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Central banking reform and overcoming the moral hazard problem: the case of Brazil

A reforma do Banco Central e superação do problema de risco moral: o caso do Brasil

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RESUMO: A suposição implícita de que os governos socorrerão instituições financeiras em dificuldades pode gerar incentivos negativos para o desenvolvimento de um sistema financeiro sólido. Este artigo parte da premissa de que esses incentivos negativos, que criam uma situação de risco moral, são essencialmente um problema político e não um problema técnico sobre a geração correta de incentivos institucionais. No caso brasileiro, argumentamos que o atual governo de Fernando Henrique Cardoso só conseguiu reduzir significativamente seu problema de risco moral no setor financeiro distanciando sua relação política com dois importantes atores políticos: o setor financeiro privado e os governadores estaduais. A capacidade do governo de eliminar a suposição implícita de um eventual resgate do Banco Central sobre bancos comerciais públicos e privados só foi possível através de uma série de condições políticas, que incluem o fim da hiperinflação sob o Plano Real, que reduziu a dependência do governo desses dois importantes atores políticos.
PALAVRAS-CHAVE: Autonomia do Banco Central; sistema financeiro; bancos; risco moral; economia política.

ABSTRACT: The implicit assumption that governments will bailout financial institutions under distress can generate negative incentives for the development of a sound financial system. This paper begins from the premise that these negative incentives, which create a situation of *moral hazard,* is essentially a political problem rather than a technical problem over generating correct institutional incentives. In the Brazilian case, we argue the current administration of Fernando Henrique Cardoso was only able to significantly reduce its *moral*

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hazard problem in the financial sector through distancing its political relationship with two important political actors: the private financial sector and state governors. The ability of the government to eliminate the implicit assumption of an eventual Central Bank bailout over public and private commercial banks was only made possible through a series of political conditions, which includes the end of hyper-inflation under the Real Plan, that reduced the government's dependence upon those two important political actors.
KEYWORDS: Central Bank autonomy; financial system; banks; moral hazard; political economy.
JEL Classification: E58; E44; G21; G28.

INTRODUCTION

The growing financial crisis in emerging markets in 1997-1999 has generated a growing debate within academic and policymaking circles over the benefits generated by the liberalization of international capital flows.[1] Currency crashes and its resulting capital outflows in emerging markets in Asia, Russia and Latin America have lucidly demonstrated the extent to which capital markets in emerging markets are interconnected and at serious risk from 'contagion '; the spreading of a financial crisis from one economy to the other independent of whether the neighboring country suffers from the same 'structural' flaws from the country where the crisis originated. Despite the evident impact of contagion within emerging markets, however, the recent financial crisis in 1997-1999 has also demonstrated an equally important phenomena which has received less attention: the economic repercussions of currency runs and capital outflows have varied greatly between countries.

The most evident example to the presence differential economic repercussions in response to a currency crisis is illustrated by the Brazilian case in early 1999. In part pressured by the Russian economic meltdown and subsequent domestic political crisis,[2] in January of 1999 the Brazilian government abandoned its currency peg of the Real and allowed the currency to float against the dollar. While similar devaluations in Korea, Thailand, Russia and Indonesia sparked a wave of bank foreclosures and subsequent bankruptcies in the 'real' economy, the Brazilian devaluation failed to produce similar results. None of the predictions by economic analysts in January of 1999 that a devaluation of the Real would entail a return of high-inflation, increased unemployment, and large-scale capital flight have come true.[3]

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[1] For a summary of this debate, and also for a discussion over whether a new international financial architecture is needed, see (Armijo and Felix 1999).

[2] Most notably the declaration by Governor Itamar Franco from the state of Minas Gerais that he would no longer pay its debt to the federal government.

[3] That is nor to say that Brazil's economy didn't suffer from increased unemployment and slower economic growth. We are only asserting that Brazil's economic crisis was much less severe than expectation in January of 1999.

What explains the relative resilience of Brazil' s economy to a currency devaluation that under relatively similar conditions in other countries generated much greater economic hardships? Policy analysts have increasingly come to answer that question through examining the respective country's financial sector. Currency devaluations in Thailand, Korea and Indonesia sparked a domestic economic crisis because financial markets in those countries were characterized by poorly capitalized banks with large portfolios of questionable loans, and under financial reporting of foreign liabilities. Financial institutions were highly leveraged on foreign currencies, and thus with a devaluation their respective domestic debtors couldn't meet their payments in local currencies, resulting in a wave of bankruptcies in the banking and industrial sectors. While analysts have provided persuasive, and extensive, accounts over the reasons behind Brazil's relative resilience to the 1999 currency devaluation, one factor is evident: Brazil didn't suffer from a 'risky' financial sector.[4] Brazil's financial sector, however proved much more resilient because it had already implemented a series of reforms over its banking sector that reduced the leverage of its domestic financial institutions.

Stated in other words, Brazil' s financial sector was much less prone to the moral hazard problem facing financial institutions than its Asian counterparts. Financial institutions in Thailand, Korea and Indonesia engaged in such highly leveraged operations precisely because they had the implicit safety net of an eventual government bailout.[5] The Brazilian government, however, had already significantly reduced the moral hazard problem facing its financial sector through a bank-bailout packages conducted in 1995 and 1997 which conditioned private and public sector bank bailouts upon a series of banking reforms.

In contrast to economic analysts who treat the moral hazard problem within a given financial sector as a technical problem over generating correct institutional incentives, this paper begins from the premise that correcting such a deficiency in the financial sector is essentially a political problem. The implicit assumption that the government will bailout financial institutions under distress in many instances stems from the specific political coalition supporting the government in power. Generating the correct set of institutional incentives which regulate a financial sector in such a manner to eliminate the moral hazard problem therefore also entails a political problem of generating a new coalition to sustain the government.

In the Brazilian case, we argue the current administration of Fernando Henrique Cardoso was only able to significantly reduce its moral hazard problem in the financial sector through distancing its political relationship with two important political actors: the private financial sector and state governors. The ability of the government to eliminate the implicit assumption of an eventual Central Bank bail-

[4] We are only stating a healthy financial sector was a necessary, but not sufficient, condition which explains Brazil's. quick recovery.

[5] Not coincidentally, many of the owners of these esc financial institutions had close connections to the government. See *New York Times,* 2/16/99, 2/17/99, and 2/18/99.

out over public and private commercial banks was only made possible through a series of political conditions, which includes the end of hyperinflation under the Real Plan, that reduced the government's dependence upon those two important political actors.

This paper consists of four sections. In the first we provide more detail over the nature of the moral hazard problem in the financial sector and specify how such a problem is as much political as institutional. The second summarizes our main hypothesis, which states that overcoming the moral hazard problem in Brazil constituted enacting a series of reforms which ran contrary to the interests of two important political actors: governors and the private financial sector. Such reforms therefore necessitated the correct political conditions for the federal executive to assume such political costs of reform. The next two sections respectively provide empirical detail over how the central bank attempted to reduce the moral hazard problem in the private and public financial sectors.

