THE GROWTH *CUM* FOREIGN SAVINGS STRATEGY AND THE BRAZILIAN ECONOMY SINCE THE EARLY 1990s

Luiz Carlos Bresser-Pereira

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Abstract. It took 14 years to Brazil overcome the debt crisis, turned into a fiscal crisis of the state. Yet, after that the 1994 Real Plan finally achieved price stabilization, the Brazilian economy was ready to grow. Surprisingly, it did not. The economy remained quasi-stagnant, while the foreign debt and the public debt soared, and the country faced two balance of payment crises (1998 and 2002). This paper explains such disastrous outcome with the theory of the Second Washington Consensus, based on the opening of the financial accounts and the growth *cum* foreign savings strategy. The paper discusses the conditions under which foreign savings are favorable to growth, and which are not. If a country is already indebted externally, and does not count with a cluster of profitable investment projects, capital inflows will just overvalue the exchange rate, increase artificially real wages, and cause increased consumption.

In the 1990s, in the eve of a new cycle of capital inflows to developing countries, 'growth with foreign savings strategy' was offered to all developing countries. While most highly indebted developing countries – principally the Latin American ones –, accepted, the non-indebted Asian countries rejected such strategy. Today, for Latin American economists, the critique of this strategy or theory asserting that 'the capital-poor countries should benefit from the capital transfers from the capital-rich countries in order to grow' is as important as it was, in the late 1940s, the critique of the comparative advantages theory. At that time, those countries depended on that critique to impose limits to international trade and be able to support import substitution industrialization; today, when most of them are industrialized and face a competitive global economic system, they need a critique of the growth *cum*

Luiz Carlos Bresser Pereira teaches economics at Getúlio Vargas Foundation, São Paulo, and is the editor of the *Brazilian Journal of Political Economy.* (bresserpereira@uol.com.br www.bresserpereira.org.br)

foreign savings theory to be able to impose limits to capital inflows and keep control of their exchange rate. In the 1990s capital inflows disrupted the Latin American economies not only because they were volatile but principally because they were excessive in relation to the investment opportunities existing in the region, and had as outcome not capital accumulation and growth, but artificial increase in wages, consumption, and stagnation. The extreme case of adoption of this approach supported by the rich countries was Argentina. In this paper, I will discuss the case of Brazil.[1]

Since 1980 the Brazilian economy faces quasi-stagnation. The causes are well known: the foreign debt crises in the 1970s changed into a fiscal crisis of the state and into high and inertial inflation in the 1980s. As we can see in Table 1, the *per capita* growth rate was negative in that decade. In the 1990s and early 2000s, however, the picture did not change much. This is not surprising for the period 1991 and 1994, since an extremely high inflation persisted, and limited economic growth.[2] Yet, during the 14 years between 1981 and 1994 major market oriented reforms (fiscal reform, trade liberalization, and privatization) were undertaken, while fiscal adjustment progressed (between 1990 and 1994 we had four years of balanced fiscal budget),[3] and local currency devaluation brought about large trade surpluses. At the end of this long period the state's public debt, and the nation's foreign debt had been reasonably reduced. The public debt fell from a peak of 169.5 % of GDP in 1989, to 43.8% of GDP in 1994; the foreign debt fell from a peak of 3.9 times of exports in 1990, to 3.4 of exports in 1994.[4] These reforms contributed to the success of the 1994 "Real Plan" in achieving price stabilization. At that moment, the economic prospects

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[1] For a general critique of the growth *cum* foreign savings strategy see Bresser-Pereira and Nakano (2002b). For a critique applied to the Brazilian case, see Bresser-Pereira (2001).

[2] The monthly average rate of inflation between 1991 and 1993 was 23.5%, the yearly average rate, 1,371.1 %. In the first semester of 1994 the annualized inflation rate was 859.2% (INPC from IBGE). Since then, the yearly inflation came under control, remaining in one digit, except in the two years in which exchange rate depreciation took place (1999 and 2002), when it temporarily crossed the two digit line.

[3] The budget deficit or public sector financial requirements in real terms in relation to GDP: 1990: -1.32; 1991: 0.19; 1992: 1.74; 1993: 0.80; 1994: -1.57. After that, the budget zero would go up in the next four years, staying around 5% of GDP; it only started to come down in 2000; in 2002, it zeroed. Source: Ipeadata, actualized March 2004.

[4] The main sources of data on the Brazilian economy are from the Ipeadata and the FIBGE. In 2002 the public debt was 57.8% of GDP and the foreign debt was 3.77 times of exports.

for the nation seemed to be excellent. Yet, ten years later, the economy remains semi-stagnant, presenting in the period a yearly per capita growth rate of only 0.69%, while the two macroeconomic balances – the budget and the current account balances – had been lost. Despite economic policy privileged stabilization to growth, in this period the country faced two balance of payment crises (1998 and 2002), and, again, accumulated an extremely high foreign debt and a high public debt. The crisis reflected the policy mistakes that I will discuss in this paper, and shows the inconsistency of such policies not only with growth but also with fiscal and foreign account macroeconomic equilibrium.

Despite these two balance of payment crises, which were essentially originated in the lack of confidence of international finance in the Brazilian economy – the fear either of government default on its public debt, and, principally, of the nation's default on its foreign debt – the Cardoso administration (1995-2002) and the Lula administration (starting in 2003) counted with the support of the official community in Washington and of the financial community in New York, in so far as the Brazilian economic authorities followed closely the conventional orthodoxy shared by those two communities. By 'conventional orthodoxy' I mean the collection of economic beliefs based on neoclassical economics, which are adopted by the Washington policymakers in the Treasury, in the IMF, and in the World Bank, and by the New York financial economists.[5] The specific form assumed by this orthodoxy in the 1990s I will call the 'Second Washington Consensus'.

