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**Article**

## Brazilian Structural Adjustment in the Nineties: Dependence without Development

Vierteljahrshefte zur Wirtschaftsforschung

**Provided in Cooperation with:**

German Institute for Economic Research (DIW Berlin)

*Suggested Citation:* Cintra, Marcos Antonio Macedo (2000) : Brazilian Structural Adjustment in the Nineties: Dependence without Development, Vierteljahrshefte zur Wirtschaftsforschung, ISSN 1861-1559, Duncker & Humblot, Berlin, Vol. 69, Iss. 1, pp. 53-68, <https://doi.org/10.3790/vjh.69.1.53>

This Version is available at:

<https://hdl.handle.net/10419/99133>

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# Brazilian Structural Adjustment in the Nineties: Dependence without development

By Marcos Antonio Macedo Cintra\*

## Summary

*Monetary, financial and exchange rate crises in Mexico (1995), in Southeast Asia (1997–98), in Russia and in Venezuela (1998), in Brazil and in Ecuador (1999) reveal a similar process underlying the economic and financial instability in peripheral countries, the so-called emergent markets. All these countries carried out both capital account liberalisation and financial deregulation. The financial instability began with a considerable increase in capital inflows followed by an abrupt loss of international reserves. This paper seeks to show the limits and contradictions inherent in such an economic strategy on the example of the policy which was pursued by the Brazilian economic stabilisation program and implemented between June 1994 and January 1999 and which later deepened with the devaluation of the Brazilian currency (real). The author argues that such an international insertion model has deepened the country's external dependence and has not led to a development process capable of integrating the less-privileged classes into the Brazilian society as a whole.*

## 1. Introduction

Monetary, financial and exchange rate crises in Mexico (1995), in Southeast Asia (1997–98), in Russia and in Venezuela (1998), in Brazil and in Ecuador (1999) reveal a similar process underlying the economic and financial instability in peripheral countries, the so-called emergent markets. All these countries carried out both capital account liberalisation and financial deregulation. They were then subject to the despotism of national and international financial markets, that is to say, susceptible to capital flights and to the risks of financial collapses and of speculative currency attacks. In all these countries, the exchange instability started with a significant increase in capital inflows followed by an abrupt loss of international reserves. Net private capital flows into the so-called emergent markets fell sharply from US \$ 260 billion in 1997 to US \$ 152 billion in 1998, i.e. a 41% drop according to the International Institute of Finance (IIF). In 1998 net inflows were lower than half of US \$ 327 billion record level registered in 1996. The five economies most affected by the financial crisis in Asia — Indonesia, Malaysia, Philippines, South Korea, and Thailand — received a volume of net capital investments totalling US \$ 103 billion in 1996. In the same countries the net capital flight amounted to US \$ 1 billion in 1997 and reached US \$ 28 billion in 1998. Net private capital inflows declined from US \$ 106 billion in 1997 to US \$ 88 billion in 1998 in Latin America. The flow of financial resources into emergent European economies fell from US \$ 69 billion to US \$ 41 billion.

Considering the monetary and financial regulations and practices and stable exchange rates prevailing in the early 1990s, lenders and borrowers decided to run more risks.

Such a neglectful behaviour led progressively to increased capital flows into emergent economies. The capital inflows reinforced expectations of exchange stability and attracted a large volume of financial resources to stock exchanges, fixed income funds and the purchase of fixed assets and real estate. The capital inflow brought about a trend towards a valued exchange rate and increased interest rates as it bore a “risk premium” equivalent to expectations of the exchange rate depreciation. This combination of factors stimulated external indebtedness by domestic economic agents — banks and large corporations — which decided to capture credits (and lend them, in the case of banks) in undervalued currencies at lower interest rates. Therefore, in a context of different interest rates between national financial markets, arbitrage between interest rates tends not to homogenise, but to reinforce differences between several financial centres. Continuous capital inflows attracted by different profitability levels reinforced the appreciation of local currencies, thus intensifying inflows and expanding external liabilities. Increased international reserves created the impression of a strong currency (with external indebtedness), thus providing the credibility necessary for the prevailing exchange rate. However, the sterilisation of

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I am most thankful for comments received during various stages of preparation from Omar Thomaz, Álvaro Comin, Carlos Cavalcanti, Maria Luiza Levi, José Carlos Braga, and Barbara Fritz. I am grateful to Marta Helena de Macedo e Cintra for her support in the English version.

international reserves, that is to say, the exchange of foreign currencies for public securities denominated in the domestic currency and/or indexed to the dollar led to an increase in the national public debt and put pressure on interest rates in the domestic monetary markets, thus reinforcing differential interest rates and attracting more capital inflows in search of highly profitable arbitration. In this sense, despite specific features of each country, the mobility of capital flows resulted in an unsustainable setting of exchange rate appreciation, increased external private debt and internal public debt in Asia, Latin America, and Eastern Europe. It eventually led to exchange crises, financial fragility, and lack of liquidity in domestic financial markets. Therefore, successive surges of financial turbulence which devastated emergent countries were related to the instability inherent in globalised and deregulated capital markets.

## **2. The model of competitive integration: Stabilisation with trade and financial liberalisation**

The political and economic elite geared the Brazilian economy to this pattern of volatile capital flows prevailing in globalised financial markets subject to turmoil in their assets and exchange markets. Since its very beginning, the administration of president Fernando Henrique Cardoso defended the internationalisation and argued that it represented a historic opportunity for the country to adhere to the wave of liberalisation reforms that spread world-wide beginning in the early 1980s. According to the ruling elite, the modernisation process of the Brazilian economy depended heavily upon reinsertion in the circuit of a globalised capital, since there was no alternative to its subordinate integration in the process of capitalist restructuring but marginalisation and misery.

This strategy adopted by the Brazilian political and economic elite led the process of “dependent and associated development” to its paroxysm. During the late 1960s and the mid-1970s, such a process was identified by then-Professor Fernando Henrique Cardoso. According to this process the Brazilian bourgeoisie had already abdicated any intention to lead the development of capitalism in Brazil (Cardoso/Faletto, 1970). Brazil’s social and economic development took place with the participation of foreign capitals and state-owned enterprises. Under contemporary conditions, Brazilian economic growth could only take place by deepening the association with globalized and deregulated markets capable of implementing an effective and balanced allocation of resources from private investors, chiefly international ones.

The restructuring model, the so-called “competitive integration” founded on a real exchange rate, was based on three main assumptions: the stability of domestic prices would favour economic decision-making in the long run

and would foster domestic private investments; foreign direct investments would be increased as a result of new business opportunities; consequently, the Brazilian economy would show considerable productivity gains, thus improving competitiveness in foreign markets (Franco, 1998). Strengthened relationships between companies operating in Brazil and the international production network would be responsible for technological innovations, new capital goods and intermediate goods, and greater investment and trade opportunities, together with productivity gains and reduced financial and operating costs. Such a strategy would allow for a greater volume of exports and would reverse trade imbalances regarded as “temporary”. In fact, the initial external deficit would contribute to the modernisation of the Brazilian economy financed by foreign capitals. The fixed exchange rate and high interest rates would impact negatively on the fiscal performance, however only transiently. Different reforms in the public sector, privatisation activities and reduced public sector borrowing requirements in addition to expansion of the modernised private sector would generate greater tax inflows allowing for the redemption of the public debt.

However, the trade liberalisation<sup>1</sup> combined with a valued exchange rate and high interest rates prevailing since the beginning of the *Real Plan* inhibited the entrepreneurial spirit of the Brazilian business community. The entrance of foreign investors was related to a large offer of liquid funds in search of profitable opportunities in the world economy.<sup>2</sup> The volume of foreign direct investments rose significantly. In 1998, it totalled US \$ 25.9 billion in comparison to only US \$ 1.9 billion in 1994 (see table 1). Nevertheless, a large amount of these resources — eager for high and rapid gains — was directed to privatisation. Another considerable fraction was used in the purchase of Brazilian private companies, i.e., of existing companies, mere transfers of ownership. The remaining amount was invested in transnational corporations already operating in Brazil. Just a small amount of total inflows was used for greenfield investment purposes (see table 2).

This transfer of ownership of national assets — both in the public and private sector — to foreign hands had hardly any positive impact on investments, income and employment. It was essentially a mini-cycle of modernisation in the period 1995-97. However, no solution for the recovery of domestic economic growth and for external imbalances was found. Table 3 shows the evolu-

<sup>1</sup> The average import tariff declined from 51% in 1985 to approx. 14.3% in 1994 and to 11.1% in 1997. In 1998, after persistent external imbalances this tariff increased to 14.6% (Silva, 1999).

<sup>2</sup> In a few cases, such as in the automotive industry, foreign investment inflows were also related to fiscal incentives granted by state governments. This was referred to as a “fiscal war” (Prado/Cavalcanti, 1998).

