PANOECONOMICUS, 2019, Vol. 66, Issue 1, pp. 51-67
Received: 02 May 2016; Accepted: 16 January 2017.

UDC 339.72.053:316.323.6(81)
https://doi.org/10.2298/PAN160502002F
Original scientific paper

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Policy Space in a Financially Integrated World: The Brazilian Case in the 2000s

Summary: This paper makes the argument that policy space in Brazil has been narrowing since the trade and capital opening made in the 1990s. This is so because the opening of the Brazilian economy has implied that real and nominal interest rates have been kept high and the real exchange rate has shown a trend towards appreciation. The behavior of the main macroeconomic prices of the Brazilian economy brought, as a minimum, two negative results to economic growth. On one hand, the annual average growth rate was reduced because structural change had been moving towards less technologically productive sectors, which deepened deindustrialization. On the other hand, short-term economic growth had become more volatile, given that the evolution of the investment position of the country increased its potential degree of external fragility.

Key words: Policy space, Brazilian economy, Balance of payment dominance.

JEL: O11, O14.

Acknowledgement: The authors wish to thank the editor and anonymous reviewers for their very helpful comments. All remaining errors are the authors' responsibility.

We will argue in this paper that the catching up process that would enhance growth potential of developing economies actually demands an economic policy agenda different to the one proposed by the neo-liberal agenda. The main reason is because policy space is too constrained in economies which are dependent on foreign savings and are also financially integrated. This is the case for the Brazilian economy, one of the fastest growing economies in the world after the Second World War. But the Brazilian economy lost its vigor, defeated by the external debt crisis in the beginning of the 1980s, and also the high inflation regime that lasted until the mid-1990s. Brazil joined the Brady Plan to solve its external debt problem in 1992, and embraced most of the Washington Consensus recommendations. Among all of the economic reforms adopted by Brazil in the 1990s, opening the short-term capital account has probably been the most responsible for exposing the Brazilian economy to the instability of the worldwide economy. Because this economic opening contributed in reducing the contribution towards sustaining economic growth previously made by monetary fiscal and exchange rate policies. As an illustration of how economic opening has reduced the policy space of the Brazilian economy, we should mention that the Brazilian economy presented the lowest average growth rate in the 2000-2015 period, compared with the BRICS economies. Brazil grew in average 2.9% per year in the period, while South Africa

increased 3.1% per year; Russia registered 4.0% per year; India 7.0% per year; and China 9.5% per year, according to world economic indicators.

This paper is divided into three sections. In Section 1 we will discuss the policy space that developing economies have, which can put into force counter-cyclical economic policies in the context of increasing financialization in international relations. Following the structuralist analytical perspective, we will argue that developing economies are prone to "balance of payment dominance" (José Antonio Ocampo 2013). In Section 2, we will discuss recent developments in the Brazilian economy as an example of limited space for growth policies. The final section presents our concluding remarks.

1. Policy Space and Economic Opening: A Keynesian Approach

Financial liberalization was already well established in developed countries when it spread to developing economies. Continuous financial deregulation during the 1980s and 1990s has created an environment favorable to the dominance in financial relations over major economic decisions (see, among others, Carlo Panico et al. 2013). The core proposition of financial liberalization advocates free financial markets without any intervention. If developing economies follow this basic orientation, then the excess of capital in the financial markets of developed countries would be attracted to developing countries that offer higher rates of return. A clear assumption is that capital movement would behave in a counter-cyclical way. Therefore, developing countries should benefit from increased supply of credit to boost investment and thereby accelerate economic growth.

Ronald I. McKinnon (1973) and Edward S. Shaw (1973) in the early 1970s were the main authors to provide a theoretical background to capital liberalization as the preferred method to boost economic growth. They elucidated that the poor performance of investment and growth in developing countries would be due to the extensive use of interest rate controls and other instruments aiming at directing private credit to selected sectors of the economy. These restrictions would be responsible for imposing a "financial repression", which would be associated with inefficiency in the intermediation of resources by the financial system. Hence, the "financial repression" would explain a low savings rate, credit rationing and low levels of investment (leading to low growth and eventually to economic stagnation). Capital account liberalization and other liberal reforms of the financial system would provide the alternative to increasing domestic saving and investment, allowing greater capital flow through loans to domestic banks, and foreign direct investment and portfolio. In more general terms, financial liberalization would enable the global allocation of savings and help channel resources to the productive sector, increasing the economic long-term growth rate of developing countries.

However, as pointed out by many authors, after over three decades of capital account liberalization in most economies, the results of financial liberalization experiences are not reassuring (neither for developed nor for developing economies). For both economies, as pointed out by Philip Arestis (2006), the advances in the liberalization reforms in the early 1980s to the financial system have increased the frequency and severity of banking crises, with impacts on the real economy. They imply a

downturn in economic activity for the local economies involved. On the other hand, as pointed out by Ocampo and Joseph E. Stiglitz (2008), for developing economies, the pro-cyclical nature of short-term capital flows has been the main pattern of capital movement, increasing their macroeconomic volatility of their economies, and undermining their growth prospectus (see, also, Bruno Bonizzi 2013).

