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Working Paper

Brazil: Another lost decade? Domestic policies and attractiveness for foreign capital

Kieler Diskussionsbeiträge, No. 188

Provided in cooperation with:
Institut für Weltwirtschaft (IfW)

Suggested citation: Funke, Norbert; Nunnenkamp, Peter; Schweickert, Rainer (1992) : Brazil: Another lost decade? Domestic policies and attractiveness for foreign capital, Kieler Diskussionsbeiträge, No. 188, http://hdl.handle.net/10419/746

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Brazil: Another Lost Decade?

Domestic Policies and Attractiveness for Foreign Capital

by Norbert Funke, Peter Nunnenkamp
and Rainer Schweickert

CONTENTS

- Formerly a favourite location for private capital inflows, Brazil was virtually cut off from further bank lending in the 1980s. The country's rating in secondary loan markets plummeted, and foreign direct investment dwindled. New external financing was replaced by an accumulation of interest arrears. Retained resources were used for consumption or fueled capital flight, rather than being used for productive investment.
- Brazil is significantly lagging behind Asian and Latin American competitors in facing the fiercer worldwide competition for foreign capital. The seriously impaired attractiveness in international capital markets is to be attributed to pronounced macroeconomic instability, excessive government interference into goods and factor markets, as well as confrontation with commmercial lenders and restrictive attitudes towards foreign investors.
- After having lost one decade, Brazil should not risk another one. The country should follow the example of Chile and Mexico, where the implementation of domestic policy reforms was supported by voluntary debt-service concessions of external creditors. This cooperative approach lowered the perception of country risk, led to the repatriation of flight capital, and triggered a favourable investment response.
- Domestic policy reforms are indispensable for regaining access to international capital markets. The centerpiece of macroeconomic stabilization in Brazil must be to break inflationary expectations through sustained fiscal consolidation. Recent progress in dismantling trade barriers must be supplemented by abandoning the tradition of interventionist price policies in domestic goods markets. The deep-rooted structural deficiencies of labour and financial markets have to be tackled, in order to stimulate human capital formation and enhance efficient financial intermediation.

INSTITUT FÜR WELTWIRTSCHAFT KIEL · JULI 1992

ISSN 0455-0420

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Die Deutsche Bibliothek - CIP-Einheitsaufnahme

Funke, Norbert:
Brazil: another lost decade? : Domestic policies and attractiveness for foreign capital / by Norbert Funke, Peter Nunnenkamp and Rainer Schweickert. Institut für Weltwirtschaft Kiel. - Kiel : Inst. für Weltwirtschaft, 1992
(Kiel discussion Papers ; 188)
ISBN 3-89456-027-4
NE: Nunnenkamp, Peter:; Schweickert, Rainer:; Kieler Diskussionsbeiträge

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Printed in Germany
ISSN 0455 - 0420

I. Introduction

During the 1970s, foreign investors and creditors were eager to engage in Brazil in order to participate in the "Brazilian Economic Miracle" of high growth and booming exports. The large though untapped domestic market as well as the country's endowment with vast natural resources and semi-skilled labour offered favourable profit opportunities. Foreign loans were easily available, and the country was considered a priority location for foreign direct investment (FDI).

The situation has changed fundamentally in the 1980s. With the eruption of the debt crisis, it became evident that the domestic market potential as well as the availability of natural resources and labour were insufficient ingredients to guarantee high returns on investment in the longer run. External shocks and misguided economic policies rendered it impossible to sustain the impressive growth of real gross domestic product (GDP) of 8.6 per cent in the 1970s. Foreign investors and creditors became increasingly reluctant to transfer further capital to Brazil (Table 1).

Only recently, foreign investors seem to rediscover Brazil. In the first quarter of 1992, Brazilian borrowers raised external financing through new bond issues

Table 1 - Brazil: Selected Economic Indicators, 1970-1990

	1970-1979(a)	1980-1984(a)	1985-1987(a)	1988	1989	1990
Real GDP growth (per cent)	8.6	1.4	6.5	0.0	3.3	-4.0
Inflation (per cent)(b)	38	142	194	697	1284	2710
Gross domestic investment (per cent of GDP)	25.6	19.4	19.4	22.8	24.9	21.7
Foreign debt, long-term						
- US$ billion	5.1(c)	72.0	99.0	101.4	90.3	89.9
- per cent of all developing countries	8.3(c)	13.1	11.6	10.5	9.0	8.6
Net transfers, long-term (US$ billion)(d)	1.5(c)	-0.3(e)	-7.0	-8.0	-7.4	-2.8

(a) Period averages. - (b) Wholesale prices. - (c) 1970. - (d) Net resource flows minus interest on long-term debt and profit remittances. - (e) 1980.

Source: World Bank [b]; IMF [b]; EIU [b, 1991-92].

of over US$ 1 billion denominated in US dollars [World Bank, a, 1992, No. 1, p. 4]. Furthermore, the Brazilian stock market posted strong gains in the first quarter of 1992 with a 36 per cent rise [ibid., p. 7]. However, a continued availability of foreign capital has not been established so far. First market reactions to perceived economic improvements do not yet seem to be based on fundamental and sustainable policy reforms. At the end of March 1992, President Fernando Collor de Melo had to change his cabinet almost completely, in order to cope with increasing political pressure and persistent macroeconomic problems.

In sharp contrast to Brazil, the advanced developing countries of Asia have established far-reaching economic reforms which enabled them to prevent major financing problems in the 1980s [Lal, 1987]. Even in Latin America, Brazil remains one of the last countries to face reality. The country still sticks to its muddling-through politics of the 1980s [Nunnenkamp et al., 1992]. By contrast, the reform process in neighbour countries, including Argentina, Chile, and Mexico is already more advanced and pronounced.

In the subsequent analysis, Brazil's position in the international competition for foreign capital is critically evaluated. The overall aim is to assess how the country's access to internationally mobile capital could sustainably be enhanced. Following this introduction, Section II analyzes the costs of Brazil's economic policies with respect to its attractiveness for commercial lenders and foreign investors. Referring to empirical evidence from cross-country studies, Section III reveals the crucial role of domestic policies for attracting capital inflows. The most important policy areas are identified: macroeconomic stability, goods and factor market policies, as well as the attitudes towards foreign lenders and investors. Section IV evaluates Brazil's position vis-à-vis major competitors with respect to these policy areas. The analysis results in conclusions on economic policy measures which may help to improve the country's competitiveness in international capital markets (Section V).

