

**Working
Paper**

427

Setembro de 2016



**SAO PAULO SCHOOL
OF ECONOMICS**

Why developing countries should not incur foreign debt: The Brazilian experience

Luiz Carlos Bresser-Pereira

Os artigos dos *Textos para Discussão da Escola de Economia de São Paulo da Fundação Getulio Vargas* são de inteira responsabilidade dos autores e não refletem necessariamente a opinião da FGV-EESP. É permitida a reprodução total ou parcial dos artigos, desde que creditada a fonte.

Escola de Economia de São Paulo da Fundação Getulio Vargas FGV-EESP
www.eesp.fgv.br

Why developing countries should not incur foreign debt: The Brazilian experience

Luiz Carlos Bresser-Pereira
Thiago de Moraes Moreira

Paper to the book edited by Juan Pablo Bohoslavsky and Kunibert Raffer, *Sovereign Debt Crisis. What Have we Learned?* - to be published by Cambridge University Press. August 2016.

Abstract: What we should learn from foreign debt is, essentially, that developing countries should not get indebted in foreign money. Not only because foreign debt leads countries cyclically to balance of payment financial crises and are constrained to long and painful restructuring. Principally because, contrary to conventional wisdom, the current account deficits and its financing, even if made by foreign direct investments, in most cases do not promote but hinder economic growth, in so far that they incite consumption, not investment. Something often forgotten is that a current account deficits corresponds an overvalued currency, which makes the business enterprises in the country utilizing technology in the world state of the art non competitive, and, so, discourages investment. In consequence, we observe in developing countries a high rate of substitution of foreign for domestic savings. Instead of recurring to foreign indebtedness, developing countries should develop domestic financial institutions to finance investment.

JEL Classification: O10, F31, F34.

Developing countries get indebted in foreign money because they are persuaded that they *need* foreign savings to grow. There is a growing literature showing that growth with the foreign savings policy is a mistaken strategy: besides subjecting the developing country to cyclical financial crises, it discourages investment as it causes the long-term appreciation of the exchange rate. In this paper we use the case of Brazil to reject this view. Not only because countries that get indebted in foreign money sooner or later will fall into balance of payment or currency crises – after which they become prisoners of a foreign debt that they are unable to pay – but also because, at least in case of middle-income countries like Brazil that adopt a floating regime, the long-term appreciation of the local currency associated with the current account deficit will reduce the competitiveness of the existing and potential competent business firms by reducing their expected profit rate, thereby blocking domestic investment.

Brazil has a long history of currency or balance of payment financial crises: 1930, the 1980s' Foreign Debt Crisis, the 1998-99 currency crisis, which had a deleterious effect over the Brazilian economy. The suspension of the rollover of the foreign debt was in all cases the direct cause of such crises. In the second part of the 20th century, particularly after the 1980s, multinational corporations spread all over the world financing current account deficits, but these flows didn't translate into higher growth of the investment rates. In contrast, East Asian countries accepted foreign direct investments, but not to finance the current account, which was most of the time positive – and grew fast. What *should* we have learned? Essentially, that developing countries should *not* get indebted in foreign money, except in special cases; that they may receive foreign direct investments but not to finance deficits. Or, in other words, that they should pursue growth with domestic savings.

One of the major causes why countries like Brazil grow at a slower pace than they might is the tendency to the cyclical and chronic overvaluation of the exchange rate that usually exists in developing countries, or, in other words, are the current account deficits and the corresponding long-term overvaluation of the exchange rate. At the same time, they incur in cyclical expansion of the foreign debt, cyclical current account deficits and in cyclical currency or sovereign crises involving radical currency depreciation. Besides, the resulting high foreign debt burden turns into a major obstacle to growth, and governments get involved in negotiations with the creditors aiming at the restructuring of foreign debt – a painful “confidence building” process achieved on conditions often contrary to the national interest.

This book asks what we have learned from the foreign debt crises. Our response in this chapter is simply that developing countries should *not* get engaged in foreign indebtedness; that developing countries that already have means to domestically finance their investments should not incur in current account deficits. We've already learned that the accumulation of the external deficits can lead to sovereign crises, which can generate complex problems in terms of debt restructurings, as faced by Brazilian economy. However, the idea here is not to treat the foreign debt crises and the suffering of the indebted economies that have to deal with them, but rather focus on the negative impacts of these deficits on the growth, specifically the high rate of substitution of foreign for domestic savings that we observe in developing countries as a consequence of overvaluation of the exchange rate that is associated to the level of current account deficit.¹

We know that this is not an easy path to follow. First, because it is apparently logical that “capital rich countries transfer their capitals to developing countries”, or, in other words, because current account deficits represent “foreign savings” that are supposed to finance additional investment. Second, because current account deficits (and the exchange rate overvaluation) are associated with artificially high wages and other revenues and higher consumption, which makes them attractive to populist politicians on the left and on the right. Third, because rich countries have an interest in current account deficits in developing countries, insofar as they legitimize the occupation of developing countries' domestic markets by multinational corporations. And, fourth, because developmental economists in developing countries have been, for long, unable to formulate logical and clear arguments to reject current account deficits or the growth *cum* foreign savings policy.

