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**EARMARKED CREDIT IN BRAZIL:  
CURRENT SITUATION AND OUTLOOK**

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# EARMARKED CREDIT IN BRAZIL: CURRENT SITUATION AND OUTLOOK <sup>1</sup>

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## **Abstract**

In Brazil, as well as in the rest of the world, the State earmarks banking and non-banking credit according to political and economical priorities. Currently, the government earmarks around one-third of Brazilian bank loans. The total amount of those operations at the end of 2005 reached R\$ 202.1 billion, out of which 61% were BNDES liabilities. Still, in the last two years, earmarked credit has been criticized as being negative for economic development. Some critics have even proposed its immediate extinction. This paper aims at analyzing the different mechanism of credit earmarking in Brazil, on a comparative basis to similar experiences in other countries. It also points out some perspectives for earmarked credit in Brazil.

## **Introduction**

At the end of 2005, bank credit to the private sector in Brazil reached almost 30% of GDP (see *Banco Central*, 2006). This was good news for the country. It was the highest level reached in a decade. It also represented the continuation of the economic recovery process which started after the strong shock of the last two quarters of 2002, generated by the electoral instability.<sup>3</sup> Since then, credit has increased seven percentage points in GDP (See Graph 1).

Despite this result, credit in Brazil continues to be relatively scarce. In more advanced countries, the ratio between credit and GDP is generally over 100%. Even in other South American countries, such as Chile, this figure is more than 70% (see *World Bank*, 2005). And, what's worse, in addition to this scarcity, credit in Brazil is very expensive and volatile, as is evident through comparisons to other countries (see IBD, 2005).

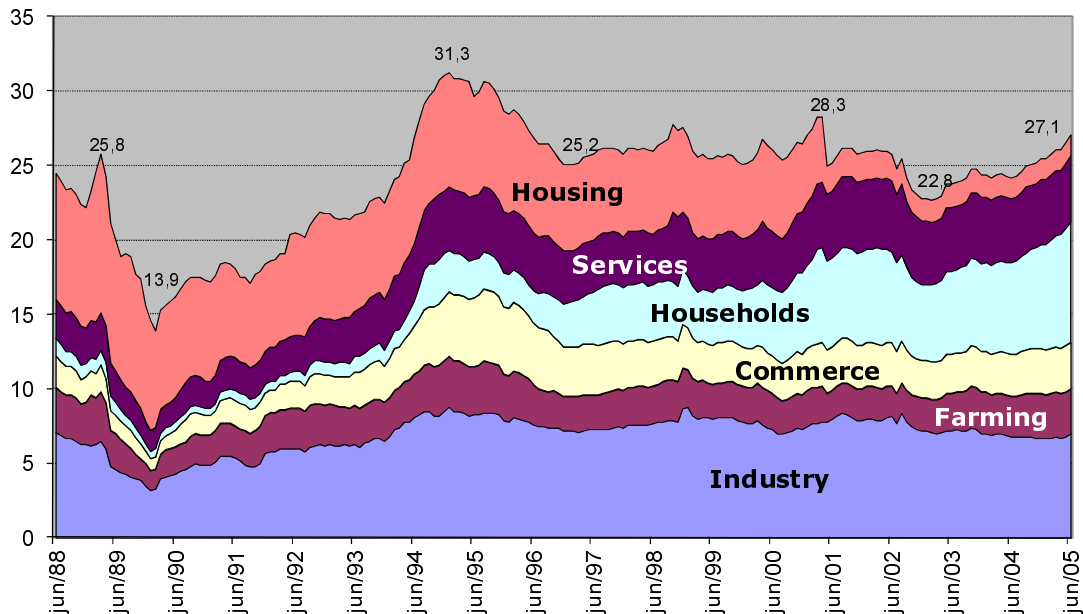
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<sup>3</sup> Between September 2002 and February 2003, credit for the private sector decreased from 25% to its lowest involvement in GDP: 22.7%.