FINANCIAL SECTOR REFORM AND THE MORAL HAZARD PROBLEM

The importance of financial sector reform in the context of international financial deregulation has been increasingly acknowledged in policy and academic circles as essential to mitigate the negative economic repercussions of currency speculations.[6] One of the primary objectives of financial sector reform is to reduce the *moral hazard* problem amongst financial agents, which refers to conditions in which borrowers have an incentive to take risks aimed at capturing potential gains under good states of the world, while not losing more than the capital they have invested if the state of the world were to run bad. In specific to the banking sector, moral hazard arises when a bank has an incentive to undertake risky credit operations because it has the expectation that if the operation were to turn sour the bank owners would *only* loose the capital they had initially invested. If such a perception is widespread, and financial institution subsequently become highly leveraged, the chances of a systemic financial crisis like the ones which occurred in East Asia greatly increase.

What generates a moral hazard problem in the financial sector? While the causes of such a problem may be varied, one important cause stems from the perception amongst financial agents that the government will act as a lender of last resort in case the institution runs into financial troubles. Such an implicit guarantee on the government side, which arises either because the institution is 'too big to fail' or because it is too important politically, then gives financial agents the incentive to engage in more profitable and risky credit operations. If the costs to an eventual bankruptcy are distributed amongst taxpayers at large, while the benefits concen-

[6] See chapter three in Burki and Perry (1998).

trated to the financial agent, banks who don't engage in such behavior would be receiving the 'sucker 's payoff '.

Critical toward generating the problem of a moral hazard, however, is the perception amongst financial agents that an eventual government bailout in times of financial crisis will email a loss to bank owners *only* equal to the sum they originally invested. The relevant question therefore is not whether the government will, or will not, act as a lender of last resort in case of a run-on financial institutions. The social costs to a banking run and systemic financial crisis can he tremendous, thus the more relevant question is whether financial agents believe an eventual government bailout will also incur costs to bank owners greater than the sum they originally invested. The presence of moral hazard in the financial sector therefore stems from the generalized belief that government bailouts will be lenient upon bank owners – for it is only that assumption which makes risky credit operations worthwhile.

How can a moral hazard problem be mitigated or reduced? The most straightforward solution would be for the government to credibly commit against a favorable bailout, thus convincing bank owners against engaging in irresponsible practices. Due to the large social and political costs against an eventual bailout, how ever, such a commitment is often difficult to enforce, thus analysts agree that in order to prevent such a problem financial regulation should develop a sound ex-ante safety net. In contrast to an ex-post safety net (one in which the central bank only intervenes during a crisis), an ex-ante safety net attempts to intervene in the financial market in order to prevent the risks associated with moral hazard and an eventual systemic crisis from emerging in the first place.

The literature on banking safety nets usually stresses the existence of three components necessary for a sound ex-ante safety net: capital, monitoring, and closure.[7] Capital, the simplest of the three components, refers to the difference between assets and liabilities, and represents the ownership interest in a firm. The greater amount of capital bank owners has invested in the institutions, the greater their interest in monitoring bank managers against excessive risk taking. While regulations which stipulate large capital ratios reduce the systemic risks associated with moral hazard, "too much" capital can increase lending rates and reduce financial deepening.

The next two components, monitoring and closure, are less straight forward for the can encompass a number of potential regulatory measures. Monitoring refers to the ongoing oversight conducted by the central bank to ensure that banks are conducting sound financial practices. Central bank resolutions should therefore foster adequate capitalization of banks, restrict insider lending, and ensure appropriate rules for asset classification, and loan-loss provisioning. Appropriate regulations, however,

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[7] A sound ex-ante safety net can be generated through government regulation *and* through spontaneous self-enforcement within the financial sector (such as the emergence of credit bureaus and internal monitoring within financial institutions). Without diminishing the import of self-enforcement mechanisms, we focus on how the government can aid in the creation of an ex-ante safety net. For analysis over banking safety nets, see Calomiris (1997), Rojas-Suárez (1997) and Burki and Perry (1998)

should be accompanied by a dynamic assessment over the quality of financial management – a difficult task for it requires a competent technical corps within the central bank's external auditing team. The third and final component, closure, also refers to central bank regulations over the financial sector but are specific to rules governing the mechanisms the central bank acts as a lender of last resort in cases of financial distress. Again, in order to ameliorate the moral hazard problem, it becomes necessary to design closure rules with consistent bank-failure resolutions, intervention, and prompt corrective actions for banks who receive assistance.

The literature over financial sector reform, and the moral hazard problem in specific, has a well-developed body of research which specifies the requisites for an ex-ante safety net conducive to financial deepening. Such analysis often has the implicit assumption that overcoming the moral hazard problem is essentially a 'technical' problem requiring an institutional fix.

We argue, however, that implementing such institutional reform entails significant political costs which are often much larger than developing a competent technical corps in the central bank capable of monitoring financial institutions. The reason is simple – a well-designed ex-ante safety net imposes significant costs upon powerful political actors. As one analyst of financial reform stated, "Closing down or stringently disciplining a bank is inherently a political act in all countries" (Garber 1997, p. 184).

Before developing the politics of financial sector reform in Brazil, one must make clear an important qualifier as to when financial systems can develop a moral hazard problem. A key distinction amongst financial systems must be made between those which are "repressed" as opposed to "deep" (McKinnon 1973). In contrast to deep financial system found in industrialized economies with well-developed capital markets, "repressed" financial systems are those characterized by active government intervention and severe distortions in resource allocation. In Latin America, such a pattern emerged with the advent of import substitution industrialization as a response to the economic crisis of the 1930s. The allocation of credit was often dominated by governmental institutions, and even in the private sector the government played a critical role in the regulation of savings and banking practices. Under such a financial system banks rarely failed, for a good portion of banks' portfolio assets were held as central bank reserves, treasury bonds and low-risk credit to protected import substituting firms (Burki and Perry 1998, p. 48).

The moral hazard problem therefore can only surface in financial systems which are making the transition away from financial repression where the government doesn't play as large a role in the allocation of credit – a process in which most Latin America countries have embarked upon during the 1980s and 1990s. From a political standpoint, the timing of the transition away from financial repression couldn't be more pertinent. Central Banks have faced the difficult task of implementing sound ex-ante safety nets exactly when countries throughout Latin America have made the transition to democratic rule.

The following section examines the politics of implementing a sound ex-ante safety net in Brazil.

THE POLITICS OF REDUCING THE MORAL HAZARD PROBLEM IN BRAZIL

Brazil's financial sector was characterized by a moral hazard problem for much of the 1980s and early l990s. Both public and private commercial banks operated (correctly) under the assumption that the Brazilian Central Bank would act as a lender of last resort in case they became insolvent. Such a problem was most egregious in the case of state government commercial banks. Throughout the 1980s governors used their respective commercial banks to indirectly finance budget deficits[8], and with each state banking crisis (which coincided with the electoral cycle) the central bank enacted a bailout package which eventually returned the failed bank to its respective state government. [9] The central bank attempted to impose restrictions on the ability of such a crisis from re-occurring, but such measures either lacked in scope or were simply ignored. With regard to the private financial sector the moral hazard problem wasn't as blatant, yet as the subsequent section will demonstrate, private commercial banks not only were privileged by central bank policies, but unsound banking practices were often masked by substantial inflationary revenue.

With the implementation of the Real Plan in 1994 and the end of hyper-inflation, however, the Brazilian Central Bank (BACEN) took a number of initiatives with the explicit objective of eliminating the *moral hazard* problem facing the centra bank.[10] In other words, the central bank attempted to create incentives which would prevent banking institutions from engaging in high-risk credit operations which were implicitly premised upon an eventual government bailout. Such measures not only addressed rules over the closure of financial institutions, but also the two other items of reforms which constitute a well-developed ex-ante safety net: capital and monitoring.