In recent years one of the authors of this paper developed additional arguments against the attempt to grow by engaging in foreign debt. Current account deficits imply an exchange rate that is overvalued in the long-term (instead of just being “volatile”) and makes existing and potential local firms utilizing world state-of-the-art technology non-competitive. In this chapter we, first, summarize the main aspects of the critique of the growth *cum* foreign savings policy; second, we offer a brief history of Brazilian foreign debt, focusing on an analysis since 1973; and, third, we conclude by highlighting some worrying aspects of the Brazilian economy's current external situation.

A misguided growth model

The supposed need of developing countries to resort to foreign funds is an old mainstay of economics literature. Mainstream economics starts from the accounting macroeconomic identity between saving and investment and from the assumption that the availability of domestic savings stands as an important constraint against the expansion of investment, and comes to the conclusion that foreign financing is the solution to the problem. Insofar as a large share of middle-income countries, Brazil included, usually show low domestic saving rates, access to surplus funds in the form of foreign savings (equivalent to the current accounts deficit) coming from developed, higher-income countries have been presented as a means to overcome the problems of limited domestic funds to finance investment.

But this view, aligned as it is with common sense (it would be only natural, after all, for rich countries to transfer capital to poor ones), is essentially misguided. Only in particular cases do foreign savings add to domestic ones and benefit developing countries. Starting in the early 2000s, several papers began to discuss the consequences for the Brazilian economy of a continued process of accumulating current-account deficits without that the rate of growth accelerated. We may point out a stream of essentially econometric studies that concluded that neoclassical current-account solvency models did not stand in the Brazilian case, that is, that the supposed boons of foreign debt were not found.²

From an alternative angle, also in the early 2000s, another group of Brazilian economists – including one of the authors of this chapter – began developing an approach based on classical developmentalism and on post-Keynesian macroeconomics that became known as new developmentalism³. New developmental macroeconomics is a new theoretical approach based on the idea that the market is incapable of setting “right” *macroeconomic prices*, in particular the foreign exchange rate and the profit rate of the manufacturing sector – the former becoming overappreciated and the latter correspondently depressed for lengthy periods of time. The main causes explaining this tendency, which makes the country to go from currency crisis to currency crisis are: the Dutch disease and three habitual policies adopted by developing countries: the growth *cum* foreign savings policy, the use of the exchange rate as an anchor to control inflation, and a monetary policy conduced by the central bank around a high level interest rate.⁴ This chapter will focus on how the latter relates with the appreciation of the foreign exchange rate, as well as other macroeconomic developments.

For the new developmental macroeconomics, determination of the exchange rate in the medium run depends less on capital inflows and outflows (which do matter in the short run) than on the determination relationship between the current-account deficit and the exchange rate. The greater the current-account deficit, the more appreciated the foreign exchange rate. New developmentalism argues that a growth strategy for peripheral countries to embrace must not depend on foreign funds financing high current-account deficits. Instead, it must lie based on domestic financing. The foreign financing that the accumulation of current-account deficits necessitates triggers a process of substitution of foreign for domestic savings, with negative consequences for investment and output growth. Furthermore, the continued expansion of foreign debt (or liabilities) increases the vulnerability to balance-of-payments crises. It is no surprise that the success of the developmental strategy adopted by dynamic Asian countries, beginning with Japan, was not based on absorbing foreign funds, but on generating current-account surpluses.

We therefore argue that there is a trend toward cyclic and chronic overappreciation of the foreign exchange rate in economies that rely on the growth *cum* foreign savings policy. We emphasize that, before this new approach, econometric papers⁵ indicated a positive relationship between foreign debt and exchange rate appreciation, in addition to a negative relationship between an overappreciated currency and growth. These studies lacked a theoretical foundation, however. The new developmental track sought to fill this gap, producing arguments for a deeper understanding of the causal links between the foreign exchange rate and economic development, particularly in economies that adopt the foreign financing strategy.

The focus on current-account deficits and the long-run overappreciated foreign exchange rate to explain low growth is a relatively new element in the theoretical approach to development. According to the classical view of Prebisch and Furtado, peripheral countries experienced a structural foreign constraint, but the authors did not deduce from this constraint a need to control the foreign exchange rate, but simply to industrialize in order to overcome the constraint by means of high customs tariffs or multiple exchange rates.⁶ Authors like Rodriguez and Thirlwall⁷ picked up the foreign constraint problem, but also failed to deduce the need to make the foreign exchange rate competitive.

