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# Why Brazil has not Grown: A Comparative Analysis of Brazilian, Indian, and Chinese Economic Management

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# Why Brazil Has Not Grown: A Comparative Analysis of Brazilian, Indian, and Chinese Economic Management

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## *Introduction*

In November 2001, Jim O’Neill and his colleagues at Goldman Sachs argued that global convergence trends augured well for certain large emerging markets and that these would soon displace traditional European economies and, in one case, even Japan and the United States, in terms of market size by the year 2050 (see O’Neill, 2007). These countries, namely Brazil, Russia, India, and China (known by the acronym BRIC), were likely to offer some of the best investment opportunities in the coming decades. Over the next few years, they produced a number of papers which reinforced their original argument through new favorable data (Wilson and Purushothaman, 2003; O’Neil *et al.*, 2005). In 2007, they published *Brics and Beyond*, a full-length book which collected essays that analyzed the trajectories of the BRICs countries, the N-11 (11 other countries that have growth potential), and other possible markets. In the introduction, Jim O’Neill wrote that since the original paper on the BRICs countries was written, the equity markets in the BRICs countries have expanded tremendously (in Brazil by 369%, India by 49%, Russia by 630%, and China by 201% – see O’Neill, 2007, p.5) and that Goldman Sachs continues to be bullish about them.

Brazilians, on the other hand, who have heard that their country is the country of the future for more than half a century, are likely to ask what sort of impossible dream Goldman Sachs is selling. After all, regardless of equity market growth, between 2001 and 2006 Brazil averaged only 2.9% economic growth. Goldman Sachs’ Paulo Leme is sanguine about this, writing “Brazil has underperformed not only relative to our expectations but also compared with all the other BRICs. Since 2003, real GDP growth rates in China, India and Russia have averaged 10.2%, 8.0% and 6.9%, in each case far exceeding our estimates of their long-term potential (4.9%, 5.8% and 3.5%, respectively)” (Leme, 2007<sup>1</sup>, p.75). Leme expects Brazil to reach a target 5% economic growth, given the success of macroeconomic stabilization programs, though he believes that the second Lula government will be unlikely to carry out the reforms necessary to allow for an acceleration of growth. His response is that Brazil needs to perform reforms in four crucial areas: 1) increase savings and investment; 2) increase trade openness; 3) improve quality of education; and 4) improve institutions with the aim of “increasing total factor productivity”

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<sup>1</sup> Leme wrote this essay in 2006 but it was published with the rest of this book in 2007.

(Leme, 2007, p.75). He demonstrates this by comparing Brazil to the other BRICs countries.

This paper does not aim to dispute that Brazil would benefit from reforms in any or all of these areas. Rather, the paper offers a skeptical perspective on reform menus and proposes an alternative explanation for the faster growth of Brazil's peers India and China<sup>2</sup>. The paper begins by introducing (section 1) the idea of the BRICs countries, to establish the basis for comparisons of most similar cases. It then surveys the results of a generation of Washington Consensus era growth (section 2). Although there is a considerable amount of divergence over what causes growth, it seems that something approaching a consensus holds that universally applicable holistic reform programs have been largely discredited by economic performance in developing countries over the last two decades. Section 3 argues that post-Keynesian approaches, which focus on maintenance of monetary and fiscal policy autonomy, offer a compelling explanation for the difference in growth results of Brazil, India, and China. That is, the inflation targeting system in Brazil has failed to adequately control inflation, and contributed to slow start-stop growth while the more managed approaches favored by China and India have done the reverse.

### *1. Not Another BRIC in the Wall*

Investors perpetually search for the next market. It was with this in mind that Jim O'Neill and his colleagues at Goldman Sachs proposed the concept of the BRICs countries (Wilson and Purushothaman, 2003). The premise was that these four countries possess sufficient market size and ability to influence and be influenced by the international economy to make them attractive sites for investment. Since then, investment banks and economists have either adopted the framework of BRICs countries, or added one or two other important emerging markets (O'Neil *et al*, 2005; O'Neill, 2007; Economist, September 16, 2006, p.10). The concept of BRICs countries also has appeal outside of the area of investment analysis and economics, though social scientists find it difficult to get leverage from the concept (Armijo, 2008).

While in other areas, such as historical legacies, culture, and regime type, to name but a few, the similarities between BRICs countries break down quickly, in the area of policy reform, the BRICs countries constitute an interesting case of most similar analysis. All four countries had economies where state intervention was considerable up until the 1980s (Brazil, and China) or 1990s (Russia, and India) and all have moved considerably in favor of freeing market actors and reducing the role of the state. The governments in each of these countries entered the post-World War II period, with a very clear awareness of a need to catch up and with a belief that governments should either actively fill market gaps or that they should wholesale collectivize productive activity. Post War policies involved state-led growth through ambitious multi-year industrialization plans with considerable variety in degrees of success. All pursued policies that were decidedly inward in orientation and Brazil, India and China, displaying little trading, save traditional sectors which were increasingly disadvantaged by macroeconomic policies. The Soviet economy, while more global in orientation, understood its trade profile as part of a larger context of Communist solidarity and its trade was determined by political motivations more so than by traditional concerns of price, productivity and quality. Thus, while the Soviet Union was engaged in

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<sup>2</sup> Russia is excluded here because the dominance of global oil and gas prices as explanatory factors for Russian growth makes a comparison difficult.

trade, it did so through the Council of Mutual Economic Assistance, a relatively closed association.