We argue the obstacles faced by the government to reduce the moral hazard problem, however, were much more political than institutional. In addition to the administrative difficulties of creating an adequate ex-ante safety net, in order for

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[8] While in some cases state commercial banks did conduct direct loans to state governments, state commercial banks played a more important indirect role through financing state government SOE (State Owned Enterprises), holding stat government bond which were not absorbed by the private market, and in more stark cases, providing Revenue Anticipation Grants (Antecipação de Receita Orçamentária)

[9] Brazil's gubernatorial elections were first opened in 1982, with subsequent elections for the governor's office held every four years; 1986, 1990, 1994, and 1998.The first Central Bank bailout of state banks occurred in 1983, followed by a series of interventions in 1987 and 1991. These crises, however, also coincide with the various stabilization programs adopted over the last 10 years: the Cruzado Plan of 1986, and the Collor Plan of 9990. For explanations with focus on the electoral connection see Banco Central do Brasil (1992) and Paes (1996). For an analysis which focuses on the impact of stabilization, see Buchi (1995.

[10] As the article will make evident, most of these initiatives, ought to implement international banking standards adopted by the Basle Accord to Brazil's financial system.

financial sector reform to stick the government had to be willing to incur significant political costs. In Brazil the moral hazard problem has benefited two important political actors: governors and the private financial sector. Any analysis whose objective is to explain the creation of an ex-ante safety net in Brazil therefore has to also explain how the government was able to distance itself from these two important political actors. This section argues the current administration was able to do so through a combination of economic and political factors which coincided with the advent of the end of hyper-inflation and the Real Plan in 1994-1995.

The Private Financial Sector and Governors: Privileged Coalition Partners

Before providing an explanation over how the Central Bank was able to implement a sound ex-ante safety net, however, one must make clear the emergence of the moral hazard problem in the 1980s was due to political rather than institutional reasons. Both governors and the private financial sector were able to act under the assumption the central bank would enact a favorable bailout precisely because they exerted significant influence over the political decision-making process.

The relative influence of the private financial sector upon the conduct of monetary policy in Brazil expanded throughout military rule, but dates to the military government of Costa e Silva (1967-69). Such an active partnership between the government and private finance stands in contrast with the previous administration of general Castelo Branco (1964-1967) and is best illustrated by the composition of National Monetary Council (CMN), the board responsible for conducting monetary policy and the country's newly created Central Bank. Under the aegis of Minister of Finance Delfim Neto, the Nacional Monetary Council increased its membership to include members from the private industrial and financial sectors. In other words, the military government established an explicit policy to include the private financial sector into the decision-making apparatus of monetary policy.[11] With the transition to democracy in the 1980s, the relative influence of the private financial sector didn't diminish. Not only did the first democratic administration under José Sarney (1985-1989) retain the increased private sector representation in the CMN which occurred under the outgoing military administration of João Figueiredo (1979-1985), but Sarney further increased its representation by one.[12] The introduction of direct gubernatorial elections 1982, and the subsequent transition to civilian democratic rule in 1985, re-introduced into Brazilian politics the prominent position held by the governor's office; the second political actor exam-

[11] Campos (1994) for example, cites Gastão Vidigal, owner of Banco Mercantil de São Paulo, as one of the members of the National Monetary Council. As a bank manager of a medium sized investment bank stated, "The basic problem on the government side was that they needed funds. So, as they needed funds they used the banking system to obtain these funds. So they gave power to the banking system and wirh that they produced the conglomerate system" (Barker 1990).

[12] The Sarney administration introduced a labor representative in the CMN.

ined in our analysis. The relative political strength of the governor's office is well documented in recent analysis,[13] yet an important explanation for the ability of governors to use their state banks under the assumption of an eventual government bailout, relates to the *sequence* by which democracy was restored.

By the time Brazilian civilian rule was re-established in 1985-86, the strategy of political devolution adopted by the military had been under way for almost 10 years. For our purposes it is sufficient to stress two major aspects. First, the introduction of competitive elections at the state level occurred *prior to* that at federal level. Open gubernatorial elections were re-introduced first in 1982, with the opposition parties (PMDB and PDT) electing a significant number of governors committed to democratization in the most economically and politically powerful states (São Paulo, Minas Gerais, Rio de Janeiro e Rio Grande do Sul). Second, the economic strategy adopted by the military government of Ernesto Geisel (1974-1978) ensued a process of accelerated economic decentralization at an early stage of political liberalization. Geisel radically changed the previous pattern of industrialization which focused on the already industrialized south-east.

This sequence is critical to understand the manner in which the political drive for autonomy at the state-level translated into a centrifugal pull. Economic, and eventually democratic devolution at state level prior to liberalization at the federal level[14] helps explain the difficulties later faced by the federal executive to exercise a *coordinated authority* and implement an agreed strategy and support amongst governors. [15] In sum, the relative political strength of the private financial sector and the governor's office were critical factors for their correct assumption the central bank would act as a lender of last resort in case of financial distress for financial institutions of both actors.

The Relative Decline of Private Finance and Governors

What, however, explains the ability of the central bank to conduct financial sector reform which significantly reduced the moral hazard problem in relation to these two important political actors subsequent to 1994 and the Real Plan? We argue the ability of the federal executive to conduct such a reform was due to its increased bargaining power over governors and the private financial sector subsequent to the implementation of the 1994 Real stabilization plan and the end of hyper-inflation for both purely political and economic reasons. On the political end, we argue the current administration had unprecedented *interest* and *leverage* to implement reform. The federal executive is usually the branch of government held accountable for maintaining macroeconomic stability, therefore any federal execu-

[13] See Abrucio (1994), Sallum Jr. (1996), and Samuels (1998).

[14] Here we are referring to the federal executive. Congressional elections were held during most of the military period.

[15] Stepan makes this argument in connection to the electoral sequencing.

tive would have an interest to maintain a stabilization program. The government of Fernando Henrique Cardoso, however, differs from previous administrations by the *extent* of its interest in upholding a stabilization program. Fernando Henrique launched and won his bid for the presidency almost entirely based upon his role of crafting the Real stabilization program as minister of Finance under the outgoing Itamar Franco administration (1993-1994). Whereas previous presidents could craft a stabilization program after being elected, have it failed, and still have time for a second 'go', Fernando Henrique did not have that option because he won the presidency on a *specific* stabilization program – the Real. As a result, Fernando Henrique knew his chances for reelection in 1998 were dependent upon the continued success of the Real.[16]

In addition to an unparalleled interest in sustaining the current stabilization program, the executive branch gained added leverage over the legislature and governors through the introduction wedded presidential, legislative, and state elections in 1994 and subsequently in 1998. The Brazilian transition to democracy was marked not only by the re-introduction of direct elections for governor *prior* to the presidential elections, but also by concurrent gubernatorial and national legislative elections in 1982, 1986, and 1990. Direct presidential elections were only re-introduced in 1989 – an 'off' election year. Brazilian legislative candidates during the 1980s and early 1990s therefore benefited from riding 'gubernatorial coattails' rather than presidential.[17] Fearing the possible victory of the presidential candidate for the Worker's Party (PT), the legislature passed a constitutional amendment shortening the presidential term to four years, thus coinciding presidential, legislative and statewide elections in 1994. For the first time in Brazil's recent democracy, legislative and gubernatorial candidates had the potential of riding presidential coattails.