The pro-cyclical nature of capital movement is observed either when foreign lenders sharply cut new lending and refuse to roll over old loans when they are needed (when lenders' expectations become risk aversion). Also when domestic investors, anticipating currency devaluation of their currencies, precipitate a capital flight. These patterns have been largely registered in the balance of payments crisis in the 1990s in Asia and Latin America. Moreover, according to Ocampo and Stiglitz (*op. cit*), the instability in capital flows is not only observed in short-term speculative flows, but also in longer term portfolio investments, including foreign investment. Although volatility in this latter case is much less accentuated, nowadays foreign investment is mostly in bond issues and bond financing, which are strongly pro-cyclical.

Differing from the conventional wisdom which assumes that the capital movements are not pro-cyclical, John M. Keynes's (1936) investment theory helps to understand why capital movements behave pro-cyclically. To convey this idea in a simple way, we can say that according to this theory, investment decisions are made based on expectations about the future value of the assets. This implies that financial cycles are closely correlated to forming expectations, which in the context of uncertainty, greatly rely on the degree of confidence agents have on these expectations.

This insight points to an important feature of the problem we are dealing with: why do developing economies that have opened their capital account as a strategy to absorb foreign savings from private markets end up with reduced policy space? In open economies with free capital markets, policy space is also dictated by the *perception* of the international financial markets about the ability of the economies to fulfill their financial commitments. This is equally so whether for developed or for developing economies, and this evaluation greatly determines their financial stability.

In the case of developing economies, financial stability may be more difficult to attain when we take into account that these economies engage in debt financing in a currency different from their own (Luis Carlos Bresser-Pereira and Paulo Gala 2008). This means to say that the process of foreign indebtedness involves the risk of a mismatch between the value of the assets to be financed and the financial obligations assumed in the process (besides the risk of maturity mismatch in private balance sheets). An immediate consequence of this reasoning is that devaluations of the domestic currency might cause dramatic losses in the stock owned by wealthy debtors in this foreign currency, a problem known in the literature as "original sin".

Hyman P. Minsky (1982) deepened Keynes's investment theory, linking it to the behavior of financial markets. The core of his contribution is to show that the dynamics of financial markets are endogenously unstable. During booms, market agents are more prone to take excessive risk, which eventually leads to a crisis, and the opposite occurs when expectations change, and lenders turn more risk averse. Therefore, according to the Keynes-Minsky investment theory, the benefits of capital market liberalization for developing countries (considering they do not issue debt in their own

currency) should be assessed, keeping in mind the risks of augmenting financial instability and macroeconomic volatility. Mentioned as well by Ocampo and Stiglitz (2008, p. 4), "capital market liberalization is an example of a structural policy that affects both the nature of the shocks the economy experiences and the way the economy responds to these shocks".

The balance of payments dominance view, as proposed by Ocampo (2013), helps us to understand why macroeconomic volatility is increased in developing economies with open capital accounts. This is because in these economies, capital accounts play an important role in causing cyclical shocks. Moreover, this view stresses that financial cycles are stronger for those economies that are considered riskier by financial markets, because of their segmented integration into the global financial market. The segmented integration is understood by the way that risk evaluation is made. In line with the Keynes-Minsky's theory, risk evaluation in this case leads to easier access to credit during the boom (when international liquidity is plentiful and the inflow of foreign capital is in excess to the finance balance of payments equilibrium). Also, credit rationing and a worsening of conditions during the crisis can occur, when international liquidity is scarce, leading to a balance of payment crisis. Therefore, financial markets, under the assumption of asymmetric information and, in a more radical view, of non-probabilistic uncertainty, adopt practices and procedures leading to risk evaluation, that tend to stress the financial cycle (derived from the capital account of financially integrated developing economies). There are three main consequences to the macroeconomic policy management, stemming from the dependence of financially integrated developing economies. One is that nominal and real interest rates tend to be relatively higher; and the second is that real exchange rates tend to be appreciated over time. The third is that since both trends can lead these economies to reduce their long-term capacity to grow (see, for instance, André Nassif, Carmem Feijo, and Eliane Araújo 2015a, b), fiscal policy is pro-cyclical, limiting the space for growth policies. In what follows we will discuss the policy space of monetary, fiscal and reserve accumulation policies in financially integrated developing economies.

