Healing compulsive vices of contemporary financial capitalism: preventive regulation, public banks and macroprudential policy

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Luciano Coutinho
President

BNDES *Brazilian development bank*

Compulsive vices of modern capitalism

- ✓ Economic cycles that are pressured by a pro-cyclical expansion of credit, with careless attention to risk ;

- ✓ Creative capital markets and investment banks potentialize innovation that deepens pro-cyclical trends;

- ✓ Euphoria multiplies the levels of leverage and induces high-risk/irresponsible behavior that compromise several institutions and may result in critical systemic risk.

Lessons from the 2008 crisis

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- ✓ Countries less affected by the international financial crisis, in general, presented some or all of the following characteristics:
  - ✓ **A well-regulated financial system;**
  - ✓ **Strong public banks;**
  - ✓ **A large domestic market; and**
  - ✓ **Proactive public policies**.

The moment the economy recovered, the State's efforts were fundamental

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✓ Several countries adopted proactive policies with direct intervention from the State to offset the effects of the crisis on the private market

Tax Incentive and Support to the Financial System in Selected Economies (% of GDP)

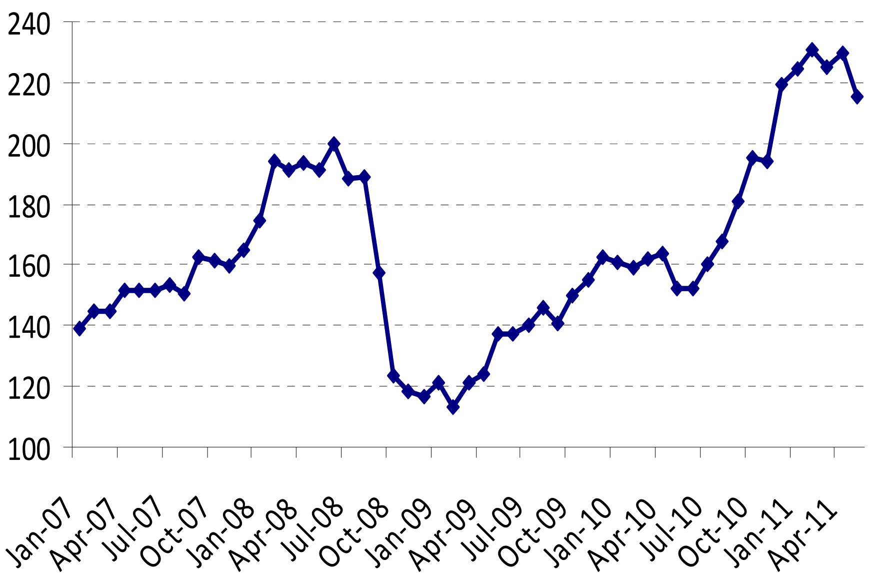
	Tax Incentive	Support to Financial System	Years to spend the tax incentive
Developed Economies	**3.7**	**48.5**	-
France	1.5	19.1	2
Germany	3.6	22.2	2
Japan	4.7	22.3	3
United Kingdom	1.9	81.7	3
United States of America	5.5	81.1	3
Emerging Economies	**4.7**	**2.9**	-
Brazil	5.6	1.5	1
China	6.2	0.5	2
India	1.8	6.4	3
Russian Federation	5.4	8.0	2
Total	**4.0**	**36.1**	-

Source: UNCTAD Trade and Development Report, 2009.

