LATE GLOBALIZATION AND MALADJUSTMENT: THE BRAZILIAN REFORMS IN RETROSPECTIVE

By

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> "It is true that the backwarderness and the attempts to keep up have internal causes, but it is also true that forms and techniques … that are adopted at times of modernization were created out of social conditions very different from ours, and that their importation produces *maladjustment* which is a constant trait of our civilization."
>
> Roberto Schwartz
> In Misplaced Ideas

Introduction

The development strategy followed by Brazil in the post-war period up to the debt crisis in 1982 is generally described as import substitution industrialization (ISI). High levels of import tariffs and a relatively high dispersion of the tariff structure protected domestic production. Overvalued exchange rates discriminated against the exports of primary goods and favored imports of intermediate and capital goods. The rate of growth was as a result highly dependent on the expansion of domestic demand.

The debt crisis led to a revision of the conventional wisdom on development that culminated in the so-called Washington Consensus (Williamson, 1989). According to this view, inward-oriented strategies produced tremendous inefficiencies, associated to excessive State intervention, leading to lower rates of growth and increasing inequality. The successful experience of East Asian countries led many authors, and the World Bank (World Bank, 1993; Edwards, 1995), to conclude that outward oriented development strategies were conducive to rapid and sustainable development.

Brazil, however, was a late convert to the liberalization, deregulation and privatization creed of the Washington Consensus.[1] Only after the Real Plan of July 1994, Brazil was clearly adopting the set of policies promoted by Washington, even though trade and capital account liberalization started in the early 1990s under the Collor administration.[2] A peculiarity of the Brazilian reform process was the co-existence of the trade and capital liberalization and high inflation in the early 1990s. This might, in part, explain the excessive zeal in the use of the exchange rate as a stabilization instrument, and the disregard for the consequences of exchange rate overvaluation in the context of trade liberalization.

It should be noted that reform minded authors such as Franco (1999) argue in favor of an overvalued exchange rate, for this would reduce the costs of imported goods, leading to the rising imports of intermediate and capital goods.[3] The rise of imports of intermediates and capital goods would, in turn, lead to an increase of productivity and, as a result, a rise in exports and of the rate of growth. This export boom would make the

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[1] Conventional wisdom asserts that globalization is the outcome of technological developments in the information technology and telecommunications industry that made the increasing integration of markets inevitable. In contradistinction, we believe that far from inevitable, globalization should be seen as the outcome of policies designed to liberalize the trade and capital accounts of the balance of payments. In that respect, the adoption of the Washington Consensus policies reflects the late globalization of the Brazilian economy, which in turn is only one more phase in the development of the Brazilian late and peripheral capitalist economy.

[2] Many Latin American countries such as Argentina and Chile initiated the reforms in the 1970s, only to revert them temporarily. Others like Mexico started in the mid-1980s. However, in almost all the other countries reforms were well under way by the early 1990s. Also, according to Stallings and Peres (2000), Brazil could be classified, along with Colombia, Costa Rica, Jamaica and Mexico, as a cautious reformer, while Argentina, Bolivia, Chile and Peru, are aggressive reformers. The main source of the difference according to the authors is related to the previous performance. That is, countries that did well in previous periods were more reluctant to adopting the reforms.

[3] According to Franco (1999, p. 53) the higher productivity of the Brazilian economy in the early 1990s meant that a certain degree of appreciation was desirable. In contrast, other pro-reform authors disagree on the role of exchange rate policy. For example, Dornbusch (2000, p. 10) admits that "trade liberalization calls for real depreciation and a fall of the wage in dollars."

initial trade deficits sustainable in the longer run perspective. Also, it was expected that the market-friendly reforms would lead to an increase in foreign direct investment (*FDI*), which would also translate into higher rates of growth. In particular, it was argued that *FDI* would generate a positive macroeconomic externality and lead to an increase in domestic investment.

By and large the expectation was that post-reform growth would be higher and led by exports. Greater emphasis on exports together with a more efficient use of imports would produce larger trade surpluses. An important complement of the reform package would be labor market deregulation that would maintain real wages and unemployment relatively low. As a result the reforms would lead to higher growth and productivity with a relatively low level of unemployment. Finally, it was believed that higher rates of growth and productivity and a relatively stable macroeconomic environment would reduce poverty and inequality.

Few, if any, of these expectations were fulfilled during the 1990s. In fact in a recent evaluation of the macroeconomic performance, sponsored by the Banco Nacional de Desenvolvimento Econômico e Social (BNDES), Castelar, Giambiagi and Gostkorzewciz (1999, p. 13) argue that is difficult not to agree with the proposition that the 1990s have been a second lost decade.[4] In their view, the only important achievement was stabilization. Yet, they argue that reforms might lead in the future to higher rates of growth, and for them the solution for the economic woes would be speeding up reforms, in particular the fiscal reform. In particular reforms should force the reduction of fiscal deficits, since "[fiscal] deficits reduce saving and investment" (Dornbusch, 1997, p. 13).

Critics of the stabilization process, such as Delfim Netto (1998) and Tavares (1999) have argued that one of the consequences of foreign exchange appreciation in particular, and of the reforms in general, would be higher unemployment and reduced international competitiveness. This would in turn imply higher trade deficits, making the economy extremely dependent on short-term capital flows, and leading to increasing balance of

[4] This is in fact a general phenomenon among developing countries (Easterly, 2001).

payments vulnerability. Finally, for some of authors the high interest rates needed to attract capital flows are the most important cause of the soaring budget deficits. The crisis of January 1999, even though lacking the depth of the Mexican or Asian crises, put on display the fragility of the reforms.[5]

This paper discusses the effects of the reforms on macroeconomic performance, growth, employment, wages, income distribution, poverty and other social variables. Next section discusses the economic reasons for the lateness of the reforms. The succeeding section analyzes the growth performance of the Brazilian economy, before and after the reforms. The following sections examine the effects of the reforms on the labor market, and on income distribution and social variables respectively. The last section pulls the results together for an evaluation.

Stabilization and Late Globalization

The international debt crisis triggered by the Mexican default in August 1982 had severe impacts on the Brazilian economy. High levels of inflation and stagnant rates of growth marked the macroeconomic performance during the 1980s, the so-called lost decade. The average rate of inflation in the 1980s was around 341 percent per year, and at the peak annual inflation was 2596%, as measured by the implicit price deflator of *GDP* (table 1). Also, looking at the whole post-war period, one must conclude that the growth performance of the Brazilian economy is divided in two periods, before and after the debt crisis. The real *GDP* growth was on average 7.45 from 1948 to 1980, and it slowed down to only 2.47 in the 1981 to 2000 phase. The real rate of growth in the 1980s was 3.3 if we exclude 1980 and 3.94 if we include it. In the 1990s growth has been even lower, at 1.78 for the whole decade, 2.69 if we exclude the 1990 recession, 2.62 for the period after stabilization, and 2.41 for the whole of Fernando Henrique Cardoso's administration. Table 1 also shows the differences between the first part of the 1990s and the post-

[5] In fact, the talk in Washington turned towards 'second-generation reforms,' 'governance,' and 'reinvigorating the state's capability.' The reason for this change is the widespread dissatisfaction with market-oriented reforms.

stabilization period. Inflation decreased drastically, but the rates of growth recuperated only slightly. As far as growth rates are concerned the 1990s and not the 1980s, as one would expect, is the lost decade.