1.1 Interest Rate Behavior in Financially Integrated Developing Economies

In theoretical terms, according to the traditional Mundell-Fleming model, monetary autonomy is an expected result for a small economy under a floating exchange rate and capital mobility. This conclusion is based on the interest rate parity theory of the exchange rate (Fernando J. Cardim de Carvalho 2009), which can be expressed as $i = i^* + e^e + \psi$, meaning that i, is equal to the international rate, i^*, plus the expectation of an exchange rate devaluation, e^e and the country risk premium, ψ. Any difference between i and i^* implies variation in e^e or in the country risk. Assuming that there is no variation in the country risk, than the exchange rate should move to compensate for the investors' financial gains measured in the same currency. Thus the interest rate parity equation establishes a relationship between monetary policy and the international capital market, and as long as the monetary authority is willing to let the exchange rate bear the burden of the adjustment, the monetary policy group will keep its autonomy to be able to set the domestic interest rate.

The autonomy to set the interest rate to control aggregate demand is very constrained when financially integrated economies are under a balance of payment dominance. This is true because in this circumstance, monetary authority may be prone to accommodate changes in direction in capital flows using the interest rate differential. If, for instance, a high instability in the foreign exchange market is observed, the threat of a devaluation puts pressure on the domestic interest rate to keep domestic assets attractive. Therefore, an appreciation of the exchange rate is expected. The systematic increase in the interest rate differential, because of the increase in the domestic interest rate, represents an additional incentive to sustain the excessive flow of capital to the financing of the current account. Therefore, under unstable expectations in relation to the behavior of the exchange rate, the expectation of exchange rate appreciation should be added to the yields obtained from the interest rate differential.

Another feasible assumption is that in the context of rising inflationary expectations, monetary authority raises interest rates, which has the effect to attract capital. As a consequence, exchange rates will appreciate and inflationary pressures will cool off. If the economy adopts inflation targeting, then monetary authority will be more willing to tolerate the trend towards an exchange rate appreciation, keeping the interest rate differential positive, since an appreciated exchange rate avoids the inflationary effect that a decrease in the domestic value would have on inflation (Jan Kregel 1999).

Under the balance of payment assumption, the capital inflow will continue, as long as the favorable perception about the prospects of the economy continue. However, the deterioration in the current account that follows after a long period of exchange rate appreciation will at some point change the perception of foreign investors. This will eventually lead to a sudden stop in the economy, and sharp exchange rate depreciation. Such a reversal in the capital flow will be associated with a sharp adjustment in the current account (from deficit to surplus), in the output contraction, and in a downgrading in credit ratings. In a word, an under balance of payment dominance, (when chronic imbalances in the capital account might induce either capital flights or capital floods); causes the interest rate parity theory to be violated, since monetary authorities tend to accommodate exchange rate fluctuations through the manipulation of the interest rate. That is the reason why real interest rates tend to be higher in financially integrated developing economies and the real exchange rate tends to be appreciated. As concluded by Ocampo (2013, pp. 18-19), interest rate shocks are pro-cyclical in economies under balance of payment dominance, which implies that an excessive burden has been placed on the exchange rate as a counter-cyclical policy instrument.

The balance of payment dominance can also be interpreted as a modified version of the "impossible trinity" of economic policy. In its modern version, in a world where flexible exchange rate regimes predominate, policy makers may simultaneously choose any two (but not all) of the following three goals: monetary independence, exchange rate stability and financial integration (Joshua Aizenman, Menzie Chinn, and Hiro Ito 2010). These options should be considered for those economies where the balance of payments equilibrium depends on continuous flow of foreign capital. This implies the practice of having high rates of interest in order to attract capital, which most of the time is composed of short-term speculative capital. Capital movement volatility puts pressure on the exchange rate and on private and public debt, penalizing

long-term growth. Ocampo (*op. cit*) suggests that an alternative way of reading this "trilemma" is that economic authorities should pursue a mix of possibilities among different degrees of autonomy of the monetary policy, foreign exchange intervention and capital mobility (see, also, Roberto Frenkel and Lance Taylor 2006).

In the analytical perspective of balance of payment dominance, the mix of policies should aim for not only price stability, but also real and financial stability in order to avoid volatility in the real output growth and employment. The emphasis on the reduction of macroeconomic volatility should result in a sustainable profit rate, which will stimulate capital accumulation and structural change. As well, it will keep the level of the real interest rates lower, and offer a competitive real exchange rate, a low level rate of inflation and a wage rate consistent with productivity growth. Once structural change is envisaged as a priority for financially integrated developing economies, the exchange rate stands out as the most important macroeconomic price, according Bresser-Pereira, José Luís Oreiro, and Nelson Marconi (2014). As we have seen, pro-cyclical monetary policy will inevitably lead to an appreciation trend of the real exchange rate, which, through many channels, negatively affects the level of aggregate demand and the long-term growth rate. The long-term growth rate, on the other hand, is affected by the appreciation trend of the real exchange rate, which contributes to early deindustrialization (see, Bresser-Pereira 2010; Oreiro and Feijo 2010; Feijo and Marcos T. Lamônica 2012, among others).

