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An Evaluation of Prevention Policies designed by
Argentina and Brazil against the Transmission of
the World Economic Crisis

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Abstract

Having benefitted from improvements in their terms of trade for almost a decade, Brazil and Argentina have adopted policies to prevent the international crisis from affecting the domestic economy.

Brazil's positive real interest rates keep inflation under control. Simultaneously, they fail to prevent excessive appreciation of the currency, thus maintaining industrial competitiveness. Brazil steers the economy without endangering currency stability or investors' trust. In Argentina, currency and import controls aim at defending the foreign trade surplus, while real interest rates are negative and inflation soars. There is shortage of foreign currency and rapidly falling investment. Argentina is probably heading for a new crisis.

Key words:

Financial and economic crisis – South America – Brazil – Argentina – Crisis transmission – Exchange rates – Interest rates – Inflation – Growth – FDI – Trade policies – Poverty

1. Introduction
2. The world financial and economic crisis
3. Developments in South America
4. Prevention and interruption mechanisms and instruments
5. Brazilian and Argentine policies in comparison
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1. Introduction

This article discusses the chances of Brazil and Argentina to isolate themselves from the financial and economic crisis currently affecting the advanced nations¹. It describes the main tools employed by the governments to steer the domestic economic process in relative independence of the international conditions. While profiting from the improvement in their terms of trade, both Brazil and Argentina have set up a number of barriers to the transmission of negative impulses deriving from the international crisis.

Such policies and measures are representative of those being applied throughout the emerging world. Many countries resort to controlled experiments in currency depreciation, in order to keep imported goods expensive and simultaneously provide incentives to exports. This might push inflation upwards, a reason why monetary policy has to remain tight. This shows the risks associated with such isolation efforts and thereby the relevance of this study.

The article begins by summarizing the current financial and economic world crisis as has been explained elsewhere. In the following, the main factors behind the current strength of the South American economies are highlighted. In a further step, the authors take a look at the usual mechanisms a country can resort to in order to prevent "importing a crisis". A short review of the policies applied since the eighties are designed to help the reader understand today's developments. Then, the prevention measures adopted by Brazil and Argentina as well as their effectiveness are considered. Finally, the main lessons from this experience are discussed.

2. The international financial and economic crisis

The crisis in the advanced economies originated in the USA housing and mortgage sector, leading to it being called subprime residential mortgage crisis or, in short, subprime crisis². Many economists, however,

1. The word is used in the sense given to it by the International Monetary Fund (IMF), see: <http://www.imf.org/external/pubs/ft/weo/2013/01/pdf/statapp.pdf>.

2. The Report of the Financial Crisis Inquiry Commission provides an extensive analysis of the causes and immediate consequences of the crisis in the USA. Noticeable is the conviction that the crisis, which rendered 26 million Americans unemployed as well as four

see in the subprime problem more a triggering factor than the fundamental cause of the current recession in Europe and North America. It is regarded as either a symptom of the crisis of capitalism³ or at least of unregulated markets⁴. As to the dimension of the current crisis, some regard it as being even more serious than the Great Depression, since all major sectors of the world economy appear to have been affected⁵.

The following conditions facilitated the rapid propagation of the crisis:

- a. The low propensity to saving in the United States, visible in a current-account deficit of seven per cent of Gross Domestic Product (GDP) in 2007. This deficit was largely financed by the purchase of US-bonds through the Chinese and other central banks. The worsening of the US current account had been regarded as a “time bomb” as early as 1999⁶.
- b. The issue of derivatives on housing lending, which were rated AAA by the leading rating agencies. European banks purchased heavily such assets, transferring the risk outside the US. Beside the role of the banking system, some economists bemoan the passivity of state control institutions⁷.
- c. Behavioral factors also influenced reactions at the financial markets. These factors can analytically be related to such explanatory concepts as “animal spirits”⁸, irrationality, or “financial folly”⁹.
- d. Shortcomings in monetary policies underlie the process of speculative rent-seeking by financial-market participants, especially the low-interest-rate policies of the Federal Reserve, the European Central Bank (ECB) and the Bank of Japan. Interest rates had been low since the nine-eleven attacks of 2001. The Federal Reserve, however, showed no signs of increasing them even after the US economy had recovered. This led at the housing market to overvaluation of property, while diminishing the quality of debtors.

As interest rates finally rose in 2006-07, the US economy plunged into recession, disconcerting many who had thought current recession-prevention mechanisms sophisticated enough to bypass it at the first signs¹⁰. During 2008, the crisis swept over to Europe, hitting especially Germany, at that time the world’s export leader. Beside the crisis in production, which was dealt with by subsidies (e.g. to the car industry), the existence of so-called toxic assets among European banks made necessary large sums of money for troubled monetary institutes.

Europe’s crisis appeared to come to an end during 2009. However, while recovery in industrial countries like Germany and the Netherlands proved solid, in Spain, Greece and Portugal current-account deficits coupled with growing public sector borrowing requirements (PSBR) led to a worsening of ratings, thus intensifying the governments’ financial troubles. Although the European crisis was not primarily a crisis

million homeless and further over four million on the way to homelessness, could have been avoided. Bad Corporate Management on the part of important banks, lack of transparency regarding the derivative values stemming from housing loans, blind trust in the rationality of the financial markets on the part of the Federal Reserve and the abolition of many control rules by its former Governor Alan Greenspan are considered to have been the main causes of the crisis [United States of America Financial Crisis Inquiry Commission USFCIC (eds.), *The Financial Crisis Inquiry Report. Final Report of the National Commission On The Causes of the Financial And Economic Crisis In The United States* (New York: Public Affairs, 2011)].

3. Adair Turner, *Economics after the Crisis. Objectives and Means* (Cambridge, Mass.: The MIT Press, 2012).

4. Frederick S. Weaver, *The United States and the Global Economy. From Bretton Woods to the Current Crisis* (Plymouth, UK: Rowan & Littlefield, 2011).

5. Michel Chossudovsky, “The Global Economic Crisis: an Overview”, in Michel Chossudovsky and Andrew Gavin Marshall, A.G. (eds.), *The Global Economic Crisis. The Great Depression of the XXI Century* (Montreal: Global Research Publishers, 2010), pp. 3-60

6. Robert A. Blecker, „The Ticking Debt Bomb: Why the U.S. International Financial Position Is Not Sustainable“, in Economic Policy Institute Briefing Paper 85, pp. 1-22, reprinted in H.P. Gray and J.R. Dilyard (eds.), *Globalization and Economic and Financial Stability*, pp. 460-81 (Cheltenham, UK/Northampton, MA, USA, 2005), p. 474.

7. Nouriel Roubini and Stephen Mihm, *Crisis Economics: A Crash Course in the Future of Finance* (New York: Penguin Press, 2010).

8. George A. Akerlof and Robert J. Shiller, *Animal Spirits: How Human Psychology Drives the Economy, and Why it Matters for Global Capitalism*. New York: Princeton University Press, 2010.

9. Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly*. New York: Princeton UP, 2009.

