# GOVERNMENT, MARKET AND DEVELOPMENT: BRAZILIAN ECONOMIC DEVELOPMENT IN HISTORICAL PERSPECTIVE

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# *Abstract*

In the last 30 years the World has been swept by neoliberal doctrine. Under neoliberal conceptions, freedom of the market mechanism has precedence in the process of development. Neoliberalism has had a major impact on the mindset of policymakers, on government strategies for development and on economic performance.

This thesis is about the economic consequences of neoliberalism in Brazil. It approaches the problem from a historical perspective. By examining government economic strategies in Brazil from the 1930s through the 1970s it undermines a central neoliberal argument that government interventions in the economy are either inimical or irrelevant to economic development. While government failures did occur indeed, in the Brazilian case it is shown that the government performed a crucial role in this period in building key institutions that guided market forces towards industrial transformation.

Since the mid-1970s, Brazil has been a laboratory for neoliberal economic policymaking. Restrictive macroeconomic policies alongside liberalised markets have been the cornerstones of policymaking. The second line of argument developed here is that neoliberalism has since constrained economic development in Brazil. During this period the country has been through several financial crises and has experienced low economic growth and unprecedented unemployment. Compared with the previous period of government-led development, neoliberal policies and institutions fall far behind in terms of overall economic performance.

Thirdly, it is argued that under neoliberalism government policy and institutions in Brazil have been directed to satisfy rentiers' interests at the expense of a socially acceptable economic development. Finally, this thesis calls for the reinstatement of discussion over the government's role as an agent of a democratic, economic and social transformation. This is a discussion that has been obstructed by neoliberal doctrine for too long.

To my beloved girls Cristiane and Helena

# *Contents*

*List of Tables* .......... 9

*List of Figures* .......... 11

*Acknowledgements* .......... 13

*1. Introduction* .......... 15

*2. Towards a Historically and Institutionally Grounded Perspective in Development Economics* .......... 21

Introduction .......... 21
The Problem of Government Intervention in the Unfettered Market Perspective .......... 23
Historical and Cross-Sectional Evidence .......... 28
Theoretical Limitations of the Neoliberal Approach .......... 39
Elements of an Alternative Approach .......... 42

*3. The Changing Character of the State and of the Economy* .......... 61

Introduction .......... 61
The Political Economy of the Brazilian Primary-Export Economy .......... 62
The Emergence of the Brazilian Developmental State .......... 68
Assessment of the Limits of the Economic Transformation in Brazil .......... 77
Final Remarks .......... 80

*4. Rupture with Continuity: The Double Character of the Military Economic Reforms* .......... 81

Introduction .......... 81
Transforming the Brazilian Model .......... 82
The "Economic Miracle" and the Model of Accumulation .......... 96
The Political Economy of the Stabilisation Policy .......... 98
The Growth of State Entrepreneurship .......... 102
The Government as a Financier .......... 106
The Political Economy of Foreign Capital and External Debt .......... 111
Final Remarks .......... 116

*5. The Reemergence of Economic Liberalism* .......... 119

Introduction .......... 119
The Strategy of 1974 .......... 121
The Government's Objectives Change in 1976 .......... 124
The Road Towards the External Debt Crisis .......... 131
The Road to Public Financial Fragility .......... 137
External Shocks and Economic Turmoil .......... 140
Final Remarks .......... 146

*6. Weathering the External Debt Crisis: The Neoliberal Way* ...................................... 149

Introduction ........................................................................................................... 149
External Debt and the Political Economy of the Adjustment ........................................ 151
The Brazilian External Debt Negotiation and the Problem of the Net Financial Transfers ........................................................................................................... 155
Domestic Effects of the Adjustment Policies on Growth .............................................. 164
Financial Instability and Fragility Resulting from the Adjustment Policies .................. 169
Public Financial Fragility ........................................................................................ 174
The "Securitisation" of the Wealth of the Non-Financial Sector ................................... 177
"Financialisation" in the Financial System ................................................................. 181
Final Remarks ........................................................................................................ 185

*7. The Economic Consequences of the Neoliberal Reforms in the 1990s* ....................... 189

Introduction ........................................................................................................... 189
Neoliberal Structural Reforms .................................................................................. 191
Raising Great Expectations ...................................................................................... 202
Economic Growth under Market-Oriented Reforms: the second lost decade ................ 204
Finance Interests and the State Financial Fragility ....................................................... 213
The State's Loss of Political Autonomy .................................................................... 221
Final Remarks ........................................................................................................ 226

*8. Summary and Conclusions* .................................................................................... 229

*References* ............................................................................................................ 237

# *List of Tables*


Table 1 Target Plan Sectors' Expansion: Planned and Realised – 1957-1961 .................... 74
Table 2 Target Plan: Foreign Capital by Sector (US$ Million)........................................... 75
Table 3 Productivity of Workers in Agriculture and Manufacturing.................................. 77
Table 4 Brazil Indicators of Income Distribution ............................................................... 78
Table 5 Federal Government Tax Revenues by Type of Tax (% of Total Federal Revenues) ...................................................................................................................... 84
Table 6 Main Credit Lines for Export: Institutions and Characteristics of the Loan........... 93
Table 7 Effective Tariff Rates by Sector (%), 1958-1984 .................................................. 94
Table 8 Distribution of Brazilian Exports by Products and Regions – Percentage of Total Exports, 1967-1973......................................................................................... 96
Table 9 Industry: Sectoral Rates of Annual Real Growth, 1966-1973 ................................ 97
Table 10 Monetary Aggregates and Inflation Indexes......................................................... 99
Table 11 Sectoral Allocation of Public Enterprise Investment (%), 1947-1979................ 103
Table 12 Growth of Manufacturing Firms Amongst the 300 Largest (Percent of Assets) 105
Table 13 Composition of Monetary and Non-Monetary Financial Assets (%), 1966-1973 ...................................................................................................... 107
Table 14 Financial System: Main Sources of Loans to Private Sector (% of Total), 1966-1972 ...................................................................................................... 108
Table 15 BNDES's Loans and Sources of Resources, 1970-1980 ................................... 123
Table 16 Rate of Investment as Percentage of GDP and Rates of Annual Growth (%), 1971-1982 ...................................................................................................... 126
Table 17 II PND: Sectoral Distribution of Investments (% of FBKF) ............................. 127
Table 18 Sectoral Rates of Growth – Annual Average (%), 1963-1983 ........................... 129
Table 19 Foreign Debt Profile (U$ Million), 1970-1982.................................................. 132
Table 20 Public and Private External Borrowing Under Law 4131 and Resolution 63 in US$ Millions and as a Share of the Total Capital Inflows, 1972-1981 .................... 135
Table 21 Factors Determining Current Account Deficits, 1970-1983.............................. 136
Table 22 Financial Assets and Monetary Aggregates as a Share of GDP (%), 1970-1983 ...................................................................................................... 139
Table 23 Indexes of Terms of Trade of Brazil and Other Regions (1979 = 100), 1978-1983 ...................................................................................................... 141
Table 24 Renegotiation of Brazilian External Debt: Agreements with the Private Creditors................................................................................................... 155
Table 25 Renegotiation of Brazilian External Debt: Agreements with the Paris Club...... 157
Table 26 Financial Flows by Creditors – US$ Million, 1982-1989.................................. 157
Table 27 Net Resources Transfered Abroad (US$ Million) and as a Share of GDP (%), 1981-1989 ...................................................................................................... 160
Table 28 Indicators of External Debt, 1981-1989............................................................ 161
Table 29 External Debt: Public and Private, 1981-1989 .................................................. 163
Table 30 Rates of Annual Growth of Output and of Demand and Balance Trade and GDP Ratio (%), 1981-1989.............................................................................. 165
Table 31 Rates of Investment as a Share of GDP and Rates of Growth by Agent, 1980-1989 ...................................................................................................... 165
Table 32 Rates of Annual Growth of Output and Labour Productivity of Manufacturing, 1975-1990 ...................................................................................................... 167
Table 33 Annual Interest Rates (%), 1980-1989.............................................................. 171

Table 34 Money Aggregates and Financial Assets as a Percentage of GDP (%), 1979-1980 ....174
Table 35 Net Public Debt as a Percentage of GDP (%), 1982-1990 ....175
Table 36 Public Deficits in Alternative Concepts and Actual Interest Burden (% GDP), 1981-1989 ....175
Table 37 Some Indicators of Financial Posture and Performance of the Thousand Largest Firms in Brazil (by ownership of capital) – Percentage, 1978-1989 ....179
Table 38 Selected Assets and Liabilities of Private Commercial Banks (% of Total), 1978-1989 ....183
Table 39 Main Characteristics of Brazilian Privatisation Exercise, 1990-2002 ....194
Table 40 Mergers and Acquisitions, Foreign Firms Investments and Participation in Brazilian Sales by Sector ....195
Table 41 Bank Participation in Selected Indicators by Ownership – Percentage of the Total Banking System, 1996-2004 ....200
Table 42 International Comparison of Economic Growth (%), 1980-2004 ....205
Table 43 Annual Average Growth of Output, Employment and Productivity by Sectors (%) ....207
Table 44 Rates of Real Growth of Expenditure and Trade Balance as a Share of GDP, 1990-2005 ....208
Table 45 Relative Weight of High-Tech Sectors in Total Manufacturing Output and Employment (Percentage) ....210
Table 46 Imported and National Machines and Equipments Sector (US$ Billion), 1989-2003 ....212
Table 47 Net Capital Inflows to Brazil (US$ Billions), 1990-2005 ....215
Table 48 Indicators of Stock Exchange Markets, 1990-2005 ....217
Table 49 Loans as a Percentage of GDP to Private Sector (by Sectors) and to the Whole Economy, 1990-2005 ....218
Table 50 Indicators of Banking Concentration (%), 1995-2004 ....219
Table 51 Firm Financing Patterns, 1994-1998 (Publicly-listed firms, sorted by size) - Percentage ....219
Table 52 Public Total Net Debt and by Bonds, 1991-2005 ....221
Table 53 Financial Requirements of the Public Sector as a Percentage of GDP, 1990-2006 ....223

## *List of Figures*

Figure 1 State Owned Enterprises Price Index, Wholesale Price Index and GDP Deflator (%) ........ 86
Figure 2 Monthly Exchange Rates Index, 1964-1983 – Purchase Power Parity ........ 92
Figure 3 Annual Inflation Rates: Wholesale Price Index and GDP Deflator (%), 1955-1983 ........ 99
Figure 4 Relative Indices of Minimum Wage, Industrial Salary and Industrial Labour Productivity (1970 = 100) ........ 100
Figure 5 Income Distribution of Industrial Value Added: Wages and Profits, 1964-1980 ........ 101
Figure 6: Rate of Investment as Percentage of GDP (%), 1955-1973 ........ 103
Figure 7 Stock Markets: Transactions and Shares and Debentures Issues (Δ% Yearly), 1967-1973 ........ 109
Figure 8 Public Financial Agents' Loans and Capital Formation, 1966-1972 ........ 110
Figure 9 The Ratio of Capital Inflows to Gross Capital Formation (%), 1964-1973 ........ 111
Figure 10 External Resources Absorption: Capital Costs, Real Transfers and Reserves Changes as a Proportion of Net Capital Inflows 1963-1973 ........ 113
Figure 11 BNDES' Loans to Capital Goods Purchases (Δ % Annual), 1970-1983 ........ 128
Figure 12 Absorption of External Resources (US$ Million), 1970-1983 ........ 137
Figure 13 Domestic Real Interest Rates, 1974-1982 ........ 138
Figure 14 Real International Interest Rates (%), 1978-1983 ........ 142
Figure 15 Federal Public Enterprises Investments in Infrastructure Sectors as a Percent of GDP, 1970-1989 ........ 166
Figure 16 Ratio of Manufacturing Exports to Manufacturing Output and GDP Growth Rates (Percentage) ........ 169
Figure 17 Monthly Inflation Rates (%), 1980-1989 ........ 173
Figure 18 Total Financial Investments of Firms – (% of Net Worth), 1978-1989 ........ 180
Figure 19 Adjusted Leverage of the Banking System – Assets/Capital, 1978-1989 ........ 182
Figure 20 Brazilian Legal Tariff by Sectors (%), 1980-2005 ........ 191
Figure 21 Effective and Purchasing Power Parity Exchange Rates (%), 1990-2003 ........ 192
Figure 22 Expected Engine of Growth of the Neoliberal Reforms ........ 203
Figure 23 Labour-Share and Capital-Share in GDP (%), 1990-2003 ........ 206
Figure 24 Interest Rates Spread and Banking Net Profit Margins (%), 1994-2003 ........ 219
Figure 25 Selected Assets and Profitability of the 50 Largest Banks in Brazil (%), 1995-2005 ........ 220
Figure 26 Neoliberal Degeneration of the Channels of Economic Growth ........ 226

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# *1. Introduction*

Neoliberalism and related institutional reforms have been dominant throughout the developing world for the last thirty years or so. Neoliberalism is a doctrine that regards the free market as the domain of individual freedom and the unfettered market as the best mechanism to achieve economic progress.  It asserts that free market is generally the most efficient way of allocation of scarce resources and the only non-coercive form of coordination of many individuals acting independently. The kernel of the neoliberal political economy is the proposition that market competition should not only be free of restrictions of any type or form but also that competition and market method should rule and expand to every possible aspect of human life. As of the state role, neoliberalism condemns interventions which increase the state role as regulator, coordinator and an agent of cohesion of the social interaction. That is, deeds which place the state as a guiding agent of economic activity. In accordance with the neoliberal doctrine, the domestic role of the state is to defend competitive markets and to minimise fraud and cheating. Domestically, government role is to take care of the rules of the game in which individual freedom and unfettered markets will emerge.

The political economy of modern neoliberalism arose largely as a reaction to the policies and institutions of the state-led economic development that prevailed in many developing countries in the aftermath of the Great Depression of the 1930s and the Second World War. In this context, neoliberal economists featured the government intervention as generally perverse, managed by self-seeking politicians and bureaucrats incapable of taking due care of public interest as they were pressured by and client of narrow interest groups. The government intervention ended disturbing market mechanism operation instead of guaranteeing its utter operation. Attempts to minimize the role of the state in favour of self-regulating markets have been the tenet of that neoliberal reforming project. Milton and Rose Friedman (1983, p.68) synthesized the neoliberal task: “We have permitted

government to grow too large. We must now cut it back to size. The tyranny of the status quo makes it hard to do. But it can and must be done." According to the neoliberal doctrine, freer markets should result in faster economic growth than in an economic model in which the government guides economic forces. Neoliberal policies and institutional reforms include restrictive macroeconomic policies, trade and current account liberalisation, privatisation, and deregulation of domestic markets.[1]

This study challenges neoliberal claims by analysing economic interventions by the Brazilian state in pursuit of economic development, and by looking at neoliberal reforms from a historical comparative perspective. In addressing the past economic development of Brazil it refutes the neoliberal argument that government intervention has either been inimical or irrelevant to structural transformation. By scrutinising neoliberal policies and institutions it refutes the notion that unfettered markets are conducive to the kind of economic transformation a developing country like Brazil needs.

In Chapter 2, the theoretical and empirical foundations of neoliberalism are evaluated. It is argued that there are neither sound theoretical nor empirical bases for defending unfettered markets as a better means of fostering economic development. As is well known, even conventional market theory and welfare economics recognise that actual markets may not comply with the stringent requirements for the economy to achieve optimal resource allocation. As markets can fail, the government may be needed. While the market failures approach may provide interesting insights, it is still limited when it comes to addressing the problem of government intervention in a developmental context. Actual government interventions that take place are not necessarily led by contrivances of achievement of ideal equilibrium positions. Government interventions result from a complex of factors composed by interest groups pressures, the government strategies of political and economic surviving as government is an autonomic institutional body with rights on its own and from broader institutional context they inherited. At a lower level of abstraction, a survey of historical evidence and cross-sectional empirical works shows there is only shaky empirical support for neoliberal claims that freer markets have been more conducive to economic growth.

[1] Neoliberal doctrine and policies have been proposed by a very influential group of economists. The works by Nobel Laureates Friedrich von Hayek (1944), Milton Friedman (1962), and James Buchanan (1978) along with influential economists like Gordon Tullock (1970;1979), Anne Krueger (1974;1990b), and Deepak Lal (1994), to cite a few, are among those that established the neoliberal doctrine and policy prescriptions.

Chapter 2 also provides a survey of the theoretical perspective followed herein. For the study of the dynamic between government intervention and economic development it resorts to what it terms the institutionally and historically based perspective. The crucial tenet of an institutionally and historically grounded perspective is found in the dynamic interaction between individuals, institutions and the changing environment. In other words, instead of the attainment of an optimum allocation of resources by given individuals, this is a perspective which focuses on the cumulative process of change while institutional and individual changes are unfolded along the way. As Thorstein Veblen (1898, p.391) put it, "The economic life history of the individual is a cumulative process of adaptation of means to ends that cumulatively change as the process goes on, both the agent and his environment being at any point the outcome of the past process…What is true of the individual in this respect is true of the group in which he lives." Therefore, the general concern of this study is not about more or less government intervention, but rather the kind of government interventions that produce the cumulative processes that lead (or not) to economic development and with the institutions those interventions have bequeathed to future generations.

Chapters 3 to 7 present a chronological historical analysis of Brazilian economic development from the 1930s to the present. The period is divided into two sub-periods, 1930-79 and 1980 to the present, in which the state has played significantly different roles. From the 1930s to the 1970s, the government took a much more strategic and leading role in order to bring forth and mobilise forces leading to economic development. Since the late 1970s, however, government leadership has been contested and its policy-making has been oriented according to a neoliberal perspective.

Throughout these chapters, an attempt will be made to develop a comparative analysis of government intervention in each period. Government intervention is of course multifaceted and complex, so it is necessary to delimit what kind of evidence we are looking for. The focus will be on policies aimed at augmenting and creating markets, as opposed to merely conforming to the market and following its lead by adopting price-neutral policies. It focuses on the policies affecting the rates of investment from a macroeconomic perspective, yet some disaggregate evidence is assessed. It is also interested in the policies, regulations and other institutions introduced by the state to foster industrial investment and to channel it to sectors whose growth is more important in the long term. Special attention is devoted

to policies with regard to the financial system and public budgeting distribution. From a broader perspective it assumes, with Schumpeter, that government finances encapsulate quite a lot of the ideologies, culture, structure and deeds of a society. In a more specific sense, in the words of Alexander Gerschenkron (1962, p.46), "it was the budgetary policies of the state that must be considered as the strategic factor in capital supply."[2] Therefore, much of the evidence here investigated will concern government finances and how they have been used (or not) to foster investment in new and growing industrial enterprises. More importantly, however, it endeavours to show which factors have most influenced public finances in terms of their level and composition. It is important to emphasise that the interesting issue is not capital accumulation and its causal relations with growth, employment, and technical progress, since they have been well established empirically and theoretically. The important issue here is to bring to light the factors that shaped state activities, and how they did it.

Chapters 3 and 4 substantiate the argument that Brazilian development was a deliberate project initiated by state policies seeking industrialisation and development, with the state decidedly assuming a Hirschmanian function as the binding institution of development. This shows the flaws in the common neoliberal argument that Brazilian industrialisation came about spontaneously. Indeed, the Great Depression of the 1930s and the Second World War broke the mould of *laissez faire* hegemony in Brazil and elsewhere in the world. The new institutional settings and ideologies that emerged in Brazil in the aftermath of the Second World War and the widespread demand for development opened the door to greater state involvement in economic and social life, replacing the dominion previously enjoyed by local oligarchies and their foreign associates. The government took the lead, consciously bringing development to the fore. It imposed trade controls, administered the foreign exchange shortage, provided selective and subsidised credit and tax exemptions, created public enterprises, and invested in basic infrastructure. This new era of government intervention, tailored to foster structural transformation, produced the basic institutions that buttressed Brazilian industrial development and led to very rapid economic growth until the mid-1970s.

[2] Gerschenkron continues saying that "This is not to say that this was the only available source…But this much seems clear: all the other sources do tend to pale into insignificant compared with the role of budgetary finance of the new and growing industrial enterprises."(1962, p.46)

In summary, this era illustrates the role the state can take on in fostering economic development. Undoubtedly, there were also failures in the attempts to tame market forces so as to deliver a more dynamic and less uneven society. For instance, the government failed to enhance the capability of national capital to take over the lead foreign capital still enjoyed in domestic markets. As a consequence it failed to change its technological and trade policies, especially exports, so that they became independent of foreign interests and based on domestic firms. The government failed to turn the private financial system from rent-seeking towards the provision of long-term finance. It failed to reduce income and wealth concentration by adopting distributive policies such as land reform and full employment. In short, the government made many mistakes when attempting to mobilise resources towards development. Nevertheless, the government, even when highly imperfect, still has huge comparative advantages when it comes to delivering economic transformation. Accordingly, when all is said and done, it is undeniable that industrialisation in Brazil was a great success.

Chapters 5 and 6 deal with the transformation of the state into a neoliberal framework. From the mid-1970s onwards, the mechanisms the Brazilian state had built to control flows of investment were deactivated one by one. Between the first oil shock and the external debt crisis the government role as an engine of industrial transformation was substituted by one of guarantor of financiers' confidence and rewards. The international debt crisis in the early 1980s bears much of the responsibility for this transformation. With the international crisis and with the IMF and international creditors pressing for restrictive policies, the state had to bear most of the costs of the adjustment. In addition, inflation and financial instability de-legitimised and weakened the state as the binding agent of developmental forces. Pressed by the IMF and the economic crisis, the state lost control over the instruments it used to foster development. It may be said that while the Second World War broke the chains of circular causation that had kept Brazil in a state of underdevelopment, the international financial crisis in the 1980s broke the agent that galvanised the cumulative factors of development. The absence of this agent, and hence the lack of development, ushered in the return of *laissez faire*.

Chapter 7 covers the neoliberal reforms implemented in Brazil in the 1990s. After a description of the main measures it proceeds to an evaluation of the outcomes in terms of economic growth. The chapter substantiates the following claims: a) the neoliberal reforms

have been ineffective as a model of development; b) the tenet of the neoliberal model in Brazil has been one of pursuing the interests of rentiers at the expense of more socially acceptable form of economic development. In the neoliberal era the government has been reduced not to a socially required minimum but to a nightwatchman for the interests of financiers.

Finally, Chapter 8 offers some general concluding remarks.

# *2. Towards a Historically and Institutionally Grounded Perspective in Development Economics*

## Introduction

In the 1980s and 1990s, neoliberal rhetoric and policies conquered economics worldwide. The process stemmed from the conservative wave that had started in developed countries, especially the United States under President Reagan and Britain under Prime Minister Margaret Thatcher, in the early 1980s. In both countries Keynesian macroeconomics was toppled by monetarist policies. The effects of the political and intellectual climate change in the developed countries produced immediate consequences in developing countries. Development economics, which shared some similarities with Keynesian economics, was castigated by proponents of unfettered markets. They saw it as an exotic variant of the Keynesian approach, and associated it with excessive *dirigisme*.

Keynes had argued that the lack of effective demand produced the kind of depression that developed countries experienced in the 1930s. Simply reducing wages would do more harm than good, as wages constituted great part of the aggregate demand. The solution for the unemployment of workers and machines was to increase effective demand, whether by deficit spending or another mechanism that could increase investment and consumption. The contributions to development economics stressed the specific circumstances which prevailed in developing countries – inelasticity of exports, dependence on primary-export products, restricted domestic markets, unskilled workers, pervasive unemployment, misdirected entrepreneurship so on and so forth – problems whose solutions were not entirely at odds with Keynesians'. As in Keynesian economics, development economics saw that resources were available but underutilised, and misdirected instead of absent or scarce. Mobilising and reorienting these available and latent resources demanded even stronger government interventions than the deficit spending required by unemployment in developed countries. The neoliberal attack condemned government as the main cause of the

misallocation of resources and advocated the replacement of Keynesian policies in developed countries and in development economics by one universal policy. Efficient allocation of given resources, governed by scarcity prices, was reasserted as the proper employment and developmental policies. In this study we concentrate on economic development issues.

To be persuasive, policy propositions need to show adherence to historical and empirical evidence. Neoliberal economics claimed that the most successful developing countries, those of East Asia, were living proof of the superiority of free market mechanism as a promoter of economic development (Balassa 1985; Krueger 1990a; Lal 1997[1983]). Having assumed that the East Asian countries adopted freer market policies, neoliberal economists cited these countries' policies as the benchmark against which the development achievements of other developing countries were judged. Any economic performance failing to match or surpass those of the East Asian countries was deemed to be a failure – and failure was attributed to *dirigisme*, a group of policies based on delusions propelled by development economics. The neoliberal doctrine gained increasing influence over multilateral institutions, such as the IMF and the World Bank, and over the controllers of those institutions, the governments of developed countries. As the 1980s drew to a close, the IMF, the World Bank, and the United States Treasury established a group of neoliberal policy principles, the so-called Washington Consensus, which was prescribed for developing countries in programmes of financial aid managed by the IMF and the World Bank. Accordingly, governments should be pressured to adopt restrictive macroeconomic policies, trade and capital account liberalisation, privatisation and deregulation (Fischer and Thomas 1990; Williamson 1990). The governments in developing countries have also adopted this doctrine, either because they wished to emulate the successful cases or because they were forced to by the prevailing circumstances. A group of developing countries, especially the indebted Latin American countries, were suffering due to deteriorating fiscal conditions, inflationary pressures, grave balance of payments imbalances and poor economic performance against a backdrop of rising social demands. The formula for adopting the neoliberal propositions was complete: an analytical framework from which to derive policy propositions; a group of successful case histories; examples of failure among those who had not adopted the policies; a long economic crisis that made governments desperate enough and weak enough to keep their legitimacy at almost any cost; and

powerful and resourceful international institutions that could support and sponsor the adoption of neoliberal policies.

Later in this thesis, it is our objective to evaluate from a historical perspective the specific circumstances and the results of the implementation of the neoliberal policies and reforms in Brazil (chapters 5, 6, and 7). In the 1990s, Brazilian governments fully embraced the neoliberal doctrine. Much earlier, however, during the political and economic turmoil of the 1980s, neoliberalism had begun to overturn the development policies that had previously been implemented by the Brazilian government for 30 years. The Brazilian governments of the 1980s and 1990s did not only want to emulate the success stories depicted by the neoliberal economists, but they were also pressured by the circumstances of a long-lasting external debt crisis and domestic economic turmoil. In order for the free market perspective to prevail, it was also vitally important to understate the developmental impact of previous government interventions in Brazil. This thesis therefore adopts a historical perspective in order to highlight crucial features of the role of government in development, and also to scrutinise the accounts written from a free-market perspective (chapters 2, 3 and 4).

For the moment, however, this chapter has two objectives. First, it sketches out the general tenet of the free market perspective that has dominated policy-making since the early 1980s. It then brings together some empirical evidence that calls into question the general validity of free market prescriptions in developing countries. The second objective is to point to some intrinsic difficulties that free market perspective faces in order to evaluate properly developing countries and economic development. To do so, it brings together contributions of institutionally and historically based perspectives that highlight those faults. It follows the conceptual approach that buttresses an alternative perspective based on the institutionally and historically grounded perspective. Finally, it outlines the scope and strategies of investigation that orient the case study.

### The Problem of Government Intervention in the Unfettered Market Perspective

Proponents of the free market perspective have based their contempt for development economics and ensuing government interventions on welfare economic theory. According to Deepak Lal (1997[1983], p.5) the major essential element of the "*Dirigiste Dogma*," as

he dubbed development economics, "is the belief that the price mechanism, or the working of a market economy, needs to be supplanted (and not merely supplemented) by various forms of direct government control, both national and international, to promote economic development." Other misleading notions would complement *dirigisme* creeds such as: that the efficiency gains from better allocation of given resources is rather small; that the liberal case for free trade is invalid for developing countries and that government control on prices and distribution of income and assets are necessary for bringing together economic growth, alleviation of poverty and better wealth distribution. All those creeds would have misled development economics to propose exotic theories applied in developing countries only. According to Lal (1997[1983], p.105) the distorted government interventions to which development economics gives rise stem from the denial that economic rational behaviour, the technical substitutability and institutional features assumed in orthodox economics were also valid in developing countries. The root of *dirigiste* misconceptions was, according to Lal, "the neglect of the one branch of economic theory which provides the logic to assess the desirability of alternative economic policies, namely, welfare economics"(p.10).

The upshot of this turn to welfare economics and the general theory of rational economic behaviour was the denial of alternative theories of the market and the usefulness of timing and context-grounded theories of economic development. Resorting to efficient allocation of given resources to generate economic development diverted attention to the use of perfectly competitive market theory to base the judgements on policy prescription. The more closely an economy resembles the model of a perfectly competitive economy, and its supplementary hypothesis of complete markets and information, the better the allocation of resources. Within perfect markets and with the help of the special hypotheses which complement it, it is believed that if the economy is left free to respond to true social opportunity costs, profit incentives will conduct the economy to maximum production potential with full employment of resources over time (Balassa 1985).

The neoliberal choice of theory to contest development economics is somewhat unfortunate. Welfare economics is unlikely to provide the only logic with which to evaluate policy alternatives, not mention to deal with economic development problems. To begin with, the theory is conspicuously silent regarding the distribution of income and wealth. That is, even if an efficient allocation of resources in the Pareto sense were ever attainable under ideal market conditions, welfare economics does not imply that the optimum should

also be equitable. In this vein, agents may think government should intervene to "correct" income, wealth or power distribution and this intervention would be judged totally outside the welfare economics criteria (Pitelis 1994).

Apart from the silence regarding wealth distribution, further problems emerge from the requirement to achieve an efficient allocation of resources. Theoretical research has pointed to the difficulty, if not impossibility, of real markets complying with the stringent requirements of a perfectly competitive market. Failure of complying with theoretical contrivances show that actual market mechanism may not lead to the optimality the theory assumes. Market failures are those non-Pareto optimal situations in which it is possible to improve the well-being of one person without compromising that of another person. That is to say, there exist circumstances in which individual self-interested behaviour, following price signals, may fail to account for all the costs and benefits involved in their decisions, and hence may fail to achieve Pareto efficiency. It is said that markets fail in the presence of increasing returns, externalities, transactions costs, public goods, asymmetric information and incomplete markets (Bowles 2004; Schotter 1985; Stiglitz 1989). Therefore, it is obviously the case that a wholly 100 per cent free market economy is not attainable. Governments are recognisably part and parcel of a market economy, even in conventional theoretical models.

Neoliberal economists have not denied the validity of specific government intervention in all instances. Market failures arguments are generally accepted by neoliberal proponents (Friedman 1962; Lal 1997[1983]). It would be wrong to suggest that neoliberal economists do not welcome government policies to remedy well-defined and specific market failures, as long as government does not introduce distortions of its own. As Lal (1997[1983], p.15) puts it: "Given that the optimum is unattainable, the relevant policy problem becomes that of assessing to what extent particular government interventions may raise welfare in an inherently and inescapably imperfect economy." This does not change the basic evaluation that the theory of perfectly competitive markets and welfare economics are still the best reference to judge the desirability of alternative policies. Having recognised that conventional theory does not support the idea that unfettered markets will necessarily lead to efficient resource allocation, let alone to development, neoliberal economists have sought to press their case against government intervention by showing that it introduces more inefficiencies than market imperfections. Lal set out the main tenet of neoliberal

propositions, which is to "give reasons, rooted both in the experience of developing countries and in theory, why, of the only feasible alternatives – a necessarily imperfect planning mechanism and a necessarily imperfect market mechanism – the latter is likely to perform better in practice" (p.106). John Toye (1993) has also observed that one way neoliberal economists have attempted to show that imperfect market mechanism is preferable to imperfect government intervention is by downplaying the relevance of non-policy distortions. As such, "All those distortions which are not induced by policy, which are not government acts, such as import quotas or investment rationing schemes, are to be magically argued out of existence" (p.103). A complete denial of non-policy distortions would be extreme, and most likely unfounded, for few economists would say actual markets function in the way ideal perfect market theory implies.

A second alternative has been to argue that governments do not actually care about the public interest and that most market imperfections actually result from government interventions. The conservative attack on government is then twofold. First, instead of being the repository of public interest, governments are institutions constituted by individuals who pursue their self-interest in the same way as everyone else. As such, these individuals, whether acting as politicians or civil servants, put their job security or political survival ahead of any public interest (Tullock 1979). Moreover, politicians are under constant pressure to favour their parochial constituencies, whose interests may have a greater bearing than national issues on the politicians' survival. Furthermore, informational and monitoring problems also emerge between politicians/constituents and bureaucrats/politicians making it difficult for constituents to monitor politicians' actions and for politicians to monitor bureaucrats' actions. In short, far from representing the general will the state may be fostering the particular interests of its officials and correspondent supporters.

Accordingly, more government intervention would reduce economic efficiency, either because officials have vested interests away from Pareto efficient allocation or because firms and individuals divert productive resources to compete for privileges. Bringing this argument to its limit, Anne O. Krueger (1974) envisaged that increasing government interventions would build a rent-seeking society in which "regulations would be so all-pervasive that the rent-seeking would be the only route to gain. In such a system, entrepreneurs would devote all their time and resources to capturing windfall

rents"(p.302).[3] So, this literature implies that the costs of government failures are so high that they surpass any market failures. Moreover, the type of distortions involved in public affairs, like information problems, rent-seeking behaviour, and lack of monitoring, cannot be sorted out by offering more information, by increasing the quantity and improving the quality of public staff, by establishing meritocratic and competitive public jobs and so on.[4]

In the contemporary world, where government would have already gone too far, neoliberals suggest elimination of the government's ability to allocate resources whether directly by privatisation, deregulation and the like or indirectly by introducing market-like mechanisms in public affairs. Furthermore, neoliberals suggest that the adoption of a freer market regime imposes efficiency upon the government. As Milton Friedman (1962, pp.2-3) put it long ago: "By relying primarily on voluntary co-operation and private enterprise, in both economic and other activities, we can insure that the private sector is a check on the powers of governmental sector…" Neoliberal propositions are to tame government development interventions and to limit them to much less significant tasks.

To get around market failures, however, the neoliberal perspective has to face other difficult issues. It has been demonstrated by R. G. Lipsey and Kelvin Lancaster (1956-1957, p.12) that "in a situation in which there exist many constraints which prevent the fulfilment of the Paretian optimum conditions, the removal of any one constraint may affect welfare or efficiency either by raising it, by lowering it, or by leaving it unchanged." In other words, even if we believe that every situation can be perceived in only one way and therefore the government can set out selective and clear policies to remedy specific market failures, there is no way to guarantee that removing such specific distortions would result in an increase in welfare. Thus, before the imperfections of actual markets, welfare economics seems to leave one in the lurch with regard to the possibility of the unfettered market achieving optimum resource allocation.

Whilst the unfettered market is likely to be an insufficient mechanism to deliver efficient allocation of given resources it may be even less advisable a mechanism to deliver economic development. This is so because economic development is by its very nature a dynamic process of change. Economic development implies quantitative and qualitative

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[3] See in the same vein Mancur Olson (1982).

[4] Indeed, Anne O. Krueger (1990b) has argued that the developing countries' governments when recruiting high qualified staff crowds-out private sector due to the short provision of management abilities characteristic in those countries. See also World Bank (1983;1987).

changes in resources themselves. Lal (1997[1983], p.107) recognised that only a historically grounded analysis can provide a truly dynamic account of the process of economic development. He believes that what neoclassical economics can offer is only a comparative equilibrium analysis of different equilibrium positions, which neglects the adjustment process between the two. And, as market failures analysis implies, this equilibrium might not even be optimal in the Pareto sense. He then candidly concedes that: "It is true, however, that economic theory is unable to offer a rigorous account of the *process* of development, the so-called dynamic aspects which much concern some *dirigistes*"(*op.cit.*, p.106). If that is true, welfare economics cannot be the logic by which to appreciate government interventions towards economic development. Welfare economics is too limited a tool to take into account the causes of government changes in objectives and interests as it is based on the given individuals and preferences.

In summary, welfare economics does not provide a proper answer for the development issues and government interventions accordingly. To begin with, the market failure argument has shown that free markets are unlikely to produce an efficient allocation of resources in the Pareto sense. As market failures are pervasive, various government interventions will be necessary in order to address them. Welfare economics is mute about equity issues, taking income and wealth distribution as given data. Furthermore, economic development involves problems very different from that of attaining the proper equilibrium allocation of given resources. Development also means changing the quality and availability of resources. In this context government intervention might have to deal with the change, the process of development, not merely with equilibrium, the efficient allocation of given resources. In short, contrary to what is claimed by Lal, it is unlikely that neoliberal economists have found support in theory to arrive at a balance of likelihood between market imperfections and government imperfections that result in an unequivocal advantage for the former. And when it comes to development economics it is even more unlikely.

### Historical and Cross-Sectional Evidence

Neoliberal economists have claimed that the evidence supports their case for freer market policies (Balassa 1985; Krueger 1990a; Lal 1997[1983]). Before we point to more

problematic concepts involved in this *equilibrium-determined role of the state* and outline an alternative *institutional-historically determined role of the state*, let us present some comparative historical and empirical evidence supporting the freer market case. This section argues that neoliberal policy propositions are lacking in support from historical and empirical evidence.

The German economist Friedrich List (1909[1841]) produced in his magnum opus, *The National System of Political Economy*, a sophisticated rebuttal of the *laissez faire* doctrine and its empirical validity. In the first book, *History*, he surveyed the economic history of some of the most important developed countries of today. List demonstrated that Britain, United States, and France, for instance, had been masters in applying tariffs and realising other public investments to protect and spurt their infant industry, including science and arts.

List stated that Britain was the first industrial power because it was the first to apply a deliberate policy of promoting industry. According to List, "having attained to a certain grade of development by means of free trade, the great monarchies perceived that the highest degree of civilisation, power, and wealth can only be attained by a combination of manufactures and commerce with agriculture…Hence they sought, by a system of restrictions, privileges, and encouragements, to transplant on to their native soil the wealth, the talents, and the spirit of enterprise of the foreigners"(*op. cit.*, p.90). Under the protection of Queen Elizabeth wool production prospered; under the protection and encouragement of Kings James I and Charles I textile production produced the decisive industrial spurt; and with the Navigation Laws (obliging British trading to be carried in British ships) and the export policies under King George I, Great Britain dominated the world manufacturing production and commerce. Indeed, List showed that England is better an example of how to acquire industrial productive powers by means of government incentives and protection than by means of *laissez faire*. As List wrote, "whoever is not yet convinced that by means of diligence, skill, and economy, every branch of industry must become profitable in time,…., let him first study the history of English industry before he ventures to frame theoretical systems, or to give counsel to practical statesmen to whose hands is given the power of promoting the weal or the woe of nations"(*op. cit.*, p.32). Patrick O'Brien, Trevor Griffiths, and Philip Hunt's (1991) detailed discussion of the British Parliament's role in the protection of the home textile industry against Asian imports in the beginning of the

Industrial Revolution has recently just confirmed List's kernel argument. They demonstrated that the early British world supremacy in textile manufactory was highly dependent on the British Parliament enactment of laws that protected domestic markets from Asian imports.[5] As they put it, "important as they were, market forces were neither natural nor distinctively English. They operated within a framework of legislation promulgated and enforced by the central government in London. Between 1696 and 1774 laws emerged which were critical for the subsequent development of the cotton industry" (*op. cit*., p.396).

List also shows how Colbert fostered French industrialisation by the same protectionist means and spoke of the pains of the United States governments in trying to escape the imposition of *laissez faire* by England and France, to pursue industrialising policies, and "to [perhaps in two generations] exalt itself to the rank of the first naval and commercial power in the world" (*op. cit*., p.77). Doron Ben-Atar (1995) says that Alexander Hamilton, the first United States' Treasury Secretary, publicly urged the United States government to support a breach of Britain's laws and "wholeheartedly supported technology piracy" (*op. cit.*, p.390).[6] Ha-Joon Chang (2002b), in turn, has covered United States industrialisation policies for most of the nineteenth century and early twentieth century. He confirmed that the United States' industrial spurt, which ultimately led it to overtake Great Britain as the most powerful industrial country in the last century, was a result of the adoption of protectionist policies. Chang points out that it was hardly a coincidence that "the two best 20-year GDP per capita growth performances during the 1830-1910 period were 1870-1890 (2.1 per cent) and 1890-1910 (two per cent)…[were] both periods of particularly high protectionism" (*op. cit.*, p.30). Twentieth century and current days witness the righteousness of List's forecasting about the empowerment of the United States through government-led development.

The history of Britain and the United States has been singled out because these two countries are usually portrayed as the homelands of the free market and because they have been strong proponents of free market policies in developing countries in recent times. It is

[5] It is somewhat ironic that in that time Indian producers had to use the argument of free trade to contest the British protectionist stakes (O'Brien, Griffiths, and Hunt 1991, p.403).
[6] Zorina Khan and Kenneth Sokoloff (2001, p.237) point out that since the early stages as a nation the United States' copyright statutes "did not allow for copyright protection of foreign works for a full century" as "the United States was long a net importer of literacy and artistic works, especially from England, which implied that recognition of foreign copyrights would have led to a net deficit in international royalty payments."

worth pointing out that Britain and the United States are counselling policies to developing countries that they themselves forewent when they decided to boost their industries when they were in the brink of industrialisation. Moreover, it is not merely the case that Britain and the United States used to grant protection and other incentives to their industries and now they deny them to less developed countries: even today they do not necessarily follow the policies they prescribe to less developed countries. As John Williamson (1990) put it in his famous paper summing up the policies advocated by Washington-based institutions – the IMF, the World Bank and the United States' Treasury – to developing countries: "Washington does not, of course, always practice what it preaches to foreigners."[7]

The United States and Britain were not the only countries to attain development by means of governmental promotion of industrialisation. Indeed, in the same work mentioned above, Chang has covered the developmental policies of an even larger group of today's developed countries and confirmed a similar pattern across the board.[8] According to Chang (2002b, p.59), "while virtually all countries used infant industry promotion measures, there was considerable diversity across countries in terms of exact policy mix." In a comparison of the recent economic and social performances between countries adopting liberal capitalism (the United States and the UK) and social democratic countries (Sweden and Norway), Mica Panić (2007) finds that the later model "outperforms…the liberal model." The differences, of course, should be counted on the specificities of time and space when and where those experiences took place, two hardly relevant factors in a theory based on a "system of natural liberty." Panić then concludes that the "[social democratic] institutions and social policies that have enabled most countries in Western Europe to adjust to rapid changes in the international environment without heavy social costs." Collectively guided development instead of ruthless competition of unfettered markets emerges as the real force behind those successful histories.

The impressive success of some East Asian countries in spurt industrialisation in the second half of the twentieth century, often associated with staggering growth in exports, has prompted free-marketeers to claim those experiences as demonstrations of the efficacy of unfettered markets in bringing economic growth by improving resource allocation

[7] In a very detailed study of the commercial relations between Brazil and the United States, the Brazilian Embassy in the United States shows the highly protective barriers that country raises against foreign competition in general and against Brazilian products in particular. See Brasil (2002).

[8] The sample of developed countries Chang has analysed includes: Great Britain, the United States of America, Germany, France, Sweden, Belgium, the Netherlands, Switzerland, Japan, Korea and Taiwan.

(Krueger 1990a; Westphal 1990). However, even the evidence quoted in support the neoliberals has not been convincing, and there is in fact a considerable amount of evidence to contest their propositions. Let us present the evidence, grouping it according to fashionable themes: government size; trade and capital account policies; and price distortions.

*The Size of the State and Economic Growth*

Neoliberal political economy suggests economic growth is negatively correlated with government size – due to red-tape, increasing government controls of trade and international payments, numerous state-owned enterprises, regulations, excessive staff, more taxes, more expenditures and corruption. It is widely recognised, however, that measuring the size of government and its relation to growth posits huge, if not insurmountable, practical and theoretical obstacles.[9] Even recognising the empirical and practical difficulties, Anne Krueger and David Orsmond (1990) carried out econometric tests for 26 countries – 11 developed and 15 developing countries, covering 1976-1977 to 1980-1981 – willing to grasp the relationships between government size and economic development. Their regression exercises showed that "governments appear in many countries to have a large negative impact upon economic growth" and such effects "are more negative in developing compared with developed countries" (p.16). However, their results barely support a sweeping conclusion. The authors themselves opted against a strong conclusion since "the results presented here are highly tentative" (p.17). In addition, the stronger correlations that Krueger and Orsmond found should be regarded with caution since the database is remarkably small to authorise any valid generalisation.

Rati Ram (1986), using a larger sample of 115 countries for the 20 years between 1960 and 1980, reached opposite conclusions: a) government size had in most cases positive impact on growth; b) externality effects of government size is generally positive; c) and the positive effects of government size on growth is stronger in lower income contexts (pp.191-192). The main conclusion one can safely reach from this evidence is that there is no definitive evidence that government scope negatively affects economic growth. At best, the general neoliberal assumption that government size has negative effects on economic growth needs improvements in order to define which amongst many potential size variables

[9] See for instance Anne O. Krueger and David Orsmond (1990) and José M. Salazar-Xirinachs (1993).

affects growth and in which way; to achieve valid independent measurements of such variables and so on.

There is also another route that suggests neoliberal doctrine has not much evidence to support its case against big government. It seems the neoliberal hope that greater international influence on domestic affairs would check government growth has little, if any, empirical support. David R. Cameron (1978) carried out econometric tests which found trade openness (narrowly defined as imports plus exports as a share of the GDP) was the variable most closely related to the scope of government (measured by public revenues) for 18 developed countries covering 1960-1975.[10] Cameron's explanation for his findings is that "governments use a variety of policy instruments to shelter their economies from competitive risks of the international economy" whether by using "neo-mercantilist policies", or by favouring "certain enterprises", or also by "providing a variety of income supplements in the form of social security schemes, health insurance, unemployment benefits, job training, employment subsidies to firms, and even investment capital" (p.1260). More recent studies have also reached similar conclusions. In a similar vein to Cameron's study, Geoffrey Garret (1995) analysed data for 15 developed countries covering the period of 1960-1990 and added capital mobility to his variables of openness. He concluded that "the conventional wisdom is too simple and considerably overdrawn. The propensity to deficit-spend is the political economic sine qua non of social democracy. But rather than being constrained by increasing trade and capital mobility, the relationship between left-labor power and fiscal expansions has strengthened with greater internationalization" (p.682). Also inspired in Cameron's research, the Harvard University's economist Dani Rodrik (1998) carried out a meticulously study covering data of over 100 countries for the 1980s and early 1990s in order to evaluate the correlation between trade openness (as usually defined) and government size (measured by the ratio of real government expenditures in consumption to GDP). Like Cameron, Rodrik concludes that: "The scope of government has been larger, not smaller, in economies taking greater advantage of world markets. Indeed, governments have expanded fastest in the most open economies."

[10] Cameron tested six variables against the scope of government, namely: level and rate of economic growth; indirect and social security taxes; partisanship of government and the frequency of elections; inter-governmental structure and degree of centralisation; openness of the economy.

In summary, contrary to the neoliberal expectations, the cross-sectional studies show that more internationally integrated economies seemed to be associated with a greater extent of government activities. More international contact may indeed foster government intervention well beyond the extent prescribed by neoliberalism, potentially creating a trade off for neoliberal policies. Either they promote freer trade or they promote scant government activities. As Dani Rodrik (1998) puts it: "scaling governments down without paying attention to the economic insecurities generated by globalization may actually harm the prospects of maintaining free trade"(p.1029).

*Is free trade conducive to growth?*

Some authors associate "outward oriented" trade with freer trade (or "neutral" structure of incentives) and non-interventionist (or government interventions which do not distort relative prices). On the other hand, "inward oriented" trade policies are associated with protectionist and perverse government interventions. By the same token, "outward oriented" economies are associated to dynamic economic growth while "inward oriented" economies with lagging performance (Balassa 1985; Krueger 1980; 1993; World Bank 1987). However, it has been recognised that the comparative advantage theory "provides little guidance as to the role of trade policy and trade strategy in promoting growth…There is nothing in theory to indicate why a deviation from the optimum should affect the rate of economic growth" (Krueger 1980, p.288). Conversely, adopting trade liberalisation measures may have only once-and-for-all resource allocation but no enduring results on economic growth.[11] So, while trade theorists have regarded comparative advantage as no guide for trade strategy promoting growth, the belief that freer trade policies might have positive effects on economic growth might have emerged from empirical evidence.

The World Bank's *World Development Report 1987,* for instance, attempted to provide some empirical support for the positive relation between freer trade regime and economic growth. In this World Bank report, empirical research found better performance amongst economies with outward oriented trade. This *Report* further classified 41 developing economies into four distinct groups, from strongly outward oriented, to moderately outward oriented, to moderately inward oriented, to strongly inward oriented countries. It also

[11] And Dani Rodrik (1988) in the same vein: "the theory of trade policy is generally silent on the effects of liberalization on the *rate of growth* of output or productivity. The conventional benefits of liberalization are once-and-for-all gains, and although such gains can accumulate over time they do not necessarily put the economy on a superior path of technological development"(p.4).

divided the analytical period between 1963-1973 and 1973-1985, owing to "policy changes" and because "the world trade has been unsettled since 1973"(World Bank 1987, p.82). Strongly outward oriented countries were those where "trade controls are either nonexistent or very low…There is little or no use of direct controls and licensing arrangements"; moderately outward oriented countries those where "the overall incentive structure is biased toward production for domestic rather than export markets", but effective rates and range of protection were relatively low; moderately inward oriented was defined as those countries where "the overall incentive structure distinctly favors production for the domestic market" and whose effective protection and range were relatively high; finally, strongly inward countries would be those where incentives strongly favour domestic markets as well as the effective protection were high and wide.

In effect, the "outward oriented" countries performed better with regard to most of the 12 indicators adopted by the World Bank report. However, as noted by Hans W. Singer (1988), the performance of strongly outward oriented countries in the sample (South Korea, Singapore and Hong Kong) was overtly dominated by South Korea's, which renders the category inconvenient as a policy guide. Or, as Robert Wade (1990), following Singer's tack, has wittily put it: "only anthropologists are allowed to draw sweeping conclusions from a sample with less than two" (p.18). In addition, it is not all clear that moderately outward oriented countries performed better than moderately inward oriented countries, as the latter performed better in six out of twelve indicators compared to the former.

It is true, however, that the strongly inward countries performed quite poorly compared to the other categories. However, as Singer (1988) detected, these countries happened to be those with much lower levels of per capita income, an indicator "not taken into account in the demonstration that 'outward orientation works'[in a mention to one of the subtitles of the *World Development Report 1987*]" (p.233). The report could have concluded from its figures that the poorer countries, seeking faster economic growth and knowing that the comparative advantage trade theory is not a guide for that objective, may have found it difficult to follow "outward oriented" policies before assessing the risks associated with an "unsettled" world trade in the 1970s. Wealthier developing countries in turn could be structurally better prepared to face greater risks in world trade as their economies had reached higher levels of competitiveness and resilience. In summary, the report's claim regarding a positive empirical relationship between "outward oriented" trade policies and

economic growth, apparently lending support to liberalisation policies, actually turned out to be based either on an exceptional case, on ambiguous results, or on second best variables.

Further doubts also emerge from the country classification adopted by the World Bank. For instance, Robert Wade (1990) noted that, despite South Korea being the prime example of a strongly outward oriented country, it "had nearly as much variation in effective protection to different manufacturing sectors as Colombia, and more than Argentina" (p.19).[12] It is therefore not clear that South Korea should be classified as a strongly outward oriented country, instead of moderately outward or even strongly inward oriented. Besides, as it will be shown in detail in the forthcoming chapters, Brazil's industrialization was a classic and arguably the most successful case of import substitution amongst Latin American countries, possessing all the biases and government interferences with the relative prices this implies. Its significant rates of export growth in the 1960s and 1970s were to a great extent the result of industrialisation itself, and the interplay of a complex range of government-created institutions to control and concede numerous and voluminous export incentives to manufacturing sectors. In other words, as well as South Korea's and Taiwan's experiences, the outward performance of Brazil had nothing to do with free trade or a non-distorted price system.[13] Therefore, as long as "outward oriented" policies are associated with freer trade or neutral incentives it bears no resemblance to the actual policies pursued in those countries. Given these limitations of the World Bank study, Paul Krugman (1995, p.722) seems to be quite right when he claimed that "the correlation between 'outward orientation' and growth turns out to be largely in the eye of the beholder: when countries are classified using objective criteria, rather than by researchers whose classification is biased by their knowledge of who has been economically successful, the supposed strong relationship between trade policy and growth melts away."

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[12] Colombia was classified as a moderately outward oriented economy and Argentina as a strongly inward oriented economy by the World Bank's Report.

[13] Yet, the way export contributes to industrialisation may be more distinct than that suggested by the comparative advantage based argument. As Albert Fishlow (1990) put it, "exports partially count for their earnings of foreign exchange, not their allocative benefits…" meanwhile "the favourable impact of export growth will be mediated by its form; export-led industrialization is different from specialization in exports that are resource-based" (p.65).

*Price distortions and economic growth*

Neoliberal theory implies that price distortions have an adverse effect on economic growth. Lower price distortion means higher economic growth, and vice-versa. The government should therefore scale down its activities and abandon policies that distort market prices. This argument was also presented in the influential World Bank's study reported in the *World Bank Development Report 1983*, which additionally carried out some econometric regressions. A "composed index of price distortion" was calculated for 31 developing countries (including Brazil) and regressed against GDP growth rates in the 1970s. It found that "the average growth rate of those developing countries with low distortions in the 1970s was about 7 per cent a year – 2 per cent points higher than the overall average. Countries with high distortions averaged growth of about 3 per cent a year, 2 per centage points lower than the overall average"(World Bank 1983, p.61). Apart from a number of criticisms that could be made with regard to the study's methodology, even accepting this research at face value one can easily dismiss its conclusions. Commenting on the study, Robert Wade (1990) noted that while one should expect a high correlation between exchange rate distortion and export growth, "there is no statistically significant relationship between the growth of export volume and the exchange rate distortion index"(p.19) – by far the most important component in the index.

It is convenient to note a few aspects in the World Bank study that are related to Brazil. It has been commonplace in neoliberal attacks on the "Brazilian development model" prior to the 1980s to deem it highly inefficient and ill-conceived (Franco 1998; 1999; Moreira 1995). For instance, Maurício M. Moreira (1995) in a study comparing Brazil's and South Korea's industrialisation process suggested that the performance gap favouring the Asian country was a result of the "surgical" and "selective" approach of the South Korean government, while the Brazilian government would have adopted "indiscriminate" interventions "which disrupted well-functioning areas of the market, damaging resource allocation and static comparative advantages"(p.11). The alleged difference in performance between the respective interventions was in turn attributed, as implied by Krueger's theory, not to the pervasiveness of government interference (true in both cases) but to the checks produced by the international economy on the government's ability to distort relative prices.[14]

[14] See Alice Amsden (1989) for an alternative interpretation of South Korea differential performance.

Returning to the World Bank's study – and leaving aside the validity of each indicator – in fact South Korea performed better than Brazil in 4 out of 7 indicators.[15] South Korea's performance also outstripped that of every country but Tunisia (three "victories" to each) in the whole sample of thirty-one countries for the same margins or above than it did in relation to Brazil. In particular, South Korea's export performance was an outstanding 23 per cent average annual growth rate, almost double that of second placed Mexico. However, Brazil outperformed all the other countries in the sample, including those in the category of least price distorted index (e.g. Brazil outperformed Tunisia in four indicators), and the high export performers – here deemed as those whose annual growth rate of export surmounted the world and the Brazilian average (e.g., Mexico, Thailand, Indonesia, Chile, and Argentina). In short, despite the fact that Brazil was not amongst the price righteous countries and came only seventh in export performance, its overall performance was only slightly inferior to that of South Korea.[16] Surfing the global wave of neoliberalism, Brazilian economists resorted to generic economic concepts and applied them to Brazil's economy – so much so that over time they had to dismiss the relatively good performance of Brazil's economy in the 30 years after 1950 to adapt the actual economy to the concepts of generic economics.

Returning to the general evaluation of the neoliberal propositions, the most relevant point is to stress the World Bank study's findings on the relation between price distortion and growth. It found that only about a third of the growth rate of those thirty-one economies could be accounted for by the price composed distortion index (World Bank 1983, Box 6.1, p.63). The rest derived from "other economic, social, political, and institutional factors" (*op.cit.*, p.63). Such results are in line with many institutionally and historically grounded theories, as will be seen later. That is to say, some deliberate "distortions," triggering dynamic cumulative processes, may actually be critical in fostering

[15] The World Bank study's indicators are: price distortion index; annual GDP growth rate; domestic savings income ratio; additional output per unit of investment; annual growth rate of agriculture; annual growth rate of industry; annual growth rate of export volume. From these, Brazil "performed better" in additional output per unit of investment; annual growth rate of agriculture ("more" is "better"); worse in price distortion ("less" is "better"); annual GDP growth rate; annual growth rate of industry; annual growth rate of export volume ("more" is "better"); and drew in domestic savings income ratio.

[16] It is interesting and even surprising that, given the Brazil's interventionist and "import substitutive" growth model in the 1970s, in its "getting prices right" Report the World Bank considered Brazil as pertaining to the "success stories" and pursuing a "flexible" and "pragmatically managed" industrialisation process along with Japan and South Korea. See for instance World Bank (1983, Box 7.4, p.69). Be as it may, in the 1980s and 1990s Brazil pursued "neutral" policies incentives and their performance will be compared to the period of "indiscriminate" and "non-selective" policy incentives.

economic growth. As far as economic policies are concerned, one should bear in mind that the price distortions are perhaps a result of some or all of those “other economic, social, political, and institutional factors” that “explain” two thirds of economic growth. Between the two, the logic of the economist should suggest one should stick with that choice with greater payoff or lower costs. Consequently, “distorting” those other institutions only to correct distorted prices may be counterproductive in terms of structural change and growth.

In summary, there are theoretical and empirical grounds for being sceptical about neoliberal policy prescriptions with regard to government intervention and the primacy of price correction for growth. By the same token, the empirical evidences conveyed show that pervasive government intervention and distorted relative prices may be associated not simply with perverted economic activities, such as the pursuit of rents or of directly unproductive profits, but may be conducive to structural change and economic growth.

### Theoretical Limitations of the Neoliberal Approach

Thus far an attempt has been made to show that neoliberal policy prescriptions towards government intervention and the primacy of the price system lie on shaky empirical grounds as far as the record of economic development is concerned. While neoliberal prescriptions are lacking in convincing empirical support, this is not the only area in which the neoliberal doctrine is faulty. Mounting criticism of the theoretical foundations on which neoliberal propositions are built has also suggested that neoliberalism contain deficiencies at a deeper level. The objective of this section is twofold. First, it aims to outline some criticisms of foundations of the theory underpinning neoliberal’s prescriptions. Second, it suggests the elements of the institutionally and historically grounded perspective that will buttress the analysis in the remainder of this thesis.

Neoliberal doctrine concerning the market and the state assume from the outset that individuals behave selfishly, no matter their institutional setting. Implicitly, they accept Adam Smith’s “system of natural liberty” by which individuals have a natural propensity to trade, which in turn gives rise to markets, division of labour, productivity and growth. Furthermore, apart from this natural propensity to trade everything else which intrudes into markets turns out unnatural. Nonetheless some economists may find some unnatural institutions necessary, the necessity of these institutions is judged according to their

functionality for allowing individuals to choose as freely as they wish. Milton Friedman´s appraisal of firms and money is a case in point. Friedman (1962, p.14) said: "Despite the important role of enterprises and of money in our actual economy, and despite the numerous and complex problems they raise, the central characteristic of the market techniques of achieving co-ordination is fully displayed in the simple exchange economy that contains neither enterprises nor money." In other words, these unnatural elements have no rights of their own. They are made conditional to the free market primacy.

However, it has been reasonably well established that "without the appropriate institutions no market economy of any significance is possible"(Coase 1992, p.714). That means that the proper analysis of markets should not stop at the supply and demand schedules but should go further into the legal structures and social organisations which shape market relations, such as firms and the state as well as the social values carried by the members of a particular society. As Geoffrey Hodgson (1988, p.174) defines them: "markets, in short, are organized and institutionalized exchange." Accordingly, the proper functioning of the market economy can barely be grasped by concentrating on the exchange act alone since many institutions regulate exchanges themselves: what can or cannot be exchanged; who can or cannot; the ways supply prices are determined, presented and negotiated, so on and so forth.

To emphasise the point, markets are not natural entities but institutional ones and states have played a large role in creating and fostering markets. As Karl Polanyi (1944, p.139) pointed out "there is nothing natural about *laissez-faire*…*laissez-faire* itself was enforced by the state." In addition, for relying on a concept such as state of nature neoliberal economists lose the sense of historical specificity which marks all development experiences. The countries' strategies of development are certainly marked by their resources endowments, but also by their geographical position, their colonial or feudal past, their current social organisation, by the timing they started to industrialise. In short, the actual experiences of states creating and fostering markets, despite similarities, possess marked uniqueness.

In addition, the proposition that human nature (or individuals' preferences) is given and fixed is incompatible with the central idea that economic development entails the process of learning and knowledge acquisition, technological innovation and structural transformation. The neoliberal proposition of a given human nature belittles the capacity of institutions to

affect human views, values, objectives and behaviour. Neoliberal economists abhor mistakes, above all on the part of government, and see no good in them. They celebrate only the correct policies and institutions, which is to say those that lead to optimal resource allocation. It therefore undermines the very meaning of a learning process, which inevitably involves mistakes. By the same token, neoliberal concentration on optimality and equilibrium underrates change and dynamic as a historical and endless process.