Table 1 Inflation, Growth and Labor Productivity

Years	Inflation (*GDP* deflator)	Real *GDP* Growth	Real *GDP* per Capita Growth	Productivity Growth
1948-1980	45.3	7.45	4.40	4.1
1981-1989	341.2	3.30	1.28	0.6
1990-1994	1643.6	0.79	-0.77	1.0
1995-2002	8.1[a]	2.41	1.18	2.8[b]
1990-2002	653.3	1.98	0.37	1.8[b]

Source: FGV, IBGE and Bonelli, 1994
[a] Figure for the 1996 to 2002 period
[b] Figure goes up to 1999

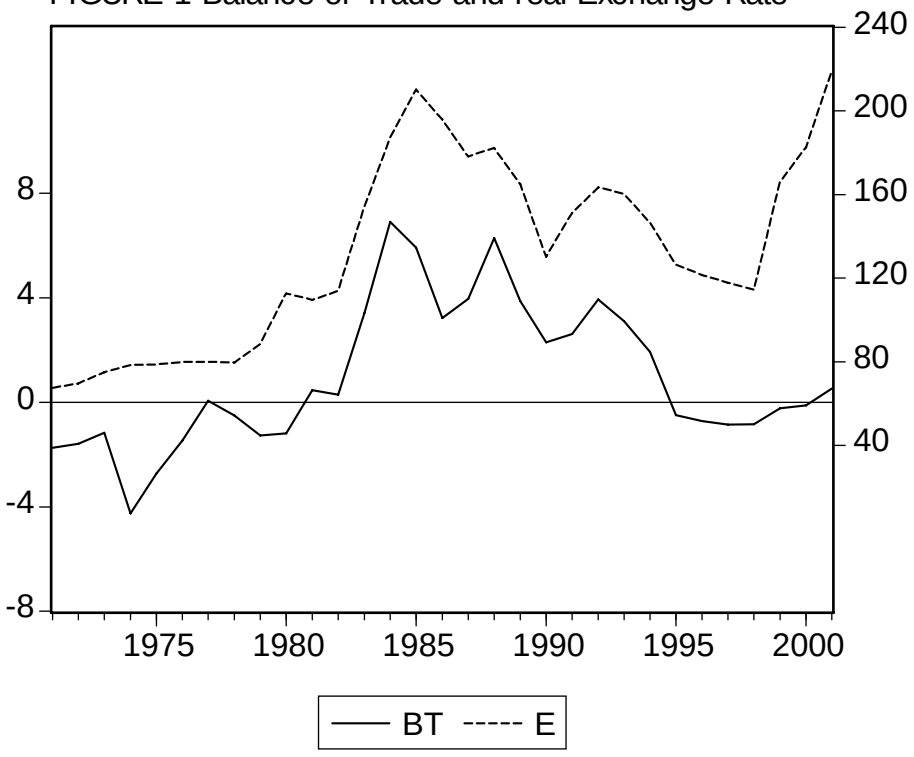
Finally table 1 shows that labor productivity growth was higher in 1990s, in both sub-periods, with respect to the 1980s. However, rate of growth of productivity is still considerably below the level of the import substitution period. This is not surprising since there is a well-established positive correlation between output and productivity growth.

The results in table 1 show that the effects of the debt crisis were powerful. Yet the crisis did not lead immediately to a dramatic change in policy orientation in Brazil, at least in the direction of liberalization. Arguably, the extremely successful growth performance of the post-war period, with an average rate of growth of 7.45 percent, led to considerable inertia in policy formulation. The 1980s were marked by heterodox stabilization plans that build on the structuralist explanations of inflation, according to which inflation was caused mainly by balance of payments constraints, and propagated by generalized indexation (Arida and Lara-Resende, 1985; Bresser and Nakano, 1987; Lopes, 1986). According to this view, both a fixed exchange rate and deindexation were crucial for successful stabilization. All the heterodox plans (Cruzado, Cruzado II, Verão, and

Bresser) froze domestic prices, and eliminated wage indexation rules in order to eliminate inertial inflation.[6]

According to the structuralist view, two problems still remained elusive in the early 1990s and made any attempts at stabilization problematic. First, indexation prevented incomes from being eroded, but also tended to freeze the pre-existing set of relative prices. This set of relative prices did not necessarily correspond to the equilibrium set, that is, the one that was desired by economic agents. Hence, a price freeze and the elimination of indexation rules also tended to freeze an out of equilibrium relative price structure. When the freeze was removed prices exploded as agents tried to impose their incompatible income claims. In this case, Amadeo (1994) suggests a social pact is needed if stabilization is to succeed.

FIGURE 1 Balance of Trade and real Exchange Rate



Source: FGV Data (Author's Calculations)

[6] The Collor plan is more difficult to classify. Prices were frozen for only one month, but the main measure of the plan was the blocking all financial assets for eighteen months, reducing the holdings of M4 in almost 70%. For a discussion of the technical aspects of the plan see Simonsen (1990).

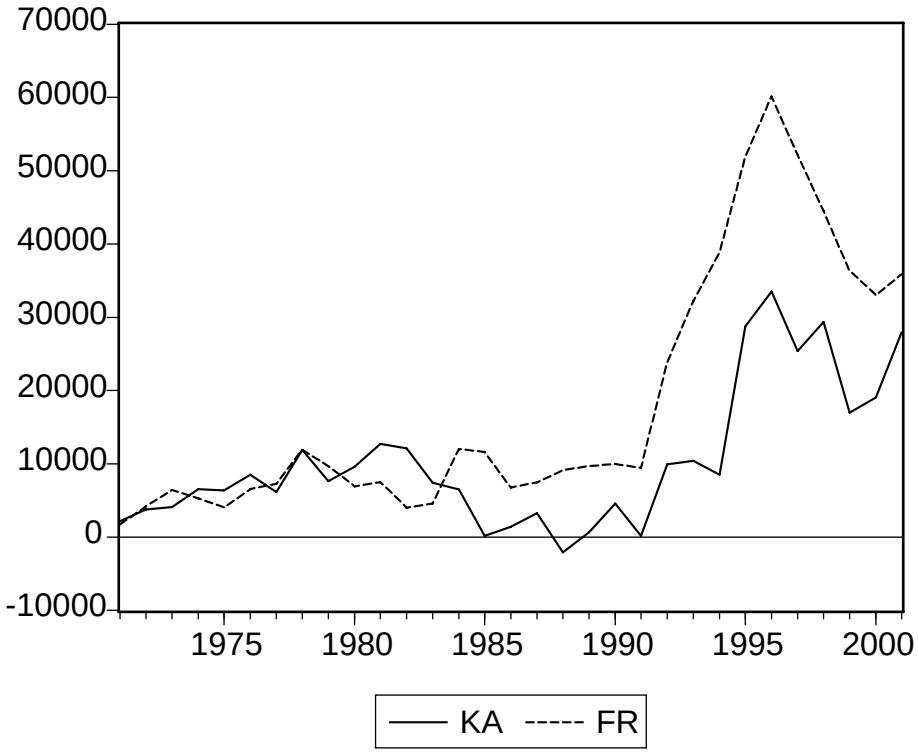
The second problem was the outflow of capital caused by the debt crisis. In fact, the debt crises not only eliminated external finance, but also reversed the direction of capital flows, forcing a huge drain of resources from Brazil to developed countries (Cardoso and Fishlow, 1988). Figure 1 shows the large trade surpluses (positive *BT*) that were generated in order to pay for the service of the foreign debt, and the variation in the real exchange rate (*E*) needed to obtain those surpluses. A trade deficit of 2.2 of *GDP* in 1980 was transformed in a trade surplus of 5.9 of *GDP* in 1984. It must be emphasized that this was achieved through large devaluations and also by a reduction of the rate of growth.