Table 1

**Net Capital Inflows — Brazil (1993–1999)**  
US \$ Millions

|   | 1993   | 1994   | 1995   | 1996   | 1997   | 1998    | 1999   |
|---|--------|--------|--------|--------|--------|---------|--------|
| <b>Net Capital Inflows</b>  | 8,482  | 9,775  | 30,196 | 34,103 | 60,882 | 25,661  | 16,558 |
| Investments   | 6,170  | 8,131  | 4,663  | 15,540 | 20,664 | 20,883  | 30,122 |
| Foreign   | 7,264  | 9,251  | 6,607  | 16,016 | 22,233 | 24,281  | 31,489 |
| Foreign direct investments  | 614    | 1,972  | 4,313  | 9,976  | 17,083 | 25,893  | 29,968 |
| Portfolio investments   | 6,650  | 7,280  | 2,294  | 6,040  | 5,300  | -1,843  | 1,522  |
| Sao Paulo Stock Exchange  | ...    | 542    | 513    | 3,379  | 523    | -2,621  | 2,232  |
| Brazilian <sup>(a)</sup>  | -1,094 | -1,037 | -1,559 | 56     | -1,569 | -3,398  | -1,368 |
| Medium- and long-term finance <sup>(b)</sup>  | -2,908 | -1,907 | -2,198 | -2,005 | 13,782 | 3,788   | -7,169 |
| Loans <sup>(c)</sup>  | 5,865  | 3,712  | 9,113  | 14,696 | 7,067  | 27,754  | -157   |
| Finance made available by Brazil  | -245   | -450   | -679   | -211   | -1,836 | -2,755  | -583   |
| Short-term capital <sup>(d)</sup>   | 900    | 909    | 18,834 | 5,752  | 17,531 | -27,320 | -5,861 |
| Others  | -1,300 | -640   | 463    | 331    | 3,674  | 3,311   | 206    |
| <i>Memorandum</i>   |        |        |        |        |        |         |        |
| Investment rate (as a percentage of GDP)  | 14,4   | 15,3   | 16,6   | 16,5   | 17,9   | 17,4    | 17,2   |
| Foreign direct investment/Investment total (%)  | 1,2    | 2,4    | 3,7    | 7,8    | 11,9   | 19,0    | 19,4   |
| Foreign direct investment /GDP (as a percentage of GDP)   | 0,2    | 0,4    | 0,6    | 1,3    | 2,1    | 3,4     | 3,3    |
| <small>(a) Brazilian investments abroad. — (b) Includes multilateral institutions, government agencies, suppliers/buyers. — (c) Includes commercial papers, bonds, notes (floating and fixed), inter-companies loans, etc. — (d) Includes credit lines.<br/>Source: Central Bank of Brazil, Nota para Imprensa, several issues. Brasília, D.F. URL: <a href="http://www.bcb.gov.br">http://www.bcb.gov.br</a></small> |        |        |        |        |        |         |        |

tion of investments in major subsectors of the manufacturing industry. The comparison between results recorded in the 1970s and those in the above-mentioned period shows improved performance in the metallurgy/steel and iron industry and in the consumer goods industry (transportation material and food) and worsened performance in the textile industry and in the segments of intermediate goods (chemicals and non-metallic) and capital goods (mechanical), that is to say, in the entire industrial production chain.

In fact, a process of industrial specialisation took place with the following features: reduced value added in all complex industrial chains; intense replacement of end products by imported products; loss of profitability in competitive sectors of large scale (pulp and paper, steel and iron industry, etc.); discontinuance of a number of products in the chemical, petrochemical, metal-mechanic (particularly auto parts and capital goods) and electric-electronic industries. The “shrinkage” of these production chains meant a reduction in the value added for a similar gross production value. In practical terms, it represented the elimination of income and employment.

Moreover, the particular combination of value exchange rate and high interest rate impacted negatively on the investment allocation in different sectors since it discouraged the establishment of new production facilities oriented to the manufacturing of tradable goods. Over 50 per

cent of foreign direct investments were directed to domestic market-driven industries: automotive (25.3%), household appliances (12.7%), chemical and pharmaceutical (19%), with a marked importation of equipment and components. The majority of foreign direct investments was increasingly directed to service industry, in particular the finance system and those industries to be privatised (electric power, telecommunications, etc.) which are non-tradable sectors (see table 4). In 1998, the service industry absorbed 83% of foreign direct investments recorded by the Central Bank of Brazil. The deepening of internationalisation in the finance industry took place chiefly by the acquisition and/or expansion of foreign shareholders in national banks. The share of foreign

Table 2

**Profile of Foreign Direct Investments in Brazil**

|   | %        |
|---|----------|
| Transnational corporations already operating in the country | 40 to 45 |
| Privatisation activities                                    | 30 to 35 |
| Acquisitions of Brazilian private enterprises               | 15 to 20 |
| Greenfield investments                                      | 5 to 10  |
| Source: Laplane & Sarti (1997).                             |          |

Table 3

**Rate of Fixed Investments in the Manufacturing Industry  
(selected years)**

As a percentage of GDP/value at current prices in 1980

|  | 1971–80     | 1981–88     | 1995–97     |
|--|-------------|-------------|-------------|
| Steel and Iron/Metallurgy                | 0.70        | 0.77        | 0.75        |
| Transportation Material                  | 0.42        | 0.21        | 0.44        |
| Food                                     | 0.52        | 0.31        | 0.37        |
| Electric and Electronic                  | 0.21        | 0.14        | 0.15        |
| Plastic                                  | 0.10        | 0.09        | 0.12        |
| Pharmaceutical                           | 0.08        | 0.02        | 0.06        |
| <b>Subtotal</b>                          | <b>2.03</b> | <b>1.54</b> | <b>1.89</b> |
| Chemicals                                | 0.63        | 0.53        | 0.33        |
| Mechanical                               | 0.37        | 0.21        | 0.17        |
| Non-metallic                             | 0.30        | 0.18        | 0.13        |
| Pulp and Paper                           | 0.17        | 0.13        | 0.10        |
| Textile                                  | 0.29        | 0.16        | 0.19        |
| Rubber                                   | 0.06        | 0.03        | 0.03        |
| <b>Subtotal</b>                          | <b>1.82</b> | <b>1.24</b> | <b>0.95</b> |
| Others                                   | 0.66        | 0.44        | 0.45        |
| <b>Total</b>                             | <b>4.51</b> | <b>3.22</b> | <b>3.29</b> |
| Source: Bielschowsky (1998), 6, table 4. |             |             |             |

banks in total assets rose from 21% in June 1995 to 30% in June 1997 in the private banking system. A similar trend was observed in credit transactions and total deposits (Freitas, 1998).

The share of imported goods in the manufacturing industry soared from 4.8% in 1989 to 18.8% in 1998. A rise from 11.6% in 1989 to 60.4% in 1998 was observed in the electronic and telecommunications industries. Other strongly affected industries were machinery and equipment: the share of imported goods was 13.3% in 1989 in comparison to 51.4% in 1998 (see table 5).

In conclusion, the recent cycle of foreign direct investments in the Brazilian economy intensified its propensity to import and reduced its propensity to export. Thus, industrial growth intensified trade imbalances, while the “confidence” of economic agents in the ability of the Brazilian production structure to generate the trade surplus needed to compensate for deficits in current transactions was being undermined.

**3. The Brazilian stabilisation program:  
An exchange rate anchor with free capital flows**

This accumulation regime founded on stabilisation with a fixed exchange rate was subordinate to the logic of globalised and liquid financial markets. The long period of scarce private external funding that characterised the 1980s came to an end in the early 1990s when inflation rates were still high in Brazil. Liquid and deregulated international financial markets eagerly sought to gain opportunities in emergent markets (high risks). Abundant liquid capitals allowed for the implementation of a monetary reform under the aegis of the *Real Plan* (1994). This was a *sine qua non* for the use of the exchange rate (crawling peg), as a nominal anchor. Thus, the *Real Plan* was a result of deregulated, liquid and globalized financial markets. Brazil offered high interest rates and the possibility to acquire undervalued assets, particularly with the prospect of expanding the privatisation programme. Therefore, financial markets anticipated the stabilisation and its possible outcomes, such as high income for short-term investments and capital gains resulting from the “valuation” of assets — public and private — acquired at lower prices (Coutinho/Belluzzo, 1996 and Prates, 1999).