As far as government interventions are concerned, neoliberals deny that officials introduce regulations and policies having in sight the public interest, instead of their own, on the basis that selfish human nature is fixed and given. However, this proposition is evidently defective. Even a limited role as a "nightwatchman" would require a minimum legal apparatus with officials enacting, enforcing and monitoring the observance of these minimum social contracts. Why should officials care more about enforcing the minimum public interest embodied in the neoliberal state than other public interests? Why should officials enforcing the minimum neoliberal state be satisfied with this function instead of using their policing and monitoring powers to increase their own benefits? There is no sustainable answer to these issues if self-interested officials with fixed preferences continue to run the neoliberal state. As a consequence, maintaining the self-interested officials with fixed preferences would eventually degenerate the "nightwatchman" neoliberal state. On the other hand, if officials can retain the minimum public interest to perform those functions required for the minimum functioning of the markets, then there would be no satisfactory reasons to expect that those officials could not retain the public interest in other public matters. In summary, the neoliberal conception of the state is based on an unattainable theoretical proposition.

Neoliberal propositions with regard to state affairs are also defective in another sense. For neoliberal economists have proposed several policy prescriptions such as privatisation, deregulation and free trade which would be planned, organised and executed by public officials. How could someone confer such social responsibilities to self-interested rent-seeking bureaucrats and expect that they would keep the public interest above their own interests? Indeed, if the neoliberal theory of the behaviour of public officials is correct they would not carry out neoliberal proposed policy reforms in a way to improve market efficiency. In addition, neoliberal prejudices and policies in respect to public officials' behaviour may even undermine and deteriorate high standards of public morality and

values whenever they exist. As Ha-Joon Chang (2002a) argues "some of the neo-liberal recommendations that are intended to improve the behavioural standards of public personages may be downright counter-productive, if they undermine the non-selfish motivations that had previously motivated the public personages in question…"(p.554). It is so much important when one seriously appreciates the constitutive powers of institutions on individuals like theoretical constructs, learning, authority and the like.

## Elements of an Alternative Approach

As stated above, this thesis employs a historically and institutionally grounded perspective to show that the neoliberalism is lacking in strong empirical support and is faulty on theoretical grounds, particularly in critical areas for economic development. Despite all the theoretical and empirical problems, however, neoliberal prescriptions continue to rule the roost in contemporary policy-making. Unless a coherent theoretical alternative arises, neoliberal influence will continue. Achieving such an alternative is extremely difficult, and the modest objective of this section is merely to point to some elements of a solution that have been kept alive by historically and institutionally grounded writers on the subject of economic development.

### *The Constraining, the Enabling and the Constitutive Features of Institutions*

Perhaps the most influential and cited definition of what an institution is comes from Douglass North (1990). In his concept "[i]nstitutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction." (p.3). North also posits that as a consequence institutions have quite a large role in the determination of economic performance and development as "they structure incentives in human exchange, whether political, social, or economic. Institutional change shapes the way societies evolve through time and hence is the key to understanding historical change." (p.3).

Whenever one thinks about institutions it is certain that things such as laws, norms, organisations and government will spring to mind. There is an already established view that institutions can be constituted of formal or informal rules. John Commons (1990[1934], p.72) for instance, seems to make that distinction when states that "[c]olective action is

even more universal in the unorganized form of Custom than it is in the organized form of Concerns." Modern writers on institutions also seem to follow it. Notably, Douglass North (1990) has clearly made this partition.[17] According to him (1991, p.97), "[institutions] consist of both informal constraints (sanctions, taboos, customs, traditions and codes of conduct), and formal rules (constitutions, laws, property rights)." Thus, it seems beyond contest that the rules and conventions which structure social interactions may take formal or informal form.

Notably, any modern industrial society has a tangled system of laws, norms and rules which structures economic interactions. Douglass North comes to associate the formalisation of rules with the growing complexity of economic system. According to him (1990, p.46), "[t]he increasing complexity of societies would naturally raise the rate of return to the formalization of constraints…The creation of formal legal systems to handle more complex disputes entails formal rules; hierarchies that evolve with more complex organization entail formal structures to specify principal/agent relationships". Similarly, Yoram Ben-Porath (1980) asserts that "[i]mpersonal social institutions provide substitutes for family [and others identified traders] transactions" (p.13), and with "[t]he development of markets…the benefits from a connection [like family] decline as identity becomes less important" (p.18). One of Ben-Porath's examples is money that value is independent of the sellers' identity, provided money has its value and liquidity backed up and guaranteed by powerful formal and impersonal institutions (p.13).

However, whereas the most advanced modern industrial society would not work without their working rules and going concerns, that is, without formal and impersonal rules and organisations, and even though they have shown up to be ever-growing with the complexity of economic system, one should not overstate the role of formal rules in structuring social interaction at the expense of informal ones. Only in the perfect world of neoclassical general equilibrium economics, where the world is not complex and uncertain and agents have unlimited rationality, contracts are perfect and all the 'state of natures' are contractible. In a complex and uncertain world, individuals possessing bounded brainpower cannot bear to write all the possible contingent future events, rights and obligations in a

[17] Note, however, that North seems to refuse to use the term informal rules preferring informal constraints instead. North prefers to use the term *rules* applied to formal institutions such as laws, and *constraints* applied to informal institutions such as table manners. However, Hodgson (2004, p.9) points out that it may create an insurmountable problem for North's definitions for "[*i*]*f all rules are formal, and institutions are essentially rules, then all institutions are formal*."

*contract* - understood here as private or "social" contract.[18] There must be something other than only formal institutions on which agents rely on in order to enter in long-run contracts. By the same token of the previous discussion, in which an action entails non-rational as well as rational mind processes, in a contract there are also non-contractual elements.[19]

In this instance, Douglass North (1990) has pointed out that "[i]n our daily interaction with others, whether within the family, in external social relations, or in business activities, the governing structure is overwhelmingly defined by codes of conduct, norms of behaviour, and conventions." (p.36). Hodgson (1988, p.167), in turn, affirms that "exchange in modern society has to be understood through an examination of the symbiotic relationship between *both* its contractual and non-contractual features." According to him, the 'impurity principle' along with the 'principle of dominance' – that is "the notion that socio-economic systems generally exhibit a dominant economic structure" (p.168) –, may provide it for a more complete and pluralistic view of the economic structure.

Close to the above is the consideration of the consciousness or spontaneity of institutional emergence (Hayek 1949; Hodgson 2004; North 1991, 1990; Schotter 1981; Sugden 1989).[20] Roughly speaking, those who follow Humenian and individualist liberal perspectives tend to emphasise spontaneous order and self-enforcement in the making of, permanence and evolution of a system of rules, while those out of *laissez-faire* aspirations allow a constitutive role for designed institutions as well (Rutherford 1994, p.83).[21]

Some non-legal institutions may evolve spontaneously in the sense that they can "emerge organically by human action but not by human design and are the result of individual but not collective human behavior" (Schotter 1981, p.28). The persistence of such rules and conventions would be maintained by themselves instead of by any external enforcer, while individuals are pursuing their self-interest (Sugden 1989, p.86; Schotter 1981, p.28). In Andrew Schotter's (1981) game theoretic approach, institutions act more like an informational device system in which individuals will coordinate because it will pay

[18] In passing, one should note that by 'implicit contracts' sometimes is implied a sort of awareness by the parties when writing a contract of one type inconsistent with our description of a complex, uncertain world inhabited by individuals with bounded rationality (for surveys on this literature see Rosen 1985; Tirole 1999).
[19] See Hodgson (1988, pp.156-17) for a discussion of pure and impurity contracts.
[20] Evidently, they have or to do a great deal with normative issues, in particular, those related to the role of the state and the government policies.
[21] Very often, some herald the superiority of markets' over the states' rules so long as they reckon markets as the kingdom of spontaneous order and self-enforced rules. On the other hand, governments would be the kingdom of designed order and externally enforced rules.

the parties to live up to them. Schotter pointed out that "[s]ocial and economic institutions are informational devices that supplement the informational content of economic systems when competitive prices do not carry sufficient information to totally decentralized and coordinate economic activities" (p.109). In his evolving models, institutions will emerge to allow players to know the historical moves of other players or rules of determined games, to form informed expectations about possible future moves of others and to pass on behaviour patterns towards heirs (p.118).

However, in many other instances it has been recognised that different systems of rules do not correct themselves in order that external sets of institutions may intervene to alter the incentives of agents potentially driving them to a better off situation (Bromley 1989; Hargreaves-Heap 1989; Hodgson 2002; North 1990; Rutherford 1994; Schotter 1985; Vanberg 1986). In a world of limited rationality, uncertainty and complexity, possessing an insurmountable and impersonal number of players and exchanges they realise, one cannot guarantee that interaction – with the same payoff structure and probabilities – will be repeated and the traders will be the same or will learn the rules of the game and the signals of the other participants. As Viktor Vanberg (1986, p.95-96) has put it,

> "…the mechanism of reciprocity cannot be expected to generate sufficient incentives for cooperative behavior generally, but under certain restrictive conditions only. In general, the chances that the interacting parties may meet again and the chance that a defector can be identified as such have to be large enough that sufficient expected gains and losses from future interaction are at stake to make cooperation the preferable choice. These chances typically decrease, however, with increasing numbers of individuals involved in the relevant setting and with a decreasing length of the time-horizon with which individuals engage in particular groups".

If that is the case, designed institutions might be necessary to sort out or to improve problems of coordination which agents – given the incentives and preferences – could not achieve by just searching their own interests. As Hodgson (2002, p.334) has put it, "[i]n a world of incomplete and imperfect information, high transaction costs, asymmetrically powerful relations and agents with limited insight, powerful institutions are necessary to enforce rights." In that case, planned governing structures are as important as spontaneous ones in the shaping of the human behaviour.

From a transaction costs perspective, Oliver Williamson has emphasised designed institutions – in his words "governance structures" – which deal with transactions between traders. In Williamson's terms, the economic world is formed by a range of more or less hierarchical governance structures – from markets to organisations (firms and states) –, following their relative advantages in terms of transaction costs minimisation. As Williamson (1981) points out "[t]he study of transaction-cost economizing is thus a comparative institutional undertaking which recognizes that there are a variety of distinguishably different transactions on the one hand and a variety of alternative governance structures on the other"(p.1544). According to Williamson, institutions replace markets when traders cannot individually bear the "ex ante costs of negotiating and writing, as well as the ex post costs of executing, policing, and, when disputes arise, remedying the (explicit or implicit) contract that joins them" (p.1544) – that is, transaction costs –, due to bounded rationality and also opportunism.

To sum up the point made so far, much of the analyses on institutions have concentrated on their informational and coordination roles. If one is to follow rules this means that one will have disposition to do *Y* in situation *X*. Thus, following conventions, rules of thumb, routines, norms and laws one may reduce, or even eliminate, an otherwise overwhelming, unbearable calculus to a rationally bounded individual.

At a first glance, institutions are constraints on human choices which allow predictability in human behaviour. According to North (1990), "it is the existence of an imbedded set of institutions that has made it possible for us not to have to think about problems or to make such choices."(p.22). However, one should not overemphasise the constraining aspects of institutions. Institutions not only constrain but also enable people to do many things otherwise unachievable. So, excessive emphasis on the constraining role of institutions would be too narrow a view. Institutions do constrain some individual behaviour but, very often, they do it by enabling others to do other things. For instance, intellectual property rights permit inventors to enjoy profits from their inventions while at the same time it may delay or even thwart scientific progress.

That enabling feature of institutions was highlighted long ago by the first institutionalists. John Commons (1931, p.649), for instance, defined an institution as "collective action in control, liberation and expansion of individual action." He reckoned,

therefore, that institutions not only enabled individual action but also broadened the effects of individual action.

Unarguably, the institutions concept as discussed above attach to them a decisive role in the explanation of economic performance and economic development, for formal and informal institutions are crucial elements in shaping human interaction and behaviour. That discussion of the constraining and enabling features of the institutions leads us to conclude that institutions are crucial to enable human interaction whether through market exchange or hierarchised organisations (e.g., firms, governments, non-governmental institutions etc). So, for economic development matters it is crucial to understand how the governing rules of human interaction are established and followed. According to Richard R. Nelson (2005), there are two matters about the role of institutions on the economic growth that are consensual:

> "One is that one ought to bring in institutions to deepen the analysis and try to explain some of the variables treated as proximate factors behind growth. Thus this strand of growth theorizing tends to involve reflections on the institutions supporting technological advance, physical capital formation, education, and the efficiency of the economy and the resource allocation process.
>
> The second broadly shared conception… is that institutions influence, or define, the ways in which economic actors get things done, in contexts involving human interaction." (p.152)

Thus, institutions are behind the factors which determine economic development, namely, the way humans interact and hence build their economic activities. Further questions are raised regarding the ways the established rules are sanctioned in peoples' practice. What are the determinants of the peoples' compliance with the rules?

Part of the answer to those questions is found in that institutions are a crucial factor in the frame of human nature and people's perception of the environment they live in (Bowles 1998;Hodgson 2005;2006). As Geoffrey Hodgson (2006, p.7) puts it, institutions "have the power to mould the capacities and behaviour of agents in fundamental ways: they have the capacity to change aspirations instead of merely enabling or constraining them." This being the case, the assumption of an ever self-interested individual with fixed preferences has to be dropped to allow the analysis of other possible motivations engendered by different

institutions to come alive. Individuals' motives gain dynamic in this perspective. This is not merely that individuals respond to incentives but individuals themselves will change with the economic development. Being part of individuals' shared habit of thought, institutions directly affect the process by which everyone evaluates and acts. The sense of change here is similar to that of a change, for instance, from a slave society to one in which workers are free. That is, today slavery is not only rejected because it is against the law but also because we feel it to be morally wrong.

It is important to notice though that to accept that institutions shape individuals' motives is not the same thing as accepting that individuals' motives are conflated with institutions. From the outset it should be assumed that individuals also affect institutions, change their features and so on. Indeed, the dynamic of economic development emerges from the permanent interaction of institutions and individuals motivations and actions. Accepting the constituting feature of institutions has a number of implications for understanding markets, the state and development.

Individuals, whether acting in financial institutions, or in productive firms or as state managers, are not disembodied agents. The assessment they make of problems and the ways for solving problems depend crucially on the institutional context inherited from a long historical process of problem assessing and solving. This complex of historically emergent institutions is previous to any given individuals and interests. In this sense, the behaviour of individuals is not merely constrained by existing institutions but the very interests of individuals are also framed by them. Therefore, what the problem itself is and how to deal with it is contingent on the institutional setting individuals are embedded. In consequence, time and space specificities are all more important (Hodgson 2001).

This proposition is a long-running strand in the history of economic thought. List had criticised Adam Smith's conception of division of labour based on the individual and trade as causes of the enhancement of the productive powers of the nation. To List, while physical and mental abilities acquired by individuals are no doubt important, they depend "on the conditions of the society in which the individual has been brought up…"(List 1909[1841], p.111). List emphasised that the cause of the difference in behaviour and values individuals possess lies "partly in the different kind of social habits and of education…, partly in the different character of their occupation and in things which are requisite for it"(*op. cit.*, p.159). Accordingly, he believed that the industrial society

embedded considerable transformation in the productive powers because it transformed the degree of civilisation of individuals as "manufacturing occupations as a whole…develop and bring into action an incomparably greater variety and higher type of mental qualities and abilities than agriculture does" because "manufactures are at once the offspring, and at the same time the supporters and the nurses, of science and the arts"(*op. cit.*, p.161). In addition, the superior state of science and art and of mental and productive capabilities of the nation are not related to individuals, as in Adam Smith's division of labour, but are a "result of the accumulation of all discoveries, inventions, improvements, perfections, and exertions of all generations which have lived before us; they form the mental capital of the present human race, and every separate nation is productive only in proportion in which it has know how to appropriate these attainments of former generations and to increase them by its own acquirements…" (*op. cit*, p.113). In short, List considered that individuals are greatly malleable by the institutional setting in which they are immersed by changing the individuals' perception and valuation of their environment. List acutely perceived the historicity of institutions as they accumulate before us and will survive (perhaps modified) anyone of us and forcefully pointed to the social character of the productive power of a nation. Such acute insight in the constitutive dimension of the institutions led List to perceive that what goes on in the markets, including the individual behaviour, is fundamentally shaped by the interplay of a complex web of institutions.

By the same token, state officials, like any other social individuals, are not immune to the influences of social needs and the habit of thoughts prevailing in their time and space. To ensure their political survival and internal peace state rulers cannot merely pretend to care about public interests while in fact only taking into account only their own interests when deciding on public policies. Furthermore, the constitutive character of institutions is no less important in the public sphere than it is in the market. As previously mentioned, any public policy proposition, even neoliberal, is proclaimed in the name of public interest. As Karl Polanyi (1944) notes, whilst the public interest is obviously evident in public goods, such as education and infra-structure, the public interest is also present even in the private sphere. He also demonstrated that rulers of the first industrialising countries were very much forced by very objective circumstances to adopt measures which were not related to narrow group interests. Of course, no one can take for granted that public officials will always behave in the best public interest. But to assume that they will always behave in

their self-interest with catastrophic consequences for the public interest is to deny the possibility of political change – which is a central part of economic development.

### *Historical Specificities and the State as a Galvanising Agent in the Development Process*

Starting from recognising the constitutive feature of institutions paves the way for paying greater attention to the dynamics of the context in which market exchanges and the government intervention take place. Here the contrast with the neoliberal doctrine is twofold. The first is the already-noted emphasis on the dynamics instead of on equilibrium. The other is the perception that development is likely to emerge from varied institutional settings instead of the usual neoliberal catchphrase "there is no alternative." One is therefore less concerned about listing preconditions and institutions which "must exist" in order for development to take place than to describe the dynamic of development as a historically and spatially contingent process of selection of the institutions for development. The explanation of how specific dynamics of development come about seems to have been the tenet of many historically and institutionally grounded theorists of development. This section builds mainly on the innovative, influential and representative works of Alexander Gerschenkron (1962), Gunnar Myrdal (1957), and Albert Hirschman (1958) and some others to sketch out the role of government in the process of development.

Alexander Gerschenkron (1962) suggested that developed countries represent a major incentive for underdeveloped countries to adopt development policies, as developed countries themselves are indicative of the fruits of progress. The more evident the progress of developed countries, the more the backward countries will perceive the benefits of being developed and the costs of being backward. However, whilst the progress of developed countries tempts backward countries to adopt developing policies, the experience of developed countries would hardly be repeatable. According to Gerschenkron (1962, p.16), the paths to development differs "1) because of the existence of certain backward countries where no comparable features of industrial development can be discovered and 2) because of the existence of countries where the basic elements of backwardness appear in such an accentuated form as to lead to the use of essentially different institutional instruments of industrialization." Gerschenkron suggested that the path of development a country followed

varied with the degree of backwardness of that country. He depicted the late industrialising countries in the six following propositions:

> "1. The more backward a country's economy, the more likely was its industrialization to start discontinuously as a sudden great spurt proceeding at a relatively high growth of manufacturing output.
> 2. The more backward a country's economy, the more pronounced was the stress in its industrialization on bigness of both plant and enterprise.
> 3. The more backward a country's economy, the greater was the stress upon producer's goods as against consumer goods.
> 4. The more backward a country's economy, the heavier was the pressure upon the levels of consumption of the population.
> 5. The more backward a country's economy, the greater was the part played by special institutional factors designed to increase supply of capital to the nascent industries, and, in addition, to provide them with less decentralized and better informed entrepreneurial guidance; the more backward the country, the more pronounced was the coerciveness and comprehensiveness of those factors.
> 6. The more backward a country, the less likely was its agriculture to play any active role by offering to the growing industries the advantages of an expanding industrial market based in turn on the rising productivity of agricultural labor." (Gerschenkron 1962, pp.353-364)

So, if backwardness is to differ among countries, the propositions, especially the fifth one, imply that the path of development is likely to differ as well. This is not to deny that similarities exist. For one, the strong national and diversified manufacturing had been the leader of development in Britain, Germany, the United States and Japan. To identify similarities in the final product by no means provides a full account of the factors that contributed towards its creation. Accordingly, for Gerschenkron the timing of industrialisation determined the institutional, technical and financial resources that should be mobilised to result in development. The technical requirements and plant size of big business, and the military power of advanced countries, suggested to Gerschenkron that in the twentieth century the governments of backward countries should have to play a central role in the strategy of development, whether prompted by military security or by entrepreneurial profit. The tenet of Gerschenkron's argument was that if backwardness were to be overcome the state should intervene by creating those institutions to compensate for the inadequate capital formation, skilled labour, entrepreneurship and technological capacity encountered in backward countries seeking modernisation.

Albert Hirschman (1958) pointed out, however, that Gerschenkron failed to consider that it is during the process of development itself that the features of backwardness emerge and then force further changes, if development is to proceed. Accordingly, contrary to what Gerschenkron seems to suggest, there is not an a priori, fixed list of elements of backwardness that are waiting to be tackled. Countries will only discover the features of their backwardness when they set out on the path to development. According to Hirschman (*op. cit.*, p.10), "It is in this fashion [concurrently to the process of development itself] rather than a priori that they [developing countries] will determine which of their institutions and character traits are backward and must be reformed or given up." In this way, development is less a question of measuring and responding to costs and benefits of progress and more one of discovering the road to progress in specific adverse conditions.

Gunnar Myrdal's (1957) circular causation of a cumulative process highlights the dynamics of the road to progress. According to Myrdal's circular causation concept, "a change does not call forth countervailing changes but, instead, supporting changes, which move the system in the same direction as the first change but much further"(p.13). Myrdal thought of this process being applied to the domestic factors, international factors and the interaction between the two which either impede or enhance the process of change. Concerning investment, for instance, a decision to create an industry in a particular community will increase the community's income through the well known multiplier effect on incomes, perhaps by the transfers of workers from lower paid occupations to higher paid ones, and by the employment of the unemployed. Market size increases in that area and other investors and workers come about. Rising profits and incomes then generate increasing savings. Tax collection increases, allowing tax-rate reductions and the improvement of public services. Better public services and reduced tax rates attract more business and workers and the process of a circular cumulative causation goes on and on. Perhaps more striking are the cumulative effects of knowledge, which increases with learning, which in turn increases knowledge and so on. For instance, the exercise of taking investment decisions increases the experience and knowledge of entrepreneurs, which in turn increases their ability to take more investment decisions. An underdeveloped country is one where these upward circular causations of a cumulative process have yet to be sparked off. It makes the task of underdeveloped countries all the more difficult, as the principle of circular causation runs against the development of these countries. That is, the

forces that make a country backward act to keep it that way, while the developed countries possess forces that pull them upwards. Myrdal noted that *laissez faire* policies were no good for activating countervailing forces against underdevelopment. In fact, he emphasised that unfettered markets run against underdeveloped countries. In this regard, contrary to the equilibrating factors that free-market economists have in mind when arguing for trade and capital account liberalisation, Myrdal held that in fact both would favour the developed country the most. As Myrdal (1957, p.28) put it: "The freeing and widening of the markets will often confer such competitive advantages on the industries in already established centres of expansion, which usually work under conditions of increasing returns, that even the handicrafts and industries existing earlier in the other regions are thwarted."

Similar dynamic considerations emerge from Hirschman's (1958) backward and forward linkages. He thought of the problem of economic development not as a search for missing factors such as capital, technical knowledge or entrepreneurship, which could be dropped from outside to fulfil the gap and to establish a higher level of economic equilibrium. According to his analysis, underdeveloped countries are better described not so much as those lacking factors of development but as those countries with idle, latent or misdirected labour and entrepreneurship, unutilised ability to save, wide and varied usable skills. That is, in underdeveloped countries resources are not to be considered fixed in amount and quality and they will come into play as soon as development decisions require them. Accordingly, what is needed for economic development to take place is a binding agent that "will elicit and mobilize the largest possible amount of these resources" (*op. cit.*, p.6). What is needed for the process of development is decision making towards it for "development is held back primarily…by a shortage of the ability to make and carry out development decisions"(*op. cit.*, p.36). Contrary to the equilibrium approach, Hirschman believed the binding agent should maintain decision makers under high tension in order to make them act and bring the development factors into play. Hirschman's backward and forward linkages deploy those mechanisms by which the binding agent could exercise pressure to mobilise decision-making. For instance, investments in sectors with greater backwards linkages call for further decision making from those that supply inputs for the investor. Growing the market through increased demand "is a powerful energizing influence that creates a growth mentality even when there was none in existence to begin with and that places strong pressures on managers to improve the organization of the production

process."(*op. cit.*, p.140). It may also increase the morale of personnel and competition between firms thereby providing further stimulus to performance (*op. cit.,* p.140). The developmental effects of demand here are the compulsions it provokes in managers and personnel to take decisions for improving organisation and performance. A second criterion to rouse action for development is achieved by investing in sectors which require large ventures, constant and rigorous maintenance, that must observe high quality standards and so forth as these activities require permanent and skilful decision making from private and public agents alike. In such activities, things cannot go wrong in order that decision makers are far more compelled to deliver. In short, in so far as decision-making is a learning activity, the more decisions are taken, the greater the ability to take further decisions in future. The more they request alertness and knowledge, the more the decision maker is going to learn. The driving force of a decision for the development process comes through the web of decision-making it commands. That is, the more and more complex decision making related to a primary decision centre, the more effects it is likely to have over development when this primary decision centre is activated.

From List to the centre-periphery theory of Raúl Prebisch (1959) the increasing returns and the linkage effects over the rest of the economy associated to industry vis-à-vis relatively sluggish productivity of agriculture possessed much more importance for development than the natural endowments of countries. As for Myrdal, the open contact implied in a *laissez faire* context between industrial countries and agricultural countries would instead increase the productivity differential between the two. Their quarrel was neither that an integrated economy might be better than an autarky economy, nor that underdeveloped countries should not take advantage of their natural endowments and comparative advantages. The tenet of their theories was that some sectors are more dynamic than others, that in industrial economies dynamic sectors are constantly being recreated, and that developed countries are better equipped to reap the advantages of these dynamics. Better allocation of factor endowments will hardly produce such dynamic effects. In such circumstances an unfettered contact between developed and underdeveloped countries would work against the development of the underdeveloped countries as they do not have a stake at the most dynamic productive sectors. For List, as well as for the centre-periphery scholars, what was needed for fostering a process of economic development was a structural transformation from within the underdeveloped

countries which, once produced, would allow not only an increase in the international integration of the world economy but one on a more even footing.

So the question comes down to the nature of the agent that can break the mould of the downward circular causation forces prevailing in underdeveloped countries, bringing about the upward circular causation forces of development. Catastrophes, wars, invasions and interruption of international commerce have often figured amongst factors which induce changes to take place. Often these events prompt individuals to strip off their self-interest and chase broader aims. But, can the state deliberately and persistently bring about and mobilise factors of change towards economic development? If economic development is a process that can be constructed to legitimise the state domestically and strengthen it internationally, the state is likely to perform such a role. The state's power to impose order by legislation and enforcement by monopoly of violence, to tax and manage money, and its obligation to be a guardian of the interests of a nation and the compulsions it receives from the citizens may be conducive to promoting the forces of the development.

If the state is to be the agent responsible for the decisions that engender the changes, it has to do it, among other things, by managing market forces. To bring about structural changes it is likely that the state will have to act both on the supply side and on the demand side. In the dynamic perspective outlined here, one cannot simply assume that the state will take on development decisions without setbacks or obstacles. As has already been mentioned, obstacles and hindrances are found along the road to development and discovering and overcoming of them is the very process of development. According to Hirschman, hindrance for the state to take development decisions is likely to emerge whether as a result of mentality which works against development or as a result of vested interests affected by development decisions. Excessive distributive qualms may lead to the idea that progress ought to be equally distributed through all members of the society (Hirschman 1958, p.11). Such a mentality is likely to block development decisions that require some sort of "pick the winner policy." For instance, infant industry policies that often protect some industrial sectors instead of others and grant them with privileged access to credit and fiscal exempts clearly may be aborted by excessive distributive awareness.

Perhaps more inimical to economic development is the individualist mentality, or ego-focused image in Hirschman's original terminology (*op. cit.*, p.14). In this case, individuals reinterpret development as an individual adventure, a result of his/her bold behaviour as a

risk taker or a "Schumpeterian entrepreneur".[22] This mentality hampers development decisions by downplaying coordination, cooperation, and policy instruments as contributors to enhance or give way to individual potentiality which otherwise could not come into play. The individualist mentality gives rise also to misdirection of entrepreneurial capability by leading to excessive liquidity preference and "wholesale and hasty abandonment of useful ongoing ventures and forms of production in favour of some 'get rich quick' activity."(p.20). So, it may be the case that government policies and regulation to direct credit to priority long term investment and to avoid speculative behaviour may find great resistance from financial institutions, domestic and external, as financial markets in developing countries are typically small and thin and informational problems are more serious (Stiglitz 1989). In short, excessive individualist mentality may hinder the development of long-term financial markets which in turn reinforces short-sighted investments. Note that it is not assumed a priori that the government will make efforts to elicit a long-sighted financial market nor that any kind of governmental effort is to be successful in it. However, it has been suggested that the kind of downward circular causation which leads to financial short-sightedness and financial system weaknesses in developing countries is likely to be reinforced by financial liberalisation suggested by neoliberal doctrine (Arestis and Stein 2005; Grabel 1995; Kregel 1997; Singh 1997; 2003; Stiglitz 1991; 2000). For instance, Ilene Grabel (1995, p.146) points out that several experiences with financial liberalization in the Southern Cone and Asian-Pacific countries resulted in the "preponderance of high risk, short-time horizon investment activities, the rise of secondary and tertiary financial sector activities, the low level of real sector investment, and the financial crises and macroeconomic instability…" So, simply stripping financial markets of government regulations may reinforce the kind of individualist mentality and behaviour just mentioned.

Hirschman (1971) considered another frame of mind, perhaps more related to public officials and policymakers, which may shun development decisions by government. He coined the term *fracasomania* to express an intellectual disposition to think of their own development efforts as a failure – a state of mind which he found particularly diffused among Latin American policymakers (*op. cit.*, pp.87-89). Lack of perception of success in attempts to bring about change may discourage renewed efforts, or produce a retreat to a

[22] Hirschman associated this mentality particularly to Latin America, more than he did with group-focused image.

defensive position by government as it loses legitimacy to carry out the development process. In Brazil in the 1980s, disenchantment with the vigorous process of development was to a great extent a consequence of external debt. This state of mind seems to have favoured the acceptance of neoliberal doctrine even by non-neoliberal policymakers.[23]

Recent research into late developers has pointed to some general traits which have to a greater or lesser degree prevailed in developmental states, that is, where desire and potential to bring about and mobilise the forces of change became capable of doing so. Alice Amsden's (1989) study on South Korea and Robert Wade's (1990) on Taiwan are two such studies. In her study of South Korea's industrialisation, Amsden (1989, p.14) argues that the state "has set prices deliberately 'wrong' in order to create profitable investment opportunities." Low interest rates to rouse investments; tariffs and quotes to protect infant industry; and tax exemption to stir exports also entered into the procedures taken. Tampering with market forces is described by Amsden as pervasive, and she says that even though Korea violated the principles of neoliberal economic wisdom, it grew very quickly (p.139). She sees its success as crucially stemming from reciprocity requirements from the state in exchange for subsidies and incentives. The South Korean state sought transformation by imposing "performance standards on the interest groups receiving public support" (p.145). In short, successful state interventions seeking economic development are likely to occur when the state exchanges performance for incentives. So, contrary to neoliberal doctrine, for state intervention to be successful along these lines it should not be preventively constrained in the use of incentive instruments. Therefore, given the crucial

[23] The non-orthodox Brazilian economist and former Finance Minister Luis Carlos Bresser Pereira (1990), for instance, held that the Brazilian financial problems of the 1980s were mostly a result of the orthodox short-term adjustments the IMF and the international creditors imposed on indebted countries. That is, policies clearly contrary to the previous development interventions adopted in Brazil. Even so, he held the Brazilian model of state intervention dead as a result of the financial crisis which emerged. As he put it, "A deep economic crisis, such as the crisis of the 1980s in Brazil, is a clear signal that the old strategy of economic development is exhausted...[It] is clear today in Brazil that the form of state intervention that was crucial for the extraordinary pace of Brazilian industrialization between the 1930s and the 1970s must now suffer a complete overhaul"(p.513). Then, he pointed that the new model of state intervention should follow the World Bank's neoliberal reforms as "the general orientation of these proposals is correct…[as] state intervention expanded too much, provoked distortions, and must now be reduced and changed"(p.514). A non-fracasomaniac evaluation of Brazilian crisis would certainly not oppose that the crisis called for changes in the state style of intervention, in particular when it was returning to a democratic regime. On the contrary, the way the 1980s crisis was addressed deserves extensive criticism. Besides, since one accepts that the state had a "crucial" role in the "extraordinary pace" of structural changes in Brazil, one should not be particularly compelled to accept that the state intervention in Brazil was such a failure crying out for a "complete overhaul" in state interventions even less a necessary overturn to neoliberalism.

role prices play in the market system, some reasonable price distortions may produce the kind of dynamic effects that induce development decisions.

Robert Wade (1990) has also stressed that the success of development in East Asia was due to high levels of investment and government intervention directing these investments to particular industries, and towards exports. In his own words (1990, p.28):

> "the governments [in East Asia] guided the market by: (1) redistributing agricultural land in the early postwar period; (2) controlling the financial system and making private financial capital subordinate to industrial capital; (3) maintaining stability in some of the main economic parameters that affect the viability of long-term investment, especially the exchange rate, the interest rate, and the general price level; (4) modulating the impact of foreign exchange; (5) promoting exports; (6) promoting technology acquisition from multinational companies and building a national technology system; and (7) assisting particular industries."(p.28)

In summary, these studies point to government interventions as a binding agent using its tools or developing the tools required to educe and mobilise forces to foster economic development. The crucial role of the state in development, as suggested by Hirschman's (1958) book title, is to provide the strategy of development and manage the instruments available or creating them to entice other actors towards it. As development decisions proceed in a complex and uncertain environment, the instruments the government may use to bring forth economic development are likely to involve more than prices. It should be observed, however, that this does not mean markets play no role in development. On the contrary, it implies market institutions perform a very important role in development. As a consequence, the state should also be allowed to control certain prices and use markets forces and non-market forces to deliver the process of development that otherwise could not occur. The state must be allowed to use its powers to offer incentives, to exchange them for performance as well as to undertake its own activities. It is convenient to notice at this moment that, to say that the government may have the greatest potential to educe and mobilise the forces of development is not to say that it will. Potential is a guarantee neither of desire nor capability. As Hirschman (1958, p.54) put it: "A task that private enterprise or market forces are unable to handle does not ipso facto become ideally suited to performance by public authorities. We must recognize that there are tasks that simply exceed the capabilities of a society, no matter to whom they are being entrusted"(p.54). Besides, there are many examples of bad government interventions leading to social and

economic catastrophes (Evans 1995). Therefore the neoclassical distrust of government should not be removed altogether but accepted as a warning to policymakers, including those who hold neoliberal convictions. Government must be autonomous enough to demand performance in exchange for incentives. It has to be able to plan the goals and enforce compliance. To perform both activities, the government must have resources, technical capacity and political support. It has to have authority and distributive policies might be needed to acquire and to maintain a minimum of legitimacy.

Thinking of development as a dynamic and strategic process with false starts and unknown obstacles lying ahead, as suggested by Hirschman, one should expect that its organisers are likely to make many mistakes and experience failures. Obviously, however, mistakes and failures are not necessarily sufficient grounds to give up on an undertaking. Dispensing with the state is impossible, so enhancing it to achieve development objectives is invariably the better option. In addition, to think of the roles of government and markets as a balance between well-defined costs and benefits of each one is unattainable since the list of probable failures in a learning process, like development, is potentially infinite. Furthermore, as John Zysman (1983, p.290) pointed out, "unless we believe that every situation can be perceived in only one way and can generate only a single solution, we cannot argue that the economic problems define goals that are pursued or the strategies that are adopted." Instead, groups and institutions define goals and adopt policies for their attainment, policies that can fail to achieve their original aims. In the following chapters we are going to evaluate the impacts of government interventions on economic development, taking into account declared government objectives. As outlined earlier, development involves overcoming obstacles that are encountered along the way. The neoliberalism that came to dominate policymaking in Brazil in the 1980s and 1990s are a case in point: it is necessary to evaluate it, and the achievements to which it gave rise, in order to surpass the obstacles it brings to development.

# *3. The Changing Character of the State and of the Economy*

## Introduction

The Brazilian economy took one hundred and twenty years to roughly double its per capita income between 1820 and 1940, with most per capita income growth coming after 1900.[24] For most of this period Brazil was a primary-exporter economy with its rate of growth largely dependent on exports of one or a few agricultural or low value-added products from the primary sector. In the 1890s, for instance, agriculture accounted for about 56 per cent of GDP, and about half of all agricultural product was sold abroad (Moreira 1995, p.88). Coffee alone constituted more than two-thirds of total Brazilian exports in the 1920s, and still represented almost 60 per cent in the late 1950s. Four agricultural products – coffee, cocoa, rubber, and tobacco – accounted for over 80 per cent of total exports. In the late 1920s about 45 per cent of exports went to the United States (in 1962 the figure was still 40 per cent), while in the late 1920s and the late 1930s more than 80 per cent went to just six countries – the United States plus France, Germany, the United Kingdom, the Netherlands, and Italy.

Meanwhile, Brazil imported manufactures from the industrial countries, mostly to supply consumer goods to a numerically small elite as well as to provide the necessary production goods for the reproduction of the primary-exporter engine. In short, the primary-export structure prevailing in Brazil entailed a cumulative process in which investment was concentrated in the agrarian sectors at the same time that demand diversified towards goods supplied from abroad.[25] The backward and forward linkages were quite weak in this system as the export sector was limited to a few, not very complex and geographically

[24] Unless otherwise stated, the statistical source of this chapter is IBGE. *Estatísticas do Século XX* (www.ibge.gov.br).
[25] Maria da Conceição Tavares (1977) is a classic work on which the arguments in this paragraph have been built. See also Celso Furtado (1968).

concentrated productive systems. In addition, the dynamic factors emerging from the growth of the leading sectors would more likely leak to the world economy.

The years after the Great Depression and the Second World War, however, brought about a great transformation in the Brazilian economy. In the early 1960s, it had become an industrial economy and an urbanised society. The rate of economic growth took off. Per capita income in 1965 was US$ 1,723 (at 2005 prices), three times what it had been in 1930. The rapid industrialisation and rates of economic growth were to a great extent a result of government planning and deliberate intervention. At the same time, while government intervention had been successful in shaping such fast and far-reaching transformations, the inherited conditions in which such transformations took place also shaped the government.

The main objective of this chapter is to outline the historical conditions in which the developmental state in Brazil arose. It also intends to show that industrialisation in Brazil began to accelerate as a response to government initiatives rather than being a natural development prompted by free market forces. This outline aims to stress government management of the factors – situations and agents – that offered the greatest resistance to change and those that fostered change. This discussion emphasises some enduring aspects of Brazilian development that have conditioned and moulded government dealing with development in Brazil. The next section briefly outlines the role of the government in augmenting the market economy in Brazil since the early 1900s. It argues that the interventions the primary-export economy requested from the government ended up being undermined by the way in which the primary-export economy itself functioned. Subsequently, it discusses the emergence of the developmental state from the 1930s onwards, underlining the institutional arrangements created to buttress industrialisation. It goes on to highlight some imbalances stemming from the interplay between the new economic structures with the survival of structures related to the primary-export economy.

## The Political Economy of the Brazilian Primary-Export Economy

In his classic work on Brazilian economic growth, Celso Furtado (1968, pp.258-259) pointed out that in a primary-export economy "external induction is the main dynamic factor in the establishment of the level of effective demand. When the external stimuli

weaken, the entire system contracts through a process of atrophy…This kind of interdependence between external stimuli and internal development was in full operation in the Brazilian economy until World War I, and to a lesser extent until the third decade of this century." This period of economic growth led by external demand has been associated with a period of negligible government intervention (Suzigan 1988). This interpretation of the government role in this period matches well with the ideological free-market and anti-state intervention stance of the coffee oligarchy that ruled Brazil before the 1930s. It sheds little light, however, on the underpinning changes that were ongoing in the economy and in the state prior to the 1930s which would ultimately transform the character of the state and society. The point emphasised here though is that without broadening the domestic backward linkages through which the export-drive would produce its multiplier effects, favourable external conditions would have had by far a much lesser effect on the economy. From this perspective, government involvement in creating these backward linkages was anything but negligible.

It was the Aurea Act of 1888 that set slaves free and broadened the labour market and the consumer markets by booming monetary transactions. As well as providing monetary compensation to farmers for the abolition, the Republican government, which took over from the monarchy in 1889, also subsidised a programme for attracting European immigrants which kept real wages low on the farms (Furtado 1968, p.165).[26] Over a ten year period, starting in 1890, this policy attracted about a million immigrants, which raised foreigners' share in total population from 2.5 per cent to 7.3 per cent. Both the expansion of a salaried workforce and immigration have been recognised as the most significant events for Brazilian economic development in the late nineteenth century (Furtado 1968). As Werner Baer (1995, p.27) noted, "The large immigration population employed in the coffee and coffee-related sectors provide a large market for cheap consumer goods."

The government was not only augmenting the consumer markets but it also adopted measures that protected them from foreign competition. Increasing protective tariffs had

[26] The signature of the Aurea Act by the Princess Isabel was one of the reasons why the coffee oligarchy gave support to the Republican movement which resulted in the regime's change in 1889. In addition, planters wanted to be compensated for the slave emancipation and the crown did not seem to be interested in doing that (Martin 1921). According to Richard Graham (1970), not all planters were in favour of the Republican ideals, but supported the Republican movement in order to be influential in the Republic to avoid the land reform which was amongst the objectives of the abolitionists.

been adopted from the mid-1800s through to the 1920s (Baer 1995; Moreira 1995).[27] Whilst the protective tariffs might have been adopted for fiscal reasons and compensated for by exchange appreciation, it is more difficult to dismiss the developmental effects of measures like the "law of similar" (1887); tariff exemption to capital goods import; loans, public purchase facilities and profit-guarantees to coal mining, the steel industry, cement and caustic soda (Topik 1980b). After all, the improvement of exports alone cannot account for the fact that 72 per cent of the textile firms, 90 per cent of the chemical firms, 93 per cent of the food firms, and 97 per cent of the cloth firms existing in 1912 had been established after 1890. Between 1901 and 1913 the industrial sector grew at an average of 6 per cent per year, a rate that would be maintained over the following two decades.

The government also adopted an active role in infrastructure investment. Between 1901 and 1929 an average of just about one-third of the public budget was allocated to transport, coming second only to the budget for the Ministry of Finance. Government involvement with railways was far the most significant in expenditures on infrastructure. Since 1850 the government had offered subsidies for railway companies, mostly foreign owned, in the fashion of guaranteed minimum dividends to investors at rates which hovered typically between 5 per cent and 7 per cent per year (Summerhill 1998; Topik 1979; 1980b; 1985). According to William R. Summerhill (1998, p.545): "The subsidies implicit in the guarantee policy reduced the perceived risk and permitted the railway either to obtain capital that it would not have received, or to obtain it more cheaply than would have otherwise been possible." Indeed, with the guaranteed profitability, investments in railways soared. Whilst in 1850 there was no railway in Brazil, in 1905 Brazil possessed some 17,000 kilometres of track, in 1919 28,000 kilometres, and in 1940 34,000 kilometres. Certainly this was not entirely a result of the public-private partnership venture, as between the tracks there was outright government ownership. The Central do Brasil railway company, for instance, was acquired by the federal government when a private company went under. By 1930, two-thirds of the 30,000 kilometres of track belonged to the state (Topik 1979, p.337). Little wonder that the government's incentives to railways had been tailored to support the coffee export sector with ampler services and subsidised freight. Indeed, the six regions involved in coffee exports accounted for more than 85 per cent of

[27] According to Steven C. Topik (1980b, p.606) "the United States Federal Trade Commission found in 1916 that Brazil had the highest tariff in the Western Hemisphere."

total railroad in 1905.[28] However, reasons of security and geographical integration also played a part in the location of railways (Topik 1979). As a consequence, in the heydays of railway construction, the share of total railway tracks for these six regions tended to be lower.[29]

These investments in transport and the government incentives to keep freight low resulted in the expansion of coffee production. As Brazil dominated three-quarters of the world market this meant serious downward pressures on the international prices of coffee. After 1906 the government put in place the coffee defence policy, which consisted of purchases of coffee by the government in order to keep supply down and prices up. The government of São Paulo State and the federal government spent the equivalent of the entire 1929 federal budget on five interventions between 1906 and 1929 (Topik 1980b, p.604). Other credits to the coffee sector and even some coffee purchase in the defence programme had been operated through the Banco do Brasil, a state-owned commercial bank also the largest bank, mainly in the periods of rupture with the gold standard. In short, it was the aforementioned government interventions – such as the constitution of a wage earning class, geographical integration of the economy, and some protective measures – which, allied to the maintenance of coffee sectors' income, produced cumulative effects to the rest of the economy and its growth.

It is true that despite the positive effects of those government interventions, they seemed unintentional with regard to industrial development. In addition, despite the faster industrial growth that marked the First Republic, the performance of the economy was still dependent on the primary-export sector. Furthermore, the First Republic governments still preached free trade and held an anti-interventionist view of the state, as the coffee oligarchy feared a loss of power over its local constituencies. But, as Steven Topik (1980b, p.609) puts it: "State activity was directed not so much by abstract principles as by the pragmatic need to conform to the country's economic and political realities." Accordingly, from the point of view of a primary-export economy, justice, defence and infrastructure constituted most of the areas in which the market could likely fail. Whilst the productivity of the export sector depended more on the availability of fertile land and cheap labour and transport, the

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[28] The six regions were: Pernambuco, Bahia, Minas Gerais, Rio de Janeiro, São Paulo, and Rio Grande do Sul.

[29] For instance, whilst the rails tracks doubled between 1905 and 1936, the share of the six states were reduced to 73.5 per cent of the total tracks.

government would hardly be required to invest much in knowledge and workers' training. A fully-fledged and consciously interventionist government would have to wait until the Great Depression in the 1930s to show up when the economic and political conditions weakened at once foreign and coffee oligarchy positions. However, it would be a huge mistake to belittle or neglect the government role in the beginning of Brazilian industrialisation in the First Republic based on the ideological stance of the ruler class and on the importance of the external markets.

To understand the emergence of developmental government in the 1930s and 1940s, which prevailed up until the 1970s, it is necessary to consider the financial structure of the Brazilian economy and the increasing involvement of the state in business. During the First Republic the banking system was small, regionally concentrated and conservative in terms of its investments (Topik 1980a). The capital markets were smaller still, and were concentrated on public bonds and foreign exchange transactions (Topik 1980b, p. 610). Most of Brazil's financial sector was dominated by foreign banks, with high stakes in the trade sector and none in domestic activities (Triner 1996; 1999). Foreign banks financed coffee commercialisation and the investments in infrastructure that served the export sector. Adopting defensive behaviour against currency mismatch, foreign banks did not get much involved with activities destined to domestic markets and maintained higher cash reserves than domestic banks (Triner 1996). Foreign bankers were vocal defenders of the gold standard and worried that expansionist policies could devalue the domestic currency and the value of their investments (e.g., bills of exchange and public bonds). In short, their preference for financing export-oriented sectors and for the gold standard sought to protect the value of assets and the yields to be remitted abroad. In times of high international prices, as it was in the first half of 1890s, the coffee planters could serve their debts with the foreign banks. However, in times of lower international prices, as in the second half of the 1890s, the coffee planters pressured the government into devaluing the domestic currency. The government in turn resisted to devaluate the domestic currency generally because it would cause protest from the part of bankers, industries and urban segments of society. The government intervention which suffered the least resistance was the direct purchasing of the coffee surpluses which prevailed in the first half of the twentieth century.

The public sector very often took foreign loans to defend the exchange rate and to finance the above-mentioned activities related to the export sector, such as compensation

for slave release, coffee purchase operations, and profit-guarantees to railways investors to bail out or acquire failed railway ventures. But these very government initiatives in support of the coffee sector, aimed either at reducing transport and labour costs or maintaining coffee prices, fostered coffee investments which in turn tended, with a lag, to reduce coffee prices. As a consequence, the economy was subject to recurrent balance of payments crises. To avoid this, recurrent government interventions to maintain the prices of coffee were required, and were carried out five times during the First Republic (1908, 1917, 1921, 1923, and 1924). Under the convertibility rules, to maintain the exchange rates the government had to resort to foreign loans to compensate for the expansionist effects of the coffee defence. As a consequence, the government assumed the lion's share in an increasing external debt. During the First Republic, the ratio of external debt to exports rose from 1.2 in 1890 to 4.0 in 1930. These debts required rising services whose burden increased in times of external crisis and compelled the government to further external indebtedness. The ratio of debt service to exports increased from under 6 per cent in 1890 to 30 per cent in 1930. The price cycles of the coffee and the burdensome external debt servicing left the balance of payments in structural fragility, which very often ended in crisis with capital flights and further indebtedness (Abreu 2001). The services on external debt were not only the most important item in the balance of payment account but rapidly also came to take up a sizeable portion of the public budget. Whilst external debt servicing claimed 12 per cent of public revenues in 1910, in 1930 it claimed some 26 per cent . Foreign banks had as much say as coffee planters with regard to government budget and policies. However, to serve both interests was becoming increasingly difficult as it frequently ended in crisis, and also because both economy and society had become much more complex.

In short, the Brazilian economy was organised in such a way that the government was constantly called to intervene to rescue the export sector income. The reality of an increasingly dynamic and complex economy not merely permitted but actually required such involvement. Whatever the ideological stance of the coffee oligarchy, their economic circumstances obliged them to accept and actually to claim more government interventions. Nevertheless, under the convertibility rules the government interventions broadened the financial gap in the balance of payments and in the government accounts themselves, as those interventions represented further external indebtedness and costly debt servicing. In

summary, the financial dependence on foreign sources blocked the developmental actions the state might have pursued by creeping public finances when the internal economy was becoming more complex and more sectors reclaimed government support. The internalisation of the sources of financing of the Brazilian economy and of the government was still to be seen up until the government could be able to pursue deeper developmental activities.

**The Emergence of the Brazilian Developmental State**

The crack in the coffee planters' dominion came precisely when President Washington Luis, a coffee planter himself from São Paulo, refused to continue the coffee valorisation policy after the international crash of 1929. President Washington Luis refused to support coffee prices to favour the gold standard, as he was animated by the flood of foreign capital of prior two years. With the 1930s Great Depression Brazil experienced two external shocks: one from the free fall of international coffee prices and another from painful capital flight. Both shocks forced the government to suspend external payments, to devaluate the domestic currency, and to abandon the gold standard. In 1930 the economic and political turmoil among the planters and the rupture with the gold standard gave those who had previously been outside the circle of power an opportunity to take over, in a movement that empowered the central government and the urban and industrialist interests.

The fifteen years of the Getúlio Vargas government, which became a civil dictatorship in 1937 (the *Estado Novo*), mark, in fact, the very process of institutional building towards development. President Vargas' administration was marked by balancing the demands of the coffee oligarchy, as planters still held a central political and economic role in the country, with an emergent industrial bourgeoisie, while at the same time promoting state-led industrial growth. There is an erroneous perception that as Vargas' administration adopted coffee defence it was anti-industrialist and a champion of coffee interests (Evans 1979, p.86). However, no social or economic project could neglect the fact that coffee exports amounted to over 70 per cent of total exports, and that exports constituted about 10 per cent of GDP.

During the Great Depression the government supplemented coffee planters' income by purchasing coffee excess through pump-priming and later by incinerating coffee stocks.

According to Celso Furtado (1968, p.211), with the valorisation policy financed by issuing money rather than by foreign loans, "Brazil was in fact constructing the famous pyramids which Keynes was to envisage some years later." Indeed, it takes no great stretch of the imagination to perceive that the defence of international coffee prices and domestic income was a policy of development in a time of balance of payments crisis and domestic recession. Accordingly, the maintenance of domestic income and the devaluation of domestic currency that followed the balance of payment crisis gave the incentives domestic industry needed to flourish in Brazil. Differentiated protective tariffs in turn guaranteed that increasing domestic demand for consumer goods was carried to domestic production, while at the same time permitting imports of capital goods.[30] As a consequence, manufactured goods such as textiles mushroomed by 14 per cent per year between 1933 and 1937; others like paper and furniture grew over 30 per cent a year in the same period. Overall, industry, which had begun to recover in 1932, grew over 11.5 per cent from 1933 through 1937. In short, the anticyclical policies of President Vargas were fundamental for stabilising the economy and for arresting support to the deeper transformations his government produced in the structure of the state and of the economy at large. From the beginning, his administration set up a mammoth reform of the state apparatus in order to spur industrial accumulation,[31] many of them surviving until today, and it could hardly have been initiated if the economy had been left to heal itself.

Given the aforementioned shortage of foreign currency, and the dependence on foreign capital inflows to balance the current accounts, the management of the foreign reserves were crucial to achieve higher levels of industrialisation. With the international crisis the government imposed exchange controls and empowered the Banco do Brasil to distribute these resources according to the industrialisation objectives and public payments of external debt (Abreu 2001). In addition, two specialised offices (*Carteira de Exportação e Importação* and *Carteira de Crédito Agrícola e Industrial*) were institutionalised within the structure of the Banco do Brasil in order to finance agriculture, industry and trade. Meanwhile the Banco do Brasil did not constitute at the time in a classical development bank, it advanced loans up to ten years whilst the other commercial banks concentrated on

[30] In 1935, in a pact with the United States, the Brazilian government granted 20 per cent to 60 per cent of cost reductions in capital goods imported from the United States meanwhile this country conceded advantages for Brazilian export products – coffee, cocoa, and rubber (Fonseca 2003). See also (Hilton 1975).

[31] See Sonia Draibe (2004) for a detailed discussion of the state institutional building of this time. The following discussion is mainly based on her description of the institutions created during Vargas' first term.

short-term financing. These innovations strengthened the position of the Banco do Brasil whose loans in 1944 accounted for 46 per cent of total commercial bank loans in Brazil. The strengthening of the Banco do Brasil also represented a step towards the internalisation of the financing centre of decision as the credits supplied by foreign banks reduced from about 30 per cent in the early 1920s to less than 5 per cent in the 1940s. Further control of monetary policy and regulation of the financial system by the state was achieved with the creation of the SUMOC (*Superintendence of Money and Credit*), an institution which carried out most of the central bank's functions – regulation of the financial system, determination of the interest rate and the exchange rates and the like.

The new orientation of the state for transforming the agrarian economy into an industrial economy was clearly revealed by the constitution of state-owned enterprises, mostly in the sectors of transport and industrial inputs. Facing the possibility of bottlenecks in steel imports for industry during the Second World War, and the inability or disinclination of a foreign company – Belgo Mineira, the main inland producer – in increased productive capacity, Getúlio Vargas managed to get United States support to finance a state-owned steel enterprise (Hilton 1975). Direct investments by the state also resulted in the creation of the *Companhia Vale do Rio Doce* (CVRD) in 1942.[32]

In order for the new, industry-oriented interventionism on the part of the state to be accepted it would be necessary changes in popular sentiments. Getúlio Vargas' speech at the opening of the Steel National Company (*Companhia Siderúrgica Nacional* – CSN) illustrates his frequent appeal for a new mentality:

> "Here it is planted, in cement and steel, defying scepticism and discouragement … It was difficult not only because of material obstacles, but also due to the resistance and negligence of a public mentality that seemed to prevent us from implementing the solution to the great problem.
> It is no exaggeration to attribute [this mentality] to the provincial Constitution of 1891 and to the industrial countries' interest in keeping us as simple suppliers of raw materials and customers for their industrial products.
> The basic problem of our economy will soon be on new conditions. The semi-colonial, agrarian, manufacturing importer and raw-material exporting economy will be able to afford the responsibilities of an autonomous industrial life, providing its more urgent needs of defence and retooling. The solution cannot wait any longer…"[33]

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[32] Today the second largest mining company in the world.

[33] Republished in BNDES (2004, p.260). Even before this speech Getúlio Vargas had shown he was aware that the development involved not merely a material but also a cultural change of the nation. For instance, on the 7th of September of 1936, at the celebration of the Brazilian Independence Day, he said: "We have already

President Vargas clearly held the view that the main government priority should be the development of the country and to that end the relations between the public and private sectors needed to change so that the public sector would "buttress and favour the surge of new crops and industries" (Fonseca 2003, p.143). After President Getúlio Vargas' period in power a new consensus would emerge with regard to the pattern of Brazilian development in the following decades. First, development in Brazil was a state-led process. If the private sector did not wish to or could not invest in the sectors the government identified as bottlenecks or strategic for the process of development, the government itself would take such a responsibility. Second, the state drew the private sector into every state project in order to develop domestic entrepreneurship. By the same token, whilst policymakers welcomed international finance, direct investments and technical cooperation they ensured domestic participation in projects granted to foreign companies (Evans 1979).

Perhaps the first great test for the resilience of the state interventionism towards industrialisation came in the aftermath of the World War II. During the years of the World War II, Brazilian foreign reserves had achieved historical records. With the end of the Getúlio Vargas dictatorship in 1945 a new, economically liberal government was elected and returned to the liberal exchange rate policies. The exchange rate returned to the pre-1929 depression level and exchange controls were relaxed. In addition, a restrictive macroeconomic package of policies was adopted to curb inflation, which had reached 20 per cent in 1944 and about 15 per cent in 1945. In a span of two years alone the current account went from a five years surplus to a deficit of US$ 150 million in 1947, as imports doubled from 1946 to 1947. The crisis of the balance of payments triggered in 1948 a selective policy of imports along with control of exchange rates to favour more essential products.[34] Some authors convincingly argue that, given the liberal character of the government then in power, such measures are better understood as a response to the urgent balance of payments crisis instead of being a deliberate move towards the protection of domestic industry (Vianna 1990, p.123). Whatever the reasons for such measures though the undeniable fact is that these policies protected the domestic production from foreign competition and impelled import-substitutive industrialisation. In fact, as the fine study of

achieved a high level of cultural, institutional and economic development…We are no longer an exclusively agrarian country, forced to fight for costumers of raw-material and crushed by the weight of the industrial product acquisitions" (Fonseca 2003, p.143).

[34] Devaluation was not adopted because Brazilian policymakers had learned that exports were not elastic to reductions in price whereas imports in turn were quite inelastic to price increases.

Sonia Draibe (2004) shows, the previous fifteen years had already established a cumulative process towards the industrialisation of the economy in order that the short-period of liberalisation was unable to change the deeper institutions created. On the contrary, the failure of the brief period reinforced, albeit involuntarily, further industrial development.

President Vargas was elected back into power in 1951, as a reaction to the frustrating results of the freer market policies of the immediate post-war period. In his second term the process of planning industrialisation, and defining the roles of government and private capital, took on a much more formal and deliberate character (Draibe 2004). Three state endeavours in this period epitomise the return to the fully-fledged policies of industrialisation. First, in 1951 a Brazil-United States Mixed Commission (CMBEU) was created to provide technical evaluation of the Brazilian economy. This Commission counted on U$500 million, to be raised by the World Bank and Eximbank, to finance its projects. The Commission's report resulted in the Programme for Retooling and Stimulating the National Economy, which identified transports, energy, ports, and communication as the main bottlenecks to Brazilian industrialisation and development process. The Brazilian representatives in the Commission pushed for the creation of a bank for financing the investment projects, as the scale and maturity of the industrial projects requested a development bank similar to that which financed Germany's and Japan's industrialisation. In spite of the fact that the external loans never materialised, in 1952 was created the National Bank for Economic Development (BNDE, Banco Nacional do Desenvolvimento Econômico)[35], which would turn out to be the most important individual financier of long-term projects of the Brazilian economy in the years to come (BNDES 2002a). The initial years of the Bank though were marked by the lack of resources with the BNDES' loans hardly attaining 1.5 per cent of the gross capital formation in 1954. According to Werner Baer and Annibal Villela (1980, p.426), though, the lack of financing activities allowed the Bank's staff to spend "a large proportion of its time developing the type of research activities on the Brazilian economy which had been started by the Joint Brazil-United States Mission. The resulting accumulation of information and capacity for analysis of the BNDE made it an influential institution in the planning of future governments."

[35] In 1982, with the creation of a directory for social projects, the BNDE became BNDES, with S standing for social.

Second, in its deliberate pursuit of rapid import-substitution industrialisation, the government had to make the most of the foreign exchanges generated in the external sector. Exports did not perform so well to keep up with the import requirements of a burgeoning industry. Facing difficulties in the balance of payments, in 1953 the government instituted Instruction 70. According to this, the imports were ranked according to their essentiality – clearly favouring the import of industrial inputs rather than consumption imports or, as they were named, superfluous goods – with multiple exchange rates to turn import cheaper or more expensive in accord with its essentiality. Once more the Banco do Brasil was enlisted to control the distribution of foreign currency to each category in order that government could discretionary distribute resources according to its industrialisation aims. Instruction 70 contributed considerably to the industrialisation objectives whether protecting domestic production from external competitors or reducing exchange costs of capital goods and basic inputs essentials for the industrialisation process.

The third important mark of the new roles of the government was the definitive establishment of the government as an entrepreneur, providing infrastructure and basic input for industrial development. The creation of Petrobrás (the Brazilian petroleum company)[36] is a case in point. In his first term, Vargas had created the National Petroleum Council to establish policies for the sector. During the liberal government of 1947-1950 that body attempted to open up oil refining to private companies, but they were unsuccessful in persuading foreign firms to sign long-term contracts for supplying crude oil, and production fell well short of domestic consumption (Evans 1979, pp.90-91). This prompted a backlash against the liberals and strengthened the nationalists' positions to such an extent that in the end the national solution also turned out to be the state-owned company. In 1953, the government created the Petrobrás and the National Congress conceded to it the monopoly for the exploration and refining of petroleum.[37]

By the mid-1950s the political victory of industrialism had been consolidated with the electoral victory of President Juscelino Kubitschek, who promised to make Brazil "grow fifty years in five." The Kubitschek administration embarked upon an investments programme which would ultimately launch the Brazilian economy into a process of

[36] Petrobrás is today remains a state-owned company and the largest in Brazil.
[37] The domestic production of diesel and fuel, which in 1953 satisfied only 3 per cent and 4 per cent respectively of the domestic demand, five years later made 42 per cent and 65 per cent of the domestic demand.

economic growth led by industrial accumulation. The so-called *Plano de Metas* (Target Plan) retook the projects of investments recommended by the joint Brazil-United States Commission and a joint BNDES-CEPAL Commission to constitute a massive programme of industrial and infrastructural investments, public and private.[38] President Kubitschek constituted a powerful Council for Development, directly linked to the presidency, to conduct the Target Plan which was chiefly planned and executed by the BNDES' staff and expertise (Baer and Villela 1980; Lessa 1983). Table 1 below shows some of the main quantitative targets and results of the plan.

