Managed Care for Brazil's Banks

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Much of the contemporary focus on financial sector reform in emerging market economies centers on the need to do away with restrictive regulations and eliminate government's presence in the markets themselves. Yet real-world practice is quite varied. Regulations on capital flows and financial instruments differ significantly across even those countries where substantial opening has already taken place. Moreover, while the predominant experience among emerging market economies is toward a lesser role for government in financial markets, the policy path chosen by individual governments to reach this goal has been neither linear nor uniform.

This article explores financial liberalization in Brazil by examining one key aspect of that country's reforms: the reform and opening of the domestic banking sector. Although initial efforts to liberalize trade began in the late eighties and early nineties, a series of economic and political concerns limited the extent of the reform. The biggest impediment to reform was the country's ongoing battle against inflation. The 1994 introduction of the Brazilian economic stabilization program known as the *Real* Plan provided the long-sought-after economic stabilization but did not automatically improve the outlook for the financial sector. Instead, policymakers were forced to initiate a managed restructuring of both the private and public banking sectors to prevent financial institutions from collapsing because of the loss of the generous revenue received from inflation-related activities. By the end of the decade the government had instituted broad banking sector reform and avoided the devastation of a systemic banking crisis.

Understanding the differing structures and constraints of financial markets in emerging market economies like Brazil may provide useful information to U.S. policymakers assessing the international environment. Further, the establishment of safe and sound financial systems in Latin America promotes economic stability in the region, thereby decreasing the chances that a financial crisis there would critically stress U.S. financial institutions.

A discussion of some of the mechanics and policy choices facing government decision makers in opening domestic financial sectors follows, along with an examination of the basic features of Brazil's financial liberalization efforts. Special consideration is given to elements of policy choice in banking sector reform because this review is helpful in understanding how domestic needs and interests interact with capital to determine policy. The final section of the article discusses Brazil's banking sector reform within the context of other important changes and policy objectives taking place in that country.

Policy Choices in Financial Sector Liberalization

Although open capital flows are perhaps the most well known aspect of financial sector liberalization, the process may include several other important changes. Beim and Calomiris define financial liberalization as including a combination of the following elements: "1. Elimination of interest rate controls. 2. Lowering of bank reserve requirements. 3. Reduction of government interference in banks' lending decisions. 4. Privatization of nationalized banks. 5. Introduction of foreign bank competition. 6. Facilitation and encouragement of capital flows" (2001, 119).

Given that the financial sector is composed of several different but overlapping markets, any discussion of financial sector liberalization must address the objective and impact of reforms across markets. Principally, these areas would include the credit market, where banks allocate funds to both individuals and businesses, and the capital market, where institutions broker investment funds through financial instruments such as stocks and bonds. Reforms in the credit and capital markets will have strong spillover into monetary policy as well. Therefore, architects of financial sector liberalization must not only target change in these individual markets but also be attuned to the effects of spillover into other areas, including regulatory issues.[1]

A number of variables may influence decisions to change existing policy orientations or to construct new policies. In many cases, policy changes have been preceded by economic crises or prolonged downturns.

Many countries attempting financial sector liberalization have initially focused on capital account liberalization to facilitate the rapid entry of foreign funds into capital-starved domestic markets. In many instances, painful and costly financial crises have ensued as distortions were introduced into poorly regulated and sometimes fragile systems. In fact, a study by Kaminsky and Reinhart (1999) confirmed that financial liberalization may aggravate or stimulate underlying weaknesses in the banking sector and cause a situation where balance-of-payments problems become banking crises, or vice versa. These experiences demonstrate why policymakers must be attentive to counterbalancing any distortions by sequencing reforms and introducing regulations to promote financial stability. Johnston and Sundararajan (1999) and Eichengreen and Mussa (1998) contain excellent discussions of sequencing reforms and prudential regulation's critical role in preventing a crisis during the opening of the capital account.

A number of variables may influence decisions to change existing policy orientations or to construct new policies. In many cases, policy changes have been preceded by economic crises or prolonged downturns. Even in these situations, the content of the policy may be informed by a range of domestic and international factors. The next section outlines some of the principal decisions and variables facing policymakers weighing financial opening.

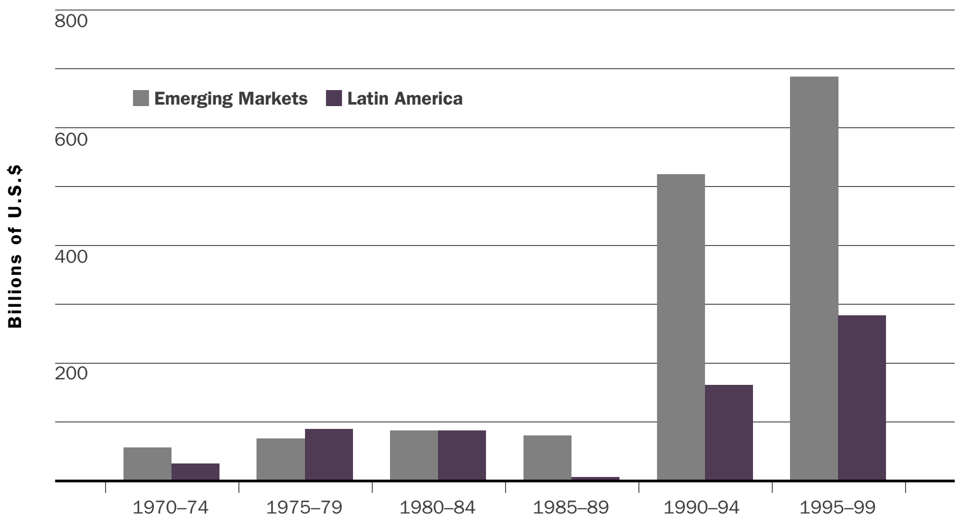
Considerations for Policymakers

Possible Risks. Critics of open capital accounts argue that liberalization exposes domestic financial sectors to a barrage of destabilizing short-term capital flows. As mentioned in the previous section, some countries that have opened their financial borders have experienced severe crises. Another criticism of open capital accounts is that open financial borders harm domestic business interests by exposing them to unfair competition from international firms possessing greater economies of scale and better technologies.

Other considerations may also enter into the decision to maintain protectionist barriers in the real economy or in the financial sector. Elected politicians in both developing and industrialized countries depend on support from a diverse set of constituency groups, and some of these groups might benefit from protectionist barriers or a delay in lowering existing restrictions. Therefore, a decision to establish or maintain some sort of financial barrier (or trade protection) should not necessarily be equated with favoritism or corruption. As noted above, opening sheltered financial markets to global capital can result in unwanted or unintended consequences, and countries in the process of opening need to establish policies that promote liberalization without triggering unnecessary volatility.