The foreign exchange shortage led to the suspension of the payments of the service of external obligations in 1987. The episode was short lived and Brazil resumed payments in 1988. Not long after the Brazilian moratorium, in March 1989 the U.S. government announced the Brady Plan. Recognition that the existing debt could not be serviced on its original terms led to this major program of re-structuring of the terms of obligations. The Brady Plan and the structural adjustment loans of the World Bank were negotiated on the basis of the capacity to repay, which in turn was seen as being dependent on the implementation of the reforms. This indicates that, although it may have taken some time, the debt crisis was instrumental in forcing countries into restructuring their economies according to market friendly lines.

In the early 1990s, contemporaneously with the Brady negotiations, capital flows returned to Latin America, and the new problem in the agenda was how to cope with the increasing and volatile capital inflows (Agosin and Ffrench-Davis, 1996). Figure 2 shows that the resumption of capital flows, represented by the change in the sign of the capital account (*KA*), led to an unprecedented accumulation of foreign reserves (*FR*). Foreign reserves went from less than 10 billion dollars after the default, to approximately 60 billion dollars in the late 1990s. According to Calvo, Leiderman, and Reinhart (1993), the central reason for the reversion in the direction of capital flows was external, namely: the recession in the U.S. and the reduction in U.S. interest rates. One should add from the recipient side the market friendly reforms were also important.

In most Latin American cases, reforms and the reversal of capital flows were accompanied by stabilization. The Brazilian experience is in fact unique because of the persistence of high rates of inflation well into the 1990s. The obvious question then is: why did it take so long for the Brazilian authorities to implement one of the most important precepts of the Washington Consensus, namely, macroeconomic stability.

FIGURE 2 Capital Account and Foreign reserves



Source: Boletim do Banco Central

The answer is related to the accumulation of foreign reserve by the central bank. As can be seen in figure 2, it is only in the aftermath of the Collor Plan that foreign reserves start to be accumulated. This accumulation of reserves allowed a successful exchange rate based stabilization plan in 1994, along the lines of the plans implemented in other Latin American economies. The Real Plan was designed to follow the consensus on therapy shock, which appeared to include some of the lessons from the heterodox plans of the 1980s. According to Bruno (1993, p. 7), "the root of high chronic inflation, like hyperinflation, turns out to lie in the existence of a large public-sector deficit, the quasi-stability of the dynamic process … [comes] from an inherent inertia strongly linked with

a high degree of indexation or accommodation of the key nominal magnitudes (wages, the exchange rate, and monetary aggregates) to the lagged movements of the price level."

The adoption of a fixed exchange rate regime would eliminate the propagation mechanism, but successful stabilization would require fiscal reform. In general the explanation for the advantages of exchange rates as anchors is rooted in the literature on credibility and time consistency rather than on the inertial inflation (Edwards, 1995, p. 101). With respect to exchange rate regimes, this debate has been translated into the consensual view that fixed exchange rate systems create environments that are more prone to produce fiscal discipline and low inflation. The argument is that if foreign central banks were committed to price stability, then a worldwide concerted assault on inflation would be successful. In this sense, fixing the exchange rate might be a good strategy for fighting inflation. This was the basic argument in favor of the exchange rate based stabilization policies in Latin America, in particular in the Southern Cone stabilization plans of the 1970s, in the Convertibility Plan in Argentina, and the Ecuadorian dollarization process.

Interestingly enough the Brazilian exchange rate based stabilization plan seems to be more related to the heterodox plans of the 1980s, than what is generally assumed.[7] First, the deindexation process was engineered in a way that resembles the so-called Larida proposal of the mid-1980s. A new unit of account corrected for inflation by the average of three different inflation indexes was introduced. Inflation accelerated in the old currency, while the new unit of account was unaffected by inflation. This process had a great advantage over the previous price freezes, since it allowed relative prices to change before the monetary reform. The adjustment of relative prices in the transition period increased the distributive neutrality of the monetary reform.[8]

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[7] The case of Mexico where a social pact was crucial for stability also contains some heterodox features. Argentina and Chile, on the other hand, represent the typical orthodox stabilization programs.

[8] The Real Plan created a parallel currency – the Unidade Real de Valor (URV) – that was indexed to three widely used inflation indexes. While prices in Cruzeiros Reais changed, absolute price in URVs was relatively constant, and relative prices were allowed to change. Finally, the monetary reform of July 1

Table 2 Public Surplus, Public Debt (% *GDP)*

Year	Primary Surplus	Operational Surplus	Net Public Debt
1991	2.8	-1.4	37.9
1992	2.3	-2.2	37.2
1993	2.7	0.3	33.0
1994	5.3	1.4	29.2
1995	0.4	-4.9	30.5
1996	-0.1	-3.8	33.3
1997	-1.0	-4.3	34.5
1998	0.01	-7.5	42.4
1999	3.2	-9.4	49.5
2000	3.5	-1.2	49.5
2001	3.7	-1.4	52.0
2002	3.9	0.01	57.3

Sources: Boletim Banco Central and IPEA Data

Second and most importantly, Brazil never carried the fiscal adjustment that was crucial for the consensus therapists. In fact, a quick inspection of table 2 shows that in the first half of the 1990s primary fiscal surpluses (revenue minus spending excluding interest payments) were obtained and co-existed with high inflation, and that the primary deficit only increased after the Real Plan. In contrast the operational deficit has been high all through the 1990s, with the exception of 1993 and 1994, but exploded after the Mexican crisis of December 1994. In other words, the fiscal results worsened after stabilization.

