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**SEQUENCING TRADE AND CAPITAL
ACCOUNT LIBERALIZATION:
THE EXPERIENCE OF BRAZIL IN THE 1990s**

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EXECUTIVE SUMMARY

The debate on sequencing has revolved around two major issues: what sequencing can facilitate the implementation of reforms and maximize their net benefits, and what needs to be done to avoid reversibility. To shed new light on these two issues, the paper firstly reviews the literature on sequencing, which is organized within a historical perspective to the extent that the arguments can be associated with particular historical contexts or events. Secondly, the paper analyses the sequencing of liberalization reforms in Brazil in the 1990s, in particular the rationale behind the sequencing pursued which, unlike the conventional wisdom, had capital account liberalization implemented simultaneously with other major reforms. Was the order pursued compatible with sustainability? What, and how, political factors and policy objectives have influenced the order and pace of reforms? The study concludes that although there was a rationale behind the order of reforms undertaken, the analysis of a few key sustainability indicators show that the policy regime was not sustainable. This was explained by a combination of policy inconsistencies and the fact that the potential benefits of capital account liberalization, for example in the form of new flows of investment in the tradable sector, did not materialize in the levels originally envisaged.

INTRODUCTION

1. The liberalization of different markets in developing countries has been an issue extensively explored by the literature, at least since the early 1970s. Initially, much of the discussion was led by a group of influential economists to whom developing countries pursuing inward-oriented development strategies were exhibiting less than satisfactory growth performance. Their work was to show that a market-oriented economy was clearly superior to a controlled one on both efficiency and welfare grounds.

2. In an important contribution to the debate on sequencing, *McKinnon* (1986) draws the attention to the fact that some of the reform outcomes can be perceived as specific, when appropriately placed in their historical context:

“...the case of the Southern Cone in the 1970s is hardly very pure; in that period virtually all the less developed countries overborrowed, and then got themselves into a debt crisis. This era was complicated by recycling from the oil shock on the one hand, and then by what I consider to be a major breakdown in the public regulation of Western commercial banks on the other. The result was gross overlending by banks in the world economy at large, and to the Third World in particular’ (page 219)”.

3. The hypothesis raised by *McKinnon* (1986), viz., that the international financial markets can play an important role in how our judgement on the sequencing of reforms is formed as well as in the results that such reforms can deliver will be explored here. This task will be pursued with the help of the ancillary hypothesis that such financial markets differ between the 1970s and the 1990s to the such an extent that they generate specific reform outcomes. This hypothesis is based on the well-documented phenomenon that international financial markets in the 1990s appear to exhibit new features and operate differently due, inter alia, to underlying structural changes in its various market segments as well as the functioning of connected markets. Such changes are associated with the introduction of new regulatory settings in developed countries, and with informational innovations that have pervaded the services sector.

4. The failure of the Southern Cone liberalization attempts over the late 1970s and early 1980s brought great attention to the dynamic aspects of markets liberalization, in particular to the need to better understand the problems associated with the sequencing and speed of reforms. Numerous studies emerged to discuss the issue, focusing particularly on the appropriate order of liberalization of two, closely inter-connected, parts of the balance of payments: the current and the capital accounts. Analytical frameworks were developed to explore the subject, but it was amply recognized that the most pertinent insights were owed to the careful analysis of the above mentioned liberalization experiences. From such experiences a consensus emerged that reforms should be sequenced, with capital account liberalization coming last.

5. This study shall investigate the liberalization reforms in Brazil in the 1990s. The Brazilian experience is particularly interesting and casts new light on the issues of sequencing, since it challenged the consensus on the order of reforms established in the 1980s. In particular and most importantly, capital account liberalization preceded the 1994 stabilization plan. Furthermore, Brazil shares with other reforming countries in the 1990s both opportunities and problems in connection with external capital flows, thus permitting to examine their time-specific effects (but common across countries) over the process of reforms.

6. The paper is organized as follows. The literature on sequencing of liberalization reforms, with a focus on the trade and capital accounts, is reviewed in chapter I and is followed by the case study on liberalization reforms in Brazil in the 1990s (chapter II). This case study is divided into three sections. Section A investigates the macroeconomic objectives underlying the sequencing of reforms, whereas section B focuses on the specific role of capital account liberalization. Section C addresses the crucial issue of sustainability of reforms.

Chapter I

LITERATURE REVIEW

7. Two interrelated aspects of the process of reforms were of particular concern in the sequencing literature of the 1980s. The first referred to the question: what order could facilitate (and make viable) the implementation of reforms in their entirety? The second had a more long-term perspective and was embedded in political economy considerations: once implemented, how could reforms be sustained? Crisis episodes were carefully examined because they were very costly but above all because they tended to blow up reforms.

8. Sustainability remained a key issue in the 1990s. However, unlike the 1980s and early 1990s, the concern with the reversibility of reforms has been since then gradually overshadowed by the discussion of a different type of sustainability: that of policy regimes of already liberalized economies. This shift of focus seems to be explained by the fact that many middle-income countries that have been the object of case studies have undergone reforms whose reversibility is seen lately as not only undesirable but implausible, despite the crisis episodes involving emerging market economies in the late 1990s.

9. A conventional explanation why reform reversal sounds implausible is that a more ambitious version of the Washington consensus would have won the ideological debate over what economic model can maximize growth and welfare. In fact, the Washington Consensus as summarized by Williamson (1990) would look rather timid when confronted with the reform experiences that were implemented shortly afterwards in Latin America. What has been less noticed is the fact that external capital that had flown away from crisis countries has returned once these countries changed their policy regimes guaranteeing in this way the continuity of reforms.

10. The literature on sequencing has examined the above issues by relying on a number of approaches. Initially, welfare economics was a basic framework used by economists in static analysis. However, since the sequencing problems were essentially of dynamic nature and although efforts were made to apply welfare theory to the study of dynamic issues, other analytical frameworks grounded in macroeconomic theory were developed to explore the dynamics of economic reforms.

11. To complement this, the political economy of reforms was relied upon as a body of knowledge that provided key insights into the matter. Within these approaches the following aspects have been addressed and extensively discussed in the literature: macroeconomic and welfare effects of liberalization reforms, adjustment costs, credibility issues and the relation between stabilization and liberalization. Most academics and policy-makers devoted to the topic have incorporated elements of these different approaches in their analyses, as no theoretical framework would be sufficient to address sequencing problems in their entirety. These approaches therefore should be seen as complementary rather than conflicting.¹

12. This study adopts McKinnon's early view that our judgement on the sequencing of reforms is very much influenced by the way financial markets operate, and therefore try to organize the literature review within a historical perspective. The arguments supporting one or another sequencing of reforms – or no sequencing at all - that will be highlighted here are those raised by the literature irrespective of their association with a particular approach. They will be presented in a chronological order to the extent they can be associated with a particular historical context or event. The macroeconomic and political economy aspects of reforms will be prioritized in this review because these are the ones that will guide the discussion on sequencing in Brazil.

A. The 1970s: the sequencing of IMF-supported stabilization programmes

13. The sequencing issues were already explored in the early 1970s when proponents of liberalization policies assessed the benefits and costs of trade and capital account liberalization based on their analysis of the IMF sponsored stabilization programmes many developing countries had adopted since the late 1950s. These programmes used to entail in varying degrees liberalization measures in the external sector of the economies concerned.

14. The first major insights into the problems associated with the sequence of liberalization came from McKinnon (1973), whose stylized description of the order of events associated with stabilization and liberalization encapsulates many of the issues examined below. He discusses the order of liberalization of the current and capital accounts of the balance of payments based on his assessment of stabilization programmes adopted by developing countries in response to balance of payment crises.

¹ The point that different approaches should be seen as complementary is made by Toye (1998), who also proposes a critical path analysis (CPA) as an encompassing framework to explore sequencing issues.

15. McKinnon implicitly shared with the IMF the traditional view that such crises basically reflected excess domestic absorption, which resulted in inflation and an overvalued exchange rate. His major concern was that liberalization measures which accompanied stabilization programmes had normally been reversed, arguably because distortions tended to be aggravated rather than reduced in stabilization packages that combined partial trade liberalization measures and reliance on foreign capital.

16. In McKinnon's view at that time, trade liberalization should be implemented in depth and preceded by fiscal adjustment and domestic financial liberalization. Domestic financial reforms were seen as necessary to raise internal savings, therefore reducing the country's dependence on external capital. The latter was seen as undesirable given its tendency to cause currency appreciation thus generating a bias against export activities and sending the wrong signal to economic agents.

B. The late 1970s and early 1980s: higher capital mobility and the Southern Cone reform experiences

17. The late 1970s witnessed higher international capital mobility, which magnified problems arising from balance of payments liberalization (Diaz-Alejandro, 1981). In this new context McKinnon (1981) reiterates that controls on external capital should be removed last, due to the undesirable effects on the economy concerned more generally, and on its tradable sector in particular, problems that he had underlined and that gained primary attention with the Southern Cone stabilization experiences.

18. In his analysis of the Southern Cone stabilization attempts, Diaz-Alejandro (1981) notes that the countries' move towards liberalization in the context of more fluid international capital markets included reforms in the domestic financial markets with relaxation of restrictions over external capital movements. Defeating chronic inflation was a key objective and a pre-announced exchange rate devaluation was used as a tool to co-ordinate inflationary expectations. According to him, such an exchange-rate policy proved perverse because under liberalized financial markets it resulted in an overvalued exchange rate, massive capital inflows and further distortions in the price system, penalizing particularly exporters and domestic manufacturers of import-competing activities.

19. This analysis led Diaz-Alejandro to concur with McKinnon that other reforms in the domestic financial market and trade regime should precede capital account liberalization. Diaz-Alejandro (1985) even suggests based on his analysis of financial distress that some capital account control appears inevitable for all but those very few countries with highly developed domestic financial system. Attention was given to exchange rate overvaluation, not just because of the macroeconomic disruption it was perceived to cause, but also because of its effects in terms of welfare and adjustment costs (which reinforced its negative macroeconomic consequences), and the array of speculative-induced behaviour it was believed to trigger.

20. Edwards (1984) among others points out that the simultaneous liberalization of current and capital account is not advisable because unnecessary adjustment costs may be incurred. Given that financial markets tend to adjust more quickly than the goods markets, and that the liberalization of such accounts have opposite effects on the exchange rate - opening the current and capital accounts leads to depreciation and appreciation, respectively -, liberalization would result first in exchange rate appreciation, inducing production factors to move towards the non-tradable sector of the economy.

21. As capital flows recede and the effects of trade liberalization start to be felt, the exchange rate reverses its trajectory and becomes devalued, with production factors being re-channeled to tradable activities.² Some economists advocate synchronizing liberalization measures in order to avoid such swings of factors between sectors, while Bruno (1985) makes the point that in addition to adjustment costs simultaneous liberalization may imply irreversibility (due to investment lags and habit formation) with negative welfare costs.³

22. While trade economists contributed analytically to the further understanding of welfare and adjustment costs of liberalization, a number of international finance and macroeconomists started to approach the output effects analytically by using macroeconomic frameworks and providing simulation exercises (e.g. Harberger, 1986; Khan and Zahler, 1983).

23. Harberger (1986), for example, centres attention on the impact of surges in capital inflows on macroeconomic variables other than the exchange rate. The author provides some simulations based on a standard macro model which show that when capital inflows are spread over a longer period of time, output oscillations around its mean become considerably smoother. This would recommend that not only the quantity but also the speed of absorption of capital flows would have to be taken into account.

24. Harberger also addresses welfare issues, with the hypothesis that the supply curve of foreign capital is upward sloping for developing countries, including the small ones, because such countries bear a risk premium for the country risk. This implies a divergence between the average and marginal cost of international credit, which generates a negative externality. A partial liberalization of the capital account, for example in the form of the use of taxation to tackle the externality problem, would be seen as a first best policy.