1.2 Fiscal Space in Developing Economies Financially Integrated

For several reasons, the balance of payment dominance also narrows the space for fiscal counter-cyclical policies in financially integrated developing economies. On one hand, because these economies are prone to foreign capital shortages during the downturns and excess of foreign capital during the upswings, public spending tends to increase when access to external financing is readily available, and it decreases when external finance is scarce (Ocampo and Rob Vos 2008, p. 46).

Furthermore, during the downswing, the burden of interest payments on public debt will increase, which combined with a downward pressure on public-sector revenues, will trigger a pro-cyclical cut in primary spending, in order to keep a stable debt-to-GDP ratio (Ocampo 2003). This is a rational behavior by the public authorities considering that in the context of limited space of the monetary policy, the primary surplus is the only variable left for the government to use to try to control the public-debt ratio.

On the other hand, Alcino F. Câmara Neto and Matías Vernengo (2002/2003, p. 11) make the point that a higher interest rate, aiming to avoid capital flight, will lead to higher interest payments on the public debt and consequently, higher nominal deficits. The authors argue that when the public debt is indexed to the short-term interest rate, the monetary policy translates into high debt servicing. This process has an important distributive effect since debt holders are among the richest people, and are those that benefit from higher interest rates paid on public debt (at the expense of the less fortunate who depend on public spending on social programs).

Finally, there is the impact of public spending that strongly influences long-term investment private spending. If the government has the fiscal space to increase

public expenditures, reduce taxes and provide subsidies to private enterprises, the adverse impact on long-term investment and growth would be reduced.

Therefore, there is a high price to pay when one limits the space of the fiscal policy, when trying to enhance long-term growth is seen as the main policy target. Either because of the distributive effects or because of the impact on short- and long-term growth, fiscal policy should be the most important instrument that developing economies have to count on in order to promote structural change and increase long-term growth. However, the reduced capacity to implement counter-cyclical policies implies not only that access to international financial flows affects the real economy, but also it amplifies the business cycle. Thus, once developing economies are dependent on foreign savings and their monetary policy is constrained by capital volatility, these factors leave little alternative to counter-cyclical fiscal policy to be implemented.

1.3 Accumulation of Reserves to Widen Policy Space

From the lessons learned after the Asian foreign exchange crisis in the mid-1990s, the pattern followed by developing economies has been that of a floating exchange rate regime associated with the accumulation of reserves in large volume. In an international financial market, where capital movement is characterized by the boom and bust of the flow of capital, to accumulate reserves becomes an important defensive mechanism in order to reduce external vulnerability. In this sense, the accumulation of reserves would play a key role in the exchange rate stability, which would be essential in promoting foreign trade and also the stability of the domestic financial system (Ocampo, Codrina Rada, and Taylor 2009, p. 107). Under the same token, Cardim de Carvalho (2010) shows that the accumulation of reserves works as a "liquidity cushion" to protect economies against adverse short-term changes in the balance of payments and allows for the accommodation of sudden demands for foreign currency. This would be a demand for foreign reserves as a "precautionary" motive. According to the author, the accumulated reserves can give some space breath for economic authorities to try to avoid the worst consequences of a sudden stop. However, it is assumed that the volume of reserves, *per se*, is not a solution for overcoming structural vulnerability of economies that are dependent on debt commitment in a currency different from their own.

Regardless of the strategic importance of the accumulation of large volumes of foreign reserves for developing economies, in the large majority of cases this increase is not a choice, but a consequence of the capital inflows that are beyond the control of the economic authorities. In some other cases, reserve growth may be the result of the expansion of net exports, and as such (as pointed out by several authors) the reserve accumulation strategy would be for a "mercantilist motive" (see, for instance, Aizenman and Jaewoo Lee 2007; Moritz Cruz 2015). This latter motive has played a less prominent role than the precautionary motive.

The management of foreign reserves as a policy instrument imposes restrictions on domestic policies, since the impact of capital inflows and outflows should be sterilized. If economies work with relatively high rates of interest, consequently the cost of sterilization will be higher. Furthermore, this cost is reflected in an increase in the burden of public debt. To sum up, the accumulation of high levels of reserves in a

volatile environment of capital flows is an important instrument (though not a sufficient one) to counterbalance the uncertainty surrounding the behavior of the capital account in economies that have limited capacity to issue liabilities in their own currency.

Besides accumulation of reserves, a return to some form of capital account regulation would be an important factor in widening policy space. Capital management rules would help to reduce exchange rate volatility. In several recent documents, the International Monetary Fund (IMF) (once a strong advisor in favor of capital opening), has recognized that some sort of capital management has an important impact on reversing the negative effects of capital flood or capital flight (IMF 2011, for instance).

