Banking Cultures of the World

Edited by Leo Schuster

with Contributions
from throughout the World

Fritz Knapp Verlag
Frankfurt am Main

ISBN 3-7819-0580-2

Gestaltung: Service & Agentur, H. Nöbel, Hofheim/Ts
Einband: Gestaltung und Reproduktion Assenmacher-Design, Köln
Foto: Angelika Fertsch-Röver, Frankfurt/Main
Gesamtherstellung: Fuldaer Verlagsanstalt GmbH, Fulda
Printed in Germany

Table of Contents

Banking Cultures of the World

The Art of Living with Inflation: The Brazilian Banking System

BARBARA FRITZ

1. Introduction

Talking of the banking culture in Brazil necessarily entails talking of the culture of inflation. Brazil must be the country that has lived through the longest period of very high inflation without suffering a hyperinflationary breakdown of national production. Equally unique is the fact that the banks of the country were able to achieve high profits, despite the monetary instability and the constant changes in economic policy. In other countries of the Latin American continent a similar economic situation led to huge banking crises.

Brazil is generally regarded as a threshold country (NIC), whose economic structures are marked by a high degree of heterogeneity. In Brazil, a partly rural subsistance economy coexists side by side with a highly-developed and complete industrial structure. The structural problems Brazil has are certainly not to be sought in a shortage of commercial banks and other finance institutions. Brazil is by no means "underbanked" (Hankel), but rather "overbanked", if one considers the finance sector's share of the gross national product.

What makes the Brazilian finance institutions stand out is above all their great ability to adapt to an unstable situation that is constantly undergoing rapid changes. At the same time that the inflation rate rose to four figures, the banking sector was able to increase its profits; the sector was therefore regarded as being to a large extent dependent on inflation. Contrary to all expectations, however, up to now this sector has comfortably survived the stabilization of the economy which has been taking place since 1994.

It is this inflation culture of the Brazilian banks, which in an international comparison of banking systems must count as unique, that is the topic of this article. After a brief description of the structure of the national financial sector, the development of this sector from the beginning of the 1980s will be presented. The third part is dedicated to the business practices of the banks under high inflation, which facilitated the large profits. The fourth and last part of the article exemplifies the adaptation strategies of the commercial banks, dealing with three stabilization programmes which in the short term caused abrupt changes in the macroeconomic situation.

2. The Structure of Brazilian Banking

The structures of the Brazilian finance sector which are still prevalent today chiefly go back to the currency reform that was carried out from 1964 to 1966 by the military government following the coup. The weaknesses of the prevailing financial system up to that time had already come to light all too clearly, when inflation rose drastically from the beginning of the 1960s and a deep recession set in. The "Usury Law" of 1933 was still in effect, however, which prescribed a nominal interest rate cap of 12 %. The consequences of the 100 % currency depreciation were the almost total decline of the credit market and a steep decrease in bank deposits up to the year 1964.

In the course of the reform of the currency and the financial system, far-reaching changes were made. The central bank was founded, though it was not granted independence in financial policy-making or the monopoly on money creation. In the *Conselho da Moeda Nacional,* the decision-making body for financial policy, along with representatives from private enterprise the government representatives were in the majority; the biggest state-owned bank, the *Banco do Brasil,* kept hold of certain rights to money creation. The importance of this and other state-owned banks increased considerably in the following years, since they received the more favourable refinancing terms (cf. Lipkau 1980). During the 1980s and 90s the complicated institutional entaglement between the monetary authorities and fiscal organs was partly unravelled; this is regarded as one of the prerequisites for inflation control. Nevertheless, the independence of the central bank and a strictly two-tier banking system have still not been fully accomplished[1].

With the currency reform of the 1960s the principle of special-purpose banks was introduced, which led in due course to the establishment on the market of a wide variety of institutions; at present there are thus only few all-purpose banks, but a multitude of merchant banks, investment banks, finance companies for consumer credit, savings banks, brokerage and distributions firms for foreign exchange and securities trading, leasing firms, and various others. The obligation to specialize led to the formation of larger conglomerates, which brought together finance institutions of all types under one roof, each with its own independent legal standing, at the centre of which a large merchant bank is generally to be found. At the beginning of the 1990s, the establishment of all-purpose banks became possible again. For this reason, one has been able to observe the gradual disappearance of this fragmented structure over the last few years.

The aim of the past restructuring was the clear division of the lending business into short-term, medium-term and long-term financing. This was supposed to facilitate the channelling of credit into strategic sectors. To make economies of scale possible the government instigated a massive merger scheme in the private banking sector. The consolidated degree of concentration on the Brazilian banking market since the 1970s is ranked as high by the World Bank (World Bank 1991). Around 20 large finance conglomerates, some of which are linked to large industrial complexes through family ownership structures, control 90 % of the market. According to the financial newspaper *Gazeta Mercantil*[2], in 1994 the five largest banks in the country had a 56.8 % share of the finance institutions' total deposits.