Although the new Lula administration, which took office in the beginning of 2003, won elections principally by criticizing the economic policies and the economic outcomes of the previous administration, economic policy remained unchanged. The new economic authorities explained this decision as their intention to cause a 'credibility shock', in this way recovering international credit and trust. This assertion suggested that the compliance would be transitory, but after sixteen months in office no change had been undertaken. Washington, New York, and the local financial system declared pleased, credit was

[5] Observe that 'conventional orthodoxy' is not the same that 'neoclassical economics'. Although neoclassical macroeconomics is much weaker than neoclassical microeconomics, there are outstanding neoclassical economists who do not share conventional orthodoxy's tenets.

recovered, the country risk declined. Yet, in April 2004, when I was writing this paper, economic growth had not been resumed, and Washington and New York gave increasing signals of impatience.

Table 1: GDP growth in Brazil

Period	GDP	GDP per capita
1971-1980	8.67%	5.81%
1981-1990	1.67%	-0.28%
1991-1994	2,82	1,28
1995-2003	2,05	0,69%

Source: Ipeadata – www.ipeadata.org.br. Data based on 2003 prices.

Brazil's bad economic outcomes since 1995 may be attributed to three kinds of interrelated factors: (1) an agenda mistake: the definition of inflation instead of balance of payments equilibrium as the major problem that government should face from 1995 on; (2) the Second Washington Consensus, according to which economic development should be financed by foreign savings in the context of open financial accounts; and (3) the lack of a national project on the part of the Brazilian elites. This paper is divided into four sections. In the first one, I discuss the mistaken agenda adopted, where inflation remained the main problem to be faced although high inflation had been defeated in 1994 with the neutralization of inertia, and an exchange rate as the main tool to keep inflation down. In the second session, I attribute the poor results achieved to the adoption of the growth *cum* foreign savings strategy which is the central aspect of the Second Washington Consensus. In the third session, I discuss the conditions under which foreign savings are positive or negative to the economy. In the fourth session, I briefly discuss the political economy involved in the mistaken policy choices. The assertion of Brazil as an autonomous nation, which had progressed between 1930 and 1980, underwent a serious fall back since the early 1990s, as the country again started to accept without the required critic the recommendation coming from the North.

The agenda mistake

A first explanation for the disappointing economic outcomes since 1995 is related to the policy agenda. Macroeconomic stability does not mean just price stability; it also means balanced fiscal and foreign accounts, and a reasonable full employment. After having succeeded in stabilizing high inflation, Brazil did not manage to achieve macroeconomic stability and resume growth, because it assigned an excessive priority to price stability – a priority that justified an extremely high basic interest rate and an overvalued exchange rate. In July 1st 1994 high and inertial inflation ended in Brazil, after the three months in which the URV (indexed accounting money) neutralized inflationary inertia. At that day, each real was defined as equivalent to one dollar. Immediately after, Brazil was flooded with dollars, and the capital inflows appreciated the real. It was only when the exchange rate was reaching R$ 0.80 that the monetary authorities decided to intervene. As a consequence, the Brazilian economy was headed to a serious balance of payments unbalance, which the new administration, beginning in January 1995, proved unable to correct in the next four years. The exchange rate was kept low, 'to fight inflation', and the interest rate artificially high, 'to attract foreign savings'. As a result of this perverse macroeconomic equation (high interest rates, low exchange rate), the country was unable to stabilize, invest and grow. On the contrary, the high basic interest rate paid on an again increasing public debt (coupled with high social expenditures) restored the fiscal unbalance, while the low, overvalued, exchange rate reestablished the foreign accounts unbalance – the two balances that had been so hardly conquered in the previous years. In the name of fighting inflation, and in accordance to the tenet that the country should not control capital inflows and exchange rate, but grow with foreign savings, Brazil didn't achieve a competitive exchange rate, compatible with its high foreign indebtedness. On the contrary, the overvalued exchange rate artificially increased wages and consumption, while the extremely high basic interest rates made domestic investments impracticable.[6]

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[6] I am referring to the basic or short term, not the market or long term rate of interest. The basic interest rate (in Brazil is the Selic) is the exogenous rate on which the monetary authorities have control. Conventional orthodoxy, however, in the case of Brazil almost invariably 'fails to remember' the difference, although using the basic rate as an exogenous policymaking variable in their own countries.

The definition of high inflation as the main enemy to face represented a serious agenda mistake. Instead of realizing that the Real Plan was successful because it was able to neutralize inflationary inertia, conventional orthodoxy wrongly attributed this success to an 'exchange rate anchor', and, thus, decided to keep it in the years ahead. Conventional economists never understood what was inertial inflation. It is surprising that the same economists that in 1994 used a mechanism for neutralizing the staggered or indexed character of the Brazilian inflation up to 1994, when confirmed in the new administration were not able to realize that an exchange rate anchor was not necessary to keep inflation under control.[7]

Between 1990 and 1993, the country had been engaged in a trade reform which made domestic prices exposed to foreign competition. This and the de-indexation of the economy were the two major guarantees that high inflation would not be back. Inflation still deserved attention, but there were other challenges to be fought. . After the Real Plan, the two major enemies were the high real interest rate and the appreciated exchange rate – with the consequent intertemporal disequilibria of the fiscal and particularly of the foreign accounts. An appreciated exchange rate leads to increased consumption and to reduced domestic savings, and, eventually, to a balance of payment crisis; the high real interest rate reduces investments, promotes fiscal unbalance, and may end up in a financial crisis. Yet, these simple facts were ignored, and the economic team kept the exchange rate severely overvalued and the interest rate artificially high between 1995 and 1998.