In addition to being relatively closed economies, credit had been cheaply provided through the extensive presence of government in credit markets. Public development banks (Brazil, and India) or government monopolies in banking directed low cost capital to sectors favored by government plans. While planning was more significant and effective in the USSR and India then in China and Brazil, in all cases, the private financial markets were 'repressed' (Beim and Calomiris, 2000). The rise in global interest rates, sharp fall in oil prices and global consumption in the early 1980s exposed many structural weaknesses in the models pursued by all four countries. Particularly, increased indebtedness to external creditors, rising inflation, and persistent fiscal deficits plagued Brazil, Russia and India, while China suffered from a rise of inflation, heavy state and quasi-state debt. A perception that domestic market processes had been exhausted, inability to access viable external credit markets and external shocks lead to crises in the four countries encouraged all of these governments to pursue reform (Brazil 1980s, 1990s, 1998-9, 2002-3, USSR 1980s, Russia 1991-1999, India 1990-2, China 1981, 1989-1992, the latter being more domestic in orientation). Overwhelming, economists prescribed some degree of liberalization.

The BRICs countries differed in the speed, pace, and content of the reforms that they implemented, as well as the amount of pressure they endured from international financial institutions and trading partners. But all moved towards liberalizing their economies to degrees unknown by any of those countries for most of the twentieth century. Importantly, all moved towards transforming state-owned enterprises into private or mixed partnerships whose performance would be determined by market rather than political conditions, increasing the role of domestic and foreign (China to a lesser extent) participation in capital markets, and welcoming foreign and domestic private investment, particularly in industries once considered sensitive or part of national security (again, China to a much lesser extent). Given these similarities, what is telling is the stark difference in economic growth over the last decade. Compared to the other BRICs countries, Brazilian growth is anemic registering between 33-50% of the growth of its peers. Examining the puzzle of Brazilian growth within the context of India and China constitutes a most similar case analysis (Przeworski and Teune, 1970) in that it reduces the number of potential explanatory variables by identifying divergent results from otherwise very similar circumstances. Thus, finding out why Brazil is not just another BRIC in the wall, should help identify what explains economic growth.

## *2. Washington Consensus Era Growth*

All of the governments analyzed here have been pressured by both domestic and foreign groups to liberalize to some degree, somewhat along the lines of the Washington Consensus. The premise behind the Washington Consensus is that following policies that economists recognize as being correct reduces inefficiencies in countries and produces growth (Williamson, 1990). The Washington Consensus was not the 95 Thesis that many, for good or ill, have thought it to be (Williamson, November 2002). Rather, it was an attempt to show that a robust consensus among the principal economic policymakers in Washington (those in the international financial institutions and in the US Treasury) existed about what sort of policies developing countries needed to correct structural weaknesses and restore growth. If anything, the Washington Consensus was designed with the idea of

convincing developed country economists that they should not abandon developing countries (Williamson, November 2002).

Certain commonalities existed among the many countries and regions in the world which had been hit hard by the rise in oil prices, the global recession in the early 1980s, and its aftermath. These conditions included high or hyper-inflation, overvalued exchange rates, excessive indebtedness (often incurred in a foreign currency), rigid labor markets, inefficient tax collecting agencies, and lack of credibility of monetary policymakers, among others. Many reformers believed that state intervention in markets had distorted incentives creating conditions of moral hazard, crowding out private actors, and prioritizing employment over productivity. At the same time, a remarkable consensus emerged among economists that favored positions held by classical economists – such as that inflation is primarily a monetary phenomenon (Blustein, 2003). With the increased consensus around liberal ideas, the rise of a scientific and mathematical approach to economics, the collapse of command economies in Europe, and the liberalization of China reinforced an impression of technical infallibility to economic theory (Guilhot, 2005). Economists and policy makers spoke of getting the (macroeconomic) ‘fundamentals’ correct or getting prices ‘right.’ In such an environment, the Washington Consensus quickly moved from ten policies which emerge from a sum of cumulative wisdom of the discipline of economics to a complete set of rules to be followed closely and in tandem<sup>3</sup>. Not without some credibility did supporters and critics call it the “Ten Commandments.”

Problems emerged relatively rapidly because although economists ‘knew’ that these prescriptions were correct, evidence was weak and, sometimes, contradictory. Stallings and Peres (2000) found that some reforms had positive effects on growth and inequality, whereas others did not. This led to debates about the importance of sequencing, with authors arguing that certain reforms needed to be done before others. Political scientists and political economists pointed to the absence of attention to institutions and argued that rule of law, a competent judiciary, governability, and other issues were necessary for economic transitions (Haggard and Webb, 1994). Such institutional reforms were considered ‘complementary’ and part of a ‘second generation’ (Krueger, 2000). These reforms were more difficult because they involved more political maneuvering and implementing governments required more political support in order to sustain such changes. Finally, another debate emerged, based largely on comparative analyses of the experiences of the People’s Republic of China and the former Soviet Bloc countries, about the virtue of ‘shock therapy’ versus gradual reform (Nolan, 2002; Aslund, 2002; Hui, 2005).

Interestingly, most proponents in the various debates believed that reforms were good, necessary, and applicable in all cases. The problem lay in timing, political will, or passing additional reforms to make the first set work more efficiently. The crisis in Asia in 1997 began to chip away at that perspective. Harvard economist Dani Rodrik led the charge against blind support of liberalism and globalization (Rodrik, 1997) arguing that particular policy approaches might work better than a dogmatic set of policies. Particularly challenging to liberals, though somewhat overstated, was the importance played by capital controls in the Malaysian response and recovery (Haggard and Lo, 2000). This sparked a debate among economists (Larraín, 2000) about the virtue or dangers of capital controls but discussions of holistic problems with the Washington Consensus were largely muted,

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<sup>3</sup> This does not mean that countries indeed followed all ten. In fact, most countries emphasized only a few policies though there were less dedicated efforts to complete the list.

though it was clear that problems abounded. The collapse of Argentina in 2001 was particularly traumatic particularly because the stylized impression was that Argentina had been a 'poster child' of the Washington Consensus and if it – and its convertibility system – was dead and buried, so should 'neoliberalism' (see Blustein, 2006).

