

The second Washington consensus and Latin America's quasi-stagnation

Abstract: It took more than ten years for Latin America to overcome the debt crisis, which turned into a fiscal crisis of the state. Yet in the early 1990s, most of Latin America had undergone deep reforms (particularly trade liberalization and privatization), and, thanks to exchange rate devaluation and fiscal adjustment, they had reduced the foreign and the public debt. Yet growth was not resumed. The basic reason for that was the adoption of the growth cum foreign savings strategy coupled with financial opening (the "second" Washington Consensus). The huge capital inflows created serious solvency problems, as the foreign indebtedness threshold was exceeded. On the other hand, capital inflows appreciated the national currencies, artificially increasing wages and consumption, having as trade-offs the reduction of domestic savings and, again, the increase of foreign debt. Despite sizable direct investments, the total investment rate remained constant, as growth did not resume. Only the foreign financial and patrimonial debt increased.

Key words: foreign debt, growth cum foreign savings, Washington Consensus.

The reasons Latin America did not develop in the 1980s are well known. They are broadly related to the crisis of the state and to the exhaustion of the import substitution model of growth; specifically, they are tied to the excessive foreign indebtedness acquired in the 1970s. In the early 1990s, however, most of the problems faced by the region, with a more evident symptom of high inflation, had been reasonably faced, confidence in the international financial markets recovered, capital flows resumed, and most analysts' expectations turned highly positive. Yet 14 years later, it is necessary to acknowledge that these hopes were in vain. The economic

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performance in the period was frustrating. Why? In this paper, we claim that the essential reason is the Washington-sponsored strategy of growth *cum* foreign savings strategy and the opening of the capital account. This strategy, which we call the “second” Washington Consensus, led the countries to lose relative control over their respective exchange rates. As a consequence, national currencies (which had been depreciated to face the 1980s debt crisis) reappreciated, causing the artificial increase of wages and salaries; consumption soared and domestic savings fell, to such an extent that the huge capital inflows, including direct foreign investments, were compensated for by the reduction of domestic savings, the rate of capital accumulation did not increase as expected, and the economies remained semistagnant.¹

An overvalued currency is obviously attractive. It allows for the control of inflation and, concomitantly, increases in wages and salaries. But it is as much a populist policy to increase state expenditures and incur budget deficits. Economic populism is defined as expending more than one takes in, and it appears in two forms: it is either fiscal populism, if the state’s expenditures exceed public revenues, or exchange rate populism, if the nation’s expenditures exceed exports of goods and services. In the first case, we have budget deficits, in the second, current account deficits. While the “first” Washington Consensus fought economic populism, the “second” Washington Consensus was characterized by huge current account deficits. The Latin American countries, which complied docilely with it, again accumulated a large foreign debt—a financial as well as patrimonial debt (the net assets of foreign firms)—while the investment rate remained approximately constant, and economic growth did not materialize.

While the Latin American countries accepted the argument coming from the North that there was no alternative but to follow the policies that Washington and New York recommended—that they are an inevitable “straitjacket,” in the words of Thomas Friedman (2000) summing up the globalist ideology²—the dynamic Asian countries, including In-

¹ The critique to the growth *cum* foreign savings strategy is in Bresser-Pereira (2001; 2002a; 2002b) and Bresser-Pereira and Nakano (2002).

² Globalization is a real phenomenon that we distinguish from “globalism”—the ideology asserting that national states lost significance, and that all countries are supposed to adopt the mentioned “straitjacket.” In it—or in the conservative neoliberal speech coming from the United States—neoliberal reforms turned into a kind of mantra. A country is doing well if it is “reforming”; and administration is good if it is “reformist.” In fact, market-oriented reforms are often advisable but must be evaluated case by case, because in many circumstances, they just responded to group interests.

dia, followed different policies, keeping their exchange rates relatively depreciated and holding positive current accounts. While the former stagnated, the latter experienced extraordinary growth rates. It is true that there is no alternative to capitalism, but there are many varieties of capitalism. This was true in the past for the now developed countries and is being reaffirmed in the times of globalization by several Asian nations.

As in the 1990s, Latin America still faces a challenge similar to the one that it faced in the 1940s and 1950s. At that time, the North brandished the flag of free trade to create obstacles to industrialization and growth in developing countries. Today, Washington and New York wield the banner of free capital flows to create obstacles to further growth in the South. Thus, the critique of the growth *cum* foreign savings strategy is today, for Latin America's economic development, as important as it was in the 1940s and 1950s, the critique of the law of comparative advantages in international trade. Nowadays, Latin American industrialized countries do not need to protect themselves from international competition as much as they needed to in the past, but they dramatically need to protect themselves from capital inflows that disorganize their economies. Capital inflows are welcome in given conditions—essentially if the country is not too indebted and if it offers large investment opportunities—otherwise, they may be particularly damaging for developing countries' national economies. If these two conditions are not present, they will cause harm instead of growth, not only because they are volatile, as many suggest, but also because they create major solvency problems for the countries, and because they artificially stimulate consumption.