**Table 1 Target Plan Sectors' Expansion: Planned and Realised – 1957-1961**

| | *Objective (A)* | *Realised (B)* | *B/A ( %)* |
|---|---|---|---|
| Electricity (1,000 Kw) | 2,000 | 1,650 | 82 |
| Coal (1,000 ton) | 1,000 | 230 | 23 |
| Petroleum (1,000 barrel/day) | 96 | 75 | 76 |
| Refined oil (1,000 barrel/day) | 200 | 52 | 26 |
| Railroads (1,000 km) | 3 | 1 | 33 |
| Roads building (1,000 km) | 13 | 17 | 138 |
| Roads resurfacing (1,000 km) | 5 | - | - |
| Steel (1,000 ton) | 1,100 | 650 | 60 |
| Cement (1,000 ton) | 1,400 | 870 | 62 |
| Automobiles and Trucks (1,000 units) | 170 | 133 | 78 |
| Index of National Parts in Automobiles Production (%) | 90 | 75 | - |
| Index of National Parts in Trucks Production (%) | 95 | 74 | - |

Sources: Orenstein and Sochaczewski (1990, p.180).

The government itself was a major executor of the investments forecast in the Target Plan. It dedicated over 90 per cent of its forecast investment budget to expenditure on transport, energy and basic industry to achieve expansion objectives (Studart 1995, p.95). As a consequence, this public sector investment effort led the government to account for 36 per cent of the total investment in 1961, having been 23 per cent in 1953. If one adds the investments of the federal state-owned enterprises that amount increases from 44.5 per cent of capital formation in 1955 to 61 per cent of capital formation in 1961. This high direct participation of government in the process of accumulation stemmed from the requirements of the process of industrialisation whether because of the needed overhead capital, the lack of private sector interest, or the higher scale of investments.

Although the BNDES had played an outstanding role in planning and executing many of the projects envisaged in the plan, it was not the main financier of the Target Plan.

[38] CEPAL (*Comisión Económica para America Latina y el Caribe*) or ECLAC (Economic Commission for Latin America and Caribbean) is an United Nation's organisation for carrying out economic research and providing advice for the region.

Throughout the period of the Target Plan, BNDES loans never surpassed 5 per cent of total capital formation. The public sector incurred in public deficits, which increased from 1.8 per cent of GDP in 1958 to 3.4 per cent of GDP in 1961, to carry out its programme of investments. For that, it borrowed lavishly from the Banco do Brasil, whose share destined to the public sector accounted for 55 per cent of the Bank's loans from 1956 to 1959.

**Table 2 Target Plan: Foreign Capital by Sector (US$ Million)**

| | *1955* | *1956* | *1957* | *1958* | *1959* | *1960* | *1961* |
|---|---|---|---|---|---|---|---|
| 1) Related to the Target Plan | 93.3 | 315 | 469.6 | 559.5 | 443.1 | 366.4 | 144.6 |
| Energy | 42.9 | 23.9 | 67.9 | 133.7 | 95.7 | 64.2 | 19.1 |
| Transports | 31.4 | 82.7 | 106.0 | 186.5 | 75.1 | 41.0 | 46.4 |
| Foods | 1.4 | 8.5 | 39.5 | 16.5 | 9.7 | 54.4 | 4.3 |
| Basic Industry | 17.6 | 199.9 | 256.2 | 222.8 | 262.6 | 202.3 | 74.8 |
| Steel | 6.8 | 55.1 | 10.5 | 18.6 | 131.3 | 105.1 | 34.2 |
| Cement | - | 5.4 | 0.8 | 6.2 | 2.3 | 3.1 | 3.7 |
| Pulp and Cellulose | 0.1 | 14.3 | 5.4 | 11.9 | - | 13 | 6.4 |
| Automobiles | - | 109.3 | 222.8 | 182.8 | 92.5 | 69.2 | 29.2 |
| Machinery and Heavy Electric Material | - | - | 4.4 | 1.3 | 2.8 | 4.2 | 5.9 |
| Others | 10.7 | 15.8 | 12.3 | 2 | 33.7 | 7.7 | 4.6 |
| 2) Non-Related to Target Plan | 17.4 | 51.6 | 90.4 | 30.4 | 20.3 | 45.1 | 22.7 |
| Total (1+2) | 110.7 | 366.6 | 560.0 | 589.9 | 463.4 | 411.5 | 167.3 |
| Memo | | | | | | | |
| Foreign Capital/GDP (%) | 0.3 | 1.3 | 1.8 | 3.5 | 2.3 | 2.9 | 2.3 |
| Foreign Capital/Capital Formation (%) | 2.2 | 9.0 | 12.2 | 20.5 | 12.5 | 18.4 | 17.3 |

Sources: Lessa (1983, pp.60-65) and IPEA.
* GDP and investment in dollars calculated from average exchange rates.

Also fundamental for the pattern of industrialisation established in the 1950s with permanent consequences for the Brazilian model was the institution in 1955 of Resolution 113 of the SUMOC. The shortage of foreign currency provoked once more by the fall in the international prices of coffee forced the government to implement Resolution 113 in order to attract capital inflows and to increase the capacity to import. The resolution consisted of the possibility for foreign investors to bring physical capital without corresponding foreign currency cover.[39] It also allowed foreign capital to remit profits and interests through favoured exchange rates. This mechanism was the crucial means by which foreign investment soared in the second half of the 1950s following the audacious programme of investments conducted by the government. On the other hand, the government regulated and oriented foreign investments by granting priority for remittance of profits and payments

[39] This was a huge incentive if one bears in mind the possibility for foreign companies to bring in equipments out of date to a market with high protectionist barriers. Actually, most of the automobile industry came in to Brazil favoured by the Instruction 113.

of loans for capital invested in priority areas. By the same token, as the BNDES acted as the guarantor of foreign loans the Bank guided private investments towards those priority areas (see Table 2 above).

The galvanisation of productive resources towards industrialisation that the government brought about through institutional innovations resulted in much faster economic growth and structural change. Whilst per capita income had hardly grown 1.5 per cent per year in the first three decades of the nineteenth century, in the three subsequent decades Brazil's per capita income grew by an average of over 3.5 per cent per year. In the period of fastest growth in the 1950s it grew by more than 4.5 per cent a year. At this time, agriculture output grew just over 4 per cent a year whilst manufacturing was the most dynamic sector growing over 9.5 per cent a year. This manufacturing growth changed the structure of the economy as industrial output finally surpassed agricultural output. By the time the Target Plan projects had been finished the mechanisms of expansion of the economy had been internalised. The increasing domestic market was main destination for booming production. The staggering growth of the domestic market was in turn a result of the government's deliberate mixing of market forces and institutional mechanisms in order to increase economic linkages and maintain the cumulative process. First, through the creation of state-owned enterprises the government maintained a high level of public investments in overhead capital, intermediate goods and infrastructure which generated pecuniary and technical externalities to the rest of the economy. Second, through the Banco do Brasil administration of the limited availability of foreign currency the government protected domestic consumer markets to favour domestic producers and favoured the import of industrial inputs, particularly capital goods. Third, the government created the BNDES to finance capital-intensive and longer maturity investments and at the same time orientated the Banco do Brasil to finance the expansion of the output of industry and agriculture alike. Finally, the BNDES was instrumental in attracting and orienting the foreign investments towards high technology and large scale industrial sectors. The cumulative process in turn was brought about as a sequence of public and private investments which fostered the growth of the domestic market which in turn opened up new opportunities for public, private and foreign investments.

## Assessment of the Limits of the Economic Transformation in Brazil

By the late 1950s Brazil possessed a very integrated and dynamic industrial structure. However, the process of industrialisation was neither smooth nor without imbalances. Political and economic factors conditioned the ability of the state to promote the intended transformations. The historical conditions and the rapid structural transformation of the economy created some obstacles which pressured for or requested further decision from the government and private sector alike, if development was to be pursued.

**Table 3 Productivity of Workers in Agriculture and Manufacturing**

| | *Agriculture* | | | *Manufacturing** | |
|---|---|---|---|---|---|
| | Workers (Millions) | Hectares (Thousands) | Productivity** (Output/Worker) | Workers (Millions) | Productivity** (Output/Worker) |
| 1950 | 11.0 | 232.2 | 3.1 | 1.3 | 18.7 |
| 1960 | 15.6 | 249.8 | 3.2 | 1.7 | 38.3 |
| 1970 | 17.6 | 294.1 | 3.5 | 2.6 | 55.7 |
| Annual Δ % | 2.4 | 1.2 | 0.6 | 3.5 | 5.6 |

Sources: IBGE; IPEA
* 1949 and 1959;
** In Reais (R$) of 2005.

First, development was concentrated on the productivity growth of industry whilst agriculture grew primarily on the basis of extension of cultivated area and use of unskilled labour force (see Table 3 above). Here political reasons prevented the government from bringing about the land reform which had been paramount for the improvement in income distribution and productivity of agriculture in other industrialisation experiences (Jeon and Kim 2000;Koo 1966). As a consequence, the government had to allow agriculture to grow based on the relative abundance of the factors instead of being based on the growth of productivity. On the other hand, the indexes of productivity growth of manufacturing show that there is no basis for the neoliberal reasoning that the decrease of imports as a proportion of output meant an inefficient industrial structure. Marcílio Moreira (1995, p.94), for instance, affirms that between 1930 and 1955 “external competition was totally removed” so that firms would have “little incentive to increase efficiency given the technologically poor domestic competition.” In fact, the administration of the foreign reserves and the policy of selective attraction of foreign capital guaranteed the transference of technology through import of capital goods. The rapid growth of the economy was

another factor explaining productivity growth. Firms, domestic and foreign, invested recurrently to gain a slice of the growing economy. Growing investments in industry attracted workers for factories where productivity and salaries grew faster. As a result, markets expanded and new opportunities for investment appeared. Whilst the government was able to maintain its investments and the management of resources, the cumulative process remained ongoing.

**Table 4 Brazil Indicators of Income Distribution**

| | ***Functional*** | ***Personal*** | ***Regional Per Capita Income as a Share of the SouthEast Per Capita Income*** | | | | |
|---|---|---|---|---|---|---|---|
| | Salaries/Added Value in Manufacturing | 10 +/10- | North | NorthEast | South | West | SouthEast |
| 1950 | 28.2 | - | 32.1 | 28.0 | 71.5 | 35.5 | 100 |
| 1960 | 26.1 | 34 | 42.2 | 32.6 | 74.1 | 39.8 | 100 |
| 1970 | 23.1 | 40 | 34.7 | 25.2 | 61.8 | 46.3 | 100 |

Source: IBGE.

Second, as an outcome of the aforementioned productivity differential between agriculture and industry the process of development in Brazil created disequilibria in terms of income distribution. Income was concentrated in the southern and southeastern states as these were also the states most favoured by the industrialisation policies (see Table 4). In 1960, these regions had 60 per cent of the population and 80 per cent of the national income. By the same token, in the 1950s a greater part of the workers were still attracted more by the less productive activities of agriculture, widening the income gap between industrial workers and agrarian workers. Finally, the concentration of income was also a result of the concentration of power in corporations, as illustrated by the permanent fall of the share of wages in the value-added of manufacturing. To resolve these imbalances the state would more likely be needed than not. For instance, to increase the productivity of the primary sector and improve income distribution land reform would be required to avoid population explosion in the cities. More investments would be needed from the government in public services and infrastructure to reduce transport costs to bring production from agrarian areas to urban areas as well as to improve employment and living conditions in urban areas.

Third, from the point of view of the financial arrangements the system presented a tendency towards inflation and external fragility. Although the government had created a development bank, the BNDES, it did not have the adequate resources to provide long-term

financing to the private sector. For its investments the government resorted to the Banco do Brasil's money issuing, as the low level and high concentration of income and the preference for foreign currency as a value reserve did not allow for a proper market of public bonds nor for a broad base of taxation. The private banking system in turn was never an alternative for long-term financing of private investments as they concentrated on treasury operations, consumer and working capital financing. Firms were then forced to resort to self-finance through high mark-ups. Firms seemed to have little difficulty in financing their investments with retention of internal profits, as they enjoyed market protection and market power to increase the mark-ups without much market contestation. Therefore, while the rate of inflation remained at an average of 22 per cent between 1956 and 1960, the investment grew at an average rate of 10 per cent per year in real terms over the same period.

The Brazilian industrialisation process has recently been erroneously portrayed by market-friendly policymakers as closed and privileging "the reduction of relations with the outside world" (Franco 1999, p.97). The Brazilian model was in actual fact anything but autarchic. Principally after the Target Plan, the Brazilian economy strengthened its relationships with the world economy. As such, in 1969 foreign companies controlled over 60 per cent of the assets in sectors such as chemicals and machinery, and more than 90 per cent of the assets in sectors like pharmaceuticals and transport equipment (Evans 1979, p.114). In addition, the process of investment in Brazil resorted abundantly to foreign capital loans to finance the balance of payments. Furthermore, the economy, and particularly the leading sectors dominated by foreign companies, depended greatly on the import of capital goods and intermediate goods. Therefore, the Brazilian economy was always very sensitive to the events of world economy, as a great deal of its capital formation was under influence of foreign decision centres whether to supply capital goods or to finance them. The real adverse consequence of the reliance on foreign capital was the external fragility and recurrent threats of balance of payment crisis. More often than not the Brazilian model entailed a recurrent increase in the external debt and the current account deficits related to payments of interests and profits. The external debt to exports ratio increased from a full point in 1955 to about 3 times the value of exports in 1960. As the income remittances abroad increased from 24 per cent of exports in 1955 to 39 per cent of exports in 1960, the economy progressively became dependent on foreign capital inflows.

The capital liberalisation suggested by neoliberal proponents, supposedly necessary to increase the contact to the external world, could do anything but worsening the external fragility, as we will discuss it in the next chapters.

## Final Remarks

The main objective of this chapter has been to highlight the changing nature of state intervention in Brazil throughout the process of industrialisation in the 1950s. It has shown that the state was a major constituent of the structural changes that the Brazilian economy had undergone since the early 1900s. The state was at the same time an agent and an object of change as the economy became more complex and development demanded new functions from the state. The state structures and policies built during the process came about as a response to objective problems, such as the recurrent balance of payments constraints, growth of urbanisation, and external security; and as a response to political realities, as the interaction of a myriad of domestic and foreign interests. A new politicy began in the 1930s in which the state assumed a more deliberate interventionist character and whose purpose was the industrial development of the country. It meant the redefinition of the problem of development as well as the redefinition of the solutions leading to development. The government role and instruments of intervention also changed to buttress the industrialisation process.

Undoubtedly, the process that took place was nothing like balanced growth but more like the messy dynamic of the real world. Economic and social imbalances emerged everywhere but at the time it seemed either insufficient to stop the process or in some instances even sanctioned the process. The following chapters will discuss the solutions the military governments found to respond to the pressures stemming from the unbalances of Brazilian development. Once again, some of the unbalances were only reinforced as they seemed to constitute defining characteristics of Brazilian development. Paradoxically, the crisis of the Brazilian model in the 1980s and 1990s was first and foremost a result of the abandonment to find new solutions for development under new political and economic conditions that no longer accepted some of the enduring features of Brazilian development.

# *4. Rupture with Continuity: The Double Character of the Military Economic Reforms*

## Introduction

This chapter is concerned with the major institutional changes implemented by the military government in the mid-1960s and the early 1970s. According to their mentors, these institutional changes intended to build a new development model in Brazil, whose dynamic would rely on market forces and would restrict the intrusion of government into economic affairs. The objective of this chapter is to evaluate those reforms and their immediate and long-term results. The main argument here is that, despite the pro-market rhetoric and intentions of the institutional reforms, the reforms fell well short of constituting market-led economic development. The "economic miracle" the Brazilian economy experienced during the introduction of the reforms took place as a result of an even larger government manoeuvring of the economy. On the other hand, whilst the new model was not able to introduce the desired market-led growth the reforms did produce new elements, some of which activated the dormant potential of the Brazilian economy while others served to reinforce its historical imbalances.

This chapter is organised as follows. The next section describes the institutional changes promoted by the military economic team involving three broad areas: public finances, financial system, and trade policies. Subsequently, it evaluates the role of these reforms in bringing about the remarkable growth of the "economic miracle." It argues that despite the market-friendly pronouncements of the policymakers these reforms in fact tightened the grip of the government on the economy, just as the previous model had done. However, contrary to the more nationalist mould of the previous model of development, the military policymakers' reforms brought the Brazilian economy much closer to the international

movement of financial capital. This late development was critical for the new Brazilian model as the international capital market itself experienced a new movement of liberalisation. The last section summarises some main features of the new model of development which had enduring consequences for the long-term development of Brazil.

### Transforming the Brazilian Model

With the completion of the Target Plan investments, in the late 1950s the Brazilian economy emerged more complex and diversified, made up of large companies, both national and international. However, early in the 1960s, investment fell and the economy also underwent a period of sluggish performance. In reality, the country was suffering its first recession in its industrial era. For the first time the economy was experiencing the social problems associated with a rapid industrialisation process. Urban population increased, attracted by job opportunities created by industrialisation, and demanded considerable amount of investment in urban infrastructure and public services (transport, education and health care). Also, the burgeoning working class pressed for employment and wage rises.

In the midst of the increasing social demands entailed by industrialisation the government had to face acute economic instability, as inflation accelerated and government deficits rose. The balance of payments had entered a crisis as the interest and profit remittances soared and the trade balance was in deficit with the accumulated fall of 80 per cent of the terms of trade in 1963.[40] By 1963 a stabilisation programme agreed on by the IMF was underway and despite the very restrictive economic policies and the reduction of government deficits, inflation accelerated rather than fell. In summary, the social demands for more fundamental reforms, such as land reforms and income distribution, were increasing at the same time that the economy was undergoing a downturn. Industrialists in turn resented about the market shrinkage and expensive credit at the same time that land owners claimed for property security.

[40] Amortisation, interests and profits remittances altogether represented 1.5 times the amount of capital inflows over 1960-1963.

The political and economic dissatisfaction emerging from the recession of the early 1960s assembled the stage for the military coup of 1964.[41] The first military government assembled a team of free-market policymakers to establish a plan to stabilise the economy and restore economic growth. These policymakers blamed the "lack of savings," the "populist" distribution of income and the anti-export bias of the import substitution process for the problems the economy was facing (Campos 1964; Simonsen 1972; Simonsen and Campos 1976). Accordingly, inflation was basically seen as being due to the lack of austerity of government with its finances and to the populist income distribution through generous wage adjustments. The immoderation of government expenditure and wage adjustments in turn increased consumption, reduced savings and inhibited the development of a private financial system and investments. On the other hand, years of interventionist exchange policies discouraged exports, which worsened the balance of payments.

The new team proclaimed that a new model of development in Brazil should rely on the price mechanism and circumvent the distortions the government had produced (Simonsen and Campos 1976, pp.10-14). According to its proponents, the new model of Brazilian development should be based upon the market-savings-exports triad. In short, the objectives and instruments announced were: a) to curb inflation with control of the public deficit, control of money issue and a strict wage policy; and b) to promote institutional reforms towards the long-term recovery of the economy centred on: 1) increasing domestic savings and constituting a private financial system to finance long-term investment; 2) an outward-looking process of economic growth with "realist" exchange policies; and 3) attraction of foreign investments. Before we analyse the results of the introduction of this new model, a description and evaluation of the reforms are of interest.

*Tax Reforms and Fiscal Policy*

The declared objective of the tax and public tariff reforms was to increase revenues and to rationalise the system in order that the government budget could be balanced and the tax system simplified to give microeconomic incentives to economic growth. Amongst the main changes implemented in the fiscal system were: a) establishing tax collection through

[41] A detailed discussion of the events that resulted in the military coup is not relevant to our discussion here. The interested reader can find a presentation of the chronological events and the actors of the coup in Thomas Skidmore (1988). For the role of the entrepreneurs into the coup see Leigh A. (1994). And for a critical appraisal of the United States participation into the coup, see Jan Knippers Black (1977). For a political economy analysis of the coup, see Michael Wallerstein (1980).

the banking system; b) enacting a new Service Tax (ISS); c) enactment of a new VAT (ICM - *Imposto sobre Circulação de Mercadorias*) to replace a sales tax incident upon firms revenues; d) enactment of a tax on industrial production (IPI –*Imposto sobre Produtos Industrializados*) to replace a tax on consumption; e) enactment of a financial operations tax (IOF – *Imposto sobre Operações Financeiras*); f) broadening the income tax incidence, while conceding rebates typically to expenditures of high income classes, such as healthy expenditures, schooling, and financial investments; g) establishing a fund whose revenues were to be divided amongst Federal, States and Municipal governments (FPEM – *Fundo de Participação de Estados e Municípios*), however with the shares defined by the Central Government and obligations for States and Municipals of investing 50 per cent of their shares.

The results came sooner rather than later, and constituted a form of sacrilege for those who championed of the minimum state: the tax burden increased from 16 per cent of the GDP in 1963 to over 22 per cent in 1966. This burden would continue to grow to a level of about 25 per cent of GDP in 1968, which was maintained throughout the seventies. Apart from the level of the tax burden, a proper discussion of the role of the state is required in order to take notice of the distribution of the tax burden. The reforms entailed a rapid concentration of tax collection in the hands of the central government, which conferred to it powerful control on the distribution of benefits and income distribution. In this connection, the government relied more on indirect taxes that tended to be highly regressive (see Table 5 below). As is discussed in more detail in the next sections, exporters and investments in financial assets were favoured with considerable fiscal exemptions and incentives. That pattern was in accordance with the policymakers' reasoning that concentration of income and incentives for savers was required to increase the provision of finance for long-term investments (Simonsen 1972).

**Table 5 Federal Government Tax Revenues by Type of Tax (% of Total Federal Revenues)**

| | *Customs Duty* | *IPI* | *Income Tax* | *Financial Operations Tax* | *Other* |
|---|---|---|---|---|---|
| 1965 | 5.8 | 36.4 | 28.5 | 9.7 | 19.7 |
| 1973 | 7.2 | 37.7 | 24.3 | 3.8 | 26.9 |

Source: IBGE.

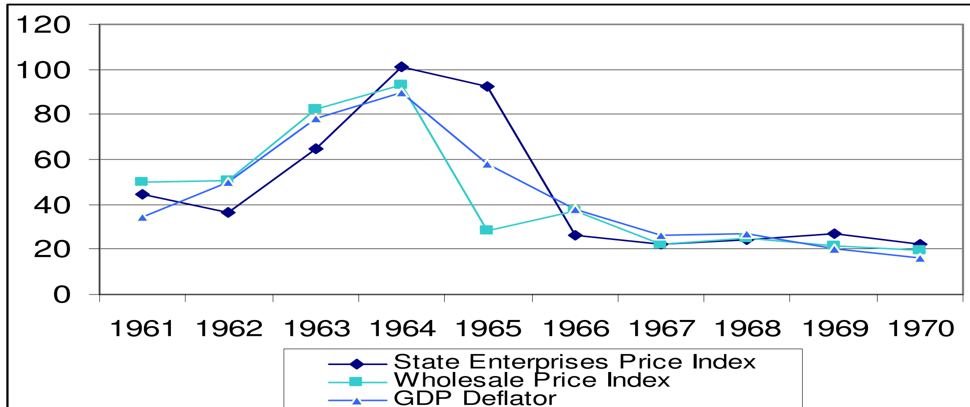
The public sector also grew in terms of expenditure. Whereas during the Target Plan the government expenditures had reached 22 per cent of GDP, peaking at 23 per cent in 1958,

the average between 1969 and 1973 (the "economic miracle" period) rose to 27 per cent of GDP per year, with a peak of 29.7 per cent in 1969. Once again, distribution here is important. Accordingly, there was a sharp contrast between the direct administration's expenditures and that of state-owned companies. The direct administration's expenditure involves the budgetary resources allocated to the administration of government and to run public services like universities, public research institutes, public hospitals, armed forces and so on. The allocation of resources to this area of government tended to be constant as a proportion of GDP. For instance, the federal government's expenditure on payroll, goods and services between 1965 and 1975 were on average 6.5 per cent of GDP. Likewise, the investments of the federal administration hardly reached 2 per cent of GDP over the same period.[42]

In contrast with the rest of the public sector, the state-owned enterprises received much more privileged treatment. The military government endeavoured to strengthen the resources available to its companies by reinforcing their capacity to generate internal funds and to obtain foreign financing instead of increasing it through the budgetary mechanism. Accordingly, despite the anti-inflation programme, state enterprises were allowed to increase prices and tariffs above inflation (see Figure 1 below). With this favoured treatment, the state enterprises enjoyed considerable financial autonomy from the government budget. This greater state-owned enterprises autonomy revealed at rates of self-financing as high as 81 per cent in 1966 (Trebat 1983, p.206). The government also stimulated the association of the state-owned enterprises with foreign companies and allowed state-owned enterprises to leverage abroad (Cruz 1999[1984]; Evans 1979). As a consequence of this financial pouring, the share of the federal state-owned enterprises' investments in the total capital formation virtually doubled from 9.2 per cent in 1964 to 18 per cent in 1972.

[42] Needless to say, in a military government the armed forces received the lion's share of these resources. Accordingly, whereas in 1964 the armed forces received 15.2 per cent of the federal budget, in 1970 they obtained over 36 per cent.

**Figure 1 State Owned Enterprises Price Index, Wholesale Price Index and GDP Deflator (%)**




Source: Trebat (1983).

In summary, the overall rationale of the fiscal and tariff reforms was to increase both the tax burden and the control of the federal government over the collected taxes. It did so by increasing taxes on consumption and exempting financial investments and exports (as we see in more detail below). Furthermore, the government sought to enhance state-owned enterprises' capacity to invest and liberate them from the disputes over public budgetary allocations. As a result throughout the military governments the direct administration investment share of government investments plummeted from 70 per cent of total public investments in 1955-1962 to 50 per cent of the public investments in 1972. On the other hand, the state enterprise's investments soared in areas like electricity, petroleum, telecommunications and roads.

*Financial Reforms*

The aims of the financial reforms were to provide the government with tighter control over the money supply and to establish private financial institutions capable of substituting the public banks' role in financing the economic growth. In addition, the reformers sought to integrate the domestic financial system with the increasing flows of international capital. Curiously enough, the creation of this pro-market financial system resorted lavishly to the government legal constraints and fiscal incentives. The financial system reforms inaugurated in 1964, indeed, came about through a number of laws and resolutions, which created several institutions, defined or redefined their functions, and established a number of incentive mechanisms to "deepen" the Brazilian financial system (Simonsen and Campos 1976, p.124).

According to the dominant view amongst policymakers, high inflation and the adoption of interest ceilings (imposed constitutionally at 12 per cent annually) hampered the development of the financial system to finance long-term investment as well as government deficits. Faced with an inflation rate that would not fall in the short term, the government constituted the monetary correction of the financial assets, that is, the indexation of financial assets to a price index. In 1964 Law 4357 introduced an indexed government bond – the Readjustable National Treasury Bond (ORTN, *Obrigações Reajustáveis do Tesouro Nacional*) – and the principle of monetary correction was extended to other financial assets, like debentures, exchange bills, housing bills and time deposits.[43] Initially, monetary correction was intended to be applied only to assets of one year or more, but pressures from banks also reduced in the inclusion of six-month assets.

Up until 1964 the Brazilian financial system was basically made up of four main institutions. At the bottom of the system there were the commercial banks and finance companies responsible for providing firms with working capital and credit for consumption. Second, there were the public commercial banks (Caixas Econômicas and Banco do Brasil) responsible for financing housing and agriculture. Third, there were the Banco do Brasil and BNDES, responsible for financing long-term and high scale investments. Despite the existence of the stock exchange markets in the main cities of the country, as in São Paulo (BOVESPA) and Rio de Janeiro (BVRJ), the capital markets had a very limited role in the Brazilian financial system. At the very top of the financial pyramid were the SUMOC (*Superintendence of Money and Credit*), responsible for the system of regulation, and the Banco do Brasil. As the former determined the system of regulation and policies, the latter had operational powers of a Central Bank (e.g., government's banker and lender of last resort of the financial system) as at the same time being a commercial bank. The SUMOC was supposed to be the Brazilian Central Bank, but the division of responsibilities with Banco do Brasil (and the commercial bank characteristics of it) many often rendered inconsistencies between the monetary and credit policies and also political wrangle between the two. The financial reforms of 1964-1966 also reorganised and created several organisations, inspired by the financial system of the United States.

[43] Monetary correction was also allowed to be applied to housing rents, taxes and firms' balance sheets, but not upon wages. Furthermore, the gains from monetary correction were exempt from taxation.

The banking system was reformulated by Law 4595, which came into force on 31st December, 1965. A National Monetary Council (CMN) was constituted to substitute the SUMOC and was placed in charge of setting the monetary, credit and exchange policies as well as was responsible for establishing the regulatory landmarks of the financial system.[44] The law also created the Banco Central do Brasil (Central Bank of Brazil, hereafter BACEN) to execute the policies and implement the regulations determined by the CMN and to assume the function of banker's bank and lender of last resort. The Banco do Brasil in turn lost part of its monetary authority functions but still remained the government's financial agent as well as a commercial bank. It also stayed in charge of the policies for rural credit and trade. With regard to the BNDE, Article 23 of Law 4595 stated vaguely that "the BNDE is the main instrument of execution of the investment policies of the Federal Government." Concretely, the government increased the resources of the BNDES with resources from the annual budget, money from monetary reserves in the BACEN and also from several other special public funds. In addition, returns on capital investments and foreign loans became the most important sources of the BNDES from the late 1960s onwards (Prochnik 1995).

Law 4380, passed on 21st August, 1964, created a complex system of financing for housing (SFH – *Sistema Financeiro da Habitação*). The law created a Housing Bank (BNH) for defining, coordinating and financing housing policies. The BNH also operated as a central bank of the financial institutions of the housing system, centralising the clearing mechanism, acting as lender of last resort and fully guaranteeing the housing bills issued by various savings and loans associations constitutive of the system. In 1966, the Law 5107 created a fund (FGTS – *Fundo de Garantia por Tempo de Serviço*), constituted of firms' deposits of 8 per cent over the payroll, which was earmarked for the BNH to finance its operations.[45] The institutions of the SFH were allowed to issue indexed bills to attract savings into the system once that the policymakers held that the constitutional ceilings on interest rates rendered a negative rate to the savers and hence repressed savings as inflation was usually over the maximum interest rate permitted by the "usury law."

[44] The law established as members of the CMN (*Conselho Monetário Nacional)*: the Treasury Minister, as president of the council; the Banco do Brasil's chairperson; the BNDE's chairperson; and six experts in economics and financial subjects nominated by the Brazilian President.
[45] The FGTS was created to replace job tenure. Workers could withdraw from their FGTS accounts when they were dismissed or retired, to buy a house or to establish their own business.

The constitution of investment banks carried the high hopes of the policymakers towards the financial system they were institutionalising. The reformers hoped that, like the system of the United States, the private investment banks could become the leading institutions in the long-term financing of the economy. Resolution 18 of BACEN, which regulated these institutions, established that they could issue long-term certificates of deposit and attract foreign loans in order to finance long-term investment projects. The investment banks' loans should be for periods longer than one year and could be indexed. Moreover, it was also expected that investment banks could have an important role in the development of stock exchange markets, as they would engage in underwriting and distribution of share and debenture operations.

To create a developed financial system in Brazil, policymakers not only attached great expectations to the stock exchange markets but also showered them with tax exemptions and credit incentives. Following this perspective, Law 4728 enacted on 14th July, 1965 brought few innovative regulations into the stock exchange markets but a package of fiscal incentives, in order to compensate for still-high inflation. It allowed, for instance, shareholders to gain rebates on income tax. Decree-Law 157 introduced further fiscal incentives allowing taxpayers to invest 5 per cent (individuals) and 10 per cent (firms) of their tax duties in investment funds. In 1970, the BACEN authorised that up to two thirds of these funds (*Fundos 157*) could purchase shares previously issued by firms registered for tax exemption. Firms also received several tax exemptions to launch shares in the stock exchange market, such as exemptions of taxes on yield distribution.

Finally, the changes in the financial system reserved special treatment for foreign capital. The military government managed right from the beginning of the regime to receive substantial financial support from the United States and the IMF for the balance of payments equilibrium, which had being one of the greatest problems for macroeconomic management and for economic growth in the early 1960s.[46] In this context, Law 4131, regulating profit remittances, which had been the source of many quarrels and tensions between Brazil and foreign investors, was amended in September, 1964, to ease relations with foreign capital. The amendment reduced the income tax on profit remittances and allowed reinvested profits to the calculus of the profits to be remitted. On the other hand, all

[46] According to Skidmore (1988, p.37), in 1964, the United States government committed U$228 million for Brazil; the USAID (United States Agency for International Development) some U$ 650 million; and the IMF another U$126 million. Altogether, those amounted to 1/3 of the total Brazilian external debt of that year.

the resources taken externally through Law 4131 should be registered in the BACEN, as the borrowers carried the risks of the loan. The BACEN guaranteed though the exchange cover of the transactions. Another fundamental change related to foreign capital was introduced by BACEN´s Resolution 63 in 1967, which was the equivalent of Law 4131 applied to the banking system. That is, through Resolution 63 national financial institutions could borrow resources from abroad, exchange with BACEN for the equivalent in *cruzeiros* and transfer them to their clients nationally. Like Law 4131 borrowers in Resolution 63 should carry over the risks of the loan, but BACEN guaranteed the exchange cover.[47]

To sum up, the reform of the financial system assumed that inflation hindered voluntary savings, repressed financial development and inhibited investment in productive projects. Besides the control of inflation itself, the introduction of indexed financial assets aimed at attracting savings for capital markets by offering positive interest rates for savers. Furthermore, the financial system was redesigned to provide the economy with private institutions for long-term financing, in particular in housing and investment banks. By the same token, a plethora of fiscal incentives was advanced to boost stock exchange markets. Finally, more open legislation was introduced with regard to foreign capital, allowing Brazil-based firms increasing access to external sources of funds, whether directly (Law 4131) or through the banking system (Resolution 63). The reforms sought to shift the long-term financing of the economy historically provided by government and its finance agents (Banco do Brasil and BNDE) to a system based upon private institutions, mainly investment banks and capital markets.

*Trade Policy*

During the period of the Target Plan the main tool for trade policy had been a system of multiple exchange rates that favoured imports or exports according to the needs of the industrialisation process and the programme of investment contained in the Plan. At the beginning of the 1960s the system of multiple exchange rates had been unified, but inflation still overvalued the rate. In 1965, the military policymakers sought to sort out the

[47] These were the main mechanisms by which firms and banks took international loans throughout the seventies up until the 1982 external debt. To give an idea of their importance, these mechanisms accounted for over 90 per cent of the capital inflows in 1972.

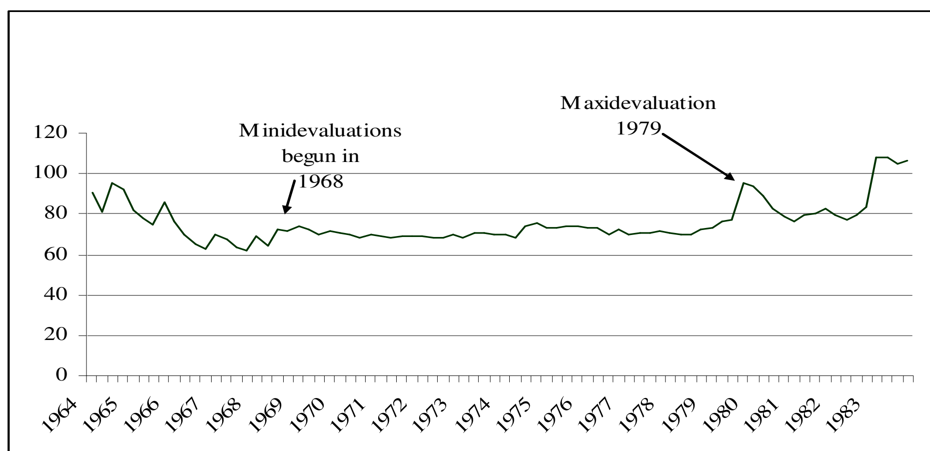
"anti-export" bias by introducing "realistic" exchange rates. This meant periodical devaluations in order to keep the real exchange rate constant. A real devaluated exchange rate was not intended because it would discourage imports and foreign capital inflow. The strategy proved to be insufficient to boost exports to the extent required in order to achieve balance of trade equilibrium. Furthermore, the time span between devaluations generated foreign currency speculations (Simonsen 1972, p.103).

In August 1968, under the second military government and with Antonio Delfim Netto heading the Ministry of Finance, the government devalued the cruzeiro and adopted a new devaluation policy. The latter consisted of mini-devaluations instead of quasi-yearly devaluations of the previous policymakers.[48] The objectives were to end both speculation with foreign currency, which happened with the devaluations, and real exchange appreciation, which happened after devaluations and discouraged exports. Despite the crawling peg (mini-devaluations) policy, the real exchange rate still held appreciated throughout the seventies, however somewhat tapered (see Figure 2 below).[49] Surprisingly enough, the performance of exports was rather remarkable in light of previous Brazilian experience. Throughout the 1967-1973 period exports grew at rates of 20.7 per cent per year compared with 4.6 per cent yearly over the previous six years. This was, in fact, 40 per cent more than total global growth of exports over 1967-1973. The staggering performance of exports stemmed from a remarkable volume of fiscal and credit incentives to exporters and the creation of a complex bureaucratic system of public entities to enact, coordinate, finance and enforce incentives to exporters.

[48] According to William Tyler's (1976, p.195) estimates, from August 1968 to August 1973 mini-devaluations occurred in an average span of 47 days.

[49] The appreciation of the real exchange rate was apparently not a deliberate government policy (Tyler 1976, p.202).

**Figure 2 Monthly Exchange Rates Index, 1964-1983 – Purchase Power Parity**




Source: Coes (1995).

Up until 1967 the single most important agency that coordinated the Brazilian export policy was the Banco do Brasil through its agency for foreign trade (CACEX – *Carteira de Comércio Exterior*). In 1966, the decisions regarding the coordination of export incentives were centralised in the hands of a National Council for Foreign Trade (CONCEX – *Conselho Nacional de Comércio Exterior*), as CACEX would still continue to be the main financial operator. This Council established a fund for financing exports and production of exports (FINEX), which would be administered by CACEX. Later on, in 1972, after having enacted a number of fiscal incentives and aiming to have a closer control of them, the Ministry of Finance created the Council for Concession of Fiscal Benefits for Special Programmes of Exports (BEFIEX – *Benefícios Fiscais a Programas Especiais de Exportação*). The BEFIEX entailed the signing of a contract between the firms and the government according to which firms should give detail of their exports commitments to have access to the fiscal and credit benefits.

The institutions mentioned above introduced and administrated several export and import fiscal incentives throughout 1964-1973. Law 4.502 of November 1964, for instance, exempted exports from the tax on industrial products (IPI). This exemption built-in also an additional incentive due to the peculiar way IPI operated. Producers could credit to their tax accounts the IPI paid when purchasing intermediaries goods. Later, when selling their goods, the IPI was paid again by the buyers and producers should deduce from the tax accounts the IPI received. In other words, the law exempted exporters from paying IPI as at the same time conceded exporters to credit to their tax accounts the tax subjacent to the

export transactions. Exporters could also enjoy exemption from the ICM, a privilege guaranteed by the Constitution of 1967. However, the exporters should pay for the ICM incident on prior stages of production. In 1970, the ICM exemption was extended to prior stages of production. In addition, exporters could gain rebates on income tax with promotion and marketing abroad as well as payments due to commission, interest and other financial expenditures. Furthermore, Law 5444 of May 1968 allowed a further tax credit, or rebate, of 50 per cent of the IPI on products exported. Moreover, the incentives for exports were not limited to fiscal exemptions and rebates but there also were three types of subsided credit lines: financing for export production, financing for exports, and financing for trade companies (merchandising and promotion). Table 6 below shows some of the mechanisms by which the public financial agents took the greatest responsibility in conceding credit for export sector, whether by financing production or commercialisation. In 1973, for instance, the loans concessions of the Banco do Brasil, CACEX and BACEN's rediscount for finance exports amounted to about 20 per cent of the total exports, as in 1969 it amounted to about 16 per cent. Furthermore, one should notice the highly subsided credit lines put in place, as interest rates were typically negative before rates of inflation around 20 per cent per year. The quantitative importance of these subsidies and incentives was calculated as 15 per cent in 1969 and 31 per cent in 1972 (Rodrik 1993).

**Table 6 Main Credit Lines for Export: Institutions and Characteristics of the Loan**

| | *Finance for Export Production* | *Finance For Export and Trade Companies* |
|---|---|---|
| Banco do Brasil | In 1964 the decree 54105 created a fund (FUNDECE) for financing up to 36 months with interest rates and monetary correction of 22 per cent year. | Operated a Fund for Financing Exports (FINEX) created in 1971 by the Resolution 68 of CONCEX. Interest rates maximum of 7.7 per cent year. |
| CACEX | Banco do Brasil's special agency for export finance. Credits of 36 months with interest rates of 18 per cent year. | |
| BNDE | Through a fund created in 1968 advanced credits for up to 48 months with interest rates of 12 per cent year. | |
| BACEN | Resolution 71 of Central Bank enacted a short-term credit finance (less than one year) for manufacturing exports, which were allocated through the commercial banks. The rates of interest were typically 8 per cent year. | Commercial Banks could rediscount loans advanced to trade companies. Interest rates of 12 per cent year. |

On the import side, from 1964 onwards the government sought to reduce costs of import, particularly production goods. Aside from the appreciated real exchange rates, in 1964 government had introduced a drawback regime that permitted duty-free (e.g., import

tax and IPI exemption) import of machinery, equipment, raw material and other intermediaries for manufactured projects whose produce was exported. Presumably, this mechanism was introduced to allow exportable producers eschew from high domestic costs and technologically lagged equipment supply. However, in 1966 only about 0.3 per cent of the Brazilian equipment imports were made through drawback facilities.[50]

**Table 7 Effective Tariff Rates by Sector (%), 1958-1984**

| | *1958* | *1963* | *1966*[1] | *1973* | *1980* | *1984* |
|---|---|---|---|---|---|---|
| **Agriculture** | - | - | 53.0 | 34.0 | 53.8 | 57.3 |
| **Industry** | 106.1 | 183.5 | 103.5 | 47.0 | 99.4 | 90.0 |
| Consumer Goods | 242.0 | 359.9 | 230.1 | 67.0 | - | - |
| Intermediates | 64.9 | 130.6 | 68.0 | 36.0 | - | - |
| Capital Goods | 53.0 | 112.5 | 69.1 | 40.0 | - | - |

Sources: Donald Coes (1991:33), Table 3.9 for figures from 1958 to 1966. Coes' estimate is adjusted by exchange rates. Braga and Tyler (1992, p.340-341), for figures from 1966 to 1984.
1 - Average of Coes' and Braga and Tyler's estimate.

Given the poor performance of drawbacks, the tariff system was reformulated in 1966 presenting a considerable amount of tariff reduction, especially in production goods (see Table 7). Accordingly, in 1973 the effective tariff rates, which measure the weight of tariffs effectively paid to imports value, had been reduced by over 100 per cent. Comparatively, this was not as lower as tariffs in developed countries, but was reasonably amongst the average of the developing countries.[51] Further incentives to import production goods were introduced when the Decree-Law 1236 of August of 1972 exempted from import tax (II – *Imposto de Importação*) and IPI imports complete plants already operating in other countries without submitting to prove compliance to similar law, as long as their production was essentially destined to exports. Doubtless, the latter favoured foreign investors and had implicit incentives to import of used equipment.

Despite the free trade rhetoric of Brazilian policymakers the military government introduced a plethora of interventionist institutions and government controls which involved since the administration of exchange rates, to constitution of regulatory agencies,

[50] Drawback import information from Tyler (1976, p.215) and equipment import for 1970 from the IBGE.
[51] In UK, effective tariff rates were measured as 8.2 per cent for machinery and transport equipment; 11 per cent for intermediate goods and 8.8 per cent for finished goods in 1972 (Greenaway 1992, p.206). Effective tariff rate for manufacturing products was 54.2 per cent in Spain 1966 (Dehesa 1992, p.314); and 11.9 per cent in German 1970 (Weiss 1992, p.136); 30 per cent in Japan 1962; 20 per cent in the United States 1962; 168 per cent in Argentina 1958; 182 per cent in Chile 1961; 313 per cent in India 1961; 27 per cent in Mexico 1960; 8 per cent in Malaya 1965; 33 per cent in Taiwan 1965; 271 per cent in Pakistan 1964; and 61 per cent in Philippines 1965 (Tyler 1976, p.245).

to a diversified pool of fiscal and credit incentives to boost exports. This government commitment to export growth and diversification paid off. Along with the already mentioned astonishing performance of exports their diversification is also noteworthy, whether with regard to the products themselves or the range of destinations. As Table 8 shows, the composition of Brazilian exports changed rapidly from primary goods to manufactured goods in substitution to the traditional coffee and non-coffee exports (sugar, cocoa, cotton etc). Moreover, there was diversification also of regional markets to where Brazil used to export, as United States lost position to the European and Asian markets.

This successful manufacturing export growth clearly vindicated the Brazilian development model implemented since the 1930s, the so-called import substitution model. It was believed by the critics of the Brazilian model that the industries implemented under the import substitution strategy were inefficient and uncompetitive. It is somewhat obvious, but not always recognised by the critics of the Brazilian development, that the extroversion of industrial production in the 1970s was only possible because the import substitution industrialisation had already introduced and established industrial production in the first place. As Hirschman (1968, p.26) put it: "It would therefore be unrealistic to expect an industry to become an exporter before it has truly taken root in the country through a variety of the more obvious backward linkage investments." In addition, to embark on riskier investments such as those which involved the conquering of markets abroad, the industrialist must have greater support from the government. Despite the free market leaning of policymakers, the trade reform of military regime was not a fully-fledged liberalisation, leaving the exchange rates bearing the burden of the adjustments. Policymakers opted for the full commitment of the government with the outward strategy by engaging in more fundamental changes in the structure of incentives and demanded more structured commitment of firms to exports.

**Table 8 Distribution of Brazilian Exports by Products and Regions – Percentage of Total Exports, 1967-1973**

| | *1967* | *1968* | *1969* | *1970* | *1971* | *1972* | *1973* |
|---|---|---|---|---|---|---|---|
| **Exports (U$Million)** | 1654 | 1881 | 2311 | 2739 | 2904 | 3991 | 6199 |
| **Products** | | | | | | | |
| Coffee | 42.6 | 41.2 | 35.2 | 34.3 | 26.6 | 24.8 | 21.7 |
| Non-coffee Traditional | 21.3 | 22.6 | 24.8 | 18.5 | 17.1 | 18.3 | - |
| Non-traditional Primary | 19.5 | 21.7 | 24.2 | 26.1 | 33.2 | 34.7 | - |
| Mining | 8.0 | 7.6 | 8.0 | 9.8 | 10.3 | 7.1 | 8.3 |
| Manufactured | 8.6 | 6.9 | 7.8 | 11.2 | 12.7 | 15.5 | 23.1 |
| **Main Partners** | | | | | | | |
| United States | 33.2 | 33.3 | 26.4 | 24.7 | 26.2 | 23.3 | 18.1 |
| EEC[1] | 27.3 | 25.5 | 29.7 | 28.1 | 27.3 | 28.3 | 37.1 |
| LAFTA[2] | 9.3 | 10.3 | 11.0 | 11.1 | 12.2 | 10.2 | 9.0 |
| Socialist Bloc[3] | 5.9 | 6.4 | 5.5 | 4.5 | 4.4 | 5.4 | 5.5 |
| Asia and Oceania | 4.4 | 4.4 | 7.3 | 8.4 | 7.9 | 9.5 | 11.1 |
| Rest of the World | 19.9 | 20.1 | 20.1 | 23.2 | 22 | 23.3 | 19.2 |

Sources: Tyler (1976, p.123); Banco Central do Brasil.
1 – European Economic Community: Federal Republic of Germany, Belgium-Luxemburg, Denmark, France, Ireland, Italy, Netherlands, United Kingdom.
2 – Latin American Free Trade Association: Argentina, Mexico, Paraguay, Uruguay, Venezuela, Bolivia, Chile, Colombia, Ecuador, Peru.
3 – East Germany, Bulgaria, Hungary, Poland, Rumania, Czechoslovakia, Soviet Union.

## The "Economic Miracle" and the Model of Accumulation

According to policymakers the economic reforms they were putting in place sought to inaugurate a new model of economic growth in Brazil, based on exports (the outward-looking strategy) and private investment with private financing (market-led) instead of the import substitution and state-led Target Plan. The government in turn should retreat from interfering with market prices and concentrate only on its classical functions of providing defence, policing, education and general infrastructure (energy, transports and communication).[52] Economic growth would resume based upon market forces, with an open and inflation-free economy. Thus far, however, it described the economic engineering the military governments got involved in since 1964, which involved bureaucracy-building, fiscal and credit subsidies and even the institution of indexation. As Peter Evans (1979, pp.93-94) put it, the military regime "was a case of espousing liberal free enterprise while acting to increase vastly the economic role of the state, both regulatory and entrepreneurial." And it paid off abundantly.

[52] These objectives were not only in the speeches of policymakers but they had also been declared as public policies in public documents. See, for instance, Resende (1990, p.199) and Lago (1990, p.236) for reproduction of official documents of the period.

**Table 9 Industry: Sectoral Rates of Annual Real Growth, 1966-1973**

| | *1966* | *1967* | *1968* | *1969* | *1970* | *1971* | *1972* | *1973* | *Average Rates of Annual Growth* | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | 1966-1967 | 1968-1973 |
| **Consumption Goods** | 6.1 | 3.6 | 12.5 | 12.9 | 9.2 | 12.4 | 13.2 | 11.5 | 4.8 | 11.9 |
| Durable | 17.1 | 9.7 | 27.0 | 33.7 | 6.0 | 34.4 | 23.5 | 18.9 | 13.4 | 23.6 |
| Transport | 16.2 | 10.0 | 22.2 | 46.8 | 5.6 | 38.8 | 21.3 | 13.9 | 13.1 | 24.0 |
| Electric and Electronic | 18.5 | 9.4 | 36.2 | 11.2 | 7.2 | 24.5 | 28.9 | 30.6 | 13.9 | 22.6 |
| Non-Durable | 4.5 | 2.7 | 10.3 | 9.2 | 9.8 | 7.7 | 10.5 | 6.0 | 3.6 | 9.4 |
| **Production Goods** | 19.8 | -0.6 | 21.9 | 7.9 | 11.7 | 10.4 | 16.5 | 20.2 | 9.1 | 14.7 |
| Capital | 15.5 | -5.4 | 25.1 | 3.3 | 13.5 | 12.7 | 20.9 | 35.6 | 4.5 | 18.1 |
| Intermediate | 21.3 | 1.2 | 20.7 | 9.6 | 11.1 | 9.7 | 15.0 | 14.9 | 10.8 | 13.5 |
| **Industry Total** | 12.4 | 1.6 | 16.9 | 10.5 | 10.4 | 11.4 | 14.8 | 15.8 | 6.8 | 13.3 |

Source: Bonelli and Werneck (1978, p.176).

After a period of recession and "stop-and-go" between 1964 and 1967, from 1968 to 1973 the economy experienced its highest rates of real income growth and real per capita income growth ever recorded in Brazilian history. The average rate of income growth of the period reached 11 per cent per year, with over 8 per cent growth of capita rate income. The industrial growth was staggering. The rates of consumer goods growth, which had been around 5 per cent in 1965-1967 increased to over 11 per cent in the 1967-1970 period. Durable consumer goods led the consumer goods sector, growing at over 13 per cent between 1965 and 1967 and over 21 per cent between 1967 and 1970. The non-durable consumer goods performed clearly below the industry as a whole. Over time, as the growth of demand eliminated idle capacity and the pace of investment increased, the sector of capital goods accelerated its rate of production.

The striking growth of durable consumer goods expressed the options taken by policymakers with respect to income distribution and credit availability. Accordingly, the fiscal and wage policies implemented were designed to discriminate against low income earners, as high income earners were to be privileged for saving more out of their incomes. In practical terms, as mentioned earlier, while other contracts (e.g., financial, rents and so on) were allowed monetary correction (indexation), minimum wages were constantly readjusted by a factor less than inflation (see next section).[53] As a result, the real minimum

[53] Firms' balance sheet should also present monetary correction. So, many firms could rebate income tax reporting losses after monetary correction. Before the introduction of the balance sheet indexation firms should pay taxes upon profits according to monetary profits without monetary correction.

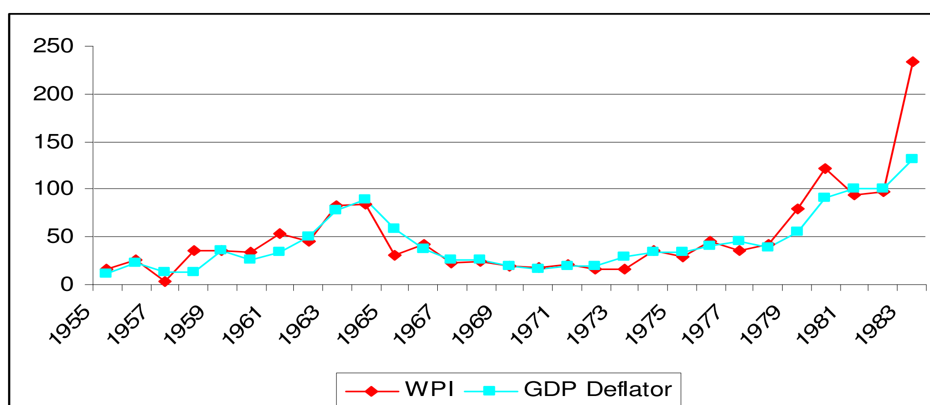
wage dropped steadily from 1964 up to 1968 and then kept almost constant throughout the "economic miracle." On the other hand, the so-called "white collar" workers benefited from the economic boom, as industrial salaries increased steadily, roughly at the same rate as productivity from 1964 onwards (see Figure 3 below). On the other hand, the financial reforms in turn stimulated the private banking system to expand credit to consumers. Thus, an important part of the durable consumer goods boom can also be traced directly back to the incentives implemented by the financial reforms, particularly to the introduction of monetary correction (indexed bills of exchange, bonds etc) and the mechanisms of foreign capital attraction (Resolution 63 and Law 4131).

Without doubt, the far-reaching amount of reforms played a crucial mundane role in achieving such a "miracle." However, the "miracle" was far from being a result of the invisible operation of unfettered market forces, just as the reforms centralised power and enhanced the coordination of the economy in the hands of the state. It also represented an increasing integration of the domestic economy with the outside economy, mainly through financial channels. In the sequence, it presents this increasing government control of economic variables that resulted in the "economic miracle" but also marked permanently the long-term development of the economy.

### The Political Economy of the Stabilisation Policy

To curb inflation, the policymakers of the first military government introduced a conventional package composed of: a) reductions of government deficits; b) control of monetary supply; and c) wages readjustment following inflation and productivity. The plan did not achieve the initial objectives – 10 per cent in 1966 – having, nonetheless, reduced inflation from 89.9 per cent in 1964 to 37.9 per cent in 1966 and 26.5 per cent in 1967. Furthermore, Figure 3 below shows a steady drop in inflation rates throughout the economic miracle. By Brazilian standards the period was one of great success in controlling price rises. Which aspects of the anti-inflation policies actually halted inflation?

**Figure 3 Annual Inflation Rates: Wholesale Price Index and GDP Deflator (%), 1955-1983**




Source: Ipeadata.

It is hard to find the reason for the falling inflation rates after 1964, and throughout the "economic miracle", in monetary control. Table 10 shows that, perhaps with the exception of 1966, the money supply cannot bear responsibility for the reduction in inflation, as monetary aggregate had been quite expansive. From 1967 onwards the means of payment kept growing well beyond the growth in prices. The explanation for the declining rates of inflation amidst a strong economic growth and monetary expansion must be found elsewhere.

**Table 10 Monetary Aggregates and Inflation Indexes**

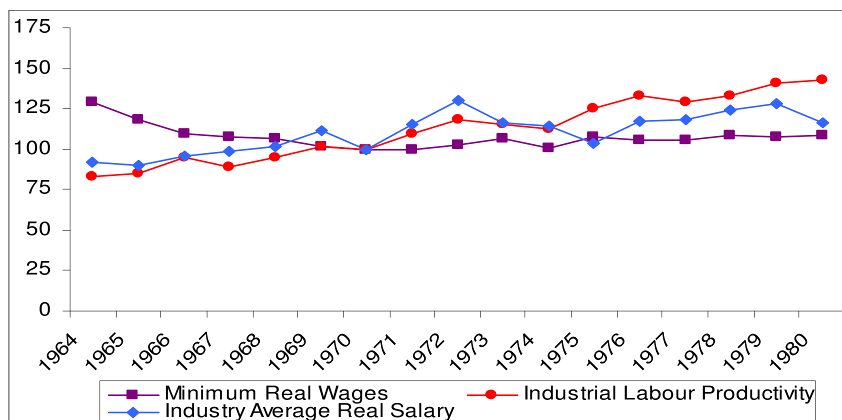
| | *Money Base (Δ%)* | *M1 (Δ%)* | *M2 (Δ%)* | *WPI (%)* | *GDP Deflator (%)* |
|---|---|---|---|---|---|
| 1960-1963[1] | 58.7 | 55.0 | - | 53.7 | 47.2 |
| 1964 | 78.5 | 81.6 | 81.2 | 93.2 | 89.9 |
| 1965 | 72.7 | 79.5 | 79.0 | 28.3 | 58.2 |
| 1966 | 23.1 | 13.8 | 14.1 | 37.4 | 37.9 |
| 1967 | 30.8 | 45.7 | 47.0 | 22.5 | 26.5 |
| 1968 | 42.0 | 39.0 | 40.4 | 25.0 | 26.7 |
| 1969 | 28.7 | 32.5 | 30.8 | 21.8 | 20.1 |
| 1970 | 16.9 | 25.7 | 27.3 | 19.4 | 16.4 |
| 1971 | 36.3 | 32.3 | 53.0 | 20.0 | 19.4 |
| 1972 | 18.5 | 38.3 | 45.5 | 17.8 | 19.9 |
| 1973 | 47.1 | 47.0 | 48.1 | 16.7 | 29.6 |

Sources: IBGE. For Deflator; M1; M2.
Ipeadata. For Wholesale Price Index (WPI).
Banco Central do Brasil. For Money Base.
1 - Average.

In 1964 the stabilisation programme of the first military government introduced a mathematical formula for minimum wage adjustment, which determined that the minimum wage was readjusted by a factor considering productivity and half of one year forecasted

inflation rate. This formula – created by Mario H. Simonsen – implied a readjust of the minimum wage of 2/3 of the increase of productivity. That is, 1/3 of the productivity was not incorporated into the minimum wage, not mention possible errors of inflation forecasting (Simonsen and Campos 1976, p.111). Figure 4 below shows the relative movements of minimum wages, industrial wages and industrial productivity indices taking 1970 as the base year. Accordingly, it suggests that inflation was reduced by imposing minimum wage rises that were repeatedly below the growth of productivity. As a result, the new policy for the minimum wage reduced the wage by 8.3 per cent in actual terms in 1965 and another 7 per cent in 1966. As Mario Henrique Simonsen (1976, p.112) asserted: "the wage readjustment formula has represented one of the main stakes of the Brazilian policy to curb inflation."

**Figure 4 Relative Indices of Minimum Wage, Industrial Salary and Industrial Labour Productivity (1970 = 100)**



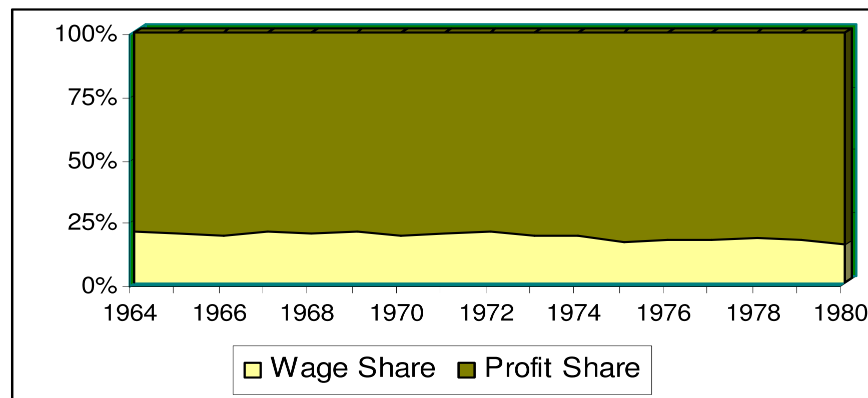

Source: IBGE.

A second element in the control of inflation in this period was the administrative control of price changes introduced by the government. A resumption of inflation late in 1966 together with the poor performance of the economy prompted a shift in the head of Finance Ministry. Antonio Delfim Netto, the new Finance Minister, adopted a "cost-push" inflation perspective. Delfim Netto basically kept the wage policies bequeathed from 1964 and set up an Inter-ministerial Price Council (CIP-*Comissão Interministerial de Preços*), closely controlled by himself, which became responsible for looking at price adjustments and even issuing price lists for some administered prices. The CIP, which also included the Planning Ministry, Commerce and Industry Ministries, had substantial power, as firms whose price

increases had not been allowed by CIP could face prohibitions to have access to subsided loans from financial public institutions.