Furthermore, the Mexican crisis forced interest rates up, having a direct impact on debt servicing, leading to an operational deficit of 9.4 percent of *GDP* in 1999. The hike in interest rates and the relatively lower rates of growth associated with the need to reduce

1994 fixed the parity between Cruzeiros Reais, URVs and Reais – the new currency – at CR$ 2,750 = 1 URV = 00R$ 1. As prices in URVs were already stable, prices in Reais were also stable.

current account deficits led to the increase in net public debt from 29.2 percent of *GDP* in 1994 to almost 50 percent in 1999.[9] These negative trends have since been reversed to a considerable extent. Growth resumed in the aftermath of the 1999 depreciation, and interest rates were reduced from more than 40 per cent on an annual basis to 16.5 per cent. Yet, despite the recent improvement, the evidence clearly shows that public deficit, especially the operational deficit, and public debt increased after the stabilization. The fiscal results indicate that the fiscal problems are the result of the stabilization process and not the cause of inflationary pressures.[10]

Bacha (1994) argues that the fiscal deficits in Brazil are repressed, and that a better measure of the deficits would be what he calls the potential deficit. According to this view, Brazilian inflation does indeed have its fundamental cause in a fiscal imbalance. Potential deficit is measured as the actual deficit inserted in the official budget approved in Congress. Potential deficits are extremely large, and according to the estimates quoted by Bacha (1994, p. 9) it would be around 10 percent of *GDP* in 1991, when the operational deficit was at 1.4 percent of *GDP*. Inflation is the mechanism that represses the potential deficit, since the budget calculations assume a lower rate of inflation than the actual rate of inflation. As a result, spending is eroded, while revenues are all indexed. This result implies the existence of an inverse Olivera-Tanzi effect, that is, a negative relationship between inflation and deficits.

Looking at the operational deficit and the GDP deflator evolution in the 1990s there is some evidence of the existence of a negative Olivera-Tanzi effect. A cursory look at the data shows that in the early part of the 1990s the operational deficit was falling while the inflation rate was soaring after the failure of the Collor Plan. The reverse is true after the

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[9] The fact that liabilities from the public banking sector are included, but not the assets muddle the actual meaning of the net public debt. However, it is the sharp increase during the 1990s is indicative of a growing problem. I would like to thank Franklin Serrano for pointing out this problem.

[10] Latin American structuralist developed the notion that fiscal deficits are endogenous in a high inflation environment. For a description of structuralist views on the role of fiscal deficits see Câmara and Vernengo (2001).

Real Plan, when the rates of inflation approached international levels, but the operational deficit increased steadily.

Table 3 Federal Government Spending by Category (%)

Year	Interest on Domestic Debt	Wages and Salaries	Transfers to States and Cities
1991	0.10	32.2	25.2
1992	10.9	32.3	24.0
1993	16.2	29.7	20.4
1994	7.1	38.3	19.3
1995	7.8	39.3	20.3
1996	10.2	37.9	19.7
1997	8.4	35.2	19.3
1998	12.5	31.9	18.2
1999	15.0	30.6	20.4
2000	10.0	22.6	15.6

Source: FGV and IPEA Data

The fact that operational deficits have soared after the Real plan, and continued increasing even after the crisis of January 1999, leads one to suspect that it is the financial component of the deficits that is problematic. One way to evaluate whether the potential deficit hypothesis or the financial hypothesis is the correct one is to look at various federal government spending categories. This would give us a more accurate picture of the composition of government spending. The potential deficit hypothesis implies that after stabilization those spending categories that were repressed would rise. According to this view, federal transfer to States and Cities, and wage and salary expenses would rise, since those categories are seen as being problematic. On the other hand, according to the financial hypothesis the interest payments on debt would increase.

Table 3 reveals that the financial component of the deficit is increasing in the second part of the 1990s. It can be seen that interest payments on debt service rise from 7.1 of total government spending in 1994 to 15 percent of government spending in 1999. In the first

part of the 1990s as a result of the Collor Plan interest payments fluctuated a great deal. On the other hand, wages and salaries expenses have been remarkably constant, while transfers to States and Cities has been falling steadily. The evolution of fiscal policy shows that the conventional view according to which sound fiscal policies and the increased openness promoted by the reforms are the backbone of macroeconomic stability do not seem to have empirical foundation in the case of Brazil (Câmara and Vernengo, 2002). Not only spending in non-financial items was kept under control and tax revenues were increased to the lower range of the OECD countries – that is around 30 per cent of GDP – but also a major civil service reform was put in practice (Bresser Pereira, 1996).[11]

It is correct to argue that reforms were influential in the reversion of capital flows in the 1990s, and capital inflows were crucial for the exchange rate based stabilization program. In that respect it is correct to say that the reforms were instrumental for price stability. However, it is also true that the reforms were only pursued with more fervor after the stabilization program. It was during the first presidential of Fernando Henrique Cardoso, that Gustavo Franco's globalization manifesto was fully acknowledged as the main strategy for development (Franco, 1999).

It also true that the furthering of the reforms and capital inflows in the second half of the 1990s, created several new imbalances. The high rate of interest needed to attract capital flows worsened fiscal deficits, and led to the appreciation of the exchange rate. This in turn has created recurrent problems of balance of payments sustainability. In addition, the combination of current and capital account liberalization has imposed considerable adjustment pressures, in particular on the ability of the government to use both monetary policy and fiscal policy for domestic purposes. The stabilization cum liberalization had severe impacts on the ability to grow without generating unsustainable current account deficits, and lead to increasing unemployment and negative effects on income

[11] It is important to note that civil service reform, while welcome in order to create more rational management of the public goods, generates less disruption when it is implemented in a period of rapid growth. For a discussion of the Brazilian experience see Bresser Pereira (1996).

distribution, as far as wage differentials are concerned (Amadeo, 1996). The following sections deal with those imbalances.

Maladjusted Liberalization

The notion that trade liberalization is an optimal development strategy has become a dominant feature of mainstream economics. In addition the notion that capital openness leads to higher rates of growth is also part of conventional wisdom.[12] Above all, the contrasting experiences of the relatively closed Latin American economies and the relatively open East Asian countries led many authors (e.g. World Bank, 1993; Edwards, 1995) to argue that outward oriented development strategies are more conducive to growth.[13]

However, the literature on the advantages of economic openness is far from being consensual. Measures of openness do not seem to be consistent across studies (Pritchett, 1996). Taylor (1991b, p. 100) argues that structuralists models of both commodity and capital flows suggest that openness or a hands-off policy in either market will not necessarily lead to faster growth or less costly adjustment to external shocks." Further, Rodriguez and Rodrik (1999) find little evidence that open trade policies are significantly associated with higher growth. In their recent study on the effects of the structural adjustment reforms in Latin America, Stallings and Peres (2000), find that capital and current account liberalization had a significant but small effect on growth in the Latin American case, but the results are highly dependent on periodization, which compares the 1990s with the 1980s, which can hardly be considered the blueprint for the ISI period.

[12] The IMF is less sure about the idea that there is a positive correlation between capital account liberalization and growth. See Prasad *et alli* (2003).

[13] In general the terms outward orientation and openness are used without distinction. One must note, however, that openness refers to absence of restrictions to trade and capital flows, whereas outward orientation means emphasizing the role of foreign markets as an outlet for domestic production.