Possible Benefits. Proponents of liberalization counter that closed financial sectors are less productive because they do not maximize available resources and are not competitive. Therefore, without capital flows, financial markets are inefficient promoters of domestic development needs. A study by Mathieson and Rojas-Suárez on capital account liberalization offered the following summary: "When accompanied by appropriate macroeconomic and financial policies, a more open capital account may give rise to four efficiency gains: (1) unrestricted capital flows benefit the international economy by facilitating specialization in the production of financial services; (2) capital account convertibility creates dynamic efficiency by introducing competition in the financial industry from abroad and stimulating innovation; (3) if international financial markets

CHART 1
Net Private Capital Flows



Source: International Monetary Fund World Economic Outlook Database <http://www.imf.org/external/pubs/ft/weo/2000/02/data/index.htm>

price the risks and returns inherent in financial claims appropriately, global savings can be allocated to the most productive investments; and (4) for countries with limited access to private external finance, freedom of capital inflows and outflows may facilitate renewed access to international financial markets" (1993, 2).

Variables and Trends. Policymakers' interpretations of how to "operationalize" financial sector liberalization have varied widely. Quinn and Inclán's (1997) multicountry study demonstrated that, even though advanced economies have displayed an overwhelming tendency toward greater financial openness over a span of nearly four decades, these same economies practiced fundamentally different policies in key aspects of the financial system until very recently. Starting in the seventies, Europe's leading economies established universal banking laws effectively allowing firms to operate in a variety of financial markets (Coleman 1996), but the United States only recently began to permit banks to engage in both securities and insurance activities (*Gramm-Leach-Bliley Act* 2000).

Similarly, a survey by Lukauskas and Minushkin (2000) demonstrated the heterogeneous nature of financial liberalization policy among a diverse group of middle-income countries. These economies demonstrated that regulations on capital flows varied by country in regard to both entry and exit rules. Furthermore, the same policies also varied over time within the same country. Another survey found that just over 80 percent of developing countries used some form of restriction on foreign direct investment (Eichengreen and Mussa 1998, 10).

A policymaker's interpretation of the set and order of policies to pursue may be influenced by a number of important economic considerations. Two general trends are notable. The first is the increased movement of capital migrating across borders. This increase in the size and velocity of capital flows has transformed the policy environment. The International Monetary Fund has referred to this phenomenon as "one of the single most profound and far-reaching economic developments of the late twentieth and early twenty-first centuries" (Eichengreen and Mussa 1998, 1).

The volume growth in these flows is clearly demonstrated in Chart 1. Net private capital flows to emerging markets in general rose substantially over the past three decades, increasing from a total of U.S.$130 billion in the seventies to U.S.$1.2 trillion in the nineties. The large increases of the last decade have enticed some emerging market economies to open their capital accounts in an attempt to capture these funds (for example, international savings) and use them for national development purposes.

1. Although banks comprise only one of the subsets of the entire financial sector, banking sector reform has important implications for all financial institutions. Furthermore, banking sector reform is fundamental to financial liberalization. Thus, the terms "banking sector reform" and "financial liberalization" are often used synonymously in this paper.

During the nineties, when total flows were at very high levels, Latin American countries received an average of U.S.$44 billion per year. Regional giants Brazil and Mexico received the lion's share of these funds. At the same time, even though the volume of capital flows to Latin America grew substantially over the past thirty years, the region's share of the total amount has fallen dramatically, from around three-fourths in the seventies to just over one-third in the nineties. This decline is due to the fact that other geographic areas now receive these flows as well.

A second key consideration for policymakers is the changing composition of capital flows and the market outlook for emerging markets as an asset class. Much of the capital inflows to Latin America during the seventies took the form of bank loans. By the nineties, however, direct investment in production facilities and processes and portfolio funds (for example, equities and bonds) dominated private flows. Chart 2 shows the substantial increases in both portfolio and direct investment to Latin America. The chart also demonstrates the more volatile nature of portfolio flows, generally considered more liquid and short-term in duration than direct investment flows.

Opening sheltered financial markets to global capital can result in unwanted or unintended consequences, and countries in the process of opening need to establish policies that promote liberalization without triggering unnecessary volatility.

A corollary to the swings in investment composition is the tendency of investors to lump all emerging markets together as an asset class. This inclination has been especially evident during crisis periods such as the aftermath of Mexico's 1994 peso devaluation and the Asian and Russian economic downturns that began in 1997. During these periods investors tended to view all emerging market economies through a single lens despite fundamental differences in their performances, outlooks, and reform records. Developments such as these crises tend to produce an emerging-market see-saw effect: capital floods in during boom times and flows out rapidly during periods of scarcity. The sharp drop-off in portfolio flows to Latin America after the peso crisis (from U.S.$62 billion in 1994 to only U.S.$3 billion in 1995) illustrates the potential for volatility that policymakers confront when weighing liberalization policies.

Other Factors. The possibility of spillover is another important factor complicating the policymaker's task of defining appropriate policies. Spillover must be considered even within what is traditionally considered the financial sector because it includes an array of markets. Surges of capital inflows or outflows may affect both bonds and equities and have a critical effect on foreign exchange. Banks are not immune from these oscillations because, in addition to competing among each other for deposits and to make loans, they may also buy and sell stocks and bonds and participate in foreign exchange markets. Thus, changes in the investment outlook in one area can have a strong effect in other markets. Similarly, reforms enacted in one area can also have an effect (sometimes unintended) on other parts of the financial sector.

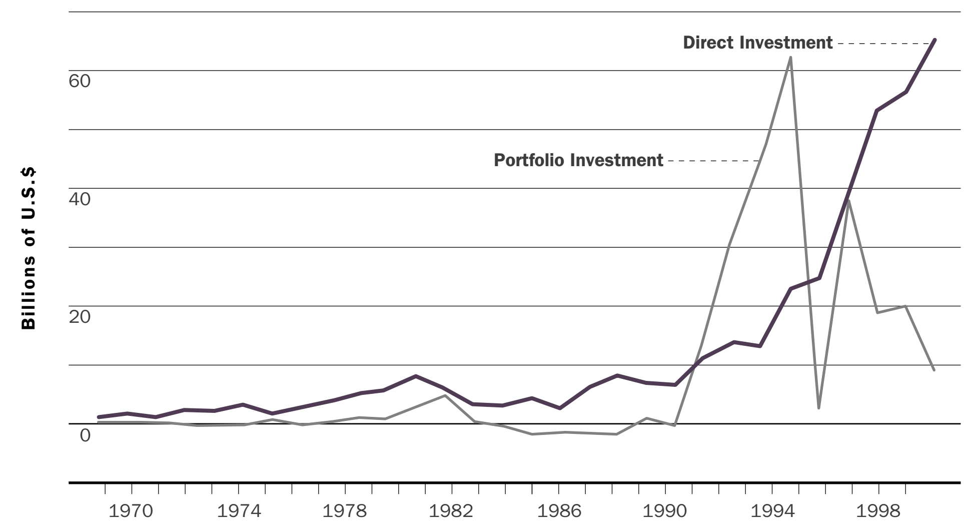
Other country-specific considerations also influence the pace and scope of financial liberalization policymakers choose. Although change exists in every political and economic system, like most developing nations, Latin America has undergone profound political and economic change over the past two decades. Many of the political systems in the region have undergone the transition from military dictatorships to elected, civilian rule during this period. Yet even though a formal system of democracy is now in place in most countries, the new rules of the game often clash with entrenched patterns of elite dominance. In addition, most economies are moving away from a closed, state-run system toward full openness and private ownership in both the financial sector and the real economy. Thus, financial liberalization is not an isolated policy change but a component of the larger processes of socioeconomic change called economic and political liberalization. Some studies have noted a positive relationship between capital flows and democracy as long as flows remain relatively stable (Armijo 1999).