Graph 1 – Bank loans to the private by sector (in % of GDP)



Source: Brazilian Central Bank.

More than 90% of credit loans to Brazil’s private sector are managed by banks. The role from other financial institutions – leasing companies, financiers, credit cooperatives, etc. – is still limited. Brazil’s credit system, therefore, is very dependent on banks, as is the case in many other countries, particularly in Latin America (see OECD, 2005 and IBD, 2005).

Approximately two thirds of Brazilian bank loans are given according to criteria established by the institutions themselves. The remaining third of bank loans follows some kind of earmarking allocation according to government regulations (which includes lower interest rates). At the end of 2005, the amount of earmarked credit in Brazil reached R\$202.1 billion (US\$ 80 billion) or 33% of total credit. Out of this value, the Brazilian Development Bank (BNDES) alone supplied 61%; loans to farmers reached 22.1% and housing 13.9% of housing.

Earmarked credit in Brazil has always been criticized as an excessive government intervention in the financial market. In the beginning of 2006, for example, Rodrigo de Rato, Managing Director of the International Monetary Fund (IMF), while officially visiting Brazil, explicitly recommended the full elimination of these mechanisms (see *Valor Economico Magazine*, 2006a). Other critics are less radical. They usually suggest a gradual elimination of the earmarked credit, including the transference to private banks of the management of the large fiscal or quasi fiscal investment funds, such as the FAT and FGTS<sup>4</sup> (see Torres, 2005 and Arida, 2005).

<sup>4</sup> FAT is a Portuguese acronym for *Fundo de Amparo ao Trabalhador*. FGTS stands for *Fundo de Garantia por Tempo de Serviço*.

However, treating earmarked credit simply as something necessarily negative or irregular misses the big picture. In every country, the State earmarks banking and non-banking credit according to its own political and economical priorities. Fiscal or quasi fiscal savings are just one of doing it. From this perspective, Brazil is no exception. Some countries (particularly richer nations) prefer to stimulate the allocation of voluntary funds from banks or capital markets by means of subsidies or loan guarantee mechanisms. Other countries, such as Brazil, also make use of fiscal or quasi-fiscal resources in order to earmark loans. International experience on earmarking credit is, therefore, very rich and diverse.

The statistics of the Brazilian Central Bank helps to increase the current confusion over earmarked credit. The Central Bank included very different operations under the same item. On the one hand, there are bank loans funded by fiscal or quasi-fiscal Funds, as FAT or FGTS. On the other hand, there are the loans using deposit which are subject to earmarking by the government. Due to that, private funds were added to public resources as if they were of the origin. Although they are both allocated according to governmental regulations, this is not reason enough to disregard the origins of their funding.

In light of this scenario, this article aims to present the different tools used in the earmarked credit programs in Brazil, including a description of the way each tool works, and then to compare these tools to similar tools used in other countries. This article will initially consider the mechanisms that use fiscal funding, and will then discuss those that are based on market resources. Finally, the article will seek to identify the perspectives on earmarked credit programs in Brazil.

## **1 Earmarked Credit Based on Fiscal and Quasi-fiscal Funds**

Earmarking credit based on fiscal funds is simply a process of setting aside tax revenues in order to use them to finance expenses of companies or households. In this case, it is a public sector savings, originated through compulsory programs, taxes or other forms of contribution, and disbursed as a loan to the private sector. The final beneficiaries take the loan on the condition that they will necessarily invest in sectors or activities which were prioritized by the government.

An example of this mechanism in Brazil is the FAT, which is funded by the corporate sector by means of an unemployment tax (PIS). This contribution is made based on their sales, and it is also used to finance unemployment insurance. If the revenues earned by the FAT Fund are greater than the current expenses of the unemployment benefits, the difference is use to fund loans of state owned banks for high-priority investment projects on favorable terms. Therefore, this Fund is a tool to promote economic development and increase employment.