Latin America's economic performance was better in the 1990s than in the 1980s, when per capita growth was negative, but this was frustrating given the reforms that were undertaken in both decades. Between 1991 and 2002, gross domestic product (GDP) per capita grew, at the modest rate of 0.9 percent a year, when that rate had been 3.32 in the 1970s (Table 1). Among the seven countries analyzed in Table 1, which represent more than 90 percent of the total Latin American and Caribbean GDP, only Chile presented positive results. In terms of unemployment, outcomes are equally dismal. As Table 2 shows, the unemployment rate for the region grew from 6.1 percent in 1980 to 8.9 percent in 2002. Not surprisingly, Argentina and Venezuela were the countries in which unemployment soared. Colombia had very high levels of unemployment throughout the period.

Why were such poor outcomes seen in the 1990s? The conventional orthodoxy behind the two Washington Consensuses will argue that reforms were not sufficient. In their turn, radical critiques will say that it

Table 1
GDP per capita growth

	GDP per capita growth (percent) average rates*		
	1971–1980	1981–1990	1991–2002
Argentina	0.87	-1.72	0.92
Brazil	5.92	-0.32	1.03
Chile	1.69	1.37	3.85
Colombia	3.17	1.50	0.43
Mexico	3.39	-0.32	1.33
Peru	1.32	-3.13	2.03
Venezuela	0.23	-2.16	-0.13
Latin America and the Caribbean	3.32	-0.64	0.93

Sources: Data from 1971 to 1980 are authors' calculations based on the database described in *International Financial Statistics Yearbook 1998*, IMF, and *World Tables 1993*, World Bank. Other periods are authors' calculations based on ECLAC (Economic Commission for Latin America and the Caribbean) data.

* Average rates at constant prices.

Table 2
Urban unemployment rate—average annual rate (percent)

	1980	1990	2002
Argentina	2.6	7.4	19.7
Brazil	6.3	4.3	7.9
Chile	10.4	7.8	9.0
Colombia	10.0	10.5	17.6
Mexico	4.5	2.7	2.7
Peru	7.1	8.3	9.4
Venezuela	6.0	10.4	15.8
Latin America and the Caribbean	6.1	5.8	8.9

Source: *Statistic Yearbook 2003*, ECLAC.

was rather the adoptions of these reforms—all mistaken reforms—that are to be blamed. We take a different position. Most of the macroeconomic policies and reforms adopted in the 1980s were basically necessary. In some cases, the policies may have been too severe; in all cases, the burden of the adjustment fell too much on the debtors when it should have been more evenly shared with the creditors. But, given the unbalance that the Latin American economies faced in 1982 when the debt crisis broke up, the depreciation of the local currencies and the fiscal

adjustment undertaken were inevitable, and reforms such as privatization and trade liberation were, in principle, advisable. The problem arose in the 1990s when Washington and New York understood that the region was ready to grow and offered the growth *cum* foreign savings strategy coupled with financial opening.

The agenda mistake

The new growth strategy was based on a policy agenda mistake: the assumption that the central problem that the region faced continued to be inflation, despite the fact that the high inflation that prevailed in the 1980s had been eliminated in all countries. Brazil was the last country to achieve this goal in 1994. Yet macroeconomic stability does not mean only price stability; it also means balanced fiscal and foreign accounts and a reasonable full employment. After having succeeded in stabilizing high inflation, Latin America did not manage to achieve macroeconomic stability and resume growth, because it assigned an excessive priority to price stability—a priority that justified an extremely high basic interest rate and an overvalued exchange rate.

Brazil is paradigmatic in this area. On July 1, 1994, high and inertial inflation ended in Brazil after the three months in which the URV (an indexed accounting money) neutralized inflationary inertia. On this date, each real was defined as equivalent to one dollar. Immediately after, Brazil was flooded with dollars, and the capital inflows appreciated the real. It was only when the exchange rate was reaching R\$0.80 that the monetary authorities decided to intervene. As a consequence, the Brazilian economy was headed toward a serious balance-of-payments imbalance that the new administration that began in January 1995 proved unable to correct in the four years ahead. It kept the exchange rate low, “to fight inflation,” and the basic interest rate artificially high, “to attract foreign savings.” As a result of this perverse macroeconomic equation (high interest rates, low exchange rate), the country was unable to stabilize, invest, and grow. On the contrary, as the high basic interest rate remunerated public debt creditors (and public expenditures were not sufficiently curtailed), the fiscal accounts of the state deteriorated. On the other hand, an overvalued exchange rate restored the foreign accounts unbalance. Thus, the two balances that had been so hardly conquered in the previous years were lost. In fighting inflation, the exchange rate was kept overvalued, and the foreign debt again increased while, also to control inflation and to attract capital, the basic interest rate was fixed by the central bank at

an extremely high level throughout the years, deteriorating the public accounts and making domestic investments impractical.³

