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Brazil's Quasi-Stagnation and the Growth *cum* Foreign Savings Strategy

Foreign finance would be the cause of crises rather than of growth if financial resources lent to a country are eventually used for consumption instead of investment. An overvalued currency, which usually goes along with capital inflows, will artificially raise salaries and fuel consumption. The latter will not be true, however, if the borrowing country, in addition to not being already heavily indebted, offers to foreigners and, principally, to nationals, investment opportunities with an expected profit rate substantially higher than the interest rate. Yet, in the 1990s, in the eve of a new cycle of capital inflows to developing countries, a growth strategy based on “growth with foreign savings” was offered to all developing countries. While most highly indebted developing countries, primarily the Latin American ones, accepted this strategy, the nonindebted Asian countries rejected such a strategy.

For contemporary Latin American economists, the critique of this strategy (or theory), asserting that “the capital-poor countries should benefit from the capital transfers of the capital-rich countries in order to grow,” is as important as was the critique of the theory

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of comparative advantage in the late 1940s. At that time, those countries depended on the critique in order to support their successful import substitution industrialization strategy. While, presently, when most of them are industrialized and face a competitive global economic system, they need a critique of the growth *cum* foreign savings theory to be protected from capital flows that, in the 1970s and again in the 1990s, disrupted their economies and kept them stagnant. In the 1990s, the extreme case of adoption of this approach was Argentina. In this paper, I will discuss the case of Brazil.¹

Since 1980, the Brazilian economy has faced 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 to 1994, because extremely high inflation persisted, and there was limited economic growth.² Yet, during the 13 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 public debt and the nation's foreign debt had been reasonably reduced. The public debt fell from a peak of 169.5 percent of the gross domestic product (GDP) in 1989, to 43.8 percent of GDP in 1994; the foreign debt fell from a peak of 3.9 times exports in 1990, to 3.4 times 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 for the nation seemed to be excellent. Yet, ten years later, the economy remains semistagnant, with a yearly per capita growth rate of only 0.69 percent, while the two macroeconomic balances—the budget and the current account balances—have been destabilized. Despite economic policy that 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 resulted from policy mistakes, to be discussed in this paper, and, more precisely, from the inconsistency of such policies not only in achieving growth but also in attaining fiscal and foreign account macroeconomic equilibrium.

Despite these two balance-of-payment crises, which 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 administration of Fernando Henrique Cardoso (1995–2002) and the administration of Luis Inácio (Lula) da Silva (starting in 2003) counted on the support of the official community in Washington and of the financial community in New York, insofar as the Brazilian economic authorities followed closely the conventional orthodoxy shared by those two communities. By “conventional orthodoxy” is meant the collection of economic beliefs based on neoclassical economics, to which have subscribed the Washington policymakers in the Treasury, in the International Monetary Fund (IMF), and in the World Bank, and the New York financial economists.⁵ The specific form assumed by this orthodoxy in the 1990s will be dubbed the “Second Washington Consensus.”

Although the Lula administration, which took office at the beginning of 2003, won the elections principally by criticizing the economic policies and the economic outcomes of the previous administration, economic policy remains unchanged. The new economic authorities explained this decision in order to cause a “credibility shock,” thereby recovering international credit and trust. This assertion suggested that the compliance would be transitory; but, after sixteen months in office (at the time of writing), no change has been undertaken. Washington, New York, and the local financial system were pleased, credit was recovered, and the country risk declined. Yet, at present, economic growth has not resumed, and Washington and New York have been giving increasing signals of impatience.

Brazil’s bad economic outcomes since 1995 may be attributed to three kinds of interrelated factors: (1) an agenda mistake: inflation instead of the balance of payments equilibrium as the

major problem that the government should address from 1995 onwards; (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. The assertion of Brazil as an autonomous nation, which had progressed between 1930 and 1980, underwent a serious fallback since the early 1990s, as the country again started to accept, without the required critique, 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 merely 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. On July 1, 1994, high and inertial inflation ended in Brazil, after the three months in which the URV (indexed accounting money) neutralized inflationary inertia. On 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 headed toward a serious balance-of-payments disequilibrium that 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 was 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 imbalance, while the low, overvalued

exchange rate reestablished the foreign accounts imbalance. In the name of fighting inflation, and in accordance with the tenet that the country should not control capital inflows and the exchange rate but grow with foreign savings, Brazil did not achieve a competitive exchange rate that would be 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

