

Talking point

BRIC banking systems after the crisis

July 11, 2011

State-led economic development, if successfully implemented, is appropriate during the early “catch up” phase of economic growth. However, as growth becomes more dependent on indigenous innovation and hence a dynamic private sector, a shift to more market-led rather than state-directed development becomes necessary. This also applies to the banking sector. Subject to proper regulation, banking systems that rely on private-sector banks and market-led credit allocation will eventually tend to generate superior economic outcomes. That said, we are unlikely to see a significant reduction in public-sector bank ownership in the BRIC countries anytime soon, nor, for that matter, a tangible increase in foreign ownership.

Following the global financial crisis, BRIC governments have become (even) less prepared to reduce their presence in the domestic banking system. After all, policymakers’ success in overcoming the credit crunch in 2008-09 in part relied on their ability to provide credit to the economy through public sector-owned banks. In the absence of often substantial public-sector bank lending, the decline in domestic demand in a number of countries (e.g. Brazil, China, India) would have been much more severe. Conventional monetary policy would have been and was insufficient to stimulate bank lending (aka Keynesian “liquidity trap”).

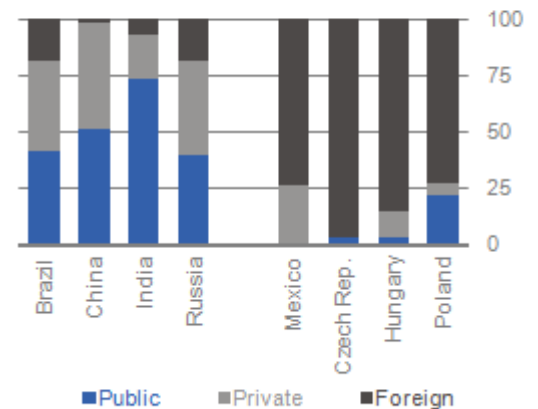
Enter the Beijing consensus, exit the Washington consensus. The Beijing consensus is committed to, among other things, the state playing an activist role in economic sectors deemed “strategic”, invariably including the banking sector. This takes the form of outright government ownership or at least significant government intervention. Instead of near-exclusively relying on private-sector, market-led processes, the state takes an activist approach going far beyond merely regulating private-sector activity. Historically, this type of successful developmentalist, state-led economic policy and development does nonetheless rely on functioning private markets – nowhere is this more evident than in today’s China, where the private sector has been the main engine of economic growth.

History suggests that this strategy, if successfully implemented, is appropriate during the early “catch up” phase, when per-capita income is low and growth is significantly driven by large-scale investment in physical infrastructure and the introduction of “off-the-shelf” technologies. However, as per-capita income rises, growth becomes more dependent on a dynamic private sector and indigenous innovation. Eichengreen et al. identify a per-capita income of USD 17,000 (in 2005 constant international dollars) as a critical threshold where economies experience a tangible downward shift in their trend growth. This is where state-directed policies are bound to become less effective in terms of generating growth than a dynamic private sector. This suggests that – following recent PPP revisions – smart state-led policies remain broadly appropriate in low per-capita-income India (USD 3,500) and, less so, in China (USD 7,700) and Brazil (USD 10,000), while they are bound to be less effective in Russia (USD 15,200), all other things being equal. Naturally, should China continue to grow at near-double-digit rates, it would, as Eichengreen et al. point out, reach the “critical threshold” before the end of the current decade.

The greater need for a shift to more market-led rather than state-directed development also applies to the banking sector. At a stage of economic development where per-capita income is low and capital productivity is high, it is not difficult to identify profitable and economic growth-generating lending opportunities. This tends to change as economies move into middle-income territory. This is why, subject to proper regulation, banking systems that rely

Extensive government & limited foreign ownership in the BRIC

% of banking sector assets



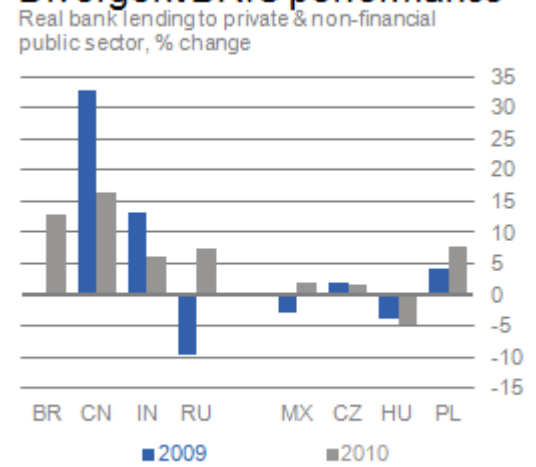
Source: Fitch



on private-sector banks and market-led credit allocation will eventually tend to generate superior economic outcomes.