Primary income remittances abroad

Adoption of a strategy based on foreign financing has an impact on domestic demand. Given the cheaper imports relative to domestic output as a result of the overappreciated exchange rate, a significant share of the capital inflows is dedicated to purchasing foreign consumer goods instead of investment goods. In other words, the strategy implies “exchange rate populism”, that is, it artificially raises consumption and discourages investment.

We must also consider the developments of foreign financing on primary income flows and remittances. The main sources of financing of current-account deficits in the Brazilian economy include capital inflows as the so-called portfolio investments, foreign direct investment (FDI) and loans. In each of these cases the capital inflows – representing the acquisition of a Brazilian asset by a non-resident or even the loans – also imply future payments to its owners. In the case of bonds and loans, be they conventional or inter-company, funds outflows prevail as interest payments. For FDI and equity purchases, profits and dividends are prevalent. Therefore, the greater the foreign liability, the greater the flow of interest, profits or dividends payments.

These outflows are the main portion of the net income from abroad (NIA), which is the difference between payments made for the domestic use of foreign factors of production and payments received for the foreign use of domestic factors. It is therefore equal to the difference between gross domestic product (GDP) – the income made in the domestic territory – and the gross national income (GNI) the income that remains in-country. Therefore, the greater the NIA, the lower the GNI. The GNI, in its turn, is a key variable in the consolidation of domestic saving (S_d), which is the difference between gross disposable income (GDI)⁸ and final consumer spending (C).

$$GNI = GDP - NIA$$

$$GDI = GNI - UT$$

$$S_d = GDI - C$$

Therefore, growth based on the foreign financing strategy necessarily incurs in increased transfers of income from the domestic economy abroad. These transfers *reduce* the national income and, therefore, domestic savings.

In any way, analysts generally argue that foreign financing by means of FDI should not be a concern from the angle of foreign vulnerability, and is even used as a positive economic indicator. This is due to the fact that direct investments are supposedly more closely linked to production than other essentially financial assets, such as shares, bonds, derivatives. This perception of the better “quality” of direct investment, which may lead to mistaken conclusions regarding the situation of the foreign accounts, explicitly emerges in the official statistics published by the Central Bank of Brazil, which uses the concept of “foreign financing needs” calculated as the difference between the current account and FDI.

However, the presence of current account deficits, regardless of the kind of capital flowing in through the financial account to finance them, is not in the country’s best interest, and likewise implies exchange rate appreciation, discouragement of investment, and the substitution of foreign for domestic savings. The interpretation might be different if FDI were to occur within a context of brisk growth, where, given favorable profit expectations and high marginal propensity to invest, foreign savings would not substitute domestic ones. A similar effect would occur if FDI flows were associated with exports growth and thereby led to rising current account balances, to a certain degree offsetting, or even reversing income transfers abroad. The next section discusses to what degree history supports the new developmental theory, which claims the prevalence of the effect of substitution of foreign for domestic savings.