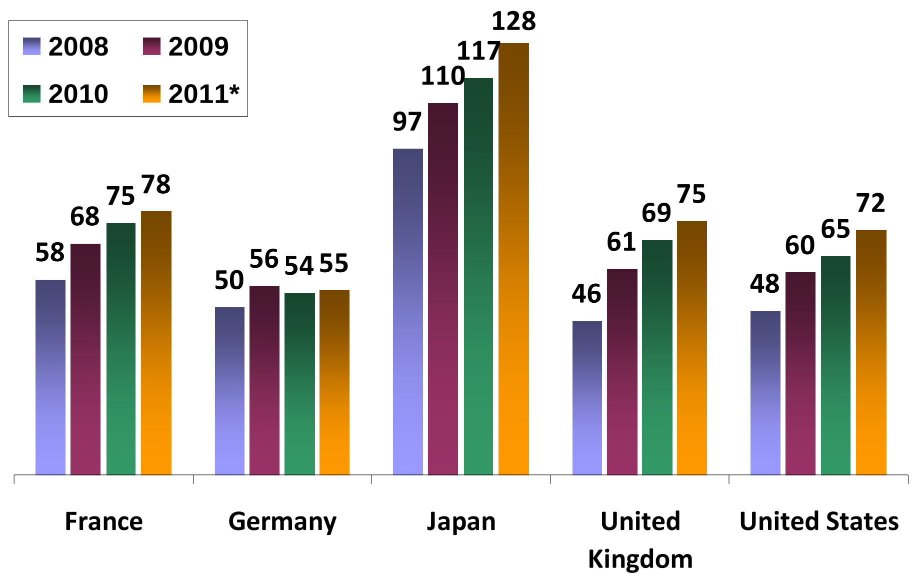
With the return to growth, incentives are being reduced or removed

✓ Now is the time for a gradual removal of incentives, with the guaranteed rise in inflation on a global level and a worsening fiscal situation in some countries.

Commodity Price Index (Base: 2005 = 100)



General Government Net Debt (% GDP)



Source: The Economist and IMF. *forecast

The current scenario has boosted interest rates across the world

- ✓ Within this context, macroprudential measures have gained considerable importance.
  - ✓ Complementing monetary policy in combating inflation;
  - ✓ Possibly reducing the magnitude of the interest rate hikes.
    - ✓ Impact on debt costs and, consequently, on the overall amount, improving the fiscal situation; and
    - ✓ Lower inflows of capital, affecting the exchange rate.
  - ✓ They may directly affect the inflow of speculative capital.

Macroprudential policy

✓Macroprudential policy focuses on the interactions between financial institutions, markets and the wider economy;

✓The purpose is to reduce systemic risk, strengthening the financial system against shocks and helping it to continue functioning stably.

Number of Macroprudential Instruments in a Sample of Developed and Developing Countries

Instrument	Developed economies	Developing economies
Measures targeting credit growth	2	13
Countercyclical Provisioning	1	5
Maturity and Currency Mismatches	1	16

Source: Committee on the Global Financial System, 2010

Macroprudential measures in several countries

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Macroprudential Polices - Selected Economies

	Capital flows	Over-heating	Exchange rate over-valuation	Macroprudential: Domestic	Macroprudential: Currency-related	Macroprudential: Capital-controls
Indonesia	Red	Red	Yellow	✓	✓	
Thailand	Red	Yellow	Red	✓		✓
Brazil	Red	Red	Red	✓	✓	✓
Colombia	Red	Yellow	Yellow	✓	✓	
Malaysia	Red	Green	Green	✓		
Mexico	Red	Green	Yellow	✓		
India	Red	Red	Yellow	✓		
Poland	Red	Yellow	Yellow	✓		
Chile	Yellow	Yellow	Yellow			
Peru	Yellow	Yellow	Yellow	✓	✓	✓
South Africa	Yellow	Yellow	Red			
Hong Kong SAR	Yellow	Yellow	Yellow	✓		
Turkey	Yellow	Green	Red	✓		
China	Yellow	Yellow	Green	✓		
Philippines	Green	Yellow	Yellow			
Israel	Green	Yellow	Yellow	✓		
Romania	Green	Green	Yellow		✓	
Russia	Green	Green	Yellow		✓	✓
Czech Republic	Green	Yellow	Yellow			
Korea	Green	Yellow	Green	✓	✓	
Argentina	Green	Red	Green	✓	✓	
Hungary	Green	Green	Yellow		✓	