At a first glance, the Brazilian experience lends little support for the notion that there is a positive correlation between openness and growth. If one classifies the 1948 to 1980 period as inward oriented, the 1981 to 1989 as the crisis or transition period, and the 1990s as outward oriented, then one must conclude that import substitution was quite successful (see table 1).[14] In the case of Brazil at least, it is difficult to agree with Edwards (1995, p. 41) view according to which "the ever-growing presence of the state in the 1950-80 period eventually stifled efficiency and growth."

According to the conventional view, the protectionist policies that dominated the agenda in Latin American economies generated an anti-export bias that discouraged both the growth and diversification of exports. Two channels were responsible for the relatively poor export performance. First, tariffs and quotas increased the cost of imported intermediate and capital goods used to produce exportable goods. Second, protectionist policies were in general complemented by overvalued real exchange rates that reduced the competitiveness of exports.

In the case of Brazil it is clear that at least from the late 1960s onwards there has been a concern with maintaining a relative competitive exchange rate regime in order to promote exports.[15] In fact, it appears that it was during the liberalization period that the anti-export bias of the Brazilian economy actually developed. Table 4 shows the evolution of the rates of growth of export and import volumes from the 1970s onwards. It is clear that in the 1990s there is an explosion in the rate of growth of volume of imports. The rate of growth of the volume of exports, on the other hand, is lower on average in the 1990s than

[14] Rodrik (1999, p. 71) argues along similar liens. For him "contrary to received wisdom, ISI-driven growth did not produce tremendous inefficiencies on an economy wide scale. The inescapable conclusion is that most countries in Latin America and the Middle East had productivity growth records prior to 1973 that look quite favorable in comparison with those in East Asia." This result stands by itself, and does not depend on Rodrik's view on the importance of the domestic institutions of conflict management.

[15] From 1967 onwards, Brazil promoted a reduction in tariffs and crawling peg system that maintained the exchange rate relatively depreciated. This liberalizing experience was partially successful in increasing the levels of manufacturing exports.

in the 1980s. That is, in the 1980s the rate of growth of exports averaged 11.5 percent, whereas in the relatively more open 1990s the rate of growth of exports was 5.6 percent.

The increase in import penetration, in conjunction with the sluggish rate of growth of exports, in the context of a relatively open economy, spells trouble for the sustainability of the current account. Furthermore, the exchange rate stabilization plan, which meant appreciated and relatively fixed exchange rates, implies that lower rates of growth are the only instrument to maintain the current account under control. These lower rates of output growth explain the fall in the rate of growth of imports.

Table 4 Exports and Imports (% Growth)

	Exports	Imports
1970-1980	15.5	–2.1
1981-1989	11.5	–1.4
1990-2002	5.6	13.2

Source: IPEA Data

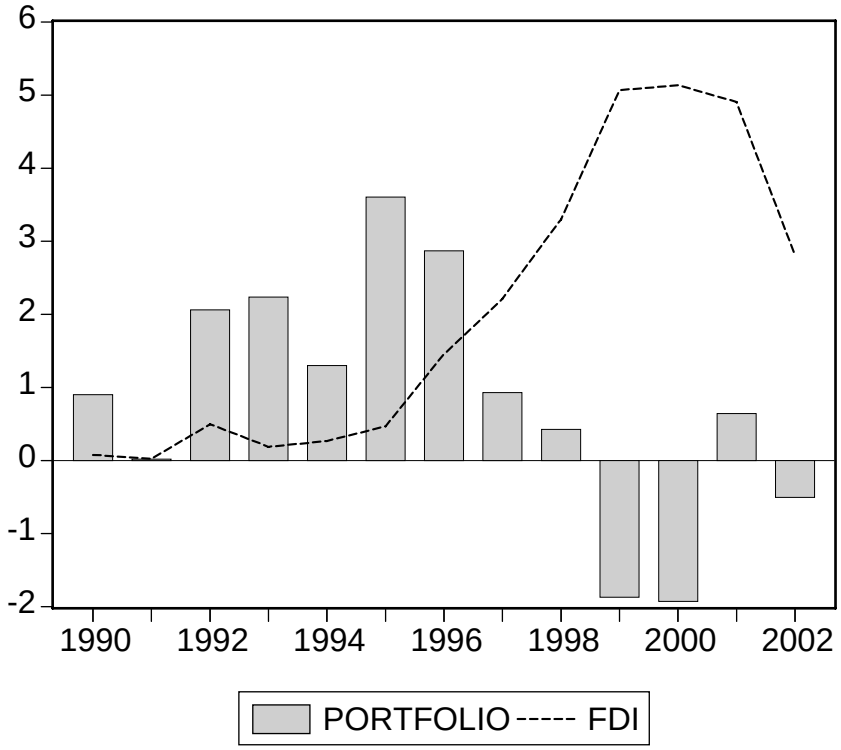
The impossibility of maintaining a depreciated currency in an economy that is more open to capital flow movements, may very well imply that the economy will be trapped in stop-go cycles. That is, relatively low levels of growth continue to be instrumental in the achievement of a sustainable trade account deficit.

Yet one suspects that the defenders of the liberalization process expected the rise in the income elasticity of imports. In their view the structural change promoted by a higher degree of openness would have certain costs, but those costs would be overweighed by the benefits. Furthermore, trade liberalization, represented by the reduction of tariffs and the elimination of non-tariff barriers would have to be complemented with the opening of the capital account. This was done in 1991 when the participation of non-residents in domestic financial markets was regulated by law (Annex IV, Resolution 1289/87).[16]

[16] It must be noted that Brazil maintained during most of the 1990s a tax on financial operation levied on capital flows. However, the motivation was less to put sand in the wheels of the international financial system than obtaining fiscal revenues.

The benefits from capital account opening depended on two events, according to conventional wisdom. First, capital account opening would lead to an inflow of long-term inflows of Foreign Direct Investment (*FDI*) rather than short-term volatile portfolio flows. Second, it was argued that the inflows of *FDI* would have a positive impact on productivity, and hence on growth and export performance, allowing the economy to grow faster without incurring in balance of payments problems.

FIGURE 3 Capital Flows (%GDP)



Source: IPEA Data

The first bet, that is, the increase in *FDI* flows relative to portfolio flows was confirmed, at least since 1995, as it can be seen in figure 3, in which both flows are measured as proportion to *GDP*. The second point regarding the positive effects of *FDI* on growth is more controversial and difficult to ascertain.

Arguably, only greenfield *FDI* would have a positive effect on domestic investment and growth, since it will not compete directly with already established firms in the host country. On the other hand mergers and acquisitions (M & A) or brownfield *FDI* inflows would have a negative effect on domestic investment.

