

## INTRODUCTION

The elementary truths of political science and statecraft were first discredited, then forgotten.

Karl Polanyi, *The Great Transformation*  
(New York: Farrar and Rinehart, 1944), p. 33

Government banks make sense. As banks, they retain competitive advantages because of greater client confidence and unbeatable brand names such as the Banco do Brasil. As policy instruments, they provide branch offices, automated teller machines and mobile services over cellular phones to reach citizens. Their staff can manage complex information about local needs, measure costs, benefits and risks, and assert contractual control to correct public policies before they run astray. Government banks provide large policy levers for political leaders and social forces. These institutions are often large enough to provide counter-cyclical credit to avert or ameliorate recessions. Federal banks may implement reforms such as privatizations and public sector modernization through 'IMF-like' conditional loans to sub-national governments. In the past, directed credit from government banks drove rapid industrialization in late-developing countries. Such policies continue in many emerging, transition and developing nations. But government banks do much more than direct industrial change. Government *savings* banks have served local communities across Europe, some for centuries, to emerge after liberalization of the industry and monetary union with increased market shares and renewed social mandates. Brazilian federal banks have also emerged from military rule, abuse by traditional elites during prolonged transition, monetary disorder and financial crises to shape development and democracy. Three big banks, a commercial-investment bank, a savings bank and a development bank provide over a third of domestic credit in twenty-first-century Brazil. These institutions are commanding heights, both in the traditional sense of directing large industry and in a new sense. Federal banks have provided a new channel for social inclusion of the bankless (80 per cent of Brazilians in 2000!) and essential policy alternatives for reform and economic management amidst boom and bust cycles.

A problem with government banks is that liberal market economies such as the United States and United Kingdom have none (ignoring support/ownership during crisis and past experiences). Government banks remain dissonant from liberal principles such as free trade and free market equilibrium. Nonetheless, these institutions remain at the centre of political economy in advanced and developing countries. Federal banks in Brazil have persisted because they provide valued policy alternatives and retain competitive advantages over private and foreign banks.

This returns to old ideas about how public banks may steer development and sustain social economies. However, the question is not whether commanding heights can centralize power and policy. This study is about commanding depth, both in a social and a financial sense. From Lenin through Alexandre Gerschenkron, Arthur Lewis and Gunnar Myrdal, central government banks were seen as critical agents for rapid industrialization and modernization. To *command depth* implies decentralization and diffusion to embed government banks in society, politics, firms and markets. Unless government banks are part of the complexity, diversity and contestation involved in citizenship, political parties, interest groups, social movements and transparent government that reflect the separation and diffusion of power true to democracy, then government banks will fall short of their potential. Large-scale lending offends liberal principles and often damages the environment. It also distances decisions from citizens, institutions of representative government and measures of supervision and control that are needed for democracy *and* prudent banking, sound risk analysis and informed decision making about resource allocation.

These claims are grounded in theories of political economy, banking and democratization. However, they differ from neo-liberal theory. The Brazilian case counters the idea of global convergence toward private banking through liberalization and privatizations. This is not an anti-market observation. The Brazilian stock market Bovespa grew from 3 per cent of GDP in 1990 to over 100 per cent of GDP in 2008 (before losing then regaining *half* its value), with a variety of futures markets, mutual funds and financial instruments now available to firms and investors. These advances notwithstanding, government banks still provide over a third of domestic credit. Government banks have not impeded financial development. To the contrary, Brazilian federal banks have led in the creation of new markets and new banking services in Brazil. Case studies describe how these institutions have been central players in the record number of initial public offerings, the unprecedented capitalization of firms on the stock market, policies designed to democratize stock and bond ownership and the creation of futures markets for interest rates, foreign exchange and commodities that have served as bellwethers to approximate public policy and investor confidence. Without government banks, Brazilian financial markets would not be where they are today.

Government banks have not crowded out financial markets. Instead, paraphrasing Polanyi's claim about regulation, government banks and markets have grown together in Brazil. Federal banks have also implemented new social services and family grants through ATM citizenship cards to help reverse severe inequality. This has impaired neither their leadership in credit, finance and capital markets, nor their ability to help adjust the economy and reform the public sector.