Moreover, the extensive changes in the economic sphere alone may take decades to implement. As Fanelli and Medhora note, "liberalization of financial markets is a process that will develop over a significant period of time . . . because it is almost impossible to make a once-and-for-all announcement and instantly eliminate all the institutional features of financial repression" (1998, 5–6). In this sense, policy-oriented research seeks to understand the process of liberalization more than the outcome per se.

Financial Sector Reforms in Brazil

A review of the major developments in the sector since the formation of a modern financial system in the sixties is helpful in understanding the role of government and private actors in Brazil's economic growth. This review is also helpful in understanding how government policy choices

CHART 2
Latin American Net Private Capital Flows



Source: International Monetary Fund World Economic Outlook Database <http://www.imf.org/external/pubs/ft/weo/2000/02/data/index.htm>

enabled the gradual, managed reform that characterized the country's financial sector liberalization during the nineties.

Early Reforms. During the 1960s Brazil's military leaders laid the foundation of the country's modern financial system with new laws on banking reform, indexation, and capital markets. The 1964 Law of Banking Reform, which established the National Monetary Council as well as the Banco Central do Brasil, also imposed discipline on national currency creation by separating money creation and circulation. Previously, the Banco do Brasil, the federal government's primary fiscal agent, had been in charge of both money creation and management. New legislation on capital markets in 1965 attempted to stimulate credit and capital inflows through the development of the domestic market and new financial instruments. Another hallmark of the military's restructuring of the financial system was the 1964 introduction of indexation, or the practice of revaluing financial assets and liabilities to parallel price increases. Indexation soon became one of the most important facets of the financial system (Gleizer 1995).

These reforms were successful in helping the financial sector and the economy to grow, at least in the short term. Total financial assets grew from 23.6 percent of gross domestic product (GDP) in 1960 to 30.2 percent in 1970. Wholesale price increases fell sharply, rising only 31.3 percent between 1965 and 1970 after having grown 82.9 percent between 1960 and 1964. Nevertheless, even these lower levels of inflation were obstacles to long-term planning, and the economy was ultimately unable to withstand the negative effects of currency volatility, rising inflation, and a disabling shortage of long-term finance capital (Gleizer 1995).

According to Gleizer (1995), the lack of long-term capital was the biggest obstacle facing the military's economic policy in the sixties and seventies. Military reformers envisioned that private investment banks would meet this market need, but the high-inflation environment was a double-edged impediment. Continued high inflation deterred potential borrowers from assuming long-term, indexed liabilities and deterred lenders from taking uncertain, long-range positions. Ultimately, the government had to fill much of this void by using the state-run development banks to lend funds to the private sector to finance the country's development needs.

Credit provided by state-run development banks fostered targeted industries and allowed the military government to promote domestic manufacturing for both consumer and capital goods, facilitating the practice of import-substitution industrialization in Brazil. GDP grew at an average annual rate of 9.8 percent between 1970 and 1974. The impressive growth achieved during this period was offset, however, by rising uncertainties in the financial system.

The decade of the seventies was also the period when financial actors began to move their assets into more liquid instruments and the financial market came to be dominated by short-term repurchase agreements. Individuals and financial institutions profited on these instruments because the repurchase price arranged at the start of the transaction generally was less than inflation (and subsequent monetary correction) during the same period. The share of these nonmonetary financial instruments grew from 38 percent of total financial instruments in 1969 to 66 percent in 1977. This shift caused problems for the sector and ultimately led the central bank to inject liquidity into the banking system and promote bank mergers and acquisitions (Andrezo and Lima 1999, 144–46).

By the end of the seventies the twin problems of rising inflation and increasing fiscal deficits were fully apparent. To keep the economy expanding, the government offered credit lines to the real sector and high-yield bonds to financial investors. Both of these activities resulted in growing public sector deficits. The second oil crisis in 1979 and an already mounting external debt stimulated the government to meet its financing needs in the domestic market. According to Andrezo and Lima, "Internal financing, along with the indexation mechanisms prevalent in the economy, triggered an inflationary process as well as strong [upward] pressure on interest rates" (1999, 147).

Domestic financial institutions continued to be willing buyers of government debt—the volume of which rose dramatically during the early nineties. Banks became "administrators of investment 'funds'" rather than intermediators of credit.

As a result of these factors, inflation began to rise ever more rapidly. Chart 3 shows the evolution of consumer price inflation starting in the early eighties. Inflation rose steadily in the early part of the decade, averaging a monthly increase of just over 8 percent from 1981 to 1985. By the second half of the eighties, however, consumer price increases accelerated to average almost 20 percent per month from 1986 to 1990. Chart 3 also shows that this trend worsened in the nineties before the introduction of the *Real* Plan. Monthly consumer price increases averaged 27 percent between 1990 and June 1994, when the new currency was introduced and inflation began a rapid decelerating trend.

Foreign Bank Involvement. In terms of foreign participation in the banking sector, Brazil was generally closed to new foreign entrants during the 1970s. Nevertheless, the importance of foreign banks increased sharply as the government borrowed from international creditors. Brazilian monetary authorities also began to allow domestic firms, including banks, to borrow directly and indirectly from foreign creditors. The central bank's Resolution 63 allowed banks to withdraw long-term funds from foreign banks and relend those same funds in the domestic market for shorter periods of time. The ratio of foreign bank loans to domestic bank loans grew threefold, from 13.8 percent in 1970 to 40.2 in 1981 (Gleizer 1995, 231). These flows increased the importance of foreign banks and agencies already present in the country. The share of total assets held by foreign banks grew from 1.7 percent in 1964 to 12.6 percent in 1980 (Abreu and Verner 1997, 116).

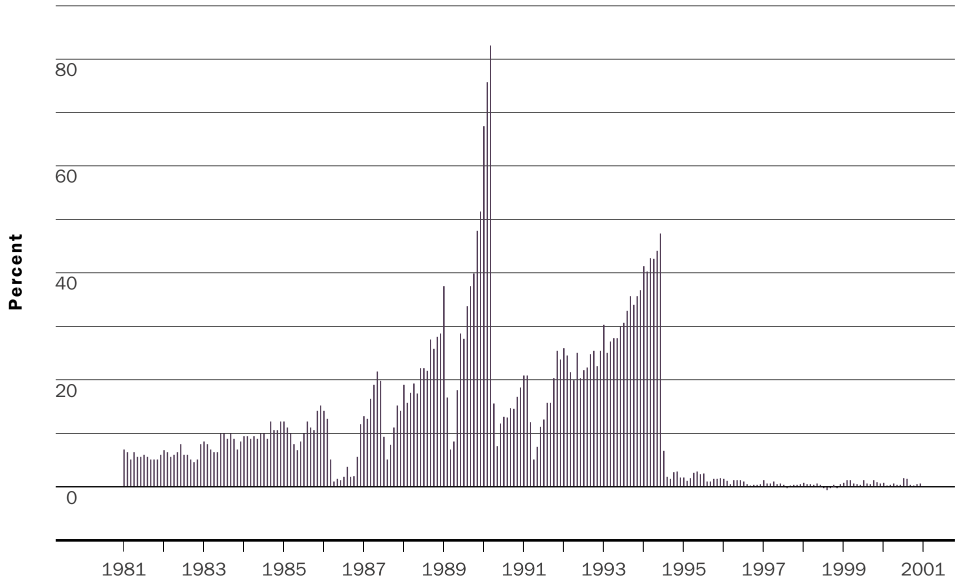
The influence of foreign banks in Brazil changed as international liquidity evaporated in the early eighties. At this point the government was issuing domestic debt in order to pay the interest on the external debt and had virtually ceased its massive public investment programs. These less favorable conditions cost the military government the support it had previously enjoyed from the business community. The military returned power to civilian rule in 1985 during a period of economic decline (Frieden 1991).