Laplane and Sarti (1997) show that around 30 percent of all FDI inflows go to the privatization process, 20 percent corresponds to M & A and the rest goes to the modernization of already established multinational firms, or new multinational firms. That is, around half of FDI inflows imply only a change in the ownership. Arguably, this change in ownership might lead to an improvement in management and an eventual increase in productivity. Moreira (1999, p. 343) argues that foreign ownership (defined as foreign ownership of the majority of the voting capital) has a positive effect on labor productivity.

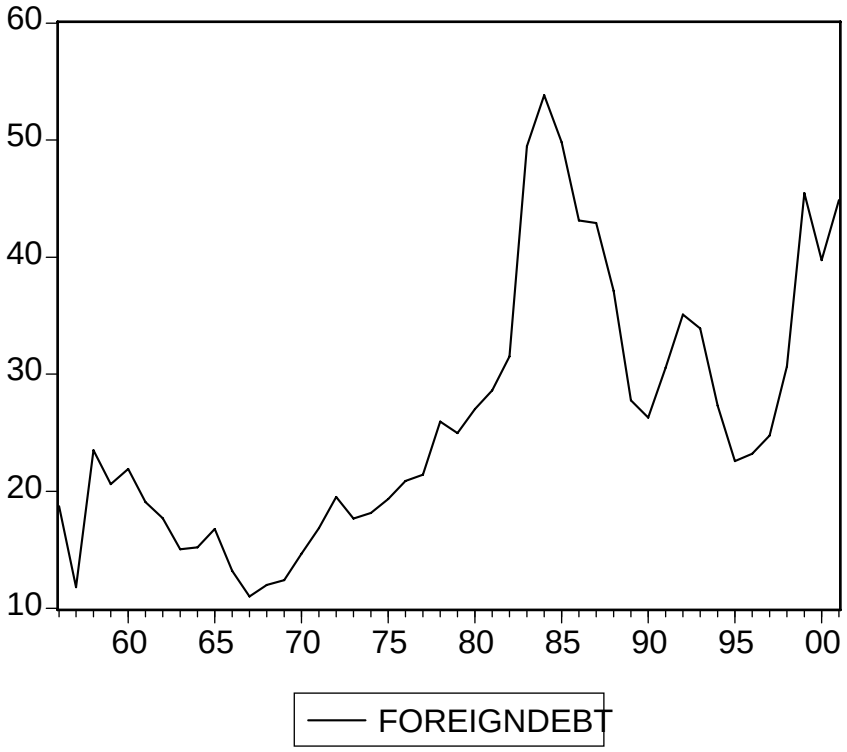
However, even if that is the case it is still true that the expected boom in exports did not occur. This seems to indicate that, although positive, the effects of *FDI* have been negligible. Domestic investment did not recover to the levels of the 1970s, mainly because output growth, or capacity utilization, did not recover either. In addition, the main reason for lower rates of growth in the second part of the 1990s has been associated to the need to maintain the balance of trade under control. Yet, the combination of current account liberalization with an exchange rate based stabilization program and the consequent appreciation of the domestic currency led to a perverse structural change and the persistence of relatively high trade deficits during the second half of the 1990s.

As it is well known, current account deficits imply the need to attract capital flows to finance the deficit. In other words the deficit country becomes a debtor. The foreign debt to GDP started growing after the Real Plan and reached in 2001 44 percent, which corresponds to the level of the debt crisis (see figure 4). Figure 4 also shows that it is only in the 1970s – when the import substitution was complete for the most part – that the foreign debt to GDP ratio explodes. The second explosive growth of the foreign debt occurred exactly after the liberalization process.

Two important conclusions may be derived from the Brazilian experience that shed light on the growth and openness debate. On the one hand, it is clear that a relatively depreciated – more depreciated than before the reforms – currency is essential to

maintain growth and a balanced current account. The main consequence of the need for a depreciated currency is a rate of inflation higher than the rest of the world. In fact, in 2000 the Consumer Price Index (FGV) was 6 per cent, and the GDP deflator (IBGE) was 7.4 per cent. This will pose difficulties to the Central Bank that is adopting a strategy of inflation targeting (Bogdanski, Tombini, and Werlang, 2000). In fact, the accumulated inflation in the first quarter of 2001 already encompasses half of the total target for the year. On the other hand, the Brazilian experience is peculiar, since depreciation did not lead to a considerable contraction as in most developing countries. In general, depreciation leads to a contractionary adjustment if the economy has a trade deficit or if it redistributes income to capitalists (Krugman and Taylor, 1978). All in all the effects of openness have been lower rates of growth, and persistent current account deficits.

FIGURE 4 Foreign Debt (%GDP)



Source: IPEA Data

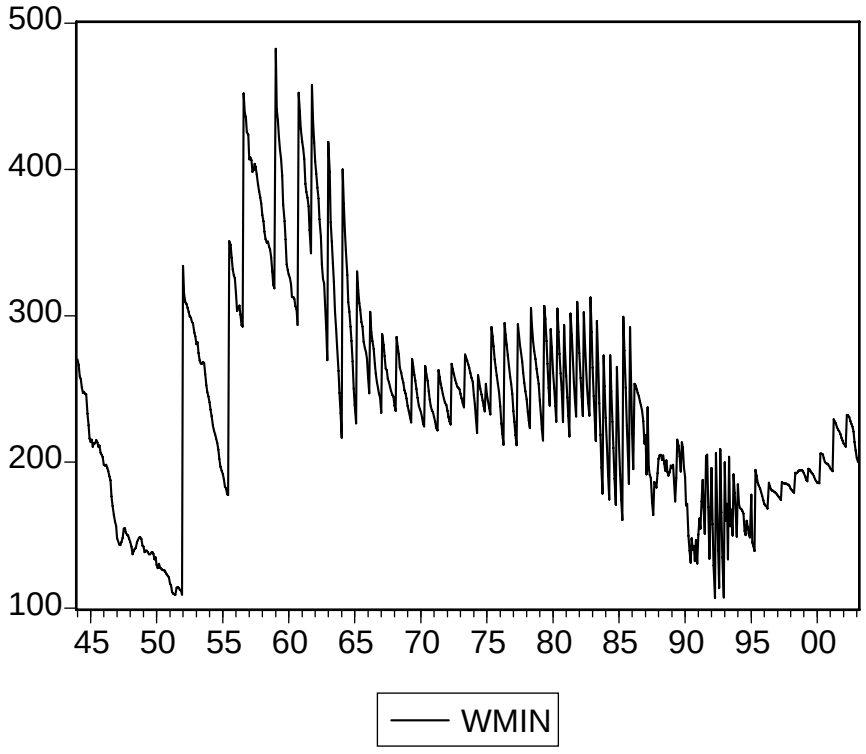
In sum, both the persistent current account deficits, and the supply side constraints associated with the lack of investment in infrastructure during the last decade imply that the economy is stuck in a low-level equilibrium trap. This poor macroeconomic

performance had, as one would expect, negative impact on the labor market performance, as we discuss in the following section.

