

THE ROLE OF CONCESSIONARY FINANCE IN BRAZIL

A presentation by: Professor Armando Castelar Pinheiro



Professor Armando Castelar Pinheiro is a Brazilian economist and former head of the economic department at Banco Nacional de Desenvolvimento Econômico e Social (BNDES), Brazil's largest development bank. He served as the head of the BNDES economic department for eight years. He holds degrees in mathematics from the National Institute of Pure and Applied Mathematics (Rio de Janeiro), in business administration from the Federal University of Rio de Janeiro (UFRJ), in economics from the University of California, Berkeley, and in electronic engineering from Brazil's Technological Institute of Aeronautics. He is a professor at UFRJ, a member of the Brazilian Federation of Banks, and coordinator of the Brazilian Institute of Economics of the Getulio Vargas Foundation. Castelar taught at the Catholic University of Rio de Janeiro. He was also a researcher at the Institute of Applied Economic Research until 2009.

Introduction

The ANC discussion document on economic transformation – released on 5 March 2012 – declares ‘as a matter of urgency, the state should regulate a substantial part of retirement and life assurance funds (public and private) in order for these funds to be invested in State Owned Enterprises and Development Finance Institutions, as well as additional investment programmes. These funds can be used to provide concessionary finance’¹

The idea of expanding ‘concessionary finance’ in South Africa is part of an on-going policy thrust through which government aims to boost the investment rate and influence the direction of the economy. This policy thrust includes setting up a state-owned mining company and converting the Postbank into a fully-fledged banking institution. Another key instrument is the Industrial Policy Action Plan 2012 (IPAP 2012/13 – 14/15). This will provide subsidies and protection to selected economic sectors and be used to establish industrial development zones.

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Concessionary finance is intended to play a part in the overall strategy by providing loans at below market rates to favoured industries and to infrastructure projects. The state institution primarily tasked with this is the Industrial Development Corporation (IDC). In 2011, President Jacob Zuma announced that the IDC would make R10 billion available to companies at three per cent below the prime interest rate.² More recently, the government expressed the intention to expand the IDC's borrowing from R8 billion in 2011 to R30 billion over the next two years. Funds targeted for use in concessionary financing include the R900 billion Government Employees Pension Fund, and other union retirement funds.³

A major inspiration behind this policy initiative is the example of the Brazilian Development Bank. The *Banco Nacional de Desenvolvimento Econômico e Social*, (BNDES) is widely credited with promoting the economic success of Brazil through policies of concessionary finance.⁴ As part of an initiative launched by the Centre for Development and Enterprise (CDE) to explore whether South Africa is learning the right lessons from Brazil, Professor Armando Castelar Pinheiro was invited to assess how BNDES has actually influenced Brazilian development.

In a seminar with senior government officials in Pretoria in March 2012, CDE asked Professor Castelar to discuss a number of issues. Among the questions CDE put to Professor Castelar were: Who have been the primary beneficiaries of concessionary finance in Brazil? How is the Bank funded and how are these funds administered? What are the lessons that South Africans should learn from BNDES's performance?

Opening Remarks: Ann Bernstein, Executive Director, CDE

CDE is engaged in a process of strengthening our ties with think tanks in Brazil and India, two very important emerging democracies from whom South Africa can learn a great deal. By collaborating with leading think tanks in India and Brazil, CDE aims to learn more about each country and their development strategies and to find ways of bringing this experience into South African policy debates. This international think tank consortium intends to provide an independent perspective on growth and development from the democratic South, casting greater light on how these three countries are seeking to achieve sustained and inclusive growth in dynamic, democratic contexts.

A critical issue in the light of recent policy proposals is whether South Africa is learning the right lessons from Brazil. At the outset, we need to recognise that there are important differences between the two countries. South Africa's entire population is equivalent to the population of São Paulo state, one of the 26 states (*estados*) that make up Brazil. But the countries do share similarities in their backgrounds and in their aspirations. They are both democracies and very important countries within their regions; the two countries have enormous challenges of poverty and inequality that must be addressed; and Brazil and South Africa have both achieved a significant level of development, and are determined to build on that success.