From a long-term perspective, however, the wage policy had strong impacts upon income redistribution as the productivity gains tended to benefit profit earners. Indicators of personal income distribution such as the Gini Index worsened in 1970 when compared with 1960 (Fishlow 1972). An alternative measure for income distribution is shown in Figure 5 below. These figures relate wages paid in the industry with the industrial value added. Looking at from the income point of view, the value added is composed by wages and profits, in order that these figures show the functional income distribution, with profits being the difference of value added to wages share. It shows a striking income concentration favouring profits which became worse throughout the economic miracle and the 1970s. Whilst industrial workers gained only about 23.5 per cent of the industrial value added in 1964, their share fell to about 23.2 per cent in 1973 and decreased further to about 19 per cent in 1980.

**Figure 5 Income Distribution of Industrial Value Added: Wages and Profits, 1964-1980**




Source: IBGE.

That income concentration seemed to be a deliberate and desired result of the wage policies adopted not merely as an anti-inflation policy but also because it permitted accumulation of profits. In other words, as profit earners save more than wage earners, the income policy favoured a distribution towards profit that would be used for investment purposes by firms. The dominant view amongst policymakers towards income distribution was voiced by Mario H. Simonsen (1972, p.56): "economic development, at certain stage, involves some differentiation [of income] that results in an increase in the degree of income concentration." He then reasoned that in a boom there is "a natural growth of profits of

firms and, consequently, a rise in entrepreneurs' and managers' income," which was very functional in order to "transfer resources from those with greater propensity to consume towards those with greater propensity to save."[54]

For certain, in a democratic society one could hardly impose such a wage formula without provoking disputes. The suppression of competition in industrial relations implemented by the policymakers – despite their verbal defence of free-market system – was seen as something of an advantage by them. As Simonsen (1976, p.112) put it:

> "…there is a remarkable advantage of creating an arbitrary fashion for wage negotiations. The greatest problem of those negotiations in the modern world, including the wage determination by government decision, is that they are forcefully affected by political power of trade unions and employer syndicates, by electoral criteria and many other factors well far from any economic theorem of efficiency. A formula like that has the advantage of substituting a simple calculus for an infinite number of strikes and pressure games."

It seems that the impressive economic growth and hence productivity growth of the period, along with policies favouring profit accumulation, might have placated potential entrepreneurial protests against price controls. For workers, however, reaction against the wage policy was impossible as the political repression of trade unions and social movements was at its height by the late 1960s.

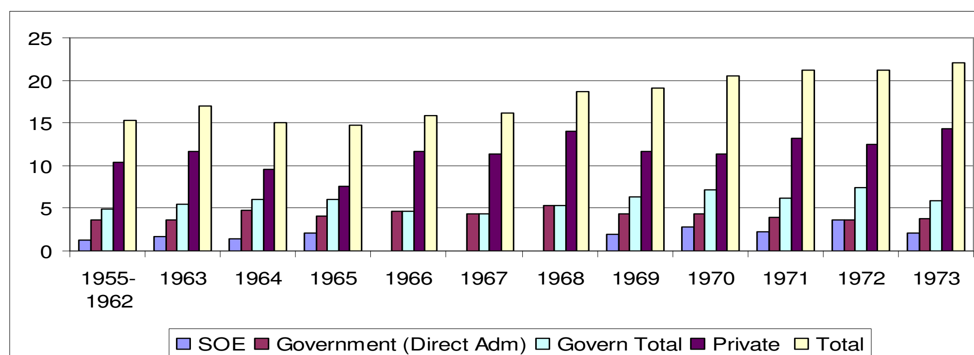
### The Growth of State Entrepreneurship

During the "economic miracle" the investment rates recovered from their dormant stance since the end of the Target Plan (see Figure 6). Investments as a percentage of GDP increased progressively between 1967 and 1973, achieving a peak of 23 per cent in 1973. The economic liberalism of the policymakers which commanded the economy over 1964-1967 clearly clashed with the military project of building a powerful national economy. Between 1964 and 1967 the government reduced its total investment as a percentage of the GDP from 6.1 per cent in 1964 to 4.4 per cent in 1966, as a result of the austere economic policies of the period. These policies were followed by a disastrous economic performance which culminated with in a fall of private investments and discredited the economic liberalism. It was quite clear by then that an economic recovery would only come about if

[54] See also Roberto Campos (1974, pp.77-78).

the strategic sectors commanded by the state-owned enterprises were contemplated with massive investments. It happened so when the government began to increase its investments consistently from 1967 onwards, which went from 4.3 per cent of GDP in 1966 to 7.6 per cent of GDP in 1972. The private sector in turn followed suit just after 1970, as evidence of the multiplier effects of the public investments.

**Figure 6: Rate of Investment as Percentage of GDP (%), 1955-1973**




Source: IBGE.
* There is no available data for SOE's investments for the period 1966-1968.

The government investments had historically been oriented to sectors providing infrastructure (e.g., roads and communications) and basic industrial inputs (e.g., petrochemical and steel) (see Table 11). So the presence of public enterprises was important in sectors with high downstream industrial linkages and in which the efficient scale of production was capital intensive. Therefore, the government investments produced significant externalities to the Brazilian economy as a whole in order that the state-owned enterprises were placed at the verge of channels of communication between the various productive sectors and markets.

**Table 11 Sectoral Allocation of Public Enterprise Investment (%), 1947-1979**

| | *1947* | *1956* | *1965* | *1966-1969* | *1970-1975* | *1976-1979* |
|---|---|---|---|---|---|---|
| Steel | 34 | 16 | 46 | 4 | 9 | 13 |
| Mining | 10 | 8 | 6 | 4 | 6 | 4 |
| Petroleum and Petrochemical | 1 | 52 | 20 | 19 | 21 | 23 |
| Telecommunications | - | - | - | 6 | 9 | 10 |
| Electrical energy | - | 5 | 13 | 55 | 43 | 40 |
| Railroads | 39 | 12 | 10 | 12 | 12 | 10 |
| Not classified | 16 | 7 | 5 | - | - | - |
| Total | 100 | 100 | 100 | 100 | 100 | 100 |

Source: Trebat (1983, p.120).

The growing influence of state-owned enterprises came not only through the investment of old public enterprises but also through the creation of many new companies. Thomas J. Trebat (1983, p.48) counted the creation of as many as 231 state enterprises between 1968 and 1974, most of them (175) in public utilities, with 107 in electricity, gas, water and communications. According to Trebat (1983, p.49), this expansion of "state ownership also derived from growth in scale and national expansion of monopolies in electricity and telecommunications and other infrastructure areas in which neither the Brazilian private sector nor foreign investment had much interest." Moreover, the data available on the productivity of state-owned enterprises contrast outright with the neoliberal story. According to Trebat's (1983, p.163) estimate the labour productivity of state enterprises increased sharply by about 15 per cent per year between 1966 and 1975 against 11 per cent in manufacturing sector for the same period. Therefore, as a provider of the fundamental inputs and infrastructure for the industrial accumulation, the state enterprises investment and production acted to eliminate or to smooth bottlenecks for industrial growth in a very efficient way.

The state-owned enterprise investments proved as productive for themselves as they were lucrative to the private sector. In a study carried out with 3,790 largest firms in Brazil, Alvaro A. Zini (1984) reported the financial performance of Brazilian firms according to capital ownership. Zini's (1984, p.98) figures show that the rate of profits (net profits/net assets) of private national firms went from 14.9 per cent in 1969 to 16.8 per cent in 1972; foreign firms from 13.8 per cent to 16.2 per cent and the state enterprises from 6.9 per cent to 9.5 per cent for the same period. Peter Evans (1979, p.223) also reported figures showing that the state enterprises' rate of return fell behind foreign firms. Accordingly, in a sample of the 5 largest state enterprises, the rate of return between 1967 and 1973 was 10.8 per cent, against that of the foreign companies' (in a sample of ten selected companies), which was 16 per cent. These figures support the claim that state enterprise investments had great positive linkage effects over the private sector. On the one hand, state enterprises investments acted counter-cyclically for increasing effective demand for industrial production; on the other, the state enterprises' output provided fundamental infrastructure and basic inputs needed by industrial accumulation.

Another longstanding feature of Brazilian development reinforced by the "economic miracle" was the leading position enjoyed by foreign firms in relation to national firms.

Table 12 shows the assets share of private national, foreign, and state enterprises amongst the 300 largest manufacture companies operating in Brazil in the period of the "miracle." Accordingly, it supports the identification of state enterprises and foreign firms as the main dynamic poles of the economy during the analysed period, yet with the state enterprises leading the process. The shares of state in the total assets almost doubled, followed in importance by international firms. Private national firms in turn clearly lost share to state enterprises.

**Table 12 Growth of Manufacturing Firms Amongst the 300 Largest (Percent of Assets)**

| *Selected Sectors* | *1966* | | | *1972* | | |
|---|---|---|---|---|---|---|
| | Foreign | Private Local | State | Foreign | Private Local | State |
| Iron and Steel | 4 | 34 | 62 | 15 | 16 | 70 |
| Chemicals | 69 | 24 | 7 | 69 | 19 | 12 |
| Petroleum (refining and distribution) | 25 | 11 | 64 | 12 | 6 | 82 |
| Total for all manufacturing (excluding petroleum) | 51 | 41 | 8 | 50 | 35 | 15 |
| Total share including petroleum | 47 | 36 | 17 | 42 | 28 | 30 |

Source: Evans (1977, p.222).

In this connection, Maria da Conceição Tavares (1977, p.177), in a chapter co-authored by José Serra, asserted that:

> "there also exists a greater organic solidarity between the State and the international capital, since both dominate the investment and production of main dynamic sectors without important contradictions between them with respect to decision-making...
> In the actual stage of the development of the capitalist economy, the Brazilian State has no, contrary to what happened in the past, major commitments with the so-called 'national' bourgeoisie or with populist schemes…Therefore, the development of an increasing solidarity between both [international and state capital] in the investment and production of the so-called strategic sectors was possible: petrochemical, mining, steel, electricity, transports and communications.
> In this division of labour the State is, in general, in charge of the heavier responsibilities, that is, to provide the domestic market with low cost basic inputs and with external economies in order for international firms to expand domestically and even to export, exploring opportunities of foreign trade that it can control by itself" (pp.177-179).

The entrepreneurial role played by the Brazilian government through its enterprises had a remarkable influence on private investments and the staggering performance of investment during the "miracle." In the recovery, state investments increased private profitability while government orders used up idle capacity, which had been raised during

the period of stabilising policies and recession. Furthermore, although the state enterprises' price policies had followed the principle of "realistic" tariffs, there are signs that it did not seem to hurt the most dynamic private sectors, as the high profitability indicates. This could be either because the rate of growth compensated for public rising prices or because the private sector enjoyed subsidised prices and decreasing wage costs. Beyond the big push that was initiated by the state enterprises investments, the private sector still enjoyed numerous fiscal and credit incentives. For the foreign capital, the government not only extended all fiscal and credit incentives but also offered a much more friendly policy of profit remittances.

**The Government as a Financier**

The financial reforms of 1964-1966 explicitly sought to develop a private financial system to finance long-term investments to substitute the state in the provision of finance. As Table 13 below shows, as a result of the financial reforms there was actually a staggering increase in and diversification of the financial assets, that is, there happened a "deepening" of the financial system took place. Notably, monetary assets gave rise to new non-monetary financial assets expressing the emergence of new financial intermediaries. In addition, policymakers would have that the inflationary financing of government deficits gave rise to finance based upon savings, as the reforms constituted a considerable market for government bonds.[55] Furthermore, as Table 14 below shows, the amount of credit provided by private financial system accounted for over 50 per cent of all credit advanced to the economy. After the financial reforms, firms and consumers had a more diversified financial system for obtaining external finance.

[55] One can compare the Brazilian market for government bonds with the United States. From 1966 to 1973, the United States government bonds accounted for about 10 per cent of the total financial assets (Tavares 1983, p.115). However, the growth of the public bonds was in reality an attempt to control the increasing liquidity stemming from the flood of capital inflows. The next chapter deals more with that issue.

**Table 13 Composition of Monetary and Non-Monetary Financial Assets (%), 1966-1973**

| | *1966* | *1967* | *1968* | *1969* | *1970* | *1971* | *1972* | *1973* |
|---|---|---|---|---|---|---|---|---|
| **Monetary Assets** | 79.4 | 73.0 | 66.9 | 63.5 | 56.8 | 49.6 | 45.0 | 43.6 |
| Currency | 17.8 | 13.9 | 12.8 | 12.1 | 10.8 | 9.2 | 8.1 | 7.6 |
| Demand Deposits | 61.6 | 59.0 | 54.1 | 51.4 | 46.1 | 40.5 | 36.9 | 36.0 |
| **Non-Monetary Assets** | 20.6 | 27.0 | 33.1 | 36.5 | 43.2 | 50.4 | 55.0 | 56.4 |
| Savings Deposits | 0.1 | 0.4 | 1.0 | 2.0 | 3.3 | 4.0 | 5.4 | 6.6 |
| Time Deposits | 2.4 | 3.3 | 4.6 | 4.7 | 7.1 | 10.2 | 12.0 | 12.0 |
| Indexed | 1.1 | 1.8 | 2.0 | 1.9 | 2.4 | 3.8 | 4.5 | 3.6 |
| Non-Indexed | 1.3 | 1.1 | 1.2 | 0.4 | 0.3 | 0.2 | 0.2 | 0.1 |
| Bills of Exchange | 6.9 | 10.4 | 15.6 | 16.3 | 16.6 | 22.4 | 22.8 | 25.3 |
| Housing Bonds | 0.4 | 1.4 | 2.0 | 2.7 | 3.2 | 3.4 | 3.5 | 3.0 |
| Federal Bonds | 10.9 | 11.9 | 11.1 | 13.2 | 16.2 | 16.6 | 18.5 | 17.8 |
| **Total** | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |

Source: Banco Central do Brasil.
* In Current values.

However, the government attempt to create a private financial system that could provide long-term finance for the private sector fell well short of the expectations. Although the private financial system showed great interest to finance consumption of durable consumer goods and working capital for firms it was much more conservative in respect to financing the long-term investments. Bills of exchange became the most important source of credit after banking operations. Finance companies issued bills of exchange to finance consumption of durable goods, mostly directed to household acquisitions of automobiles. Investment banks in turn increased rapidly its operations as they accounted for the greatest part of the total time deposits, received transfers from public funds (coming from the BNDES), and could borrow abroad through Resolution 63. They also issued bills of exchange to finance working capital loans instead of the long-term investment as policymakers expected. Commercial banks, whose main source of resources was demand deposits and time deposits, also concentrated on working capital finances and government bonds. In a nutshell, despite all the incentives and favours (including real interest rates by indexing financial assets) and the creation of special institutions (investment banks) to finance long-term investments, the Brazilian banking system maintained its operations mostly concentrated upon short-term finance. They preferred, and the government conceded, to keep flexible and anchored in indexed public and private bonds.

Nowhere was the failure of the financial reforms to transform private financial system in order to constitute a capital market for financing long-term investment more evident than in

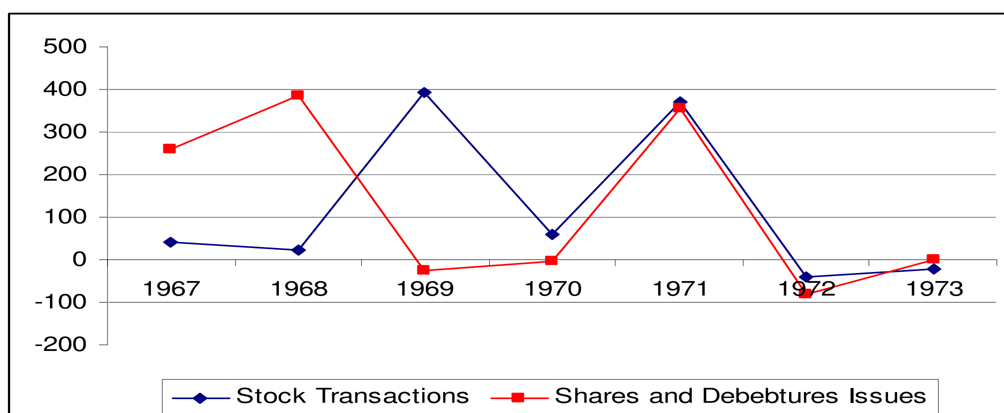
the stock exchange markets. Despite the fiscal subsidies increasingly conceded by the government, stock exchange markets showed too much instability and leaning towards speculation to become an important source of finance for industrial investments. As Figure 7 below shows, the two main stock markets, São Paulo (BOVESPA) and Rio de Janeiro (BVRJ), saw a striking growth in transactions soon after the first package of fiscal incentives came about with the financial reforms. In August, 1969, however, market transactions decreased briskly, forcing the enthusiastic government to enact a second package of fiscal incentives. The stock markets underwent another speculative boom only perceived when they burst again, now more vigorously than before, in 1971. Since then it would never reach the transactions amount of the previous periods. What is more, regardless all the excitement with the stock markets amongst policymakers and dealers, even in their greatest moments, primary issuing never represented much of the total capital formation. For instance, in 1970 the value of outstanding bill of exchange was twice the amount of transactions with stock exchange in the stock exchange markets of Rio de Janeiro and São Paulo together (Tavares 1977, p. 231). In short, stock exchange markets proved to be too thin to lure big foreign and state enterprises and, at the same time, too risky to rather ancillary and familiar controlled national private firms.

**Table 14 Financial System: Main Sources of Loans to Private Sector (% of Total), 1966-1972**

| | *1966* | *1967* | *1968* | *1969* | *1970* | *1971* | *1972* |
|---|---|---|---|---|---|---|---|
| **Investment Finance** | 23.9 | 24.6 | 23.3 | 27.0 | 28.4 | 28.7 | 28.7 |
| BNDE | 8.3 | 6.3 | 4.2 | 4.8 | 4.6 | 5.0 | 5.0 |
| FINAME[1] | 0.8 | 0.9 | 1.0 | 0.9 | 1.0 | 1.0 | 1.0 |
| Investment Banks | 0.1 | 0.1 | 0.2 | 0.5 | 0.6 | 0.5 | 0.5 |
| Banco do Brasil | 5.1 | 4.7 | 4.8 | 4.5 | 4.8 | 4.7 | 4.7 |
| BNH | 8.0 | 11.1 | 10.8 | 14.2 | 15.6 | 15.0 | 15.0 |
| Other | 1.6 | 1.5 | 2.4 | 2.1 | 1.8 | 2.7 | 2.7 |
| **Working Capital Finance and other** | 76.1 | 75.4 | 76.7 | 73.0 | 71.6 | 71.3 | 71.3 |
| Finance Companies | 9.1 | 12.3 | 10.4 | 12.2 | 12.1 | 12.9 | 12.9 |
| Commercial Banks | 47.4 | 42.5 | 38.8 | 34.9 | 33.3 | 31.1 | 31.1 |
| CEF | - | - | - | 2.2 | 2.2 | 2.3 | 2.3 |
| Banco do Brasil | 15.5 | 15.4 | 16.2 | 14.3 | 12.9 | 11.4 | 11.4 |
| Investment Banks | 3.9 | 5.0 | 7.5 | 7.8 | 8.7 | 11.5 | 11.5 |
| Other | 0.2 | 0.2 | 1.6 | 1.7 | 2.4 | 2.2 | 2.2 |
| **Total (A + B)** | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| **Annual Growth** (Δ%)[2] | - | 32.5 | 35.0 | 21.0 | 28.5 | 26.5 | 32.5 |

Sources: Banco Central do Brasil. * Balance at the end of the period.
1 - Created as a BNDE's fund in 1964 (Decree 55275). Transformed into a public enterprise subsidiary of BNDE in 1971 (Law 5662).
2 - Real rates. Values deflated by GDP deflator.

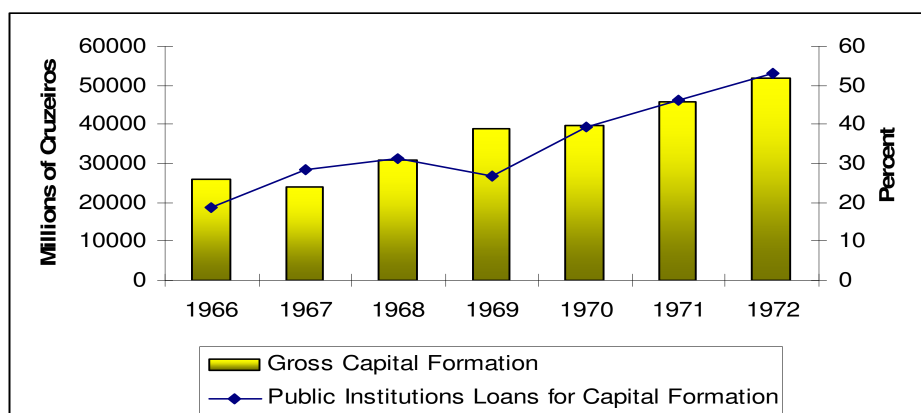
**Figure 7 Stock Markets: Transactions and Shares and Debentures Issues (Δ% Yearly), 1967-1973**




Source: Banco Central do Brasil.

With the failure of financial reforms to constitute a private financial system for providing long-term finance, the investment finance of the Brazilian economy depended upon the loans advanced by the public financial institutions (BNDES, Banco do Brasil, BNH and BACEN), which were supplied with a wide range of public funds allocated with subsidised rates. Accordingly, the three main financial public agents were relied upon to finance the recovery of the economy, as their loans accounted for about 90 per cent of the total investment financing throughout the "economic miracle." Furthermore, the more investment grew, the more important the public institutions became as the main source of finance. As Figure 8 below shows, whilst public financial institutions sources accounted for 18 per cent of the total investment in 1966, in 1972 they already accounted for over 50 per cent of it. One should bear in mind, though, that these numbers might be underestimated as many private sector operations actually constituted only of intermediation of funds and programmes from public institutions, like the BNDES or the BACEN, to their clients. Even leaving these transfers aside, public banks' loans for investment increased at much faster rates than the capital formation during the economic boom so that public banks' loans as a proportion of capital formation grew from 20 per cent in 1966 to 60 per cent in 1972. One should note, however, that the finance supplied to industrial investment was greatly due to the financing of construction sector. Accordingly, the BNH's loans to the construction sector increased strikingly increased elevenfold in six years and accounted for 31 per cent of total investment in 1972. The loans to the manufacturing sector in turn provided mostly by the BNDES and the Banco do Brasil (also the main provider of rural credit in Brazil) increased at smaller rates amounting to 22 per cent of the total investment in 1972.

**Figure 8 Public Financial Agents' Loans and Capital Formation, 1966-1972**




Sources: IBGE and Banco Central do Brasil.
* Values deflated by GDP deflator.

One important shift in the priorities of the public financial institutions was their increasing commitment to private sector projects. In the 1950s, the Banco do Brasil and the BNDES devoted most of their resources to public investments. Between 1957 and 1961, for instance, the Banco do Brasil loans to the public sector represented 58 per cent of all Banco do Brasil's loans and 82 per cent of the BNDES' loans. In 1970, the Banco do Brasil's loans to the public sector had fallen to 5 per cent and those of the BNDES loans to public sector had been reduced to 21 per cent in 1972 (Baer and Villela 1980).[56]

In short, the ideological drive of the financial reforms under the military regime was to establish a private financial sector which could coordinate the process of saving-investment in substitution to the public institutions. Pivotal to this reform was the introduction of monetary correction to financial assets and several fiscal subsidies in order to guarantee real interest rates to private financial sector. The financial release resulting from these measures should contribute to foster savings. The result showed that the real world is much more complicated than that forecast by the theory of financial repression. Whilst the private financial system loans were certainly important in the recovery of the economic growth, it did so by financing consumption instead of investment. Whereas the private banking system concentrated upon short-term finance of the economy the stock exchange markets never developed and were shown to be highly speculative. On the other hand, the loans for long-term investment depended heavily on the Banco do Brasil and the BNDES and the public funds of special programmes commanded by these institutions. The housing boom

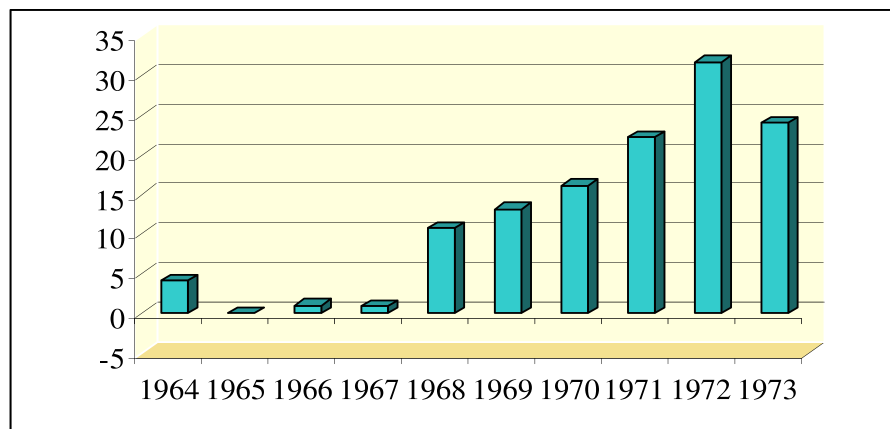
[56] The Banco do Brasil's data is from IBGE "*Estatísticas do Século XX*." The reference of the BNDES' data is Werner Baer and Annibal Villela (1980).

and the construction sector in turn were totally dependent on the SFH. In other words, the government still commanded the allocation of funds for investments and did so with generous subsidies.

## The Political Economy of Foreign Capital and External Debt

The reforms of 1964-1966 reserved special treatment for foreign capital, justified by policymakers on the basis of technical progress and the complementary factor of domestic savings they would bring about. Just after the reforms had been completed and the economic growth resumed capital inflows came pouring in at staggering amounts. Between 1967 and 1973 capital inflows became over 80 times greater, and as can be seen in Figure 9 below, external sources reached to about 1/3 of the investment rate in 1972.

**Figure 9 The Ratio of Capital Inflows to Gross Capital Formation (%), 1964-1973**



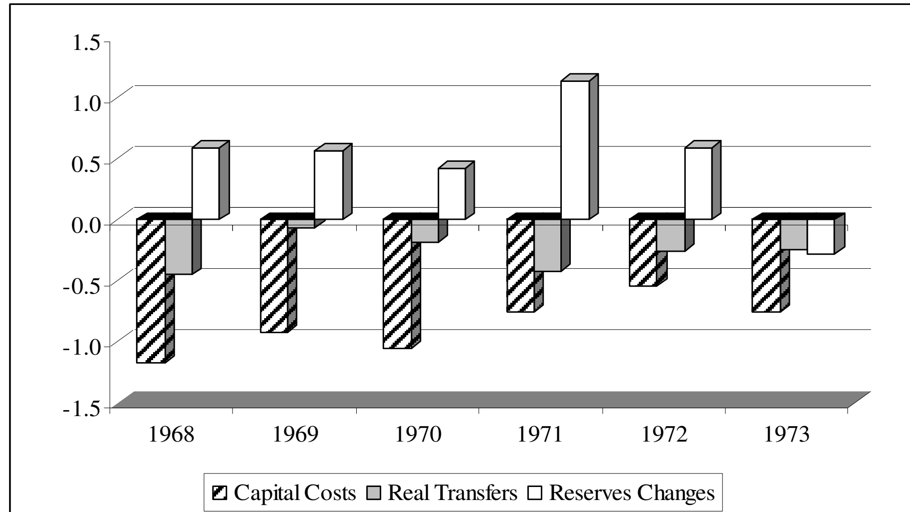

Sources: Banco Central do Brasil; *Conjuntura Econômica*.
* In current dollars.

The conventional explanation for resorting to such a volume of external borrowing is that faced with a lack of domestic savings, a country which seeks economic growth will run current account deficits. The so-called real resources gap is equivalent to the current account deficits. The greater the country's resource gap, the more this country has to resort to external savings to close that gap. The country is living beyond its resources. However, looking at Brazilian current account figures for the period of the "miracle," there is little support for the conventional account. Without doubt Brazilian external indebtedness was a result of financial factors instead of real transfer gap. Figure 10 below illustrates this point very graphically. It is assembled as follows. Real transfers involve trade balance and non-

factor service (transport, for instance). Capital costs in turn encompass profit remittances, interest charges and amortisation upon debts. The reserves are the foreign currency held by the BACEN and capital inflows (direct foreign investment and loans) are taken as their usual definition. In the figure, real transfers, capital costs and reserves changes were scaled by net capital inflows. When capital costs and real transfers are negative they demand financing. When the reserves changes are negative they are financing current account deficits. If the reserves changes are positive they are absorbing the excess of capital inflows over the current account deficits. As the figures show, the financial costs of capital accounted for most of the capital inflow, 90 per cent, whereas real transfers accounted for 30 per cent of the capital inflow between 1968 and 1973. On the other hand, with the intensification of the capital inflows throughout 1968-1973, the BACEN accumulated reserves, which amount to international purchase power left idle.

This strategy resulted in increased external vulnerability despite the striking performance of exports. To begin with, between 1967 and 1973 capital inflows rose about U$1.8 billion per year, overcoming by 1½ times the total transaction account deficit and more than doubling net external debt. Second, despite the fact that exports increased over 20 per cent per year throughout 1967-1973, current account deficits increased over 33 per cent per year as a result of increasing payments of interest, profits and amortisation that capital inflow provoked. Therefore, whereas in 1973 exports covered almost three times the current account deficit, by 1982 the former would have represented only a half of the latter, if those rates of growth were kept.

**Figure 10 External Resources Absorption: Capital Costs, Real Transfers and Reserves Changes as a Proportion of Net Capital Inflows 1963-1973**




Source: Banco Central do Brasil.

Why did Brazil increase its external indebtedness well beyond its real transaction needs, concurrently increasing its external vulnerability? The conventional and simplistic answer is that in an inward looking strategy of development the government has to overborrow abroad to compensate for its anti-export bias and hence the foreign currency shortages. It obviously neglects the crucial developments of the international financial system in the 1960s. It was clear that the financial reforms in Brazil were tailored to tap into the international liquidity being abundantly created in the Euromarkets, and that had as much to do with domestic as with international policymaking.

Several authors have pointed to the relationship between the United States balance of payments deficits since the 1950s and the emergence of the Euromarket to the rising of international liquidity in the 1960s (Eichengreen 1996; Frieden 1983; Griffith-Jones and Sunkel 1986; Helleiner 1994). Barry Eichengreen (1996) points out that the United State's balance of payments deficits were paralleled by the reserve hoarding in European banks. Over time, as the United States deficits did not diminish, it increased European doubts that gold could be exchanged for the dollar reserves they were carrying over. In other words, European governments doubted that the dollar was convertible to gold at the rates established in the Bretton Woods agreement. Furthermore, European governments, like Germany, would fear inflationary effects stemming from the accumulation of reserves.

According to Eric Helleiner (1994, pp.83-84) by 1960 British banks had already started to make international loans based upon their dollar reserves encouraged by the Bank of England. Soon they were followed by their United States colleagues, trying to escape from domestic controls. The United States government started to stimulate the United States banks' Euromarket operations not merely because it favoured its corporation interests. The United States government also perceived that Euromarket loans were "a way of increasing the attractiveness of dollar holdings to foreigners" (Helleiner 1994, p.94). Thus, a heating loan market for these dollars abroad eschewed the United States government of readjusting dollar-gold parity, while maintained the dollar as the international unit of account. However, while the United States deficits increased, some developed countries disputed the United States seigniorage privileges. As countries like France were accumulating dollars and increasingly refraining from the United States manoeuvres to persuade European central banks to hoard dollar reserves, the United States should find other countries interested in maintaining dollar reserves. Developing countries, like Brazil and other Latin Americans, presented themselves as natural candidates for that role as those countries were eager to receive foreign loans and to hold dollar reserves. According to Helleiner (1994), the liberalisation of the international financial system was fostered by the United States policymakers "as a way of preserving their policy autonomy in the face of growing external constraints" (p.91).

Stephany Griffith-Jones and Osvaldo Sunkel (1986, p.73) in turn argued that "intense competition, and the search for new borrowers, seem to have been intensified by the rapid increase in the number of banks active in the Euro-markets." Between 1964 and 1973 Euromarkets soared, increasing over 30 per cent per year and achieving over U$ 130 billion in 1973 (Griffith-Jones and Sunkel 1986, p.72). Developing countries seeking rapid economic growth could find international money to borrow easily, as the international liquidity was high and banking system anxious to extend its business. As Sunkel and Grifith-Jones (1986, p.74) showed, the international banks preferred to lend to those medium-income developing countries and to those they became acquainted when providing finance to the subsidiaries of their corporate clients.

Such developments in the international financial system had an obvious bearing upon the Brazilian economy as long as that country experienced high levels of integration with corporate international interests. For instance, in 1972 foreign companies contracted more

than 47 per cent of the loans through Law 4131 and foreign banks contracted more than 37 per cent of the loans realised through Resolution 63 (Cruz 1999[1984], pp.119 and 146). Furthermore, along with the liberal attitude towards foreign capital, the Brazilian government looked after the differential between domestic and international interest rates for providing additional incentives for private capital to take loans abroad. Finally, government support for private borrowers was also crucial, for instance by guaranteeing exchange covering, as it reduced the lenders' risk. The government also used as much its financial and non-financial enterprises to lever external borrowing. As will be shown in more detail later, the appetite of government for foreign finance increased throughout the 1970s.

The economically liberal Brazilian policymakers showed no concern with the rising external vulnerability provoked by the over-borrowing at adjustable interest rates. On the contrary they had been captured by the stunning growth of international financial markets and justified the increasing external indebtedness as the means of enhancing economic development. A BACEN annual report stated that the policy of indebtedness was deliberately pursued because "the attraction of foreign resources, loans and risk capital, is one of the means which will permit the country to widen its investments" (p.8). Furthermore, there was a perception that external indebtedness should not be alarming since "what the external creditors most often do is analyse the solvency of debtor countries" (Simonsen 1972, p.107). On the other hand, policymakers believed that foreign reserves accumulation would shield the economy from the volatilities of the international markets. Even more optimistically there were those like Simonsen (1972, p. 72) who maintained that "the exhibition of these reserves, *in passim*, reinforces remarkably the external credibility of Brazil, luring more foreign capitals." In short, the indebtedness not only did not bother Brazilian policymakers but also constituted a deliberate policy intended to increase foreign reserves with the justification of enhancing economic growth and protecting against international volatility.

To sum up, the rise of external indebtedness throughout the "miracle" did not express any real transfer. The Brazilian external indebtedness policy, which started with the financial reforms of 1964-1966, was closely linked to the developments of the international financial system, with the development of the Euromarket and with the United States defence of the dollar role in the international monetary system. From the international point

of view the Brazilian financial system was performing its role as holder and recycler of the international dollar liquidity. Domestically, the desire of policymakers to accumulate reserves found an international private banking system keen to lend to developing countries, as well as the support and incentive of the United States government concerned with maintaining the international role of dollar and finding buyers for its products abroad.[57] This process depended greatly not only on the support of the developed countries to spur the Euromarket system (Frieden 1983; Helleiner 1994) but also upon the underdeveloped states to support and stimulate external debt. The Brazilian policymakers of mid-1960s and of 1970s opened up the economy to the movement of capital.

### Final Remarks

The economic policymakers who rose to prominence with the military coup of 1964 aimed to abolish the state interventionism that had previously characterised Brazilian development. Their rhetoric cherished market forces as a means of restoring equilibrium and blamed government interventionism for the unbalanced development of import substitution and the political turmoil of the mid-1960s. In practice, however, the policymakers' ideology gave way to the military government's political desire for development. As discussed above, several reforms enhanced the government's means to induce private-sector investment as well as its own participation in the process of capital accumulation. A rather rough list of the government's interventions can be drawn up as follows:

a) The government increased its expenditure from 22 per cent in 1964 to 29 per cent in 1970. Most of that growth was a result of the growth of the state-owned enterprises. These companies doubled their share in the investments of the largest manufacturing firms;

b) The government produced a successful programme of export subsidies for the manufacturing sector, making it grow twice as much as domestic demand and 30 per cent more than world exports;

[57] Between 1948 and 1965 the Brazilian trade balance with the United States was in surplus all the years but two, accumulating over U$2 billion surplus. From 1966 to 1973 trade balance between the two countries turned against Brazil, which accumulated deficits of roughly U$2 billion between 1966 and 1973.

c) Finally, the government created several public funds to support the expansion of the private sector providing financing through the BNDES and the Banco do Brasil. Virtually all long-term investment in Brazil, which constituted 23 per cent of GDP in 1973, was financed by public institutions.

By far the most important new element of the new development model lay in the opening of the domestic financial system to the international capital markets. The government passed legislation (Law 4131 and Resolution 63) that created a very favourable environment for capital inflows. Firms and banks, mostly foreign going concerns, borrowed lavishly in the growing Euromarket funds. To a somewhat lesser extent, public banks and state-owned companies also resorted to foreign resources to increase their operations. The vulnerability of this strategy of growth was largely ignored given the export success, the overall economic performance between 1967 and 1973, and the salient support of international community. After the oil crises in 1974, however, the external fragility of this government strategy began to show its ugly face.

# 5. *The Reemergence of Economic Liberalism*

## Introduction

This chapter is concerned with the transition from the development policies which prevailed from the 1930s to the dominance of the macroeconomic stabilisation policies in the late 1970s, up until the external debt crisis in 1982. The objective is to show that by relying on foreign capital inflows, the government lost its grip on economic development as it had to compromise development objectives to enjoy foreign credibility. This period saw the first signs of the re-emergence of economic liberalism in its contemporary version, that is, neoliberalism. Worse still, instead of leading to stability, the orthodox policies actually brought greater domestic instability and external vulnerability, ultimately leading to the 1982 crisis. The greatest casualties of this process were government finances and the government's ability and legitimacy to pursue further economic development, as the burden of financial instability, and then of the debt crisis, were borne by public institutions.

In previous chapters it has been shown that the rapid economic development the Brazilian economy experienced up to the early 1970s had been achieved through a process that progressively strengthened government control of mechanisms of economic growth. Through several instruments, the government commanded and directed a considerable amount of investment flowing within the economy. Public funds, fiscal incentives, public banks and public enterprises were all oriented towards industrial development. In 1974 the government launched a new programme of investments, the Second National Plan of Development (II PND), which was intended to sustain the rapid economic growth with further structural change, just as in the mid-1950s. In 1976, however, this attempt was partially abandoned in order to follow a conventional adjustment of the economy to the external shocks. That meant curtailments in the programme of investments and a

Mckinnon-style financial policy, which is to say deregulation and a consequent increase in interest rates. The latter move not only sent the economy into an expected downturn but also, due to the institutional characteristics introduced by the reforms of 1964-1967, increased the external debt and triggered a speculative bias in the domestic financial markets. As a result, whilst the structural development was halted with the cancellation of the programme of investments the restrictive policies increased macroeconomic instability. Increased macroeconomic instability prompted the government to adopt further restrictive measures and to turn the instruments of economic development into instruments of macroeconomic stabilisation. By the end of the 1970s the Brazilian economy found itself in a downward cumulative process which led to its worst-ever economic crisis, in the early 1980s, and to the external debt crisis in 1982.[58] To understand the particular features of the Brazilian indebtedness process is important here in two ways. First, in part, the interpretation of the causes of the problem influenced the management of the debt crisis in the 1980s. That is, understanding how this process took place in the 1970s will help to understand the consequences for the management of the Brazilian economy in the 1980s. Second, in the 1990s, Brazil experienced a new cycle of external indebtedness which shared similar features with the cycle in the 1970s, including a financial crisis in the end of the process.

The following sections analyse this downward cumulative process in detail. The first section conveys the objectives of the II PND and its achievements. It studies the plan from the point of view of the capital accumulation and consequent results for the economic growth. From either point of views it shows that the programme fell short of its objectives as the government reduced its investments and the economy entered into a reduced path of growth. It then evaluates the financial strategy of the period and shows that the financial instability – inflation and external indebtedness – was a consequence of the orthodox monetary policies. In an economy with indexed financial assets the conventional stabilisation policies caused even greater macroeconomic instability, increase in public indebtedness and speculation with public bonds.

[58] This chapter is interested in the internal factors that led to the Brazilian external indebtedness. The external factors of the external debt crisis of 1982 are dealt with in the next chapter.

## The Strategy of 1974

At the time of the first oil shock in 1973, the Brazilian economy was already nearing the end of the remarkable economic growth it had enjoyed for six consecutive years. The boom in durable consumer goods, which had led the industrial growth during the years of the "miracle", would hardly be maintained. The narrowness of this market, due to the concentrated income distribution and the high levels of consumers' indebtedness, indicated that the growth in demand for these products would not continue. Besides, productive capacity was being almost fully utilised in all sectors, including capital goods. To grow at the same rates as before it would be necessary to import capital goods, and indeed such imports had already grown at a rate of 22.7 per cent per annum since 1970 (Batista 1987, p.68). On the external side, Brazil's exports had shown striking rates of growth during the "miracle" but were not expected to perform any better given the recessive trends in the world economy. Moreover, oil accounted for 30 per cent of Brazil's total imports and 80 per cent of total domestic consumption. In short, the prospects for demand growth suggested that the private sector would not sustain it. On the supply side, production costs tended to increase in tandem with the rising in raw-material prices whilst the productive capacity tended to become idle.

These pressing economic problems called for government action. Mario Henrique Simonsen, the Finance Minister, defended an orthodox approach to the adjustment of the economy and favoured monetary and fiscal controls to reduce domestic absorption along with a devaluation of the *cruzeiro* to spur exports. João Paulo dos Reis Velloso, the Planning Minister, defended the strategy of continuing the structural transformations of the Brazilian economy instead. In 1974 the government refuted the conventional adjustment and opted for a programme of investments instead. The economic reason for refuting the conventional adjustment was that a devaluation of the currency would not increase exports as the world was in recession, whilst imports were already restricted to essentials. In addition, the recession needed to compensate for the probably explosive inflationary effect of the currency devaluation in a wholly indexed economy would be socially unbearable. Political factors therefore seemed to play their part in the plan. The new military government, under General Ernesto Geisel's presidency, announced a political compromise of "decompressing" the regime gradually from 1974 onwards. As the objective was to continue such "decompression" until the military party (ARENA) was able to beat the

single official opposition party (MDB), which had won the congressional election of 1974, a recession would certainly not contribute to strengthening the popularity of the military's party (Skidmore 1988).

Thus, in the midst of increasing political contestation, General Geisel bent to the "developmentalist" perspective and decided to adopt the II PND. The II PND constituted of an ambitious programme of investments, like the Target Plan was, which sought to maintain high rates of economic growth and to promote a deep transformation of the economic structure.[59] The II PND entailed a broad programme of investments in basic inputs (steel, chemicals, pulp and cellulose, etc), energy (petroleum, electricity, alcohol combustive and nuclear energy), transport (roads, ports, airports, and railroads), telecommunications and capital goods (machines and electric equipments, transport equipments). The objectives were not only to "close" the "empty" spaces in the Brazilian industrial matrix but also to give a structural solution to the problems of the balance of payments, as the investments sought to promote as much import substitutions (e.g., petroleum and capital goods) as they sought to increase and diversify exports of manufacturing sectors (e.g., pulp and cellulose, non-ferrous minerals and chemicals).

As in a typical Gerschenkronian model of industrial development, the II PND relied heavily on the state-owned enterprises as direct instruments to achieve such a level of investment and on the public budget to provide subsidies for the private sector to invest and export. The state owned enterprises' investments would act either on the supply side or on the demand side of the process of development. From the supply side, as the main providers of basic inputs (e.g., petroleum, alcohol hydrated and steel), the state-owned enterprises would ease the negative effects stemming from the increase in raw material costs after the hike of oil prices. On the other hand, beyond maintaining the level of economic activity with its purchases, the state-owned enterprises' investments would be instrumental in the objective of strengthening the domestic capital goods sector. The II PND sought to strengthen the private national firms in the "triple alliance" by giving priority to the private national firms in the public enterprises' purchases of capital goods and requiring indices of localisation from foreign suppliers. The II PND targeted a rate of investment at 25 per cent of GDP to prevail until the end of the decade (see Table 15 below).

[59] For detailed discussion of the II PND see Carlos Lessa (1998[1988]).

The bloc of investments entailed in the implementation of the II PND required a massive amount of long-term finance, as the priority sectors were typically capital intensive and had a long horizon of maturation. The failure of the private financial system to provide such long-term finance prompted the government to reinforce the role of public institutions by increasing the compulsory public funds carried to the priority sectors, and the BNDES was elected as the main financing institution for the investment projects entailed in the II PND. In 1974, the BNDES obtained control of two important funds which had been created in the early 1970s and were under the control of the National Housing Bank (BNH), namely: the Program of Social Integration (PIS) and the Public Employees Financial Reserve Programme (PASEP). Such relocation of funds had important bearings upon the continuity of the BNDES' provisions. On the one hand, these funds gave a boost to BNDES' sources. On the other, they also disjointed an important part of the BNDES' resources from the disputes of government general budget allocation, in order that the BNDES had greater stability of resources. It is worth mentioning also the increased importance of the foreign resources among the BNDES' sources. In only three years, from 1974 through 1977, foreign resources increased over 2.5 times. In 1979 foreign sources accounted for over 15 per cent of the BNDES sources. Overall, the total amount the BNDES commanded increased at 17.8 per cent per year in real terms in the seven years from 1973. The funds PIS/PASEP alone accounted for 54 per cent of the BNDES' sources in 1976 (Table 15).

**Table 15 BNDES's Loans and Sources of Resources, 1970-1980**

| | *Investments (US$ 1000)* | *BNDES' Transfers as a Share of Investment Banks' Loans* | *Sources of Finance* | | | | |
|---|---|---|---|---|---|---|---|
| | | | (U$ 1000) | Internal (% of Total) | PIS/PASEP (% of Total) | External (% of Total) | Other (% of Total) |
| 1970 | 312,550 | - | 754,466 | 29.2 | - | 2.9 | 67.9 |
| 1971 | 428,703 | - | 635,917 | 42.4 | - | 2.6 | 55.0 |
| 1972 | 629,481 | - | 517,369 | 30.6 | - | 14.9 | 54.5 |
| 1973 | 874,259 | 10.0 | 753,181 | 38.9 | - | 15.0 | 46.1 |
| 1974 | 1,637,972 | 16.4 | 1,609,720 | 18.9 | 20.9 | 6.6 | 53.6 |
| 1975 | 2,734,111 | 21.2 | 2,900,861 | 18.0 | 46.1 | 9.3 | 26.6 |
| 1976 | 3,020,596 | 30.8 | 2,843,955 | 21.9 | 54.3 | 5.7 | 18.1 |
| 1977 | 3,455,595 | 37.5 | 3,581,825 | 21.8 | 47.1 | 11.3 | 19.9 |
| 1978 | 4,051,769 | 43.9 | 4,038,883 | 25.4 | 45.2 | 13.7 | 15.7 |
| 1979 | 4,163,492 | 49.1 | 4,998,145 | 45.2 | 30.4 | 15.4 | 9.1 |
| 1980 | 3,329,044 | 52.6 | 4,382,470 | 49.4 | 25.8 | 13.7 | 11.1 |

Source: BNDES (2002a) and Marta Prochnik (1995).

The importance of the BNDES as the financier of the II PND projects can be evaluated by the percentage of the BNDES' loans in the total capital formation. Accordingly, whilst in 1973 the BNDES' loans accounted for less than 4.4 per cent of total Brazil's capital formation, they amounted to almost 19 per cent in 1978. Not surprisingly, the sectors that received the lion's share of the BNDES' loans were those pertaining to the II PND's priorities, such as steel, pulp and cellulose and energy (BNDES 2002a). Through its transfers to the private banking sector, the BNDES attempted to overcome the conservative posture of the banking system by engaging it in the financing of the long-term investments. To have access to the transfers from the BNDES, the private banks should commit part of their resources to the financed project. As Table 15 shows, the amount transferred from the BNDES to the investment banks increased considerably as a percentage of investment banks' loans. Finally, the resources advanced by the BNDES were heavily subsidised as the typical monetary correction was 20 per cent in times of inflation of no less than 35 per cent in the second half of the 1970s.

For the trade regime, the government avoided the devaluation and maintained the mini-devaluations inaugurated in 1968. In addition to the investments in tradable sectors seeking to increase the capacity to export, the government increased the amount of incentives and subsidies it had created during the "economic miracle" to foster the diversification of exports towards manufacturing products. As had been the case since 1968, the incentives for exports somehow compensated for the appreciation of the official exchange rate.

**The Government's Objectives Change in 1976**

The 1974 strategy managed to achieve high rates of investment as a percentage of GDP from 1974 to 1976, when this indicator attained levels higher than during the "miracle" (see Table 16 below). Consistent with the II PND's objectives, public enterprises' investments in transports, communications, and energy grew considerably and commanded 30 per cent of capital formation in 1976. Spurred on by the II PND's investments, private firms were also investing massively. In 1976, for instance, investments in the manufacturing sectors increased 34 per cent in real terms meanwhile the manufacturing output grew 12 per cent. Investments in capital goods sectors such as mechanic, transport material, electric and communication equipment doubled in real terms in the three years from 1973. Without

doubt, as the productive capacity was growing well beyond current demand, the entrepreneurial success of these investments depended on the growth of future demand. Demand for capital goods in turn depended on the maintenance of the public investments announced in 1974. In other sectors, like intermediate goods, the stimulus to grow came from the external markets. The stimulus for the consumer sectors depended on economic growth in general, which in turn depended on total investment in the economy as a whole. In short, the success of the II PND depended on the continuity of the very process of investment initiated in 1974. The reasons for that were quite straightforward: as entrepreneurs had entered into debt to build new capacity, inclusive above the current demand, current decisions of investment were crucial in order to generate incomes to validate previous decisions of indebtedness and investment. Otherwise firms would suffer with sluggish sales, idle capacity and increasing fix costs.

The programme of investments did not go very far though. As it is shown in Table 16 below, the rates of growth of investment began to decline in 1977, dropping from 25.5 per cent of GDP in 1975 to 23.5 per cent in 1980 and 20 per cent in 1982. This was a result of the change of priorities in the economic policies adopted by the government. In 1975 the government observed a decline in its foreign reserves and so a worsening of the external debt indicators (more about that later in this chapter). As policymakers had often announced that the foreign reserves were the main indicator of credibility of the external debt policy, the foreign reserves fall prompted a shift in the policy priorities. Starting in 1976, policymakers decided to adopt the conventional monetary adjustment of the balance of payments, which had been refused in 1974. The current account payments and the restoring of the international good rating with the financial markets became first priorities. The instruments with which the Brazilian state had operated to produce the industrial development then became tools to pursue macroeconomic stability instead. Before a more detailed discussion of the macroeconomic instability of the period, it is necessary to look at the consequences of the policy switch in terms of structural change.

The government would use its weight in the aggregate demand to reduce domestic absorption. First, the government imposed an import reduction of 25 per cent on public entities' purchases. Most importantly, the government decided to axe its expenditures which materialised in 3.6 per cent reduction in government's consumption and investment or something like 2.5 per cent of GDP in 1977. After this first mega-cut, the government

expenditures began to increase below the GDP and to show great instability. Public investment as a whole was reduced from 12 per cent of GDP in 1975 to 6.6 per cent in 1980. Nonetheless the government policy turned decidedly towards fiscal restraint, the burden of expenditure cuts followed the compromise of maintaining the generation of foreign reserves. In this connection, subsidies, which were mostly destined to export sectors, were not only preserved but even increased. On the other hand, in its social dimension, public administration's investments involving expenditures in education, healthy, defence etc, suffered the lions' share in the public retrenchment, with a fall of 32.5 per cent in the four years from 1976. Beyond the depressing effects such a reduction in the public expenditures has on economic growth, the social character of this expenditure suggests that income distribution should have worsened. So, a first feature of the spending retrenchment proceeded in the second half of the 1970s was its income concentration bias.[60] The second was the subordination of the structural changes envisaged by the II PND to short-term macroeconomic price stability.

**Table 16 Rate of Investment as Percentage of GDP and Rates of Annual Growth (%), 1971-1982**

| | *Government Investments* | | | | *Private Enterprises (D)* | *Total* | |
|---|---|---|---|---|---|---|---|
| | Public Administration (A) | Public Enterprises (B) | Total (C=A+B) | Δ % Annual | | (C+D) | Δ % Annual |
| 1971 | 4.6 | 2.4 | 7.0 | -13.4 | 14.1 | 21.1 | 15.3 |
| 1972 | 4.2 | 4.0 | 8.3 | 85.8 | 13.8 | 22.0 | 16.7 |
| 1973 | 4.3 | 2.4 | 6.7 | -31.6 | 16.7 | 23.4 | 21.0 |
| 1974 | 4.4 | 4.5 | 8.8 | 99.8 | 15.6 | 24.5 | 13.3 |
| 1975 | 4.4 | 4.9 | 9.3 | 16.5 | 16.2 | 25.5 | 9.7 |
| 1976 | 4.5 | 7.3 | 11.8 | 63.1 | 13.0 | 24.8 | 7.0 |
| 1977 | 3.6 | 6.8 | 10.5 | -1.6 | 13.0 | 23.3 | -1.2 |
| 1978 | 3.3 | 5.6 | 8.9 | -14.2 | 14.4 | 23.3 | 4.7 |
| 1979 | 2.4 | 4.4 | 6.8 | -16.7 | 15.9 | 22.7 | 3.9 |
| 1980 | 2.3 | 4.3 | 6.6 | 7.3 | 17.0 | 23.6 | 13.5 |
| 1981 | 2.4 | 4.2 | 6.5 | -6.5 | 15.0 | 21.6 | -12.2 |
| 1982 | 2.1 | 4.0 | 6.1 | -3.7 | 14.1 | 19.9 | -6.8 |

Source: IBGE.
* Investment deflated by the capital formation implicit deflator. Gross output deflated by the implicit deflator of GDP.
** 1980 = 100.

Although government social spending tends to be hardest hit in orthodox-style budget adjustments, the accomplishment of the programme of investments announced in 1974

[60] The Gini wage index went from 0.56 in 1970 to 0.59 in 1980. According to IPEA's estimate, whilst about 40.7 million people (40 per cent of population) were below the poverty line in 1977, in 1981 they were over 50 million (43 per cent of the population).

could not be maintained in the light of so many cuts.[61] Although some projects would be maintained, the restrictive orientation of the economic policy resulted in the dismantlement of the initial objectives of the II PND. The consequences for the II PND are shown by the gap between initial intentions and what was actually accomplished (see Table 17 below). Even in the priority sectors of energy and basic industries, whose investments increased in relation to the "miracle" period, the level of planned investments could not be sustained.

**Table 17 II PND: Sectoral Distribution of Investments (% of FBKF)**

| | *Before the II PND 1970-1974* | *II PND Realised 1975-1979* | *II PND Projections* |
|---|---|---|---|
| **Energy** | 8.4 | 10.1 | 19.4 |
| Petroleum | 1.1 | 1.7 | 2.0 |
| Coal and Gas | 0.0 | 0.0 | 2.4 |
| Electricity | 7.3 | 8.4 | 15.0 |
| **Industry** | 18.6 | 17.8 | 22.8 |
| *Basic Industries* | 10.5 | 10.7 | 19.3 |
| Steel | 2.4 | 2.7 | 6.8 |
| Transport Material | 1.8 | 1.5 | 2.3 |
| Mechanic and Electric | 2.0 | 2.5 | 2.7 |
| Chemical | 2.4 | 2.2 | 4.5 |
| Non-Ferrous Metals and Pulp and Cellulose | 2.0 | 1.8 | 2.0 |
| *Other Industries* | 8.1 | 7.2 | 3.5 |
| **Transport[1]** | 11.6 | 9.4 | 10.2 |
| **Communication[2]** | 3.1 | 3.5 | 3.8 |

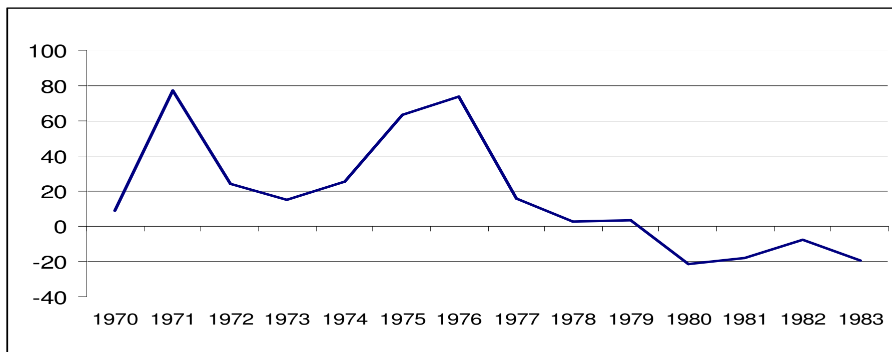
Source: Batista (1987, p.70).
1 - Ports, airports, roads, railways, and other.
2 - Postal and Telecommunications.

The retrenchment of investment created difficulties for sectors that had already increased productive capacity while at the same time increasing the uncertainties associated with a redefinition of priorities as resources were reduced.[62] The II PND's priority sector of heavy industry is a case in point. Unsurprisingly, the costs of the option to slash investments were first and foremost carried by the capital goods sector. The entrepreneurs in capital goods sectors received with euphoria their election as the II PND's priority, which meant credit and fiscal incentives and preference in the purchases of state-owned enterprises.[63] This

[61] The Planning Minister, João Paulo dos Reis Velloso, who had won the battle against the recessive adjustment in 1974, announced in 1976 that: "For 1977, the government has decided to make reductions in its investments before the necessity to act austerely in relation to inflation and to obtain better results in the balance of payments." Cited in Paulo Davidoff Cruz (1999[1984], p.69).
[62] For the definitive discussion of the coordination problems of the II PND, see Carlos Lessa (1998[1988]).
[63] The leaders of capital goods sector were not shy to declare total support to the "interventionist" programme of investments announced in 1974. Cláudio Bardella, president of the Brazilian Association for the

euphoria translated into investments which in 1976 were almost the double those of 1974. However, this initial optimism gave way to frustration when the first cuts in public investments were announced and were soon followed by cuts in the private sector itself. The demand for BNDES loans to finance the purchases of capital goods, which had increased by a staggering average of almost 70 per cent per year over the previous two years, plummeted to 3 per cent in 1978-1979 and then to negative rates from 1980 onwards (see Figure 11 below). As a consequence, while the purchase of machines and equipment had grown strongly and around 18 per cent in the first half of the 1970s, in the second half its growth was faltering, unstable and presenting an overall negative rate of growth (- 0.5 per cent annual average).

**Figure 11 BNDES' Loans to Capital Goods Purchases (Δ % Annual), 1970-1983**




Source: BNDES (2002).

With this appalling performance of investments in machines and equipment, the growth in the output of the capital goods sector dropped threefold in the second half of the 1970s and fell even more spectacularly in the early 1980s (see Table 18 below). The sector tried to compensate for faltering domestic demand with external sales, whose volume increased a sharp annual average of 36 per cent between 1977 and 1980. This rise in the sales to foreign markets though was more a result of entrepreneurs trying to escape from a depressing domestic market than a long-term strategy of gaining external market and scale. Indeed, the accumulation of idle capacity in the capital goods sector, which in 1979 reached double the level of 1974, witnessed the marginal effects of the external markets on the recovery of the sector.

Development of Basic Industries, declared in 1974 that "now the government is attending the machine and equipment industry's aspirations of 20 years." The president of the Syndicate of Machines and Equipments of São Paulo, Carlos Villares, called on the sector to invest: "Both custom-made capital goods and the capital goods in general must now assume a position of optimism, of confidence in relation to the government plans." Both cited in Carlos Lessa (1998[1988], p.139 and p.140).

The stumbling growth of demand left the capital goods sector struggling with inefficient scales of production and specialisation with grave consequences for technical progress. A comparative study of the capital goods sectors in China, India, Brazil and South Korea carried out by the UNCTAD (1985, p.134) indicated that "in Brazil, the irregularity and relative weakness of local demand…have led to a diversification of the output of several custom order capital goods manufacturers for the internal market, considered by some analysts to be excessive," in order that such "diversification has taken place at the expense of specialisation in the case of indigenous makers of capital goods." In addition to the sluggish growth of the domestic orders the development of the capital goods sector also faced problems with the fact that foreign companies dominated it. The entry of Brazilian firms into a sector already dominated by large foreign companies when the market was stumbling made it even more difficult for those firms to obtain economies of scale and specialisation (Bonelli and Façanha 1978). In short, the objective the II PND had set up for the growth of the capital goods sector and the structural change of the Brazilian economy were the first victims of the restrictive policies introduced in 1976. The lack of high and stable rates of investment compromised the sector's technical development and caused its depressed output (see Table 18 below). Hence, in 1980 the capital goods sector still represented only about 15 per cent of the manufacturing production when it had been about 15.5 per cent in 1975 anyhow well far from the 30 per cent this sector achieved in developed countries (UNCTAD 1985, p.xiv).

**Table 18 Sectoral Rates of Growth – Annual Average (%), 1963-1983**

| | *1968-1973* | *1974-1976* | *1977-1980* | *1981-1983* |
|---|---|---|---|---|
| **GDP** | 11.2 | 7.9 | 6.5 | -2.1 |
| **Agriculture** | 4.6 | 3.5 | 5.9 | 2.4 |
| **Industry** | | | | |
| Mining | 10.0 | 9.7 | 7.2 | 6.7 |
| Construction | 10.9 | 9.1 | 6.0 | -7.7 |
| Manufacturing | 13.3 | 7.9 | 6.1 | -5.5 |
| Durable Consumer Goods | 23.6 | 10.3 | 8.6 | -5.9 |
| Non-Durable Consumer Goods | 9.4 | 4.8 | 4.1 | -0.6 |
| Capital Goods | 18.1 | 13.0 | 3.4 | -17.8 |
| Intermediate Goods | 13.5 | 8.7 | 8.0 | -3.6 |
| **Services** | 6.5 | 9.1 | 7.0 | -0.3 |

Sources: Serra (1982, p.58) and IBGE.