II. Brazil's Position in International Financial Markets

During the 1981 peak, total net resource flows to developing countries amounted to US$ 138.6 billion, and 46.1 per cent of all flows were directed towards the Western Hemisphere [OECD, 1989]. After the outbreak of the debt crisis, total net resource flows to developing countries declined gradually until 1986. This downward trend was dominated by sharp cuts in private capital flows and particularly pro-

Table 2 - Share of Asia and Latin America in Total Net Resource Flows to Developing Countries, 1980-1990 (per cent)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Asia	19.4	22.4	24.0	33.7	31.9	34.8	33.1	32.7	37.6	33.3	33.7
Latin America and the Caribbean	44.2	46.1	42.6	29.2	34.9	27.2	22.5	23.6	22.1	24.3	28.2

Source: OECD [1989; 1991]; own calculations.

nounced for Latin American countries [Nunnenkamp et al., 1992]. The share of net resource flows to the Western Hemisphere dropped significantly in the beginning of the last decade, and oscillated around this lower level thereafter (Table 2). By contrast, the share of Asia increased remarkably in the early 1980s and remained relatively stable thereafter.

Only at the end of the last decade, capital flows to Latin America started to increase in absolute and relative terms compared to the seriously depressed level of the second half of the 1980s. However, the financial situation among the countries of the Western Hemisphere remained diverse. Only a small number of countries benefited from the increase of private flows after 1988 (essentially Mexico, Chile, Colombia, and Venezuela) [OECD, 1991, p. 21]. The majority of Latin American countries including Brazil remained unattractive for foreign capital. This is true for international bank lending as well as FDI.

Table 3 reveals most obviously the fundamental problem Latin American countries and, in particular, Brazil were facing. In Asian countries which continued to service their debt, disbursements were increasing during the 1980s. By contrast, credit disbursements of commercial banks to Latin American countries diminished considerably. In 1980, disbursements reached US$ 33.0 billion, while debt-service payments (interest and principal payments) amounted to US$ 30.2 billion. In 1989, disbursements were down to US$ 5.1 billion, while debt-service payments were reduced to US$ 18.7 billion. This resulted in considerable negative net transfers, which decreased only recently. In 1990, Chile as the country with the longest reform history became the first Latin American country to have positive net transfers after 1982.

Despite the similar pattern of commercial bank lending to major Latin American debtors, secondary loan prices indicate sharp differences in the market valuation of the debt (Table 4). Secondary loan prices of Brazilian debt were highest in

Table 3 - Commercial Bank Lending to Developing Countries: Disbursements, Debt Service and Net Transfers, 1980-1990 (US$ billion)

	1980	1985	1989	1990
All developing countries				
Disbursements	56.4	34.5	30.4	30.8
Debt service	46.9	64.1	52.7	46.8
Net transfers	9.5	-29.6	-22.3	-16.0
East Asia and Pacific				
Disbursements	7.7	10.7	11.8	14.0
Debt service	5.2	14.1	14.9	14.2
Net transfers	2.5	-3.4	-3.1	-0.2
South Asia				
Disbursements	0.8	1.5	1.7	0.9
Debt service	0.2	1.3	1.5	1.6
Net transfers	0.6	0.2	0.2	-0.7
Latin America and the Caribbean				
Disbursements	33.0	8.7	5.1	6.3
Debt service	30.2	29.7	18.7	13.3
Net transfers	2.8	-21.0	-13.6	-7.0
Argentina				
Disbursements	4.1	3.0	0.1	0.0
Debt service	2.2	4.7	0.3	0.5
Net transfers	1.9	-1.7	-0.2	-0.5
Brazil				
Disbursements	8.1	0.4	1.5	1.5
Debt service	10.7	7.0	4.4	1.9
Net transfers	-2.6	-6.6	-2.9	-0.4
Chile				
Disbursements	3.3	0.8	0.9	1.6
Debt service	1.8	1.6	1.3	1.2
Net transfers	1.5	-0.8	-0.4	0.4
Mexico				
Disbursements	10.1	3.0	1.1	2.0
Debt service	8.2	10.8	7.8	4.0
Net transfers	1.9	-7.8	-6.7	-2.0

Source: World Bank [b, 1991-92].

1986 (75 per cent) compared to Argentine (66 per cent), Chilean (67 per cent), and Mexican (56 per cent) debt paper. Brazil's notation plummeted by more than 50 percentage points to 22 per cent in the fourth quarter of 1989 and the subsequent improvement remained relatively weak. The drastic decline is only comparable

Table 4 - Secondary Loan Prices: Selected Latin American Countries, 1986-1992 (a) (per cent of face value)

		Argentina	Brazil	Chile	Mexico(b)
1986		66	75	67	56
1987	I	65	66	68	57
	II	47	61	69	56
	III	37	39	56	47
	IV	34	47	61	50
1988	I	28	51	57	49
	II	24	50	61	50
	III	23	46	60	47
	IV	22	43	55	44
1989	I	17	29	56	39
	II	14	31	62	40
	III	18	28	61	41
	IV	13	22	59	36
1990	I	11	24	66	40
	II	14	24	66	43
	III	13	22	72	43
	IV	20	25	74	46
1991	I	17	27	85	53
	II	27	34	88	56
	III	39	36	88	60
	IV	38	31	90	62
1992	I	42	36	88	63

(a) Bid price. - (b) Prices after February 1990 refer to par bonds offered under the Brady Initiative.

Source: World Bank [a].

to Argentina, where prices fell by 53 percentage points to 13 per cent in the same quarter. For a number of years, the notation for Argentine debt paper was below the notation for Brazilian debt. Recently, however, Brazil was outperformed even by Argentina. The impressively improved notation for Argentina's debt reflects the ongoing reform efforts in this country. Maintained reform efforts in Chile had as a consequence that secondary market notations never fell below 55 per cent and increased to 90 per cent in 1991. Mexican loan prices increased from less than 40 per cent in 1989 to 63 per cent in 1992, which can again be attributed to sustained policy reforms.

As in the case of commercial credits, FDI flows were concentrated on developed countries after the outbreak of the debt crisis [Langhammer, 1991; UNIDO, 1990]. The share of FDI flows to developing countries decreased significantly after 1982 to 15-16 per cent in 1989/90 (Table 5).[1] FDI flows to Latin America were twice as high as FDI flows to Asia in 1980. Subsequently, FDI flows to Asia increased nearly sixfold, while flows to Latin America were less than 20 per cent higher in 1990 as compared to 1980.

Table 5 - Foreign Direct Investment Flows, 1980-1990

Host countries	1980 (a)	1982 (a)	1985	1989	1990	1980	1982	1985	1989	1990
	US$ million					per cent of total				
Total	49289	53970	48261	192446	179558	100.0	100.0	100.0	100.0	100.0
Industrial countries	40310	28927	36212	164333	150913	81.8	53.6	75.0	85.4	84.0
Developing countries	8978	25042	12050	28114	28645	18.2	46.4	25.0	14.6	16.0
Asia	3099	4226	4863	15785	18553	6.3	7.8	10.1	8.2	10.3
Latin America and the Caribbean	6217	6191	4018	6727	7323	12.6	11.5	8.3	3.5	4.1
Argentina(b)	681	225	919	1028	2036	11.0	3.6	22.9	15.3	27.8
Brazil(b)	**1913**	**2922**	**1348**	**1267**	**1028(c)**	**30.8**	**47.2**	**33.5**	**18.8**	**14.0**
Chile(b)	213	401	64	269	595	3.4	6.5	1.6	4.0	8.1
Mexico(b)	2184	1644	491	2648	2548	35.1	26.6	12.2	39.4	34.8

(a) Data expressed in SDRs are converted into US$ based on the US$/SDR exchange rate (period averages) as given in IMF [b]. The sum of FDI flows to Asia and the Western Hemisphere is larger than total flows to developing countries in 1980 because FDI flows to the Middle East were negative. - (b) Percentage values refer to Latin America and not to world total. - (c) Not necessarily comparable to previous data; source: Banco Central do Brasil [1992].