In short, according to the Keynesian approach, financial liberalization in developing economies without capital control results in an overvalued real exchange rate, which, through its distributional effects, increases dependence on foreign savings and consequently leaves little space for a decrease in the domestic interest rate. The interest rate differential inhibits investment in capital accumulation, especially those industries with higher technological content and exports. In case of a reversal of the capital flow, the economic conditions turn more adverse, forcing even more of an increase in the interest rates to attract capital, which increase the burden on public and private loans. We should add that besides this is a "fear of inflating" which dominates the macroeconomic policy (Carlos Eduardo Schönerwald da Silva and Vernengo 2008); it inevitably leads the economy into a semi-stagnation growth pattern.

2. The Brazilian Case

The Brazilian economy well illustrates the case of balance of payment dominance after economic opening (in the 1990s) and of narrowing its policy space. Since economic liberalization, economic growth has been poor relative to the economic history of the country, and nowadays perspectives to redeem higher and less volatile growth rates seem to be slim. After more than two decades of financial integration, the Brazilian economy is clearly falling behind compared with other emerging economies (Nassif and Feijo 2013).

A closer look at the Brazilian performance in the last two decades shows that the period immediately after the end of the high inflation regime and economic opening, growth rates were disappointing (1.6 per cent on average, during the 1996-1999 period), and not surprisingly the gross capital formation stagnated (Table 1, see, also Feijo, Lamônica, and Julio Cesar Albuquerque Bastos 2016). During the stabilization period, the external environment did not favor growth, given the succession of external shocks: in 1997 the Asian crisis and in 1998 the Russian crisis. In January 1999, after resisting several speculative attacks against the domestic currency (*real*), the Brazilian authorities changed the exchange rate regime and let the *real* be devalued (Figure 1). This change was followed by the introduction of inflation targeting.

In the 2000s, growth picked up to an average annual rate of 3.8 per cent until 2008. The performance in the 2000s is explained primarily by the commodities boom, which implies that the economy was stimulated by the increase in price of the commodity exports. This period of external bonanza is associated with greater domestic demand, which has been largely met by increased imports. The period of higher

dynamism was short lived though, because of the international financial crisis in 2008 that threw the developed economies into a severe recession, which after 2010 reached countries worldwide. Since 2011, the Brazilian economic growth rate has been following a stop-and-go pattern, and in 2015 it registered the worst result since 1990 (-3.8%). Therefore, financial integration has not delivered a more dynamic growth rate; as a matter of fact, the average annual growth rate of gross domestic product (GDP) *per capita* was 1.4 per cent (from 1990 to 2014), much lower than the average annual growth observed before the economic opening (1961-1989 period) of 3.1 per cent a year.

Table 1 Average Growth Rates of GDP and Aggregate Demand - Brazil - 1996-2015

	GDP	Private consumption	Government consumption	Gross capital formation	Exports	Imports
1996-1999	1.6	1.5	1.1	0.0	5.2	0.7
2000-2008	3.8	3.5	2.6	4.5	8.3	7.6
2009-2015	1.7	2.8	1.9	1.1	2.0	3.1
1996-2015	2.6	2.9	2.0	2.4	5.4	4.6

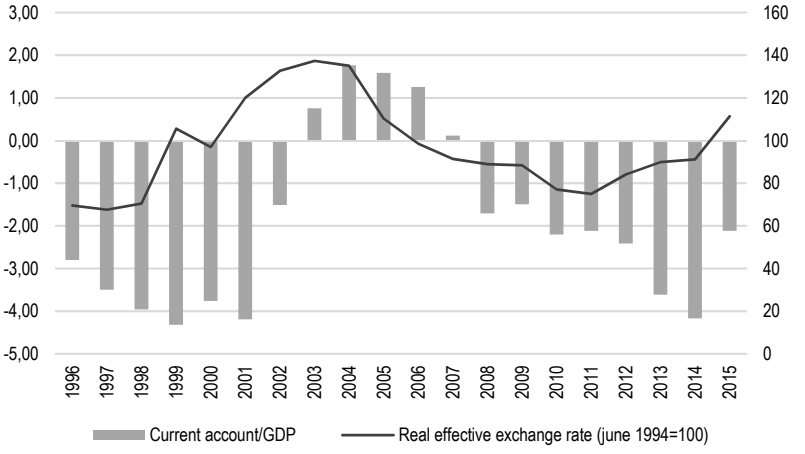
Source: Brazilian Statistical Office (2019)[1].

