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"BRAZILIAN EXTERNAL ADJUSTMENT IN THE 1990s: THE ROLE OF FOREIGN DIRECT INVESTMENT"

Winston Fritsch*
e
Gustavo H.B. Franco*

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1. Introduction

There is almost universal agreement that an unprecedented effort to raise net exports in Latin America, together with measures of domestic reform aimed at increasing residents' savings, are essential parts of the adjustment process induced by the debt problem. This same consensus is not to be found on the policy packages being advertised as the most appropriate to bring this about, and the ever present liberal-orthodox solution for the long run external adjustment problem has been very loudly stated in an influential recent document[1]. In addition to the the usual prescriptions regarding the reduction in the role of the state in economic affairs, emphasis is also being assigned to trade liberalization, especially by the Fund and the Bank, despite the poor record of past attempts in this regard in the Southern Cone. Trade liberalization has also been paramount in official initiatives, such as for example, the Baker Plan, where policy reform in some debtor countries is now seen as its great - and only - achievement in the absence of its other promised components, viz. , adequate financial flows from banks and multilateral agencies and faster and sustained OECD growth.

There is little novelty on these proposals, and even less on their advocates. Their finding more support now than ever before, despite having never been very popular in the continent among both politicians and scholars alike is, however, very significant. It seems to suggest *prima facie* that either the current payments difficulties are self inflicted, i. e. the inevitable by-product of mistaken policies that should be redressed, or, alternatively, that some positive change has occurred in trading opportunities, or "engines of growth" available in the international economy. As regards the former alternative, it is hard to accept that the debt problem could have been created by distortive policies at the micro level in all debtor countries at the same juncture. Ignoring or even minimising the influence that shocks stemming from exogenous fluctuations in commodity prices, interest rates, and OECD activity levels in the early eighties and, eventually, the sudden withdrawal of the provision of financial accommodation by private banks had in generating the dramatic problems these countries now face is an appalling omission. As regards the latter, it is significant that the liberal recipe has not come with a sound diagnosis on the nature of recent changes in the world economy and of the opportunities now open and, consequently, with an answer as to why *laissez faire* would be the best possible approach to these tendencies.

It is obvious that different perceptions as to these issues can lead to radically different solutions. This paper argues that global developments in international trade and investment are more important to frame patterns of growth and integration into the world economy to open semi-industrialised economies than it is usually thought. In this connection it is suggested that

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[1] B. Balassa et al. (1986).

emmerging global trends in foreign direct investment may offer ways by which Brazil could go a long way towards adjusting to the debt problem without necessarily vindicating the free market solution while implementing a limited, and possibly highly managed, trade liberalization with a sound macroeconomic rationale.

The paper is organized in five sections: sections 2 and 3 are addressed to establish the importance of multinational corporations (MNCs) as exogenous determinants of trading and industrialization patterns in host developing countries. Section 4 discuss recent propects related to trade and international investment from OECD countries in relatively developed semi-industrialised economies, with the purpose of informing active industrial policies. Lastly, section 5 explores the importance of investment (domestic and foreign) recovery for regaining a sustained growth path, and argues that not only the recovery of direct investment can have a very significant impact as far as the balance of payments is concerned, but also that trade liberalization, or a meaningful increase in imports, can be justified on macroeconomic grounds as a means of increasing external savings if adequate external capital flows, market access and financial stability in the OECD prevails.

2. MNCs as exogenous determinants of trade policies and patterns

The last two or three decades have witnessed marked changes in the world organization of industry with far reaching effects for the evolving modes of integration of developing countries in the world economy. The long run process of worldwide industrial redeployment has been intensified, which can be gathered from gradual reduction of Western countries share in world manufacturing value added observed in the post war period, from 77% in 1963 to 64% in 1985, and the corresponding increse in the share of LDCs, from 7.8% to 11.3% in the same period[2]. In parallel, the rapid growth of MNCs was one of the outstanding features of the post war period. In the late 70s one could observe that MNCs have indeed secured shares of domestic industrial production in most developed countries, between a third and a quarter on average[3]. In Latin America these shares are of this same order of magnitude: for 1980 the shares of industrial production due to broadly defined foreign corporations in Brazil and Mexico are 27.5% and 27.2% respectively[4]. The shares for other countries in the mid-seventies are similar - Argentina (31%

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2 Comparisions for a longer period are difficult (see R. Ballance & S. Sinclair (1983, p. 14) R. Ballance (1987, pp. 42-43)) but the available indications are that these trends have been clear since before World War II.

3 UNCTC (1983, pp. 136, 350-351).

4 Foreign firms are defined as those with at least 10% (15% for Mexico) foreign participation in capital. Figures from W. P. Nunez (1988, p. 38) and L. Willmore (1987, p.163).

for 1971-73), Chile (25% for 1978), Colombia (43% for 1974) and Peru (32% in 1974) - though definitions of foreign firm vary from case to case[5].