Joseph Stiglitz unleashed a number of critiques of the Washington Consensus which were particularly important given his position as former Chief Economist at the World Bank (Stiglitz, 2002; Onis and Senses, 2005, p.274). Stiglitz suggested a number of reforms, a 'post-Washington Consensus,' which was more likely to produce sustainable and equitable development. In a reflective piece, Williamson replied by recognizing that on certain policies he may have overstated the amount of consensus among economists, but he largely stood by the ten principles he initially laid out (November 2002). What is rather remarkable is that not only Williamson, but many of his critics, believe that there is a particular set of reforms will bring about growth. They disagree on which reforms and the pace and sequencing, but there is a considerable amount of faith in reform agendas writ large.

Particularly exemplary of such faith-based economics can be found in Williamson's reflections on the Washington Consensus ten years later in which he writes "in practice there would probably not have been a lot difference if I had undertaken a similar exercise for Africa or Asia' (2000, p.255, quoted in Rodríguez, 2006, p.2). Similarly, Larry Summers, former US Secretary of Treasury writes:

"I would suggest that the rate at which countries grow is substantially determined by three things: their ability to integrate with the global economy through trade and investment, their capacity to maintain sustainable government finances and sound money; and their ability to put in place an institutional environment in which contracts can be enforced and property rights can be established. *I would challenge anyone to identify a country that has done all three of these things and had not grown at a substantial rate.* And I would challenge anyone to identify a country that for any significant period has been held back either by excessive trade links with the global economy, overly sound public finances, or property rights and contracts that are excessively enforced' (Summers, 2003, quoted in Hausmann and Rodrik, 2005, p.46).

In fact, Harvard economists Ricardo Hausmann and Dani Rodrik did find one such economy, El Salvador. In two important papers (Hausmann and Rodrik, 2005; Hausmann, Rodrik, and Velasco, 2005), they show that despite having made considerable reforms in the area of macroeconomic policies, El Salvador has had only moderate growth.

In analyzing El Salvador's poor record of growth, they show that bank liquidity is considerable, remittances are significant, foreign debt is low, the country's debt is investment grade, and inflation is low. In fact, El Salvador is a "star reformer" but not a "star performer" (Hausmann and Rodrik, 2005, p.43). As they attempt to analyze why growth lags, they discard issues related to high taxation, macroeconomic stability, property rights regime, and infrastructure. Instead, they argue that the fundamental binding constraint in El Salvador is the "absence of new ideas [which] explains why the expected return to current investment ideas is low, and why investment and growth are low" (Hausmann, Rodrik, and Velasco, 2005, p.17). They recommend that El Salvador pursue "a strategy of economic transformation"(Hausmann and Rodrik, 2005, p.83) which would be based on the idea constraints particular to El Salvador, rather than simply assuming that adopting the right reforms would produce growth.

Hausmann, Rodrik and Velasco (2005) propose reforms that are targeted to the particular ‘binding constraints’ of the countries in question. As opposed to having a standard set of prescriptions, they place weight on local priorities and concerns. This seems to follow the advice Deng Xiaopeng offered so many other heads of state, that each country should find its own way. Deng’s advice was remarkably vague – a problem for much criticism of the Washington Consensus as well – but Hausmann, Rodrik and Velasco (2005) apply a workable framework. Other economists have also been successful in stressing the limitations of both Washington and Post Washington Consensus in that neither gives appropriate attention to structural and contextual issues (Sindzingre, 2005; Onis and Senses, 2005). Similarly, William Easterly’s critique the approach employed by the International Monetary fund (IMF) is that it tends to see all crises in similar manners, disdains local knowledge, and lacks appropriate accountability and feedback mechanisms (2006). Specifically, Easterly and Levine (2002) have argued that institutions, not policies matter, dealing a very serious blow to the idea of any set of policies which can consistently produce growth.

The BRICs countries are quite interesting in this regard. China’s remarkable growth over the last quarter of a century is, no doubt, partially due to liberalizing its markets and shedding a very sclerotic economic structure. At the same time, the Chinese state has been far too involved in production, regulation and planning to discount state developmentalist approaches (Onis and Senses, 2007, p.270). Similarly, Russian growth has occurred during periods of reversal of liberalization and the reclaiming of planning on the part of the state (Ferdinand, 2007). Of course, most of this has consisted of a recovery of income to pre-collapse times and has occurred during a phenomenal boom in petroleum and natural gas prices which makes it more difficult to assess the role of the state in generating growth. Similarly, although Indian growth was weak in per capita terms for most of the pre-reform years, and has been robust since “there is no statistically valid break in the series in 1991, implying that, so far, on a trend basis, GDP has continued to grow since 1991/92 at the same rate as it did during the previous decade-at 5.7% per year” (Nagaraj quoted in Adams, 2002, p.5). In the case of Brazil, reforms appeared piecemeal during the late 1980s and early 1990s. It was not until the presidency of Fernando Henrique Cardoso (FHC) (1994-2002) that comprehensive reform agenda was proposed and largely implemented (Spanakos, 2004). Hyperinflation was eliminated and inflation was brought under control, though the country remained susceptible to external shocks (see below). While this constituted a clear and palpable improvement, growth during the FHC years was indistinguishable from the pre-reform era.