The market share of the public banks is relatively high, at 33 % (in relation to the total deposits for 1991). The number of enterprises operating on the Brazilian money, credit and capital markets is now relatively stable. In 1993 Brazil had a total of 233 finance institutions, of which 195 are all-purpose banks and 36 merchant banks. 167 banks are under exclusive Brazilian ownership. 48 institutions have a mixed capital structure, and 18 institutions are completely foreign banks (Conjuntura Econômica, June 1993).

The private business enterprises on the Brazilian domestic market were at no time able to obtain long-term financing in domestic currency from the private Brazilian commercial banks. Even at the time of the so-called "Brazilian economic miracle" – a phase of very high growth between 1968 and 1973 – these banks were not prepared to provide longer-term financing, although by Brazilian standards inflation during this time was very low (see also table 1). Apparently they regarded the risk involved as being too great, in view of the lack of long-term confidence in the debt-paying ability of the Brazilian currency.

From the 1960s onwards, capital investment financing was the business of the state-controlled banks, which were in a position to offer favourable interest rates. (For some sectors these were even lower than the inflation rate.) The second source of financing was foreign exchange loans from the international banks, which took on a central role from the 1970s. The private banks specialized in short-term and medium-term corporate loans (maximum maturity period: two years) and in the financing of real estate loans and consumer credit.

In the course of the 1980s, this type of financing also rapidly lost importance for the banks, due to the rise in inflation. At the same time, the short-term finance operations became increasingly important, whereby the trade in government securities began to dominate more and more. Firms, private persons and banks invested virtually all of their takings and deposits at the so-called "over"[3], in order to avoid losses due to inflation of up to 1 % a day. In phases this was certainly a lucrative business, due to the high real yields of the government debt issues for all transactors who had surplus funds available. The banks therefore tried to obtain a maximum of deposits and then to invest these immediately in government securities. The largest profits were made possible by the delay in transactions, since in this period not only the real yields, but also the borrower's losses due to inflation fell as profit to the banks.

Since the beginning of the 1990s, private Brazilian firms have gradually been gaining access to the international capital markets. These markets had been closed to them during practically the whole of the "lost decade" of the 1980s, due to the Brazilian foreign debt crisis. For some years now, Brazilian commercial banks have been channelling foreign exchange loans, which they have obtained as Eurodollar bonds or the like, to large and solvent companies in Brazil; in the meantime there are now maturity periods of several years as well. This development only affected a limited number of "blue-chip" firms, however, and besides, there was no continuation on the credit market in domestic currency.

Accordingly, the ability of the Brazilian banking specialists in granting credit became lost. The techniques of how to evaluate the creditworthiness of companies in general and to recognize the conditions under which long-term financing should be made available were simply not known any longer. On the other hand, though, Brazilian bankers became internationally sought-after specialists for extremely fast, short-term financial transactions under constantly changing framework conditions.

3. *The Growth of the Banking Sector during the Stagflation since the Onset of the International Debt Crisis*

The share of the financial sector of the Brazilian national income is a large one, compared with that of the industrialized nations and those with a stable currency. For them, a share in the order of 5 % of GDP counts as "normal". In Brazil, the financial sector's share of the GDP fluctuates clearly, and this is apparently dependent on the inflation rate, as is shown in table 1.

Year	Share of the banking sector[1]	Inflation[2]	Year	Share of the banking sector[1]	Inflation[2]
1970	6.4	19.3	1982	11.2	99.7
1971	6.7	19.5	1983	13.8	211.0
1972	6.4	15.8	1984	13.2	223.8
1973	5.6	15.5	1985	13.2	235.1
1974	6.2	34.6	1986	8.4	65.0
1975	6.7	29.4	1987	16.2	415.8
1976	7.3	46.2	1988	16.7	1,037.6
1977	7.5	38.8	1989	26.4	1,782.9
1978	8.3	40.8	1990	13.6	1,476.6
1979	8.1	77.2	1991	8.6	480.2
1980	8.3	110.2	1992	9.8	1,158.0
1981	11.1	95.2	1993	9.7	2,708.6

TABLE 1: *Share of the financial sector of the Brazilian GDP, and annual inflation rate (in percent)*

Sources: Instituto Brasileiro de Geografia e Estatística – IBGE (1994) (IBGE/DPE/DECNA): Contas Consolidadas para a Nação 1980-1993, and Anuário Estatístico do Brasil 1990. 1991 and 1992; FGV/IBRE – Banco de Dados, quoted in Carvalho 1992 and 1995

1) Calculation of the services of the finance sector to factor costs as share of GDP[4].

2) Inflation index used: IGP-DI (general price index)

While in the 1970s the finance sector thus had an average share of 6 to 8 % of the GDP, in the 1980s this proportion rose clearly and continually. In Brazil, as in practically every other Latin American country, this decade was marked by the foreign debt crisis. This reached its peak in the year 1989: the Brazilian finance sector, puffed up by the high inflation, managed to obtain more than a quarter of the national income[5].

The finance sector not only increased its total lendings in the 1980s; at the same time the banks managed to make larger profits during this period. This applies in comparison both with the banks of other Latin American countries that had to struggle against similar stagflation problems (Morris 1990: 32-35), and with Brazilian enterprises outside the banking sector.

