

ECONOMIC GROWTH WITH FOREIGN SAVING?

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Abstract. Highly indebted countries, particularly the Latin American ones, presented dismal economic outcomes in the 1990s, which are the consequence of the ‘growth *cum* foreign savings strategy’, or the Second Washington Consensus. Coupled with liberalization of international financial flows, such strategy, which did not make part of the first consensus, led the countries, in the wave of a new world wide capital flow cycle, to high current account deficits and increase in foreign debt, ignoring the solvency constraint and the debt threshold. In practical terms it involved overvalued currencies (low exchange rates) and high interest rates; in policy terms, the attempt to control the budget deficit while the current account deficit was ignored. The paradoxical consequence was the adoption by highly indebted countries of ‘exchange rate populism’, a less obvious but more dangerous form of economic populism.

In this paper we make a critique of the growth strategy that developed countries adopted in the 1990s in relation to severely indebted countries, and of the economic teams that domestically accepted uncritically such policies. Yet, we do not repeat the typical critiques to international economic institutions, particularly the IMMF, which emphasize their monetary and fiscal orthodoxy in detriment of employment. On the contrary, our main contention is that they adopted a soft current account constraint, which kept the developing economies under persistent threat of balance of payments crisis. Paradoxically, by abandoning the mutually agreed regulations on controls of international capital flows, and building a growth strategy based on financial opening, such policy made worse the foreign exchange constraint. In the past, such constraint meant that developing countries had no sufficient access to international financial markets; now, it derives from the opposite situation – of an excessive access to such markets.

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Since the 1980s foreign debt crisis, the indebted countries, particularly the Latin Americans, have been learning the following basic message from the rich countries: “we understand that you don’t count with enough domestic resources to finance your growth, but don’t worry: just control the budget deficit, open and reform your economy and give access to domestic assets, that we will finance your economic development”. In other words, take care of your state’s finances, and engage in market-oriented reforms that international market capital flows will take care of you, and you will experiment economic growth again. Such foreign saving, – it was added – will come in the form of direct investments rather than loans the better you behave. This view, coming from the developed countries, from the official international organizations, from multinational corporations investing abroad, and from the international financial system, seems reasonable, so reasonable that in the early 1990s, when international financial flows resumed after the foreign debt crisis, it turned into a firm belief, or a conventional wisdom, in developed and developing countries. Yet, we will argue in this paper that, given the high indebtedness of most developing countries, this ‘growth *cum* foreign saving’ policy is just flawed economic policy based in poor economics. In the 1970s the respective expression was ‘growth *cum* debt’. It proved finally a mistake, but not such a huge mistake as the respective policy in the 1990s. As long as countries accepted it, they suffered serious economic losses. Today, as no systematic critique of this kind of policy has been undertaken, it continues to have detrimental effects on highly indebted developing countries – although, as we will see, some major mainstream economists begin to show concern in relation to it. Principally it is became clear, since the report of the Meltzer Commission, that there is a moral hazard problem involved, or, in other words, that the American Treasury and the IMF cannot indefinitely bail out the commercial banks that make irresponsible loans, and the local governments that accept them.

The argument that low income and low saving rate countries should grow faster with foreign saving inflow seems logical and reasonable. In fact, if capital inflows finance current account deficits due to increase in the imports of capital goods, and if the rate of investment rises, the economy will grow faster. So, this strategy of dependent growth has been accepted as ‘true’ by almost everyone uncritically in Latin America, and became an assumption behind the reasoning of the economists, politicians, businessmen and also of all government decisions. Most Latin American countries – but not only Latin American countries, as we saw by the 1997 Asian crisis, and by the 1998 Russian crisis – have followed this recipe and have experienced deep transformation in the last decade. The traditional fiscal unbalances were largely eliminated, both trade and financial markets were liberalized, bias against foreign capital was removed, privatization was widespread adopted, and many institutional reforms implemented with the support of multilateral organizations and the applause of international financial markets.

Yet, the empirical records of the results of this liberalization policy and dependent growth strategy in the last decade have been deceiving: stagnation, and continuing macroeconomic instability. In Argentina, unprecedented economic collapse, deep political crisis, and social tragedy¹. The question that needs a clear answer is what went wrong?

In discussing these questions, we are thinking in the large Latin American countries, like Brazil, Mexico, and Argentina, which have stabilized prices after the debt crisis with the adoption of an exchange rate anchor. In consequence, the international financial system reestablished their credit, thus allowing them to incur again in large current account deficits, financed in part by foreign direct investment. The exchange rate was kept low, and interest rates, usually, high. What happened with investment rates and growth? Why did they not increase? What eventually happened to macroeconomic stabilization itself? The new dependent growth strategy, or development with debt strategy, enhanced, or, rather, debilitated macroeconomic stability?

The paper is divided in seven sections, besides the conclusion and an appendix with the econometric test. In the first section, we will discuss the assumptions behind the conventional wisdom, which, in the 1990s, assumed the form of the growth *cum* foreign saving strategy. In the second section, we discuss the limits to foreign indebtedness, bring to discussion the Feldstein-Horioka ‘puzzle’. In the third, the foreign debt threshold is analyzed. In the fourth, we present an econometric test showing the irrelevance of foreign savings to growth, especially for indebted countries. In the fifth section we relate the growth *cum* foreign savings strategy with the populist cycle and the capital inflow cycle. In the sixth section we analyze the strategy taking particularly Mexico, Brazil and Argentina into consideration. Finally, in the seventh section we show how the growth *cum* foreign saving strategy perpetuates macroeconomic instability, and eventually leads the country to domestic and debt crisis, as it maintains the local currency overvalued. This is not a policy paper, thus we will not discuss the way out of the present situation, although in the conclusion we offer some indications about it.²

Growth *cum* Foreign Savings or Soft Current Account Strategy

The conventional mainstream theory of growth for open economies asserts that countries with lower capital intensity and lower per capita income will grow faster

¹ See Caballero, 2001.

² In relation to Brazil, our analysis and policy proposals are in Bresser-Pereira and Nakano (2002) In www.bresserpereira.org.br this document, written at the request of the house representative José Aníbal, president of PSDB, and most of the national debate that it raised is available.

than the ones with higher respective ratios because they have higher return on capital and thus, if there is no restriction to capital mobility, saving will move and increase investment and growth in those countries. The condition is that developing countries open its economy, take care of its macroeconomic stability, maintain domestic free markets, and develop an institutional system that guarantees property rights and contracts.