This is not to say that reforms have no effect on growth, only that the relationship is more complex than conventional wisdom suggests. In addition to the problem of fitting reforms with the context, suggested earlier, there may very well be a real problem in reform agendas in terms of complementarity. That is, some reforms may not be complementary and the outcome of one reform might prevent good results from another or may block medium term goals. Hausmann, Rodrik, and Velasco show how implementing certain ‘correct’ reforms could actually be harmful in these reforms exacerbated local binding constraints (2005, p.15). Their findings in analysis of El Salvador, Brazil, and the Dominican Republic are confirmed in larger n- empirical studies. In their study of reforms in Latin America, Stallings and Peres (2000) found that reforms lacked perfect complementarity. Additionally, Eichengreen and Leblang (2002) and Rodrik (1998) show that it is difficult to establish a robust relationship between financial liberalization and

economic growth performance for developed and, specially, emerging countries. Examining all regions from 1975-2000, Francisco Rodríguez (2006) argues that the data correlated openness and growth is very inconclusive. Instead, he writes “development thinking should be specific to a country’s institutional and structural characteristics and (...) thinking about a ‘list’ of policy prescriptions to apply to a broad group of developing economics is methodologically erroneous.” (Rodríguez, 2006, p.4). This leads him to the conclusion that “one size does not fit all” (Rodríguez, 2006, p.5).

### 3. *The strategy of macroeconomic policy adopted by Brazil, China and India*

Despite the limitations in the Brazilian reform process, it is clear that it has pursued liberal reform in a more holistic way than either India or China (see Font and Spanakos, 2004). Similarly, the Brazilian experience, like that of India and China, and unlike that of Russia (and Argentina and Peru), is considered a case of gradual and pragmatic reforms (Pinheiro *et al*, 2004). Given the above discussion, it is suggested that the menu of liberalization did not produce the growth that was expected while less liberalized systems (India and China) grew more robustly. This section will argue that selective reforms, particularly in the area of monetary policy contributed negatively to Brazilian growth. This revives the debate over exchange rate regimes (floating *vis-à-vis* managed) and capital controls in emerging markets, a debate which intensified given exchange rate and financial crises in Mexico (1994-95), East Asia (1997), Russia (1998), Brazil (1998-99) and Argentina (2001-02)<sup>4</sup>.

The main outcome of this debate is that implementing a free-floating exchange rate regime and ample capital mobility, even when backed by responsible or credible economic policy – in line with Washington Consensus prescriptions<sup>5</sup> –, leaves emerging countries prone to the humors and short-term logic of capital accumulation. The conventional argument on the difficulties facing such countries is to attribute the volatility of foreign financing to the irresponsible economic policies they adopt (Caramazza and Aziz, 1998)<sup>6</sup>. The heterodox view, meanwhile, regards floating exchange rate and high capital mobility as a destabilizing combination of factors that intensify exchange rate crises in emerging countries. While Brazilian policy implementation was not without fault, the argument presented here, through comparative analysis, supports a more heterodox position.

Support for post-Keynesian positions might be surprising given the certainty with which mainstream economists and international financial institutions, such as the IMF, consider liberalization of capital accounts. They endorse largely unregulated capitals

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<sup>4</sup> These exchange rate and financial crises yielded a consensus among academics and policy makers as to the need to restructure the international monetary system as an indispensable condition for the world economy, and particularly the emerging economies, to see a return to periods of expansion and economic prosperity. While there is a consensus that the international monetary system needs restructuring, the same cannot yet be said with regard to the mechanisms proposed to mitigate and/or put an end to instability in world exchange and financial markets. On this point, Eichengreen (1999, Chapters 6 and 7), Eatwell and Taylor (2000), Davidson (1994, Chapter 16, and 2002, Chapter 14) and Isard (2005, Chapters 7 and 8) offer a summary of the main options for restructuring the international monetary system.

<sup>5</sup> The neoliberal measures advocated for emerging countries by the Washington Consensus are as follows: (i) reduction or elimination of tariff barriers; (ii) free capital mobility, whether for foreign investment or for convertible currency transactions; (iii) fiscal discipline; (iv) tax reform; (v) financial deregulation; and (vi) privatizations.

<sup>6</sup> It is important to add that the conventional theory argues that a responsible economic policy is based on flexible exchange rate, capital mobility and inflation targeting regime.

market, capital mobility, and a perfectly flexible exchange rate (IMF, 2002<sup>7</sup>). Under such a regime, domestic financial assets (securities) are regarded as perfect substitutes for international securities, and thus effective monetary policy is defined by parity between domestic and international interest rates, i.e. monetary expansion brings down domestic interest rates to levels below the international rate, leading to capital flight and consequent exchange rate devaluation, whose beneficial effects on current transactions come to generate an expansion in aggregate demand, which raises domestic interest rates until equilibrium is re-established in the balance of payments; symmetrical effects are produced by restrictive monetary policy.

Economists from this liberal position argue that a flexible exchange rate regime with capital account convertibility is fundamental for emerging countries to absorb the capital inflow and respond to the changing productive capacity in these economies (Edwards and Savastano, 2000; Edison, Levine, Ricci and Slok, 2002, Fischer, 1998; Obstfeld and Rogoff, 1995). Accordingly, the benefits of a flexible exchange rate and unregulated capital flows for an emerging market is that these policies (i) reduce the sources of external vulnerability, and (ii) increase the autonomy of monetary policy. Similarly, financial liberalization (i) allocates efficiently savings (domestic and foreign), (ii) disciplines macroeconomic policies, and (iii) improves the economic growth performance.