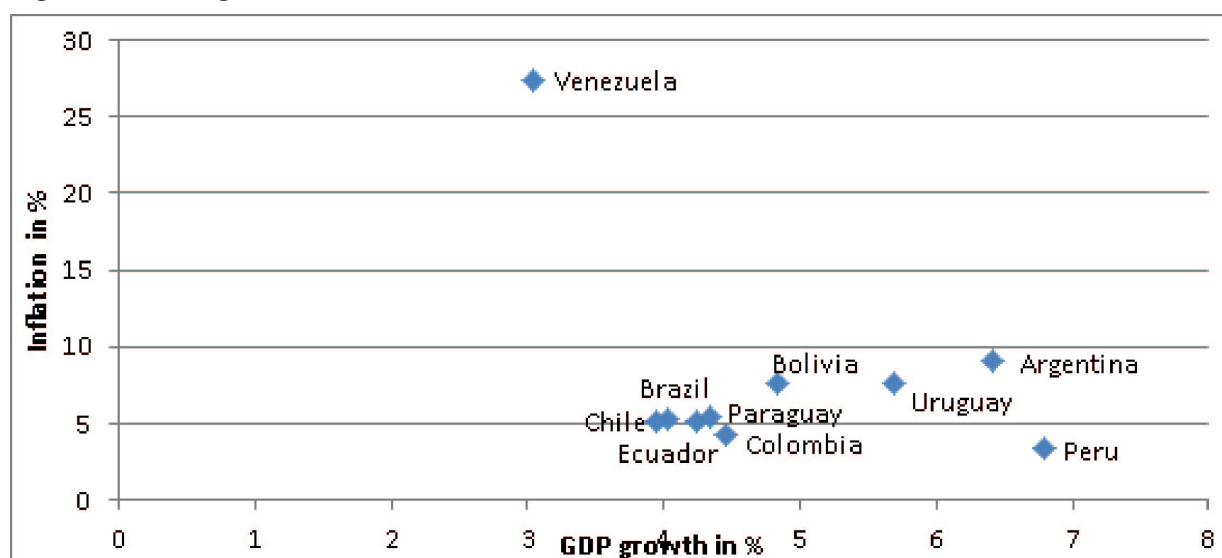
10. Krugman, Paul, *The Return of Depression Economics and the Crisis of 2008* (New York: W.W. Norton & Company, 2009), p.10. Already in the late 1960s the question as to the end of the business cycle was a matter of contention among economists. After crises in the 1970s it became less relevant, only to acquire renewed impetus in the 1990s. “...both Robert Lucas and Ben Bernanke went on record a few years ago with the claim that while the economy would continue to suffer from occasional setback, the days of severe recessions, let alone worldwide depressions, were behind us” (Krugman *ibid.* p. 15).

of the common currency, the Euro became an issue as the ECB showed preparedness to commit itself in rescuing its ailing members¹¹. Interest rates below the area inflation rate subsidized deliberately the worst performers. In an attempt to stop the falling ratings, the ECB purchased itself – although not directly from the states, but on the capital markets - sovereign bonds, a measure bearing little resemblance to the institution's original mandate. Also, rescue packages were agreed on which involved, albeit indirectly, country-to-country help¹².

3. Current Developments in South America

During the main period of crisis (2007-12), the South American economies remained all in all stable. While GDP growth was mostly negative in 2009, the following years showed a strong recovery, while inflation remained mostly under control by regional standards (Figure 1).

Figure 1 – Average Inflation and GDP Growth in South America 2007-12



Source: author's elaboration from International Monetary Fund, *World Economic Outlook*, Oct. 2012. Data for 2012 are estimates. Data for inflation in Argentina stands under special IMF Scrutiny.

For this - historically quite astonishing - development there are basically four reasons:

Before 1990, demand for South American products stemmed largely from Europe and the US. The new century found the region far more linked with the emerging economies of Asia. The strong economic growth after the Asian crisis of 1997-99 ensured a continuing increase in the demand for agricultural and industrial raw materials. Asia's share in South American exports grew rapidly at the expense of Europe's and North America's¹³.

11. The ECB states that „With regard to monetary policy, the Treaty tasks the Eurosystem with the clear, primary objective of maintaining price stability in the euro area as a whole. With regard to fiscal policy, it is the responsibility of the national authorities to ensure a commitment to sound public finances ...“. On the other hand, „The financial crisis has highlighted that threats to financial stability and weak public finances can have a tremendous influence on both monetary and fiscal policy... This adverse financial-fiscal feedback loop poses challenges to monetary policy, as volatile and illiquid sovereign bond markets, as well as a struggling banking system, put the smooth functioning of the monetary policy transmission mechanism at risk“ (European Central Bank, *Monthly Report*, July 2012, p. 51).

12. The European Financial Stability Facility (EFSF) was created in May 2010 as a temporary rescue mechanism. Its mandate is to safeguard financial stability in Europe by providing financial assistance to individual states subject to a macroeconomic adjustment programme. It may intervene in the primary and secondary bond markets and provide funds for financial institutions through the national governments. In October 2010, a permanent rescue mechanism called European Stability Mechanism (ESM) was created. The ESM is now the main instrument to finance new programmes, while the EFSF will continue its ongoing help for Greece, Portugal and Ireland. See for more details: <http://www.efsf.europa.eu/about/index.htm>.

13. John Rowe Jr. (*The Crisis and Beyond*, Finance & Development, June 2012, vol. 49, No. 2) writes: “Unlike in earlier global downturns, emerging market and low-income economies were hurt less and recovered sooner than their advanced counterparts in North America and Europe. Their good fortune was due in part to strong economic policies before the recession that prepared many to fight the downturns. It was also thanks to luck—commodity prices on which many rely remained relatively higher than in earlier recessions, these economies are less tied to their advanced counterparts than before, and their less-sophisticated financial systems

The terms of trade of South America improved strongly between 2001 and 2008. Within this period, the price of a barrel of oil jumped from barely US\$ 12 to 150, a ton of copper from US\$ 2,000 to over 8,000, a ton of soy beans from US\$ 150 to over 500. But also industrial trade has suffered less in emerging and developing economies than in advanced ones¹⁴.

After a number of crises had shown the weakness of South American public finance systems, a combination of restraint in expenditure and economic growth managed to restore confidence and make the need for further PSBR almost redundant. Several countries (Argentina, Brazil) could repay their debts with the IMF in full. A substantial improvement in their ratings took place in the case of Brazil, Colombia, Chile and Peru.

Most central banks were allowed to pursue stability policies similar to those of the advanced countries. This strengthened local currencies. Interest rate differentials vis-à-vis the central countries led to net capital inflows, with the effect of a further strengthening of the regional currencies. Inflation rates decreased to historical records. With the exception of Venezuela and Argentina, inflation rates lie today under seven per cent.

This positive development appears to be under threat now. The extreme low interest rates in Europe, the US and Japan have led to a wave of capital flows from the advanced to the emerging economies, where interest rates are comparatively higher. The result has been a tendency to appreciation on the part of the emerging countries' currencies as well as accelerated import growth, endangering existing trade surpluses or intensifying current deficits.

The emerging markets are therefore in danger of repeating their experience of the nineties, with current-account deficits being financed through (initially low-cost) foreign capital. This entails the peril of lower ratings in the future, when increasing foreign debt might be again assessed as an instability factor. A repetition of the emerging-country crises cannot thus be ruled out. Furthermore, the high commodity prices especially that of oil, might delay worldwide recovery, indirectly posing a problem for commodity exporters.

Crisis Prevention and interruption mechanisms

A crisis is understood in the sense of a downward trend in the business cycle, with the national economy going through a phase of recession and/or depression of different types, grades and duration. In general, the authors adhere to the analytical statement by *Krugman*: "failures on the demand side of the economy – insufficient private spending to make use of the available productive capacity – have become the clear and present limitation on prosperity for a large part of the world"¹⁵.

The following passages deal with the instruments that normally allow a country, which has not itself fallen into a crisis and does not share the problems which have led to crisis elsewhere, to prevent or at least reduce the transmission of recessive tendencies to the national economy. Any such transmission must follow the usual channels of international economic relations, e.g. the transactions between the residents of a country and residents abroad.

4.1. Exchange rates, capital flows and monetary policy

The existence of compatibility (or lack of it) between simultaneous exchange-rate, capital-flow and monetary policies is a standard topic in international economics. Monetary policy is autonomous if it is designed to steer domestic growth while keeping inflation at bay. Autonomous monetary policy is compatible with a combination of flexible exchange rate and free capital movements (as in the US or Great Britain today). Also, a fixed exchange rate in combination with controlled capital flows makes monetary autonomy

had little of the high-risk debt that caused advanced financial markets to seize. But emerging and low-income economies may be less well prepared to deal with any new crises."

14. "World trade collapsed dramatically during the global recession of 2009 and was one of the reasons the recession evoked fears of another Great Depression and a resort to protectionist measures by governments seeking to shield domestic industries from foreign competition. But world trade has rebounded, and again the pace is quicker in the emerging economies than in advanced ones (see Chart 3). Vertical specialization, in which a number of countries are involved in the production process of individual goods, may have restricted the use of traditional protectionist measures" (M. A. Kose, P. Loungani and M. E. Terrones, M.E., *Tracking the Global Recovery*. Finance & Development, June 2012, vol. 49, No. 2.)