² However, Edwards (1984) raises the argument that if capital inflows are sustainable, a lower exchange rate should be perceived not as overvalued but as oscillating around its long-run equilibrium level. As restrictions on capital movements are relaxed, capital inflows are expected to jump initially, but then to gradually slow down to the point they reach a magnitude compatible with a sustainable level of external debt (p. 5).

³ The sectoral effects of capital account liberalization are modeled (with analytical results) in Edwards (1986).

C. The late 1980s: simultaneous stabilization and reforms?

25. Until the late 1980s a certain consensus had been established that stabilization should be a prerequisite for liberalization reforms to be implemented successfully. However, the protracted economic instability in developing countries, especially in the Latin American region due to the debt crisis, together with pressures from the international community for these countries to undertake broad structural reforms brought back to the centre of the debate whether stabilization and liberalization should be pursued simultaneously.

26. Edwards (1992) in the wake of ambitious stabilization-cum-liberalization initiatives in almost all over Latin America argued that in countries of low and middle inflation level simultaneous stabilization and reforms seemed feasible. But in high inflation countries stabilization should be tackled first in order to avoid problems with competing instruments. The key competing instrument was the exchange rate, required to devalue for liberalization to be successful, but which tends to appreciate in stabilization programmes which rely on the exchange rate as a nominal anchor to guide prices and expectations. A second instrument was the reduction or elimination of tariffs that affect tax revenues negatively. Uncertainty associated with high inflation was also pointed out as a major reason for defending stabilizing first, as it is believed to affect investors' decisions, with investment going to the 'wrong sectors'.

27. This view was however contested by Latin American-based researchers to whom the two-stage-approach with stabilization being tackled first and liberalization second, ignores the macro-micro dynamic interactions between these two stages (Fanelli and Frenkel, 1993)⁴. The understanding of the micro-macro interrelations proved useful later in interpreting the initial results of stabilization in Latin America in the 1990s that were carried out together with sweeping economic reforms. In the case of Brazil (which will be discussed below in detail) a particular feature was the need to address high and chronic inflation and the reliance on reforms as instruments to achieve the stabilization objective. A particular instrument was the use of external capital as a stabilization tool.

28. It has been seen that a key feature of the Southern Cone stabilization experiences in the late 1970s and early 1980s was the use of a fixed exchange rate in guiding expectations in stabilization programmes. In spite of such failing experiences the exchange rate was again used as a key microeconomic tool in stabilization programmes, thus reviving the discussion on its potential benefits and costs. Although seen with caveats, some admit that this may prove useful for high inflation countries.

⁴ It should be noted that these researchers were critical of the conventional approach to stabilization and supporters of policies that tackled structural problems, and not of liberalization of markets in the fashion proposed by defenders of sweeping reforms.

29. Sachs et al. (1995) acknowledge that a pegged exchange rate can be an effective instrument to combat inflation, provided its use is restricted to the early stages of an inflationary programme. The problem rests on how to move from a fixed to a flexible exchange rate regime. They put in doubt the deeply ingrained view among economists that credibility is a key factor for the success of a programme based on a fixed exchange rate regime, being fundamentally associated with government's commitment to such a regime. Their view is that not just commitment to such a regime matters but the authorities' ability to sustain it. (Lately in view of repeated currency crises in countries with fixed exchange rate regimes, the tide turned strongly against the fix-exchange rate option and in favour of inflation targeting within a flexible exchange rate regime).

30. The credibility approach – and indeed the political economy of reforms – permeated the discussion on sequencing throughout the period under analysis, but became highly popular as experience on the subject accumulated, offering key insights into the discussion and being used both to support and deny the appropriateness of sequencing.

31. Contrary to most economists until the mid-1980s, Lal (1986) by that time – and earlier than that as well – advocated the immediate capital account liberalization with the adoption of a floating exchange rate regime. He questions the assumptions of omniscient governments (required to tax capital flows optimally and to manage the exchange rate) and myopic agents (who cannot realize that the initial real exchange rate appreciation 'scenario' will be reversed), as well the institutional lacunae in developing countries such as the absence of forward exchange markets. Grounded in a political economy reasoning, he argued that the key factor behind failed liberalization attempts rests on the credibility attached to governments and their policies.

32. Edwards (1984) also turns to credibility arguments, but to support the view that simultaneous liberalization of the capital and current accounts may prove pernicious. If trade reforms were not credible, import-competing firms which would go bankrupt in a context of liberalized trade can instead survive by borrowing external capital from abroad under the belief that trade reforms are temporary. Along the same lines Calvo (1987) argues that if just one component of reforms is not credible, the liberalization of other markets will have negative welfare effects. For example, the lack of credibility of the trade reform, when accompanied by liberalized capital flows movement, may lead to excess of imports and welfare losses (cited by Edwards, 1992).

33. The credibility argument can also be extended to the speed of trade reforms (see Edwards, 1986). According to Bruno (1985), a pre-announced path of gradual tariff reduction would be preferable to a sudden and drastic drop of such tariffs if such a policy were perceived as credible. If agents however expect policies to be reversed, investment will be channeled to the wrong industries. Edwards (1995) argues that when reforms lack credibility, firms are less inclined to undertake effective restructuring.

34. In a critical assessment of the sequencing literature, Fanelli and Frenkel (1993) observes that reforms analysts tend to conclude that credibility is a phenomenon very much associated with the speed of reforms. Decisive policy actions towards quick and deep changes may persuade economic agents that reforms are not to be reversed, making them abide with such reforms rather than fight against them, through economic or political means. Thus, credibility of reforms may be related to the government commitment to them, but also with the way these are formulated and implemented (see also Edwards, 1995) or with government's past actions (on this point see Choksi, 1986; Falvey and Kim, 1992).

35. Bhattacharya (1997) presents the argument that a gradual approach may be more appropriate since it may avoid disruptions that in turn may block reforms, while giving time for the emergence of reform's beneficiaries that can lend support to such reforms. Based on similar sort of political economy reasoning, other economists are led to opposite conclusions. Krueger (1986), for example, puts forward the view that a gradual removal of trade barriers is not advisable, because reform losers will have time to build political pressure against reforms.

36. The economic and political weakening caused by successive failed stabilization attempts in Latin America in the 1980s led observers like Fanelli and Frenkel (1993) to call attention to the following crucial aspect of the political economy of reforms that is not properly addressed by the sequencing literature. The inconsistency between the implicit call for a strong State to implement reforms successfully and the fact that in many countries the State lacks the capacity to implement such reforms or to design an adequate and feasible programme of reform (p. 83).

D. The 1990s: the transitional economies, shock therapy and private capital flows to the emerging economies

37. The engagement of the transitional economies in market reforms in the early 1990s was a watershed in the debate on sequencing. Their reform experiences were supported and sometimes assisted by western economists who advocated the shock therapy. This consists of comprehensive reforms that include, in the words of Sachs (1994), price stabilization and decontrol coupled with currency convertibility right at the beginning of a programme of reforms, together with speedy trade account opening and other deregulation measures in domestic goods markets. Privatization was also recommended to start quickly, but this was admitted to be a gradual process (pp. 29-30).

38. The arguments in favour of the shock therapy rely on welfare theory – quick removal of all sorts of distortions to maximize efficiency and welfare – and political economy arguments of the sorts already mentioned: move fast before political resistance builds. Gradualists instead defend a two-track reform strategy in which a de-controlled, private-based economy coexists with a still regulated state-owned

sector until market institutions can be established, so as to avoid a vacuum of institutions.⁵ Other political economy reasoning in favour of gradual reforms is that to be solid and sustained these need to be based on a broad political coalition that takes time to engineer.⁶ The inclusion of a social safety net in the programme of reforms was seen as crucial by gradualists but also admitted by shock therapists as an important component of the whole package.

39. McKinnon (1991) also defends a gradual stance regarding privatization, but for fiscal reasons. According to him, time is required to implement a broad tax base that can replace revenues from government-owned enterprises. Otherwise a balanced public finance and price stability which should be at the forefront of a successful reform programme are put at risk. A gradualist strategy is by McKinnon seen as important for the whole reform package, whose sequencing should be: stabilization-domestic financial liberalization-current account opening with capital account coming last.

40. The early 1990s were also marked by another major event, which was the resumption of external private capital flows to middle-income developing countries – and then transitional economies as well - that in the 1980s had been severely rationed of foreign credit. Many of these new recipients of foreign flows also embarked on comprehensive reforms in the lines recommended to transitional economies, despite their marked structural and institutional dissimilarities.

41. The widespread adoption of market reforms across different countries and regions in the world would be in the view of some just reflecting an ideological shift towards market liberalism (McKinnon, 1991, p. 2). For others, however, the reasons why historically highly controlled economies embarked on reforms were less clear. Rodrik (1996) for example discusses a number of factors that may trigger reforms. A deep crisis is seen as an important factor, which also might help explain why these are in the end adopted in such a broad fashion.

42. Rodrik (1996), however challenges the view that reforms are triggered by deep crises, first because the argument seems tautological and second, for the lack of logic in the need for reforms to be broad, like the ones adopted in Latin America, as in his view what stabilization requires is macroeconomic policies and not a whole package that includes microeconomic reforms. He instead searches for more logical explanations in analytical studies, one of which presenting the argument that the degree of cohesion in society linked to the expectations over the distributive burden of reforms would be the key factor behind their adoption (Rodrik, 1996, based on Alesina and Drazen, 1991). He interprets it by arguing that societies with better distributional records would exhibit a higher degree of cohesion being therefore more prone to reforms.

⁵ These arguments can be found in a review offered in OECF (1995) 'Transitional Strategies and Economic Performance: 'Gradualism' Revisited', OECF Discussion Papers No. 8, September.

⁶ See Rodrik, 1996, who discusses different perspectives on the subject.

43. Moving forward from the discussion on what is needed for reforms to be triggered, a number of factors or conditions have been identified as necessary for reforms to be sustained, based on political economy analysis. These and many others are presented in Williamson (1994, summarized in Rodrik, 1996, p. 32), and include two that can be seen as conflicting with each other: i. reforms should be comprehensive and of rapid implementation; and ii. they should have a solid base of political support. The former condition fits well with the shock therapy proposed to transitional economies in the 1990s, while the latter is in close connection with the notion that consensus should be carefully built, calling therefore for gradualism.

44. The 1990s witnessed a number of sweeping reforms across the world that did not reverse despite crisis episodes. This appears to be reorienting the debate from the focus on the sustainability of reforms to the sustainability of policy-regimes, this being an important analytical distinction underlying the latest developments in the sequencing debate. The reason why reforms have been carried out or maintained despite crisis episodes has not been explored as yet, but seems to us to be associated with the availability of private capital flows to emerging economies. This factor was absent in the 1980s and thus may explain why at that time macroeconomic policies and reforms were altogether reversed by an economic crisis.

45. The currency and financial crises that affected East Asia, Russia and Latin America in the late 1990s have given a new breath to the sequencing proponents, whose arguments, though refined in the early 1990s as a response to the shock therapy approach, had stayed in the backstage for some years. The sequencing debate is back however in a more confined territory, focused on the liberalization of the capital account and being motivated by concerns regarding the sustainability of policy-regimes and no longer of the reforms themselves as just mentioned. It is our view that this trend may last to the extent that private capital flows continue to provide finance to reformed economies.

46. The group of sequencing proponents has received unexpected allies, who have defended phasing the capital account liberalization, although some would still be more comfortably identified with full capital account convertibility. The argument for phasing capital account opening has been associated with the admission of market overreactions to negative signals, herding behaviour, sudden change in investor sentiments and contagion (Fischer, 1998). These elements are seen as global factors that, in conjunction with the domestic ones that called for capital account restrictions in the 1980s, determined the successive currency and financial crises witnessed in the late 1990s.