In spite of the stabilisation — the inflation rate fell from 1,093.8% in 1994 to 14.78% in 1995, and continued to drop up to 1.71% in 1998 —, the significant appreciation of the *real* exchange rate combined with the deepening of trade liberalisation soon led to increased trade balance

Table 4

**Foreign Direct Investment by Industry<sup>(a)</sup>**

| Industry   | Stock          |               | Inflows        |               |                |               |                |               |
|--|----------------|---------------|----------------|---------------|----------------|---------------|----------------|---------------|
|  | 1995           |               | 1996           |               | 1997           |               | 1998           |               |
|  | US \$ millions | %             | US \$ millions | %             | US \$ millions | %             | US \$ millions | %             |
| Farming and cattle raising/<br>mining  | 689            | 1.62          | 111            | 1.44          | 456            | 2.98          | 151            | 0.68          |
| Manufacturing  | 23,402         | 55.03         | 1,740          | 22.70         | 2,036          | 13.30         | 3,625          | 16.28         |
| Service  | 18,439         | 43.36         | 5,815          | 75.86         | 12,819         | 83.72         | 18,496         | 83.05         |
| <b>Total</b>   | <b>42,530</b>  | <b>100.00</b> | <b>7,665</b>   | <b>100.00</b> | <b>15,311</b>  | <b>100.00</b> | <b>22,272</b>  | <b>100.00</b> |
| <sup>(a)</sup> This sampling corresponds to 73.6%, 81.6%, 83.5% of total foreign direct investments in 1996, 1997 and 1998, respectively.<br>Source: Central Bank of Brazil, Nota para Imprensa, several issues. Brasília, D.F. URL: <a href="http://www.bcb.gov.br">http://www.bcb.gov.br</a> |                |               |                |               |                |               |                |               |

Table 5

**The Share of Imported Goods in the  
Brazilian Industry (%)**

| Sectors   | 1989       | 1994        | 1998        |
|---|------------|-------------|-------------|
| Communications and electronic equipment   | 11.6       | 32.3        | 60.4        |
| Machinery and equipment   | 13.3       | 32.7        | 51.4        |
| Chemicals   | 15.1       | 17.7        | 34.2        |
| Pesticides and fertilisers  | 9.8        | 22.9        | 30.4        |
| Motors and auto parts   | 6.0        | 17.9        | 30.4        |
| Spinning and weaving  | 3.5        | 13.0        | 18.1        |
| Pharmaceuticals   | 6.9        | 12.7        | 16.7        |
| <b>Total</b>  | <b>4.8</b> | <b>11.1</b> | <b>18.8</b> |
| <b>Imports/Output</b>   |            |             |             |
| Sectors   |            |             |             |
| Labour-intensive  | 1.5        | 5.6         | 11.7        |
| Technology-intensive  | 6.9        | 16.8        | 44.1        |
| Natural resource-intensive  | 2.9        | 6.0         | 8.1         |
| Capital-intensive   | 8.7        | 13.5        | 24.2        |
| <b>Total</b>  | <b>4.3</b> | <b>10.4</b> | <b>20.3</b> |
| <b>Imports/Domestic consumption<sup>(a)</sup></b>   |            |             |             |
| Type by use   |            |             |             |
| Consumer non-durables   | 2.6        | 4.4         | 8.1         |
| Consumer durables   | 7.8        | 12.3        | 30.3        |
| Intermediate products   | 2.2        | 7.5         | 10.4        |
| Capital goods   | 11.4       | 28.0        | 57.0        |
| <b>Total</b>  | <b>4.5</b> | <b>10.6</b> | <b>19.3</b> |
| <sup>(a)</sup> Domestic consumption = output + imports – exports.<br>Source: Moreira (1999a). |            |             |             |

deficits and expanded external liabilities. It intensified the country's dependence on capital inflows. Gross external liabilities of Brazil — total external debt (US \$ 243.1 billion) plus the stock of foreign direct investments (US \$ 161.6 billion) — accounted then for 52% of GDP in 1998 (see table 6).

The external debt increased rapidly from US \$ 159.3 billion in late 1995 to US \$ 243.2 billion in December 1998. The main reason lies in the private sector. Relying on the

target exchange rate policy and gradual depreciation of the *real*, Brazilian enterprises and affiliates of transnational corporations went further into debt abroad. By the end of 1998, the external debt of the private sector amounted to US \$ 147.9 billion whereas that of the non-financial public sector totalled US \$ 95.2 billion (see table 7). The deficit in current transactions rose from US \$ 17.9 billion in 1995 to US \$ 33.6 billion in 1998 corresponding to 4.33% of GDP (see table 8). In the period 1995-1998, the accumulated deficit in current transactions totalled US \$ 108.1 billion. However, exporting capacity did not grow and the trade deficit reached US \$ 23.8 billion.

Under these circumstances, despite the great volume of international reserves, future exchange and interest markets were extremely sensitive to changes in the conditions of external funding provoked by hesitating foreign investors, concentration of amortisation in a certain period or an upwards trend in the trade balance deficit. The view of markets on the unsuitability of the exchange rate was evident throughout this period.

This scenario was aggravated by the perception that the monetary and exchange rate regime endogenously generated an increasing imbalance between the volume of international reserves and total domestic financial assets swollen by high domestic interest rates. At the beginning of the *Real Plan* the financial status of the Brazilian public sector was rather comfortable. The previous administration had conducted a fiscal and public debt adjustment on a large scale. In 1993, the primary surplus was 2.6% of GDP. Both the net public sector debt and the federal securities debt were relatively small in relation to GDP (see table 9 and 12).

However, the balance of federal securities issued in public offers soared from R \$ 61.7 billion in December 1994 to R \$ 176.2 billion in late 1996. Continuing its upward trend it reached R \$ 255.5 billion in 1997 and R \$ 323.8 billion in December 1998 (see table 10). This rise in the federal securities debt was associated with the need to attract foreign capital to finance deficits in current transactions and accumulate international reserves that were

Table 6

**Total Gross External Liabilities of Brazil and Annual Nominal Cost**

|  | 1993  | 1994  | 1995  | 1996  | 1997  | 1998  | 1999 <sup>(a)</sup> |
|--|-------|-------|-------|-------|-------|-------|---------------------|
| Total external liabilities (US \$ billions) <sup>(b)</sup>   | 218.4 | 239.4 | 256.2 | 307.0 | 359.7 | 404.7 | 346.9               |
| External liabilities as a percentage of GDP  | 50.8  | 44.1  | 36.3  | 39.6  | 44.9  | 52.2  | 62.6                |
| Annual nominal cost (US \$ billions) <sup>(c)</sup>  | 11.4  | 11.0  | 14.1  | 16.6  | 20.9  | 23.5  | 23.7                |
| Evolution of average cost of total indebtedness <sup>(d)</sup>   | 6.9   | 5.6   | 7.2   | 8.0   | 8.0   | 8.0   | 8.5                 |
| <sup>(a)</sup> Estimate. — <sup>(b)</sup> Total external liabilities = total external debt + stock of foreign direct investments. — <sup>(c)</sup> Annual cost of external liabilities = gross profit and dividend remittance + payment of gross interests. — <sup>(d)</sup> Mean interest rate.<br>Source: Barros et. al. (1999). |       |       |       |       |       |       |                     |

Table 7

**Total External Debt (by Debtor)**  
US \$ Millions/End of Period

|   | Dec/1995 | Dec/1996 | Dec/1997 | Dec/1998 | Dec/1999 <sup>(c)</sup> |
|---|----------|----------|----------|----------|-------------------------|
| Medium- and long-term debt <sup>(a)</sup> | 128,732  | 142,148  | 163,283  | 219,999  | 211,442                 |
| Non-financial public sector               | 91,421   | 88,431   | 79,967   | 91,809   | <sup>(d)</sup> 96,598   |
| Private sector                            | 37,311   | 53,717   | 83,316   | 128,190  | 114,843                 |
| Short-term debt                           | 30,524   | 37,787   | 36,715   | 23,164   | 25,504                  |
| Non-financial public sector               | 3,708    | 5,232    | 5,737    | 3,383    | 3,318                   |
| Obligations of the Central Bank           | 287      | 70       | 42       | 28       | 0                       |
| Credit lines                              | 3,421    | 5,162    | 5,695    | 3,355    | 3,318                   |
| Private sector <sup>(b)</sup>             | 26,816   | 32,555   | 30,978   | 19,781   | 22,186                  |
| Obligations of commercial banks           | 26,235   | 30,611   | 26,501   | 17,911   | 7,766                   |
| Short-term debt <sup>(a)</sup>            | -        | 1,944    | 4,477    | 1,870    | 2,716                   |
| Resolution no. 2148 (rural financing)     | 581      | 1,944    | 4,003    | 1,399    | 24                      |
| Total external debt                       | 159,256  | 179,935  | 199,998  | 243,163  | 236,945                 |
| <i>Memorandum</i>                         |          |          |          |          |                         |
| External debt services/Export             | 38.9     | 56.9     | 81.4     | 96.7     | 136.9                   |

<sup>(a)</sup> Debt recorded in the Central Bank of Brazil. — <sup>(b)</sup> Includes loans to exporting companies, *bridge-loans*, and other transactions with 30-day maturity. — <sup>(c)</sup> Includes exchange rate variations, preliminary data. — <sup>(d)</sup> Includes US \$ 20.4 billion regarding disbursements from the IMF loan.