It is apparent that the Brazilian banks survived these years of crisis more than comfortably – in contrast to the other enterprises in industry and trade. On the one hand, their profits were greater than those of the other economic sectors throughout almost the whole of this period. On the other hand, the evidence shows that during the years of negligible or even negative growth, on the whole the profits of the non-banks noticeably decreased, while this applied for the banks only to a limited extent.

Year	Finance institutions[1]	Non-banks[2]	Growth of the GDP
1981	20.5	7.5	–4.3
1982	14.7	6.3	0.8
1983	10.7	3.7	–2.9
1984	10.5	6.6	5.4
1985	11.7	5.4	7.8
1986	8.0	8.7	7.5
1987	5.2	2.1	3.5
1988	12.4	4.7	–0.1
1989	15.4	7.0	3.2
1990	9.8	–1.8	–4.4
1991	7.9	...	0.2
1992	9.5	2.2	–0.8

TABLE 2: *Profits of the banks and non-banks, and economic growth in Brazil* (in percent)

Source: Revista Visão, No. 21, May 1992 (quoted in Carvalho 1995), and IBGE.

1) Net profits as percentage of equity capital

2) Large and medium-sized enterprises in the non-banking sector that are listed in the "Quem é Quem na Economica Brasileira" (Who's Who in the Brazilian Economy)

This becomes especially clear if we consider the developments in the 1990s. As table 1 shows, under continuing high inflation the total lending volume of the finance sector decreased, after having peaked in 1989. The profits were also lower than in the preceding years. Compared to the non-banks, however, that had to cope with the gradual loosening of the hitherto very tight import restrictions under negative economic growth, the banks could also count these years as a success.

The excellent performance of the Brazilian banks during the period of time in question becomes all the more extraordinary when the development of the lending volume is considered. As the figure below shows, this decreased considerably during the 1980s, although during the same period Brazil's gross domestic product in real terms increased from US-$ 415 billion to 486 billion.

We can see that the decrease in total bank lending affected above all the field of private enterprise financing. The amount of consumer credit granted rose slightly, while lending to the public sector reached a comparably high level in the middle of the 1980s, and then likewise decreased again, since the State was finding it more and more difficult to meet its repayment obligations.

What this figure does not show is that in addition to the reduction in total lending, a clear shortening of credit periods also occurred. In view of the great insecurity in anticipating the rate of inflation and the direction government economic policy would take, the commercial banks more or less refused to give loans with a credit period of longer than three months; from roughly the middle of the 1980s, this period then counted as long-term lending. On average, the credit periods were considerably shorter, often only a few days[6].

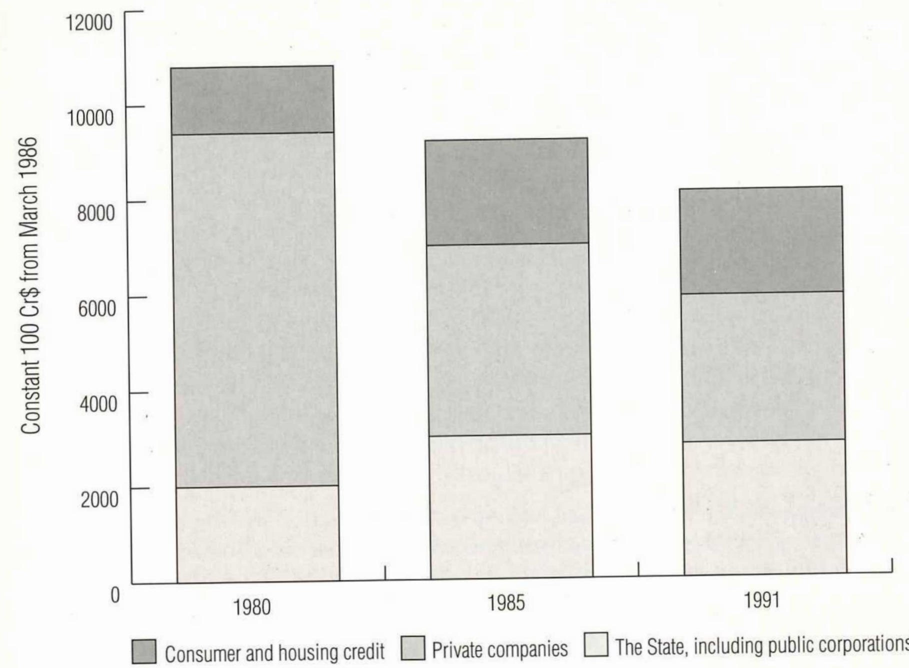

FIGURE 1: *Bank lending in Brazil, according to borrowers*

Source: Banco Central do Brasil, Boletim Mensal, various issues.

4. *Banking Operations with Inflation*

In order to explain the origins of the banks' high profits, some specifics of the Brazilian monetary structure as well as banking practices in the stricter sense of the word during the period of time in question need to be dealt with at this point.