47. The pre-requisites for moving toward full capital account convertibility consists of the strengthening of the domestic financial system, basically by establishing or improving a supervisory framework and prudential controls (Fischer, 1998). In the words of Garber (1998), this should include upgrading supervisory personnel, risk-control management, provisional rules, bankruptcy laws, capital requirements and proper accounting systems (p.29), in addition to others such as the requirement of a minimum degree of hedging in foreign currencies to reduce foreign exchange risk. Some would point out the difficulties in pursuing that task without promoting ‘unfair competition’, unless such prudential rules could be internationally harmonized (Cooper, 1998).

48. Others (e.g. Dornbusch, 1998) agree with Mckinnon’s early position of eliminating financial repression and the current one of adopting stringent prudential regulations, accompanied with mechanisms to assess vulnerability (rather than sustainability). In addition, he defends rapid liberalization, once the banking system is de-repressed and regulatory institutions in place, together with the pursuit of a preventive strategy based on: structuring the debt maturity, hedging liabilities, increasing reserves and the creation of backup facilities (i.e. access to international insurance by the domestic banking system; p. 26).

49. A more critical approach has been taken by another group of academics, like Rodrik (1998) who simply questions the wisdom of capital account convertibility at all by arguing that empirical evidence disproves the thesis that there is a positive causal-relation between capital opening and growth. Others are focusing on the need to redesign the international financial architecture, and to create mechanisms for regulating players (e.g. mutual funds) and instruments (derivatives) that in recent years have gained increasing prominence and power in the international financial markets, while on the domestic side to adopt controls over short-term capital inflows, believed to be more volatile and therefore potentially disruptive (e.g. Griffith-Jones, 1999).

Chapter II

THE SEQUENCING OF LIBERALIZATION REFORMS IN BRAZIL

50. In the early 1990s several countries in Eastern Europe and Latin America adopted broad liberalization reforms in the fashion recommended by shock therapists. As it was previously seen, the main characteristic of such a strategy consists of pursuing reforms in various fronts simultaneously and at high speed. The design of the package of liberalizing measures adopted in Brazil in early 1990 was inspired in this type of reforms. The purpose of policy-makers was to rapidly transform Brazil from an inward-looking, highly inflationary country into a market-based, competitive economy founded in economic stability and fully integrated in the world markets.

51. The purpose of this study is to examine such broad market reforms, with a focus on the order of the liberalization of the current and capital accounts of the balance of payments. Unlike other studies aimed at evaluating the reforms themselves, we intend to look at the results reforms were capable of generating in so far as this can help illuminate the sequencing issues.

52. The objective is essentially to try to answer the following question: was the sequencing adopted in Brazil appropriate? This question involves both short-term, operational problems associated with the process of reforms, as well as concerns of a broader perspective. These short- and long-term dimensions will be addressed separately, in two parts.

53. The first part, with a focus on the short- and medium-term issues, will address the questions: was it wise to liberalize the capital account when the trade account opening was still at its early stages? To what extent did the capital account opening contribute to the implementation of the whole package of reforms and to the stabilization objectives being pursued simultaneously? In other words, an attempt will be made to evaluate the extent to which the strategy pursued facilitated the implementation of reforms, by making them more feasible (both technically and politically) and less costly than would otherwise be.

54. The second part will take a more long-term perspective. It will examine the extent to which the strategy pursued was sustainable. Given the recent attention that the sustainability of policy-regimes has received, the focus here will be on this type of sustainability and not that of the economic reforms (see literature review). Different operational indicators of sustainability as defined in Milesi-Ferreti and Razin (1996) with others proposed in the literature (e.g. Reisen, 1998) will be discussed: the balance of payments solvency, balance of payments indicators, as well as the trade and fiscal regimes.

55. Before proceeding in the analysis of the short- and long-term effects of capital account liberalization on the process of reforms (to be pursued in sections B and C) in section A, we will briefly describe the main features of the trade and capital account liberalization with emphasis on the context in which these were undertaken as well as the role of political and economic factors in affecting the speed and timing of their implementation.

A. A brief description of reforms and their context

56. The package of reforms started to be implemented in Brazil in March 1990, when the newly democratically elected Collor Government took office. This included a stabilization programme, thus being aimed at simultaneously stabilizing prices and creating a market-based competitive economy.

57. The structural reform component was broad, covering various aspects of the economic system: liberalization measures in the foreign trade regime and the currency markets; the elimination of a web of subsidies and incentives long-established within the logic of import-substitution to support specific sectors and industries, together with others geared to regional development; an administrative reform which included the lay-off of public sector workers and the extinction of government institutes; and the creation of measures for a privatization programme.⁷

58. What triggered such broad reforms this time, after previous stabilization programmes that had included only timid reforms? The combination of a very deteriorated economic situation and a newly elected Government could explain why such broad reforms were launched, but later it would be seen that popular support rapidly eroded while organized political groups built resistance to the point major components of the reforms programme were obstructed. The absence of solid social and political support played an important role in reshaping the sequencing and timing of their implementation. Reforms were slowed down considerably, especially the privatization programme, but to a large extent the fiscal adjustment as well, owing to political and operational obstacles. It will be examined here in greater detail the liberalization of the trade and capital accounts of the balance of payments, whose order and timing of implementation were influenced by political pressures, but perhaps more predominately by short-term macroeconomic objectives.

⁷ For a description of the package measures see among others Baer, 1995.

1. The liberalization of the foreign trade and the capital account

1.1. *The foreign trade*⁸

59. Trade liberalization in Brazil has been a gradual process that was initiated in 1988 and scheduled to complete by 2006. It can be divided into three phases:⁹

- a) 1988-1989
- b) 1990-1993
- c) 1994 onwards

60. The first phase – 1988-1989 – consisted of cutting the redundancies in import tariffs that had been established many years before as part of the country's import-substituting policies. The second phase, initiated with the Collor plan I in March 1990, and concluded in 1993, was the most effective of the three in promoting trade liberalization.¹⁰ It comprised the following measures¹¹:

- the elimination of non-tariff barriers
- a selective increase in tariffs
- the announcement of a timetable of tariff reduction, to be implemented in four steps: the first in February 1991 and the remaining three in January 1992, 1993 and 1994. In February 1992 the two last rounds of tariff reduction were brought forward to October 1992 and July 1993.

61. The gradual tariff reduction between 1988 and 1993 can be visualized in table 1. Between mid-1988 and mid-1993 the nominal tariff (weighted average) was reduced from 34.7% to 11.4%, while the effective tariff went from 42.6% to 14.5%.

⁸ The basic reference for this sub-section is Kume (1996).

⁹ This division has been suggested by Kume (1996).

¹⁰ Hay (1998) is among those who acknowledge that such trade liberalization was far from radical or rapid by international standards, but that nonetheless was significant enough to change the behaviour of the manufacturing sector (p. 7).

¹¹ For a list of the measures, see Boletim do Banco Central, section 'Principais Medidas de Política Económica', various issues.

Table 1
Nominal and Effective tariffs between over 1988-1993
(in per cent)

Tariffs	July- 1988	Sep- 1989	Sep- 1990	Feb- 1991	Jan- 1992	Oct- 1992	Jul- 1993	Dec- 1994	Dec- 1995	2006
Nominal										
Simple average	38.5	31.6	30.0	23.3	19.2	15.4	13.2	11.2	13.9	11.9
Weighted average ^a	34.7	27.4	25.4	19.8	16.4	13.3	11.4	9.9	11.5	10.6
Effective ^b										
Simple average	50.4	45.0	45.5	35.1	28.9	22.5	18.9	14.4	23.4	15.3
Weighted average	42.6	35.7	33.7	26.5	21.7	17.2	14.5	12.3	12.9	15.4

Source: Kume (1996), tables 1, 3 and 4.

^a The weight is based on the free-trade value added.

^b Effective protection is calculated by Kume (1996) and defined as the increase in value added under protection relative to the value added under free trade.

62. This period can be characterized by a relatively predictable foreign trade liberalization policy, when assessed in terms of the behaviour of import tariffs and the real exchange rate. Import tariffs were reduced as initially planned, except for the remaining two rounds of tariff reduction, which were brought forward as part of an aggressive government initiative to combat increasing domestic instability.¹² At the same time, the real exchange rate was devalued over the period 1991-1992 (to compensate for the previous appreciation associated with the inflationary policy of the late 1980s) followed by a moderate gradual appreciation from then until mid-1994, thus contributing to a smooth change in the trade regime.

63. By contrast, the tariff structure from 1994 onwards became more variable, with a further tariff reduction in 1994 followed by a partial reversal by the end of 1995 (see table 1). Meanwhile, the real exchange rate suffered a sharp appreciation in 1994, followed by a slow and gradual nominal (and real under certain criteria) devaluation from 1995 onwards.

64. The further round of tariff reduction in 1994 was clearly determined by the price stabilization objectives, which were firmly pursued that year with the implementation of the Real Plan. This was an ambitious exchange-rate based stabilization programme that included a monetary reform, an initial parity of the new domestic currency with the US dollar, and the further opening of the trade regime, the latter

¹² This initiative consisted of a set of measures that were implemented over a period of less than a year, and included: capital account liberalization (May 1991), currency devaluation and domestic interest rate shock (September-October 1991 in response to a mini-balance of payments crisis) and foreign trade liberalization (February 1992).

aimed at disciplining domestic prices. The tariff reduction in 1994 was also determined by the common external tariff within the Mercosul regional agreement, designed to be fully in place by January 1995.¹³

65. The tariff reduction initiative in 1994 seems to have contributed effectively to the price stabilization objective (see below), but this had the negative effect of deteriorating the country's trade balance. This led to an increasing reliance on foreign capital flows to finance the current account of the balance of payments. In response to the sudden reversal of capital flows caused by the Mexican crisis in December 1994, the Government raised import tariffs on those products whose import values had greatly increased in the previous year.

66. Therefore, from 1994 onwards the import tariffs were used as an instrument to target stabilization and the deteriorating external accounts. Their use was seen as episodic responses to macroeconomic problems, being accepted that the ultimate structure would be determined by the long-term objective of providing the country with a rational tax system that contributed to a higher degree of efficiency and competitiveness in the economy. The Mercosul regional agreement has contributed to the shaping of a more rational tax system, indicating what its final structure will be in the year 2006.

1.2. The capital account

67. The 1990 reform package was broad and ambitious, but measures involving the liberalization of the capital account were absent.¹⁴

68. Liberalizing the capital account together with other reform measures would not be in any case convenient given that the package of measures had expected negative external sector effects. Liberalizing measures were thus initially adopted during 1990, but limited to relaxing previous restrictions on capital movements such as profit remittances, capital return, payments overdue associated with debt arrears, and the authorization of the issuing of commercial papers by the domestic financial system, previously restricted to non-financial companies.¹⁵

69. In 1991, a new economic team led by the Finance Minister Marcilio Marques Moreira launched a series of initiatives towards the liberalization of the capital account.¹⁶ These included the further opening of the domestic capital markets to foreign portfolio investment, the permission given to Brazilian

¹³ To the common external tariff agreed within the Mercosul there is a list of exceptions, whose products inclusion has been flexible, sometimes determined unilaterally in response to short-term macroeconomic objectives and sectoral demands, sometimes in negotiations with Mercosul partner-members. Their tariff rates are expected to converge to the same point in 10 years, counting from 1995.

¹⁴ Some limited capital account opening had taken place in 1987 with the permission of portfolio investment in stock markets. Further liberalizing measures in this area would be undertaken only in 1991 (see below).

¹⁵ See Boletim do Banco Central, 'Principais Medidas de Política Económica', various issues.

¹⁶ Unlike his predecessor, Mr. Marcilio Marques Moreira was seen as someone genuinely identified with a programme of market reforms.

companies to issue different types of securities abroad, and the adoption of tax relief over the issuing of bonds in the international markets with maturity of over 2 years, as well as over profit remittances and royalties by multinational companies.