Liberalization Efforts. During the late eighties, civilian policymakers began to realize that import substitution industrialization was no longer a viable model for Brazil. Even so, initial efforts to change the policy orientation during the presidential administration of José Sarney in the late 1980s did not formally take hold until 1990 when President Fernando Collor took office. At that point both the pace and scope of commercial sector reforms accelerated sharply. Although Collor had campaigned on a populist platform, he introduced a rapid timetable of tariff reduction that significantly reduced the average tariff from 32.2 percent in 1990 to 14.2 percent in 1994 (McQuerry 1995).

In the financial sector, similarly, the initial liberalization efforts started in 1988 when Brazil freed interest rates on deposits and loans, but efforts proceeded much more slowly than in the trading sector. As discussed below, further efforts to reform the financial sector were rather timid until the *Real* Plan (see the box on page 34), introduced in 1994, began to fundamentally reshape the nation's economic and financial landscape by dramatically lowering the country's chronic inflation.

Any attempt to enact further reform would likely have been futile given that the problems produced by Brazil's chronic and rising inflation eclipsed all economic developments. As previously demonstrated in Chart 3, inflation remained at chronic levels in the

CHART 3
Monthly Consumer Price Inflation (1981–2000)



Source: Instituto Brasileiro de Geografia e Estatística <http://www.ibge.net>

late eighties and first half of the nineties despite repeated efforts to combat price increases.

Furthermore, failed reform ran the risk of triggering a systemic financial crisis, sending the economy into a more rapid cascade of deterioration. Instead, domestic financial institutions continued to be willing buyers of government debt—the volume of which rose dramatically during the early nineties. Yields on this debt rose with Brazil's sovereign risk. Investors increasingly demanded shorter-term paper with fixed yields. As a result, banks became "administrators of investment 'funds'" rather than intermediators of credit (Andrezo and Lima 1999, 202).

Political factors may also have promoted the delay in broader liberalization. The rapid opening of the real economy was widely protested by important segments of the private sector as well as by many politicians and the general public (McQuerry 1995; Kingstone 1999). Other factors may also have clouded the short-term viability of a broader external opening. In March 1990, President Collor angered banks and account holders when he froze bank accounts as a component of his anti-inflation program, and his 1992 resignation and subsequent impeachment ensured that policymakers were more focused on concerns of succession and rebuilding than economic liberalization policies.[2]

The banking sector was not a vocal proponent of liberalization either. Financial institutions had little incentive to reform the system because the high interest rates paid by government bonds ensured a continuing revenue stream even when lending and other financial instruments were not profitable. This situation gave the financial sector considerable clout because authorities could raise funds domestically, where maturities were longer and market access was guaranteed.

During the early 1990s the banks remained highly profitable by playing the float and using customer funds held in the banks as investment capital. These transactions were profitable for the banks because the customers' checking accounts paid a rate less than inflation to the account holders, but the banks were able to apply these same funds in short-term accounts, generally bonds, paying interest rates that far exceeded inflation. The gains on

2. The comparative review of financial opening in Argentina, Brazil, and Mexico by Penido and Prates (2000) characterized Brazil's liberalization efforts in the 1990s as "less intense" than those of the other two countries. Brazil's liberalization also differed in its approach to regulations on the use of foreign currency in the domestic money supply, purchase of domestic bonds by foreign nationals, and access to domestic equity markets. The prohibition on bank accounts with U.S. dollar deposits and relatively few allowances for dollar transactions in the financial system continues to set Brazil's liberalization apart from the next two largest Latin American economies.

BOX

The *Real* Plan, or the Program of Economic Stabilization

The July 1, 1994, introduction of the *real*, Brazil's new currency, was the final step in a three-stage process designed to permanently stabilize the national economy and bring an end to the country's chronically high inflation. The three steps were

1. rationalization of government accounts by reducing expenses and increasing federal tax receipts (spiraling government expenditure was considered the primary cause of chronically rising inflation), along with a series of other measures including restructuring public sector banks;
2. creation of a stable standard of value for monetary transactions (called the URV) to supplement inflation as the basis for economic contracts; and
3. dissemination of this standard of value as a new national currency called the *real*.

Source: Brazilian Ministry of Finance

these transactions are often referred to as inflation transfers or inflation revenue. Revenue estimates for the float were around 4 percent of GDP in each of the years between 1990 and 1993. Float income is estimated to have averaged 38.5 percent of the banks' output during the same period (Mendonça de Barros and Almeida 1997, 3–4). Inflation had other benefits for the banks as well. Baer and Nazmi (2000) note that chronic price increases promoted solvency by reducing the real value of debts, and the increase in the money supply injected liquidity into the system, helping borrowers repay their loans.

The types of bonds purchased by the financial sector evolved along with the economic situation. Table 1 demonstrates the changing composition and growth of government bond issues. In 1993, the last full year before the *Real* Plan was implemented, 42.1 percent of bonds were indexed to the inflation rate at the time of maturity. As inflation began to drop dramatically, other instruments were substituted in order to attract buyers for government bonds.

For the financial institutions, one of the more interesting trends has been the return on bonds linked to the overnight interest rate (SELIC). Whereas high inflation had previously stimulated the issuance of these bonds, the stimulus now was the government's growing fiscal deficit. As Table 1 shows, the share of bonds linked to the SELIC rate more than doubled to 37.8 percent of all bonds in the twelve-month period from 1994 through 1995. That share fell sharply in 1996 before picking up again in 1997 as concerns heated up over Brazil's fiscal situation, and problems in developing Asia pressured other emerging market economies. By year-end 1998, just before the January 1999 currency devaluation, the share of bonds linked to the overnight interest rate had risen to nearly 70 percent. Thus, financial institutions have had a strong incentive to participate in the financial markets and have reaped generous profits even after inflation was stabilized.[3]

A notable consequence of low inflation in Brazil has been the growth in public debt issuance. No longer able to curb deficits by printing money, the government sold bonds to meet revenue shortfalls. Debt issuance grew more than 1,000 percent in 1994—the year the *Real* Plan was instituted. Although the growth rate was not nearly as steep in the following years, debt issuance grew steadily between 1995 and 2000 (see Chart 4.) Clearly the downward trajectory in Brazil's foreign debt had begun well before, in the late eighties, when the country was shut out of international credit markets. As the *Real* Plan was instituted, however, domestic debt grew rapidly from a sum representing around 19 percent of GDP at the end of 1993 to 30 percent at the end of 1997.