In January 1999, after foreign creditors had fully suspended the rollover of the Brazilian foreign debt, President Fernando Henrique Cardoso decided to let the exchange rate float. The decision proved to be wise.[8] After a necessary rise in the interest rate, the

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[7] On inertial inflation see, among others, Bresser-Pereira and Nakano (1987) *The Theory of Inertial Inflation.*

[8] Surprisingly, however, only the President of the Central Bank, Gustavo Franco, lost his position, whereas the finance minister, Pedro Malan, was kept, regardless of having been contradicted by the President. The new President of the Central Bank, Francisco Lopes, who had been the only member of the economic team that supported the exchange rate fluctuation, remained only a few days in office. Without the minister's support, and confronted by the natural difficulties that followed the exchange rate fluctuation, he was replaced by Armínio Fraga, who remained in office till the last day of the Cardoso

Central Bank started to correctly reduce it. However, soon after, the Central Bank decided to introduce an inflation target policy in Brazil, despite the fact that the real basic interest rate was still extremely high and the exchange rate still correspondingly overvalued. According to the conventional orthodoxy of that moment, Brazil required a monetary anchor to replace the exchange rate anchor. The reduction of the basic interest rate continued throughout 2000. In mid 2001, however, it was stopped, as a mistaken response to a modest heating up of the Brazilian economy, to the beginning of recession in the USA, to the triggering up of the Argentinean crisis, and specially to the moderate exchange rate depreciation that had started. The Central Bank increased the basic interest rate despite the fact that it was around nine per cent in real terms, and despite the fact that the rise in inflation was consequence of the domestic currency depreciation, not of excess demand. The Central Bank additionally sold US$ 8 billion in the domestic market, and converted US$ 20 billion government bonds into dollar-indexed bonds. Thanks to this double intervention (interest rate rise and dollar purchases), the monetary authorities succeeded in reducing the exchange rate, which had gone from about R$2.40 in the beginning of the year (R$1.95 a year before) to R$ 2.80 per dollar in April. This 'successful monetary policy' prevented from a small and temporary rise in the inflation rate, but its medium run costs were high. As the expected growth of exports did not materialized, in the following year a new balance of payments crisis fell over the country. As a consequence of the balance of payments crisis the exchange rate soared again, overshooting to almost R$4.00 per dollar, although the exorbitant levels of the basic interest rate.

Why this new balance of payments crisis? Some tried to explain that by Lula's rise in election polls in mid 2002. PT's candidate, however, insistently reassured investors that, if elected, he would respect property rights and contracts. The real cause must be searched in the country's international financial fragility, which the 2001 incorrect policy left once again exposed to international analysts. When the economic crisis severely hit Argentina in that year, people correctly remarked that Brazil had de-linked itself from that country's fate with the correct (despite delayed) January 1999 devaluation. In fact, Brazil, which followed a path similar to Argentina's, avoided a major disaster when its exchange rate floated.

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administration (December 31, 2002). All the economists mentioned are faculty members of Rio de Janeiro's PUC (Pontifical Catholic University).

Argentina's big mistake, at that moment, was not having followed its neighbor. But that de-linkage from Argentina was limited, since both countries were equally vulnerable in their foreign accounts by following essentially the same policy directives coming from Washington and New York. In the first months of 2002, when Brazil again presented disappointing trade surpluses (which might have been avoided had the monetary authorities been more realistic and let the exchange rate to slide up in 2001), international banks' analysts recalled the losses they had incurred with Argentina, and, at the earliest opportunity, began their speculative attack on the real. Despite conventional orthodoxy concentrated its attention on the primary surplus and in the public debt, it was again the foreign debt and the current account deficit that caused the crisis. IMF's prompt help prevented the worst, but falsified the Second Washington Consensus belief that the relevant economic indicators are the primary surplus and the public debt in relation to GDP. In the (externally) highly indebted countries, financial crises originate invariably on the foreign side. When creditors realize that the current account deficit and the foreign debt become too high, and that the service of the debt is in danger, they suspend the rollover of the old debt. If there is no rescue on the part of an agent of last resort – the IMF supported by the US Treasury – default becomes unavoidable.[9]

The Second Washington Consensus

Why did the Brazilian authorities adopted an incorrect agenda and let the local currency rise up to 2002? This mistake may be attributed to technical and emotional incompetence; or to an exaggerated fear of inflation after the terrible high and inertial inflation experienced between 1980 and 1994. These explanations are partially legitimate, but I will present here a more specific one. Brazil was victim of the form that the conventional orthodoxy coming from Washington and New York assumed since the end of the debt crisis – a form that I call the Second Washington Consensus. According to this new

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[9] Even in the case of Brazil, when Finance Minister Dílson Funaro declared the country's default in February 1987, it may have looked as if Brazil had taken the initiative: in fact, the country had no alternative. Creditors had already declared the Brazilian default.

Consensus, formulated in the early 1990s by the Washington authorities,[10] highly indebted countries should open their capital accounts and resume economic growth by resorting to foreign savings. This second 'growth' consensus should not be mistaken with the first Washington Consensus. The latter was a 'stabilization and reform' consensus, which summarized the American policy in relation to the highly indebted countries since de debt crisis broke up in 1982. Thus, itt is a 1980s' consensus. As expressed by John Williamson, in a 1989 paper, the first consensus consisted of a series of principles advocating structural adjustment and market-oriented reforms.[11] It became a symbol of the neo-liberal policy of those years, although it didn't necessarily propose ultra-liberal reforms aimed at reducing the state to a minimum, and, what is more important, it didn't include financial opening, which Williamson expressly excluded.[12] The Second Washington Consensus should not, also, be confused with the recent attempts to revise the first one, in face of the poor performance exhibited by the countries that followed its recommendations. Expressly, it should not be mixed up with the recent book edited by Williamson and Kuczynski (2003).