The effects of the international spread of MNCs have been much discussed, and it is commonly emphasized that heavily internationalized MNCs would develop a global outlook as regards strategic planning that would affect several diferent aspects of the working of the international economy including the transfer of technology, factor mobility, and especially patterns of trade[6]. In fact the outstanding growth of manufactured exports from a small group of NICs observed in the 60s and 70s, which have been a crucial dynamic element in the long run process of redeployment referred to above[7], can be associated to a significant extent to MNCs[8]. This influence can be assessed by the shares of MNCs' affiliates on exports of manufactures from some of the most succesful exporters among NICs. Among Asian NICs Singapore provides an extreme case, with MNCs participation in exports being 92% (1978). South Korea shows a 27% share in 1978, which is significant given that MNCs participation in total industrial production was of only 11% in 1975[9]. For Brazil this share in 1980 was estimated in 38.3%[9A]. For Mexico, exports of foreign enterprises represented 27% of total non-oil exports in 1981; in 1987 this share incresed to 55%[10]. Shares of over 30% are reported in Argentina and Colombia[11].

To a significant extent these exports flow through intra-firm channels: a study has shown, for instance, that in 1977 no less than 48% of US imports involved "related parties"[12]. In the specific case of Brasil, another study would observe that for 1972 about 50% of imports and 73%

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5 UNCTC (1983, p. 136).

6 Accounts of the consequences of advanced internationalization of MNCs' activities, and of systemic effects of MNCs difusion worldwide are provided by R. Vernon (1979)'s revision of his original product cycle model and by C. F. Bergsten et al. (1978, ch. 8) respectively.

7 This positive export performance of MNCs' affiliates are related to a corresponding loss of importance of exporting from parent firms, as observed by I. Kravis & R. Lipsey (1987).

8 G. K. Helleiner(1973), D. Nayyar (1978) and J. de la Torre (1974).

9 UNCTC (1983, pp. 136-137).

9A Considering foreign firms as those with more than 10% share in capital, cf. L. Willmore (1987, p. 163).

10 W. P. Nunez (1988, p. 269)

11 UNCTC (1983, pp. 136-137).

12 That is, the US importer had an equity share of at least 5% of the foreign supplier. See G. K. Helleiner (1981, pp. 28-29). A not much lower percentage of total US imports, about 39%, took place within the same corporation, i. e. when the US importer had control of the foreign supplier. UNCTC (1983, p. 161). A more recent study uses a sample of 329 MNCs, and notes that a very significant percentage of parent firm's exports and imports were intra-firm transactions: for US parents this proportion would reach 45.5%, the European average would come to 29.7% and for Japan it would be 17%. The average for the whole sample would be 32.8%. Cf. J. H. Dunning & R. D. Pearce (1981, p. 132). Apud UNCTC (1983, p. 161).

of exports of US affiliates were intra-firm transactions. For Mexico these numbers would reach 58% and 82% respectively for this same year. In general terms, it is estimated that no less than 30% of world trade takes place between parents and affiliates[13].

From these considerations one easily concludes that simple notions of comparative advantage bound on perfect competition and essentially static notions of efficiency should not be taken as guidance for policy. Strategic planning by globally minded MNCs operating on global oligopolistic structures are a crucial determinant of trading patterns in manufactures. The precise consequences of these developments in terms of the scope and the nature of trade policies are still unclear. Indeed, as noted in a recent survey on international investment, "current modes of thinking and analysis have not yet absorbed the full implications of the fact that a large proportion of various international economic transactions takes place within transnational corporations"[14]. This is by no means reassuring; the demise of simpler notions of comparative advantage leads to a world in which there is perhaps even less policy autonomy to exercise, or at least a world in which trade policies are carried out through very different channels. Experience has shown that MNCs are very difficult to regulate in view of their flexibility in accomodating a single countries' policy changes, for instance, by means of transfer pricing, interaffiliate financial flows, and so on. Apart from this, it is important to note that these firms are indeed very sensitive to international developments. Given the importance of MNCs for domestic industrial production in Latin American countries, one easily notes that global trends as regards trade and investment patterns seem to have a stronger influence on Latin American economies than the usual measures of openess would authorize. It has always been a paradox that economies that have been so closed - in terms of their trade to GDP ratios - have been so vulnerable to external developments.

3. MNCs and patterns of trade and industrialization[15]

The presence of foreign capital is an important determinant of several structural features of manufacturing activity in host countries, and among the latter is certainly their trade propensities. It is natural to assume, therefore, that MNCs affect patterns of industrialization and trade in host countries, at least as regards "outwardness". This should be especially relevant in economies in which the presence of foreign capital is very strong, and Brazil certainly ranks well even among OECD countries: the share of MNCs affiliates in domestic industrial production in Brazil is inferior only to the Canadian and Belgian ratios for 1977 - 56.6% (1977) and 44%

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[13] Ibid. p. 160.
[14] Ibid. p. 6.
[15] This sections draws heavily from W. Fristch & G. H. B. Franco (1988).

(1975) respectively [16].

Many influences, endogenous and exogenous, act to shape trade and industrialization patterns in host countries and outward orientation isd certainly affected by the host country's trade policies. Yet globally minded MNCs are likely to respond to a much broader environment than the one shaped by domestic policies. The crucial issue in this connection is whether "outward orientation" of MNCs differ from the one of its host countries, or whether MNCs affiliates have higher trade propensities than domestic firms when controlling for other influences. In general the answer to these questions are on the affirmative, despite some mixed evidence on specific cases[17].