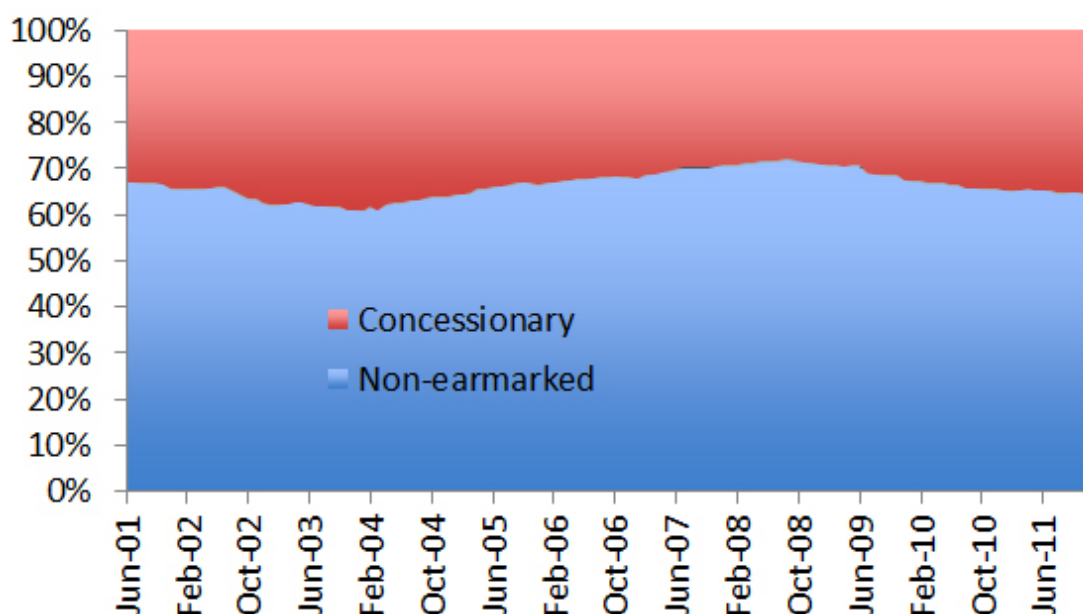
Concessionary Finance in Brazil: Professor Armando Castelar Pinheiro

My presentation begins by providing background facts about BNDES's operations and the concessionary finance environment in Brazil. Many of these facts point to some of the real strengths of BNDES. The talk then outlines some causes for concern before drawing conclusions about the applicability of the BNDES model for South Africa.

Background Facts and BNDES's Strengths

In Brazil, concessionary finance is a very large component of total credit.