The assumption behind this model is that developing countries, hurt by the 1998s' debt crisis, did not count with enough domestic saving to finance their economic development. Thus, they would have no alternative than to count on foreign saving. This is a false assumption. Extremely poor countries, as most sub-Saharan countries and a few Latin American ones, like Haiti, indeed did not complete their primitive accumulation, nor their capitalist revolution, and remain unable to finance growth. All intermediary countries, however, although hurt by a domestic fiscal crisis and the international debt crisis, continue able to finance their growth. The central question is not to provide savings for them, but to create a stable and secure economic environment, where entrepreneurs can invest, expand industrial capacity, and generate the required savings.

The theoretical presumption behind is that, even if we relax the previous assumption, foreign saving will increase domestic investment and advance economic development. Free capital flows promote efficient international allocation of resource, with capital flowing from countries with high capital/labor ratio to countries with low capital/labor ratio. As developing countries have higher rate of return on capital, foreign capital inflows will increase the investment rate in such countries. Capital would move quickly to equalize the marginal productivity of capital and hence, the convergence on output per capita should inevitably occur.

More important, free capital movement disciplines governments, especially their macroeconomic policy. Policies deemed unsustainable, distorting market allocation, will result in capital outflow. To attract foreign capital into the country, governments have to follow policies considered exemplary by the potential investors. As international markets are supposed to be efficient in allocating resources, if each government limits intervention, keeps free the domestic market, and respects macroeconomic fundamentals, the country will grow and converge to the levels of growth achieved by developed ones.

The central foundation of a credible macroeconomic policy is a responsible fiscal policy, or budget equilibrium. Populist fiscal policies should be avoided and the primary surplus should be such as to keep the government's domestic debt to GDP ratio under control. Based on fiscal balance foundation, the country should adopt fixed-exchange rate regime (currency board or dollarization would be a good alternative...). Thus, monetary policy would just respond to capital mobility respecting the interest rate parity relationship. The domestic interest rate is viewed

as endogenous and just has to be adjusted to international interest rate and the country risk.

Given the external shocks that developing economies have been subject to, due to successive international financial crises, contagion effects, and speculative attacks, mainstream economists and multilateral organizations revised their opinion and are now accepting floating exchange rate regime. In this case, as central banks recover some discretion in adopting an active monetary policy, they should follow a ‘conservative policy’, often translated into high interest rates, and should have independence to conquer the credibility of foreign and domestic investors.

Under such conditions, and given capital account convertibility, which opens the developing economy to world financial markets, foreign saving would become, according to principles of mainstream economics, the key factor for faster growth. The fact that foreign saving corresponds to current account deficit is not usually mentioned. When it is, the rationale that IMF uses to play down its role is a typical mainstream assumption: the twin deficits theory. Keeping under control the budget deficit would mean, automatically, to control the current account. The fact that exchange rate unbalances often falsifies the twin deficits assumption is ignored. The commercial banks and, more generally, the international financial system to which the Treasury and IMF respond, are not interested in such small questions.

Some authors try to provide an empirical evidence for such reasoning, arguing that since 1930 Latin America has imposed restriction on capital mobility and thus has lower performance than Asian countries that did not.³ We will not discuss this kind of argument. Latin American countries did restrict capital mobility, but all other countries did the same. This was an assumption of the Bretton Woods agreements. Capital mobility would be kept under control allowing countries to have freedom to manage monetary and exchange rate policy. As Bluestone and Harrison observed, “Article VI of Bretton Woods Articles of Agreement *required* members to institute such controls as would be deemed necessary to maintain global economic stability”.⁴

In the first fifty years, the results of such restriction in most Latin American countries were favorable. Rates of growth were, in most cases, satisfactory, and, particularly in Brazil, excellent. Yet, distortions began to accumulate already in the 1970s, and, in the early 1980s, the debt crisis and the fiscal crisis of the state signaled the collapse of the developmentalist strategy that they adopted since the 1930s. Since mid 1980s Latin American countries implemented badly needed fiscal adjustment and market oriented reforms, that came to be known as the Washington

³ See, for instance, Taylor, 1999.

⁴ Bluestone and Harrison, 2000: 135.

Consensus, but such should be distinguished from the Second Washington Consensus that dominates the 1990s and is the object of this paper. First, the consensus' reforms did not include the liberalization of the capital account. Commenting Sebastian Edwards' proposal of concomitant liberalization of domestic capital markets and international capital flows, Williamson remarked in the book in which he defined the consensus that "restrictions on international capital flows should be maintained until after the domestic capital markets had been liberalized and trade reform had been largely completed".⁵ Second, according to Williamson, the consensus "disfavor both negative and (because of the discouragement of investment and the implications for government and corporate solvency) excessively positive interest rates". Third, exchange rates should be competitive, since "there is now a very wide consensus in Washington that export led growth is the only kind of growth that Latin America stands any chance of achieving in the next decade."⁶

Thus, the first consensus should be clearly distinguished from the second one, which is a phenomenon of the 1990s, after Brady Plan disentangled the debt crisis. The Second Washington Consensus the was sponsored by the international organizations and American government, and became part of the conditionality to lend to these countries. It is the outcome of adding the liberalization of international capital flows with the growth *cum* savings strategy. In practical terms it involved overvalued currencies (low exchange rates) and high interest rates; in policy terms, the attempt to control de budget deficit while the current account deficit was ignored.⁷

The first consensus was widely criticized by the left in Latin America, although most of its propositions – that added to macroeconomic adjustment and market oriented reforms – were quite sensible policies provided that executed with

⁵ On the same line of thought see Arteta, Eichengreen and Wyplosz, 2001. For a political economy analysis of capital account liberalization, see Armijo (2000).

⁶ Williamson, 1990: 18, 21, 72. The ten areas of policy reform included by Williamson in the consensus are fiscal discipline, public expenditure reform, tax reform, domestic financial liberalization, competitive exchange rates, trade liberalization, welcoming attitude to foreign direct investment, privatization, deregulation.

⁷ We don't think necessary to substantiate with facts IMF's support to such strategy. Just look the limit case, Argentina. While an overvalued peso was producing high current account deficits and leading the foreign debt to unimaginable level, IMF was concerned with the budget deficit and the domestic debt. If one wants substantiation for this claim, he will have just to read what the newspapers published about Argentina and the IMF from early 1999, when the crisis began to take full form, to 2001, when it blew up. The budget deficit and the domestic debt are always present, while the current account deficit and the foreign debt, ignored.

moderation.⁸ The second was more ambitious, since it suggested a growth strategy, and its economic consequences, just disastrous. Today there is in Latin America a general resistance to neo-liberal reforms, which are equated to the Washington Consensus, although what was really detrimental to developing countries was the Second Washington Consensus. Dependency theory had been exhaustively discussed in the 1970s in order to understand the obstacles that Latin America had faced to grow, but, paradoxically an effectively dependent strategy of growth – growth dependent on foreign saving – was only now, in the late 1980s or early 1990s, adopted.