This flies in the face of policymakers' recent successful experience with counter-cyclical state-directed credit policies. After all, the extensive use of government-directed bank lending played an important role in sustaining domestic demand and economic growth (China, India) or may, at least, have prevented an even sharper economic contraction (Brazil, Russia). Interestingly, real bank lending grew significantly faster in the BRIC countries, where governments play an important role in the banking sector. Real credit growth averaged almost 25% in China in 2009-10, while public-sector banks in Brazil, impressively, doubled lending from 10% of GDP in 2008 to 20% of GDP in 2010. This contrasts sharply with the contraction in credit experienced by many developed markets and relatively anemic credit growth in those emerging markets where government ownership of banks is very limited (e.g. Mexico, Eastern Europe). Admittedly, other factors such as extensive foreign ownership and significant cross-border lending may also have contributed to differential credit growth. But the role played by public-sector banks was undoubtedly important.

Divergent BRIC performance



It is perfectly sensible to pursue counter-cyclical state-directed credit policies if the banking system is dysfunctional and is suffering from market failure. However, time inconsistency and politicians' desire to dish out favours risk turning counter-cyclical policies into pro-cyclical ones. Interestingly, among the BRICs, only Brazil seems to have given in to this temptation, while China, more accustomed to state-directed lending and more concerned about its inflationary consequences, has not. But unless top-notch governance regimes are in place, extensive state-directed credit allocation, especially if sustained over a longer period of time, carries the risk of capture by "rent-seekers". And rare is the government (or the bureaucracy) that manages to privilege medium-term economic efficiency over short-term political considerations in a consistent manner. An economy that grows at double-digit rates may be able to afford this (China), whereas most economies, especially those constrained by low savings rates (Brazil), cannot. Last but not least, an extensive public-sector presence also undercuts, and if does not undercut then it certainly slows, the development of a more sophisticated banking and financial sector capable of sustaining economic development once an economy moves into middle-income territory.

That said, it is difficult to see why the BRIC governments would be willing to substantially reduce, let alone relinquish their role, in the domestic banking sector over the next few years. Some BRIC governments have sold (China) or are planning to sell minority stakes (Russia) in major state-owned banks. But none of them is seriously considering giving up control. True, Brazil did fully privatise a number of its public-sector banks in the 1990s (and even sold some of them to foreigners), but this occurred against the backdrop of severe financial pressures and an urgent need to resolve a banking crisis. Short of a major crisis, which is unlikely given solid economic fundamentals, we will not see a substantial decline in public-sector ownership and control in the BRICs over the next decade or so.

Similarly, if the history of banking sector opening since the 1990s is anything to go by, none of the BRIC economies will see a significant increase in foreign bank ownership. While opening the banking sector to foreigners has always been a politically unpopular proposition in the BRICs, economically and intellectually it seemed difficult to contest its benefits. The view that greater foreign ownership is unambiguously a good thing, bringing superior regulation, fresh capital, financial innovation and better risk management, has at least been called into question in the wake of the global financial crisis. There are also concerns among BRIC policymakers that a large foreign presence may allow external shocks to be transmitted more easily. This is debatable, however. Extensive foreign ownership may actually have helped avert a larger crisis thanks to co-ordination committing foreign banks to maintain the lending of their domestically incorporated subsidiaries, recapitalise local subsidiaries (if necessary) and, more generally, allow for an "orderly" de-leveraging (e.g. Vienna Initiative). Still, we are not likely to see either a significant reduction in public-sector ownership or a substantial increase in foreign ownership in BRIC banking sectors in the near or even medium-term future.



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