Source: IMF. World Economic Outlook April 2011

- ✓For each indicator economies are assigned “traffic lights” based on where they stand relative to other G20 economies.
- ✓Output above the precrisis trend is indicated by a red light. Output less than 95% of the trend is indicated by a green light.An output gap > zero is indicated by a red light. A gap < 2 % is indicated by a green light.
- ✓Gross capital flows over the past year compared with the average during 2000–07. Current flows >150% of the average are assigned a red light; a yellow light denotes flows > 100%.
- ✓Economies with exchange rates higher than warranted by medium-term fundamentals are assigned a red light. Economies with lower-than-warranted exchange rates are assigned a green light.

Measures to control capital aim at preserving the competitiveness of economies

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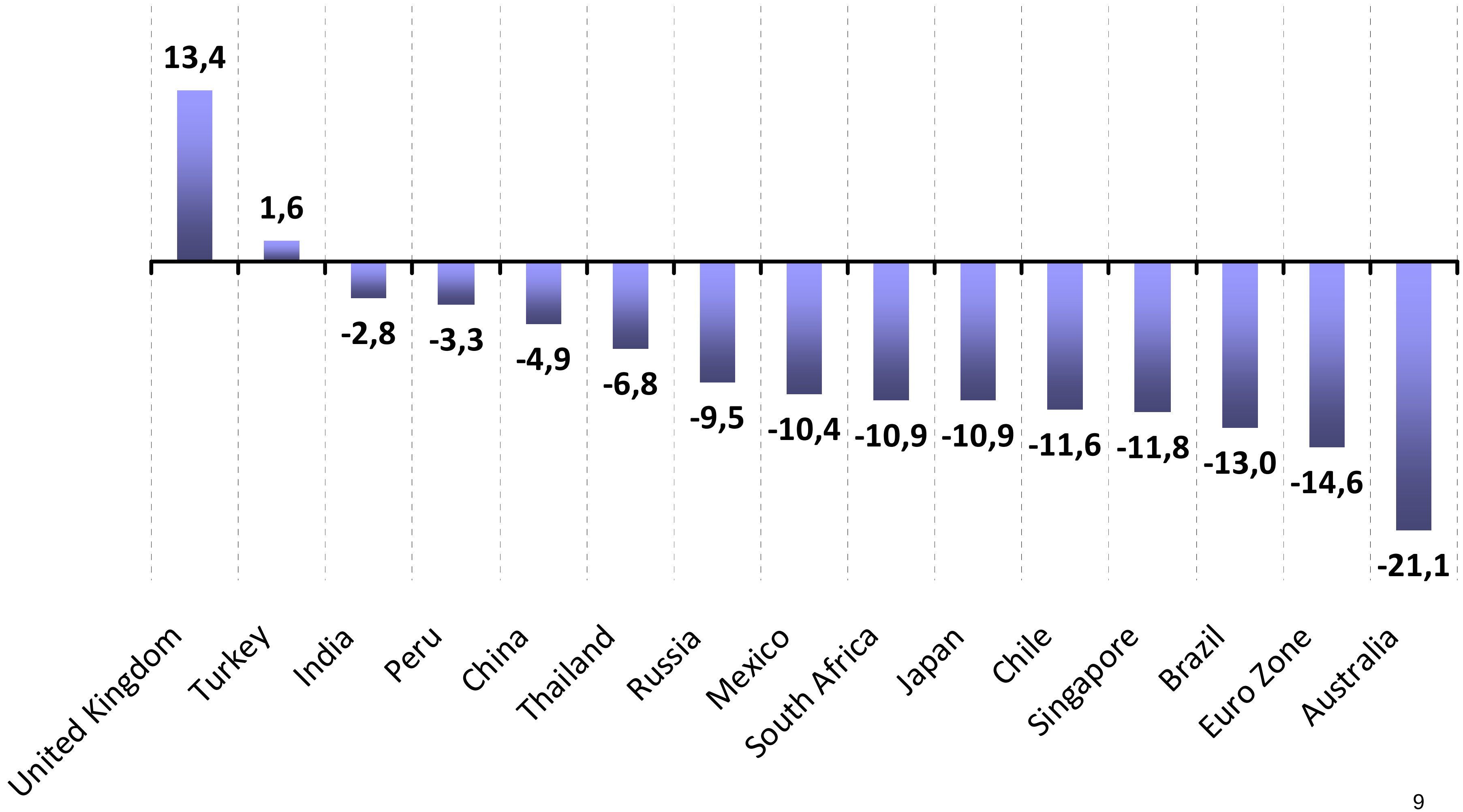
Variation of the dollar against several other currencies