70. Portfolio investment involved both the stock (and derivative) markets and fixed income (i.e. bonds). Only institutional investors were permitted to invest in stock (and derivative) markets, but restrictions in place since 1987 regarding composition criteria, minimum initial capital and permanency period were abolished (Prates, 1998, p. 7). It was in the latter category – bonds markets - that the government exercised varying degrees of control over time (Prates, 1998). In times of surges, it restricted the entry of flows by raising tax and non-tax barriers, while at times of reversal, generally caused by crisis contagion, it facilitated their entry instead. The decision to tax investment in fixed income (i.e. bonds) and not stocks reflected the desire to interfere in the composition of different categories of capital flow and to reduce the monetary/public finance impact of flows used in the acquisition of domestic bonds (Garcia and Valpassos, 1998).

71. Unlike other Latin American countries, non-resident deposits in foreign currency were forbidden, as well as their ability to borrow in the domestic financial markets (Prates, 1998, chapter 1). This means that capital account liberalization in Brazil was broad, but not as deep as in other emerging markets.

72. As regards external borrowing, unlike the seventies when only non-financial institutions could operate with bonds, in the early 1990s financial institutions were also permitted to issue them to raise financial resources in the foreign markets (and new instruments were created for that purpose). These resources could initially be lent to industry, commerce and services. Later – 1995 and 1996 – banks could also lend to the agricultural sector, housing (building, mortgage) and export companies.

73. As with certain modalities of portfolio investment, the Government varied the degree of controls over external borrowing for macroeconomic management purposes. This was done by taxing financial operations over the issuing of bonds, and by changing the length of maturity required. At the other end of the operations, the length of loans permitted to the domestic borrowers also varied, as well as the rules concerning the purchase of government instruments, especially those with currency hedging (see Prates and Freitas, 1998, chapter 2).¹⁷

74. Therefore, controls fell over different types of external flows, taxation being one of the main instruments relied upon. However, taxation by being selective and favouring investment in stock markets also reflected the purpose of interfering in the composition of flows, according to growth objectives. Garcia and Valpassos (1998) points out that control measures between the adoption of the Real plan

¹⁷ A full description of all sorts of instruments with their characteristics is provided in Prates and Freitas (1998).

(mid-1994) and the Mexican crisis (December 1994) had the clear purpose of improving the quality of external capital by restricting short-term flows and stimulating long-term ones (p. 28).

75. Together with taxation, additional instruments were used to control capital flows, such as payment operations regarding trade flows. In July 1994 the exchange rate regime became flexible, thus resulting in nominal exchange rate appreciation in the context of massive capital inflows. In order to avoid further downward movements in the exchange rate, some measures were adopted to stimulate capital outflows. For example, the contracting of exchange for future liquidation concerning financial operations was permitted (until then only possible with commercial operations), as well as Brazilians to invest abroad (provided 60% was in internationally issued Brazilian government bonds – Garcia and Valpassos, 1998, p. 27). Until then, opening the capital account had been mostly limited to capital inflows.

76. From the above description on the trade and capital account liberalization, we can see that, first, the capital account opening started in 1991, therefore much before the major liberalization of the trade account, whose partial (though significant) completion only took place by mid-1993, with further liberalization rounds being undertaken from then on. Second, such an order was not originally planned. Financial liberalization was only implemented with the arrival of a new finance minister more identified with market reforms. Third, the opening of the capital account was quick, but not complete. For example, full convertibility with residents and non-residents holding foreign currency in the domestic financial system is not permitted. And fourth, taxation (together with other measures) has been largely relied upon as an instrument to control capital flows for macroeconomic management purposes.

B. Assessing the capital account opening

77. We have seen that capital account liberalization took place in Brazil before economic reforms had been fully carried out, and even before price stabilization had been achieved. This suggests that the sequencing and timing of reforms in Brazil does not fit in the classical order of liberalization suggested in the literature (which calls for stabilization coming first and the opening of the capital account, last).

78. The purpose of this section is to further examine what factors were important in explaining their order and pace in Brazil, but mainly whether there was an economic rationale in bringing forward the opening of the capital account. The question we ask is: what role, if any, has the capital account liberalization played in the process of reforms?

79. In order to understand why reforms did not follow the conventional order, in what follows the role of capital account opening will be assessed in terms of facilitating (or obstructing) three major economic objectives: price stabilization, trade liberalization and fiscal reform.

1. Price stabilization

80. Price stabilization is believed to be a pre-requisite for economic reforms. Inflation is viewed as essentially reflecting a domestic imbalance which, caused by excessive public expenditure, generally leads to balance of payments problems in countries with limited access to foreign finance. Stabilization efforts take the form of prudent macroeconomic management that includes tight monetary and fiscal policies. In order to restore external balance more quickly currency devaluation is also recommended as a stabilization package component.

81. Until 1994 Brazil had high and chronic inflation, whose central feature is inflation inertia. Although inflation was deep-rooted in fiscal problems which still today call for lasting restructuring in the country's public finances, the major stabilization challenge the country faced in the early 1990s was to defeat the inertial component of its inflationary process. In the early 1980s a view started to emerge that conventional stabilization policies were not sufficient to address inertia (Modiano, 1990; Messember, 1997, for a critical review). An inflationary culture had become ingrained, so combating inflation would require innovative actions to tackle institutional arrangements, habits and expectations established over the course of many years.

82. Targeting inflation inertia meant, it was believed, radically changing economic agents' expectations regarding the future path of inflation. Between 1986 and 1994 Brazil tried at least five stabilization plans which included a fixed exchange rate (together with price freezing) as one of the anchors of the programme.¹⁸ In all such plans inflation was brought down to very low levels to return soon after with even greater strength.

83. In 1994 the Real stabilization plan had once more the exchange rate as a key anchor, expected to break inflation inertia. A distinctive feature of this plan in relation to the previous ones was that inflation was brought down this time, not by means of price freezing but with the temporary adoption of a dual-currency system in which the additional currency held parity with the dollar and gradually overtook the old currency as the country's major unit of account. Once the exchange rate stopped being nominally devalued by early 1994, nearly all prices that in the 4 previous months (the period over which the country held a dual-currency system) had converged to the exchange-rate as their indexing mechanism stopped growing altogether or continued to grow, but much less than before.

84. Thus, the Government managed to break inertia by adopting an ingenious monetary device, while getting away with the discredited price-freezing measure. However, would this be sufficient to explain why, unlike in the past, the plan succeeded in keeping inflation rates at very low levels from then until January 1999, when the exchange rate finally collapsed?

¹⁸ These were: the Cruzado Plan (March 1986), the Bresser Plan (June 1987), the Summer Plan (January 1989), the Collor I Plan (March 1990) and the Collor II Plan (February 1991).

85. We put forward the view that the balance of payments opening in 1991 in a context of external capital availability played a crucial role in the stabilization process. These two factors combined with a very aggressive interest rate policy resulted in massive capital inflows, which in turn helped the country to build large foreign reserves.

86. As Garcia and Valpassos (1998) put it, capital inflows had been the real anchor of the Real stabilization plan. By that the authors meant that such flows played a financing role in a stabilization programme that lacked a solid fiscal reform (this point will be discussed below).

87. While accepting that external capital played an important role at a macroeconomic level by helping to finance the stabilization plan, we emphasize policy and microeconomic mechanisms associated with the accumulation of foreign reserves that contributed to price stability.¹⁹ The first of these (interrelated) mechanisms was to enable the Government to set the exchange rate policy in accordance with its policy objectives, thus affecting economic agents' expectations about the sustainability of the exchange rate regime. The second was indirect and related to its role in helping to sustain the foreign trade reform (see below). These two factors were crucial in changing the agents' price-setting behaviour.

88. Until the early 1990s when the country faced limited access to private capital flows, the exchange-rate regime in place consisted of a crawling-peg by which the domestic currency was devalued in line with the country's inflation (minus the international one). This maintained competitiveness in the export sector, which helped generate a large trade surplus to finance the overall balance of payments. Any slowing down in exchange rate devaluation would trigger speculative movements by exporters and importers involving trade flows contracts as well under- or over-invoicing of exports and imports. This would lead to a fall in net trade inflows, a situation that the Government could not afford given the limited availability of foreign exchange.

89. At the same time, government financing relied heavily on very liquid bond markets, whose rolling-over was made possible by offering investors high yields. This policy additionally worked as an incentive for exporters to internalize their foreign earnings and importers to postpone their payment obligations. Any fall in such yields would therefore affect the country's balance of payment position.

¹⁹ Actually we could delimit two phases: initially, capital inflows contributed predominately to building foreign reserves; later, when the country's trade position deteriorated sharply, it helped to finance the deficit in the current account. At this later stage reserves would still grow (except for the period of contagion-related crisis) but from an already very high level.

90. Foreign reserves gave the Government power to set the exchange and interest rates at levels consistent with their policy objectives and no longer with the need to stimulate inflows of foreign exchange. Policy-makers gained degrees of freedom to design and implement effective macroeconomic policies and above all to sustain an exchange-rate based stabilization programme.

91. The role of the exchange rate in guiding expectations about the future inflation path was enhanced by structural changes taking place in the economy. As commitment to liberalization policies was reaffirmed in 1991 and trade reforms speeded-up in 1992 (see previous section), external prices became increasingly important in determining manufacturing prices. This opened the way for the exchange rate to be used as an effective stabilization instrument from mid -1994 to early 1999.

92. In an economy that becomes gradually open external prices are expected to play an increasing role in the price setting rules of manufacturers through costs and competition channels (Corbo and McNelis, 1989). Costs become increasingly dictated by prices of imported raw materials and intermediate goods, while a pricing policy is bounded from above by external competition. The hypothesis of external prices playing an increasing role in determining manufacturing prices has been tested in Gottschalk (1999) for the manufacturing industry as a whole, as well as for nine different manufacturing industries over the periods 1992-94 and 1992-98, based on manufacturing price equations derived from a semi-open economy model of Corbo and McNelis (1989).

93. Results show that this hypothesis holds for the whole industry and for those industries more sensitive to foreign competition. Further statistical tests also confirmed that the increasing role of external prices in determining manufacturing prices was associated with the higher degree of trade openness such industries started to experience from early 1992 onwards.

94. The following micro events were thus expected: in addition to cost reductions, a convergence between domestic and external prices followed by a path of behaviour by which these two prices would be closely linked, though with some asymmetry. That is, domestic prices would be allowed to move below external ones but not above. The convergence movement was expected to happen more significantly in the initial stages, and this would be reflected in lower mark-ups, provided cost reduction (even being big) were limited to some components of the overall cost structure.

95. Moreira (1999) in a study on the efficiency and allocative gains associated with trade openness in Brazil, finds that between 1990 and 1995, mark-ups fell substantially – 21,1%. For the Brazilian manufacturing as a whole, this phenomenon being observed for nearly all industries: only 6 out of 38 manufacturing industries exhibited increases in mark-ups, being exactly those either with strong non-traded characteristics (drinks), or with production highly concentrated internationally (pharmaceuticals) or those with concentrated market structure (e.g. siderurgy). The decline in mark-ups continued between 1995 and 1998, but the magnitude became considerably smaller (5,3%).

96. Moreira acknowledges that other factors could also explain the mark-up behaviour mentioned above, one of which being economic activity, but this is seen by the author as likely to have played a minor role. The author also provides statistics showing that the import coefficient of the industry as a whole increased markedly during the 1990s, especially in those industries previously highly protected.

97. Similarly, Hay (1998) in an econometric study on the effects of 1990 trade liberalization on the performance of 349 large Brazilian manufacturing firms, showed that trade opening caused in the firms under analysis a reduction in their market shares, large increase in efficiency and decline in profits. The latter fell sharply, by 35% between 1986-1988 and 1993-1994, bearing a positive relationship with levels of protection. Hay also shows that the decline in profits would have been even larger were it not for significant efficiency gains (i.e. cost reductions) occurring simultaneously, also in response to greater competition threat.