Despite the delays and curtailments, investments in export promotion and the production of basic inputs were somehow preserved, in line with the current account adjustment. This

was the case with regard to public investment in energy and intermediate inputs to promote import substitution, and in sectors such as pulp, cellulose, non-ferrous metals and steel, destined mainly for the world market. By the same token, fiscal subsidies and credit incentives were increased to exports of manufacturing sectors such as automobiles. As a result, manufacturing exports grew spectacularly by 21.4 per cent between 1973 and 1979, virtually doubling the manufacturing share of Brazilian exports from 23 per cent to 44 per cent. That exports performance sustained the growth in the intermediate, agricultural and durable consumer goods sectors, while the domestically oriented sectors, like non-durable consumer goods, slipped into a low path of growth.[64]

In spite of the severe reduction in government spending that had been announced in reaction to growing macroeconomic instability, and despite the striking performance of exports, the Brazilian macroeconomic environment became even gloomier. Economic growth proved to be unsustainable as manufacturing productivity and output declined sharply. Inflation escalated from 29 per cent in 1975 to 35.5 per cent in 1977, to 43 per cent in 1978. Whereas in 1975 the net external debt to exports ratio was 2 to 5, in 1978 it had increased to 3 to 2. From 1979 onwards, when the international crisis got worse and domestic inflation rose, the government adopted even greater restrictions on public spending with the imposition of drastic cuts and limits on public investments and imports along with rigid credit control. As a consequence, in 1980 total public investment was only 70 per cent of what it had been in 1976, and 80 per cent of the 1978 level. Although those policies provoked a stark contraction in domestic income in the early 1980s, the macroeconomic instability that those policies intended to solve only became worse. The thrust of the growth of the macroeconomic instability, often neglected by neoliberal observers, lay precisely in the adoption of restrictive policies along with a liberal attitude towards capital flows. That is, the very adoption of a restrictive bias in domestic economic policy, epitomised by the increase in real interest rates, prompted increasing capital inflows and fuelled market speculation with public bonds. We will now elaborate this alternative account of the role of the state in the context of external indebtedness in the 1970s.

[64] From the perspective of the records of economic growth in the last 26 years in Brazil, the numbers in Table 18 may not seem to be those of recession. However, in historical perspective it should be seen as a recession for the previous period was of a staggering economic growth.

### The Road Towards the External Debt Crisis

Starting in 1969 the Brazilian economy underwent a vigorous process of external indebtedness. This pattern was reinforced throughout the 1970s, and its rupture after the Mexican default in 1982 explains much of the Brazilian economic crisis of the 1980s. Table 19 below shows the striking growth of Brazilian external debt throughout the 1970s, in the lead up to the external debt crisis in 1982. Following a brief reduction in the early 1970s, the ratio of net external debt to exports increased almost every year from 1973. What is more, the public sector accounted for the lion's share of this increase. Various authors have pointed out that the increase in Brazilian external indebtedness was a result of the government's rebuff of the devaluation-cum-recession adjustment of the balance of payments in 1974 in favour of the maintenance of elevated economic growth (Baer 1995; Coes 1995; Fishlow 1986; Malan and Bonelli 1983). According to this line of argument, as the government refuted the conventional adjustment, the external debt grew as a result of the current account deficit stemming from the oil price shock. In addition, as the state-owned enterprises were selected to execute a large portion of the II PND's investments, the government became highly indebted externally itself, resulting in negative consequences for public finances. The thrust of this interpretation is that the external debt increased because the government failed to adopt a type of adjustment in accordance to the change in the international relative prices. This theory, however, does not seem to fit well the Brazilian indebtedness in the 1970s.

First of all, as Table 19 shows, the external debt was already growing rapidly even before the first oil shock. In addition, in contrast to the conventional interpretation summarised above, it has already been shown that from 1976 the government had in fact made a huge cut in public investment that reduced economic growth in the second half of the 1970s to 4/7 of the level of the first half. As a result of the economic slowdown and the restrictions imposed on imports, the volume of imports contracted in the second half of the 1970s. The contribution of imports to the external debt, measured by capital inflows for import financing, fell from 23.7 per cent in 1974 to 20.7 per cent in 1979. All these facts suggest that the true explanation for the massive Brazilian external debt lies not in the conventional account of excessive domestic absorption, but elsewhere. That is, instead of

the current account deficits, it is the capital account adjustments that were the primary culprits for causing the crisis.

**Table 19 Foreign Debt Profile (U$ Million), 1970-1982**

| | *External Debt* | | | | *Reserves* | *Net External Debt* | *Net External Debt/Exports* | *Interest Rates* |
|---|---|---|---|---|---|---|---|---|
| | Public (%) | Private (%) | Total (US$ Million) | As a Share of GDP (%) | | | | (%)[1] |
| 1970 | - | - | 5,295 | 12.5 | 1,187 | 4,108 | 1.5 | - |
| 1971 | - | - | 6,622 | 13.6 | 1,723 | 4,899 | 1.69 | 11.8 |
| 1972 | - | - | 9,521 | 16.3 | 4,183 | 5,338 | 1.34 | 5.1 |
| 1973 | 52.0 | 48.0 | 12,571 | 15.0 | 6,416 | 6,155 | 0.99 | -4.8 |
| 1974 | 49.7 | 50.3 | 17,166 | 15.6 | 5,269 | 11,897 | 1.5 | 24.4 |
| 1975 | 54.0 | 46.0 | 21,171 | 16.4 | 4,040 | 17,131 | 1.98 | 14.6 |
| 1976 | 57.1 | 42.9 | 25,985 | 17.0 | 6,544 | 19,441 | 1.92 | -2.9 |
| 1977 | 60.3 | 39.7 | 32,037 | 18.2 | 7,256 | 24,781 | 2.04 | -8.3 |
| 1978 | 63.2 | 36.8 | 43,511 | 21.7 | 11,895 | 31,616 | 2.5 | 22.4 |
| 1979 | 68.1 | 31.9 | 49,904 | 22.5 | 9,689 | 40,215 | 2.64 | 18.2 |
| 1980 | 69.3 | 30.7 | 53,847 | 22.7 | 6,913 | 46,934 | 2.33 | 33.0 |
| 1981 | 68.0 | 32.0 | 61,411 | 23.9 | 7,507 | 53,904 | 2.31 | 27.8 |
| 1982 | 67.5 | 32.5 | 70,197 | 26.0 | 3,994 | 66,203 | 3.28 | 20.0 |

Sources: IBGE and Banco Central do Brasil
1) Real Interest Rates. Interest rates paid on net external debt deflated by the term of trade.

In fact, the great increase in foreign capital inflows resulted from the deliberate state manoeuvre to bind together the domestic financial markets with the foreign capital flows, which was materialised by the institutional reforms of the mid-1960s and reinforced in the mid-1970s. From the external point of view, or the supply-side perspective, the channels linking domestic and external financial institutions were nourished by the emergence of the Euromarkets. Flooded with petrodollars, foreign banks, and especially the United States banks, were anxious to turnover their enlarged deposits (Helleiner 1994). Lending to underdeveloped countries became a very lucrative business for foreign banks as, unlike in their domestic markets, Euromarkets carried floating interest rates so that the price risk fell onto the borrowers. Most of Brazil's foreign debt in the 1970s was constituted by cash loans from private banks, with the ratio of cash loans to total external debt rising from less than 20 per cent in 1967 to 58 per cent in 1975 and 62 per cent in 1979. Needless to say that Brazil was seen as an attractive client economy by the international banks since the Brazilian economy was heavily occupied by affiliates of foreign companies, that is, the usual clients of those banks in their own homeland. In addition, loans from Euromarkets to underdeveloped countries counted with eager support of the government of developed countries. Their governments backed Euromarket lending to underdeveloped countries as

developed economies would benefit from the imports that these countries would realise with their enhanced foreign power purchase.[65] Here, again, Brazil was a typical example of the developed countries' benefits from the underdeveloped countries' external borrowing in the 1970s. Brazil's trade balance with the developed countries went from an average surplus of US$ 125 million over the twenty years from 1950 to an average deficit of one billion dollars over the ten years from 1970.[66] So, the increasing capital inflows to Brazil had as foreign determinants the commercial interests of foreign banks whose loans abroad in turn soared as governments of developed countries backed the Euromarkets growth.

From the domestic point of view, the external indebtedness of the 1970s was directly linked with the policymakers' perception that tapping into the emergent Euromarkets was unproblematic and at the same time was critical for the whole strategy of growth ingrained since mid-1960s. Policymakers used to hail the massive capital inflows in the early 1970s and consequent increase in the Brazil's foreign reserves as an unmistakable benefit for the development of the country as well as a synonym for international credibility in the economic policy (Simonsen 1972). By the same token, the maintenance of foreign reserves by the BACEN was seen as a central indication of such credibility of the domestic economic policies. That is, foreign banks found in Brazil not merely a client very much dominated by foreign companies but a government sharing foreign banks' beliefs and committed to maintaining its foreign credibility. The latter meant compromises in order for the government to guarantee due payments of debt servicing and the stability of the external value of the domestic currency. In this context the external indebtedness of the Brazilian economy from mid-1970s is better explained by a combination of several measures of capital account liberalisation by which policymakers sought to offer the Brazilian market for foreign lending as well as to increase the foreign credibility of their policies.

The government sponsorship of foreign borrowing intensified from 1974 when the BACEN liberated resources obtained in foreign loans from compulsory reserves. In the same year the BACEN reduced the income tax rate from 25 per cent to 5 per cent on interest and commissions of external loans (Resolution 305). Despite these measures, the inflow of capital reduced slightly from US$ 6,531 to US$ 6,374, which resulted in a

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[65] According to Eric Helleiner (1994) and Barry Eichengreen (1996), the United States government had especial importance in the development of Euromarkets as it sought the foreign countries indebtedness a fashion to defend the value of dollar without imposing restrictive conditions domestically.

[66] The developed countries considered were: West Germany, the United States, Italy, Great Britain, Japan, France, Holland, Switzerland, Belgium, and Canada.

reduction of the reserves in 1975 (Table 19). In face of this reduction in the reserves, in 1976 the BACEN enacted Resolutions 361 and 389 freeing finance companies, investment banks and commercial banks from interest rates ceilings aiming to increase the gap between domestic and international interest rates and to ration the domestic credit in order to turn borrowing abroad more attractive. In 1977, Resolution 432 and Instruction 230 of the BACEN instituted the protection against changes of exchange rates by allowing firms and banks to deposit foreign currency in the BACEN. The BACEN also assumed the external interests on these deposits and exempted the depositors from income tax, virtually making foreign borrowing risk-free for the private sector.

The government also launched several measures and directives to force public institutions to borrow abroad. The government reduced the ability of state-owned enterprises to generate internal funds by imposing controls on their price policies (Trebat 1983, p.206), which was also part of the anti-inflationary strategy of the government. In addition, Resolutions 445 of 1977, 521 of 1979, 623 and 656 of 1980, increasingly limited state enterprises' access to domestic sources of finance, which were reserved for private borrowers. Therefore, with limited capacity to generate internal funds, either because economic activity had slowed down or because their prices were controlled, state enterprises were left with only the external loans alternative to finance their expenditure. As a case in point, the public electricity and steel companies' indebtedness, whose investments were less affected by the cuts in the second half of the 1970s, accounted for 29 per cent of total capital inflows under Law 4131 in 1979 (Cruz 1999[1984], p.116).

Table 20 below shows public and private borrowing through the main legal mechanisms of foreign borrowing in Brazil: Law 4131 (direct borrowing by firms) and Resolution 63 (borrowing intermediated by banks). Given the size and the creditworthiness of the ultimate guarantor of the loan, it is hardly surprising that within the private sector the affiliates of foreign banks and non-financial companies were those that benefited the most from the favours and incentives conceded to borrow into the Euromarkets. Accordingly, whilst in 1972 the borrowing of financial and non-financial foreign enterprises was only 1.3 times above those of private national firms, in 1975 foreigners borrowed 4.4 times more than nationals, and still 3 times more in 1978. Overall, however, the private sector responded in accordance with the incentives and borrowed heavily up until 1978. The private sector naturally reduced its foreign borrowing when the costs of it began to increase from 1978

with rising international interest rates and increasing uncertainty in the international scenario.

**Table 20 Public and Private External Borrowing Under Law 4131 and Resolution 63 in US$ Millions and as a Share of the Total Capital Inflows, 1972-1981**

| | *Law 4131* | | | | *Resolution 63* | | | | *Total as a Share of Capital Inflows (%)* |
|---|---|---|---|---|---|---|---|---|---|
| | Total | Public | Private | | Total | Public | Private | | |
| | | | National | Foreign | | | National | Foreign | |
| 1972 | 2,497.5 | 623.1 | 680.6 | 1,193.8 | 1,465.2 | 172.8 | 686.3 | 606.1 | 91.8 |
| 1973 | 2,849.2 | 1,130.9 | 655.6 | 1,062.7 | 1,066.5 | 152.1 | 493.6 | 420.8 | 87.3 |
| 1974 | 3,109.5 | 1,098.0 | 431.8 | 1,579.7 | 1,608.0 | 691.6 | 476.5 | 439.9 | 67.1 |
| 1975 | 3,773.0 | 1,900.9 | 234.8 | 1,637.3 | 928.3 | 413.7 | 205.6 | 309.0 | 76.6 |
| 1976 | 3,826.0 | 1,953.3 | 139.5 | 1,733.2 | 1,429.0 | 343.1 | 428.8 | 657.1 | 67.6 |
| 1977 | 4,857.4 | 2,500.5 | 292.6 | 2,064.3 | 1,321.4 | 412.1 | 406.4 | 502.9 | 76.8 |
| 1978 | 8,828.9 | 5,317.4 | 465.5 | 3,046.0 | 3,053.8 | 890.3 | 982.6 | 1,180.9 | 89.0 |
| 1979 | 8,650.3 | 6,642.9 | 554.1 | 1,453.3 | 1,574.5 | 397.5 | 572.9 | 604.1 | 90.2 |
| 1980 | 4,811.1 | 3,687.0 | 1,76.2 | 947.9 | 3,500.9 | 1,191.0 | 1,080.6 | 1,229.3 | 69.0 |
| 1981 | 7,596.6 | 5,285.5 | 427.7 | 1,883.4 | 5,467.1 | 1,496.2 | 2,200.4 | 1,770.5 | 72.3 |

Source: Paulo Davidoff Cruz (1999[1984]); and BACEN.

With the natural retrenchment of private borrowers in the unstable and costlier circumstances of the international financial markets in the late 1970s, the state role in the process of external borrowing had to be increased to maintain the credibility in the policy and the foreign payments regularly. It was in the context of a worsening current account profile that the government forced public institutions into further foreign borrowing to provide backing for private debt reductions. Hence, as Table 20 above shows, public institutions intensified their borrowings taking up more than 72 per cent of the capital inflows under the Law 4131 and the Resolution 63 in 1978 and about 80 per cent in 1979. In this context, the public sector indebtedness played a sort of borrower of last resort role in a sense that its indebtedness allowed the remittance of interest, profits and amortizations which could not be sustained only with the private external indebtedness. As has been argued, little of this indebtedness had to do with the conventional theory of real transfer, or excess of domestic expenditure over domestic savings.[67] In fact, Brazilian indebtedness followed a cumulative process where the increased capital inflows resulted in increased debt services which led to increased current account deficits.

[67] As Delfim Netto recognised later, the state-owned enterprises had been instrumental in borrowing abroad as their "indebtedness was contracted to pay the petroleum expenditures and the interests. The [II PND's] projects in execution were only good excuse to borrow." Cited in Antonio Barros de Castro and Francisco Eduardo Pires de Souza (1985, p.56: n.72).

**Table 21 Factors Determining Current Account Deficits, 1970-1983**

| | Current Transactions (U$ Million) | Real Transactions (%) | | | Capital Incomes (%) | Other services (%) | Unilateral Transferences (%) |
|---|---|---|---|---|---|---|---|
| | | Productive Services | Balance of Trade | Total | | | |
| 1970 | -839 | 30.1 | - 27.7 | 2.4 | 72.5 | 25.1 | -2.5 |
| 1971 | -1630 | 21.8 | 21.1 | 42.9 | 43.9 | 13.3 | -0.9 |
| 1972 | -1688 | 25.8 | 14.3 | 40.1 | 41.3 | 18.2 | -0.3 |
| 1973 | -2085 | 33.1 | - 0.3 | 32.8 | 51.6 | 16.1 | -1.3 |
| 1974 | -7504 | 15.4 | 62.5 | 77.9 | 16.8 | 5.1 | 0.0 |
| 1975 | -6999 | 14.7 | 50.6 | 65.3 | 28.4 | 6.1 | 0.0 |
| 1976 | -6426 | 17.1 | 35.1 | 52.2 | 39.9 | 7.7 | 0.0 |
| 1977 | -4826 | 24.1 | - 2.0 | 22.1 | 70.7 | 7.0 | 0.0 |
| 1978 | -6983 | 20.4 | 14.7 | 35.1 | 61.4 | 4.9 | -1.0 |
| 1979 | -10708 | 16.1 | 26.5 | 42.6 | 52.1 | 5.6 | -0.1 |
| 1980 | -12739 | 17.3 | 22.2 | 39.4 | 55.1 | 6.6 | -1.1 |
| 1981 | -11706 | 16.7 | - 10.3 | 6.4 | 87.8 | 9.1 | -1.6 |
| 1982 | -16273 | 10.8 | - 4.8 | 5.9 | 83.6 | 14.7 | 0.1 |
| 1983 | -6773 | 16.2 | - 95.5 | -79.4 | 163.6 | 34.1 | -1.6 |

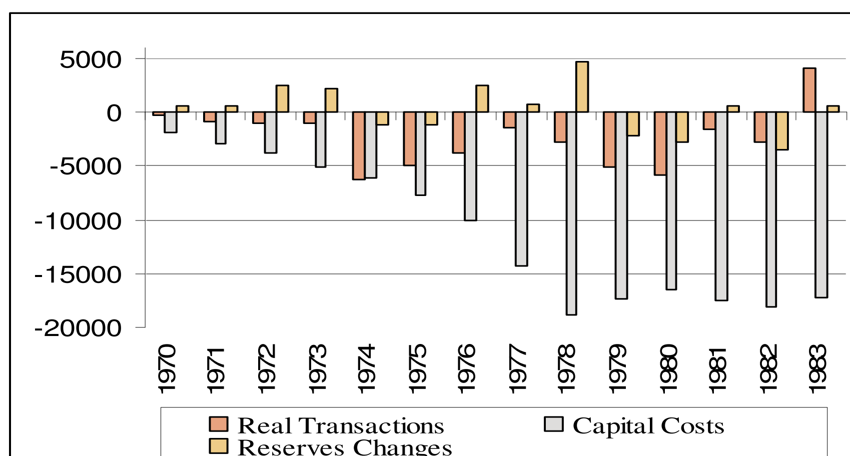
Source: Banco Central do Brasil.

The data in Table 21 and Figure 12 illustrates this cumulative process. As most accounts have it, in 1974 and 1975 real transfers became the main determinant of the external borrowing needs as a result of the effects of the oil crisis on imports, the international recession on exports, and the maintenance of economic growth in Brazil. However, as soon as the greater initial impact of the oil shock lessened, the trade balance tended to equilibrate and real transfers reduced its impact on the external debt already by 1976. On the other hand, capital costs (e.g., interests and profits) increased cumulatively accounting for over 50 per cent of the deficits in the current account after 1977. Although in 1978 the economy was growing at only half the rate that it had been in 1976, profit remittances were twice as high. Interest payments alone accounted for about 40 per cent of the current account deficits, therefore more than the real transactions. In addition, if we look at the total cost of servicing the external debt, one may unmistakably see that financial factors, that is, foreign reserves and capital costs (profits, interests and amortisation), took up the lion's share of the external borrowing to finance them. As illustrated in Figure 12 below, capital costs took up US$ 60 billion between 1970 and 1979, representing 70 per cent of the capital inflow in the period.[68] In short, the Brazilian debt was growing to roll-over financial costs of the debt

[68] Real transactions required only US$ 27.5 billion in financing between 1970 and 1979.

itself. In other words, instead of the current account deficits being directly responsible for the external indebtedness problem, it was the capital account transactions that triggered off the self-sustaining process of the external indebtedness crisis, as rising debts led to rising current account deficits which then reinforced the external indebtedness.

**Figure 12 Absorption of External Resources (US$ Million), 1970-1983**




Source: Banco Central do Brasil.

## The Road to Public Financial Fragility

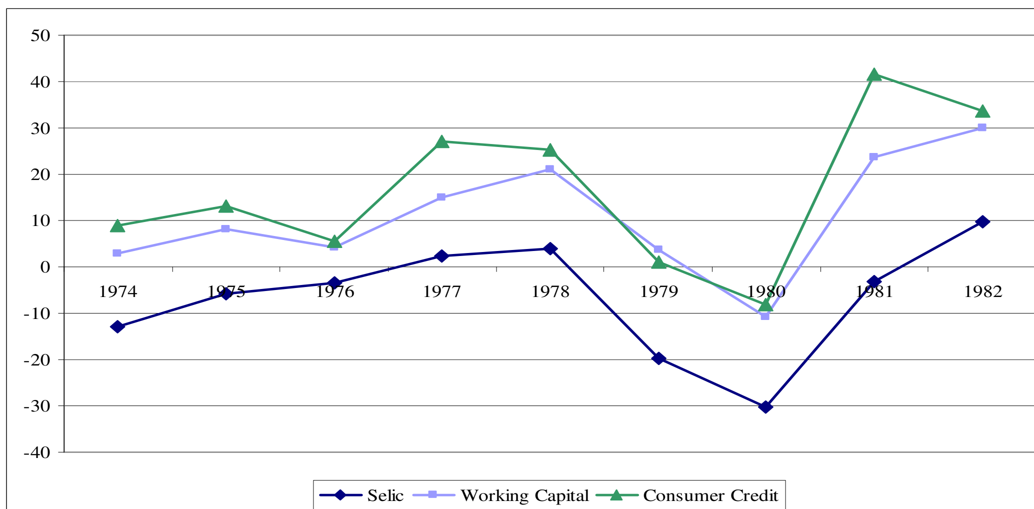
External indebtedness was matched by a similar and related process of public domestic indebtedness. The unconventional way by which external indebtedness linked to public domestic indebtedness is rarely if ever mentioned in neoliberal accounts. It may be so because in part external and internal indebtedness were increased and bound together by the very liberalising policies adopted in the mid-1970s.

The domestic objective of the Minister of Finance, Mario Henrique Simonsen, was to curb inflation by constraining domestic demand. As mentioned above, in 1976 Simonsen had liberated the interest rates of the banking system. In addition, by creating a gap between domestic loans and external loans, policymakers hoped the rise in interest rates would reduce domestic consumption and domestic investment, which in turn would eliminate excess demand, seen as the cause of inflation.

As shown in Figure 13 below, the interest rates on consumption financing, on working capital financing and on public bonds rapidly swelled from negative to positive rates in 1977 and 1978. However, in terms of inflation and control of money supply the results

were rather disappointing. The rates of inflation showed to be resistant to the orthodox policies by climbing to high levels and becoming more unstable. The monetary policy was in part responsible for the escalation of the inflation rates as higher interest rates increased financial costs to firms, which in turn transferred these costs to prices. From 1978 to 1979, for instance, the financial costs of the thousand largest firms in Brazil tripled as a percentage of their operational incomes, whilst their mark-ups remained around 40 per cent in 1979.

**Figure 13 Domestic Real Interest Rates, 1974-1982**




Sources: Ipeadata.
* Selic is the interest rate on Public bonds.
** Interest rates deflated by General Price Index (IGP-DI).

On the other hand, by attracting more international capital the monetary policy tended to undermine its own domestic objectives as the increase in foreign reserves to some extent offset and frustrated the domestic monetary actions. At the same time as the BACEN increased the banking reserves ratio on deposits, in an attempt to limit the ability of the banking sector in advancing credit, the commercial banks breached those regulations by increasing their foreign borrowing under Instruction 63. For instance, whilst deposit on demand decreased about 3 per cent from 1976 through 1979, foreign resources took over deposits as the main liability of the commercial banks by increasing 116 per cent in real terms at the same time. As a consequence, the real rates of interest became difficult to sustain, either because foreign reserves tended to increase the money supply or because inflation became out of control.

To maintain their targeted real interest rate, policymakers had no option but to resort to open-market operations in order to sterilise the inflows. By offering indexed public bonds the government allowed the public to substitute the highly liquid and profitable public bonds for non-indexed money (M1). As shown in Table 22 below, in the six years from 1975 the means of payments dramatically fell over 5 percentage points in GDP. Whilst the means of payments reduced as a percentage of GDP to a minimum to allow current transactions, the financial assets increased by 2.5 percentage points in GDP in three years from 1975.

In sum, the first impulse which led to domestic public indebtedness was the need to keep interest rates positive amidst excessive capital inflows. Therefore, most of the substitution of financial assets for payment means was due to the government issuing public bonds to sterilise money effects of capital inflows and to keep the real interest rates positive. This process tended to develop a life of its own, resulting in ever-increasing public indebtedness to compensate for capital inflows and to avoid the interest rates to become negative. From the point of view of the private sector, in turn, in the context of economic slowdown and rising uncertainties, indexed public bonds became a better alternative than productive investments as they were protected against inflation and had liquidity guaranteed by repurchase agreements.

**Table 22 Financial Assets and Monetary Aggregates as a Share of GDP (%), 1970-1983**

| | *Financial Assets* | *Means of Payment* | *Non-Monetary* | | | | |
|---|---|---|---|---|---|---|---|
| | | | Public Bonds | | | Private | Total |
| | | | Total | LTN | ORTN | | |
| 1970 | 32.4 | 18.2 | 5.2 | 0.4 | 4.8 | 9.0 | 14.2 |
| 1971 | 35.7 | 17.9 | 6.0 | 1.5 | 4.5 | 11.8 | 17.8 |
| 1972 | 40.5 | 18.4 | 7.6 | 2.9 | 4.6 | 14.5 | 22.1 |
| 1973 | 41.4 | 18.3 | 7.5 | 3.4 | 4.1 | 15.6 | 23.1 |
| 1974 | 39.1 | 16.8 | 6.4 | 2.0 | 4.4 | 15.9 | 22.3 |
| 1975 | 42.7 | 17.1 | 9.3 | 3.6 | 5.7 | 16.3 | 25.6 |
| 1976 | 41.4 | 15.2 | 9.4 | 4.2 | 5.2 | 16.8 | 26.2 |
| 1977 | 39.3 | 13.7 | 9.6 | 4.9 | 4.8 | 16.0 | 25.6 |
| 1978 | 41.4 | 13.4 | 9.9 | 5.4 | 4.5 | 18.1 | 28.0 |
| 1979 | 40.3 | 14.0 | 8.7 | 4.5 | 4.2 | 17.6 | 26.3 |
| 1980 | 33.4 | 11.9 | 6.8 | 2.1 | 4.7 | 14.7 | 21.5 |
| 1981 | 41.4 | 11.6 | 12.9 | 4.6 | 8.3 | 16.9 | 29.8 |
| 1982 | 44.1 | 9.5 | 16.2 | 3.0 | 13.1 | 18.4 | 34.6 |
| 1983 | 47.9 | 8.4 | 23.3 | 4.3 | 18.9 | 16.2 | 39.5 |

Source: Ipeadata.

Therefore, apart from the intrinsic ineffectiveness of the restrictive monetary policy in bringing down inflation in the context of concentrated and powerful industrial structure and high integration of the financial markets, the directive to maintain high interest rates and foreign reserves entailed new connections between the public sector and private accumulation. That is, while the public sector was losing its ability to realise fiscal policies to channel public and private investments into industrial transformation,[69] as the adjustment imposed increasing restrictions on public spending, the public indebtedness (external and internal) became functional in supporting the private speculative activities.

**External Shocks and Economic Turmoil**

In 1979, the increasing financial instability of the current accounts of the balance of payments and domestic inflation led to the removal of Simonsen from his position as Finance Minister even before the external shocks intensified in the second half of the year. In his place, the military government recalled Antonio Delfim Netto, Finance Minister during the "miracle" period. This was a late and ineffective attempt to restore developmental policies. The international interest rates hike coupled with the second oil price shock in October and November of 1979 – and, more importantly, the responses of the Brazilian policymakers to these events – had already destroyed the ability of the state to govern investment flows and to deter the private sector from speculative investments.[70]

[69] To be sure, this has been said of the process of industrial transformation because by 1979 a few investment projects coalesced by the II PND were still being accomplished. However, as shown in the third section of this chapter, the government had already lost its grips on the process of transformation by 1976. As a result, the up-date of the industrial structure envisaged by the II PND had been halted.

[70] According to Ajit Singh (1995, p.116) in the late 1970s and early 1980s "developing countries…were subject to four different kinds of external shocks: a demand shock, a terms-of-trade shock, an interest rate shock and a capital supply shock." So, in addition to the oil prices and interest rates hike, industrialised countries entered in recession and international banks suddenly arrest lending to debtor countries.

**Table 23 Indexes of Terms of Trade of Brazil and Other Regions (1979 = 100), 1978-1983**

| | *Brazil Price Indices* | | *Brazil* | | *Asia*[1] | *America* | *Indebted Countries*[3] |
|---|---|---|---|---|---|---|---|
| | Exports | Imports | Terms of Trade With Oil | Terms of Trade Excluding Oil | Terms of Trade[2] | Terms of Trade[2] | Terms of Trade[2] |
| 1978 | 91 | 84 | 109 | 104 | - | - | - |
| 1979 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| 1980 | 106 | 128 | 82 | 94 | 98.6 | 107.4 | 113.7 |
| 1981 | 100 | 142 | 70 | 88 | 97.8 | 101.3 | 109.3 |
| 1982 | 94 | 137 | 68 | 85 | 98.4 | 93.4 | 101.8 |
| 1983 | 88 | 130 | 67 | 79 | 99.2 | 88.9 | 97.5 |

Sources: Banco Central do Brasil; Baer (1993, p.76, Table 3.4) for Asia's, America's and Indebted countries' terms of trade.
1) Excluding China;
2) Weighted average according to the exports/imports country's shares;
3) Fifteen highly indebted countries : Argentina, Bolivia, Brazil, Chile, Colombia, Ivory Coast, Ecuador, Philippines, Yugoslavia, Mexico, Morocco, Nigeria, Peru, Uruguay and Venezuela.

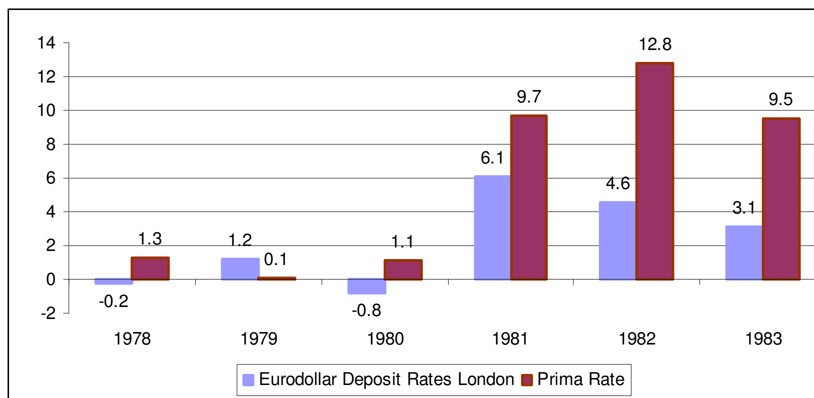
While the external vulnerability of the Brazilian economy had already been acute, the double international shock undeniably complicated matters further. When the second oil shock struck, oil imports accounted for over 87 per cent of Brazil's oil domestic consumption and more than 50 per cent of the total imports. Table 23 above shows Brazil's terms of trade compared to other countries. Accordingly, it is clear that up until 1981 the terms of trade deteriorated mostly as a result of the effects of the oil shock upon import prices. Import prices increased 76 per cent between 1978 and 1981. Further deterioration in the terms of trade that occurred after 1981 appears to be related to the effects that recession and protectionism in Brazil's main export markets (OECD) provoked upon export prices. All in all, Brazil experienced a total deterioration in its terms of trade of about 35 per cent between 1979 and 1982. Compared with other countries Brazil suffered an excessive deterioration in terms of trade – 35 times higher than the average in Asia, 13 times higher than that of other indebted countries, and 3 times higher than the average for other countries in the Americas.[71]

In contrast with the developments in the aftermath of the first oil crisis, which also provoked a sudden increase in Brazil's current account deficits, the second wave of external

[71] Balassa (1986) finds that "outward" countries suffered stronger external shock than "inward" countries, in which Brazil was included. Considering in our data Asia as a proxy for "outward" countries, one can affirm that Balassa's findings misled a correct comprehension about the effects of the shocks upon Brazil.

shocks brought a much stronger and lasting rise in the international interest rates. The nominal Prime rates climbed from an average 6.8 per cent in 1977 to 12.6 per cent in 1979, as did nominal Eurodollar deposit rates in London from 6.7 per cent to 14.5 per cent over the same periods. Figure 14 below shows that real interest rates, albeit lagging due to the inflationary shock of oil prices, also climbed during the period to attain as much as 13 per cent.

**Figure 14 Real International Interest Rates (%), 1978-1983**




Source: Ipeadata.
* Prime rate deflated by United States Wholesale Index Price.
* Eurodollar deposit rates deflated by United Kingdom Wholesale Index Price.

This sudden and hefty rise in international interest rates after 1979, brought about by a return to monetarism in the United States, comprised the most important destabilising factor in the deterioration of Brazil's external conditions.[72] The extremely fragile situation of Brazil's external accounts to interest shocks stemmed from two coupled factors: the already considerably high external debt which in turn had been mostly contracted in the fashion of floating interest rates. In 1980, the U$57.3 billion Brazilian net external debt mounted to 3 times total exports (see Table 19 above). According to Paulo Nogueira Batista Júnior (1987, p.29), loans contracted under variable interest rate clauses typically accounted for more than 60 per cent of the guaranteed external debt. Since non-guaranteed external debts were basically short-term ones, one can assert that the hike in the interest rates had a rather immediate impact upon Brazilian balance of payments.[73]

[72] As Brazil's main external markets (OECD) plunged into deep recession in the aftermath of the interest rates hike, one can argue for the indirect effects of this factor upon Brazil's export prices. Actually Brazil's export prices began to decline just after 1981, when international interest rates reached their heights.
[73] Carlos Diaz-Alejandro (1983, pp.521-522) suggests also that the international borrowing by Brazilian firms was essential for their exports. In consequence, the increase in interest rates and the halt of new lending in 1982 to the country should have had an additional effect in the export performance.

A more accurate account of the impact of interest-rate hikes upon Brazil's external debt is the effective interest rates Brazilian borrowers paid. Measuring the interest rates by interest paid on net external debt in December of each previous year and deflating them by the Brazil's terms of trade, it was found that the real interest rate paid by Brazil increased from 18 per cent in 1979 to 33 per cent in 1980. These figures show with sufficient eloquence that the interest shock struck Brazil much squarely than suggested by the mere observance of the behaviour of international interest rates would suggest.

The international interest rate hike determined a quick reduction of Brazilian foreign reserves, the measure of the creditworthiness and solvency of the country. As a consequence, external financiers became more reluctant to extend new lines of credit, which made extra indebtedness unavailable to compensate for the increasing requirements wrought by interest payments. The reluctance of international banks also materialised in the conditions new credit concessions were extended. Short-term debt increased swiftly from 11 per cent of the total debt in 1979 to 19 per cent in 1980. In fact, according to Paulo Nogueira Batista Júnior (1987) official figures as presented above may underestimate the true shortening of Brazil's external debt for a portion of long-term debt was actually broken into short-term inter-bank loans. "As a result, a growing proportion of Brazil's supposedly long-term debt was in effect a short-term debt of Brazilian banks operating abroad" so that "by December 1982, Brazil's short-term debt… had reached an estimated… 27.8 per cent of total foreign debt" (*op.cit,* p.39). In short, the Brazilian profile of indebtedness and the external conditions of financing suggest that the economy was running fast towards insolvency.

The first response of the government to the shocks came as an attempt to ease the increasing imbalances in the current account. Pressured by developed countries to eliminate subsidies, Delfim Netto introduced various liberalising measures to satisfy commercial partners and multilateral institutions: eliminating of export subsidies; correcting of public prices and tariffs; eliminating of prior deposit on imports; relaxing of the law of similarity and, as a compensation for the previous measures, the 30 per cent devaluation of the national currency. The currency devaluation broke a convention prevailing for twelve years of mini-devaluation (crawling peg) of the exchange rates and exerted far-reaching impacts on the financial stability of the country. Unsurprisingly, a devaluation of such a magnitude would have major inflationary effects. In Brazil, the inflationary effects of the maxi-

devaluation widened as a result of the widespread indexation of the economy. As inflation rose, the government desperately attempted to regain control over the economy by introducing ceilings in the interest rates, pre-setting monetary correction and exchange rates in 40 per cent and 45 per cent of the inflation rate. Soon, however, these measures proved to be ineffective. In 1980, inflation reached over a 100 per cent; the combination of negative interest rates and overvalued exchange rates prompted speculative purchases of imported raw materials. As a consequence, the current account deficits skyrocketed.

In the first half of 1980, Delfim Netto turned back to orthodox measures. The objective was to produce an IMF-like adjustment without resorting to the IMF, as that would have made the government highly unpopular in the elections of 1982. Full indexation of exchange rate was reintroduced; most interest rates freed and turned positive in real terms; banking credit ceilings were imposed, particularly on the Banco do Brasil. Interest rates on consumer credit swelled to 40 per cent in real terms in 1981 and on working capital to 23 per cent. Credit advanced by commercial banks had dropped by 3 per cent in 1981 and the Banco do Brasil's credit plummeted 20 per cent in real terms that year. In addition to the strong credit restrictions, the government imposed ceilings on public expenditure, especially in public enterprises.

The immediate output of these measures was an unprecedented industrial recession lasting over three consecutive years in which manufacturing declined 5.5 per cent and real GDP per capita fell by 4.2 per cent. Meanwhile, consumption dropped by 5.7 per cent, and investment fell by 12.2 per cent. The plunging effective demand resulted in an idle capacity of machines and equipment of over 22 per cent and unemployment of the labour force in the main capital cities of about 8 per cent. Manufacturing sectors like the mechanical, electrical and communications equipment, and transport sectors, which require a highly-qualified labour force, lost 20 per cent, 9 per cent and 15 per cent of their labour force in two years from 1980. In short, a considerable part of Brazil's technical and physical capacity of production was being wasted in the name of adjustment. In contrast, with liabilities protected by deposits in foreign currency in the BACEN and enjoying enormous spreads on lending, the banking system was doing extraordinarily well.[74] The largest banks

[74] As a protection against the international interest rates hike and the maxi-devaluation of 1979, firms intensified their transferences of external debt to Brazil's public sector. Accordingly, foreign currency deposits in the BACEN (under Resolution 432 and Circular Letter 230) more than doubled between 1978 and 1983, going from 4 per cent to about 9 per cent of GDP (Lundberg 1985).

in Brazil, especially the affiliates of foreign banks, were obtaining profitability of 30 per cent to 35 per cent of their net worth (Belluzzo and Almeida 2002, p.249).

Nonetheless, the policymakers looked favourably on the recession as a contribution to turning the trade balance from deficit into surplus, as imports plummeted and exports swelled. They expected to regain international credibility for their policies, meaning the maintenance of capital inflows into the country. However, this did little to resolve the nature of the external debt and the associated financial instability. While the country's capacity to pay, that is the trade surplus, increased by US$ 3.6 billion between 1980 and 1982, the costs with amortisation, interest, and profit remittances increased by US$ 8.5 billion over the same period. As already noted, external debt had created a life of its own by increasing as a result of its own servicing. It kept growing and the obvious insufficiency of the voluntary adjustment led to a worsening of the debt profile. A solution for this situation would only come with a willingness on the part of foreign banks to finance Brazil's debt at falling interest rates, which was obviously improbable, or a renegotiation that would extend the external debt profile. However, neither the government nor the foreign creditors desired to renegotiate the debt as this would indicate serious problems both domestically and in the international financial system.[75] This denial lasted even after the Mexican default of 1982 when the international community and domestic authorities treated the debt crisis as a situation of illiquidity rather than insolvency on the part of the indebted countries (Cline 1985;WorldBank 1983). By attempting the voluntary adjustment, though, the Brazilian public sector operated a downward process in which recession led to further contraction of output and destruction of the state's developmental capacities. Reductions in public expenditure, especially investments, led to further reductions in economic activity and public revenues. The fall in public revenues in turn prompted the government into further reductions in expenditure, starting the process all over again. The financial instability of the country and the recessive environment forced the government to rescue and take over troubled firms; other firms simply transferred to the state the onus of their adjustment by investing idle resources in public bonds or by literally transferring their external debts to the state through foreign deposits in the BACEN.

[75] In November 1982 Brazil would have its general elections (except for president) and a renegotiation of the external debt would certainly be seen as a defeat of the regime.

**Final Remarks**

The 1974 Plan and the 1982 external debt crisis respectively marked the heyday and the collapse of government intervention aimed at structural change in Brazil. The II PND sought to promote, through enhancing government control of the flows of investments, a structural change that would put Brazilian industry amongst the most dynamic in the world. It employed the capacities created since the 1930s: public subsidies, investments of public enterprises and public financing. Since the 1930s the process of industrialisation governed by the state had repeated almost the same model: government investments provided leading industrial sectors with a firm source of demand; public financing and subsidies guaranteed cheap and reliable sources for long-term investments and a secure margin of profits. Crises and bottlenecks served to induce further changes in the institutional settings and incentives needed to maintain the process. For instance, in the 1970s exports of manufactured were favoured by an enormous and successful amount of fiscal and credit incentives to compensate for the concentrated and narrowed domestic markets and the recently expanded industrial capacity. Likewise, the increased liquidity coming from the Euromarkets was not fully sterilised by open-market operations leading to a remarkable increase in the credit for consumption and working capital. The increased purchasing power of a buoyant middle-class led in turn to consumption of durable goods and occupation of the idle capacity.[76] For long-term and high-scale investments, the government provided finance through the BNDES and Banco do Brasil, which operated as Gerschrenkonian development banks. Were we still in 1976, the Brazilian state would be described today as a successful example of a "developmental state."[77]

After 1976, however, the developmental capacities of the state began to wither. It forwent the long-term planning and the investments envisaged in 1974 in favour of international credibility, that is, the maintenance of high levels of foreign reserves. Ironically, in its pursuit of international credibility the state became increasingly unable to mediate the relationship between the domestic and the international economy, especially in

[76] It is important to note that the institutional setting mentioned above put into place to resolve that particular bottleneck of Brazilian industrialisation in the 1960s and 1970s should not be seen as the only alternative. Other institutional settings could have been arranged in a different political climate. For instance, the broadening of the markets could also have been entailed by a better income distribution, land reform and public investments in social overhead capital.

[77] See Peter Evans (1995) for a discussion of this concept. Also, Evans describes Brazilian state as an intermediate case between the "developmental state" and the "predatory state."

its financial orbits, and was gradually forced to retreat from the direct and regulatory mechanisms by which the state governed the flows of investment within the country. It needs to be emphasised that the state was not receding with regard to its role of providing an environment for capital accumulation. It was being transformed from the planner and supporter of industrialisation into an instrument of the speculative and rent-seeking accumulation of domestic and international capital.

First and foremost, capital inflows, which since the reforms of 1964-1967 had been seen as an instrument of development by increasing domestic credit and extending its horizons, should now be sterilised by issuing public bonds. Capital inflows became only a token of the international credibility by which the security of the domestic policies would be judged. By the same token, the security of the value of the contracts should be guaranteed by an anti-inflation policy that meant restrictions on domestic credit, reductions in consumption and investments, and most of all a compromise with real interest rates. In all these new priorities the public institutions were likely to play a greater, not lesser, role. In this context, given the state's share in the total expenditure the state's investments through public enterprises and direct administration became instrumental to reduce domestic absorption whereas public financial institutions became instrumental in reducing domestic credit. Likewise, public prices and tariffs became an instrument of inflation control instead of an instrument of internal financing of public investments. Furthermore, the capacity of public enterprises for indebtedness was used to attract capital inflow in order to offset the current account deficits. Last but not least, public bonds and the interest rates they paid became an instrument of capital accumulation whilst physical and technical accumulation lost prominence to speculative accumulation.

The outcome became fully apparent after the 1982 external debt crisis when the IMF's programmes of adjustment were implemented in full. After the failure of voluntary adjustment, the Brazilian policymakers joined in the neoliberal chorus that the external debt crisis was a result of ill-managed expansionist domestic policies and that a review of the state-led development model was necessary. An important consequence of this misled conclusion was that, by blaming government failures, the neoliberal policies of the 1990s simply neglected the unanticipated and undesirable consequences of unfettered capital flows for developing countries. A delusional perspective towards capital flows re-emerged with the return of the capital flows themselves in the 1990s. Close attention will later be

paid to the way in which Brazilian policymakers forgot the lessons of the debt crisis of the 1980s. Before that, however, it is important to discuss how the Brazilian state had to sacrifice itself, and the productive capacity of the economy, for the benefit of the resolution of the outstanding external debt and the adjustment of the private sector. The next chapter will address the nature and purposes of the external debt negotiations, and their domestic consequences.

# *6. Weathering the External Debt Crisis: The Neoliberal Way*

## Introduction

In 1982, Mexico's default on its external debt launched an external debt crisis whose effects spread rapidly through the Brazilian economy.[78] As a consequence, in the 1980s Brazil experienced low economic growth tending towards stagnation, high inflation tending to hyperinflation, and high and increasing public deficits. Neoliberal economists have blamed the prolonged poor economic performance and high financial instability of the 1980s on the supposed rejection of free-market reforms by Brazilian policymakers. This chapter argues, on the contrary, that many of the troubles the Brazilian economy experienced in the 1980s were derived from the adjustment of the economy to the settlement of the external debt crisis along the lines established by the IMF and the foreign creditors. The Brazilian state had to sacrifice its own financial wealth, financial stability and hence the sustained long-term growth of the economy to comply with the net transfer to pay the debt servicing to foreign creditors.

The second section will show that, despite using the rhetoric that market forces are better than planning, the governments of developed countries had in fact decided to intervene in the settlement of the external debt through the IMF in order to avoid a general collapse of the foreign banks. Even neoliberal economists favoured political intervention in the market to rescue the international financial system from bankruptcy (Lal 1997[1983]). Nevertheless, as far as the governments of developed countries were concerned, renewed monetarist and supply-side policy-making bore no responsibility for the external debt crisis.

[78] For all the relevant issues surrounding the Latin America external debt and ensuing implications for the economic growth of the region see Stephany Griffith-Jones and Osvaldo Sunkel (1986) and Osvaldo Sunkel (1993). For a discussion of the economic policies promoted by the IMF in Latin America see Leonardo V. Vera (2000). For an orthodox account see Sebastian Edwards (1995).

Their guiding principle for the settlement of the external debt crisis was to impose a regime of net transfer from debtors to creditors. Despite the uneven distribution of punishments amongst the free-contractors and the moral hazard (in relation to foreign creditors) involved in the IMF intervention, free-market economists took the view that not only was the medicine correct but also that the more bitter it was, the better the cure would be. That is, to purge their improvidence in borrowing abroad and to be accepted again in the international capital markets the governments of developing countries should be forced to adopt "unpalatable changes in [their] economic policies" (Lal 1997[1983], p. 67). The more painful the IMF's conditionality programmes were, the more therapeutic effects on the patients and the more positive externalities on the would-be patients the programmes would have. That is, the IMF's conditionality would not only restore sound macroeconomic policies and foreign credit of the troubled developing economies but it would also warn other governments of the dreadful risks entailed in falling into the hands of the IMF. The brief digression on the international political and economic restrictions prevailing in the 1980s is intended to serve as a background for the analysis of the economic policies adopted in Brazil provided in the remainder of the chapter.

The third section discusses the actual conditions of the Brazilian external debt negotiations. It shows that the negotiations entailed a heavy burden of net transfers abroad from Brazil, historically comparable only to the reparations paid by Germany after the First World War.

Subsequently, section four discusses the consequences for economic growth (mainly through the impact of the adjustment on investment, manufacturing output, productivity and exports). The main concern is to show that at the deliberate request of the IMF and foreign creditors the government had to axe its investments – with dreadful consequences for efficiency and economic growth.

The fifth section discusses the domestic financial instability that arose from the implementation of the adjustment policies. Financial instability exacerbated the inhospitable environment for sustained economic recovery as it disrupted previous conventions and introduced great uncertainty into the economy. This financial instability did not result in a general crisis because the government turned its policies to support the private sector financial restructuring. Therefore, contrary to the neoliberal view, it is argued that the ever-increasing public deficits and debts were a direct reflex of the rules of the

adjustment. For sure, the government deficits and debt were not made in the name of the social prosperity, but they were instrumental in maintaining the net transfers abroad and in guaranteeing minimum profitability for financial and non-financial conglomerates. It concludes by proposing that the adjustment policies had a straightforward meaning: the prioritisation of the interests of international and domestic rentiers with regard to government policies and resources, at the expense of economic and social development.

### External Debt and the Political Economy of the Adjustment

In the wake of the external debt crisis of 1982, the international financial community had to come up with an urgent solution in order to rescue the international banking system from what could have been a devastating crash of the banks' capital and earnings. According to Robert Guttmann (1994, pp.229-230) the nine largest United States banks had lent about 120 per cent of their entire capital base to Mexico, Brazil and Argentina alone. In Brazil alone, the exposure of the nine largest United States banks was calculated at 45.7 per cent of their primary capital (ECLAC 1988, p.8). Japanese, British and Canadian banks also had lent heavily to Latin America countries (Palma 1995). Clearly, if Brazil and Argentina followed Mexico in defaulting on their external debt it would inexorably erode the capital of a number of international banks with probable disruptive results for the world financial system.

The situation was critical and worsened by the market incentives for individual creditor banks not to lend, as new lending would only provide an opportunity for other creditors to retrieve. Surely, if no one was lending, that would mean the banks losing out as debtor countries would not be able to pay their debt services, and would hence be forced to default on their debts. Although the stage was set for a catastrophe in the international financial system, it did not take place.[79] Coordinated and cooperative actions from developed government and multilateral institutions were called for. Instead of a free agreement between creditors and debtors, the solution found for the rescue of the troubled credit lent to debtor countries, and used in Brazil's case, was a strong intervention from multilateral

[79] In fact, throughout the debt crisis and thereafter the United States banks' earnings were at higher levels than before the crisis (ECLAC 1988, p.10).

institutions and governments which allowed for a coordinated bank's retirement.[80] In the management of the 1982 external debt crisis there emerged what Christian Suter and Hanspeter Stamm (1992, p.647) called "the actor structure on the creditor's side" which constituted of "strong cooperative networks among creditors [capable] to exert far-reaching influence on debtor countries and to enforce hard terms of debt settlements against the interests of debtor countries…".

This actor structure operated at three levels. First, multilateral intervention cooled off the crisis by adopting three immediate steps: a) the advancement of an immediate bridge loans programme whose resources were put forward by the central banks of developed countries, the Bank for International Settlements (BIS) and the United States Treasury to guarantee a minimum flow of capital to avoid further moratorium declarations and also to avoid a disordered outpouring of resources from troubled indebted countries, since both events would have obvious deleterious consequences for the creditor banks' equity values (Baer 1993, pp.60-70;Guttmann 1994, pp.230-235);[81] b) the availability of credit lines under the IMF supervision, conditioned to a macroeconomic programme of adjustment and austerity,[82] to repay the bridge loan and reschedule future payments; c) case-by-case negotiation with debtor countries in order to avoid the constitution of debtors' cartel as strong as the creditors' cartel, which also counted on the creditor government persuasion on debtor countries. Second, creditor banks organized themselves into cartels, which came to be known as "Creditor Bank Committees", headed by the largest commercial banks, to negotiate on behalf of all creditors. These bank committees had as function to present

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[80] In June 1982 (Mexico's default was declared in August of 1982), all United States banks' exposure in Latin America mounted to 124.4 per cent of banks' capital. In Brazil it was 31.1 per cent. In March of 1987 the exposure had been reduced for 65.3 per cent in Latin America and 19.7 per cent in Brazil (ECLAC 1988, p.8).

[81] As Guttmann (1994, p.231) points out, such strategy was fundamental in order for the baking system to "manipulate accounting rules governing losses to their advantage". Accordingly, with the provision of a minimum of resources, which allowed debtors countries to realise parcel of the interest payments, the banks could avoid to rate assets related to LDC's debt at lower levels, like "loss" or "doubtful." Therefore, as Guttmann asserts, the banks could "continue to record interest income on loans that were actually nonperforming, as long as they considered those 'well secured' and 'in the process of collection'. Their willingness to give LDCs new funds for payment of interest on old loans was precisely aimed at assuring that status" (*op. cit.*, pp.231-232). In turn, a solution through the free-market would have imposed an insurmountable loss to the international banking system. As showed by Stanley Fischer (1987, pp.166-167) the secondary markets priced Brazilian debts at 75.5 per cent of its face value in 1986. In June 1987 Brazilian debt was priced in the secondary markets at 60 per cent of its face value, at 52 per cent in June of 1988 and at 31 per cent in June of 1989 (Rivera-Batiz and Rivera-Batiz 1994, p.318). That is, by allowing the banks to bend the counting legislation the governments of advanced countries permitted banks to continue to carry LDC debt at face value.

[82] For a detailed discussion of the theoretical underpinnings of the IMF's adjustment macroeconomic programmes see Leonardo V. Vera (2000).

proposals in bloc impeding therefore that debtor countries explored possible interest divergences between largest banks and small ones.

Third, a coordinated solution to the external debt depended on the cooperation of Latin American countries that chose adjustment over default, that is, they decided to accept to bear the debt settlements. Many authors have argued that in previous debt crises, notoriously in the 1930s, debtor nations defaulted on their debts and bore much lower costs than in the 1980s (Dornbusch 1987; ECLAC 1988; Eichengreen and Portes 1989; Sachs 1986; Sachs and Huizinga 1987; Suter and Stamm 1992). Why did debtor countries accept creditors' conditions instead of defaulting on their debts or trying a better deal with the international creditors? Why did the costs of adjustment in the 1980s seem lower than those of defaulting? First, as has already been noted, debtor countries were unable to establish a "Debtors Committee" following the creditors' example, in part because of the IMF's strategy of negotiating case-by-case agreements, in part due to divergence amongst themselves. Therefore, they were in an unlikely position to obtain good deals against a coordinated and backed creditors' cartel. Second, the multilateral institutions and the banks insisted that the situation was manageable and the adjustment would be temporary. For instance, the World Bank (1983, p.3) held that "the debt problems of most major developing countries are caused by illiquidity, not by insolvency." In addition, debtor countries were threatened with the forecasts put forth by the IMF and creditors according to which rebels (default declarers) would spoil their creditworthiness and hence would be excluded for much longer from the international financial credit system (Boughton 2001, p.542). Third, as creditor governments backed their banks' claims to fully receive interest and incomes upon troubled credit strengthened the threat of exclusion from the international financial markets. The creditor government intervention has been referred to by many authors as the most important factor to persuade debtor countries to comply with the net transfers of financial resources to creditor banks (Dornbusch 1987; Eichengreen and Portes 1989; Sachs 1986; Sachs and Huizinga 1987; Suter and Stamm 1992). As Jeffrey Sachs (1986, p.411) put it:

> "In the 1980s, the United States has managed the debt crisis with a view toward maintaining continued commercial bank debt servicing. Under the U.S. aegis, the other creditor governments and, through them, the multilateral institutions have supported that basic strategy. The ability of the banks to enforce their loan agreements has rested not only on their own bargaining power, but also, crucially, on the willingness of the

> U.S. government to back them up at critical junctures. With the creditor governments placing so much emphasis on continued servicing of bank debts, a decision by a country unilaterally to suspend its debt repayments is as much a foreign policy decision as a financial one."

Eric Helleiner (1994, p.181) points out that the strong position of the governments of developed countries and the cooperation of debtor countries were also related to the "ascendancy of neoliberal frameworks of thought in both creditor and debtor countries in the early 1980s", a condition that guaranteed debtor and creditor enthusiasm in adopting an orthodox adjustment. Therefore the issue was not that in the 1980s debt crisis creditor governments were more or less interventionist, but as Barry Eichengreen and Richard Portes (1989, p.29) stressed:

> "Essentially, the difference in government intervention in the 1930s and 1980s lies not in its extent but its direction. Where U.S. officials in the eighties have made clear the priority they attach to maintaining debt service, in the thirties and forties, when governments intervened, they might pressure both debtors and creditors to reach an early agreement."

In summary, throughout the eighties the relations between creditors and debtors favoured the former as the governments of developed countries and the IMF forced debtor countries to follow economic policies compatible with the full servicing of debts. These institutions played the role of lender of last resort by advancing a minimum amount of resources which could first evade a massive default declaration by debtor countries and then allow creditor banks to retire from troubled credits. As the resources advanced in the debt negotiations were insufficient to cope with creditor banks' withdraw, debtor countries had to bear the bulk of the adjustment as they had to generate massive transferable financial resources abroad. In short, the debt settlement in the 1980s was characterised by close cooperation between creditor banks and multilateral financial institutions as supporters of creditors up against debtors individually as the executors of the adjustment.

### The Brazilian External Debt Negotiation and the Problem of the Net Financial Transfers[83]

The Brazilian negotiations proceeded in accordance with the above pattern, with the burden of adjustment shouldered by the Brazilian economy. The principles that underlay the debt negotiations materialised in the agreements signed by Brazil and its creditors throughout the 1980s (see Tables 24 and 25 for the terms of the agreements). The principles were: a) a rapid settlement of the external debt in order to avoid the disruption to the international financial markets that a Brazilian default was likely to provoke; b) to force Brazil to generate enough resources to pay debt servicing in full, a coordinated reduction in exposure of foreign banks (which meant they would reduce their credit lines to Brazil), and little, if any, debt forgiveness; c) to make the Brazilian government comply with the IMF adjustment programme and surveillance.

**Table 24 Renegotiation of Brazilian External Debt: Agreements with the Private Creditors**

| | Stage I (25/2/1983) | Stage II (27/1/1984) | Stage III (1985-1986) | Stage IV (22/9/1988) |
|---|---|---|---|---|
| New Money (US$ Billion) | 4.4 | 6.5 | - | 5.2 |
| Rescheduled Principal (US$ Billion) | 4.3 | 5.2 | 15.7 | 61 |
| Consolidation (years) | 1 | 1 | - | - |
| Maturity (years) | 8 | 9 | 7 | 12 |
| Grace period (years) | 2.5 | 5 | 5 | 5 |
| Interest rates | Libor or Prime | Libor or Prime | Libor | Libor |
| Spread upon Libor (% per year) | 2 1/8 | 2 | 1 1/8 | 13/16 |
| Flat Fee (%) | 1 1/2 | 1 | - | 1 or 1 1/8 |
| Compromise Commission (%) | 0.5 | 0.5 | - | - |
| Re-lending | Total | Total | Total | Total |
| Trade Commitment Letter (US$ Billion) | 10.4 | 9.8 | 9.5 | 9.7 |
| Interbank Facility Commitment (US$ Billion) | 6 | 5.4 | 5.3 | 4.7 |
| Investment Bonds Exchange Agreements | - | - | - | 1.05 |

Source: Ceres Aires Cerqueira (1996).

The speed with which the negotiations were conducted was based on a desire to avoid default declarations. As Brazil faced difficulties in servicing its external debt in the wake of the Mexican default, international multilateral organisms and creditor governments offered

[83] All the figures on balance of payments and other figures thereof derived have as source Banco Central do Brasil (BACEN) unless otherwise stated.

a bridge loan of US$ 4.2 billion (of which US$ 544 million came from the IMF; US$ 900 million from the US Treasury; US$ 500 million from the BIS; and US$ 2.3 billions from private commercial banks) until Brazil negotiated a definite deal with creditors under IMF supervision. On the other hand, the amount of resources advanced by multilateral institutions was sufficient only to maintain debt servicing – it was not enough to meet Brazil's balance of payments needs. As a consequence, a further US$ 4.5 billion was drained from Brazil's international reserves so that balance of payments could break even, leaving the country practically without reserves. These conditions put Brazilian negotiators in a very weak position to begin official rescheduling agreements with the IMF and creditor banks in November 1982, a situation which favoured the imposition of conditionality by the IMF.[84]

Second, unwilling to declare default, Brazilian policymakers accepted the so-called "reverse" adjustment, which meant first to estimate the amount of resources the creditors would be willing to grant and then the amount of trade surplus needed to close the gap of transactions account. Despite being rescheduling agreements, commercial interest rates and fees for covering the negotiation costs were charged. As shown in Table 24 above, the terms of the rescheduling resulted in stringent conditions for Brazil's payments with high interest rates and short periods of consolidation, maturity and grace. In parallel to the negotiations with the private creditors, which accounted for 7/8 of Brazil's external debt, negotiations were also conducted with official creditors, a group of 16 developed countries organised within the so-called the Paris Club. In the first agreement, the Paris Club rescheduled US$ 3 billion of Brazil's external debt. During the negotiations, which took place throughout the 1980s, as a political entity, the Paris Club played the role of pressuring Brazil to formalise accords with the IMF and to accept its conditionality. As a rule, the Paris Club only accepted open negotiations with Brazil when the country had already formalised a financing accord with the IMF. As Table 25 shows, terms and conditions of the negotiations with the Paris Club were not necessarily better than those agreed with the private creditors. That meant that Brazil's conditions to pay the external debt services were

[84] The delay between the Mexico's default and the beginning of Brazil´s official negotiation with the IMF is accounted for by internal political conditions. In 1982 there would take place the first direct election for local governors and parliament after the 1964 military coup. The government's party estimated that an agreement with the IMF would represent the recognition of the failure of the regime, particularly knowing the kind of policies the IMF would recommend, whose sentence would be a massacring defeat in the November elections.

stringent throughout the decade, that is, that country counted on small renewal of credit and high payment of debt services.