The Second Washington Consensus emerges in the early 1990s, when the debt crisis had been reasonably settled by the 'Brady agreements' and a new capital inflow wave transformed developing countries into 'emerging markets'. It is not primarily concerned with stabilization, but with growth. For the fulfillment of such objective, it offered a simple recipe: each developing country should keep fiscal adjustment, and execute an additional institutional reform: to open its capital account. As a reward, it would receive foreign savings which would finance its economic growth. In other words, instead of the 'growth *cum* debt' approach of the 1970s, the emerging markets should involve into a 'growth *cum* foreign savings' strategy.

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[10] This policy's main proponent was the Treasury's Under-secretary Lawrence Summers.

[11] See Williamson (1990). The ideological charge against Williamson's text was greatly exaggerated. Williamson is not an ultra-liberal, and the consensus he detected in Washington wasn't an ultra-liberal consensus, and didn't aim to reduce the State to a minimum. It only had a liberal bias (or neo-liberal, in the English language, in which 'liberal' means progressive). This didn't prevent ultra-liberals from adopting it.

[12] In a debate with Williamson, Stanley Fischer suggested the inclusion of financial opening in the list of reforms, to which Williamson answered that he didn't find such reform necessary nor included in the effective consensus of the time (1989, when this debate took place).

A wide-ranging debate was opened in the 1990s among economists of developed countries on the subject of financial opening and capital flows – some of them critics of liberalization, others, enthusiasts. The latter, starting from the neo-classical assumption that liberalization is beneficial, asserted that financial liberalization is as necessary to development as trade liberalization, and must occur at the same time or immediately after. Among the critical papers, one of the most significant was the one by Rodrik (1998: 61) showing that there was no evidence that countries without capital controls grow faster. Eichengreen and Leblang's (2002) paper, "Capital Account Liberalization and Growth: Was Mr. Mahathir Right?", is also revealing. Yet, this literature should not be confused with my criticism of the Second Washington Consensus. Its critic on the financial opening is primarily concentrated on the problem of international financial instability caused by uncontrolled capital flows,[13] whereas my critique is more general. It challenges the idea that the growth *cum* foreign savings strategy is adequate for developing countries provided that capital flows are stabilized. Consequently, it rejects the view that a major problem faced by developing countries is how to attract foreign capitals. On the contrary, a central concern for developing intermediate countries is to curb excess capital inflows.

With this paper I claim that the degree of foreign indebtedness, as measured by the foreign debt/export ratio, and the way this problem is being faced, as expressed by the current account deficit/GDP ratio, should be the two central concerns for already indebted countries. Countries face a solvency constraint which should not be minimized in any case, and particularly when the country surpasses the 'foreign debt threshold'. Consequently, this paper intends to criticize the 1990s' conventional orthodoxy which underestimates the foreign unbalances, and is just concerned with fiscal problems, thus being inconsistent with macroeconomic stability. Additionally, it underlines that capital inflows tend to dangerously evaluate domestic currencies; and, as a result, besides causing balance of payment disequilibrium, tend to reduce domestic savings in such a way that the incoming positive foreign savings are neutralized by the negative reduction of domestic savings. Finally, given the strategic role played by the exchange rate, the paper criticizes the

[13] On this debate concerning the volatility of financial flows see, among others, Calvo, Reinhart and Leiderman (1995), Eichengreen (2001), Eichengreen (2002), Eichengreen, Hausmann and Panizza (2003), Reinhart, Rogoff and Savastano (2003).

ideological and ill considered character of the advice that developing countries should fully open the capital accounts. In so far as they must keep control not only of their external balances, but also of their savings rate, they must have the possibility of imposing controls on excessive capital inflows.

The growth strategy imbed in the Second Washington Consensus has a simple and clear statement, which seems reasonable as every successful ideology does. It may be summarized in a sentence that citizens of developing countries have heard many times since the early 1990s:

> "We understand that you no longer have resources to finance your development, but don't worry, carry out structural adjustment and reforms, including financial opening, that we will finance your growth with foreign savings, possibly with direct investments".

The sentence is therefore composed of four terms. The first term, or the premise, "we understand that you no longer have resources to finance your development", is obviously false, although the countries' high foreign indebtedness makes it appear as true. If countries with much smaller per capita incomes are being able to finance economic growth with their own savings, an intermediate developing country like Brazil may do the same as well. Up to 1970, the enormous growth that Brazil experienced was essentially financed with domestic resources. Even after replacing part of the domestic savings with foreign savings, as a result of the Second Washington Consensus, four-fifths of the investments are still financed by domestic savings. Brazil doesn't have at its disposal 'all' the desirable resources to finance its development. But who has them?

The second term ("but don't worry, carry out the structural adjustment and reforms, including financial opening") is the most reasonable of the four terms, except for the financial opening. It includes three conditions. The first condition (fiscal adjustment) is correct: given its high public debt, fiscal adjustment is a condition for strengthening the state organization. Market-oriented reforms are also required, provided that they are concerned in strengthening both markets and the state. Reforms that debilitate the state end by hampering the markets, which depend on state institutions.

The third condition ("including financial opening") must be discussed together with the third term ("that we will finance your growth with foreign savings"). There lies the trap

that explains why most of the already highly indebted countries experienced little growth in the 1990s, despite the adjustment and reforms that they were involved into in the 1980s and early 1990s; there lies the origin of the balance of payment crises whose limit case was Argentina; there lies the major explanation for the continuing macroeconomic instability and international fragility of the Brazilian economy, and for the two balance of payment crises: one in 1998, the other in 2002. The central theme of this paper is the critique of these two ideas, and I will return to it.

Finally, the proposition of the fourth term ("possibly with direct investments") is the more attractive of all. The 'foreign equity debt' or 'foreign patrimonial debt', represented by the net foreign capital stock in the country, is not included in the calculation of the indebtedness rates for its lower liquidity. Thus, if direct investment is actually intended to finance capital accumulation in plants and equipment, it will be undoubtedly welcome, particularly if, in addition, it produces tradable commodities.[14] Yet, even in this case, the capital inflow may turn negative to the country if – as it may well happen – the inflowing capital turns eventually into consumption due to the lack of investment opportunities. Differently to what happens in developing countries, direct investment in rich countries is not received to finance current account deficits, but as a consequence of each country's interest in taking advantage of the technological innovations brought by other countries' multinational corporations. Thus, the possibility that direct investments finance consumption instead of capital accumulation usually does not arise, because these countries are both investors and recipients, and the net foreign investment tends to be small.