The definition of high inflation as the main enemy to combat 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 maintain this anchor in the following years. Conventional economists never understood inertial inflation. It is surprising that the same economists, who 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 that exposed domestic prices to foreign competition. This and the de-indexation of the economy were the two major guarantees that high inflation would not return. 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 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 of 1999, after foreign creditors had fully suspended the rollover of the Brazilian foreign debt, President Cardoso decided

to let the exchange rate float. The decision proved to be wise.⁸ After a necessary rise in the interest rate, the 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 United States, to the coarsening Argentinean crisis, and especially to the moderate exchange rate depreciation that had started. The Central Bank increased the basic interest rate, despite the fact that it was around 9 percent in real terms and despite the fact that the rise in inflation was a consequence of the domestic currency depreciation, not of excess aggregate demand. The Central Bank additionally sold US\$8 billion in the domestic market and converted US\$20 billion government bonds into dollar-indexed bonds. Because of 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 at the beginning of the year (R\$1.95 a year before) to R\$2.80 per dollar in April. This “successful monetary policy” prevented a small and temporary rise in the inflation rate, but its medium-run costs were high. As the expected growth of exports did not materialize, in the following year, a new balance-of-payments crisis arose. As a consequence of this latter crisis, the exchange rate soared again, overshooting to almost R\$4.00 per dollar.

Why this new balance-of-payments crisis? Some tried to explain this by Lula’s rise in the election polls in mid-2002. The Workers Party candidate, however, insistently reassured investors that, if elected, he would respect property rights and contracts. The exact cause is to be found elsewhere, particularly in the country’s international financial fragility, whereby a misguided policy mix in 2001 left Brazil once again exposed to international analysts. When the economic crisis severely hit Argentina in that year,

analysts correctly remarked that Brazil had delinked itself from Argentina'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. Argentina's big mistake, at that moment, was not to have followed its neighbor. But that delinkage from Argentina was limited, because 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 slide in 2001), international banks recalled the losses that they had incurred with Argentina and, at the earliest opportunity, began their speculative attack on the real. Despite conventional orthodoxy that concentrated its attention on the primary surplus and on the public debt, it was again the foreign debt and the current account deficit that caused the crisis. The IMF's prompt response helped prevent the worst, but it 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 are becoming 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 U.S. Treasury—default becomes unavoidable.⁹

The Second Washington Consensus

Why did the Brazilian authorities adopt an incorrect agenda and let the local currency appreciate until 2002? This mistake may be attributed to technical and emotional incompetence or perhaps to an exaggerated fear of inflation after the high and inertial inflation experienced between 1980 and 1994. These explanations are partially legitimate, but I will present here a more specific one. Brazil

fell victim to the form that the conventional orthodoxy coming from Washington and New York assumed since the end of the debt crisis—a form dubbed the Second Washington Consensus. According to this new 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 that summarized the American policy in relation to the highly indebted countries since the 1982 debt crisis. Thus, it is a 1980s’ consensus. As expressed by John Williamson, in a 1990 paper, the first consensus consisted of a series of principles advocating structural adjustment and market-oriented reforms.¹¹ It became a symbol of the neoliberal policy of those years, although it did not necessarily propose ultraliberal reforms aimed at reducing the state to a minimum, and, what is more important, it did not include financial opening, which Williamson expressly excluded.¹² Also, the Second Washington Consensus should not be confused with 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 Kuczynski and Williamson (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 wave of capital inflow transformed developing countries into “emerging markets.” It is not primarily concerned with stabilization, but with growth. For the fulfillment of such an 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 that would finance its economic growth. In other words, instead of the growth *cum* debt approach of the 1970s, the emerging markets would benefit from a growth *cum* foreign savings strategy.