**Table 25 Renegotiation of Brazilian External Debt: Agreements with the Paris Club**

| | Stage I (Agreed Minute 3/11/1983) | Stage II (Agreed Minute 21/1/1987) | Stage III (Agreed Minute 29/7/1988) |
|---|---|---|---|
| Rescheduled Principal (US$ Billion) | 3.0 | 3.7 | 5.0 |
| Maturity (years) | 8 | 6 | 9.5 |
| Grace Period (years) | 4 | 3 | 5 |

Source: Ceres Aires Cerqueira (1996).

**Table 26 Financial Flows by Creditors – US$ Million, 1982-1989**

| | *1982-1984* | *1985-1987* | *1988-1989* |
|---|---|---|---|
| *Official Sources* | | | |
| Financing | 11,528 | 5,763 | 2,779 |
| Amortisation | 2,976 | 7,439 | 6,802 |
| Interest | 2,894 | 5,552 | 4,346 |
| Net | 5,658 | - 5,513 | - 6,745 |
| *Private Sources* | | | |
| Financing | 25,429 | 1,377 | 5,028 |
| Amortisation | 8,019 | 1,312 | 3,055 |
| Interest | 27,172 | 19,177 | 15,912 |
| Net | - 9,762 | - 19,112 | - 16,359 |
| *Other Sources* | | | |
| Financing | 5,516 | 2,167 | 2,028 |
| Amortisation | 4,118 | 1,443 | 1,535 |
| Interest | 4,197 | 1,394 | 868 |
| Net | - 2,799 | 670 | - 375 |
| *Total* | | | |
| Financing | 42,473 | 9,307 | 10,258 |
| Amortisation | 15,113 | 10,194 | 11,392 |
| Interest | 34,263 | 26,123 | 21,126 |
| Net | - 6,903 | - 27,010 | - 22,260 |

Source: Carneiro (2002, p.132).

Table 26 above synthesises the flows of resources to and from creditors according to their official or private feature. Clearly there is an increasing gap between the resources Brazil received throughout the 1980s and those Brazil paid, as a result of the external debt negotiations. Consistent with the principle of avoiding a default, in the first two years after the crisis, the capital inflow financed all the amortization and part of the interest paid in those years. It is also evident that in this period the resources provided by multilateral official sources bailed out part of the private sector withdrawal. However, as the

negotiations continued each time with increasingly fewer resources being provided by the creditors, whether private banks or officials, financing plummeted and became insufficient even to cover amortization, let alone interest payments. Therefore, all the resources to cover amortization and interest had to be provided by Brazil's own resources. It is worth emphasizing that throughout the period the resources provided by private sources had been always below amortization and interests in order to allow those creditors to reduce their exposure to the country. From 1985 onwards, however, even the contribution of multilateral official sources was reduced to amounts below amortization in order to ensure that it would be Brazil's resources guaranteeing the net transfers to reduce creditors' exposure.[85]

The third aspect of the external debt settlement was how to guarantee that Brazil would comply with the terms and conditions of the negotiation. To enforce the observance of the mechanisms of financial transference for creditors the IMF was called to step in. The typical IMF stabilisation programme derives its economic policies from the national accounting identities, by which the national product (GDP) equals domestic expenditure in addition to trade surplus. Trade surplus in turn is the difference between GDP and domestic expenditure. Since the net transfers required maximum generation of trade surpluses, from these identities the IMF suggests increasing the difference between GDP and domestic expenditures, which can be achieved by "switching demand" policies or by "expenditure reducing" policies.[86] In addition to the IMF intervention, the compliance with the negotiation terms and the IMF adjustment policies was facilitated by the framework of thought of Brazilian policymakers who shared the IMF's approach. Even before the agreement with the creditors in 1982, Antônio Delfim Netto (1980, p.21), the Planning Minister then, held the view that it was because of the "mismatch between supply of goods and services and demand of goods and services…[that] inflation and current account deficits emerge." In the letter of intentions sent to the IMF in December of 1982, for instance, the government announced an economic programme which promised to "reduce considerably the external and internal disequilibria" while in the medium-term it "will

[85] For an informative discussion of the effects of the debtor countries net transfers for the United States commercial banks, see Jeffrey Sachs and Harry Huizinga (1987).
[86] For details of the IMF's model of balance of payment adjustment see: Stanley Fischer (1997); Michael Mussa and Miguel Savastano (1999); Francisco L. Rivera-Batiz and Luis A. Rivera-Batiz (1994); and for a critical point of view: Anthony Thirlwall (2003) and Leonardo Vera (2000).

*promote structural changes* in the economy which will bring back *high and sustainable rates of economic growth*" (Finance Ministry of Brazil 1983, p.140).

Throughout the 1980s the IMF advised Brazil to adopt its conventional package combining reductions in domestic expenditure and measures to replace domestic with foreign markets, which included interest rate increases, real wage reductions, public expenditure curtailment, and exchange devaluations. On the assumption that demand-switching towards foreign markets is sufficient to compensate for domestic demand-reducing policies – that is, if external demand increases as much as domestic demand is reduced (adjusted for their relative participations in the total output) – a country could reverse current account deficits into surpluses and still maintain economic growth. Brazilian policymakers also announced that such objectives would be achieved by augmenting "significantly the domestic savings, *especially in the public sector*, and to make the economy more efficient, objectives which will be attained by correcting the relative prices of many sectors of the economy, getting rid of subsidies, and reducing the government's direct and indirect intervention in the economy" (*op.cit*). In other words, the neoliberal framework, which prevailed amongst the government in the developed countries, in the IMF, and amongst the creditor banks, moulded the domestic policies adopted to adjust the economy to the external debt crisis. So, as the above quotation shows, the domestic policies should eliminate price distortions and reduce government intervention to make more room for the market forces to take care of themselves. Indeed, for most of the period from 1982, Brazil's trade surpluses more than compensated the net financial transfers (Table 27 below).

The only period in which the government departed from the IMF adjustment package was between 1986 and 1987, when policymakers attempted to combine economic growth with price stabilisation by de-indexing the economy.[87] In 1986, the government signed an agreement with creditors without signing an agreement with the IMF, which freed

[87] Amongst Brazilian economists and policymakers there was a consensus that Brazilian inflation was fairly determined by the generalised indexation of contracts which spread and perpetuated shocks throughout the economy. In consequence, few economists believed in the orthodox measures, at least taken alone, for controlling Brazilian inflation. For discussions see Mario Henrique Simonsen (1985); Francisco Lopes (1985); Pérsio Arida and André Lara Resende (1985). The Cruzado Plan was the first to bring to the fore measures aiming at de-indexing the economy. For measures of the Cruzado Plan and discussions see Luiz Carlos Bresser Pereira (1986); Werner Baer (1995, ch.8); Lavínia Barros de Castro (2005).

policymakers from the IMF's conditionalities.[88] In addition, even without IMF surveillance, the terms of the agreement improved in relation to the previous agreements and the net financial transfers were reduced. However, the rapid resumption of economic growth following the stabilisation plan reduced the trade surplus in order that, although the net financial transfers had been reduced, Brazil was forced to use its reserves to keep up with the transfers (see Table 27 below). The precarious situation of reserves forced the Brazilian government to declare moratorium in February of 1987. With this moratorium Brazil suspended interest payments on medium and long-term debts, which imposed further reductions in the financial transfers abroad. In addition, interbank deposits in the Brazilian banks abroad were frozen. Both measures should last until Brazil and the creditors arrived at a new agreement. In April of 1987, however, the lack of domestic political support for the moratorium resulted in the resignation of Dilson Funaro, the Finance Minister, and most of his team.[89] By the end of 1987, Brazil had already returned to the conventional negotiation setup with the creditors and under the IMF's surveillance and policies, resuming interest payments even before any formal negotiation with the creditors was achieved. This period illustrates the constraints imposed on the domestic policies, that is, the virtual impossibility of resuming economic growth with price stability under net transference abroad.

**Table 27 Net Resources Transfered Abroad (US$ Million) and as a Share of GDP (%), 1981-1989**

| | Real Transfers | Net Financial Transfers | Reserve Changes | Net Financial Transfers/GDP |
|---|---|---|---|---|
| 1981 | -654 | 2,474 | 594 | 1.0 |
| 1982 | -1,522 | -1,394 | -3,513 | 0.5 |
| 1983 | 5,166 | -3,589 | 569 | 1.9 |
| 1984 | 12,177 | -4,942 | 7,432 | 2.6 |
| 1985 | 11,802 | -11,062 | -387 | 5.2 |
| 1986 | 6,969 | -9,694 | -4,848 | 3.8 |
| 1987 | 10,205 | -7,060 | 698 | 2.5 |
| 1988 | 17,555 | -14,183 | 1,682 | 4.6 |
| 1989 | 15,142 | -11,918 | 539 | 2.9 |

Source: Banco Central do Brasil.

[88] According to Paulo Nogueira Batista Júnior, a Brazilian negotiator at the time of the moratoria, in a speech before Brazilian Congress Hearings on External Debt: "The organization of the negotiation is utterly set up by the creditors and adverse to the debtors. When in the government…we learned that it was needed to change procedures, the rules, the form, the forum and the site of the negotiation."(Brazil 1988, p.9).

[89] According to Paulo Nogueira Batista Júnior "Brazil retreated in the external debt negotiations not because of fear, retaliation or pressure from foreigners, but fundamentally due to the lack of domestic political support for the initiative taken in February 1987…It not only did not have support but also suffered from intense domestic resistance from several powerful sectors of the country"(Brazil 1988, p.20).

Whereas the IMF approach adopted at the inception of the external debt crisis was effective in reducing creditor banks' exposure to Brazil, it was less effective in reducing the country's debt burden. Table 28 below shows indicators of Brazil's external debt and Brazil's creditworthiness during the 1980s. Despite the striking transference of resources abroad, the Brazilian external debt kept on growing over 1982-1987 as the transfers only paid for interest on old debt. Net debt as a proportion of GDP, a major indicator of countries' creditworthiness, in turn worsened through the mid-1980s and returned to the same pre-crisis levels late in the decade. The same happened with the debt to export and debt service to export ratios. The trend of these ratios indicate that the management of the debt crisis did not improve the external creditworthiness of the country, contradicting the usual IMF's and creditors' argument that the sacrifices would be awarded with a quick return to the international financial market.

From 1987 onwards, Brazil generated enough trade surpluses to pay not only the interest but also the amortisation so that the external debt tended to be reduced. This reflected the impact of the better terms and conditions in the negotiations after the Brazil's moratorium in 1987. Although the Brazilian moratorium had failed to get support from domestic political forces, it led the foreign banks to accept losses of capital in external debt and the government of advanced countries to propose reductions in the external debt (Palma 1995; Toye 1993). The Brazilian short default in 1987 forced the foreign creditors and governments to review their practices in negotiations that favoured debt reductions and improved debt indicators.

**Table 28 Indicators of External Debt, 1981-1989**

| | *1981* | *1982* | *1983* | *1984* | *1985* | *1986* | *1987* | *1988* | *1989* |
|---|---|---|---|---|---|---|---|---|---|
| Long-term Debt (US$ Billion) | 61.4 | 70.2 | 81.3 | 91.1 | 95.9 | 101.8 | 107.5 | 102.6 | 99.3 |
| Short-term Debt (US$ Billion) | 12.6 | 15.3 | 12.4 | 11.0 | 9.3 | 9.4 | 13.7 | 11.0 | 16.2 |
| Total Debt (US$ Billion) | 74.0 | 85.5 | 93.8 | 102.1 | 105.2 | 111.2 | 121.2 | 113.5 | 115.5 |
| Net Debt (US$ Billion) | 66.5 | 81.5 | 89.2 | 90.1 | 93.6 | 104.4 | 113.7 | 104.4 | 105.8 |
| Net Debt/GDP (%) | 25.7 | 30.0 | 47.1 | 47.5 | 44.3 | 40.5 | 40.3 | 34.1 | 25.4 |
| Net Debt/Exports | 2.9 | 4.0 | 4.1 | 3.3 | 3.6 | 4.7 | 4.3 | 3.1 | 3.1 |
| Debt Service/Exports (%) | 31.9 | 42.1 | 28.7 | 26.6 | 34.8 | 33.2 | 26.7 | 42.0 | 31.3 |

Source: Banco Central do Brasil
* Numbers may not add due to rounding.

Whereas the size and the dynamic of growth of the external debt are important to understand the burden the Brazilian economy had to carry through the 1980s, the composition of the domestic debtors is crucial to understanding the domestic dynamic of

adjustment. In other words, while it is clear that the external debt settlement should benefit the foreign creditors at the expense of domestic economy, the costs of the adjustment were unevenly distributed within the domestic economy. Despite the free-market rhetoric of the foreign banks and the governments of developed countries, they nevertheless called on the Brazilian state to play a central role in adjusting the Brazilian economy to the debt crisis. By placing the responsibility on the government, creditors reduced the risk of default as well as shared transaction costs with the Brazilian government.[90] This meant that the Brazilian government should assume responsibility for all the resources agreed on in the negotiations, whether new money or the rollover of the principal. Resources for financing public or private debt were then deposited in the BACEN which became the guarantor for the debt. Debtors in turn were allowed to pay their foreign debt making deposits in domestic currency in the BACEN, while the latter remained responsible for making them good along with the final creditor. In short, the BACEN became the only debtor in foreign currency of the resources renegotiated with the creditors, being responsible for the interest and other costs incident on the deposits accorded with the creditors.[91] These mechanisms served to reduce the creditors' risk and allowed transference of private external debt to public sector.

Table 29 shows data on external debt by debtors in Brazil, from which a clear general picture emerges. Public external debt as a share of the total net external debt grew at a rate of 2.8 percentage points of the total external debt per annum from the early to the mid-1980s, and then its growth fell towards the end of the decade. The sharper growth of the public share in the net external debt happened as a direct result of the negotiations with the creditors and the IMF, which made the BACEN and Central Government primarily responsible for the management of the external debt. Accordingly, the external debt of the BACEN and the Central Government rocketed from 21 cents on the dollar due in 1982 to 30 cents on the dollar in 1984, and about 50 cents on the dollar in 1988. This nationalisation of the external debt happened not only to guarantee the interests of foreign

[90] As one banker put it candidly: "We foreign bankers are for the free-market system when we are out to make a buck and believe in the State when we are about to lose a buck" (quoted in Gabriel Palma (1995, endnote 36)).
[91] While these arrangements directly increased the public external debt, they allowed also that second order factors lifted public debt, such as: the BACEN assumed debt payments of original debtors that were not able to make their debt good; the BACEN assumed interest and other fee charges incident upon the deposits while keeping them; the BACEN assumed the costs of exchange devaluation upon the deposits.

creditors but also to bail out domestic private debtors. Throughout the 1980s the private sector reduced its indebtedness by transferring it to the public sector.

Since the mid-1970s the BACEN had enacted several resolutions and circular letters for controlling the inflows of foreign capital borrowed through the Law 4131 and Resolution 63.[92] The two most important of these regulations, Circular Letter 230 and Resolution 432, provided covering for foreign currency remunerated deposits (DMRE) made in the BACEN against exchange rate variations. The private sector used these mechanisms to transfer its external debt to the public sector in order to protect itself from the devaluation of the exchange rates and from the increase in the international interest rates.[93] After 1985 the growth of public external debt lessened somewhat to an average of 1.6 per cent per year mostly as a consequence of the appreciation of the effective exchange rate and the debt reduction.[94]

**Table 29 External Debt: Public and Private, 1981-1989**

| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|---|---|---|---|---|
| External Debt (US$ Billions) | 61.4 | 70.2 | 81.3 | 91.1 | 95.8 | 101.7 | 107.5 | 102.5 | 99.3 |
| Net External Debt (US$ Billions) | 53.9 | 66.2 | 76.7 | 79.1 | 84.2 | 95.0 | 100.1 | 93.4 | 89.6 |
| I - Private External Debt (% Net Debt) | 36.3 | 34.4 | 27.4 | 24.4 | 20.4 | 15.4 | 14.4 | 12.3 | 11.0 |
| II - Public External Debt (% Net Debt) | 63.6 | 65.6 | 72.6 | 75.6 | 79.7 | 84.6 | 85.6 | 87.7 | 89.1 |
| a) BACEN and Central Government | 19.7 | 21.1 | 31.7 | 30.0 | 30.0 | 39.1 | 46.0 | 50.3 | 55.5 |
| b) Public Enterprises | 40.0 | 40.2 | 37.4 | 41.2 | 44.2 | 40.0 | 34.9 | 32.5 | 29.5 |
| c) State and Municipal Governments | 3.9 | 4.2 | 3.5 | 4.4 | 5.5 | 5.5 | 4.7 | 4.9 | 4.2 |

Sources: Banco Central do Brasil; Ipea.
* Numbers may not add due to rounding.

The nationalisation of the external debt in the aftermath of the debt crisis had important consequences for public finances. First, the stock dynamic of public external debt, dominated by the mechanisms of transference of external debt to public sector, was of paramount importance in determining interest payments on public external debt, and hence public deficits, in the 1980s. Interest payments on external debt became an extraordinary cost for the public sector. Second, as external debt concentrated on the central government and the state enterprises, the adjustment of the public finances to accommodate the interest

[92] The BACEN's Circular Letter 230 of 1974 and Resolution 432 of 1977 allowed deposits in foreign currency in the BACEN.
[93] Paulo Nogueira Batista Jr (1990, p.15) estimated in 34 per cent the accumulated depreciation of the real effective exchange rate between 1982 and 1985. Most of it occurred in 1983 as a result of the maxi-devaluation in February that year. From then on, exchange rates would be indexed to domestic inflation alone making sure the devaluation would be higher than if following purchase power parity principle.
[94] According to Batista Jr´s (*op.cit.*) estimate there took place an effective exchange rate appreciation of about 17 per cent in actual terms between 1985 and 1988.

payments came through reductions in public investments. The next sections discuss in greater detail the domestic adjustment.

### Domestic Effects of the Adjustment Policies on Growth

As already mentioned, the adjustment was implemented in a country in which neoliberal convictions held sway. It was broadly accepted by Brazilian policymakers that reductions in (presumed generally inefficient) public investments would be replaced by (presumed generally efficient) private investments, which in turn would increase as a result of the undistorted trade policies (e.g. reduction in subsidies and real devaluated exchange rates). By eliminating the direct and indirect government interference, Brazilian policymakers believed the economy would be rescued by market forces. Table 30 below shows, however, that it was virtually impossible to maintain historical levels of economic growth along with the generation of high levels of trade surpluses. Historically, trade surpluses in Brazil had been compatible only with negative or modest economic growth, as was the case in 1981-1983 and 1987-1989. Whenever rates of economic growth experienced recoveries, as in 1984-86, the trade surpluses tended to decline either because imports increased or exports grew, or both.

It is very clear that the demand-reducing strategy concentrated heavily on cutting investments, and in this respect public investment bore the brunt of the adjustment. As is clearly shown in Table 31 the investments of public enterprises declined almost every year in the 1980s. Indeed, in 1989 the investments made by public enterprises amounted to only half the level in 1981. Nevertheless, public administration also had its investments slashed throughout the 1980s. All in all, public investments fell from 6.6 per cent of GDP in 1980 to 4.4 per cent in 1984, until reaching the lowest level in 1989. Unsurprisingly, the only period in which public investments recovered was when the government strengthened its negotiating position with the IMF and international creditors and eased external restrictions. However, these periods were short as the recovery of investments endangered the generation of trade surpluses by increasing imports and/or diverting exports to domestic markets.

**Table 30 Rates of Annual Growth of Output and of Demand and Balance Trade and GDP Ratio (%), 1981-1989**

| | *GDP* | *Consumption* | *Investment* | *Export* | *Import* | *Trade Balance/GDP* |
|---|---|---|---|---|---|---|
| 1981 | -4.3 | -5.7 | -12.2 | 21.4 | -12.4 | 0.5 |
| 1982 | 0.8 | 4.2 | -6.8 | -9.2 | -6.0 | 0.3 |
| 1983 | -2.9 | -2.0 | -16.3 | 14.3 | -17.4 | 3.4 |
| 1984 | 5.4 | 2.7 | -0.2 | 22.0 | -3.0 | 6.9 |
| 1985 | 7.8 | 2.8 | 8.8 | 7.0 | 0.1 | 5.9 |
| 1986 | 7.5 | 12.3 | 22.6 | -10.6 | 28.6 | 3.2 |
| 1987 | 3.5 | 1.7 | -1.4 | 19.2 | -2.9 | 4.0 |
| 1988 | -0.1 | -1.3 | -4.9 | 13.1 | -1.1 | 6.3 |
| 1989 | 3.2 | 3.8 | 1.2 | 5.1 | 9.0 | 3.9 |

Source: IBGE; Ipeadata.

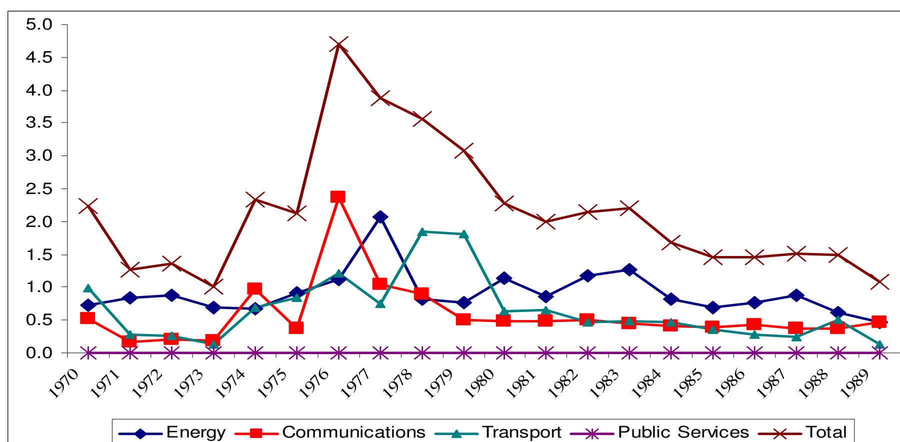
The reasons why the burden of the adjustment fell on public enterprises are quite straightforward. First, the economic crisis reduced the operational revenues that could be used by public enterprises to finance their investments. Second, the government controlled public enterprises' price policies, adjusting these prices below inflation, in order to curb inflation. Therefore, public enterprises had their cash flows reduced also by reductions in their relative prices. Third, the retreat from international financial markets in the 1980s not only took away that source for funding for new investments, but the shortage of resources deriving from the external debt negotiation also made it difficult to rollover old debts accumulated in the 1970s. To serve old debts, without sufficient resources to roll them over, public enterprises drew upon their funds for investments.

**Table 31 Rates of Investment as a Share of GDP and Rates of Growth by Agent, 1980-1989**

| | *Private Investment* | | *Government Investments* | | | | | | *Investment Total* | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | Enterprises | | Administration | | Total | | | |
| | (%GDP) | (Δ%) | (%GDP) | (Δ%) | (%GDP) | (Δ%) | (%GDP) | (Δ%) | (%GDP) | (Δ%) |
| 1980 | 17.0 | 16.2 | 4.3 | 7.3 | 2.3 | 6.6 | 6.6 | 7.1 | 23.6 | 13.5 |
| 1981 | 15.1 | -14.8 | 4.2 | -6.5 | 2.4 | -3.6 | 6.5 | -5.5 | 21.6 | -12.2 |
| 1982 | 13.9 | -7.3 | 4.0 | -3.7 | 2.1 | -9.4 | 6.1 | -5.8 | 20.0 | -6.8 |
| 1983 | 12.0 | -16.1 | 3.6 | -12.4 | 1.6 | -24.9 | 5.2 | -16.8 | 17.2 | -16.3 |
| 1984 | 11.9 | 4.4 | 2.7 | -21.3 | 1.7 | 12.4 | 4.4 | -10.7 | 16.3 | -0.2 |
| 1985 | 11.6 | 5.5 | 2.4 | -1.4 | 2.4 | 46.3 | 4.8 | 17.5 | 16.4 | 8.8 |
| 1986 | 13.6 | 25.4 | 2.2 | -3.1 | 3.0 | 35.1 | 5.2 | 15.7 | 18.8 | 22.6 |
| 1987 | 13.0 | -0.7 | 2.3 | 9.5 | 2.5 | -12.2 | 4.9 | -3.0 | 17.9 | -1.4 |
| 1988 | 12.5 | -4.2 | 2.1 | -8.7 | 2.4 | -5.4 | 4.5 | -7.0 | 17.0 | -4.9 |
| 1989 | 13.2 | 9.5 | 1.6 | -21.8 | 1.8 | -21.4 | 3.4 | -21.6 | 16.6 | 1.2 |

Source: IBGE.
*Numbers may not add up due to rounding.
** Deflated by the FBKF implicit deflator and GDP implicit deflator accordingly.

**Figure 15 Federal Public Enterprises Investments in Infrastructure Sectors as a Percent of GDP, 1970-1989**




Source: IBGE.
* Investment deflated by the implicit deflator of FBKF and GDP deflated by the implicit deflator of GDP.

In addition, the adjustment by cutting public investments was as much a result of the high concentration of external debt on public enterprises as it was a result of the neoliberal creed that inspired the adjustment policies. Accordingly, government investments crowd out private investments so that reductions in the former allow increases in the latter. Contrary to this creed, however, the heavy restrictions imposed on public investments in the 1980s also produced considerable reductions in private investment (Table 31). In the Brazilian institutional setting, it should come as no surprise since public investments had traditionally concentrated on sectors complementary to the private sector, such as electricity, petroleum, telecommunications and transport. As shown in Figure 15 above, public investments in infrastructure fell sharply as a proportion of GDP throughout the adjustment period.

Needless to say, these reductions in investments not only affected short-term industrial output but also competitiveness, and hence the long-term prospects for domestic industry. Many years previously, Nicholas Kaldor (1967) had emphasised the cumulative causation between growth and productivity, in which growth fostered productivity and vice versa. Accordingly, growth in manufacturing output plays a central role as its increasing returns spread to other sectors, increasing productivity and growth throughout the whole economy. Moreover, Kaldor insisted that the causation ran from increased demand for manufactured products, especially investments, to increased productivity and general economic growth.

In Brazil the adjustment to the external debt entailed a vicious cycle of decline, the opposite of the Kaldorian cumulative process. As Table 32 shows, the growth of manufacturing output plummeted in the 1980s, especially in the aftermath of the external debt crisis.[95] The lack of public and private investments affected the capital goods output the most. As a consequence the long-term competitiveness of the industry plummeted as the rate of productivity growth of the labour force employed in manufacturing in the 1980s was four times lower than in the 1970s. Much of this dismal productivity performance can be attributed to the curtailment of public investments that had been concentrated not only on infrastructure but also on education and training.[96] In short, public investments in Brazil were not only complementary to private investments, as the curtailments in the first resulted in reductions in the second, but they also buttressed increases in productivity of the manufacturing sector for providing cheap inputs and a firm market for the growth of industrial output and productivity.

**Table 32 Rates of Annual Growth of Output and Labour Productivity of Manufacturing, 1975-1990**

| | *1975-1980* | *1981-1984* | *1985-1990* |
|---|---|---|---|
| Manufacturing Output[1] | 7.3 | -0.4 | 0.4 |
| Capital Goods | 4.2 | -5.3 | 0.6 |
| Intermediate | 9.0 | 1.4 | 0.2 |
| Consumption | 6.1 | 0.9 | 1.2 |
| Manufacturing Labour Productivity[2] | 3.1 | 0.4 | 1.3 |

Source: IBGE.
1 - Simple averages.
2 - Compound rate of growth of manufacturing output per worker. For 1985 the number of workers data from Economic Census. For the other years the data are from the Annual Industrial Research.

The ideological eagerness with which the Brazilian policymakers embraced the outward-oriented adjustment, switching the relative price incentives in favour of tradable

[95] The slight recovery of the second half of the decade showed in Table 30 was actually influenced by the effects of the Cruzado Plan, a stabilisation plan which broke with the adjustment policies and sought to increase public and private investments. During the Cruzado Plan the manufacturing output increased 11.3 per cent; capital goods output 22 per cent; intermediate 8.4 per cent and consumption goods 11 per cent.

[96] However, it is important not to overemphasise the lack of education and training of labour force. In the eighties, the degree of instruction of the labour force in Brazil increased in a faster pace than in the 1970s. For instance, workers with four or less years of schooling were 68 per cent of employed labour force in 1975 and in 1980; then fell to 59 per cent in 1985 and further to 48 per cent in 1989. On the other hand, workers with 9 or more years of schooling increased their share in the employed labour force from 13 per cent in 1975 to 15 per cent in 1980 to 21 per cent in 1985 and to 24 per cent in 1989. Continued qualification and training are not in dispute in relation to their contribution to productivity growth. However, it is possible that a better qualified labour force will not suffice without adequate availability of physical capital. Besides, in an overall speculative environment, as it will be described, the better qualified workers (e.g., engineers) might be allocated to activities non-related to production.

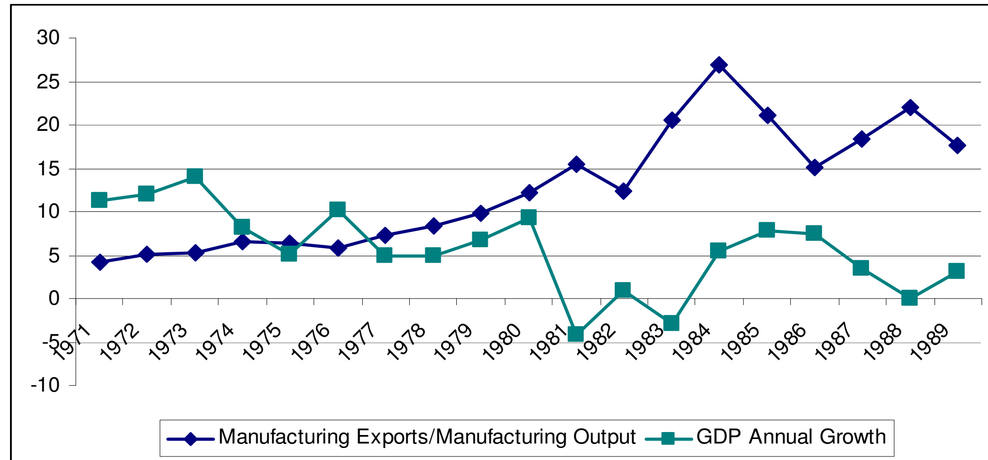
production, in turn did not compensate the industry for the loss of markets and competitiveness resulting from the collapse of domestic investments. Despite the domestic industrial recession and the devalued exchange rates, exports contributed considerably to the growth of only a few traditional sectors of industry, agriculture, and as a result of the maturity of some II PND investments (cellulose, steel and electronics). Overall, though, external markets contributed significantly to economic recovery only in 1984, when exports accounted for 27 per cent of the manufacturing output (see Figure 16 below). Even so, the utilisation of capacity in manufacturing sectors increased only marginally in that year, from 73 per cent to 74 per cent,[97] and was therefore only a very weak stimulus to investment. As Table 30 and Figure 16 illustrate, it is clear that throughout the 1980s external markets were only a weak and occasional alternative to domestic market growth. That is, export performance varied inversely to the domestic market cycles and demonstrated a very weak capacity to lever industrial investment.

Therefore, contrary to the well-known examples of East Asian countries, where investments enhanced technological capabilities and productivity and paved the way to increase exports to spur economic scales, in Brazil the outward strategy in the 1980s, based only upon "correcting" relative prices, failed to establish a consistent international integration on the same bases as the East Asian economies. As a consequence, the integration of manufacturing into international trade was insufficient to boost manufacturing production; it was unstable, because it varied with domestic cycles instead of being part of a consistent strategy of growth; and it was regressive, based upon low-skilled labour and resource-based manufacturing[98] that resorted to wage repression and sharp depreciations instead of investment, productivity and structural change.

[97] Data from IPEA (2006).

[98] Throughout the 1980s, products from agriculture, mining, footwear, clothing, textiles, cellulose and paper, steel, and fabricated metal accounted for over 60 per cent of Brazilian exports. According to UNCTAD's (1996) classification, those are sectors characterised to be based on natural resources or on low skill, technology, capital and scale requirements.

**Figure 16 Ratio of Manufacturing Exports to Manufacturing Output and GDP Growth Rates (Percentage)**




Source: IPEA (2006).

In short, the restrictions the IMF programme imposed on the Brazilian economy reduced the ability of the government to adopt a planned, consistent and gradual structural adjustment. By discouraging investments, above all public investments in infrastructure, the adjustment produced a downward cumulative process which locked the economy into low-level investment and productivity. While public investments were cut indiscriminately – either for fiscal reasons or due to the neoliberal ideological dominance – private investment was discouraged by the slower or negative growth in domestic demand. Low investment and productivity led to the poor performance of exports and economic growth, and to complete the picture they were exacerbated by the highly unstable and uncertain economic environment introduced by price corrections. The new configuration of relative prices and incentives introduced by the IMF' programmes increased financial instability. Next section will provide a more detailed analysis of this process.

### Financial Instability and Fragility Resulting from the Adjustment Policies

The price "corrections" (or switching policies) aimed at inducing greater net exports, and the restrictive fiscal and monetary policies aimed at reducing domestic absorption (expenditure reducing policies), produced awkward financial instability expressed in the increasing volatility of inflation, exchange rates and interest rates.

A devalued exchange rate was selected as the main mechanism to increase exports and to adjust the economy to the regime of resource transferences. The first consequence of the policy of devaluation was the introduction of considerable uncertainty concerning the exchange rates as they became highly unstable throughout the 1980s. In addition, the inflationary effects of devaluation were powered by the widespread indexation of the Brazilian economy, which added to the instability and uncertainty of the exchange rates. For instance, after the maxi-devaluation of 30 per cent in 1979, Brazil's wholesale price index quickly climbed from around 40 per cent per year in 1978 to around 120 per cent in 1980. As inflation reversed the exchange rate policy objectives, in February 1983, when the adjustment package became tighter under IMF rules, another maxi-devaluation of 30 per cent came about. To impede another appreciation of the real exchange rate by inflation the government indexed the nominal exchange rate to the domestic inflation rates.

The second and complementary leg of the adjustment policies was the maintenance of high real interest rates. The objectives of the monetary policies were twofold: to prevent inflation from rising and to contract domestic demand in order to generate a trade surplus. The typically negative interest rates of the 1970s and the great deal of subsidised credit provided by public financial institutions as earmarked funds came under great pressure from the IMF in 1983. The IMF technical note of its staff mission to Brazil in 1983 asserted that "the chief fault in Brazil's economic policy management continues to be the official position in relation to interest rates." It then stressed that "it is time to abandon the huge subsidies in the interest rates enjoyed by some economic sectors and carry through the liberalisation of interest rates across the financial system…It has also to be permitted that the higher financial costs to the producer be passed on to costumers" (IMF 1983, p.154). Indeed, the real interest rates charged on public securities (Selic) began their ascending trend in 1980, became positive in 1982 and went to levels of 10 per cent to 15 per cent per year by 1985. By the same token, the real interest rates charged on firms' borrowings for financing working capital showed the same trajectory with the only difference that the actual interest rates charged on those loans reached staggering levels of 25 per cent to 45 per cent per year (see Table 33 below).

**Table 33 Annual Interest Rates (%), 1980-1989**

| | *Nominal Annual Interest Rates* | | *Actual Annual Interest Rates* | |
|---|---|---|---|---|
| | Selic | On Working Capital Loans | Selic | On Working Capital Loans |
| 1980 | 46.3 | 87.5 | - 26.7 | - 6.1 |
| 1981 | 89.3 | 141.7 | -2.2 | 24.9 |
| 1982 | 119.3 | 159.8 | 9.5 | 29.7 |
| 1983 | 199.7 | 265.5 | 7.8 | 31.5 |
| 1984 | 255.5 | 346.5 | 15.0 | 44.5 |
| 1985 | 275.6 | 309.8 | 11.1 | 21.0 |
| 1986 | 66.5 | 58.9 | 4.6 | - 0.2 |
| 1987 | 352.9 | 491.3 | - 8.4 | 19.6 |
| 1988 | 1057.6 | 1105.6 | 5.9 | 10.3 |
| 1989 | 2407.3 | 2529.4 | 27.7 | 34.0 |

Source: Ipea.
* Deflated by the National Consumer Price Index (INPC).

Despite the astronomical interest rates and a consequent reduction in demand for money, inflation kept on rising. The orthodox stabilisation programme was clearly inadequate to deal with the institutional setting of the Brazilian economy. The high instability of the exchange and interest rates perverted the conventions sustaining normal pricing practices within Brazilian economy as financial and production costs – especially of imported raw material – could change unpredictably. As Maria da Conceição Tavares and Luiz Gonzaga Belluzzo (1986, pp.52-53) pointed out, "both the inventory prices and the value of assets and liabilities begin to oscillate without control during the production period, turning uncertain the horizon of capitalists' calculus…[The] supply prices, planned by producers, tend to be relentlessly overstated in an attempt to *anticipate* a likely devaluation of the net worth…Thus, the desired profit margin, instead of being a stable mark-up over the prime costs turns out to be an uncertain margin." In other words, past inflation was abandoned as a guide for forming expectations about the future supply prices and demand prices. The IMF's diagnosis that excessive demand caused inflation was unwarranted as the risk firms run of under-pricing and of losing profits per unit of produce sold became higher than the risk associated with sales lost.[99] Accordingly, firms in Brazil used their market power to

[99] According to Roberto Frenkel (1979), in actual fact, under high inflation, producers will interpret lost in sales not as a threat to their position in the market as all other producers are adopting the same process of pricing and forming inflationary expectations. Producers will judge the sales lost against the benefits obtained with keeping up with the inflationary process so that if "an increase in the mark-up, for yielding higher profits per unit of sale, compensates for or surpasses the losses stemming from lower sales, producers do not receive incentives to lessen their price decisions and to reduce their mark-ups." (*op. cit*., 40).

protect their wealth and profitability by increasing their mark-ups irrespective of the decrease in their sales (more about it later). Inflation in turn more than doubled in relation to the level observed in 1982 and achieved 235 per cent per year in 1983, rapidly approaching hyperinflation levels.

From a conventional point of view, Brazil's institutional structure established a bewildering relation between price formation and interest rates. The existence of the indexed money established a positive correlation between higher real interest rates and faster growth in prices. As a consequence the orthodox measures adopted to control inflation by increasing interest rates in actual fact had the opposite effect, fuelling inflation hikes. Although it was not only due to theoretical beliefs or unawareness of the problem that policymakers insisted on keeping real interest rates high and allowing inflation to burst, both those factors played a part. The ultimate reason seemed to lie in the fact that economic policy was stuck in the foreign currency trap established by the net transfer abroad. With the net transfer regime, foreign currency became *the* liquid asset in the Brazilian context in order that any easing of monetary policy – a reduction in the real interest rate – would threaten the economy as the bondholders would convert their liquid financial assets into foreign currency and press the BACEN's foreign holdings.

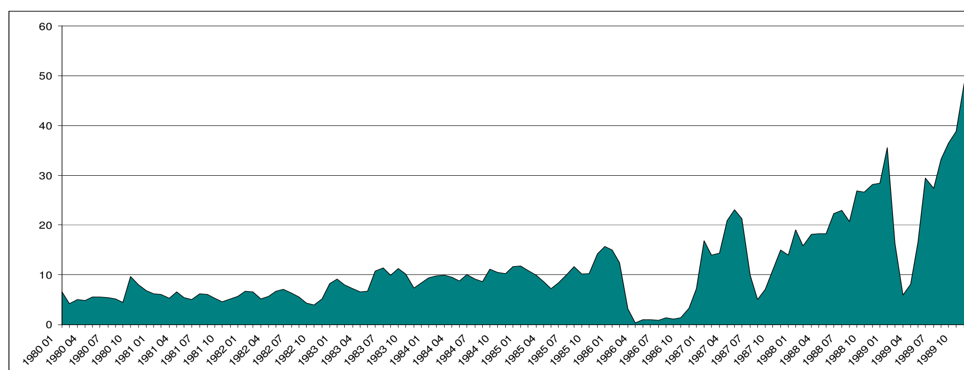
The prevailing perception amongst Brazilian economists was that the financial volatility was associated with the indexation, particularly of the exchange rates (Carneiro 2002, p.206;Lopes 1985). In other words, to stabilise the economy it was crucial to stabilise the exchange rates, which then would allow for reductions in the interest rates. In 1986, the Cruzado Plan had this diagnosis. Along with de-indexing measures and the freezing of prices and wages, it fixed exchange rates and reduced interest rates. As already noted, it soon turned out to be at odds with the net financial transferences imposed upon the economy.[100] As economic growth returned with the reversion in the restrictive policies, trade surpluses had to be reduced either because imports increased or because to some extent exports were diverted to domestic markets, forcing government to use its reserves to comply with the net transfers overseas. Losses in foreign reserves weakened BACEN's

[100] The parallels between the Brazilian inflation process in the 1980s and that of German in the 1920s were not mere coincidence. Both countries had been put under the stringent requirements of net transfer abroad, resulting in highly unstable exchange rates. See Paulo Nogueira Batista Júnior (1992). In fact, as it is discussed in the next chapter, inflation in Brazil was only sorted out in the mid-1990s when the problem of net transference stopped as much because external debt was reduced as because capital flows returned to Brazil, both allowing the stabilisation of exchange rate.

position in its role of defending the value of domestic currency in order that the exchange rate could not be kept fix for longer.[101] In addition, lower real interest rates also prompted bondholders to speculate with foreign currency against the domestic currency, taking advantage of the fragile position of official reserves.

Following the failure of the Cruzado Plan, inflation became even higher and unstable over the rest of the decade. The following anti-inflation plans in 1987 ("Bresser Plan") and 1989 ("Summer Plan") also attempted to de-index the economy, while maintaining devaluation and high nominal and real interest rates to guarantee the trade surplus and a minimum level of reserves. In fact, high interest rates became the government's only tool for controlling inflation, albeit an ineffective one.

**Figure 17 Monthly Inflation Rates (%), 1980-1989**




Source: IBGE.
* National Consumer Price Index (INPC).

This overwhelming financial instability associated with high interest rates imposed a high social cost by reducing public and private investments and the long-term growth of the economy. However, the burden of instability costs was unevenly borne. In the conditions of the exchange and monetary policies prevailing in the 1980s the government financed the restructuring of financial and non-financial companies at the expense of the financial fragility of the state. However, instead of financing productive restructuring for the private sector, so as to be able to emerge from the crisis with greater competitiveness, the public sector ended up financing the emergence of the rentier behaviour of the private sector. The next two subsections describe these consequences of the adjustment policies, which have largely been neglected in neoliberal accounts.

[101] It is worth noting that under the net transference requirements it was enough for any reduction in the trade surplus to provoke pressures on exchange rates. In 1986, for instance, net export was still US$ 8.3 billion.

**Table 34 Money Aggregates and Financial Assets as a Percentage of GDP (%), 1979-1980**

| | Base Money | M1 | Public Securities | M2 | Saving Deposits | M3 | Time Deposits | M4 |
|---|---|---|---|---|---|---|---|---|
| 1979 | 4.0 | 10.3 | 6.4 | 16.7 | 6.7 | 23.4 | 5.0 | 28.4 |
| 1980 | 3.4 | 8.8 | 4.2 | 13.0 | 6.3 | 19.3 | 4.0 | 23.3 |
| 1981 | 2.8 | 7.3 | 5.4 | 12.7 | 7.0 | 19.8 | 3.7 | 23.5 |
| 1982 | 2.6 | 6.5 | 6.8 | 13.4 | 8.1 | 21.4 | 4.5 | 26.0 |
| 1983 | 2.1 | 5.2 | 6.0 | 11.2 | 9.2 | 20.4 | 5.0 | 25.3 |
| 1984 | 1.6 | 3.8 | 6.6 | 10.4 | 9.4 | 19.8 | 5.7 | 25.5 |
| 1985 | 1.6 | 3.7 | 10.4 | 14.1 | 9.2 | 23.3 | 6.2 | 29.5 |
| 1986 | 3.2 | 8.2 | 9.3 | 17.5 | 8.1 | 25.6 | 6.1 | 31.7 |
| 1987 | 2.2 | 4.6 | 10.1 | 14.7 | 9.7 | 24.4 | 4.9 | 29.2 |
| 1988 | 1.4 | 2.8 | 12.2 | 15.0 | 10.8 | 25.7 | 4.1 | 29.8 |
| 1989 | 1.3 | 2.1 | 13.9 | 16.0 | 8.1 | 24.1 | 2.8 | 26.9 |

Source: Banco Central do Brasil.

## Public Financial Fragility

The government's attempts to reduce domestic demand and to switch market outwards by increasing real interest rates and devaluating exchange rates created cumulative fiscal problems. First, as mentioned above, by 1983 most of the Brazilian external debt had been nationalised as foreign creditors and the domestic private sector sought protection with Brazilian government. In addition, the maxi-devaluation in 1983 produced an additional increase in public sector indebtedness. Secondly, by making the public sector the main external debtor the adjustment created a link between public external debt and public internal debt. To repay its debt, the BACEN had to purchase the foreign exchange generated by the private sector. As the adjustment entailed a restrictive monetary policy, the only way to repay the debt was by increasing public internal debt. As Table 35 below shows, public debt increased by 20 per cent of GDP in only two years from 1982.

Such an astonishing increase in the public debt had a destabilising impact on the public current deficits by increasing the interest rates payments. In the first years of the adjustment the government tried to compensate for this increase in public deficits with a mixture of tax increases and expenditure reductions. Indeed, it shrank public operational deficits by 4 percentage points of GDP (Table 36 below). This policy was, however, clearly insufficient to sort out the deficits due to the by-products of the restrictive policies. First, the interest payments on public debt were increasing with the interest rates. Second, high interest rates reinforced inflation and recession and both tended to reduce public revenues and to turn

more difficult the fiscal adjustment. In short, whereas the monetary policy tended to produce reinforcing effects on public deficits and indebtedness, public finances became increasingly dominated by the interest of the rentiers or bondholders.

**Table 35 Net Public Debt as a Percentage of GDP (%), 1982-1990**

| | *Central Government* | *Municipal and States* | *Public Enterprises* | *Total* | *Internal* | *External* |
|---|---|---|---|---|---|---|
| 1982 | 8.9 | 6.0 | 17.9 | 32.8 | 14.9 | 17.9 |
| 1983 | 19.0 | 6.5 | 26.0 | 51.5 | 18.4 | 33.1 |
| 1984 | 21.7 | 7.0 | 27.1 | 55.8 | 22.4 | 33.4 |
| 1985 | 18.9 | 7.1 | 26.6 | 52.6 | 21.7 | 30.9 |
| 1986 | 20.0 | 6.6 | 22.9 | 49.4 | 20.6 | 28.8 |
| 1987 | 20.4 | 7.9 | 22.0 | 50.3 | 19.3 | 31.0 |
| 1988 | 19.6 | 6.7 | 20.6 | 46.9 | 21.3 | 25.6 |
| 1989 | 19.9 | 5.9 | 14.4 | 40.2 | 21.7 | 18.5 |
| 1990 | 15.2 | 7.8 | 17.6 | 40.6 | 17.8 | 22.8 |

Source: Banco Central do Brasil.

**Table 36 Public Deficits in Alternative Concepts[102] and Actual Interest Burden (% GDP), 1981-1989**

| | *Primary* | *Actual Interest* | *Operational* | *Nominal* |
|---|---|---|---|---|
| 1981 | -- | -- | - 6.3 | - 12.5 |
| 1982 | - 0.8 | - 5.8 | - 6.9 | - 15.8 |
| 1983 | 1.7 | - 4.7 | - 3.1 | - 19.9 |
| 1984 | 4.2 | - 6.9 | - 2.8 | - 23.3 |
| 1985 | 2.6 | - 7.0 | - 4.4 | - 28.6 |
| 1986 | 1.6 | - 5.2 | - 3.6 | - 11.3 |
| 1987 | - 1.0 | - 4.6 | - 5.6 | - 32.3 |
| 1988 | 0.9 | - 5.8 | - 4.9 | - 53.0 |
| 1989 | - 1.0 | - 6.1 | - 7.1 | - 83.1 |

Source: Ipea; Conjuntura Econômica (August 2003).
* All levels of government and public enterprises.

Between 1986 and 1989, the public finances scenario worsened as the economy approached hyperinflation. The BACEN was forced to introduce institutional innovations that not merely protected bondholders against inflationary depreciation but also constituted profitable mechanisms for them.[103] It introduced a public bond – first called BACEN Bills

[102] In 1983 the IMF requested a reformulation in the public finances' accounts to show the "actual" conditions of public finances as many programmes of investment and subsidies fell out of fiscal budgets. However, the conventional PSBR concept was prone to be overstated because it incorporated monetary correction and exchange devaluations applied upon public debt. Therefore, the IMF and the Brazilian government introduced the concept of PSBR-operational which deduced the effects of indexation (caused by inflation or devaluations) from the traditional PSBR. Finally, the Primary deficit concept takes into account all public spending but interest in order that the difference between Operational deficit and Primary deficit measures the expenditures with interest and other financial costs with debt (fees, commissions, etc).

[103] Over this period three major economic programmes came along to control inflation, all of them adopting some kind of price freezing. The first was the Cruzado Plan introduced in 1986. During that plan there was a

(LBC – *Letras do Banco Central*), and then, in 1987, Treasury Bills (LFT – *Letras Financeiras do Tesouro*) – which was indexed to the daily interest rate (*overnight*). With this mechanism of indexation, those public securities embodied inflation expectations for the next month, making the value of government debt almost immune to rises in inflation. Moreover, these public bonds possessed high liquidity as they served as second-order banking reserves and were "automatically" negotiable with the BACEN.[104] The operation of this mechanism permitted a reduction of the average maturity of public bonds, which plummeted from around 28 months in December 1983 to less than 5 months in December 1989. In addition, those indexed bonds and the mechanism of daily repurchase agreement guaranteed the bondholders enough flexibility to evade attempts by the government to lower public debt by expelling monetary correction. In a nutshell, those mechanisms concurrently protected the real value of bondholders' wealth and warranted high liquidity, features which maintained the attraction of public bonds *vis-à-vis* other speculative investments, especially foreign currencies, even in condition of hyperinflation. From the point of view of public finances, however, this implied an increasing transference of resources from taxpayers to bondholders, a transference mirrored by the increase in public expenditures with interest payments at the expense of public investments.[105]

While the neoliberal perspective usually suggests that in the eighties public deficits resulted from persistent government overspending in an attempt to maintain previous levels of growth, it has shown that the actual mechanisms by which Brazilian public debt grew in fact derived from the external debt negotiation, the orthodox adjustment policies and the protection and incentives offered to the private sector to avoid the costs of the adjustment. In fact, whilst the underlying problems of public finances – that is, its contracting bias and

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re-monetisation (increase of M1 and money base) of the economy allowed by the sudden and ephemeral success of the plan in reducing inflation rates. In part a result of the failure of Cruzado Plan, the hyperinflation loomed the economy since and until mid-1990s. To detailed discussions of the stabilisation plans in the 1980s see: Mônica Baer (1993); Werner Baer (1995); Lavínia Barros de Castro (2005).

[104] Through a system known in Brazil by "*zeragem automática*" (automatic balance), the BACEN compromised, as a rule-of-thumb, to buy or sell all reserves required by the banking system at the end of the day. *Any* excesses (lack) of compulsory reserve requirements could be sold to (purchased from) the BACEN for the period of one day in exchange for LFTs and repurchased (resold) next day through repurchase agreements. For discussions about this system and its effects upon the monetary policies see: Carlos Eduardo Carvalho (1993); Peri Agostinho da Silva (1993); Valdir Ramalho (1995); Luiz Fernando Rodrigues de Paula (1996).

[105] As Luiz Gonzaga Belluzzo and Júlio Gomes de Almeida (2002, p.152) point out, the introduction of these institutional innovations "allowed the access to 'inflation tax' to all the agents (not only the banks) who acquired or 'purchased' in the old money, which was instantly devaluated by high inflation, while lent or 'sold' in the 'indexed money'." The next section it appraises the behaviour of the firms and banks within this context.

hence the lack of a restructuring industrial policy – were worsened by the adjustment policies, the government became increasingly more fragile to redirect the economy towards a renovating industrial structure with investments in infrastructure, let alone in training and employing a high-skilled (and more expensive) labour-force. Worse still were the incentives the government conceded to the private sector, financial and non-financial, which lived the life of a rentier on the float of the indexed financial assets.

### The "Securitisation" of the Wealth of the Non-Financial Sector

As a result of the increasing financial instability caused by the adjustment policies, financial and non-financial corporations developed new methods for evaluating good performance that can be described as *financialisation*. Their portfolios became increasingly similar to those of financial corporations and in both the measurement of performance became dominated by short-term financial gains stemming from indexed financial assets. The aforementioned public indebtedness played a central role as those indexed financial assets were either public daily indexed bonds (e.g. LBCs) or backed by them (e.g. any overnight bank deposits). In other words, the adjustment of the private sector was symmetrical to the indebtedness of the public sector.

Table 37 shows that as far as profitability (profits after-tax/net worth) is concerned the decade began badly for non-financial firms. The profitability of Brazilian private firms dropped dramatically between 1978 and 1983. The profitability of foreign firms also dropped, although less sharply. In that period, there was a significant increase in financial costs for all firms, but above all for public enterprises. The orthodox policy of high interest rates along with decreasing effective demand dictated the increase in firms' financial costs and the consequent fall in profitability. To protect themselves against these costs, private firms reacted with reductions in their physical investments on the one hand, and with increases in their mark-ups to retire their debts on the other. Table 37 shows that by the mid-1980s foreign firms and private national firms had already reduced indebtedness, increased mark-ups and profitability.

Regarding public enterprises it is worth noting some constraints related to their role in economic policies that served to make their experience of adjustment different from that of the private sector. It should be noted that public enterprises began to reduce their

indebtedness only from the mid-1980s onwards, when the private sector had already completed its adjustment, despite the fact that before the crisis began, the gearing of public enterprises was no different from that of the private sector. In part, the indebtedness of public enterprises increased as government deliberately forced its firms to borrow abroad to compensate for foreign reserves leaking. By the same token, public enterprises' mark-ups were forced down in order to help economic policy to halt inflation (Baer 1993; Werneck 1985; 1986). In addition, the under-pricing policy of public enterprises also helped private sector to adjust as public enterprises operated in sectors providing fundamental industrial inputs.

When financial instability was at its worst after the failure of several stabilisation plans, firms intensified their financial restructuring by increasing mark-ups and investing in indexed financial assets. As noted earlier, firms began to adopt the daily indexed overnight interest rates to determine prices to ensure that their profit margins would cover their prime and financial costs as the economy was permanently threatened by hyperinflation. Luiz Gonzaga Belluzzo and Júlio Gomes de Almeida (2002, p.182) describe this mechanism as the "financialisation of pricing," a concept which reflects the detachment of pricing formation from the costs of production and from capital reposition to the emergence of speculative behaviour in price formation. As financial instability accelerated and financial costs increased with interest rates, firms sought to anticipate events by increasing their mark-ups. Indeed, from 1987 to 1989, the mark-ups resumed an ascendant trajectory at a higher speed, achieving maximums of 92 per cent (local private capital) and 62 per cent (foreign capital) in 1989.[106]

[106] In a typical process of the self-fulfilment of prophesy, this behaviour of non-financial firms led the economy to hyperinflation when by 1988-1989 inflation rates went into three digits.

**Table 37 Some Indicators of Financial Posture and Performance of the Thousand Largest Firms in Brazil (by ownership of capital)[107] – Percentage, 1978-1989**

| | *1978-1980* | *1981-1983* | *1984-1986* | *1987-1989* |
|---|---|---|---|---|
| **Foreign Firms** | | | | |
| Profitability | 16.3 | 9.7 | 12.3 | 15.1 |
| Mark-up | 28.4 | 31.5 | 33.5 | 51.9 |
| Indebtedness | 128.2 | 115.4 | 86.1 | 88.6 |
| Financial Costs | 4.6 | 7.9 | 6.9 | 14.2 |
| Prime Costs | 65.6 | 66.3 | 66.1 | 54.6 |
| **National Private** | | | | |
| Profitability | 23.1 | 9.0 | 10.6 | 7.1 |
| Mark-up | 45.0 | 47.0 | 53.3 | 80.3 |
| Indebtedness | 92.3 | 76.3 | 46.8 | 50.1 |
| Financial Costs | 4.9 | 9.2 | 8.3 | 20.7 |
| Prime Costs | 64.0 | 60.6 | 57.7 | 49.3 |
| **Public Enterprises** | | | | |
| Profitability | 8.2 | 5.5 | 5.3 | 0.4 |
| Mark-up | 47.8 | 34.0 | 45.6 | 52.9 |
| Indebtedness | 116.4 | 128.1 | 129.7 | 107.1 |
| Financial Costs | 22.6 | 44.1 | 19.0 | 36.2 |
| Prime Costs | 61.1 | 67.4 | 62.1 | 59.2 |
| **All Firms** | | | | |
| Profitability | 13.2 | 6.8 | 7.8 | 3.8 |
| Mark-up | 41.1 | 38.4 | 45.9 | 64.0 |
| Indebtedness | 110.4 | 111.7 | 95.7 | 85.7 |
| Financial Costs | 10.6 | 21.7 | 11.9 | 24.7 |
| Prime Costs | 63.5 | 64.4 | 61.1 | 53.9 |

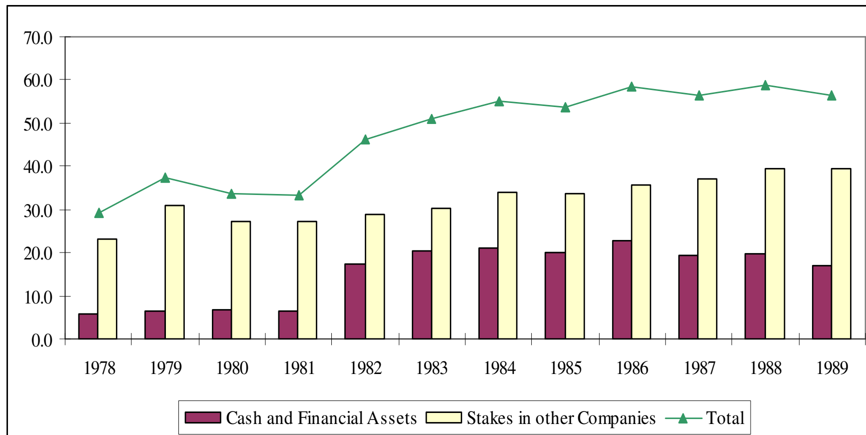
Source: *Conjuntura Econômica* (various years).
Notes: Profitability: Profits after-tax/Net Worth
Mark-up: (Revenue – Prime Cost)/Prime Cost
Indebtedness: Debt/Net Worth
Financial Costs: Financial Expenditures/Operating Income
Prime Costs: Cost of Production/Operating Income

Financial instability produced a second fundamental change in the behaviour of firms in the 1980s, which is related to their preferences between productive investments and financial investments. The combination of weak effective demand, exchange depreciation and high interest rates brought enormous threats to the net worth of firms. As a consequence they discouraged productive, hence less liquid, investments as well. The high

[107] It uses balance sheets of the 1000 largest quoted non-financial corporations with activities in Brazil publicised in *Conjuntura Econômica* in November 1986, December 1988, and November 1990. It should be observed that however it uses the same number of firms for all the period, the sample is not constituted of the same firms throughout. The figures were made from three different samples: 1978-1979; 1980-1987; and 1988-1989. Nonetheless, we considered that the comparability of the data can be sustained on sound grounds. First, over 90 per cent of the firms are the same across the databases. Second, fortunately, the database possess overlapping years in order that it was possible to compare figures for at least one year for all three samples. Therefore, it was possible to test how comparable the three samples are. The conclusion is that they are fairly comparable.

interest rates, on the other hand, opened opportunities to the most liquid firms to invest in financial assets to such an extent not merely to compensate for the increase in financial costs but also to gross the high returns paid upon financial assets.[108]

**Figure 18 Total Financial Investments of Firms – (% of Net Worth), 1978-1989**




Source: As Table 37.

Figure 18 above illustrates the financialisation of the non-financial corporation market value. Accordingly, a considerable proportion of those financial investments were closely related to the value of public bonds as firms invested their ready cash in sight deposits in banks. As inflation rose, banks began to remunerate these deposits based on the overnight interest rates. As virtually all financial assets gyrating in the overnight system were indexed to the public bonds (LFTs or LBCs), the value and profitability of those investments, and then an important part of the value of the non-financial corporations, became dependent on the value of public bonds and the interest rates paid on them. In other words, the counterpart of the public debt and interest payments on it, which counted for most of the public deficits, constituted wealth for firms.

Another salient aspect of the "financialisation" of non-financial corporations' capital structure is related to their diversification towards other firms. This type of financial investment increased steadily as a proportion of total assets throughout the decade (Figure 18). Suffering with idle capacity, higher capital costs, and instability, most non-financial corporations hesitated to invest huge funds in uncertain long-term projects. It seems that the observed diversification had been prompted by the same motives that led to an increase in investments in financial assets. That is, holdings of other firms' equities had not been

[108] Similar behaviour is documented by James Crotty (2002) for the U.S. non-financial corporation sector.

associated with building new capacity, improving production process or conquering new markets. Instead, they represented the financial diversification of market risks and a speculative search for profitable opportunities through capital gains.

As a result of these processes of financialisation of pricing and investments, the profitability of the private companies in 1989 were as high as before the recession of 1981-1983 (Table 37). These processes had an unequivocal conclusion: it became quite profitable to hold money and other financial assets and certainly much less risky than productive investments.

