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Financial governance in Brazil 1998-2010: An overview

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HISTORICAL BACKGROUND

The current financial system in Brazil has its key roots in the 1950s. At that time, several of the features were established, which are still in evidence today. Of course, there have been changes, mainly in the 1990s and more recently, in the first decade of this century. However, it could be said that the most important features of the Brazilian financial system have not changed, especially in the field of long term financing.

The Brazilian financial system is until today a typical, *credit based* one where the State has a peculiar and noteworthy role. State-owned banks share the financing of the economy with private banks but the former have a prominent role in long term financing and the latter in the short term. Moreover, most of the *funding* for long-term financing comes from two public funds (FGTS and PIS-PASEP) and other public, constitutional funds. In addition, the public system encompasses parts of private bank loans due to enforceability (*exigibilidades*), calculated on cash deposits.

In this context capital markets used to have very little relevance in the financing of the economy. During the time of the industrialization process financing of investment and even working capital have mostly come from public funds and banks as well as external financing. The abnormal presence of the latter is a testimony of the incapacity of the domestic financial system to provide the financing necessary for the development process.

There has been a consensus as to the reason that shaped these features of the Brazilian financial system in the past: a high and volatile inflation rate. This characteristic has made operations of term transformation very risky, leading to the exclusion of private banks from financial intermediation. All these kinds of opera-

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tions were driven by the State and with their guarantee. This was not only the case of domestic financing, as pointed out above, but even of the external financing where the State has created various expedients to protect the private sector — banks and enterprises — from exchange rate fluctuation.

THE EARLY 1990s

For the financial system in Brazil, this decade is paramount. Changes were not related to financing itself, as a consequence of low growth rate, but to institutional changes. In this decade there were two interconnected processes: huge changes in the ownership of banks and a significant increase in financial openness.

In the first dimension we have witnessed an increase in the de-nationalization and privatization of banks, which has as its main result the privatization and partial de-nationalization of the Brazilian sub-national bank system (*sistema de bancos estaduais*). This has increased the concentration level and the share of international banks in the banking activity in Brazil. Despite this, a very important part of state-owned banks — comprised of the three national and the three regional banks — remains untouched.

In the ambit of financial openness, the changes have been comprehensive and outstanding. The transformation encompasses a complete modification of the regulation, to adapt to alterations, which had taken place in the international scenario and mainly related to securitization. As a result, a high level of financial integration was achieved in both dimensions: outward and inward transactions. In the former, the process could be considered finished by the year 2000 with the assimilation between resident and non-resident investors. In the latter, there are no meaningful impediments nowadays — except for those which arise from the cost of transactions — to invest abroad.

THE YEARS 2000

The trends featured above have continued in the early years of the new century, associated with a significant change in the performance of the economy. Since 2003, the Brazilian economy has begun to grow at a more rapid pace and to increase the investment rate. From the point of view of the financial system, this introduces a significant modification in the nature of financing demand because it has become more concentrated in the long term.

In spite of the changing profile of demand, we notice a very similar response from the financial system: the preservation of the distribution of tasks among private and state-owned banks, the timid role of capital markets and the increased relevance of external financing. From these trends emerges one main question: why, in spite of achieving price stability from 1994 onwards, was the Brazilian economy and its financial system unable to build up a private financial system with the capac-

ity to finance the investment and the long term? To answer this question let us observe the behavior of the financial system in recent times.

Private banks, in spite of having reached a high degree of concentration, remained attached to the short term financing and only get involved in long term financing when public or external funding were available. They were unable to create long term funding based on private and voluntary savings. Despite this, the new stance of getting involved with the long term and bearing the credit risk was a good sign. State-owned banks, in turn, kept their role in financing the long run and diversified their operations to activities typical of the private ones, establishing a new pattern of competition.

Capital markets continued to play a minor role in long run financing. The stock exchange, in spite of growing activity in primary and secondary markets, and a significant level of issuing of new stocks (IPOs), was branded by a high level of volatility or a *feast and famine* pattern. This was due to the speculative nature of this market where traded shares are very concentrated in a few sectors, mainly in commodities' enterprises, and the investor's base is concentrated in non-residents as well.

This evidence suggests that the continuity of growth of the Brazilian economy will pose a financing problem related to excessive concentration of long term financing in state owned banks and the dependence of public funding. In the recent past this was even intensified by new loans from the Treasury to public banks, backed by the issuing of public debt. In the light of these facts, it is necessary to consider an enlargement of private banks in the long run as a means to avoid disproportionate concentration in the public sector and excessive dependence on external financing.

THE MACROECONOMIC CONSTRAINT

The financing activities of private banking in Brazil were marked by a huge risk aversion. As pointed out above, for a long time this was due to a high and volatile inflation rate. However, since the mid nineties, the country has achieved price stability and the reason for excessive risk aversion should have vanished. Apparently this has not happened because the private banking keeps its distance from long term financing.

There are two different macroeconomic motives to explain this stance of private banks: the level of the basic interest rate (Selic) and the lack of monetary stability. The high level of basic interest rate that hampers the formation of a yield curve, has diverse determinants. In the past, persistent external vulnerability, associated with great levels of public debt, were responsible for the high risk premium of the Brazilian sovereign debt, both external and domestic. Since the middle of the first decade of this century these causes have faded away. In spite of still being high, the interest rate has decreased meaningfully since then. On the eve of the 2008 financial crisis, this was compatible with a restricted development of private long term financing.

Regarding the interest rate, it is plausible to conclude that the reduction of its level is an important precondition to the development of private financial intermediation. Nowadays in Brazil this is a question increasingly associated with the management of the inflation target regime, on the cyclical side of the subject, and with the superpower of *rentiers* in the structural dimension of the problem.

The decrease in the interest rate is a necessary but insufficient condition for the build-up of a strong private intermediation. The sufficient condition is the removal of monetary instability and its consequences. It is worthwhile to distinguish the latter from price stability. Monetary instability means a high degree of volatility in the core macroeconomic variables: interest rate and exchange rate. These features were chiefly determined by the nature and quality of external insertion and, last but not least, by the international liquidity cycle.

Monetary instability sharply increases the risks of financial intermediation or balance sheet risks, allowing the private bank system to avoid long term transformation and even imposing very high spreads in short term financing. To circumvent this problem the financial system has used the indexation of securities and loans with the short-term interest rate (Selic) on a large scale. As a matter of fact, in the recent past this has been a device used by public sector to absorb the intermediation risk and make possible the issue of securities as well as to roll over the public debt in an environment of meaningful monetary instability.

This device spills over to the private sector but with more significant implications. The risk transfer, from banks and financial intermediaries, to the borrower has led to a huge decrease in the demand for financing, thus obstructing the development of private financing. To sum up, in the near future, the development of private financing and the participation of banks and financial intermediaries in the financing of development will depend on: the decreasing of the basic interest rate and the reduction of the effects of monetary instability by means of the elimination of financial indexation.