98. These results are clearly consistent with the hypothesis of changes in the pricing policy of the manufacturing industry in the early 1990s, and that such changes were associated with trade openness. Moreover, the larger changes occurred in the first five years of the 1990s (i.e. the convergence movement), indicating that structural changes that could support stabilization started much before July 1994 when the Real plan was fully implemented.

2. Trade reform

99. In what ways could capital account liberalization have helped to sustain the trade reforms? It is possible to identify at least two. First, by affecting agents' expectations that trade liberalization would not be reversed. Second, by making external financing more easily and widely available to support the modernization of the manufacturing industry, a necessary process given the presumed threat of foreign competition.

100. In relation to the first point, capital account liberalization permitted a quick and remarkable increase in reserves that seems to have truly affected economic agents' expectations that trade reforms would not backfire. In fact, working against reforms would prove a very costly bet against a Government strongly backed by foreign reserves. The lack of short-term speculative behaviour with imported goods (as warned by Edwards, 1984, as a possible outcome of simultaneous liberalization in case trade reforms were not credible) lends support to the above hypothesis. This is reinforced by numerous studies reporting efficiency and allocative gains deriving from concrete restructuring in manufacturing activities in response to trade liberalization.

101. In relation to the second point, external finance may have possibly played a microeconomic role as well, in supporting modernization in the manufacturing industry. This can happen indirectly, as capital

inflows tend to put downward pressure on the exchange rate - and directly, by taking the form of new investment²⁰ but also of cheap import credits. In the first case, a sharp (nominal) currency overvaluation took place in July-August 1994. Although this was followed by a period of nominal exchange rate stability and, later, gradual devaluation, the initial appreciation largely remained providing great stimulus to import activities, though investment decisions for the purpose of modernization might have been more strongly influenced by other factors.

102. In the second case, Nonnenberg (1996) provides some trade credit statistics showing that imports were increasingly externally financed after the capital account opening. In a context of rapid overall growth of imports, the share of externally financed imports in total imports grew from 60% to 67% between 1992 and 1995 (excluding oil and related products).

Table 2
Growth of total and externally financed imports over 1993-1995
(in per cent)

Category of products	1993		1994		1995	
	Financed	Total	Financed	Total	Financed	Total
Raw materials and intermediate products for industry	30.3	36.2	30.5	19.1	60.5	45.7
Capital goods for industry	11.9	14.6	74.7	51.9	46.5	38.7
Total	14.1	22.9	33.0	31.0	52.6	50.1

Source: Nonnenberg (1996), table 10, p. 13.

103. Table 2 shows the growth rate of total imports and imports financed with external trade credits over the period 1993-1995 for imports geared to industry. It is possible to see that the growth rate of raw materials, intermediate inputs and capital goods for the industry financed with external trade credit grew remarkably over those years. Nonemberg notes that particularly from 1994 on, such a trend is largely explained by interest rate differentials, which grew sharply in 1994 thereby offering very attractive financial gains to import activities being externally financed.

²⁰ The role of external capital in financing new investment in manufacturing will be examined in the section on sustainability.

104. The combination of external trade credit availability and high interest rate differentials, together with an overvalued exchange rate in addition to the reduction of import tariffs certainly facilitated modernization in the industry. But growth rates of total imports were also very high indicating that some imports have also probably resulted in unfair competition and resource misallocation. Whilst it is difficult to assess such microeconomic effects, the macroeconomic impact of such a surge of imports will be examined in detail in the discussion on sustainability.

3. Fiscal reform

105. Brazil has witnessed fiscal imbalance during the whole process of reforms.²¹ However, prior to the implementation of the Real plan, this did not result in external imbalance because the overall saving-investment relation was balanced (due to a private sector savings surplus). Exports benefited from a competitive exchange rate, and imports were still contained given the time-lag effects of changes in the trade regime. None of these factors was present during the Real stabilization plan. A consumption boom took place²², the exchange rate became overvalued and the effects of import liberalization started to be fully felt, as distribution networks of imported products were established.

106. This new situation resulted in a large external imbalance that was only compatible with price stability because, as Garcia and Valpassos (1998) have pointed out, external capital in the absence of fiscal adjustment became the true anchor of the Real stabilization plan. Capital inflows resulting from capital account liberalization have thus permitted that stabilization were achieved and maintained without fiscal adjustment. Would not it be wiser to provide stabilization with a fiscal anchor instead?

107. This alternative had been attempted in Brazil in 1990 and 1991, but failed, presumably because a quick and deep fiscal adjustment implies reforms that face political constraints. In addition to political resistance to such reforms that most countries usually face, the Brazilian case seems particularly more complicated due to constraints imposed by the 1988 constitution, and by the fact that the country is organized according to federalist principles. In the pursuit of ensuring that the stability achieved be sustainable, a fiscal reform has been underway, but due to political resistance and such constraints this process has been slow.

108. Although the availability of external capital has lent time for this process to move forward, this strategy has been risky and subject to the moods of international investors. In this context the need for fiscal adjustment gains a new dimension. That is, in addition to fulfilling the macroeconomic balance requirement, it is an element of increasing importance in forming investor's expectations. The latter in

²¹ Except for 1994, when the public sector exhibited a fiscal surplus (including interest payments) of 1.06% of the GDP (Giambiagi, 1997,p. 13).

turn not only influences the direction of capital flows but can also play a key role in triggering currency crises. Would it therefore be still advisable to rely on external capital for stabilization purposes? Moreover, is it not the case that external finance hinders rather than helps the process of fiscal reforms?

3.1. *Political resistance to fiscal reform*

109. The literature review suggested that sustainability of reforms as discussed in Rodrik (1996) has to do with the intrinsic characteristics of the whole process (e.g. speed, scope); and from a political economy perspective, with the building of social cohesion. In Brazil, the adoption of a gradual reform path despite the way the Collor plan was designed suggests that reforms were launched without solid social cohesion, the latter being a process that has been slowly built.

110. The Collor plan was designed to address different reform areas simultaneously, with the strength of a newly elected president who claimed to be eager to confront and fight all forces opposing his proposed initiatives. President Collor was impeached in September 1992 for being involved in a corruption network, but from the political economy perspective this event could be interpreted as resulting from the deep lack of political support to his ambitious programme. Whether Collor and his programme were identified with specific groups or interests, the fact is that, as put by Abranches (1993), by 1993 the country's elite was still lacking cohesion or the political power to impose its own interests (p. 23; on that point see also Pereira, 1993). Reforms did not stop though, but took a much slower pace, especially in areas in which consensus seems a factor that is hard to build.²³

111. Abranches (1993) identifies various elements of collective action that makes the process of consensus building, or the creation of a majority with decision power, especially hard in Brazil. Some of these elements relate to the country's ability to promote progress on fiscal issues. The country's asymmetric federalist system (see below), political fragmentation resulting from the process of democratization, institutional inadequacy to respond to the increasing number of demands and interests, the capacity agents have to adapt to crisis situations (with the side-effect of short-term behaviour becoming prevalent over long-term ones with lasting solutions), and the existence of a certain kind of complacency by which results with marginally decreasing returns become acceptable (p. 25).

²² Models of overborrowing syndrome (e.g. McKinnon and Pill, 1998) predict a private-led consumption boom following stabilization. It should be noted however that in the Brazilian case private savings actually increased in the 1994-1995 period, consumption growth being therefore led by higher public expenditure (Messemberg, 1997).

²³ In relation to fiscal reforms, some analysts believe that there is a common objective regarding what sort of fiscal regime is desirable, which is supported by a majority but blocked by the veto power of the minorities (Nobrega, 1993). Others see the Brazilian society essentially as highly heterogeneous whose elite lacks legitimacy to put forward a project that represents the totality of interests (Pereira, 1993).

112. At the same time, the author suggests that the country's social dynamics can be interpreted according to three sorts of collective actions: tension control, muddling through and sustainable mobility. The first involves situations of stress and strategies to mitigate them. The second – muddling through - can be characterized by a gradual process with marginal gains (or eventual losses). The third corresponds to qualitative leaps as a result of strategic collective actions supporting a common objective or project and put forward under the challenge of external competition (p. 27).

113. Actions to tackle the inflationary process until 1994 could fall into the first pattern (Abranches, 1993). Responses to the change in the trade regime as described here might fit in the third pattern. And the muddling-through strategy could be useful to characterize negotiations involving fiscal changes, since this pattern seems to imply small, positive advances, but gradual, involving second-best solutions in face of the complexity of the problems being addressed. Obstacles to first-best solutions could be purely political, originate in conflict of interests, or be related to constitutional constraints.

114. The transition from the military to a democratic regime in Brazil between the late 1970s and the late 1980s initially included the transfer of top government posts (at sub-national levels) to politicians chosen through the electoral system. This transfer of power was accompanied by a de-centralization of revenues collected by the central Government, as a reaction to the centralizing trend observed in the 1960s (Dain, 1995). Nobrega (1993) provides information on revenues collected by the central Government which were transferred to the governments at sub-national levels from the late 1970s until the 1988 constitution.

Table 3
Share of Central Government Revenues Transferred to Sub-National Governments
(in per cent)

	Until 1979	1979	1983	1986	1988 constitution
Income tax	20	24	28	33	47
Tax on Industrialized products	20	24	28	33	57
Specific taxes on products, services and utilities ^a	40	40	60	60	100

Source: Nobrega (1993), pp. 92-93.

^a Such specific taxes became collected in their entirety by the state governments by 1988.

115. Table 3 shows that government revenues transferred from the central to sub-national levels increased dramatically in the 1980s, being constitutionally determined in 1988 at even higher levels. The central Government fiscal position deteriorated even further by a number of additional constitutional expenditure obligations, and by the fact that among the existent ones very few were transferred to the other government levels.

116. The current constitutional rigidities thus partly reflect a reaction to the authoritarian regime, but as implicitly suggested also to a notion of federalism that includes decentralized resource management. In fact, these two movements – democratization and a new federalism – coincided chronologically in Brazil. As Fiori (1995) acknowledges, although these two concepts are not identical, they hold a high degree of affinity, being difficult to address them separately.

117. Analytically though, in relation to the first concept efforts towards fiscal reforms can be largely seen as a re-equilibrating response to the fiscal problems originated in the democratization process. According to Franco (1995), the latter created a mis-match between the existent institutions that were designed to support a fiscal regime under an authoritarian regime and the new democratic demands. Therefore, a more general process of building up institutions, mechanisms and practices is required to respond to, and deal with, a plurality of interests and demands that has emerged in the new democratic regime. Within that broader perspective putting forward a project of fiscal reforms means searching for a fiscal regime that is not only compatible with an open and competitive economy but that can also be equipped with mechanisms that make it functional in a democratic society.

118. This indicates that though political resistance to reforms can be found in most places its nature and dynamics are specific to each country, and that in the Brazilian case this can be seen as a positive social phenomenon. It partly reflects the emergence of a more complex and democratic society. From that perspective it follows that reforms in Brazil by undertaking a gradual pace are just reflecting the timing dictated by an evolving democratic process, that external finance has supported this process, and that in its absence it is hard to foresee how speedy reforms might have taken place.

119. In relation to the second concept, the form federalism takes depends on the results of a negotiation process and on the correlation of forces at the time the process takes place (Fiori, 1995, p. 23). Table 6 shows a trend of redistribution of tax revenues that while it followed federalist principles weakened the fiscal position of the central Government. A fiscal reform that can rehabilitate central government finances implies renegotiating the distribution of revenues and expenditures, which in political terms means having to deal with a federalist conflict that is vertical for involving the central and sub-national government levels. However, fiscal federalism also involves another conflict vector, that is horizontal and that relates to the fiscal relations among regions and different state governments (Albuquerque, 1998).

120. The horizontal conflict in the fiscal area can be exemplified with the VAT, a value added tax under the competence of the state governments. As Dain (1995) has pointed out, unlike various other countries, in Brazil VAT is charged at the point of origin. Besides the fact that this contradicts international norms to promote international trade, it generates a conflict between regions and states in Brazil, as each of them relies on VAT exemptions in their competition with other states to attract domestic and international investment.