Source: Macrodados.

Constantly perfecting regulation

Basel III: International regulatory framework for banks

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Basel III aims to strengthen regulation, supervision and risk management of the banking sector:

- ✓ improving the banking sector's ability to absorb shocks arising from financial and economic stress;
- ✓ improving risk management and governance;
- ✓ strengthening banks' transparency and disclosures.

The reforms target:

- ✓ bank-level or microprudential regulation, which will help raise the resilience of individual banking institutions in periods of stress;
- ✓ macroprudential, system-wide risks that can build up across the banking sector as well as the pro-cyclical amplification of these risks over time.

The presence of the State in the economy mitigated the harsh effects of the crisis

But the efficiency of measures were heterogeneous/differentiated

Even prior to the crisis, Brazil had efficient regulation of the financial system

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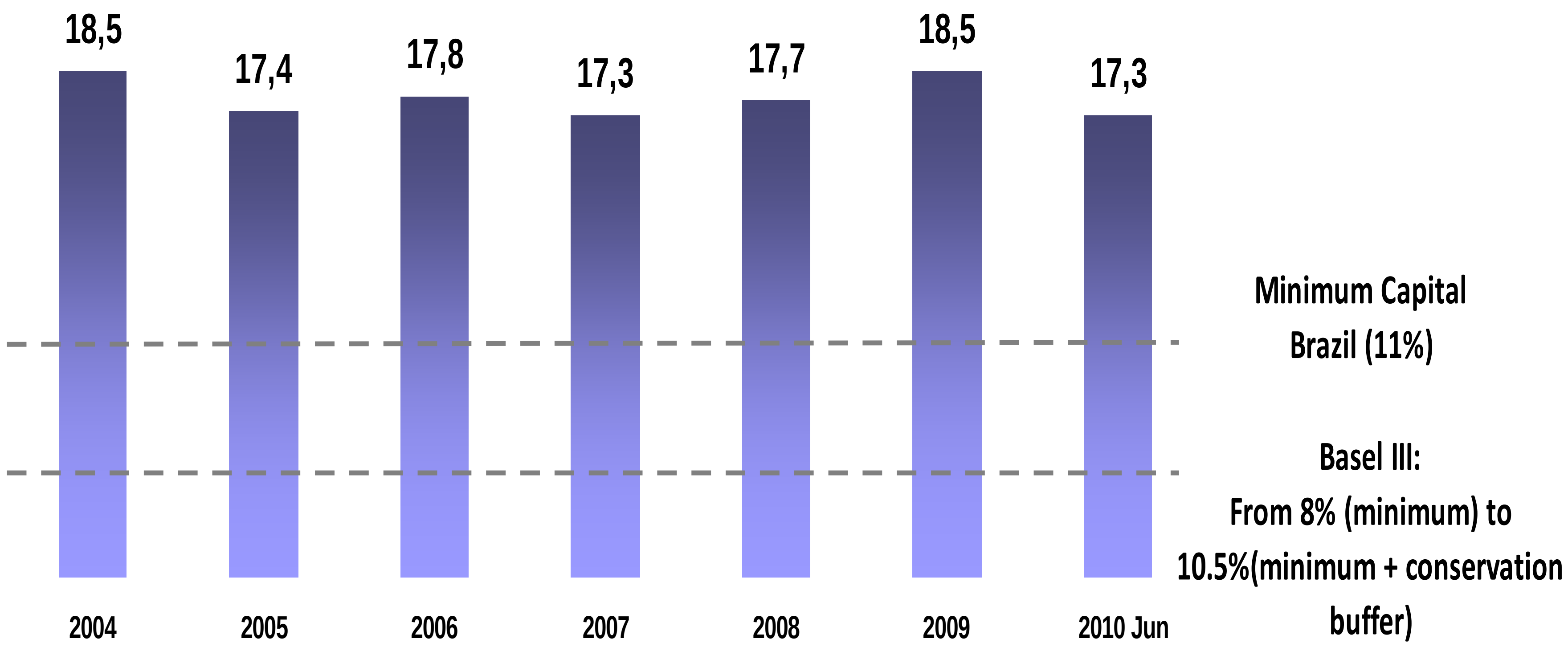
✓ In 2009, Obama launched a plan with several measures to regulate the financial system. Brazil had already adopted the main rules.