A variation of this mechanism is a quasi-fiscal Fund. In this case, the main difference is that the compulsory payments made by the companies are transferred directly to private entities (employees) accounts. These funds are also used to provide loans according to government priorities, but the risk of this allocation is entirely taken by the government. Due to the quasi-fiscal nature of these Funds (that is to say, the use of a compulsory revenue mechanism and public guarantees), the interest rates payed by the Fund to the workers is low, and the liquidity of their deposits is limited. Withdrawals are only allowed on special occasion, such as home acquisition, death etc. Brazil's FGTS Fund is an example of a quasi-fiscal fund.

Financing companies with fiscal or quasi-fiscal resources is not a simple task. A specific feasibility study of the project and risk analysis must be completed beforehand in order to analyze the risk of each investment. If the debtor meets the legally determined criteria to be defined as a priority and if he is able to demonstrate its ability to repay the loan, the lender and borrower will have to sign a legal contract. Next, the use of public money must be audited and monitored to confirm that it has been used for the ends that were agreed to.

Due to these procedures, banks are the best agents to originate loans to private investors with fiscal or quasi-fiscal funds. They routinely finance and monitor companies and projects. They have branches all over the country, which means large geographical coverage and easy access for the companies involved. Furthermore, banks pay interest to their depositors and are fully responsible for their loans, charging a spread to bear their administrative costs and the risk they take. Thus, rather than creating new public bureaucracies to perform these activities, it is far more rational to make use of already established financial institutions.

The use of the banking system as a method of distribution of public funds solves some problems, but also creates others. Loaning money to commercial banks is not a simple activity to manage, and is even less so in the case of public money. Banking activity in Brazil is regulated by the Central Bank, but it is subject to risk. Not all banks are the same. Occasionally, some of them go bankrupt, and their depositors make a loss. Additionally, it is necessary that fiscal Funds monitor and audit banks to make sure they are correctly administrating public savings, especially to make sure they are investing public funds according to governmental priorities.

Therefore, the government needs a public agency to analyze the risks of the banks which will invest those public funds, to fix credit limits for them, and to monitor if they are maintaining compliance with their obligations, allocating those resources according to government priorities. National Treasury (Tesouro Nacional) <sup>5</sup> as fiscal authority, is not the appropriate state entity to

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<sup>5</sup> Brazil's *Tesouro Nacional*, lit. National Treasury, is an organ of the Brazilian government within the Ministry of Finance, distinct from the Ministry itself and from the Central Bank (translator's note).

these tasks. On the other hand, Central Bank, as monetary authority and auditor of the banking system, has other more important duties to complete.

In the case of the FAT fund, this responsibility is taken by the Brazilian Development Bank (Banco Nacional do Desenvolvimento Econômico e Social), a large investment state-owned bank. In 2005, BNDES's credit assets were worth at R\$ 148 billion, or approximately US 60 billion. Disbursements from the same year reached R\$ 47 billion this year, 53% of which were loans to other banks through more than 114,000 operations.

Like Brazil, other countries have earmarked credit mechanisms based on fiscal and parafiscal resources. In Japan, for example, there is a fund that is similar to Brazil's FAT, the Fiscal Investment Loan Program (FILP). It is managed by Japan's Ministry of Finance. At the end of 2003, FILP assets were worth more than US\$1 trillion. This Japanese fund is used, in part, to finance large projects, as well as small and medium enterprises, either directly or through public credit institutions.<sup>6</sup>

Another interesting example from Southeast Asia is found in Singapore, a country that has a quasi-fiscal tool, the Central Provident Fund (CPF), which is very similar to Brazil's FGTS. This Singaporean fund is composed by individual employee accounts, and it is financed by compulsory contributions from both employers and employees. The fund's resources are invested by the government and can only be accessed by employees in special occasions, such as when buying a house. At the end of 2004, total assets in Singapore's CPF were worth US\$70 billion.