Source: IMF [a]; own calculations.

[1] High FDI flows of US$ 11.1 billion to Saudi Arabia contributed to the extraordinary high share of FDI flows to developing countries in 1982. Omitting this special effect, their share of FDI inflows amounted to 32.5 per cent.

Within Latin America, Brazil's situation deteriorated dramatically. In 1982, nearly half of all FDI flows to the Western Hemisphere were directed to Brazil. The share of Brazil decreased significantly to 14 per cent in 1990. By contrast, the Mexican, Chilean and Argentine situation improved in relative and absolute terms recently.

In summary, the analysis of foreign capital flows suggests that reform efforts in Asian as well as selected Latin American countries were honoured by foreign lenders and investors. Empirical evidence on the major determinants of debt and FDI inflows will help to reveal the major bottlenecks towards an improved attractiveness for foreign capital in Brazil.

III. Major Determinants of Private Capital Flows to Developing Countries

This section summarizes the main results of recent empirical studies on the impact of the recipient countries' economic policies and the risk perceptions of capital suppliers with respect to a country's access to international capital markets. The focus is on results which appear to be highly relevant for Brazil.[1] Since the determinants do not have to coincide, debt and FDI flows are analyzed separately, although Section II provided first clues on similar reaction patterns of foreign lenders and investors.

1. Determinants of International Creditworthiness

Even after risk illusions had been destroyed in the early 1980s, it continued to be heavily debated whether the access to foreign loans could be encouraged by favourable domestic policies and good economic performance. The confusion about the determinants of commercial bank lending appears to be mainly because conflicting hypotheses apply to different lending regimes. Most importantly, a distinction has to be drawn between voluntary lending and defensive lending (which is sometimes called "involuntary" lending):[2]

---

[1] Therefore, lending to non-constrained borrowers is not considered in the following.

[2] Defensive lending is defined according to Watson et al. [1988]. This lending regime comprises countries for which concerted credit extension, i.e., equiproportional increases in loan exposure coordinated by bank advisory committees,

- Ample evidence suggests that the borrowers' economic policies figured prominently in determining whether or not external debt became unmanageable.[1] Hence, well performing countries should have had better access to voluntary lending recently.
- Under conditions of defensive lending, however, favourable policies and good performance may even lead to reduced, rather than increased bank lending [Krugman, 1988; 1989]. It may be in a bank syndicate's interest to provide loans "involuntarily" to problem debtors such as Brazil in order to protect existing claims. According to this reasoning, the incentive of banks to orchestrate new loans is weakened if the market valuation of the inherited debt improves due to policy reforms and better economic performance of the debtor.

These conflicting hypotheses have been tested by running separate (pooled cross-country) regressions for 14 developing countries for which defensive lending had been orchestrated in the 1980s and for 12 developing countries not benefiting from such lending [Nunnenkamp, 1990]. The empirical results strongly contest the notion of bad policies inducing further lending. The estimates rather indicate that private creditors honoured adjustment efforts by easing credit constraints. The access to international credit markets was improved e.g. by higher investment ratios, better world-market performance and real exchange rate devaluation.[2] This result also holds for developing countries like Brazil for which defensive lending took place. Hence, it was a losing proposition if Brazil attempted to attract more (defensive) lending by unfavourable economic policies.

This does not mean, however, that narrowly defined adjustment programmes were a sufficient condition for a resumption of commercial bank lending. This qualification is particularly relevant for Brazil and other Latin American economies where sovereign-risk and credibility problems have become evident since the early 1980s [El-Erian, 1991]. Sovereign-risk considerations relate to the willingness of a country to service external obligations. The impact of sovereign risk on private lending to developing countries is ambiguous at the theoretical level:

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took place. The lending to countries without such concerted credit extension is considered voluntary.

[1] For a discussion of domestic policies with regard to debt problems, see e.g. Baneth [1986]; Khan and Knight [1983]; Nunnenkamp [1986] and Zaidi [1985].

[2] The latter result indicates that real exchange rates were overvalued in many developing countries [Edwards, 1989].

- According to standard arguments, rational lenders will consider the borrowers' incentives to default when deciding whether to grant further credits (for an overview, see Eaton et al. [1986]). Therefore, voluntary lending is supposed to be negatively related to the benefits to be reaped from defaulting on external debt, and positively related to the potential costs of such debtor behaviour.[1]
- By contrast, the expectation of default may induce, rather than prevent further lending to constrained borrowers once debt-servicing problems have emerged [Krugman, 1988; Cohen, Sachs, 1986, pp. 539 f.].

Empirical estimates support the standard sovereign-risk argument that net transfers are negatively related to the benefits that debtors may realize by defaulting on external debt [Nunnenkamp, 1990]. Defensive loan disbursements did not improve the borrowers' access to international credit markets in terms of net transfers.

2. Determinants of the Attractiveness for Foreign Direct Investment

The question of how to revitalize FDI flows is today all the more relevant, as expectations are being pinned increasingly on FDI to alleviate foreign debt problems. Pooled cross-country regressions for the 1980s revealed that the traditional set of explanatory variables[2] has to be extended [Agarwal et al., 1991]. Most importantly, sovereign-risk considerations, the impact of political and economic instability as well as the host country's attitudes towards FDI have to be included.

Major results that are relevant in the Brazilian context can be summarized as follows. First, foreign investors accounted for risks originating from difficulties of developing countries to service their external debt. Under conditions of a debt overhang, foreign investors refrained from further engagements. The underlying fear is that income from productive investment declines due to higher future taxes (in order to service the inherited debt) [Sachs, 1989] and stagnating markets. Consequently, overindebted countries such as Brazil will face difficulties in attracting FDI unless debt problems are overcome.

[1] The borrowers' benefits from default primarily depend on the debt-service burden [Eaton, Gersovitz, 1981, p. 302]. When considering the default costs, the borrowers have to take into account the sanctions that may be imposed on them by the creditors [Sachs, 1984, pp. 17 f.].

[2] They include trade relations, the size and the growth of the host countries' domestic markets, currency valuation, and labour costs.

Second, the expectation of continued political and economic instabilities tend to increase the problems of cost-benefit analysis by entrepreneurs. It is, hence, not surprising that instability clearly reduced the attractiveness of a country for foreign investors [see also Edwards, 1991; Schneider, Frey, 1985].