The lower growth rates since the economic opening were followed by our current account deficits in most of the period. Figure 1 (see below) shows that current account surplus were registered only between 2003-2007, during the period of fast growth in world trade. Figure 1 also shows the evolution of the real exchange rate, and it is clear that our current account balance responded to the real exchange rate movements. Likewise, it confirms that there has been a persistent trend of real appreciation of the domestic currency in the last decades. This was only interrupted by sudden internal or external shocks, such as the five listed here: in 1999 (due to the speculative attack against the Brazilian *real*); in 2001 (due to a serious lack of sufficient electricity crisis); in 2002 (due to negative expectations of the election of Luiz Ignacio Lula da Silva, then evaluated as a radical leftist by markets); in the aftermath of the September 2008 global financial crisis; and in mid-2014, due to the announcement by the Federal Reserve Bank of an increase in the American interest rate (which only happened in December 2015, but it then precipitated a capital flight). The recent reversion in the exchange rate movement is largely explained by the deepening of recession in the country, and a deterioration in the evaluation of future prospects of the economy by rating agencies.

The appreciation trend of currency can be interpreted as a negative effect of the opening of the capital account, without appropriate instruments used for capital management – i.e., with little room for maneuver to avoid both capital flight and capital flood. Thus, capital opening resulted in increasing dependence on foreign savings, in exposing the economy to the volatility of foreign capital and by increasing the risk of currency mismatch in units with liabilities in foreign currency. This context explains a

[1] **Brazilian Statistical Office.** 2019. Quarterly National Accounts Database. http://www.ibge.gov.br/estatisticas-novoportal/economicas/contas-nacionais/9300-contas-nacionais-trimestrais.html?=&t=o-que-e (accessed January 23, 2019).

"fear of depreciating", which causes the manipulation of the domestic interest rate, in order to attract capital and as a collateral effect, the currency tends to be overvalued as time goes by (see, for instance, Nassif, Feijo, and Araújo 2015c). This reasoning should be taken into account, mainly after the international financial crisis in 2008, when interest rates in developed economies have dropped close to zero (or have even become negative) in order to fight recession in these economies, while the Brazilian real and the nominal interest rate are still among the highest in the world.



Source: Institute of Applied Economic Research (IPEA 2019)[2] data and Brazilian Central Bank (2019)[3].

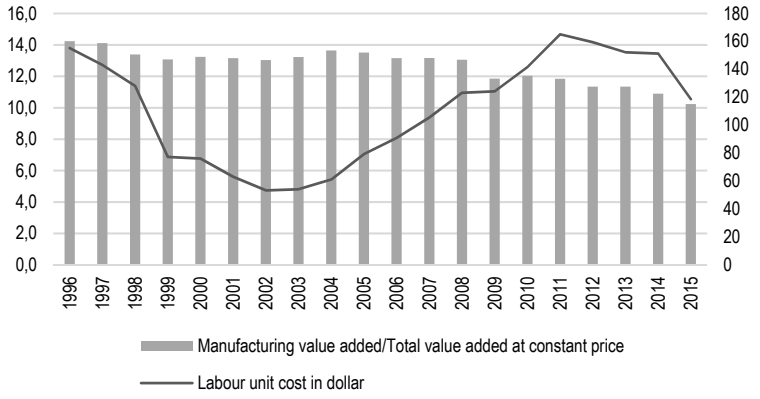
Figure 1 Current Account Balance as a Share of GDP and Real Effective Exchange Rate Index - 1996-2015

The long appreciation trend of the Brazilian currency also had a negative impact on the productive structure. One of the most important effects is to increase unit labour costs, with two negative consequences to the long-term growth of the economy. On the one hand, companies are forced to transfer demand abroad, leading to an early deindustrialization process, mainly in sectors which are more technologically advanced or those with less comparative advantages (see, for instance, Bresser-Pereira 2010; Feijo and Lamônica 2012; Bresser-Pereira, Oreiro, and Marconi 2014; Nassif, Feijo, and Araújo 2015a, among others). In a word, companies in general and those in less competitive sectors in particularly are forced to import technology to face increasing labour costs and to catch up with their competitors. On the other hand, an increase in labour costs above productivity (in a context of an appreciation trend of the real exchange rate) implies loss of competitiveness of the exports.

Figure 2 illustrates how the loss in the weight of the manufacturing industry (the most dynamic sector in the economy) in total value added is negatively correlated with

[2] **Institute of Applied Economic Research (IPEA).** 2019. Database for Current Account/GDP. http://www.ipeadata.gov.br/Default.aspx (accessed January 23, 2019).
[3] **Brazilian Central Bank.** 2019. http://www.bcb.gov.br/ (accessed January 23, 2019).

the appreciation movement in the cost of labour. Additionally, the Brazilian export basket is becoming increasingly specialized in products that consume intensive amounts of natural resources. The share of primary products and manufactured products which consume intensive amounts of natural resources was approximately 40 per cent of total exports in 2000, and in 2014 this share went up to over 60 per cent, according to statistical information from the Ministry of Industry and Technological Development. This is a consequence of the deindustrialization process that implies that the country loses space in the most dynamic markets in international trade, which contributes, in turn, to diminish domestic growth dynamism.