The unparalleled interest in sustaining a stabilization plan combined with a wedded election in 1994 and 1998, however, do not constitute sufficient causes for a successful centralization of monetary authority in the central bank or financial sector reform. Essential to this process has been the economic impact the end of inflation had upon state and private commercial banks and state government finances. State governments have been running fiscal deficits for quite some time before 1994. The end of high inflation made those deficits unsustainable. High inflation generates winners and losers. A clear winner under high inflation in Brazil was the financial sector. Each year between 1990 and 1993, the banking sector (both public and private) generated inflationary revenue to the sum of four percent

[16] The Brazilian Congress approved a constitutional amendment to permit executives of a aa three levels of government to run for re-election. Again, this institutional change further increased the power of FHC, as noted by an increased flocking of congressional deputies to the president's party after the amendment was approved.

[17] For the effect this electoral calendar had upon subnational influences over the national legislature, see Linz and Stepan (1992); Abrucio (1994); Willis, Garman, Haggard (1999); For the timing of elections at the national level, see Shugart and Carey (1992).

of the country's GDP – with public banks appropriating roughly two thirds of that total.[18] In fact, floating revenue became a principal reason for preventing many state banks from entering complete bankruptcy during much of the 1980s and early l990s. While most of their credit operations (assets) were directed to the public sector in the form of long-term financing, their liabilities derived primarily from short term deposits, or bank bonds (CDBs, RDBs). Without this floating revenue state banks had increasing difficulties to meet their cash requirements. When a bank does not balance its account by the end of the business day, it has two options: either borrow the money over the 'inter-bank market' *(mercado inter-bancário)* at a hefty interest rate, or resort to the Central Bank's discount line *(linha de redesconto)*. By the end of 1994 the private market was no longer accepting state bank CDBs or RDBs (bank bonds), and thus prominent state banks like Banespa and Banerj (who made up 60% of the state banking financial sector) repeatedly turned to the Central Bank's discount line – providing the impetus for their subsequent intervention; a process which had its parallel in private banking the subsequent year.

The end of inflation further deteriorated state government finances through two fiscal mechanisms. First, states could no longer keep budgetary costs down through using inflation as a means to corrode away real spending on items like public payroll. Governors and mayors would often swell the public sector with political appointments prior to elections in order to help elect their successors, and once in office the newly-elected governments would reduce spending on payroll through allowing inflation to corrode the real wage bill. Without this mechanism of spending reduction subsequent to the Real Plan, public payroll consumed an increasing percentage share of state budgets. Second, the end of inflation had the effect of dramatically increasing debt obligations. Much like the stabilization program in Argentina, the Real Plan was based upon a stabilization of the currency through the exchange rate. Such a stabilization plan forces the government kept a high interest rate in order to attract foreign capital, which consequently had the effect of higher debt payments on behalf of state and municipal governments.[19]

Before proceeding with the argument, however, two qualifications are in or der. First, we do not argue the end of inflation caused the fiscal crisis many state governments a recurrently experiencing. The first major state borrowing boom began in the 1970s under the military government's developmental project, and during the 1980s state governments were able to roll over that debt, and indirectly finance new debt through the use of their state banks. Rather than create the fiscal crisis, the end of inflation eliminated the mechanisms which sustained chronic state government fiscal imbalances.

Second, it is important to note the weakening bargaining position of state governments began prior to the imposition of the Real. State and municipal govern-

[18] IBGE 1996).

[19] See Sola, Garman and Marques (1998) for more details.

ments began a process of debt rescheduling as early as 1987, and both the Senate and the Central Bank imposed more stringent limits on the ability of subnational governments to contract new debt. With each new round of stats debt crisis during the 1980s and 1990s the federal government, and central bank, gained incremental leverage over state government finances. Following the state bank crisis of 1987, for example, the central bank, through Decree Law 2.321, gained the ability to assume temporary control over insolvent state banks. The same decree law further established more stringent rules regarding the judicial accountability of state administrators for improper banking practices. While state banks placed under federal intervention in 1987 were eventually returned to their respective state governments with no significant judicial action taken against its bank managers, the central bank gained a new tool to discipline state banks.[20] In a similar fashion, the next round of state government financial crisis during the early 1990s further placed new limits on state banks and state government finances.[21]

The ability of the central bank to exert discipline over state banks must therefore be viewed as an incremental process beginning in the early 1980s which were imposed with each successive state banking crisis. We argue, however, the recent crisis of state and private banks induced by the end of inflation in 1994 differs from the previous banking crisis on two and potentially three fronts. First, as we demonstrated, the executive branch has an unparalleled interest in disciplining state and private banks in order to sustain the stabilization program. Second, the Real Plan has so far proven a much more sustainable stabilization plan than its predecessors, thus inducing more drastic pinch on state and private commercial banks, and state government finances. Third, the central bank had more tools at its disposal to discipline commercial banks in 1994 in part because of the periodic state banking crisis describe above. The federal government therefore took advantage of both political and economic factors which weakened the bargaining position of state governors in order to, in addition to other measures, condition a federal bailout on a centralization of monetary authority in the Central Bank.[22]

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[20] One could argue the federal interventions of 1987 indicated the *strength* of state governments in relation to the federal executive. Most governors in fact desired a federal intervention of their insolvent state banks upon taking office in 1987 (the only opposition came from the governors of Santa Catarina and Rio de Janeiro, Esperidião Amim and Leonel Brizola respectively), for they were under the correct assumption their banks would he returned to them financial healthy at the end of their administration in time for the next elections. How the central bank decides to use their ability to intervene state banks, however, is analytically distinct from the incremental process we are trying to depict in which the central bank gains more tools to discipline state financial agents. For the willing participation of governors in the 1987 interventions see: *Folha de S. Paulo,* 1/31/88, *Isto É,* 3/4/87, *Correio Braziliense,* 8/10/87.

[21] CMN Resolution 1.718 of 5/29/90; CMN Resolution 1.775 of 12/26; Senate resolution n. 94, of 12/15/89; Senate Resolution n. 58 of 12/13/90; and Senate Resolution n. 36 of 6/32/92. In 1993 a Constitutional Amendment (n.3, 3/17/93) was further passed which prohibited the emission of any new state bonds except for the payment of principal. See Santos (1993).

[22] Since this paper is focusing on monetary authority, we limit our discussion primarily to how federal bailout of state finances has affected Central Bank credibility in the financial sector. The current

The evaluation by the federal government that disciplining state-level financial institutions was a necessary component to making the Real Plan work was made evident very early in his administration.[23] On December 31, 1994, the last day of the presiding state government administrations, the Central Bank intervened in the two of the largest state banks belonging respectively to the states of São Paulo and Rio de Janeiro: Banespa and Banerj.[24] While legislators from São Paulo and Rio fought against the stated aims of the Central Bank to eventually privatize both banks, initial opposition to the intervention might have been greater if it had taken place during the middle of a gubernatorial term. The economic team composed by Fernando Henrique were well aware the Real Plan could not survive without providing a resolution to the question of state banks, and taking care of Banespa and Banerj, due to their respective sizes, went a long way towards a resolution to the entire sector. Once the Central Bank had conducted the intervention of both banks, the government used whatever tools at its disposal to increase the effective threat of privatization – and this was accomplished through slowly increasing the financial market to foreign competition. The gradual opening of the domestic financial market to foreign competition, however, demonstrates a critical strategy employed by the government to create more efficient banking practices within both public and private banks. As the table below demonstrates, foreign bank participation within Brazil's national financial system increased from 10% to nearly 25% since 1994 – a policy which has been vociferously criticized by members of Brazil's private financial sector.