Set against this is the perceived need to preserve the autonomy of emerging countries' fiscal and, more importantly, monetary policy. This has reinforced the opinion of heterodox economists and some policymakers of the necessity of introducing capital controls and an exchange rate regime that prevents excessive exchange rate fluctuations. They argue that such policy autonomy is fundamental to assuring sustainable economic growth and harmonious social development. This is particularly important given that developing countries suffer from more volatility than developed countries and this contributes to recessions of longer duration (Hausmann, Pritchett, and Rodrik 2004). Heterodox approaches insist on the need of an exchange rate regime that can prevent excessive exchange rate fluctuations and external vulnerability.

Looking at the GDP performance of some emerging countries, for instance, the BRICs countries (Brazil, Russia, China and India), from 2000 to 2006, one can see that economic performance has differed among these countries: the annual average growth rate in Brazil was 3.1%, in Russia was 6.6%, in India was 6.4% and in China was 9.5%<sup>8</sup>. Ferrari Filho and Paula (2006) show that the economic performance of BRICs countries in the 2000s is the result of the exchange rate regime, capital account convertibility and fiscal and monetary regimes adopted in each country. According to authors, "Russia, India and China, administering their exchange rate regimes with restricted capital account convertibility, are cases of more or less successful macroeconomic policy management ... [while] the more clearly liberal economic policy strategies adopted in the Brazilian economy ... have not managed to assure the country sustainable growth" (Ferrari and Paula, 2006, p.219).

Considering the idea above, why, in the 1990s and 2000,s Brazil has a poor economic growth performance compared with the other Asian countries. According to us, one of the main reason for the difference in growth rates in Brazil, China and India is to be

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<sup>7</sup> In fact, one of the areas which concerned the IMF considerably about Argentina was its convertibility plan (Blustein 2006).

<sup>8</sup> These average growth rates were calculated by the author based on IPEADATA (2008) and IMF (2008).

found in Brazil's inflation targeting regime which is more liberal than in the cases of China and India.

### *3.1. Brazil: macroeconomic instability and economic growth à la stop-and-go*

In January 1999, after months of speculative pressure on the Real, the Brazilian government devalued its currency and allowed it to float. This led to significant pressure on the currency and the decision to adopt a set of economic policies based on inflation targeting (IT), primary fiscal surplus and flexible exchange rates. It is these three principles which, since 1999, have been considered fundamental to Brazilian macroeconomic policy.

Growth during the 1980s and 1990s had been low and volatile, but the expectation was that once inflation had been eliminated, Brazil could resume the high levels of growth it experienced from the post War period until the Debt Crisis. Yet, since beginning of the 21<sup>st</sup> century, the Brazilian economy continues to display patterns of low and volatile growth: between 2000 and 2006, the average GDP growth was 3.1%. This low economic growth can be explained by (i) the external vulnerability (from 2000 to 2003) due to the process of financial liberalization<sup>9</sup>, (ii) the high real interest rates (around 10.0%, the average rate between 2000 and 2006), (iii) a recessive fiscal policy (maintenance of primary surpluses to reduce debt), and (iv) an exchange rate appreciation (specially from 2003 to 2006).

Under the IT regime, monetary policy is taken as the main instrument of macroeconomic policy. It means, that the focus of monetary policy is on price stability, along with three objectives: credibility (the framework should command trust); flexibility (the framework should allow monetary policy to react optimally to unanticipated shocks); and legitimacy (the framework should attract public and parliamentary support). In fact, credibility is recognized as paramount in the conduct of monetary policy to avoid problems associated with time-inconsistency. Moreover, monetary policy is viewed as the most direct determinant of inflation, so much so that in the long run the inflation rate is the only macroeconomic variable that monetary policy can affect. Monetary policy cannot affect economic activity, for example output, employment, etc., in the long run. The results, however, have been different. Table 1 shows a consistently high interest rate and a sharp instability of the nominal exchange rate. For example from 2000 to 2006, the average nominal basic interest rate (Selic) was 18.2% per year, and the exchange rate movement was quite unstable – from 2000 to 2003 it was devaluated and after 2003 until nowadays the nominal exchange rate has been appreciated.

Monetary authorities have operated with a clear and heavy preference for maintaining low inflation. Given this priority, it has maintained high interest rates which discourage monetary expansion and are recessionary in nature. Rising interest rate punishes firms, by reducing their access to credit, and workers, who lose their jobs when firms face difficulties, but reward the *rentiers*, who hold public securities. Ironically, the expansion of Brazilian debt markets has been consistent with a decline in output and employment, and, at the same time, increased the volume of public debt.

In the IT regime, fiscal policy is no longer viewed as a powerful macroeconomic instrument (in any case, it is hostage to the slow and uncertain legislative process); in this

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<sup>9</sup>The financial liberalisation included both facilitation to outward transactions (elimination of the limits that residents can convert real in foreign currencies, with the end of the CC5 accounts) and inward transactions (fiscal incentives to foreign investors to buy domestic public securities).

way, “monetary policy moves first and dominates, forcing fiscal policy to align with monetary policy” (Mishkin, 2000, p.4). Since implementing the IT regime, the Brazilian government has maintained high target goals for a primary surplus of 4.25% of Brazilian GDP, from 2000 to 2006, to guarantee the service of the public debt outstanding. However, despite the fact that the relation between primary fiscal surplus and GDP has been increased in the last seven years, the net public debt/GDP ratio increased from 48.0% to 50.0%. Primary fiscal surplus has contributed to lowering debt, but the external vulnerability which was exposed in 2002-2003 led to an explosion of debt. Therefore, while fiscal surplus may be a medicine with long term value, it may have contributed to the conditions which increased short and medium term debt stock.