## **2 Earmarked Credit using Funds from the Banking System**

Earmarked credit based on funds from the banking system is a tool which is present in almost all market economies. Rather than supplying fiscal or quasi-fiscal funds to make credit available for investments that are considered to be priorities, governments attract voluntary private savings to the same end by means of providing public guarantees or interest rate equalization.<sup>7</sup>

For governments, these two earmarked credit tools are more economical than financing using public resources. Instead of allocating large sums of fiscal or quasi-fiscal funds, public spending, in this cases, is limited to a certain, but much smaller, amount, which is equivalent to

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<sup>6</sup> According to the FILP 2004 annual report, "through investments and loans, the Fiscal Investment Loan Program (FILP) is involved in the execution of large-scale and long-term projects that it would be difficult for the private sector to finance. In short, the FILP is an instrument to execute fiscal policies using financial techniques."

<sup>7</sup> In the case of interest rate equalization in Brazil and some other countries, the government pays a part of interest rates that are owed by the final borrower of the loan in order to reduce interest payments or to swap a variable interest rate into a fixed interest rate.

part of interest payments, in the case of equalization of interest rate; or to a eventual sum, which can be but probabilistically predictable, if a default occurs within a large portfolio of securities operations. In this latter case, this expenditure is also minimized by the payments collected by the government in compensation for issuing financial guarantees. Those two indirect financial mechanisms multiplies many times the capacity of fiscal funds to leverage the amount of earmarking credit, by means of using voluntary lenders instead of providing direct fiscal funds by the government.

However, the effectiveness of these indirect earmarking mechanisms depends on the risk charged by the market of the public debt. In the case of credit insurance this depends on the difference between interest rates and the total period of the government bonds, for example, and those which are applied to specific private credits. The larger this difference is, the more effective the credit insurance will be in terms of lowering financial cost and increasing the length of the loan. With a guarantee from the government, a private credit acquires the same quality of the public debt in terms of risk and, therefore, similar financial costs.<sup>8</sup>

Therefore, the viability of credit insurance fundamentally depends on the ability of the National Treasury to finance its debt at low interest rates and long periods. In addition, it is necessary that the premiums paid by the beneficiaries to buy the government guarantee are low and usually less than what would alternatively be charged by private insurers. The government insurance mechanism must also be agile and quick to respond, especially in cases of paying back insurance claims.

One example of a very common earmarked credit program based on private resources is the export credit insurance. Through this kind of program, a company from a country such as Germany, for example, can reduce the final financing cost of financing its exports to more high-risk countries, such as Cuba, to the lowest interest rates and longest payment terms that are offered in the international market. The implicit subsidy in this case stems from the reduction that is obtained in the interest rate, thanks to the government guarantee, minus the premium that is paid.

In addition to export credit, many countries also use public guarantees as a means for directing credit to domestic sectors that are considered politically important. This is, for example, the case of the housing market in the United States, in which there exists an important credit insurance mechanism that is responsible for almost half of housing loans. Institutions such as the National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation

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<sup>8</sup> In developed countries, financial markets charge an interest rate on the private debt that is guaranteed by the state. This interest rate is slightly higher than the rate applied to public debt with the same payment terms.

(Freddie Mac) and Federal Home Loan Banks, which enjoy implicit full faith and credit of the United States government, dominate home financing in the US. Together, they provided mortgages at a value of more than US\$4 trillion in 2005, which puts them among the largest financial institutions in the world.<sup>9</sup>

A Brazilian example of public guarantees for private earmarked credit programs is the FGPC fund.<sup>10</sup> The goal of this fund is to compensate commercial banks that are agents of BNDES in cases of defaults by small-scale companies. To do so, the government requires the payment of a specific fee. Though the FGPC was initially well received by the market, the National Treasury's constant delays in payments for defaults has caused a growing distrust in this fund and has consequently led to its disuse.