Most of Latin American countries, with notable exception of Chile, which established clear limits to the capital inflows, have followed the dependent growth strategy described in this section. And were successively presented as an example to the other by the international agencies. Yet, each major country ended in a crisis: Mexico, in 1994; Brazil, in 1998 and 2002; Argentina, in 1995 and 2001/2002. None, not even Mexico that counts with privileged relations with the United States, solved their foreign account unbalances and resumed sustained economic growth. It is interesting to note the high post stabilization rates of growth presented by Argentina in the period, with 1995 contagion crisis and the 2001/2002 dramatic end of cycle crisis demonstrated to be artificial. In the Table 1 one can compare the growth performance of Latin American countries, which adopted the dependent growth strategy, with Asian and industrialized countries. We can also compare the decade of 70s, characterized closed economy and interventionist state, and the 90s, with open economy and liberalized markets.

It is important, however, to note that such growth strategy, which accepts instead of posing limits to international capital flows, and the recurrent crisis that it entails, was not limited to Latin America. All severely indebted countries were victims of the same soft current account constraint turned into growth strategy. Even the Asian tigers, although not so much indebted, suffered growth losses as a consequence of the 1997 crisis, which highlighted the instability of international capital flows. The countries that better resisted to such policies, like China and India, are the ones that continue to grow steadily.

Table 1: GDP Annual Growth Rate 1970s-1990s

	1971/80	1981/90	1991/2000
World	3,8	3,4	3,8
Industrialized Countries	3,1	2,9	2,4

⁸ For instance, provided that did not involve privatization of natural monopolies. Or that labor regime flexibilization did not involve offense to basic social rights.

África	3,8	2,3	2,5 ^a
Ásia	5,4	7,1	7,1
Middle East	6,2	0,8	3,8 ^b
Latin America and Caribbean	6,0	1,6	3,1 ^b
Brazil	8,7	1,6	2,7

a: Period until 1998; b: Period until 1999.

Source: Giambiagi, (2002), pp. 135.

We ask again, what went wrong? The twin deficits theory is not so tranquilizing as one should expect in relation to current account deficits? Why the exchange rate tended to be overvalued in the Latin American countries just after they stabilized their prices? The adoption of an exchange rate anchor is the explanation? But, then, why it took so long to such an anchor be abandoned? Is it not true that in a stable and institutionally favorable economic environment, net inflows of capital, or current account deficits, or foreign saving (which, by definition, are equal to current account deficits) will lead to higher capital accumulation? If not, why? In what conditions? How far is macroeconomic stability consistent with dependent growth strategy? Or, more broadly, with high current account deficits, even when financed by foreign direct investment?

The Limits to Foreign Indebtdness: The Solvency Constraint

If capital flows from high to low per capita income countries contribute to increase the rate of growth of the later, the respective current account deficit in the recipient country should imply increase in its rate of investment. From the national accounting identity, we have that investment is equal to domestic plus foreign saving, the last one equal to current account deficit. Thus, a country 'benefited' by higher foreign saving should display a higher rate of investment. On the other hand, the conventional wisdom on international global markets and dependent growth, that we previously sketched, and its assumption related to free capital mobility, tells us that higher saving rate in one country does not imply higher rate of investment in this same country. Such wisdom confirms the conclusion derived from the accounting identity: saving will flow from mature, low return on investment countries, to developing ones, and growth in the later will follow.

Feldstein and Horioka, using sample of sixteen OECD countries, have tested this hypotheses, but 'surprisingly' found a strong correlation between domestic

saving and rate of investment.⁹ Other studies have shown that this saving-investment correlation is highly stable, and holds for developing countries even in recent periods, after their financial liberalization. Yet, this robust Feldstein-Horioka empirical correlation was considered as a ‘puzzle’ in the mainstream economic literature in the sense that it apparently contradicts the inferences that the observed high capital mobility, especially after the 1970s, would allow.

Actually, other authors have argued that this correlation is not a puzzle at all, but is a long-run relationship reflecting the intertemporal budget constraint, or the solvency constraint, to which each country is subject.¹⁰ A country cannot borrow or lend indefinitely: current account deficits have to be followed by surpluses, or vice versa. In the long run the current account balances have to add up to equilibrium. For some period, and up to a certain debt ratio, a country can have current account deficits issuing new debt, but after a given level the debt overhang begins to have negative effects on macroeconomic stability and economic growth, so that the country should better stop its debt ratios (foreign debt to GDP and principally foreign debt to exports). Not only foreign lenders do not accept the Ponzi game of issuing new debt to pay old debt indefinitely, although receiving increasing interests for the accrued risk: also domestic economic agents begin to demand higher interests, and domestic investments decrease. In other words, when we are analyzing a macroeconomic problem we should not forget that there are flows and stocks. Flow of foreign capital becomes a stock of debt, which has its own dynamics over time. The Feldstein-Horioka holds because countries tend to be cautious and respect the solvency constraint – a constraint that the dependent growth strategy ignored in the 1990s.

The Debt Threshold

Thus, there is a debt threshold that developing countries should not ignore. In the 1970s, when Mario Henrique Simonsen was finance minister of Brazil, this outstanding Brazilian economist used to say that the foreign debt to exports ratio should not exceed 2. Later, in an academic text, after Brazil had for long surpassed the 2 limit, he made his view more precise: a debtor country with the debt to exports ratio below 2 is in comfortable situation, between 2 and 4 a doubtful situation, and in a critical situation if this ratio is above 4.¹¹ In fact, the debt to exports ratio seems the fundamental indicator of external solvency. Foreign investors may be risk-

⁹ See Feldstein and Horioka, 1980.

¹⁰ See Rocha and Zerbini (2002) for a survey and further evidence. The authors quote studies by Sinn (1992) and Coakley et al. (1996) as evidence that the Feldstein-Horioka correlation is not a puzzle but just express a solvency constraint.

¹¹ See Simonsen and Cysne, 1995.

taking, but they charge for the risk, and may, at any time, stop rolling over a debt that they understand to big.