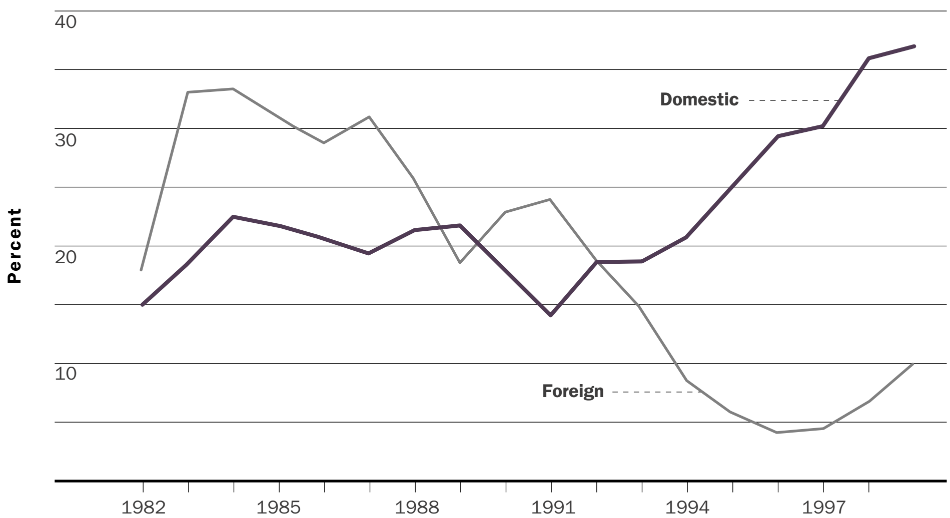
As discussed earlier in this section, banks purchased much of this domestic debt. These high-yield, relatively liquid instruments were good business for the banks. Utilizing the float funds made available during the period between custody and settlement of customer transactions, banks became dependent on these investments. In the five-year period from 1990 through 1994, profits on these inflation-related transactions averaged 35 percent of total bank revenues, reaching as much as 42 percent of total revenues in 1992, a year of particularly high inflation (Baer and Nazmi 2000).

TABLE 1
Government Bond Issues by Type of Indexation (End-of-Year Percentage of All Bonds)

	Inflation Rate	Exchange Rate (Postfixed)	SELIC Interest Rate (Pre- and Postfixed)	Nonindexed (Prefixed)	Balance (In Millions of *Reais*)	Annual Growth Rate of Government Bond Issues (Percent)
1993	42.1	17.3	3.8	26.4	4,988	NA
1994	12.5	8.3	16.0	40.2	61,782	1,138.6
1995	5.3	5.3	37.8	42.7	108,486	75.6
1996	1.8	9.4	18.6	61.0	176,211	62.4
1997	0.3	15.4	34.8	40.9	255,509	45.0
1998	0.3	21.0	69.1	3.5	323,860	26.8
1999	0.3	24.2	61.1	9.2	414,901	28.1
2000	1.6	21.7	52.4	15.3	516,114	24.4

Note: The yield on prefixed bonds is calculated at issuance; the yield on postfixed bonds is calculated at maturity.
Source: Banco Central *Boletim* (various)

CHART 4
Public Sector Debt (As a Percent of GDP)



Source: Banco Central, Dívida Líquida e Necessidade de Financiamento do Setor Público (August 1999) and 1993–99 data from Banco Central *Relatório* 1999 <http://www.bcb.gov.br>

Bank Reform Efforts

Although the factors described above stalled the possibility of banking sector reform, the *Real* Plan had established the preconditions for further financial liberalization. The prohibition of monetary indexation and continued low inflation effectively gave the banks the foundation for renewed economic activity and credit provision. These developments should have positioned the banks to move away from mutual fund management back to their traditional credit intermediation function.

The impact of stabilization (for example, the taming of inflation) and the end of wholesale profiteering on inflation can be seen in the decline of the banking sector's contribution to domestic output in Brazil. During the early nineties, the banking sector was responsible for a significant share of economic activity in Brazil. Table 2 demonstrates this importance for

3. Financial institutions were so heavily hedged in the period leading up to the devaluation that the sector reported record profits in 1999 (EIU 2000a).

TABLE 2
Brazilian Bank Output (As a Percentage of GDP)

	Private Banks	Public Banks	Total for All Financial Institutions
1990	4.6	8.1	12.8
1991	4.3	6.2	10.5
1992	5.9	6.2	12.1
1993	8.5	5.9	15.6
1994	6.9	4.6	12.4
1995	3.6	3.2	6.9

Source: Mendonça de Barros and Almeida (1997)

both private and public institutions relative to GDP throughout the early nineties and shows the abrupt decline in 1995. After averaging a 12.7 percent share of GDP in the five-year period from 1990 through 1994, the share of domestic output produced by all financial institutions plummeted by nearly half, to 6.9 percent, after the *Real* Plan was implemented. The figure has remained in the range of 6 percent of GDP since that time.

The Brazilian government's policies to liberalize the banking sector through privatization and industry restructuring have been carried out largely via two central bank programs and by careful management of the increase in foreign banks entering the sector.[4] The first central bank program involved privately owned banks and was referred to as PROER, or the Program to Support the Restructuring and Strengthening of the National Financial System. The second program targeted reduction and reform of the public-owned banking sector and was called PROES, or the Program of Incentives for the Reduction of States' Participation in Banking Activities.

PROER

President Cardoso enacted PROER by decree in November 1995 in response to Brazil's new low-inflation economic environment and its dramatic implications for the financial sector. While interest rates and the returns banks could earn on financial instruments would fluctuate over the next few years under the *Real* Plan, a general trend downward for both interest rates and inflation was necessary if the *Real* Plan were to be successful. Because financial institutions could no longer maintain profitability that was largely based on inflation-generated gains, the medium-term impact of these trends on the banking sector would be very detrimental unless a profound restructuring were carried out.

The least stable of the banks were already beginning to fail. The central bank took control of over twenty-one banks between the start of the *Real* Plan and the institution of PROER. One of the banks taken over by the central bank was Banco Econômico, which at that time was the country's eighth-largest institution and the fourteenth-largest bank in Latin America. News reports stated Econômico had more than U.S.$1 billion in negative net assets and a reserve shortfall of more than U.S.$3 billion when it was taken over in August 1995. Lacking a federal deposit insurance fund at that time, private banks made an emergency loan to Econômico so that it could guarantee its deposits (Robinson 1995).

The public sector banks, which make up a large segment of Brazil's banking system, were also already showing severe problems. The banks owned by the states of São Paulo and Rio de Janeiro, the two largest state-owned banks, had been under the control of the central bank since the *Real* Plan began. News accounts cited cash flow shortfalls in the billions of *reais* in each of these institutions.

In addition to the problems already evident in the country's banks, the international scenario surrounding the decision to establish a restructuring program was not favorable for Brazil. Mexico's economy was in shambles after the December 1994 devaluation and its banking sector had begun to experience a devastating crisis. At the time there was intense speculation about how badly Mexico's crisis would affect Argentina and Brazil.