But, could ask a naïve questioner: how can foreign investments be transformed into consumption if, in accounting terms, we know that savings are equal to investment? Don't foreign savings finance only investment? The answer is simple: foreign savings are automatically synonymous of current account deficits; direct investments are not necessarily transformed into capital accumulation; essentially they are just one of the two forms of financing the current account deficit, the other being foreign loans (reserves kept

[14] In my opinion, investment in public services, or retail banking, or in the purchase of Brazilian firms, as it happened recently, are not on the interest of a large country like Brazil. Yet, this question will not be here discussed.

constant). Thus, if direct investments are a form of financing the deficit, it may well end up financing consumption.

In which conditions foreign savings, financed either by loans or by direct investment, will finance accumulation, not consumption? When the current account deficit (or the foreign savings) is financed by direct investments we undoubtedly have a more favorable perspective, but the final outcome will depend on how the new money will eventually be used by the economy.[15] If, in a developing country, economic agents face major investment opportunities, either loans or direct investment will enhance the investment rate in relation to GDP; if this is not the case, direct investment will eventually just increase the country's debt – not the financial foreign debt, but the patrimonial foreign debt, served by remittances of dividends instead of of interests.

In so far as the growth *cum* foreign savings strategy is originated in the rich countries, they, and particularly the Washington authorities, recommend a strategy that they do not adopt for themselves. They know that foreign savings or current account deficits, either financed by loans or by direct investment, may easily be transformed into consumption. They also know that there is a solvency constraint; that the growth *cum* foreign savings approach contradicts a large portion of the international experience. Thus, they establish clear limits for foreign indebtedness. Research conducted among OECD countries, since the original Feldstein and Horioka paper on the subject (1980), showed that, although those countries receive and make direct investments among themselves, around 95% of domestic capital accumulation is financed by domestic savings. At first, neo-classical economists, attached to their assumptions in relation to free markets and on the benefits of capital mobility, defined the outcomes as a puzzle: the 'Feldstein-Horioka puzzle'. Further studies, however, demonstrated that it wasn't a puzzle, but a simple problem of solvency constraint of each country. That is to say, OECD countries are not

[15] The total amount of the country's financial and equity debt minus the reserves plus direct investments and foreign loans made by the country abroad is the country's net foreign liabilities. As, in the case of developing countries, the last two items are of minor importance, foreign liabilities correspond basically to the financial and equity debt minus reserves.

willing to go into debt to invest, or become moderately indebted. Investments are, therefore, essentially financed by national savings.[16]

Conditions

Why the acceptance by the Brazilian authorities of the growth *cum* foreign savings strategy had such disastrous consequences? Or, taking the problem from the opposite angle, in which conditions foreign savings help instead of hindering economic growth? I already suggested the reasons, but they require further analysis. First, the solvency constraint matters: there is a limit for a country's indebtedness. From a certain threshold on, it becomes increasingly dangerous to carry on with foreign indebtedness, primarily on the financial angle (but also on the equity one). In the 1970s, Mario Henrique Simonsen used to say that the foreign debt/export ratio shouldn't go beyond 2.[17] Recent research, however, demonstrates that Simonsen's rule of thumb was not severe enough. Although it's impossible to define the debt threshold accurately, empirical research confirms that there is a limit beyond which the foreign debt becomes negative for the country. The World Bank, as an interested creditor, defined this threshold by the debt/export ratio, which shouldn't go beyond 2.2, and by the debt/GDP ratio, which would be 80%. Most of debt crisis episodes took place when one of those two thresholds was crossed. In the case of Brazil, which is a relatively closed country (its export/GDP ratio is still around 10%), the foreign debt/exports ratio is clearly the critical one. Cohen (1994) was stricter. According to him, when the indebtedness rate is above 2 or the percentage of foreign debt/GDP is above 50%, the probability of debt restructuring becomes high and the negative effect on growth becomes significant. A recent study by three IMF economists demonstrates that, when the debt/exports ratio rise above 1.6-1.7 and from 35-40% of the GDP, "the average impact of

[16] See Rocha and Zerbini (2002) for a survey of the evidence. The authors quote the studies of Sinn (1992) and Coakley et al. (1996), besides those of their own study, as additional evidence that the Feldstein-Horioka correlation is not a puzzle but only a *solvency constraint*.

[17] Simonsen was Brazil's finance minister between 1974 and 1978, and regarded cautiously the growth *cum* debt strategy. Later, in a text book, he surprisingly increased this limit (Simonsen and Cysne, 1995).

debt on the income growth per inhabitant seems to become negative". The study shows that when the debt/export ratio increases from 1 to 3, the rate of growth declines 2 percentage points per year (Pattillo, Poirsin and Ricci, 2002).[18]

Second, foreign savings will be welcome if they do not involve exchange rate overvaluation. In principle, foreign savings will involve appreciation of the local currency since the market equilibrium exchange rate is lower than the equilibrium exchange rate which will prevail with a zero current account deficit. In so far as the appreciation materializes, this fact will bring two major negative consequences: on one hand, it causes balance of payment unbalance problems; on the other, it reduces domestic savings and investment. The first problem is covered by the previous discussion on the solvency constraint: if the current account deficits are large enough to lead the country to the indebtedness threshold, it means that the growth *cum* foreign savings strategy achieved its limit.