Table 1:Participation of Private, Public and Foreign in Brazil's National Financial System (by total assets)

Type of capital	1994	*1999	Prof.W/Banespa Privatization
National Private Banks	38.20	28.41	31,95/(28,41)
Public Banks	51.63	46.67	43.13
Foreign Private Banks	10.17	24.92	18,46/(24,92)

* Data are drawn from the month of September
Sources: BACEN, EFC-Engenheiros Financeiros & Consultores and Austin Asis.

rescheduling of state finances, however, involves many elements which go beyond the monetary sector. In order to receive federal financing, state governments are further being obligated to yield guarantees in future revenue (from own taxes and constitutionally allocated shares of federal taxes) and assets of their state-owned enterprises.

[23] In the Senate confirmation hearing for the president of the Central Bank, Persio Arida, for example, declared he was in favor of privatizing state banks in order to sustain price stability. *Jornal do Brasil,* 12/14/94.

[24] The Central Bank intervention of both banks was also helped by the fact both incoming governors Mario Covas of São Paulo, and Marcelo Allencar of Rio de Janeiro belong to the same political party as the president (PSDB). The fact both belong to the same party, however, could influence the outcome in either way. One could equally expect the governor to reduce a state 'rebellion' against the federal government, as one would expect the federal government to give the governor favorable treatment.

In sum, the political game between the executive, legislators, and governors has substantially altered during the 1990s. The end of inflation made the financially precarious state and private commercial bank, and thus dependent upon federal financial rescue. Subnational and private financial dependence on federal rescue, however, was combined with an unprecedented interest on behalf of the president to preserve the Real Plan and a stronger executive because of the wedded elections. Since discipline over the monetary system is a precondition for holding inflation down, FHC conditioned a federal rescue of state and private commercial banks upon a centralization of monetary authority in the Central Bank and financial sector reform which reduces the moral hazard problem.

The next two sections will on the one hand provide evidence to the fact the above measures by the central bank were enacted in such a manner to reduce the mor l hazard problem in the public and private financial sectors, and on the other hand also indicate that such measure ran contrary to the interests of two powerful political actors; governors and the private financial sector.

REAL PLAN AND PROER/PROES: THE LAST BAILOUT?

While the previous section focused on the political hurdles inherent within creating a sound ex-ante safety net capable of overcoming a moral hazard problem for the case of Brazil, this section will provide details over how the Brazilian executive has in fact done so since the creation of the Real Plan in 1994. The process of creating an ex-ante safety net in Brazil began with the last two bailout packages crafted by the Central Bank directed respectively toward private banks and state government banking institutions: PROER (Programa de Estímulo à Reestruturação e ao Fortalecimento do Sistema Financeiro Nacional) and PROES (Programa de Incentivo à Redução do Setor Público Estadual na Atividade Bancária). Both bailout packages differ significantly from previous rescue operations by the Central Bank because they impose much more severe punishment upon its respective majority shareholders. In other words, they impose significant political costs upon two important political actors: private finance[25] and governors.

White the private banking sector didn't exhibit the blatant moral hazard problem found within the state government commercial banking sector during the 1980s, private banks nevertheless operated under the assumption an eventual government bailout would be lenient. In part due to the consolidation of a 'repressed financial

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[25] The 'unfavorable' treatment by the Cardoso administration to the private financial sector requires particular note considering that donations by members of the private financial sector to the president's campaign represented roughly 20% of all donations – as estimated by Superior Electoral Tribunal (STF). *O Estado de S. Paulo,* 12/29/95.

system', the 1970s exhibited few problems within the banking sector.[26] During the 1980s the private banking sector exhibited a few bankruptcies within its medium sized institutions like Commind, Auxiliar Bank and Poupança Haspa, among others. Within the market, however, there existed a generalized belief that a few banks fit under the category of 'too big to fail', and if faced with immanent financial distress would receive assistance from the Central Bank, acting in the capacity of lender of last resort.

In addition to this generalized belief, and the existing political weight held by owners of financial institutions, the private financial sector began the 1990s by benefiting from Resolution nº 1.524/88, which created the institution of the Multiple Bank.[27] With the creation of this new banking category, many non-banking institutions were able to transform themselves into banks in order to reap benefits from a high inflation economy- a process which greatly increased the number of banking institutions, thus making Central Bank supervision more difficult. In other words, monetary authorities facilitated the appropriation of inflationary revenue within the private sector. The moral hazard problem was therefore latent within the national financial system during the early 1990s, and became evident to the extent there was a greater opening of the financial system since the mid 1990s.

One must further remember that a high inflation economy generates "... profits from non-remunerated liabilities, like cash deposits and revenue in transit, which act to compensate administrative inefficiencies and even the concession of risky credit operations".[28] The 'inflationary float' therefore permitted banks to mask their deficiencies and present successive healthy balance sheets and good profits. Banks lived in the 'best of both worlds'; large gains combined with inefficient baking oversight by monetary authorities.

The moral hazard problem, however, was most blatant for the case of state government owned public banks. A 1990 World Bank document was the first to most succinctly characterize such a problem through depicting how stare government used their respective commercial banks during the 1980s to indirectly finance their state-owned enterprises under the (correct) assumption of a favorable Central Bank bailout. Many authors, including the ex-president of the Central Bank Gustavo Loyola, have asserted such dynamic began with the re-introduction of gubernatorial elections in 1982.[29] Despite the fact the Central Bank acted in some in-

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[26] The one exception was the bankruptcy of the Halles Bank in 1974, which had a considerable impact at the time.

[27] The creation of the multiple bank had the purpose of facilitating bank fiscalization on behalf of monetary authorities. Juridical persons could declare their multiple financial statements under one single entity under the multiple bank. Many brokers, however, took advantage of this legislative breach to become a bank and reap inflationary revenue. With the advent of the Plano Real many of these so called 'banks' went bankrupt.

[28] Central Bank document on PROER – January/99 – p. 1.

[29] According to Loyola, 'the group of governors who neared the end of their mandates, most of whom lent their support to the Federal Government and were of the same party, attempted to elect their

stances as a complacent partner with state governments, the political weight held by governors within Brazil's transition to democracy clearly played a tremendous role in preventing any attempt by monetary authorities to eliminate the moral hazard problem within state commercial banks.[30]

The first financial crisis facing state commercial banks occurred in the early 1980s, with the Central Bank providing two assistance programs to state governments: PAC (Programa de Apoio Creditício) in July of 1983 and PROREF (Programa de Recuperação Econômico-Financeira) in 1984. Through both programs state government banks received favorable terms to re-financing their existing debts and fines owed to the Central Bank. The futility of such corrective measures became apparent with the implementation of the Cruzado Plan stabilization program. With a temporary end to hyper-inflation, monetary correction, and astronomical interest rates, the chaotic situation of state banks once again became apparent as many institutions were on the verge of bankruptcy. Unlike the early 1980s, however, the Central Bank decided to directly intervene in bankrupt state banks through a recently given prerogative of Decree Law nº 2.321, of 2/25/87 which created the RAET (Regime de Administração Especial Temporária).[31] Under this new mechanism the Central Bank not only was given the right to intervene in distressed public financial institutions, but also to liquidate them.