As Table 1 shows, since the end of 2003 nominal exchange rate has appreciated trending towards overvaluing, basically due to both increase of trade surplus and capital flows. The growth of trade surplus is a result of an increasing of world import demand for Brazilian products and an increase in commodity prices (mineral and agricultural). Capital flows have been attracted by high yield differentials between domestic and foreign bonds. Under these conditions, there was a quick reduction of external indebtedness and an improvement of the indicators of external vulnerability and foreign reserves have increased from USD 33.0 billion in 2000 to almost USD 86.0 billion in 2006. However, there is a great deal of concern about the future of the trade balance and current account performances. This is due essentially to two reasons: (i) continuous real exchange rate appreciation has reduced the growth rate of exports in 2006, and (ii) the possible reduction in the volume of the international trade, mainly commodities, if a decline in the economic growth of USA and China were to materialize<sup>10</sup>.

Despite the better international conditions and the growth of exports, from 2002 to 2006, GDP had a “stop- and-go” pattern during the 2000s. According to Table 1, GDP growth was 4.3% in 2000, 1.3% in 2001, 2.7% in 2002, 1.3% in 2003, 5.7% in 2004, 2.9% in 2005 and 3.7% in 2006. This average growth rate (3.1%) is insufficient for the needs of the Brazilian population and is very low when compared with those of other big emerging countries over the same period. Moreover, the volatility of growth dampens investment incentives and long term growth potential.

To conclude, the Brazilian economic performance, from 2000 to 2006, shows the following characteristics: (i) despite the fact that inflation rate was kept under control, its average rate was relatively high at 7.4% per year on average since the introduction of the IT regime; (ii) the annual nominal interest rate was around 18.2%, while the average real interest rate was around 10.0% per year; and (iii) the average annual growth rate of GDP was only 3.1%. Thus, even without comparative analysis, there are reasons to reconsider the appropriateness of the IT regime for Brazil.

### *3.2. China: economic growth with managed capital inflows*

The performance of Chinese economy from 2000 to 2006 has been terrific: the annual average rate of GDP was 9.6%. Investment is the driving force of this economic growth. Investment as a percent of GDP increased from 34.1% in 2000 to 41.6% in 2006.

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<sup>10</sup> Brazilian exports are still very much concentrated on agricultural and mineral commodities, such as soy, steel and iron, natural resources, and technological low-intensive industrial products, while there is an important presence in its import contents of products that rely extensively on technology.

This high growth rate is largely due to the growth of the export sector<sup>11</sup>. Expansion of investment in China is very obviously a result of the open-door policy initiated in the 1980s. But, it is also the result of state participation in bank credit and low interest rates have been fundamental.

Economic openness in Chinese economy was gradual and had three phases in the way to attract capital flows (Shengman, 1999): (i) from 1980 to 1986, the “mutual learning” period was developed. In this period, Chinese authorities and population and foreign investors learned from each other; (ii) the “getting ready” took place in the period 1987-91. In this period, laws and regulations were created and measures were adopted to attract foreign investment to different economic sectors and geographic locations; and (iii) since 1992 the “rapid increase” has started. In this period, there was a rapid transformation in Chinese economy (from a planned economy to a market economy) and China was benefited from the worldwide movement to allocate private investment in emerging countries. Foreign direct investment (FDI) ventures in China started in the 1980s when the Special Economic Zones were created and, at the same time, economic policies were implemented<sup>12</sup>.

China has been the principal recipient of foreign capital flows in recent years among emerging markets. Such capital inflows can cause several macroeconomic effects, such as, expanding the domestic money supply and putting pressure on the domestic prices and the exchange rate. However, it does not appear that this has happened in China. China did suffer from a short period of high inflation in the mid-1990s, but since 2000, China has experienced low inflation rates, excepting 2004: from 2000 to 2006, the average inflation rate was 1.3% per year<sup>13</sup>. In other words, inflation rates have been moderate. This has been possible because of flexible monetary and fiscal austerity enjoyed by the Chinese Central Bank (CCB).

The CCB has managed the domestic money supply needed to absorb the capital inflows. Thus, in the 1990s there were some credit restrictions to financial institutions, while in the 2000s monetary policy was more flexible – according to Table 2, the average interest rate was 2.4% per year, from 2000 to 2006<sup>14</sup>. It means that the average real interest rate (average nominal interest rate divided by average inflation rate) in the 2000s was 1.1% per year. Moreover, China has kept the domestic financial system prevented from these capital inflows because there are some (i) limitations on the entry of foreign banks in the financial market, and (ii) convertibility restrictions on the foreign currency transactions of domestic financial institutions.

During the Chinese transition from a closed to an open economy, the exchange rate regime has changed several times and has been the main instrument of economic policy. After a long period of centralized and fixed exchange rate regimes, in the 1990s, the exchange rate was devalued and a managed floating exchange rate regime was adopted. In fact,  *yuan* has been “fixed” to the US dollar since the end of the 1990s (Table 2 shows that relative stability of the exchange rate between 2000 to 2006). One of the reasons for this

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<sup>11</sup> In the 1980s, the China’s share in the world trade was around 0.8% while in the 2000s it was almost 8.0%.

<sup>12</sup> In the beginning, foreign direct investment (FDI) was highly regulated, but in the 1990s were introduced some changes to encourage FDI, such as effective tariffs on imports were reduced, the public corporations were modernized and the exchange rate regime change.

<sup>13</sup> This inflation rate was calculated by the authors according to the data of Table 2.

<sup>14</sup> The average interest rate was calculated by the authors.

stability was the CCB's intervention. Additionally, the CCB has employed capital controls mechanism on both inflows and outflows<sup>15</sup>.