The reduction in domestic savings as a consequence of exchange rate evaluations plays a major role in my analysis. The transmission mechanism is simple. In so far as the domestic currency evaluates, real wages go up. The evaluation is nothing more than a change in relative prices in favor of non-tradables, and the labor force is the key non-tradable. Real wages go up because, when the exchange rate goes down, the import component of goods goes down while wages conserve their nominal price. In the case of Brazil, the foreign debt/exports indebtedness rate was around 3 in the early 1990s. Thus, the growth *cum* foreign savings strategy was highly inadvisable. In the late 1990s, this ratio was near 4, despite the fact that a sizeable part of the indebtedness that took place during the decade has been conducted through direct investments not influencing the financial indebtedness rates (but involving debt service). Today, after the first real depreciation in 1999 and the second in 2002, it came down to around 3 times. Kalecky teaches that

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consumption is a function of real wages: when real wages increase, consumptions goes up and savings go down. Thus, savings are a negative function of the exchange rate. The literature on savings and consumption normally does not acknowledge this fact, but it is central for the process of development, in so far as savings set a limit to capital accumulation. Asian high savings rates are certainly a cultural phenomenon, but they also respond to the strategic use that policymakers do of the exchange rate, keeping it relatively depreciates. On the other hand, Keynes teaches that the savings rate is just a relative upper limit, since whenever there is idle capacity and unemployment, investments determine savings rather than vice-versa. Since we are discussing foreign savings as a means to finance investment, it is easy to see that the reduction in domestic savings caused by the domestic currency evaluation compensates partially, if not fully, the increase in foreign savings which caused the devaluation.

In which circumstance, the increase in foreign savings does not have as trade off the reduction of domestic savings? When the opportunities to invest are large in the recipient country, and the domestic interest rate is low, so that a large breach opens between expected rates of returns and the interest rate; when a cluster of investments are taking place, creating crossed externalities, and causing the expected profit rate to go up. In this circumstance, which characterized the growth of the United States in the nineteenth century, or the growth of Brazil in the early and medium 1970s, the incentive to invest will be great, and part of the increase in wages will not be consumed but invested. On the other hand, if the domestic interest rate is kept low, the incentive to invest will be still higher. None of these conditions existed in Brazil.

In so far as the economy is growing fast, and investments are strong, total savings will be increasing even if workers and the middle class increase consumption. If the economy is not growing fast, other investments creating the classical conditions, that Ronsenstein-Rodan (1943) define as the big push, even the multinational companies' investments in buildings and equipment will be annulled by the reduction of domestic savings caused by the increased consumption. Direct investment finances the current account deficit, the country's patrimonial foreign debt increases, but the economy doesn't grow nor increase its ability to remunerate the invested foreign capital.

Table 2: Some Variable as % of GNP[19]

	Foreign Savings	Foreign Direct Investment	Domestic Savings	Gross Capital Formation	Net Income Sent Abroad
1993	0,78	0,31	20,58	21,36	-2,43
1994	0,94	0,4	21,58	22,52	-1,67
1995	2,87	0,63	19,77	22,64	-1,57
1996	3,20	1,41	18,04	21,24	-1,52
1997	4,22	2,4	17,68	21,9	-1,88
1998	4,42	3,75	17,2	21,62	-2,38
1999	4,91	5,52	15,99	20,9	-3,67
2000	4,35	5,64	17,86	22,21	-3,09

Source: www.ipeadata.gov.br

In the case of Brazil, direct foreign investments sum up nearly US$2 billion per year in the beginning of the 1990s. After the Real Plan this figure was multiplied by ten. Notwithstanding, the rate of capital accumulation and the rate of growth remained stagnant, as shown in Table 2. Foreign savings, or the inflow of dollars in the form of loans and direct investment, were compensated by domestic de-savings, as the exchange rate evaluate and real wages increased.

We could add a third condition for foreign savings to be positive to the economic growth of a country: that capital flows are not volatile. This is the subject of the copious literature on capital flows and financial opening to which I previously referred. Yet, since this condition is never met, we fall back to the solvency constraint or the debt threshold. One of the reasons why this threshold is relatively low (a foreign debt/exports ratio between

[19] Gross National Product = GNP; Gross Capital Formation (Investment) = I; Domestic Savings = S_N; Foreign Savings = S_X; Foreign Direct Investment = I_X. $I = S_N+S_X$. I used the GNP instead of the GDP because, for a country highly indebted, the difference between GNP and GDP (net income sent abroad, or net interests + net dividends) is sizeable and economically relevant.

1 and 1.5) is precisely this volatility of financial markets, the herd behavior which is inherent to a market where information asymmetries are huge and ever present.

Summing up, provided that these conditions are met, the growth *cum* foreign savings strategy will be valid. In the 1990s (as today), these conditions were far from being present, but the strategy was adopted by the Washington authorities and accepted by the countries unable to make a proper critique of it, among which Brazil.

Political economy

The growth *cum* foreign savings strategy was coupled by rhetoric that the adherents of the Second Washington Consensus continue to apply despite the financial crises and the poor economic performance of the economies that accepted it. This rhetoric, to be consistent with the basic claim on the rationality of growth with foreign savings previously referred, involves the strategic use of economic indexes, which serve as performance indicators for IMF's loans, and also as country risk indicators used by risk rating agencies and financial organizations. The idea is simple: only two indexes besides inflation are relevant, the primary surplus and the public debt/GDP ratio. The classical fiscal index (the budget deficit) and the foreign accounts related indexes (the foreign debt/export ratio and the current account deficit/GDP ratio) are dully forgotten or ignored. The primary surplus is preferred to the classical budget deficit because it does not take into account the interests. As to the foreign account indexes, they are not necessary if one assumes the twin deficits. If one looks for the indicators that the IMF or the financial sector economists are explicitly tracking, one will find an absolute preference for the rhetoric indexes, instead of the really relevant indexes. Yet, the financial system, starting by the risk rating agencies, knows well the importance of the indexes that I am calling relevant. In late 2003, Russia was again upgraded by the country risk agencies. There was a certain surprise among the Brazilian analysts working for the banking sector, what led me to write a column in *Valor* (26.11.2003), from which I extract Table 3. It is self-explicative. While there is not much difference between Brazil and Russia in relation to the rhetoric indicators, there is an

enormous advantage for Russia in the relevant indexes. Again the old say is confirmed: "do what I say, not what I do".