What makes Brazil a striking exception when compared to other Latin American countries is the low degree of dollarization of the national economy. Unlike in the two other big debtor nations, Argentina and Mexico, in Brazil the flight of capital was limited (Meyer/Bastos 1990). The reasons for this can be found firstly in the relatively successful development strategy, which in the course of the import-substituting industrialization since the 1950s led to a highly differentiated and more or less complete industrial sector. Secondly, the virtually continental proportions of the huge Brazilian domestic market aroused, and indeed continue to arouse, expectations of far higher profits than is the case with smaller countries.

However, the particular shaping of the monetary structure played at least as important a part in achieving the low degree of flight from the domestic currency. The indexation[7] of money contracts, which also came under discussion in Europe during the 1970s (cf. Beinsen 1976, Geiger 1974 and others), was introduced in Brazil with the reform of the fiscal system in the 1960s, at first for wages, for public service charges and above all for government debt issues. From the 1980s, due to the rise in inflation, indexation became increasingly widespread, by means of both formal and informal mechanisms, until it had extended to practically all areas of the economy.

The contribution of indexation to both the success and the crisis of the Brazilian development model is indeed exceedingly large[8]. The price for the only limited dollarization which was achieved in this way then had to be paid by the State from the 1980s. By offering index-linked debt issues with extremely short maturity periods, the State at least guaranteed a minimum of security for assets in a currency that was becoming increasingly marked by hyperinflationary tendencies[9]. Government debt servicing was a burden on the government budget and contributed considerably to the budget deficit during the 1980s. Negotiated through complicated connections between the treasury and central bank, this was partly financed through money creation, thus aggravating the inflationary tendencies. The problem of the budget deficit was also compounded by the fact that the State had taken over the largest proportion of Brazilian foreign debts, and in order to service these now had to buy up the foreign exchange of the private exporters or to exchange them for newly-issued and likewise index-linked debt issues.

At the end of the 1980s, Brazil had arrived at a situation in which the State was absolutely the biggest debtor of the nation. Not only the banks but also the private enterprises had net claims on the State; due to the instability of the domestic market and the high interest rates for government bonds it was considerably more attractive and risk-free to speculate with these than to effect real investments.

In the year 1989, which was marked by clear hyperinflationary tendencies and a high degree of political instability, this situation reached its climax; the finance sector had swollen to a quarter of the Brazilian GDP, the banks lived more or less exclusively from the speculation with the high-yield, daily tradable government debt issues.

The Brazilian central bank ensured that the risk of holding government securities was minimised through the institutional organization of the over, the secondary market for the government debt issues. There the issues could be traded daily by the finance institutions, with low transaction costs.

Banking practices under high inflation

A bank can make inflation gains by drawing in funds on which it only partly pays interest, if at all, in a borrowing transaction. For the depositor the real value of the deposits is thus reduced by the inflation rate of the period of time in question. The bank, however, invests the funds so that they bear interest for the whole period – in the case we are examining here, on the short-term market for government debt issues, the so-called over – and thus appropriates not only the real yield, but also the nominal gain that is guaranteed through indexation. These gross inflation gains flow in with the profit from different value dates, which in classical banking business is achieved even under zero inflation in that non-interest-bearing sight deposits yield interest in lending business.

These inflation gains the banks make bear a close resemblance to the so-called inflation tax which the central bank can achieve by excessively increasing the money supply that it itself issues. Inflation gains and inflation taxes together make up the gross inflation transfer from the non-bank sector (households and businesses) to the commercial banks and the central bank.

The extent of inflation-triggered transfer depends on both the rate of inflation and the amount of money supply in circulation. The inflation tax is thus fixed according to M 1, the most restricted money supply with the highest level of liquidity. Pure inflation gains by the banks can only be achieved through sight deposits and by drawing in non-interest-bearing funds from third parties (channelling payments for public services, tax payments and other funds designed to be passed on further); the losses caused by non-interest-bearing minimum deposits with the central bank have to be deducted (Carvalho).

The higher the inflation rate, the more lucrative then was the drawing in of deposits with which short-term speculative gains (pure inflation gains due to cooling periods for interest payments on deposits and profits from different value dates) could be achieved. For this reason, the banks considerably extended their network of branches in tandem with the increase in inflation, and perfected their services to provide protection from inflation losses. The index-linked current account was very widespread at this time, for instance. All deposits that were made before 2 p.m. on any work-day were invested on the over immediately so that they would yield positive interest, even if they were withdrawn again the next day by the depositor.

Table 3 below shows the results of a study by Cysne (Cysne 1994, p.124), which examined the gross inflation transfer of the commercial banks from 1980-92. A study by the World Bank (World Bank 1990, p.4) comes up with similar results for the years 1985-87.