It was an agenda mistake to identify high inflation as the main enemy to be faced. Instead of realizing that the Real Plan was successful because it was able to neutralize inflationary inertia, conventional orthodoxy wrongly attributed this success to an "exchange rate anchor," and thus decided to keep it in the years ahead. Conventional economists never understood what inertial inflation was. Yet it is surprising that the same Brazilian economists who used a mechanism for neutralizing the staggered or indexed character of the Brazilian inflation up to 1994, when effective in new administration beginning in 1995, did not realize that an exchange rate anchor was not necessary to keep inflation under control.⁴

Between 1990 and 1993, Brazil engaged in a trade reform that exposed domestic prices to foreign competition. This and the de-indexation of the economy were the two major guarantees that high inflation would not be back. Inflation still deserved attention, but other challenges had to be met. At that time, the two major challenges that the Brazilian economy faced were the appreciated exchange rate and the high real interest rate—and the consequent intertemporal disequilibria in the fiscal and particularly the foreign accounts. An appreciated exchange rate leads to increased consumption and to reduced domestic savings and, eventually, to a balance-of-payment crisis; the high real interest rate reduces investments, promotes fiscal unbalance, and may end up in a financial crisis. Yet these simple facts were ignored, and the economic team kept the exchange rate severely overvalued and the interest rate artificially high between 1995 and 1998. It was only after two severe balance-of-payment crises—one in 1998 and the other in 2002—that the exchange rate became reasonably competitive.

Argentina's case is similar, although more dramatic. While Mexico stabilized a moderately high and inertial inflation in 1987, and Brazil got under control an extremely high and fully inertial or indexed inflation in 1994 using mechanisms for inertia neutralization, Argentina faced bleak hyperinflation for more than a year and stabilized it in 1991 with

³ We are referring to the basic or short-term interest rate, not the market or long-term interest rate. The basic interest rate (in Brazil, the *selic*) is the exogenous rate on which the monetary authorities have control. However, conventional orthodoxy, in the case of Brazil, almost invariably they "fail to remember" the difference, although they use the basic rate as an exogenous policy-making variable in their own countries.

⁴ On inertial inflation, see Bresser-Pereira and Nakano (1987).

an exchange rate anchor (the way hyperinflation is usually controlled). Whereas Brazil, after 1994, had to get rid of an exchange rate anchor that had been subsidiary to the stabilization process (the essential was the URV mechanism, which neutralized the staggered inflation), in the years following 1991, Argentina had to get rid of an effective anchor—the convertibility plan. Thus, for Argentina, where the convertibility plan turned out to be sort of taboo, it was much more difficult to reject, or impose, limits to capital inflows, which helped the country maintain an overvalued currency. And it became even more difficult when the IMF supported the overall exchange rate policy, demanding only more fiscal adjustment, and systematically skipped the exchange rate problem, which led to huge current account deficits. Argentina was “developing with foreign savings.” Only the support coming from the North can explain that the country was able to amass such a high foreign debt that more than doubled from 1990 to 2002. And only the size of the foreign debt, coupled with the taboo on the exchange rate, may explain the dimension of the 2001 Argentinean crisis.

Completely different is the case of Chile, which was the only Latin American country able to impose controls on capital inflows, therefore not only avoiding balance-of-payment crises, but also, more important, assuring satisfactory growth rates in comparison with the other Latin American countries. In 1991, Chile introduced, as the main instrument to control capital inflows, the unremunerated reserve requirements (URRs). This mechanism involved reserve requirements in capital during a certain period. The intention was to limit speculative capital inflows and, therefore, to avoid the currency appreciation, without reducing the foreign direct investment.⁵ Chile had stronger reasons to resist the “second” Washington Consensus than Brazil or Argentina. In 2002, the commercial opening coefficient in Chile was 0.65, while in Argentina it was 0.41, and in Brazil it was 0.29.⁶ The higher this coefficient, the more deadly will be an overvalued currency. Yet we should not dismiss the hypothesis that Chilean policy-makers were more competent and more able to think according to the interests of their country.