Despite the intervention on behalf of the Central Bank to many state banks, the political conditions which created the moral hazard problem within the sector continued. Rather than liquidate the bankrupt state commercial banks, the Central Bank actually returned each bank under intervention to their respective majority shareholders (state governments) after assuming many of the costs associated with 'cleaning up' assets of dubious value.

In sum, a critical component to the moral hazard relationship between the Central Bank and state banking institutions was how such a relationship acted in a manner to jeopardize the Central Bank's de facto mono poly over the country's monetary supply. By not being able to meet their balance sheet obligations at the end of the each business day, state banking institutions were forced to recur to the Central Bank's rediscount line -thus violating basic banking practices. Such practices were chronic, and given the political weight of governors, the Central Bank in one form or another assumed state commercial banking debt incurred through its use of the rediscount line. In other words, state government fiscal deficits were transferred to the federal government through state banks with the Central Bank compensating such an indirect expansion of the monetary base through emitting

personally chosen successors. In order to succeed, they used all resources available. Critical to this process was the use of state banks. The heterodox manipulation of their banks for political ends, however, didn't restrict itself to electoral ends'. Paes (1996) further agrees with this point of view

[30] For an analysis of the political strength of governors subsequent to 1982, see Abrucio (1998) and Abrucio and Samuels (1997).

[31] A more detailed account of the RAET can be found in Loyola, *op.cit.* pp. 22-3.

new Treasury bills.[32] The end of hyperinflation with the advent of the Real Plan in 1994 once again induced banking crisis within the country's financial system primarily because it brought an abrupt end to the inflationary revenue. According to a study conducted at the end of 1996, inflationary revenue (float) represented 20% of total banking revenue in 1994. With the end of such revenue banking institutions entered into crisis, and as a result the financial sector's share of GNP dropped from 15.61% in 1 993 to only 4.7% in 1996.

Since the implementation of the new economic plan, a number of small private and large public financial institutions[33] suffered intervention and even extra-judicial liquidation. Nevertheless, it was the intervention of Banco Econômico in August of 1995 (the 22nd intervention of a financial institution since the Plano Real), which caused the greatest controversy. The bank was ranked 10th according to total assets in the Brazilian financial system, had 800 thousand clients, and further had as President Angelo Calmon de Sá – ex-minister under president João Figueiredo and notorious friend of senator Antônio Carlos Magalhães, who at the time was the party leader of the PFL who was in an alliance with the president's PSDB. The economic troubles of Banco Econômico therefore constituted a classic situation where the moral hazard problem could surface, given the bank owner's strong political connections.[34]

The government of Fernando Henrique, however, gave indications the government 's monetary authorities would not continue a policy of lenient bailout packages. Within the series of Provisional Measures which created the Real Plan in June of 1994, one of them changed the composition of the National Monetary Council (CMN). Through Provisional Measure n. 542, the membership of the CMN was reduced to three: the minister of Finance, the minister of Planning and the president of the Central Bank.[35] In other words, the private sector no longer had representation within the highest decision-making body of the National Finance System.

Subsequent to the intervention of Banco Econômico, pressure within the Congress grew to provide a rapid solution to the intervention that would not impose significant cost either to the bank's clients nor to the state of Bahia. Anger from Bahian legislators intensified after a leak to the press from directors of the Central Bank indicating how the bank acted to finance electoral campaigns of many politicians -information derived from the now famous 'pink folder'[36] – leading Senator

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[32] The above description draws from Pereira Paes. For more details consult items II.3 and II.4. *op. cit*

[33] The state banks of Rio de Janeiro and São Paulo (Banerj and Banespa) suffered an intervention in 12/31/94. For an analysis over the Banespa intervention, see Garman, Marques and Silva Leite (1998).

[34] It is also important to note that the bank was one of the oldest private banks in the country, with its home office in the state of Bahia – a critical state which provided electoral support to the government.

[35] A more detailed analysis over the components to the National Financial System, and in specific the CMN, can be found in Fortuna (1999), pp. 14-5

[36] The 'pink folder' contained the names of various candidates sympathetic to banking interests, in this case the bank association FEBRABAN, who helped finance their 1990 campaigns. Under a few names

Antônio Carlos Magalhães from Bahia to call Central Bank directors 'criminals'. The senator further affirmed he would divulge a dossier against the government's monetary authorities and that legislators from the state of Bahia would demand a solution to the Econômico intervention. The bank ended up being sold and is now part of the Spanish group Bilbao Viscaya.

In October of the same year the market began to suspect troubles from another private bank of significant size, the Banco Nacional. As the newspaper *O Estado de S. Paulo* relates December 29, 1995, '... When the Banco Econômico agonized, Nacional's position in the inter-bank market was exactly the same. While solid banks like Bradesco and Itaú had less than 10% of inter-bank deposits, both banks held close to 50%'. Nacional not only was the sixth largest bank in the country according to total assets, but its owners belonged to a traditional family from the state of Minas Gerais whose patriarch and governor of the state, Magalhães Pinto,[37] had been a significant backer to the 1964 military coup. Both because of its size and political connections, the bank easily fit into the 'too big to fail' category.[38] A systemic threat to the financial system became a real possibility, and as a result the government launched the PROER bailout package to private banking institutions. It must be noted, however, that in the case of Banco Nacional, there was a great misuse of resources through conceding fictitious loans to previous bank debtors, and non-performing loans, who evidently had no knowledge of the operation.

Provisional Measure n. 1.179 and Resolution n. 2.208 of 11/3/95 created the instrument to provide assistance to private banks, yet this line of assistance differed from previous bailout packages in one important manner: the distressed banks were required to merge with another bank in sound financial condition as determined by the Central Bank. The PROER offered some advantages to the institutions which bought the distressed banks, but the package was conditioned upon a re-regulation of the private banking sector which had the objective of eliminating the sector's systemic risk. At the time the program proved quite controversial within the media, academic circles, and national parties, who began to question the validity of a bailout

the sums donated to their campaigns were also listed, names which included both senator Antônio Carlos Magalhães, and his son, deputy Luís Eduardo Magalhães. Rumors at the time indicated the content of such a folder were brought to the public by employees of the Central Bank. The vice-president of Banco Excel, Gilberto Nobre, when asked about the acquisition of the bank, highlighted the regional character to the controversy by asserting that in the Northeast there were only two private banks of weight: Banorte and Econômico. The first already experienced various difficulties and would later be acquired by Banco Bandeirantes. The second, despite its acquisition, would remain a veritable Bahian institution. See OESP, various editions.

[37] The newspaper OESP of 28/02/96, while reporting on the business Jorge Chammas, remembered that, ' much like Calmom de Sá and Magalhães Pinto, he grew his fortune through a circle of political friendships, which always consistet of governors, deputies and senators'.

[38] In the case of Banco Nacional, the political connections were especially strong. Director Magalhães Pinto not only had served as minister under the current government and participated in the president's campaign, but his daughter was married to the president's son.

package to private banks.[39] We want to make clear, however, that while on the one hand the costs to the program were relatively high and prevented the failing of many banks, on the other hand this program had the important characteristic of changing the ownership of the distressed bank – creating a new "bank-less" generation.