Source: Central Bank of Brazil, Nota para Imprensa, several issues. Brasília, D.F. URL: <http://www.bcb.gov.br>

Table 8

**Balance of Payments in Current Transactions (US \$ Millions)**

|                                     | 1993    | 1994    | 1995    | 1996    | 1997    | 1998    | 1999 <sup>(a)</sup> |
|-------------------------------------|---------|---------|---------|---------|---------|---------|---------------------|
| Trade balance                       | 13,307  | 10,466  | -3,352  | -5,539  | -8,364  | -6,591  | -1,206              |
| Exports                             | 38,563  | 43,545  | 46,506  | 47,747  | 52,990  | 51,140  | 48,011              |
| Imports                             | 25,256  | 33,079  | 49,858  | 53,286  | 61,354  | 57,731  | 49,218              |
| Services (net)                      | -15,585 | -14,743 | -18,594 | -20,484 | -27,289 | -28,798 | -25,212             |
| Interests                           | -8,280  | -6,338  | -8,158  | -9,173  | -10,390 | -11,948 | -15,168             |
| Profit and dividend <sup>(b)</sup>  | -1,931  | -2,566  | -2,974  | -2,905  | -5,748  | -7,181  | -4,058              |
| Others <sup>(c)</sup>               | -5,374  | -5,839  | -7,462  | -8,406  | -9,669  | -11,294 | -5,984              |
| Unilateral transfers                | 1,686   | 2,588   | 3,974   | 2,900   | 2,216   | 1,778   | 2,040               |
| Balance in current transactions     | -592    | -1,689  | -17,972 | -23,123 | -33,437 | -33,611 | -24,379             |
| <i>Memorandum</i>                   |         |         |         |         |         |         |                     |
| Balance in current transactions/GDP | 0.00    | -0.20   | -2.68   | -2.98   | -4.16   | -4.33   | -4.38               |
| Exports/GDP                         | 9.00    | 8.00    | 6.60    | 6.20    | 6.60    | 6.70    | 8.50                |

<sup>(a)</sup> Preliminary data. — <sup>(b)</sup> Includes reinvestments. — <sup>(c)</sup> Includes international travel, transportation, insurance etc.

Source: Central Bank of Brazil, Nota para a Imprensa, several issues. Brasília, D.F. URL: <http://www.bcb.gov.br>

“sterilised” by the issue of public securities. Moreover, the increasing balance of securities was associated with high nominal interest rates that averaged 33% per year in the period 1995-1998 (see table 11). These factors — and not excessive government expenditures — were responsible for the steady increase in the federal securities debt. The evolution of the federal securities debt is, therefore, a phenomenon of a monetary and financial nature that implies severe fiscal problems. It should be pointed out that the net public sector debt increase implies a growth of the nominal public deficit as it includes debt variations according to the concept of Public Sector Borrowing Re-

quirements. Therefore, an endogenous deterioration of the public accounts was observed: the nominal public deficit was R \$ 45.7 billion in 1996, US \$ 54.7 billion in 1997 and US \$ 72.4 billion in 1998. Other sources of fiscal deficit (states and municipalities, resources of the Programme of Incentives for the Restructuring and Strengthening of the National Financial System (PROER<sup>3</sup>), resources of the Programme of Incentives for

<sup>3</sup> It consists of a financing mechanism for the acquisition of troubled banks by reputable banking institutions. Recoverable liabilities and assets of insolvent banks were transferred to other

Table 9

## General Indicators of the Brazilian Economy (1994–1999)

|  | 1993     | 1994     | 1995   | 1996   | 1997   | 1998   | 1999                  |
|--|----------|----------|--------|--------|--------|--------|-----------------------|
| GDP (US \$ billions – nominal value)                       | 429.70   | 541.20   | 704.10 | 774.80 | 803.60 | 775.00 | 556.60                |
| GDP (R \$ billions July/99)                                | 849.80   | 899.60   | 937.50 | 963.40 | 998.90 | 997.70 | 1,005.90              |
| GDP growth rate  | 4.92     | 5.85     | 4.22   | 2.76   | 3.68   | -0.12  | 0.82                  |
| Industry   | 7.01     | 6.73     | 1.91   | 3.73   | 5.52   | -1.34  | -1.66                 |
| Farming/cattle raising                                     | -0.07    | 5.45     | 4.08   | 4.06   | 2.69   | -0.02  | 8.99                  |
| GDP growth rate <i>per capita</i>                          | 3.36     | 4.33     | 2.76   | 1.25   | 2.20   | -1.45  | -0.50                 |
| Gross capital formation at prices in 1980 (% of GDP)       | 14.40    | 15.30    | 16.70  | 16.50  | 17.90  | 17.40  | 15.60                 |
| Level of utilisation of installed capacity                 | 80.40    | 77.40    | 78.80  | 78.40  | 78.90  | 78.60  | 78.00                 |
| IPC-FIPE Indexes <sup>(a)</sup>                            | 2,491.00 | 1,173.00 | 23.17  | 10.04  | 4.82   | -1.79  | 8.64                  |
| Minimum salary (US \$)                                     | ...      | ...      | 110.13 | 112.90 | 112.78 | 113.74 | 81.19                 |
| Real mean revenue <sup>(b)</sup>                           | 9.00     | 6.00     | 11.00  | 7.00   | 2.00   | 0.00   | -5.50                 |
| Formal employment (%) <sup>(c)</sup>                       | 50.50    | 49.20    | 48.40  | 46.70  | 46.40  | 45.80  | 44.50                 |
| Informal employment (%) <sup>(c)</sup>                     | 23.10    | 23.70    | 24.10  | 24.80  | 24.80  | 25.40  | 26.40                 |
| Unemployment rate <sup>(d)</sup>                           | 5.31     | 4.96     | 4.63   | 5.46   | 5.66   | 7.60   | 7.60                  |
| Unemployment rate <sup>(e)</sup>                           | 14.70    | 14.20    | 13.20  | 15.00  | 15.70  | 18.20  | 19.30                 |
| Primary fiscal results <sup>(f)</sup>                      | -2.60    | -5.30    | -0.40  | 0.10   | 1.00   | 0.00   | -3.13                 |
| Nominal fiscal results <sup>(f)</sup>                      | 58.20    | 45.20    | 7.20   | 5.90   | 6.10   | 8.00   | 10.00                 |
| Interest paid by the public sector (R \$ billions July/99) | 25.45    | 25.93    | 46.95  | 35.40  | 33.04  | 77.29  | 125.99 <sup>(g)</sup> |

<sup>(a)</sup> Consumer Price Index of the Municipality of Sao Paulo calculated by the Institute of Economic Research Foundation of the University of Sao Paulo (IPC-FIPE). — <sup>(b)</sup> Evolution of the real mean revenue of people in employment as a percentage of that of the previous year. Calculated by the Brazilian Institute of Geography and Statistics (IBGE). — <sup>(c)</sup> Share of formal and informal (unregistered worker) employment in the labour market. — <sup>(d)</sup> Open unemployment rate in metropolitan areas, calculated by the IBGE - Monthly Employment Survey. — <sup>(e)</sup> Total and open unemployment rate in the metropolitan area of the City of Sao Paulo, calculated by DIEESE and by the Seade Foundation as a percentage of the Economically Active Population (PEA). — <sup>(f)</sup> The concept of primary fiscal result excludes expenditures with interests and the debt indexation. The concept of nominal fiscal result includes expenditures with interests and the debt indexation. Values as a percentage of GDP; the minus sign (-) means Surplus and the plus sign (+) means Deficit. — <sup>(g)</sup> Until November.

Source: Fundap, Indicadores DIESP, several issues. Sao Paulo URL: <http://www.fundap.sp.gov.br>

the Restructuring of the State Public Financial System (PROES<sup>4</sup>), etc.) were added to this setting and caused an accelerated increase in the federal securities debt.

Furthermore, in spite of efforts made by government authorities, relationships between the Central Bank and the banking system concerning turnover and liquidity of public securities did not change. These assets maintained their basic feature as quasi-currency (very short-term transactions), the average maturity date of public securities being 3.3 months in late December 1998. Therefore, a risk of flight from the Brazilian currency remained latent in case of any external shock.

In this sense, investors perceived increasing risks in maintaining long positions in *reals* and forced the issue of securities indexed to the dollar or to the market overnight rate on federal debt repos, the so-called *taxa referencial do Selic* (Selic rate). As of May 1998, the financial market refused to acquire any prefixed securities and the federal securities debt was then indexed to the overnight interest rate or to exchange variations (*ex post* or post-fixed). Table 10 below shows changes observed in the composition of the federal securities debt: post-fixed securities

skyrocketed from 26.7% to 75.8% in the period May-December 1998. Securities indexed to exchange variations rose from 17.7% to 21% and prefixed securities dropped from 55.6% to 3.5% during the same period. These were manifest symptoms of a forthcoming monetary and exchange rate crisis.

banking institutions whereas their impaired liabilities were absorbed by the Central Bank. Since the creation of this program total resources reached R \$ 20.35 billion (4% as a percentage of GDP), out of which the Central Bank recovered R \$ 5.59 billion plus interest. The outstanding debt amounts to R \$ 22.9 billion, not including resources from Brazil's deposit insurance agency, the so-called *Fundo Garantidor de Crédito*, a private institution, plus the resources from the bank reserves' availability also used by the Central Bank in the restructuring of the private financial system, according to the Report of the Congressional Fact Finding Committee on Banks by the Senate (Comissão Parlamentar de Inquérito dos Bancos do Senado Federal, 1999, 299).

<sup>4</sup> The Circular no. 2742 dated 1997 by the Central Bank determined which financial institutions controlled by the state could request financial support from PROES and the conditions for access to its resources. Resources used in the restructuring of state banks totalled R \$ 60.3 billion in mid-July 1999 (Banco Central do Brasil, *apud* Ribeiro, 1999).