FIGURE 1: Concessionary credit as a percentage of total credit

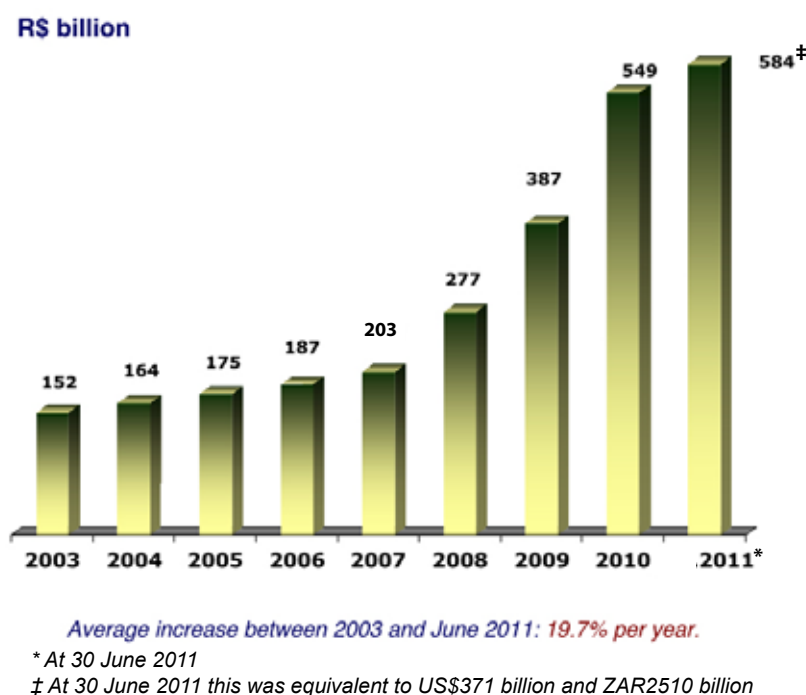


Castelar Pinheiro 2012

Concessionary credit accounted for more than 30 per cent of total Brazilian credit for nearly all of the period between 1997 and 2007. At this level, concessionary credit is equivalent to 17 per cent of Brazil's GDP. BNDES, the major provider of concessionary credit in Brazil, has seen the value of assets under its control quadruple from US\$83 billion (152 billion Brazilian *reais* – R\$) in 2003 to US\$318 billion (R\$584 billion) in 2011. Between 2003 and 2011 the average rate of increase was almost 20 per cent per year. In 2011, the infrastructure and industry sectors received the biggest shares of BNDES's disbursements, at 39 per cent and 34 per cent respectively.

The value of BNDES's disbursements is considerably larger than those of the World Bank. In 2010, for example, the value of BNDES loans was more than three times the total amount provided by the World Bank.⁵

FIGURE 2: BNDES's total assets



BNDES 2012

As a large, stable, well-run, and increasingly important government bank, BNDES has certainly played a role in helping Brazil avoid some of the fallout from the global financial crisis of 2008. In 2009, for example, BNDES increased its lending by almost 50 per cent to help cushion Brazil's economy against the global crisis.⁶

There are four forms of concessionary credit in Brazil. These are:

- Agricultural credit, provided mainly by the state owned *Banco do Brasil*;
- Credit for housing, water, and sewage, provided by *Caixa Econômica Federal* (CEF), a state-owned bank⁷, and various commercial banks;
- Micro-credit loans provided by commercial banks;⁸
- Concessionary credit for infrastructure, industry, and related sectors, provided directly by BNDES.

With the exception of micro-credit, these forms of concessionary credit have been in place in Brazil since the 1950s and 1960s. Micro-credit took off only recently, that is from about 2004, and remains a small component of concessionary lending. In Brazil, commercial banks and other types of public and private agencies are accredited to dispense the onward-lending of BNDES's financing lines. This partnership with accredited finance institutions facilitates financing for small and medium-sized companies in all Brazilian cities. In many ways this is an effective way to disseminate small loans, as the locally-based commercial banks in Brazil have a much better sense than a large national bank

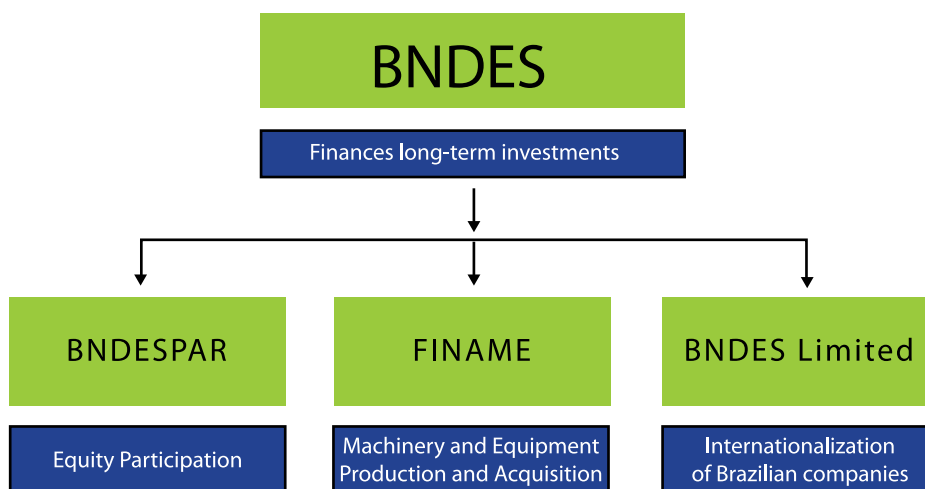
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like BNDES of how to lend to small, often informal, businesses. To make this kind of lending work you need banks that are close to and have experience with the business environments and the companies to which they are lending.