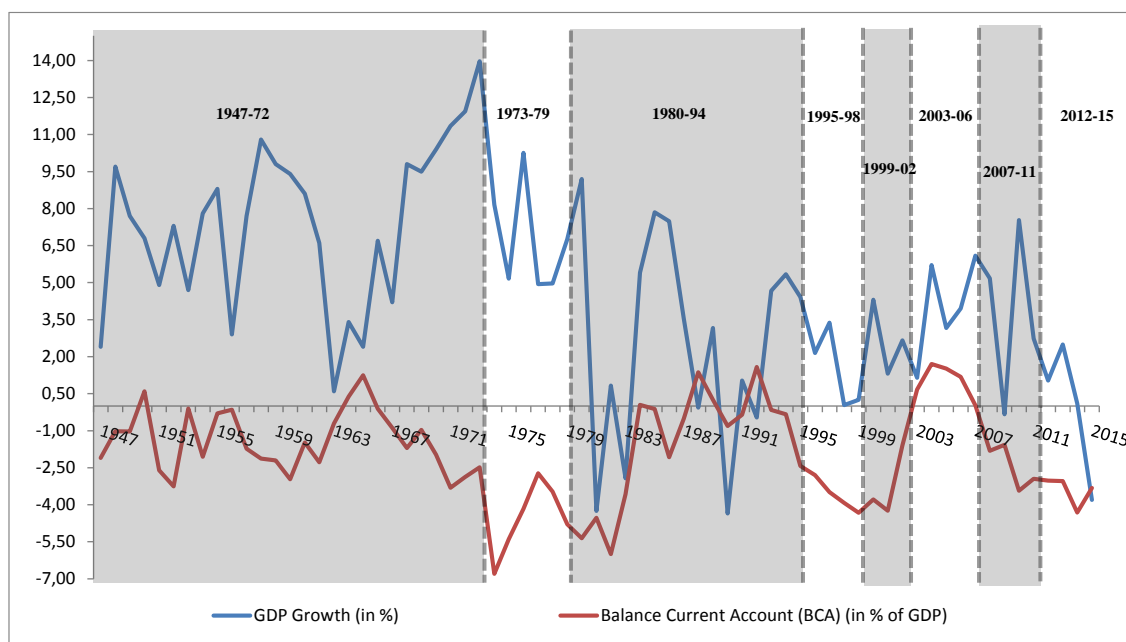
Foreign indebtedness evolution

The current-account deficit is a determining factor in the evolution of the Brazilian foreign debt, here understood in its broad sense, including the patrimonial debt. Graph 1 summarizes the evolution of Brazil’s foreign debt since 1947, dividing it into several phases according to current account changes, and therefore, capital flow changes for Brazil.⁹ Besides the foreign balances, the graph presents the growth of the GDP. The Brazilian economy’s main spurt of growth took place between 1947 and 1972, during which period the economy grew at an annual rate of 7.2 percent¹⁰. Throughout this period, there was limited resorting to foreign savings, and domestic financing prevailed. The average current account deficit in this period was 1.4% of GDP.

The growth of GDP in this period was supported in the industrialization and urbanization processes, which induced much stronger growth of the domestic demand (mainly private consumption and investment) than the external demand or exports. Despite of this performance of the domestic demand, which do not generate external resources, the deficit in the current account, and therefore the need for foreign savings, was small. This is because the accelerated growth of the domestic demand was able to generate an expressive growth of the domestic income, as suggested by the GDP performance. In this sense, it is important to emphasize the macroeconomic consistency between the high level of economic growth and the low level of the current account deficits, including verified in historical analysis of Brazilian external sector.

From 1973 we observe a major fall in growth of the economy to just 3.4% a year, while the average current account deficit increased to 2.2% of GDP. The balances’ increased volatility show periods of strong deterioration of the current-account alternating with periods of its reduction and even of a small surplus.

Figure 1: Real GDP Growth (%) and Balance Current Account (% of GDP)



Below, we present with a little more details, although quite synthetically, the main factors/events that determined the dynamics of the external debt from 1973 to 2015, dividing the period in some intervals, as indicated in Figure 1.

1973-1979. Starting in the early 1970s, just after the “Brazilian miracle” (1967-73) and the First Oil Shock (1973), the government’s official position incorporated the notion that foreign debt was crucial to keeping up that pace of growth, finding theoretical support in neoclassical analyses and the multilateral institutions.¹¹ As a result, government policy began to encourage current account deficits, which experienced an early major boost in 1973 due to the impact of the first oil shock on import expenditures. The period from 1973 to 1979 is the only one that shows an expansion of current account deficits simultaneously with the maintenance of high GDP growth rates. This combination helped support the thesis of the supposed benefits of foreign debt. But as Cruz (1984) pointed out, the rising foreign debt and the expansion of economic activity levels were explained by different processes, and no basis exists to argue for a causal link between the two.

1980-94. In 1980 the great Foreign Debt Crisis, stemming largely from the debt incurred in the immediately preceding years begins and leads the country to a major recession. Between 1989 and 1993, because of Brazil’s lack of access to international credit, current account deficits remained at low levels. A strong fiscal adjustment that began in 1981 helped this along and enabled a successful depreciation of the domestic currency in 1983, as well as retaining US dollars to honor debt service payments. In February 1987 Brazil declared a moratorium. In October of this year Brazil’s finance minister, Bresser-Pereira, proposed a plan to overcome the foreign debt, based on the securitization of the debt and the relative de-linkage between the commercial banks and the IMF in the negotiations, which was rejected by the secretary of the Treasury, James Baker, but fully adopted by his successor, Nicholas Brady.¹²

1995-1998. Beginning in 1994-‘95, when the 1980’s Foreign Debt Crisis had already been addressed by the recessive adjustment, which lasted for close to ten years, and by the Brady Plan (1989), and when the Real Plan (1994) had already stabilized the country’s high inflation, Brazil recovers its access to international credit,¹³ and the government, forgetful of the poor outcomes of the indebtedness of 1973-‘80, understood that it was time to resume the growth *cum* foreign savings strategy. In this context, neoliberal privatization reforms of the latter half of the decade helped to leverage those flows. Beginning in 1995, Brazil received even more expressive amounts of foreign funds via the financial account on the balance of payments. Capital inflows under this account jumped from US\$ 8.5 billion in 1994 to US\$ 28.7 billion in 1995, and remained at levels near US\$ 30 billion until 1998. Notwithstanding, the rates of investment and growth did not increase.