Table 10

**The Evolution of the Federal Securities Debt (1994–1999)**

| Year | Month     | Stock         | Share by indexes (%)      |          |                     |
|------|-----------|---------------|---------------------------|----------|---------------------|
|      |           | R \$ millions | Post-fixed <sup>(a)</sup> | Prefixed | Exchange rate       |
| 1994 | December  | 61,782        | 51.5                      | 40.2     | 8.3                 |
| 1995 | December  | 108,486       | 52.0                      | 42.7     | 5.3                 |
| 1996 | December  | 176,211       | 29.6                      | 61.0     | 9.4                 |
| 1997 | December  | 255,509       | 43.7                      | 40.9     | 15.4                |
| 1998 | January   | 266,074       | 43.0                      | 41.3     | 15.7                |
|      | February  | 271,450       | 39.4                      | 44.8     | 15.8                |
|      | March     | 287,814       | 34.2                      | 50.7     | 15.1                |
|      | April     | 290,893       | 29.5                      | 53.6     | 16.9                |
|      | May       | 294,260       | 26.7                      | 55.6     | 17.7                |
|      | June      | 297,002       | 48.4                      | 35.1     | 16.5                |
|      | July      | 304,873       | 60.9                      | 21.9     | 17.2                |
|      | August    | 302,278       | 67.6                      | 13.0     | 19.4                |
|      | September | 292,729       | 71.6                      | 7.0      | 21.4                |
|      | October   | 314,325       | 64.7                      | 14.2     | 21.1                |
|      | November  | 319,927       | 70.8                      | 8.2      | 21.0                |
|      | December  | 323,860       | 75.5                      | 3.5      | 21.0                |
| 1999 | January   | 364,478       | 63.6                      | 6.0      | 30.4                |
|      | February  | 379,522       | 62.7                      | 7.4      | 29.9                |
|      | March     | 365,649       | 73.3                      | 1.2      | 25.5                |
|      | April     | 365,297       | 72.4                      | 3.0      | 24.6                |
|      | May       | 372,975       | 70.1                      | 5.1      | 24.8                |
|      | June      | 383,133       | 67.9                      | 8.1      | 24.0                |
|      | July      | 384,203       | 65.0                      | 10.7     | 24.3                |
|      | August    | 401,985       | 62.2                      | 11.7     | 26.1                |
|      | September | 403,359       | 62.9                      | 10.8     | 26.3                |
|      | October   | 411,840       | 61.7                      | 11.6     | 26.7                |
|      | November  | 412,568       | 62.7                      | 11.3     | 26.0                |
|      | December  | 414,901       | 66.6                      | 9.2      | 24.2 <sup>(b)</sup> |

<sup>(a)</sup> It includes mainly securities indexed to the overnight/Selic rate. It also includes other indexes (General Price Index-Market — IGP-M, Referential Rate, Long-Term Interest Rate — BNDES). — <sup>(b)</sup> The stock of R \$ 100.4 billion in public securities indexed to exchange variations acts as a hedge for the private sector external debt totalling US \$ 147.9 billion.

Source: Central Bank of Brazil, Nota para Imprensa, several issues. Brasília, D.F. URL: <http://www.bcb.gov.br>

#### 4. The maxi-devaluation of the Brazilian currency and its monitoring

After the crisis in Asian countries, the lack of confidence in emergent markets became manifest by increased average spreads between higher risk securities and similar term bonds issued by the US Treasury. After the Russian moratorium, the aversion to risk was evident in the return of investors to safer markets, in particular to the New York financial centre. In mid-October 1998, the Brazilian economic authorities sought “preventive” financial resources in the international financial community. Their purpose was to prevent the emergence of an exchange crisis capable of causing a world-wide financial crash with deleterious effects on the US economy, in particular. This agreement was co-ordinated by the International Monetary Fund (IMF) and other creditors represented by the Bank for International Settlements (BIS) that had agreed to maintain the prevailing exchange policy. Yet, an atmosphere of low confidence in the domestic currency prevailed and investors anticipated a possible devaluation and fled to dollars. Holders of demand deposits, federal securities and short-term investment funds soon liqui-

dated their positions denominated in *reals* and changed them into dollar transactions or indexed to this currency. That is to say, rapid rearrangements of portfolios were made by investors, changing their assets from being denominated in a weak currency to being denominated in a strong currency<sup>5</sup>.

The accelerated loss of international reserves due to non-reliance by national and international investors made the defence of the *real* impossible (see tables 1 and 11). The economic authorities were forced to carry out a de-

<sup>5</sup> It is estimated that Brazil lost US \$ 45 billion in international reserves between July 1998 and January 1999. Thus, the Brazilian process has specific features that differ from other speculative exchange attacks. For instance, at the climax of the speculative attack against the French franc, on the morning of 29 July 1993, the Central Bank of France temporarily lost US \$ 100 million per minute. At the closing of the Stock Exchange in Paris, it had expended US \$ 50 billion (over the half in short position) in defence of the French currency. Early the following morning, short before the opening of Stock Exchanges in Asia, the members of the European Monetary System let their exchange rate parities float up to 15% (Goldstein, 1993).

valuation of the domestic currency. After an attempt to adopt a broad target exchange rate, the Central Bank of Brazil announced a free floating exchange rate system and left the market in order to interrupt the evaporation of international reserves. Financial markets then showed signs of instability, as there was no longer clear guidance. The companies started to operate with different exchange rates. In the face of confusing expectations, the free currency fluctuation had scarcely any chance to stabilise the exchange rate<sup>6</sup>.

The long-lasting appreciation process of the Brazilian currency led to decisions for indebtedness and maintenance of wealth that obstructed virtuous adjustments soon after the alteration of the exchange rate. The ex-

<sup>6</sup> By stabilisation we mean the definition of a nominal value of the dollar compatible with inflation expectations while keeping a real exchange rate able to signal a considerable reduction in the deficit in current transactions, chiefly by means of trade surpluses, thus diminishing needs for international reserves to keep commitments of balance of payments.

Table 11

**International Reserves, Interest Rate and Price Indexes**

|      |                     | Reserves <sup>(a)</sup> | Selic Rate <sup>(b)</sup> |                    | Real/US \$   | IGP <sup>(c)</sup> | IPCA <sup>(d)</sup> |
|------|---------------------|-------------------------|---------------------------|--------------------|--------------|--------------------|---------------------|
| 1994 | December            | 38.8                    | 1,154.0                   |                    | 0.12         | 0.57               | 1.71                |
|      | <b>Year through</b> |                         |                           |                    | <b>617.6</b> | <b>1,093.85</b>    | <b>916.43</b>       |
| 1995 | December            | 51.8                    | 38.9                      |                    | 0.72         | 0.27               | 1.56                |
|      | <b>Year through</b> |                         |                           |                    | <b>14.29</b> | <b>14.78</b>       | <b>22.41</b>        |
| 1996 | December            | 60.1                    | 23.9                      |                    | 0.60         | 0.88               | 0.47                |
|      | <b>Year through</b> |                         |                           |                    | <b>6.88</b>  | <b>9.34</b>        | <b>9.56</b>         |
| 1997 | October             | 53.7                    | 19.89                     | The Asian Crisis   | 0.61         | 0.34               | 0.23                |
|      | November            | 52.0                    | 45.84                     |                    | 0.61         | 0.83               | 0.17                |
|      | December            | 52.2                    | 39.83                     |                    | 0.59         | 0.69               | 0.43                |
|      | <b>Year through</b> |                         |                           |                    | <b>7.40</b>  | <b>7.48</b>        | <b>5.22</b>         |
| 1998 | January             | 53.1                    | 37.19                     |                    | 0.65         | 0.88               | 0.71                |
|      | February            | 58.8                    | 34.32                     |                    | 0.60         | 0.02               | 0.46                |
|      | March               | 68.6                    | 28.31                     |                    | 0.62         | 0.23               | 0.34                |
|      | April               | 74.7                    | 23.82                     |                    | 0.61         | -0.13              | 0.24                |
|      | May                 | 72.8                    | 22.60                     |                    | 0.54         | 0.23               | 0.50                |
|      | June                | 70.9                    | 20.98                     |                    | 0.56         | 0.28               | 0.02                |
|      | July                | 70.2                    | 20.29                     |                    | 0.56         | -0.38              | -0.12               |
|      | August              | 67.3                    | 19.28                     | The Russian Crisis | 1.16         | -0.17              | -0.15               |
|      | September           | 45.8                    | 34.33                     |                    | 0.74         | -0.02              | -0.22               |
|      | October             | 42.4                    | 41.58                     |                    | 0.64         | -0.03              | 0.02                |
|      | November            | 41.2                    | 38.69                     |                    | 0.67         | -0.18              | -0.12               |
|      | December            | 44.6                    | 31.21                     |                    | 0.62         | 0.98               | 0.33                |
|      | <b>Year through</b> |                         |                           |                    | <b>8.27</b>  | <b>1.70</b>        | <b>1.65</b>         |
| 1999 | January             | 36.1                    | 31.22                     | Floating Dollar    | 64.08        | 1.15               | 0.70                |
|      | February            | 35.5                    | 39.00                     |                    | 4.11         | 4.44               | 1.05                |
|      | March               | 33.8                    | 45.00 <sup>(e)</sup>      |                    | -16.60       | 1.98               | 1.10                |
|      | April               | 44.3                    | 39.50 <sup>(f)</sup>      |                    | -3.56        | 0.03               | 0.56                |
|      | May                 | 44.3                    | 32.00 <sup>(g)</sup>      |                    | 3.81         | -0.34              | 0.30                |
|      | June                | 41.3                    | 23.50 <sup>(h)</sup>      |                    | 2.64         | 1.02               | 0.19                |
|      | July                | 42.2                    | 21.00 <sup>(i)</sup>      |                    | 1.11         | 1.59               | 1.09                |
|      | August              | 41.9                    | 19.50                     |                    | 7.08         | 1.45               | 0.56                |
|      | September           | 42.6                    | 19.50 <sup>(j)</sup>      |                    | 0.33         | 1.47               | 0.31                |
|      | October             | 40.0                    | 19.00                     |                    | 1.60         | 1.89               | 1.19                |
|      | November            | 42.2                    | 19.00                     |                    | -1.55        | 2.53               | 0.95                |
|      | December            | 36.3                    | 19.00                     |                    | -6.95        | 1.23               | 0.60                |
|      | <b>Year through</b> |                         |                           |                    | <b>48.01</b> | <b>19.98</b>       | <b>8.94</b>         |