Third, FDI inflows were negatively affected by overly restrictive attitudes of host countries towards foreign investors. In the 1980s, many countries moved towards more liberal ownership regulations, non-bureaucratic approval procedures and favourable rules on the repatriation of profits and capital [UNCTC, 1988]. This trend impaired the attractiveness for FDI of host countries such as Brazil that maintained relatively strict regulations (for details, see Section IV.3). Moreover, sovereign-risk considerations influenced the behaviour of foreign investors in relatively restrictive countries. Potential benefits from expropriations - proxied by the ratio of FDI stocks over GDP - discouraged further inflows to such countries [Agarwal et al., 1991]. By contrast, high FDI stocks induced even more flows to countries with favourable attitudes towards FDI. The latter result underlines that a liberal treatment of FDI and a cooperative stance of host countries towards foreign investors helps to enhance the attractiveness for FDI through reputation building.

Furthermore, government interventions in goods and factor markets were shown to be crucially important for attracting risk capital [Hiemenz, Nunnenkamp et al., 1991]:

- Discriminatory taxes and subsidies, administrative price fixing, and similar measures interfere with the relative profitability of production among sectors. Empirical evidence also suggests that excessive trade interventions induce an inefficient use of resources, which ultimately undermines a country's position in the international competition for risk capital [see also Krueger, 1990, Part III].[1] This result challenges the widespread belief that import protection is a promising means to attract FDI.
- A country's competitive position in international capital markets is further affected by unfavourable capital and labour market conditions. Financial repression characterized by low or even negative real interest rates discourages domestic

[1] In the literature it has sometimes been argued that import barriers served as an incentive for FDI as the latter is a medium to jump over protectionist fences (see e.g. the survey results of Kayser et al. [1981]). Econometric estimates indicated, however, that export activity was a predecessor of German FDI in developing countries. Market penetration had a significantly positive impact on FDI, while the degree of import barriers in the host countries affected FDI negatively [Agarwal et al., 1991].

savings and the transmission of savings into loanable funds. Complementary domestic capital required to attract FDI remains insufficient. With respect to labour market conditions, it has frequently been argued that cheap labour represents a major element of a developing country's attractiveness for foreign capital. Notwithstanding relatively low unit-labour costs, however, a country is unlikely to become an attractive investment location if a particularly poor endowment with human capital is a binding constraint for economic development, or ineffective collective bargaining arrangements lead to excessive labour market disputes.

All in all, foreign investors responded to restrictive regulations, policy-induced distortions and transfer risks in a similar way as did foreign lenders. Parallel behaviour of capital suppliers has as a consequence that the chances of debt-ridden countries such as Brazil to restructure their external financing are limited at best unless the attractiveness for both types of foreign finance is improved. The specific reform requirements for Brazil are assessed in the subsequent section.

IV. Major Bottlenecks in Brazil to an Improved Attractiveness for Foreign Capital

Section III revealed that the major obstacles for an improved attractiveness for foreign capital are not exogenous to the policy-making apparatus, but could be removed by appropriate policy measures. Policy areas that are of overriding importance in the competition for foreign capital have been identified. They include:

- macroeconomic stability;
- the level of government interference into goods and factor markets;
- the attitudes towards foreign creditors and investors.

Macroeconomic stability and the removal of goods and factor market distortions are required in order to help improve the investment conditions and the servicing of external debt obligations. A cooperative stance towards foreign capital suppliers signals the government's willingness to contain sovereign risk and to restore credibility. As demonstrated in the following, Brazil lags behind major competitors with respect to all three policy areas.

1. Macroeconomic Instability

Sources of macroeconomic instability may derive from the domestic economy or the country's international economic relations. Therefore, indicators of both types of instability have to be considered.[1]

- **Inflation:** High and volatile inflation rates represent an obvious sign of unsound management of the economy [Greene, Villanueva, 1991; Schneider, Frey, 1985].
- **Budget deficit:** High and rising public deficits fuel inflationary expectations or make private agents anticipate a tighter credit squeeze and crowding out in the future.
- **Exchange-rate fluctuation:** High volatility of the key price concerning a country's external relations creates considerable uncertainties with respect to both trade and capital flows.

The ranking of 26 mainly middle-income developing countries with respect to the above three indicators reveals that Brazil was among the most unstable sample countries in the second half of the 1980s (Table 6).[2] The country represented the tail-light as concerns average annual inflation rates and the magnitude of budget deficits. Taking the three indicators together, Brazil achieved only 14 out of 78 possible ranking points. In this respect, only Mexico performed even worse during 1985-1988.

In contrast to Mexico, the position of Brazil has not improved substantially since the late 1980s. Recent evidence rather suggests that macroeconomic instability continued to be a major problem:

- Notwithstanding periodic price freezes and controls, the annual average of consumer-price inflation was even higher in 1989-1990 than before. After the defreezing of prices in mid-1991, monthly inflation rates again returned quickly to double-digit levels.[3]
- An astounding turnaround was achieved in the public sector accounts. Figures for 1989 put the operational deficit of the non-financial public sector at nearly 7 per cent of GDP [EIU, b, 1991-92, p. 39]. In sharp contrast, official figures for

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[1] For a detailed discussion of the underlying economic rationale and additional indicators, see Hiemenz, Nunnenkamp et al. [1991, Chapter III].

[2] For reasons of comparability, Table 6 refers to the period 1985-1988, since more recent data were lacking for several sample countries.

[3] The annual averages of inflation amounted to 1287 per cent (1989), 2938 per cent (1990) and 465 per cent (estimate for 1991) [EIU, a, No. 1, 1992, p. 3].

Table 6 - Brazil's Ranking in Terms of Macroeconomic Instability within a Sample of 26 Developing Countries, 1985-1988(a)

	Inflation		Budget deficit(b)		Exchange-rate volatility(c)	
	per cent	rank	per cent	rank	standard deviation	rank
Argentina	309.0	2	-4.45	11	1.33	19
Brazil	**314.5**	**1**	**-11.89**	**1**	**0.98**	**12**
Chile	23.6	9	-0.69	20	0.49	1
Colombia	26.2	8	-1.54	17	0.77	7
Costa Rica	17.4	11	-3.64	13	0.83	10
Ecuador	36.3	7	-0.66	21	1.25	18
Guatemala	20.0	10	-1.05	18	1.04	13
Hong Kong	5.4	20	2.25	26	1.65	24
India	7.7	16	-8.49	5	1.55	21
Indonesia	6.8	17	-1.90	16	0.52	2
Kenya	8.6	15	-4.92	9	1.48	20
South Korea	4.1	22	0.20	24	1.62	23
Malaysia	0.1	26	-7.46	7	1.55	22
Mexico	95.3	4	-10.13	3	0.54	3
Pakistan	5.4	21	-7.80	6	0.82	8
Peru	219.9	3	-3.68	12	0.62	4
Philippines	9.1	13	-2.88	14	1.09	15
Singapore	0.3	25	-0.47	22	2.30	25
Sri Lanka	6.1	18	-10.30	2	0.96	11
Taiwan	1.4	24	1.23	25	2.95	26
Thailand	3.8	23	-2.82	15	1.23	17
Tunisia	5.5	19	-5.31	8	1.07	14
Turkey	44.7	6	-4.63	10	0.82	9
Uruguay	70.6	5	-1.05	19	1.21	16
Venezuela	16.2	12	-0.26	23	0.66	5
Zimbabwe	8.7	14	-8.98	4	0.77	6

(a) Period averages and ranks; 1(26) is attached to the country with the worst (highest) attractiveness in terms of the respective indicator. - (b) In per cent of GDP; positive in the case of surplus. - (c) Standard deviation of the real exchange rate over the past five years; low (high) values if exchange-rate volatility is above (below) the sample average.