BNDES was founded in 1952, as the result of an investigation jointly sponsored by the United States and Brazilian governments. The investigation concluded that Brazil's banking sector was under-developed and the country needed a state bank to finance infrastructure and electricity provision. BNDES is wholly owned by the state. It is a well-run bank; the salaries are high and the bank attracts some of the top talent in Brazil. BNDES has also developed an ethos of efficiency and professionalism. It is considered a key instrument in implementing the Brazilian federal government's industrial and infrastructure policies. It is the main provider of long-term financing in Brazil, with a focus on financing investment projects, but it is also active in providing funds for merger and acquisition operations.

In terms of its current structure, BNDES's long-term finance is divided into three components, which are administered by three separate branches of the bank. There is BNDES Investments (Participações S.A. or BNDESPAR) which administers equity participation loans. These are loans in which BNDES obtains or has the right to obtain an ownership interest in the project being financed. The second branch is BNDES Finance (Financiamento or FINAME), which finances the production and acquisition of new machinery and equipment by domestic manufacturing firms. BNDES Limited finances the internationalisation of Brazilian companies. The aim is to both increase the Bank's visibility in the international financial community and to support Brazilian companies moving into other countries or searching for opportunities in the international market.

FIGURE 3: Corporate structure



BNDES 2012

BNDES is partly funded by a special payroll tax. The Bank has to pay interest on the amounts that are lent to it by the unemployment insurance fund, but it does not have to pay the capital amount back. Additional funding takes the form of loans from the Treasury, which are long term and are offered at a lower cost than market rates. Up until the 1970s the bank's main focus was financing public

companies. In the 1980s, it began to save failing companies and became, according to a phrase coined at the time, 'a hospital for loss-making companies'. In line with a general change in Brazilian politics in the 1990s, BNDES then became involved in providing finance to facilitate the privatisation process.

At the same time, BNDES became wary of lending money to Brazilian state-owned enterprises, as the money was not always paid back. When the building of infrastructure became privatised, BNDES began to fund infrastructure development once again. In recent years BNDES has become involved in financing a very wide range of activities, from shopping centres and trucks to exports and hydropower plants.

Causes for Concern

BNDES is a large and well run bank. There are, however, areas of concern that mostly relate to the bank's impact on the Brazilian economy.

- *Public versus private banks*

There is a wealth of literature on the role of public or state banks in development.⁹ A review of this literature reveals that government banks are more common in poor countries with underdeveloped financial systems, interventionist governments, and poorly-protected property rights. Government banks tend, in general, to be less productive than private banks. The Brazilian case supports this conclusion as privatisation has generally improved bank performance there. In Italy, it was found that the stronger a political party was in the area in which a borrower firm was located, the lower the interest rate charged by government banks, suggesting corrupt and politicized banking practices. In many developing countries, government banks lend more and perform worse in an election year. In conclusion, the literature suggests that, as a whole, government banks generate less financial development, lower expansion of per capita income, and less productivity growth than private banks. These adverse effects are strongest in poor countries.