Trade (export) propensities of MNCs affiliates located in different regions differ very sharply, as seen in table 1 below showing those for US firms:

Table 1: US MOFAs[a]: propensities to export (%)

	exports / total sales[b]			exports to the US / total sales[b]		
countries	1966	1977	1982	1966	1977	1982
all countries	18.6	30.8	33.9	5.6	9.1	9.7
developed	20.4	33.1	36.6	6.1	9.1	9.1
. Canada	16.1	29.9	34.5	13.2	26.1	29.3
. Europe	25.8	37.7	41.2	2.1	2.3	2.5
underdeveloped	8.4	18.1	22.0	3.2	9.1	12.1
. Latin America	6.2	9.7	11.9	2.2	3.6	4.7
. Brazil	3.0	8.7	12.4	2.7	2.3	2.8
. Mexico	3.2	10.4	10.8	1.5	6.5	7.6
. Asian NICs[c]	-	81.2	76.2	-	52.5	56.1

(a)"Majority onwed foreign affiliates", or firms with more than 50% US share. (b)Only in manufacturing. (c)Hong-Kong, Korea, Singapore and Taiwan. Adapted from M. Blomström (1987, p. 20).

To a significant extent these differences in export propensity of majority-owned US MNCs affiliates can be explained by domestic policies, as mentioned above, and also by factors like by sectorial composition[18], size, R & D intensity, etc. In addition to these factors, however, such

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16 UNCTC (1983, p. 350).

17 Recent econometric evidence indicated that onwership exerts a strong and independent influence over export performance in host countries, cf. L. Willmore (1987) and B. Levy (1988). Direct comparisons between export propensities of foreign and domestic firms also seem to point towards foreign onwership as implying greater trade orientation, cf. R. S. Newfarmer (1983, pp. 179-180), B. L. Cohen (1975), R. Jenkins (1979). The issue is discussed in fuller detail in W. Fritsch & G. H. B. Franco (1988).

18 While majority owned US investment in Latin America is quite diversified, in Asia is heavily concentrated on electrical equipment, cf. M. Blomström (1987, p. 22). In this connection well known differences as regard the degrees of international verticalization would explain trade propensities.

sharply different export propensities can also be explained by the fact they refer to different vintages of foreign investment. In this respect it is interesting to compare the outward drive of US MNCs of the 1950s and 1960s, with the late multinationalization of European, and the even later migration of Japanese firms in the 1970s and 1980s. The patterns of multinationalization observed during the first wave, dominated by US firms ("the American Challenge"[19]), originated a model of foreign direct investment, first proposed by S. Hymer(1960) and C. P. Kindleberger (1969) and later matured in the so called ecletic theory put forward by J. H. Dunning (1979): firms in possession of an "unique asset", unexploitable by means of exporting from the parent country - in view of trade restrictions - or by means of licensing - in view of imperfections in markets for technology - choose to establish affiliates abroad. This kind of investment is geared at domestic markets, and it has even been described as "anti trade oriented"[20] when contrasted to the Japanese early pattern of multinationalization, which was basically a strategy for relocating exports made uncompetitive by real wage increases in Japan[21]. The contrast as regards trade propensities in these two types/vintages of foreign direct investment have been extensively explored by the proponents of the so called Japanese model of foreign investment[22].

The specific trade orientation embodied in the different waves on incoming foreign investment would most likely influence the outwardness of the industrialization drive in host countries. Observers, however, have failed to explore a causal link between the pace and character of structural transformation in the semi-industrialized areas in the South and this changing nature of industrial countries' outward direct investment. The fact that the nature of industrialization in the larger Latin American economies was fundamentally altered during the "Hymerian phase" of the internationalization of oligopolistic structures geared to host country markets - which corresponds to the heyday of the import substituting industrialization in the region and the rapid building of a vertically integrated industrial sector in its larger countries

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[19] It should be fair to include in this wave of foreign investment the European firms which went multinational by means of a process described as "oligopolistic response" by F. T. Knickerbocker (1973). The "European Response" to the "American Challenge" bore, however, very much the same characteristics of the latter, cf. S. Hymer & R. Rowthorn (1970).

[20] This is very clear in the original product cycle model (cf. R. Vernon (1966)): in the first moment exports to host countries are reduced as local production are started and grow to the point it occupies the whole market in the host country. At this point, however, as the affiliate "matures", it can even become an exporter. Competitiveness at this point would depend on reaching a larger scale (Paul Krugman (1984)'s idea of import protection as export promotion), or even developing indigenous technological capabilities (thus S. Teitel & F. Toumi (1986)'s idea that Brazil and Argentina successful record as exporters of manufactures is due to industrial "maturing").

[21] M. Y. Ioshino (1974) e S. Sekigushi (1979). That does not mean, of course, that all Japanese foreign investment has this character; recent Japanese investments in the US by firms of the consumer electronics sector show a pattern that is similar to the Hymerian one described above.

[22] T. Osawa (1975 and1979), and K. Kojima (1978) for example.

during the the fifties, after many decades of "espontaneous" substitution in non-durable consumer goods - while the Asian NICs had their "take-offs" in terms of production of relatively sophisticated goods a little later, in a moment when foreign investment was already more "outward oriented"[23], could explain the well known differences in industrial sectors' tradeability between the two areas. The subject has been explored at length elsewhere[24]; for our purposes here it suffices to argue that "exogenous" patterns of trade and investment at large, even if not determinant of domestic patterns of industrialization in NICs, display an uncommon degree of consistency with the latter.