The case of Mexico is different. It was the first of the large Latin American countries to stabilize and reform, and it was the first to get involved in a typical “second” Washington Consensus crisis: the 1994

⁵ For more information, see Stallings and Peres (2000) and Baldini Júnior (2001).

⁶ Commercial opening coefficient is defined as the ratio between imports plus exports and GDP.

balance-of-payments crisis. It seems, however, that the crisis was not enough to prevent a new appreciation of the Mexican peso since then. After the crisis, capital inflows resumed strong. On the other hand, there are two other factors pressing down (appreciating) the Mexican currency in relation to the dollar: the oil revenues and the immigrants' remittances. The crude oil exports in 2003 reached \$18.6 billion (11.31 percent of the total exported); the immigrants' remittances today reach nearly \$10 billion (1.5 percent of GDP).⁷

The second Washington consensus

It is time to define more precisely the growth *cum* foreign savings strategy coupled with the opening of the capital account, or the "second" Washington Consensus—the form that conventional orthodoxy coming from Washington and New York assumed since the end of the debt crisis. According to this new consensus, formulated in the early 1990s by the Washington authorities, the highly indebted countries should open their capital accounts and resume economic growth by resorting to foreign savings. This second "growth" consensus should not be mistaken with the first Washington Consensus. The latter was a "stabilization and reform" consensus that summarized the American policy in relation to the highly indebted countries since the debt crisis broke up in 1982; it was called the 1980s' Consensus. As expressed by John Williamson (1990b), the first consensus consisted of a series of principles advocating structural adjustment and market-oriented reforms.⁸ It became a symbol of the neoliberal policy of those years, although it did not necessarily propose ultraliberal reforms aimed at reducing the state to a minimum, and, what is more important, it did not include financial opening, which Williamson expressly excluded.⁹ The "second" Washington Consensus should not be confused with the recent attempts to revise the first one, in

⁷ Instituto Nacional de Estadística Geografía e Informática (INEGI) data (www.inegi.gob.mx); ECLAC data (www.eclac.cl).

⁸ See Williamson (1990b). The ideological charge against Williamson's text was greatly exaggerated. Williamson is not an ultraliberal, and the consensus he detected in Washington was not an ultraliberal consensus and did not aim to reduce the state to a minimum. It only had a liberal bias (or neoliberal, in the English language, in which "liberal" means progressive). This did not prevent ultraliberals from adopting it.

⁹ In a debate with Williamson, Stanley Fischer suggested the inclusion of financial opening in the list of reforms, and Williamson answered that he did not find such reform necessary or included in the effective consensus of the time (1989, when this debate took place) (see Williamson, 1990a).

the face of the poor performance exhibited by the countries that followed its recommendations. Expressly, it should not be mixed up with the title of the recent book edited by Kuczynski and Williamson (2003), *After the Washington Consensus*.

The “second” Washington Consensus emerged in the early 1990s, when the debt crisis had been reasonably settled down by the “Brady agreements,” and a new capital inflow wave transformed developing countries into “emerging markets.” The consensus is primarily concerned with growth rather than stabilization. For the fulfillment of such an objective, it offered a simple recipe. Each developing country should keep fiscal adjustment and execute an additional institutional reform: to open its capital account. As a reward, the country would receive foreign savings to finance its economic growth. In other words, instead of the “growth *cum* debt” approach of the 1970s, the emerging markets should be involved in a “growth *cum* foreign savings” strategy: instead of stressing foreign finance through loans, it now stresses finance with equity and bonds.

A wide-ranging debate was opened in the 1990s among economists from developed countries on the subject of financial opening and capital flows—some of them critics of liberalization, others, enthusiasts. The latter, starting from the neoclassical assumption that liberalization is beneficial, asserted that financial liberalization is as necessary to development as trade liberalization and must occur at the same time or immediately after. Among the critical papers, one of the most significant is that by Rodrik (1998, p. 61) showing that there is no evidence that countries without capital controls grow faster. Eichengreen and Leblang’s (2002) paper “Capital Account Liberalization and Growth: Was Mr. Mahathir Right?” is also revealing. Yet this literature should not be confused with our criticism of the “second” Washington Consensus. Its financial opening critique concentrates primarily on the problem of international financial instability caused by uncontrolled capital flows,¹⁰ whereas our critique is more general. It challenges the idea that the growth *cum* foreign savings strategy is adequate for developing countries. Consequently, it rejects the view that a major problem faced by developing countries is how to attract foreign capital. On the contrary, a central concern for developing intermediate countries is to curb excess capital inflows.

¹⁰ On this debate concerning the volatility of financial flows, see, among others, Calvo et al. (1995), Eichengreen (2001), Eichengreen and Leblang (2002), Eichengreen et al. (2003), and Reinhart et al. (2003).