15. Krugman, Paul, *The Return of Depression Economics and the Crisis of 2008*, p. 182.

possible (as in the case of China). On the contrary, a fixed exchange rate in combination with free capital flows deprives monetary policy of autonomy – this was the case under the gold standard system. It follows, that fixed exchange rates and free capital flows are incompatible with monetary autonomy. The system of compatibilities and incompatibilities can be summarized as in Table 1 below.

Table 1. Stability of policy combinations

Combination	Exchange rate	Capital flows	Monetary policy	Stability
1	Flexible	Free	Autonomous	+
2	Fixed	Controlled	Autonomous	+
3	Fixed	Free	Not autonomous	+
4	Fixed	Free	Autonomous	-

Source: Juan J. Güida, "Internationale Volkswirtschaftslehre: Eine empirische Einführung" (Stuttgart: Kohlhammer, 2007, p. 191).

The real exchange rate (RER) of a currency is a dynamic concept, which is normally used to express the de- or appreciation of the national currency in terms of the (weighted) currencies of the main trade partners. It can be expressed as:

$$\Delta RER_{(i,a)} = \Delta NER_{(i,a)} \cdot [(1 + \Delta P_i/P_i) / (1 + \Delta P_a/P_a)]$$

whereby i reflects the domestic, a the foreign values, NER is the nominal exchange rate, $\Delta P_i/P_i$ is the domestic inflation rate and $\Delta P_a/P_a$ the inflation abroad. RER corresponds therefore to the change in NER account taken of inflation differentials¹⁶. A permanent or temporary adaptation of the NER which ideally satisfies the requirement of maintaining the RER constant is called crawling peg.

In a flexible exchange system, NER are normally a product of the interaction of the market forces. The existence of a basically market-determined exchange rate, which is, however, not totally free from central bank intervention is called dirty floating. By buying or selling calculated amounts of foreign currency, the central bank pursues to achieve such goals as restoring or keeping the economy's competitiveness, of lowering domestic inflation, as well as influencing expectations on the part of the market's participants.

4.2. Interest and exchange rates

As in the Asian crisis of 1997 and those following in Russia, Brazil and Argentina, high interest rates have been a key element in defending fixed NER. With domestic inflation rates well above those in the advanced world, the fixed NER rendered the RER overvalued and the export branches uncompetitive. A growing trade-deficit made it compulsory to raise domestic interest rates in order to attract foreign capital. It has been duly noted that foreign capital inflows - mostly short-term financial capital - were at a peak in Mexico as well as in Asia immediately before the crisis broke out¹⁷.

As interest rates grow, long-term investors regard this as a sign of increasing distrust in the ability of government policies to prevail, thus refraining from further engagement in the country. On the other hand, short-term, speculative capital holders recognize an opportunity to raise stakes. The success of their engagement results from their ability to forecast the point in time at which the pegging cannot be sustained any longer and the exchange rate will be given up. The speculator's success would be highest and the collapse of local currency largest if it were possible to withdraw the whole allocated sum from the country immediately before depreciation takes place. In practice, and due to deviating risk assessments, many speculators will withdraw their sums well in advance of depreciation.

It follows that high interest rates – important as they may be to keep inflation at bay – might cause considerable damage in an open, emerging country economy with a fixed exchange rate and free capital

16. With foreign inflation of yearly 2 per cent and domestic inflation at 5 per cent, a nominal depreciation of 9.1 per cent after three years renders an RER equal to its original level.

17. Guillermo Ortiz Martínez, *What Lessons Does the Mexican Crisis Hold for Recovery in Asia?* In: Finance & Development, 35/2, 1998, pp. 6-9.

flows. This lesson appears to have been learnt in countries such as Brazil, Turkey and others. In these countries emphasis has been laid on lowering the PSBR, thus avoiding crowding-out effects on the credit market and keeping interest rates near the inflation level. It is well known that current account results are usually correlated with PSBR – if investment and savings are equal, both results would even be identical¹⁸. In view of sinking surpluses in foreign trade, both Brazil and Argentina need now to keep an eye on public spending.

4.2. International trade, developmentalism and the Dutch disease

The rise in commodity prices also induces a stronger specialization on primary production and an industrial setback in South America. In 2011, 56 per cent of Argentine and Brazilian total exports consisted of commodities and their by-products. China's growing demand for raw materials continues boosting South American exports and protects them from other distortive trade policies, such as the EU Common Agricultural Policy and the US Farm Bill. In a world potentially ruled by Ricardo's comparative advantages, industrial specialization would be a matter for Chinese manufacturers.

While the development of South America took place in a Ricardian world until 1930, this changed radically after the Second World War as a consequence of the rise of developmentalism¹⁹. The underlying assumption of this school is the determinism of capitalist socioeconomic development. Thus, it is up to any country to create the conditions under which its (unavoidable) capitalist progress will occur. A key role is assigned to massive investment by international companies and banks as well as loans from multilateral financial institutions and governmental agencies. In order to prevent the recurrent current account deficits which occur when the economy grows, the national economy should be integrated through better transport and communications infrastructure, energy supply growth and import-substituting industrialization (ISI)²⁰. Developmentalist politicians and economists are critical of classical or monetarist views on inflation, arguing that only investment and growth will lead to long-term price stability by allowing goods supply to keep pace with their demand. In at least one sense, developmentalism is a (mild) form of modern mercantilism: where developmentalist policies are applied, national production (e.g. the infant industries) will almost invariably be protected from foreign competition. As such, developmentalism and a Ricardo-type international division of labor are in full opposition to each other.

Industrial policies in emerging countries have also been linked with the notion of the “Dutch disease”, a term used by *The Economist* in December 1977 to describe the upward pressure put by Dutch gas exports on the currency of the Netherlands. It is used today to describe any “resource curse” stemming from extreme export specialization – especially on commodities - during booming times. The net inflow of capital resulting from trade surpluses leads to appreciation of the national currency, which makes exports by other sectors (e.g. manufacturing) more difficult. Eventually, these branches are given up and their production replaced by imported goods. When the commodity price boom ends, the economy finds itself deprived of important, technologically complex and highly productive sources of employment. In this manner, a temporary and cycle-typical fluctuation produces a structural change in a country's production profile. New studies reformulate the matter by comparing the positive impact of a commodity price boom with the negative effects of its typical volatility on economic growth²¹: the negative growth effects offset the positive impact of commodity booms. In comparison, the diversification of exports in commodity abundant countries contributes to faster growth. It is therefore volatility, rather than the abundance of resources per se, which explains the “resource curse”.

18. In an open economy, if the consumption goods market is in equilibrium, the sum of private investment (I), exports (X) and public expenditure (G) will equate the sum of savings (S), tax revenue (T) and imports (M). If $I=S$, it follows that $X+G=T+M$. This is to say, $X-M=T-G$.

19. Propagated after the 2nd world war through the World Bank and in Latin America through the Alliance for Progress and the UN Economic Commission for Latin America, it reached its intellectual peak with the works of Prebisch [Raúl Prebisch, “El desarrollo económico de América Latina y algunos de sus principales problemas.” 1950 in *Boletín Económico de América Latina VII* (1962)] and the ECLA on the terms of trade. Its greatest political influence was under the presidencies of Frondizi (1959-62) in Argentina and Kubitschek (1956-61) in Brazil. See also: Kathryn Sikkink, *Ideas and Institutions: Developmentalism in Brazil and Argentina* (Ithaca, NY, Cornell University Press 1991) and Frederick Weaver, *Latin America in the World Economy: Mercantile Colonialism to Global Capitalism* (Boulder, Colorado, Westview Press, 2000).

20. Rubén Marx, *Latin American Transnational Corporations in the Southern Cone: the analysis of Brazilian FDI in Argentina* [Madrid, XXII World Congress of Political Sciences. International Political Sciences Association (IPSA), 2012].

21. Tiago V. de V. Cavalcanti, Kamiar Mohaddes, & Mehdi Raissi, *Commodity Price Volatility and the Sources of Growth* (Cambridge Working Papers in Economics, 2001).