Under these conditions of stable exchange rate, increasing trade surplus and inflows of FDI<sup>16</sup>, since the end of the 1990s China has accumulated an impressive amount of international reserves: according to Table 2, international reserves increased from USD 186.3 billion in 2000 to USD 1,068.5 billion in 2006. As a consequence of the continuous trade surplus, the expressive accumulation of international reserves, the capital controls mechanisms and a low level of external debt, external vulnerability is low.

Chinese fiscal policy has been operated to balance the government deficit. As a result of not increasing the fiscal deficit – in 2006 the fiscal deficit dropped to 0.7% of GDP – the domestic debt has been stable (in 2006 it was 17.3% of GDP).

There are many reasons to explain the successful of “market socialism model” in China and its high economic growth, such as: (i) China adopted incentives policies for FDI; (ii) a large domestic market size; (iii) the low production cost and the high labour productivity, (iv) the State intervention in the economy – the financial and banking system is basically controlled by public banks, the main corporations are state companies, and some of the most important sectors of economy, for instance, oil and energy sectors, are in the hands of State. The government still controls almost of 40.0% of GDP. –, and (v) nominal exchange rate relatively unchanged during the last years and managing capital inflows mechanisms.

### 3.3. *India: economic growth with economic reforms and partial financial liberalization*<sup>17</sup>

In the 1980s and, especially, a few years after the financial crisis of 1991, India had low economic growth. However, since the mid-1990s India has had an expressive economic growth and, as a result, a real progress has been made. Looking at the data for the since 2000 (Table 3), the annual average rate of GDP was 6.7% per year. The main reason for this strong GDP performance is the investment rate (from 24.3% of GDP in 2000 to 33.8% in 2005). The success of economic performance in India has been the result of its enormous domestic consumer market, labor productivity<sup>18</sup>, financial market regulation, management of economic policies and the implementation of successive economic reforms.

Like other emerging countries, India trade account liberalization was introduced in the 1990s, after the *rupee* crisis in 1991. The economic liberalization was characterized by (i) a sharp reduction in the import tariffs – they were reduced from 90.0% on average in the beginning of the 1990s to 25.0% on average at the end of the 1990s –, and (ii) a partial capital account liberalization<sup>19</sup>. Moreover, the exchange rate regime changed from a fixed exchange rate to a managed floating exchange rate regime. Despite the fact that India adopted a “floating” exchange rate regime, the Reserve Bank of India (RBI) acts in the financial and the exchange rate markets to avoid exchange rate volatility. This kind of

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<sup>15</sup> Capital controls in China has been used to keep monetary policy independent, to prevent firms and financial institutions from taking external risks, to maintain balance of payments equilibrium and keep exchange rate and to avoid the economy from foreign financial and exchange rate crises.

<sup>16</sup> It is important to add that FDI has been attracted by the long-term growth perspective of Chinese economy.

<sup>17</sup> This section is based on Paula (2007).

<sup>18</sup> Labour productivity in India is a consequence of investments and improvements in human capital formation.

<sup>19</sup> Long term capital flows are flexible while short term capital controls are still significant.

management has been possible due to the adoption of capital controls mechanisms. For these reasons, the volatility of exchange rate was so low in the 2000s (see Table 3).

Under these conditions of trade liberalization and gradual and limited liberalization of capital in India has attracted FDI and portfolio investment, instead of external debt, reducing, in this way, the country's vulnerability to external crises<sup>20</sup>. According to Table 3, the foreign reserves increased from USD 40.0 billion in 2000 to USD 177.6 billion in 2006 (an increasing of almost 350.0%).

Monetary policy and interest rates have been operated by RBI to expand economic activity. Going in this direction, bank interest rates are subject to control in a few areas. According to Table 3, from 2000 to 2006, the average nominal interest rate and the average real interest rate were and 7.4% and 2.8% per year, respectively<sup>21</sup>. Moreover, due to the economic reforms, the presence of private actors (including foreign ones) in the financial and banking systems has grown considerably.

As a result of the combination of a managed "floating" exchange rate with trade liberalization, domestic inflation has been relatively low: the average inflation rate was around 4.5% per year, from 2000 to 2006. Only in 2005 and 2006, the inflation became higher than the average rate: 5.3% and 6.7%, respectively in 2005 and 2006. It is interesting to observe that inflation rate has been reduced while domestic interest rate has also declined.

In the 1990s and in the beginning of the 2000s, fiscal policy had been operated as a powerful macroeconomic instrument. However, lately fiscal consolidation has been addressed: in 2000, the fiscal deficit was 9.5 of GDP, while in 2006 it dropped to 6.4% of GDP. As a result of fiscal constraints, the government was forced to privatize some infrastructure sectors, such as telecommunications, ports, electricity and aviation market. Moreover, due to the unstable behavior of domestic interest rate, public debt has been very high, around 76.1% of GDP (the average rate from 2000 to 2006, according to Table 3). In conclusion, the India experience with partial capital account liberalization was fundamental to reduce vulnerability to external shocks and financial crises in the 1990s, avoid real exchange rate appreciation, increase the degree of monetary independence and reduce the costs of currency crises (Epstein *et al*, 2003).

### *Conclusion*

Recent revisionist literature of growth, particularly analysis of the Washington Consensus and its heirs suggests that there is no set of policies that consistently increases growth. In fact, the effect of policies on growth may be weaker than initially imagined by economists and this is especially the case when policies are linked to other policies. This does not mean that reforms and policies do not matter, only that they should be appropriate to the particularities of the markets they seek to improve. It was shown that the Chinese and India monetary authorities have maintained more policy autonomy, less external vulnerability and better performance in terms of growth and inflation than is the case in Brazil.