This scenario likely influenced the Brazilian Central Bank in determining the PROER guidelines. One government report stated the purpose of the program as no less than preserving "the solvency of the National Financial system by eliminating those institutions that posed a risk to the system" (Banco Central 1997, 50). Thus, even though Brazil had not entered into a systemic banking crisis at that point, it was, arguably, on the cusp of one.[5]

PROER aimed to help private banks clean up their balance sheets and to reduce the number of institutions through mergers and acquisitions. Specifically, the program involved a special central bank credit line to banks in need of liquidity and/or funds for restructuring. As a condition of these loans, the banks pledged collateral (for example, real estate or Brady bonds) valued at 120 percent of the loan. The measures also gave the central bank more control over mergers by requiring that institutions seeking to acquire troubled banks get central bank approval, obtain majority shareholder approval for the purchase of another bank, retire all merger costs within five years, and assume the liabilities of the institution being acquired. In return, eligible banks could receive lines of credit from the central bank to fund bank mergers and acquisitions. A related measure promoted mergers over the establishment of new banks by increasing reserve requirements to 32 percent of total capital for new banks but allowing merged banks to maintain only 8 percent of capital in reserve (Christie 1995).

A series of complementary measures were also decreed in late 1995. These included fiscal incentives for banks to acquire other financial institutions, the establishment of a deposit insurance fund (the Fundo de Garantia de Créditos [FGC]) guaranteeing up to R$20,000 per depositor and disincentives for establishing new banks (for example, increased capital requirements). Separately, new central bank regulations aimed to promote accountability and avoid bailouts by insuring that shareholders of institutions that were sold or transferred were still liable for any previous wrongdoing.

Perhaps the most significant of these new measures was the law giving the central bank authorization to restructure financial institutions that were not meeting system requirements or were demonstrating financial problems. While a form of this law had existed previously and the central bank was authorized to place banks under one of three forms of "special regime" (a temporary system of special administration, intervention, or extrajudicial liquidation), these measures lacked a preventative character. Now the central bank was empowered to prescribe preventative remedies such as increased capitalization, transfer of stockholder control, or mergers and acquisitions for faltering banks, and certain assets of failing banks could now be confiscated (Banco Central 2001b).

These instruments have shrunk the number of institutions in the financial system as a whole and the number of banks.[6] Central bank records show that a total of 135 financial institutions (all types) were intervened in or taken over between November 1995, when PROER began, and year-end 2000. Among these institutions, thirty-three (24 percent) were banks. Overall, sixty-seven (almost half) of the 135 financial institutions were closed. Among the banks, twelve (36 percent) of the thirty-three institutions were closed. The financial institutions that were not closed were either sold or remain in a state of liquidation or presale restructuring (Banco Central 2001d, 2001e).

Financial institutions had little incentive to reform the system because the high interest rates paid by government bonds ensured a continuing revenue stream even when lending and other financial instruments were not profitable.

The number of banks in operation has also fallen during this period. At the end of 1995 there were a total of 233 commercial and multiple banks in operation in Brazil, but the number had fallen to 191 by year-end 2000 (Banco Central 1997, 2001f).

PROES

The Brazilian government expanded its restructuring efforts to include banks owned by state governments in the second half of 1996. By this time the program to restructure private banks had been initiated and the first wave of state banks had been taken over or intervened with by the central bank. Banks belonging to the states of São Paulo (Banespa), Rio de Janeiro (Banerj), Rio Grande do Norte, and Alagoas had been placed under central bank direction at year-end 1994. Three other state-owned banks joined this group by February 1995

4. This section does not discuss the series of prudential regulations put in place during this same period by the central bank. While these reforms are extremely important for sound functioning and growth of the banking sector, the focus here is on the two restructuring programs. See Herculano (1999) for a review of Brazil's progress toward implementing the Basel Agreement on Banking Supervision.
5. Alves, Carvalho, and Studart (2001) note that it is not clear that Brazil was entering a banking crisis of systemic proportions because there was not mass capital flight or a significant drop in the overall level of deposits. Nevertheless, they argue, the question of whether Brazil was about to enter a banking crisis is ultimately unanswerable because the restructuring programs may have prevented an exodus of deposits and capital that otherwise would have ensued as more banks failed without government programs in place.
6. These data include both public and private sector–owned banks.

(Banco Central 2001c). Reports of the alleged problems within some public sector banks were of alarming proportion. Banespa, which was later taken over by federal authorities, was reported to have had a balance-sheet deficit of U.S.$23 billion when the central bank first intervened—a substantially larger amount than the U.S.$10 billion hole in the Bank of Credit and Commerce International (Gall 1996).

As mentioned in the previous section, grave problems in public sector banks became evident soon after the *Real* Plan ended dramatic price increases and stabilized the inflation outlook. In the eighties politically motivated lending and economic volatility had generated problems for some public sector banks, but the nature of the problems was now more severe. Ness (2000) notes that the public banks had always struggled with the conflict between their nature as a business and the political and economic goals assigned to them by government policy.

PROER aimed to help private banks clean up their balance sheets and to reduce the number of institutions through mergers and acquisitions. Specifically, the program involved a special central bank credit line.

In general, state governments had abused their banks as deficit finance vehicles. Many public sector banks had also contracted foreign loans to finance local projects and had issued bonds to meet their financing needs, entailing high debt-servicing costs in local and foreign currency. Previously, excess domestic currency spending had been camouflaged by inflation, government capitalization injections, and inflation-related revenue garnered by these institutions. After the *Real* Plan stabilized the economy, these practices were no longer viable. Further, public sector banks were less adaptable to economic change because they were unable to take advantage of technological advancements and their customer base was limited to cash-strapped public sector entities. Thus, the scope of problems in public sector banks was now quite severe.

The goal of restructuring state banks was to stop using the banks to clean up imprudent fiscal policies and to minimize the size of the public sector involvement in banking. Public banks were even more dependent on float income and inflation transfers than their private sector counterparts, taking in an estimated 63 percent of the inflation income for the whole banking sector; this dependence made the end of high inflation an even harsher awakening for these institutions. Mendonça de Barros and Almeida argue that the loss of inflation income hurt the public banks more than the private banks given that that public banks had been in decline well before the *Real* Plan was initiated and were unable to introduce competitive gains (1997, 9).

In cleaning up state banks the government hoped to improve the fiscal performance of the entire public sector. According to the central bank, PROES "was designed to hold back states' presence in banking activity as a means to curb credit extension to states and municipalities" (Banco Central 2000a, 1). This step was necessary not only to reduce the public sector presence in banking but also because the liabilities of state and municipal banks were, ultimately, sovereign liabilities. Accordingly, state- and municipal-owned financial institutions were prohibited from making new loans to their governments.

Brazilian authorities motivated the states to give up their banks by financing 100 percent of debts owned by these banks at very reasonable interest rates and terms of repayment. In order to get these terms, the banks agreed not to issue bonds until 2010. Additionally, the states could chose from five options for the future disposition of the institutions: "restructure balance sheets of the banks, transfer ownership control to the Federal government, sell to the private sector, transform banks into nonfinancial development agencies, or cease banks' operations" (Banco Central 2000a, 1). In exchanging their impaired assets for central government bonds, the banks' state owners rolled the costs of these bonds into their existing debts to the federal government.

PROES was successful in reducing the presence of state banks in the financial system both in terms of balance sheets and in the number of institutions in operation. At year-end 1995, just before the program began, banks owned by states and municipalities comprised 18 percent of system assets and liabilities. The presence of these banks was reduced to around 8 percent of both system assets and liabilities by the end of 1997. At year-end 1999, the share was further reduced to around 5 percent of both system assets and liabilities (IMF 2001, 173).