Table 3: Brazil and Russia compared on country risk indexes

Indexes		Russia	Brazil
Ratings	**Moody's ratings**	Baa3	B2
	Country risk (points)	222	616
Rhetorical indexes	**Primary surplus as % of GDP[1]**	3,4	3,92
	Public debt as % of GDP[1]	43,4	57,8
Relevant indexes	**Public Deficit as % of GDP[1]**	+0,60	-4,66
	Foreign debt/Exports (times)[1]	1,47	3,77
	Current account deficit as % of GDP[1]	+8,80	-1,71

Source: Moodys, Central Bank of Brazil, IPEA, IMF, *The Economist*. Observation: (1) 2002 data.

The adoption of rhetoric instead of relevant indexes is part of the justification system adopted by the Second Washington Consensus. Conventional orthodoxy's proponents are not interested in showing disagreeable numbers such as the extremely high interests paid by the state on its domestic and its foreign debt, or the numbers that reveal the precarious conditions that the nation's foreign account eventually presents. Thus, they justify the substitution of the primary surplus for the budget deficit with the argument that they want to know the country's capacity to serve its debt. And they ignore the current account deficits and the foreign debt with the justification that, according to the twin deficits theory, the primary surplus already takes care of the problem. It does not matter that such theory has been falsified numberless times.

This is not the moment to further discuss the poor economics of these justifications, but a political economy analysis is required. Why the Washington authorities and the international financial markets adopted such equivocated approach, and why the Brazilian authorities and the local elites accepted it? Political economy analysis is not substitute for the economic analysis, but, after having offered the economic reasons why the growth *cum* foreign savings strategy proved disastrous for Brazil in the 1990s, the question which imposes itself is to know why rational economic agents either recommended or accepted such policy.

The interests in Washington and New York are related to the need to legitimate another cycle of capital inflows to the emerging markets. Despite the fact that these markets are marginal when compared to the central markets, they offer substantially higher long term interest rates to bond holders, and higher profit rates for multinationals investing abroad. Thus, rentiers and the financial system on one side, and multinationals on the other, are highly interested in investing in intermediary developing countries. On the other hand, these countries, with their low labor costs, represent a threat to the developed world since the 1970s, when the first NICs (new industrial countries) appeared. Thus, an overvalued currency is a warranty for them against international competition. Conventional orthodoxy is an expression of these interests. Neoclassical economics, with its ultra-liberal approach to the relations between markets and the state, offers the required theoretical foundation.

On the part of the Brazilian elites and economic authorities, we have also rational reasons for the acceptance of the growth *cum* foreign savings strategy. The rentier and the financial elites are interested in the higher interest rates that are consistent with the strategy. The whole society is interested in the short run in higher wealth, income, and, consumption. Or, in other words, they are attracted by ‘exchange rate populism’.

In fact, what we had with the growth *cum* foreign savings strategy was exchange rate populism with the support of the IMF and the World Bank. There are not just one but two forms of economic populism, the fiscal one (the state to expend more than what is

collected) and the exchange rate populism (the nation to expend more than it gains).[20] The first form is more obvious than the second, both are disastrous. Yet, exchange rate populism is more critical or more dangerous, in so far as the crises of developing countries always begin with a balance of payments crisis, creditors suspending the rollover of the foreign debt. Obviously, financial crises may also take place as a result of large public deficits and lack of monetary control, combined with a period of economic boom, and, therefore, of excessive demand. Yet, since the 1980s, Brazil, as well as the other Latin American countries, hasn't experienced such a kind of crisis.[21]

The populist cycle usually combines fiscal and exchange rate populism. The last episodes are the 1979-80 attempt of provoking the convergence of expectations and the fall of inflation through the exchange rate (1979-80), the Cruzado Plan (1986), and the post-Real Plan policy (1995-98). In those three episodes, fiscal unbalance was combined with exchange rate evaluation. In all cases, inflation remained under control, real wages increased, imports and consumption soared, but ended in the suspension of the rollover of the debt, and in a balance of payment crisis – the duration of the cycle depending on the relative size of the budget deficit and the current account deficit.

In the case of the Brazilian elites, besides the 'rational' there are also 'irrational' motivations: on one side, the trauma caused by 14 years of high inflation; on the other, the difficulty faced by the Brazilian elites to defend national interests. The Brazilian National Revolution (meaning by that the transference of the decision centers to Brazil and the formation of a real nation-state), started in 1930, and was successful in promoting industrialization and economic growth. Yet, with the major crisis of the developmental strategy of the 1980s, while a neo-liberal and globalist ideological wave gained strength

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[20] Adolfo Canitrot (1975) made exchange rate populism clear in his classical 1975 paper. Jeffrey Sachs (1989) wrote the definitive paper on the subject. Yet these authors, as many others that discussed the issue, do not distinguish fiscal from exchange rate populism. These and other papers on the subject are in Bresser-Pereira, org. (1991).