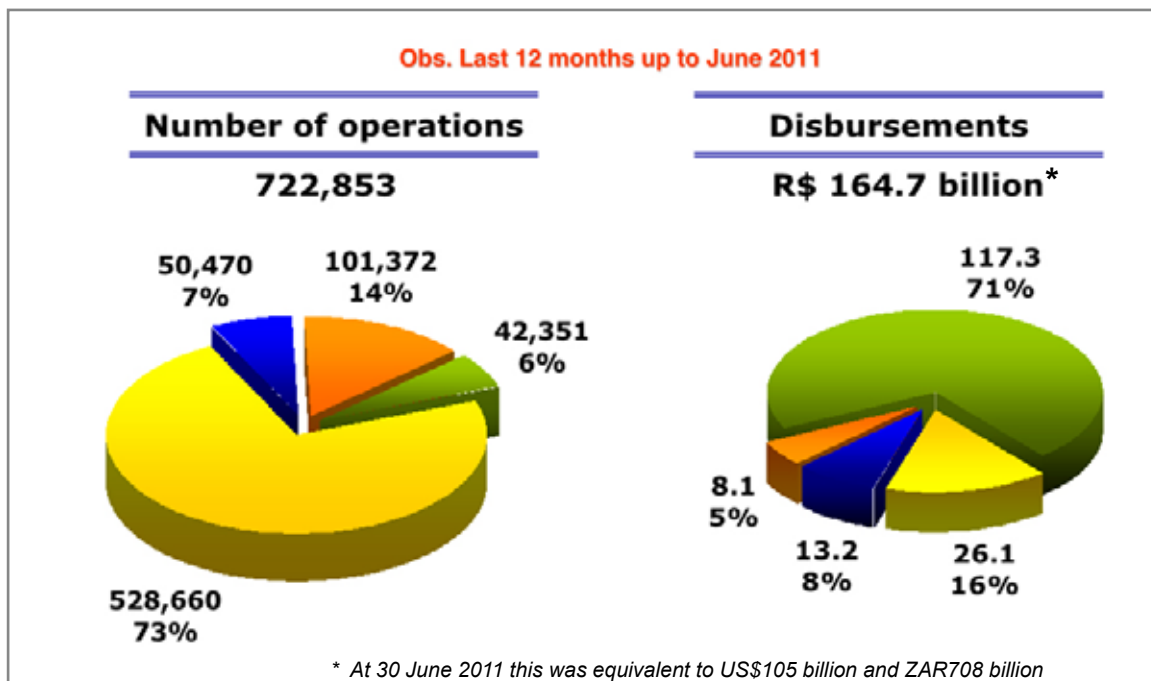
- *Inappropriate beneficiaries*

Although only six per cent of the operations or projects that BNDES finances are with big companies, 71 per cent of the bank's disbursements go to large companies. The ten largest BNDES customers account for 36 per cent of the total. Many of these large companies benefitting from BNDES's concessionary finance are established multinationals, such as Vale and Petrobras. This raises the question of whether these are the types of companies that should be benefitting from concessionary financing. Such large, well-established companies could easily raise loans, both from commercial Brazilian banks and from international institutions.

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Figure 4 (below) illustrates this dominance of lending to large companies. In 2010/11 the number operations aimed at small and micro businesses was 528,660, but the 42,351 operations aimed at large businesses in fact constituted R\$117 billion (or 71 per cent) of the R\$164 billion disbursed.

FIGURE 4: BNDES allocations July 2010-June 2011



BNDES 2012

The table below confirms that the largest customers receive the biggest slice of BNDES's portfolio (36 per cent) and that the 160 largest customers receive almost 85 per cent of the portfolio.