121. This phenomenon can be exemplified by the offer by state governors of generous fiscal incentives to attract foreign car assemblers to their respective states. This results in a fiscal erosion that is amplified by the fact that all sorts of mechanisms are used by state governors in order to permit their economies to become internationally competitive and integrated (Albuquerque, 1998). In addition to tax revenue losses and distortions in the tax system, such a system as a whole is further distorted with the creation of cumulative taxes to fill in growing fiscal gaps, taking the country further away from a rational and internationally compatible tax system (Dain, 1995).

122. Federalist constraints to a rational tax system are not only related to fiscal wars but also to the marked regional disparities in economic and social terms that require equalizing fiscal actions that put further pressures on the system (Dain, 1992; 1995). A further federalist-related problem raised by Giambiagi (1997) as an important factor in explaining the increasing public deficit in recent years refers to the creation of numerous new municipalities all over the country, a fact that can hardly be reversed.

123. Corrective actions towards a rational, internationally compatible tax system, together with the objectives of fiscal balance and a fiscal federalism that is supportive of more competitive regions, states and localities with less unequal disparities across them can be only achieved gradually and by including negotiations around a new federalist pact. Quick solutions would probably backfire in face of the order of problems and number of actors involved.

C. Capital account opening and the sustainability of the policy-regime

124. In the previous section we examined ways by which capital account liberalization may have supported the process of reforms. The question that then arises is whether the policy-regime that emerged from a strategy of capital account opening coupled with an exchange rate based stabilization programme was sustainable. The 1999 currency crisis demonstrated that the answer is negative. To understand why, we will focus on a few sustainability indicators. We will initially examine the country's balance of payments position and, subsequently, follow Milesi-Ferreti and Razin's (1996) recommendation to broaden the analysis by looking at other, potentially more meaningful, sustainability indicators. This task will be pursued through focusing on the recent developments of two key macro-structural features of the economy: the trade and the fiscal regimes. Emphasis will be given to the interactions between balance of payments opening, macro economic policies and the trade/fiscal areas.

1. The balance of payments: solvency and vulnerability

125. A country is solvent when the present value of its future stream of trade surplus equals the current value of its external liabilities (Milesi-Ferreti and Razin, 1996; Maka, 1997). This notion of solvency is linked to the inter-temporal approach to the balance of payments, according to which agents (savers, investors) take forward-looking decisions (Obstfeld and Rogoff, 1995). However, as Milesi-Ferreti and Razin point out, any debt will be of an acceptable level if future budget (or trade) surpluses are large enough to fulfil the solvency criteria.

126. Assessing the sustainability of a country's balance of payments position therefore requires more restrictive assumptions, for example regarding the policy-regime of the country concerned. A notion of sustainability that will be adopted here is that proposed by Milesi-Ferreti and Razin (1996), to whom lack of sustainability can be characterized when the continuation of a policy regime leads to a crisis or a drastic policy shift (p. 3).

127. The above definition of sustainability becomes particularly pertinent in cases in which a government shows firm commitment to a specific policy regime that nonetheless is perceived as in need of change. In the case of Brazil, the exchange rate based stabilization programme led to large current account deficits. However, changes in the regime though seen as necessary were believed to entail costs which 'ex-ante' were hard to assess. But was the option of maintaining the regime sustainable? In early 1999 Brazil experienced a currency crisis caused by capital outflows that forced the Government to float the currency in order to avoid complete depletion of its foreign reserves. Although an external

factor – contagion effects – may have triggered the crisis, we propose to see whether the country's balance of payments position contributed to increasing the country's vulnerability to external shocks.²⁴

128. Between 1994 and 1999 the country's gross external debt changed from US\$ 148 billion to US\$ 235 billion, a nominal increase of 59%. Foreign reserves varied sharply, moving from US\$ 38.8 billion in 1994 to US\$ 60.1 billion in 1996, and falling back to US\$ 44.6 billion in 1998. This was an oscillatory behaviour associated with sudden capital reversals that took place from time to time but which were relatively short-lived and followed by periods of capital inflows.

129. In 1998 the country's gross external debt-GDP ratio reached 30.3% and the net external debt-GDP ratio, only 23.2%. These ratios were far away from benchmark levels considered critical by investors (generally around 50% according to Reisen (1998)). However, costs of external finance are associated with interest payments related to debt stocks but also and increasingly with repatriation of earnings and profits in the case of FDI, and interest and dividend payments in the case of FPI (UNCTAD, 1999, p. 23). Consequently, external liabilities that include not just external debt but also stocks of physical and financial assets owned by foreigners, indicate more accurately the magnitude of external obligations the country faces.

130. According to our estimates the net external liabilities-GDP ratio reached 46.6% in 1998²⁵. This need not be perceived as necessarily bad given that the ownership of domestic assets is expected to be increasingly foreign as the economy becomes more open. But the fact is that if one believes that such a ratio should stop increasing, external obligations should be at least partially covered by real resource transfers.

131. Real transfers take the form of a surplus in the goods and services (net of factors) balance of the current account. In order for the net external liabilities-GDP ratio to be kept constant at the 46.6% over time, a trade (of goods and services net of factors) surplus would have to be generated. But the exact magnitude (in proportion to the GDP) would depend on the evolution of the following variables: GDP growth rate, average remuneration of external liabilities, the real exchange rate and the world inflation.

132. By undertaking some calculations based on a set of hypotheses regarding the behaviour of the above variables, six different cases for the required trade surplus were considered (see annex 2 for the formula used and detailed results).

²⁴ Sustainability relates to the internal conditions of a given country, but a crisis can be triggered by an external event that is unrelated to the country or such conditions, in which case the notion of vulnerability might be more appropriate.

²⁵ See details on how net external liabilities are defined and calculated in annex 1.

133. In case 1, which considers average remuneration of liabilities at 6%, and GDP growth rate of 3.3% (the average growth observed between 1994 and 1999), the trade surplus required would have to be 1.2% of the GDP for the country's ratio of external liabilities to GDP to be kept constant at 46,5%. In case 5 in which some world inflation and real exchange rate appreciation are permitted, the surplus required would be slightly smaller. In the extreme case in which average remuneration of liabilities increases to 9% and GDP growth rate is just 2%, the surplus required would be much higher, over 3% of the GDP.

134. These estimates are in sharp contrast with the country's trade balance observed by the end of 1998, which reached a deficit of approximately 1,8% of the GDP. This means that if net external liabilities in proportion to GDP were to be maintained constant, the trade balance would have to exhibit a turn around of nearly 4% of the GDP, which in 1998 corresponded to US\$ 31 billions.

135. Such a turn around implied that the saving-investment gap would have to be reduced. Given the unsuitability of reducing investment in a reforming economy, adjustment would have to fall on private and government expenditures. GDP growth would be adversely affected in either way - via supply in the case of cuts in investment or via demand in the case of a reduction in consumption. A lower GDP growth would by itself make the dynamic path of adjustment even harder.

136. The alternative to a domestic absorption reduction would be a change in relative prices, in the form of a sharp devaluation in the exchange rate. This is what in fact happened in early 1999. And an alternative to such a sudden policy shift that Brazil experienced would be for external investors to accept further increases in the country's liabilities-GDP ratio while expecting that the trade balance could be gradually adjusted, mainly through an expansion in exports (without a sharp devaluation). Was this scenario feasible?

2. The trade regime and recent developments

137. Foreign trade performance is considered a crucial sustainability indicator of policy regimes of newly reformed countries. Two phases are expected along the process of reforms. In the first phase the current account of the balance of payments tends to be negative, due to import liberalization, and service payments associated with the new foreign-owned stock of assets arising from net capital inflows. In the second phase the trade account is expected to increasingly generate a surplus thereby offsetting the deficit in the services account. Higher exports would be reflecting the maturation of (partly externally) financed investments in the tradable sector.

138. Proponents of free trade believe that this process can evolve naturally, as the economy will be subject to less distortion, with relative prices reflecting the true scarcity of resources. Investments will be channeled to sectors and industries in which the country has inherited comparative advantages.

139. Today researchers devoted to foreign trade in Brazil consider in their analysis elements of the neo-classical theory upon which free-trade proponents rely but add to that a structuralist concern. They believe that trade liberalization can induce a competitive shock in the economy but that i. there is also a need to build a trade structure based on export products that have high value added and that belong to dynamic trends in the international trade and that ii. this will be only achieved with policies specifically designed to support selected sectors and industries.

140. Poor trade balance performance is believed to have been one of the reasons why international investors became increasingly reticent about the country's abilities to meet its external obligations in the months that preceded the 1999 exchange rate crisis.

141. Exports increased on average 7.1% a year between 1991 and 1998. Imports, however, grew at a much higher speed – 15,5%. This shifted the country's trade balance from a surplus position to a negative one. Although at first view this seems consistent with a newly liberalized economy where exports take time to adapt to a new trade regime and imports are decompressed, a closer analysis suggests that exports did under-perform.

142. For example, it can be seen from table 4 that the share of Brazilian exports in world exports increased from 0.91% in 1970 to 1.37% in 1985, falling back to roughly the 1970 level in the early 1990s and since then exhibiting a random behaviour around this lower level.

Table 4
Share of Brazilian exports in world exports

Year	Share %
1970	0.91
1975	1.02
1980	1.04
1985	1.37
1990	0.93
1991	0.91
1993	1.04
1995	0.92
1997	0.96

Source: Frischtak and Pessoa (1999), based on Kume (1996).

143. The determinants of trade performance can be broadly identified as structural (according to the view mentioned above), cyclical and price-related. This section aims to examine how trade and capital account liberalization might have affected these three areas. We will examine each of these areas in turn.

2.1. Trade structure

144. By looking at the evolution of the country's export composition ²⁶over the 1980s and into the early 1990s, it is possible to see that although primary products and industrial commodities corresponded to about 70% of total exports in 1981, this share fell gradually down to 61% in 1992. In the meantime, the share of manufactured exports increased from 28% to 39% over the same period (see table 5). This indicates that at least until the early 1990s the export composition changed toward more value added products.

Table 5
The Brazilian export composition between 1981 and 1992 (selected years)
Share (in per cent)

	1981	1985	1989	1990	1991	1992
Primary products	22	26	20	20	21	18
Industrial commodities	48	44	44	44	42	43
Natural-resource-based manufactured products	9	11	13	14	15	15
Manufactured products not based on natural resources	19	17	22	20	21	24
Non- classified	2	1	1	1	1	1

Source: Fundap/Iesp, based on information from the ITSY-UN.

145. The information provided by these trends can be complemented once more by contrasting them with the world trends. This can be done more elaborately by adopting Fajnzylber's (1991) suggestion that exports can fall into four different situations: very good, vulnerable, lost opportunities and withdraw. These situations reflect the combination of the following trends over a given period of time: i. the change in a country's share of a given group of products in the world's exports of the same group of products (measure of performance) and ii. the change in the share of the world exports of that group of products in the world's total exports (measure of dynamism). The four possible combinations can be represented in chart 1.

²⁶ Products are grouped according to the content of natural resources they embody, as suggested by Batista (1993).

Chart 1Export situation according to performance (i.) and dynamism (ii.)^a

	High ii.	Low ii.
High i.	<i>Very good</i>	<i>Vulnerable</i>
Low i.	<i>Lost opportunities</i>	<i>Withdraw</i>

^a i. the share of a given product in the world's exports of the same product;

ii. the share of the world exports of that product in the world's total exports.

146. The very good situation corresponds to the combination of a high performance occurring in a dynamic group of products, whereas at the other extreme the withdrawing situation corresponds to a low performance occurring in a group of products that lacks dynamism in the global trade. In turn, the very good and lost opportunity situations relate to those groups of products considered dynamic, whereas the vulnerable and withdrawing situations relate to those groups of products whose global export shares in total global exports are losing ground.