The profile of Brazil's foreign liabilities then undergoes a change. Although conventional debt contracts (loans from financial institutions or multilateral agencies) remained a relevant source of funds inflows, portfolio investments (in particular fixed-income securities and stocks), intercompany loans¹⁴ and, above all, FDI increased as share of foreign liabilities. On the other hand, as a reflection of the growth *cum* foreign savings policy and the resulting over appreciation of the foreign exchange rate, the balance of current accounts once again showed rising deficits. It jumped from US\$ 1.2 billion in 1994 to approximately US\$ 18.7 billion in 1995, or from .3 percent to 2.4 percent¹⁵ of GDP in a single year. Despite the negative effects of the currency over appreciation on GDP growth and, therefore, on the growth of imports in the following years, the current-account deficit continued to increase as a result of the behavior of the services balance (due mainly to increased international traveling) and income transfers abroad. These were decisive to cause the current account deficit to reach 3.9% of GDP in 1998, equal to US\$ 33.9 billion. These macroeconomic dynamics based on the use of the exchange rate anchor as a means to control inflation proved to be unsustainable.

The international context was not also favorable for the stability of the growth model based on an appreciated exchange rate and on consumption, particular note being due to the Asian crisis of 1997 and the Russian crisis of mid-1998. In this context, foreign debt continued to grow, rising from US\$ 159.2 billion to US\$ 241.6 billion between 1995 and 1998¹⁶, despite the previously mentioned diversification of liabilities. As a consequence of this increase, in the final quarter of 1998 foreign creditors suspended the foreign debt's rollover, and a new financial crisis began. The effects were not more severe because the US government quickly directed the IMF to give Brazil financial support.

1999-2002. In this context of financial crisis, the Brazilian government was forced to abandon the exchange rate anchor in early 1999, devaluing the rate of exchange. Then began the period in which the Brazilian government's official discourse upheld the so-called macroeconomic policy "tripod", one of whose pillars was a floating exchange rate. The tripod also included inflation targeting and primary surplus targeting for the public accounts. The new discourse assumed that the deteriorating foreign accounts and, consequently, the need for foreign savings, came as a result of lacking fiscal austerity, forgetting that the high current-account deficits that caused the crisis were the result of the government's formally adopted policy of growth *cum* foreign savings.

Thanks to the 1999 depreciation of the Brazilian Real and the world economy's good performance, exports show expressive growth. However, due mainly to income transfers abroad, the current account deficit remained high and relatively stable from 1999 to 2001, at around 4 percent of GDP. On the fiscal level, austerity was indeed put into practice. But because foreign debt and current-account deficits remained high, in late 2002, within the context of a political crisis caused by the election of a left-wing presidential candidate Luís Inácio Lula da Silva, creditors once again suspended foreign debt rollovers, the country entered a new balance of payments crisis and was once again rescued by the IMF. In this scenario, the exchange rate depreciation that began in 1999 took a brisk plunge.

2003-2006. Within the framework of two depreciations and the commodities boom, Brazil achieved current account surpluses in this period. The main factors underlying the positive foreign trade flows and the reversal of the current account deficit were, therefore, depreciations and the beginning of a lengthy cycle of rising international prices for the main Brazilian exports, that is, agricultural and metal commodities. This dynamics enabled a significant improvement to the Brazilian economy's terms of trade. The reversal of the foreign accounts that began in 2003, as in previous cases, was independent from fiscal indicators. By enabling massive inflows of US Dollars, the rising exports enabled current account surpluses from 2003 to 2006, despite the intense appreciation of Brazil's currency¹⁷. Another highlight from this period includes the rising levels of international reserves (from US\$ 49.3 billion to US\$ 85 billion) and the reduction of the foreign debt (from US\$ 235.4 billion to US\$ 199.4 billion). In 2005, the Brazilian government settled its debt with the IMF, anticipating payments scheduled for later years. All of these indicators created a sense of euphoria and the (false) feeling that the foreign disequilibria were being corrected, creating a belief that the country was "eliminating" its foreign vulnerability.

2007-2011. In this period, the Brazilian economy went back to showing increasingly high current-account deficits because of the huge currency appreciation that had been under way since 2003, once again confirming the trend to cyclic and chronic exchange rate over appreciation. The Brazilian Real's appreciation continued to favor private consumption and harm domestic manufacturing. In this period, the exchange rate was far below the competitive, or "industrial equilibrium", exchange rate – a central concept of the New Developmental view.¹⁸ Positive current account balances were then reversed, and the foreign debt's downward path changed, but international reserves continued to grow exponentially.