Year	Inflation[1]	IS[2]/GDP[3]	IT[2]/GDP[3]	TT[2]/GDP[3]	IS[4]	IT[4]	TT[4]
1980	110.2	2.46	3.81	6.27	7.86	12.23	20.09
1981	95.2	1.84	2.64	4.48	6.21	8.94	15.15
1982	99.7	1.97	2.49	4.45	6.53	8.29	14.82
1983	211.0	2.58	2.89	5.47	6.35	6.98	13.33
1984	223.8	2.03	2.23	4.26	4.61	5.09	9.70
1985	235.1	2.11	2.45	4.56	4.65	5.19	9.84
1986	65.0	1.34	1.88	3.22	3.71	5.16	8.87
1987	415.8	3.27	3.42	6.69	10.71	11.58	22.29
1988	1,037.6	3.45	3.06	6.50	10.27	9.06	19.33
1989	1,782.9	4.35	2.36	6.70	13.70	7.72	21.42
1990	1,476.6	3.39	1.89	5.28	14.36	7.69	22.06
1991	480.2	3.08	2.11	5.20	9.90	6.62	16.52
1992	1,158.0	2.69	1.90	4.59	8.53	6.01	14.54
mere average 1947-92[5]	85.9	2.26	1.94	4.20	4.11	3.78	7.89

TABLE 3: *Inflation tax (IS), inflation transfer to the commercial banks (IT) and total transfer (TT = IS + IT)*

Source: Fundacão Getúlio Vargas, Projeto Áries, quoted in Cysne (1994).

1) índice Geral de Preços – IGP-DI (Fundacão Getúlio Vargas – FGV)
2) Aggregate money-flows, calculated to the monthly mean
3) GDP at constant US-Dollars from 1987
4) in billion US-Dollars, constant value from 1987
5) From 1947 to 1979 the monetary base of the Banco do Brasil includes sight deposits.

The figures given here should be treated with caution, due to various measurement difficulties. On the one hand they are necessarily based in part on estimations, and on the other hand exclusively gross profits are given here. The net inflation tax, for instance, would probably be considerably lower by a degree corresponding to that by which M 1 was increasingly replaced by index-linked bonds by the transactors, where the State had virtually to raise a negative inflation tax in the form of a higher real rate of interest for its debt issues, by means of which it had to compensate the inflation risks of its currency. This is similarly true for the banks, which possibly had to bear higher transaction costs in order to be able to compete for non-interest-bearing deposits. Nevertheless, the transfers triggered by inflation were very high in the past years, as the figures in the table suggest. In a later newspaper article, the author of this study estimated the inflation gains of the total banking system for the year 1993 to be approximately US$ 9 billion; this would represent around one third of the banks' total profits (Gazeta Mercantil, 15.3.1995). This is heightened by the fact that the redistribution did not only take place simply between banks and non-banks, but took on considerably differing dimensions depending on income, and accordingly on social class. With the rise in inflation the banks did indeed offer ever more ingenious services; however, this was only for larger sums of money, or a high minimum deposit was required. Small savers and low earners only profited marginally, if at all, from such services.

Brazil has an extremely unjust income distribution as it is; around three-quarters of the population live on or below the poverty line and in many cases do not have a bank account. It was precisely this marginalized majority of the population that had to bear the brunt of the inflation losses to a very great extent. These business practices thus led to a regressive distribution of inflation transfer, contributing to the already bad public image of the Brazilian banks, which had a reputation as "speculators" and "exploiters of the poor".

5. *The Performance of the Finance Sector in the Course of the Stabilization Attempts of the 1980s and 1990s*

Until now we have been dealing with the ability of the Brazilian finance institutions to achieve high profits not only in spite of but indeed because of the increasing depreciation of the national currency. Naturally, however, there were attempts made by the Government and monetary authorities to put an end to this monetary breakdown. Since the middle of the 1980s, Brazil has seen some half a dozen more or less spectacular stabilization attempts, all of which have had one thing in common: they were indeed able to bring down inflation abruptly, yet only for a short time in each case. Afterwards the inflation rate rose again to a higher level, as the following graph impressively illustrates[10].

It is these very stabilization programmes, which led to a fall in inflation more or less overnight, that presented the Brazilian banks with great problems; for with the fall in the inflation rate the profits from the inflation business described above fell equally drastically.

"In an economy that is shaped by a high degree of insecurity in the macroeconomic sphere and in which the players can easily make mistakes and misjudgements, the ability to swiftly revise past decisions enjoys a high economic premium" (Carvalho 1995). In this sense the banks have adapted relatively optimally to a situation marked by increasing insecurity and abrupt changes.