Our claim is that the degree of foreign indebtedness, as measured by the foreign debt/exports ratio, and the way this problem is facing, as expressed by the current account deficit/GDP ratio, should be the two central concerns for already highly indebted countries, as most Latin American countries are. All countries face a solvency constraint that should not be minimized in any circumstance, and particularly when the debt/export ratio surpassed the "foreign debt threshold." The 1990s' conventional orthodoxy, which is being extended through the 2000s with minor adjustments, underestimates the foreign unbalances. On the other hand, we underline the fact that uncontrolled capital inflows tend to dangerously cause domestic currencies' evaluation, which, besides causing balance-of-payment disequilibrium, results in a tendency to reduce domestic savings in such a way that the increase of foreign savings is neutralized by the negative reduction of domestic savings. Finally, given the strategic role played by the exchange rate, we criticize the advice that developing countries should fully open the capital accounts. Insofar as they must keep control not only of their external balances but also of their savings rate, they must have the possibility of imposing controls on excessive capital inflows.

The growth strategy presented in the "second" Washington Consensus has a simple and clear statement, which seems reasonable, as every successful ideology does. It may be summarized in a sentence that developing countries' citizens have heard many times since the early 1990s:

We understand that you no longer have resources to finance your development, but do not worry, carry out structural adjustment and reforms, including financial opening, that we will finance your growth with foreign savings, possibly with direct investments.

The sentence is composed of four terms. The first term, or the premise, "we understand that you no longer have resources to finance your development," is obviously false, although the countries' high foreign indebtedness makes it appear to be true. If countries with much smaller per capita incomes are able to finance economic growth with their own savings, an intermediate developing country, such as Brazil, may well do the same. Up to 1970, the enormous growth that Brazil experienced was essentially financed with domestic resources. Even after replacing part of the domestic savings by foreign savings, as a result of the "second" Washington Consensus, four-fifths of the investments are still financed by domestic savings. Brazil does not have at its disposal "all" the desirable resources to finance its development. But who has them?

The second term, "but do not worry, carry out the structural adjustment and reforms, including financial opening," is the most reasonable

of the four terms, if it were not for the financial opening. It includes three conditions. The first condition (fiscal adjustment) is correct: given its high public debt, fiscal adjustment is a condition for strengthening the state organization. Market-oriented reforms are also required, provided that they are concerned with strengthening both markets and the state. Reforms that debilitate the state end by hampering the markets, which depend on state institutions.

The third condition, “including financial opening,” must be discussed together with the third term, “that we will finance your growth with foreign savings.” Therein lies the trap that explains why most of the already highly indebted countries experienced little growth in the 1990s, despite the adjustment and the reforms that they got involved with in the 1980s and early 1990s; therein lies the origin of the balance-of-payment crises whose most extreme example was Argentina; therein lies the major explanation for the continuing macroeconomic instability and international fragility of the Brazilian economy, and for the two balance-of-payment crises—one in 1998, the other in 2002. The central theme of this paper is the critique of these two ideas, and we will return to it.

Finally, the proposition’s fourth term, “possibly with direct investments,” is the more attractive of all. The “foreign equity debt” or “foreign patrimonial debt,” represented by the net foreign capital stock in the country, is not included in the calculation of the indebtedness rates for its lower liquidity. Thus, if direct investment is actually intended to finance capital accumulation in plants and equipment, it will be undoubtedly welcome, particularly if it produces tradable commodities.¹¹ Yet, even in this case, the country’s capital inflow may turn negative if—as it may well happen—the inflowing capital eventually turns into consumption due to the lack of investment opportunities. Unlike in developing countries, in the rich ones direct investment is received not to finance current account deficits but as a consequence of each country’s interest in taking advantage of the technological innovations introduced by other countries’ multinational corporations. Thus, the possibility that direct investments finance consumption instead of capital accumulation usually does not arise, because these countries are both investors and recipients, and the net foreign investment tends to be small.

A naive questioner could ask how foreign investments can be transformed into consumption. If, in accounting terms, we know that saving

¹¹ In our opinion, investment in public services, or retail banking, or in the purchase of Brazilian firms, as happened recently, are not in the interest of a large country such as Brazil. Yet this question will not be discussed here.

is equal to investment, is it not true that foreign savings finance only investment? The answer is simple: foreign savings are synonymous for current account deficits; direct investments are not necessarily transformed into capital accumulation; essentially, they are just one of the two forms of financing the current account deficit, the other form being foreign loans (reserves kept constant). Thus, if direct investments are a form of financing the deficit, it may well end up financing consumption.