Simonsen's intuition was correct. Although difficult to be clearly defined, recent empirical research points out the existence of a threshold beyond which debt becomes negative. The World Bank has found that 220% of exports and 80% of GDP is such threshold because most of episodes of debt crisis and renegotiations took place within these limits. Cohen finds lower numbers: when the debt/export ratio reaches 200% and the debt/GDP ratio, 50%, the probability of rescheduling becomes great and the effect on the growth becomes significantly negative.¹² A recent detailed empirical study by three IMF economists gets to similar conclusion. They find a nonlinear effect of increasing debt on growth, "the average impact of debt on per capital growth appears to become negative for debt levels above 160-170 percent of exports and 35-40 percent of GDP". Their study suggests also that "doubling debt slows per capita growth by about half to full percentage point", so when the debt ratio rises from 100 percent to 300 percent, per capita growth declines by full 2 percentage points per annum.¹³

A large macroeconomic literature was oriented to a similar but different question. Instead of asking if there is a threshold for foreign indebtedness, it asked for the appropriateness or not of financial liberalization. Following the neoclassical assumptions behind the dependent growth strategy, the deductive conclusion was that such liberalization was as sound as trade liberalization. Yet, the empirical studies do not confirm such deduction. A 1998 paper by Rodrik concludes that there is no evidence that countries without capital controls have grown faster, invested more, or experienced lower inflation continues unchallenged. Such conclusions have not been challenged by new evidence. Capital controls are essentially uncorrelated with long-term economic performance once we control for other determinants.¹⁴ On the contrary, there are evidences that some countries that relied on foreign capital inflows have experienced financial debacle that combines balance-of-payment collapse and a banking crisis (Mexico in 1994, Thailand in 1997, Argentina in 2001).

Summing up, we see that in the long-run the inflow of foreign saving does not necessarily increase the investment rate as long as there is debt threshold; second, that financial liberalization, that limits the capacity of the developing country to contain the undesirable capital flows cannot be equated to trade liberalization. Trade liberalization was necessary to Latin American countries, and continues necessary, but involves a continuum negotiation process. Financial

¹² See Cohen, 1993.

¹³ See Pattillo, Poirsin and Ricci, 2002.

¹⁴ Rodrik, 1998: 61.

liberalization involves much higher risks. Its critics often emphasize the intrinsic instability that characterizes financial markets. We are accentuating a different aspect: the risk, in the long-run, of excessive foreign indebtedness – a risk that the market mechanism does not avoid, and that the multilateral organizations, beginning with IMF, do not take into consideration as they should. They do not because they assume the twin deficits, and, so, limit themselves to control the budget deficit; more broadly, because the economic theory adopted starts from the wrong assumption that foreign saving means increase in the domestic investment rate.

Over a long period, it is possible that a country benefits from foreign saving, provided that, in the borrowing phase, it invests and increases its potential growth rate in permanent way, so that the lower rate of growth in the debt payment phase is more than compensated. But this is true only if we analyze the short-term dynamics of saving, investment and debt, and revert the causality between investments and saving. Instead of saying, with neoclassical economics and conventional wisdom, that higher saving will increase investments, we should say, with Keynes, that, in a closed economy, the rate of investment determines the saving rate. In an open economy, the investment rate depends on imported capital goods, and so the investment rate faces foreign exchange constraint. Thus, if the incentive to invest is strong, the expected rate of profit is considerably higher than the market rate of interest, the investment rate can be higher with foreign saving supplementing domestic saving, to the extent that foreign savings turn the investment financially viable. If the growth of external debt is kept under control (i.e., the debt ratios are kept within prudent limits), the incoming foreign saving will foster the growth rate of the economy. Thus, under these conditions, if in the borrowing phase the country has a reasonable macroeconomic stability, an investment program, and strong incentive to invest on the part of domestic entrepreneurial class, and its foreign debt did not overcome the debt threshold, the availability of foreign saving will represent a positive factor in promoting economic growth. None of these conditions existed in Latin America and in most highly indebted developing countries in the 1990s.

Foreign Savings and Growth: Econometric Test

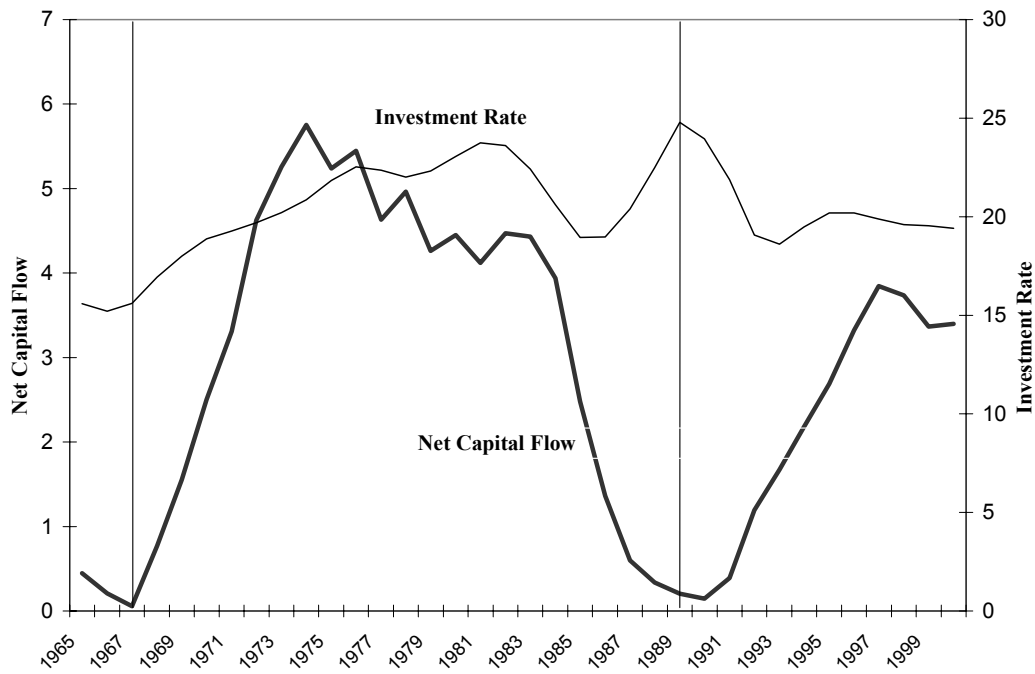
In order to test the relationship between foreign saving and the GDP growth we have estimated the econometric impact in GDP per capita growth of an increase of the foreign saving rate in GDP growth. We used a sample of 51 countries for which the data were available. The period studied was 1979 to 1998. The results are quite clear, and are consistent with the Feldstein-Horioka findings. For the total sample, 1 percent increase in foreign saving in relation to GDP has a long-term impact of 0.005 percent in GDP per capita growth, that is, the income elasticity of foreign savings is only 0.005. Considering just Latin America countries, most of which are highly indebted, the impact of foreign savings in the same period, as expected, is

still smaller: 0.001 percent, a result that is not statistically different from zero. This demonstrates clearly that growth is made at home. If this is true for all countries in the period studied, it is particularly true for the ones already severely indebted. When the country is highly indebted, additional current account deficits will only make more instable their economies, turning growth negative. In the Appendix, we present the econometric model, the source of data, the relation of countries, and the econometric test.