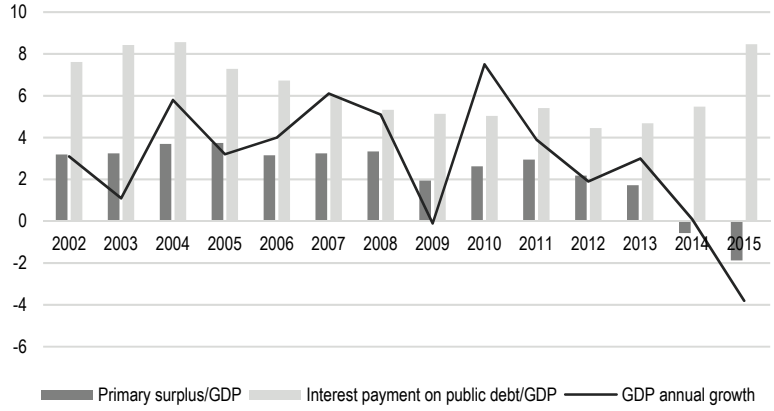
Source: Brazilian Central Bank (2019) and Brazilian Statistical Office (2019).

Figure 2 Percentage Share of the Manufacturing Value Added in Total Value Added at Constant Price and Labour Unit Cost in Dollar (June/1994 = 100) 1996-2015

In spite of the negative long-term effects on the productive structure, the appreciation trend of the real exchange rate has been working as an important instrument in controlling inflation (Nelson H. Barbosa-Filho 2015). The stabilization plan in 1994 established a fixed exchange rate as an anchor to price stability, and so price stability became (to a great extent) dependent on exchange rate appreciation. Even when the floating exchange rate regime was adopted in 1999, the exchange rate continued to work as an anchor to prices. The recurrent trade deficits and, consequently, current account deficits (observed during almost all the period since price stabilization) increased dependence on capital inflows. To sustain capital flow, the Brazilian Central Bank had little choice but to keep a positive interest rate differential to ensure the balance of payments solvency and temporarily relieving the foreign exchange constraint, mainly after the international financial crisis in 2008.

A monetary policy that is biased towards attracting foreign capital also limits the space for fiscal policy, because to sustain real interest rates at a relatively high level leaves little room for maneuvering for the government wishing to manage countercyclical fiscal policy (Kregel 1996, 1999). This is clear in the Brazilian case since until 2008, the primary result had been kept above three per cent of GDP, notwithstanding the fluctuation in the output growth rate as time went by (see Figure 3). After 2008,

primary results diminished as a percentage of GDP, but were still positive even after the first signs that augmented capital volatility, increased current account deficits, and the persistence of the appreciation trend of the real exchange rate would reduce the rate of output growth (see, for instance, André M. Cunha, Daniela M. Prates, and Fernando Ferrari-Filho 2011). After 2014, due to the deceleration of GDP, the primary result was negative for the first time since 2002, but interest payments on the public debt as a share of GDP jumped from 4.7 per cent in 2013 to 5.5 per cent in 2014 and to 8.5 per cent in 2015, deteriorating the public-debt ratio. The deterioration of the public-debt ratio increases risk aversion, which in its turn demands higher primary surplus, reinforcing a pro-cyclical fiscal policy.

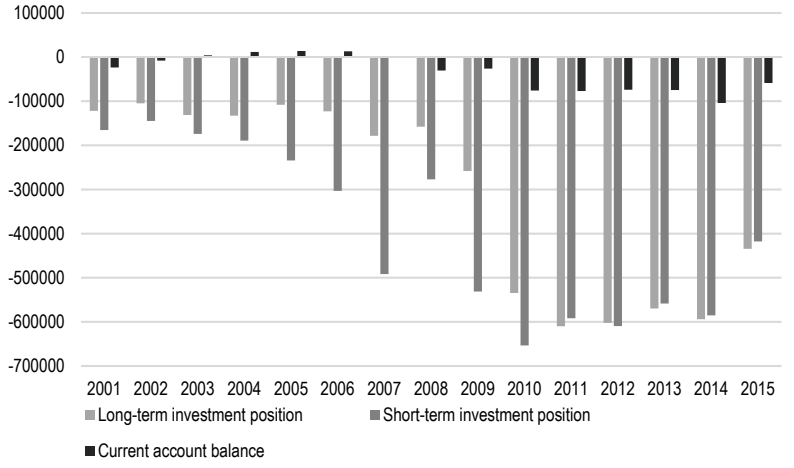


Source: Brazilian Central Bank (2019) and Brazilian Statistical Office (2019).