Table 6The Situation of Brazilian Exports
Share in total (per cent)

Categories	Situation ^a				
	Very good	Vulnerable	Lost opportunities	Withdraw	Total ^b
Primary products	0.0	12.7	1.2	1.1	15.0
Industrial commodities	15.6	6.4	10.6	12.2	44.8
Natural-resource-based manufactured products	5.5	1.4	7.9	0.5	15.2
Manufactured products not based on natural resources	10.7	1.1	10.5	2.8	25.0
Total	31.8	21.5	30.1	16.6	100.0

Source: Fundap/Iesp, based on information from the ITSN-UN.^a Based on trends over the 1981-1992 time-period.^b The share of each category in the total differs from table 5 due to information gaps.

147. From table 6 it can be seen that in the year 1992 when trade liberalization gained speed, about 60% of Brazilian exports involved products belonging to groups of products considered dynamic in the global trade. However, only about a third of total exports fell into the very good situation. Although these broad features do not correspond to a very dynamic trade pattern overall, they could serve as a basis upon which a stronger export performance could be built along the process of trade liberalization.

Trade reforms through modernizing the manufacturing industry could lead to better quality products being produced more efficiently and thus to higher exports. The extent to which this process led to more value added products the trade pattern could become more dynamic. Capital account liberalization by providing more and easier access to external finance could support this process.

148. Several studies on the Brazilian export performance acknowledge that the manufacturing industry did modernize through the adoption of organizational and technological changes in the 1990s in response to trade reforms and that this was to some extent reflected in more exports. However, as Frischtak and Pessoa (1999) pointed out this process of searching for higher quality and competitiveness was concentrated on few manufacturing industries, thus being seen as vulnerable and therefore easily offset by other factors, such as exchange rate overvaluation and the expansion of the domestic demand (especially after 1994). This proposition appears to contradict evidence reported in previous section, which indicates that the manufacturing industry did respond to foreign competition. A possible answer is that in most industries such a response did exist, but was limited to guaranteeing long-held domestic markets, and that only a few industries undertook a more offensive strategy aimed at breaking into foreign markets.

2.2. Cyclical factors and capacity expansion

149. Frischtak and Pessoa (1999) have noted that very few companies in Brazil invest in productive expansion aimed at building export capacity. Consequently, most exports are of a counter-cyclical nature. This is indeed the case even in those internationally competitive industries that produce industrial commodities and that are responsible for the mainstream of Brazilian exports. Export analysts have correctly pointed out that the country's export performance in the 1990s was to a considerable extent associated with the country's level of economic activity. Exports expanded in the early 1990s in response to domestic recession and lost dynamism in terms of quantum from 1994 onwards in part as a result of economic recovery (e.g. Frischtak and Pessoa, 1999).

150. To what extent is external capital contributing to break this cyclical pattern by supporting new investment programmes in capacity expansion - even if in commodity-based industries that would reinforce the current trade structure? Although research in this area has been incipient, preliminary evidence indicates that very little.

151. Prates (1999) examines on a tentative basis how each of the three main forms of internalising external capital – foreign indebtedness, portfolio investment and foreign direct investment – may have affected the country's export capacity.

a) *Foreign indebtedness*

152. Foreign debt can take the form of bank loans or securities. Both forms of indebtedness have been important in the 1990s. In the case of bank loans, unlike the 1970s and 1980s when they were predominately made on a long-term basis, they became short-term in the 1990s (Prates, 1999, p. 22). Apparently they were used to finance foreign trade activities as suggested in the previous section. In the case of securities, data compiled by Prates²⁷ show that 73% of the amount of security-related debt created in the 1990s were owned by the private sector, 41% of which by the non-financial private sector.

153. These resources were mainly captured by big national companies and used to substitute foreign for domestic debt, process by which the debt profile was considerably lengthened (Prates, 1999), but also to implement restructuring/modernizing strategies (Motta Veiga, 1999).²⁸ The other 59% of total private securities were issued by the financial sector, about 40% of which passed on to the non-financial private sector, and the remainder used to obtain public bonds. Most of the financial resources transferred to the non-financial private sector – 80% - were used for debt restructuring therefore not geared to productive/investment purposes (Prates, 1999, p. 26). This new foreign debt profile was hedged against exchange rate risk in so far as these companies were into export activities.

b) *Portfolio investment*

154. Prates (1999) notes that the participation of foreign investors in the volume of transactions taking place in the Bovespa, the country's biggest stock market and responsible for 90% of the national market, increased from 6% in 1991 to 29% in 1995. According to the author, this was at the root of the following changing features in the market: the daily volume of transactions increasing from US\$ 32 million to US\$ 400 million (between 1991 and 1996), and the market capitalization, from US\$ 43 billion to US\$ 255 billion (between 1991 and 1997). However, these trends were not translated into less market concentration – the 10 most negotiated stocks corresponded to 81, 9% of the total value both in 1992 and 1997, as most transactions involved stocks of a few big public enterprises being (or waiting to be) privatized.

²⁷ Data were produced by Sociedade Brasileira de Estudos de Empresas Transnacionais e da Globalizacao Economica (Sobeet), 1998.

²⁸ Multinational companies would instead rely on inter-company loans.

155. This lack of overall dynamism due to market concentration is believed to be one of the reasons why the issuing of new stocks by domestic private companies increased only relatively modestly during financial liberalization, from US\$ 900 million in 1992 to US\$ 2 billion in 1998, with the number of companies involved in the operations increasing from 861 to 1012.²⁹ This suggests that portfolio investment in the stock markets was closely linked to the privatization process, involving in the early stages companies operating in commodity-based industries (Vale do Rio Doce) and later companies that provide public utilities and services (Telabras, Eletrobras). Portfolio investment being channeled to the acquisition of new stocks was far more modest, indicating that this was not a relevant source of investment in new productive capacity.

c) *Foreign Direct Investment*

156. Foreign direct investment increased markedly in Brazil (see table 7), contributing to 7,4% of the country's total investment in 1996 against an average of 6,5% observed in the 1970s (Laplane and Sarti, 1999). How much of that has been directed toward expanding export capacity?

Table 7
Net Foreign Direct Investment in the 1990s

<i>Year</i>	<i>Value US\$ billion</i>
1992	1.2
1993	0.4
1994	1.9
1995	3.0
1996	9.2
1997	16.9
1998	26.0

Source: Central Bank of Brazil

157. According to Laplane and Sarti (1999), while in 1989 the manufacturing industry was responsible for 71% of the total foreign investment stock in the country, in 1995 this share fell to 55%. As regards the direction of flows in the most recent years, from a total of foreign direct investment with values of above US\$ 10 million, only 23% and 13% went to the manufacturing industry in 1996 and 1997, respectively (Laplane and Sarti, 1999, p. 14). In 1996 and 1997, 76% and 84% were invested in the services sector, part of that being associated with the privatization process.

²⁹ Prates, 1999, based on CVM monthly letter, various issues.

158. Acquisitions and merge explained around 30% of the total invested in 1995 and 1996, an increase from the 19% observed in 1992. Between 1992 and 1997, 58% of acquisitions took place in the manufacturing sector. Laplane and Sarti (1999; 1998) also detected by relying on a sample of 79 big foreign companies that between 1994 and 1998 19% of the total investment being planned or undertaken were used for merge and acquisitions, 58% for new capacity and 23% for expansion and modernization.

159. This information indicates that a considerable part of FDI in Brazil is being directed to the non-tradable sector and part to the tradable sector, in the latter case to acquisitions and merge although some has also been used to expand capacity. However, still according to Laplane and Sarti (1999; 1998) and Prates (1999) such new investment (together with acquisitions and merge) has been concentrated on a few industries (automobile, chemicals, electronics, food and drinks) whose dynamism is primarily associated with the growth of the domestic market after 1994. Exports from such industries will be therefore residually determined with tendencies to increase in recession periods. Thus the counter-cyclical characteristic of Brazilian exports has not been overcome by new waves of FDI in the manufacturing industry.

2.3. Price-related factors

160. Recent empirical evidence supports the view that poor export performance was not due to the country's inherited export composition biased toward groups of products with low dynamism in the international trade, but to a decline in competitiveness, which was both price and non-price related (Motta Veiga, 1999).

161. The key factor behind loss of competitiveness has been the exchange rate overvaluation, intensified after 1994 and which explains why poor trade performance due to loss of competitiveness was observed across nearly all export industries. (Exports have responded to the 1999 devaluation supporting the hypothesis that in fact this is a key factor explaining their performance). An overvalued currency also affected the import-competing sector negatively by lowering even further the degree of protection it used to enjoy before trade liberalization. This partly explains the sharp increase in imports in the 1990s especially after 1994. In addition, although costs were reduced in response to trade opening this process may not have been sufficient to compensate for extra-firm costs associated with a distorted fiscal tax system or the deteriorated transport infrastructure. Moreover, the same cost-reduction initiatives have been undertaken by the major country's competitors as well.

162. Overall it appears that external capital did not support capacity expansion or deep change in the structure of the export sector. Financing modernization was limited. The reliance on external capital was apparently associated with the government interest rate policy, which encouraged debt restructuring by those industrial groups or firms that had access to external finance. The lack of a change in the export

composition towards more value added products seems to support the hypothesis that this can only take place if capital inflows are accompanied by government policies specifically designed to support industries that have export potential or whose competitiveness needs to be enhanced.

163. This lack of more proactive government policies together with high domestic interest rates may partly explain why capital inflows were insufficiently channeled to investment in tradable activities. The other reason relates to exchange rate overvaluation that affects profitability and therefore investment in tradables especially in the long-term. Although capital inflows did not cause overvaluation alone given that the Government still had large control over the foreign exchange market, it created difficulties for the exchange rate after the 1994 overshooting to move back more speedily to a competitive level.

3. The fiscal regime

164. In a context of capital inflows the Government had to acquire reserves in the foreign exchange market to avoid further appreciation of the exchange rate, and to conduct sterilization operations to avoid excess monetization. A high interest rate policy was pursued at times to restrict domestic demand but also to avoid massive capital outflows in periods of crisis contagion. The policy inconsistency between pursuing high domestic interest rates to restrict domestic demand but which tends to attract external capital in a context of a liberalized capital account was resolved by re-imposing capital controls.

165. The restrictive policy aimed at containing domestic demand had the objective to avoid not just inflation spurs but also further deterioration of the trade deficit, much of it explained by the rapid increase in imports. This policy has proved very costly in fiscal terms, since it contributed to the building-up of a very vulnerable fiscal position.

166. The country's overall primary public deficit increased from -0.4% in 1995 to 1% (as a GDP share) in 1997 and to a balanced position in 1998. However, the nominal deficit (i.e. after including nominal interest rates) has been since the implementation of the Real stabilization plan very large, ranging from 7,2% in 1995 to 8,0% in 1998 (table 8).³⁰

³⁰ Information on the nominal deficit in 1994 and before is less meaningful since it was distorted by high inflation.

Table 8
Primary and Nominal Public Deficit⁽¹⁾
In per cent of GDP

Year	Primary	Nominal
1995	-0.4	7.2
1996	0.1	5.9
1997	1.0	6.1
1998	0.0	8.0

Source: Central Bank of Brazil, Relatorio 1998.

^a Includes all government levels and public enterprises.

167. Financial expenditures associated with interest payments have therefore been largely responsible for the country's deficit in recent years, a phenomenon that reflects an increasing public debt and the change in its composition towards domestic debt, which bear higher interest rates. Between 1995 and 1998 the total net public debt increased markedly, from 30.5% to 42.7% of the country's GDP. While the net external public debt as a share of the GDP remained low though increasing slightly from 5.6% to 6.6% between 1995 and 1998, the net domestic public debt went up from 24.9% to 36.1% in the same period (table 9).