The problem of effectiveness is also present in interest rate equalization mechanisms. In this case, governments pay the creditors – banks or bond holders - part of the interest that would be due by the final borrower. Payments are made over the long term, and they follow the same amortization schedule and total financing terms. In exchange, these investors supply funds and take the risks of these operations, including the equalization payment.

Thus, the extent to which equalization can mobilize private resources depends, at target, on the risk that the market attributes to the country that is involved in the operation. This rate will be used to discount the flow of future equalizations. If the risk is high, the present value of this flow, particularly for payments in the distant future, tends to be irrelevant.

In Brazil, private voluntary earmarked credit programs have thus far had limited success. Though the country's export credit insurance has existed since the 1960s, it has always been in low demand. The last attempt to reform the program occurred in 1997 with the adoption of the French model: the National Treasury received premium payments and assumed responsibility for the payments of future claims, but the technical management of the process was assumed by a private securities firm focused exclusively on export credit. The reorganization of the export credit insurance system did not reach expected levels of acceptance. Private banks remained uninterested in the system. Thus far, almost all policies established through this new system have listed BNDES as the beneficiary.

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<sup>9</sup> According to Holtz-Eaken (2003), "the implicit guarantee [of Fannie Mae and Freddie Mac] is communicated to investors in capital markets through a number of provisions of law that create a perception of enhanced credit quality for the enterprises as a result of their affiliation with the government. Those provisions include a line of credit at the U.S. Treasury; exemption from the Securities and Exchange Commission's registration and disclosure requirements; exemption from state and local income taxes; and the appointment of some directors by the President of the United States." (See also Greenspan, 2004.)

<sup>10</sup> FGPC stands for *Fundo de Garantia para a Promoção da Competitividade*, which literally translates to "The Guarantee Fund for the Promotion of Competitiveness" (translator's note).



Unlike the credit insurance, equalization for export credits was a tool that came to see relative success in Brazil from the 1960s through the 1980s. However, at the beginning of the 1990s, equalization payments that had already been made were suspended for a few months due to legal problems. Since then, private institutions have never regained their trust in the program. Today, the main beneficiaries of interest rate equalizations for export financing are state-owned banks – particularly BNDES.

As voluntary earmarked credit programs have yet to prove their efficacy in Brazil, and because domestic credit is still scarce, especially for high-priority sectors, the government has still operates compulsory earmarked credit programs funded by bank deposits. Out of all savings accounts – which have full government guarantee, 65% should, in principle, be used to finance housing, and the rural sector continues to be compulsory the beneficiary of 25% of all demand deposits.

Thus, in addition to their compulsory deposits, which are required by the Central Bank for monetary policy reasons, Brazilian commercial banks<sup>11</sup> have to lend other amount of their demand deposits according to government criteria and charging favorable rates. In this case, those funds are provided by the banks' clients and the risk of these loans rests with the banks.

However, the main providers of this kind of earmarked credit, which have to focus the rural and housing sectors are state-owned banks, such as *Banco do Brasil* and *Caixa Econômica Federal* (see Footnote 9). These institutions operate with implicit guarantees from the federal government. Therefore, their depositors, in reality, do not run any risk related to the loans given by those banks. It is a type of guarantee that is an alternative to credit insurance. Rather than private investors maintaining a policy for cases of defaults by one or more specific final lenders, the account holders at these banks enjoy a governmental guarantee for all of their deposits. From this perspective, the difference between the two Brazilian banks and Fannie Mae or Freddie Mac in the US is found in their style, but not in their content. All of these institutions offer public guarantees to their creditors in exchange for the right to earmark funds for high-priority investments. In Brazil, public guarantees still need to reach the public through state-owned banks, or else their costs will be too high. This is completely different from the experience of the US.