Source: Hiemenz, Nunnenkamp et al. [1991].

1990 recorded a surplus of 1.3 per cent of GDP, and a similar figure was expected for 1991. However, this drastic improvement is difficult to sustain. It was largely achieved through extraordinary measures and transitory influences such as the accumulation of arrears on the external debt and the deferment of pay-

ments on the internal debt [see also Ohana, Mussi, 1991].[1] The resurgence of inflation in mid-1991 reflects the low credibility of fiscal consolidation.

- As concerns exchange-rate volatility, recent evidence suggests increased rather than reduced instability. The index of the real effective exchange rate (deflated by wholesale prices) plummeted from 1988 = 100 to around 50 in March 1990, indicating a drastic real appreciation of the domestic currency. Considerable fluctuations continued in 1990 and 1991 [EIU, a,].

All in all, macroeconomic instability continues to be a major stumbling-bloc to an improvement of Brazil's attractiveness for foreign capital. It remains the centerpiece of macroeconomic reforms to break inflationary expectations. To this end, fiscal consolidation must be sustainable, i.e., based on a permanent restructuring of government revenues and expenditures. Without success at the inflation front any attempt to devalue the real exchange rate is not sustainable [Schweickert, 1991] and will, therefore, add to real exchange rate instability.

2. Interventionist Government Policies

a. Goods Market Distortions

The competitive position of Brazil with respect to goods market distortions is difficult to assess in quantitative terms in a cross-country perspective.[2] Nevertheless, there is strong evidence that policy interventions in goods markets contributed considerably to the country's impaired attractiveness for foreign capital. The assessment by the World Economic Forum [a], which includes qualitative survey data, clearly points to competitive disadvantages of Brazil vis-à-vis nine major competitors. State intervention was considered to be most pervasive in Brazil in 1990, and the international orientation of the economy was revealed to be weaker only in India and Indonesia. More specifically, the ranking of Brazil was extremely unfavourable in the late 1980s and early 1990s as regards particular indicators of goods market distortions [Nunnenkamp et al., 1992, Appendix III; World Economic

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[1] Expenditures on federal debt servicing fell by 88 per cent in real terms in 1990; their share in total expenditure fell from 33.8 per cent to 6.1 per cent [EIU, a, No. 1, 1991, p. 14].

[2] The empirical verification suffers from data constraints and conceptual flaws due to country-specific circumstances. This applies especially to the tax system and openness indicators (for details, see Nunnenkamp et al., [1992]).

Forum, a, 1991, p. 117]. Most noteworthy are: entry regulations resulting in oligopolistic market structures [see also Porst, 1991, p. 53], excessive state ownership, price regulations, price distortions by government subsidies, unequal fiscal treatment among enterprises, high trade barriers, and restrictive local-content requirements.

Further evidence on policy-induced goods market distortions has been presented in country-specific analyses [see e.g. EIU, a; Carneiro, Werneck, 1989; Porst, 1991]. According to Carneiro, Werneck [1989], 3-4 per cent of GDP was transferred each year to the private sector in the form of government expenditures or forgone revenue during the 1980s. To a large degree, these transfers were selective and discriminatory. Examples were the plethora of fiscal exemptions, as well as cheap inputs and special credit facilities for so-called priority sectors. The applied import-substitution strategy "implied the choice of selected capitalists which were eligible to receive substantial transfers from the public vaults. In return, the level of direct bureaucratic controls over imports, prices and export permits has probably never been so high and widespread in the Brazilian economy" [ibid., pp. 26 f.].

More recently, some goods market distortions were relaxed while the government continued to resort to periodic domestic price controls. Since the late 1980s, the government has lowered import tariffs quite considerably (most notably for industrial inputs). The number of prohibited import items has been reduced, quantitative restrictions have been relaxed, financing restrictions on capital goods imports have been removed, and selective export incentives under the so-called BEFIEX-scheme have been phased out. Most importantly, the extensive system of discretionary and non-tariff barriers has been tackled.[1] These measures were certainly steps in the right direction, i.e., to improve the Brazilian industry's competitiveness by helping it to lower production costs. However, the sustainability of trade liberalization is threatened as long as the domestic currency is overvalued in real terms (see Section IV.1), thereby putting considerable pressure on the balance of payments.

Interventionist price policies persisted at the internal front. The Summer Plan of early 1989 represented another attempt to tackle run-away inflation through a freeze on the prices of 180 basic products. Serious price distortions emerged, combined with speculative buying and hoarding. Erratic price-policy changes continued

[1] An important administrative change was the abolition of the Foreign Trade Department of the Bank of Brazil (CACEX) in 1990, which may have reduced uncertainties about the future course of foreign trade policy.

into the Collor administration. Although formal price controls were removed in 1990, prices remained policed with hundreds of companies being forced to submit monthly reports on production costs and prices, and the government being committed to prevent "abusive" pricing [EIU, a, No. 3, 1990, p. 9]. In another abrupt change of course, the government adopted a new price freeze in early 1991 (the fifth since 1986) after inflation had soared and attempts to form a social pact (Entendimento Nacional) had failed.

The return to double-digit monthly inflation rates points to the importance of macroeconomic stability for a credible reduction of goods market distortions. Interventionist policies will be expected to persist or to return unless fiscal restraint is credible (see Section IV. 1) and trade liberalization is accompanied by a competitive real exchange rate.

b. Factor Market Distortions

Labour costs, the extent of labour market unrest and the endowment with human capital determine the attractiveness of **labour-market conditions**. Cross-country comparisons of unit-labour costs mainly refer to the mid-1980s.[1] Nevertheless, they indicate important policy challenges facing the Brazilian government. Brazil had clear labour cost advantages in manufacturing industries such as iron and steel as well as automobile production during the 1970s, not only vis-à-vis industrialized countries but also vis-à-vis newly industrializing competitors such as South Korea [Picht, 1987; Fischer, Nunnenkamp et al., 1988]. However, trends in unit-labour costs since the mid-1970s showed a rise of unit-labour costs in Brazil, whereas cost reductions were achieved e.g. in South Korea, Mexico and Taiwan. Brazil's loss in unit-labour-cost advantages was due to relatively large increases of hourly labour costs and an insufficient improvement of labour productivity. Its position was increasingly challenged by a small group of other newly industrializing countries.