A wide-ranging debate appeared in the 1990s among economists

of developed countries on the subject of financial opening and capital flows, some of them critics of liberalization and others, enthusiasts. The latter, starting from the neoclassical 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 by Rodrik (1998: 61), showing that there was no evidence that countries without capital controls grow faster than the rest. 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. The former was focused primarily 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 capital. On the contrary, a central concern for many developing countries is to curb excess capital inflows.

In this paper, I wish to argue 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 that should not be minimized, particularly when the country surpasses the foreign debt threshold. Consequently, one must criticize the 1990s' conventional orthodoxy for being inconsistent with macroeconomic stability, because it underestimates the importance of the foreign imbalances and is concerned only with domestic fiscal problems. Additionally, it underlines the fact that capital inflows tend to dangerously appreciate domestic currencies; and, as a result, besides causing balance-of-payments disequilibria, 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 ideological and ill-considered character of the advice whereby developing countries should fully open their capital accounts. Insofar as they must keep control not only of their external balances but also of their savings rates, they must have the possibility of imposing controls on excessive capital inflows.

The growth strategy embedded in the Second Washington Consensus has a simple and clear statement that 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 openness, 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 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 may not 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 openness”) is the most reasonable of the four terms, except for the financial openness. 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 with 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 openness”) 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 carried out during the 1980s and early 1990s. Moreover, there lies the origin of the balance-of-payment crises that had Argentina as its limit case; 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, to which I shall return.

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 for the country if, as it may well happen, the inflowing capital eventually turns into consumption due to the lack of investment opportunities. Different than what happens in developing countries, direct investment in rich countries is not received to finance current account deficits but is 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, one may naively ask, how can foreign investments be transformed into consumption if, in accounting terms, we know that savings are equal to investment? Would foreign savings not finance only investment? The answer is simple: foreign savings

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

Under what conditions will foreign savings, either in the form of loans or direct investment, finance accumulation, not consumption? When the current account deficit (or the foreign savings) is in the form of direct investments, we undoubtedly have a more favorable perspective, but the final outcome will depend on how the new money will eventually be used in 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 just increase the country's debt—not the financial foreign debt, but the patrimonial foreign debt, served by remittances of dividends instead of interest.

Insofar as the growth *cum* foreign savings strategy 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 countries belonging to the Organization for Economic Cooperation and Development (OECD), 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 percent of domestic capital accumulation is financed by domestic savings. At first, neoclassical economists, being attached to their beliefs in free markets and the benefits of capital mobility, defined the outcome as a puzzle: the “Feldstein–Horioka puzzle.” Further studies, however, have demonstrated that, far from being a puzzle, it was a simple problem of solvency

constraint facing each country. That is to say, OECD countries are not willing to go into debt to invest or become moderately indebted. Investments are, therefore, essentially financed by national savings.¹⁶

Conditions

Why has 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, under which conditions would foreign savings help instead of hinder economic growth? The reasons were suggested earlier, but they require further analysis. First, the solvency constraint matters: there is a limit to a country's indebtedness. From a certain threshold onwards, it becomes increasingly dangerous to expand one's foreign indebtedness, primarily on the financial angle (but also on the equity side). In the 1970s, Mario Henrique Simonsen used to say that the foreign debt/export ratio should not exceed 2.¹⁷ Recent research, however, demonstrates that Simonsen's rule of thumb was not severe enough. Although it is impossible to define this debt threshold accurately, empirical research confirms that there is a limit beyond which foreign debt becomes problematic for the country. The World Bank, as an interested creditor, defined such a threshold level in terms of the debt/export ratio as being 2.2, and in terms of the debt/GDP ratio as 80 percent. Most debt crisis episodes took place when foreign debt ratios exceeded one of those two thresholds. In the case of Brazil, which is a relatively closed country (its export/GDP ratio is still around 10 percent), the foreign debt/exports ratio is clearly the critical one. However, Cohen (1994) was stricter. According to him, when the indebtedness rate is above 2 or the ratio of foreign debt/GDP is above 50 percent, the probability of debt restructuring becomes high, and the negative effect on growth becomes significant. A recent study by IMF economists demonstrates that when the debt/export ratio rises above 1.6–1.7 and from 35–40 percent of GDP, "the average impact of 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 two 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, however, foreign savings will involve appreciation of the local currency, because the market equilibrium exchange rate is lower than the equilibrium exchange rate that would prevail with a zero current account deficit. Insofar as the appreciation materializes, this fact will bring about two major negative consequences: on the one hand, it causes balance-of-payment 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 bring the country to the indebtedness threshold, then the growth *cum* foreign savings strategy has 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. Insofar as the domestic currency evaluates, real wages go up. The evaluation is nothing more than a change in relative prices in favor of nontradables, and the labor force is the key nontradable. 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/export indebtedness ratio 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 sizable part of the indebtedness that took place during the decade was 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 fell to approximately 3. In his writings, Kalecki teaches that consumption is a function of real wages: when real wages increase, consumption 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 to the process of development, 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