Despite the lack of data, Banco do Brasil and CEF together hold most of the earmarked credit out of the books of BNDES. There are no official data of the share of private banks on those loans but from the data to the Central Bank of Brazil (2006), the share of private banks in all of funds which are earmarked would be 10.5% at most. Thus, the earmarked credit statistics

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<sup>11</sup> These commercial banks include Brazil's *Caixa Econômica Federal* (CEF), or the Federal Savings Bank.

published by the Central Bank of Brazil are nothing more than a euphemism for credit from the public sector to the private sector.

### 3 Proposals for Earmarked Credit Reform

The discussion over earmarked credit is still relatively simplified and confusing. The idea that the current mechanisms can be eliminated in the short run is, to an extent, based on wishful thinking. In the absence of these tools, it is believed that the market will immediately respond and will be able to easily and satisfactorily meet the demand that remains unmet. Because almost all earmarked credit today is provided by public banks, there is also the idea (whether implicit or explicit) that these institutions would stop filling this role in some way or would simply be eliminated.

This type of belief has been present since the beginning of the recent debate. It began at the end of 2003 when the Central Bank of Brazil first raised the question of the impact that earmarked credit was supposed to have on interest rates. From the Central Bank's point of view, earmarked credit, defaults and legal risks would be one of the three main causes of the very high bank spreads in Brazil (see Banco Central do Brasil, 2004).

This argument may essentially be summed up by the following: because earmarked credit represents 33% of total credit, and because the interest rate on it is low, banks must make up for this "relative loss" and impose these costs upon non-earmarked credit. According to the Central Bank's calculations, cross subsidization occurred at the equivalent of 8.2% of the spread that was applied to non-earmarked credit (see IEDI, 2004). There are indications that this same reasoning was also behind the proposal to eliminate earmarked credit made by Rodrigo de Rato, Managing Director of the IMF, at the beginning of the 2006 (see *Valor Econômico* Magazine, 2006a).

This argument has been contested by other institutions, particularly by the Brazilian Industrial Development Studies Institute<sup>12</sup> and by BNDES (see IEDI, 2004, BNDES, 2005, and Belluzzo, 2004). As mentioned before, private bank direct participation in earmarked credit is relatively low for most of the earmarked credits are offered by state-owned banks and their funds should not be included in this calculation. These institutions are, in their very nature, mechanisms for earmarking credit. Their main objective is to reduce the cost of high-priority projects for the government, either by making use of these deposits from the public or by utilizing fiscal or quasi-fiscal funds.

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<sup>12</sup> The Brazilian Industrial Development Studies Institute refers to the Brazilian *Instituto de Estudos para o Desenvolvimento* Industrial, which is often shortened to "Iedi" (translator's note).

Additionally, private resources that have been earmarked make up a small part of portfolios of commercial banks. According to the Central Bank of Brazil, the total of these credit operations amounted R\$248.6 billion at the end of 2005. Earmarked credit made up only R\$21.1 billion, or 8.5% of the total. If the government or monetary authorities had a real interest in compensating private banks for their contributions to earmarked credit, there would be other, less traumatic ways to reach the same objective. One example would be to reduce mandatory deposits from the banking system at the Central Bank. These deposits reached almost R\$150 billion at the end of 2005.

So far, those who advocate for the immediate elimination of earmarked credit have not made any proposals that would indicate how this reform should be put into place, or what the possible consequences of it would be. The only author that concerned himself with this question to any extent was Arida (2005), whose proposals were the object of criticism in Torres (2005).<sup>13</sup>

The most important aspect of Arida's proposal, which needs to be mentioned here, is his recommendation that current earmarked credit mechanisms be eliminated slowly. In the case of the FAT Fund in Brazil, this phasing out of the earmarked credit system would be initiated by eliminating the PIS tax and creating another long-term interest rate indexation system for new contracts, one that would follow a methodology based on a domestic price index. The entire banking system – not only state-owned banks – would be authorized to have direct access to the FAT fund through auctions. Funds for the “New FAT Fund” would be provided by interest and amortization of old operations. There is no mention of how current unemployment insurance obligations, which are the responsibility of today's FAT Fund, would be financed. If those expenses continued to be an obligation of the “New FAT”, this Fund and BNDES would be condemned to extinction. At the end of his study, Arida mentions his concern over the eventual negative consequences that his proposals would have on new investments.

