of risks and uncertainties, particularly in greenfield investments.

Many participants agreed that Brazilian infrastructure investments could be an attractive opportunity for foreign investors. However, while foreign investors expressed interest in Brazilian infrastructure investment in principle, in practice they remained wary, holding only about 5% of debentures. One reason offered was that institutional investors generally demanded highly-rated, liquid debentures. However, completion risk had led to weakened ratings, and most debentures remain illiquid. Other concerns for foreign investors included the applicability of the IOF, withholding taxes, and concerns about Brazilian bankruptcy courts. Macro factors remained important as well—participants noted that a combination of high inflation in Brazil and volatility in US T-bonds had caused recent sell-offs. Also, it was not evident to participants that returns on infrastructure investment would be attractive enough to either foreign or domestic investors to provide the amounts of private-sector financing needed to fund Brazil's infrastructure needs.

Financing Infrastructure in the U.S.

Infrastructure was also an issue in the U.S., where maintenance and upgrading had been deferred in many areas. Some participants cited a spending gap of $1.6 trillion between 2013 and 2020. They noted that traditionally, most infrastructure spending was done by states and municipalities, while private financing took only a small role except in utilities and communications. For the most part, financing of infrastructure projects was managed through the well-developed U.S. municipal bond markets, so there had been little need for direct private involvement.

In recent years, however, several initiatives had been taken to try to bring the private sector more directly into infrastructure financing. For example, an increasing number of states had put in place legislation to allow PPPs, although the rules varied greatly across jurisdictions. Participants note that actual use of PPPs had remained quite limited.

At the federal level, the Obama administration had made several proposals to encourage private sector involvement. One of these was Build America Bonds (2009-10), which allowed state and local governments to receive a cash subsidy when issuing taxable bonds. This created a taxable municipal bond supply that could be seen as attractive by all investors rather than just by high tax-bracket individuals. Proponents saw it as a more efficient way of subsidizing interest costs than traditional tax-free municipals bonds. Other proposals included the establishment of a National Infrastructure Bank and offering tax relief to foreigners investing in infrastructure. Whether these proposals would be passed or would have their desired effect remained to be seen.

LEAD SPONSORS

2013 Symposium on Building the Financial System of the 21st Century: An Agenda for Brazil and the United States

GLOBAL SPONSORS

citi

STATE STREET

2013 Symposium on Building the Financial System of the 21st Century: An Agenda for Brazil and the United States

SPONSORS

MUFG Bank of Tokyo-Mitsubishi UFJ

CME Group