In which conditions will foreign savings, financed either by loans or by direct investment, finance accumulation instead of consumption? When the current account deficit (or the foreign savings) is financed by direct investments, we undoubtedly have a more favorable perspective, but the final outcome will depend on how the new money will eventually be used by the economy.¹² If, in the developing country, economic agents face major investment opportunities, either loans or direct investment will enhance the investment rate in relation to GDP; if this is not the case, direct investment will probably increase domestic consumption and, eventually, will just increase the country's patrimonial foreign debt, serviced by remittances of dividends.

The growth *cum* foreign savings strategy originated in the rich countries, but they make a recommendation to developing countries that they themselves do not adopt. They know that foreign savings or current account deficits, financed either by loans or by direct investment, may easily be transformed into consumption. They also know that there is a solvency constraint—that the growth *cum* foreign savings approach contradicts international historical experience. Thus, they establish clear limits for their own foreign indebtedness. Research conducted among OECD (Organization for Economic Cooperation and Development) countries, since the original Feldstein and Horioka paper on the subject (1980), shows that, although those countries receive and make direct investments among themselves, around 95 percent of domestic capital accumulation is financed by domestic savings. At first, neoclassical economists, attached to their assumptions in relation to free markets and on the benefits of capital mobility, defined the outcomes as a puzzle: the “Feldstein–Horioka puzzle.” Further studies, however, demonstrate that it was not a puzzle, but a simple problem of solvency constraint of

¹² The total amount of the country's financial and equity debt minus the reserves plus direct investments and foreign loans made by the country abroad is the country's net foreign liabilities. As in the case of developing countries, the last two items are of minor importance, foreign liabilities correspond basically to the financial and equity debt minus reserves.

each country. That is to say, OECD countries are not willing to go into debt to invest, or become moderately indebted. Investments are, therefore, essentially financed by national savings.¹³

Conditions

Why did the acceptance by the Latin American and Caribbean authorities of the growth *cum* foreign savings strategy have such disastrous consequences? Or, taking the problem from the opposite angle, under which conditions did foreign savings help instead of hinder economic growth? We already suggested the reasons, but they require further analysis. The first condition is that the foreign debt threshold be respected. The solvency constraint matters: there is a limit for a country's indebtedness. From a certain threshold on, it becomes increasingly dangerous to carry on with foreign indebtedness, primarily on the financial angle (but also on the equity one). In the 1970s, Mario Henrique Simonsen used to say that the foreign debt/export ratio should not go beyond 2.¹⁴ Recent research, however, demonstrates that Simonsen's rule of thumb was not severe enough. Although it is impossible to define the debt threshold accurately, empirical research confirms that there is a limit beyond which the foreign debt becomes negative for the country. The World Bank, as an interested creditor, defined this threshold by the foreign debt/export ratio, which should not go beyond 2.2, and by the foreign debt/GDP ratio, which would be 80 percent. Most debt crisis episodes took place when one of those two thresholds was crossed. In the case of Brazil, which is a relatively closed country (its export/GDP ratio is around 0.16), the foreign debt/export ratio is clearly critical. Table 3 shows these variable results for some Latin American countries. According to Cohen (1994), who is stricter, when the indebtedness rate is above 2 or the foreign debt/GDP ratio is above 50 percent, the probability of debt restructuring becomes high, and the negative effect on growth becomes significant. Considering the World Bank criterion, in 2002, only Chile, Mexico, and Venezuela did not have one of those two thresholds crossed;

¹³ See Rocha and Zerbini (2002) for a survey of the evidence. The authors quote the studies of Sinn (1992) and Coakley et al. (1996) as additional evidence, besides those of their own study, that the Feldstein–Horioka correlation is not a puzzle but only a *solvency constraint*.

¹⁴ Simonsen was Brazil's finance minister between 1974 and 1978, and he regarded cautiously the growth *cum* debt strategy. Later, in a textbook, he surprisingly increased this limit (Simonsen and Cysne, 1995).

Table 3
Foreign debt

	Foreign debt/exports of goods and services (ratio)		Foreign debt/GDP (percent)	
	1990	2002	1990	2002
Argentina	4.14	4.90	43.39	137.59
Brazil	3.52	3.36	26.65	51.94
Chile	1.69	1.90	57.12	63.89
Colombia	2.00	2.63	36.23	46.05
Mexico	2.40	0.79	44.54	21.56
Peru	6.17	3.12	86.91	50.88
Venezuela	1.91	1.16	74.08	34.04
Latin America and the Caribbean	2.89	1.89	41.75	44.02

Sources: Authors' calculations based on the software and database described in *Statistic Yearbook 2003*, ECLAC, and *International Financial Statistics Yearbook 1998* and *International Financial Statistics Yearbook 2003*, IMF.