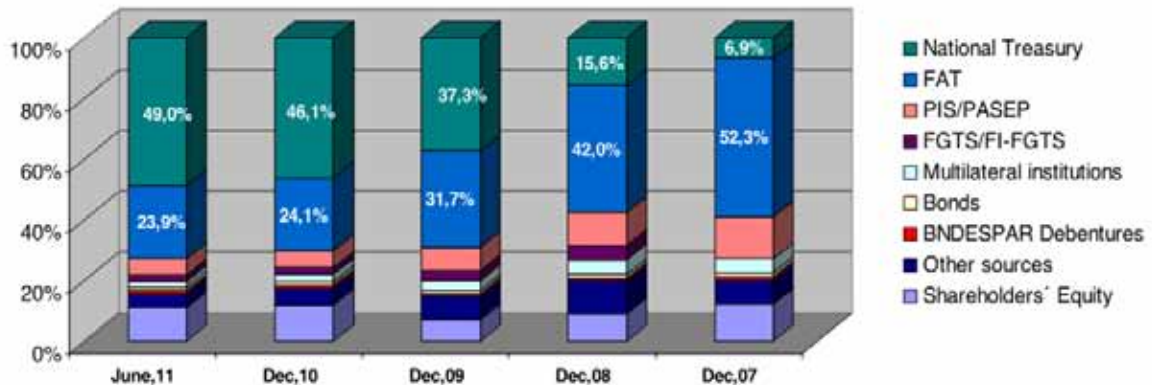
Portfolio Concentration				
	R\$ million			
	As of June 30,			
	2011	%	2010	%
10 largest customers	149,117	39.3%	116,553	36.2%
50 next largest customers	115,380	30.4%	103,500	32.1%
100 next largest customers	58,787	15.5%	51,828	16.1%
Other customers	55,955	14.8%	50,069	15.6%
Total	379,239	100.0%	321,950	100.0%

BNDES 2012

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In recent years there has been a massive increase in the funds that BNDES receives from the Treasury. Half of the money channelled to BNDES in 2011 came from the national budget. The Treasury borrows at 11 per cent but lends to the Bank at six per cent. In effect, the bank receives an annual US\$10 billion subsidy from the Brazilian government, which is then largely channelled to established companies that could easily raise their own capital in established credit markets.

FIGURE 5: Funding, 2010 – capital structure

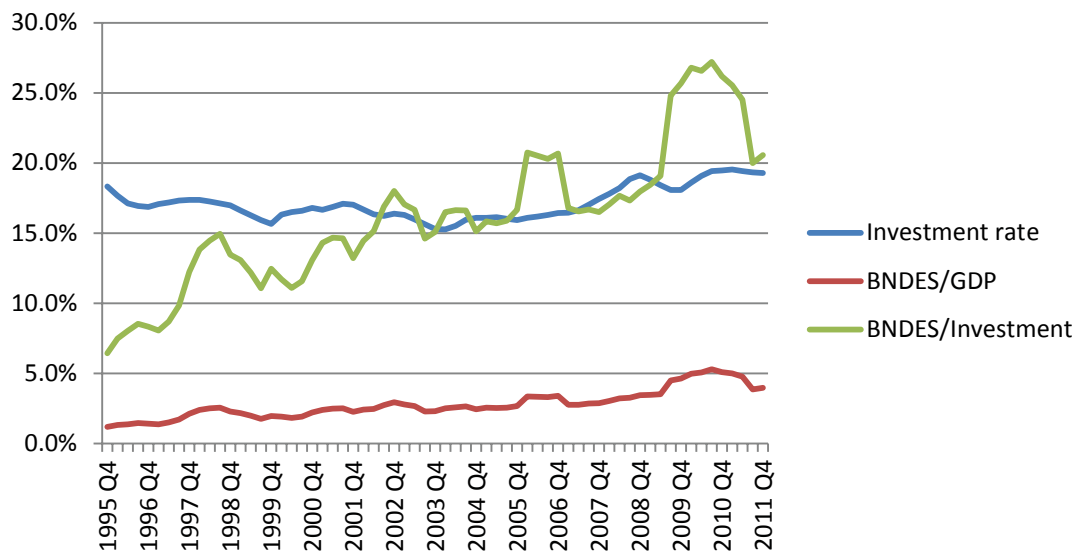


BNDES 2012

- *Failure to shift the investment rate*

Figure 6 below reveals that BNDES's disbursement as a proportion of total Brazilian investment has increased dramatically from five per cent in 1995 to 25 per cent in 2010. However, the overall investment rate has remained relatively static over this period at between 15 and 20 per cent of GDP.