More Control over the Financial Market	
Obama's main proposals	**...while in Brasil**
• Create a regulamentory and supervisory council.	• This is the role of the National Monetary Council (CMN).
• Increase the Fed's control.	• Brazil's CB already inspects & regulates.
• Strengthen demand for capital and intelligent regulation.	• The minimum capital of Brazilian banks is 11%, above the 8% required by the BIS.
• Demand registration of hedge, private equity and venture capital funds at the SEC.	• All funds must be registered at the CVM (similar to the US' SEC).
• Strengthen supervision and regulation of securitization.	• Little securitization and the system of subordinate quotas requires the originator of the operation to participate.
• Regulate over-the-counter derivatives market, including credit default swaps (CDS).	• Over-the-counter derivatives are registered on the Stock Exchange in Brazil.
• Strengthen supervision of payment systems.	• The Brazilian Payment System has already strengthened supervision.

Source: Newspaper Valor Econômico.

Brazilian banks with low leverage

Relation between capital and assets, adjusted according to risk



Source: Brazilian Central Bank

During the crisis, public banks stood apart in the Brazilian economy

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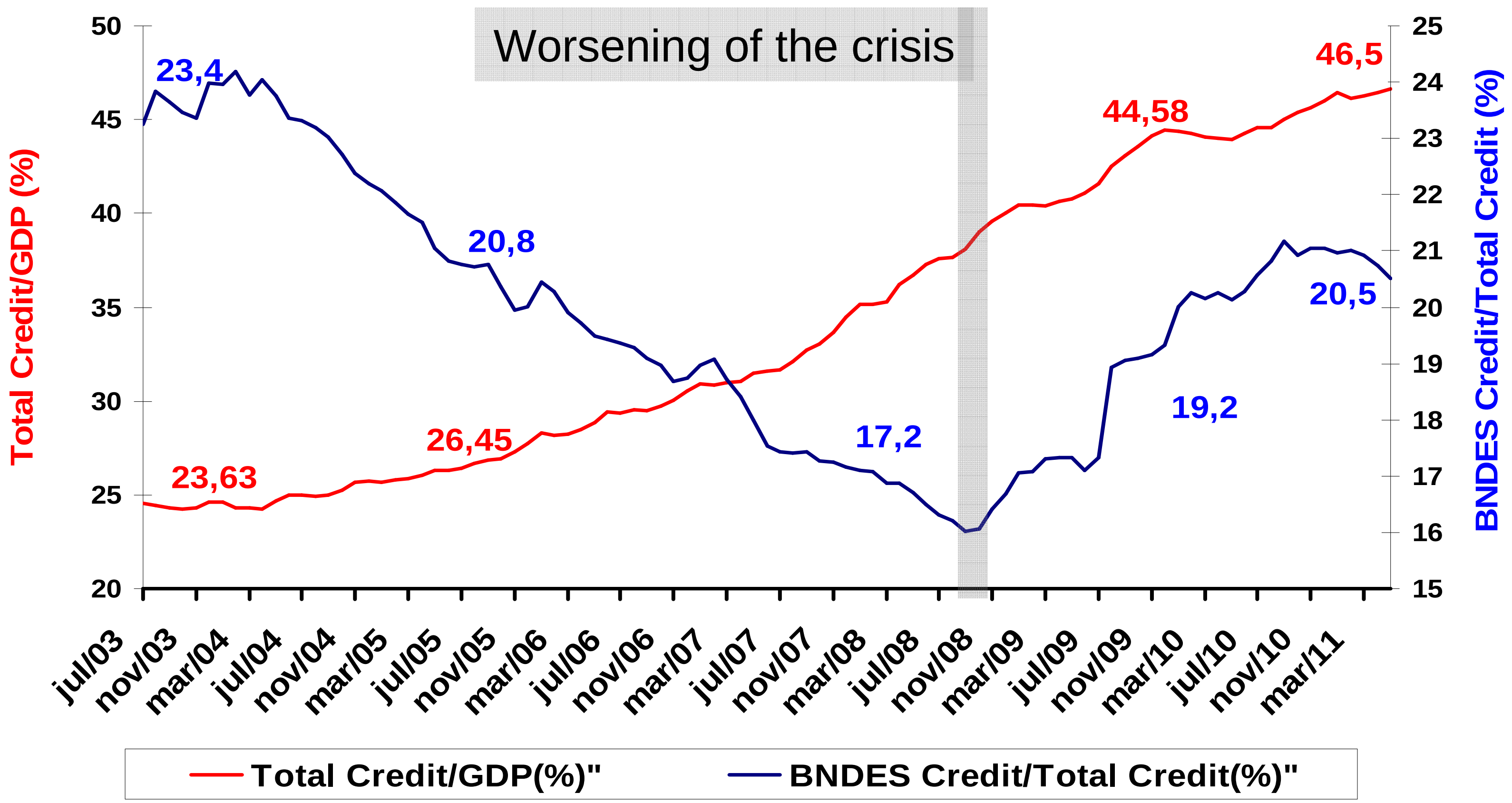
✓ The BNDES operated in an anti-cyclical fashion, preventing the withdrawal of credit from the economy

Total Credit X BNDES Credit



Source: Brazilian Central Bank

BNDES vs. Multilateral Banks

US$ millon	BNDES	IDB	IBRD	CAF	China DB
	Dec 31, 2010	Dec 31, 2010	Jun 30, 2010*	Dec 31, 2010	Dec 31, 2009
Total Assets	329,504	87,217	282,842	18,547	665,168
Shareholders' Equity	39,551	20,960	37,401	5,753	55,471
Net Income	5,950	330	(870)	166	4,673
Loan Disbursements	96,322	10,341	28,854	4,584	92,998
Total Loans	217,006	63,007	120,103	13,873	543,196
Capitalization	12.0%	24.0%	13.2%	30.8%	8.3%
ROA	2.1%	0.4%	-0.3%	1.6%	0.8%
ROE	21.2%	1.6%	-2.3%	3.7%	8.8%
Established	1952	1959	1945	1968	1994

IDB = Inter-American Development Bank

IBRD = The International Bank for Reconstruction and Development (World Bank)
(*) Unlike other institutions, 12-month fiscal year ends June 30th

CAF = Corporación Andina de Fomento
CDB = China Development Bank

Capitalization = Shareholders' Equity / Total Assets
ROA = Return On average Assets
ROE = Return On average Equity

Due to accelerated growth and rising inflation, measures to control credit have been implemented