Provisional Measure nº 1.182 of 11/17/95 further created the legal apparatus necessary to enable monetary authorities to discipline the financial system. Through this legislation the 'solidarity' responsibility of majority shareholders was extended to all institutions under intervention or extra-judicial liquidation (previously they were only applicable to those under RAET). Such a measure facilitated the disappropriation of all assets from institutions which entered financial distress, and further facilitated the ability to decree a RAET on those institutions which didn't meet the necessary banking practices established by the Central Bank.[40] Such measures dictated by executive decree were transformed into legislation in March of 1997 (Law nº 9.447). The PROER bailout package clearly differed from previous rescue efforts enacted in the past because of its clear intent to reduce the moral hazard problem. The first evidence that such a concern prevailed is that none of the majority shareholders of the banks under distress were able to maintain control over their banks. Second, there was a weak correlation between political connections and adhesion to the conditions demanded by the bailout program. The case of Econômico, Nacional and Bamerindus demonstrate that despite the significant political connections of the respective majority shareholders, neither one them was able to maintain their banks.

The government further demonstrated its resolve to enact unpopular measures vis-a-vis private finance through increasing the number and participation of foreign banks within the Brazilian market. This measure was extremely unpopular amongst Brazilian bankers because it exposed them to greater competition. The latest 'round' within this controversy took shape over the privatization of São Paulo's state commercial bank (Banespa), where Brazilian bankers and even exmembers of the government advocated a privatization which excluded foreign banks as potential buyers because the bank represents roughly 3.5% of total national assents in banking (September 1999).[41] Despite such opposition, the government permitted foreign bids, a decision which allowed Santander (a Spanish bank) to purchase Banespa.

The federal intervention of Bamerindus, one of the largest Brazilian banks,

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[39] In fact, there were judicial sentences which temporarily suspended the program, but the Central Bank was able to revert each one.

[40] For a more sophisticated analysis over the measures which enabled the PROER see the Central Bank document written by Barros, Loyola and Bogdanski (1998).

[41] In an interview with the *FSP* in 1/2/2000, banker and ex-president of the Central Bank Fernão Bracher condemned in a ferocious manner the presence of foreign banks in the country. In the same newspaper, on 1/16/2000, ex-minister of FHC Luiz Carlos Bresser-Pereira also was against the privatization and called for the state to defend its 'national interests in a clearer fashion.'

yields another paradigmatic case. The bank was the fourth largest in Brazil according to total assets in December of 1994, and began to demonstrate successive problems in 1996 which forced its owner, the minister of Agriculture José Eduardo Andrade Vieira,[42] to leave his post and attempt to rescue his bank. The bank's balance sheet of 6/30/96 already indicated serious liquidity difficulties (large inter-finance loans), a disequilibrium between short term assets and long-term liabilities, and a high rate of non-performing loans.[43]

It seemed like one more case where political and economic force would ally to leave the bank essentially intact. A federal intervention, however, was decreed in 3/26/97 in addition to freezing the personal assets of the majority shareholders. Control of the bank was transferred to the HSBC Group and constituted the third largest operation within the PROER (see table 2).

Table 2: PROER Operations
As of April 1999 (values in million R$)

Bank	Loan Taken	Date	Value Paid	*Debt Remaining
Econômico	5,226	May and Ag/96	-	6,87
Nacional	5,898	Nov/95; Jan/96	1,1	7,612
Bamerindus	2,945	Mar & May/97	3,768	-
Banorte	476	May/96	471	36
Merc.Pernambuco	530	Jun & Aug/96	-	689
CEF**	5,037	May & Sept/96	-	7,587
Pontual	125	Sept/96	180	-
Antonio de Queiroz	120	March/96	71	104

* Includes principal and interest.
** The EF, despite being a public bank, used funds from PROER in order to buy back non-performing mortgage loans from other banks.
Source: BACEN and Gazeta Mercantil.

As has already been discussed, with regard to state commercial banks the scenario also began to change subsequent to 1994. In addition to intervening in Banespa and Banerj on the 30th of December, the Central Bank subsequently intervened in the State Bank of Alagoas (1/23), the State Bank of Mato Grosso (2/6) and the State Bank of Rondônia (2/20). In actuality, the insolvency of these banks was already well known to government's previous economic team, but the measures needed to solve such problems were too costly politically. Furthermore, and in the words

[42] Andrade Vieira was senator to the PTB-PR, one of the parties within the government's governing coalition. Furthermore, the bank collaborated actively in the successful campaign of FHC in 1994 through making its personal jets available and donating money to his campaign.

[43] *OESP* of 12/25/96 indicated the bank drew upon the interbank market at an average rate of R$ 2.6 billion a day.

of Paolo Zaghen,[44] their insolvency became even more explicit, ' ... exactly at a time where the finances of state governments were also completely deteriorated'.

In August of 1996 the government issued Executive Decree nº 1.514 which created the state government bailout program – the PROES which constitutes the most recent rescue program to state banks. According to this package, the federal government agreed to refinance state governments debt to their respective banks in exchange for a few conditions. States were given two options: a) complete federal refinancing entailed an eventual privatization, extinction, or transformation of the bank into a development agency, or b) 50% federal re-financing of state debts to their respective banks in exchange for bank administrative reform and more transparent rules for the concession of loans.

More effective action on behalf of the Central Bank vis-a-vis state banks subsequent to 1994 characterizes a new relationship between monetary authorities and the National Financial System: the conditions were present to resolve the moral hazard problem, a hurdle which impeded the development of a 'deep' financial market in Brazil. Three are a few further indicators the Central Bank enacted more efficient regulatory mechanisms during this new period. During 1995 and 1996, for example, public banks printed various losses on their balance sheets. Such negative results, however, reflect that new regulations over the classification of assets with dubious value were being enforced. Administrative (payroll) costs of public banks dropped, indicating that voluntary demotion programs imposed by the Central Bank rook effect. Finally, credit operations by state banks directed to the public sector (generally state governments) also dropped, a trend which was fruit not only of debt renegotiations included within PROES, but also regulations enacted during the 1980s which prevented the concession of new credit lines to state governments. It must be noted, however, that the largest problem of these banks was essentially a fiscal problem because a large share of their assets took the form of loans extended to state governments who couldn't meet their debt obligations.[45]

All of these measures implemented by rh e Central Bank aimed at reducing the moral hazard problem within state commercial banks constituted a reform not only guided by economic criteria, but also a reform replete with political negotiations between the federal government and state governors. With regard to private banks the political bargaining game was more restricted to the federal executive and the private financial sector.

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[44] Interview conceded to Christopher Garman and Moisés Marques in 5/8/98.

[45] For Barros, Loyola and Bogdanski (1998, 'In reality, the problems faced by state hanks are primarily fiscal rather than banking, but its dimensions don't permit any other type of solutions', p. 10.

Table 3: Amount Involved on PROES – According to the Original Value (Billion of R$)

Banespa	24,40	Baneb	0, 2	Badesc	0,20
Nossa Caixa	5,60	Banrisul	0 56	Banestes	0,20
Banerj	3,88	Beron	0,50	Besc	0,11
Banestado	3,85	Desenbanco	0.43	Banacre	0,10
Bemge	1,56	Produban	0,43	Badern	0,09
Minas Caixa	1.42	BEG	0,42	Banpara	0,09
CEERGS	1,40	BEA	0,36	Baner	0,03
Bandepe	1, 26	Credirea l	0,35	Banese	0,03
BMDG	1,07	Bemat	0,28	Banap	0,03
BEC	0,95	BEM	0,27	BEP	0,01

Source Banco Central do Brasil.