If the above conjecture is relevant, we are again in the presence of the paradox eluded in the end of last section, namely that of the "excessive" influence of international developments to economies that are very closed in terms of export-imports/GNP ratios. This should not imply necessarily, however, that there is little scope for policy, but merely that in the past, and to varying extent, industrialization in these NICs have been consistent to global trends, and most likely for this same reason they made the most of available opportunities. In this connection, it is important for policy makers to be able to identify newer opportunities; interpreting global trends as regards foreign investment and changes in competitiveness in the OECD area, either induced by industrial maturity or by exchange rate movements can be very useful to spot new "engines of growth" and to frame domestic policies in potential hosts.

4. Trends in international direct investment and trade

Global trends as regards trade in manufactures and international direct investment in the years to come would be decisively conditioned by slower than historical growth in the OECD area, by the ongoing changes in competitiveness determined by technological factors (the maturing of some industries and rapid technological innovation in others) and exacerbated by a depreciating dollar real effective exchange rate.

The changes in competitiveness among major OECD countries are best seen if we examine the evolution of their exports of manufactures ranked by technological intensity, as shown in table 2. It is interesting to note that the exceptional Japanese performance, as regards their trade balance in the last decade is not only due to the remarkable growth of its exports of manufactures of higher technological density compared to the North Atlantic economies, as shown in table 2, but

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23 It is interesting to note that not only "new" foreign direct investment, Japanese and even American, was more outward oriented, but also older affiliates, established during the 50s and 60s, became also more outward oriented as the degree of internationalization of such firms increased and their markets and their planning became global (cf. R. Vernon (1979)).

24 W. Fritsch & G. H. B. Franco (1988).

also to a continuous process of structural change which kept its imports of manufatures stable and below 3% as proportion of GDP, in sharp contrast to other industrial countries[25]. The extent of exchange appreciation since 1985 and the further weakening of the dollar projected for the future, added to rising real wages in Japan should, however, provoke a rapid erosion of Japanese competitiveness in several sectors classified as of low technological intensity in table 2, such as shipbuilding and metalurgy on which the European countries have been facing problems of competitiveness, restructuring and reduction of capacity for some time.

Besides, in the areas of average and high technological intensity, exchange rate fluctuations should pressure relatively more European industry, whose trade performance in recent years has been inferior to Japan. In these sectors, exchange rate changes should contribute to accelerate the process of vertical desintegration in some industries as transport equipment and eletronics - intensifying processes of sourcing and subcontracting - and also to increase outward investment, either by greater internacionalization of activities of large MNCs, either by means of rellocation of certain industries in order to preserve competitiveness in the dollar area. In the case of Japan this effect should accelerate the ongoing process of loss of competitiveness and migration of industries intensive in labor and imported raw materials. The most remarkable aspect of these changes should be the internationalization of Japanese industry - whose production outside the country represents today only 3% of the total, against 20% for the US and Germany - and the form by which this phenomenon would take place, if by means of exporting the keiretsu[26] or through the vertical desintegration of its industrial system

In sum, there is an important nexus between changes in the patterns of trade in manufactures in the OECD area and the geographic and sectorial distribution of outward investment flows from these countries and trading opportunities for the semi-industrialized periphery. The acceleration of the process of industrial restructuring in Europe and Japan reinforced by exchange rate changes open new perspectives for export oriented investments in LDCs located in the dollar area and whose size had allowed the building of a relatively integrated industrial base. In fact, to the rellocation of industrial capacity in a global scale towards the South in the past decades (in sectors such as textiles, footwear, apparel and electronics) the decisive locational factor was the cost and docility of labor in the exporting economies. Scale economies and integration and technological sophistication of host countries industrial base did not have the determinant role they can have now, since that wave of investment was based of relatively simple labor intensive

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[25] From 1962 to 1985 total imports of manufactures as proportion of GDP increased from 1.3% to 6.1% in the US, from 6.0% to 14.9% for Germany, from 4.8% to 12.9% for France and from 4.7% to 17.8% for the UK. Cf. UNIDO (1987, p. 30).

[26] See M. Aoki (1986).

Table 2

Developed countries: shares over total manufactured exports ranked by R & D intensities (in %)

exporting country	shares over total group exports 1970	1975	1980	1985
		high intensity'		
USA	25.6	26.9	26.1	26.8
Japan	8.3	9.5	12.4	18.3
EEC(7)''	46.0	48.4	48.8	41.3
. Germany	16.7	16.8	16.6	13.8
. France	7.0	8.6	8.6	8.0
. UK	10.5	10.5	11.8	9.1
. Italy	4.8	4.5	4.6	4.3
Other	16.2	15.2	12.7	13.5
		average intensity'		
USA	19.9	19.0	16.3	15.6
Japan	9.4	11.0	14.7	20.2
EEC(7)''	54.5	54.4	53.6	48.7
. Germany	21.3	20.5	19.6	17.9
. France	7.8	9.2	9.1	7.3
. UK	10.8	9.4	9.9	7.2
. Italy	6.5	6.4	6.2	6.0
Other	16.3	15.5	15.4	15.6
		low intensity'		
USA	11.0	9.4	9.6	9.0
Japan	11.2	11.9	8.9	9.7
EEC(7)''	50.5	53.4	55.5	53.2
. Germany	12.5	14.2	13.7	13.4
. France	9.0	10.0	10.3	9.1
. UK	7.4	6.4	7.1	6.3
. Italy	7.2	7.9	9.3	10.2
Other	27.3	25.3	26.0	28.2