This is rather unlikely to have changed significantly, notwithstanding temporary setbacks in manufacturing earnings in recent years. According to the World Economic Forum [a], Brazil's ranking continued to be extremely poor as far as labour productivity developments are concerned. The poor record in terms of R&D efforts and technological improvements points into the same direction [Nunnen-

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[1] For a discussion of conceptual flaws and data problems, see Picht [1987].

kamp et al., 1992, Appendix III]. Discrepancies between wage and productivity developments may at least partly be traced to a wide range of labour-market interventions. They comprise, e.g., minimum wages, regulations on effective working time and job termination, and non-wage labour costs [Spinanger, 1988; see also Porst, 1991, pp. 126 ff.]. Brazil's international competitive position was affected in particular vis-à-vis Asian countries where labour markets have remained relatively free of policies either directly or indirectly increasing labour costs. Hence, labour-market policies should be carefully reviewed and revised where necessary.

Such a review should include collective bargaining arrangements which gave rise to labour-market unrest. Measured by the number of strikes and lockouts per worker in the manufacturing sector, Brazil ranked in a medium position among 21 sample countries in 1985-1988 [Hiemenz, Nunnenkamp et al., 1991, Table 17]. But this situation marked a significant deterioration of industrial relations during the 1980s. The number of strikes and lockouts per 1000 workers soared from 1.7 in 1981 to 26.1 in 1987. Frequent strikes and unofficial stoppages continued to be a salient feature more recently: "an increase in labour militancy" was reported in 1990 [EIU, a, No. 4, 1990, p. 7]. It is, thus, not surprising that Brazil ranked most unfavourably when experts were asked to which extent industrial relations in ten newly industrializing countries were conducive to labour peace [World Economic Forum, a, 1990, p. 227].

Brazil's competitive position is similarly weak as concerns its endowment with human capital. The scarcity of skilled labour can be traced to the public education system and vocational training facilities, which are both inadequate to meet the requirements of a competitive economy [Nunnenkamp et al., 1992, Appendix III].[1] Further evidence is provided by comparing the ratio of secondary school enrollees in per cent of the respective population age cohort among developing countries [Hiemenz, Nunnenkamp et al., 1991, Table 18]. During the 1980s, Brazil hardly succeeded to raise this ratio (1979-1984: 34-35 per cent; 1985-1988: 37 per cent). Consequently, Brazil ranked at the lower end of a sample of 26 countries in the late 1980s, and was even surpassed by countries with significantly lower per capita income such as Colombia, Ecuador, Indonesia, Peru, the Philippines, Sri Lanka, and Zimbabwe.

In a summary assessment of labour-market conditions in 95 countries, Frost & Sullivan [1988] placed Brazil in the least attractive country group. The ranking

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[1] See also EIU [b, 1990-91, p. 9]: "The quality of education has deteriorated dramatically since 1980."

was based on the availability of adequate labour, the level of wages, and the flexibility in the use of labour. This unfavourable position of Brazil appears to be consistent with the evidence presented above.

As concerns **domestic capital market conditions**, the picture is similarly bleak. This is evident from Brazil's tail-light position in terms of capital market performance and the quality of financial services [World Economic Forum, a]. A deterioration of Brazil's ranking was reported since the mid-1980s. Three factors stand out at the beginning of the 1990s: First of all, financial intermediation is generally deficient and does not meet the requirements of an internationally competitive economy. Banks play a limited role as a source of lending, and the range of financial alternatives available to enterprises is fairly narrow. Second, the government and state banks strongly interfere with the allocation of financial resources. Private sector companies, and particularly foreign enterprises, are at a disadvantage vis-à-vis the public sector in accessing capital markets. Third, lending for non-privileged enterprises is expensive. Short-term interest rates were typically very high in real terms in recent years [EIU, a].

The lending possibilities of banks have often been constrained in the context of stabilization programmes. A freeze on lending was an element of the Summer Plan of early 1989. Similarly, commercial lending was curtailed by the Collor Plan which asked the banks to use a significant share of their funds for buying privatization certificates (Certificados de Privatização). Generally, it is hardly possible to provide medium and long-term investment loans because savers prefer extremely short-term deposits (e.g. in the overnight market). It is, thus, not surprising that bank credits contracted in real terms over much of the 1980s [Hiemenz, Nunnenkamp et al., 1991, Table 13].

Financial deepening, proxied by the supply of broad money (M2) relative to GDP, was found to be particularly poor in Brazil. The country ranked at the bottom of the sample of 26 developing countries and was again surpassed by many less advanced competitors [ibid.].[1] This unfavourable position has, of course, largely to be attributed to the highly inflationary environment in Brazil. Extremely high rates of inflation contributed to the demonetization of the economy. The evidence on financial deepening provides another indication of the interrelatedness of policy failures, and underlines the earlier conclusion that comprehensive and consistent reforms are required to improve Brazil's international competitiveness.

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[1] For example, the indicator values of the proxy of financial deepening were about twice and three times higher for Sri Lanka and Uruguay as compared to Brazil in the mid-1980s.

Isolated financial market reforms will be of limited use unless macroeconomic instability is contained. At the same time, macro stabilization is unlikely to do the job alone. The structural deficiencies of the Brazilian financial system are clearly demonstrated by the fact that financial deepening was lower than in other Latin American countries which were plagued by similarly high inflation (e.g. Argentina and Peru).

3. Attitudes towards Foreign Capital Inflows

a. External Debt

Brazil's external debt strategy was characterized by partial default, temporary and unilateral debt-service moratoria, and protracted debt renegotiations with its foreign creditors [see e.g. EIU, b, 1991-92, pp. 46 f.]. In contrast to other debtor countries, most recently Mexico, Brazil did not adjust to the debt crisis by attempting to restore its international creditworthiness through sustained macroeconomic stabilization and structural reforms. It rather pursued a non-cooperative debt strategy. Within two years (1983-1984), Brazil submitted seven letters of intent to the IMF. The result were two waivers, three modifications of targets, and two suspensions [Cardoso, Fishlow, 1989, p. 84]. Negotiations with the IMF broke down in late 1985, and Brazil declared a moratorium on interest payments to commercial banks in early 1987. Resumed IMF negotiations were again suspended in 1989 because of the government's failure to meet the targets on public sector deficits. As a result, interest arrears on commercial bank debt soared (end-1990: US$ 9.6 billion [World Bank, b, 1991-92]).[1]

Underlying Brazil's debt policies throughout the 1980s was the politicians' believe that there exists a choice between paying the external debt and domestic economic growth (see e.g. the statements of various politicians during the electoral campaign of 1989). However, Brazil's actual performance clearly demonstrates that such an alternative does not exist:

- Non-cooperative debt policies resulted in lower rather than higher net transfers (see Section II). Mutually agreed debt reschedulings proved to be particularly difficult under Brazilian conditions. The amount of Brazilian debt which was re-

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[1] An agreement on interest arrears with commercial banks was achieved in May 1991, which was again followed by negotiations with the IMF.

scheduled (relative to GDP) was lower than in most other middle-income countries with serious debt problems (Table 7).