The Social Effects of the Reforms[17]

It is important to notice when discussing the effects of liberalization and stabilization on the labor market that most economists tend to agree that the elimination of the inflation tax and the redistribution towards wages would cause demand pressures to build up. In the absence of a negotiable social pact, contractionary demand policies were then seen as the only alternative. In other words, in a wage-led economy, if stability leads to higher wages, then contractionary fiscal and monetary policies are advisable.

FIGURE 5 Minimum Wage



Source: IPEA Data

Yet, when we look at the long-term evolution of the real minimum wage (figure 5) we find out that real wages are lower in the 1990s than in the high inflation period of the

[17] This section is based on Vernengo (2002).

1980s. Further real wages were higher in the import substitution period. Hence, real wages were compressed both in the period of inflation acceleration and in the stabilization phase. There is no clear relation between increasing real wages and higher inflation, although there is a clear relation between higher real wages and higher growth of real output in the import substitution period.[18]

In addition to the poor performance of wage remuneration, it must be noted that open unemployment increased more than 80 percent from 1995 to 1999 from 4.6 to 8.4 percent, and remains at high levels (Table 5). Furthermore, when we look at the data on hidden or disguised unemployment for the metropolitan region of São Paulo we find a similar pattern, with rates of unemployment soaring in the second part of the decade.[19]

The higher rates of unemployment reflect the relatively poor performance of the economy in the post-Asian crisis period. However, it is important to notice that the increase in unemployment cannot be completely blamed on cyclical or short run factors. In the first half of the 1990s unemployment was on average lower, despite the negative effects of the recession of 1990. One possible explanation is that in the post-stabilization period the intensification of the liberalization process led to higher rates of structural or long-term unemployment. If this is the case, the recovery from the 1999 crisis will not be sufficient to reduce unemployment to pre-reform levels. It seems that in the second part of the decade the economy has accommodated to a situation with higher rates of unemployment.

Also, it is important to notice that the process of liberalization was marked by another clear trend in the labor market, namely: an increase in the degree of informality of labor

[18] The rate of inflation is clearly related to the readjustment period of the minimum wage as described by the inertialist theories of inflation (Taylor, 1991a).

[19] Open unemployment is defined as those that were unable to find a job in the last week. Hidden unemployment is defined to include workers that have an irregular and discontinuous job, and those that are discouraged and dropped out of the labor force. It must be noted that total unemployment in table 5 is the sum of hidden unemployment and open unemployment in the metropolitan region of São Paulo, which is not shown in the table.

relations. According to Amadeo and Pero (2000, p. 127) the reduction in the share of formal wage earners is associated with the downsizing strategies pursued in the industrial sector after the liberalization process.

Table 5 Unemployment

Year	Open Unemployment[a]	Hidden Unemployment[b]	Total Unemployment[b]
1990	4.3	2.9	10.3
1991	4.5	3.1	10.9
1992	5.8	6.0	15.2
1993	5.3	6.0	14.6
1994	5.5	5.3	14.2
1995	4.6	4.2	13.2
1996	5.4	5.1	15.1
1997	5.7	5.7	16.0
1998	8.1	6.5	18.2
1999	8.4	7.2	19.3
2000	7.8	6.6	17.6
2001	6.2	6.4	17.6
2002	7.3	6.8	19.0

Source IBGE and DIEESE
[a] Data for the six metropolitan regions of Recife, Salvador, Rio de Janeiro, Belo Horizonte, São Paulo e Porto Alegre
[b] Data for the metropolitan region of São Paulo

In sum, the process of liberalization led to a marked decrease of industrial employment, and a shift to the service sector. Also, the increase in informality signals the deterioration of employment conditions. In particular, increasing informality has led some authors to conclude that institutional reforms are needed in order to improve the quality of the jobs created. In this view, the costs imposed by the payment of benefits on formal contracts are too high and force many firms into hiring in the informal market. Pochmann (1998, p. 171) estimates that benefits add from 25 to 30 percent on the costs of manufacturing employment, a range that is within the international standards, and that cannot justify the

massive increase in informality. Hence, the main reason for the increase in precarious jobs is the lack of good jobs, and this in turn is partially explained by the process of liberalization.

In addition, the effects of the stabilization plan and the reforms on labor markets had repercussions on income distribution. In fact, several government officials considered the improvement in income distribution caused by the reduction of the inflation tax to be one of the most important features of stabilization program (Franco, 1999).

In fact, looking at the Gini or Theil T coefficients in the post-stabilization period one can notice a slight improvement with respect to the pre-stabilization period (see table 6). Interestingly enough this trend precedes the Real Plan and dates from the early 1990s, which may indicate that the plan has not contributed significantly for the improvement of income distribution as measured by the Gini coefficient. On the other hand, some authors associate the reduction of almost 25 percent in poverty rates to the stabilization plan (Amadeo and Neri, 1999).

Table 6 Income Distribution and Poverty

	1990	1993	1995	1996	1997	1998	1999
Gini	0.62[a]	0.58	0.57	0.57	0.57	0.56	0.58
Theil T	0.78	0.77	0.73	0.73	0.74	0.74	0.72
Poverty	44.2	44.1	33.2	34.1	34.1	33.4	34.9

Source: IBGE
[a] Figure for 1989

Two factors must be emphasized about the evolution of income distribution in the last decade. First, the improvement in income distribution as measured by Gini and Theil coefficients was relatively small and short lived, since progress in the base of the distribution is insufficient to improve the Gini coefficient, which is driven by the behavior of the middle quintiles (Rocha, 2000, p. 3). Second, it is not clear that income

distribution did in fact improve during the 1990s, when we look at alternative measures.[20] For instance, the share of wages in total income was 51.4 percent approximately in 1993 and only 40.7 percent in 1999. The flip side of the reduction in the participation of wages is the increase in the net operational surplus (interest, profits, rents, etc) from 35.4 to almost 46 percent in the same period.

The reduction in the participation of wages in total income indicates that the process of liberalization and the increase in unemployment reduced dramatically the bargaining power of workers. Furthermore, the maintenance of high rates of interest as part of the exchange rate based stabilization program allowed an increase in the remuneration of capital, despite the increasing competition from abroad. These results show a considerable worsening in income distribution, in contrast with the picture presented by the Gini coefficient. Part of the explanation for this apparent ambiguity is that both the Gini and the Theil indexes are calculated on the basis of wage income. Hence, the relative small reduction in inequality in the 1990s reflects a reduction in overall wage inequality, while the participation of wages in total income has been compressed. Also, it must be emphasized, real wages are in the 1990s lower than in the 1980s and that in the import substitution period.

A second type of question not directly connected to the discussion of whether the Real Plan improved income distribution is about the relation between income distribution and poverty. The effects of reduced inequality, as measured by the Gini coefficient, have had negligible effects on poverty reduction. In fact, Rocha (2000, p. 6) shows that poverty also fell considerably after the short-lived period of stability during the Cruzado Plan in the mid-1980s, a period in which income distribution was deteriorating. One may conclude that price stability was the main explanatory variable in poverty reduction.