Notwithstanding the negative effects of the financial crisis that erupted in late 2008, leading to a small (- .3 percent) retraction of the GDP in 2009, the period as marked by accelerating GDP growth (4.2 percent p.a., on average). This growth was founded on the expansion of commerce (averaging 4.9 percent p.a.), pushed by private consumption (5.7 percent p.a. expansion). A central element of this dynamics was the adoption of public policies fostering domestic demand, including that of real minimum-wage gains, tax exemptions/reductions for the purchase of durable consumer goods (particularly since 2009) and stimuli for increased individual credit.

Investment, too, showed marked average expansion in this period (9.3 percent p.a.), by rising credits granted by the National Economic and Social Development Bank (“*Banco Nacional de Desenvolvimento Econômico e Social*” – BNDES). A breakdown analysis of investment shows, however, that this growth was largely due to increases in housing construction and automotive purchases (trucks in particular). Neither had as a main driver of manufacturing sector, which posted average annual growth of a mere 2.5 percent. Construction expansion was largely based on the rising income and expanding credit of individuals. The purchase of vehicles, in its turn, was due largely to the rationale of commerce expansion, which in its turn was due far more to sales of imported goods than of domestically produced ones. In addition, the period was marked by ample international liquidity, low international interest rates (and an increasing spread relative to Brazil’s domestic interest rates) and reduced perceived risk on the part of international investors. All of these elements enabled increased foreign capital inflows into the Brazilian economy, which were central to the previously discussed dynamic of appreciation of the domestic currency.

After a period of more intense foreign capital outflows, particularly in late 2008 as a result of the financial crisis, in 2009 significant foreign funds inflows resumed for the Brazilian economy. After a balance of payments surplus of a mere US\$ 3 billion in 2008, positive balances jumped to US\$ 46.7 billion, US\$ 49.1 billion and US\$ 58.6 billion in 2009, 2010 and 2011, respectively. These surpluses helped maintain the rising path of international reserves, which rose from US\$ 180.3 billion in 2008 to US\$ 352 billion in 2011. This supposedly favorable outcome came at the expense of a marked increase in foreign debt, from US\$ 240.5 billion to US\$ 404.1 billion, despite the increased share of other forms of liabilities, in particular direct investment in capital and equity stakes. As a result, total foreign liabilities also expanded markedly from US\$ 889.3 billion in 2007 to US\$ 1.47 trillion in 2011.

Although resumed GDP growth in 2010 and 2011 (of 7.5 percent and 3.9 percent, respectively) helped the consolidation of favorable expectations, the appreciation of the domestic currency¹⁹ and the resulting loss of competitiveness for domestic output continued to severely weaken the Brazilian productive structure. In this period, commodity prices and terms of trade, after a brief drop in 2009, also remained favorable to the Brazilian economy, enabling successive surpluses on the balance of trade in goods. However, the expanding imports of services, added to profits, dividends and interest transfers, caused negative services and income balances, more than offsetting the balance of trade surpluses and causing a current account deficit that reached 3 percent of GDP by yearend 2011.

2012-15. This period was marked by stagnant Brazilian GDP. The world economy’s pace of growth decelerates starting in 2012 and the cycle of rising international commodity prices comes to an end. At first, the drop in commodity prices was slight, and they remained stable at still high levels until mid-2014. With the Central Bank of Brazil’s sharp basic interest rate cut of 2012, the domestic currency finally depreciated. The average annual exchange rate rose to 1.95 and 2.16 R\$/US\$ in 2012 and 2013, respectively. In addition to the fact that the devaluation was relatively timid compared to what was needed to stimulate the manufacturing sector, within the context of decelerating world trade and dropping international commodity prices, exchange-based stimuli to Brazilian exports proved themselves insufficient.

On the other hand, the lower interest rates helped maintain the expansionary path of domestic demand, a growing share of which was met by imports, which continued to expand far in excess of GDP and deepened the manufacturing sector’s crisis. The lower revenues from exports and the rising imports were decisive to maintaining high current account deficits, which remained at levels close to 3 percent of GDP.

Brazil’s foreign situation began to deteriorate more abruptly since August/September 2014, when new and more expressive commodity price drops occurred. The retraction of exports in US Dollars terms was expressive as well, helping the current accounts deficit to reach its highest level since 1999 at 4.3 percent of GDP, or US\$ 104.2 billion. GDP, in turn, decelerated to a real growth of mere .1 percent. The deterioration of Brazil’s international accounts was central to the confidence crisis that emerged in 2015, triggering a new and severe round of depreciation of the Brazilian currency²⁰, even as the economic

recession deepened, reducing GDP by -3.8 percent. This recessionary adjustment reduced the current account deficit to 3.3 percent of GDP, or US\$ 58.9 billion. It is worth emphasizing that this recession was not directly associated with a balance of payments crisis, as foreign debt rollovers were not suspended, and international reserves remained at high levels, at US\$ 368.7 billion by yearend 2015.