[21] To relate economic populism with the neo-liberal agenda adopted by the Washington international institutions in the 1990s may seem surprising, but it is not something absolutely new. Kurt Weyland (1996, 2003), for instance, has been writing about the subject, although with a different approach, for some years.

everywhere, the local elites bowed to it, major decisions on the Brazilian economy again came from the North, and the existence of Brazil as a nation was almost forgotten.[22]

Conclusion

Despite having successfully floated the real in January 1999, the Fernando Henrique Cardoso administration kept interest rates high and the exchange rate still overvalued. Thus, notwithstanding the good results achieved in controlling the budget deficit since 1999, the administration ended in 2002 with a second balance of payment crisis. This crisis led to an overshooting of the exchange rate, the real almost reaching R$ 4.00 in the end of that year. The fear that the new president, Luiz Inácio Lula da Silva, caused on foreign investors contributed to this crisis. Already during the presidential campaign, however, the candidate asserted insistently that he and his political party, the Workers' Party, did not represent a threat: that a non-populist policy respecting property rights and contracts would be followed. As soon as President Lula took office, he engaged in a 'credibility shock'. Confidence was soon restored, and capital inflows resumed. They resumed so strongly that in few months the exchange rate went down to R$ 2.90 per dollar. Nevertheless, at that level a second real depreciation (the first had been in 1999) allowed that a large trade account materialized, and the current account broke even.

The dollar would have continued to go down in relation to the real if a clamor had not rose against the passive attitude adopted by the monetary authorities ("a floating exchange rate is a free exchange rate") when the real began again to evaluate. People remembered the two previous balance of payments crises, particularly the 1998 one, and

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[22] Neo-liberal is the ideology that intends to reduce the state regulation of the economy to a minimum, but, as market regulation is required, it expects that a-political bodies perform this job. Globalist is the ideology that asserts that national states lost relevance in the present global system, and, from this false assumption, concludes that developing countries have no other alternative than the 'straight jacket' proposed by Washington and New York . Thomas Friedman (2000) writes explicitly about the supposed straight jacket, which is a basic assumption adopted by the Washington consensus. He, as all other globalists, mixes up the Washington and New York views on economic policy and institutional reform with capitalism. The only alternative to grow is capitalism, but there are many varieties of capitalism.

realized that a strong real could be nice in the short run but would have disastrous consequences in the medium run. This event demonstrates the importance of democracy in turning economic authorities minimally accountable. In some cases, democracy may foster economic populism, but, as democracy gets consolidated, as it is the case of Brazil, political debate and public opinion are major tools to control macro rent-seeking of the type involved in the Second Washington Consensus, in overvalued currency and excessive basic interest rate. Given the strong manifestations coming from the most varied sources,[23] by the middle of 2003 the economic authorities started buying dollars in order to stabilize the exchange rate. Since then it is maintained around the R$ 2.90 level. I, particularly, spoke for a higher real, that should be around R$ 3.50 per dollar. With this rate Brazil would be adopting the growth strategy that the Asian countries follow: to use the exchange rate as the major tool to promote increasing exports, savings and investments (Dooley, Folkerts-Landau and Garber, 2003). Yet, with this second best R$ 2.90 per dollar rate, the competitiveness of the Brazilian economy seems satisfactory, leading to the prediction that again in 2004 the current account will break up even. For this outcome, the evaluation of the Euro is helping.

Since the 1997-98 financial crises, the growth *cum* foreign savings strategy is loosing credibility everywhere, including in Latin America. The critique in the central economies focus on the volatility of financial flows, instead of questioning growth *cum* foreign strategy as a desirable one given the two problems involved: the national solvency constraint, and currency overvaluation. The poor performance of the countries that followed such strategy, and the good performance of the ones that did not follow it, however, is compelling. Only it can explain the Brazilian resistance to a new overvaluation. Does this mean that the Brazilian economy is finally heading for growth? Not yet. Now, not so much because the exchange rate is overvalued, but because the basic interest rate remains artificially high, keeping the budget deficit around 5% of GDP, and making unviable investment in capacity expansion, except in some agro-business ventures which became highly attractive with the real depreciation achieved by the 2002 balance of

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[23] Including a major banker, Fernão Bracher, formerly president of the Brazilian Central Bank.

payment crisis. As the fixed and overvalued exchange rate counted with the support of Washington and New York in the recent past, now the high basic interest rates also can count on this support. Competent macroeconomics models treat the basic interest rate as an essentially exogenous variable, recognizing the fact that there is no correlation between country risk ratings and the basic interest rate, but as conventional orthodoxy had arguments to keep the exchange rate overvalued, it has now other arguments to make Brazil an exception, and to tie the short term to the long term interest rate, despite the fact that countries with equal or higher long term have much lower basic interest rates.[24]

According to Celso Amorin, the difference between the Asian and the Latin American countries is in the fact that the former grow with domestic savings and foreign markets, while the later expect to grow with foreign savings and domestic market.[25] In this paper I argued that the second alternative is self-defeating. Growth must be financed with domestic savings. This is what the international experience says; this is what the Brazilian experiences confirms. Given the solvency constraint and the fact that capital inflows tend to overvalue the domestic and increase consumption, growth based on foreign debt may occur only during limited spaces of time, in moments when a cluster of investment projects with crossed externalities create particularly favorable investment opportunities. Except for these rare moments, developing countries will be successful if government and the business class, the state and the market, are associated in a national development strategy where the control of the exchange rate is a crucial variable. For many years Brazil fulfilled this condition and grew at high rates. Since the 1990s, however, and as a consequence of a major debt crisis coupled with a neo-liberal ideological and globalist wave coming from the North, Brazil stopped thinking in national interest terms, adopted the growth *cum* foreign

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[24] An argument that recently became popular in the Brazilian financial sector is the one which explains the high interest rates with lack of institutional reforms. Since Brazil has a basic interest rate higher than all other Latin American countries, the argument that jurisdictional uncertainty would only be valid if all those, from Paraguay to Venezuela, had better or safer financial institutions than Brazil. It does not seem probable that this is the case.

[25] This phrase was referred by Rubens Ricupero in a lecture at the School of Economics and Administration of the University of São Paulo, August 27, 2001. I retrieved it from my notes.

savings strategy coupled with high basic interest rates, and, since then, remains quasi-stagnant.

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