FIGURE 6: Rate of investment and BNDES's disbursements



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In the 1950s and 1960s BNDES played a vital role in promoting Brazilian development, particularly by financing infrastructure provision. It no longer has such a focus and now largely provides subsidised credit to many of the biggest firms in Brazil. The overall level of investment and the efficiency of the Brazilian economy are largely unaffected by concessionary credit programmes. Instead, these growth-promoting factors are determined by broader conditions, such as the environment for investment and the education levels of the population. If either the Brazilian government, or any other government hoping to learn from the Brazilian example, wants to promote growth and development it should work on improving the investment climate and the quality of the schooling and post-schooling systems.

- *Crowding out the private sector*

It appears that the subsidised credit that BNDES provides is effectively crowding out private credit provision. In other words, the low interest credit that the bank provides is not stimulating new investment. Instead, established companies are drawing increasingly on the cheaper credit BNDES provides instead of going to the more expensive private banks. It also appears that BNDES credit is correlated neither with more labour-intensive production nor any noticeable increases in R&D expenditure.

Concessionary finance also has the effect of raising Brazilian interest rates in general, as the state has to borrow in order to fund the subsidy that BNDES provides. Thus, while the bank is by-and-large an effective institution, questions have to be raised about the subsidies it provides, which are mostly channelled to Brazil's largest, most credit-worthy corporations, while undermining the development of the private financial sector.

- *Blunting the impact of monetary policy*

The existence of concessionary financing means that monetary policy has less power in Brazil. BNDES interest rates are not affected by central bank determination so monetary policies seeking to shift the rate at which individuals and firms borrow will affect only two-thirds of the credit market that is represented by the loans that BNDES does not provide. In addition, credit subsidies are more likely to be accessed by bigger firms, meaning SMEs and poorer households have to borrow at higher rates.

- *Lack of accountability*

Furthermore, there is little accountability with regard to which projects BNDES funds, even though it is a public bank. There is no public discussion on the treasury allocations to BNDES and, apart from reviews of procurement procedures, there are no external assessments of the bank. A six or seven-person board appointed by the president makes all the decisions about who should receive what credit. The bank hides behind secrecy laws, which should not be applicable to subsidised financing.

The Applicability of the BNDES model to South Africa

BNDES is a large and effective institution that provides loans efficiently at a reasonable rate. It plays an important role in Brazil, but it is not clear that it is achieving the aim that was behind the original introduction of a concessionary finance programme. In other words, it is not certain that BNDES has played a significant role in shaping the rate and direction of Brazil's economic development.

Originally, the role of the bank was to strengthen the underdeveloped Brazilian banking sector and to provide funding for the development of Brazilian infrastructure. This may have been an important factor in Brazilian development for a while, but as the economy and the banking sector developed, BNDES increasingly took on the role of a large bank financing large companies at reasonable interest rates. This created fewer opportunities for private banks to develop and has entrenched a massive subsidy, which is channelled towards large corporations from the tax contributions of the working class. At the same time, critical issues in the development of the Brazilian economy, such as the rate of investment and the productivity of the economy, are largely unaffected by concessionary finance.

Therefore, a country like South Africa, which has a sturdy and deep financial sector and many cash-rich companies reluctant to increase their investments until they face a more certain future, would be learning the wrong lessons from Brazil if it used the BNDES story to justify the expansion of concessionary finance.

Final Thoughts

Professor Castelar's presentation raises many questions about the lessons South Africa should be learning from BNDES's role in Brazilian development. Rather than bringing about a transformation of the Brazilian economy, BNDES is an institutionalised feature of the current status quo. It is a large and stable bank, and was mostly immune from the downturn that affected the global economy in 2008/09. Rather than changing the structure of the Brazilian economy, BNDES serves large, well-established firms. It offers these firms a special interest rate, and effectively provides them with a massive subsidy (US\$10 billion per annum) paid for by tax payers. The operations of BNDES are not transparent and the existence of the bank retards financial deepening in the private sector, while also blunting the impact of monetary policy by setting interest rates independently of the central bank. Most importantly, the activities of BNDES have little impact either on the investment rate or on the levels of Brazil's productivity. Investment rates and productivity levels are the key factors that determine economic growth. To achieve the critical goal of moving towards a much higher growth rate, South Africa, like Brazil, needs to create a better, more certain business environment, a more educated workforce, and, particularly in the case of South Africa, a much larger supply of the work-related skills that could be employed to expand the size and the productivity of the economy.