' Product classification according to technological intensity was done according to ratios of R & D expenditure to sales. "High intensity" industries are: aerospace, computers and office equipment, electronic produts and components, farmaceutics, electric instruments and machines and some segments of chemicals and mecanics. Among "average intensity" industries we can relate: automobiles, chemicals, other manufactures, non-electrical machines, rubber, plastics and non-ferrous metalurgy. "low intensity" industries are: non-metalic minerals, food and beverages, tabacco, shipbuilding, oil refining, ferrous metalurgy, metals, paper and pulp, wood and furniture, textiles, footware. '' includes Germany, France, UK, Italy, Holand, Belgium and Luxemburg.
Source: UNCTAD (1987, Table 32, pp. 116-117).

assembly operations. The sectors now affected by the need of restructuring cannot be easily rellocated to "export platforms", and it is by no means trivial to switch from the producing for export through labor intensive investment to producing for export through capital intensive investment[27]. The bulkiness and presence of indivisibilities are characteristic features of the new cycle of export oriented foreign investments in industries of average and high R & D intensity - and even in sectors of lower intensity, but capital intensive. In this connection, the choice of potential recipients will be governed by very specific locational factors, namely the existence of a vertically integrated and well developed industrial structure, with technological capability, and the commitment to export promotion policies. These characteristics are to be found only in a small group of developing countries that in the last decades managed to increase their market shares of manufactured exports, even in manufactures of greater technological sophistication[28]. Among these two regional groups are easily identified: the SouthEast Asian NICs - Korea, Taiwan, Hong-Kong and Singapore - and the larger Latin American economies, notably Brazil and Mexico[29].

Recent projections of the geographical configuration of inward direct investment in these two areas in the next years are heavily influenced by the perspectives of slow growth, high inflation and possible exchange restrictions generated by the debt crisis in Latin America. It is then forecasted that the share of Asian NICs in North-South direct investment flows in the next few years would be increasing and Latin America's share could even be negative[30]. There is little question that Asian economies, including the members of the ASEAN (Association of Southeast Asian Nations), besides Hong-Kong, Korea and Taiwan, enjoy exceptional locational advantages to host Japanese plants made uncompetitive by recent changes in real wages and exchange rates. In fact, these economies have been receiving significant inflows of Japanese direct investment associated to the migration of several labor intensive low-tech industries[31]. In the case of more technology intensive investments or Japanese investments in capital intensive industries, which are likely to have growing importance in the future, perhaps only Korea, and to some extent Taiwan, among Asian NICs, could provide the inter-industrial linkages and infra-structure necessary to produce

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27 OECD (1987, p. 39).

28 Considering developing countries as a group, their share of manufactured exports of higher technological intensity increased form 1.7% of the world total in 1970 to 7.7% in 1985. In average and low technological intensity the increases were from 2.1% to 6.0%, and from 5.8% to 12.3% respectively. Cf. UNCTAD (1987, table 33).

29 In fact only Brazil and Korea have managed to increase very significantly their shares over the total manufactured exports from LDCs: their shares have increased from 2.8% and 2.3% in 1965 to 7.4% and 15.6% in 1980, respectively. The shares of Mexico, Argentina and Hong Kong have declined in this period and Singapore's share have increased slightly. Cf. D. Nayyar (1983, p. 17).

30 See, for example, Group of Thirty (1984, pp. 33-36) e OECD (1987, pp. 14-15).

31 See Why Japan Invests in Asia, em The Economist, 1/23/1988, p. 65.

efficiently[32]. Besides, especially for export oriented investments, a number of factors can negatively affect Asian NICs relative advantage as regards potentially new investors. First and foremost should figure the increasingly difficult prospects for their manufactured exports stemming from a combination of reduced market access due to targeted US - and possibly increasing European - protection; growing competition from an increasing number of other developing exporters; G-7 pressures for currency apreciation, especially over Taiwan; and the impact political change will have on the cost and docility of labour in Korea, traditionally seen as an important locational advantage by foreign firms. Moreover, if export dynamism falters in the presence of these adverse developments and continued slow OECD growth, their high degree of openess will also imply poorer economic performance.

In view of these factors, and also of the lesser European tradition in manufacturing in the Pacific basin, locational advantages may indeed change in favour of Latin American economies, and the revival of foreign direct investment could be very important, as discussed in detail in the next section, to define a genuine process of adjustment. It is very important to emphasize, however, that in larger and fairly closed semi-industrialized economies foreign investment decisions, even if export oriented, are mostly determined by perspectives as regards domestic market growth, or by the overall investment climate. The latter, however, is clouded by distress with high inflation, budget deficits, balance of payments difficulties and macroeconomic instability. In this connection before we dwell into more specific aspects of the Brazilian balance of payments adjustment in the presence of a recovery in domestic and foreign investment, we must warn that an essential pre-requisite for such a recovery is a solution for the inflation/stabilization problem. Ignoring the latter is certainly an heroic assumption, but one that must be made if the issue of medium run viability of a growth trajectory under increasing internationalization is to be addressed.