4.3. Inflation and growth

If restrictions are imposed on international investments and trade, the conditions for economic growth and inflation are similar to those of a closed economy: the achievement of a high rate of growth entails the danger of increasing inflation pressures, if rising demand is not matched by a similarly expanding supply²². This recalls the Keynesian view of a flexible aggregate supply, as opposed to the classical conception of supply as essentially price-inelastic. Supply is only price-inelastic when the frontier of production possibilities (full employment) has been reached and corresponds there to the classical view. Underneath this frontier, however, supply may vary and adapt to the level of effective demand –unemployment is therefore possible, if effective demand lies below the production capacity limit. This approach has the advantage of making the inflationary impact of demand shifts less straight and mechanical than in the classical view.

If demand increases during a recession, the overall effect will be greater on real supply than on prices. This is due to the attitude of firms under recession. Reducing fix-cost burdens by raising production is given priority over profiting from higher prices. As the economy grows, a larger effective demand will lead to more balanced effects, causing real supply growth as much as inflation. When the capacity border has been reached, any further increase in demand will, in the short-run, only generate inflation. Although this short-run model excludes, per definition, capacity effects, it can be adapted to fit any case in which effective demand grows at a pace higher than the creation of new capacities.

The inflation rate – for the purposes of this article the Index of Consumer Price Inflation (CPI) shall be taken - as compared to the rate of real income growth can thus be taken as an indicator of a demand overheating and, as an extension, of the existence or creation of further, un- or underutilized capacities. Under 6.3 below, recent developments in Argentina are shown to fit well into this theoretical framework.

5. Brazilian and Argentine policies in comparison

5.1. Economic policy in Brazil and Argentina in the period 1983-2003

Argentina returned to democracy in 1983, Brazil in 1985. At that time, both countries faced low rates of economic growth, high inflation and large foreign debt.

In Brazil, the “Cruzado Plan” of 1985 and the “Bresser Plan” of 1986 sought to freeze prices and wages. While the former established price controls and tax increases, the latter combined a crawling-peg and high interest rates. None was able to either contain the rising PSBR or strengthen the currency²³. Some progress was possible under the new Constitution of 1988, which granted local governments and the federal states additional control over the tax system.

In the nineties, Brazil embraced the Washington Consensus²⁴. The local capital market was opened to foreign direct investments (FDI). International financial institutions and banks also took part in the ongoing privatization process.

In 1994, the Real Plan was launched. The new currency “Real” (R\$) was pegged at near parity level to the US\$. The subsequent consumption boom and the appreciation of the RER of the R\$ made the economy accumulate current account deficits between 1994 and 1998. The high interest-rate policy of the Brazilian Central Bank (“Banco Central do Brasil”: BCB) made Brazil a target for short-term, speculative capital. Following the Asian crisis of 1997 and the Russian crisis of 1998, Brazil suffered strong capital drainage. At the beginning of 1999, the pegging of the R\$ was given up. It immediately depreciated from 1.1 to 2.3 R\$/US\$. In the same year, Brazil adopted a floating exchange rate and introduced gradually inflation targeting in a way similar to the advanced countries²⁵.

22. Juan J. Güida, “Los precios agrícolas y la Argentina en el marco regional e internacional”, Documento de Trabajo N° 213, Universidad de Belgrano, 2008. Link: http://www.ub.edu.ar/investigaciones/dt_nuevos/213_guida.pdf

23. Rubén Marx and Ana Turdó, “Desarrollismo en Argentina y en Brasil: un modelo y dos efectos”. Paper presented at the I Jornadas de Economía Política. Universidad Nacional de General Sarmiento, Buenos Aires, 2007.

24. Consensus view reached in Washington in 1989 at the Institute for International Economics. It considered market reforms desirable for Latin American countries. See: John Williamson, *From Reform Agenda to damaged brand name. A short history of the Washington Consensus and suggestions for what to do next*, in Finance and Development, Sept. 2003.

25. Luis Burlamanqui, J.A.P. De Souza and N. Barbosa-Filho, “The Rise and Halt of Economic Development in Brazil, 1945-2004:

In Argentina, for the most part of the period before 1990, inflation was at the center of attention. Like in Brazil, most stabilization plans emphasized monetary measures, like pegging the domestic currency to the regionally dominant US\$ and setting interest rates high with the purpose of attracting foreign capital and divert domestic investors from preferring foreign assets. Most of these plans had initially some success. In the longer-run, however, they systematically failed, none being able to keep inflation at bay for more than two years²⁶. By 1990, the Argentine government recognized that a more radical approach was required in order to combat inflation sustainably. The radical reform of April 1991, generally known as Convertibility Law (“Ley de Convertibilidad”), replaced the existing currency Austral created only in 1985 by the Peso (arg\$) in proportion 10,000:1. Parity was established between the arg\$ and the US\$. At parity, both currencies became fully convertible into one another. The Argentine Central Bank (“Banco Central de la República Argentina”, BCRA), while formally keeping its name, was transformed into a currency board, institutionally independent from the national government. The board was entrusted with ensuring the maintenance of the parity, for which it was compelled by the law to ever maintain free available US\$ assets in an amount equivalent to that of the circulating national currency. The law prohibited the currency board to finance PSBR.

In the period 1991-1994, the Argentine currency reform became the center of international attention and an export model to other emerging and developing countries. The combination of growth rates of around 8 per cent and an inflation rate under 2 per cent yearly impressed the IMF as much as the other countries in the region. Like Brazil, but much more enthusiastically, Argentina embraced the Washington Consensus, privatizing virtually all state utilities and enterprises for which a buyer could be found. This led to a continuous surplus in the capital account²⁷. The 1998-99 crisis in Brazil, however, put an abrupt end to this success: by then, Argentina had become Brazil’s most important trade partner, following the creation of the Common Market of the South (“Mercado Común del Sur”, MERCOSUR), in 1991. In 1999, Argentine exports to Brazil broke down, total exports falling by 11.3 per cent. Heavy loads by interest payments stemming from the Argentine foreign debt of more than 40 per cent of GDP worsened the country’s current account. For its part, the capital account - a source of stability in the previous period - was also driven into negative figures by increasing outflows resulting from the general distrust in the future of the emerging countries. On top, Argentina depended more than other emerging countries on the international sovereign bond market²⁸.

After a US\$ 20 billion stand-by agreement with the IMF, Argentina’s economic policy recalled a self-fulfilling prophecy, as public expenditure cuts and rising taxes only deepened recession. Further cuts in pensions and public sector salaries in April 2001 and eventually the freezing of bank accounts in November 2001, designed to stop the continuous drainage of deposits, led to a public revolt and the government’s resignation in December 2001. In subsequent steps, the service of the foreign debt was suspended, the currency suffered a depreciation of 30 per cent and, in February 2002, it was allowed to fluctuate under a form of dirty floating.

5.2. Growth and stability during the period 2003-07

On the whole, for most of the last decade, Brazil has let the R\$ float freely, focusing on lowering interest rates as inflation gradually receded. Since 1999, the Brazilian Central Bank’s Monetary Policy Committee (COPOM) has followed inflation targeting goals. In January 2013, the COPOM confirmed the ongoing level for the short term interest rate for overnight interbank loans (SELIC) of 7.25 per cent yearly. It also evaluated positively that the yearly inflation rate measured by the extended price consumer index (IPCA) had reached 5.84 per cent in 2012²⁹.

Industrial Catching-up, Institutional Innovation and Financial Fragility”, in Ha Joon Chang (ed.), *Institutional Change and Economic Development* (New York: United Nations University Press, 2007).

26. The crawling-peg policies of the period 1979-81 were able to lower inflation from yearly 175 per cent to 80 per cent, but they had to be given up in March 1981 due to a deepening recession and an extreme overvalued currency, which resulted in a large current-account deficit. A novelty of this experiment was, however, that the state resorted to the capital markets in order to obtain fresh money. The “Austral Plan” (1985-87) and the “Plan Primavera” (1987-88) followed a usual pattern by pegging the new currency Austral to the US\$. However, the central bank returned to financing PSBR, as a stop in the service of foreign debt made access to the capital market impossible. By 1989 public deficit reached 17 per cent of GDP and Argentina returned to hyperinflation.

27. Especially Spanish companies, but also French, British and US firms engaged strongly in the privatization process. Foreign loans to the government sector and portfolio investment in Argentine state bonds also contributed to boost net capital inflows.