<sup>(a)</sup> Values expressed in US \$ millions, according to the concept of international liquidity that comprises cash and medium- and long-term commitments. It includes disbursements by the IMF — US \$ 9.3 billion in December 1998, US \$ 9.2 billion in March 1999 and US \$ 1.1 billion in December 1999 —, on the basis of the agreement signed in December 1998 totalling US \$ 41.5 billion. — <sup>(b)</sup> Annual Selic rate calculated on the basis of 252 working days in a year. — <sup>(c)</sup> General Price Index (IGP) calculated by FGV. — <sup>(d)</sup> Amplified Consumer Price Index calculated by IBGE. It is the official index for inflation targets used by the government. — <sup>(e)</sup> The interest rate was set at 45% per year until 22 March and 42% per year from 23 March to 5 April. — <sup>(f)</sup> The Central Bank reduced the interest rate to 34% per year on 15 April and to 32% per year on 20 April. — <sup>(g)</sup> In May, the interest rate was further reduced from 32% per year to 29.5% per year and then to 27% per year and late May to 23.5% per year. — <sup>(h)</sup> In June, the interest rate dropped twice: from 23.5% per year to 22% per year, and late this month to 21% per year. — <sup>(i)</sup> During July the interest rate dropped from 21% per year to 19.5% per year. — <sup>(j)</sup> In mid-September the interest rate dropped from 19.5% per year to 19% per year.

Source: Central Bank of Brazil, Nota para Imprensa, several issues. Brasília, D.F. URL: <http://www.bcb.gov.br>

Table 12

**Net Public Sector Debt<sup>(a)</sup>**

R \$ Billions

|                                   | Dec./ 1994 |       | Dec./ 1995 |       | Dec./ 1996 |       | Dec./ 1997 |       |
|-----------------------------------|------------|-------|------------|-------|------------|-------|------------|-------|
|                                   | Stock      | % GDP | Stock      | % GDP | Stock      | % GDP | Stock      | % GDP |
| Total net debt                    | 153.2      | 28    | 208.5      | 30    | 269.2      | 33    | 308.4      | 35    |
| Federal gov. And the Central Bank | 65.8       | 12    | 90.4       | 13    | 128.4      | 16    | 167.7      | 19    |
| State gov. and Municipalities     | 51.1       | 9     | 72.5       | 10    | 93.4       | 11    | 115.9      | 13    |
| State enterprises                 | 36.2       | 7     | 45.6       | 7     | 47.4       | 6     | 24.8       | 3     |
|                                   | Dec./ 1998 |       | Jan./ 1999 |       | Feb./ 1999 |       | Nov./ 1999 |       |
|                                   | Stock      | % GDP | Stock      | % GDP | Stock      | % GDP | Stock      | % GDP |
| Total net debt                    | 385.9      | 42    | 484.1      | 52    | 500.8      | 52    | 517.6      | 48    |
| Federal gov. And the Central Bank | 231.3      | 25    | 305.5      | 33    | 317.4      | 33    | 318.4      | 30    |
| State gov. and Municipalities     | 130.9      | 14    | 140.0      | 15    | 143.3      | 15    | 167.3      | 15    |
| State enterprises                 | 23.7       | 3     | 38.6       | 4     | 40.1       | 4     | 31.9       | 3     |

<sup>(a)</sup> Includes the internal and external debt less international reserves.  
Source: Banco Central do Brasil, Boletim Mensal, Brasília, D.F., January 1998 and December 1999.

change rate was devalued much more than would be necessary to turn trade deficits into trade surpluses. The local currency went through “exaggerated” 64.08% devaluation against the dollar in January (see table 11). Given the fear of reigniting inflation — very high private external liabilities in relation to international reserves and indexed federal securities debt —, an unexpected movement to liquidity preference, i.e. the dollar, by investors was observed. This new configuration of expectations strengthened the flight from financial assets denominated in *reals*.

The marked devaluation of the *real* associated with the political decision to raise the domestic interest rate to 39% per year and soon after to 45% per year triggered a sharp increase in the public debt. The total net public sector debt rose from R \$ 388.67 billion in December 1998 to R \$ 500.78 billion in February 1999 (see table 12). In the federal range, the net debt rose from R \$ 231.26 billion to R \$ 317.37 billion in the same period. According to an estimate by the Central Bank, 91.5% of the increase in the total net public sector debt resulted from the process of currency devaluation implying a cost of R \$ 103.3 billion. The need to nationalise or hedge private sector liabilities denominated in dollars, particularly that debt lent by banks to local private borrowers (Resolution #63/1967), and at the same time to attempt to convince economic agents that the exchange rate parity would be kept lies behind this increase in the net public sector debt. The cost of the expansion of securities indexed to exchange variations totalled R \$ 48.55 billion; the cost of transactions in the derivative market (swaps and dollar future markets) between January and February 1999 amounted to US \$ 7.6 billion (Izaguirre, 1999). The remaining cost, i.e. R \$ 47.17 billion, derives from the impact of exchange rate maxi-devaluation on the external debt stock. The ratio net

public sector debt to GDP increased from 42% in late 1998 to 52% in February 1999.

Since its early days the trajectory of the floating exchange rate was rather unstable: the dollar rose to R \$ 2.20, dropped to R \$ 1.65, rose again to R \$ 2.00, and fell to R \$ 1.85 in December 1999, with a declining trend. First, the exchange rate floated freely and expectations for the performance of the Brazilian economy were fairly gloomy. In the period March/April 1999 after the announcement by the Central Bank of the green light from the IMF to use US \$ 8 billion of international reserves to provide the exchange market with liquidity, the sales of US \$ 3.4 billion by the Central Bank brought about considerable dollar devaluation. Interventions by the Central Bank in the exchange market, moving from a free floating exchange rate regime to a managed floating exchange rate system, increased interest rates and flexibility of regulations for inflows of external capital — including reduced Tax on Financial Transactions (IOF) from 2% to 0.5% on foreign investments and diminished minimum terms for external financial funding, managed to revert the exaggerated exchange rate devaluation and promote a reflux of short-term foreign capitals. These measures encouraged the return of foreign and local investors to the domestic financial market, enabling the country to return rapidly to international capital markets. These capital inflows were attracted by low prices (in dollars) of equities and of local state-owned and private companies. Moreover, the monitoring by the Central Bank of Brazil together with the IMF and large international banks, chiefly US banks, which made trade credit lines available again, allowed for a transition from a free floating exchange rate regime to a managed floating exchange rate system. Therefore, the economic authorities

action — by extending the offer of dollars from international reserves yet available, by encouraging capital inflows, and by making new trade credit lines available — allowed for a revaluation of the *real* against the dollar. This revaluation movement of the real (from R \$ 2.20 to R \$ 1.65 per dollar) was, without any doubt, crucial to minimising the financial status of debtors in dollars, once not all economic agents were hedged by the exchange rate mechanism, and to lessening inflation expectations, thus avoiding reindexation and insolvency.

Nevertheless, as of May, the dollar quotation presented an upward trend again, at the same time that the Central Bank decided not to intervene in the exchange market. This behaviour allowing a free exchange rate fluctuation on the part of the Central Bank was changed in late October when a re-negotiation of the floor of net international reserves (minus disbursements from the IMF and BIS) with the IMF was announced and the Central Bank intervened in the exchange market.

Despite the instability in the exchange rate, the dollar variation was not used as a guideline to set domestic prices. Only a few price increases were observed in products using imported raw materials. The reason for this was the financial and trade liberalisation in the early 1990s that triggered significant changes in the price formation pattern by corporations operating in Brazil. Available foreign credit allowed for expanded imports and the foreign competitiveness became the major threat to these corporations, leading to changes in their strategies. In this context, corporations needed intense and rapid productivity gains achieved by cost cuts. The price management was then subordinate to the need to keep their market share more than to maintain their profit margin. These factors deeply affected the price dynamics during the *Real Plan* and, as a rule, did not change after the currency devaluation.<sup>7</sup> The Amplified Consumer Price Index (IPCA) accumulated an increase of 8.9% and wholesale prices — which are very susceptible to the exchange rate fluctuation — rose 29% in 1999.<sup>8</sup> This reveals that the currency devaluation primarily meant a cost shock. These pressures on costs were absorbed by a reduction in profit margins and a drop in the nominal salary cost by produced unit, in an environment of low demand and depression in the labour market.