The debt rollover, which helped prevent a more expressive drop in international reserves, was done under unfavorable conditions after the Brazilian economy lost its investment-grade status given by the main international risk ratings agencies. In addition, the maintenance of high FDI flows (of US\$ 96 billion in 2014 and US\$ 75 billion in 2015, in net terms), which also prevented a greater reserves loss, took place basically in response to the strong loss of market value of Brazilian firms, and to these firms' need to sell assets (or equity stakes) stemming from their high levels of foreign indebtedness. These flows, in their turn, have not stimulated an increase in the rate of investment, nor a growth of the exporting sector, with funds largely set aside for debt payments.

Closing comments

This chapter uses a historical analysis of foreign accounts to show the validity of the New Developmental school of thought's theoretical arguments for the Brazilian case. The persistent accumulation of current account deficits must not, under any circumstances, be named as a fundamental element for the creation of favorable macroeconomic conditions for sustained output growth. To the contrary, the causal link proposed here, which treats the absorption of foreign savings as the main determinant of a structural dynamics of an appreciated exchange rate, tends to create severe economic frailty, particularly in terms of the weakening of the productive tissue.

We have shown that, even where such frailties do not cause a balance of payments crisis, they can still constrain or hamper the dynamics of economic recovery. In other words, adopting a foreign financing strategy creates external constraints that limit output growth, even if a major foreign crisis does not occur.

In this sense, we emphasize two fundamental aspects of the current economic situation that are generally noted as indicative of supposed peace of mind vis-à-vis Brazil's foreign accounts: the maintenance of relatively high international reserves and/or foreign direct investment.

Although it prevents more significant international reserve losses, the greater stake of foreign capital reinforces foreign constraints. In addition to, once again, not being linked with strengthening potential exports or expanding productive investments, these funds can widen the channels for reducing national income by means of income transfers abroad. As a result, when the Brazilian economy recovers a more consistent growth path, it will be more difficult to achieve positive current account balances, reinforcing the vicious cycle of exchange rate appreciation. In addition, firms have been rolling over their debt under far less favorable conditions than those found in previous periods, which should increase the interest payments flow, an element that equally reinforces the need for foreign savings

Fighting the Brazilian economy's foreign constraints requires important macroeconomic policy management changes to recover the weakened productive tissue in such a manner as to enable it to generate foreign currency, reducing the need to absorb funds from abroad by means of rising foreign debt and/or liabilities. That is, relieving the foreign constraints against Brazil's economic growth requires generating current account surpluses via trade flows. To this end, managing the exchange rate is indispensable for competitive domestic production, in addition to improved growth of the exporting sector, particularly as concerns goods and services with greater technology content. The decreased dependence on foreign funds via the financial account creates the conditions for financing growth with own funds.

Finally, we believe that the Brazilian experience is quite representative of what can happen with others middle-income economies that already have a diversified productive structure, and adopt the growth with foreign savings strategy. This does not mean that multilateral organisms' initiatives, led by the most developed countries, in order to contribute to the financing for development of less developed countries mobilizing external funds, are not important. But, we believe that a sustainable and autonomous development depends on the generation of own resources for financing it. For that, the developing countries need a strengthened productive structure enough to stimulate the growth of the domestic income and, consequently, domestic savings. As discussed, the dynamic of accumulation of current account deficits (and growth of external debt) hinders consolidation of a more autonomous development process.