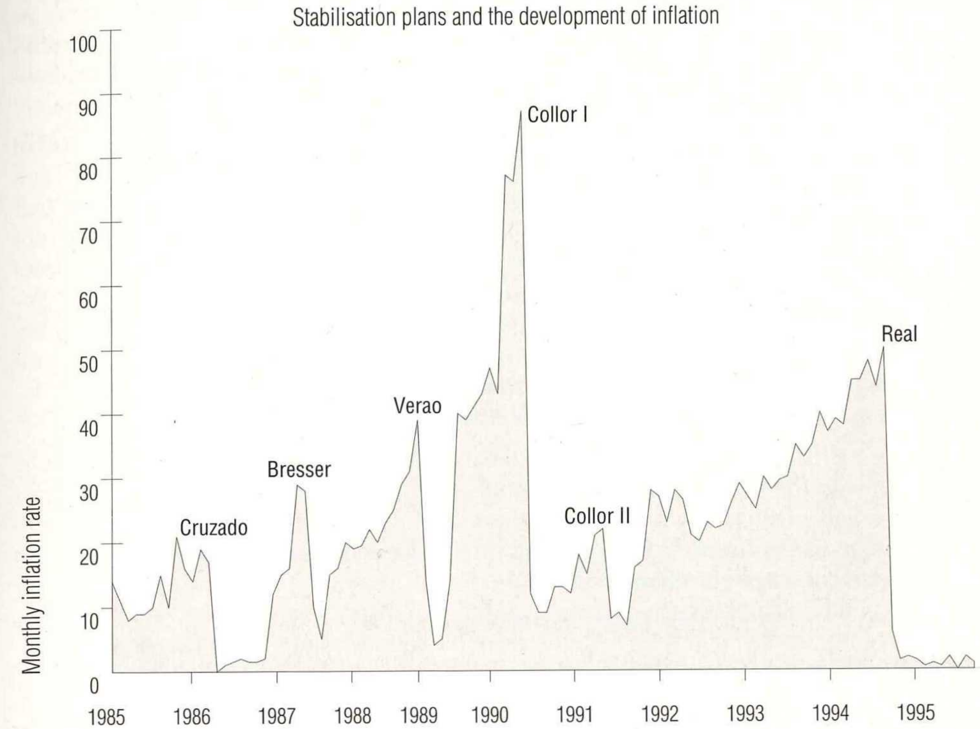

FIGURE 2: *Stabilization programmes and the development of the inflation rate in Brazil 1985-95*

Plano Cruzado (1986): the first shock

This phenomenon could be observed for the first time in 1986. The so-called *Plano Cruzado* was based essentially on a total wage and price freeze, which kept inflation very low for almost a year and additionally led to an enormous boom in consumption. The indexation of wages, public service charges and also government debt issues was abandoned; since the central bank wanted to support the process of remonetarizing the economy, the interest rate was pegged at a very low level[11].

"The money was burning a hole in our pockets," said one banker, reminiscing. The solution lay in the return to classical banking business, the advancing of loans to private customers. Especially consumers, who in view of the low prices could fulfil long-postponed consumption wishes, and also a high number of newly-established small and one-man businesses made use of the credit on offer.

The success of the *Plano Cruzado* was only short-lived, however. The wage and price freeze led swiftly to supply bottlenecks and the formation of black markets; the necessary structural reforms which would have been needed to support long-term stability were not undertaken. The final result was that in the following year, 1987, the central bank had to return to a high interest policy – the boom had ended and inflation rose again. Following this, many of the banks' debtors experienced serious repayment problems. A large proportion of the newly-formed small and one-man businesses were forced into bankruptcy. For the first time in decades the banks had to struggle with the problem of high and doubtful accounts receivable. Accordingly, the profits of the banks in 1987 were the lowest in the whole of the period examined.

The banks reacted to these difficulties with massive dismissals and the reduction of the number of branches: the number of persons employed in the finance sector fell from 993,000 (1985) to 883,000 (1987). In precisely this phase – rising inflation and the bad performance of their debtors- the banks began increasingly to hold government debt issues and to trade in these. While total lendings in the year of the Plano Cruzado were about two-thirds lower than in the previous year due to the low interest and the increased demand for credit, in 1987 they rose to seven times that level (Bulhões 1993: 46). From this point on, the banks were clearly making an effort to draw in a maximum of deposits, since high spreads could be achieved through trading in debt issues, and the short-term risks involved in this business were virtually non-existent.

In order to be able to keep pace with the increasing number of financial transactions that came with the rise in inflation, during this time the automation of banking business developed and electronic data transfer was carried through extensively. The level of technology put to use in Brazilian banks is thus often regarded as being on a par with that in industrialized countries (Bulhões 1993: 47).

Plano Collor (1990): the beginnings of reorientation

The dramatically soaring inflation was temporarily put to an end in 1990 through the so-called *Plano Collor*, Brazil's second significant stabilization attempt. At the core of the shock programme was the freezing of 80 % of all financial investments in Brazilian currency for a period of 18 months. In addition, a one-time tax of 20 % on all credit balances was imposed. The result was a dramatic shortage of liquidity, at least in the early stages. On top of this, the State changed the regulations for the transmission of tax payments and public service charges, which the banks collected on behalf of the government and public corporations; holding these back for a few days or weeks had been a simple source of profit for the banks. Now the float income from these transactions was reduced. What is more, both the direct taxation of the banking sector and the indirect taxation of financial transactions were increased, since in the previous period the profits had risen so distinctly.

By formal and also informal means, the freeze on credit balances was quickly weakened. The big enterprises and banks were apparently able to make restitution of their assets within only a few months, and since the necessary structural reforms did not take place, the inflation rate rose once again. In the end then, the crisis of the banking system due to the almost total draining of liquidity was only short-lived.