Table 1
Real GDP Growth in Brazil (at annual rates)

	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.

that policy makers make of the exchange rate, keeping it relatively depreciated. On the other hand, Keynes teaches that the savings rate is just a relative upper limit, because whenever there is idle capacity (and unemployment), investments determine savings rather than vice versa. Because we are discussing foreign savings as a means to finance investment, it follows that the reduction in domestic savings caused by the domestic currency evaluation compensates partially, if not fully, the increase in foreign savings that caused the devaluation.

In what circumstance does the increase in foreign savings not have as trade-off the reduction of domestic savings? There is no trade-off 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 externalities, and causing the expected profit rate to go up. In this latter circumstance, which characterized the growth of the United States in the nineteenth century, or the growth of Brazil in the early and mid-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. Unfortunately, none of these conditions prevailed in Brazil.

Insofar 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 enough, additional foreign investments create the classic

Table 2
Some Relevant Variables as % of GNP

	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

Note: 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 measure, because for a country highly indebted, the difference between GNP and GDP (net income sent abroad, or net interests + net dividends) is sizable and economically relevant.

conditions that Ronsenstein-Rodan (1943) defined as the big push, whereby 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 neither grows nor increases its ability to remunerate the invested foreign capital.

In the case of Brazil, direct foreign investments summed up to nearly US\$2 billion per year at the beginning of the 1990s. After the Real Plan, this figure increased tenfold. However, that 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 for by domestic dis-saving, as the exchange rate appreciated and real wages increased.

We could add a third condition for foreign savings to have a positive impact on 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, because 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/export ratio between 1 and 1.5) is precisely because of this volatility of financial markets—the herd behavior that 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 uncritically by numerous countries, including 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 performances 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 that serve as performance indicators for IMF loans and also as country risk indicators used by risk-rating agencies and financial organizations. The idea is simple: in addition to the inflation rate, only two indexes are relevant: the primary surplus and the public debt/GDP ratio. The traditional fiscal index (the budget deficit) and the foreign accounts-related indexes (the foreign debt/export ratio and the current account deficit/GDP ratio) are drearily forgotten or ignored. The primary surplus is preferred to the traditional budget deficit, because it does not take into account interest payments. 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 with the risk-rating agencies, knows well the importance of the above-mentioned relevant indexes. In late

Table 3
Brazil and Russia Compared on Country Risk Indexes in 2002

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: Moody's, Central Bank of Brazil, IPEA, IMF, *The Economist*.

¹2002 data.

2003, Russia was again upgraded by the country risk agencies. There was a certain surprise among the Brazilian analysts working for the banking sector, which led me to write a column in *Valor* (November 26, 2003), from which I extract Table 3. The table is self-explanatory. 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 dictum is confirmed: "do what I say, not what I do."

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 interest paid by the state on its domestic and 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. Needless to

say, it does not matter that such a theory about the twin deficits has been falsified numerous times.

Given the prime focus of my article, one cannot discuss further the poor economics of these justifications; but a political economy analysis is required. Why have the Washington authorities and the international financial markets adopted such a questionable approach, and why have the Brazilian authorities and the local elites accepted it? Political economy analysis is not a substitute for 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 that imposes itself is to know why rational economic agents either recommended or accepted such policy.