considering Cohen, only the latter two countries are within the acceptable limits. A recent study by three International Monetary Fund (IMF) economists demonstrates that "the average impact of debt on per capita income growth appears to become negative for debt levels above 160–170 percent of exports and from 35–40 percent of the GDP." The study shows that when the foreign debt/export ratio increases from 1 to 3, the rate of growth declines two percentage points per year (Patillo et al., 2002, p. 20).¹⁵

The second condition to make foreign savings desirable for developing countries is that it does not involve exchange rate overvaluation and it involves increase in consumption instead of in capital accumulation. In principle, foreign savings will involve appreciation of the local currency, because the market level of the exchange rate when capital inflows are taking place is lower than the level that would prevail with zero capital inflows (or zero current account deficit, assumed reserves

¹⁵ In the case of Brazil, the foreign debt/export indebtedness rate was around three in the early 1990s. Thus, the growth *cum* foreign savings strategy was highly inadvisable. In the late 1990s, this ratio was near four, despite the fact that a sizable part of the indebtedness that took place during that decade had been conducted through direct investments not influencing the financial indebtedness rates (but involving debt service). Today, after the first (1999) and the second (2002) real depreciations, as exports went up, the ratio came down.

constant). Insofar as the appreciation materializes, this fact will bring two major negative consequences: on one hand, it causes balance-of-payment unbalance problems, which will eventually end up in a crisis; on the other hand, it reduces domestic savings and investment. The first problem is covered by the previous discussion on the solvency constraint: if the current account deficits are large enough to lead the country to the indebtedness threshold, it means that the growth *cum* foreign savings strategy achieved its limit. The second negative consequence—the reduction in domestic savings as a consequence of exchange rate evaluation—plays a major role in our analysis. The transmission mechanism is simple. Insofar as the domestic currency evaluates, real wages go up. The evaluation is nothing more than a change in relative prices in favor of nontradables, and the labor force, whose price are the wages, is the key nontradable. Real wages go up, because, when the exchange rate evaluates, the price of the imported component of consumption goes down, while wages conserve their nominal price.

Michal Kalecki teaches that consumption is a function of real wages: when real wages increase, consumption goes up, and savings go down. Thus, domestic savings are a negative function of the exchange rate. The literature on savings and consumption normally does not acknowledge this fact, but it is central to the process of development, insofar as savings limit capital accumulation. Asian high savings rates are certainly a cultural phenomenon, but they also respond to the strategic use of the exchange rate by policy-makers, keeping it relatively depreciated. On the other hand, John Maynard Keynes teaches that the savings rate is just a relative upper limit to investment, because whenever there is idle capacity and unemployment, investments determine savings rather than vice versa. As we are discussing foreign savings as a means to finance investment, it is easy to see that the reduction in domestic savings caused by the domestic currency evaluation compensates partially, if not fully, the increase in foreign savings that caused the devaluation.

In what circumstance does the increase in foreign savings not have as a trade-off the reduction of domestic savings? This occurs when the opportunities to invest are large in the recipient country, and the domestic interest rate is low, so that a large breach opens between expected rates of returns and the interest rate; and when investments are taking place in a cluster, creating crossed externalities, and causing the expected profit rate to go up. In this circumstance, which characterized the U.S. growth in the nineteenth century, or the Brazilian growth in the early and mid-1970s, the incentive to invest will be great, and part of the increase in wages will not be consumed but invested. Thus, despite the

increase in wages and in consumption, domestic savings will be increasingly pulled by capital accumulation. Moreover, if the domestic interest rates are kept low, the incentive to invest will be still higher. None of these conditions existed in Latin American countries. But how can we say that the Latin American countries did adopt the growth *cum* foreign savings strategy coupled with the opening of the capital accounts? Table 4 presents the more relevant data related to the fact. First, capital inflows, which turned negative in the 1980s, became highly positive in the mid-1990s, to become negative again in the early 2000s. Did this fact cause local currencies' appreciation? We do not dispose directly of the relevant data, but the behavior of the current account shown in Table 4 is clear. Capital inflows obviously appreciated the local currencies. In the early 1980s, when capital inflows fell, the national currencies remained depreciated, thus reducing the current account deficit to near zero, while in the 1990s, the new wave of capital inflows appreciated the national currencies, and the current account deficits increased as expected.

What were the outcomes of such a strategy? We have already seen, in Tables 1 and 2, the outcomes in terms of per capita growth and unemployment. In Table 4, we can see that, despite the huge capital inflows occurring in the 1990s (including high rates of direct foreign investment), the rate of capital accumulation in 1995, 1997, and 2000 averaged 19.8 percent, against 18.5 in 1985 and 1990, when capital inflows were negative. While the positive difference in capital accumulation was just 1.3, the difference in capital inflows was 4.0 percent.