28. Nouriel Roubini and Brad Setser, *Bailouts or Bail-Ins? Responding to Financial Crises in Emerging Economies* (Washington: Institute for International Economics, 2004, p. 67).

29. Banco Central do Brasil, Copom Minutes, 172nd meeting.

After repeated setbacks provoked by political mistrust before and in the aftermath of national elections at the end of 2002, the R\$ has appreciated ever since. By 2007 it had reached about 80 per cent of its purchasing power as of 1998. The high SELIC interest rate, which doubled the inflation rate as measured by the Consumer Price Index (CPI), was a key factor in stabilizing both currency and prices.

Argentina, for its part, adopted since 2002 many of the policies which had been successfully applied by Brazil after the 1999 crisis. However, Brazil had managed to renegotiate its foreign debt, achieve a good international rating and return to the international capital markets. Argentina, on the contrary, has only partly restructured its debt in 2005. Failure to repay the outstanding debt to the Club of Paris, to satisfy investment funds in possession of Argentine bonds or to accept IMF supervision during negotiation has pushed the yields of Argentina's bonds issued under US or European law well above 10 per cent. This has led to a shift towards domestically issued debt denominated in arg\$. In order to reduce its external financial vulnerability, the country has striven to maintain its current account in surplus, seeking to accumulate international reserves to guarantee its solvency.

Like Brazil, Argentina has returned to an active monetary policy as defined in table 3. If price stability is to be maintained despite monetary autonomy, the central bank should not be required to finance PSBR. During the period 2003-2007, duties on agricultural exports benefitting from the commodity price boom helped to ensure a federal government's fiscal surplus. The selective duties introduced a multiple exchange rate regime, reducing at first the risk of accelerating domestic inflation³⁰. Simultaneously, the surplus in trade made possible an excess supply of foreign currency³¹. In order to prevent appreciation of the arg\$, which could affect the country's manufacturing sector competitiveness, sterilization procedures were used³². However, growing inconsistencies between monetary and fiscal policies began to appear by the end of 2006. In the following years, it became clear that the country was heading for a repetition of the conditions which made possible the crisis of 2001: export growth could not match import growth, while domestic prices increased more rapidly than world prices³³.

5.3. Foreign Direct Investment in Argentina and Brazil

A common characteristic of both periods has been the FDI boom, which has also swept other Latin American and Asian countries. In the nineties, this process had been driven by a wave of privatization affecting state companies and services, in conformity with the ideas propagated at the time by the Washington consensus. FDI took place massively in areas such as oil, gas, other mining, as well as electricity, transport, water and telecommunications. Further investments were made in the automotive, food and chemical industries, as well as in commerce and banking. Figure 2 shows the net FDI flows to both countries.

As a recipient of FDI, Brazil surpassed Mexico in 2010, and has ever since consolidated its position as the first destination in Latin America and the fifth worldwide. In order to curb the inflow of speculative capitals that kept appreciating the R\$, Brazil imposed a 6 per cent tax on foreign corporate loans for a period shorter than 2 years. Like Brazil, Argentina reemerged from the 2001-2002 crisis attracting new FDI flows. Since June 2005, however, the BCRA ruled a compulsory one-year deposit of 30 per cent on foreign capital inflows. Exempted were investments in Argentine companies, in real estate and certain loans with a repayment period of more than 2 years. The fall in net FDI inflows after 2000 is explained by the growing mistrust in the country's future as well as the rising repatriation of dividends made by private companies. In October 2011, in an effort to curb repatriation, the government made such transactions dependent on specific permits, a measure which appears to have momentarily reversed the trend³⁴.

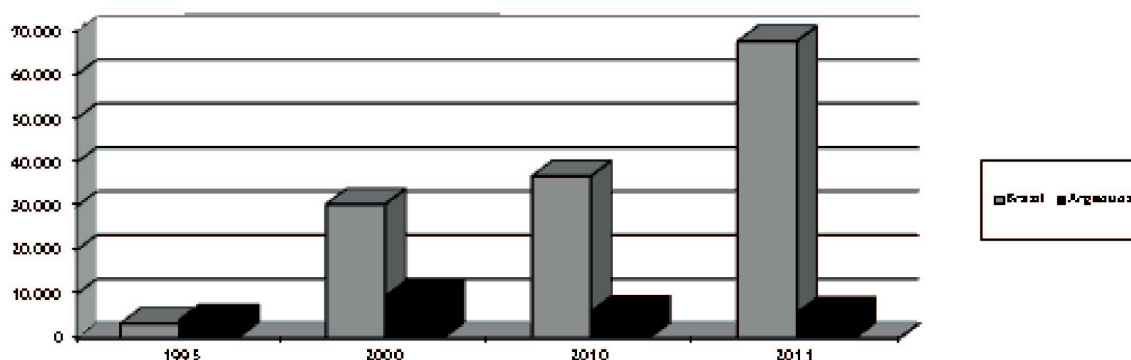
30. A country exporting agricultural commodities experiences in booming times a greater-than-average pressure on domestic prices, with second round effects over salary increases which might endanger long-term price stability.

31. D. Rodrik, "Who Needs Capital-Account Convertibility?" In Stanley Fisher et. al, *Should the IMF Pursue Capital-Account Convertibility?*, Princeton Essays in International Finance 207, May 1998.

32. Money is sterilized by the central bank through the emission of short-term liabilities, which catch totally or partly surplus money supply. In Argentina, three-month central bank bills are usual.

33. Juan J. Güida, "Los precios agrícolas y la Argentina en el marco regional e internacional", 2008.

34.

Figure 2. Brazil and Argentina: Net FDI inflows 1995-2011

Source: author's elaboration from data in UnctadStat. Figures in US\$ million.

Notwithstanding Brazil's success in attracting foreign capital, total investment has historically been poor in the country. In the period 2003-2012, Brazil's investment/GDP-ratio has only twice (in 2008 and 2010) surpassed the 20 per cent mark. Argentina, for its part, has twice reached over 25 per cent (in 2008 and 2011) in the same period. One of the reasons for this difference lies in Argentina's traditionally greater emphasis on – both private and public – housing construction expenditure³⁵.

5.4. Facing the international crisis

In Brazil, the strength of the domestic currency has become a major issue since the outbreak of the crisis. This reflects for the most part the strong capital-account surpluses, especially the FDI inflows. In an effort to steer away from further appreciation, between April and May 2011 the BCB increased its intervention on the currency market, buying excess foreign currency through emission of R\$ and lowering interest rates. The NER fell from R\$ 1.59 to R\$ 2.00 per US\$. Since then, the NER has fluctuated around that level, reflecting the belief of the market participants in the power of the BCB to determine an appropriate NER level at any time. In accordance with Brazil's overall macroeconomic policy, overly currency appreciation is to be dealt with by changes in the SELIC interest rate.

A decade long (2002-2011), the real interest rate was kept at an average of almost 8 per cent (nominal interest being 14.6 against inflation of 6.6 per cent). Internationally compared, Brazilian real interest rates even reached a level of 34.5 per cent in 2011³⁶. Since then, the BCB has gradually reduced the SELIC rate to an all-time low of nominally 7.25 per cent at the begin of 2013.

With CPI Inflation still at 5.8 per cent, this can be interpreted as implying that, on the whole, inflation targeting has lost importance in Brazil. In view of economic growth under one per cent during 2012, the BCB appears prepared to ease monetary targets in order to prevent further appreciation of the R\$.

At the same time, Brazil has begun retreating from some free-trade agreements like those signed with México in 2002 for the automotive industry. In March 2012, Brazil and México established export quotas over a three-year period. Since December 2011, Brazil also increased by 30 per cent the IPI tax for imported cars from outside the MERCOSUR and México³⁷. While the country's trade surplus for 2012 was considered satisfactory, the first four months of 2013 brought an accumulated trade deficit of more than US\$ 6 billion, contrasting to the US \$ 3.3 billion surplus registered in the same period of the previous year³⁸.

35. National accounting rules according to international standards consider all house construction as investment.

36. The appreciation of the domestic currency increases the international purchasing power of the returns to invested capital. The increase is added to the pure interest return and the resulting sum, divided by the invested capital, renders the international real interest rate.