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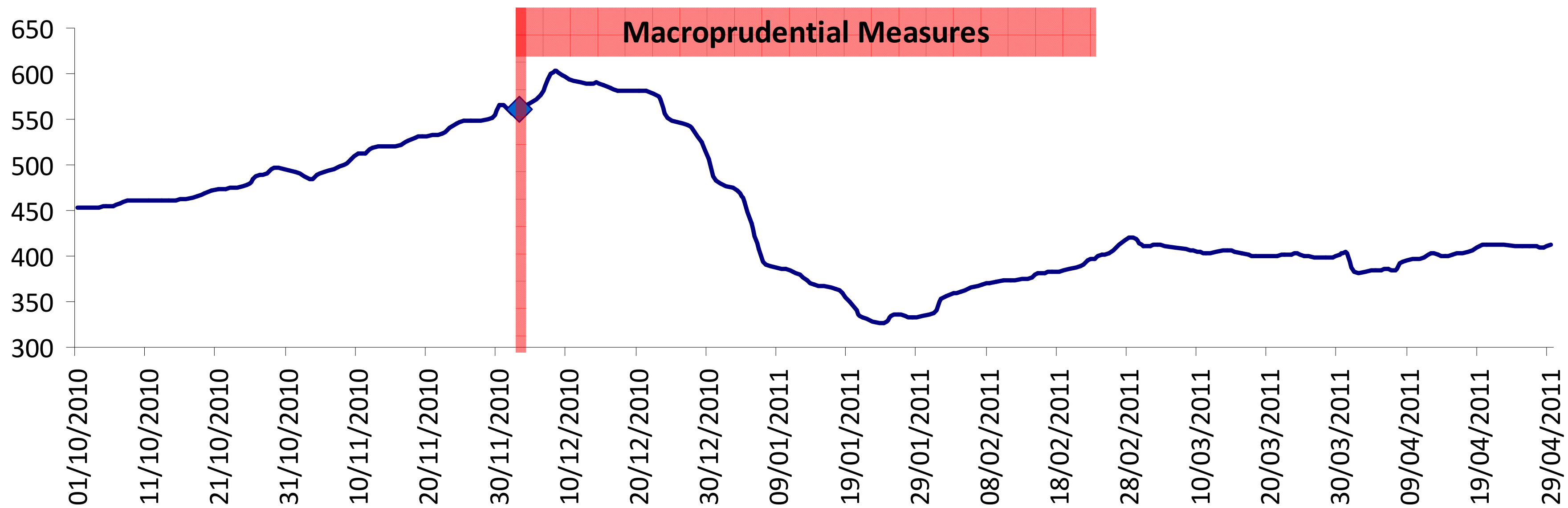
Macroprudential measures in Brazil

- ✓ December 2010: increase in required capital in banks for loans to individuals with terms longer than 24 months and a rise in compulsory deposits.
- ✓ April 2011: increase in tax on financial operations (IOF) for loans to individuals.

Credit to Individuals: Vehicle Loans
(22-day moving average – data in R$ million)



Source: Brazilian Central Bank and APE/BNDES

Challenges to face in the ensuing years

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- ✓ To reach a point of equilibrium in the State's involvement in the economy with regulation and strong institutions;
- ✓ To balance several instruments of economic policy:
  - ✓ Interest rates, macroprudential measures and control of capital
- ✓ Reform of the international monetary system:
  - ✓ Floating exchange rates;
  - ✓ Reduction of exchange rate manipulation;
  - ✓ Less expansive monetary policies combined with fiscal policies.
- ✓ Reform of the international financial system:
  - ✓ Market regulation and decrease in leverage.

Learn from the past

✓The need for effective and comprehensive regulation and strong public institutions that can prevent/avoid bubbles and mitigate any failure in financial markets.

The State should be proactive, without limiting the private sector's efforts

✓Public banks with the capacity to operate in an anti-cyclical fashion as well as provide long-term financing;

✓Occupy the gaps that the private market cannot fill and coordinate efforts of the agents;

✓Long-term planning aimed at maximizing social well-being;

✓Innovate in macro-policy, seeking alternatives with a high benefit/cost ratio.

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