5 . Direct investment, external finance and trade liberalization in Brazil in a longer term perspective

The foregoing speculations as to the future patterns of direct investment between different currency areas and their likely impact on larger Latin American economies if they succeed in restoring conditions of domestic stability, have important policy implications for Brazil. Indeed, if the economy regains a sustained growth path, even just the restoration of the share of foreign direct investment in total investment, if not accompanied by an increase in their remittances rates, can provide an important contribution to balance of payments equilibrium in a longer run

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[32] The strategy of economic opening now being followed in mainland China might turn her into a very important receiver of foreign investment. The perspectives as regards continuity of this strategy are, however, quite uncertain.

perspective where the likely scenario of meagre financial flows from private banks prevails.

The main reasons for this are twofold and relates to structural characteristics of the Brazilian economy. Firstly, foreign onwed firms have a substancial presence in Brazilian industry. In fact, in the years prior to the present crisis direct investment flows of well over 1% of GDP prevailed. Secondly, there is the unusually low propensity to import - near 6%, a third of which are fuels - reached by Brazil in the mid-eighties in the wake of over a decade of strenuous and successful efforts at structural adjustment to external schocks, and her unitary import to output elasticity[33]. This means that small relative changes in gross foreign exchange earnings - either coming from exports or from the capital account - minus interest payments can provide substantial relief for the foreign exchange constraint to output.

The extent to which these favourable characteristics can help in restoring growth is an empirical question whose answer rests on the fulfillment of several other conditions. To test how sensitive Brazil's foreign exchange constrained growth path is to a recovery of direct investment flows under plausible assumptions regarding the outcome of the ongoing debt negotiations and the world economic outlook, a simulation was carried out with the help of a very simple model the formal structure of which is presented in the Appendix. It is assumed that:

(i) output growth recovers from an annual rate of 2% in 1988 to 6% in 1989, 6.5% in 1990, 6% in 1991 and settles at a steady 5.5% path afterwards.

(ii) foreign exchange inflows related to direct investment recover from their presently depressed levels to 0.8% of GDP over the next five years, while profit remittances remain at their present (normal) levels relative to GDP. Besides, it is assumed that 75% of new investments take advantage of the debt-equity swap facility at a 15% discount.

(iii) as the outcome of the ongoing debt negotiations the spread over base interest rates falls to slightly above 0.8%, a multi-year rescheduling agreement is arranged involving the total bank plus Paris Club debt with a grace period of ten years and repayments spread over fifteen years, and net inflows from official and multilateral agencies can raise slow but steadily in the nineties.

(iv) an international scenario of no terms of trade shocks, slow recovery of OECD growth rates towards levels near potential output growth and stable interest rates at around 4% in real terms. The values projected for these variables, together with those of the structural parameters used in the simulations are presented in table 3.

Before discussing the simulation results it is important to note that for a potentially savings constrained economy such as Brazil today, after the dramatic fall in her investment to

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[33] See M. P. Abreu (1986).

Table 3
Structural parameters, international scenario and expected domestic production of oil

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Real change in OECD output(%)	2.5	2.5	2.5	2.8	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Interest rate on debt'	9.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Changes in prices of:													
. oil	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
. other imports	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
. exports	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Elasticities of'':													
. Exports	1.5	1.5	1.5	1.5	1.5	1.6	1.7	1.8	1.9	2.0	2.0	2.0	2.0
. Non-oil imports	1.0	1.0	1.8	2.5	2.5	2.3	2.0	1.8	1.8	1.5	1.5	1.5	1.5
. Oil consumption	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Target oil production*	637	710	780	810	888	966	1,044	1,122	1,200	1,260	1,320	1,440	1,500

' exclusive of spreads and comissions. '' refer to quantum of indicated variables with respect to real OECD output, in the case of exports and with respect to Brazilian real output for the others. * Projections from Petrobrás S.A. in millions of barrels per day.

output ratio, the objective of reaching the maximum current account deficit compatible with overall external equilibrium is a crucial one. Thus, given the determinants of export performance and service transactions, as defined by the assumptions made above, for a given output growth path external savings will be maximized if the propensity to import is left to rise in accordance with the availability of foreign exchange. In fact, this provides a solid rationale for import liberalization in Brazil if - and this is a big if - financial accommodation is forthcoming in adequate terms and amounts. Thus, in the simulations we tested for the maximum attainable extent of trade liberalization under the assumption that international reserves recover rapidly towards the value of six months imports and remain at this level throughout the horizon of the projections.

The results are presented in tables 4 and 5. They show that with the small recovery in the flows of new money, if direct investment flows are restored to normal levels, reasonable growth rates and external equilibrium are compatible with moderate trade liberalization and a recovery of foreign savings to around 1.5% of GDP. The most striking aspect of these simulations is the continuous and large fall in net debt to extremely low values either in relation to exports or output. This happens by the joint operation of three factors: (a) because the slow current account deterioration does not generate large financial requirements; (b) because reserves grow in line with faster growing imports, and (c) the erosion of the nominal stock of consolidated gross debt caused by debt-to-equity conversions which in a ten years horizon adds to some US$ 30.4 billion. This effect is also responsible for the substantial reduction in the value of the ammortization payments on consolidated debt from 1999, and illustrates the importance that the recovery of foreign investment levels can have in a longer time frame[34]. It is also interesting to note that the change in the composition forecast for the services account - with the growth in the relative important of direct investment related payments and of non-factor services ~~vis-à-vis~~ interest on debt - greatly contributes to diminish the vulnerability of the economy relative to fluctuations in international interest rates.