The financial interests in Washington and New York are concerned with the need to legitimate another cycle of capital inflows to emerging markets. Despite the fact that these markets are marginal when compared to the core markets internationally, 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 intermediate developing countries, such as Brazil. On the other hand, these countries, with their low labor costs, have represented a threat to the developed world since the 1970s, when the first NICs (newly industrialized countries) appeared. Thus, an over-valued currency is a guarantee against international competition. Conventional orthodoxy is an expression of these interests. Neoclassical economics, with its ultraliberal 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 also have rational reasons for the acceptance of the growth *cum* foreign savings strategy. The rentier and the financial elites are interested in higher financial returns that are consistent with that strategy. The whole society is interested in the short run, that is, in higher wealth, income, and, consumption. 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 spend more than what it collects) and the exchange rate populism (the nation to spend more than it gains internationally).¹⁹ The first form is perhaps more obvious than the second, but both may be disastrous. Yet, exchange rate populism is more critical or more dangerous, insofar as crises in 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 aggregate demand. Yet, since the 1980s, Brazil, as well as the other Latin American countries, has not experienced such a crisis.²⁰

The populist cycle usually combines fiscal and exchange rate populism. The last episodes are the 1979 to 1980 attempt at provoking the convergence of expectations and disinflation through the exchange rate (1979 to 1980), the Cruzado Plan (1986), and the post-Real-Plan policy (1995 to 1998). In those three episodes, fiscal imbalance was combined with exchange rate evaluation. In all cases, inflation remained under control, real wages increased, and imports and consumption soared, but this 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 “rational,” there are also “irrational” motives: on one side, the trauma caused by fourteen years of high inflation; on the other, the difficulty faced by the Brazilian elites in defending national interests. The Brazilian National Revolution (meaning by that the transference of the decision center to Brazil and the formation of a true 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, and with a neoliberal and globalist ideological wave gaining strength everywhere, the local elites bowed to it. As a result, major decisions on the Brazilian

economy again came from the North, and the existence of Brazil as a nation was almost forgotten.²¹

Conclusion

Despite having successfully floated the real in January 1999, the Cardoso administration still kept interest rates high and the exchange rate overvalued. Thus, notwithstanding the good results achieved in controlling the budget deficit since 1999, the administration faced in 2002 a second balance-of-payments crisis. This crisis led to an overshooting of the exchange rate, the real almost reaching R\$4.00 at the end of that year. The fear that the new president, Luis Inácio da Silva, caused in the financial markets 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: a nonpopulist policy respecting property rights and contracts would be followed. As soon as Lula took office, he engaged in a “credibility shock.” Confidence was soon restored, and capital inflows resumed. They resumed so strongly that in a few months the exchange rate reached R\$2.90 per dollar.

The dollar would have continued to go down in relation to the real if a clamor had not risen against the passive attitude adopted by the monetary authorities (“a floating exchange rate is a free exchange rate”) when the real again began to evaluate. People remembered the two previous balance-of-payments crises, particularly the 1998 one, and 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 is the case in 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,²² 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, even though a rate at around R\$3.50 per dollar would be desirable. With this rate, Brazil would be adopting the growth strategy that the Asian countries have followed: 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 even, especially with the help of a rising euro.

Since the 1997 to 1998 financial crises, the growth *cum* foreign savings strategy is losing credibility everywhere, including in Latin America. The criticism frequently voiced focuses on the volatility of financial flows, instead of questioning the growth *cum* foreign strategy itself, especially 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. This may explain the Brazilian resistance to a new overvaluation. Does this mean that the Brazilian economy is finally heading for growth? Not yet. In this case, it is not so much because the exchange rate is overvalued, but because the basic interest rate remains artificially high, keeping the budget deficit around 5 percent of GDP, and making investment in capacity expansion largely unviable. As the fixed and overvalued exchange rate counted on the support of Washington and New York in the recent past, now the high basic interest rates also can count on this support. Contemporary macroeconomic 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. However, as conventional orthodoxy had arguments to keep the exchange rate overvalued, it now has 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 rates have much lower basic interest rates.²³

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 latter expect to grow with foreign savings and the domestic market.²⁴ In this article, it has been argued that the second alternative is self-defeating. Growth must be financed with domestic savings. This is what the international experience says; this is also what the Brazilian experiences confirm. Given the solvency constraint and the fact that capital inflows tend to overvalue the exchange rate and increase consumption, growth based on foreign debt may occur only during limited periods, when a cluster of investment projects with 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 neoliberal ideological and globalist wave coming from the North, Brazil stopped thinking in national terms, adopted the growth *cum* foreign savings strategy coupled with high basic interest rates, and, as a result, since then remains quasi-stagnant.