In the case of Latin America and the Caribbean, direct foreign investments summed up to nearly \$7 billion per year in the beginning of the 1990s. At the end of this period, this figure was multiplied by 10. Notwithstanding, the rate of growth remained stagnant, as shown in Table 1.¹⁶ Foreign savings, or the inflow of dollars in the form of loans and direct investment, were compensated by domestic de-savings, as the exchange rate appreciated and real wages increased.

We could add a third condition for foreign savings to be positive to the economic growth of a country: that capital flows are not volatile. This is the concern of the copious literature on capital flows and financial opening to which we previously referred. Yet, because this condition is never met, we fall back to the solvency constraint or the debt threshold. One of the reasons this threshold is relatively low (a foreign debt/export ratio between 1 and 1.5) is precisely this volatility of financial markets, the

¹⁶ Foreign direct investment in Latin America, which was \$7.8 billion in 1990, soared to \$77 billion in 2000.

Table 4
Some relevant variables—Latin America and the Caribbean

	1980	1985	1990	1995	1997	2000	2002
Foreign capital flows/GDP (percent)	3.69	-1.42	-0.43	2.00	4.29	2.92	-0.34
Current account balance/GDP (percent)*	-3.55	-0.39	-0.14	-2.24	-3.21	-2.32	-0.83
Foreign direct investment/GDP (percent)	0.73	0.85	0.69	1.76	3.20	3.86	2.56
Gross fixed capital formation (percent of GDP)	25.9	18.6	18.3	19.0	20.7	19.6	17.9

Sources: Authors' calculations based on the software and database described in *Statistic Yearbook 2003*, ECLAC, and *International Financial Statistics Yearbook 1998* and *International Financial Statistics Yearbook 2003*, IMF.

* (-) means deficit.

herd behavior that is inherent to a market where information asymmetries are huge and ever present.

Summing up, insofar as the economy is growing fast, and domestic investments are strong, total savings will be increasing even if workers and the middle class increase consumption of the relative appreciation caused by capital inflows. Yet, if the economy is not growing fast, even multinational companies' investments in buildings and equipment will be annulled by the reduction of domestic savings caused by the increased consumption. Direct investment will actually be financing the current account deficit caused by the increase in consumption, and the country's patrimonial foreign debt will keep increasing, but the economy will not grow and it will not increase its ability to remunerate the invested foreign capital. The second alternative has essentially been the case of Latin America from the early 1990s until now. The 1997–98 financial crisis put this perverse growth strategy under scrutiny, but the critique that conventional orthodoxy was able to make was superficial, and the basis strategy was maintained. In the 1990s (as today), the conditions required for a positive role of foreign savings were far from being present in Latin America, but the strategy was adopted by the Washington authorities and accepted by the Latin American countries—they were also unable to make a proper critique of it.

Conclusion

Since the 1997–98 financial crisis, the growth *cum* foreign savings strategy, coupled with the opening of capital accounts, is losing credibility in Latin America. Even in the rich countries we see discomfort, although their economists focus on the volatility of financial flows instead of questioning the growth *cum* foreign strategy itself. Thus, by tackling an issue that is real, they skip the two major problems involved: the national solvency constraint and the currency overvaluation derived from uncontrolled capital inflows. The poor performance of the countries that followed such strategy, and the good performance of the ones that did not follow it, however, is compelling. According to Celso Amorin, the foreign minister of Brazil since 2003, the difference between the Asian and the Latin American countries is in the fact that the former grow with domestic savings and foreign markets, whereas the latter expect to grow with foreign savings and domestic market.¹⁷

¹⁷ This phrase was referred to by Rubens Ricupero in a lecture at the School of Economics and Administration of the University of São Paulo, August 27, 2001. Retrieved from Bresser-Pereira's personal notes.

In this paper, we argued that the second alternative is self-defeating. Growth must be financed with domestic savings. This is what the international experience says; this is what the Latin American experience confirms. Given the solvency constraint and the fact that capital inflows tend to overvalue the domestic currency and increase consumption, growth based on foreign debt may occur only during limited periods, in moments when a cluster of investment projects with crossed externalities create particularly favorable investment opportunities. Except for these rare moments, developing countries will be successful if government and the business class, the state and the market, are associated in a national development strategy where the control of the exchange rate is a crucial variable. For many years, the majority of the Latin American countries fulfilled this condition and grew at high rates. Since the 1990s, however, and as a consequence of a major debt crisis coupled with a neoliberal and globalist ideological wave coming from the North, Latin America stopped thinking in regional interest terms, adopted the growth *cum* foreign savings strategy coupled with high basic interest rates, and, since then, remains quasi-stagnant.

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