Bank change in Brazil thus confirms core ideas in political economy about varieties of capitalism and institutional foundations of competitive advantage. Differences from liberal market economies and neo-liberal theory do not imply dysfunctionality. And Brazil is not an outlier. Government banks remain at the centre of both coordinated market economies across Continental Europe and many emerging and developing nations. This anomaly for liberal theory and market-centred approaches both inspired this study and shaped its course. Research began in 2001 when privatization remained an unshaken principle at international financial institutions and largely accepted as best policy by scholars. Orthodoxy was also adopted by the coalition government led by President Luis Inácio Lula da Silva's Partido dos Trabalhadores (Worker's Party, PT) in 2003 to avert a foreign exchange crisis that would have delegitimized the Brazilian left for a generation. Consensus about neo-liberalism has since given way, but comparative studies, causal analysis and alternative theories remain embryonic. To explain why federal banks remain so important in Brazil, it was necessary to go back to basics in political economy, public policy and banking.

Debates in comparative financial economics about bank-centred versus market-centred financial systems first led me astray. The compelling fit between this dichotomy and Hall and Soskice's varieties of capitalism (liberal and coordinated market economies) seemed to provide the key to explaining why government banks remained so important in Brazil. However, as reference to the booming Brazilian stock market suggests, the dichotomy between bank- and market-centred financial systems is forced and now out of favour. Financial economics now emphasizes the importance of legal systems and the particularity of domestic configurations of banking and finance. The liberalization and deepening of financial markets in traditionally state- and bank-centred systems such as France and Japan (and Brazil, ignoring differences for the moment) also reveals that banks and markets mix better than scholars feared. But the banks versus markets dichotomy tends to obscure a more fundamental reality about Brazil. Advanced political economies tend to have *both* deeply leveraged bank credit and capital markets. Developing nations tend to have *neither*.

This is a study of how federal banks helped bring Brazil out of underdevelopment, military rule and monetary chaos by providing policy options for adjustment, reform and social inclusion. Brazilian federal banks helped buffer shocks, induce reform, reach the bankless and manage the economy. This has

involved innovations in electronic banking and information technology, growth more driven by the service sector and popular consumption, second-generation or microeconomic reforms and the organization of a new democracy in a large but underdeveloped emerging economy. Theory and evidence suggest that government banks may steer financial systems toward social inclusion, sustain growth during crises and compete against private and foreign banks.

Since the late 1990s, citizenship cards (110 million), family grants (12.5 million), new simplified bank accounts (9.8 million) and bank correspondents (110,000) have reached an estimated 40 million bankless Brazilians. Social banking has a long history. And micro-credit, finance and insurance have become widely discussed since the United Nations declared 2005 International Year of Microcredit and the 2006 Nobel Peace Prize was rewarded to the Grameen Bank and Muhammad Yunus. Microcredit has profound implications for political economy. A core assumption in theories of both Welfare States and democratic breakdown is that markets constrain political change and limit social policy. This is now only partially correct. Theories of banking and money, information technology and innovations such as ATM citizenship cards suggest that past constraints to change may be circumvented. Not ignored, circumvented. New policies and channels for change are at hand. Advances in monetary theory and policy, central banking, credit risk analysis, more transparent financial reporting standards, basic income policies and client confidence in public institutions suggest that capitalism in the twenty-first century provides different channels for change than the large wage increases and fiscal excesses that fuelled conflict and contributed to democratic breakdown in the past. The microeconomics of social inclusion differ from the macroeconomics of populism. This has fundamental consequences for labour parties, social movements, theories of the state, conceptions of constraints to change and comparative studies of public policy and democratization.

These arguments were not clear in 2001. Nor were they apparent to Brazilian policymakers. Indeed, the intuitive reluctance to privatize federal banks in Brazil illustrates how policymaking differs in developing countries. Instability, uncertainty, complexity, volatility and shifting circumstances mean that policymaking in developing countries is usually closer to Lindblom's description of *muddling through* than derived from theories or ideologies. The centrality of Brazilian federal banks is thus as surprising to participants and observers as it is an anomaly for liberal theory. The structure and content of this book reflect this element of surprise, puzzle in the face of anomaly and search for explanation amidst deeply contested concepts and theories that cross several social science disciplines.