In other words, investment depends on the ‘animal spirits’ of businessmen (Keynes), or on their innovation capacity and disposition (Schumpeter), which is constrained by domestic saving and the capacity to import capital goods. The current account deficit may be a way of overcoming this constraint, to the extent that the correspondent foreign saving turns into investment, not in consumption. When one correlates inflow of foreign saving with increase in domestic capital accumulation, he is presuming that all the resources available through domestic and foreign saving are productively invested in the economy in each period. This is possible only if the country, besides having strong domestic entrepreneurial class and a government engaged in active and competent industrial, technological, and trade policies, has reached macroeconomic stability – which here is not understood as just price stability. Macro stability requires also relatively low interest rates, consistent with debt ratios kept under control and the corresponding country risk, and a ‘realistic’ exchange rate, which assures sufficient trade surpluses to assure the balance of payments’ intertemporal equilibrium.

In Latin America, in the recent episode of large capital inflow, such conditions have not been present, so that much of the foreign saving turned into domestic consumption. The rate of total domestic investment did not increase, or increased only slightly, and economic growth did not accelerate, as foreign saving had as trade-off reduced domestic saving. The inflow of capitals evaluated the local currencies, increased wages, spurred consumption, reduced exports and increased imports, causing increased macroeconomic instability. In Figure 1, we can see clearly, in the case of Brazil, the capital inflow cycle and the investment rate. It is interesting to observe that in the 1970s the investment rate increases as the net capital inflow soars till 1974. In contrast, in most of the 1980s, when the country turned highly indebted, having exceeded the debt threshold, the investment rate and the capital flow have inverse signals. In 1992 a new inflow cycle begins, but the investment rate, after increasing slightly, stabilizes and then goes slightly down.

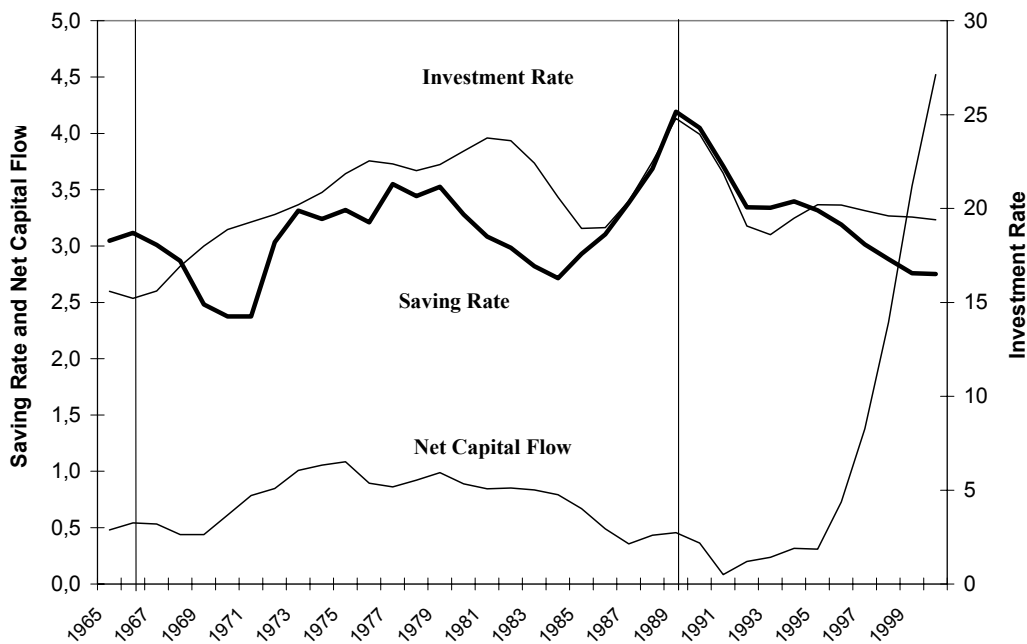
Figure 1: Brazil: Capital Inflow Cycle and Rate of Investment - % GDP (Moving Average 3 years)



Source: FIBGE and Central Bank of Brazil

In Figure 2 we have another view of the problem, in which the Feldstein-Horioka constraint appears, as the investment rate and domestic saving follow similar paths. In this figure we can see foreign saving as the difference between the two lines. Between 1968 and 1983 foreign saving is positive and the investment rate is increasing. After a transition the current deficit is near zero, while the investment rate increases sharply till 1989 as a consequence of classical populist expending, to fall in the same proportion immediately after. With price stabilization and the capital inflow cycle, current account becomes again negative, but the correspondent positive foreign saving does not cause the increase in the investment rate. At the same time, foreign direct investment surges, financing the current accounting deficit, but not promoting increase in investments.

Figure 2: Brazil: Investment and Domestic Saving Rate (Foreign Saving), and FDI



Source: FIBGE and Central Bank of Brazil

The Populist Cycle and the Capital Inflow Cycle

Why does the debt threshold tend to be ignored? Why the Feldstein-Horioka findings were for long viewed as a puzzle instead of a solvency constraint? To understand what happened in Latin American economies since the early 1990s, we have to look more closely to the facts, and specifically to two types of related cycles: the populist cycle and capital inflows cycle. On the point of view of the debtor countries, the explanation lies in the populist cycle. In relation to the creditor countries and the international financial system, in the capital flows cycle dynamics. The strong demand for price stabilization is a third explanation, as long as the use of an exchange rate anchor is a permanent (and populist) temptation.

The classical work on this matter was written by Canitrot (1975), who describes the populist cycle having as inspiration Díaz-Alejandro's (1963) seminal

analysis of the impact of exchange rate devaluation on distribution.¹⁵ Being Argentinean, he is well acquainted with Peronist economic populism, and generalized out three attempts to distribute income in the short run through wage increases and exchange rate appreciation, two of which under a Peron administration (1946-52 and 1973-75).¹⁶

The populist cycle may be described with stylized facts. It begins with high inflation and recession. The populist administration raises nominal wages, increases state expenditures, and fixes the exchange rate. Soon, the exchange rate gets overvalued, the inflation rate goes down, real wages go up, consumption and imports soar, and exports decline. The episode ends with a balance of payments crisis, exchange rate devaluation, and the adoption of tight fiscal and monetary policies. In the beginning of the cycle, nominal wage increases are restricted, in principle, to civil servants. Thus, we derive that we can have three types of economic populism: fiscal populism, when government expends more than its revenues permit; exchange rate populism, when we have exchange rate overvaluation; and the sum of both: total economic populism. The second type is directed related to the capital inflow cycles.