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[20] Barros and Corseuil (2001, p. 288) additionally argue that trade liberalization had a smaller impact than the capital account liberalization on income inequality. Their conclusion that the continuity of the external liberalization would not create greater benefits or costs for social welfare, however, is more difficult to support. In particular given the dismal performance in terms of job creation. Unless one believes that unemployment does not hurt social welfare.

Poverty rates, however, have been falling since the 1970s, according to Rocha (2000). Hence, other sources than price stability are also important for poverty reduction.

Amadeo and Neri (1999) argue that the increases in the minimum wage in the post-stabilization period, that is, after 1994, were sufficient to reduce poverty in the urban areas substantially. That is, the increase of the minimum wage in an environment of price stability proved to be an important factor in the reduction of poverty. The argument, however, is not completely convincing when looked in a long time perspective, since real minimum wages were constant in the 1970s and falling in the 1980s while poverty was falling all through the period. Hence, higher real minimum wage is only part of the explanation.

The question remains then, what is the main force behind poverty reduction. Output growth is the obvious candidate, but it cannot explain all poverty reduction, since poverty also fell in the first part of the 1980s, a period in which the economy stagnated as a result of the debt crisis. In retrospective the most likely explanation is that the reduction of poverty was a consequence of the process of industrialization, and the consequent migration from rural to urban areas.[21] All in all, cities provide greater access to electricity, treated water, medical care and public schools.

Finally, it has become common sense to argue that despite the external fragility and unemployment the social agenda advanced during the reform years. The main problem was not associated to low levels of social spending, but to the proper management of public funds in the social sphere (Schwartzman, 2000). Several social indicators, such as life expectancy, illiteracy, infant mortality and fertility rates did improve in the 1990s implicating to some that criticism of the reforms might have been exaggerated.

[21] The problem of rural poverty was associated to uneven regional development. Furtado (1958) describes the problems created by the decay of the export oriented plantation system, and the development of a subsistence system in the Brazilian northeast.

Table 7 Social Indicators

Year	Life Expectancy	Illiteracy Rate	Infant Mortality	Fertility Rate
1940	43	56	158	6.1
1950	46	50	138	6.2
1960	52	40	118	6.3
1970	54	30	117	5.5
1980	60	25	88	4.4
1990	65	19	50	2.7
1996	67	17	41	2.1
1998	68	14	36	NA

Source: IBGE

However, if one looks at table 7 it is evident that all those social indicators were improving before the reforms, going back at least to the 1940s. This seems to indicate that the market friendly reforms had a limited, if any, role in the improvement of social conditions. The real cause, as much as in the case of poverty reduction, seems to be the process of urbanization, and the benefits associated to urban dwelling. The implication is that alternative macroeconomic policies, which put a lesser burden on social spending, might in fact accelerate social progress, which is still sorely needed in the Brazilian case. The last section discussed some of the dilemmas faced by the recently elected administration, in light of the received inheritance.

Is There a Progressive Alternative

The relatively poor performance in terms of growth rates, unemployment, and income distribution begs the question of why the government pursued the current strategy. The consensus around the current strategy has foreign and domestic sources. In the foreign front, the recurring balance of payments problems that were intensified with the development of the Euro-dollar market and the oil and interest rate shocks of the 1970s led to an increasing consensus that outward oriented strategies were the only solution. In

fact, the US used the debt crisis of the early 1980s to impose liberalization as part of the conditionality agreements to re-schedule the debts of developing countries.

Also, mainstream defenders of outward orientation tended to argue that export-led growth was behind the successful experience of the Asian countries. Export-led growth was equaled with more integrated to the world economy and a laissez faire approach to trade policy, which would lead to a better allocation of resources and higher rates of growth.[22] This argument would reach its high point with World Bank (1993) East Asian Report, according to which East Asian economies implemented market-friendly policies. Several authors have shown the limitations of the World Bank position.

On the domestic front, the incapacity to tame the inflationary pressures during the 1980s, and the failure of the heterodox plans led to the notion that only orthodox stabilization strategies would work. Thus, fiscal conservatism has complemented the notion of outward orientation as part of the lessons of the lost decade.

With respect to outward orientation, despite the strong export-orientation, the East Asian economies were not fully integrated with the world economy. Import substitution was an integral part of the East Asian strategy in the 50s and 60s. The equalization of export orientation with free trade is also misleading. At least in the Korean case, the State intervened heavily in the economy. Besides, the East Asian financial markets were relatively closed, when compared to other underdeveloped regions such as Latin America.

The difference between East Asian and Latin American economies is of particular interest, since the former are normally associated with export-led growth strategies, while the latter are connected with inward oriented strategies. While it is true that the East Asian economies trade regime was more open that that of Latin America, the opposite is

[22] Some mainstream authors have toned down this view. Rodrik (1999, p. 1) admits, "the relationship between growth rates and indicators of openness … is weak at best."

true when one looks at the financial regime.[23] Capital inflows and outflows were much more heavily regulated in Asian economies until the 1990s at least. This is the basic cause of the greater resistance to financial crises that Asian economies displayed until the late 1990s, when the financial liberalization was well underway.

One possible implication of the above discussed is that the nature of the financial regime rather than the trade regime is more relevant to understand the perils of development. In other words, it is not the difference between inward and outward looking development strategies that matters, but the difference between closed and open financial regimes. Opening the capital account is supposed to bring financial inflows that would stimulate investment and productivity growth. This part of the liberal credo remains wishful thinking in the case of Brazil. Contrariwise liberalization has led to the need for maintaining low rates of growth to maintain, or at least try to maintain, the current account under control. One of the consequences of low rates of growth was the increase in unemployment rates since 1997.

Additionally, in Brazil rising capital inflows following liberalization led to real exchange rate appreciation, which in turn is linked to high real interest rates, which add to production costs, and to the financial costs of the public debt.

Policy alternatives in an increasingly interdependent world are difficult to implement. It is true that the current account liberalization process has been consolidated in a series of multilateral and bilateral trade agreements, in particular the Mercosul, in accordance with the World Trade Organization (WTO). Thus, the scope for changes in trade policies, even when desirable, is limited.

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[23] Arguably, some Asian countries did open their capital accounts as early as Latin America. Indonesia, Malaysia and Thailand will be the cases in point. However, as Jomo et al. (1997) show the second tier tigers were less successful than the more financially closed among the first tier tigers (South Korea and Taiwan Province of China).

Capital account liberalization has been less widespread, as the cases of Chile, China, India and Malaysia demonstrate, and the sequence of international financial crises has made the imposition of capital controls less controversial. In our view, the main advantage of a relatively more closed financial regime would be the ability to control interest rates for domestic purposes.

Lower interest rates would reduce the financial components of fiscal deficits and would free resources for social policies. A reduction in the participation of interest, profits and rents in total income and the increase in the participation of wages may lead to an increase in effective demand and higher rates of growth and employment. Furthermore, higher rates of growth tend to stimulate productivity growth leading to virtuous circles of cumulative growth. Whether the recently elected Worker's party will be able and willing to move in that direction is something to be seen.

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