Figure 3 Primary Result and Interest Payment as a Share of GDP and GDP Annual Growth Rate - 2001-2015

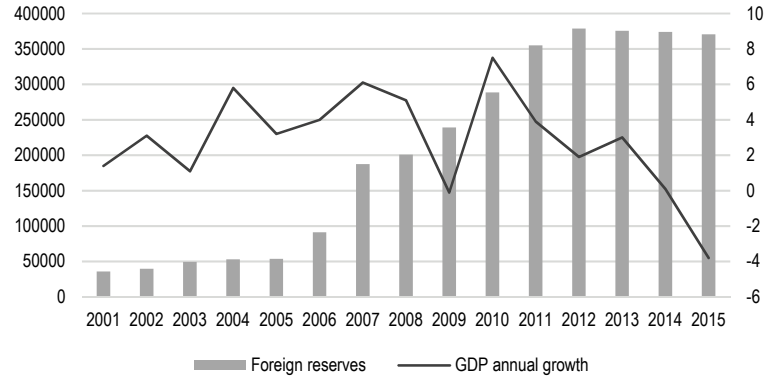
If policy space has been constrained by financial integration, mainly after the financial international crisis, the Brazilian efforts to attract capital have been well succeeded, as the accounts of the international investment position (Figure 4), either long-term and short-term, signal a large amount of capital inflow in the country, in particular after 2005.

As a result, the accumulation of reserves (Figure 5) had increased after 2005 partially due to the trade surplus generated during the commodity boom, as well as the large increase in the volume of capital that entered the economy. The accumulation of reserves has been praised as an important achievement in order to relax the short-term balance of payment constraints. Indeed, the importance of foreign reserves, as we have seen, is to give some time to the economic authorities to devise better economic measures in the case of capital flight. Compared with the 1990s, the large amount of foreign reserves had improved the external situation of the Brazilian economy in the 2000s. In this sense, the amount of foreign reserves can be seen as widening the policy space of the economy in the 2000s. However, as argued in the first part of this paper, it does not prevent a balance of payment crisis. The real prevention would have



Source: Authors' own elaboration based on data from Brazilian Central Bank (2019).

Figure 4 Long- and Short-Term Investment Position and Current Account Balance 2001-2015 (US$ Million)



Source: Brazilian Central Bank (2019) and Brazilian Statistical Office (2019).

Figure 5 Foreign Reserves (US$ Million) and GDP Growth Rate (Percentage) 2001-2015

occurred if the flow of capital that entered the country had been mainly directed to promote structural change towards more technologically advanced sectors to improve trade balance in the long-term. As shown in Figure 4 below, a great part of the capital flow increased the short-term investment position. Concerning this aspect, it is worth noticing that from 2012 onwards the amount of accumulated reserves corresponds to less than 40 per cent of the net short-term investment position. This should be taken into consideration when evaluating the contribution foreign reserves made in widening policy space. Figure 5 also shows the change of the GDP growth rate, which illustrates another negative aspect of the financial integration, which is expressed by the necessity

to sustain a high volume of liquid assets as foreign reserves, in the context of a recession. In this sense we can say that the policy of accumulation of foreign reserves also reduces the policy space of developing economies that are financially integrated.

To summarize, given the Brazilian economic performance in the last two decades, prospects are not favorable to the recovery of our former dynamism, as seen in the post-War period. The reason for this is because policy space has been much narrower due to the capital opening which inevitably led to a balance of payment dominance, linking the evolution of the Brazilian economy to the international liquidity flow, which is always volatile and pro-cyclical. Unless some other policy instruments come into play (such as capital controls) the economy will continue to fall behind its previous highs.

3. Concluding Remarks

In this paper we have argued that capital opening in the early 1990s narrowed the policy space of the Brazilian economy, and as a result, it has lost its vigorous growth and is falling behind. As pointed out by the literature, the asymmetric insertion of developing economies in the international financial market put these economies under the "balance of payment dominance". This means that capital flows play a decisive role in their growth dynamics, because when international liquidity is plentiful, economic policies are expansive and *vice versa*.

We have argued that the expected benefits of capital opening (to promote a continuous reallocation of resources in order to enhance potential output) are not accomplished through capital liberalization. This is because the allocation of resources occurs through price adjustments, and in developing economies dependent on capital flow, policy space is too narrow in order to manage the main macroeconomic prices. Domestic interest rates tend to be higher than in developed countries and the real exchange rate tends to be volatile and overvalued, increasing labour costs. Fiscal space is limited, since the burden of public debt is pro-cyclical. Business cycles are strong in financially integrated developing economies, compromising structural change towards more technologically advanced productive sectors. And, according to the structuralist literature, structural change towards more technologically dynamic sectors is a *sine qua non* condition for developing economies to relax their long-term balance of payment restrictions to growth, which will allow Brazil (and others) to catch up with developed economies.

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