Capital inflow and debt crisis

While the populist cycle has a political origin, the capital inflow cycles are essentially an economic phenomenon. From abundant recent empirical studies, we can derive some new stylized facts about inflow of foreign capital to developing countries, which guard a clear relationship with the populist cycle. First of all, these studies show that these events are also cyclical, and mostly initiated by exogenous factors like low interest rate or current account surplus in the developed countries, rather than domestic conditions or domestic policies attracting private capital inflow. More important, inflows have been characterized by strong lending boom and sudden reversals. Factors affecting developed countries economies and finance are 0a main cause for these lending booms.

In a typical episode of capital inflow cycle the average duration is of about six years and the macroeconomic indicators are affected in the following way:¹⁷

¹⁵ See Canitrot (1975), Diaz Alejandro (1963,1982). Observe that economic populism should be distinguished from political populism – the direct relation of a political leader with voters without political parties' intermediation.

¹⁶ Later, Sachs (1989) offered also a significant contribution to the matter. Dornbusch and Edwards, and Bresser-Pereira edited in the same year, 1991, books on the subject. See

¹⁷ See Calvo, Leiderman and Reinhard, 1993, 1995; Gourinchas, 2001.

- The real exchange rate appreciates significantly;
- The domestic real interest rate increases, while the international real interest rate incurred by country increases but less significantly;
- There is an overall turnaround in the current account from surplus (or low deficit) to high deficit in the peak of capital inflow boom;
- The government budget surplus or deficit worsen significantly;
- The rate of investment rises above the previous trend but declines subsequently;
- There is a consumption boom with its ratio to GDP rising during the whole episode;
- There is a temporary output gain perversely compensated by significant and long lasting decline in potential output growth;
- The episode ends with international financial markets suspending suddenly the rollover of the debt, a strong domestic adjustment following.

Observe that differently from the previous populist cycles, there is no increase in nominal wages, or pro-cyclical expending binge. Populism appears in exchange rate evaluation, and the corresponding increase in real wages and salaries, particularly of the middle classes, whose consumption displays a higher import coefficient.

The upsurge of capital flows create the opportunity for the growth *cum* foreign savings strategy, or, in other words, to increased international indebtedness. The debt crisis produced many studies and an important literature on the relationship between debt and patterns of growth.¹⁸ Yet, it seems that economists in Latin America, Washington and New York, have not yet learned the lessons. It is unambiguously the fact that the debt accumulated in the 1970s generated the crisis of the 1980s, when the domestic investment rates of these highly indebted countries fell much below the historical trend. The debt overhang was interpreted as a ‘tax on domestic resources’, with negative effect on the rate of investment and growth. We have seen above, among our stylized facts, that potential rate of growth of the economies subjected to capital inflow boom declines significantly. Why do this happen? Which is the transmission mechanism?

¹⁸ See, for instance, Cohen, 1994.

Conventional wisdom's fundamental assumption is that in an open economy, markets will be an efficient mechanism to impose discipline on the macroeconomic policy. Thus to the extent that this policy responds to market signals, we will have macroeconomic stability. A simpler version of such wisdom teaches that economic and financial liberalization plus fiscal responsibility will produce macroeconomic stability. Thus, if the government controls the budget deficit, markets will consider the macroeconomic policy exemplary, deserving credibility. Key words in this view are macroeconomic stability and credibility, in the sense just described. Fiscal policy would be the only relevant economic policy, given that monetary policy, i.e., the rate of interest and exchange rate would be endogenous variables.

Most Latin American governments, in the 1990s, followed this prescription, or tried to do their best to follow it. Thus, IMF and other international institutions, that viewed Mexico as an example in the early 1990s, considered Argentina and Brazil exemplary for most of the decade. In practice, the macroeconomic policy in these countries responds most of the time to the financial market signals. First, because financial markets respond more quickly to any information, and try to anticipate the events and behave based on expectations. Second, because in the dependent growth strategy capital flows is what matters: the real sector of economy is already taken care by the market. The economic policy has clear financial bias.

Yet, the predictions of the growth *cum* foreign saving strategy did not work. Not because markets were not free, or because fiscal adjustment was not enough (although always could be better), but because such strategy does not lead to macroeconomic stability and credibility. On the contrary, it leads to continuing instability derived from financial fragility of external sector. Such mainstream economic policy intrinsically destabilizes the economy for at least two reasons: the growth dynamics of the foreign (and domestic) debt combined with markets' shortsightedness, and the tendency to the over-evaluation of the local currency. Macroeconomic policy reacts to a short-term strategy, not to a long-term one; and capital inflow tends then to evaluate the local currency and eventually cause financial crisis.

Moreover, it is well known that it is impossible to have together fixed or controlled exchange rate, autonomous monetary policy, and capital mobility. We have to choose any two from three policy variables. As the growth *cum* foreign savings strategy just emphasizes capital mobility, and as foreign investors search to reduce the exchange rate risk, the Second Washington Consensus originally proposed fixed exchange rate regimes (currency board or, preferably, dollarization), what meant, according to the macroeconomic trilemma, that countries would not have autonomous monetary policy. Developing countries would be, anyway, would be incompetent to use such policies. Adopted the consensus, the domestic interest rate is determined by the 'country risk' and by other conditions prevailing in the international capital markets, and would tend to be high so as to be

able to attract capital inflows. But, as interest rate grows, the foreign and the public debts increases and the country risk becomes higher and higher.

The alternative, that countries like China, India and Chile adopted in order to keep control of their economies, was to establish some controls to capital inflows. In doing that these countries were able to practice active and autonomous monetary and exchange rate policies.

The Overvalued Exchange Rate

The growth *cum* foreign savings strategy usually begins with the adoption of an exchange rate anchor to control inflation. This fact leads to an overvalued exchange rate, which tends to perpetuate itself as long as such rate, on one side, respond to political interest of the middle and upper classes, and, on the other, is the outcome of an intrinsic tendency in this direction involved in the idea of capital inflow and permanent current account deficits. In order to understand this, let us examine the recent capital inflow to Latin America, which began in the early 1990s. The stylized facts above tell us that low international interest rates (or current account surpluses in the developed countries) promote a capital flow boom to 'emerging markets'.¹⁹ After the debt crisis of the 1980s, most Latin American countries have engaged in fiscal adjustment and implemented liberalizing reforms. In the early 1990s most of them had already opened up their economies and controlled the inflation using exchange rate anchor. Brazil was the last major country to achieve price stability, in 1994.

Most of these countries adopted a fixed exchange rate regime, or some sort of pegged system. Capital inflows brought additional pressure on real exchange rate, appreciating it, while the price of domestic assets increased with demand. Central banks, in order to avoid the explosive increase in money supply and in credit, had to implement a sterilizing policy, which resulted in higher domestic interest rates. This rise in the interest rate attracted more capital, creating a vicious cycle of current account deficits and borrowing boom. As long as the domestic real interest rate is above the international rate, there is strong attraction of short-term capital inflows, interested in arbitrage gains. Thus, with the exception of Chile, that implemented a mechanism of short-term capital control, this policy created a bias in favor of short-term capital inflows.