#### **4 Financing Development: A New Outline for the Discussion on Earmarked Credit**

An evaluation of the earmarked credit mechanisms around the world has shown that the debate over earmarked credit in Brazil is out of focus. Dissolving current compulsory earmarked credit mechanisms alone would not solve the problem of how to make effective other earmark credit mechanisms in Brazil. Privatizing the management of fiscal and quasi-fiscal funds for financing does not seem to be a feasible solution (see Arida, 2005 and Torres, 2005). Nowhere in the world are these kind of funds allocated freely by the private sector.

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<sup>13</sup> For more on the authors and their respective publications on this topic, see Torres (2005).

Therefore, the discussion on this subject should move towards other topics. The initial point should be how to extend access to credit in Brazil. Local credit is still scarce, expensive, volatile, and largely short term. The second important point should be how to operate the substitution of current earmarked credit mechanisms, particularly compulsory mechanisms, for voluntary mechanisms. Finally, the role of public banks in this process should also be discussed.

Though the domestic market is very limited, the main source of financing for companies (after their own resources) continues to be bank loans (see OECD, 2005). Even after increasing significantly between 2002 and 2005, the total amount of these operations in the private sector was slightly more than 30% of GDP at the end of 2005. In more advanced countries, this value is often over 100%.

The reasons that led to this stagnation in the credit market in Brazil's recent past are largely macroeconomic in nature. Similar to that which occurred in other Latin American countries, growth of domestic credit was limited by successive balance of payments crises, such as the limitations that resulted from "sudden stops" in foreign capital inflows (see IBD, 2005).

The recent restructuring of foreign debt, particularly public foreign debt, as well as higher trade surplus, both currently guarantee a certain level of comfort for Brazil on the international stage. Therefore, once these internal restrictions are eliminated, credit can increase at even faster rates. The central issue is how to convince a market that is accustomed to high market liquidity and spreads to accept lower interest rates and longer terms on loans. The best way is to operate this transformation first on the public debt.

If this change happens, the process of converging earmarked and non-earmarked markets would occur naturally. In this scenario, voluntary mechanisms of earmarking private savings (such as credit insurance and tax equalization) would be more effective. In a scenario of higher growth, lower interest rates, and longer period of amortization for debts, the country's current capacity to finance new projects through fiscal and quasi-fiscal funds could likely be more limited.

The success in the implementation of these new earmarked credit mechanisms would impulse a revision of the current mechanisms. In this case, compulsory earmarked credit programs using commercial bank resources, for example, could disappear.

## **Conclusion**

Imagining a credit market without any type of earmarked credit does not seem to be a realistic or desirable vision. All over the world, earmarked credit programs are important tools used by governments to reach their social and economic policy goals. The mechanisms used to do

so adhere to the historical contexts of each country, as well as to the scale and extent of their national credit systems.

International data shows that there is no contradiction between the existence of a clearly developed national credit market that is internationally integrated and the existence of national public earmarked credit mechanisms, including fiscal and parafiscal funds. Some Asian and European countries have illustrated how this process tends to occur naturally. As the credit market increased and access to credit was extended, banks and public financial institutions in these countries came to develop new functions and to find new specific niches.

Therefore, the current debate needs to move away from the wishful thinking of those who propose a complete and simple elimination of earmarked credit, and even to move away from recommendations, such as those from Arida, to “accelerate the process.” In a scenario in which interest rates are falling and foreign involvement and integration is increasing, any sudden movement may not only compromise economic growth but may also cause a substantial transfer of asset gains from the public sector to the private sector. It would be wiser if the process of reforming current earmarked credit mechanisms were gradual and accompanied by the evolution of the rest of the market.

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