However, the moratorium on the internal government debt, which the temporary freezing of credit balances in effect represented, severely shook the confidence of assetholders in the Brazilian State as debtor. Admittedly, with the return to a high interest policy from 1991 the banks were able to achieve substantial profits again through the trade in government bonds, but nevertheless, the risk of a new freeze on the part of the State now seemed all the greater; for in the meantime the servicing of the public debt now swallowed up about one third of the total government budget, and the inflation rate was rising.

In the following years the inflation rate in Brazil was marked by such a high degree of instability that it seemed possible that a hyperinflationary crisis would break out. This would also have meant the onset of massive capital flight, which after all had been relatively low during the 1980s, compared to other Latin American countries, due to the attractive provision of "index-linked money" in the form of government debt issues.

Against this background the banks strove for two things. Firstly, they had to try to intensify their other business besides bonds trading, which in the subsequent years remained distinctly below the level of 1989. It was practically impossible, however, to start up in the classical lending business in view of the high real rate of interest; therefore, especially business on the interbank market was increased, and foreign exchange loans transmitted. Some banks withdrew from the general deposit-taking business altogether, since under rising inflation the transaction costs of a comprehensive network of branches were becoming higher and higher. Secondly, in particular medium-sized and small commercial banks increasingly sought market niches and offered specialized financial services such as the managing of investment funds, financial engineering, etc. The opportunities for restructuring lending business were relatively limited, however, in view of the great macroeconomic insecurity.

Therefore, the strategies for rationalization on diversification were more decisive. The transaction costs were sunk by those banks that remained in the market through massive cut-backs in personnel. While in 1988 the banking sector maintained 803,000 jobs, by 1991 the number of employees had been reduced to 631,000 (Carvalho 1995). In addition, the banks reinvested a portion of their high profits in the further automation of banking business. Equally significant, however, was the strategy of risk-spreading. Some banks became heavily involved with the privatization of Brazilian public-sector companies which took place from 1991. Investments in other branches, too, especially tourism and insurance, increased in these years. Altogether the banks were aiming at building up their capital base, in order to be forearmed for the very uncertain future.

The high level of dependence on the inflation business remained, though, for as long as inflation was high.

Plano Real (1994): no banking crisis – despite the stable currency.

The sector's good performance in the first year of the Plano Real was thus all the more surprising. Since July 1994 this new stabilization programme has kept inflation down at a very low level by Brazilian standards (approx. 1 to 3 % per month) and in contrast to its predecessors it appears to have good prospects of success in the medium-term. This time neither a wage and price freeze was imposed nor was the stock of the internal government debt drawn on, but instead the decrease in inflation was achieved with the aid of an artificial transitional currency. Since then inflation has been kept low above all through the upward revaluation of the exchange rate and unilateral measures to liberalize trade, whereby the competition from cheaper imports exerts increased competitive pressure on the domestic producers[12].

Although the inflation gains of the banks thus practically disappeared, their profits remained high: in the first six months of 1994 the commercial banks managed to make profits of between 10 and 20 % (net profits in relation to equity capital); around one third of the banks even achieved profits of considerably more than 20 %[13].

How was this possible? The banks met the changed situation, which may not have come as a surprise but was abrupt nevertheless, in two ways. Firstly, for the first time they introduced a scale of charges for their services; previously, charges had not been explicit, but rather had been accounted for implicitly in the high profits. Secondly, just as they had done in 1986 under the first stabilization plan Cruzado, the Brazilian banks developed a kind of cyclicality: they replaced their inflation business by considerably increasing their credit supply, the demand for which had risen to a high degree as a result of the consumer boom triggered by the new stability.

For the sudden fall in inflation led above all in the lower income groups, who had no access to the inflation protection mechanisms, to definite increases in real income and hence to a considerable intensification of consumer demand. The central bank did try to stem the expansion of the credit supply as far as possible, in order to prevent the economy from overheating. However, to all intents and purposes a policy of high interest was not available as a monetary policy instrument to steer the economy[14]. Therefore the requirements for minimum deposits for the commercial banks were successively raised. Nonetheless, the finance institutions still managed to extend their credit supply, by anticipating restrictive measures on the part of the central bank or by finding ways to circumvent these measures by means of indirect financing methods. The volume of consumer credit, for instance, rose by 150 % in the first few months following the introduction of the new currency, and the volume of lending to industry and trade was more than doubled (Carvalho 1995).

The effort of the banks to lay out the highest possible credit volume, although the macroeconomic framework conditions were still far from being consolidated and the medium-term expectations were relatively insecure, can be explained by the clearly increased spreads, which were able to compensate for the fall in float income. The monthly spread for consumer credit and overdraft facilities rose on average from 3 to between 6 and 7 %; the difference for corporate loans between interest charged and interest paid rose on average from 15 to 35 % p.a. (Carvalho 1995).