### "Financialisation" in the Financial System[109]

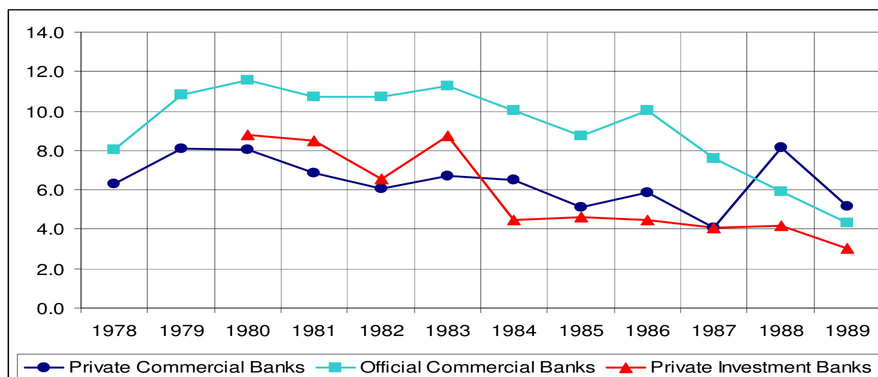
The growth in the output of financial institutions as a percentage of GDP – from around 8 per cent in 1980 to nearly 21 per cent in 1989 – epitomises the greatest beneficiary of the adjustment policies in the 1980s.[110] The other sectors of the economy only managed, at best, to keep pace with mediocre economic growth, enough only to keep their position in the total output. The mechanisms by which such a performance had been achieved were not very distinct from what took place in non-financial corporations. In actual fact, the banks became the principal agents operating the financialisation of non-financial corporation investments and became in the process the main beneficiary of the increase of the real interest rates resulted from the restrictive monetary policies.

Facing the increasing uncertainties introduced by the adjustment policies, banks reacted by reducing their leverage, measured by assets as a proportion of the bank's own capital (see Figure 19).[111] The private banks showed greater flexibility than official commercial banks in reducing leverage. Public banks, especially state ones, in turn could not process such rapid reduction of leverage because they bailed out local business and governments. In this connection, it is worth noting that the bank's adjustment proceeded mostly through reductions in credit operations to private sector and reallocation of resources for financing public sector, by this time a less risk client. In the face of the increasing credit risk stemming from the recession, and the restrictions imposed by economic policy, the private

[109] Unless otherwise specified, the source of the numbers in this section are various years of the Boletim do Banco Central do Brasil (Bulletin of the Central Bank of Brazil).
[110] Data from IPEA (2005).
[111] As public bonds are risk-free and can be used as secondary banking reserves, the data showed in Figure 19 adopted an adjusted measurement by discounting from total assets the banks' federal public bond holdings.

commercial bank's credit operations decreased 4.6 per cent per year on average between 1978 and 1983. Even after the economic recovery experienced between 1984 and 1985, the amount of credit private banks conceded was still only 96 per cent of the 1982 amount.

**Figure 19 Adjusted Leverage of the Banking System – Assets/Capital, 1978-1989**




Source: Banco Central do Brasil.
* Official Commercial Banks do not include Banco do Brasil.

In addition to the reduction in credit operations, the private banks' strategy constituted the concentration of investments in assets issued or granted by the public sector. First, banks promptly redirected credit operations conceded to private sector towards public entities (see Table 38 below). Second, the foreign currency remunerated deposits in the BACEN (regulated by the Circular Letter 230) became very popular amongst commercial banks. Whereas in 1978 those deposits accounted for 1.6 per cent of the banks' total assets, the maxi-devaluations in December of 1979 and in February of 1983 led them to increase about six times between 1979 and 1983 and made them accounting for 9.3 per cent of the total commercial banks' assets in 1983. Third, the BACEN promptly attended to the banks' desire to replace public risk-free securities with risky assets the banking system was carrying. The BACEN issues of public securities were the main reason why commercial banks' investments in shares and securities increased from 3.2 per cent of total assets in 1979 to around 9 per cent in 1983 (with a peak of 14 per cent in 1982). Whereas public securities accounted for only 17 per cent of investments in shares and securities in 1979, in 1983 they accounted for 80 per cent.

The banking system also showed great flexibility in adjusting to and profiting from inflation and the hikes in real interest rates. Between 1980 and 1984 the banking system number of branches increased by 31 per cent to leverage deposit collection (Paula 1998).

Free of charge services and high investments in automation were also marked features of banking competition. The race for idle cash, especially sight deposits, was totally justified by the massive gains with *float* provided by growing inflation. That is, banks profited considerably by collecting non-indexed money from the public in sight deposits to invest them in indexed public securities or other indexed financial assets.

**Table 38 Selected Assets and Liabilities of Private Commercial Banks (% of Total), 1978-1989**

| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | | | | | | |
| **Banking Reserves** | 16.7 | 13.6 | 11.9 | 10.0 | 8.1 | 4.3 | 6.7 | 6.2 | 12.6 | 6.1 | 1.4 | 1.2 |
| **Foreign Currency Deposits in the BACEN (DMER)** | 1.6 | 2.8 | 1.6 | 2.9 | 2.8 | 9.2 | 7.4 | 6.4 | 2.3 | 1.4 | 0.5 | 0.2 |
| **Credit Operations** | 57.0 | 55.5 | 53.1 | 49.6 | 47.5 | 40.1 | 42.5 | 51.0 | 58.5 | 41.8 | 39.7 | 43.1 |
| **Exchange Operations** | 11.5 | 14.7 | 14.5 | 16.1 | 14.9 | 22.9 | 20.9 | 12.1 | 7.6 | 8.8 | 9.0 | 11.3 |
| **Shares and Securities** | 3.5 | 3.2 | 7.8 | 9.2 | 13.9 | 8.8 | 6.8 | 9.8 | 9.7 | 27.9 | 39.6 | 33.2 |
| *Public Securities* | 0.6 | 2.0 | 5.9 | 6.9 | 9.5 | 6.2 | 5.4 | 7.5 | 1.7 | 23.7 | 6.1 | 25.6 |
| *Private Securities and Shares* | 2.9 | 1.2 | 2.9 | 2.3 | 4.4 | 2.6 | 1.4 | 2.3 | 8.0 | 4.2 | 33.5 | 7.6 |
| **Liabilities** | | | | | | | | | | | | |
| *Deposits* | 46.4 | 45.4 | 40.8 | 32.7 | 29.8 | 23.5 | 27.8 | 37.8 | 59.7 | 28.5 | 50.4 | 39.1 |
| **Exchange Operations** | 26.3 | 32.2 | 36.1 | 42.4 | 43.4 | 56.2 | 53.0 | 41.0 | 22.4 | 24.1 | 17.6 | 18.5 |

Source: Banco Central do Brasil.

Among the developments described above it is worthwhile to stress the importance of the BACEN economic policy directive in supporting the banking system adjustment and profitability. As non-financial corporations and households were reducing their demand for credit, the aggressive indebtedness policies launched by the BACEN constituted the principal market for banks to invest into. As the BACEN was determined to keep the high real interest rate upon public securities the banking system got large room to arbitrate between the rates paid upon time deposits and those received on assets. Therefore, in the midst of the roughest industrial recession ever recorded in Brazil, and despite the staggering reduction in credit operations by banks, the profitability (net profits/net worth) of the eleven largest private local banks and the four largest foreign banks was around 25 per cent and 30 per cent in 1981 and around 20 per cent in 1983 (Belluzzo and Almeida 2002, p.249).

That the banks' performance depended on high real interest rates and inflation was made clear with the reduction of interest rates and inflation in 1986. The conjunction of factors which had determined the changes in banking behaviour and profitability through the adjustment period were briefly reversed with the introduction of the Cruzado Plan. First, along with the elimination of indexation of financial contracts and the reduction of inflation to one digit monthly, the gains with floating were decisively reduced. Second, interest rates plummeted to quite moderate levels at the same time that the government substituted money issues for security issues. From the supply side, the banking system gained access to much cheaper resources to finance its operations. The end of inflation and the increase in public demand for means of payment allowed banks to increase sight deposits by 155 per cent in real terms, or to 30 per cent of their total liabilities. However, the test of the banks' adaptability to a low inflation environment would come from their adjustments on the assets side. On the active side, as the public sector reduced its indebtedness, to maintain its profitability the banking system had no alternative but to expand credit operations with the private sector. While the total shares and securities private commercial banks held stayed at around 10 per cent of total assets, banks' holdings of public securities fell to 1.7 per cent of total assets compared to 7.5 per cent in 1985. And yet, while overall credit operations increased 54 per cent in real terms, they increased 72 per cent to the private sector. The commercial banks rapidly resumed their lines of short-term credit to consumers and working capital to corporations, leading credit operations to non-financial private sector to achieve 48 per cent of commercial banks' total assets, returning to levels similar to those levels attained in the late 1970s. All these transformations resulted from lower inflation and interest rates represented reversions in several trends occurred in the banking behaviour between 1980 and 1985. They also represented heavy losses in profits for the banks, as the largest banks' profitability halved with the reduction in floating and interest revenues (Belluzzo and Almeida 2002, p.259;FUNDAP 1989). In short, the Cruzado Plan destroyed indexed money, the source of the huge gains of the banking system.

Between 1988 and 1989, with the firm conviction that the failure of the Cruzado Plan was due to the excessive increase in credit and in expenditures in general, policymakers returned to policies of high real interest rates upon public securities and controls on credit

allowances. The banks[112] in response reduced their credit operations and returned to invest in financial assets, especially public securities, moving in the direction desired by the policymakers. Accordingly, from 58 per cent of the total assets banking credit operations came to around 40 per cent on average in the last three years of the decade. What is more, the investing in financial securities and shares soared from around 10 per cent of the total assets in 1986 to account for almost 33 per cent in 1989. Most of these financial assets (70 per cent) took the form of public bonds which paid overnight interest rates and had daily liquidity warranted by the BACEN. Once again the banking system's strategy of investing heavily in public securities and liquid financial assets amidst a high inflation of four digits proved remarkably rewarding. In 1989, for instance, the rate of profitability achieved 17.3 per cent for the largest local banks and 20 per cent for the largest foreign banks (Belluzzo and Almeida 2002, p.268).

It is worth noting that the banking developments described above created strong solidarity not only amongst non-financial corporations and banks but also between banks and wealthy citizens. The financial system performed the central role in connecting non-financial corporations' and wealthy citizens' idle balances with the circuit of financial accumulation developed around the indexed public securities and other indexed financial assets negotiated in the overnight system. In addition, those speculative gains were nurtured by the inflation process so that the banking system and its wealthier clients became associates of the inflation hikes. On the other hand, the government lost control of public finances as in this system it could not adopt an active fiscal policy and yet had to finance its deficits at high costs.

### Final Remarks

In conclusion, the external debt crisis management package implemented from 1982 resulted in significant institutional changes that transformed the nature of the Brazilian economy and brought latent tendencies to the fore. First, the negotiations with the IMF and

[112] In 1988 was implemented a banking reform which basically constituted of reversing the segmentation introduced by the 1964-1967 financial reforms. This time round was introduced the concept of multi-bank, defined as an institution operating concurrently in commercial and investment segments at least. To be sure, as the main commercial banks also dominated the other segments, the reforms acted more in the sense of corroborate it. However, it is important to underline that for the following empirical analysis it is referring to the multi-banks accounts, a difference that should be taken into account when compared to the rest of the decade.

the creditor banks resulted in a pro-creditor solution to the debt crisis. In addition to the shock represented by the sudden cease of foreign financing, the IMF management package produced profound changes in the institutions which had buttressed Brazilian development since the early 1930s. To begin with, the adjustment carried conventional prejudices against the efficiency of public investments to produce heavy-handed cutbacks in that sector. The de-legitimisation of the public sector, which became common in the policymakers' rationalisation for their policies, was as detrimental as the reduction in public investments upon the whole efficiency of the economy. Public investments became a synonym for waste and public enterprises became a synonym for inefficiency. The validity of those rationalisations was less important than the interests that they served.

On the opposite side of the productive investments of the state, the adjustment policies favoured the financier interests. First, the nationalisation of debt was imposed on the state, either to guarantee foreign creditors' claims or to permit the private domestic sector to reduce its indebtedness. The government in turn lost control over its monetary policies as it had to acquire foreign exchange from the private export sector to repay the external debt services. Whereas the exchange rate should be devalued to stimulate exports, the domestic interest rates should be high to induce private sector to hold public debts. In Brazil, high real interest rates were maintained through a complex and sophisticated mechanism of daily indexed public securities. Unsurprisingly, most conventional analysts have identified the financial instability of the eighties, especially its inflationary dimension, with the public deficits in a way that causality went from deficits to money issuing to inflation (Edwards 1995; Franco 1999; Pinheiro, *et al.* 2001). However, the indexed money mechanism was more complex than that, and in fact causality ran the other way around. To avoid flight to real or risky (especially foreign currency) assets, monetary policy should be tight and real interest rates warranted. High interest payments explained almost all the public deficit in the eighties. In macroeconomic balance, the public debt and deficit must be private credit and surplus.

The adjustment in the private sector was naturally quite the opposite of that in the public sector. The private sector reduced its indebtedness, in part, by transferring them to the public sector as a result of the effects of inflation on debts. More extraordinary than that was that the monetary policy that raised interest rates paid on indexed public debt provided a high profitable market for corporations and wealthy households. The high gains obtained

from financial investments, guaranteed by the high real interest rates, virtually attracted all idle resources whether from the banking system, or from non-financial corporations, or even from the wealthiest households. The financial system bound strong interests around the investments in financial assets, which developed around indexed public bills. The problem in the Brazilian economy, however, was that public indebtedness and deficits were neither resulting in production nor being evenly distributed. In actual fact, public resources were being used to protect bondholders at the expenses of one sole debtor, the state.

In the 1990s, the proximate factors that had prompted the external debt crisis came to an end as capital flows returned to Brazil, and the shortage of foreign exchange also became a thing of the past. Along with the return of capital inflows Brazil implemented several institutional changes that fully complied with the neoliberal requirements of the international financial community. Could neoliberal institutions rescue Brazil from the predicament neoliberal adjustment had brought about in the 1980s? What would be the consequences of market-led development for the Brazilian economy in the 1990s? These are the issues that are dealt with in the next chapter.

# *7. The Economic Consequences of the Neoliberal Reforms in the 1990s*

## Introduction

In the 1990s, Brazilian policymakers embraced neoliberal reforms in the hope that the flimsy economic growth and the instability of the 1980s could be reversed. Within the neoliberal framework of the IMF, the World Bank and the governments of developed countries, the troublesome economic situation of the 1980s was proof of the exhaustion of the state-governed development of countries like Brazil. Naturally, the new model of development should follow the neoliberal framework of the multilateral institutions, a framework largely and eagerly shared by Brazilian policymakers.

The neoliberal reforms are part of an agenda identified with a wide range of liberalising economic reforms encamping from balance of payments accounts, to state retrenchment from market regulation and privatisation of public owned enterprises.[113] The economist John Williamson became famous by synthesising and dubbing such agenda of reforms as the Washington Consensus.[114] The ten reforms scheduled by Williamson (1990) covered three broad areas: first, macroeconomic stability achieved through monetary and fiscal austerity; second, measures to foster greater integration with the world economy through trade liberalisation and financial mobility; the third area of reforms suggested divesture of public firms and deregulation of markets – in special financial and labour markets. Integration with the international markets associated with the reduction of government

[113] See John Williamson (1990;1992), Stanley Fischer and Thomas Vinod (1990), and Sebastian Edwards (1995), for neoliberal policy propositions. And Thomas Palley (2004) and Ha-Joon Chang and Ilene Grabel (2004) for a critique of neoliberal policies and institutions.
[114] According to Williamson (1990): "The Washington of this paper is both the political Washington of Congress and senior members of the administration and the technocratic Washington of the international financial institutions, the economic agencies of the US government, the Federal Reserve Board, and the think tanks."

direct intervention would increase the efficiency of the economy and hence growth whereas macroeconomic austerity would bring stability, then reinforcing the fundamentals of growth.

The political conditions for implementing the neoliberal reforms were created in the late 1980s in the context of the negotiations of the external debt under the Brady Plan. In Brazil, an eager reformist stance associated with a somewhat moralist discourse on the macroeconomic austerity of the Collor administration in 1990 fitted well with the middle classes' disenchanted views towards the state and equality (O'Dougherty 1999). Structural reforms of the kind proposed by neoliberal economists came faster than stability of prices, which had to wait until the mid-1990s. When inflation dropped to single figures with the adoption of the Real Plan in 1994, the expectation was that sustainable economic growth would return on the basis of neoliberal strategy. However, apart from short-lived and consumption-led growth the reforms failed to live up to the expectations surrounding them. The high expectations with regard to the new model came to an end with the 1999 exchange rate crisis. The poor institutional framework that these reforms left behind has naturally outlived the disillusionment with them.

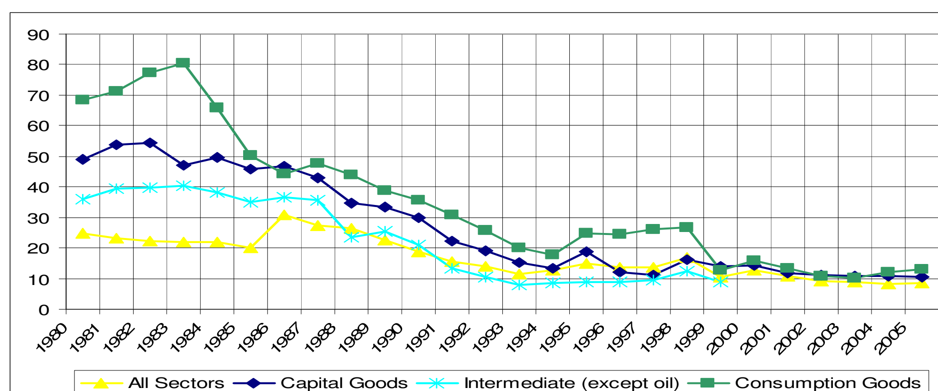
This chapter discusses the market-oriented reforms and economic policies implemented in Brazil in the 1990s. First it describes the structural changes produced by the market-oriented reforms and draws the perceived working of it by policymakers. It then evaluates the actual consequences of this new model with regard to the accumulation of capital, productivity growth, and the growth of industry and the economy as a whole. It is argued that the reforms in Brazil have failed to live up to the expectations they raised to resume economic growth of Brazilian economy and to improve income distribution. Subsequently, it shows that the market-oriented regime has failed to stabilise the Brazilian economy in a broader sense than price stability. Finally, it concludes by arguing that, the very policies introduced under the insignia of neoliberalism if not created at least reinforced the structural features that led Brazilian economy to damaging low growth and to a highly fragile situation in the 1990s.

## Neoliberal Structural Reforms

*Trade and Exchange Policies*

Tariffs had been reduced in Brazil since 1988, but it was during the Collor administration that the liberalisation exercise really took off. The reforms involved the abolishment of the Anexo C, a list of 1300 products whose imports were not permitted; the elimination of non-tariff barriers; and almost all special regimes of imports were eliminated, with the exception of drawbacks, the Exports Processing Zone in Manaus (Amazonia), and information technology. While the elimination of non-tariff barriers left tariffs as the only protective mechanism to government discretion, the government scheduled a four-year reduction in tariffs in which, at the end of the period, the tariff profile should range from zero (e.g., some machines and equipments not produced in Brazil) to 35 per cent (e.g., computers and automobiles) with a modal value of 20 per cent. The process proceeded faster than scheduled and in 1994 the tariffs had already achieved the levels expected to come into force with the development of the regional common market – or Mercosur.[115] Figure 20 below shows the tariff structure after this reform and further developments throughout the decade. Although in 1995 some tariffs were held back (especially for automobiles, trucks and buses) as Brazil faced growing trade deficits, the liberalising reforms were carried throughout the 1990s with the general tariffs and dispersion between tariffs of the sectors being consistently reduced.

**Figure 20 Brazilian Legal Tariff by Sectors (%), 1980-2005**

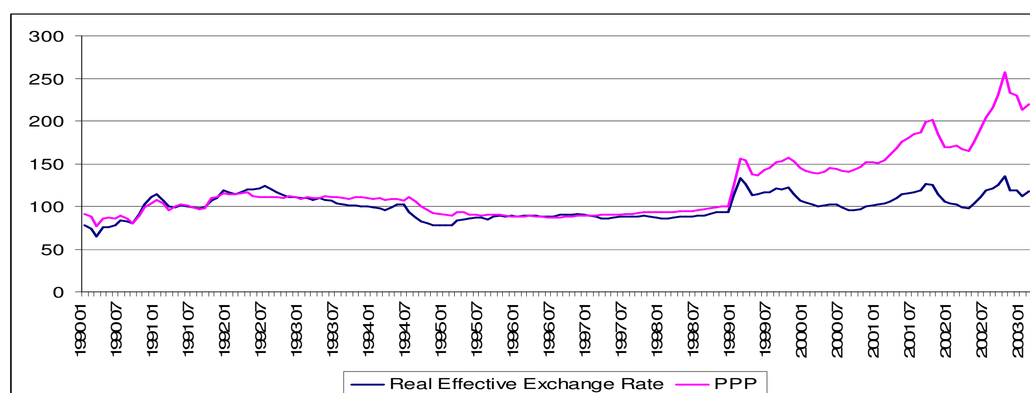



Source: Ipeadata.

[115] Involving Brazil, Argentina, Paraguay, and Uruguay it established a common external tariff ranging from zero to 20 per cent, with some exceptions negotiated amongst the partners.

On the exports side, since 1983 a process of deactivation of incentives and subsidies took place to render the exchange rate as the main incentive to exports. In 1988 almost all the incentives, subsidies and financial institutions supporting export sectors created between 1968 and 1972 were dismantled. In 1990, apart from exchange rates devaluation, not much had been left to stimulate exports. As the last landmark of these changes it is worth noting the extinction of CACEX and BEFIEX, which constituted crucial institutions for financing and conceding benefits to exports in the 1970s.[116] As most of the incentives for exports sectors have been cut off and the protection system has significantly been reduced, the exchange rate policy became a crucial government tool to affect trade performance in the 1990s. From the beginning of the decade the exchange rate suffered great pressure to appreciate due to the increasing inflow of capital accruing to the country as a result of the capital account liberalisation and external debt negotiation. In 1994 the Real Plan anchored largely on the exchange rate to regulate domestic prices in order to curb inflation. As a matter of fact, the exchange rates either measured by its effective concept or by purchase power parity, appreciated sharply and kept this way up until the depreciation in January, 1999 (see Figure 21). In short, the direct export promotion incentives were phased out as policymakers believed that exports would increase anyway through the gains of efficiency resulting from the inception of a more competitive environment determined by the import openness (Barros and Goldenstein 1997; Franco 2000).

**Figure 21 Effective and Purchasing Power Parity Exchange Rates (%), 1990-2003**




Source: Ipeadata.
* Real effective exchange rate calculated as the relation between the Real and the currency of the 16 main Brazilian trade partners, weighted by their share in trade with Brazil, and deflated by respective wholesale price indexes.
** Nominal exchange rate between Real and Dollar deflated by respective consumer price indexes.

[116] See Chapter 4 of this work for a discussion of the role and weight of these institutions in the exports boost of the 1970s.

*Privatisation and Re-regulation*

Privatisation had entered into the Brazilian government agenda since the early 1980s in the wake of the external debt crisis as a solution for the public finance deficits (Pinheiro and Oliveira-Filho 1991). The rate of progress of these reforms was quite slow in the first half of the 1980s as the bleak economic environment discouraged private firms from investing in adventures of this size: public enterprises were highly indebted; many private firms were also facing high debts; economic growth prospects were gloomier than ever and the foreign capital was in its way out cycle; public sector would not dispose funding for privatisation.[117] In the second half of the decade, however, the government was increasingly pressured by the World Bank and external creditors to privatise its large entrepreneurial sector. International institutions used the external debt negotiations as a powerful mechanism of persuasion to enforce their policies in Brazil.[118] In the specific instance of privatisation, for example, negotiations of external debt came to entail swaps of debt for participation in privatised corporations. In this context, in 1990, the Collor government set up a far-reaching programme of privatisation and new regulation for several markets under the strict control of the government. On 12th April, the government enacted the Law 8031 instituting the National Plan of Denationalisation (PND - *Plano Nacional de Desestatização*) which established among its objectives:

a) to redirect the role of the State towards those sectors where the State is fundamental and transfer to the private sector "activities unduly explored by the State";

b) to contribute to the reduction of the public debt;

c) to increase the rate of investment in the sectors where public enterprises used to operate;

d) to increase competition and entrepreneurial capability;

e) to foster the capital markets.

The same Law created a Commission, subordinated to the President, responsible for the evaluation, conception, execution, supervision and monitoring of the programme with

[117] Through 1981-1989 38 firms were privatised grossing US$700 million (Pinheiro and Oliveira-Filho 1991).
[118] Edwards (1995) reports that studies and indoctrination seminars, courses, meetings and so on carried out by the World Bank and the IMF had played an important role in convincing Latin American political and economic elites to adopt the neoliberal reforms.

periodical publication of its results. Given its long experience of evaluating and financing long-term investment projects and then the recent experience acquired with privatisation in the 1980s, the BNDES naturally emerged as the agent of privatisation (and its president as the head of the Commission of Denationalisation). Throughout the process, which extended through the 1990s, not much of this institutional setting was changed unless for the width of the process which broadened. From 1995 the government became more adamant about privatisation, and reformulated the 1988 Constitution to include several sectors in the block of privatisations and concessions as well as to facilitate foreign participation in those sectors subject to privatisation where the 1988 Constitution did not allow foreign ownership.

**Table 39 Main Characteristics of Brazilian Privatisation Exercise, 1990-2002**

| | US$ Billion | % | | US$ Billion | % |
|---|---|---|---|---|---|
| **National Plan of Denationalisation** | 72.5 | 69.0 | **Type of Buyers**[2] | 87.2 | 100 |
| Oil and Gas | 7.4 | 7.0 | **Foreigners** | 42.1 | 48.3 |
| Electricity | 33.0 | 31.3 | United States | 14.0 | 16.0 |
| Petrochemical | 3.7 | 3.5 | Spain | 12.7 | 14.5 |
| Mining | 8.8 | 8.3 | Portugal | 4.9 | 5.6 |
| Steel | 8.2 | 7.8 | Italy | 2.6 | 3.0 |
| Sanitation | 1.1 | 1.0 | Others | 7.9 | 9.2 |
| Transports | 2.3 | 2.2 | **Nationals** | 45.1 | 51.7 |
| Financial | 6.3 | 6.0 | Financial Institutions | 7.4 | 8.4 |
| Miscellaneous firms' share sales | 1.1 | 1.1 | Pension Funds | 5.8 | 6.7 |
| Others | 0.6 | 0.6 | Non-financial Firms | 23.9 | 27.4 |
| **Telecommunications**[1] | 32.8 | 31.0 | Individuals | 8.0 | 9.2 |
| **Total Revenue** | 105.3 | 100 | **Type of Sellers**[3] | 105.3 | 100 |
| Transferred Liabilities and payments with Public Debts | 18.1 | 17.2 | Federal Gov. | 70.7 | 67 |
| Cash | 87.2 | 82.8 | Sub-National Gov. | 34.6 | 33 |

Source: BNDES (2002b) and FUNDAP/DIESP (2004). Numbers may not add due to rounding.
1 - The telecommunication privatisation was considered a special programme, aside the PND, involving divestiture of public enterprises and concessions for exploitation of new services (mobile phone; high speed internet connexion etc).
2 - Considering cash revenues only.
3 - Considering cash and liabilities transferences.

The first public enterprise to be privatised was Usiminas, a company operating in the steel sector, on 24$^{th}$ October 1991, for a little less than one billion dollars. Table 39 above shows the main figures of the whole process of privatisation that took place in Brazil. It is worth noting some essential characteristics of the process. First, the privatisation exercise spread over a wide range of sectors, from industry (petrochemical and mining), to infrastructure (electric and transports) to public utilities (telecommunications and water and

sanitation system) to financial sector (mostly commercial banks), privatising about 133 public enterprises and grossing just over US$ 105 billion between 1990 and 2002. Second, cash was the main means by which firms were privatised for, albeit liability transferences had not been negligible a part. Indeed, up until 1995 most of the selling was accomplished accepting a variety of public bills and bonds, in order to facilitate the purchase for interested buyers without cash.[119] Third, the foreign buyers had a large participation in the process of privatisation, figuring with almost 50 per cent of the whole amount purchased, with 99 per cent of it coming after 1995.

**Table 40 Mergers and Acquisitions, Foreign Firms Investments and Participation in Brazilian Sales by Sector**

| Mergers and Acquisitions | | 1990-1999 |
|---|---|---|
| US$ Million | | 67,893 |
| Number of Mergers and Acquisitions | | 1,055 |
| | | |
| Foreign Direct Investment by Sectors (%) | | 1995-2000 |
| Agriculture | | 1.5 |
| Manufacturing | | 15.5 |
| Chemical | | 2.8 |
| Machines and Equipments | | 1.0 |
| Electronic | | 1.4 |
| Automobile | | 3.7 |
| Services | | 70.5 |
| Electricity and public utilities | | 11.3 |
| Telecommunications | | 19.2 |
| Financial Institutions | | 13.4 |
| Services for Firms | | 15.0 |
| Others | | 12.5 |
| Total (US$ Million) | | 118,435 |
| | | |
| Foreign Firms Share in the 500 Largest Firms' Sales (%) | 1993 | 2000 |
| Food | 31.9 | 57.7 |
| Beverage | 9.0 | 15.3 |
| Textile | 2.8 | 23.2 |
| Electronic | 32.5 | 77.4 |
| Steel mills | 18.2 | 32.7 |
| Public Services | - | 64.6 |
| Telecommunications | - | 63.0 |
| Total | 44.0 | 53.6 |

Sources: Banco Central do Brasil; Marcelo Nonnenberg (2004); João Carlos Ferraz *et alli* (2004).

[119] One of the reasons why some privatisations had been flawed in the 1980s was the lack of public financing for them. Accepting public bills and bonds for privatising attracted interest not only from domestic buyers but from foreigners as well.

Through deregulation, the government also sought to transfer activities previously restricted to public entities to be operated by private sector and specially sought to bolster foreign participation in domestic economy. Accordingly, the reforms in the 1990s broke the constitutional public monopolies in the areas of telecommunications and natural resource exploitation (including petroleum, mining and water), as well as eliminated discrimination between Brazilian firms, most of whose capital was national, and firms with headquarters in Brazil but whose control pertained to foreigners. This latter change facilitated the participation of foreigners in the privatisation and concession process and allowed foreign companies to obtain financing and fiscal subsidies advanced by public entities. Those institutional changes associated with the process of privatisation and mergers and acquisitions resulted in the end of the old complementary association between private national, state and foreign capital, giving way to a much stronger weight of the foreign capital, especially in services and high technological sectors, with foreign capital taking over the position of state owned enterprises (Table 40).

*Financial Sector Reforms and Liberalisation of Capital Account*

In the 1990s, Brazil liberalised its financial accounts and financial system – hereafter financial liberalisation – aiming to expand the interconnection between the domestic and international financial system. In the early the 1990s, the Brazilian government gradually began a series of reforms to reduce transactions costs with which residents had to face to invest in assets or issue debt abroad and non-residents had to deal with to invest in the domestic economy. It is interesting also to note that the changes in the regulation of financial transactions came not through a general reformulation of the regulatory framework bestowed by the 1964-1967 reforms, but took the form of norms, circular letters, amendments and new interpretations of the laws and norms already in place. Besides, despite its far-reaching influence upon the economy, most of these new regulations were enacted by the BACEN without being scrutinised by broad political bodies, neither National Congress nor less civil society.

In 1987 the BACEN enacted Resolution 1289 institutionalising and regulating the foreign portfolio investments, allowing investors to enter into distinct markets whether organised in the form of foreign investments companies, foreign investment funds, or stock and bond portfolio investments. In 1991, this resolution was amended with the Annex IV to

allow investment into primary and secondary stock exchange markets by foreign investors, dispensing with minimal requirements of capital, composition criteria, minimum permanence period, and exempting income tax on capital gains. Also in 1991, the Resolution 1806 created foreign privatisation funds, allowing foreign investors to purchase shares or debts from public enterprises subject to privatisation; and, in 1993, the Resolution 2028 created the foreign fixed yields funds. In 1996, other two foreign investment funds were created: investment fund in emerging companies and housing investment funds. None of these resolutions established limits of permanence or specific taxation on the profits of these investments. They only requested that these investments should be registered with the BACEN for the purposes of remittance of profits abroad, since only registered capital was allowed to remit profits and capital gains abroad.

Since the 1964-1967 financial reforms, the two most important mechanisms by which domestic institutions could obtain resources from abroad were through Law 4131 (for productive companies) and Resolution 63 (for banking system to transfer to domestic clients). In general, these instruments continued being applied but their scope was enlarged. For instance, banks were now allowed to lend resources obtained abroad, not only to industry as before but also to agriculture, housing and to finance car leasing contracts. In relation to the direct indebtedness abroad, firms were allowed to issue fixed income debt certificates (such as commercial papers, exports securities and convertible debentures). By the same token, the Annex V to the Resolution 1289 allowed domestic firms to issue debts negotiable in stock exchanges abroad. Through this Annex, domestic firms could issue Depositary Receipts (DR), either on the United States stock exchange markets (issuing American Depository Receipts – ADR) or other foreign exchange markets (issuing Global Depositary Receipts – GDR), integrating more closely the movements of the domestic stock exchange market with the international stock exchange markets.

One of the most radical changes took place regarding the ability of residents to invest abroad. Since 1969 the Circular Letter 5 (better known in Brazil as CC5)[120] regulated non-residents banking accounts allowing flows without previous authorisation by the BACEN. In 1992, the Circular Letter 2259 and the Circular 2242 allowed banks to accept domestic deposits in non-resident accounts converting them into foreign deposits (or deposits

[120] In Portuguese *carta* means *letter* so that Circular letter becomes in Portuguese Carta Circular. CC5 is therefore the acronym for Carta Circular no.5.

denominated in foreign currencies) through floating exchange rate markets. This new regulation and functioning of the exchange market introduced the possibility of transferences abroad regardless previous inflows of resources by the remittent. For the first time Brazil authorised, through administrative decision of the BACEN officials, the possibility of full convertibility of domestic currency into foreign currency.

Beyond the aforementioned incentives tailored to embark on the growing international financial flows, the government also entertained foreign direct investments. It has already been mentioned that the Fernando Henrique Cardoso government abolished the public monopolies in petroleum and telecommunications as well as the distinction between national and foreign capital, both moves facilitating the participation of foreign investors in the process of privatisation. Moreover, it allowed the remittance of royalties due to intellectual and patent rights and reduced the income tax on profit remittances from 25 per cent to 15 per cent.

Since the 1930s, the state had sought to control domestic flows of credit by reducing foreign banks' participation and increasing the role of public banks (Topik 1980a; 1985; Triner 1996; 1999). The 1988 Constitution still limited the foreign banking sector participation into domestic market (Vidotto 1999). Brazilian financial liberalisation also advanced in this area by promoting the entry of major foreign commercial banks. It is interesting to note that the increasing participation of the foreign institutions in the Brazilian banking system took place without the abolishment of the legal barriers raised for this sector, despite government rhetoric about the abolition of privileges and support to greater competition across all economic activities. The participation of foreign institutions in the banking system in Brazil began only in 1995 when the Minister of Finance, Pedro Malan, made a statement (called exposition of motives no. 311, dated 29th August, 1995) to President Fernando Henrique Cardoso pointing out to the relevance of allowing foreign institutions to enter into Brazilian banking system according to the *government's* interests.[121] This document combined generic praise for the alleged advantages which should accrue from greater foreign competition in the banking system such as increase in the technological capabilities, reduced interest rates for borrowers and higher for savers

[121] In this document, which possessed no normative power, Pedro Malan suggested to President Fernando Henrique Cardoso the use of the rights conferred by the 1988 Constitution to "recognise as the Brazilian government's interest the participation or augment in participation of physical or juridical entities, non-residents, in the capital of national financial institutions." Refer to Carlos August Vidotto (1999) for more details of this communication.

(spread reductions). Macroeconomic benefits would emerge chiefly from improvements in the balance of payments and public finances as foreign institutions would bring resources from their parent companies and the government would get ride of private and public institutions at the government bay.

The opportunity for this turn around in relation to the openness of the banking system for foreign ownership came about after the banking crisis following the price stabilisation attained by the Real Plan.[122] Between 1994 and 1996, over 115 financial institutions experienced some form of BACEN's intervention, mostly due to a combination of the extinction of floating revenues the banking system obtained with high inflation and the increase in non-performance credits in banks' balance-sheet.[123] In 1995, the BACEN began a programme for restructuring and strengthening the financial system (PROER – *Programa de Estímulo à Reestruturação e Fortalecimento do Sistema Financeiro*), which constituted bailing out financial institutions through special lines of financial assistance, releasing compulsory resources and lessening the reserves requirements.[124] In 1997 a similar programme was set up for public banks belonging to state governments (PROES – *Programa de Estímulo à Redução do Setor Público Estadual na Atividade Bancária).*[125] It was in following up these programmes that the BACEN stimulated greater involvement of foreign institutions in the Brazilian banking system, whether by transferring broken private banks' assets to foreign institutions or by privatising public banks of state governments.[126]

[122] In 1995 two of the largest banks in Brazil, Nacional and Econômico (fifth and sixth in assets among private institutions), went bankrupt mostly as a result of the elimination of the inflationary revenues (see discussion in previous chapter) and also from the euphoria of credit concession with the increase in consumption of lower income earners which came to an end with restrictive measures adopted by the government after the Mexico crisis at the end of 1994.

[123] Since the beginning of the Real Plan in mid-1994 up until 1996 over 30 banks were liquidated or put under administration by the BACEN.

[124] The PROER was enacted by Provisory Measure 1179 and Resolution 2208 on 3rd November, 1995. According to Carlos Eduardo Carvalho *et. alli* (2002), this programme was announced on 4th November, 1995, a Saturday, and the regulations, despite being publicized on the subsequent Monday, came with the date of November the 3rd.

[125] Instituted by the Provisory Measure no. 1514, on 7th August 1996. See Cleofas Salviano Júnior (2004) for a historical account of the events related to the PROES.

[126] Vidotto (1999) points out that there was divergence between members of the Fernando Henrique Cardoso administration in respect to the participation of foreign institutions in the Brazilian banking system with the BACEN and the Finance Ministry being favourable to openness while the Planning Ministry being against it.

**Table 41 Bank Participation in Selected Indicators by Ownership – Percentage of the Total Banking System, 1996-2004**

| | *Private National Banks*[1] | | | *Foreign Banks* | | | *Public Banks* | | | *Banco do Brasil and Caixa Econômica Federal*[2] | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1996 | 2000 | 2004 | 1996 | 2000 | 2004 | 1996 | 2000 | 2004 | 1996 | 2000 | 2004 |
| Net Worth | 54.2 | 50.3 | 52.9 | 11.4 | 28.3 | 27.1 | 12.4 | 5.7 | 4.7 | 20.7 | 13.7 | 12.8 |
| Assets | 38.3 | 35.2 | 41.7 | 10.5 | 27.4 | 22.4 | 21.9 | 5.6 | 5.5 | 29.0 | 31.0 | 28.9 |
| Deposit | 33.4 | 33.9 | 39.4 | 7.2 | 21.1 | 19.9 | 21.5 | 7.3 | 6.6 | 37.7 | 36.5 | 32.7 |
| Credit | 31.9 | 34.5 | 41.3 | 9.5 | 25.2 | 25.1 | 23.5 | 5.1 | 4.4 | 34.6 | 34.0 | 26.8 |

Source: Banco Central do Brasil.
Notes: Only depositary institutions;
1 - Including banks with foreign participation;
2 - Federal institutions. Separated from other public institutions due to their size.

Enjoying the PROER's benefits, four banks were transferred to domestic banks before the first transference of a troubled bank to a foreign institution. The latter happened in April 1997 when HSBC received the assets of Bamerindus, then the seventh largest Brazilian bank in terms of assets, raising the participation of foreign institutions to about 13 per cent of total banking assets. Table 41 above shows the increasing participation of foreign institutions in the Brazilian banking system as a result of government manoeuvrings favouring those institutions. Foreign banks reinforced their participation in the Brazilian banking system through the acquisition of some state owned banks, including the privatisation of Banespa,[127] the fourth biggest bank in terms of assets, to the Spanish bank Santander in 2000. The privatisation of the state owned banks was then the greatest single contributor to the increased participation of foreign institutions in the domestic banking system, followed by the wave of mergers and acquisitions promoted by the PROER. In short, the process unfolded by the government of restructuring the domestic financial system resulted in a substitution of private ownership for public ownership, particularly in benefit of the foreign banks. The way this increase in the participation of foreign banks came about, that is by privatising the state owned banks, have chiefly been determined by the political power enjoyed by the domestic incumbent banks.

[127] Banespa was a bank of São Paulo, the largest and richest Brazilian state.

*Price Stability with Macroeconomic Austerity*

Under the Collor government, a price stabilisation plan was attempted by freezing prices and wages and, in a dramatic manner, by freezing all financial assets for 18 months above the limit of US$ 1,500 on bank and savings accounts withdrawal.[128] Yet adopting very restrictive monetary and fiscal policies, which generated a surplus in the public operational budget of 1.2 per cent of GDP (there had been a deficit of 7 per cent of GDP in 1989) and a GDP drop of 4 per cent in 1990, inflation did not recede even to double digits. Uncertainties in respect to exchange rates derived from the external debt payments still dominated the economic scene and, together with a corruption scandal and ensuing political crisis which plagued the Collor administration, fuelled financial speculation and inflation rates.

It was only in 1994 that Brazil launched a price stabilisation programme that counted on capital inflows and competitive pressure from higher coefficient of imports to succeed in halting and reducing inflation.[129] This programme, the Real Plan, pertained to the family of de-indexing prices and wages programmes attempted and failed in the 1980s.[130] This time, however, the programme launched a nominal anchor for formation of price expectations by semi-fixing the exchange rate in relation to dollar,[131] which was eased and made credible, as the economy was flooded with foreign capital. It was also praised by the World Bank, which in an early report commending Brazilian price stabilisation and liberalising reforms, considered "the new exchange regime…a useful tool in the stabilization effort" (World Bank 1994, p.73). Tough monetary quantitative goals were established along with promises of reducing government expenditures to indicate the government's compliance with the austerity package. In addition, the market power of firms to fix mark-ups had been checked by increasing foreign competition, as the government further reduced tariffs and facilitated

[128] For detailed accounts of Fernando Collor stabilisation plan, see Belluzzo and Almeida (2002, ch.7).

[129] For detailed accounts of the making of and the measures of the Real Plan, see Gustavo Franco (1995; 1996) and André Modenesi (2005, ch.5).

[130] Indeed, many of the Real Plan makers had also made the stabilisation plans in the 1980s. Among other there were economists like Francisco Lopes, Pérsio Arida and André Lara Resende who were identified with the inertial theory of inflation in the Brazilian case. See André Modenesi (2005).

[131] The initial idea was to have a one to one parity between the *real* and the dollar. However, with the flood of capital inflows, the BACEN acted in favour of Fernando Henrique Cardoso's candidacy for president in the election in October of 1994, and left the real to appreciate up until 0.84 reais for one dollar. With the Mexican crisis in December 1994, Brazil adopted a tacitly fixed crawling peg exchange rate with devaluation of about 7 per cent per year until 1999, when a floating exchange regime followed a maxi-devaluation.

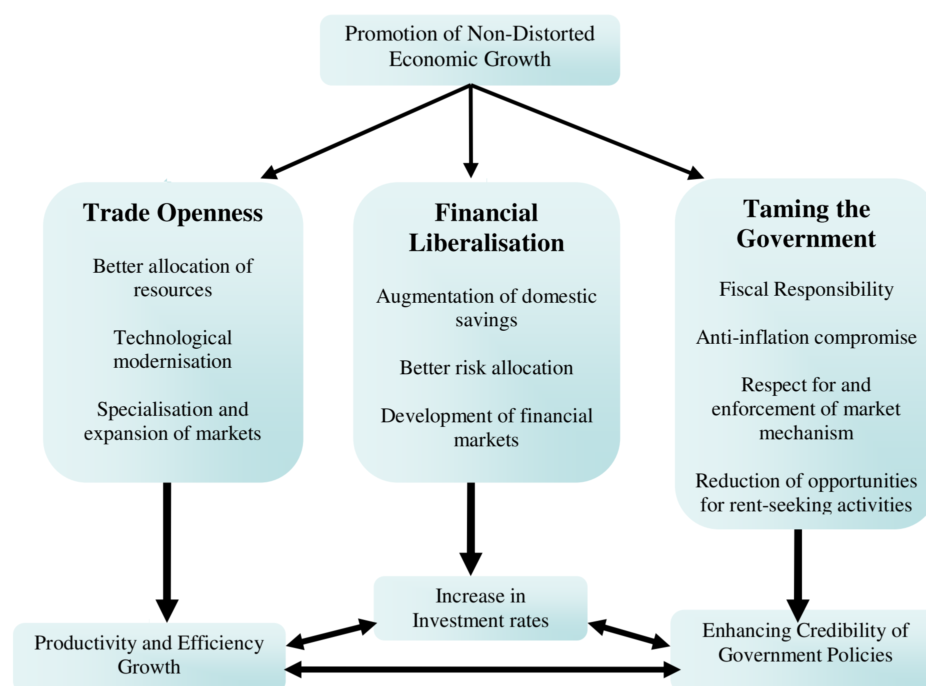
imports through post office to hasty price reductions towards the end of 1994.[132] Be that as it may, the Real Plan had an immediate and enduring effect upon inflation, reducing it from 42 per cent in April 1994 to 0.6 per cent in December 1994 (as measured by the general index price). Inflation continued to fall in the coming years from 15.0 per cent in 1995 to 9.2 per cent in 1996, to 7.1 per cent in 1997 and to 1.8 per cent in 1998. In contrast to the 1980s, when devaluation nurtured an inflation explosion, the devaluation of domestic currency in the crises of 1999 and 2002 seemed not to have cumulative effects on inflation.

**Raising Great Expectations**

From this summary of the neoliberal reforms and policies implemented in Brazil, a clear picture emerges. From the early 1990s the Brazilian economy became a much more internationally integrated economy with regard to its commerce, the structure of ownership, and the financing of the economy. In the 1990s, the government relinquished several mechanisms – fiscal and monetary as well as legal – by which it used to control, influence and direct the level and the flows of investments within the economy in the heyday of state-led development. In the 1990s Brazil had definitely turned towards the market mechanisms, outward oriented economy which neoliberal economists claim as the engine of development as noted in the second chapter of this study. That is, growth would now be based on efficiency gains stemming from better allocation of resources and fostered by enhanced market competition at undistorted market prices. By the same token, in a regime of capital account openness rigid macroeconomic rules of austerity are natural requirements in order to maintain the confidence of foreign investors. In a nutshell, the idea is to put in place rules of the game in which the government had no direct control over the various mechanisms coordinating the investment flows within the economy and one that market forces (instead of unlikely political goodwill) would oblige the government to guarantee macroeconomic austerity. Figure 22 below presents the channels through which the reforms were expected to lead to market-led economic growth.

[132] Between 1993 and 1996, the industrial mark-up reduced over 14 per cent (Pereira 2000). See also Mauricio Mesquita Moreira and Paulo Guilherme Correa (1998).

**Figure 22 Expected Engine of Growth of the Neoliberal Reforms**




Among Brazilian policymakers, the reforms were met with enthusiasm not only relating to the structural changes and growth prospects but also to the income distribution. José Roberto Mendonça de Barros and Lídia Goldenstein (1997, p.15), respectively a former official at Finance Ministry and an adviser to the BNDES presidency, stressed that "the Brazilian economy is going through an impressive restructuring process which… is leading it into a 'virtuous circle' that… will warrant its dynamism and the return of high rates of growth." By the same token, President Fernando Henrique Carodoso in his inaugural speech in January of 1995 expressed his optimism by saying that "today there is no serious specialist who forecasts for Brazil anything but sustained growth in the long term." And the forecast growth realised by his government in its Four Year Plan was no less than 4.6 per cent per year between 1996 and 1999, with the per capita income growing at rates of 3.3 per cent per year over the same period. Gustavo Franco (1999), a former BACEN governor, added that "thanks to the opening, and to the outstanding productivity growth derived from it, the wage gains and income distribution produced by the stabilisation have proven to be enduring."

These great expectations with regard to the reforms have not been met, however. We will now turn to the results of the market-oriented reforms and to an explanation of why they failed to deliver sustainable and reasonable economic development.

### Economic Growth under Market-Oriented Reforms: the second lost decade

*Records*

The stagnation that prevailed in the Brazilian economy in the 1980s helped pro-market reformers to make their case – albeit misleadingly – against the previous model of development, and to legitimise their reforms by promising a regime of sustained growth. Convinced that the troublesome 1980s represented the vengeance of markets against government-led development, Brazilian policymakers embraced free-market reforms faithfully instead of developing the state capabilities to rescue the economy from the stagflation. In order to eliminate uncertainties and gain investors' confidence, policymakers made the permanent combating of inflation – by means of macroeconomic austerity – their primary objective.[133] The reality, however, proved to be more complicated than the pro-market reformers seemed to suggest or believe.

The initial hopes that market-oriented reforms could be able to resume high rates of sustained economic growth rapidly gave way to despondency over the actual facts. Although inflation has been reduced to historically low levels, fifteen years of market-oriented reforms in Brazil have failed to produce sustainable economic growth, with records even worse than the so called "lost decade" (the 1980s). As Table 42 below shows Brazilian economic growth fell well behind the rest of the world. Of course, averages conceal flotation around them. The best performance was observed between 1993 and 1995 when the economy grew at rates of 5 per cent per year in part as a result of the Real Plan and consequent increase in businesses' and households' confidence. Nevertheless this was the period of triumphant politicians' and official economists' statements (as quoted above) announcing the success of the new model, it is ironic that the driver of that growth was domestic demand instead of being export-driven as the new model supposed. Be that as it may, it was a short-lived economic recovery as from 1995 onwards the positive effects of

[133] Typical amongst conventional economists was the belief expressed by Marcio Ronci, an IMF's economist, in a paper with Giuseppe Tulio, that "the end of hyperinflation will soon imply the return of very high real growth rates for Brazil"(Tullio and Ronci 1996, p.637).

the price stabilisation had gone and the rates of growth tended to be more unstable and lower.

**Table 42 International Comparison of Economic Growth (%), 1980-2004**

| | *1980-1989* | *1990-1999* | *1990-2004* |
|---|---|---|---|
| World | 3.2 | 3.2 | 3.4 |
| EU (15) | 2.2 | 2.2 | 2.1 |
| USA | 3.0 | 3.1 | 2.9 |
| Korea | 7.3 | 6.0 | 5.7 |
| Mexico | 2.1 | 3.3 | 3.0 |
| Chile | 3.7 | 6.4 | 5.6 |
| Argentina | -0.7 | 4.1 | 2.9 |
| Brazil | 3.0 | 2.0 | 2.1 |

Sources: IBGE. OECD.
Note: Simple average.

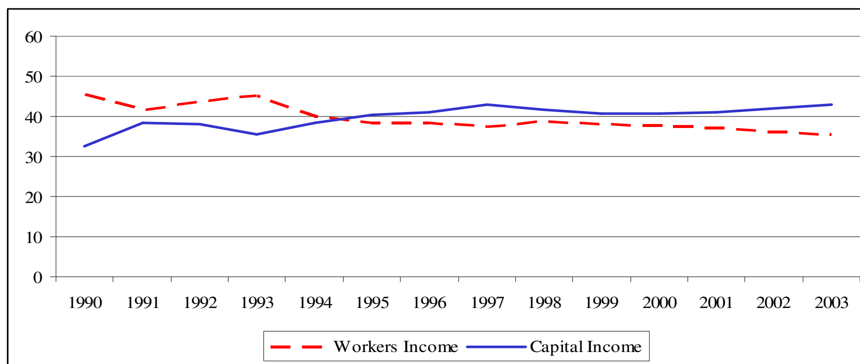
Along with the feeble economic growth, high rates of unemployment became a permanent feature of the Brazilian economy in the 1990s. With the shock treatment of the Collor administration, the rates of unemployment grew from 3.4 per cent in 1989 to 5.7 per cent in 1992.[134] After reaching a bottom level in 1995 of 4.6 per cent, unemployment soared reaching 7.6 per cent in 1999 and 7.1 per cent in 2000. Moreover, due to the low economic growth, increasing difficulty to find jobs and a legislation which lowered firing costs and stimulated high labour turnover, the unemployed found themselves forced into lower paying jobs and contracts (Baltar 2003; Klein 2003; Moretto*, et al.* 2003).[135] The high rates of unemployment associated with the creation of low skilled and low paid jobs seemed to have compensated the positive effects of income distribution likely to emerge from the reduction of inflation rates. That is, whereas less organised wage earners would

[134] These official numbers for unemployment, collected by IBGE, should be taken with a pinch of salt. Alternative measurement done by the DIEESE (Inter-syndicate Department of Statistics), a trade union think tank, found at least the double of IBGE's figures. The difference seems to lie in the methodology used. Meanwhile IBGE considers only over the age of 14- as old enough to work (according to legal determination), DIEESE consider people over 10 years old as old enough to work (their argument is that many below legal age are forced to work due to economic and social conditions); IBGE also consider as employed any person who worked for at least 15 hours per week in the last 30 days, while DIEESE in turn classify as "hidden unemployment" those who, despite having worked occasionally in voluntarily or temporary jobs during the last 30 days, were looking for a permanent job. The IBGE changed its methodology in 2002 to include 10-year-olds or more as the economically active population. For the twelve months of 2002, when IBGE used both methodologies, it found an average 4 percentage point higher unemployment in the new methodology. Be as it may, there is a general concordance between the trends of the IBGE's and DIEESE's figures.

[135] The share of formal workers in the total employed reduced from 58 per cent in 1989 to 49 per cent in 1994 and further to 44.5 per cent in 1999. The number of self-employed and informal workers in turn increased from around 18 per cent and 19 per cent in 1989 to around 23.5 per cent and 26.5 per cent in 1999 respectively. On the other hand, self-employed and informal workers' average income is 14 per cent and 18 per cent lower than that received by formal workers. Data from IBGE.

have been favoured with lower inflation, the higher levels of unemployment and creation of jobs in low paid posts have resulted in a dramatic turn around in the position of labour and capital in the appropriation of income. Figure 23 below shows very clearly that labour income reduced dramatically under market-oriented reforms losing nothing less than 10 percentage points in GDP for capital incomes.[136] Not surprisingly, although reduced inflation had had an initial positive effect on real wages, its effects soon vanished with the overall poor performance of economic growth and employment.[137]

**Figure 23 Labour-Share and Capital-Share in GDP (%), 1990-2003**




Source: IBGE.
Note: Workers' income includes wages and allowances. Capital income includes profits, interest and rents.

Another failure of the announced objectives of the market-oriented reforms has been their inability to sustain productivity growth (see Table 43 below). The relatively high growth in productivity of manufacturing in the initial years of the reforms was associated with the effects of the reforms on gains of efficiency with elimination of less competitive firms, reduction in costs of raw material and organisational rationalisation (Bonelli 1994; Carvalheiro 2003; Feijó and Carvalho 2002; 2003; Feijó, *et al.* 2003; Moreira 1999b; Moreira and Correa 1998; Pinheiro, Gill, Serven, and Thomas 2001; Saboia and Carvalho 1997). Labour productivity in manufacturing sectors, however, has declined since the

[136] It is true that the number of indigents dropped from 28 million people in 1993 to around 22.5 million people in 1995 due a combination of price stabilisation, economic growth and also social policies bestowed from the 1988 Constitution (data from IPEA). Since then, however, the number of indigent has maintained around 23 million people.

[137] The index of real average wages (July 1994 = 100) in the six main capital cities (São Paulo, Rio de Janeiro, Belo Horizonte, Porto Alegre, Salvador and Recife) increased from 100.4 in 1993 to 130 in 1997. Since then it has declined to 120 in 2000 and 111 in 2002 (data from IBGE's Monthly Employment Survey). As the methodology changed in 2002 data are not comparable from then on.

second half of the 1990s to rates comparable to those prevailing in the 1980s.[138] Beyond its insufficiency growth in productivity has been achieved with considerable reductions in employment and deterioration of labour relations instead of being a result of strong economic growth. In addition, agriculture – whose output and productivity growth has stood out for reasons largely unrelated to the reforms – has proven to have a weaker capacity to spread its gains of productivity to the remainder of the economy. Either way, the figures seem to have behaved in accordance with the Kaldorian cumulative process according to which economic growth determines increases in productivity (Kaldor 1967), rather than the conventional supply-side assumption adopted by neoliberal reformers.

**Table 43 Annual Average Growth of Output, Employment and Productivity by Sectors (%)**

| | *Agriculture* | | *Manufacturing* | | *Services* | |
|---|---|---|---|---|---|---|
| | 1990-1995 | 1996-2003 | 1990-1995 | 1996-2003 | 1990-1995 | 1996-2003 |
| Output | 3.1 | 3.7 | 2.2 | 1.0 | 3.0 | 2.0 |
| Employment | 0.4 | -2.0 | -1.8 | -0.1 | 2.4 | 2.7 |
| Productivity | 2.8 | 5.8 | 4.0 | 1.1 | 0.6 | -0.7 |

Source: IBGE. Numbers may not add due to rounding.

*Causes*

Behind the failure of the market-oriented reforms to resume sustainable rates of economic growth, and its bias to increase unemployment and worsen income distribution, lies a weak effective demand regime aggravated by the weakening of backward linkages (see Table 44). To begin with, the major element of effective demand in any economy, namely consumption, has increased very slowly apart from during a short-lived increase after the price stabilisation. Indeed, the immediate income effect of the price stabilisation above mentioned produced a mini-cycle of consumption-led growth, especially of low-income earners. By 1996, however, the consumption-drive derailed as the labour income decreased with unemployment and insolvency increased with the higher interest rates prevailing in the economy (more about that later). Rising unemployment and low wages in turn have been largely a result of downsizing and outsourcing strategies adopted by firms to face the fiercer international competition stemming from trade openness.

[138] Contrary to the initial enthusiasm with which increases in productivity were associated with the trade liberalization (Moreira and Correa 1998), econometric studies testing the correlation between trade opening and productivity with more recent data have shown that there is no such evidence. See Regis Bonelli (2002) and Armando Castelar Pinheiro, Regis Bonelli and Ben Ross Schneider (2004).

**Table 44 Rates of Real Growth of Expenditure and Trade Balance as a Share of GDP, 1990-2005**

| | *Consumption* | *FBKF* | *Exports* | *Imports* | *GDP* | *Trade Balance/GDP* |
|---|---|---|---|---|---|---|
| 1990 | -0.9 | -10.9 | -4.9 | 10.9 | -4.3 | 1.2 |
| 1991 | 0.5 | -4.7 | -4.8 | 11.1 | 1.0 | 0.8 |
| 1992 | 0.1 | -6.6 | 16.5 | 4.5 | -0.5 | 2.5 |
| 1993 | 4.1 | 6.3 | 11.7 | 26.8 | 4.9 | 1.4 |
| 1994 | 5.9 | 14.3 | 4.0 | 20.3 | 5.9 | 0.4 |
| 1995 | 7.0 | 7.3 | -2.0 | 30.7 | 4.2 | -1.8 |
| 1996 | 3.1 | 1.2 | 0.6 | 5.4 | 2.7 | -1.9 |
| 1997 | 2.9 | 9.3 | 11.1 | 17.8 | 3.3 | -2.4 |
| 1998 | 0.0 | -0.3 | 3.7 | -0.3 | 0.1 | -2.2 |
| 1999 | 0.3 | -7.2 | 9.2 | -15.5 | 0.8 | -1.5 |
| 2000 | 3.2 | 4.5 | 10.6 | 11.6 | 4.4 | -1.5 |
| 2001 | 0.6 | 1.1 | 11.2 | 1.2 | 1.3 | -1.0 |
| 2002 | 0.0 | -4.2 | 7.9 | -12.3 | 1.9 | 2.1 |
| 2003 | -0.8 | -5.1 | 9.0 | -1.7 | 0.5 | 3.6 |
| 2004 | 3.0 | 10.9 | 18.0 | 14.3 | 4.9 | 4.7 |
| 2005 | 2.7 | 1.6 | 11.6 | 9.4 | 2.3 | 4.4 |

Source: IBGE.