References

- Baer, M. (1995) "Sistema financeiro internacional: Oportunidades e restrições ao financiamento do desenvolvimento". *Novos estudos*, CEBRAP, 42.
- Batista Jr., P and A. Rangel (1994) "A renegociação da dívida externa brasileira e o Plano Brady: avaliação de alguns dos principais resultados". In: *Caderno Dívida Externa* n.7, PEDEX, São Paulo.
- Bresser-Pereira, Luiz Carlos (1999) "A turning point in the debt crisis", *Brazilian Journal of Political Economy* 19 (2): 103-120.
- Bresser-Pereira, Luiz Carlos (2001) "A fragilidade que nasce da dependência da poupança externa" [The fragility that originates from the dependency on foreign savings], *Valor 1000*, September: 34-38.
- Bresser-Pereira, Luiz Carlos and Paulo Gala (2008) "Foreign savings, insufficiency of demand, and low growth", *Journal of Post Keynesian Economics* 30 (3), Spring 2008: 315-334.
- Bresser-Pereira, Luiz Carlos and Fernando Rugitsky (2016) "Industrial policy and exchange rate skepticism". Department of Economics FEA/USP, Working Paper Series 2016-08.
- Bresser-Pereira, Luiz Carlos and Yoshiaki Nakano (2003) "Economic growth with foreign savings?" *Brazilian Journal of Political Economy* 22 (2) April 2003: 3-27. In Portuguese; in the printed edition, in English, in the journal's website: www.rep.org.br
- Bresser-Pereira, Luiz Carlos, José Luis Oreiro and Nelson Marconi (2014) *Developmental Macroeconomics*. London: Routledge.
- Cardoso, Fernando Henrique and Enzo Faletto (1969 [1979]) *Dependency and Development in Latin America*. Berkeley: University of California Press, 1979. Original publication in Spanish, 1969.
- Chenery, Hollis and Michael Bruno (1962) "Development alternatives in an open economy: The case of Israel", *Economic Journal*, March 1962: 79-103.
- Cruz, Paulo Davidoff (1984) "Dívida externa e política econômica: a experiência brasileira dos anos setenta". São Paulo: Brasiliense.
- Dollar, D. (1992) "Outward-oriented developing economies really do grow more rapidly: evidence from 95 LDCs, 1976-85. *Economic Development and Cultural Change*, 40, p. 523-544.
- Razin, O. and S. Collins (1997) "Real exchange rate misalignment and growth". NBER Working Paper n. 6147, Cambridge, MA.
- Rocha, F. and Bender, S. (2000) "Present values tests of the Brazilian current account. *Revista Economia Aplicada*, São Paulo, v.4, n. 2, p. 203-22.
- Rodriguez, O. (1977) "Sobre la concepción del sistema centro-periferia". *Revista de la Cepal*, n.3, Santiago de Chile.
- Senna, F. A. and Issler, J. (2000) "Mobilidade de capitais e movimentos da conta corrente do Brasil: 1947-1997". *Estudos econômicos*, 30 (4): 493-523.
- Thirlwall, Anthony P. (1979) "The balance of payments constraint as an explanation of international growth rates differences", *Banca Nazionale del Lavoro Quarterly Review*, 128: 45-53.

¹ See Bresser-Pereira and Nakano (2003), Bresser-Pereira and Gala (2008), Bresser-Pereira, Araújo and Gala (2014), and sizable number of empirical studies on "savings displacement".

² See Senna & Issler (2000); Rocha & Bender (2000).

³ See Bresser-Pereira (2001; 2010); Bresser-Pereira & Nakano (2003); Bresser-Pereira & Gala (2008).

⁴ See Bresser-Pereira, Marconi and Oreiro (2014).

⁵ See Dollar (1992) and Razin & Collins (1997).

⁶ See Bresser-Pereira & Rugitsky (2016).

⁷ See Rodriguez (1977) and Thirlwall (1979).

⁸ As the equation shows, the only difference between GDI and GNI lies in the so-called Unilateral Transfers (UT). The balances of these accounts, however, are of small shares of GDP, of approximately .1 percent.

⁹ The Brazilian foreign sector's official database, elaborated and published by central bank, underwent important methodological changes over the course of this period in an effort to align with international standards. The latest base, called BPM6⁹ and published in April 2015, only goes as far back as 1995. Therefore, for information from 1947 to 1994, the data used in this article correspond to the previous base of Brazilian foreign accounts, called BPM5.

¹⁰ From now on, all data about the Brazilian external sector were extracted of the official database of the central bank. The data about GDP were extracted of the institution responsible by the System of National Accounts in Brazil that is the "*Instituto Brasileiro de Geografia e Estatística*" (IBGE).

¹¹ We emphasize the work of World Bank economists who used Prebisch's foreign constraint model to formulate the "two-gap model". For additional information, see Chenery & Bruno (1962).

¹² See Bresser-Pereira (1999).

¹³ See Baer (1995) and Batista Jr & Rangel (1994).

¹⁴ According to the official Balance of Payments accounting methodology used by the Central Bank of Brazil until 2001, intercompany loans were accounted for separately from FDI. Beginning in 2001, when the BPM5 base was published, these loans were included in the FDI.

¹⁵ The two bases – BPM5 and BPM6 – yield the same results for current account deficit as of % of GDP.

¹⁶ This includes intercompany loans in addition to loans from banks and multilateral agencies, and public and private debt bonds.

¹⁷ In 2003, the annual average exchange rate was 3.08 R\$/US\$, down to 2.18 R\$/US\$ in 2006.

¹⁸ According to development macroeconomics, the industrial equilibrium, or competitive, exchange rate is that which makes for competitive makers of tradable non-commodities using world state-of-the-art technology. See Bresser-Pereira, Oreiro & Marconi (2014).

¹⁹ After a small devaluation in 2009, the exchange rate resumed marked appreciation and peaked, in average annual terms in 2011 at 1.67 R\$/US\$.

²⁰ The average annual exchange rate went from 2.35 R\$/US\$ in 2014 to 3.33 R\$/US\$ in 2015.