The above table indicates the total level of resources dedicated toward PROES, which reached up to R$ 50 billion, or two times the amount devoted on the bailout program directed towards private banks. One must further note that Banespa, São Paulo's state bank, corresponds to nearly 50% of the program's total costs. Furthermore, São Paulo's other state bank, Nossa Caixa, has been reformed, both Banestado and Besc are scheduled to be privatized, Minas Caixa and CEERGS ceased to exist, and Banerj, Meridional, Credireal, Bemge, Baneb and Bandepe were all privatized – demonstrating the Central Bank is earnestly disposed to eliminate old vices held within public banks (primarily state), and has had political success in doing so. One must keep in mind, however, a significant difference between PROES and PROER. Unlike the private sector bailout, PROER was structured as a debt-swap; the federal government swapped federal bonds for the sum of debt held by state banks. Such a swap left state governments with the responsibility of honoring those bonds, but also left the state banks solvent.

Despite such successful efforts, there nevertheless remain persistent problems which can generate new moral hazard problems within both the public and private banking sector. The recent rescue efforts by the Central Bank directed to both Marka and Fonte Cindam banks which followed the government's devaluation in early 1999 is still shrouded with unexplained justifications regarding its economic merit. These doubts further compound with the fact that 80% of the loans conceded under the PROER program are still outstanding. Furthermore, as the title of this section indicates, there are still doubts over whether both the PROER and PROES really constitute the last bailout program to both private and public banks.

Despite these remaining doubts, all private banks with financial difficulties were either liquidated or changed their respective majority shareholders, and a good portion of state banks has been or is about to be privatized. Such measures indicate that many of the financial practices conducted in Brazil's financial system since the creation of the Central Bank of Brazil has changed significantly, not only to adapt

the financial system to the end of hyper-inflation, but also to ensure financial institutions are acting in accordance to international financial standards.

TOWARD THE CONSOLIDATION OF AN EX-ANTE SAFETY NET

Concomitant to the adoption of both bailout programs, the Central Bank has adopted a series of measures to create an ex-ante safety net within the financial sector aimed at preventing the recurrence systemic problems which created the need for both bailouts in the first place. In other words, not only have the bailout programs under the current administration differed from previous programs, but the Central Bank has further acted to create a stronger banking regulatory regime even after the immediate crisis came to an end.

The Central Bank has taken several measures to consolidate a sound ex-ante safety net subsequent to the PROER and PROES bailout packages. Within its bank supervision department, the Central Bank implemented a Consolidated General Inspection (IGC) approach which replaces compartmentalized with 'global' oversight – a method which adopts market criteria for the risk evaluation of liquidity, credit, and quality of assets. Furthermore, the Central Bank implemented independent audit boards (through Provisional Measure n. 1.334 of 3/96), created a Credit Risk Board (Central de Risco de Crédito; Resolution n. 2.930 of 6/97), and further implemented greater control over money laundering.

Financial regulation has become much more prudential, as good bank supervision stipulates, and the Central Bank has been able to implement a regulatory structure which can better prevent banking crisis.

All of these measures have contributed to increase credibility within the financial system and induce greater responsibility on behalf of directors and majority shareholders, including over establishing better mechanisms of evaluating technical expertise.[46] Only to have rough estimate over the extent to which the Central Bank has been active in disciplining banking institutions, since the Real Plan in 1994 through 1997, forty three banks suffered intervention or extra-judicial liquidation, with 80% of them being from the private sector. In all, there was a 20% reduction in the number of total financial institutions in between December of 1993 and June of 1999.

During this period monetary authorities also created the Credit Guarantee Fund (FGC), which covers credit operations of up to R$ 20 thousand per person, and in accordance with Resolution n. 2.212 of 11/16/95 and the Basle Accord, further increased the minimum capital required to create a new bank. New standards were also adopted to better evaluate the financial credibility of potential bank

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[46] At the extreme, the CB can even veto candidates up for directorship positions in financial institutions if they have sufficient doubts over their technical capabilities.

owners, and the government also eliminated differential capital standards for opening a bank between foreigners and domestic citizens.

With Resolution n. 2.682 (passed at the end of 1999), banks had to completely change their method of classifying credit and non-performing loans through adopting risk criteria using techniques such as: credit scoring, credit behavior and ratings. Rumors in the financial market also have it the Central Bank will most likely adopt similar standards employed by the FED to supervise banks and classify assets according to risk and existing controls. All of these measures have obviously contributed to the permanence of only sound financial institutions in the market.

Most recently, the National Monetary Council passed Resolution nº 2.685 in January of 2000 to more strictly discipline the ability of banks to use the rediscount line at the Central Bank and operations of liquidity assistance. After an established period of time, such operations will only be accepted with the approval of the Collegial Directory at the Central Bank, and institutions who make use of the discount line will have to 'demonstrate financial necessity' and 'a restructuring program with the objective to capitalize or sell operational control of the bank, signed by the majority shareholder, and to be implemented in the time period prescribed'. The rediscount interest rate was further delegated to the COPOM (Comitê de Política Monetária), such that monetary authorities can have the ability to punish frequent uses of the rediscount with higher interest rates. With the restructuring of National Monetary System, it appears there no longer will be leeway for systematic abuse of the rediscount line.

Over the last five years the Brazil's financial system has undergone a significant transformation. Whereas the banking system previously acted in a manner to check the authority of the Central Bank, now Monetary Authorities have been able to implement banking regulation which significantly has reduced the risks associated with a systemic crisis due to unsound banking practices. Despite such advances, however, we do not believe the moral hazard problem facing the financial system has been completely resolved. Banking failures and the implicit assumption of a government bailout is always a risk, but the recent implementation of a more effective ex-ante safety net without a doubt has reduced such risks for the Brazilian case.

CONCLUSION

The objective of this paper has been to introduce a new line of research for economists and political scientists who are concerned about the study of financial institutions and the manner in which they change. The economics literature has characterized in a sophisticated manner the moral hazard problem within financial systems, and also has a well-developed body of work describing its institutional solutions. This literature, however, is silent over a discussion to the political obstacles involved in actually implementing such institutions. Our article has attempted to take a step toward filling this weakness. With regard to political science, we

believe this article make a contribution with regard to a subject area which is rarely studied: the relationship between policies and financial systems.

In addition to an institutional analysis, our work attempted to explicate the political conditions which lead to the ability of Brazil's monetary authorities to tackle the moral hazard problem amongst financial agents. We are cognizant, however, that our conclusions up for debate. While some analysts, who might be sympathetic to our conclusions, argue Brazil 's financial system has been undergoing a 'silent revolution' since the implementation of the Real Plan and is en route to a 'deep financial system', others would argue the Brazilian economy is now more than ever dependent upon international economic factors – a dependence which trumps any institutional change. Our article, however, has attempted to demonstrate that even though the moral hazard problem has not been resolved in Brazil, the recent set of reforms implemented by the Central Bank have gone a long way toward reducing system risks in the financial system.

We conclude with one final caveat. Despite our purely domestic level of analysis, the current administration's concern toward creating an ex-ante safety net cannot be attributed solely to domestic motivations. The set of reforms implemented by the Central Bank must be examined in an international context where financial regulation has been receiving increasing importance – as exemplified by the Basle Accord which has established international standards over financial and banking regulation. Despite such international influences, however, our analysis has focused more on domestic constraints to the implementation of such reforms. Financial regulation across countries is far from uniform, as is evident by the variable impact of currency crisis, and our article has begun from the assumption such variation derives from domestic political constraints.

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