Notes

1. For a general critique of the growth *cum* foreign savings strategy, see Bresser-Pereira and Nakano (2002). 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 was 1,371.1%. In the first semester of 1994, the annualized inflation rate was 859.2% (INPC from IBGE). Since then, the yearly inflation rate came under control, remaining in the one-digit levels, except in the two years during 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; and 1994: -1.57. The budget balance would then go up in the next four years, managing to stay at approximately 5% of GDP; it only started to come down in 2000; in 2002, it reached a zero balance. Source: Ipeadata, 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 the value of exports.

5. Observe that “conventional orthodoxy” is not the same as “neoclassical

economics.” Although neoclassical macroeconomics is much weaker than neoclassical microeconomics, there are outstanding neoclassical economists who do not share conventional orthodoxy’s tenets.

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) should be considered the exogenous rate over which the monetary authorities have control. Conventional orthodoxy, however, in the case of Brazil almost invariably “fails to remember” the difference, although the basic rate is used as an exogenous policy-making variable in other countries.

7. On inertial inflation see, among others, Bresser-Pereira and Nakano (1987).

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 to support 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 until the last day of the Cardoso administration (December 31, 2002). All the economists mentioned are faculty members of Rio de Janeiro’s PUC (Pontifical Catholic University).

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.

10. This policy’s main proponent was the U.S. Treasury’s Undersecretary Lawrence Summers.

11. See Williamson (1990a). The ideological charge against Williamson’s text was greatly exaggerated. Williamson is not an ultraliberal, and the consensus he detected in Washington was not an ultraliberal consensus and did not aim to reduce the state to a minimum. It only had a liberal bias (or neoliberal, with “liberal” signifying progressive in the United States). However, this did not prevent ultraliberals from adopting it.

12. See Williamson (1990b). In a debate with Williamson, Stanley Fischer suggested the inclusion of financial openness in the list of reforms, to which Williamson answered that he did not find such a reform necessary and therefore was not included in the effective consensus of the time (i.e., 1989, when this debate took place).

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

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

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.

16. See Rocha and Zerbini (2002) for a survey of the evidence. In addition to their own study, the authors quote the studies of Sinn (1992) and Coakley et al. (1996) 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 he cautiously regarded the growth *cum* debt strategy. Later, in a textbook, he surprisingly increased this limit (Simonsen and Cysne, 1995).

18. In the case of Brazil, the foreign debt/export indebtedness ratio was around 3 in the early 1990s. Thus, the growth *cum* foreign savings strategy was highly inadvisable. In the late 1990s, this ratio was nearly 4, despite the fact that a sizeable part of the indebtedness that took place during the decade had been conducted through direct investments, thereby not influencing the financial indebtedness rates (but involving debt service). Today, after the 1999 first and the 2002 second real depreciation, the ratio fell to approximately 3.

19. Adolfo Canitrot (1975) made exchange rate populism clear in his classic 1975 paper. Jeffrey Sachs (1989) wrote the definitive paper on the subject. Yet these authors, as many others who discuss the issue, do not distinguish fiscal from exchange rate populism. These and other papers on the subject are in Bresser-Pereira (ed.) (1991).

20. To relate economic populism with the neoliberal 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.

21. Neoliberalism 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 apolitical bodies perform this job. Globalist is the ideology that asserts that national states have lost relevance in the present global system and, from this false assumption, concludes that developing countries have no other alternative than the "straitjacket" proposed by Washington and New York. Thomas Friedman (2000) wrote explicitly about the supposed straitjacket, 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 achieve growth may be capitalism, but there are many varieties of capitalism.

22. Among these sources is a major banker, Fernão Bracher, formerly president of the Brazilian Central Bank.

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

24. This phrase was referred to by Rubens Ricupero in a lecture at the School of Economics and Administration of the University of São Paulo, August 27, 2001. It was retrieved from my notes.

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