Financial Development

The state and the financial system

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THE VERY DIFFERENT FINANCIAL SYSTEMS of Brazil and China have one thing in common: inadequate development, which is a drag on their economies. In general, access to stronger and more diversified financing instruments is directly related to increased productivity, as they help in efficient allocation of resources and support technological development, making possible higher-risk projects that have longer maturities. Armando Castelar, IBRE researcher, and Zhang Yu, Dagong School of Credit Management of the University of Finance and Economics in Tianjin, believe that for both countries enhancing the diversification of financing tools depends largely upon reducing the role of the state in the financial sector.

Nevertheless, both countries have made progress in building up their financial systems. In Brazil, the last decade has been marked by a significant improvement in the size and quality of the capital market and an explosion in credit from banks, which doubled between 2004 and 2011 as a proportion of GDP. Credit expansion was helped by lower interest rates and bank spreads, and institutional reforms have improved collateral and established mechanisms such as payroll loans and liens on real estate.

Financial systems and GDP

The share of the financial system in GDP, however, remains low compared to fully developed economies. "Financial intermediation is still concentrated in state-owned banks, which account for more than half of bank credit," Castelar said. He indicated that this result is a legacy of practices in the 1960s, which focused on earmarked credit, when the financial system was less developed and still needed government support. He noted that "Another feature we bring from the period of high inflation is that debt maturities are relatively short, [though] today, there have been efforts to develop long-term private debt." After state banks were privatized and other federal banks were restructured after going bankrupt when inflation was brought down in the mid-1990s, Castelar believes that Brazil missed the opportunity to do something more responsible, noting that in the last decade the share of state-owned banks has again gone up.

The National Bank for Economic and Social Development (BNDES) has greatly expanded its lending. Castelar is of the view that the BNDES mission to stimulate job creation and technology-intensive sectors is not reflected in how it allocates subsidized resources; instead, it favors large companies with low credit risk that could obtain financing in the market, which would help reinforce it. Other negative consequences of the predominance of the public sector in the financial system are a capital market that is relatively small for the size of the Brazilian economy, particularly the fixed income market, such as debentures.

In China, the share of the financial system in GDP is much larger than in Brazil, but the state is even more predominant, focused on financing large state-owned companies. Although between 1979 and

1993 the four main institutions—Agricultural Bank of China, Bank of China, Construction Bank of China, and Industrial and Commercial Bank of China—were restructured, they continued to fund state-owned companies. In 1997, the Asian crisis revealed the weaknesses of the financial sector in terms of poor quality of assets and bad loans. In response, the government injected large amounts of capital into its financial institutions to clean bad loans from their balance sheets. Since 2003, the financial restructuring has been followed by, e.g., allowing in as shareholders foreign investors, who introduced not only new capital but also technology. Even with these advances, Zhang observes that in addition to the financial sector preference for lending to state-owned companies, it also discriminates against lending to small and medium companies, explaining that "The distortions in China's financial system cause resource allocation decisions to be based more on political than economic interests."

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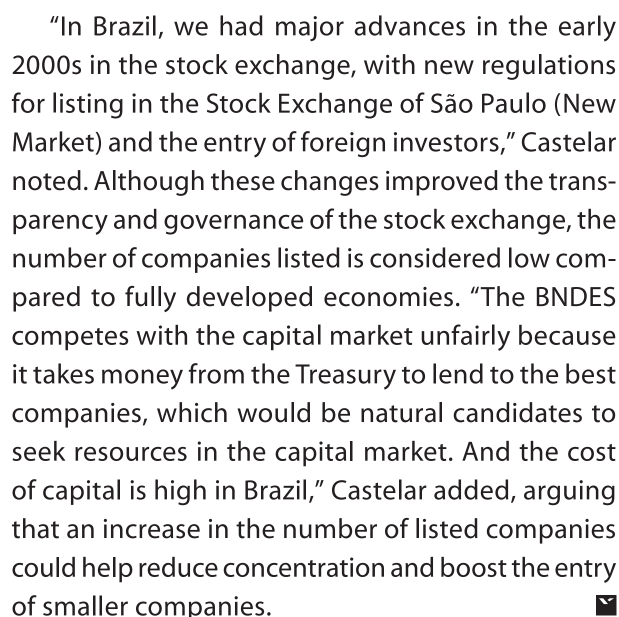
> ***Zhang Yu***

Roberto Dumas, professor, Institute of Education and Research (Insper), who holds a Master's degree in the Chinese economy from Fudan University (China), has pointed out that the choice of banks to concentrate on investing in large projects is also reflected in the interest rates on deposits, which are below inflation; this is known as financial repression. Dumas noted that this feature is mostly negative for an economy that wants to redirect its focus to domestic growth: "It is more difficult to stimulate consumption if banks do not pay interest rates above inflation, penalizing savers to subsidize businesses, even more in the context in which rising workers wages still fall short of productivity and GDP and the exchange rate does not favor income gains."

Credit restrictions and financial repression have stimulated the growth of shadow banking, offering wealth management products (WMP), lending for high-risk projects, and paying higher rates but without legal guarantees. "Today it is estimated that the shadow banks move RMB33 trillion. Added to RMB67 trillion from the official banking system, this represents leverage of about 200% of GDP," Dumas says. "This does not imply a risk that would break the banking system—the country has sufficient reserves and there are controls on movement of private capital [in and out of the country]—but certainly it will have a cost," he says.

Even with a large number of companies listed on the Chinese stock exchanges, about 3,400 in 2010, analysts see a need to improve their operations. Zhang has suggested, for example, that the preference of companies for issuing shares in Shanghai is often motivated by factors unrelated to expansion and productivity, such as fewer restrictions, a weak evaluation system which allows for prioritization of shareholder profits, and greater influence of government action on market fluctuations.



"In Brazil, we had major advances in the early 2000s in the stock exchange, with new regulations for listing in the Stock Exchange of São Paulo (New Market) and the entry of foreign investors," Castelar noted. Although these changes improved the transparency and governance of the stock exchange, the number of companies listed is considered low compared to fully developed economies. "The BNDES competes with the capital market unfairly because it takes money from the Treasury to lend to the best companies, which would be natural candidates to seek resources in the capital market. And the cost of capital is high in Brazil," Castelar added, arguing that an increase in the number of listed companies could help reduce concentration and boost the entry of smaller companies.