With abundant supply of foreign exchange and the consequent exchange rate appreciation, the demand for foreign goods increases, causing a huge turnaround in the trade balance from surplus to deficit. Yet, despite the current account deficit, the overall rate of investment increases only slightly because most of the trade deficit is

¹⁹ See Calvo, Leiderman and Reinhard, 1993, and Gavin, Hausmann and Leiderman, 1996.

due to a consumption boom, which increases imports of goods and services. The consumption of domestic goods also increases with the exchange rate appreciation, augmenting domestic output. The overall investment rate increases just slightly because only the firms having access to international financial markets have the possibility of obtaining cheap credit, and because this sort of growth strategy rewards consumption, not investment. The inflow of foreign capital does not affect much the rate of investment. In some cases, the previous downward trend of investment rate is not altered. When, instead of short-term portfolio and arbitrage investments, we have direct foreign investments, such investments consist mostly of mergers and acquisitions.

On the other hand, the exchange rate evaluation and the consequent artificial increase in wages and salaries reduce domestic saving in such a way that it perversely compensates foreign saving resulting from current account deficits. In a country like Brazil, in the late 1990s, foreign saving represented about 4% of GDP: it was almost in the same proportion that domestic saving to GDP decreased in the decade.

Evidently, this policy of appreciating the exchange rate, increasing in real wages and consumption, while inflation is under control, has strong popular appeal. Actually, it is a modern form of populism: just exchange rate populism, or neo-populism. As the country presents a small primary deficit, or even a primary surplus, the budget deficits seem under control, and the overall policy has the support of financial markets, mainstream economists, and the IMF. Actually, in the period of capital inflow boom, governments are able to finance their budget deficits, which, in spite of government's attempts to control expenditures, increase, leading to a high internal debt. The budget deficit increases, even with a primary balance, because domestic interest rates remain high. After some time, such interest rates lead the domestic debt also into an explosive trajectory.

After some years of huge accumulation of foreign and domestic debts, financial conditions deteriorate. Such deterioration raises negative expectations on the part of local and international enterprises, as it has happened in Argentina since 1999, and the investment rate decreases, leading to recession. The consequent reduction in government's revenues increases perversely the budget deficit. On the other hand, creditors become increasingly uneasy. The country risk increases, as external debt to exports ratio increases much beyond a debt threshold. Speculative attacks are essayed. The reversal of capital flows can start for contagion, herd behavior and self-fulfilling prophecy. The country is then prone to international default and domestic crisis.

It is interesting to observe that the capital inflow boom of the 90s was mostly of private capital. And so the defendants of dependent strategy argue that there is no such thing like debt problem. As debt was issued by private sector there will be

some market solution. The problem is not that simple, because with the strong pressure from private sector it is the government in the end that provides hedge for holders of foreign currency liabilities. As the demand for foreign currency for hedging increases, the exchange rate goes up, and the central bank, before the foreign creditors suspend the rollover of the debt, has to sell its reserve of foreign currencies and obtain financing from multilateral organizations like IMF, World Bank and IDB. This is done to avoid the explosive increase of the exchange rate (which would theoretically resume the rollover of the debt and return capital flows to equilibrium), and, so, avoid inflation. As the loans from international organizations are insufficient to stabilize the exchange rate, government has also to issue debts indexed to foreign exchange. This creates an additional debt problem, because now a large proportion of domestic debt depends on the exchange rate, and such proportion tends to increase, as an increasing number of domestic investors prefer government bonds indexed to foreign exchange. The resistance to have a realistic exchange rate turns stronger, as the foreign account unbalance gets worse.

At different moments, in the 1990s or early 2000s, each Latin American country suffered speculative attacks started by different reasons. In all cases, the growth *cum* foreign saving strategy was behind. All had devalued their exchange rate and had no other alternative but to ask for IMF. In the late 1990s, after the 1997 Asian crisis, when the countries were in a much better fiscal situation than the Latin Americans, concern about the ‘international financial architecture’ began to rise in Washington. The report of the Meltzer Commission, created by the American Congress, was a first signal that it was time to revise the growth *cum* foreign saving strategy. Its main recommendation was that developing countries should show more transparency in their financial reports, and that IMF should cease to bail out the commercial banks. It was an indirect but major denunciation of the growth strategy of the 1990s. When Anne Krueger, at the end of 2001, became the new IMF’s chief economist, she proposed the bankruptcy mechanism, or article 11 system, to countries unable to rollover their sovereign foreign debts. It was, again, a clear signal, by a second outstanding mainstream economist (the first being Allan Meltzer) that it was time to reexamine IMF’s alliance with the commercial banks and more generally with the international markets. Its role is to control such system, not to be coopted by it. Yet, one should not conclude that the United States and the international agencies changed their policies in relation to developing countries. Kenneth Roggoff, IMF’s Chief Economist, writing on the invitation of *The Economist*, wrote that developed countries, whose population is aging, should have as large current account surpluses with developing countries:

Isolationists in industrialized countries should stop and look at their populations' advancing age structure. As the dependency ratio explodes later this century, who is going to provide goods and services for all the retirees? There are many elements to a solution, not least allowing expanded immigration from the developing world, with its much younger population. Regardless, one desirable element has to be for the industrialized countries to save abroad by

running large current-account surpluses vis-à-vis the developing world. These cumulated surpluses, while facilitating much-needed investment in poorer countries right now, could later²⁰ be drawn down as the baby-boomers stop working.

Rogoff may be right that there is a potential welfare gain in allowing the North to save more than it invests and exporting the capital to the South. The question is how to achieve that without running into debt crises that more than negate the potential benefits. The solution would be equity rather than debt investments, but real equity investments, not just portfolio investments that are as liquid and as dangerous, if not more, than financial debt.

Conclusion

In conclusion, the Latin American countries are subject to cyclical process of capital inflow booms. The cycles are mostly initiated by low interest rate or surplus in the current account of developed countries. Adopting, in the 1990s, the dependent growth or growth *cum* foreign saving strategy – a revised version of the 1970s growth *cum* debt strategy –, the inflow of foreign saving increases slightly the investment rate in a first moment, but does not create the conditions for the payment of the increased debt in the future. Most of foreign savings are canalized to consumption. The rate of growth may increase, but the potential rate of growth declines significantly. With the accumulation of debt, and the increase in the interest rates, the interest payments absorb larger and larger portion of exports revenues. On the other hand, the increase in domestic interest rates lead to increasing internal debt, and to the reduction of investments and finally to recession. The countries that hoped they had achieved macroeconomic stability when they achieved price stability begin to realize that real macroeconomic stability is further and further away. A domestic demand crisis, and foreign debt crisis is in on the way.