37. The tax on Industrialized Products (IPI) is a federal excise tax levied on both imported and domestic products. For sales within the Brazil, the calculation basis is the selling price. In the case of imports, the taxation basis is the FOB price plus the Import Duty (II). The IPI is thus a market-conform policy instrument to encourage or discourage the consumption of certain goods. The rates are inversely proportional to the degree of necessity represented or satisfied by the good. They vary from zero (commodities) to 300 per cent (cigarettes), according to the Table of IPI Levy of 2011. The IPI can be offset with the tax paid on previous operations. (<http://www.brasil.gov.br/para/invest/taxes/excise-tax-on-industrialized-products-aka-ipi/br>).

38. <http://www.tradingeconomics.com/brazil/balance-of-trade>

In Argentina, the country's new achieved competitiveness due to the currency depreciation of 2002 has been largely eroded. Between 2002 and 2011, Argentina's average nominal short-term interest rate reached 7.8 per cent against an average official inflation of 10.8 per cent³⁹. While negative real interest rates are used by the BCRA to promote loans to private and public companies, the investment/GDP-ratio is falling⁴⁰. The increasing capital controls imposed since 2011, including limitations to purchase foreign currency with the purpose of saving, buying houses or repatriating profits, have led to stagnation of FDI in the country. Argentina remains a high-risk country in the assessment of most rating agencies. The remaining debt arrears make it unlikely that the country may recover anything like an "investment grade" at short notice. On the whole, Argentina seems to rely heavily on domestic savings for further growth. In May 2013, the government announced a tax redemption program for former tax evasion on the condition that they invest their assets into an energy and construction bond plan.

Another important divergence from Brazil's path refers to the trade policies applied by Argentina: as full members of the MERCOSUR, both Argentina and Brazil have adopted a common tariff system, tariff rates ranging from zero to 35 percent ad-valorem for imports from outside the region. In December 2011, member countries were allowed to propose up to 100 positions where the maximum 35 per cent tariff should be applied. In July 2012, Argentina adopted a 14 per cent tariff on imported capital goods produced in the region and a 2 per cent one on those not produced in the region. After the trade surplus was halved during 2011, however, Argentina has been enacting restrictions on imports designed to ensure a critical surplus of US\$ 12 billion regarded as necessary to face debt arrears and improve the BCRA foreign reserves. In view of booming imports and stagnating exports, the list of items affected by non automatic import licenses was expanded to 598⁴¹. In a sharpening of quantitative restrictions, Argentina suspended in June 2012 the application of the Mexico agreement. In December 2012, both countries reached a new temporary agreement, granting Mexico lower import quotas until 2016. After a loosening of controls, new import restrictions have been enacted in April 2013. Trade policy in Argentina consists today of a set of measures designed to ensure a particular (variable on a year-to-year basis) trade surplus.

6. The impact of the implemented crisis prevention policies

6.1. Poverty

In Latin America and the Caribbean poverty accounts for 28.8 per cent of the population. Argentina's national statistics show that urban poverty has declined from 11.3 per cent in 2009 to only 5.7 per cent in 2011 and 5.4 in 2013⁴². On the basis of private estimates, however, the basket of goods considered necessary in order not to live in poverty is three to four times as expensive as the official estimates. The conclusion would be that three to four times as many households are poor as officially accepted. This result corresponds to those deriving from a survey by the Argentine Catholic University (UCA)⁴³. While poverty at 22 per cent (2011) is certainly much lower than the estimates for 2002 (over 50 per cent), it shows less improvement compared with the 25 per cent estimated by the INDEC for 1998. High among the efforts conducted by the Argentine government to alleviate poverty ranks the Universal Child Allowance ("Asignación Universal por Hijo"), aimed at 3.6 million poor children and young people under 18 years. The benefit was extended in 2011 to over 2.9 million pregnant women.

39. Private estimates – e.g. der "IPC-Congreso", made publish on a monthly basis by opposition representatives at the National Congress - put inflation at yearly 22-25 per cent, what appears indirectly confirmed by government adjustment of minimal wages, pensions and family allowances of yearly 20-25 per cent.

40. After reaching a technical peak of 26,1 per cent in 2011 due to restrictions on repatriation of dividends, the Investment ratio fell to its near historical level of 23,8 per cent in 2012 and will continue to fall, reaching 23 per cent in 2015 according to IMF estimates.

41. Since 1st February 2012, a mandatory sworn affidavit of planned imports has to be sent to the AFIP. This statement is usually revised by the Under Secretariat of Foreign Trade Management at the Secretariat of Industry and Commerce. The National Food and Drugs administration may also intervene, before a free trade certificate is issued. The Industry and Commerce Secretariat reviews the export/import performance of each firm, their pricing policy in the domestic market, as well as their latest investments in the country. In May 2012, the European Union, the United States and other 12 countries presented a request for consultations at the WTO Dispute Settlement Board.

42. Instituto Nacional de Estadísticas y Censos, Buenos Aires, April 2013.

43. Universidad Católica Argentina (UCA), Observatorio de la Deuda Social Argentina (ODSA). http://www.uca.edu.ar/uca/common/grupo68/files/Microsoft_Word_-_SERIE_ODSA_TASAS_DE_INDIGENCIA_Y_POBREZA_2006-2011.pdf

Brazil also developed successful poverty reduction strategies since 2003. Brazil urban poverty dropped from 22.1 (2009) to 18.2 per cent (2011)⁴⁴. The Family Allowance (“Bolsa Familia”) project, a part of the strategy called Brazil without poverty, consists of cash transfers for poor families. About 13.7 million families receive a monthly lump sum between US\$ 35 and US\$ 175, the aid is tied to children’s school attendance and health checks. The overall budget increases from US\$ 8.7 billion (2011) to \$10 billion (2012) and to US\$ 11.5 billion (2013 budget). Taking into account the Human Development Index (HDI) measured by the United Nations Development Program (UNDP), population in both countries improved their conditions regarding health, education and income. Argentina ranks 45 (very high HDI-country) above the Latin American and Caribbean regional average, while Brazil ranks 84 (high HDI-country) below regional average⁴⁵.

Progress is undisputed regarding unemployment, with Brazil unemployment rate falling from 12.3 per cent in 2003 to only 5.5 per cent in 2012. In Argentina, unemployment of 17.2 per cent was registered in 2003 and has fallen to 7.2 per cent in 2012⁴⁶.

6.2. Finance

Both countries’ foreign debts burden has been drastically reduced from the 2002 levels. Argentina’s success, however, has been accomplished by transferring the problem to the BCRA (see below).

The Brazilian government made efforts to reduce public investments during 2012, a year in which neither domestic nor international demand grew significantly. As a consequence of the implementation of Brasil Maior Plan (2011-2014), corporate pay roll contribution to social security was cut from 20 per cent to zero for labor-intensive industrial productions, such as textiles, footwear and furniture. The industrialized product tax (IPI), charged on imported and domestic manufactured products, was reduced for manufactured home appliances and cars complying with regional component requirements. The VAT collected by state governments levied on imports and on interstate transactions was unified at a level of 4 per cent. This decision ended with a decade of “fiscal wars” among the Brazilian states.

In Argentina, the financing of new social projects was set forth through the nationalization of the private pension insurance system (AFJP) created in the nineties. Recently, the renationalization of YPF, Argentina’s former oil industry flag-ship, from the Spanish Repsol Group, also appeared designed to pour new resources into the national budget. With state spending growing at a pace of 30 per cent yearly, a policy of nationalizing private funds could hardly prove sustainable, account taken of Argentina’s limited availability of national champions as well as to growing concern among private industry and potential investors.

In an effort to reduce public spending, subsidies to transport and public utilities were cut by the end of 2011. Nevertheless, there still were federal funds available to finance productive investments, with almost US\$ one billion allocated to the “Programa de Financiamiento Productivo del Bicentenario” 2012 (mostly directed to the steel, automotive and pharmaceutical industries as well as for the purchase of agricultural machines by larger agricultural enterprises), and another US\$ one billion aimed at financing small and medium enterprises.

The financial situation of both countries could face future challenges derived from beneficial commodity prices. A worsening PSBR would also affect both the current and the capital accounts, leading to a deficit in the first and a need for net inflows in the latter.

