**A ripple begets a flood**

*A politically inspired surge in lending is weakening state-owned banks in Latin America's biggest economy*

In 2008 Luiz Inácio Lula da Silva, then Brazil's president, boasted that by the time the "tsunami" unleashed by Lehman Brothers' collapse hit his country's shores it would dwindle to a "little ripple". The stimulus programme he put in place helped to carry Brazil through the credit crunch relatively unscathed. But five years later public money is still pumping into its economy, with ever more negative consequences. Public debt is rising. State banks are taking more of the credit market. And the government is warping accounting standards in its attempts to disguise all this.

Concerned that consumers are overstretched, private banks have held back on lending in recent years. But since 2008 the corporate loan book of BNDES, the national development bank, has grown by 24% annually, far above nominal-GDP growth of 11%. Caixa Econômica Federal, a state retail bank, has expanded lending by 42% annually for the past three years (see chart). By June state banks had 50.3% of all outstanding credit, up from 33% in 2008—the first time they passed the halfway mark since a wave of bank privatisations in 1999.

BNDES and Caixa are funded by a tax on workers as well as recycled loan repayments and, in Caixa's case, deposits. But hectic loan growth means both are stretched thin. Caixa's loan-to-deposit ratio has soared from 49% to 113% in the past five years. The treasury now accounts for more than half of BNDES's funding, from almost nothing five years ago. Treasury funding of state banks grew from 14 billion reais ($6.5 billion) in 2007 to 406 billion reais, 9.2% of GDP, last year.

As lending has increased, the quality of state banks' capital has worsened. A growing part consists of shares in state-controlled firms, which are less liquid and more volatile than cash, but can be handed over by the treasury without it having to borrow. By the end of 2012 BNDES's Tier 1 capital—the most solid sort—had fallen to 8.4% of assets and Caixa's to 6.6%, far below the 12.1% average for Brazilian banks.

BNDES has high underwriting standards and good collateral. But its ten biggest borrowers account for a worrying four times its Tier 1 capital. And Caixa's retail borrowers are often first-timers of unknown creditworthiness. The early months after taking a loan should be the least fraught, meaning the bank's big expansion should have cut the share of loans in arrears. That it did not suggests trouble for the future. More risks come from a government-subsidised scheme giving poor Brazilians cheap loans to buy computers, furniture and white goods. Leaked documents show that Caixa's analysts think default rates will be 30-50%.

In March Moody's, a ratings agency, downgraded both BNDES and Caixa to match Brazil's sovereign debt. Their stand-alone ratings, which assume implicit government support, are now below investment grade. The reason, says Alexandre Albuquerque, a Moody's analyst, is that both have become entwined with government economic policy: "They are no longer a better risk than public debt."

Much of the state banks' lending is at rates lower than the government's own funding costs. The difference is borne by the treasury. Mansueto Almeida of IPEA, a government-funded think-tank, estimates that it will reach 24 billion reais this year—about the same as the Bolsa Família anti-poverty programme, which tops up the income of nearly 14m very poor families.

BNDES was set up to increase investment. But even as its loan book has ballooned, Brazil's overall investment rate has stagnated. Burdensome paperwork and its fondness for national champions mean that much of its lending goes to firms big enough to seek private funding rather than small ones that are starved of credit. Its subsidised rates crowd out private loans. "BNDES loans have replaced some investment from companies' own resources," says Gabriel Leal de Barros of the Fundação Getúlio Vargas, a research institute. "The subsidies mean it can be cheaper to borrow than to self-fund."

The desire to mask the consequences of increased state lending has tempted the government to fudge both its own and the banks' accounts. Last December it put off paying for the subsidies on a particularly cheap credit line for BNDES until 2015. BNDES has been allowed not to book losses on shares it holds until it sells them, and to use transfers from the treasury to lend more before bolstering its Tier 1 capital. Another ruse comes close to a shell game. Treasury funding for a state bank does not count as outgoings in the national accounts. But the higher dividends that such funding lets the bank pay do count as government income.

Even the government seems at last to realise that the flood of public money gushing through Brazil's state banks must slow. In April Luciano Coutinho, the president of BNDES, said the bank had been so successful in creating national champions that it could now ease off. On October 14th Guido Mantega, the finance minister, said the treasury would cut transfers to BNDES over the next few years.

But putting such good intentions into practice collides with other aims of the government. Though Caixa's consumer loans make for bad risks, they are vote-winners for the president, Dilma Rousseff, who is seeking re-election next year. And her plans to upgrade Brazil's skimpy transport links by auctioning concessions to build and run infrastructure will stretch BNDES as never before. It is supposed to be funding around 70% of the costs—170 billion reais over the next five years.

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