By early 1998 all forty-five state-owned financial institutions had been reviewed with the following outcomes: ten banks were liquidated, seven banks had been or were scheduled to be cleaned up and privatized by the states, six banks had been or were scheduled to be cleaned up and privatized by the federal government, five banks underwent restructuring and renewed normal operations, and fourteen banks were transformed into state development agencies. The remaining three banks did not take advantage of PROES and restructured on their own (Banco Central 2000a, 3).

Political wrangling and juridical disputes repeatedly delayed the privatization of Banespa, the largest of the state-owned banks. The institution's sheer size and checkered history ensured that its privatization received considerable attention by bank analysts and the news media. Although Banespa had been plagued by mismanagement and abused for political purposes, it was nevertheless a giant bank with an asset base of nearly U.S.$15 billion and a 573-branch network in the country's most affluent state. These attributes made the acquisition attractive to both foreign and domestic firms. A controlling share of Banespa was sold to the Spanish banking conglomerate Santander in November 2000 for R$7.05 billion (U.S.$3.59 billion), an amount 281 percent above the minimum bid (Dow Jones 2000).

The huge premium and the increased presence of a major international bank in Brazil in many ways vindicated the federal government's efforts to restructure Banespa into a salable asset. Nevertheless, there were high costs for the government as it waged a complicated and combative five-year struggle to restructure the bank. One unofficial report estimated that the federal government's restructuring of Banespa cost around R$55 billion, more than seven times what it brought at auction (*Jornal do Commercio* 2000).

Finally, it is important to note that financial institutions owned by the federal government were not included in PROES—only state-owned banks. While federal banks suffer many of the same difficulties as state-owned banks, these institutions have an advantage: they can rely on the central government for necessary funding shortfalls. Indeed, the Banco do Brasil, which is the largest federal bank as well as the nation's largest bank, was recapitalized in 1996 (Ness 2000). Further capitalizations will be costly, however, requiring the federal government to take these funds from other areas or to issue additional debt.

To address concerns about the future of this sector, the Brazilian Central Bank commissioned an external study. The report's main conclusions were that federal banks are an important segment of the banking system and that whatever course is chosen for them will affect the entire sector. At the end of 1999 federal banks held 38 percent of system assets, down only slightly from 40 percent in 1995. The study also pointed out the urgency in beginning to restructure this sector by identifying "a series of deficiencies in the structure and operation of the federal financial institutions, which suggest that they are not efficiently fulfilling the role for which they exist." If these deficiencies are not addressed, they may cause the banks "to lose R$1.3 billion per year in the 2003–05 period." The report did not recommend privatization for these institutions but did suggest that their "commercial" role should no longer be carried out by the state (Booz-Allen and Hamilton—FIPE 2000).

The Role of Foreign Capital

This article has offered various claims to support the argument that Brazil's adoption of banking sector liberalization has been more pragmatic in orientation than it was ideological. The successful implementation of the *Real* Plan meant that the existing banking system, with its abundance of banks more engaged in financial investments than traditional banking activities, was no longer viable. The new consensus reached was that the banking system must modernize along with the real economy. Problematic banks must be removed in order to reduce the potential for systemic crises. Both the PROER and PROES programs shared this fundamental characteristic.

The goal of restructuring public sector banks was to stop using the banks to clean up imprudent fiscal policies and to minimize the size of the public sector involvement in banking.

The increased foreign bank presence testifies to the banking reform's pragmatic nature. While the government certainly solicited domestic private capital for new investment in the banking sector, domestic capital was in a somewhat uncertain state in that during the last half of the nineties it was undergoing a series of adjustments to adapt to the country's new economic reality. Domestic capital did purchase several of the privatized banks and is likely to play a critical role in further changes to banking sector composition.

From the perspective of systemic risk reduction, however, domestic institutions have two important limitations. First, foreign banks generally utilize more advanced technology than do domestic banks in developing countries. When foreign banking capital enters emerging market economies, domestic banks tend to respond to these demands by introducing the same techniques. If foreign banks do not invest in Brazil, then domestic banks have reduced incentives to modernize. The top handful of private, domestic banks in Brazil already have many of these advantages, but the remainder do not. The second and more salient limitation of the use of only domestic capital is that the Brazilian Central Bank continues to serve as the lender of last resort for national banks. Foreign banks, on the other hand, receive this service from their respective home country regulators, thus reducing Brazilian domestic liabilities while simultaneously improving system soundness.

Despite the pragmatic necessity of introducing greater foreign capital into the Brazilian financial system, the role of foreign capital in Brazil's policy has been both confusing and intriguing. The confusion centers on the fact that the country's policy seems to be simultaneously for and against greater foreign participation. Overall, foreign capital has long been an important part of the Brazilian economy, even during the military regime. Prior to 1971, foreign banks were allowed to enter Brazil without restrictions, but limits were placed on foreign capital participation from 1971 to 1988. Even so, new foreign capital entered Brazil during this period within these limits (Arraes 2000).

The role of foreign capital in Brazil's policy has been both confusing and intriguing. The confusion centers on the fact that the country's policy seems to be simultaneously for and against greater foreign participation.

Legal changes enshrined in the 1988 constitution seemingly resolved any discussion on foreign banks; lawmakers included a temporary act (Article 52) prohibiting new foreign banks from starting until new, comprehensive financial sector legislation could be prepared. However, this same temporary act contradicted that ban by allowing foreign capital to enter the system through "authorizations resulting from international agreements" (*CFRB* 1988).

In 1996, soon after PROER was initiated, the administration of President Cardoso provided some clarification to its own policy intent by affirming that greater foreign participation in the financial system was in the nation's best interests because it would allow for the utilization of foreign savings, the introduction of new technologies, and increased efficiency (Banco Central 1997). Several times over the next few years President Cardoso used the "international agreements" clause of the constitution to allow new and greater foreign banking operations in Brazil.

Although the constitutional prohibition on foreign capital is a hallmark indicator that Brazil's financial system lacks a fundamental element of liberalization, the international agreement clause in the 1988 constitution has also proved to be a powerful tool to influence the direction of the financial system. Implemented as a guiding hand, this policy allows the central bank to encourage foreign banks to purchase public bank assets instead of using other avenues of entry such as chartering a new bank or acquiring a private bank. Another instance of this guidance was the closing of the retail banking market to expansion by foreign banks and to the entrance of new foreign institutions until all the state-owned banks could be sold (EIU 2000b).

As Table 3 shows, assets held by foreign-controlled banks in Brazil remain at low levels compared to those in other developing countries. Although the share of foreign-controlled banks in Brazil's banking system doubled to 17 percent in the five-year period after the restructuring programs were implemented, this share is less than half the levels in Argentina (49 percent), Chile (54 percent), and Venezuela (42 percent). In this survey, only Korea, Malaysia, Thailand, and Turkey have a lower percentage of foreign-controlled assets (Mathieson and Schinasi 2000).