A second factor depressing aggregate demand and reducing domestic linkages was the trade deficits. As a consequence of the appreciation of the domestic currency propped up by the flood of capital inflows chasing high real interest rates and tailored to reduce inflation has been a major factor to evaporate the huge trade surpluses observed in eleven years since 1983. Despite promulgating the advantages of the external markets as a vent for surplus which would enhance the economic scales and the productivity of domestic firms, the 7 per cent growth of exports has not been a historical record for the Brazilian economy. Between 1965 and 1979, usually seen as a period of inwardly-oriented policies, exports grew at 9 per cent per year whereas in the troublesome 1980s exports grew over 10 per cent per year. In international perspective, the Brazilian exports, which in the 1970s and 1980s grew above the world rates and Latin American rates, in the 1990s have felt well behind them (World Bank 2000/2001, Table 11). From the point of view of the backward linkages with the domestic economy, exports have been linked to less dynamic sectors. According to the UNCTAD's (2003) study, for instance, in 2000 over 52 per cent of Brazilian exports were realized by primary, low skilled and natural resources sectors.[139] The lack of selective

[139] It is interesting to notice that as far as dynamic export sectors are concerned the most successful sectors in Brazil have been just those subject to selective government incentive and policies, namely, aircraft (basically EMBRAER, a former state owned enterprise) and automobiles (completely dominated by foreign firms). See José Cassiolato; Roberto Bernardes and Helena Lastres (2002) and UNICAMP-NEIT (2002).

strategies for orienting the exports towards the most internationally dynamic markets, whether in terms of technological capabilities or demand growth, has played a part in the weaker performance of the exports and their weak linkage with the rest of the economy. The dismantling of the exports incentives in the wake of neoliberal policies already in the aftermath of the 1982 external crisis and the ideological eagerness with which policymakers in the 1990s embraced flawed neoliberal conceptions on trade left the country with no instrument to promote exports. As a result, more often then not foreign markets have been only a poor substitute for the faltering domestic demand of many manufacturing sectors.[140]

On the other hand, the unilateral and radical opening to imports along with the appreciation of domestic currency resulted in a vigorous increase in imports of all sorts. Whereas in the 1970s the income elasticity of imports was around a full point, in the 1990s it more than tripled. In the nine years before the exchange devaluation in 1999, imports increased by more than 3.5 times the growth in exports so potential economic growth was shattered as the already slow effective demand was uncontrollably being diverted to foreign goods. More importantly, the substitution of domestic production for external suppliers has affected negatively those sectors using advanced technology and high skilled workers. As Table 45 illustrates, apart from transport equipment, the other high-tech sectors have lost weight either as employer (chemicals), or in the value-added (scientific and professional products), or yet in both (electric and electronic equipment). No doubt that the growth of imports was a desired consequence of the reforms in order to coerce incumbent firms to operate more efficiently. What neoliberal policymakers may not have anticipated was that the coercive competition their policies entailed resulted in the economy specialising in lower value-added sectors with incumbent firms abandoning local production of high tech products and laying off high qualified and more expensive employees.[141] The latter in turn had to turn to lower paid jobs aggravating income distribution and the lack of effective demand reinforcing the vicious circle just described.

[140] During the period of economic growth between 1993 and 1996, the manufacturing sectors' coefficient of export declined from 11.6 in 1992 to 9.6 in 1996. From 1997 onwards, when the economic growth fell, this coefficient increased up to achieve 15.4 per cent in 2003.

[141] It is certainly not for coincidence that, apart from transport equipments, the high-tech sectors were those with a higher degree of imports penetration.

**Table 45 Relative Weight of High-Tech Sectors in Total Manufacturing Output and Employment (Percentage)**

| | *Value-Added* | | | | *Employment* | | | |
|---|---|---|---|---|---|---|---|---|
| | 1990 | 1995 | 2000 | 2003 | 1990 | 1995 | 2000 | 2003 |
| Transport Equipment | 15.4 | 17.7 | 18.6 | 17.3 | 10.1 | 9.0 | 9.5 | 11.5 |
| Electric Equipment | 3.5 | 3.0 | 2.0 | 1.4 | 2.2 | 1.9 | 1.6 | 1.5 |
| Electronic Equipment | 4.4 | 4.4 | 3.0 | 2.1 | 1.8 | 1.5 | 1.2 | 1.2 |
| Chemicals | 7.7 | 6.8 | 8.0 | 9.0 | 1.0 | 0.9 | 0.7 | 0.8 |
| Scientific and Professional Products | 2.7 | 2.4 | 2.3 | 2.2 | 2.9 | 3.3 | 3.8 | 4.2 |
| Total | 33.7 | 34.3 | 33.9 | 32.0 | 18.0 | 16.6 | 16.8 | 19.2 |

Source: IBGE.

The market-oriented reforms have also failed to emulate the staggering rates of investments in East Asian countries, the neoliberals' blueprint models, whereas those reforms have also failed to match the rates achieved in the period of state-led development in Brazil. Table 44 shows investment rates that on average have grown barely one full percentage point from 1990 through 2003. Compared to the 1980s the rate of investment has been fallen by 4 per cent of GDP since the beginning of the reforms. A fleeting recovery of investment rates took place just after the price stabilisation plan in 1994, which produced also a brief growth of the output. However, the rates of investment as a percentage of the GDP even in this period of heights never achieved 17 per cent and since 1997 they have been declining up till 13 per cent in 2003. The generalised opening could only aggravate the consequences of that poor investment regime as part of the investment demand ended up being satisfied by foreign suppliers. As Table 46 below illustrates, the rate of growth of imported machines and equipment increased almost 3 times that of the national machines and equipment in the fourteen years from 1989, increasing therefore the participation of imported capital goods in the total capital formation in almost threefold between 1989 and 2003. Most of this surge in imports of capital goods over domestic production took place between 1994 and 1999 as a result of the combination of high availability of cheaper foreign credit and appreciated exchange rates which reduced the costs of imported capital goods (Moguillansky, *et al.* 2001; Moreira 2004).[142] The greater income-elasticity to import ingrained by the reforms transformed domestic capital goods sector in complementary to imports as a greater part of the demand for capital goods was

[142] The relative capital goods price index, measured as the relation between wholesale price index for capital goods (IPA – production goods) in relation to the general price index (IGP), fell by over 26 per cent between 1990 and 1998 and by 9 per cent between 1990 and 2005.

provided by imports at the expenses of the domestic capital goods sector's utilisation capacity. As a consequence, the domestic capital goods sector growth tended towards zero suffering with high rates of idle capacity even in the periods when the rates of investments grew the fastest.[143]

Whilst reforms, especially privatisation, attracted a historical record of foreign direct investment,[144] they have actually contributed to the weakening domestic aggregate demand. First, they surely have not been enough to compensate for the decline of the domestic investments, especially those of the government. Contrary to the period of state-led development, in the 1990s the FDI flows were markedly driven by asset transfers in order that they did not contribute directly to increase productive capacity. Secondly, foreign companies have come to service sectors attracted by the size of Brazilian markets (extended with the creation of *MERCORSUR*) instead of being oriented to export sectors (ECLAC 2004). Therefore, while these investments directly contribute to higher imports (or to worsening the current account deficits) they hardly represent increases in exports. In this connection, even foreign firms in manufacturing sectors have shown greater propensity to import than to export reinforcing then the above mentioned structural trade deficits (Laplane and Negri 2004; Moreira 1999a; Negri 2002).

In short, lower rates of investment associated with the diversion of domestic demand to foreign markets have damaged the long-term growth capacity of the economy, either by reducing current effective demand or by reducing the future provision of productive capacity, or by weakening the ability of domestic producers to compete internationally.[145] In short, the reforms have not been able to recover the investment growth even from the low rates prevailing in the 1980s. At any rate, they remain far below the 25 per cent identified by the UNCTAD (2003) study as the minimum necessary to buttress a process of economic transformation and sustained growth in developing countries. The great market uncertainties introduced by far-reaching reforms affecting the degree of contestability of

[143] The capital goods' average capacity utilisation was less than 73 per cent between 1990 and 2003 and had a peak of 81 per cent in 1997, after five years of positive rates of investment growth.

[144] In 1999, for instance, it reached 5 per cent of GDP and amounted to 26.5 per cent of capital formation, while in the heydays of the state-led industrialisation, it never achieved either 2 per cent of GDP or 7 per cent of capital formation.

[145] For instance, according to Maria Honorio Szapiro (2000, p.23) "the connections established by the new MNSs subsidiaries with the other components of the local system are not related to developing and strengthening the knowledge base. In essence, the type of investment by newcomers, as they concentrate on assembling activities, is having a deep effect on the local system of innovation, decreasing local content, networking and learning processes."

incumbent firms and the competitiveness conditions in which firms operated certainly figured amongst the reasons for a decline in the domestic entrepreneurs' confidence in the future and the reduced commitment with long-term investment.[146]

**Table 46 Imported and National Machines and Equipments Sector (US$ Billion), 1989-2003**

| | *1989* | *2003* | *Change (%)* |
|---|---|---|---|
| Imported Machines and Equipments | 2.2 | 7.1 | 324.3 |
| National Machines and Equipments | 11.0 | 13.1 | 118.6 |
| Imported Machines to National Machines Relative Growth | - | - | 2.7 |

Source: Ipeadata.
* At prices of 1980.

In summary, the market-oriented reforms have broadly failed to recover economic growth on a more even basis. From a comparative perspective the records of the neoliberal era have largely fallen short when compared with the period of state-led development, whether one takes into account economic growth, per capita income growth, or productivity growth. On the one hand the neoliberal reforms have not been able to overcome the longstanding concentration of income characteristic of Brazilian development, whereas they have had deadly consequences in terms of unemployment and lost of participation of wage earners in the income. Behind the poor performance of the Brazilian economy after the neoliberal reforms lies a regime biased to reduce effective demand and the long-term linkages which used to bind together the various productive forces of the economy. And behind that lies the several institutional changes produced by the reforms that limited or eliminated the government controls or inducements over the investment flows within the economy. For instance, simply eliminating all the incentives and institutional settings that supported Brazilian exports proved very dear for exports to grow. Equally harmful was the radical and non-selective opening of the economy to foreign competition with severe consequences for domestic industrial structure with at best only temporary benefits in terms of productivity gains. Pressured by fiercer competition on the one hand and by a feeble growth in aggregate demand on the other, firms adjusted by laying off employees and by reducing wages both resulting in uneven income distribution and low levels of consumption growth. Crowning all the failures of neoliberal reforms to resume sustainable economic growth in Brazil was the frail performance of investment growth. The lack of increase in

[146] A World Bank's (2005) survey of 1,642 entrepreneurs in 2003 found that 76 per cent of them thought policy uncertainty as a major constraint to invest in Brazil; 72 per cent of these entrepreneurs thought that finance also was a major constraint to invest in Brazil.

productive capacity has shown its costly toll in the form of a reduced growth of productivity (after the temporary effects of the decrease of labour-force firing on productivity had gone).

The next section will argue that this weak effective demand regime and hollowed productive structure have been exacerbated by a speculative regime that followed the market-oriented policies. In fact, it is argued that one possible reason why the market-oriented reforms have become an obstacle to development in Brazil is that policy-making and government institutions are subordinated to attending powerful financial interests instead of being oriented to enhance the government capabilities to govern the market.

### Finance Interests and the State Financial Fragility

Two arguments will be developed in this section. Firstly, by pursuing financial liberalisation and privatisation of public financial institutions the government sought to constitute an unprecedented private financial system able to substitute the Gerschenkronian role performed by the public financial institutions as the providers of loans to long-term and risky projects.[147] In line with the Mackinnon-Shaw type of argument, policymakers hoped that by deregulating financial markets the loanable funds would flood the domestic financial system, in special the capital markets, and increase the availability of resources for investments. Very often neglected by financial liberalisation advocates is the fact that Brazilian private financial markets have shown a particular proclivity to speculative and short-sighted behaviour. In these conditions, as Ilene Grabel (1995, p.137) has noticed "the financial deepening that attends FL [financial liberalisation] expands these [speculative and short-sighted] opportunities precisely by creating instruments that transform ownership of claims on illiquid real assets into extremely liquid positions, and by installing institutions and technologies that facilitate the trading of such assets." In other words, the institutions that emerge from financial liberalisation in a context of under-developed and under-regulated financial markets may become dysfunctional for economic development.

Secondly, the mobility that such extremely liquid positions confer to financial investors also bestows on them also prominence in government policies. In the context of financial liberalisation, financiers become increasingly able to vote against monetary policies

[147] See Chapter 3 for the constitution and the roles of the Banco do Brasil, BNDES and BNH.

supportive of development by withdrawing resources from the host country (Frieden 1991). As a consequence, along with financial liberalisation it has been necessary to adopt or maintain restrictive policies in order to secure investor confidence and rentier rewards. Since the inception of the 1982 external debt crisis policy-making in Brazil has been dominated by finance interests in that sense. Restrictive policies throughout the 1980s were in part followed to guarantee the repayment of debt services. In the 1990s, the finance interest continued to be served with restrictive policies as domestic economic policies relied heavily on capital inflows and financial investors' confidence. In a country with a long history of high inflation like Brazil, to allure financers' confidence policymakers have exaggerated interest rates and exchange rates upwards to proof their austerity credentials to financiers. Accordingly, the domestic interest rates have followed the so-called covered interest parity, i.e., the BACEN determined domestic interest rates with a mark-up on the international interest rate enough to cover the general risk associated to the country and the risks of exchange devaluation. Given the low position of Brazil's currency in the hierarchy of the international monetary system and the combination of appreciated exchange rates with increasing current account deficits, the covered interest parity convention meant high real domestic interest rates.

However, whatever efforts the government makes to gain the confidence of financiers, financial investors' expectations are highly volatile and subject to sudden changes prompted by the most varied sources such as changes in interest rates abroad or domestically, looming currency depreciations, contagion from crises in other countries' crises, political developments, and so on. The potential for sudden reversions is latently present in financial investments due to their liquidity which is in turn enhanced by financial liberalisation (Grabel 1996). Situations such as these led Brazil to several financial crises (banking crisis in 1995, currency crises in 1999 and 2002). In addition, the financial instability and the financial crises stemming from financial liberalisation have been costly managed at the expenses of the government financial position, the country sustained economic growth and better income and wealth distribution. In this sense, by impinging constraints in the growth of effective demand and by restraining the government deeds to the financial interests (whether to reward financiers or to rescue them from major crisis), the financial liberalisation has been the cornerstone of the end of developmental policies in Brazil which resulted in the stagnant economic growth discussed in the previous chapter.

The next two sections discuss these financial shortcomings of the neoliberal reforms in Brazil and the constraints on policy autonomy implied by them.

*Capital Markets and the Internationalisation of Domestic Banking System as Poor Substitutes for Public Controlled Institutions*

As would be expected with the high returns being offered on Brazilian financial assets, foreign capital came flooding to Brazil (Table 47). The first wave came in the form of portfolio capital, a novelty in relation to the banking syndicated loans of the 1970s, which accounted for over 60 per cent of the flows in 1996, when net flows achieved its peak. The second wave came in the shape of direct investments as a result of the process of privatisation in the late 1990s. These unprecedented inflows of capital fuelled Brazilian financial markets network. The stock exchange markets, for instance, experienced historically unequalled growth as the capitalisation market ratio climbed from 2.4 per cent by 1990 to 22.5 per cent in 1993 and to further 42.5 per cent in 1999 (Table 48). Although it had reversed this path in the three years after the 1999 crisis, it returned to 45 per cent in 2003. Likewise, the daily turnover of shares increased from US$ 16 million in 1990 to US$ 750 million in 1997.[148]

**Table 47 Net Capital Inflows to Brazil (US$ Billions), 1990-2005**

| | ***FDI*** | ***Portfolio*** | | | ***Others*** | ***Total Net Inflow*** | ***Reserves*** |
|---|---|---|---|---|---|---|---|
| | | Fixed Yield Funds | Stock Exchange Funds | Total | | | |
| 1990 | 0.4 | 0.5 | 0 | 0.5 | 3.8 | 4.6 | 9.9 |
| 1992 | 1.9 | 12.8 | 1.7 | 14.5 | -6.4 | 9.9 | 23.8 |
| 1994 | 1.5 | 43.7 | 6.9 | 50.6 | -43.4 | 8.7 | 38.8 |
| 1995 | 3.3 | 6.2 | 2.9 | 9.2 | 16.7 | 29.1 | 51.8 |
| 1996 | 11.3 | 15.7 | 5.9 | 21.6 | 1.1 | 34.0 | 60.1 |
| 1997 | 17.8 | 6.1 | 6.5 | 12.6 | -4.7 | 25.8 | 52.2 |
| 1998 | 26.0 | 17.1 | 1.0 | 18.1 | -14.4 | 29.7 | 44.6 |
| 1999 | 26.9 | 2.1 | 1.7 | 3.8 | -13.4 | 17.3 | 36.3 |
| 2000 | 30.5 | 5.8 | 1.1 | 6.9 | -18.1 | 19.3 | 33.0 |
| 2001 | 24.7 | -1.3 | 1.4 | 0 | 2.3 | 27.0 | 35.9 |
| 2002 | 14.1 | -6.7 | 1.6 | -5.1 | -1.0 | 8.0 | 37.8 |
| 2003 | 9.9 | 2.6 | 2.7 | 5.3 | -10.1 | 5.1 | 49.3 |
| 2004 | 8.7 | -6.7 | 1.9 | -4.7 | -11.3 | -7.4 | 53.0 |
| 2005 | 12.7 | -0.8 | 5.6 | 4.9 | -26.4 | -8.8 | 53.8 |

Source: Banco Central do Brasil.

[148] By 1997, the volume negotiated in the Brazilian stock exchange markets was larger than the transactions realised in Mexico, Korea, Malaysia, and Australia for instance. Data from World Federation of Exchanges web site: www.world-exchanges.org/WFE/home.Asp.

In spite of this spectacular growth in liquidity the Brazilian domestic capital market has not developed into a significant and reliable source of funds for the growth of Brazilian firms. First, most of these capital flows came to acquire already existing domestic firms, especially those in the process of privatisation, instead of being directed to finance new investments. Second, most trade has typically occurred in a reduced number of stocks which account for a considerable part of the total market capitalisation. Third, the number of listed firms in the Brazilian stock exchange fell during the 1990s, thereby constituting a process of concentration of transactions in fewer companies and hollowing the market. Fourth, and more important from the perspective of this study, it is striking that the growth of capital market has been associated with its increasingly insignificant role in the process of creation of capacity in the country. In 1997, for instance, new issues accounted for only 8 per cent of the fixed capital formation and in 2005 to less than 3 per cent of it. This low and decreasing role that the capital markets have performed in the financing of the productive capacity is even more striking if one considers that it took place with a decreasing capital formation ratio as discussed earlier. That is, the stunning growth of the volume negotiated in Brazilian capital markets was chiefly led by patrimonial and speculative behaviour of investors. In this connection, the increased liquidity of the Brazilian capital market concentrated in a small number of stocks and its greater integration with the international markets have transformed the Brazilian financial markets greatly fragile to financial shocks whether they originated outside or inside the country. Graciela Kaminsky and Carmen Reinhart (2003) show, for instance, that the Brazilian stock markets had been highly influenced by the turmoil in Mexico in 1994 and by the LTCM collapse in 1998. Thus, the stock exchange markets in Brazil have rather behaved in a bandwagon and speculative way, serving as a transmission chain of financial instability for the rest of the economy and contributing with almost none for the real economic growth.

**Table 48 Indicators of Stock Exchange Markets, 1990-2005**

| | *1990* | *1995* | *2000* | *2005* |
|---|---|---|---|---|
| Market Capitalisation Ratio (%) | 2.4 | 21.0 | 38.0 | 60.0 |
| Trade Ratio (%) | 0.9 | 1.7 | 17.0 | 27.4 |
| Concentration Index (%) (no. Firms in brackets) | - | 66.0 (27) | 65.3 (23) | 65.0 (19) |
| Number of Listed Firms (unit) | 579 | 544 | 467 | 381 |
| New Issues/FBCF (%) | - | 5.0 | 5.8 | 2.9 |

Source: World Federation of Exchange.
Notes: *Market Capitalisation ratio is the market capitalisation to GDP.
*Trade ratio is the ratio of the value traded of stock exchanges to GDP.
*Concentration index is the 5 per cent of the most traded companies in the domestic market share trading value.

The Brazilian banking system, which is responsible for most of the credit of the Brazilian economy, also took advantage of the increased volume of resources coming from abroad either by tapping into them directly or by borrowing in the boosted domestic capital markets. Thus, up until 1995, the Brazilian banking system was the main issuer of external debt, accounting for over 55 per cent of the external borrowing that year. However, like the capital markets, this easier access to foreign resources has not necessarily resulted in a proportional increase in the banks' credit supply, in particular for financing long-term capital investments. Typically, whilst the amount of credit conceded by commercial banks in Brazil has not reached 40 per cent of their assets, it has increasingly been concentrated on financing consumption. As Table 49 shows, the advancement of credit to households grew quickly after the price stabilisation in 1994. The specialisation of the financial system in the short-term segment of credit increased with the privatisation process and entry of the foreign banks into the Brazilian market. However, even after the foreign banks' entry – whose increased participation the government expected would increase the availability of credit due their allegedly greater expertise, lower operational costs and greater access to foreign markets –, the volume of credit has not changed. Although foreign banks have greater propensity to borrow abroad than domestic banks, their credit to assets ratios behaved similarly to domestic banks.

**Table 49 Loans as a Percentage of GDP to Private Sector (by Sectors) and to the Whole Economy, 1990-2005**

| | *Industry* | *Housing* | *Agriculture* | *Commerce* | *Households* | *Others Services* | *Whole Economy* |
|---|---|---|---|---|---|---|---|
| 1990 | 4.9 | 6.7 | 2.0 | 1.4 | 0.5 | 2.0 | 24.1 |
| 1991 | 5.0 | 6.0 | 2.5 | 1.6 | 0.6 | 2.2 | 24.1 |
| 1992 | 6.3 | 7.0 | 2.8 | 2.0 | 0.9 | 2.9 | 28.6 |
| 1993 | 6.7 | 6.4 | 2.6 | 2.6 | 1.2 | 3.4 | 29.0 |
| 1994 | 8.2 | 7.7 | 3.5 | 4.1 | 3.1 | 4.4 | 36.6 |
| 1995 | 8.3 | 6.9 | 3.4 | 4.6 | 2.4 | 4.2 | 35.0 |
| 1996 | 7.4 | 5.9 | 2.4 | 3.5 | 2.9 | 3.6 | 31.2 |
| 1997 | 7.5 | 5.6 | 2.5 | 3.2 | 3.9 | 3.5 | 28.9 |
| 1998 | 7.8 | 5.8 | 2.7 | 2.7 | 3.9 | 4.7 | 29.9 |
| 1999 | 7.9 | 5.0 | 2.5 | 2.7 | 3.9 | 3.6 | 27.2 |
| 2000 | 7.4 | 4.8 | 2.5 | 2.7 | 5.4 | 4.0 | 28.0 |
| 2001 | 7.9 | 1.9 | 2.2 | 2.9 | 6.3 | 4.8 | 26.7 |
| 2002 | 7.3 | 1.5 | 2.3 | 2.5 | 5.3 | 4.3 | 24.2 |
| 2003 | 7.3 | 1.6 | 3.0 | 2.7 | 6.2 | 4.5 | 26.2 |
| 2004 | 6.8 | 1.4 | 3.2 | 3.0 | 7.4 | 4.3 | 27.0 |
| 2005 | 7.1 | 1.5 | 3.4 | 3.3 | 9.7 | 5.1 | 31.2 |

Source: Banco Central do Brasil.

Besides, as a consequence of the reduction of the number of public financial institutions and internationalisation of domestic banking system, the latter became even more concentrated and enjoyed market power with direct consequences for the maintenance of very high interest rate (Belaisch 2003; Moguillansky*, et al.* 2004). Accordingly, whereas the number of banks decreased continuously throughout the 1990s, resulting in an increased concentration of deposits in the ten largest institutions (Table 50), the interest spread and the net profit margin of the banks have been held at very high levels[149] (see Figure 24).[150] This concentrated structure of the banking system and the reduced role of compensating public institutions leave firms, specially the small ones, financially-constrained. The supply of credit as a proportion of GDP hardly changed since the early 1990s positing around 30 per cent of GDP (see Table 49). Given the expensiveness and short-term profile of bank's loans, in order to growth firms have to resort to funds internally generated. As Table 51 shows, over 2/3 of funds to finance firms' investment in Brazil come from internally generated resources. Taking into account the weak effective demand regime that market reforms have entailed, which in turn results in greater difficulties for firms to generate

[149] Whereas the BACEN has pressured for reductions in the interest spreads through administrative measures, the banks have been successful in compensating for it by increasing their net profit margins.
[150] The interest margins in Brazil were 11 per cent above the Latin America's average between 1999 and 2002 (Gelos 2006).

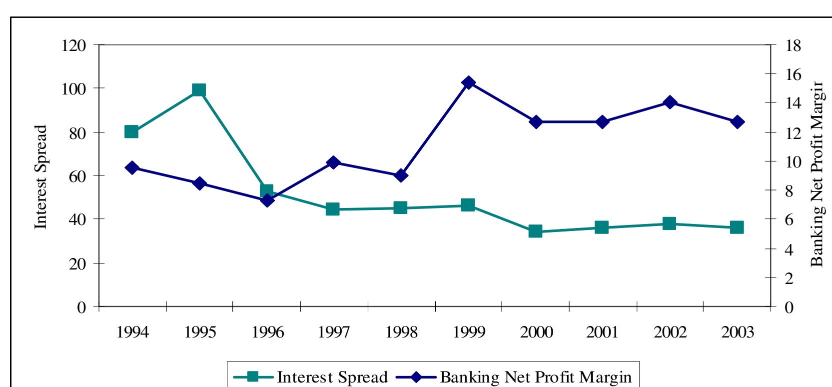
internal funds for investment, one concludes that firms faced compounded difficulties to lever funds to finance investment.[151]

**Table 50 Indicators of Banking Concentration (%), 1995-2004**

| | *1995* | *2000* | *2004* |
|---|---|---|---|
| Top Ten Banks | | | |
| Share of Total Assets | 60.1 | 64.1 | 68.0 |
| Share of Total Deposits | 78.8 | 85.6 | 82.4 |
| Share of Total Credit | 69.0 | 64.1 | 67.5 |
| Number Total of Banks | 205 | 163 | 139 |

Source: Banco Central do Brasil.

**Figure 24 Interest Rates Spread and Banking Net Profit Margins (%), 1994-2003**




Source: Banco Central do Brasil.
Note: Banking Net Profit Margin is defined as the interest spread less administrative costs, taxes and default risk.

**Table 51 Firm Financing Patterns, 1994-1998 (Publicly-listed firms, sorted by size) - Percentage**

| | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|
| Internal Financing | 67.8 | 69.1 | 69.1 | 70.6 | 72.3 |
| Banks | 18.4 | 17.7 | 20.8 | 10.8 | 13.5 |
| Capital markets | 8.4 | 15.2 | 12.3 | 15.0 | 3.7 |
| Trade Financing | 5.4 | -2.0 | -2.2 | 3.7 | 10.6 |
| Total External Financing | 32.2 | 30.9 | 30.9 | 29.4 | 27.7 |

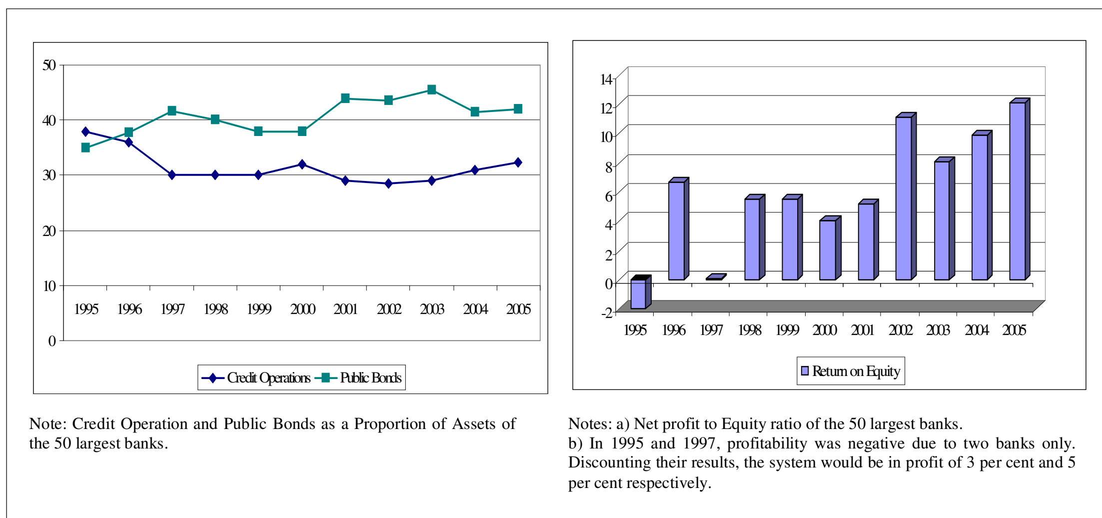
Source: Stijn Claessens, Daniela Klingebiel and Mike Lubrano (2000).
Note: Database for 156 to 170 non-financial, publicly listed corporations. Flow data.

Finally, although the Real Plan de-indexed the prices of the economy, many financial assets continued indexed to some kind of price index. Daily indexed public bonds (LFTs), which had been created during the high-inflation years of the 1980s to protect bondholders from inflationary corrosion, continued being the preferred assets amongst banks because of their high profitability and daily liquidity. In this context, banks have retreated from

[151] In addition, financial constraints are unevenly distributed as the 20 per cent of largest firms amass almost 70 per cent of the funding provided (Claessens, *et al.* 2000, p.11).

conceding credit as the prevailing high interest rates keep debtor's risks permanently high, and have preferred public bonds as they are very profitable and risk-free (Figure 25). Accordingly, banks have held around 40 per cent of their assets in the form of public bonds meanwhile their loans have corresponded to only 30 per cent of their assets. The banks' growing profitability shows that this strategy of preferring highly liquid assets has perfectly suited private gains although it has at the same time discouraged credit operations.

**Figure 25 Selected Assets and Profitability of the 50 Largest Banks in Brazil (%), 1995-2005**




Note: Credit Operation and Public Bonds as a Proportion of Assets of the 50 largest banks.

Notes: a) Net profit to Equity ratio of the 50 largest banks.
b) In 1995 and 1997, profitability was negative due to two banks only. Discounting their results, the system would be in profit of 3 per cent and 5 per cent respectively.

Source: Banco Central do Brasil.

In short, the market reforms eliminated or deactivated the Gerschenkronian substitutive institutions created during state-led industrialisation to channel and finance long-term capital with low interest rates but left nothing in their place. The greater reliance on high interest rates and under-regulated private banks resulted in lower and costlier credit supply; the private banks have been highly risk-averse preferring to finance household consumption and investments in indexed public bonds instead of investments of long-term maturation. In this sense neither the greater access to foreign sources nor the greater participation of foreign banks resulted in a corresponding rising in the supply of credit and reduction of its costs. In fact, foreign banks have rather tried to adapt to the old practices of incumbent banks instead of being agents of institutional change. That is, instead of being agents of development by providing long-term capital, foreign banks along with domestic banks have preferred to operate in the short term and more liquid tier of the asset spectrum.

### The State's Loss of Political Autonomy

In spite of the anti-interventionist stance with which the market-oriented reforms were announced, policymakers have more often than not promoted "big government" when the results of market forces have jeopardised financiers' income and security. As the first column of Table 52 shows the net public debt expanded at fast rates of growth in the second half of the 1990s. Most of the reduction in the public net debt before 1994 was due to the renegotiation of external debt,[152] whose burden reduced from 24 per cent of GDP in 1991 to 8.4 per cent of GDP in 1994.[153] A different account began in the second half of the 1990s, though, when the public indebtedness rapidly high-skied in a well-known Mynskian "Ponzi" pattern increasing in almost 30 percentage points of GDP in the 9 years beginning in 1994. This process of indebtedness becomes even more astonishing if one takes into account that the privatisation process gained momentum in the same period, whose proceeds mounted to 23 per cent of GDP in 2002, and the tax burden increased from 28 per cent of GDP in 1994 to 35 per cent in 2002 (FUNDAP/DIESP 2004).

**Table 52 Public Total Net Debt and by Bonds, 1991-2005**

| | Net Debt Total (% of GDP) | Public Bonds (% of GDP) | Percentage of Public Bonds by Indices | | | | |
|---|---|---|---|---|---|---|---|
| | | | Selic | Other Interest rates | Exchange rate | Pre-Fixed | Price Index |
| 1991 | 38.0 | 3.0 | 67.2 | 0.0 | 11.5 | 16.1 | 5.3 |
| 1992 | 37.2 | 8.9 | 9.0 | 9.6 | 3.0 | 54.8 | 23.6 |
| 1993 | 33.0 | 9.2 | 3.8 | 10.4 | 17.3 | 26.4 | 42.1 |
| 1994 | 29.2 | 12.4 | 16.0 | 23.0 | 8.3 | 40.2 | 12.5 |
| 1995 | 30.5 | 17.3 | 37.8 | 8.9 | 5.3 | 42.7 | 5.3 |
| 1996 | 33.3 | 27.6 | 18.6 | 9.2 | 9.4 | 61.0 | 1.8 |
| 1997 | 34.6 | 31.7 | 34.8 | 8.6 | 15.4 | 40.9 | 0.3 |
| 1998 | 42.4 | 36.7 | 69.1 | 6.0 | 21.0 | 3.5 | 0.4 |
| 1999 | 47.0 | 38.9 | 61.1 | 3.1 | 24.2 | 9.2 | 2.4 |
| 2000 | 49.4 | 41.8 | 52.3 | 4.6 | 22.3 | 14.8 | 6.0 |
| 2001 | 52.6 | 48.2 | 52.8 | 3.8 | 28.6 | 7.8 | 7.0 |
| 2002 | 56.5 | 37.8 | 60.8 | 3.6 | 22.4 | 2.2 | 11.0 |
| 2003 | 58.7 | 44.4 | 61.4 | 4.3 | 10.8 | 12.4 | 11.1 |
| 2004 | 51.7 | 42.2 | 57.1 | 6.3 | 5.2 | 19.7 | 11.7 |
| 2005 | 51.5 | 49.3 | 52.1 | 3.6 | 1.9 | 27.2 | 15.2 |

Source: Banco Central do Brasil.

[152] Reduction in the public domestic debt was also brought about in this period as a result of the freezing of financial assets imposed by the Collor government.
[153] Source of data the same as Table 52.

Indeed, it is more than a coincidence that the rapid public indebtedness was a result of the maintenance of high interest rates and of other policies tailored to gain investors' confidence and curb inflation. First, whereas by maintaining high exchange rates the excessive entry of capital helped policymakers to check on price increases at the same time it forced the BACEN to issue public bonds to sterilise the monetary effects of the capital inflows. That is, whereas on the one hand interest rates have been used to attract foreign capital, on the other the government has to issue public bonds to maintain interest rates high and to avoid the expenditure to grow. As Table 52 shows, public bonds increased rapidly and turned almost the sole form of indebtedness by public institutions. As public bonds paid higher interest rates than the government received from its investments in foreign assets and from tax revenues, the sterilisation of foreign capital inflow resulted in further increases of public deficits and debts (Palma 2001). So, a cumulative process leading to increasing public indebtedness is built-in by the government's attempt to curb inflation resorting to capital inflows.

Second, the tighter monetary policy after the Mexican crisis in the end of 1994 triggered a banking crisis as the high interest rates affected the debtors' ability to repay bank loans leading banks to witness an increase in provisions for underperforming credits and consequent worsening of their balance sheets. In 1995 three important private commercial banks went bankrupt due to the end of inflation revenues and due to the increase in the provision for underperforming loans, loans that had been conceded amidst the euphoria with the end of inflation. Even the tougher proponents of the free-market laws became loud sponsors of the government intervention to impede the spread of the banking crisis (Loyola 1996). As already mentioned, the government launched a programme to bail out private banking sector (the PROER) whose costs, estimated by the IMF attained around 10 per cent of GDP (IMF 1998), had substantial impact on the public debt (Belluzzo and Almeida 2002; Carneiro 2002; Palma 2001).

Less noticed, however, is that the public indebtedness has been the cornerstone of the process of financial liberalisation by providing the security and profitability required by domestic and foreign private agents. As Table 52 shows indexed public bonds, an old lasting institution born in the 1964 financial reforms to eschew the depreciating effects of inflation and developed through the high-inflation process of the 1980s, continued to be offered by the BACEN after the price stabilisation. Thus, a significant part of public debt

issued by the BACEN was indexed to the exchange rate to serve as hedging for those agents whose dollar-linked liabilities increased with the financial liberalisation. Accordingly, while public debt indexed to exchange rates accounted for less than 8 per cent of the total public bonds in 1995, they scaled to 15 per cent in the second half of 1997, to 21 per cent in the brink of the devaluation in the second half of 1998, and to 30 per cent in the month of the devaluation in January 1999. Therefore, unlike Asian countries where the private sector suffered acutely with the currency crisis in 1997, during the Brazilian's currency crisis in 1999 no important financial institution or non-financial corporation suffered solvency difficulties or failures.[154] So, although since the early 1990s the external indebtedness has been mostly a private process, especially by foreign banks and non-financial corporations, the exposition to foreign-currency crises was absorbed by the public sector through dollar-indexed bonds.

**Table 53 Financial Requirements of the Public Sector as a Percentage of GDP, 1990-2006**

| | *1990-1993* | *1994-1998* | *1999-2002* | *2003-2006* |
|---|---|---|---|---|
| Nominal | 41.9 | 10.9 | 5.3 | 3.0 |
| Central Government and BACEN | 14.8 | 4.6 | 2.9 | 2.8 |
| State and Municipalities | 15.6 | 4.7 | 2.8 | 1.0 |
| State Owned Enterprises | 11.4 | 1.5 | -0.3 | -0.9 |
| | | | | |
| Operational | 0.4 | 3.8 | 0.7 | 0.9 |
| Central Government and BACEN | -0.2 | 1.7 | 0.8 | 1.6 |
| State and Municipalities | 0.1 | 1.8 | 0.3 | 0.1 |
| State Owned Enterprises | 0.5 | 0.3 | -0.4 | -0.9 |
| | | | | |
| Primary | -2.8 | -1.0 | -3.5 | -4.6 |
| Central Government and BACEN | -1.4 | -1.0 | -2.1 | -2.8 |
| State and Municipalities | -0.6 | 0.2 | -0.6 | -1.0 |
| State Owned Enterprises | -0.8 | -0.2 | -0.8 | -0.8 |
| | | | | |
| Real Interest Payments | 3.1 | 4.8 | 4.3 | 5.4 |
| Central Government and BACEN | 1.2 | 2.6 | 2.9 | 4.4 |
| State and Municipalities | 0.7 | 1.6 | 0.9 | 1.1 |
| State Owned Enterprises | 1.3 | 0.5 | 0.4 | -0.1 |

Source: Ipeadata.
Note: A positive figure is deficit and a negative is surplus.

The concession of indexed public bonds has been a fundamental strategy of credibility building along with investors. Table 53 above shows that the costs of maintaining investors' confidence have come in the form of an increased government interest payment

[154] The BACEN bailed out two small banks, Marka and Fonte Cidam, which operated with derivatives in the exchange rate market.

and a reduced government's investment. The interest payments on public debt became the sole determinant of public deficits whereas primary accounts have obtained increasing surpluses. In the last 15 years the interest payments made on public debt have mounted on average to 4.5 per cent of GDP. Therefore, whereas the operating public deficit has been on average 1.7 per cent of GDP in the same period, the primary accounts have been in surplus of 2.7 per cent of GDP. Reduction in government investments and maintenance of primary surpluses turned the cornerstone of neoliberal policies for conquer investors' confidence in the policymakers' compromise with austerity. In this connection, the government has reduced investment as a percentage of GDP not only by privatisation but also by declining direct administration investments. Accordingly, while privatisation naturally made public enterprises investments drop from 2.2 per cent of GDP in 1995 to 1.3 per cent of GDP in 1999, direct administration's investment, which holds responsible for investments in areas such as education and health, also plummeted from 2.5 per cent of GDP in 1995 to 1.7 per cent of GDP in 1999. Public investments in infrastructure (transport, communication, power and sanitation) in turn dropped from 2.7 per cent of GDP in 1995 to 1.4 per cent of GDP in 1999.[155] Thus, a first order consequence of the high real interest rates has been to carry the government expenditures away from those expenditures related to employment generation, productivity enhancing, income growth, and income distribution.[156]

As the 1999 and 2002 currency crises made clear, the rentier-friendly policies adopted by Brazilian policymakers could not guarantee financial stability. The 1999 speculative attack against the Real was facilitated by the increasing and unsustainable current account deficits, which in turn resulted from the inevitable appreciation of the exchange rate produced by the flood of capital inflows and due to trade liberalisation. Austerity on the government primary expenditure and a reduced economic activity were not enough to counter the crisis as the lions' share of the current account deficits has been the interest and profits remitted abroad. Therefore, the increasing fragility of the external accounts in the context of a deregulated capital account let the government vulnerable to the punishment of rentiers through capital flights. After the crisis in 1999, greater concessions to the rentiers' interest had to be made in order to regain investors' confidence. To force surpluses on

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[155] According to a World Bank's estimate, to achieve the same level of infrastructure coverage as in Korea today Brazil would need invest 9 per cent of GDP up to 2010 (World Bank 2007).

[156] The reduction of public investments in infrastructure was not compensated by increases in private investments for, as noticed earlier, privatisation was mere asset transference with no much consequence in terms of expansion of infrastructure stock. See also World Bank (2007).

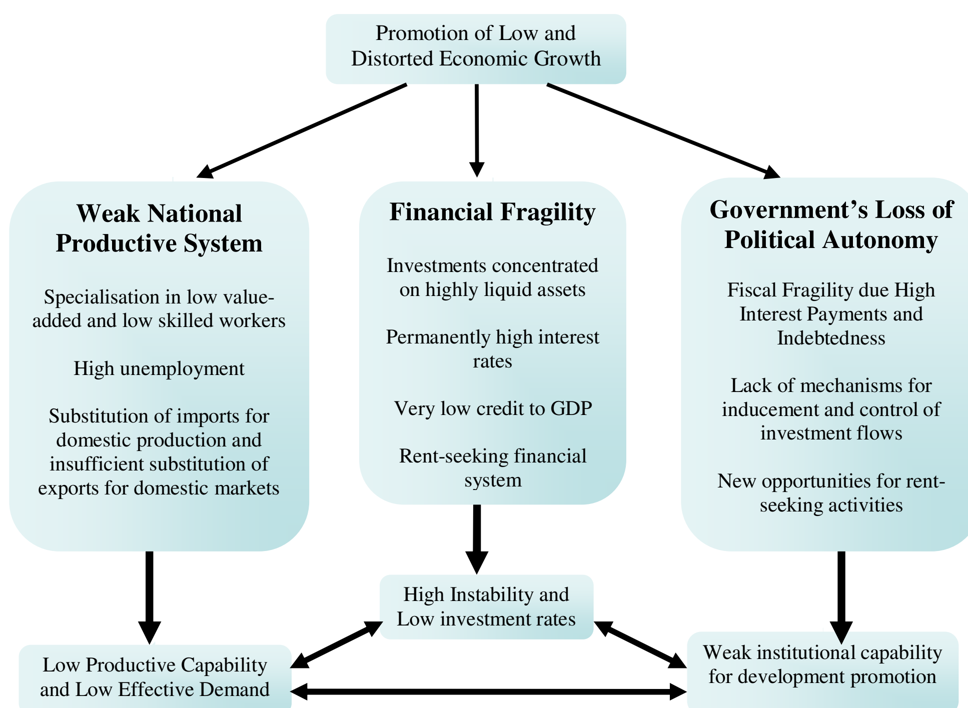
current account without restraining interest payments, during the accord with the IMF further restrictions on government expenditures were required leading the government to approve a Law of Fiscal Responsibility in 2000. This Law sought to establish an annual budget balance by imposing ceilings on public expenditures and public debt. However, no limit was established for expenditures on public debt services so that the government became obliged to make further investment cuts to maintain the stability of public debt to GDP ratio (Afonso*, et al.* 2005). Once again, compliance with the IMF requirements did not guarantee investors' mercy when they foresaw profit opportunities emerging from the financial fragility of the country. Even having repaid the IMF's financial package in advance, in mid-2002 Brazil entered in another financial turmoil which led to a new agreement with the IMF after the spreads on external debt had increased and the exchange rates depreciated. Not surprisingly, in the following years Brazilian economy remained well into the low growth path it has presented since the early 1980s when neoliberal policy-making became dominant.

Thus, the high interest rates adopted in Brazil to award and conquer investors' confidence have epitomised the numbered constrains the neoliberal policies have put on the economic growth and wealth distribution. To begin with, the high interest rates have constrained the concession of credit by banks that have preferred to invest in highly profitable and risk-free public bonds. The high interest rates have also encouraged firms to take on financial investments to gain income from financial assets instead of engaging in productive activities. The high interest rates have led to a trend of appreciated exchange rates which reinforces the current account deficits. The high interest rates have constrained government employment-generating and productivity-enhancing expenditure on infrastructure in order to accommodate expenditures with interest payments. The high interest rates have favoured rentiers' income at the expense of employment and wage earners, resulting in an alarming worsening of income distribution between capital and workers earnings. Finally, by discouraging the concession of credit by banks, high interest rates force firms to finance their investments through retained profits. However, the current account deficits, the low rates of investments, the government primary surpluses and the lower real wages have reduced the sales and profit prospects of domestic firms, and hence their ability to finance investment with internal resources.

## Final Remarks

This chapter aimed to scrutinise the nature of neoliberal reforms in Brazil in the 1990s. Those reforms were far-reaching, and profoundly changed the main mechanisms through which the Brazilian state controlled or influenced the amount and the direction of flows of investments in the economy. It seemed clear that the interventionist stance that had prevailed in the past should give way to the private sector and the international players as leaders of Brazilian economic development. In the new model, international transactions in trade and finance would be freer in order to force domestic firms to compete at international prices, to become more efficient, to sell into the larger external markets, and at the same time to borrow in the larger international savings pool. The picture of a sound model of development would be completed by less intervention by government in the productive sphere (privatisation and deregulation) and by a stubborn observance of orthodox macroeconomic policies. By the mid-1990s, Brazil's reforming efforts seemed to be paying off with the recovery of growth and an unprecedented reduction in inflation. The international community showed confidence in the new model by pouring money into the domestic financial markets and privatised companies.

**Figure 26 Neoliberal Degeneration of the Channels of Economic Growth**



However, as a model for long-term development the neoliberal reforms have left much to be desired. Figure 26 represents the weaknesses in the Brazilian productive and institutional system that have been introduced or reinforced by the neoliberal reforms. The neoliberal reforms have failed to deliver fast economic growth. They have failed to return the rate of investment and productivity growth to sustainable levels, they have also failed to address the longstanding problem of uneven income distribution, and they have produced unprecedented rates of unemployment. To some extent the poor results can be attributed to the sluggish growth in aggregate demand and a chronic trend towards financial instability embedded in the reforms themselves. Trade and capital account liberalisation led the economy to experience serious current account deficits whose financing depended on the renewing of foreign capital flows. Thus, to adopt Jan Kregel's (2004) terminology, Brazil was building "financial" capital instead of "real" capital, which required lenders to be continuously convinced and willing to lend to the country. These flows, however, have been highly volatile and prone to flee from the country during bouts of speculation. Even with policymakers eager to gain lenders' confidence by following their preferred policies, Brazil nevertheless suffered two attacks against its national currency (in 1999 and in 2002).

More fundamentally, by dismantling old instruments by which the government used to "govern the markets," to use Robert Wade's (1990) terminology, and by not developing substitutes for them, the neoliberal reforms entailed a weak economy led by speculative behaviour and rentier interests. More to the point, the government has not merely lost the capability to manage the economy towards self-determined objectives but has itself become a prisoner of the rentier interest which developed around the interest rates and the public indebtedness. Lenders' confidence gained prominence over other possible objectives of a democratic society, such as full employment and fairer wealth distribution.[157] And yet austerity has the status of economic law for the neoliberal policymakers, the defence of the neoliberal reforms took the Brazilian state to the brink of bankruptcy. While neoliberalism promotes a radical offensive against the state, particularly as it is an entity that embodies something of the public interest, it is hardly credible that the destruction of the state's capacity for intervention, and its subjugation to financial speculation, have been only a

[157] According to Eli Diniz (2003)during the 1990s the decision-making in Brazil becomes highly concentrated in the economics ministries and bureaucracies that enjoy high degree of insularity from the civil society and Congress. In addition, the access to these bureaucracies continues to take place through informal and personal connections.

result of purposeful calculation. If this is right, there still is room for change towards something wanting in Brazil since the first stroke of a new civilization in the 1930s. But this requires to strip off neoliberal mistrust of the state and the constitution of a more balanced policymaking in Brazil, one in which rentiers' interest is subordinated to more broad social aims.

# *8. Summary and Conclusions*

Neoliberalism emerged as a new ideological consensus in the late 1970s. As a result of its influence, important institutional changes in the structural framework of economic policies for development have been taking place. Neoliberalism upholds that unfettered markets and tamed governments will perform better than state-guided development, a claim apparently supported by the economic turmoil that unfolded after the oil shocks of the 1970s. This thesis has analysed Brazilian economic development as a "natural test" of the neoliberal doctrine, as the country has experienced policies inspired by state-guided development and also, more recently, it has been a laboratory for an experiment in neoliberalism. The aim has been to challenge the neoliberal claims with the argument that when the Brazilian government embraced the task of pursuing economic development it was able to bring about deeper structural changes and much faster economic growth than it did during the later years of neoliberal reforms. The main conclusion is that there is no evidence from Brazil to support the neoliberal proposition that the economic and social development of a country following liberalising policies will be an improvement on state-led development policies. Furthermore, the state makes a real difference with regard to structural transformation, so the neoliberal hypothesis of "state irrelevance" should be discarded. Yet, it has been argued that the true consequence of neoliberal reforms in Brazil has been to favour the interests of financiers at the expense of democratic and socially-oriented economic development, and indeed they have been the main factor undermining the state's ability to serve as an agent of transformation. In this respect, if a democratic and socially just society is to be built in Brazil, neoliberal policies should be overturned and the state should be rethought and rebuilt as an agent of that transformation.

In the second chapter, the neoliberal perspective was evaluated on its broader theoretical and empirical basis. First, on the theoretical basis it has been recalled that even leading

neoliberal authors have accepted that markets will not behave as perfect competition as the theory suggests. Markets can fail, making government interventions crucial in order to improve social well-being. The important point however is not that actual markets may not comply with the conventional theory of markets, requiring then government interventions to correct such market imperfections. Indeed, the pervasiveness of market failures would make it impossible to define the precise array of government interventions needed to resolve identifiable market failures without producing many more. The crucial limitation of the conventional theory of markets and welfare economics is their inadequate apparatus for dealing with economic development as a dynamic process. Given individuals with given preferences as well as with given resources waiting for better allocation are helpless to understanding the changes occurring throughout history, when preferences and resources are qualitatively and cumulatively changing. In a dynamic context, as suggested by the institutionally and historically based perspectives, individual preferences, states and markets are not merely independent entities bound together; they constitute each other. As far as the proper role of the government is concerned, it is the interaction of inherited institutions and groups embedded into institutions that define government goals and strategies. And, crucially, as far as governments help to produce the kind of structural changes that development entails, it is accordingly changing institutions and organisations that will provoke changes in the state itself. Therefore, by taking the conventional theory of markets and welfare economics as their foundations, neoliberal economists are not well placed to substantiate their case against government intervention and, more importantly, they lack the instruments to evaluate the changing nature of the state, markets, and of other social institutions over time.

Having identified the theoretical weaknesses of neoliberalism and its disregard for the dynamics and specificity involved in any development experience, this study has adopted a historically and institutionally grounded approach as a paradigm on which to base a view of economic development. Authors of this stripe – from List, to Gerschenkron, to Hirschman, to Myrdal, to Prebisch and many others – stress development not as a result of optimal resource allocation but associate it with a process of discovering and developing the potentialities of a country as well as with the overcoming of its limitations. An adequate government role in buttressing development would be one of maintaining pressure on decision makers to develop those potentialities; decisions which will provoke further

developmental decisions in an upward cumulative process. As in any tentative process the government's attempts to foster development may fail or be misdirected, but will not necessarily be inimical to development. Failures and false starts entail learning – which is a basic factor in the process of development. Diminishing the role of the state because it might make mistakes is not the answer. To develop state capability and democratic controls to better intervene is, indeed, the antidote to neoliberal reforms. As long as the state does not give up its sovereignty, it will potentially be able to foster developmental processes by undertaking and enthusing development decisions.

With those general principles in mind, in Chapter 3 we began our analysis of the Brazilian case. The first steps from a primary-export economy towards industrialisation in the early 1900s were decisively supported by a state ready to invest in railway infrastructure, to concede credit through its banking system and even to guarantee the income of coffee producers – some of whom later turned into industrialists. It was, however, still a primary-export state with scope for transformative action restricted by the narrow interests of the agrarian-export elite, by the dependence on foreign financiers, and by its weak industrial class. The window of opportunity to enter a new industrial state was opened by the international crisis of the 1930s, when the export-agrarian economy and elite showed their weakened position into the international division of labour. Moving between the narrowness of the agrarian elite and a weak industrial class, the state was able to build the institutional setting that buttressed over 30 years of industrial development. As a Gerschenkronian or Hirschmanian agent the state used its budget as a substitute for missing capital markets while at the same time provided infrastructure in order to support transformative industrial investments. In the 1950s the state's role as provider of new capital for long-term investment was enhanced by the creation of the BNDES. Through the BNDES' role in the approval of investment loans and the Banco do Brasil's control over the foreign currency allocation the state multiplied induced decision-making. Deliberate government-led development took the form of the Target Plan in the mid-1950s, a programme of investments in which the government used several instruments to coordinate public and private decision-making, celebrating close links between public firms, private national and foreign firms – which came to be known as the Triple Alliance (Evans 1979). Contrary to what has recently been suggested by neoliberal authors (Fraga 2004), the

astonishing economic growth and economic structural transformation that took place in those years cannot be regarded as a spontaneous event.

As neoliberal economists have suggested, there was no lack of limitations or deficiencies in Brazilian industrial development. However, they were of a kind not recognised by neoliberal economists, much less solvable by neoliberal policies. A concentrated industrial and land structure associated with trade dependence on primary goods accounted for the unequal distribution of wealth and the chronic balance of payment problems that marked the process of industrialisation throughout; meanwhile an underdeveloped financial system did no wonders for the financial stability of the country as inflation and deficits in the current account were endemic.

Those limitations and deficiencies were not enough, however, to obstruct state-led economic modernisation, albeit a form of modernisation without a just distribution of wealth and power. Accordingly, the military regime that seized power in 1964 reformed the financial system and the structure of export incentives and built on the 1950s industrial structure in order to produce an "economic miracle." The declared objective of those reforms was to eliminate trade distortions and to create a private financial system in line with the principles of a liberal model. Instead of "getting prices right", however, the usual institutions of the developmental state came in to tightly command the "miracle" through public enterprises investments, public financial loans and manufacturing exports incentives. The triple alliance model that had characterised Brazilian development was unchanged, as the rhythm and structure of development were still being led by government interventions.

The institutional setting constructed from the early 1930s, which bolstered Brazilian development up until early 1970s, began to break down with the oil shocks and the financial crises in the 1970s and the 1980s. The government had launched into an international borrowing adventure, which had been pushed by banks and governments of developed-countries thirsty to find borrowers for the enhanced liquidity propped by the emergence of the financial deregulated markets (the Euromarkets). Since the early 1970s, this external overborrowing had already been detached from real transfers needs and had become a self-reinforcing financial process in which the capital costs associated with the capital inflows (e.g., profits and interest) tolled the lion's share in the form of current account deficits. Piling up current account deficits in turn increased the borrowing needs leading to a circular cumulative process. When the private sector, especially the affiliates to

foreign private banks, lessened their appetite for borrowing abroad the government stepped in to maintain the wheel ongoing. Needing it or not, public institutions, especially public-owned enterprises, were forced to borrow abroad. The cumulative process then continued and the increase in international interest rates in the late 1970s only oiled the wheel to go faster until the 1980s debt crises.

The increasing borrowing needs also led the government to pursue "sound" economic policies to maintain or acquire credibility with the lenders. By the late 1970s, the Brazilian policymakers were already speaking the language of the neoliberals, in which restrictive macroeconomic policies take the place of government actions towards structural transformation. Capital inflows flooded the country stirred also by the priorities and policies that policymakers had now embraced. The Brazilian external commitment should increase with the demonstration of such credibility. By this time, international financial community, private banks and official organisations (e.g., IMF and World Bank), and developed countries governments praised Brazil for its "successful" policymaking.

However, the tripling oil prices and the hikes in interest rates broke the capital inflows and hence the very seeking-for-credibility policymaking. The external debt crisis of 1982 was decisive to the definitive dismantling of the Brazilian developmental institutions. The amiable evaluation of domestic policies and cooperative financing of creditors gave place to criticism of debtor countries borrowing imprudence and their overall policymaking. Yet one could argue that in any economic deal between free parties is usually agreed upon anticipated mutual benefits and that in the 1970s creditors overtly pressured underdeveloped countries to tap into liquid international financial markets, neither argument was popular amongst neoliberals let alone amongst creditors. Facing the threats that the Third World external debt launched over the international financial markets, before a far-reaching programme of liberalising reforms could take place, the government of developed countries and the IMF and the World Bank pushed for adjustment policies which privileged the generation of current account surplus to repay external debt services – the net transference problem. The neoliberal solution for the external debt overhang was to blame debtor countries and to favour creditors' interests.

Such stance materialised in the agreements that Brazil signed with the IMF, which stepped in as the caretaker of the creditors' interests. The external debt management allowed creditors' loans to be paid in full, although secondary markets rated Brazilian debts

with sizable discounts. Besides, the agreement held the government responsible for all the external debt in order to guarantee agreement compliance and creditors security. The adjustment measures also favoured domestic financial interests at the expense of the public financial stance by maintaining high real interest rates amidst burdensome financial instability. As the exchange rate was drastically devalued and interest rates rapidly increased the costs of external debt became even heavier. For that, the government was called to step in with guarantees and salvage operations which resulted in transference of private external debt, carried by financial intermediaries, to public responsibility. These results are ironic in which much of the adjustments above described had been justified in name of restoring free market.

As a consequence of the adjustment imposed on the country, the 1980s were marked by an unprecedented hyperinflationary process and a state that was unable to meet the expectations that democracy brought to the country. In this context, it was relatively easy for neoliberal economists to be heard by policymakers, and for their policies to be adopted. The neoliberal tales of Leviathan governments combined very well with the resentment that politicians and the population nurtured against so long a period of dictatorship and little improvement, if any, for workers and the poorest. Furthermore, international institutions like the IMF and the World Bank, which had turned into the operational arm of neoliberal policies and reforms, used the foreign debt negotiations to get the liberalising reforms adopted by developing countries. Since the Collor government in the early 1990s Brazil has been a dedicated reformer. Of the ten points on John Williamson's Washington Consensus list it seems that none had been forgotten. Controls on trade were eliminated; privatisation was far-reaching; financial liberalisation was comprehensive and austere macroeconomic policies to achieve price stabilisation were put in place. By the mid-1990s the success of the reforms seemed to have been demonstrated according to the neoliberal reformers by the rapid control of inflation and the resumption of economic growth.

However, apart from a few months of enthusiasm over price stabilisation, the neoliberal reforms have not been able to deliver their promise of reinstating economic growth and stability (broadly speaking) in Brazil. The neoliberal reformers thought their policies and institutional reforms would install sound and lasting economic development based on faster and permanent growth of productivity accruing from better allocation of resources. Nevertheless, the data covered here clearly show that the neoliberal era has been marked by

far worse economic performance when compared with the results of the "bad" policies and institutions which prevailed in Brazil from the 1930s to the 1970s. Not only growth but productivity growth also increased much faster in the state-led development than during the neoliberal era. Moreover, the growth of productivity during state-led development came as a consequence of structural diversification and integration sponsored by deliberate policies, whereas in the neoliberal era it happened more as a consequence of modernisation by importing machines and equipment and mainly by faster workers firing than the growth in production. Not only was economic growth anaemic but it has been accompanied by an unprecedented increase in unemployment and fall in wage participation in GDP to the benefit of capital income earnings. Moreover, the country has suffered with several financial crises that more often than not have led to increases in interest rates.

It has also been argued that the neoliberal policies and institutions entail a feeble effective demand and that the insufficiency of it is the main cause of the poor growth performance during the neoliberal era. The roots of the extremely weak effective demand growth are found in the entangled effects of indiscriminate trade openness, which has led to a wholesale increase in imports not accompanied by a similar increase in exports; reduced investments as a result of a fiercer competition of imports and narrowness of domestic markets; as the result of unemployment and reductions in wages, which led to insufficient growth of consumption; and as a result of a very high real interest rates and restrictive fiscal policies.

The high real interest rates and restrictive fiscal policies that have prevailed in the neoliberal era deserve special attention as they epitomise the nature of neoliberalism in Brazil. The substitution of market-led growth for state-led development means the government must comply with the agenda established by financiers in order to gain the "confidence of the market". More often than not, it has meant draconian and one-sided anti-inflationary macroeconomic policies of a kind that supersede pressing social needs. To gain investors' confidence the government finances must be sound, which is to say balanced, no matter the economic circumstances. To attract investors' capital the government must reward them with high interest rates; the government budget is constrained as interest payments increase at the expense of government investments in infrastructure and other social needs. By trying to comply with the rentiers' requirements the government becomes a prisoner in a quandary and to conquer financiers' confidence it has to relinquish its ability

to manage the economy. To attract capital flows the government has maintained high interest rates. It has led in turn to high fiscal costs for the government and hence to high public indebtedness. Moreover, to protect bondholders' wealth, government debt is indexed either to the interest rate or to the exchange rate. On the other hand, deregulated financial markets and shortsighted private financial institutions have resulted in financial speculation and financial crises, the extremely high costs of which have been carried by the public finances. In short, to serve financiers' interests the government has lost its capability to serve the public at large.

In summary, the structure and policies of the neoliberal regime have been fundamentally flawed. Its tenet that unfettered markets could bring prosperity with improved allocation of resources has been eloquently refuted in Brazil by feeble economic growth, extremely high unemployment and the concentration of income and wealth. While it is true that not all governments can bring prosperity with reasonable wealth distribution and social security, and many government interventions may do harm when attempting to do good, neoliberalism has failed to understand that government power is a crucial force for social transformation because it helps to constitute other social institutions, including markets themselves. Likewise, the social structural changes that emerged partially as a result of state action will be superseded by the new structures and organisations the state action has created. It is therefore of fundamental importance to rebuild the capability of the state to be a Gerschenkronian and a Hirschmanian agent of transformation in Brazil, a state that can bind together dispersed social energies. Judging by Brazil's historical experience this will require the rejection of neoliberal policies and institutions. It will be necessary to construct a consensual and cooperative democratic model – something that has yet to appear in a country still trying to escape from institutions left over from its colonial past.

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