6.4. Exchange rates and the role of the central banks

More than ten years after the economic collapse, it has become generally accepted that the advantages of fixed exchange rates (predictability, monetary discipline) can be achieved without the risks they entail

44. United Nations Economic Commission for Latin America and the Caribbean (ECLAC), *Social Panorama of Latin America*. (Briefing Paper. Santiago de Chile, 2012, p. 60).

45. United Nations Development Program, *National Human Development Report for Argentina and National Human Development Report for Brazil*, 2011. Links: <http://hdrstats.undp.org/en/countries/profiles/BRA.html>
<http://hdrstats.undp.org/en/countries/profiles/ARG.html>

46. Data taken from IMF, *World Economic Outlook Database*, April 2013.

(inflexibility, lack of protection of domestic business vis-à-vis the international business-cycle). That this is possible in South America is shown by Brazil, Chile and Peru, among others.

Brazil's financial system appears strong. Foreign currency reserves amount to US\$ 376 billion (BCB, 21/02/2013) and they show no sign of stagnating. The pressure on the domestic currency remains directed upwards. The BCB supervises monetary and financial institutions effectively. Interest-rate decisions are reached by consensus by the central bank's board of directors, and its minutes and reports are published regularly. However, with inflation reaching 5.8 per cent, a sluggish GDP growth rate of 0.9 per cent and a growing current-account deficit, critiques resent the growing BCB's market interventions and demand that it should focus again on inflation targets.

It can be stated that, on the whole, Brazil has followed an orthodox macroeconomic approach using interest rates to steer the exchange-rate of its currency. The introduction of a tax on short-term corporate loans has helped to avoid excessive appreciation of the national currency, without essentially altering the validity of the market-equilibrium orientated policy. As a result, the R\$ has been consistently gaining ground against all major foreign currencies.

Since 2003, the BCRA appeared to follow a similar path as the BCB. Thanks to the original downward overshooting of the peso, it was possible to defend a stable NER, while simultaneously permitting a gradual, but not excessive, appreciation of the RER. To prevent any potential upward pressure on the arg\$, surplus foreign currency was bought by the BCRA. Helpful in achieving this goal proved a policy which can be broadly described as deliberate uncertainty. It consists of creating the conditions under which the institution can react in more than one way: it can take measures designed to support or to weaken the national currency. The other market participants find it difficult to predict the direction of changes. Uncertainty increases the risk of currency transactions and the cost of speculation. Until 2007, the BCRA was able to raise the level of foreign currency reserves from only ten to US\$ 50 billion.

In 2007, however, the sudden repayment of US\$ ten billion to the IMF brought about a substantial decrease in foreign reserves, which were replaced by US\$-denominated Argentine bonds. Such a swift in assets is, at least in a country with Argentina's past, a cause of shrinking trust in the national currency - at current ratings, Argentine par bonds are worth less than a third of their nominal value. In 2012, more than US\$ four billion were transferred by the BCRA to the treasury with the same purpose. A similar transaction is already planned for 2013, as foreseen in the national budget law⁴⁷.

Since the international crisis began, and very especially since 2010, the BCRA has lost much of its independent status. Lacking access to the capital market, the government's anti-cyclical policies are being financed by resorting to central bank assets. A recent change in its statutes allows explicitly the use of such assets to finance PSBR within certain limits. The original mandate of preserving monetary stability has been complemented by new goals such as fostering employment. Over the past years, the free available currency reserves have fallen from over US\$ 53 billion to less than US\$ 40 billion⁴⁸. In the meantime, Argentina's money supply has been growing by over 30 per cent yearly. The shift in the relationship between money supply and foreign reserve assets lead market participants to expect a continuous depreciation of the arg\$.⁴⁹ Bank deposits in foreign currency have been halved since the purchase of foreign currency was set under state control on 29th October 2011⁵⁰. Demand for foreign currency increases continuously. In May 2013, arg\$ 10.4 had to be paid for one US\$ on two different parallel markets. One of them is the so called "blue"⁵¹, an illegal market. At a second, legally established market, internationally traded stock (e.g. securities like bonds or shares) can be bought locally and sold abroad. The exchange rate results from the difference between the purchase price in arg\$ and the sale price in US\$ at a foreign stock exchange.⁵²

47. BCRA, Monthly Bulletin, July 2012.

48. BCRA, *Ibid*, April 2013.

49. While surprising to European readers, the years of the currency board have accustomed the public in Argentina to estimate the future exchange rate of the arg\$ by dividing the domestic money supply M1 (money in circulation + current account deposits) by the foreign currency assets in possession of the BCRA.

50. BCRA, *Ibid*, July 2012.

51. Under recent Argentine legislation, purchase of foreign currency may only take place with a concrete objective (normally imports of merchandise and service as well as private foreign travel) and in strict proportion to the declared earnings of such individuals and companies demanding it. It follows, that any other currency market as the official, like the blue market, must be regarded as illegal and suspect of channeling undeclared sums. Whether this is the case, or whether blue transactions also channel sums which are derived from normal work or business activities seeking foreign currency as a haven against inflation and depreciation cannot be definitely answered in the context of this paper.

52. This market exchange rate, known in Argentina as „contado con liquidación”, is essentially a blue-chip swap, conditioned

The spread between the parallel and the official exchange rate has by May 2013 reached 80 per cent. Thus, in Argentina, measures designed to prevent capital outflows are generating exactly the opposite.

6.5. The problem of inflation and growth

Brazil has not tried to establish a competitive gap by interrupting the transmission mechanisms linking international with domestic prices. Much to the contrary, the strong R\$ and the relatively high domestic prices have operated as a further break against inflationary pressures. The present rate of R\$ 2.01:1US\$ corresponds roughly to the purchasing-power-parity level of 1998. In Brazil, inflation has been reduced from yearly 10 (2003) to 5.8 per cent (2012).

In Argentina, the relative success of the economic policies applied in the period 2003-10 was made possible by the fact that domestic prices responded to the depreciation of the peso with a considerable time-lag. This was due to the long period of monetary stability until 2001 and the recession-induced deflation after 1999. Thus, the arg\$ remained under its purchasing-power for over seven years. Inflation took place in a way very similar to that predicted by the Keynesian approach explained under 4.3, growing from less than 4 per cent in 2003 to over 10 per cent after 2005. Even if the less than trustable INDEC⁵³ figures are laid down for the calculation, the difference between real GDP growth and inflation – a quantitative approach to the concept of inflation-free growth – has been worsening in Argentina over the years, while it has improved – albeit slightly – in Brazil. Today, Argentina's international price advantage in tradable – especially non-food – goods has virtually disappeared.