In the meantime, though, the stabilization programme has come into difficulties, related in part to the Mexican currency crisis at the end of 1994, forcing the introduction of measures to slow the economy down. The most important money policy instrument for this is the high interest policy. Since April 1995, the real rate of interest in Brazil has been over 40 % p.a. For a large number of bank debtors this distinct rise in the interest rate brought with it repayment difficulties, which were further deepened by the cooling down of the economic situation. The proportion of debtors in arrears and the doubtful accounts receivable in the banks' holdings rose to a level almost as high as that of 1987, when the consumer and credit boom of the first stabilization programme came to an abrupt end.

What was a rational adaptation strategy on the part of the banks during the first phase of inflation reduction is now becoming a problem for the finance institutions as well: that with a higher level of debt in the overall economy the high interest policy is becoming an efficient instrument for steering economic development, and that the bank debtors' ability to pay is becoming worse accordingly. Right from the beginning of the stabilization programme some small finance institutions had to be closed down by the central bank, owing to the increased minimum deposit required and the decrease in inflation gains. In the wake of the high interest policy however, even one of the ten biggest commercial banks in the country was forced to declare its insolvency, temporarily triggering a certain degree of panic amongst the depositors in the Brazilian banking system. A great banking crash is not really to be expected, but the aggravated conditions will certainly contribute to a considerable heightening of competition. The spate of mergers which can be expected under these circumstances will intensify the degree of concentration of the Brazilian banking market still further.

References

1. A detailed treatment of the Brazilian monetary constitution and the changes it has undergone in recent decades can be found in Lees/Botts/Cysne 1990 and Welch 1993; for a brief description in German, see Nicolas 1995, p.147ff..
2. Gazeta Mercantil (São Paulo, Brazil) 25.3.95, p.6
3. or alternatively, at the successor institutions of the "overnight" market after its formal dissolution in 1991; in principle these functioned in a similar way, though.
4. Allowances must be made for the fact that this data involves considerable measurement problems. The Brazilian National Statistics Office (IBGE) points out that the figures given can only be regarded as approximations. In most cases, the commercial banks charged no or only insignificant fees for their services. Therefore the difference between the borrowing and lending rates of interest of the commercial banks was estimated (minus the profit from interest from their equity capital), in order to obtain a realistic approximate value. For a more detailed explanation, see Carvalho 1995.
5. An exception is the year 1986, during which inflation sank distinctly, at least temporarily, as the result of a stabilization programme. This phase will be dealt with in Section 4, where the clear diminution of the banking sector at the beginning of the 1990s will also be analyzed.
6. The revival of foreign exchange loans during the last few years, which was discussed in the first section, probably led to a slight increase in the total lending volume from around 1992. Due to the lack of available data, this new development cannot be presented graphically.
7. Indexation means that the nominal value of a money contract is automatically adapted to the inflation rate, so that the real value of the contract is preserved. This can be in the form of pre-indexation, in which the inflation rate for the coming period is estimated and incorporated preventatively in the contract, or of post-indexation, when the inflation rate of the past period leads retroactively to the corresponding nominal raising of the contract. In theory, the redistributory effects of inflation which arise between creditors and debtors but also among all other participants with long-term money contracts, e.g. wage contracts, are supposed to be neutralized in this way. That this attempt to denominalize monetary relations was bound to fail and indeed contributed decisively to the budget crisis of the Brazilian State does not concern the topic of the present discussion.

8. For further information cf. Fritz 1995, p.4ff, and Nicolas 1995, p.146ff.
9. A detailed analysis of the relationships between the Brazilian monetary structure, national debt and inflation can be found in Doellinger 1995.
10. At the beginning of the 1980s, after the failure of the import-substituting development and the onset of the international debt crisis in the Latin American countries, Brazil also attempted to fight inflation with an orthodox stabilization programme à la IMF (International Monetary Fund). It became evident that in the Latin American economies this economic policy generated a combination of stagnation and inflation with immensely high social costs, rather than laying the foundations for a new development model. Especially in connection with the country's return to democracy, this kind of policy also became increasingly unpopular. For now the problem of the extremely uneven income distribution was becoming more and more the central theme of political discussions and demands. Both of these factors presented Latin America, and Brazil first and foremost, with the opportunity to consider counter-plans for stabilization programmes, the so-called "heterodox shock". This aimed at putting an abrupt halt to the inflationary process, in order to eliminate the so-called inflation memory, which transports the inflation of the past into the future periods. A theoretical rationale for the "heterodox shock" is provided by Arida/Lara Resende (1985). Despite the failure of this policy, orthodox advocates do admit that under certain circumstances heterodox elements are justified in a stabilization policy (cf. Kiguel/Liviathan 1992).
11. A comprehensive description of the Plano Cruzado can be found in "Austral- und Cruzado-Plan: Helfen heterodoxe Schocks?" (1987).
12. The Plano Real is described and analysed in detail in Fritz 1995.
13. Gazeta Mercantil, 20.3.1995, p.1
14. This would have affected above all the State, as the principle debtor of the nation, and increased the budget deficit, and would only indirectly have influenced the level of production, since, of course, the enterprises on the Brazilian domestic market had kept their debts in the domestic currency as low as possible, due to the prohibitively high real rate of interest.