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<sup>20</sup> It is important to add that despite the fact that FDI has increased since the 1990s, according to IMF (2005) it is still low compared with other emerging countries: the relation between FDI and GDP in 2002 was 3.7% in China, 3.1% in Brazil and 0.6% in India.

<sup>21</sup> These rates were calculated by the authors. The average real interest rate is the average interest rate divided by average inflation rate.

This suggests the necessity of (i) balancing the fiscal deficit to aim at implementing social programs and promoting investments, in particular to rebuild public utilities in energy production and road construction, among others, (ii) ensuring that monetary policy has a significant positive impact on the level of economic activity, (iii) directing financial markets toward financing development rather than rentier-like behavior, and (iv) creating efficient anti-speculation mechanisms to control (or regulate) movements of capital in order to prevent monetary and exchange rate crises and augment the autonomy of domestic decision-makers. Exploring the last issue, the main difference among Brazil, China and India is that, paraphrasing and adapting Stiglitz (2002), financial liberalization and capital mobility in the Brazilian economy in the 1990s were at the center of its currency crisis, while China and Indian, due to their measures of capital controls, could manage independent monetary and fiscal policies pro-economic growth.

Not all reforms work and not all reforms work in all places at all times and financial liberalization has been one of the most troublesome of the reforms particularly in Latin America (Stallings and Peres 2000). But there may be a danger of babies and bathwater here. Reforms and policies do matter, but they need to be appropriate to the particularities of the markets for which they are designed (Hausmann, Rodrik, and Velasco, 2005).

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## Appendix

**Table 1**  
**Some Macroeconomic Indicators of Brazilian Economy**

Macroeconomic Indicators/Year	2000	2001	2002	2003	2004	2005	2006
IPCA (%)	5.97	7.67	12.53	9.30	7.60	5.69	3.14
GDP growth (%)	4,3	1,3	2,7	1,3	5,7	2,9	3,7
Interest rate (Selic), average (%)	17.4	17.3	19.2	23.0	16.4	19.2	15.2
Exchange rate, average (R\$/USD)	1.83	2.35	2.93	3.08	2.92	2.43	2.17
Trade balance (USD billion)	- 0.7	2.6	13.1	24.8	33.6	44.7	46.1
Current account (USD billion)	- 24.2	- 23.2	- 7.6	4.2	11.7	13.9	13.5
Foreign reserves (USD billion)	33.0	35.9	37.8	49.3	52.9	53.8	85.8
Country risk/EMBI, average	730	890	1,380	830	542	313.8	n.a.
Fiscal surplus/GDP (%)	3.5	3.6	3.9	4.3	4.6	4.8	4.3
Net public debt/GDP (%)	48.8	52.6	55.5	57.2	51.7	51.5	50.0
Investment rate (% of GDP, 1980 prices)	14.8	14.8	13.9	13.1	13.8	13.8	n.a.

Source: IBGE, IPEADATA and BCB.

**Table 2**  
**Some Macroeconomic Indicators of Chinese Economy**

Macroeconomic Indicators/Year	2000	2001	2002	2003	2004	2005	2006
Consumer Price Index (%)	0.9	- 0.1	- 0.6	2.7	3.2	1.4	2.0
GDP growth (%)	8.4	8.3	9.1	10.0	10.1	10.4	11.1
Interest rate, average <sup>1</sup> (%)	2.6	2.5	2.1	2.6	2.8	1.8	2.5
Exchange rate, average (Yuan per USD)	8.28	8.27	8.28	8.28	8.28	8.18	7.96
Trade balance (USD billion)	24.1	22.6	30.4	25.5	32.1	102.0	177.5
Current account (USD billion)	20.5	17.4	35.4	45.9	68.7	160.8	249.9
Foreign reserves (excluded gold) (USD billion)	168.3	215.6	290.8	408.3	614.5	822.1	1,068.5
Country risk/EMBI, average	n.a.						
Fiscal balance/GDP (%)	- 2.5	- 2.3	- 2.6	- 2.2	- 1.3	- 1.2	- 0.7

Net public debt/GDP (%)	n.a	17.7	18.9	19.2	18.5	17.9	17.3
Gross fixed investment/GDP (%)	34.1	34.4	36.3	39.4	40.7	42.1	41.6

Note: (1) Short-term interest rate.

Source: ADB and OECD.

**Table 3**  
**Some Macroeconomic Indicators of Indian Economy**

Macroeconomic Indicators/Year	2000	2001	2002	2003	2004	2005	2006
Annual Inflation, Consumer Prices (%)	3.2	5.2	4.0	2.9	4.6	5.3	6.7
GDP growth (%)	5.4	3.9	4.5	6.9	7.9	9.0	9.7
Annual Interest rate* (%)	9.8	10.5	7.4	6.1	5.4	5.4	7.1
Exchange rate, average (Rupee/USD)	44.9	47.2	48.6	46.6	45.3	44.1	45.4
Trade balance (USD billion)	- 12.8	- 6.0	- 7.6	-8.7	- 14.3	- 28.0	- 46.1
Current account (US\$ billion)	- 4.6	1.4	7.1	8.8	0.8	- 7.8	- 9.5
Foreign reserves (US\$ billion)	40.0	48.0	70.3	100.6	131.2	137.2	177.6
Country risk/EMBI, average	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiscal surplus/GDP (%)	- 9.5	- 9.9	- 9.6	- 8.5	- 7.5	- 6.7	- 6.4
Net public debt/GDP (%)	67.8	73.3	78.3	79.8	80.4	78.0	74.8
Investment/GDP (%)	24.3	22.9	25.2	28.0	31.5	33.8	n.a.

Note: (\*) Long term (Yield of Government of India Securities).

Source: IMF, ADB and Reserve Bank of India.