6. Summary

The paper argued that there are some promising trade and investment opportunities to be explored, or new "engines of growth" available to semi-industrialized economies in an

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[34] Note that the net result described in (c) above do not actually depend on the existence of the debt-to-equity swap facility but only on the recovery of foreign investment to historical levels as a proportion of GDP, and thus not assumed to be strongly influenced by the existence of debt conversion. The assumption about conversion is made solely to conform better with existing institutional realities.

Table 4
Balance of payments, international reserves and external debt
(as % of GDP)

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
1 Exports (FOB)	10.6	10.6	10.3	10.1	9.9	9.8	9.7	9.7	9.6	9.6	9.6	9.6	9.7	9.7
2 Imports (FOB)	-6.1	-5.8	-5.9	-6.3	-6.6	-6.9	-7.2	-7.4	-7.5	-7.7	-7.9	-8.1	-8.2	-8.4
3 Trade balance (1+2)	4.5	4.8	4.4	3.8	3.3	2.9	2.5	2.3	2.1	1.9	1.7	1.5	1.5	1.3
4 Services	-4.9	-5.1	-4.6	-4.0	-3.9	-3.6	-3.5	-3.3	-3.2	-3.1	-3.0	-2.9	-2.9	-2.8
4.1)Interst	-3.6	-3.8	-3.4	-2.7	-2.5	-2.3	-2.1	-1.9	-1.7	-1.6	-1.5	-1.4	-1.3	-1.2
4.2) Dividends	-0.4	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
4.3) Other[1]	-0.9	-0.8	-0.7	-0.8	-0.9	-0.8	-0.9	-0.9	-1.0	-1.0	-1.0	-1.0	-1.1	-1.1
5 Current account	-0.4	-0.3	-0.2	-0.2	-0.6	-0.7	-1.0	-1.0	-1.1	-1.2	-1.3	-1.4	-1.4	-1.5
6 Capital account	0.7	0.6	0.5	0.8	1.1	1.2	1.4	1.4	1.6	1.6	1.7	1.8	1.9	2.0
6.1) Direct investment (net)	0.2	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.8	0.8
6.2) Loans	1.8	1.8	1.8	2.0	2.2	2.3	2.4	2.4	2.5	2.5	2.6	2.7	2.7	2.8
6.3) Ammortization	-1.3	-1.3	-1.4	-1.3	-1.2	-1.2	-1.2	-1.2	-1.1	-1.1	-1.1	-1.1	-1.6	-1.6
7 Overall balance (5+6)	0.3	0.3	0.3	0.6	0.5	0.5	0.4	0.4	0.5	0.4	0.4	0.4	0.5	0.5
Memo														
International reserves	2.7	2.9	2.9	3.1	3.3	3.5	3.6	3.7	3.8	3.8	3.9	4.0	4.1	4.2
Debt conversion	0.1	0.2	0.2	0.3	0.4	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.0	0.0
Net debt	40.8	38.2	34.2	31.3	28.3	26	23.8	21.9	20.1	18.7	17.3	16.2	15.4	14.8

[1] Includes transfers.

Table 5
Balance of payments, international reserves and external debt
in billions of current dollars

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
1 Exports (FOB)	26.2	28.2	30.4	32.8	35.5	38.5	41.9	45.7	50.0	54.8	60.3	66.4	73.0	80.3
2 Imports (FOB)	-15.0	-15.3	-17.2	-20.5	-23.8	-27.2	-30.9	-34.8	-39.2	-43.9	-49.3	-55.3	-62.0	-69.6
3 Trade balance (1+2)	11.2	12.9	13.2	12.3	11.7	11.3	11.0	10.9	10.8	10.9	11.0	11.1	11.0	10.7
4 Services	-11.5	-13.5	-13.6	-13.2	-13.8	-14.4	-15.1	-15.8	-16.8	-17.7	-18.8	-20.1	-21.6	-23.3
4.1)Interst	-8.8	-10.1	-9.9	-8.8	-8.9	-8.9	-9.0	-9.0	-9.1	-9.2	-9.3	-9.5	-9.8	-10.2
4.2) Dividends	-0.4	-1.4	-1.5	-1.7	-1.8	-2.0	-2.1	-2.3	-2.6	-2.8	-3.1	-3.4	-3.7	-4.1
4.3) Other[1]	-2.3	-2.0	-2.2	-2.7	-3.1	-3.5	-4.0	-4.5	-5.1	-5.7	-6.4	-7.2	-8.1	-9.0
5 Current account	-0.3	-0.6	-0.4	-0.9	-2.1	-3.1	-4.1	-4.9	-6.0	-6.8	-7.8	-9.0	-10.6	-12.6
6 Capital account	1.8	1.4	1.4	2.5	3.9	4.8	6.0	6.9	8.2	9.1	10.4	12.0	13.8	16.5
6.1) Direct investment (net)	0.5	0.2	0.2	0.3	0.5	0.6	0.8	0.9	1.0	1.1	1.2	1.3	5.8	6.4
6.2) Loans	4.4	4.7	5.2	6.4	7.8	8.9	10.3	11.5	13.0	14.3	16.1	18.3	20.0	23.2
6.3) Ammortization	-3.1	-3.5	-4.0	-4.2	-4.4	-4.7	-5.1	-5.5	-5.8	-6.3	-6.9	-7.6	-12.0	-13.1
7 Overall balance (5+6)	1.5	0.8	1.0	1.6	1.8	1.7	1.9	2.0	2.2	2.3	2.6	3.0	3.2	3.9
Memo														
International reserves	6.8	7.6	8.6	10.2	11.9	13.6	15.4	17.4	19.6	21.9	24.6	.27.7	31.0	34.8
Debt conversion	0.3	0.5	0.6	1.1	1.4	1.8	2.3	2.7	3.0	3.3	3.6	3.9	0.0	0.0
Net debt	100.7	101.0	100.4	102	101.5	101.8	102.4	103.1	104.5	106.2	108.4	111.3	116.2	122.6