The level of utilisation of installed capacity was about 78% according to Federation of Industries of the State of Sao Paulo. According to Brazilian Institute of Geography and Statistics (IBGE) — Monthly Employment Survey —, the open unemployment rate in metropolitan areas reached 7.6% in 1999. However, according to DIEESE and the Seade Foundation, the total and open unemployment rate in the metropolitan area of the City of Sao Paulo was 19.3% as a percentage of the Economically Active Population (PEA). The reason for this difference lies in their methods of calculation: according to the former a

person who looked for a job during the week prior to the survey date is counted as a potential worker, while the latter also counts someone who has been looking for a job in recent months. The revenue average of employees dropped 5.5% in real terms in 1999 when compared with that in the previous year. And the working conditions have also deteriorated (see table 9).<sup>9</sup>

Designed to promote the external adjustment, the economic policy adopted after the maxi-devaluation — a floating exchange rate combined with a gradual reduction of the interest rate — with the support of multilateral organisms (IMF, World Bank, Inter-America Developing Bank) allowed for a substantial appreciation of the *real* in May and June 1999. It mitigated inflationary pressures that were also repressed by the deepened recession started in mid-1998. The successful minimisation of the impact on inflation together with reduced interest rates mitigated the recession. In mid-1999, there was an auspicious atmosphere in financial markets. It was believed that the Brazilian economy had overcome strong impacts of the maxi-devaluation without falling back to the inflationary spiral and without plummeting into a deep recession (Carvalho, 1999). In 1999 the GDP growth rate showed a small positive variation of 0.82% (see table 9).<sup>10</sup>

The economic policy succeeded in stabilising prices. However, it increased the vulnerability of the balance of payments, led to a disorganisation of the manufacturing sector, and deteriorated the fiscal balance. The trade balance figures were disappointing. Despite a 48% nominal currency devaluation and a 14.7% drop in imports, the trade balance deficit totalled US \$ 1.2 billion in 1999 after exports had dropped 6.1% in value (see table 8). Adverse

<sup>7</sup> For a discussion on mechanisms that resulted in the drop of the inflation rate during the *Real Plan*, see Andrei (1998).

<sup>8</sup> In mid-1999, the Central Bank adhered to the model of inflation target defined at a yearly basis (8% in 1999, 6% in 2000, and 4% in 2001) and in a very flexible manner as a parameter for the implementation of the monetary policy. However, in Brazil's letter of intent to the IMF, announced in the first week of December 1999, significant changes were included in the inflation targeting system turning it into a considerably more inflexible model. A "consulting mechanism on inflation" was determined which forces the Central Bank to submit this inflation targeting system to the IMF control. Thus, the risk that the Central Bank — under a closer and tutorial guidance by the FMI — will be forced to respond by increasing the interest rate or taking other measures for credit restraint became higher in case of future deviations from inflation targets. The framework of the inflation target system was established by the Decree No. 3088, dated 22 June 1999. For a discussion on this system, see Delfim Netto (1999).

<sup>9</sup> According to IBGE, the drop in the mean real revenue of workers during the 90's was 8%. The share of informal employment, i.e. without welfare benefits, rose from 19.1% in 1990 to 26.4% in 1999. In contrast, the share of formal employment fell from 56.9% to 44.5% in the same period (Folha de Sao Paulo, 2000).

<sup>10</sup> The average growth rate of the Brazilian GDP was about 1.6% during the 1990s. In 1998, it declined by 0.12% in relation to that in 1997, according to IBGE.

price conditions in the international markets — particularly among primary products and semi-manufactured — jeopardised the recovery of foreign sales. On the other hand, imports of consumer goods, more sensitive to the *real* devaluation, suffered the most severe setback (–31.3%) followed by those of capital goods (–15.8%), and raw materials and intermediate products (–10.3%). This asymmetric behaviour between import and export prices resulted in an estimated 12% loss in international terms of trade (Funcex, 1999).

The combination of value exchange rate and high interest rate prevailing during the stabilisation process of the *real* discouraged projects oriented to the diversification of exporting items. The manufacturing of less technology-intensive products was privileged,<sup>11</sup> “predatory” imports were fostered, and the share of foreign companies in the stock of domestic capital rose. The share of foreign firms reached 93% in the automobile industry, 89% in the hygiene, cleaning and cosmetics industry, 79% in the electric and electronic industry, and 75% in the telecommunications industry (Gonçalves, 1999 and Batista Jr., 1999). The above-mentioned factors added to a drop in commodity prices help explain the slow response of exports to the exchange rate devaluation and the increase in the remittance of profits, interests and dividends abroad. The total interest remittance to foreign countries rose increasingly during the 90s and amounted to US \$ 15.2 billion in 1999, with profits and dividends at US \$ 4 billion. The current account deficit reached about US \$ 24.4 billion in 1999 and was settled by foreign direct investments totalling US \$ 31.5 billion (see tables 8 and 1). This dynamics made evident how vulnerable the balance of payments is.

Regarding the net public sector debt, the agreement with the IMF imposed a maximum level of R \$ 513.5 billion (49% as a percentage of GDP) in December 1999. It appears that these limits will be obeyed. In November 1999 the net public sector debt reached R \$ 517.6 billion (48% as a percentage of GDP) (see table 12). During 1999, the share of post-fixed securities in the total federal securities debt dropped slightly: after reaching a maximum of 73.3% in March it dropped to 66.6% in December (see table 10). This trend, as stated above, reflected the government's difficulties in rolling over its debt by means of the issue of prefixed securities in an environment of intense uncertainties, and consequently, of expectations of increasing interest rates. The uncertainty on the future interest rate led the financial market to refuse prefixed securities or to demand very high risk premiums to acquire them.<sup>12</sup> As a result, the economic authorities started to issue post-fixed securities indexed to the overnight/Selic rate so as to guarantee the debt rollover. It represented a clear deterioration of the public debt profile.

In November, the Central Bank announced a series of measures aimed at gradually lengthening the debt profile and increasing the share of prefixed securities. The fed-

eral securities issued in public offers totalled R \$ 403.4 billion in September and its average maturity date was 3.63 months, being predominantly indexed to the overnight/Selic rate or to exchange variations.<sup>13</sup> In general, the goal of the government is to increase the liquidity of prefixed securities, particularly by means of a consolidation of a secondary market. After achieving this objective, the economic authorities try to make longer-term securities more attractive and at the same time to reduce the premium on federal securities placement.

Despite these decisions of the Central Bank, the ratio interests of the net public sector debt/GDP rose from 3.2% average in 1990/94 to 5% in the period 1994/98. In 1998, the burden of interest became clearly dominant in the composition of the public deficit when the expenditures with nominal interest of the debt reached about 8% as a percentage of GDP. This financial nature of the public deficit continued to aggravate in 1999. In late November the nominal deficit of the public sector reached R \$ 93.2 billion, i.e. 10.6% as a percentage of GDP, and the volume of interests at all government levels — federal, state and municipal — and state enterprises amounted to R \$ 126 billion.<sup>14</sup> The accumulated primary surplus — a concept that excludes expenditures with interest and the debt indexation — reached R \$ 32.8 billion, i.e. 3.6% as a percentage of GDP, a better result than that anticipated in the agreement with the IMF. Figures recorded in October exceeded the surplus of R \$ 30 billion expected for 1999.

## 5. Final considerations: the deepening of the passive international insertion

The stabilisation model with financial, trade and exchange liberalisation was followed by a fast growth in the external liability of the Brazilian economy. The cycle of for-

<sup>11</sup> In 1999, the agriculture and cattle raising industry accounted for 41.25% of Brazilian exports, resulting in a trade surplus of US \$ 13.4 billion (Ministry of Agriculture, *apud* Zanata, 2000).

<sup>12</sup> The activities of the banking sector concentrated again on federal public security transactions generating 43% of their income whereas loans to the private sector accounted for just 17% in late 1998 (Pinto, 1999a).

<sup>13</sup> The version of the Brazilian agreement with the IMF, announced on December 2<sup>nd</sup> 1999, established the need to stabilise the federal securities debt indexed to exchange variations. It will mean a reduction in the offer of exchange hedge to the market by the government (*International Monetary Fund* Memorandum on Economic Policies, December 2<sup>nd</sup> 1999, URL: <http://www.imf.org>).

<sup>14</sup> Between January 1995 and August 1999, R \$ 326 billion were paid as interest — the federal government and the Central Bank were accountable for 63% of this total. It is twice as much as total expenditures on education and health by the federal government in the same period. As the accumulated nominal deficit will reach R \$ 318 billion in the period 1995/99 and the stocks of interests will total R \$ 342 billion, paid nominal interests will account for 107.5% of the deficit (Silva, 1999)

eign indebtedness associated with the expansion of international credit in the 1990s intensified the vulnerability of the Brazilian economy to an external shock. And, when it had barely overcome the debt crisis in the 1980s, the country was again plunged into a new exchange rate crisis, and therefore, into a new IMF adjustment program.