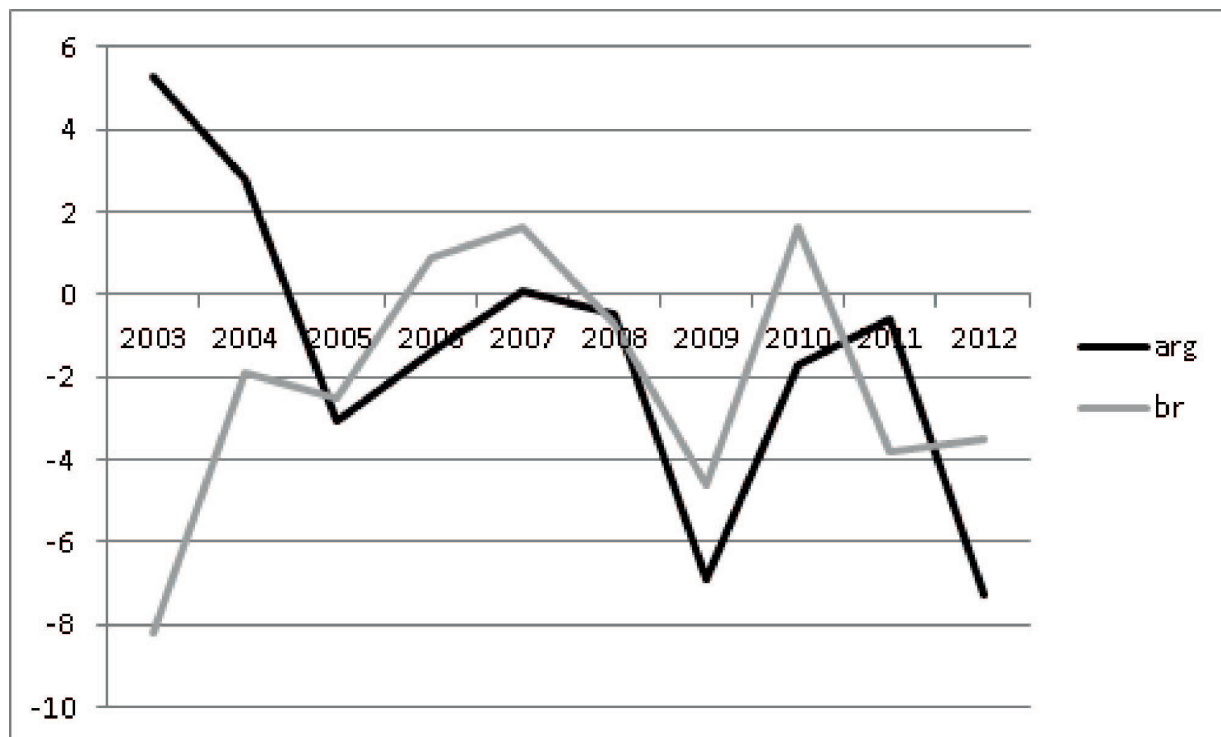
Figure 3 shows the results of comparing the differences between GDP growth and inflation for the period 2003-12 in both countries⁵⁴. Brazil seems to have reached a plateau, with inflation slightly higher than economic growth. This can be interpreted as meaning that the five per cent inflation threshold in Brazil has structural rather than cycle-related reasons. The consequence would be that further measures to lower inflation in the short run might worsen real growth.

In Argentina, the inflationary cost of trying to maintain higher economic growth has been rising constantly, since recovery of the deep crisis of 2001-02 began. The Argentine government has recently sought to cut inflation by introducing price controls and seeking agreements with trade unions on a maximum wage increase rate. It has until now rejected implementing an orthodox monetary and fiscal adjustment to reduce inflation as recommended by the IMF. On the contrary, it pursues an increasing stimulation policy to boost consumption and public as well as private investment.

by the BCRA through a compulsory minimal three-day period between purchase and sale.

53. The official CPI is generally considered to underestimate inflation by more than 50 per cent after the national government intervened the INDEC for apparently exaggerating the inflation figures. This affects not only the measurement of inflation, but probably also the estimate of real growth. An example: for August 2012 supermarkets are reported by the INDEC to have sold, at constant prices, 12.7 p.c. more than in August 2011. This results from an increase, at current prices, of 26.3 p.c. and a deflator (implicit prices) for the sector of 10.3 p.c. Private consulting companies, however, estimate price increases of 20-24 p.c. yearly, representatives in Congress (to whom they report) made public a mean value for all estimates of almost 23 p.c. If these figures are transferred to retail sales – a legitimate procedure in absence of better data –, real sales by supermarkets cannot have risen by more than 3-4 p.c. This hypothesis is backed by reports made by the Association of Retailers, which point out at a shrinking of real sales levels. Trade unions, for their part, are demanding salary increases of 22-35 p.c. in order to cope with inflation. The whole picture suggests, therefore, that while CPI can be seen as grossly underestimating inflation, GDP figures are to be treated at least with great caution.

54. The difference between the GDP growth rate and the inflation rate is understood as an indicator of inflation-free growth. The maintaining of a high rate of economic growth accompanied by rising inflation is an indicator of an economic overheating. As explained under 4.3, growth is free from inflationary pressures when the economy expands under conditions of low employment (short-run view) within the limits of production possibilities. In a longer-run view, inflation-free growth is possible when investment-led capacity-effects ensure that supply can easily keep pace with demand – e.g. bottlenecks are excluded.

Figure 3. Brazil and Argentina: Difference between GDP-Growth and CPI-Changes (both % figures) 2003-2012

Source: author's elaboration from International Monetary Fund, World Economic Outlook, Database, October 2012.

7. Conclusions

The paper has described the main tools employed by the Argentine and the Brazilian governments to steer the economic process in relative independence of the international conditions: while profiting from the improvement in the terms of trade, both Brazil and Argentina have set up a number of barriers to the transmission of negative impulses deriving from the crisis in the advanced economies.

While Brazil's policies have been basically directed to correct the appreciation of the national currency via the interest rate, thus restoring industrial competitiveness, Argentina has embarked on a comprehensive policy of direct import control. The declared aim of defending the trade surplus can appropriately be described as open mercantilism. The tightening of import authorizations was pursued even at the expense of endangering economic activity.

GDP growth has slowed down in both countries, although a recovery is expected during 2013. While Brazil sets hopes on measures designed to boost domestic consumption, Argentina expects impulses from abroad – basically a boost of exports through agricultural prices and a good harvest result, as well as Brazil's own demand for Argentine industrial goods.

Brazil's policies correspond, on the whole, to classical market principles, emphasis being laid on prices, not on quantities. Neither has the government restrained the amount of foreign currency its citizens and companies can purchase, nor has it set relevant quantitative controls on imported goods. Furthermore, inflation remains under relative control thanks to positive real interest rates. If anything, Brazil's worries can be explained by the traditionally low investment/GDP-ratio, which remains unsatisfactory despite strong FDI inflows. Social investment programs like housing for the poor are restrained by the government's own priority of maintaining financial discipline.

By means of the above mentioned policies, Brazil's BCB continues increasing its foreign currency reserves, which have reached an all-time high of US\$ 378 billion as in April 2013.

In Argentina, the opposite has occurred. Currency and import goods purchase undergo quantitative controls, while real interest rates are negative and inflation lies officially at 10 and unofficially at above 20 per cent. The consequences have been growing mistrust in the arg\$, the emergence of unofficial exchange rates well above the official one, the collapse of the private housing market (where transactions are traditionally in US\$) and a slowdown in industrial production due to shortages in imported inputs.

As different from most advanced economies, Argentina's economic policies have traditionally regarded exchange rates as a key instrument to price stabilization. Since 2003, exchange rates are also seen as a key instrument in achieving long-term industrialization and full employment. It is thought that the current crawling-peg-like administered floating should enable the country to protect domestic production without generating additional inflation.

Bearing in mind the process of deindustrialization which took place in the nineties, the underlying assumption appears to be that, if competitive prices are held over a period of time long enough, the country's infant industries will reach a technological and thus a productivity level similar to that of more advanced economies.

Argentina, however, is losing its grip on the exchange rate as an instrument of long-term development policy. Rapidly growing imports of merchandise and services, debt payments and, lately, speculative purchases of foreign currency anticipating a depreciation of the arg\$ lead the government in October 2011 to impose controls on the purchase of foreign currency, and tighten then ever since. In this context, the BCRA has been confronted with losses of net reserves, which hit a six-year low at less than US\$ 39 billion in May 2013. The more controls are set on the foreign exchange, the more private demand for foreign currency shifts to alternative ways of acquiring it. Having been a leader at the currency market until 2007, the BCRA has become a follower, chasing through weekly crawling-pegs the unofficial exchange rates. Argentina's only advantage in comparison to Brazil, the higher investment/GDP-ratio, fell strongly in 2012 despite a near compulsory reinvestment of FDI. Preliminary figures for 2013 show a further, combined decline in foreign as well as domestic investment.

An end to the low-interest rate policies in the advanced economies appears unlikely in the short-run. Should it occur, however, it would bring to an end one of the causes of current capital flows to South America. While this would alleviate upward pressure on the regional currencies, it would be accompanied by lower commodity prices and a resurgent industrial trade. The position of the central banks will look less comfortable than it does today. The more competitive the national industries are, the brighter the future prospects of a country will be.

Brazil's more classical policies of moderate growth and preventing currency appreciation appear appropriate to steer further industrialization without endangering price stability. Argentina's more mercantilist, beggar-thy-neighbor approach faces mounting problems, from foreign currency shortages - with currency reserves needed to serve and repay foreign debt -, high inflation and ailing foreign investment. Without serious corrections to the present course, the country could well be heading for a new economic crisis.