Table 7 - Debt Rescheduling in 11 Middle-Income Developing Countries, 1985-1988(a)

Argentina	11.8	Mexico	17.5
Brazil	3.7	Peru	2.9
Chile	5.8	Philippines	9.9
Costa Rica	6.8	Uruguay	8.4
Ecuador	18.7	Venezuela	15.9
Guatemala	1.2		

(a) Average amount rescheduled in periods t, t-1, and t-2 in per cent of GDP.

Source: Hiemenz, Nunnenkamp et al. [1991].

- Resources retained through partial default did not result in better economic performance. The Brazilian situation at the end of the 1980s was rather characterized by stagflation (Table 1). The investment ratio was still lower than in the 1970s. Under such unfavourable economic conditions, retained resources were used for consumption or fueled capital flight, rather than being used for productive investment.

Brazil fits fairly well into the cross-country evidence presented in Section III. Non-cooperative debt policies reduced net debt inflows and, additionally, impaired the attractiveness of the country for foreign investors. The costs of unilaterally enforced debt-service reduction might be reduced or even avoided if Brazil follows a two-sided approach. The implementation of sound economic policies would then be supported by voluntary and market-based debt and debt-service reduction. This is basically the cooperative strategy adopted by Chile and, more recently, Mexico, which had several positive effects for these countries: [1]

- It triggered a better investment response than the non-cooperative approach of Brazil. The share of private investment in GDP increased from the bottom value of 11 per cent in 1983 to 14.8 per cent in 1990 in Mexico, and from 4.9 to 15.6 per cent in the case of Chile [Pfeffermann, Madarassy, 1992].

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[1] In the case of Chile and Mexico, the menu of mutually agreed debt concessions included voluntary market-based debt-equity conversions, direct cash buybacks, conversions of debt into collateralized discount bonds, reduced interest par bonds, etc.

- The debt burden was alleviated substantially. Chile reduced its debt to banks by more than half in four years. Gross bank-debt reduction through conversions into bonds amounted to US$ 15 billion in the case of Mexico [El-Erian, 1991].
- The perceptions of country risk were lowered, and debt-overhang concerns of foreign capital suppliers were reduced (see Section II, Table 4).
- Flight capital was repatriated to a significant extent. A study by Chartered West LB Ltd., quoted in El-Erian [1991], estimated net total inflows of flight capital of US$ 14 billion for Chile, Mexico and Venezuela in 1989-1990 (as compared to outflows of US$ 4.5 billion in 1987-1988).[1]

In summary, the experience of Chile and Mexico demonstrates that even highly indebted Latin American countries are able to overcome external financial constraints by opting for domestic policy reforms and cooperative debt negotiations. Both countries clearly outperformed Brazil with respect to the attractiveness for credit suppliers.

b. Foreign Direct Investment

Brazil's relative attractiveness for FDI deteriorated during the 1980s even though the country did not change dramatically with respect to its overall openness towards FDI.[2] This is not surprising since cross-country evidence clearly indicates that the decisions of foreign investors are influenced by risk perceptions which relate to the external debt situation (see Section III.2). Moreover, other major recipients of FDI in the Third World liberalized regulations to a considerable extent [UNCTC, 1988], leaving Brazil with a relatively poor image in recent years. The deterioration of Brazil's relative position is evident from Table 8, which compares the ranking of developing countries in 1980 and 1988 with respect to their openness towards FDI:

- The 1980-ranking is based on an assessment by the Ifo Institute for 36 countries [Osterkamp, 1983]. This study covers various aspects of FDI regulations, e.g. restrictions on the financing of FDI; locational choices; the use of imported and domestic inputs; employment opportunities; production technologies; production and distribution activities; pricing policies; capital and profit remittances. Addi-

[1] For a detailed discussion on Mexico, see Lustig [1991].

[2] The rather restrictive Leí da Informática represented a notable exception.

tionally, tax rates, the administrative efficiency, uncertainties arising from dispute settlement, and expropriation risks were evaluated.

- The 1988-ranking is constructed from an assessment by Frost & Sullivan [1988] for 95 countries. The nine criteria included in the ranking of Table 8 are similar to the 1980-assessment: controls on ownership, approval process, dispute settlement, employment of nationals, performance requirements, exchange controls, repatriation restrictions, investment incentives, and tax rates.

Although the two rankings of Table 8 are not strictly comparable,[1] the decline of Brazil from the top to the bottom of the sample is striking. A similarly drastic change in the ranking (in the opposite direction) is only observed for South Korea, which opened up towards FDI in the 1980s. The liberalization of FDI regulations in major competing countries leaves much to be desired about Brazil's relative attractiveness for FDI.

On closer inspection of the various criteria underlying the 1988-ranking, some areas can be identified in which policy action is most urgently required to improve Brazil's position. For six (out of nine) criteria, the country is posited in a very unfavourable category (score 2; the average score of all 95 countries for the respective criterion is given as a reference measure in parentheses):[2]

- approval process, i.e.: the amount of time and expense involved in obtaining required bureaucratic approvals; honesty and competence of the bureaucracy; de facto requirements for local agents and cash outlays (average: 2.75);
- employment of nationals, i.e.: the existence and enforcement of quotas mandating employment of host country nationals; requirements for local participation in management; residence requirements for foreign nationals intended to limit expatriate employment (average: 3.25);
- performance requirements, i.e.: regulations concerning local content, offsetting part of imports with exports, countertrade, barter, and devoting a percentage of production to exports; regulations concerning the use and sharing of technology (average: 3.42);
- exchange controls, i.e.: ease of access to the foreign exchange needed to conduct business; use of multiple exchange rates (average: 3.08);

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[1] Differences exist in the selection of indicators, and national biases in the evaluation are likely. The assessment by the Ifo Institute is mainly based on "learned judgement" by German experts.

[2] Each country was scored by Frost & Sullivan [1988] on a 1-5 basis, with "1" being the least favourable and "5" being the most favourable score.

Table 8 - Ranking of Developing Countries with Respect to Their Openness towards FDI, 1980 and 1988(a)

	1980	1988	Change 1980-1988
Hong Kong	1	1	0
Singapore	2	1	-1
Tunisia	3	4	-1
Brazil	**4**	**18**	**-14**
Morocco	5	9	-4
Ivory Coast	6	7	-1
Thailand	7	5	2
Argentina	7	15	-8
Malaysia	9	9	0
Kenya	9	15	-6
Philippines	11	3	8
Mexico	12	13	-1
Colombia	13	6	7
Indonesia	14	14	0
India	15	17	-2
Pakistan	15	9	6
Peru	15	20	-5
Venezuela	18	18	0
Egypt	19	9	10
Nigeria	20	20	0
South Korea	21	7	14

(a) For explanations, see text. Only those countries are included for which both rankings were available. Rank 1(21) reveals the most open (closed) economy.