Is there a way out of the crisis before the country loses control of the economy? The way out involves a stronger fiscal adjustment, above the levels often required by IMF, combined with reduction of the domestic interest rate, and devaluation of the local currency. The commitment with fiscal austerity and low levels of inflation, consistent with international standards, has to be combined by an equal commitment with realistic exchange rates that equilibrate the intertemporal equilibrium in foreign accounts. The central obstacle that the countries that adopted the growth *cum* foreign savings strategy face is the external constraint, but this does not mean that the countries will overcome it by additional lending. On the contrary, these countries need to increase exports or to engage in competitive import substitution in order to reduce the foreign debt ratios and achieve foreign account balance. As the commitment made by the Latin American countries in the late 1980s

²⁰ Kenneth Rogoff, 2002.

to fiscal responsibility and to the control of inflation, they have now to make a similar commitment to a reasonably stable and rewarding exchange rate to exporters. The strategy of fighting inflation with an exchange rate anchor will have to be abandoned for good. The related growth *cum* foreign saving strategy must have the same fate. Foreign domestic investments continue to be extremely interesting to highly indebted countries like the Latin American ones as long as they help the country to reduce its financial debt, and not as a way of legitimizing a continuous and dangerous increase in foreign assets which have to be served. The exchange rate commitment, that will represent a major incentive to firms to invest in export capacity, must be accompanied by an active trade policy, since the increase of exports is now the major goal – the only way out of a crisis triggered by a mistaken dependent growth strategy. Foreign saving and financial opening may help countries that are not heavily indebted, and that have achieved macroeconomic stability. While these conditions are not fulfilled, they represent a major threat to developing countries.

Appendix

Following the standard growth model and adding the assumption that $I = S + CAD$, where I is investment, S is domestic saving and CAD is current account deficit, we can get the following equation:

$$\ln(Y/L) = a + \frac{\alpha}{1-\alpha} \ln s + \frac{\alpha}{1-\alpha} \ln(1+\gamma) - \frac{\alpha}{1-\alpha} \ln(n+g+d) + \mu$$

where (Y/L) is the Gross Domestic Product per worker; s is the domestic saving per effective work; $\gamma = \frac{CAD}{S}$; n is the population growth rate; g is the innovation rate; d is the depreciation of the capital.

Taking the partial derivative with respect to s and CAD , we get $\frac{\partial y}{\partial s} \frac{s}{y} = \beta_1 - \beta_2 \cdot \frac{cad}{S+CAD}$, where $cad = CAD$ per effective-labor, and $\frac{\partial y}{\partial CAD} \frac{CAD}{y} = \beta_2 \cdot \frac{CAD}{S+CAD}$.

To estimate the effect of the current account deficit on the GDP, we used a panel data set of 51 countries for the period 1979-1998. The data source is *World Development Bank – CD ROM 2001*. The first-difference estimated equation is:

$$\Delta \log(ypc)_{it} = \alpha_0 + \beta_1 \Delta \log(s)_{it} + \beta_2 \Delta \log(1 + \gamma)_{it} + \beta_3 \Delta \log(n + g + d)_{it} + \beta_4 d80_t + \dots + \beta_{22} d98_t$$

where ypc is the Gross Domestic Product per capita; s is domestic saving/ GDP , n is population growth rate; g is innovation rate (2%); d is depreciation of the capital (3%)²¹; $\gamma = cad / s$ (with cad being the current account deficit); and $d80$ - $d98$ are time dummies. The group of countries is shown in table A.1.

²¹ The g and d were calculated by Mankiw, Romer and Weil, 1992.

Table A.1

1	Argentina	18	Ghana	35	Norway
2	Australia	19	Guatemala	36	Pakistan
3	Austria	20	Honduras	37	Paraguay
4	Bangladesh	21	Hong Kong	38	Peru
5	Belgium	22	Iceland	39	Philippines
6	Bolivia	23	India	40	Portugal
7	Brazil	24	Ireland	41	South Africa
8	Canada	25	Italy	42	Spain
9	Chile	26	Jamaica	43	Sweden
10	Colombia	27	Japan	44	Switzerland
11	Costa Rica	28	Kenya	45	Thailand
12	Dominican Republic	29	Korea	46	Trinidad and Tobago
13	Ecuador	30	Malaysia	47	Tunisia
14	Egypt.	31	Mauritius	48	United Kingdom
15	El Salvador	32	Mexico	49	United States
16	Finland	33	Netherlands	50	Uruguay
17	France	34	New Zealand	51	Venezuela

At the first step, OLS - Ordinary Least Squares- estimates of all parameters were computed. The quantities in parentheses are the usual OLS standard errors; the quantities in brackets are standard errors robust to both serial correlation and heteroscedasticity. Testing for AR(1) serial correlation yields $\hat{\rho} = 0.394$, $t = 13.34$, so serial correlation exists. Then, estimates of β 's were computed by FGLS – Feasible General Least Squares.

Table A.2 - OLS

$\Delta \log(ypc_{it}) =$.00548	+ .2530241 $\Delta \log(s)$	+ .0294989 $\Delta \log(1 + \gamma)$	– .128073 $\Delta \log(n+g+d)$
	(.005)	(.032)	(.006)	(.063)
	[.005]	[.036]	[.008]	[.061]
		$n = 969$	$R^2 = 0.18$	

White test to heteroscedasticity: $F = 4.42$; p -valor = .0123.

Serial correlation test to serial AR(1): $\rho = .3942$; $t = 13.34$.

Table A.3 - FGLS

$\Delta \log(ypc_{it}) =$	– .00210	+ .206784 $\Delta \log(s)$	+ .024251 $\Delta \log(1 + \gamma)$	– .182154 $\Delta \log(n+g+d)$
	(.004)	(.039)	(.005)	(.072)
		$n = 918$	$R^2 = 0.15$	

test $\Delta \log(s) = \Delta \log(1 + \gamma)$; $\Delta \log(s) - \Delta \log(1 + \gamma) = 0.0$

$F(1, 897) = 22.39$, Prob > F = .0000

Table A.4

$\frac{\partial y}{\partial CAD} \frac{CAD}{y} = \beta_2 \cdot \frac{CAD}{S + CAD}$	= .005
$\frac{\partial y}{\partial CAD} \frac{CAD}{y} = (\beta_2 + \beta_{23}) \cdot \frac{CAD}{S + CAD}$	= .001*

(*) Estimated with an interaction between *CAD* and Latin American countries.

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