We may then conclude that the increased internationalisation of the productive structure and of the financial system, as well as the increased external borrowing requirements to meet commitments in the balance of payments gave rise to dependence without development capable of integrating the poor, the so-called “unemployable” by current president Fernando Henrique Cardoso.<sup>15</sup> It becomes increasingly clear that large banks and institutional investors (pension funds, mutual funds, insurance companies, hedge funds, and the like) operating at a world-wide scale and transnational corporations will be of little assistance to the country in following contemporary changes in the world economy. These banks and investment funds remained eager for short-term gains and the transnational corporations simply modernised their production facilities based on the strategies set by their parent companies, on their exporting targets, and on the evolution of the domestic market. Brazil’s role in the contemporary international dynamic was restricted to that of exporter of traditional manufactured products and importer of high-tech products and services. Therefore, Brazil has lost its ability to guide its autonomous growth originating from investments in the new and dynamic manufacturing industries. It has also subordinated its economic policy and its economic growth goals to fluctuations in the globalised capital markets moving abruptly from euphoria to depression.<sup>16</sup> This strategy of internationalisation and “financerisation”<sup>17</sup> of wealth and income of upper classes (R \$ 7.00 out of each R \$ 8.00 of the public deficit were paid as interest in 1998) together with a differentiation process of consumption by upper and middle class segments resulted only in a restricted modernisation of the Brazilian economy and the destruction of jobs and an increased social exclusion.

This economic policy also affected negatively the relationship between state enterprises and the national private sector. A virtuous interaction existed between public investments/expenditures and private sector decisions during the period known as national development. The current administration ignored the strategic role played by investments made by the state productive sector in the coordination of private decision-making. The outcome might have been less disastrous if the privatisation process had allowed a sector diversification and a financial and technological strengthening of large national private companies by increasing their capacity to compete in the domestic and international market. Until December 1999, resources from privatisation of state enterprises amounted to US \$ 72.4 billion, out of which US \$ 32.1 billion, i.e.

44.4% was foreign capital needed to settle increasing deficits in the balance of payments.

The Brazilian agreement with the IMF represented the deepening of this strategy of passive international insertion with financial, trade and exchange liberalisation. This event was explicit in the announcement made by the Brazilian economic authorities and the IMF board of directors, when they emphasised their strong commitment to: “the maintenance of a flexible interest rate policy; non-imposition of any control over capital outflows; integral payment of the internal and external debt service; continuing efforts to perform structural reforms in the social security, tax system, political institutions, budget process, financial system, labour market, and privatisation, among others”. The political and economic elite decided to double their bet on this model — complying with the international financial community’s requirements. Such a policy was adopted, as if it were an unavoidable historical imperative.

In view of these prospects, the president of the Central Bank of Brazil, Arminio Fraga, after the country’s return to the international securities market by means of a bonus issue of US \$ 3 billion in April 1999, supported the future implementation of policies designed to promote further deregulation of the domestic financial system — a reduction in the compulsory credit transactions and in the restriction to certain transactions — and more integration with the international financial market by means of an improvement in financial supervision rules, in mechanisms of risk management and in minimal capital adequacy standards (Basle Agreement) (Lucchesi, 1999 and Pinto, 1999b). Moreover, in mid-November, the Central Bank announced its intention to adopt the free convertibility of the *real* — the permission to exchange the domestic currency for a foreign currency without any restrictions — in the first half 2000. Currently, a natural person may buy for-

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<sup>15</sup> According to an estimate by professor Marcio Pochmann from the University of Campinas, social exclusion indicators tend to fall back to levels observed prior to the Real Plan. In 1993, 44.2% of the poor were included in the Economically Active Population (PEA). This percentage declined to 31.3% in 1996. However, it rose again as of 1997. In 1998, the poor accounted again for 33.2% of the PEA totalling 20.2 million inhabitants. Cf. Toledo (1999).

<sup>16</sup> Cf. Kregel (1996), p. 11: “The government has clearly lost control over monetary policy, after having voluntarily relinquished control over fiscal policy as part of the stabilisation programme. But, it is the latter which has adopted the increased globalisation as an integral part of stabilisation policy. Thus while there is little question that the increased globalisation of the economy has sharply reduced policy autonomy, the loss of sovereignty is not wholly due to the impact of globalisation itself. It is in part due to the acceptance of a particular type of economic stabilisation based on market liberalisation and on monetary targeting which has increased volatility in both money and foreign exchange markets.”

<sup>17</sup> Cf. Braga (1997).

<sup>18</sup> According to a report by the Central Bank of Brazil R \$ 124.12 billion were remitted abroad in the period 1992–1998 by using the CC-5 (Maschio, 1999).

foreign currency up to US \$ 10,000 and part of any remittance of foreign currency abroad must be made by the so-called CC-5 (an account originally created for transactions by non-resident investors).<sup>18</sup> According to these new regulations, there will be no limit on the purchase of foreign currency by natural persons and the remittance of foreign currency abroad will be free, though it will have to be stated in the tax return. The accounts in foreign currency within the country will remain banned (Pinto, 2000). Therefore, the Central Bank intends to deepen the liberalisation of capital flows by deregulating the exchange market and by facilitating and guaranteeing remittances of revenues abroad.

Several reforms are continuously proposed for the sake of this strategy. They are regarded as indispensable for the country to achieve sustainable economic growth by means, which in fact lead to further disorganisation of the functioning mechanisms of Brazilian capitalism. For the sake of this "modernisation", the Brazilian economy, which has one of the most integrated manufacturing systems among developing countries, will likely experience an increasing market share of transnationals, dismantling of its industrial facilities and growth in its external indebtedness. The international insertion will, according to this scenario, continue to be oriented towards productivity gains imposed on local manufacturers by foreign competitors. Economic growth will, then, depend essentially on foreign investments. The share of foreign direct investment in total Brazilian investments accounted for 19.4% in 1999 (see table 1). Finally, financing conditions will be tied to advances in the financial liberalisation, and will seek a hypothetical convergence between the domestic and international interest rates.

We hope we have clearly shown the limits and internal contradictions of the economic strategy implemented by the current administration. For the past 20 years the sup-

porters of economic liberalisation have been spreading promises of a new surge of social and economic development supported by foreign capital. As a matter of fact, liberalisation processes have been leading to low economic dynamism, increasing unemployment rates, precarious labour relations, wage drops, greater social inequality and successive waves of financial and exchange rate crises.

An alternative policy should be the adoption of capital flow controls that would allow for a better co-ordination of the domestic money and credit. The maintenance of a relatively free capital account certainly implies a continuous volatility of the exchange rate and limits for a reduced domestic interest rate. Moreover, a pro-active policy to foster exports and to replace imports should be adopted in order to achieve trade surpluses to finance current transaction deficits. From our standpoint, the crisis will not be effectively overcome before expressive surpluses in the trade balance are achieved. In this sense, it will be necessary to engage transnational corporations in export targets as they account for two-thirds of the world trade and for about 43% of manufacturing product exports in Brazil, as shown by Moreira (1999b, table 13, p. 19). In addition, conditions for a further strengthening of large Brazilian corporations should be created in order to make them global players. Currently there are only three of them: Petrobras (exploration and refinement of oil), Embraer (passenger air transportation), and Cia. Vale do Rio Doce (mining). The consolidation of a group of Brazilian corporations at an international level could foster the development of endogenous centres of technical advances/new technologies able to establish Brazilian trademarks, originate new markets, and generate activities and jobs for qualified personnel. Foreign capital can only partly accomplish these functions since it tends to focus its activities on innovation centres in their respective headquarters.

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## **Zusammenfassung**

*Die Währungs-, Finanz- und Wechselkurskrisen in Mexiko (1995), in Südostasien (1997–1998), in Russland und Venezuela (1998), sowie in Brasilien und Ekuador (1999) zeigen einen ähnlichen Prozess der Wirtschafts- und Finanzinstabilität von Peripherieländern. Alle diese Länder führten in diesem Zeitraum sowohl eine Liberalisierung des Kapitalverkehrs als auch eine Deregulierung des Finanzsektors durch. Auslöser der monetären Instabilität war eine erhebliche Zunahme der Kapitalzuflüsse, denen krisenhaft abrupte Abflüsse folgten. Dieser Artikel versucht, die inhärenten Grenzen und Widersprüche einer solchen Strategie zu zeigen. Als Beispiel dient die brasilianische Politik des Stabilisierungs- und Strukturanpassungsprogramms zwischen Juni 1994 und Januar 1999. Der Autor argumentiert, dass ein solches Modell einerseits die Auslandsabhängigkeit des Landes vertiefte und andererseits zu keinem nachhaltigen Entwicklungsprozess führte, der fähig gewesen wäre, eine Integration der weniger privilegierten Schichten in die brasilianische Gesellschaft zu ermöglichen.*