Source: Osterkamp [1983]; Frost & Sullivan [1988].

- repatriation restrictions, i.e.: severity of restrictions on repatriating profits and capital, including limitations and taxes (average: 3.56);
- investment incentives, i.e.: scope and magnitude of incentives in the form of tax holidays, free trade zones, and subsidies (average: 3.39).

The deviation from the sample average was most pronounced with respect to performance requirements and repatriation restrictions. More recent studies on the climate for foreign investment in Brazil suggest that the picture has not changed fundamentally since the late 1980s.[1] One of the major concerns is that restrictions

[1] It is noteworthy, however, that Porst [1991, p. 81] draws a much more favourable picture as far as repatriation restrictions in Brazil are concerned. He points out that the government generally refrained from imposing transfer restrictions even when the foreign exchange situation was critical. Major exceptions were delayed remittances in 1989 and the blocking of dividend and profit remittances which foreign investors had deposited in central-bank accounts in March 1990

imposed on technology transfers may lead to a technological isolation of Brazil. Bottlenecks are mainly due to bureaucratic interference with licensing agreements, technology contracts and consultancy [Porst, 1991, p. 96].

The overall picture on FDI policies in Brazil indicates that reform requirements go far beyond the most recent steps to revive FDI.[1] In May 1991, a proposal permitting FDI in the Brazilian stock market was approved by the National Monetary Council. Until recently, foreign institutional investors could only buy Brazilian stocks through foreign equity funds established in the country. Similar possibilities for foreign companies and individuals were envisaged.

A great potential for FDI was seen in the context of debt-equity conversions linked to privatization operations.[2] These swaps involve a considerable subsidization of investors. Under conditions of a seriously eroded credibility of the government, the temporary subsidization of FDI may be justified until the confidence of investors has been restored.[3] However, attempts to attract FDI by offering subsidies while, at the same time, maintaining restrictive regulations are likely to fail. FDI promotion schemes must not be misunderstood as a substitute for a comprehensive review of restrictive FDI policies which have contributed to the country's impaired attractiveness for foreign risk capital.

V. Policy Conclusions

The "Brazilian Economic Miracle" of high real growth is long over. Formerly a favourite location for foreign creditors and investors, Brazil's attractiveness for

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(Collor Plan). Additional problems with which foreign investors are confronted in Brazil comprise: strictly limited access to local financing [EIU, b, 1990-91, p. 48; Porst, 1991, pp. 82 f.], no access to subsidized credits of the national development bank (BNDES), and discrimination of foreign companies in public procurement.

[1] In early 1992, the Congress discussed to eliminate the progressive taxation of dividends above 12 per cent of registered capital, the prohibition of intra-firm royalty payments, and the tax on foreign exchange transactions in the capital account [EIU, a, No. 1, 1992, p. 22].

[2] However, restrictions on debt-equity swaps were maintained until early 1992 [EIU, a, No. 1, 1992, p. 22].

[3] However, any subsidization must be limited to the degree which is necessary to compensate for increased risk during the transition period [Agarwal et al., 1991]. A waste of public resources can be avoided by introducing auction mechanisms into debt-equity swap operations.

capital inflows has been seriously eroded during the 1980s. A non-cooperative debt strategy as well as frequent and unsuccessful stabilization attempts characterized the country's politics in the past decade. This muddling-through approach discouraged private capital inflows. Only very recently, Brazil regained access to some international financing. However, first rewards for perceived political changes are not yet based on fundamental and sustainable economic reforms.

Empirical evidence from cross-country studies stresses the significant role of domestic policies to regain access to foreign capital on a sustainable basis. Major bottlenecks towards an improved attractiveness in international capital markets are not exogenous to the policy-making apparatus. However, isolated policy measures, e.g. the promotion of FDI through subsidization, are not promising. Internal adjustment efforts have to be comprehensive and credible. Macroeconomic stabilization, the removal of goods and factor market distortions, as well as a liberal and cooperative attitude towards foreign creditors and investors, are all prerequisites for the recovery of substantial private capital inflows. Brazil was clearly outperformed by its major competitors with respect to these crucial policy areas. This explains the country's low attractiveness for foreign private capital and, simultaneously, indicates the policy agenda for the coming years.

It remains the centerpiece of macroeconomic reforms in Brazil to break inflationary expectations. To this end, fiscal consolidation must be sustainable, i.e., based on a growth-oriented restructuring of government revenues and expenditures. Success at the inflation front would also help to stabilize real exchange rates and, thereby, plug another source of macro instability.

The government should continue to remove policy-induced goods market distortions. The recent progress achieved in dismantling trade barriers must be sustained, which, inter alia, requires to avoid exchange-rate overvaluation. Liberalization at the external front must be supplemented by discontinuing the tradition of interventionist price policies in domestic markets.

As concerns factor market policies, the competitive position of Brazil in the global race for risk capital must be improved by overcoming labour market deficiencies. It is illusory to expect that this could be achieved within a short period of time. Insufficient labour productivity, non-cooperative industrial relations and the shortage of human capital are deep-rooted in the socio-political climate of the country. However, this must not be regarded as an excuse to carefully review restrictive labour market regulations, and to evaluate the possibilities for restructuring government spending in favour of human-capital formation. Similarly, it will take time to overcome the structural deficiencies of domestic financial markets in

Brazil. But again, there is scope for immediate policy action. Most importantly, discriminatory practices with regard to the allocation of financial resources should be discontinued.

Brazil is well advised to build up a reputation as a cooperative borrower and host of FDI. Persistent confrontation with its creditors will not only impair the chances for renewed private lending. It will also have adverse implications on FDI inflows. The recent liberalization of FDI regulations in major competing countries (e.g. in Asia) leaves much to be desired about Brazil's relative attractiveness for FDI. Reform requirements go beyond recent steps to revive FDI. The first priority should not be given to costly promotion schemes, e.g. in the context of debt-equity swaps. It is more promising to relax restrictive performance requirements and to refrain from bureaucratic interference with licensing agreements etc. Brazil could then benefit from technology transfers to a greater extent.

Obviously, the above policy areas are closely intertwined. Structural reforms in particular markets may fail if macroeconomic instability is going to persist. At the same time, the chances for macro stabilization could be improved if structural weaknesses of factor and goods markets were overcome. Reform programmes have to be comprehensive and consistent to restore the Brazilian government's credibility and to trigger a favourable response by foreign capital suppliers (and domestic investors!). A renewed inflow of capital, in turn, would add to the sustainability of domestic adjustment efforts.

Economic integration in Western Europe and the transformation process in Central and Eastern Europe will further intensify the global competition for foreign capital. Debt and FDI flows to developing countries will not necessarily be impaired by these developments. However, immediate action is required by countries with unfavourable investment conditions. Otherwise they will be pushed to the sidelines. Brazil is seriously lagging behind, even in a Latin American context, in facing the ongoing changes in the international economic environment. It is time to make substantial progress in liberalizing and stabilizing the economy. After having lost one decade, Brazil should not risk another one.

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