It also seems clear that even when concessionary finance works, as it may have done in Brazil after the Second World War, it does so only when financial systems are very imperfect, when investors struggle to raise capital, and/or when finance is very expensive. None of these conditions currently prevail in South Africa. South African banks are stable and well-organised and interest rates, 5.5 per cent compared to 9 per cent ¹¹, are lower than they are in Brazil. South African firms have large retained earnings that they could easily re-invest if they wanted to. This has been confirmed by local reports and by an in-depth World Bank study.¹⁰ Lowering the cost of capital will not alter the magnitude of investment in South Africa. What cheaper capital will achieve is to encourage further factor substitution – capital for labour. This is especially likely in a situation where restrictions on the labour market are tightening rather than loosening, thereby raising the relative cost of labour.

South Africa has a great deal to learn from other middle income developing countries. It is important that we get the facts right about other countries and their institutions and innovations before deciding on the applicability for this country and its particular challenges.

Notes

1. ANC, Economic Transformation: Policy Discussion Document on State Owned Entities and Development Finance Institutions, 05 March 2012, <http://www.anc.org.za/list.php?t=Discussion%20Documents>
2. Carol Paton, IDC plan to boost economy gets off to slow start, Business Day, 20 March 2012
3. Carol Paton, Retirement savings not the 'big bang' the ANC hopes for, Business Day, 19 March 2012
4. Joe Leahy, Brazil: Platform for Growth, Financial Times, 15 March 2011
5. Sergio G. Lazzarini, Aldo Musacchio, Rodrigo Bandeira-de-Mello, Rosilene Marcon, What Do Development Banks Do? Evidence from Brazil, 2002-2009, Harvard Business School Working Paper, 12-047, 8 December 2011, p. 3.
6. Mary Stokes, Brazil's development bank at heart of policy controversy, Timetric, 28 February, 2012
7. <http://www.relbanks.com/south-america/brazil/caixa-economica-federal>: Caixa Econômica Federal (CEF or CAIXA) is a government-owned Brazilian commercial bank founded on 12 January, 1861 by Emperor Dom Pedro II. CAIXA is a Brazilian behemoth and one of the largest financial institutions in Latin America. It has more than 38 million customers, some 17,000 locations and some 19,000 ATMs (for example, Bank of America has the largest number of ATMs in the US - about 18,500). There are 8.5 million current account holders and more than 30 million savers, which corresponds to 34% of all the national savings market. Caixa Economica Federal serves not only its clients, but the whole Brazilian population through lotteries, urban infrastructure investments and social programs payments. It is the manager of most Brazilian lotteries, especially the most popular ones, such as Mega-Sena, Quina and Loteca. The bank is also the main fiscal agent for the government. With over 82,000 employees, CEF has total assets of US\$296.7 Billion (2011).
8. Banks have to micro-lend 2% of their sight deposits or deposit the equivalent amount at the Central Bank, earning no remuneration on it.
9. For a useful overview see, Eduardo Levy Yeyati, Alejandro Micco, Ugo Panizza, Should the Government be in the Banking Business? The Role of State-Owned and Development Banks, Paper prepared for the seminar Governments and Banks: Responsibilities and Limits, IDB-IIC Annual Meetings, Lima, Peru, March 28, 2004.
10. G.R.G Clarke, J. Habyarimana, M. Ingram, D. Kaplan, V. Ramachandra, An Assessment of the Investment Climate in South Africa, World Bank, 2007; Carol Paton, Retirement savings not the 'big bang' the ANC hopes for, Business Day, 19 March 2012
11. This was the Brazilian rate in April 2012

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