The continued large role played by public sector banks in Brazil will limit growth of foreign bank participation. In mid-2000, 49 percent of assets in the top fifty banks in Brazil were held by public sector banks (federal and state-owned). Brazilian private entities controlled 22 percent of the remaining system with the other 29 percent held by banks with foreign control or foreign participation (Banco Central 2000b).

Political constituencies also influenced the content and scope of policy. Interest groups, made powerful by past policies, will naturally seek to resist reforms detrimental to their well-being, even if their actions postpone policy change only temporarily. The development of both the private and public banking sector in Brazil was characterized by what Makler calls financial federalism and entailed "encouraging the development and shepherding of sub-national public banks and sub-national private financial conglomerates in exchange for support to achieve national and regional development as well as to strongly establish the country in international markets" (2000, 4).

Thus, if it is to be successful, banking sector liberalization in Brazil must simultaneously seek to dismantle these constituencies and replace them with viable alternative engines of financial sector development. This need may have been one of the motivations behind the decision to reform the private banking sector before starting the public sector reform program even though the state banking sector may generally have been in worse shape than the private banking sector.

TABLE 3
Assets Held by Foreign-Controlled Banks in Brazil (Percentage of Total Assets)

	1994	1999
Czech Republic	5.8	49.3
Hungary	19.8	56.6
Poland	2.1	52.8
Turkey	2.7	1.7
Argentina	17.9	48.6
Brazil	8.4	16.8
Chile	16.3	53.6
Colombia	6.2	17.8
Mexico	1.0	18.8
Peru	6.7	33.4
Venezuela	0.3	41.9
Korea	0.8	4.3
Malaysia	6.8	11.5
Thailand	0.5	5.6

Note: Foreign control is defined as owning 50 percent of total equity. Data are end-of-period.

Source: Mathieson and Schinasi (2000)

The previous sections showed how inflation and the government's need to finance its deficit benefited private banks in Brazil. The analysis by Armijo (1996) demonstrates the way in which inflation-generated revenue promoted a pro-inflation constituency in the financial sector. While Brazilian policymakers likely did not seek to prolong inflation in order to benefit the financial sector, politicians did not have to respond to mass preferences during the period of military tutelage. When the political system fully returned to elected leaders in 1990, mass preferences became much more important. Given that inflation undermines the precarious economic condition of poor and lower-income groups, politicians in Brazil were obliged to increase their own commitments to a low-inflation economy. The fact that banking authorities lacked the institutional means to carry out full-blown banking reform when problems first arose is one indication of the influence exercised by elite groups such as bank owners.

In many regards, Brazil's banking sector liberalization appears to be the outcome of a delicate and sometimes shifting balance between three competing factors: the need to continue promoting national developmental needs within the constraints of fewer government resources, the limitations of existing legal barriers on foreign capital entry into the financial system, and the mitigation of the demands of new and old political constituencies.

Costs and Benefits

A complete evaluation of bank reform policies must also include an economic cost-benefit assessment. While this task is outside the scope of this article, it is clear that the structure of the PROER and PROES programs entailed different levels of cost outlay and long-term liabilities. Under the restructuring program for the private banks, the government incurred direct liabilities through cash loans to financial institutions. These loans must be repaid with interest. In the case of a bank's defaulting on its loan, the outstanding balance (that is, the potential loss) would be offset by what the government could get for the banks' assets pledged as collateral. At the end of 1999 the Brazilian Central Bank reported R$15.7 billion, or approximately U.S.$7.8 billion, in liabilities from PROER (*Gazeta Mercantil* 2000).

The PROES program, on the other hand, did not generally include loans and cash outlays to the state banks because it featured debt-for-bond swaps. The banks exchanged their old, nonperforming state bonds for performing federal bonds. Thus, the federal government did not incur the direct fiscal liabilities that it did with PROER; however, it does have to pay interest on the bonds to the states.

As of August 2000 the face value of bonds already issued was R$55 billion (nearly 6 percent of 1999 GDP). When interest income is considered, the value is R$92 billion. Central bank data show that the bulk (53 percent) of these bond swaps were issued to Banespa, the largest of the state banks (IMF 2001, 167, 169). The takeovers of Banespa and the six other banks by the federal government did involve direct fiscal outlays because the central bank funded the restructuring costs necessary to make the banks attractive to private buyers.

Banking sector reforms also promoted other policy objectives such as attracting greater international investment to Brazil. The *Real* Plan's success in stabilizing the economy brought new credibility to economic policy and made Brazil a much more attractive destination for foreign investment. The country's privatization program, which had begun in the early 1990s, gained new impetus after the *Real* Plan was instituted, in part because of increased international interest. A notable portion of these inflows was for the purchase of federal or state-owned institutions. At year-end 2000, privatization receipts resulting from the sale of financial institutions totaled close to U.S.$4 billion, representing 14 percent of total federal privatization receipts excluding transferred debts (BNDES 2001). The six privatizations of banks owned and sold directly by the states brought in approximately U.S.$1.5 billion (IMF 2001, 172).

The financial services industry has also fared well as a recipient of foreign direct investment, taking in U.S.$10.8 billion in nonprivatization funds between 1995 and 1999. Financial services' share of foreign direct investment represented 9.3 percent of all such investment during this period and totaled 14 percent of investment channeled to the services sector (Banco Central 2001a).

Another important contribution of the Brazilian government's bank reform policies is that the absence of a systemic banking crisis there has allowed the government to continue focusing on the task of improving fiscal accounts and other economic fundamentals, rather than digging out from a financial system collapse. Other Latin American countries have not enjoyed such a good situation. Mexico suffered a harsh banking crisis after the 1994 peso devaluation.[7] Argentina, Chile, and Uruguay experienced crises in the early eighties. In the nineties Argentina again underwent a profound crisis and restructuring in the banking sector, along with Colombia and Venezuela. Had Brazil suffered a full-blown banking crisis, the gains achieved by the *Real* Plan and economic stability would have been jeopardized. Nevertheless, these reforms were not sufficient to offset structural problems in the real economy or to prevent the January 1999 devaluation.

Finalizing banking sector reforms will be difficult in the absence of a new financial system law that specifies the ground rules and provides a sound legal foundation for the country's financial system.

Conclusion

Ultimately, Brazil's banking reform is rather hard to characterize. The absence of an economic crisis has encouraged gradualism and fashioned a reform that, in many regards, is narrow in scope and slower than in other countries. At the same time, Brazil's reform may also be labeled somewhat radical considering that the new enabling legislation for the financial sector has not yet been written and that the constitution formally limits greater participation by foreign capital in the banking sector.

These contradictions affirm that the government's policy for the banking sector has not yet been fully defined even though reforms have been under way since late 1995. Indeed, further reform will likely be necessary in both the public and private banking sectors. Finalizing any of these reforms will be difficult in the absence of a new financial system law that specifies the ground rules and provides a sound legal foundation for the country's financial system. The reforms implemented in recent years have begun to change Brazil's economic fundamentals and the prospects for the banking system. However, continued fiscal deficits will likely force the government to issue more high-yield bonds, and the presence of international volatility could pressure the central bank to keep interest rates high. Unfortunately, such conditions would shelter banks operating in Brazil from the need to return to the basic functions of supplying credit and could prolong the interregnum between stabilization and revitalization.

7. See McQuerry (1999) for a discussion of Mexican banking sector reform.

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