Table 9
Net Public Debt
(In per cent of GDP)

	1995	1996	1997	1998
Total	30.5	33.3	34.5	42.7
External	5.6	3.9	4.3	6.6
Central Government ^a	3.5	1.6	2.0	4.3
Sub-National Governments ^b	2.1	2.4	2.4	2.3
Domestic	24.9	29.4	30.2	36.1
Central Government ^a	9.8	14.3	16.8	21.1
Sub-National Governments ^b	15.2	15.1	13.4	15.0

Source: Banco Central do Brasil Relatorio 98.

^a Includes the Central Bank.

^b Includes public enterprises.

168. The rise in the domestic public debt was due to the Central government debt, which increased 11,2 percentage points of the country's GDP over a period of three years, most than half of that in 1998. The central government indebtedness reflected the sterilization operations that were based on short-term maturity bonds with high interest rates. Although the vulnerability of the country's fiscal position is largely associated with such rapidly increasing debt and the change in its profile towards short-term maturity domestic bonds, non-financial factors have also played an important part in that. The primary deficit has been relatively balanced in the recent years, but it has clearly deteriorated in relation to the primary fiscal position observed for most of the 1980s and early 1990s. For example, a fiscal surplus was observed for each year over the 1991-1994 period, averaging 2.8% of the GDP and reaching 5% of the GDP in 1994.³¹

169. The deterioration of the non-financial fiscal accounts reflected an increase in expenditures, at a larger pace than revenues. This was related to various factors, such as the end of high inflation, which used to erode non-indexed expenditures in a context of fully indexed revenues (the inverse of the Olivera-Tanzi effect), the increase in the social pension expenditures, and in nominal wages as well (especially in 1994/1995 period). Analysts have pointed out that the major problem is that previous balances were attained thanks to temporary measures such as expenditure repression and erosion (the latter due to inflation) and that unless there are constitutional changes expenditures will keep increasing, especially in the area of the pension system.

³¹ See Giambiagi (1997), p. 13, table 1.

CONCLUSIONS

170. The objectives of this study were twofold. First, to revisit the literature on the sequencing of liberalization policies, with a focus on the current and capital accounts of the balance of payments. Second, to re-examine the sequencing issues using the liberalization reforms in Brazil in the 1990s as a case study.

171. The literature review was organized within a historical perspective, to the extent that the arguments over sequencing issues could be associated with particular historical contexts or events. This form of organizing the review was inspired by McKinnon's early view that our judgement on the appropriate sequencing of reforms is to a large extent influenced by the way financial markets operate, and that the latter takes specific forms at different historical periods.

172. The debate on sequencing has revolved around two major issues: what sequencing can facilitate the implementation of reforms and maximize their net benefits, and what needs to be done to avoid reversibility. The second part of this study builds on the Brazilian unconventional sequencing of reforms, where, unlike the sequencing consensus of the 1980s, capital account liberalization came together with other reforms. We addressed the questions of what, and how, political factors and policy objectives have influenced the order and pace of reforms. It was shown that capital account liberalization at an early stage contributed to three major economic objectives: price stabilization, trade liberalization and fiscal reform. First, it helped the country defeat chronic inflation; second, it affected favourably agents' expectations that reforms would not be reversed, and finally it gave time for fiscal reforms to move forward.

173. We then analysed the sustainability of the country's policy regime rather than the sustainability of the reforms themselves. Three sustainability indicators were examined: net external liabilities to GDP, export performance and the country's fiscal position. All of them indicated that the country was in fact towards the end of the 1990s vulnerable to negative external shocks.

174. Our analysis indicates that in such broad reforms that included a high interest rate policy linked to stabilization objectives and a privatization programme, much of the external capital flowed to the country in pursuit of arbitrage and speculative gains, with considerably less flowing to investment in new (productive) capacity. External capital was also used to support micro reforms, investment and modernization, but this process was not deep or wide enough to cause an effective change in the country's export pattern or to expand export capacity to considerably reduce its counter-cyclical behaviour. Poor export performance was also explained by an overvalued exchange rate and by large fiscal deficits. The latter contributed to a vulnerable fiscal position, aggravated by the macroeconomic need to sterilize monetary expansion caused by the accumulation of international reserves. A policy-

consistency requirement would have been for the fiscal adjustment to take place much quicker, but this was not feasible due to political constraints.

175. Overall, the elements gathered in this study support the view that a more gradual liberalization approach would have been more advisable. This could have helped prevent a number of policy inconsistencies that were all but impossible to avoid given the complexity of the tasks being pursued. A gradual approach could have also contributed to less speculative behaviour in financial markets, and give time for the building-up of institutions that can help external capital to be channeled to productive activities. In the tradable sector, another lesson that emerges from the study is that liberalization policies alone do not build an export sector needed to meet the external obligations of an open, net-capital-importer economy and that such policies therefore need to be accompanied by more proactive actions to support the sector.

176. Brazil's currency crisis of early 1999 was relatively less costly, and had a quicker recovery, than other crises in the late 1990s. This milder outcome was partly explained by macro- and micro-features specific to Brazil, such as the existence of relatively high reserves when the currency was floated, and a private sector with low level of indebtedness and hedged against exchange-rate risk. But another, less commented, factor that probably contributed to that outcome was that the country did not liberalize the capital account completely, an evidence that further supports gradualism.

177. These conclusions should be tempered by the fact that capital account opening contributed to price stabilization. High inflation was a problem at the beginning of the 1990s only shared by very few other countries. The importance that Brazilian society attached to stabilization led it to policy options that though very costly as time made evident, were perceived as acceptable given the costs attached to inflation itself, and the sorts of benefits which were envisaged with its elimination.

178. The sequencing literature has its focus today on the phasing of the capital account. An increasingly held position is on the prior need to strengthen the domestic financial system, develop markets and institutions and adopt prudential controls. Brazil fulfilled a good deal of such requisites, but these were not sufficient to avoid a crisis, even though they helped reduce the after-crisis costs. Although such aspects should be borne in mind, the point is to know how external capital, in its different forms, can be beneficial to development objectives of countries whose lack of appropriate institutions precisely reflect the fact that such countries are not developed. Therefore, attention should be refocused on what supportive policies are needed for external capital to be beneficial to the development process. The sequencing literature has as a central premise that reforms are inherently good. But the Brazilian experience demonstrates that markets alone generally frustrate expectations. A useful step ahead would be to acknowledge that markets should be governed in areas like finance and accompanied by selective public policies in others like trade.

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ANNEXURE 1

Data and hypotheses used for calculating net external liabilities

179. Net external liabilities are composed of net external debt, stocks of previous foreign direct investment and portfolio assets held by foreigners. Net liabilities are calculated for the year 1998.

180. 1998 net external debt = US\$ 180.2 billions, corresponds to gross external debt, minus international reserves and credits held by Brazilians abroad. Source: Banco Central do Brasil. 1998 stock of FDI = US\$ 163.79 billions. This figure was obtained by summing the stock of FDI accumulated until 1994 (US\$ 106.84 billions, 1998 prices) and annual net FDI flows from 1995 to 1998. The 1994 stock value was calculated by Maka (1997) and brought to 1998 prices using the US Consumer price index, end of period, from the Bureau of Labour Statistics. The yearly FDI values were brought to 1998 prices using the US Consumer price index, average year. The 1998 stock of portfolio assets held by foreigners is US\$ 17.37 billions (source: CVM, Brazil). Portfolio assets held by Brazilians abroad were ignored.

ANNEXURE 2

Trade surplus required to keep the net external liabilities-GDP ratio constant over time

181. The trade surplus required to keep the net external liabilities-GDP ratio at the level of 46.6% estimated for 1998 can be obtained from a formula derived from the current account identity, as follows.³²

$$CA = D_t - D_{t-1} = rDT_{t-1} - p_t/E_t (Y_t - C_t - I_t - G_t) - UT \quad (1)$$

Where

CA = the current account deficit of the balance of payments

D = Net external liabilities in dollar values

Y = Gross domestic product (GDP)

C = Private consumption

I = Total investment

G = Current government expenditure

UT = Unilateral transfer

E = p/p^* = the nominal exchange rate.

182. The subscript t stands for time, and the small-case letters p for domestic prices, p^* for world prices and r for the average remuneration of external liabilities. Since $Y-C-G =$ total savings (S) and that $S-I = X-M$, where X and M correspond respectively to exports and imports of goods and services net of factors, equation 1 can be rewritten as:

$$(1+r) D_{t-1} = p_t/E_t TB_t + D_t \quad (2)$$

where TB corresponds to the trade balance of goods and services net of factors, $X-M$, and UT is dropped for the focus to be on trade balance only³³. If we divide all terms by $p_t^* Y_t$ and since

$Y_t = (1 + n)Y_{t-1}$ where n is the GDP growth rate, we have:

³² This part relies on Maka (1997) and Milesi-Ferreti and Razin (1996).

³³ Dropping unilateral transfers can be seen as acceptable given that in Brazil this item of the balance of payments is relatively small.

$$(1+r) D_{t-1}/P_t^*(1+n)Y_{t-1} = (P_t/E_t)(TB_t/P_t^*Y_t) + D_t/P_t^*Y_t \quad (3)$$

183. Since for our purposes D_{t-1}/Y_{t-1} will be assumed as a constant ratio, $D_{t-1}/Y_{t-1}=D_t/Y_t$. Hence:

$$(1+r)D_t/(1+n)p_t^*Y_t = (p_t/E_t p_t^*) b_t + D_t/p_t^*Y_t \quad (4)$$

where b is the ratio of TB to GDP.

$$(1+r)D_t/(1+n)p_t^* = Y_t(p_t/E_t p_t^*) b_t + D_t/p_t^* \quad (5)$$

$$[(r-n)/(1+n)]D_t/p_t^*Y_t = (p_t/E_t p_t^*) b_t \quad (6)$$

184. If the real exchange rate, e , is equal to $E_t p_t^*/p_t$, and if d is the ratio of net external liabilities to GDP, we have:

$$[(r-n)/(1+n)]e_t/p_t^*d = b_t \quad (7)$$

185. Equation 7 shows how big the trade surplus, b , should be to keep the ratio of external liabilities to GDP, d , constant. The bigger the average ‘interest rate’ on external liabilities, r , and the more devalued the real exchange rate is (that is, higher e), the bigger the trade surplus required will be. And the bigger the GDP growth rate, n , and the higher the world prices, p^* , is the smaller the required trade surplus will be. This assumes that r will always be bigger than n , otherwise increasing liabilities may be consistent with a trade deficit and constant (or even declining) d , a situation that falls into the case of the so called ‘Ponzi game’.

186. Table 2.1. reports some required trade surplus using equation 7, under different assumptions regarding the behaviour of its variables.

Table 2.1
Required trade surplus for a constant net external liability-GDP ratio

Cases	R	N	E	p*	D	b
1	0.06	0.033	1	1	0.465	0.0122
2	0.07	0.033	1	1	0.465	0.0167
3	0.08	0.033	1	1	0.465	0.0212
4	0.09	0.02	1	1	0.465	0.0319
5	0.06	0.05	1	1	0.465	0.0044
6 ^a	0.06	0.033	1% appreciated	3% higher	0.465	0.0117

^a The formula used in case 6 is slightly different from equation 7:

$$b = [(r-n)(e_t/e_{t-1})] / [(1+n)(p_t^*/p_{t-1}^*)]d.$$

187. In all cases r varies between 6% and 9% which corresponds to the range of LIBOR during the 1990s. The GDP growth rate, of 3.3% (cases 1 to 3 and 6), corresponds to the country's average growth between 1994 and 1999. In all cases e and p* were normalized in 1, except for the case 6, in which e was allowed to appreciate by 1% and p*, to increase by 3%.³⁴ Cases 4 and 5 represent extreme situations regarding the combination of r and n, and case 6 is a more realistic version of 1 by allowing e and p* to vary.

³⁴ The appreciation of e can take place over time without affecting the country's trade position provided it corresponds to productivity gains in the tradable sector that are higher than the average world gains.