[1] Includes transfers.

increasingly internationalized world economy. It draws attention to the role that may be played by foreign direct investment as a cushion and as an essential adjustment instrument to current balance of payments dificulties. It was suggested that prospective changes in competitiveness in the OECD area, which are determined by technological developments and exchange rate movements, may induce export oriented foreign direct investment towards larger semi-industrialized economies in the dollar area, provided of course that these economies, Brazil and Mexico in particular, are capable of terminating inflation and the macroeconomic mismanagement of later years.

Foreign investment has played an important role in the past to frame the trade orientation of the process of industrialization in the periphery. It naturally follows that this same influence could be important in the years to come. Apart from structural change, however, it was also argued that the direct foreign exchange contribution of revived flows of foreign investment can be very important for external adjustment in a longer run perspective. There is no question that direct investment flows, even if normalized, are small with respect to pre-1982 flows of loans, and also with respect to current debt service requirements. Yet, taking as benchmark the seriously foreign exchange constrained situation now prevailing and the fact that the Brazilian economy has already gone through a substantial current account adjustment, the contribution of normalized FDI flows to the Brazilian balance of payments can be very important. This is a direct result of two structural characteristics of the Brazilian economy: a very low import propensity and a very strong presence of foreign capital. Indeed, the simulations carried out in section 6 suggest that there could be room for a significant increase in the economy import propensity - which could certainly be improved if we allow for structural change, or a more optimistic path for exports - which would be relevant to relax the savings gap, through a reduction in real resource transfers. This macroeconomic rationale for trade liberalization has little to do with the usual efficiency arguments; in fact there should be no reason for this limited increase in imports not to be filtered by active industrial policies geared at directing import competition to mature sectors.

Appendix

The simulations presented in section 6 are based on a simple model which generates the increases in net debt required to finance target levels of reserve increase and output growth given some structural parameters and an international scenario.

It is derived from the balance of payments identity:

$$X - M - i.D_{-1} + D - D_{-1} + (I^* - IT) = R - R_{-1} \qquad (1)$$

where X and M stand for exports and imports fo goods and non-factor services, respectively, D for the net foreign debt at the end of period, I* for the inflow of foreign direct investment, IT for non-interest factor income remittances, i for the effective interest rate on debt.

Given the weight of oil in the Brazilian imports bill the latter were disaggregated as:

$$M = M_n + M_o \qquad (2)$$

where M_n and M_o refer, respectively, to oil and non-oil imports.

Exports and non-oil imports are projected as:

$$X = (X_{-1}).(1 + e_x.y^* + p_x) \qquad (3)$$

and

$$M_n = (M^n_{-1}).(1 + e_n.y + p_n) \qquad (4)$$

where e_x and e_n are income elasticities, y^* the OECD output growth rate, y the Brazilian output growth rate, and p_x and p_n are the variation in international prices of exports and non-oil imports respectively.

Oil imports are, ex-hypothesi, obtained as a residual as:

$$M_o = (p_o).(C - Q) \qquad (5)$$

where p_o denotes world oil prices and C and Q, respectively, domestic oil consumption and the production targets in the oil import substitution programme. Domestic oil consumption is specified as a stable function of domestic output as:

$$C = (C_{-1}).(1 + e_o.y) \qquad (6)$$

where e_o is the income elasticity of oil demand.

Both I* and IT are specified as functions of output and reserves are a constant fraction of the value of imports.

Thus, given time paths for an exogenously given set of structural parameters $\{e_x, e_n, e_o\}$, an international scenario $\{y^*, p_x, p_n, p_o, i\}$ basically determined by OECD performance, and domestic policy targets concerning growth, oil production, and reserve levels, one can generate a consistent time path for D_t.

If debt conversion Ω is to be introduced, I* has to be altered to take into account only the non-converted share of foreign direct investment and D has to be recursively calculated for each interaction as:

$$D = D - \Omega/(1-c) \qquad (7)$$

where c in the rate of discount in debt-to-equity swap operations.

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